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CONTEMPORARY U.S. TAX POLICY

SECOND EDITION

C. EUGENE STEUERLE



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This book is dedicated to all those who have propped me up when I could barely stand—loved ones, friends, and so many whom I have never even met. It is in people like you that I put my hope.

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Preface

Nearly every day, a tax policy debate makes the front page of newspapers—tax proposals designed to spur the economy; new tax incentives to subsidize health insurance, build low-income housing, increase charitable giving, or establish tax-favored enterprise zones; or tax boosts to support child care, help low-income taxpayers, or finance school construction. Who can be against improving the economy, helping families, or promoting good social programs? Yet there is an opposing perspective that runs in parallel: who can be for higher tax rates or raising the cost of government?

Many of these debates cannot be understood without some background on the history, economics, and politics of modern tax policy-making. Countless courses on taxation and public finance teach a particular discipline and a set of skills. But this academic knowledge does not impart the driving forces behind tax changes. We cannot assume the young have learned the lessons that this history offers. This fact struck me during a talk at Swarthmore College when I likened the early tax policy of President Reagan with that of President Kennedy. All the professors in the audience nodded to acknowledge the connection I was making. The students wore blank stares. The analogy didn't work for them because they were too young to be familiar with either half of the comparison. Yet, without some understanding of Reagan tax policy and its precedents, students will have trouble understanding the later developments. They may not understand how in practice Democrats' opposition

to tax rate cuts in the early 21st century mainly applied to high-income taxpayers, just as their opposition to the Reagan tax cuts did decades earlier. The students may fail to note that an expansion of the child care credit in the first part of the 21st century came about partly because social conservatives suddenly discovered family tax policy in the Reagan era, or that what might seem unnecessarily complicated, such as tax breaks for education, has its roots in a decades-old policy trend toward putting in the tax code provisions that are unlikely to be enacted as direct expenditures.

This effort to combine the economic, political, and historical story of modern tax policy has been well received. This second edition of *Contemporary Tax Policy* follows upon two closely related publications—a first edition in 2004 and *The Tax Decade* in 1990. I am pleased by its widespread reception—by policymakers (one member of Congress has told me he carries it around as a reference), by reporters (Robert J. Samuelson indicated in a column that it “ought to be read by every member of Congress”), by the public, and, not least, by those who are going to make tax policy tomorrow: the students in economic, law, accounting, and public policy courses where it has been adopted. *Contemporary U.S. Tax Policy* is, at its heart, the exciting, if not always pretty, tale of democratic decisionmaking at its core.

A warning is required. Those looking for a simple story of triumph and defeat will be disappointed. A better analogy is chaos theory’s explanation of the weather: new and unexpected events often occur—but usually within fixed boundaries and with some degree of correlation from one time period to the next. As you will read, Congresses and presidents usually act with an amazing herd instinct—moving one more step forward or backward on a familiar path rather than shifting paths altogether. Rather than move onward toward new societal issues with forged political agreement on the old ones, our tax policy history is normally filled with attempts and reattempts to fight on familiar battlegrounds. Yet in the midst of what appears as repetitive clamor, evolution (even revolution) does occur.

The American tax system, despite its many reforms and notable efficiencies at collecting revenues, is also broken. Reforms may not be more necessary than in the past, but policymaking processes today seem incapable of the broad and comprehensive trade-offs required to make 21st century government effective. My hope is that this book will impart some ideas about how to interpret the past in ways that increase the probability that future governmental reforms can be comprehensive enough to make the tax system significantly fairer, simpler, and more efficient.

My perspective transcends that of researcher and writer. Over the course of nearly three and a half decades, I have spent close to half my time at the Treasury Department in various roles, including deputy assistant secretary of the Treasury for Tax Analysis¹ and economic tax coordinator of the Treasury Department's 1984 to 1986 Project for Fundamental Tax Reform, which led to the Tax Reform Act of 1986. I have spent the other half as a researcher at the Urban Institute, the American Enterprise Institute, and the Brookings Institution, analyzing budget and social policy issues while writing regular columns for such publications as *Tax Notes* magazine and the *Financial Times*. I also served as president (2001–2002) and board member of the National Tax Association for many years and as an editorial advisor to the *Journal of Economic Perspectives* for its *Policy Watch* series. I've had the privilege of learning from the best minds devoted to tax and budget issues and became well acquainted with those officials and staffers of all political stripes who "made" tax and budget policy for more than a quarter-century.

Parts of this book were first published or presented before the American Bar Association, the American Enterprise Institute, the American Tax Policy Institute, the American Law Institute, the Brookings Institution, the Internal Revenue Service, the John F. Kennedy School of Public Policy at Harvard University, *The National Tax Journal*, *Tax Notes*, the Urban Institute and, where relevant, are reprinted with permission.²

Other books cover some of the politics behind the events discussed here.³ This book covers a much longer period. Its emphasis is on how the various events fit together, on the role of economic factors in the shift in the nation's fiscal and tax structure, on how reform is organized, and on where various forces are leading tax policy. My aim is to provide enough information to allow readers to judge the trends and form conclusions, even when they differ from my own. In the end, their votes, more than anything else, will determine whether good tax policy can prevail.

NOTES

1. The Office of Tax Analysis is the government's principal office for analyzing the economics of tax issue. It works closely with tax lawyers in the Offices of Tax Legislative Counsel, International Tax Counsel, and Benefits Tax Counsel. Together, they form the Office of Tax Policy within the Treasury Department.

2. See Steuerle (1983b, 1985a, 1985b, 1986a, 1986b, 1987a, 1987b, 1988, 1990c, 1991, 1992b, 2001a, 2002e, 2002g), Steuerle and Brownlee (2003); and Steuerle and Hartzmark (1981).

3. For some political perspectives on particular events, see Regan (1988) and Stockman (1986); in addition to my own work on 1986 tax reform, see books by Birnbaum and Murray (1987) and Conlan, Wrightson, and Beam (1990) and articles by Haskel (1987), Verdier (1988), McLure (1988), Minarik (1987), and Witte (1985); some tax events of the Clinton period are covered in Waldman (2000) and Woodward (1994). A special issue of the *Journal of Economic Perspectives* in 1987 included work by such stalwarts as Richard Musgrave and McLure and Zodrow. For a parallel work on the evolution of the welfare state, see Howard (2006).

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No one can write a book of this breadth or produce a second edition without much dependence on others. Alan Auerbach, Jon Bakija, Thomas Barthold, Evelyn Brody, Elliott Brownlee, Leonard Burman, Adam Carasso, Joseph Cordes, Martin David, William Gale, Daniel Halperin, Peter Orszag, Rudolph Penner, Joseph Thorndike, Eric Toder, and two anonymous referees provided an extraordinary array of helpful and insightful comments. Adam Carasso, along with Meghan Bishop, generously pulled together data and charts and finding sources for the first edition, and Gillian Reynolds did likewise for this edition. Anya Arax performed her usual wizardry in coordinating many early drafts. Kathy Courrier provided invaluable insights and Susan Kellam was amazing in her ability to make mishmash into prose, while making clear the most obscure technical points. William Bradbury copyedited both editions with distinction, while Scott Forrey managed the production process in the most professional and timely manner. None of these acknowledgments sufficiently conveys the delight I had in working with these friends and colleagues and how much I learned from them.

All errors, omissions, confusions, and other transgressions are, of course, the author's, but they are the natural consequence of tilling so long in the tax field, with ample fill of what might be called politely both productive harvest and decaying material.



Introduction

The income tax has made more liars out of the American people than golf has: even when you make one out on the level, you don't know when it's through if you are a crook or a martyr.


—Will Rogers, *The Illiterate Digest*

No area of policymaking “taxes” the brain more than taxation. Although the nuances of tax reporting and accounting are mind-boggling, they reflect the implementation of a much wider, sometimes disenchanting, but ever engaging policy process. Sound tax policy and administration—like a trustworthy judiciary and reliable financial accounting system—is one of the pillars of modern governance. Check out those nations that aspire to be republics, but have not yet firmed up this pillar, and you will find crumbling or barely viable government.

When policymakers decide to change the economy or society's behavior, the tax code is usually their tool of choice.¹ Most fundamentally, taxes are collected to support the activities of government agencies. Oliver Wendell Holmes, Jr., was referring to this basic function when he stated that taxes are the “price we pay for a civilized society.”² Today, however, raising revenues to support government's direct-expenditure programs and operations in society is only the tip of the iceberg.

There are tax breaks for homeownership that by themselves provide more subsidies than the entire budget of the Department of Housing and Urban Development. The earned income tax credit (EITC)³ is now larger than any other welfare program, such as Food Stamps or Temporary Assistance for Needy Families (TANF). The tax break for employer-provided health insurance, which costs close to \$150 billion per year by one calculation, represents the largest health subsidy granted to the nonelderly

anywhere in the federal budget and is growing faster than almost all other domestic programs. Meanwhile, every recent U.S. president has proposed expanding the use of tax subsidies for health. Tax breaks abound as a favored mechanism to “provide energy independence,” subsidize energy producers, and promote energy conservation—even when extra production works at cross purposes to conservation. In other words, to understand housing, welfare, health, energy, or almost any government policy, you have to look at what is going on in the tax code.

 Today, tax breaks rather than direct expenditures account for one-fourth to one-third of the benefits and subsidies granted to the public. As if that weren't enough to overburden the tax agenda, in recent decades politicians have decided that taxes are a primary instrument for dealing with economic growth and recession and implementing macroeconomic policy. Further, presidents and Congresses constantly try to use taxes to change the distribution of income and affect behavior among farmers, research firms, energy suppliers, the poor, and hundreds of other groups who benefit from various tax grants and subsidies. Finally, taxes powerfully influence how we all consume, work, save, and invest.

Various U.S. agencies such as the Treasury Department sometimes formally assess these nonrevenue functions of the tax system, in part through an accounting system known as the tax expenditure budget. This controversial budget attempts to calculate the size of tax provisions that operate essentially like direct expenditures even though they take the form of tax breaks. Because such a large chunk of government subsidies and expenditures is in the form of tax breaks for selected people, businesses, and activities, elected officials often turn to the Treasury and the congressional tax-writing committees to resolve budget and deficit problems.

The Budgetary Myths Surrounding Tax Policy

Everyone is an expert on three subjects—medicine, education, and taxes. After all, each of us has firsthand, sometimes harrowing, experiences dealing with doctors, teachers, and tax officials. But just as there are quack medicine and bad educational theories, so too are there pieces of conventional wisdom about taxes that are highly questionable or downright wrong. Especially for those closely associated with one political party, mythical views can develop over what the other party has done wrongly in the past. These myths need to be dispelled, or at least put in perspective, as they have been pervasive throughout the recent history of tax policy.

Of course, tax cuts and increases often influence the size of government. But a lot of other factors have to be weighed. Tax cuts can actually expand (or tax increases reduce) the government's interference in the economy. Consider a new tax cut to dairy producers that might provide a tax credit of 5 cents for every gallon of milk delivered, yielding a total subsidy of \$100 million. There is little difference between this tax cut and a direct spending program giving 5 cents per gallon to dairy producers and also costing \$100 million. In effect, an expenditure increase to dairy producers can be designed or disguised as a tax cut. But the end result is the same—even if the dairy subsidy shows up as a negative tax rather than a positive expenditure in the budget. Either way, this expenditure must also be paid for through higher tax rates. Disguised expenditures such as this hypothetical dairy subsidy are a political favorite. Since our elected officials prefer to be shown giving something away without increasing taxes, it is not surprising that they like to talk about the benefit and not the cost side of their actions.

A tax cut may not be a “cut” at all but a shift in who pays: if additional debt is incurred to finance it, then future taxpayers might pay higher taxes to pay for lower bills for current taxpayers. Much depends upon what happens to future expenditures. Higher deficits from reduced taxes might lead to reduced expenditures, but this “starve the beast” strategy has a mixed record. In the first few years of the 21st century, large spending increases accompanied tax cuts, so future taxpayers might pay for those actions through both higher taxes and reduced expenditures. While the empirical evidence on how tax changes drive expenditure changes is necessarily inconclusive, the accounting truth is undeniable: the nation's fiscal system is a balance sheet, and the tax or expenditure side can be looked at separately only by closing one eye.

Budget myths about presidential tax policy have prevailed throughout the history this book covers, and we should begin by dispelling some of their various manifestations.

The Reagan Budget Myth: Reagan's 1981 tax cuts created the deficits in the 1980s. The large revenue cutbacks of the early 1980s added significantly to deficits at that time. But broader factors also contributed to the budget deficit. A temporary and significant increase in the defense budget as a percentage of gross domestic product (GDP) coincided with the early 1980s' tax cuts. Also in that period, the inexorable growth in health and retirement programs absorbed more and more national income. In fact, the extraordinary surge in so-called entitlement spending has become the dominant

budget force over the past few decades. Essentially, the budget numbers didn't add up in the early 1980s: there wasn't enough money to pay for the tax cuts of 1981, the defense increases, and the automatic increases in entitlement spending. If several cars play "chicken" and all crash together, it is less useful to blame one car—in this case, Reagan's tax cuts—than to address the broader process that led to the game in the first place.

The Clinton Budget Myth: Clinton's 1993 tax increases were responsible for the elimination of the deficit by the late 1990s. Despite the tendency of Republicans to attack the Clinton tax increases for being historically large and Democrats to praise them for leading to extraordinary deficit reduction, the increases were moderate. Indeed, the deficit-reduction package under Clinton's predecessor, President George H. W. Bush, was larger in magnitude as a percentage of GDP than was the one President Clinton pushed through.

Again, a broader perspective is required. The 1990 budget enforcement rules helped maintain enough discipline in the mid-1990s, during a time of divided government, that few large expenditures or tax cuts were added to the budget even as the economy grew. This constraint—along with a long economic upturn—helped to temporarily reduce the deficits.

The George W. Bush Budget Myth: President Bush's tax cuts re-created large deficits in the first years of the 21st century. Once again, talking about taxes in isolation does not make sense. The tax cuts, especially if eventually made permanent, were large. But spending increases were quite large, too—not just for defense or national security, but for discretionary and entitlement spending as well. In fact, in President Bush's first term, Congress and the president went on a wild legislative "spending" spree of both tax cuts and increases in expenditures, while adding to, rather than containing, the large, automatic growth in retirement and health spending already scheduled. Meanwhile, independent from the tax cuts, revenues fell dramatically, but temporarily, early in the new century due to a recession and stock market plunge. Most importantly, with the upcoming retirement of the baby boomers, the long-term budget issue was ignored.

And Some Realities

Some factors or trends have long played important and continual roles in how tax policy has evolved.

Fact 1: Reliance on principles seems to go up when times are tough. Almost all changes to the tax law seem to be called “reform” by their sponsors, but true reform is based on principles. Many believe that principled reform requires a favorable period of budget surpluses. The “good times” rationale is that unwarranted tax breaks can be eliminated only when those people formerly benefiting from the breaks don’t have to take a hit while the former losers are compensated. For instance, suppose Tom unjustly pays less tax than Harry when in principle they should pay the same. Then with a surplus, Tom’s tax break can be eliminated and tax rates lowered for both Tom and Harry. In that way, Harry’s taxes can be reduced to the level of Tom’s, but Tom won’t pay any more because the rate reduction will roughly offset his loss of a special tax break.

The history of modern tax policy belies the notion that such easy exchanges are possible. Instead, when Congress has to show directly how it is taking something from someone—that is, when it is reducing the deficit—it has been more likely to appeal to the public on grounds of equal justice or some other principle. When there is no budgetary pressure, Congress is less compelled to remove anyone’s tax break. Indeed, when it is engaged in additional give-always, it is often indiscriminate—not worrying whether Tom gets more than Harry or Harry more than Tom as long as neither is hurt and perhaps campaign contributions go up.⁴

Of course, it is hard to adhere to all principles at the same time. As only one example, some attempt to create equity or parity can at the same time cause complexity. Nonetheless, though the coming chapters highlight important exceptions, concern for principles in general seems to wane when Congress’s or the president’s feet are not held to the fire.

Fact 2: Both political parties like to provide subsidies and expenditures through the tax system. Providing subsidies and expenditures in the form of tax breaks gives the appearance of reducing government’s size since the measure of net taxes goes down even as government interference in the economy increases. For this reason, tax subsidies have strong political appeal.

Many tax subsidies in the 1960s and 1970s were delivered as business tax breaks and deductions of greatest value to higher-income taxpayers. In that earlier period, Republicans tended to defend such breaks more than Democrats (although, as in the case of the investment credit, they were often proposed first by Democrats). But even as some of these business preferences were cut back, social tax expenditures increased and credits expanded even for those with no tax liability.

Eventually, support for using the tax code to accomplish social and economic policy, not simply to raise revenues, became increasingly bipartisan.

Fact 3: The Internal Revenue Service doesn't just collect revenues; it administers social policy and children's programs. A corollary to the bipartisan embrace of tax subsidies and expenditures has been the expanded use of the earned income tax credit, child tax credits, and other tax benefits targeted toward lower-income families, especially those with children. Because Republicans embraced helping families with children as a family issue and Democrats embraced family as an issue of progressivity, there has been bipartisan movement on this front.

Fact 4: The investment and business tax policy debate evolves toward ever more complex issues. Although tax policy is crucial for investment and saving policy, rules are neither steadfast nor consistent. Broad-based incentives, such as investment tax credits, eventually got abandoned in favor of lower rates, but selective incentives for such items as research and energy remained or expanded.

One heated and unresolved debate concerns the ways that taxpayers "arbitrage" differences in the treatment of different assets, income sources, or type of taxpayer (e.g., corporation, individual, or charity). Government seems to have limited ability to prevent new "tax shelters" born of complex forms of arbitrage, forcing Congress constantly to rewrite the law or the Treasury and IRS to reinterpret the regulations. Such shelter opportunities arise from many sources, including variations in tax rates by country, limitations on loss deductions that may be avoided when companies merge, the tax exemption for charitable activity, and the differential taxation of equity and debt. Tax professionals' growing skillfulness in exploiting every differential in the tax system, the computerization of tax accounting, and the emergence of split-second electronic transfers of billions of dollars all perpetuate the tax shelter crisis.

Fact 5: The real postwar growth in taxes occurred at the state, not the federal, level. Although most tax policy fights are over federal taxes—federal income taxes in particular—state taxes have taken larger and larger shares of national income over the post-World War II era. The state and local share grew relative to the national share, while the states themselves took over much larger shares of the combined state and local budgets.

Fact 6: The tax code must change with the times. Among tax lawyers, accountants, and practitioners, this is heresy. They are right that change is complex, and that there is an administrative, as well as efficiency, cost

to constantly retooling (Feldstein 1976). Many of the changes of the past few decades have also made the tax laws permanently more complex—increasing the time and transaction costs of dealing with tax preparers and tax professionals, filling out tax forms, and adjusting portfolios and other parts of our lives to minimize taxes.⁵

Nonetheless, the tax code is a major instrument of U.S. policy. No one argues that expenditure policy should be left alone. As an evolving society develops new needs and new information sources, institutions must change, and government must spend its money differently. The same holds true for collecting taxes. Certainly, some aspects of the tax code should be changed only gradually, especially those that involve complex accounting matters. But an equal claim for a modest pace of reform can be made for many expenditures, such as deposit insurance. Other expenditure provisions, such as size of the armed forces, must evolve more rapidly. Thus, the tax code will evolve not just because politicians can't keep their hands off of it, but also because they should not.

Fact 7: Controlling the budget plays an increasingly dominant role in the evolution of tax policy. In terms of causal direction, tax policy has always been a handmaiden to budget policy. A nation raises taxes to pay for government functions. Read almost any history of the United States that covers financial matters, and it will become clear how much of the nation's success—and at times, its survival—was made possible by coming up with the necessary money at the right time.⁶ Taxes have been raised to meet budget policy goals of reducing debt obligations arising from the Revolution, building roads and other infrastructure for westward expansion, paying for wars, and restraining the growth in national debt; they have been lowered to reduce distortions and the drain of government on the economy.

Compared to most of the nation's history, only in the contemporary period covered here has deficit reduction or surplus spending largely defined policy. During this late period, Congress has paid limited attention to the underlying purposes of tax or expenditure programs, which is unfortunate, since a government doesn't exist to reduce deficit or spend surplus. In any case, tax bills played a vital role in both deficit and surplus—with success often defined politically by the simple standard of whether enough money was raised or spent.

The name of the game in Washington in recent decades has been to “spend” or use up money before the other person does. On the expenditure side, entitlement programs like those for retirement and health are

precommitted to absorb ever-larger shares of revenue in an automatic fashion—that is, even in the absence of legislation. Not to be outdone, those who favor lower taxes have legislated tax cuts into the future. The net result is gridlock. Never in the nation's history have dead and retired officials been able to exert such control over current and future budgets, as you will read.

Principles and Principals of Tax Policy

The United States should have a tax system which looks like someone designed it on purpose.

—Former Secretary of the Treasury William E. Simon,
Blueprints for Tax Reform

Despite its seemingly random application to almost every sphere of human activity, tax policymaking is far from random. Many forces drive taxes, but principles do matter. Part of being human is “justifying” our actions according to some principle or standard. Some attribute this deep-seated impulse to a natural law.¹ When it comes to tax policy, this fascinating call of conscience to justify action might be manipulated, but it cannot be ignored. Even the narrowest special-interest pleader in the tax-policy arena couches arguments in terms of principles or theories, however illogically.

John Maynard Keynes’s famous quip that “ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood”² is even truer in the age of mass media and celebrity. Scholars today can spark new policy developments, but, just as often, they “defend the faith” of politicians by giving them academic cover for their biases and legislative actions already taken.

Basic Principles of Public Finance

The important principles, and theories applied to tax policy by influential principals in the tax arena, are defined in this chapter. As you will see, the principles they espouse sometimes conflict. A common battleground

is between progressivity and the belief that individuals are entitled to the product of their own labor or returns from their own saving. Nonetheless, principles are useful guides for policymaking. Many proposals and tax provisions unduly violate one principle without any further adherence to another. Sometimes tax legislation is aimed at removing such violations. For instance, some efforts to broaden the tax base and simultaneously lower tax rates seek to improve efficiency and equity among individuals with similar ability to pay taxes without changing progressivity or revenue capacity. More often, "reform" aims to advance one principle with less regard for the others (e.g., more progressivity regardless of complexity or more efficiency regardless of equity). In the chapter 12, we shall reprise which of these theories in recent decades might have triumphed in the never-ending tax debate.

Horizontal Equity

In the tax laws, horizontal equity—which is closely related to the notion of equal justice—asserts that those with equal ability to pay should pay equal taxes. No principle seems to permeate debates over policy—not just tax policy—more than equal justice. Yet while there is almost universal agreement on the principle, the rub in taxation is the frequent lack of agreement on exactly who are equals. Those with equal incomes? Those with equal incomes, less such extraordinary expenses as chronic medical care? Those with equal potential to earn income, whether they make the effort to realize the income or not? Or, moving beyond income, those who consume or absorb equal amounts of societal resources? Of course, how one measures who are equals and what is equal treatment are yet further complications.³

Horizontal equity is perhaps the queen of all principles affecting government policy, or at least the one to which people pay the most homage.⁴ Many tax breaks for one type of household or tax penalties for one type of business are often opposed (or favored) on the grounds that they unfairly distinguish between two types of taxpayers who should be treated equally. Politicians, of course, may skirt this principle, but seldom do they deny its existence. Even when a class of investors or consumers is favored, the principle usually applies internally to that group. For example, the subsidy allowed for charitable contributions favors those who give, but then all taxpayers who give to charity can claim roughly equal rights to the subsidy.

Vertical Equity

While horizontal equity is almost universally accepted as a principle, other principles are more likely to come into conflict with each other. Vertical equity, also known in tax circles as progressivity, suggests that those with greater needs should receive more from government and those with greater “ability to pay” should pay more. Many revile this notion. One attack on progressivity is that it prompts class warfare. While some progressivity arguments may indeed invite that risk, any general attack on the progressivity principle, in my view, is almost tantamount to an attack on natural law theory.⁵ That is, some progressivity—greater contributions to the community by those who are more capable of contributing—is apparent in nature when the stronger or older of a species support the weaker or younger. So must it be, at least at some level, with the human species. As a practical matter, for instance, those with little or no resources can hardly pay an equal share of government costs. Once on this redistributive track, the issue is not whether government will redistribute, but *how* progressive it can or should be.

Even tax experts can lose their way in tax policy discussions of progressivity because the term is usually defined narrowly as rising *average* tax rates with increasing income. On the expenditure side of the budget, however, most public discussions tend to define progressivity as greater absolute benefits for those with lesser incomes or other means. As an example, a \$100,000 educational benefit for a millionaire and \$1,000 for someone with a \$9,000 annual income does not tend to be defined as progressive, even though the latter benefit is a higher share of income for the poorer person. This inconsistency invites all sorts of confusion in the public debate, and self-defined liberals and conservatives fail to apply the progressivity principle consistently across tax cuts, tax increases, expenditure cuts, expenditure increases, and budget policy in general (Steuerle 2002a, 267–70). For example, pure flat rate taxes with no exemption for even poverty-level income are not progressive by the typical tax definition, but if those flat-rate taxes support programs with roughly equal benefits per person, then there will be a substantial net progressive redistribution from the well off to the less well off.⁶

Think about a two-person society with a 20 percent tax rate on both their incomes, with one person earning \$100 and the other earning \$10. If the tax is redistributed equally to each of them, then the richer person on net pays \$9 (\$20 paid minus \$11 received) and the poorer person receives \$9 (\$2 paid minus \$11 received). In another more real-life example, Social

Security provides greater absolute benefits to the rich while middle-income people pay a higher proportion of their wages and salaries into the system than upper-income individuals do. By either inconsistent measure cited above, this program is regressive, even though the Social Security expenditure and tax system as a whole is meant to redistribute resources.⁷

In this book, we will try to keep clear this confusing distinction between progressive policy that results in net redistribution and “progressive tax systems” defined as systems with tax rates that rise with income. When it comes to taxation, the ultimate effect on redistribution still depends ultimately on what happens to the expenditures that revenue raising makes possible.

Efficiency

The efficiency principle—a favorite of economists—suggests that programs should never avoid making someone better off if it can be done without making someone else worse off. Rare are situations where such pure tax trades are possible. In tax reform, that ideal would require creating a situation in which there are no losers and at least some households are better off after the reform. Unhindered by this pure constraint, however, many tax policy reforms tend to produce gains in overall economic output even if some individuals lose—for instance, when for no obvious or stated reason the unreformed tax arbitrarily favors one particular form of work, investment, or consumption.

Taxes by their very nature distort behavior. They usually lead people to avoid the taxed activity, whether it is work, saving, or some particular form of consumption or investment. This change in behavior—for example, doing less or more of something than we would otherwise do—causes the efficiency loss. Generally speaking, tax policy cannot eliminate but only reduce efficiency loss.

Even when distortions are minimized for some level of tax collection, those taxes, because of their remaining effect on behavior, must be justified by gains from the programs they support.⁸ Even taxes collected to support income-transfer programs depend on the notion that progressive transfers add to the good of society—a variant of an efficiency construct. In theory, that gain—however hard to measure—should be greater in value than the losses due to the economic distortions of the taxes (and expenditures) imposed.⁹

There are many applications of the efficiency principle, but in taxation, the primary applications are to choices among what is consumed or produced, between work and leisure, and between consumption today and saving today for consumption tomorrow. If a tax discourages people from working, for instance, then they will produce less than they would in the absence of the taxes and contribute less to national output. Using taxes to push growth (as opposed to removing distortions or barriers to growth) is another matter, and there is a legitimate debate over whether it is “fair” or “efficient” for one generation to enhance growth even further if the benefits go mainly to future generations who are likely to be richer anyway. Put another way, higher growth does not necessarily imply greater efficiency. Many economists suggest that the efficient part of the pro-growth reform agenda involves removing disincentives to saving rather than adding new incentives (or biases).

Individual Equity

The individual equity principle holds that individuals are entitled to the product of their labor and to a fair return on their saving.¹⁰ The principle is closely associated with the right to individual liberty. At an extreme, individual equity is violated *prima facie* by almost all government taxes, rules, or regulations that force individuals to do something they do not want to do and for which they have not voted. More practically, the principle suggests that government taxes essentially confiscate private property if the individual doesn’t get government services or benefits of at least equal worth in return. The government should provide a *quid pro quo* if the tax is mandatory; if voluntary, the taxpayer can act as one would in any market where the price is unfavorable—by refusing to buy.

Individual equity considerations come up in many situations. For instance, although Social Security tries to be progressive by design, its architects also gave some weight to the individual equity principle and granted greater (though still not proportional) benefits to taxpayers who pay more in tax. Proponents of individual accounts in Social Security often suggest that depositing an individual’s Social Security taxes into his or her own account better serves the individual equity principle.

A common application of this principle is a preference among alternative tax systems for “benefit” taxes—taxes where individuals pay what it costs government to deliver a service. Fees, such as those charged by national parks and toll roads, are classic forms of benefit taxes that

subscribe closely to individual equity norms. Benefit taxation is sometimes contrasted with taxation according to ability to pay, as per the progressivity principle.¹¹ Efficiency, as well as equity, considerations come into play with benefit taxation, since its application implies that the marginal cost of any benefit received is charged to each recipient at the margin. In practice, however, exact assessment according to benefits received is difficult (e.g., using highway tolls to charge exactly the right amount to each vehicle-weight class).

The argument for greater "choice" among individuals is another variant on this theme of paying heed to both individual equity and efficiency considerations. Here, a taxpayer would always be better off if allowed to decide between equal-costing A and B than if forced to accept A. For instance, a credit for higher education would leave the taxpayer a choice of what school to attend, in contrast to a grant specifying the school. Using vouchers or voucher-like tax credits for college education, food stamps, training programs, or health is often viewed as improving individual equity and efficiency by providing greater choice for the same expenditure or credit. In some cases, however, these programs of choice can cause distortions or inequities relative to a more universal provision of a good or service. For instance, unless designed well, vouchers for health insurance can lead those who are relatively healthy to seek health plans that exclude those who are less healthy, thus leaving the latter in a high-cost insurance pool.¹²

Simplicity

All things being equal, who opposes simplicity? Since government doesn't exist to simplify itself, the issue is not whether simplicity should be given priority so much as whether it is given adequate weight or consideration in the legislative process and administration of the law.

Complexity arises for a variety of reasons, including pursuit of other worthy principles. For instance, the attempt to tax all income equally—following efficiency and horizontal equity criteria—can work against simplicity when some forms of income are hard to measure. When Congress or the president wants to appear to do something symbolically important but doesn't want to spend the required revenues (or raise tax rates commensurately), taxes get more complex. Similarly, legislative logrolling leads to complex rules when small benefits are granted to many constituent groups. Complexity also arises from cobbling together programs as monies become available rather than implementing a comprehensive approach.

Usually the easiest way to simplify tax preferences or subsidies is to get rid of them. On the other hand, merely paring them—say, on some horizontal equity or efficiency ground—might actually add complexity and recordkeeping when the basic provision remains intact and taxpayers have to go through elaborate calculations to figure out whether they qualify.

Closely associated with the goal of simplification is *transparency*. Transparency demands that the purpose of a tax policy, including who pays and who doesn't, be presented in an open manner. Following the principle requires administrators to provide statistics and data on government programs, and it requires legislators to try to make clear what they are doing. Transparency is often the bane of special interests or those who want to hide their special status. Thus, congressional reform efforts early in 2007 attempted to add some transparency—such as identification of the sponsoring member of Congress—to special “earmarks” for selected constituencies hidden in other bills. Still, even those who claim to be “principled” on other matters often prefer to be opaque if it helps them achieve their goals.

Revenue Raising

Revenue raising is probably more a goal than a principle, but its primacy cannot be overstated. With a few small exceptions, such as a pollution tax, tax systems don't exist to increase progressivity, tax equals equally, or remove economic distortions. They are created to pay for government's activities. Revenue raising is related to efficiency in the broad sense that government must pay for what society needs and avoid the economic costs of unsustainable deficits. At stake is nothing less than government's ability to achieve its purposes and run its functions. Maximizing revenues, however, is not a principle or goal and generally violates efficiency. Still, the tax system must provide the revenues sooner or (with borrowing) later to pay for the costs of government.

The Government Principals

Many parts of government have some responsibility for tax policy. The executive branch departments—in the case of taxes, the Treasury Department—often develop proposals to be vetted through policy councils or departmental meetings, leading to decisions by the president. The

proposals are sent to Congress, which examines and amends or rejects the proposals in committees, with the House Ways and Means Committee and the Senate Finance Committee designated for tax matters. Special interests, as well as nonpartisan private individuals and groups, have the opportunity to testify on matters important to them. The committees then amend bills and report them to Congress as a whole. First the House, and then the Senate, vote them up or down, sometimes with amendments.¹³ A conference committee rewrites the different versions and reports out a compromise measure to both houses for approval. The president accepts or vetoes the legislation.

Alas, legislation seldom follows this neat path and division of labor. Many promoting different ideas—in particular, tax cuts they want—enter the process at different stages and skip the steps they consider obstacles. Only some tax policies are developed internally by the Treasury rather than other offices or departments of the executive branch—offices that typically have much less knowledge of or concern for broader tax principles. Nonpartisan staffs both in the executive branch and in Congress are frequently left on the sidelines. Their analysis, for instance, will often rise only to the level of an assistant secretary of Treasury or director and never be made public or reach the ears of the president or even members of Congress. The process often fails to give principles of taxation their due. Examples include Treasury's staff being called on to justify past political promises rather than offer options to the president, Congress not asking its own Joint Committee on Taxation to analyze the pros and cons and what might best serve the public interest, and testimony not being taken before important provisions are added to bills.

One very difficult period for a rational reform process is the first year after the election of a new president, when new political appointees in the White House typically direct the Treasury to put together packages incorporating campaign promises. The overwhelming temptation is to ignore the almost inevitable administrative, implementation, or other problems of campaign promises that are developed with limited analysis and that tend to promise maximum benefits at minimal cost to the public. Treasury staff may not even be asked to suggest alternative options that aim to achieve roughly the same end, yet more realistically deal with the impact of the promises on the budget.

In recent decades, much of what the president ends up promoting comes from the Executive Office of the President and, in particular, White House special assistants to the president and other appointees.

Only since the latter part of the 20th century have so many political appointees been put in the White House, creating numerous filters of information between civil servants and the president.

The head of the president's National Economic Council (NEC) (previously the economic coordinating council in the White House) has become increasingly powerful because he or she coordinates economic policy coming out of all parts of the executive branch. For instance, Lawrence Lindsay headed this council in the early years of the George W. Bush presidency, and he was largely responsible for developing the administration's early tax policy proposals in the campaign and for putting them forward in 2001. In the latter part of the Bush presidency, the president's Social Security reform options were largely marshaled by the council's head, Al Hubbard, and a special assistant, Charles Blahous. Two other recent heads of this office and its predecessor (James Baker and Robert Rubin) found it to be a stepping-stone to Secretary of the Treasury. Other offices with substantial influence include the Office of Management and Budget (OMB), which must put together the budget and see how expenditures and taxes add up, and the Council of Economic Advisers, which mainly advises the president on economic matters.¹⁴ These two offices still perform significant analysis, but they have seen their influence dissipated, both because of rising expertise in many of the agencies of government and because of the growing influence and number of pollsters and political advisers within the White House.

The Secretary of Treasury is considered the president's lead person on implementing tax policy, partly because the Internal Revenue Service (IRS), which administers the law, falls under Treasury's wing. In theory, if not always in practice, the Treasury has substantial say over the development of the president's economic and tax policies. As the White House staff has grown, however, the Treasury's role has often been reduced to figuring out how to make workable a rough idea emanating from a political conversation in the White House.

The largest group of nonpolitical appointees devoted to tax policy anywhere in government resides in the Treasury's Office of Tax Policy (OTP)—largely composed of economists, lawyers, and a few accountants. In general, its role is to represent the public interest in the development of tax policy by analyzing options using the principles outlined above. Along with the IRS, it also writes regulations to implement laws already passed. Among their many analytical functions, the economists estimate the revenue cost of tax bills—often causing hand wringing among

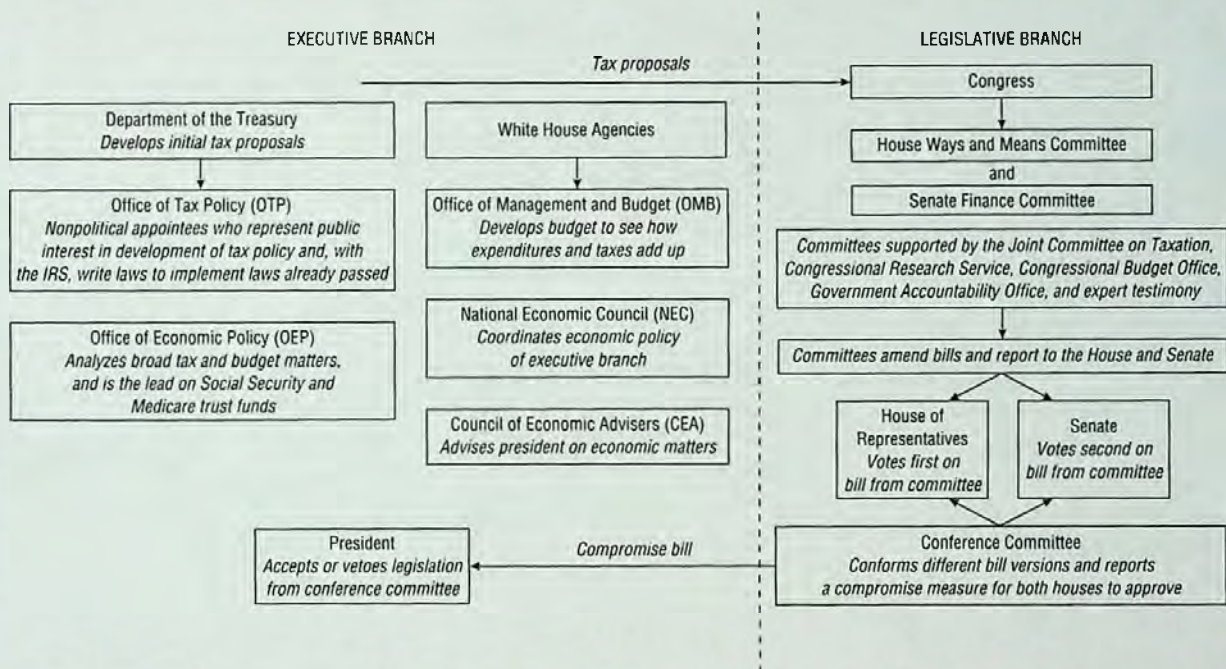
politicians who want lower costs assessed on their tax cuts.¹⁵ The Treasury's Office of Economic Policy, in turn, provides useful analysis of broad tax and budgetary matters and tends to handle the Secretary's role as lead trustee of the Social Security and Medicare trust funds. Despite its highly competent staff, at times it has been politicized and used to provide an economic justification for whatever policy the administration has proposed.

Usually, tax bills must be forwarded to Congress only after the House Ways and Means and Senate Finance committees approve them. These committees tend to control the details of what goes into the bills, often deviating substantially from what a president initially suggests and taking many actions without his backing. These tax-writing committees also have responsibility for much of the expenditure side of the budget, including Social Security, Medicare, and some welfare programs. This combination of responsibilities gives these tax-writing committees extraordinary budgetary power that extends beyond tax legislation. Throughout the period examined in this book, almost all major expenditure and budget legislation—not just tax legislation—went through these committees.

While the House Ways and Means and Senate Finance committees divide into majority and minority staffs, they often work together in a bipartisan manner and tend to be highly professional and well regarded.¹⁶ The staff of the nonpartisan and distinguished Joint Committee on Taxation (JCT), established by the Revenue Act of 1926 and composed nominally of members of each house of Congress, mainly support the tax-writing committees—in particular, their chairpersons—by providing analysis somewhat similar to that which the Office of Tax Policy makes available in the executive branch.

The Congressional Budget and Impoundment Control Act of 1974 established the House and Senate Budget Committees and simultaneously created the Congressional Budget Office (CBO) to provide nonpartisan analysis for economic and budget decisions. Like the OMB, its counterpart in the executive branch, the CBO tries to determine how well the budget numbers add up. Unlike the OMB, the CBO is especially recognized for its ability to publish and analyze budget options—including tax options—for consideration. The Government Accountability Office (GAO) and the Congressional Research Service (CRS) also provide occasional tax analysis for Congress upon request; the GAO often investigates administrative and enforcement problems, and the CRS sometimes provides background material on tax issues.

Figure 2.1. Federal Tax Legislative Process



Although nonpartisan staffs try to figure out what is in the public interest, they are not always right, and they often disagree on how to weigh sometimes-conflicting principles. Nonetheless, the Office of Tax Policy, the Joint Committee on Taxation, the Congressional Budget Office, the Government Accountability Office, and the Congressional Research Service are national treasures that need to be valued and respected. These staffs often work closely together, exchanging information, views, and methods of estimation and model building (figure 2.1).

Advocates and Their Theories

Various theories influence each of these policymakers and advisers. Unlike principles, theories tend to be more personal and tied to particular advocates, whether disinterested or self-interested. For the record, these theories are subtler than the following summaries suggest, but in political debate, they are far more crudely represented.

Taxes as a Means of Financing Government

Throughout most of history, tax policy has been viewed mainly as a mechanism for financing government. If the state wanted to collect revenue, tax policy was the means by which it was done. Traditional tax reformers are those who accept this basic function, then ask how it can be done in the most effective way.

A traditional tax reform position taught by both conservative and liberal economists in most public finance courses has been to stress horizontal equity and efficiency—mainly by trying to remove provisions that favor particular forms of income or consumption. Inevitably under such differential taxation, some taxpayers pay more than others who have equal levels of income or consumption since, by design, the system favors those who hold more tax-preferred assets (e.g., tax-exempt bonds) or tax-favored consumption goods (nontaxable fringe benefits).

Traditional tax reform is neither a strictly liberal nor conservative notion, and it has a long lineage of distinguished economic promoters, ranging from Richard Musgrave, writing mainly at Harvard, to Henry C. Simons at the University of Chicago. One problem for some liberals not steeped in traditional reform is that, strictly speaking, traditional tax reform tends to be neutral about issues such as progressivity and the size

of government. Hence, not every progressive tax enactment passes muster on the basis of principles like horizontal equity and efficiency. On the other hand, an efficient system can often attain the same progressivity and sometimes larger direct expenditures at lower tax rates.

One problem for some conservatives not steeped in traditional reform is that, until recently, many tax preferences were for businesses and capital owners, while most personal preferences were in the form of deductions and exclusions of greater value to higher-income individuals (because of their higher tax rates) and of little or no value to those who did not pay taxes. Eliminating these preferences, therefore, might simply make additional money available for other activities that progressives favored. Still, conservatives generally embrace efficiency, and there is no reason why savings from removing differentials and preferences need to finance larger spending elsewhere. The money raised this way can just as easily be returned to taxpayers in the form of lower rates, which enhance efficiency gains. When the removal of a preference finances a reduction in tax rates, there is an added benefit: any remaining preferences in the form of deductions are simply worth less because lower rates are applied to those deductions.¹⁷

Income Tax Reformers. Traditional tax reformers today can be divided into two camps with many similar, although not identical, goals. Almost since the creation of the modern income tax, traditional income tax reformers have concerned themselves with the question of whether the income tax complies with principles of horizontal equity and efficiency. Do those with equal incomes pay equal tax? Does a deduction really reflect a difference in ability to pay, or does it merely tend to favor one form of income or consumption over another? Many of the reforms reviewed in this book were adopted with these concerns in mind.

Many income tax reformers believe that capital income should be as subject to tax as is labor income. Indeed, in the early decades of the income tax, government mainly taxed capital through the corporate tax, and individual taxes, mainly on labor income, were much lighter. Today, many exceptions to taxation favor capital income. However, since those with higher incomes earn the most capital income, the underlying concern for these income tax reformers seems to be progressivity.

One overlapping subgroup of traditional reformers—usually but not always from the income tax camp—are the tax expenditure theorists who became enamored of trying to measure income tax preferences that tended to serve expenditure-like functions. For instance, tax deductions

for the purchase of health insurance compete with expenditure subsidies for the same purpose (e.g., see Surrey and McDaniel 1985). Limiting such preferences often serves simultaneously to make an income tax purer and to reduce tax expenditures.

Consumption Tax Reformers. A long-standing debate in economics is over whether people should be taxed on what they earn for society (an income tax) or what they take out of society (a consumption tax). Many of the arguments for consumption taxes are efficiency arguments—basically, that lowering taxes would lead to more saving and higher growth. Much research also suggests that taxes on capital may reduce output (or otherwise distort productive behavior) more than taxes on labor, although other research asserts that such evidence is weak since we don't estimate people's reactions to taxes well.¹⁸

Many consumption tax theorists believe that one can assess a progressive tax rate schedule on total consumption that would approximate the progressivity of the income tax (U.S. Department of the Treasury 1977). This approach differs from that of some business and capital owners who simply favor consumption taxes as a way of lowering their own taxes. These theorists say a consumption tax would be fairer on net because it would better meet horizontal equity criteria (U.S. Department of Treasury 1997). That said, whether equal progressivity can be obtained at the very top depends on the perspective used. For individuals who consume only a tiny fraction of their income—and this occurs frequently among those with substantial income—one has to accept that the tax will be collected down the road when taxpayers or their heirs finally consume out of their accumulated wealth. If the same amount has to be collected on an annual basis, the consumption tax rate might have to be well over 100 percent to collect as much revenue on an annual basis as a 35 percent income tax rate.¹⁹

One of the stronger arguments for a consumption tax relies on horizontal equity concerns. Consider the case of two people both earning the same amount; one saves and the other doesn't. Under an income tax, the saver would pay the same tax up front on the earnings and then pay an additional tax later on any interest or other income earned on the saving, while the nonsaver would pay no later tax. Since both taxpayers are initially in the same situation, the income tax tends to discriminate against the saver and the consumption tax doesn't. This equity argument gets trickier when there is inherited wealth.²⁰ Some consumption tax theorists, therefore, are willing to levy an estate tax.²¹ However, this position appears to be more of an academic than a political compromise because much of

the lobbying for consumption taxation or financing the “research” favoring that end comes from wealthy families. Since many are more concerned with the estate tax than with income taxes, the compromise of accompanying a consumption tax with a strong estate tax is unacceptable to them.²²

Among the many important debates surrounding consumption tax theory, three especially bear mention here. First, capital formation lobbyists use consumption arguments to favor the immediate write-off of expenses for capital investment. However, unwavering adherence to consumption tax theory would also deny deductions for interest paid on borrowing if the interest received were not to be taxed.²³ Second, theory suggests that a consumption tax might effectively end up taxing the additional returns over and above returns to assets like Treasury bills. Third, many small business interests adamantly oppose adopting a value-added tax—the most common form of consumption tax prevalent in many countries—in exchange for lower income tax rates. Some abhor the additional complexity, and some simply fear that the VAT is too good a tax and will too easily generate revenues to finance big government.

Taxes as an Instrument of Economic Policy

Keynesians. One of the most powerful figures among 20th century economists, British economist John Maynard Keynes, suggested that government could increase expenditures or reduce taxes to help an underemployed or depressed economy, even if higher deficits result. Often referred to as pump priming or demand stimulus, Keynesian policy seemed to prove effective in the United States when World War II wartime spending—despite large deficits—seemed to help end the Great Depression. By the 1960s, the followers of Keynes turned mainly to reducing taxes (rather than increasing expenditures) as the fastest and simplest way to disburse money, partly because employers could implement the pump priming quickly through reduced withholding rates on wages. President Kennedy, a Democrat, explicitly promoted Keynesian policies in his early 1960s tax proposals, while in 1971 the Republican President Nixon declared that “Now I am a Keynesian.”²⁴

A popular political version of Keynesian theory began to hold that almost all deficit spending was acceptable, not only when there were high levels of unemployment, but as long as the economy was headed toward a recession, in a recession, or emerging from a recession—which, politically, meant almost any time. The theory’s popularity began to wane,

especially in the 1970s, when inflation and stagnation came along hand-in-hand, and reasserted the importance of monetary policy.

Nonetheless, Keynesian policy lives on. In virtually every recession, Congress and the president have invoked the language of “stimulus” to prove they were “doing something” with tax cuts and expenditure increases to get the economy moving again. In this regard, modern conservative presidents have been little different from liberal ones. They both feel it necessary to tell the public they are doing something to deal with a downturn.

Supply-Side Theorists. Like the political Keynesians, supply-side theorists supported tax cuts—and, as with the Keynesians, the level of support sometimes seemed indifferent to the state of the economy, the size of the deficit, or the level of the current tax rates. Their emphasis was on lowering marginal tax rates to spur saving and work by people seeking greater after-tax rewards. Marginal income tax rates are the rates paid on the last or “next” dollars of income received—the rates that would apply if one worked or saved more.

Supply-side theory was espoused strongly from the late 1970s to at least the early 21st century by a few political columnists and the editorial page of the *Wall Street Journal*, where its more populist versions would appear. These pages would also attack civil servants who would not “score” feedback effects from the higher revenues from the economic expansion supposedly resulting from the tax cuts (regardless of whether expenditures were reduced).²⁵ Irving Kristol (2003b, 10), a contributor to the *Wall Street Journal* editorial pages, credits the long-time editor of those pages, Robert Bartley, with converting the Republican Party to this “new economics.” Bartley had helped convince some Republicans—in particular, Congressman Jack Kemp of New York, and, through him, Ronald Reagan—to move away from the “self-defeating” strategy of “cutting spending . . . while leaving the programmatic initiatives in the hands of Democrats.”

Supply-side supporters like Kemp frequently used the tax cuts backed by the Keynesians in the early 1960s as an example of supply-side economics, even though the original Keynesian adherents might have been appalled by the apostasy. Still, there is an important distinction in that the Keynesian notion of spurring demand is met by getting money to people to spend, whereas supply stimulus increases the incentive to work and save through lower tax rates. Although both camps often revile each other, both like to claim that the economic rebound would generate new taxes to offset some of the static cost of the stimulus. The political appeal of this idea—called “dynamic scoring”—is self-evident: politicians can make

proposals whose costs are only partially held against them. Economists may claim there is no such thing as a “free lunch,” but they understand its appeal.

In the end, supply-siders are right that a leaner, sleeker government with lower tax rates may enhance economic growth and increase revenues.²⁶ However, the “feedback” effect’s size depends on far more than tax cuts. If financed merely by increased deficits, these cuts may lead to higher taxes in the future. Much also depends on monetary policy and other choices. Taxes with broad bases will often distort less than equal-revenue taxes with narrow tax bases.²⁷ Finally, one must figure out whether expenditures financed by taxes are doing good or bad things for the economy.

Capital Formation Reformers. Like supply-siders, the capital formation reformers pay special attention to trying to lower the tax rates on capital income, but they are much less concerned with the rates on labor. The basic argument used by most in this group is that growth is good and capital formation is the way to achieve it.

Many interests fall under the capital formation banner. Some of these people represent capital-intensive industries, such as the American Council for Capital Formation. The physical capital interests tend to support almost any reduction in the tax on capital income, but their pet issue is usually incentives for depreciable capital through accelerated depreciation, cost-recovery allowances, or investment credits. Businesses more dependent on human capital, such as medical supply or software firms, instead emphasize lowering tax rates and providing research credits, and they often break ranks with the physical capital formation proponents. The capital formation advocates often support converting the income tax to a consumption tax (which would remove much of the tax on capital income), but many would not be adverse to a negative tax rate on capital either, if enough subsidies could be found.²⁸

Capital income taxation is an exceedingly dense subject. Some capital formation reformers are intent on removing all taxes on capital income, while others simply want to eliminate multiple taxation. Opposing them are some progressives who will accept almost any type of additional tax on capital, including estate taxes, property taxes, real estate taxes, franchise taxes, and corporate taxes, while other progressives simply want to ensure capital income is taxed at least once.²⁹ Academic lawyers and economists examining this issue tend to put it into the consumption versus income tax framework, but then they disagree on many issues, such as the potential for tax avoidance and evasion (see Aaron, Burman, and Steuerle 2007).

Anti-estate tax and anti-capital gains tax advocates represent some of society's economic elite. They also include farm and small business interests, who tend to save substantial amounts of their personal income in their business or land. For many of the richest people in society, income has largely been accrued as capital gains and will not be subject to personal income tax unless the underlying assets are sold and the income is "recognized." Indeed, accrued capital gains are forgiven any tax liability at death.³⁰ But the threat of the estate tax looms large even if little income tax is paid. Bill Gates, Sr., the father of one of the richest people in the world at the beginning of the 21st century, claimed that much of the opposition to the estate tax is financed by a tiny group of other extremely wealthy individuals (see chapter 11).

Although estate taxes and capital income taxes can double- or triple-tax some rich taxpayers' income, other income may escape tax altogether. As an example of multiple taxation, consider labor income that goes to purchase corporate stock directly (not through a retirement plan). The earnings of the purchased companies, in turn, are subject to corporate tax. Meanwhile, the retained earnings of the corporation will add to the value of stock an individual holds, which will be taxed again if the stock is sold. Any remaining assets the individual holds may be subject to estate tax. As an example of low taxation, some individuals achieve very large capital gains on their successful investments far in excess of any retained earnings on which corporate tax may have been paid. This income may never be taxed if it is not recognized as gains and if estate planning is successful. If they borrowed to buy the stock, taxpayers may even declare zero or negative income by taking interest deductions while recognizing few or no capital gains.³¹

Taxes as an Instrument of Social Policy

Our final category of theorists and advocates are those who view taxes as a means to achieve some social policy goal. Although liberals have historically dominated this group, this is no longer the case. Many conservatives now view taxation as a means to enact "pro-family" or "market-based" reforms of social policy.

The Progressives. Progressivity is more than a goal: it is a principle and follows from the natural order that only those with the ability to pay can pay. Still, progressivity becomes a goal when we determine that more progressivity is required to form a just society. Progressives tend to favor

higher taxes at the top of the income distribution, while at the bottom they favor tax cuts or refunds, even for those who pay little or no tax. Antipoverty advocates particularly worry about the impact of taxes on the poor or on recipients of other government assistance programs. Progressives scrutinize the distributional tables that the Office of Tax Policy and the Joint Committee on Taxation develop for the government or that such nonprofit organizations as the Urban-Brookings Tax Policy Center or Citizens for Tax Justice produce.

From its inception, the income tax has been the main instrument for promoting progressivity—higher incomes are taxed at higher rates.³² The estate tax is much more progressive but applies only to a few people. Debate exists on whether the property tax might also impose higher rates on those with more resources. In general, however, those concerned with progressivity focus their attention on the income tax.

Many progressives also tend to favor larger government, but big government and progressive taxation (as defined by tax rates rising with income) are not as compatible as they first appear. True, when the income tax was created in 1913 and when the Sixteenth Amendment to the Constitution was ratified, the tax was often linked to questions about the size of government. Those who favored higher income tax rates often favored more government expenditures and vice versa. Early “reforms” reflected the exigencies of government’s early growth.

What is generally ignored is that income tax is also inherently a conservative instrument of taxation. The flip side of a higher tax rate on the rich is a lower or zero tax rate on those with lower incomes, and a moderate amount of income exempted from tax for all taxpayers (who also benefit from the zero rates that apply at the beginning of a progressive tax rate schedule). One consequence, generally forgotten by both proponents and opponents of progressive rate tax systems, is that lower taxes on lower- and middle-income classes (and the corresponding low initial tax rates on the first dollars earned by all taxpayers) limit the revenues collected and the expenditures that those taxes would support.³³ The types of personal exemptions and credits that make the income tax progressive are generally less available for other taxes, such as sales taxes or taxes on earnings.³⁴ Thus, as the income tax began to mature by the middle of the 20th century, developed nations started to finance further expansion of government mainly through growth in Social Security and flatter-rate sales and consumption taxes—not through the income tax. The upshot is an anomaly: liberals favoring progressive rate tax systems often cannot

raise the money for the larger government they may want, whereas conservatives favoring flat-rate taxes often get the larger government these taxes support.³⁵ Unwittingly, antiprogressive proponents of flat taxes may support larger government, while pro-progressive opponents of flat taxes may help the cause of small government.

Table 2.1 shows the overall levels of taxation in numerous developed countries, as well as the reliance of each upon different types of taxes. Compared with the European Union (EU), the United States collects a similar percentage of gross domestic product through the progressive personal income tax. On the other hand, the average EU country collects almost 8 percentage points more of GDP in the form of flat or regressive (as defined by rates) consumption taxes on goods and services than the United States. Although exceptions abound, the U.S. failure to adopt a more regressive national tax on goods and services correlates strongly with its smaller government.

Tax policy, of course, can be used to support all sorts of social goals, such as charitable contributions or purchases of health insurance by taxpayers. While liberals have concerned themselves with the poor, conservatives have often worried about marriage penalties or high levels of taxation on families with children when little adjustment is made for the effect of those children on the taxpayers' ability to pay.

Other Influences

This list of other influential groups and their disparate tax positions rounds out the inner workings of the tax policy arena.

The practitioner community—tax lawyers, accountants, and some professional tax preparers—often complain about complexity. They mostly align themselves with traditional tax reformers. Maintaining a viable tax system depends in no small part on how seriously they take their profession. Their professional associations often lobby for simplification, partly because they see too many inequities arising from a complex system and partly because they are trained to account accurately and are threatened by a system under which that goal is hard to achieve. For some practitioners, simplification is a mixed blessing since less complexity can mean less business. Of course, some lawyers and accountants will lobby for special interests and find ways to skirt the edges of tax laws. As later chapters document in more detail, there is also a debate over the consequences for the tax system as greater numbers have abandoned professional goals, such

Table 2.1. Tax Receipts in Various Countries as a Percentage of GDP, 2004

	Total tax receipts	Personal income tax	Corporate income tax	Social Security Contributions		Taxes on goods and services	Other taxes
				Employees	Employers		
Japan	26.4	4.7	3.8	4.3	4.5	5.3	3.8
United States	25.5	8.9	2.2	3.0	3.4	4.7	3.3
Ireland	30.1	8.2	3.6	1.4	2.8	11.4	2.7
Australia	31.2	12.6	5.7	0.0	0.0	8.9	4.0
Switzerland	29.2	10.2	2.5	3.3	3.2	6.9	3.1
Canada	33.5	11.7	3.4	2.1	2.9	8.7	4.7
United Kingdom	36.0	10.3	2.9	2.8	3.7	11.5	4.8
Germany	34.7	7.9	1.6	6.1	6.9	10.1	2.1
Netherlands	37.5	6.1	3.1	6.8	4.2	12.0	5.3
France	43.4	7.4	2.8	4.0	11.0	11.1	7.1
Sweden	50.4	15.8	3.2	2.8	11.3	13.0	4.3
EU15 average ^a	39.7	9.1	3.2	3.6	6.6	12.1	5.1
OECD average ^a	35.9	10.1	3.4	3.0	5.5	11.4	2.5

Source: OECD Revenue Statistics 1965–2005, 2006.

EU15 = European Union 15; OECD = Organisation for Economic Co-operation and Development

a. Unweighted.

as transparent and accurate reporting, in favor of becoming salespeople for tax shelters.

Budget balance hawks can be either liberal or conservative in their view of overall levels of taxation. If conservative, like former senator and former presidential nominee Robert Dole, they are still more likely than radical supply-siders to support higher taxes to pay for expenditures already promised. If liberal, like former President Clinton, they still might be more willing than other liberals to accept some slowdown in expenditure growth. Sometimes they seem to switch: President George W. Bush's first term involved very large deficit-increasing tax cuts and expenditure increases as a percentage of national product; most of his second-term proposals suggested that both systems move in the opposite direction.

Another group hard to define along any traditional conservative-liberal continuum is the employee benefit community. Tax preferences for pensions and for employer-provided health benefits have been around since the birth of the income tax (Acs and Steuerle 1996), reinforcing the tendency to use taxes as an instrument of social policy.³⁶ The pension community often lobbies to expand tax benefits for retirement plans but not to remove all taxes on capital since the latter would eliminate the net incentive to save for retirement. Meanwhile, many progressives object that most taxpayers do not accrue much in the way of retirement benefits, while related tax subsidies accrue mainly to the well off. The health-benefit community faces a number of issues, among them that the tax benefits due to the preference for employer-provided health insurance accrue mainly to higher-income people who are in higher tax brackets and tend to have better insurance policies; the tax benefits are not available for health insurance other than that offered by an employer; and the tax benefits are open-ended, rising with the generosity of the health insurance package.³⁷ To the extent this last feature increases health costs, individuals become more reluctant to buy insurance, employers are less likely to offer it, and the number of uninsured rise.

Whatever the inequities and inefficiencies of today's system, some employer involvement in health and pensions tends to help people buy health insurance and save for retirement. Many people do not buy health insurance or retirement assets on their own, but sign on when the employer contributes directly or encourages participation. At the same time, confining many tax incentives to those offered through employers excludes many individuals and makes agreement on reform options difficult.

Democratic and Republican labels seem to mean very little when elected state and local officials lobby on tax issues. Most of these officials favor increased revenue sharing from the federal government to the states and oppose any cutbacks on their ability to float federal tax-exempt bonds. In recent years, they have become extremely adept at eviscerating state balanced-budget rules by borrowing against future tax collections, while taking advantage of federal tax preferences for this borrowing. In sum, they will take what they can get, and political party doesn't seem to matter a great deal.

Many states piggyback their own state income tax systems on federal definitions of income—whether it is adjusted gross income, taxable income, or some similar measure reported on federal returns. State receipts, therefore, are partially subject to the whims of federal legislation. For instance, state income tax revenues fall when Congress grants a more generous form of depreciation or when it generates fewer realizations of capital gains through higher federal rates. States cannot stray too far from basic federal definitions of taxable income without further complicating taxpayers' lives. Think, in particular, of a multistate business having to allocate income among various states. States also audit mainly by following the IRS lead on whom and what to audit.

Finally, as a matter of both activist social and economic policy, corrective taxes are sometimes proposed to deal with such problems as pollution and smoking.³⁸

A Summary of Changes in the Tax System

A democratic government is the only one in which those who vote for a tax can escape the obligation to pay for it.

—Alexis De Tocqueville, *Democracy in America*

This book presents contemporary tax policy developments for the most part in chronological fashion, period by period. To place these events within a broader context, however, this chapter precedes the fuller tale with a brief but thorough data-oriented history of changes in the tax system. The extent to which one action relates to another becomes clearer in this summary analysis. Many stories about the evolution of the tax system, such as the influence of rising and falling inflation rates on taxes, are also easier to visualize with graphs and tables covering long segments of time rather than filaments of legislative cycles. Details on the developments and ramifications of specific tax policies follow in succeeding chapters.

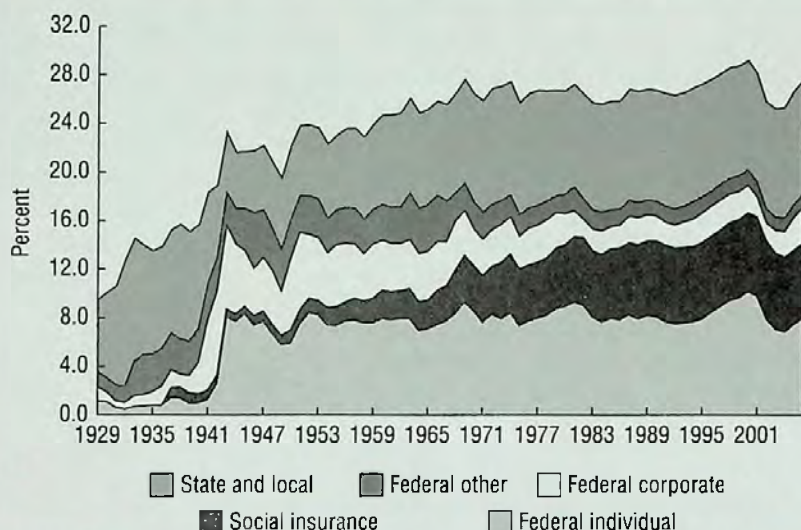
Levels of Taxation

“From a class tax to a mass tax” is how many describe the postwar explosion in income tax coverage and collections. No crisis affected the expansion of the modern income tax more than the need to finance participation in World War II (Brownlee 2004). Before the war, the federal individual income tax applied only to a sliver of the population, and it wasn’t until the war that wage withholding was applied to a large portion of the middle class. In the 1930s, federal individual income taxes never exceeded

1.4 percent of gross domestic product and federal corporate taxes never more than 1.6 percent of GDP (see figure 3.1 or, for more complete data, appendix table A.1). By 1943, these taxes had risen, respectively, to 8.1 and 6.9 percent of GDP.

Policymakers opted to maintain the withholding of taxes on wages—the principal administrative mechanism adopted to implement higher taxes during the war. As the United States entered peacetime, income taxes were reduced moderately, but to nowhere near prewar levels. For the individual income tax, a postwar low of 5.8 percent of GDP in 1949 was still over four times greater than the highest percentage before World War II. By the 1950s, even the moderate tax reductions of the late 1940s were largely offset by tax increases used to finance the Korean conflict. From that time on, federal individual income taxes remained a fairly constant

Figure 3.1. Total Tax Receipts as a Percentage of GDP, 1929–2006



Source: Bureau of Economic Analysis, NIPA tables, various years (tables 1.1, 3.2, 3.3, 3.5, 3.6, 3.7, 5.10)

Notes: "Federal other" includes federal estate taxes, gift taxes, and custom duties plus employer contributions for federal unemployment tax, railroad unemployment insurance, and federal worker's compensation. Excludes federal nontaxes. Projected 2006 levels for other federal taxes and state and local taxes are based on 2005 levels as a constant ratio to GDP.

percentage of total GDP, with cyclical low points in 1964 and 2004, and cyclical high points in 1969, 1981, and 2000.

After the Korean conflict, total federal, state, and local tax receipts increased gradually. In 1954, government at all levels received 23.5 percent of GDP. Receipts then rose gradually to a high of 28.6 percent of GDP in 1969, when a surtax was put into effect to help pay for the Vietnam War. From 1969 to the early 1990s, total tax receipts zigzagged slightly, but there was little change overall. Total taxes as a percentage of GDP dipped below 26 percent in the early 1980s, and then again in 2002 and 2003.¹

In the mid- to late 1990s, federal and state revenues began to rise again. At both levels of government, stricter fiscal regimes were adopted just before economic growth picked up. Higher growth rates not only boosted revenues but effectively pushed people into higher income tax brackets faster than the government cut their taxes. Unusual levels of capital gains realizations and stock options in a bubble stock market especially added to income tax receipts. Both total federal taxes and total government taxes reached all-time highs by 2000 (see figure 3.1) before dropping significantly as the economy slowed and new tax laws took hold. By the same token, the subsequent fall in total taxes after 2002 ranks among the most dramatic in contemporary tax history. A rebound after 2004 was due to several factors: (1) capital gains realizations returned to more normal levels; (2) more taxpayers were swept into a federal alternative minimum tax (AMT), which denies filers the use of dependent exemptions, deductions for state and local taxes, and other tax provisions that can reduce regular income taxes only; and (3) the increasing inequality in earnings pushed more income into higher tax brackets.

State and Local Taxes: The Main Source of Growth

State and local taxes were the main source of growth in the post–World War II era, rising from 5.8 percent of GDP in 1954 to a 20th century high of 9.3 percent in 1972.² This was an increase of 3.5 percentage points, compared with a total increase in all taxes (including federal taxes) of 3.2 percentage points over the same period. From 1947 to 1972, state and local taxes almost doubled as a percentage of GDP. From a longer-term perspective, state and local taxes might be viewed as simply recovering from their dramatic drop in importance as the federal government role expanded during the Great Depression and especially World War II. In the mid- to late 1970s, a tax revolt led to a modest decline in state and

local tax collections relative to GDP. Tax levels remained relatively steady for more than a decade before climbing in the 1990s and then falling off in the 2001 to 2002 economic slowdown. In 2003 and 2004, they began to rise again because of the recovery, and, in contrast to the late 1990s, because legislatures began to pass tax increases rather than decreases. By 2005, they were again close to a post-World War II high. The stock market bubble affected states with the same boom-and-bust cycle as it did the federal government.

These postwar increases in state and local tax collections came through various sources: higher tax rates on sales and income and the adoption of new taxes in many states. State and local income taxes, in particular, grew steadily more important over the entire postwar period, rising from only 0.18 percent of GDP in 1946 to 2.2 percent by 2000, before falling off to 1.9 percent by 2002. Not only did many more states adopt an individual income tax, but growth in the economy also forced taxpayers into higher tax rate brackets over time. By the mid-1970s, combined federal, state, and local income taxes had risen to a new high as a percentage of income because of state and local, not federal, tax increases. After that point, state and local taxes remained much steadier as a percentage of GDP.

Individuals were not the only ones affected by increases in state and local taxes. Cline et al. (2006) estimated that businesses paid substantial taxes in fiscal year 2005, of which \$183 billion came from property taxes, \$42 billion from state and local corporate income taxes, and \$21 billion from corporation and business license fees. Businesses also paid sales taxes on goods and services sold to other businesses, not just to consumers.³

The Rise of Social Security Taxes and Fall of Corporate and Excise Taxes

Social Security taxes stand out for their large and consistent growth up until the early 1990s. In fact, the pattern of Social Security taxation was so consistent that it can be traced by a rule of thumb: Social Security tax rates rose by roughly 3 percentage points per decade from 1950 to 1990, regardless of economic and political cycles. The combined employer and employee tax rate equaled 3.0 percent in 1950, 6.0 percent in 1960, 9.6 percent in 1970, 12.26 percent in 1980, and 15.3 percent in 1990, where it has remained. These rate increases, as well as expansions of the

Social Security tax base, resulted in Social Security taxes rising from less than 1 percent of GDP before 1950 to more than 6 percent by 1988 and thereafter.

Since Social Security and state and local taxes went up far more than total taxes, something must have gone down. First, corporate income taxes declined significantly, thanks to a combination of overlapping causes. From the 1950s through the 1970s, corporate profits became a smaller share of national income, partly because they paid out much larger shares of their total nominal returns to capital (to both stockholders and bondholders) in the form of interest payments. As a consequence, a smaller share of the nominal returns to capital (that is, a smaller proportion of the total income to both bondholders and stockholders from firms) was subject to corporate income taxation. This growth was especially prevalent as interest rates rose with inflation in the inflationary period from 1973 to the late 1980s, but even after interest rates fell with the end of that inflationary period, corporate debt remained high, at least by historical comparison, relative to corporate equity. In addition, corporate taxes fell as more tax reductions were legislated—first, tax preferences for business investment, then lower tax rates. The relative growth in foreign income deferred or excluded from domestic tax also contributed to the decline in corporate income taxes. By the early 21st century, a new wave of tax shelters for business seemed to reduce corporate tax payments significantly, but the amounts were hard to estimate (Manzon and Plesko 2002; Steuerle 2002c; Sullivan 1999, 2002a, 2002b, 2003; Yin 2001, 2002). Despite many of these trends, a surge in corporate profits by 2005 (only one part of an increasing inequality in the distribution of private-sector income) restored corporate tax revenue roughly to the level it had attained in the late 1970s.

Excise taxes, an important component of other federal taxes, also shrank. A conscious decision to rely less upon excise taxes (as witnessed in 1965 legislation),⁴ the erosion in value of fixed nominal excise taxes because of inflation, and the rising importance of services untaxed by excises, like the burgeoning health care sector, account for this decline.

Because states and localities rely heavily on excise and sales taxes, an eroding sales tax base affects them more than the federal government. Services have been especially hard to tax. For a while, states overcame these obstacles by increasing sales tax rates. Also, because many specific excise taxes are stated in terms of cents per carton or per gallon, many excise tax payments only rose with number of purchases, not at the

much faster rate of increases in prices and incomes. Even legislated tax increases driven by spurts in excise tax charges per carton or per gallon were handily outpaced by the rise in personal incomes.

Tax Preferences and the Tax Base

Complaints about levels of taxation are often bandied about in political campaigns ("no new taxes"), but they give a misleading picture of the government's use of resources. Even if levels of taxation or average tax rates stay constant, changes in exclusions, deductions, and credits—that is, various tax preferences—can affect the size of the tax base.

Exclusions, which grew from 12 to 24 percent of personal income from 1948 to 1982, and then declined to 19 percent in 2004, are the least understood source of preference because they are not counted in income subject to tax, nor are they reported on tax returns. Instead, total income, adjusted gross income (AGI), and taxable income—those income measures reported on individual income tax returns—exclude income derived from certain sources or used in certain tax-advantaged ways.

Many of these exclusions apply to a large percentage of the population, including much of the middle class. Employer contributions to health plans are one example.⁵ From 1948 to 2004, the net exclusion applying to them alone increased from 0.2 to 4.8 percent of personal income (see appendix table A.2), making this tax subsidy the most important federal health policy applying to the nonelderly. On the other hand, while exclusions for deposits to (and interest earned on) pension and profit sharing plans are enormously important, these plans have now matured enough that the taxable withdrawals have grown quite substantially relative to the nontaxed deposits. Stock market bubbles also reduce the amount employers contribute to pension plans, under the common (but questionable) actuarial practice of assuming that the higher values of portfolios due to higher stock price-earnings ratios are not offset or are only modestly offset by lower expected returns. That assumption effectively reduces deposits to cover future pension obligations.

Such nontaxable public transfers as Social Security and Medicare⁶ also grew considerably from World War II on, whereas other public transfers (like Food Stamps or Temporary Assistance to Needy Families) and nontaxable labor compensation (such as employer-provided life insurance) rose and then fell in importance relative to personal income. The expan-

sion and growth in home ownership, which the tax system favors, was another important source of exclusion.⁷

Deductions itemized on tax returns also generally increased in the earlier postwar period, except during a few brief periods. Itemized deductions are allowed for state and local taxes, interest on home mortgages, contributions to charity, extraordinary health expenses, and other miscellaneous items. As a percentage of personal income, these deductions reported on taxable returns grew from 3.3 percent in 1948 to 10.0 percent in 1970 and have hovered around there since then. On occasion, declines in overall deductions reflected legislated increases in the standard deduction (an allowance for a minimum amount of deductions that may be taken in lieu of itemizing or detailing deductions on a tax return). All in all, the standard deduction grew from a postwar low of 2.2 percent of personal income in 1970 to 6.9 percent in 1977 and was back down to 3.3 percent in 2004.

The most dramatic change in the individual income tax base over the postwar era, however, was not in the expanded use of exclusions, deductions, and credits. Rather, it was in the declining value of the personal exemption allowed to each taxpayer and dependent. On taxable returns, that exemption had eroded from over 27 to 6.4 percent of personal income between 1948 and 1978. By 2004, the value had fallen even further to 5.2 percent, after having risen mainly because of a boost in the Tax Reform Act of 1986. This decline moved many formerly nontaxable individuals into the tax system, expanding the tax base further.

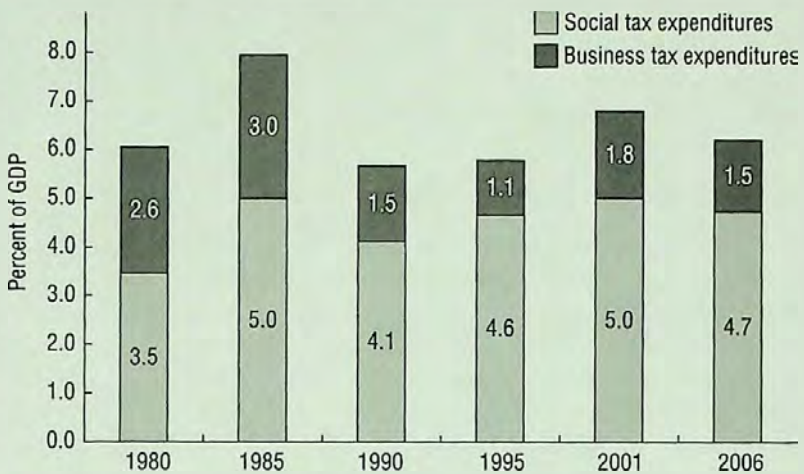
The decline in relative value of the dependent exemption for households with children eventually prompted attempts by both Republicans and Democrats to make the tax code more “family friendly,” especially as evidence showed that moderate- and low-income households were hit hard (Steuerle 1983). Press coverage of this issue began in the early to mid-1980s, and the ensuing debate launched a continual wave of reforms aimed at helping the family. These included increases in the personal exemption in the late 1980s, and, more important, in credits granted to working households with children.

The growth in tax credits has been quite large since 1986. The total value of credits hit an all-time high at the beginning of the 21st century due almost entirely to earned income tax credits (EITC) and child credits. For low- to moderate-income households—but not for middle- to upper-income households—these credit expansions have now far more than offset the long postwar decline in the value of the dependent exemption.⁸

credits eroding the tax base. For a typical taxpayer, in other words, a larger portion of income would be subject to tax unless the taxpayer sought out more tax preferences by, for example, paying more in deductible mortgage interest or shifting saving into tax-favored retirement plans. Even the personal credits more recently put into the law—which have made many low- to moderate-income households nontaxable once again—can affect behavior since they are tied to earnings and income in a variety of ways that induce more work for some individuals and less for others.

Most exclusions, deductions, exemptions, and credits can be defined as “tax expenditures”—items similar to those in spending programs. The tax expenditure budget is highly controversial, as we shall see in later chapters, partly because it is incomplete and sometimes tends to be used incorrectly to judge various preferences as “bad” simply because they are on the list. Still, it is one of the few accounting systems we have for such items, and it can gauge historic changes. In particular, economists and budget watchers sometimes categorize tax expenditures by those that benefit business and those that benefit individuals other than through businesses they own. Figure 3.3 tracks tax expenditures from

Figure 3.3. Trends in Tax Expenditures, 1980–2006 (as a percentage of GDP)



Source: Toder (1999), updated to 2006 by author.

GDP = gross domestic product

1980 to 2006, dividing these into “social” and “business” tax expenditures. Total tax expenditures peaked in 1985 at 8.0 percent of GDP, whereas social expenditures have continued to remain high—even rise—despite significantly lower tax rates after 1980 (rate cuts generally make deductions and exclusions less valuable). Accordingly, whereas total tax expenditures were of roughly the same size relative to the economy in 1980 and 2006, by 2006, social tax expenditures of over \$600 billion comprised over four-fifths of the total, as contrasted with slightly less than three-fifths in 1980.¹⁰

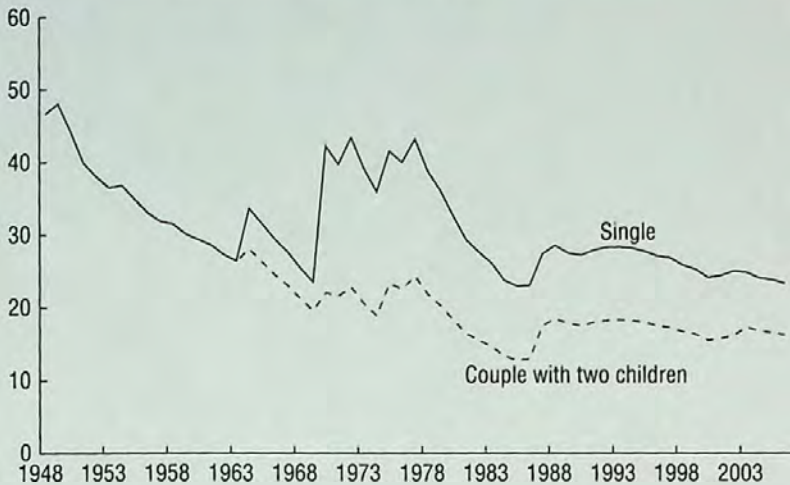
The alternative minimum tax, discussed in more detail in future chapters, has caused a growing confusion over what is in the tax base. This tax, created in its current form in 1986, denies a number of deductions—most importantly, state and local taxes, the personal exemption, and miscellaneous itemized deductions—but has its own exemption level and tax rate. So far, it has affected only upper- and upper-middle-income taxpayers, but its exemption level is not indexed for inflation, so many more taxpayers are scheduled to be affected.

In sum, though the extent to which personal income falls into the tax base varies over time, a general rule is that individuals’ behavior, especially social behavior, increasingly influences the size of the base. Exceptions exist. A few reforms removed preferences, mainly for businesses, while lowered tax rates tended to offset the extent to which the tax code was used to prefer various behaviors. In general, a legislative trend toward adding new preferences has dominated the postwar period with the major exception of the years from 1982 to 1986.

Tax-Exempt Levels of Income and Personal Tax Credits

Minimum tax-exempt levels of income—those levels below which no income tax is due—are determined mainly by the personal exemption, the standard deduction, and, for eligible taxpayers, personal credits.¹¹ Figure 3.4 presents data on tax-exempt levels of income—both before and after the earned income tax credit and the child credit are taken into consideration—from 1948 on and compares these figures with per capita personal income (see appendix table A.3 for details). As the figure shows, the tax-exempt level of income (per person in the household) in 1948 approached one-half of per capita personal income but by 1986 had declined sharply. In effect, more and more people were pulled into the tax system throughout the first decades after World War II.

Figure 3.4. Tax Exempt Threshold per Family Member as a Percentage of Per Capita Personal Income

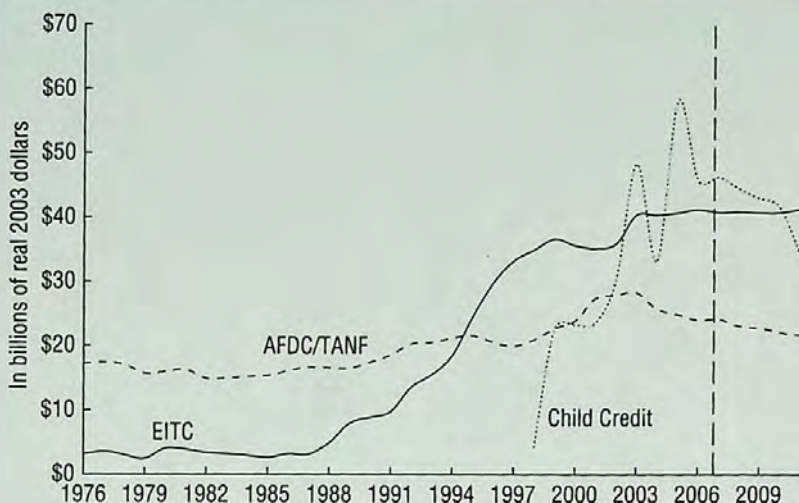


Source: Author's calculations and data from the Green Book (1996, 2000).

The Tax Reform Act of 1986 began a turnaround. The act led to an increase in the personal exemption to \$2,000 (indexed for inflation thereafter) as well as to increases in the earned income tax credit. More recently, expansions of personal tax credits—both the earned income tax credit and a newer child credit—have substantially offset the tax burden for moderate-income households with children. Even without these credits, by 2006, those filing a joint return would not begin to pay regular taxes if they had two children and income only from earnings until their joint income exceeded \$23,500—approximately 17 percent of per capita personal income multiplied by family size (appendix table A.3). Recently, personal credits have dominated this story.

Figure 3.5 shows the real “spending”¹² growth over time for the two largest tax credits that affect lower-income families—the EITC and child credit.¹³ The EITC is available to low- and moderate-income working families with earnings above zero, while the child credit is not available

Figure 3.5. Real Federal Spending on the EITC, Child Credit, and Welfare (AFDC/TANF), 1976–2011



Source: FY 2000–2008 U.S. budgets and IRS statistics on income data. The child credit curve after 2004 is driven both by increases and expirations scheduled in the law.

Notes: AFDC = Aid to Families with Dependent Children; TANF = Temporary Assistance for Needy Families. EITC and CTC aggregate amounts include both outlays and receipts.

until income reaches \$11,300 in 2006 and is largely available to those with middle to moderately high income. Together, these two credits can push the tax-exempt income threshold for a family of four to approximately \$42,000.¹⁴ The figure compares the growth in outlays for these credits against the growth in what is sometimes defined as welfare, Aid to Families with Dependent Children (later Temporary Assistance for Needy Families) (OMB 2006). In 2006, the federal government spent \$41.2 billion on families through the EITC and \$45.8 billion through the child tax credit, compared with \$24.0 billion on welfare.¹⁵

Beginning with the *Economic Report of the President* in 1964, the government began publishing statistics on the number of persons living in “poverty”—defined as having incomes below the federal poverty level. Since then, poverty-level income thresholds have been adjusted yearly

for inflation only. With the inflation rate lower than the rate of growth in income, over decades, the poverty level has fallen considerably relative to such measures as per capita or average personal income.¹⁶

Poverty statistics have had an enormous impact on tax policy development over time, as various tax acts attempted to raise the tax-exempt levels of income to reflect changes in these published poverty levels. Excluding tax credits, joint-return filers with two children—the prototypical example presented in congressional tax debates—would be exempt from paying taxes on income roughly equivalent to the poverty level. In the mid-1980s, provisions affecting tax-exempt levels were adjusted automatically over time for inflation by the same index used to determine poverty levels. Of course, real economic growth still gradually eroded the value of the exemptions and tax-exempt portion of income relative to per capita personal income.

Note that the tax-exempt level discussed here reflects the minimum amount set by the personal exemption, standard deduction, and certain personal credits. For groups with sizable exclusions, including those receiving significant Social Security checks or other nontaxable transfers (e.g., food stamps), the tax-exempt level has generally been higher.

Since the mid- to late 1980s, the growth in personal credits has especially raised the tax-exempt level well beyond poverty thresholds for working households with children. For the most part, these credits are not available to households without children. By way of contrast, in the earlier postwar period, children affected the tax-exempt level mainly through only one significant feature: a dependent exemption that was and is equal in size to the personal exemption granted to adults. The standard deduction still applies to single returns equally and to joint returns equally regardless of whether there are any children.

Changes in Tax Rates

Changes in tax rates derive mainly from two sources. Either Congress changes the rates by statute or income growth gradually pushes people into higher brackets. When tax brackets are “indexed” for inflation, real growth is the sole cause of “bracket creep.” The term is often applied merely to inflation’s affect on average tax rates, but people also creep through brackets and see their average tax rates rise when their taxable income increases because of an expanding economy.¹⁷ One way or the other, the

federal income tax and state income taxes now in 43 states¹⁸ have automatically and almost inexorably increased tax rates through bracket creep. This real and inflationary bracket creep helps explain how federal and state governments can enact multiple tax cuts over time even while people still see their average tax rates remaining the same or even rising.

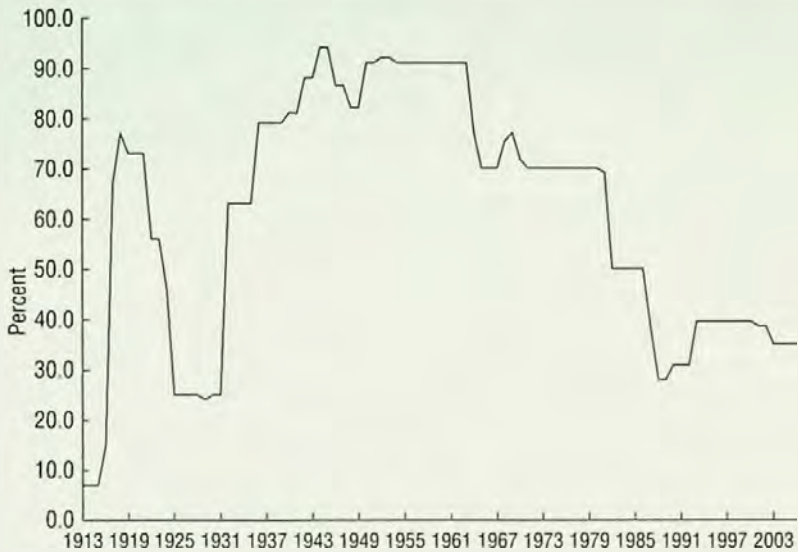
Economists are particularly concerned with the tax bracket into which the taxpayer's last or next dollar of income falls. This tax bracket reflects the marginal tax rate—the rate paid on any additional dollar of income. To the extent that taxes influence behavior—whether encouraging people to substitute work for leisure or saving for consumption—marginal tax rates are often considered the main lever.¹⁹ However, economists still dispute evidence on the scope of the behavioral response to marginal tax rates. The main exception is for discretionary items like capital gains or portfolio adjustments, where almost everyone recognizes significant portfolio shifts (Slemrod 1994).

Figure 3.6 shows how the top rate—always a prime focus of congressional attention—has changed over time. When the income tax was first introduced in 1913, it boasted a top rate of a mere 7 percent for those earning above \$500,000 (close to \$9.7 million in 2006 dollars). However, the nation's entrance into World War I prompted an explosion in the top rate to 67 percent by 1917 (the threshold for the top rate jumped fourfold to \$2 million). The top rate would remain around 70 percent until 1925, when it fell to 25 percent.

The reprieve was temporary. The top rate was revived to 63 percent in 1932, in the midst of the Depression, and jumped into the 70, 80, and 90 percentile ranges, with a peak in 1945 at 94 percent for incomes of \$200,000 or more (a historically low threshold, although still about \$2.2 million in 2006 dollars). High rates persisted through the 1950s—especially during the Korean conflict.

The Kennedy round of tax cuts in 1964 reduced the top rate to 70 percent for incomes over \$200,000 (about \$1.1 million in 2006 dollars). Outside of some very temporary surcharges for the Vietnam War, the top rate remained at 70 percent until Reagan-sponsored legislation in 1981 lowered it to 50 percent (although there already was a maximum tax on “earned” income of 50 percent). Tax reform in 1986 further dropped the 50 percent rate to 28 percent by 1988—the lowest since 1931—although the meaning of “top rate” was confused by an intermediate or “bubble” rate of 33 percent.

The 1990 budget agreement under President George H. W. Bush raised the top rate to 31 percent, while the 1993 budget agreement under President

Figure 3.6. Top Tax Rate on Individual Income, 1913–2006

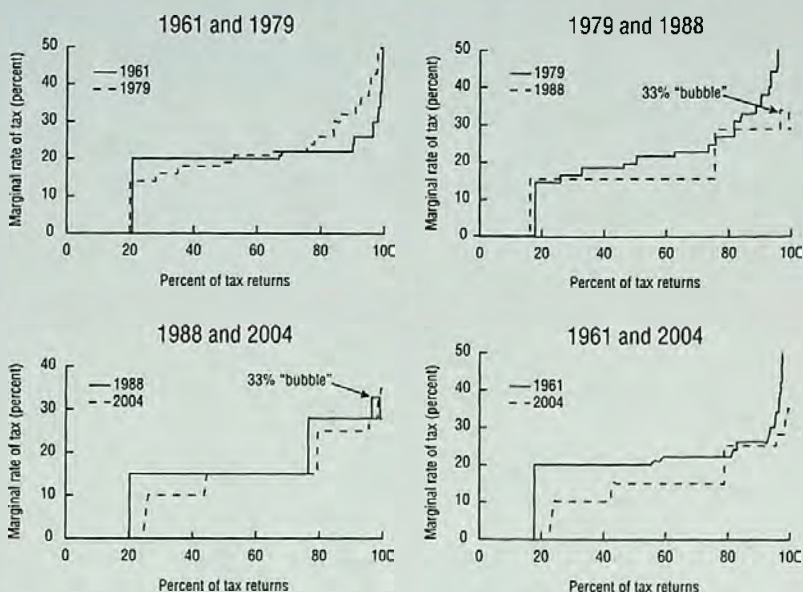
Source: Pechman (1987) and author's calculations.

Notes: This figure ignores some factors, such as a maximum tax on earned income of 50 percent when the top rate was 70 percent and implicit rates due to income-related reductions in the value of items like itemized deductions. Perhaps most importantly, it ignores the large increase in the percentage of returns subject to this top rate.

Clinton pushed the top rate to 39.6 percent (on incomes over \$250,000 or about \$325,000 in 2006 dollars). The rate was cut through 2001 legislation to 38.6 percent in 2002, with scheduled drops in successive years. However, this schedule was superseded by the 2003 tax cut that dropped the top rate immediately down to 35 percent in 2003, where it has remained (although this drop, like other features of the law enacted in 2001, is scheduled to end in 2010). Interestingly, the 35 percent rate is the same as originally proposed in Treasury's 1984 landmark study that led to the Tax Reform Act of 1986.

The distribution of returns by marginal tax rate in 1961, 1979, 1988, and 2004 are shown in figure 3.7. Although most discussions of the tax system's progressivity focus on the very top rate paid only by the wealthiest taxpayers—such a myopic view was to dominate the debates over taxes

Figure 3.7. Cumulative Percentage of Federal Income Tax Returns Taxed at or below Each Successive Marginal Rate of Tax



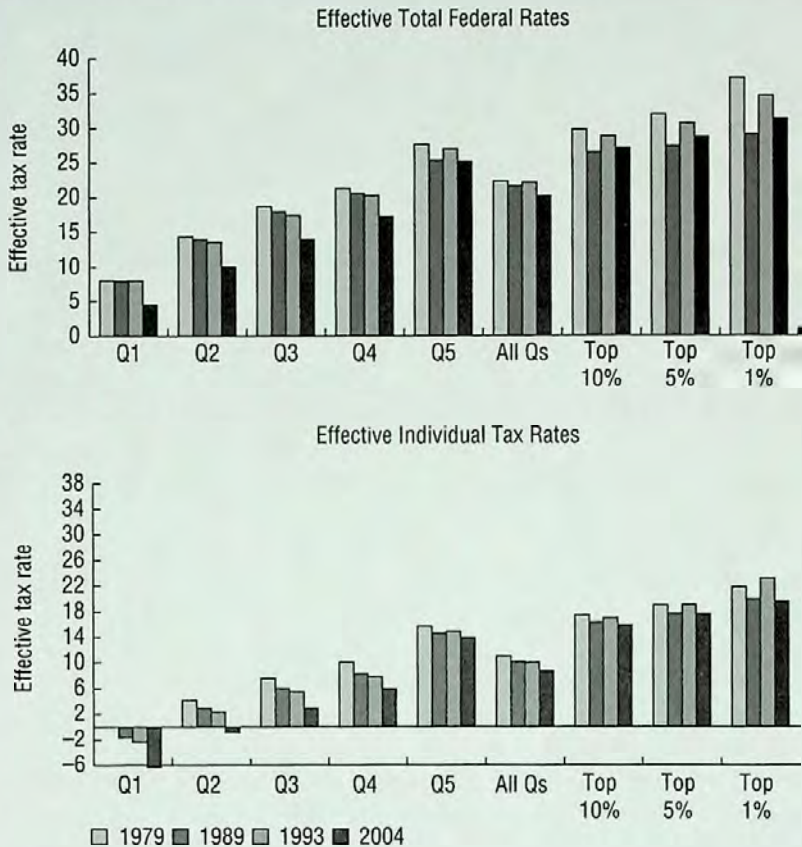
Source: IRS *Statistics on Income*, various years.

when rates were cut in years such as 1981, 1986, and 2001 and increased in years such as 1993—few taxpayers pay the top rate. The year 1961 is a year remembered by some as the pinnacle of postwar progressive taxation because the top rate was still 90 percent, even though the war had been over for 15 years. In fact, the tax rate structure then was mainly a flat rate for the vast majority of those filing taxable returns. Only about 10 percent of filers paid any positive marginal tax rate other than 20 or 22 percent (see upper-left-hand graph in figure 3.7). Over the next two decades, the effective or average tax rate structure grew much more sloped or progressive, with roughly half of all those filing returns paying higher marginal tax rates in 1979 than in 1961, and three-tenths paying lower rates (two-tenths remained nontaxable).^{20, 21} Some of the greatest changes affected filers with the highest marginal rate of tax. For instance, for returns at the 95th percentile (the richest 5 percent of all taxpayers), the marginal tax rate increased from 26 percent in 1961 to 38 percent in 1979.

After this long rise in tax rates, especially for upper-middle-income taxpayers, tax rates were cut and partially restored on several occasions. Taxpayers in the 95th percentile saw marginal rates vary up and down between 25 and 37 percent from 1961 to 2004.

Figure 3.8 features two charts that show effective or average tax rates on households by income class at four points in time. The first chart shows

Figure 3.8. Effective Tax Rates for All Households by Income Class and Select Year



Source: CBO (2006).

effective total federal tax rates for all federal taxes, including income and Social Security taxes, exemptions, and credits. The second chart shows just effective income tax rates.

The comparison years are 1979, 1989, 1993, and 2004. Despite all the economic and legislative changes over this time, there were few major changes in the basic progressivity of the federal tax structure. The effective rate fell slightly, with the biggest drop in rates for the top 1 percent and the lowest income or first quintile ("Q1"). In the latter case, individual income tax rates (see bottom part of figure 3.8) became increasingly negative as tax credits grew increasingly generous. A more permanent reduction at the top would occur if the estate tax were permanently eliminated, but the 2001 legislation has scheduled its elimination for 2010 only, a feature that inevitably will be amended.

Tax Rates at Half the Median, the Median, and Twice the Median Income

For lower-income individuals at half the median income, the average combined income and Social Security tax rate tended to increase over time until 1977 (when a tax bill temporarily reduced rates) and again following tax acts passed in 1990 and 1993. As figures 3.9 and 3.10 show (with detailed data in appendix table A.4), the average tax rate then fell significantly in the 1990s and early 2000s. Their marginal rate increased more dramatically for a while. By 1960, lower-income households had moved from being non-taxable in the income tax to being taxable, and their marginal income tax rate rose from 0 to 23 percent. Their Social Security tax rate, however, was still only 2 percent. Over the 1990s, the combined marginal rate at one-half the median income increased significantly from about 23 to 44 percent with successive expansions of the EITC and its imposition of a high phase-out rate (usually 21.06 percent). By the early 2000s, the EITC did not begin to phase out until income levels higher than half the median income, so loss of that credit does not add onto the marginal rate until higher income levels. In addition, a child credit began to phase in at about the time the EITC phased out. For a combination of reasons, then, this marginal rate fell almost 20 percentage points during that period.

For a long time after World War II, median-income households also watched their average combined income and Social Security tax rate rise. Personal exemptions or standard deductions became less and less valuable relative to income and so a higher percentage of income became tax-

Figure 3.9. Marginal Income Tax Rates for a Family of Four at Various Income Levels, 1955–2006

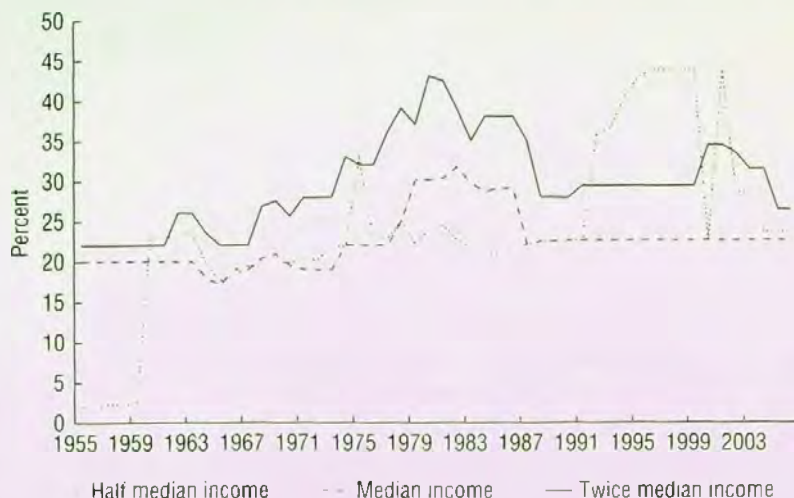
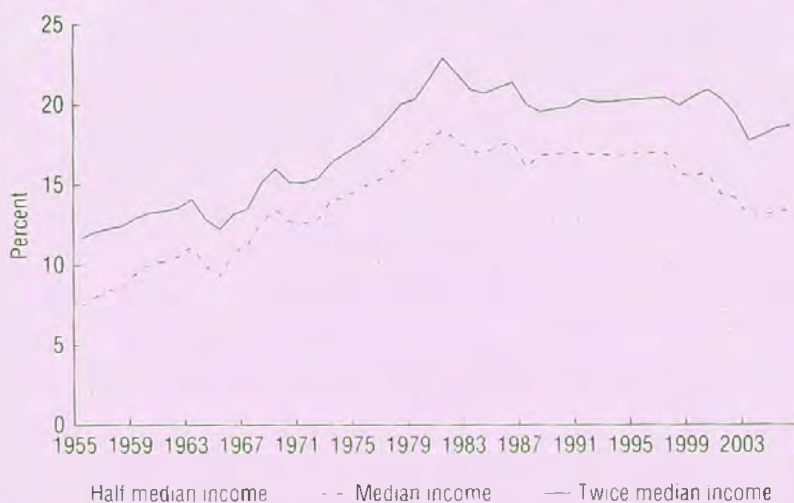


Figure 3.10. Average Tax Rates for a Family of Four at Various Income Levels, 1955–2006



Sources: Median incomes from U.S. Census Bureau, "Current Population Reports, Series P-60," various issues. Average and marginal tax rates from Treasury Department calculations through 1996, years 1997–2006 updated by Elaine Maag, the Urban Institute.

able. And Social Security tax rates continued to rise. Since 1981, however, the average combined rate has generally fallen, despite yet another increase in the Social Security tax rate. Marginal rates, on the other hand, have been relatively constant at around 19 to 23 percent of income, with peaks just above 30 percent in 1979 and 1982. They have remained at about 23 percent since 1987.

For households with twice the median income, the change in marginal tax rate has been the most dramatic. From 1967 through 1980, it almost doubled from 22 to 43 percent. After that all-time peak, it fell significantly in the late 1980s to about 28 percent, but crept upward again in the 1990s to 34.5 percent. After the 2001 and 2003 tax cuts, it fell to 26.5 percent. These households also saw their average tax rate peak in 1981, but tax cuts in the 1980s for the most part have been sustained.

In all these comparisons, it must be noted that average and marginal rates would be much higher for all types of taxpayers if we attributed the employer portion of the Social Security tax to the individual, which many economists suggest as appropriate. In that case, both average and marginal rates at all income levels would rise significantly, as the employer portion of the Social Security tax (just like the employee portion) rose from 2.0 percent of taxable earnings in 1955 to 7.65 percent for 1990 and thereafter.²²

Capital Income Taxation

No tax issues are more complicated and vexing than the taxation of capital income or of the return from assets rather than from labor. Here, we merely note some historical changes in the forces that drive how that income is taxed.

Double and Triple Taxation of Income

Legislators often attack capital income through various doors, thus leading potentially to double and triple taxation. In particular, income can be taxed when earned by the corporation and again when paid out to individuals as dividends or eventually realized as capital gains. More recently, extra taxes on capital gains and dividends have been recognized potentially as a double tax, so that a lower rate was applied to them. Other cases of multiple taxation can arise because of an estate tax, denial of legitimate

business deductions, extra layers of state and local business transactions and franchise taxes, or, as discussed below, disallowance of some real depreciation allowances in a period of inflation.

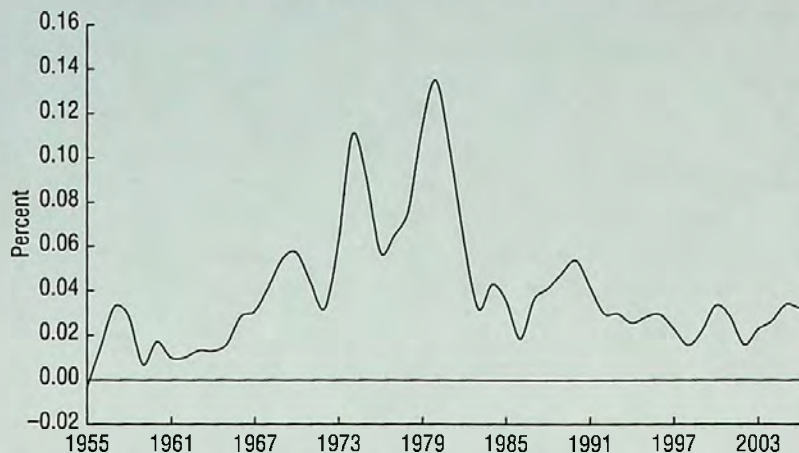
If all income were double or triple taxed equally, then the main issues would be whether the combined tax rate was appropriate or not and why the system lacked transparency. On the other hand, when only some income faces such double taxes, all sorts of portfolio and financial decisions are affected. The classical case presented is to contrast the influence of a corporate tax on the issuance of new stock, where a double tax might be paid, with bonds, where only one level of tax is paid. On the flip side, as we shall see, some capital income is not even taxed once.

Inflation and Interest Payments

The tax system does not operate in a vacuum. Taxes influence and are strongly influenced by the larger economic world. Changes in inflation and associated changes in interest payments have a powerful impact, in particular, on measures of income and income distribution among taxpayers. They can also drive taxpayers' attitudes toward the tax system.

Roughly speaking, since averaging a rate of below 2 percent for a decade after the Korean conflict ended, the nation (and most of the developed world) went through an extended cycle of rising and then falling inflation rates. As measured by the consumer price index, which the public watches, U.S. inflation reached a high of 13.5 percent in 1980 (figure 3.11) before falling to below 4 percent from 1992 to 2006.

Besides bracket creep on tax rates, inflation wreaked havoc with the financial systems. Depreciation statements, as well as accounts of interest paid and received, became misleading. As inflation accelerated, individuals with prior investments in many pensions and interest-bearing assets with fixed nominal payments saw the value of their assets decline significantly, while borrowers often made large gains. Sometimes borrowers even found themselves facing financial incentives to borrow and "dissave." As an example, a household borrowing at an 8 percent interest rate in 1976 found that when inflation rose to 10 percent, it was paying a negative real rate of interest on the old debt. On the flip side, as inflation fell, the effective real rate of interest often turned out to be very high. Those who borrowed on long-term mortgages paying 12 percent or more at the height

Figure 3.11. Percent Change in Price Level, 1955–2006

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Note: Seasonably adjusted consumer price index for all urban consumers (CPI-U).

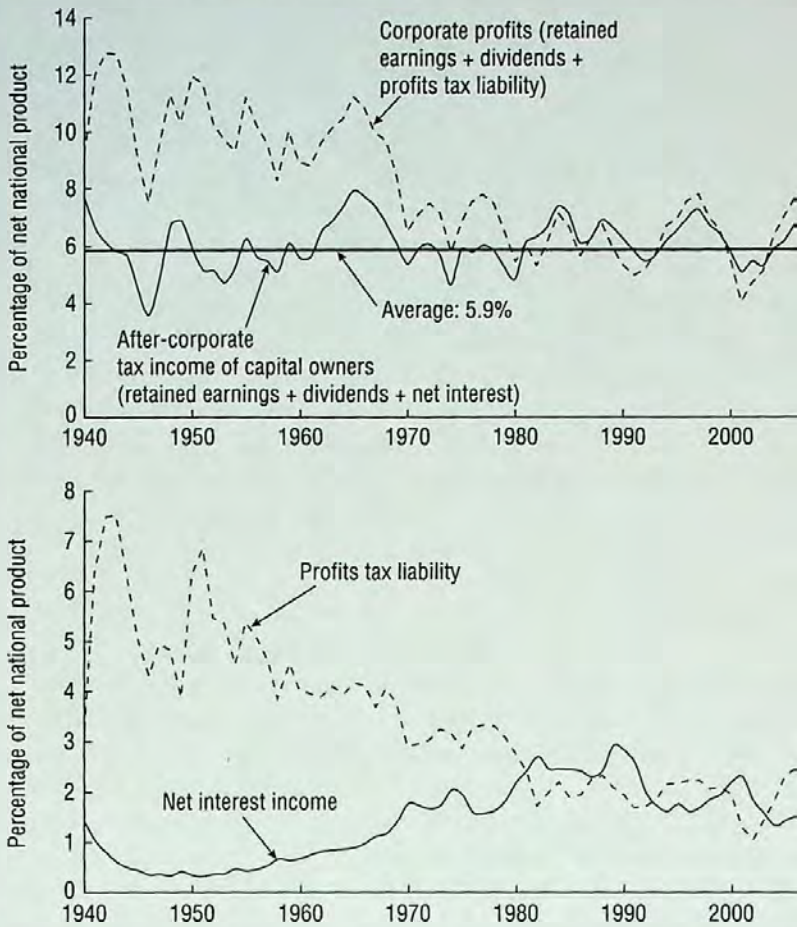
of the inflationary era found their real rate of payment increasing substantially as inflation fell toward 6 percent or less.

With changes in inflation, however, also came changes in the tax advantages and disadvantages of borrowing or lending. Meanwhile, the nation had become addicted to debt. Total private debt held by households and businesses as a percentage of GDP rose from 63 percent in 1948 to 133 percent in 1978 to 214 percent by 2005. For various reasons, the amount of interest deductions on tax returns is far in excess of the amount reported as interest received. Since for every payment there is a receipt, this gulf reflects payments to pension plans, insurance plans, nonprofit institutions, other tax preferences, tax cheating, and tax arbitrage (see page 59).²³

Total Returns to Corporate Capital

Figure 3.12 illustrates that owners of corporate capital tended to survive periods of declining corporate profits by receiving capital income in other forms or paying lower taxes. Corporations produce most of the output of the U.S. economy, so most income is generated within corporations

Figure 3.12. Profits, Returns to Capital Owners, Taxes, and Interest Income of Nonfinancial Corporations, 1940–2006



Source: Author's calculations based on data from the Bureau of Economic Analysis, Survey of Current Business 2007, tables 1.7 and 1.14.

and paid to or earned by labor, shareholders, bondholders, and, of course, the government. That mix has changed significantly over the past six decades. Despite these changes, the after-corporate-tax share of net national product received by all owners of corporate capital—shareholders and bondholders alike—did not change nearly as dramatically as total profits. Instead, it remained amazingly steady at about 5.9 percent of GDP throughout this period.

Corporate profits (as measured by the Bureau of Economic Analysis) fell significantly from their 1940s and 1950s level of 10.4 percent of GDP on average to 7.0 percent for the 1970s and 6.2 percent for the 1980s and 1990s, falling off a bit in the modest recession of 2001 before rising to 7.7 percent in 2006. At the same time that corporate profits fell, so did taxes on corporate profits and corporations' retained earnings.²⁴

How could corporate capital owners hold their own during the long declines in corporate profits? Two breaks nearly offset these losses: a decrease in corporate taxes and an increase in the net amount of interest paid to bondholders (both measured as a percentage of GDP). Correspondingly, declines in interest paid and higher taxes tend to offset periods of profit increases. Of course, there are cycles, but the fluctuation in after-corporate-tax income of capital owners is quite damped compared with the cycle of corporate profits.

Once again, inflation plays havoc with these measures when viewed in isolation. In the case of bondholders, the return for expected inflation leads to nominal interest statements in excess of the real amount received. On the flip side, inflation forces corporate shareholders to receive financial statements that understate the corporation's earnings. These two errors net to zero: bondholders receive interest the corporation deducts on behalf of its shareholders. For instance, if \$1,000 is paid out, \$500 of which represents nothing more than a return for inflation, the corporation understates real earnings (of stockholders) by \$500, while the corporation's bondholders overstate real interest received by \$500. When the statements of total returns of stock and bondholders of corporate capital are added, the errors wash out. These measurement problems prevail when inflation is high, but they continue to be important even at moderate inflation rates.

The bottom line is that after walking through all these accounts, on net, corporate capital owners suffer neither the losses nor garner the gains that are conveyed in anecdotal press stories about corporate profit cycles.²⁵

Depreciable Assets and Corporate Returns

Inflation also has a substantial impact on the value of depreciation allowances that business can take. Depreciation allowances have never been directly adjusted for inflation. When a company deducts, say, \$20 of its initial purchase cost of \$100 each year for five years, each successive year after the first year is worth less and less because the real value of each \$20 erodes with inflation. In effect, for assets bought and never resold, businesses have never been allowed to deduct all of the real cost in periods of inflation.

Congress reacted to this predicament indirectly several times in the postwar period—not by making adjustments for inflation but by shortening the period over which assets could be depreciated and, for a while, providing investment tax credits. Only sometimes was the goal stated as compensating for inflation; more frequently, Congress simply said it wanted to provide investment “incentives” or spur the economy. Sometimes the value of the tax break exceeded that of the tax penalty due to the additional inflation. As inflation rates fell in spurts after the 1970s, the real value of depreciation allowances rose again and reduced the inflation penalty. After 1986, Congress did not reduce incentives for most assets as inflation and the related tax penalty continued to fall.

Corporate tax is assessed on all equity returns from the corporate sector, not just on returns from depreciable plant and equipment. Corporations profit from ideas, inventions, new techniques, good marketing practices, and innovation. A company moving to a new region or country may “invest” heavily in learning the laws and customs in that location. Some companies have also garnered profits as monopolies or oligopolies. Service industries, which have employed increasingly larger portions of the population fairly steadily throughout the past century, generate profits from their activities without much investment in plant and equipment. These other types of investments often did not benefit, at least directly, from the tax reductions offered to physical capital. However, it can be argued that that these other firms already get to deduct many of their investments in training of labor or human capital development immediately and don’t have to amortize or depreciate them over time.

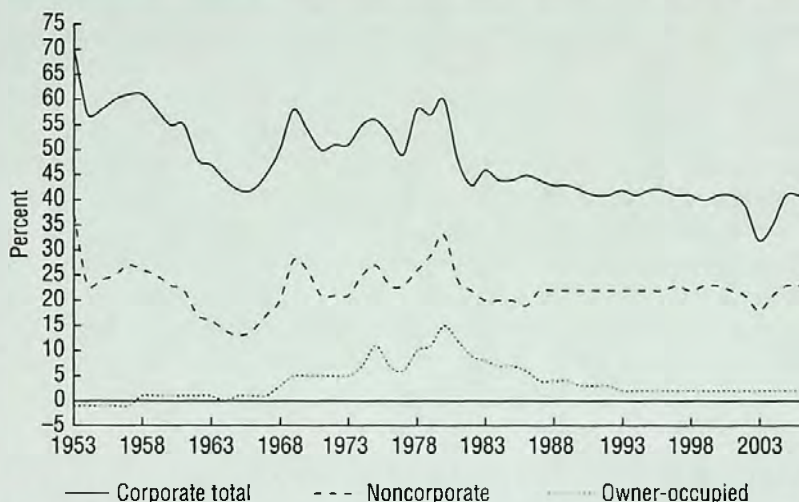
Marginal Effective Tax Rates on Capital Income

Another way to assess taxes on capital is to estimate their impact over time on investments that produce a stream of income for the future. A

summary of the marginal effective tax rates on capital income from 1953 to 2006 (Gravelle 2004) is graphed in figure 3.13 (details in appendix table A.5). Owner-occupied housing was never subject to very high rates (it briefly rose to over 10 percent in the inflationary late 1970s), while noncorporate capital, subject only to individual-level tax, has paid a marginal effective tax rate between 13 and 37 percent in this period. For long periods, the tax on noncorporate capital has been in the low 20s.

Corporate capital was subject to a rate of 70 percent in 1953 and rates between 42 and 60 percent from 1954 to 1980. After 1980, the rate dropped to the mid- to low 40s, where it hovered from 1988 on, except for a dip in 2003 and 2004. The general trend downward over the longer period has been due to several factors, including the adoption of an accelerated system of cost recovery in 1981, the replacement of investment credits and accelerated cost recovery with lower corporate and individual rates in 1986, and the steady drop in inflation (which, as explained above, increases the value of depreciation allowances). At the beginning of the 21st century, several changes again affected the effective rate: a reduction in the statu-

Figure 3.13. Marginal Effective Tax Rates on Capital Income



Source: Gravelle (2004). Estimates updated for 2005 by Jane Gravelle. Estimate for 2006 based on note to author that, due to the lack of any significant legislation, little change should be expected from 2005 to 2006.

tory rates of tax paid by individuals; a temporary “bonus” depreciation scheme adopted in 2002 and expanded in 2003, but then phased out after 2004; and lower rates of tax on dividends and capital gains adopted in 2003. These calculations assume that investments are made at the margin by individuals who have already fully used any tax reduction otherwise available through pensions and retirement accounts. If the figures were adjusted to reflect the share of investment returns essentially not taxed at the individual level because of tax preferences for retirement plans, effective marginal tax rates in recent years would fall by about 6 to 8 percentage points.

Tax Arbitrage and Tax Shelters

A key development in taxation throughout the postwar period is the rise of tax shelters and tax arbitrage. To understand the relationship between taxes and the economy, this somewhat dense subject must be tackled. Stagflation—persistent inflation combined with stagnant consumer demand and high unemployment—is also due to inaccurate accounting and its effect on investment decisions, as influenced by tax arbitrage opportunities.²⁶ Such stagflation hit the U.S. economy hard in the 1970s. In other periods as well, tax sheltering is an issue of far more consequence than simple tax avoidance; it often leads to investment in less productive assets than otherwise would occur, thus reducing the growth rate of the economy.

The most common form of arbitrage is to borrow to buy preferred assets. For instance, if one can borrow at 7 percent to purchase assets that increase in value by 7 percent a year, the tax system can be arbitrated if the 7 percent interest payment is deductible but the 7 percent return (in the form of capital gains) is not recognized for tax purposes. In this example, both net saving and net income from capital are zero in each case, but positive tax savings are generated as though one had saved and invested. Other forms of arbitrage are much more sophisticated and complicated.²⁷

Relative to taxable interest income, almost 80 percent of the individual returns from assets benefit from one tax preference or another (Steuerle 1985b). Assets are seldom subject to individual tax on both their cash yield and their change in value. For instance, houses and stocks may provide rental and dividend streams that may not be fully subject to tax, but, just as important, the gains in value are not subject to tax until sale, if ever. Even depreciable assets at times benefit from allowances that accelerate

the amount of deduction taken, basically giving their holders an interest-free loan from the government.

When individuals and corporations engage in tax arbitrage, it shows up in the world economy partly as an increase in the number of financial transactions. Usually, taxpayers sell or "sell short" one type of asset and "buy long" another—transactions they might have avoided were it not for the tax incentives.²⁸ The easiest and most common way of selling short is to borrow—that is, to promise to deliver the number of borrowed dollars plus a return rate equal to the interest rate in some future year. Commercial real estate purchases, for instance, are commonly bought with borrowed dollars even when the company has enough money to buy the real estate outright. But there are various other common short sales too—as in the stock market, where the effective rate of payment is the increase in the value of the stock that must be delivered in the future.

When a taxpayer pays interest or sells one type of asset short, the payments made are all usually recognized by the end of the sale year. In that way, the taxpayer gets to deduct those payments or losses on the tax return immediately. Thus, in the case of interest, the entire income stream, including both real interest and inflation, are deducted. On the other side of the balance sheet, the returns on many purchased assets are not recognized right away. With such assets as common stock, for instance, increases in value are not taxed until the stock is sold, or not taxed at all if left to heirs at death.

Inflation actually adds a subsidy because the taxpayer is allowed to write off more than the real full cost of payments like interest. For instance, suppose the real interest rate and the real rate of capital gain increase on a non-dividend-paying stock is 5 percent, while inflation of 5 percent increases the nominal rate of interest and the expected rate of capital gain to 10 percent. Then the taxpayer may end up deducting 10 percent each year instead of 5 percent, while still avoiding any tax on the gains as long as they are not recognized or avoiding most tax because of a capital gains tax exclusion for recognized gains.

Of course, some other person or business somewhere owns the right to those interest payments and could be forced to pay a penalty in the same way that the borrower is subsidized. However, many of these penalties are routinely avoided. In the case of interest, pensions and life insurance companies garner many receipts while accrued individual income is tax-deferred. Also, parts of the tax system are discretionary. In the stock market, there are also gains and losses, so one person can avoid declaring

capital gains earned even while another person makes sure to declare all capital losses. Over time, the law has attempted to restrict loss write-offs to constrain such tax avoidance through arbitrage, but not always effectively.

Individuals and businesses don't even have to know they are engaging in arbitrage as long as they follow incentives. Thus, more and more individuals maintain larger mortgages even as they hold more assets in individual retirement or 401(k)-style retirement accounts. Essentially, the individual borrows from himself, taking deductions for the interest paid and then deferring tax on the interest or other income received. An obvious example under current law would be someone who put money into a Roth individual retirement account (Roth IRA), which excludes interest payments from tax. After depositing the money, suppose he increases the size of the mortgage by an amount equal to the deposit. If the Roth IRA pays 7 percent and the mortgage interest rate is 7 percent, his before-tax net income from the two transactions is exactly zero. Yet he will declare an interest deduction on the mortgage each year, but never declare the interest received as income subject to tax. He is subsidized as if he has saved, but no net saving has occurred; he merely is arbitraging the tax system.

Note that the arbitrager is often playing tax games that decrease the total productivity of the economy. Tax-motivated borrowing and investing involve transaction costs that must be paid, even though net saving may be zero when an investment is financed through borrowing or negative saving.

Tax arbitrage is pervasive, affecting the lives and habits of almost every individual and business in society. Examples include using tax-deductible borrowing (e.g., by use of a primary or secondary mortgage) to purchase housing, consumer durables, pension assets, IRAs, tax-exempt state and local bonds, and real estate and corporate stock for which special treatment or exclusions are provided for capital gains.²⁹ Businesses often engage in tax arbitrage when they borrow to buy stock, create a merger, or engage in a leveraged buyout of another company. Within a business, borrowing to purchase equipment may involve some tax arbitrage, as can borrowing to buy inventory that is favorably treated through "creative" though quite legal accounting methods.³⁰ Some corporations purchase other companies' stock and are allowed to deduct dividends from income even when the interest costs of financing the purchase are also deducted. Other corporations use partnerships as tax arbitrage vehicles—perhaps

because the corporation does not want the debt to show up on the books of the corporation when it is hidden in net value of the partnership.³¹

These developments have serious consequences for tax administration. Some deductions and credits are illegitimately claimed, but the IRS generally has had to play a game of catch-up with new developments. Moreover, many types of shelters are hidden in the books in ways that make them hard to detect, so that if a taxpayer is skirting on the edge of what is legal, the IRS may have a hard time finding the item, much less contesting it.

The Treasury Department over time has put forward proposals for getting better reporting by businesses on transactions that might be shelter-like, but this is a complex matter. Businesses in the late 1990s and early 2000s were even buying shelters that had lawyers' or accounting firms' imprimaturs, but several scandals have dampened that practice. Still, businesses, like individuals, can engage in arbitrage almost inadvertently, as when they invest in a low-tax country for real investment reasons that just happen to carry along additional tax arbitrage benefits. Some argue catching most of these transactions is impossible, and one should simply throw in the towel by abandoning any attempt to tax capital income. Regardless, the use of shelters raises many ethical questions, including whether accounting firms are meeting professional standards calling for transparency when they help hide, rather than reveal, tax shelters for their clients.

Summary

For most of the post-World War II era, federal taxes have remained generally constant relative to the economy's size. Still, after hitting an all-time high in 2000, taxes quickly plummeted to their lowest level since 1950, before rising modestly again near the end of the first decade of the 21st century. Where they end up depends on many factors, including the direction of tax legislation and whether provisions with sunsets are allowed to sunset. Most growth in tax payments in the postwar period came about through state and local, not federal, tax increases. Among the major shifts in federal taxes were increases in Social Security taxes (except for the late 1990s) and reductions in corporate tax payments.

Although there are exceptions, exclusions, deductions, and credits have generally risen in importance, although for many years they were offset

by the decline in the personal exemption. More recently, lower- and moderate-income individuals have been helped by a one-time increase in (and indexing of) that exemption and by the great expansion in the availability of tax credits available even for those who owe no tax. Tax rates continually rise because of bracket creep, but Congress has legislated lowered rates. Throughout the 1990s and much of the first decade of the 21st century, there has been substantial bracket creep in the alternative minimum tax, with temporary provisions offsetting some of those increases. Capital income taxation has been ever vexing. Among the many issues involved have been inaccurate measurement of net income during periods of inflation, a system that double- and triple-taxes some income while not taxing other income at all, and the pervasive creation of tax shelters to exploit differences in tax rates and tax regimes in different countries, depending on how and where income is earned or accrued. However vexing, tax rates on capital income fell significantly between 1980 and the first years of the 21st century.

Taxation in the Postwar Period through 1980

The government that robs Peter to pay Paul can always depend upon the support of Paul.

—George Bernard Shaw

It gradually dawned on the nation by the mid-1950s that a larger government was not just a temporary wartime phenomenon. Nor was government, as in the Depression, going to be composed mainly of programs to deal with unemployment. The federal government took on new activist roles building a national highway system, expanding civil rights, and gradually increasing its social policy. Defense spending, still a sizeable portion of the economy after the Korean conflict, was to begin a gradual decline that, with some exceptions, would continue throughout the rest of the century.

When Republican President Dwight D. Eisenhower supported a significant expansion of the Social Security system in 1954, he essentially ended a debate over its survival that had been held in abeyance while the nation was at war. Eisenhower further solidified both political parties' acceptance of a modern welfare state in which the federal government took on significant responsibility for its citizens' well-being through transfer programs.

The large and significant growth in taxes brought about during World War II and the Korean conflict was essentially maintained, initially reinforced by the requirement to support a large defense establishment. In the first few years after the Korean conflict, over half of all taxes were spent on defense. But as these defense expenditures gradually fell relative to total expenses and national income, increases in domestic spending, not large tax cuts, took over defense's declining share of the national income pie.

The Easy Financing Period

In hindsight, the postwar period up until the mid-1970s can be defined as the Era of Easy Finance (Steuerle 1996). The nation's expenditure programs were mainly discretionary—that is, they required annual appropriations. As the economy expanded, uncommitted revenues grew, and only a small portion of revenue growth was committed to such entitlement programs as Social Security, which does not require annual appropriations. Still modest in size, Social Security also had fewer sources of automatic growth than it would by the mid-1970s. Thus, the increase in revenues made possible by economic growth left congresses considerable room to increase discretionary expenditures and cut taxes, at least nominally. The economic growth rate, as defined by real gross domestic product (GDP), was also significant, averaging about 3.3 percent from 1946 to 1974—adding further to potential future revenues relative to existing levels of expenditure.

But economic growth and its associated revenue growth was only one source of easy financing for domestic programs. The defense budget started out at about 14 percent of GDP at the end of the Korean conflict, and its gradual decline toward 3 percent by 2000 (back to about 4 percent in 2004 through 2007) made it possible to spend far more on domestic programs without increasing taxes. When measured in dollars near the end of the first decade of the 21st century, 10 or 11 percentage points of GDP translates to well more than \$1.5 trillion extra per year that could be spent on domestic programs without increasing average tax rates.

In addition, substantial bracket creep afflicted the income tax system, as chapter 3 documents. Besides inflation, the gradual but continual increase in the number of two-earner couples fueled bracket creep as more women entered the workforce.

With so much money sloshing around, policymakers entered a world where their primary legislative goal was to give something back to the people while seldom, if ever, suggesting cutbacks in expenditures or increases in taxes. In reality, government can never avoid the constraints of double-entry bookkeeping: someone always pays for what someone else gets. Still, in politics, it helps if payers are not identified and if their tax obligations to government can be blamed on the actions of past presidents and congresses or passed onto future ones. In short, as long as the money appeared to grow on trees, politicians only had to decide what to do with it, not how to raise it. Even when the budget got tight in brief periods

during this easy finance period, there was plenty of room to maneuver. Some people may remember that President Lyndon B. Johnson proposed a modest and very temporary surtax to help pay for the Vietnam War, but they are less likely to note that even that surtax was packaged as part of a permanent, long-run tax cut.

While the nation's system of old age support eventually would remove much budget flexibility (as will be increasingly apparent chronologically), in the 1950s and 1960s it fit in nicely with the easy finance era. Originally set up in the 1930s, its special Social Security tax was deposited to a trust fund that was supposed to cover the cost of directed Social Security programs.¹ With this partial "fiscal discipline" in place, Congress passed a number of benefit increases paid for through tax-rate increases as more and more obligations became due. When the program was young in the 1940s and 1950s, the elderly had lower average levels of income and consumption than the nonelderly. Moreover, life spans were shorter and health care less advanced and costly. On balance, the system then was more truly an "old age" system. Social Security tax increases did not make political waves, partly because future congresses were often left to implement them and future generations had to pay them. Also, the benefits to the early generations were so much higher over their lifetimes than the modest taxes they paid that it almost appeared to be a free lunch.

Finally, the continually rising inflation rates indirectly added a fourth source of easy finance: the value of old debt was continually eroding. The person who bought a government bond at a 3 percent interest rate lost out substantially when interest rates rose to 6 percent, largely because of inflation. But that person's loss was the government's gain and only added to the sense that financing the future was indeed easy.

Codification and the Turn toward Macroeconomic Policy

If there was money to be spent, it is not surprising that elected officials figured out ways to spend it. And much of the "spending" came through tax legislation. The higher level of taxation borne of war offered politicians new ways of doing "business" through the tax code, while the higher rates significantly increased the value of existing deductions and exclusions. By the early 1950s, Congress decided to codify and give greater permanence to many practices established through regulation or standard

practices of the public. The result was the Internal Revenue Code of 1954, a major achievement of legislative drafting at the time. The top individual tax rate was kept about where it had been, at 90 percent, but without additional surtaxes. Exclusions that had been allowed through administrative practice or regulations were put into the law.

One other change is worthy of note: the 1954 Code provided for accelerating depreciation allowances to the early years after an asset is purchased. Perhaps this change can be justified as reflecting the faster economic depreciation in those early years of asset ownership—and, thus, lead to a more accurate measure of income for tax purposes. It can also be viewed as a way of offsetting the penalty imposed on depreciable assets in a time of inflation (see chapter 3). From another perspective, such a depreciation allowance can be seen as the first of many investment incentives whose goal by 1981 was totally unrelated to the correct measurement of economic income. The 1954 Code carved out this path by allowing methods known as “double-declining balance” and “sum-of-the-years digits.” The wartime tax had clearly evolved into a peacetime tax.

The major economic fear, more prevalent in the 1950s than the 1960s, was that the nation would somehow return to depression. War yanked the nation out of the Depression, but what would allow economic growth to continue? And wouldn't defense cutbacks depress the economy? This combination of fears led both to conservatism in spending money before it came into Treasury and to liberalism in thinking about an activist fiscal policy.

Keynesian Heyday

It was in the later part of this easy finance period, especially the 1960s to early 1970s, that Keynesian tax policy hit its political heyday. The simplified version of this theory—which some Keynesian experts claim does not represent Keynes's theory—called for tax cuts to spur the economy as long as there were underemployed resources, which, we have noted, was politically interpreted to mean whenever the mood struck. A less tilted version of Keynesian policy suggests that active fiscal policy is fine as long as it is balanced by raising surpluses in good years or at least by having zero deficits under conditions of full employment (Stein 1994). Many economists argue that such a balanced approach to fiscal policy had long preceded Keynes. Regardless, tax legislation had now taken on a new and major role as a macroeconomic tool, not simply as a revenue

producer—to the chagrin of some who believed it could dangerous for the evolution of sound tax policy.² Furthermore, fiscal stimulus through tax cuts began to be stressed more than expenditure increases by the 1960s. (By way of contrast, during World War II the expansion in wartime expenditures, not fully covered by new taxes, provided the major spur to demand.) Tax cuts held greater appeal to some conservatives even though, according to Keynesian theory, they had less stimulative effect than direct expenditures.

Even with tax cuts, throughout most of the late 1940s to the early 1970s, the nation's debt-to-GDP ratio fell significantly. Thus, even when nominal deficits were modest, income was growing much faster than debt. Nominal income growth, moreover, was enhanced by higher rates of inflation. The rise in the inflation rate often caught bondholders off guard so that the federal government paid low and sometimes even negative interest rates on some of its public debt. At times, the nominal federal debt to the public rose even though the real value of the debt fell.

This raises the question of whether the net fiscal posture of the federal government was expansionary at all, if something like change in the debt-to-GDP ratio, rather than simply the size of the deficit, is the measure. Tax cuts weren't so expensive, after all, in an easy financing era when automatic tax increases due to bracket creep more than covered the costs of tax cuts. The two forces more or less hung in balance—witness the relative constancy of revenues to GDP (see figure 3.1).

Looking back at the literature of the day, that overall dynamic seems to have gone largely unnoticed. True, economists recognized that bracket creep produced a "fiscal dividend." Some worried it would slow growth unnecessarily, while others suggested it would slow growth appropriately when the economy began to grow too fast. But less attention was paid in those days to debt-to-GDP ratios or the problems caused by inaccurately measuring government's real interest payments by failing to take inflation into account. The focus—business as usual in politics—was on whether the next proposed discretionary tax cut was needed to expand the economy. Even opponents of stimulus policy often measured impact by whether there was any nominal deficit, as evidenced by their fights over raising the nominal rather than real debt ceiling.

In the early 1960s, President John F. Kennedy became sold on Keynesian policy. Kennedy prided himself on his connections to academics, especially those from Boston, such as John Kenneth Galbraith. Based partly on the evidence deficit spending during World War II provided, Keynesian

exciting. Economists were especially enamored of applying the incentives only to new investments, thus keeping whatever taxes could be collected on the income from already existing capital that would be ineligible for the credit.

The notion of incremental incentives—essentially granting the full benefit of incentives for new capital but zapping old capital (which didn't get the incentives and would become less valuable due to competition from subsidized new capital)—was another legacy that carried over to many future tax cuts.⁵ Almost totally neglected were such problems as the potential inequity to existing capital owners, the inability to constantly surprise the next set of "old" capital owners with changes that made their capital less valuable, the difficulty of defining what is really marginal versus what would have taken place anyway, the complexity of different tax regimes applying to different vintages of capital (depending upon age), and, in the early 1960s, a lack of recognition that the specific form of investment incentive chosen unduly favored shorter-lived capital.⁶

The U.S. Treasury in the 1960s was heavily engaged in justifying its traditional tax reform agenda with analysis, though it often lost the battles to both Congress and other parts of the executive branch when it came to legislation. The same Stanley Surrey (the assistant secretary for tax policy) who led the charge in the executive branch for a tax expenditure budget believed strongly in rooting out special exceptions that reduced the tax base and therefore caused the income tax to be less than pure. However, while the Treasury continually opposed special tax preferences, it put less emphasis on the ways in which some income would be taxed more than once, as in the case of corporate income. The concept of "negative" tax expenditures, where more than income was counted in the tax base, was given little attention.

In the late 1960s, the Treasury began work on another set of traditional tax reform studies. In this case, the lens focused on charitable foundations. The targets were some fairly rich people who seemed to be using foundations to maintain control of their corporations. Also, a number of foundations were making grants that represented only a tiny percentage of their total endowment. For instance, a foundation would pay out only 1 percent of assets while earning 5 percent.

In January 1969, outgoing Treasury Secretary Joseph W. Barr also reported to Congress that 155 individual taxpayers with incomes above \$200,000 (\$1.1 million in real 2001 dollars) paid no federal income tax on their 1967 tax returns. This announcement catalyzed the development of

various alternative minimum taxes that would affect far more people in later decades than anyone dreamed at the time (Burman, Gale, Rohaly, and Harris 2002). Congress seemed especially taken with the story of Mrs. Dodge, of the automobile family, who had earned \$1 million in tax-exempt interest income and had paid no tax (Graetz 1997, 190).

The Tax Reform Acts of 1969, 1975, and 1976

The Tax Reform Act of 1969 demonstrated that the power of traditional tax reform concerns could transcend political parties. Hardly a beat was missed when the mantle passed from President Johnson, a Democrat, to President Richard M. Nixon, a Republican. In many ways, this seamless transfer demonstrated the type of professionalism that was applied to tax policy development at the time. It also reflected the limited number of political appointees in the White House who tried to gain control over tax policy. Those days of strong control over the President's tax policy by Treasury, with its extensive nonpartisan staff, were numbered.

Although the act covered only a modest number of issues, the reforms were generally well designed and well accepted. John Nolan, a deputy assistant secretary at the time who later helped to found the American College of Tax Counsel and the American Tax Policy Institute, viewed it as among the most important tax reform achievements of that decade and the next.⁷ In many ways, it was the process rather than the size of change that was appealing. The 1969 act clearly represented a classic textbook-style reform: problems were first identified, then staff came up with options and solutions for elected officials to consider, and both political parties accepted the initial agenda. Legislative compromises were reached without sacrificing the basic objectives underlying the executive's proposal.

In the early 1970s, inflation accelerated, leading President Nixon to temporarily promote wage and price controls that quickly became impossible to administer. The Vietnam War was also winding down. With help from both bracket creep and a substantial peace dividend, Nixon presided over the largest increase in total domestic spending as a percentage of GDP under any president in history—and by a wide margin (Steuerle, Gramlich, et al. 1998, 62).⁸

Tax cuts also remained possible, and the speed of legislation picked up, including passage of the Revenue Adjustment Act of 1975 and the Tax Reform Act of 1976, both of which contained important provisions. The 1975 act included a tax cut, a tax rebate, and increased expenditures

totaling \$23 billion. The 1976 act extended the one-year 1975 tax cuts, making some \$4 billion of tax reduction permanent and extending the rest until 1977 (Joint Committee on Taxation 1975, 1976).

Because of high rates of inflation, the 1970s produced more bracket creep relative to GDP than other decades. The 1970s were also a decade of continual tax cutting that, despite the revenues available, usually left out traditional tax reform. Constantly expanding revenues, especially at high rates of inflation, tempted policymakers to do more than offset reductions in rates or increase the standard deduction. Tax preferences and favors to various interest groups were fixtures in those bills.

The 1976 act became one of many tax reductions that made traditional reform so difficult. As John Witte (1985, 194) noted,

The final Senate bill . . . was unsatisfactory to both the reform liberals and such conservatives as James Buckley [I-NY], who lamented the revenue loss and the structure of the bill as the "worst possible collection of tax preferences for lobbied interests." The liberals, in a last ditch act of defiance, proposed the word "reform" be dropped from the title of the act. . . . The bill accounted for a greater cut in taxes than any bill to that time. . . . The reduction was estimated at \$15.7 billion for fiscal year 1977 and \$11.6 billion for 1978.

Again, despite its size, the bill did not fully offset the bracket creep from previous years.

Carter as Thwarted Tax Reformer

President Jimmy Carter was elected in 1977 as a reformer. Whether his target was flood insurance, Social Security, or tax reform, he wanted to do the "right" thing—often ignoring the interest groups affected. Unfortunately, legislative politics bested this idealism, and Carter had trouble mustering even the Democratic votes that he needed. Although some blame his administration's failures on his outsider status, the greater complication was that the easy financing era had led to a legislative process that tended only to identify winners through tax cuts and expenditure increases. Whenever Carter tried to identify who would pay—whether his motivation was trying to do right or simple budgetary arithmetic—he got into trouble.

After his election, Carter put the Treasury to work designing a tax reform package. Once again, however, tax reduction was to win out over reform. The final 1978 proposals by President Carter contained only \$9 billion of revenue-raising reforms, but \$25 billion in net tax reduction for the

first year. By the time the proposals saw daylight, Congress had already convinced the White House to soft-pedal reform. The first part of Carter's program was launched in 1977 and clothed in populist and Keynesian rhetoric—it provided a spur to the economy and a quick rebate check in people's pockets. Along the way, Congress passed other reforms, such as unification of estate and gift taxation (formerly gifts to heirs were treated independently from assets passed to them at death). In 1978, Congress took up the broader package. As time passed, however, it became clearer that the support for many suggested base-broadening reforms that identified "losers" was not there. Lack of momentum was not just a question of finding common ground within the Democratic Party or between Democrats and Republicans. Inflation continued to accelerate and a second energy crisis and spike in gasoline prices (the first having reared up under President Gerald Ford) made the nation feel more vulnerable. Also, the post-war economy's capacity to constantly exceed people's expectations was shrinking. As the percentage of adults who had lived through the Depression decreased, the productivity growth that had continued until about 1974 began to slow, dashing heightened expectations.

By the time that Congress finished the 1978 legislative year, President Carter's proposals had been transformed. Most base-broadening reforms were dropped, and capital gains relief was provided, partly to counter the large percentage of capital gains due to inflation. The legislation increased the personal exemption and the standard deduction. These measures cut taxes at the bottom and pared back the number of taxpayers needing to itemize deductions (a number which otherwise grew steadily because of inflation and real income growth). The 1978 act also condensed the number of tax brackets from 25 to 15.

President Carter and Congress also later agreed on the Crude Oil Windfall Profit Tax Act of 1980 (Joint Committee on Taxation 1981). The OPEC-led restriction on oil exports had dramatically raised oil prices—a benefit to domestic as well as foreign producers. Of course, while Congress was willing to tax away these windfall gains when prices rose, it had no intention of balancing the tax with extra benefits whenever there was a windfall loss due to falling prices.

The 1980 act also retroactively repealed "carryover of basis"—a reform enacted in 1976 that no longer allowed heirs to "step up" the basis of their inherited assets to market value at time of death. (With capital gains taxation, the taxpayer pays tax on the difference between market value and basis.) This restored carryover provision effectively took the capital gains

that the deceased person had accrued but not yet realized for tax purposes and made them nontaxable to heirs. One of the major complications with the 1976 reform was that many estate lawyers complained they could not find the original basis for assets held by decedents, either because the decedents did not keep good books or because the assets involved multiple purchases, multiple sales, or changes in basis due to depreciation or additional capital purchases.

Repeal of carryover of basis also demonstrated the power of the anecdote to drive tax policy. As discussed by Graetz (1997, 190), Congress was moved by the story of a pig farmer who discussed the difficulty of determining the cost of pigs inherited from his father. "Shortly thereafter, Erwin N. Griswold, former dean of the Harvard Law School and solicitor general of the United States, told . . . of the heartaches [carryover of basis] would cause his heirs in determining their tax liability, when they sold his extensive stamp collection, which he had acquired over many years."

Beyond the always powerful impact of the anecdote, many political and economic developments influenced Americans' attitudes toward tax policy during the last part of the 1970s: the ending of the easy-financing era, the continued slowdown in productivity, an energy crisis, American hostages in Iran, the beginning of a tight money era (at the hand of Paul Volcker, chairman of the Board of Governors of the Federal Reserve System), the beginning of a military build-up and higher budgetary costs in reaction to Soviet aggression, and a very high rate of inflation driving bracket creep in the income tax. The American public decided it was ready to try something different, and that difference would become embodied in the presidency of Ronald Reagan.

5

The Early Reagan Era

Like mothers, taxes are often misunderstood but seldom forgotten.

—Lord Bramwell

In 1980, candidate Ronald Reagan campaigned against big government. True to form, he would embrace proposals to reduce taxes—the most obvious and visible costs associated with government. Early in 1981, President Reagan proposed two fairly simple but substantial tax reductions. Each proposal took partial advantage of a reaction against the impact of inflation on individual tax rates and on the taxation of depreciable capital income.

First, he proposed to reduce individual income tax rates by 10 percent per year for three years. This so-called “10-10-10” reduction in tax rates, the more expensive of the two proposals, would apply to all individual income, including wages.¹ Second, he proposed an accelerated cost-recovery system (ACRS) to make the deductions allowed for depreciable assets available in earlier years. Under this simplified scheme, the cost of any piece of machinery or equipment, even if it might last for 8, 12, or 20 years, would be written off over five years rather than over the life of the asset. ACRS was also referred to as the “10-5-3” depreciation method after the number of years of life assigned to plants and buildings (10 years) and various forms of equipment (5 years and 3 years).

Development of the 1981 Tax Proposals

The nicknames 10-10-10 and 10-5-3 had a certain flair and gave the illusion that tax law could be described simply. Both were ideal campaign proposals. Unfortunately, presidents are often reluctant to change campaign proposals immediately after election, and in 1981, some individuals who backed these proposals during the campaign were made political appointees to the Treasury. Despite inflation's influence on the tax system, President Reagan's proposals couldn't really be said to offset the adverse effect of inflation since the winners under these proposals were only occasionally those who had lost out due to inflation. The 10-10-10 reduction in individual tax rates had originally been propounded within Congress by Rep. (and later vice-presidential nominee) Jack Kemp (R-NY) and Sen. William Roth (R-DE), while the 10-5-3 proposal was developed by a business coalition led partially by the American Council for Capital Formation, a Washington-based lobbying group.

Both proposals took advantage of simmering tax revolt in the late 1970s—a revolt largely influenced by inflation's impact on tax rates and asset values. At the state level, real estate values had skyrocketed at rates even faster than the high rates of inflation, and individuals objected to the large nominal increases in taxes that typically accompanied these higher valuations. This revolt against property taxes, symbolized by California's Proposition 13—a constitutional amendment limiting tax increases for current homeowners—served as a catalyst for a revolt against federal income taxes.² Inflation moved individuals into higher income tax-rate brackets while businesses suffered from lower-valued depreciation allowances as inflation eroded the real value of future deductions. Neither proposal, however, adjusted for inflation directly. By sticking with simple campaign promises and avoiding give and take, the president set the stage for later corrections. Had redesign been allowed, some major and enduring problems, such as the inflation-induced taxation of the poor, a spurt to the growth in tax shelters, and some of the rising deficit problem, might have been avoided. Then again, mid-1980s tax reform also might never have occurred.

Tax rates mattered greatly to President Reagan, who remembered paying the 90 percent top income tax rate in place from World War II to the early 1960s.³ Supply-side economists also were concerned about tax rates—witness their emphasis on the marginal rate on the last dollar of income earned. Some enthusiasts, however, failed to recognize this phi-

losophy's full implication. Supply-side economics is closely related to the theory that ultimately a head or a poll tax (the same amount of tax collected from each individual) is the most efficient, although not necessarily the most equitable, form of taxation. That is, to distort choices the least, government should impose the highest tax rates on the first dollars of income—in the extreme, it should make taxes equal for all persons regardless of income—so that each additional dollar of income from work or saving should go untaxed. Another way of saying this is that a “lump sum” tax on people, if it were possible to impose, would be most efficient because it would eliminate any additional tax as a consequence of behavior, such as working or saving more to generate higher income.

Despite this inherent logic, supply-side economists in America never proposed anything nearly so drastic as a head or poll tax. Great Britain's conservative prime minister, Margaret Thatcher, did get a small poll tax enacted in the late 1980s—an event that some have cited as a pyrrhic victory since her downfall and the demise of the tax quickly followed, though the two are probably at best only loosely correlated. In 1981, supply-siders' main role was to provide the apologetics President Reagan needed to justify the tax-rate reductions he so fervently favored but would never be able to finance by expenditure reductions.

One distinction between President Reagan and some of his supply-side supporters may not have been fully appreciated at the time. President Reagan opposed all taxes, those paid at both the bottom and the top of the income distribution. Consistent with that view, he wanted to reduce tax rates throughout the income distribution—a costlier proposition than simply reducing the top rate of tax. Later in his administration, he would take a further stand in favor of increasing the personal exemption. Many Reagan advisers balked at these higher-cost approaches. These two moves in particular, they contended, would have at best a modest effect on marginal tax rates and, hence, on the “supply” of labor and capital.

Because supply-side economics emphasizes the last rate of tax individuals pay, it tends to emphasize the top or last rate of tax in the rate schedule more than rates at the bottom or exemptions and personal credits. In a system with progressively higher rates, the last or top rate of tax is one that applies at the margin to all who have income sufficient to reach that bracket. Personal exemptions and the other rates of tax, however, will be “*inframarginal*” to many taxpayers. For instance, consider a tax system with a simple exemption amount of \$5,000, a 20 percent tax

rate on the next \$10,000 of income, and a tax rate of 40 percent on income above \$15,000. Then, for taxpayers with incomes above \$15,000, lowering the 20 percent tax rate or, in most cases, increasing the exemption will still leave them with a 40 percent tax rate at the margin.⁴

The Not-So-Hidden Cost

When Ronald Reagan first pushed his tax proposals in the campaign, no one clamored for analyses. Now, as president, he had to ask the Treasury Department to do its job and estimate the costs of his 1981 proposals. From the beginning, the Treasury provided accurate estimates of the large costs involved. One published estimate, for instance, showed that when fully implemented by 1986, the individual rate reductions would cost \$162 billion (3.7 percent of the gross domestic product [GDP]) and the accelerated cost recovery system \$59 billion (1.3 percent of GDP) or, together, about 5 percent of GDP (OMB 1981, 16). Despite pressure to lower these cost estimates (see discussion below) and the administration's adoption of some optimistic economic assumptions, the costs could not be hidden.⁵

As the public got wind of the program's large costs, many Democrats and Republicans in Congress tried to cut back on the proposals. In particular, they envisioned limiting individual rate reductions to one year while keeping the drop in the top rate to 50 percent. This change would allow Republicans pro-business tax relief and allow Democrats the revenues needed to more easily support social programs. Many in both parties would have been happy with this compromise, even though additional tax preferences in a world of higher tax rates would have further exacerbated the tax-shelter problem.⁶

Yet a popular new president was going to get his way and a much larger tax package. The country was tired of very high inflation rates and tax rises. The changing of the political guard in the White House and the final release of the hostages from Iran signaled that it was time to try something new. President Reagan had also recovered from an assassination attempt, showing character and wit by joking to the masked surgical team about to operate on him, "Please tell me you're Republicans." Soon after his recovery, he boldly approached Congress to persuade them to enact his program while appealing directly to the American people, who were ready to sign on to a new initiative.

Congress eventually abandoned its cautious approach to President Reagan's proposals and did an about-face. A bidding war started. Many new provisions were added to the original Reagan tax proposals, including an extension of individual retirement accounts (IRAs) to taxpayers already covered by employer-provided pension plans, a new deduction for some earnings when both spouses in a family worked (a "second-earner deduction" designed to relieve marriage penalties or higher rates of combined tax that resulted when two earners married), an exclusion from taxable income of interest from qualified tax-exempt savings certificates (All-Savers Certificates), a charitable-contributions deduction for individuals who did not normally itemize expenses, a credit for increasing research activities within a business, the elimination of estate taxes for a significant number of moderately wealthy taxpayers, and a number of other special preferences.

To partly pay for these changes, the individual rate reductions were made slightly less valuable: the first rate reduction would be 5 percent—not 10 percent as originally proposed—followed by two 10-percent reductions in later years ("10-10-10" had become "5-10-10"). The net reduction in tax rates turned out to be about 23 percent, and, for three years anyway, inflation further offset some of this reduction.⁷ Perhaps the most important addition was little noted at first: Congress required that tax brackets, the personal exemption, and the standard deduction be indexed or adjusted for inflation—effective after 1984. Meanwhile, the accelerated cost-recovery system of depreciation was adopted for assets purchased between 1981 and 1984, and cost recovery deductions would be even more generous for certain assets purchased after 1984.

The Economic Recovery Tax Act of 1981 (ERTA) passed with all these bells and whistles. To give some idea of its long-term impact, the cost of the 1981 tax act was estimated for fiscal year 1990 at about \$323 billion, or close to 6 percent of the gross domestic product (Steuerle 1992, table 12.1).

Reassessing the Individual Changes

Many opponents of President Reagan claimed that the 1981 tax act was the chief cause of the budget deficits of the 1980s. To many of his supporters, the tax reductions represented the outstanding legislative success of his tenure. The story, however, is much more complex than either view allows.

Looking first at individual taxation, the cost of the rate reductions appears quite high compared with what would have happened under the 1980 law then in force. However, under the older, unindexed system, individuals would move into higher-tax brackets and see their tax rates increase significantly. Much of the 1981 rate reduction did nothing more than offset past and future increases in tax rates stemming from inflation (as well as real economic growth).

One way of seeing how these factors combined is to examine federal individual income tax receipts, which never fell below 7.66 percent of GDP during the Reagan era. In contrast, these receipts were 7.74 percent of GDP in 1976. Thus, Reagan's seemingly radical individual tax reductions did not even bring tax rates down, except for one year, to the level of only a few years earlier. In 1984, after reaching the lowest point they would hit under Reagan, average individual rates began increasing gradually. As in periods before indexation, individuals continued to move (albeit more slowly with indexation for inflation) into higher-tax brackets, owing to increases in real income.

Indexing for Inflation

The major individual reform instituted in 1981 was not the direct reduction in tax rates but the indexing of tax brackets, including (after 1984) what might be viewed as a zero-rate bracket that personal exemptions and standard deductions created for all Americans. As noted, this indexing provision was not part of the original Reagan proposals, but it has dramatically altered tax legislation ever since. No longer could Congress follow the pattern of providing tax reductions that merely offset tax increases driven by inflation. By 1990, the inflation adjustment reduced receipts by an estimated \$57 billion relative to an unindexed tax code (Steuerle 1992, table 12.1). Eventually compounded over years and decades, of course, indexing would outweigh all other provisions of the 1981 act.

An alternative way of looking at the 1981 rate reduction is to compare it with the receipts that would have been collected under an indexed tax system starting at the beginning, rather than delayed until after 1984. According to estimates by Sally Wallace of Georgia State University and formerly of the Treasury's Office of Tax Analysis, if the individual tax base had simply been indexed for inflation after 1981, by 1990, receipts would have been almost \$180 billion lower.⁸ In contrast, individual receipts

due to all provisions of the 1981 act were reduced by about \$260 billion. Indexing since 1981, therefore, would have cost over two-thirds as much as all the changes in individual receipts, including the indexing that went into effect after 1984.

The 1981 tax act, however, also embodied a reaction to the significant bracket creep of the high-inflation years before 1981. Strikingly, the entire revenue loss from provisions for individuals in 1981 could have been achieved simply by indexing the tax code for inflation from about 1979 onward.

In retrospect, it's hard to imagine that the 1980s could have passed without either an indexed tax code or, in its stead, further tax cuts. The 1981 act still reduced revenues more than indexing alone could have, but, of course, any comparison over time requires strong assumption about how much the 1981 cut deterred Congress from enacting cuts later. The national debt also went up faster than it would have had the cuts been implemented more gradually—especially since the defense build-up taking place was also expensive. The vast sums of additional interest paid on the debt could even have resulted in an increase in tax rates in the end, including legislation to reduce the deficit. Thus, the ultimate impact of the 1981 cut on receipts depends on whether one believes these payments came out of lower expenditures or higher taxes—or, most likely, both. Up front, they were still expensive.

An Uneven Effect among Individuals

The individual rate reductions did not offset inflation evenhandedly. At the time of the Reagan tax reductions, the Treasury's computer models indicated that inflation increased individual taxes proportionately for most income brackets. For the vast middle-class majority, therefore, a proportionate rate reduction of 1981 was appropriate, at least if the goal was to offset bracket creep due to inflation. However, inflation's impact was very different for two groups: high-income and low-income taxpayers.

For a person at the very highest tax rate, inflation normally cannot raise the marginal tax rate.⁹ Someone facing the top rate of 70 percent could not pay more than a 70 percent marginal tax rate no matter how much taxable income increased with inflation. Even before 1981, high-income individuals often avoided a top tax rate of 70 percent through a special provision of the tax code that limited the tax rate on earnings, or income from labor, to a maximum of 50 percent. (For many persons, an

interaction among provisions resulted in a higher marginal rate than 50 percent.) For taxpayers able to invoke that provision, therefore, the 1981 reduction of the top rate from 70 to 50 percent provided few additional benefits. But for high-income persons with capital income, the lower rate was more generous. The 20 percentage point drop in the top statutory rate also effectively reduced the top rate paid on capital gains from 28 to 20 percent, since 60 percent of reported gains could be excluded from taxation both before and after the 1981 act.

The 1981 act offset bracket creep the least at the bottom of the income distribution. If a taxpayer moved from paying no income tax to paying \$200 simply because inflation eroded the value of personal exemptions and standard deductions, a 23 percent reduction in all tax rates compensated for only \$46 of the total increase. Thus, the 23 percent rate reduction was not big enough to keep inflation from driving more people into the tax system between 1981 and 1984. Only a 100 percent offset would have kept them out of the system. Another way of saying this is that personal exemptions and the standard deduction were not indexed for inflation, so a smaller share of income was subject to tax at a zero rate. Following supply-side concerns that items like the personal exemption did not have much effect on incentives, the Reagan tax cut emphasized lowering tax rates and not worrying about such issues as the decline in the real value of the exemption.

In many ways, the neglect of the working poor in 1981 merely continued the trend of the late 1970s by allowing inflation to drop the real-income ceiling above which income is taxed. At the same time, inflation continued to force households with dependents to bear an increasing share of the total tax burden since larger households made the most use of personal exemptions available to taxpayers and dependents.

The Business Tax Cuts: Revolution or Parody of the Past?

Both supporters and opponents of the Economic Recovery Tax Act of 1981 liked to claim that the business tax changes represented revolutionary departures from the past. Supporters would tout, and opponents would protest, the extent and size of the new deductions. Here again, though, both sides' assertions were exaggerated. In many ways, the 1981 act would repeat, and even parody, the past.

Exaggerated Effects

The 1981 cost-recovery provisions were hardly unique. Taxes on depreciable capital had already been reduced three times during the postwar period. Proponents of the business cuts, especially supply-side economists, were especially fond of comparing the 1981 measures with the tax cuts and investment incentives that President Kennedy had popularized. Favoring depreciable assets had become a standard mechanism for reducing taxes on capital, especially as inflation accelerated or the government became enamored of the need to foster growth through the tax code. President Reagan's accelerated cost-recovery system and 10-5-3 proposals in many ways carried to a logical conclusion the precedents set in prior Democratic and Republican administrations. After all, if past depreciation accelerations and investment credits had been worthwhile, then why not enact yet another investment incentive and let effective tax rates on some investments drop to zero or below?

Although the costs of the 1981 business tax program were high, under some lenses that high cost was misleading. Acceleration of depreciation allowances had an exaggerated effect on revenues in the first few years. In other words, tax reductions due to the speed-up of deductions into the first years of an asset's life would be partly offset by the absence of such deductions in the later years of its life. Moreover, the acceleration of inflation justified some speed-up, though explicit inflation adjustments would have achieved this result more directly and avoided overcompensation for inflation when inflation rates fell. By the same token, the cost of the 1981 act would have been much larger had not some cost-recovery provisions been pared back through legislation in 1982 through 1984.

Despite the costs of the Reagan-era cuts, as a simple mathematical matter, the already existing investment tax credit reduced tax rates on most assets by far more than the new allowance for accelerated depreciation. This distinction proved crucial later in the decade, when an elimination of the investment credit, not a change in depreciation allowances, provided the most important revenue generator for financing cuts in corporate tax rates.

Perverse Effects

While both proponents and opponents of ACRS exaggerated the novelty of the its depreciation schedules, the new law did have some perverse

economic effects that eventually could not be ignored. The 1981 business tax cuts contained the seeds of their own destruction. Since the president's package was never reworked after the campaign with tax equity, efficiency, or compensation for inflation in mind, the final formula was simplistic and the depreciation benefits were shared unequally among holders of different forms of capital, thus distorting investment patterns.

Why? First, when combined with the investment credit, the new cost-recovery schedules resulted in effective tax rates on new purchases of certain types of equipment that were often near zero and in some cases quite negative even before taking borrowing into account (see Auerbach 1983). That is, the combination of an investment tax credit of 10 percent, plus the ability to write off equipment costs within five years, yielded allowances so generous that they were often mathematically equivalent to not taxing investment income at all. When these assets were purchased with borrowed dollars, the effective tax rate often fell below zero and became a tax shelter for income from other sources.¹⁰

Second, like past tax preferences, ACRS put all the benefits up front. The investment credit and the new accelerated deductions would be received in the first year, or first few years, of owning an asset. Since deductions and credits can be used only against other income or income tax, new businesses or businesses with current losses found themselves at a severe competitive disadvantage with respect to new investment. Almost none of them had enough income to take advantage of such generous up-front deductions and credits. On balance, the law favored old established businesses over new ventures that often face other start-up costs.

Third, under the formula for providing depreciation allowances, different forms of capital received very different treatment. The new ACRS system especially favored long-lived equipment. Yet the common five-year "tax life" for writing off costs did not correspond with the actual operational lives of assets. Why should an asset built to last 20 years and one designed to last seven years both be written off over the same five-year period? One calculation showed that returns from equipment on average would be taxed at an 11 percent rate (although the rate varied widely by type of equipment), structures at a 38 percent rate, and inventories at a 58 percent rate.¹¹ These types of unreasonable disparities meant that the return from equity investments in different assets would be taxed at different rates.

For such equipment as computers, the tax-depreciation schedule was not generous at all—it did not even allow real economic depreciation.

For plants and structures, which had never received an investment credit, acceleration of benefits in 1981 was also less than for most equipment. For returns on inventory investments, there was no direct benefit from tax preferences for depreciable assets. This failure to provide benefits more evenhandedly proved crucial later in the decade, when those industries and companies that had been left behind in 1981 joined a business coalition to support tax reform.

The Tax Shelter Bonanza

By the late 1970s, the growth in the tax shelter market had left some promoters uncertain how much further they could go. While most shelter dollars were put into oil, gas, and commercial real estate, investment in movies, alternative energy sources, rehabilitated structures—basically anything that lawyers could argue qualified for one type of incentive, quick write-off, or overvaluation leading to excess deductions—attracted capital too. The Treasury and the IRS had already tried with limited success to keep the most egregious shelters from expanding, but each year, their threat and need for legislative action became greater.

Here, then, came a tax shelter bonanza. In 1981, Congress and the president defied, or simply denied, the threat of expanding shelters and moved essentially to promote them when they were already on a substantial and untenable growth curve. Thanks to zero or negative tax rates and the availability of up-front deductions to offset current tax liability, the feasible supply of tax-shelter investments greatly expanded. Further, the tax act compounded a rapidly growing economic problem at a time of high inflation by encouraging leveraged purchases of assets at the very time when changes in inflation or interest rates made such schemes riskier. Sometimes the examples were highly visible: windmill “farms” in the desert where acres of land would be covered with small windmills generating electric power, usually at far greater cost than that produced by other utilities, or “see-through” buildings where one wall of an old building would be propped up so new construction incorporating that wall qualified for “rehabilitation” credits. Sometimes gyrations in markets, such as commodities, were responses to tax-shelter demands. The savings and loan fiasco and the bank failures of the late 1980s were also partly driven by tax-related attempts to build more and more commercial real estate on a sheltered basis, even in saturated markets.

Even though the tax-shelter craze of the early 1980s gets laid at the door of the 1981 tax act, the underlying trend was in effect well before 1981. Yet, tax arbitrage was enhanced enough in 1981 that it gave impetus to tax reform later in the decade. How?

First, the 1981 tax breaks were enacted in a way that made a mockery of traditional tax principles. Abandoning all subtlety and artifice, Congress and the president granted special favors openly and just as openly tried to create zero, or negative, effective tax rates economy-wide, but without regard to the efficiency and equity concerns that arose from providing very different tax rates for different types of assets. If they had wanted simply to favor saving, or convert the income tax to a consumption tax, there were ways to do this without creating so many distortions. But that would have required significant other changes, such as limiting interest deductions or counting borrowing as negative saving in a manner consistent with the treatment of positive saving (e.g., so that a dollar of investment financed by a dollar of borrowing would be treated as net saving of zero). This harder route was not taken, and many taxpayers began to believe that government favored not so much new saving, but the purchases of shelters with existing saving. Fear of disputes with the IRS dissipated. Elected officials seemed to claim, at least temporarily, that what was good for the tax-shelter market was good for the country.

Second, throughout the 1970s and 1980s, lawyers, brokers, and other tax experts had honed their skills and were now more poised than ever to take advantage of nuances and new tax breaks in the tax code, some of which had been around since the 1960s. Once the investment tax credit could be combined with increases in interest deductions far in excess of the real interest rate, the race was on. Shelter promoters and taxpayers moved up a learning curve at an accelerating rate, while the computer revolution made it easier to craft and sell shelters. The arithmetic behind tax preferences was easier to figure out than ever before, and the transaction time and costs shrank toward zero, even for international transactions.

Third, the amount of debt available to finance leveraged purchases of tax-preferred assets continually increased in both absolute terms and relative to the economy's size. The increased use of debt can also be traced partly to taxpayers who effectively lent money to themselves by, for instance, keeping their mortgages higher so they could add to their individual retirement accounts (Steuerle 1990b).

It Didn't Add Up

There were early warnings that some officials would try to play games with the numbers to hide the impact of the 1981 legislation on the budget. When Reagan's tax and fiscal program was presented to the Treasury to get its estimates, the news was bad. Combined with the rest of the package, particularly the increase in defense expenditures, tax cuts would lead to very high out-year deficits.

Interestingly, OMB Director David Stockman, Domestic Adviser Martin Anderson, and later Council of Economic Advisers Chair Martin Feldstein indicated that the administration was counting on, among other things, higher inflation to reduce the cost of their program. Higher inflation (at least until indexing was fully implemented) would raise individual tax rates, offsetting some of the cost of the legislated reduction. A corollary, however, is that this portion of the deficit risk could simply have been eliminated had the Treasury been allowed to replace some of the rate cut with actual indexing.¹⁴

Here it is also important to note how executive branch projections are made. The Office of Tax Analysis (OTA) in the Treasury Department estimates revenues taking into account assumptions the administration makes about GDP, inflation, interest rates, labor market participation, and so forth, *assuming* the president's proposals become law. At the same time, agencies and departments handling spending play a similar role. The Office of Management and Budget reviews the spending numbers, then compares their aggregate total with the revenue total from the Treasury Department and makes deficit projections.

In this elaborate exercise, he who calls the macroeconomic assumptions calls the tune. The OMB, along with the Council of Economic Advisers and the Office of Economic Policy in the Treasury (the "Troika") put forward a set of economic assumptions, and the OTA then provides estimates of revenues produced under those assumptions. What happens when the first set of revenue estimates are not politically attractive? Democratic and Republican administrations alike ask the Treasury if they can't do better given these economic assumptions. Time and again though, the reply has been a steadfast "No," and the OTA manages to operate above the political fray, although not without attacks on occasion that it is not a team player.¹⁵

That means that politicians go elsewhere looking for numbers more to their liking. The OTA does not control economic assumptions, and

the OMB is free to change them with the consent of the chairman of the Council of Economic Advisers and the assistant secretary of the Treasury for Economic Policy. Often, adjustments do get made. Before the income tax was indexed for inflation, assumed inflation rates might be raised to yield revenues in excess of the increased costs of expenditure programs. More likely, the estimate of real growth in the economy will be increased to raise projected revenues. At another level, corporate profits might be assumed to rise faster than individuals' income. If profits are taxed at a higher rate than individual income, then revenues go up even if assumptions about real growth in the economy do not change.

The process still creates problems for the budgeters with political briefs. Often, multiple targets for real growth, deficits, inflation, and other parameters are mutually inconsistent once politicized analysts rearrange them. Changing one economic assumption often moves one target in the "right" political direction, but another in the "wrong" direction (e.g., showing progress against inflation might reduce revenues). Multiple scenarios are then proposed. Eventually, the sobering reality sets in that not all political targets can be met, and last-minute compromises attempt to minimize the political damage. In his book, David Stockman, director of the OMB in 1981, revealed some of the wrangling over economic assumptions in 1981 and the final acceptance of a "rosy scenario" (a euphemism applied ever since to rosy economic assumptions unlikely to be met).

In fairness, most members of the executive branch do not play this game, and in many years of the 1980s, the estimates were made honestly and were proven quite accurate by events. Moreover, even in 1981, the efforts of the OTA and other agencies ensured that estimates would be consistent, even if based on rosy economic assumptions out of their control.¹⁶ Nonetheless, the 1981 fiasco hurt the executive branch's credibility for years. As we shall see, by the 1990s and the early part of the 21st century, there were other budget games to be played, but, generally speaking, rosy economic scenarios no longer seemed a part of the process.

How can such debacles be avoided? Presidents probably do not fully understand the budget process, especially when they first come to office. But it is not clear that they are absolved from ultimate responsibility. When a president says that he or she wants the best set of economic assumptions possible and does not want them tailored to fit other political goals, the problem largely goes away. The budget process could also be changed by setting parts of it, including the determination of economic assumptions, outside the political part of the process—for instance,

requiring the major economic assumptions to be determined permanently before political decisions are made as to what proposals will be submitted with the budget.

Consistency and Accuracy of Numbers

Poor and fungible economic projections have lives of their own, but short-term political gains are quickly overturned. In one of Ronald Reagan's most famous speeches, his address to the nation on February 5, 1981, he argued that "Prior to World War II, taxes were such that on the average we only had to work just a little over one month each year to pay our total federal, state, and local tax bill. Today we have to work four months to pay that bill." In fact, total taxes as a percentage of GDP had approximately doubled, not quadrupled, during that period—from about 13 percent of GDP between 1937 and 1939 to about 27 percent between 1978 and 1980 (see appendix table A.I).

When the White House speechwriters first sent this speech to Treasury's Tax Policy office to check, it responded that the numbers were wrong. Yet every time this response was sent back, another request was sent to check the same numbers. Perhaps the numbers were the president's own or were translated from some unreliable source and no one had the nerve to tell him they were wrong. Finally, a request was sent through the Office of Economic Policy, which verified the correctness of the numbers. When asked how they could possibly accept this deception, they responded, "Well, the president didn't exactly say how long before World War II!"

The speechwriters' cavalier attitude toward accuracy and their lack of professionalism is more than an interesting anecdote. Tax policymaking is a microcosm for policymaking in general and has broad implications for the public's attitude toward government. Here it meant that truthful claims would become so jumbled with distorted claims that important information and ideas would be lost. When information is misleading, contradictions almost inevitably emerge. Before long, such contradictions did appear. In 1982, Congress and the president would agree to pass a major bill that in many ways countermanded some of the putative accomplishments of 1981.

Lessons are often ignored. The flare-up in 2003 over inaccurate information that President George W. Bush and Prime Minister Tony Blair put forward about weapons of mass destruction in Iraq could be traced,

in part, to a similar lack of professional standards applied to speechwriting and the related process of fact-checking. The error keeps repeating itself until the process is reformed.

The Demise of Easy Financing and the Maturing of Entitlements

The debate over the budgetary impact of the 1981 act cannot be understood as simply a change in tax regimes. In the past, packages the size of the 1981 cuts—even packages much larger—could be adopted and the budget would be expected to move into surplus later. Yet by the 1980s, all of the post-World War II sources of easy financing for domestic expenditure or tax changes were declining in importance.

What had changed? First, consider the impact of inflation on the national debt. The national debt itself had already declined significantly relative to GDP. Thus, any fall in that ratio simply due to inflation would be smaller (and less of an offset to nominal deficits). Additionally, modest increases in the inflation rate—and the accompanying inflation tax they involved—had been abandoned by the late 1970s as useful tools of fiscal or monetary policy. Lower rates of inflation meant less of an inflation tax even if the debt hadn't fallen. Moreover, since interest rates seemed to respond with a lag to changing inflation rates, the real rate of interest on the debt went from being very small and sometimes negative to fairly large.

Second, as total defense expenditures declined in importance relative to GDP, cutting the defense budget became a less important source of revenue to fund domestic expenditures. By the late 1970s and early 1980s, both Presidents Carter and Reagan proposed increases in the defense budget's share of national output.

Third, bracket creep in the individual income tax was reduced greatly through indexation for inflation, passed in 1981 for implementation after 1984. The eventual enactment of indexation had become almost inevitable by the late 1970s.

Fourth, though given little attention in 1981, the five-decade expansion of Social Security tax rates was ending. The 1980s did see another regular increase of approximately 3 percentage points per decade in combined employer-employee Social Security tax rates, but it was the last rate increase in that century. For the first time in the lives of most Americans, no such increase would be forthcoming in the next couple of decades, if ever.

Eliminating all four of these sources of easy finance profoundly affected the politics of tax and expenditure policy. Even though changes in priorities had always required trade-offs, the sources of funds that paid for new priorities in the past became increasingly unavailable. As the era drew to a close in the late 1970s, policymaking institutions within the executive branch and Congress were caught short. They were not yet ready for the changes about to be forced upon them. When President Carter asked the Department of Health and Human Services for a deficit-neutral welfare reform bill, for instance, he was rebuffed both by Congress and his own appointees, who argued that reform had to involve significant increases in outlays and in the deficit.

In the 1980s, President Reagan supported new priorities: reducing taxes and increasing defense expenditures. Whether or not voters or their representatives agreed with those priorities, they would almost inevitably give a newly elected president some room to maneuver and present new demands. The size of these changes, moreover, was not extraordinarily large relative to some laws passed in the easy financing period.

Even apart from the end of easy financing, policymakers had become increasingly adept at putting in place programs that grew on their own without any current legislation—thus using up any potential fiscal slack long before it materialized. Expansion by formula, such as in the Social Security program, was sometimes a key.¹⁷ Formulas were set so that benefits would rise over time even if no new related legislation passed. A related phenomenon was the growth of “entitlement” programs (whether growing or not) that could be cut only through legislation, unlike discretionary programs that required annual appropriations legislation simply to be maintained. Entitlements supposedly derived from a “social contract” to pay future benefits on the basis of a formula fixed in the past. Allen Schick (1990, 123–26) similarly points to “sticky expenditures”—entitlements, obligated bonds, and long-term commitments that respond only weakly to contraction policies.

The political tendency to commit funds not yet available was hardly confined to legislation promising additional spending in future years. Each method for maintaining or increasing funding for direct-expenditure programs had a parallel on the tax side. Many tax subsidies or expenditures, for instance, might be labeled as tax entitlements rather than discretionary tax expenditures. Preferences, such as those for owner-occupied housing or to employer-provided health insurance, expand along with growth in related private spending. Except for provisions that had to be extended

every few years, policymakers rarely determined the level of tax preference or subsidy on a current or discretionary basis. In a sense, legislation enacted as long ago as 1935 or 1954 set appropriations for 1985 or 1989. Once an exclusion or deduction was granted for an activity, its cost would often expand with the private spending on the related activity.

The movement toward three- and five-year (eventually 10-year) budgeting helped formalize how Congress legislates away any positive difference between revenues and expenditures in future years. Under multiyear budgeting, programs could no longer be designed with only first-year costs in mind. At the same time, multiyear budgeting gave Congress information on exactly how much spending might take place or how much revenue might be raised. Thus, Congress often went into the hole after restrictions on spending expired. For instance, the size of a tax expenditure might be limited for five years, then be allowed to rise significantly, raising costs apace. In this negative spiral, Congress gradually eliminated fiscal slack in future years and, by the same token, hamstrung itself.

The 1981 tax reductions were in many ways an extremist parody of previous tax reform efforts, especially the Kennedy round of tax reduction. Investment incentives proliferated and drove many tax rates to zero or below. Depreciation became so accelerated that the term "depreciation"—implying an actual measure of income loss due to change in value—was replaced by "cost recovery." Base broadening to remove special preferences that reduced the tax base was abandoned—not just early on, as in the Kennedy round—but completely.

Most of all, the change in underlying budget conditions was set in the law, and Congress in 1981 effectively removed the fiscal slack that the next congresses would need to enact their own laws and set their own priorities. This was the biggest mistake of all. Whether or not the tax cut of the early 1960s represented good macroeconomic policy, the availability of future automatic sources of funds kept the cut from permanently increasing the deficit. The 1981 cut, on the other hand, was enacted in an era when it was much harder to harvest future revenues that hadn't yet been committed.

Throughout much of the post-World War II era up to 1982, concern with macroeconomic fiscal issues made it easier for policymakers to skirt or postpone hard choices and decisions about paying for what government did. Macroeconomic fiscal policy was continually demanded to spur the economy and politicians consistently interpreted it as a justification to reduce tax cuts, regardless of whether the underlying apologetics were

Keynesian or supply-side in orientation. Such issues as fairness, efficiency, and administration were disdained as microeconomic, institutional, and structural issues worthy of less or even no attention.¹⁸ After all, it was argued, spurring additional growth through changing one simple variable—whether lower average tax rates to spur demand or lower marginal tax rates to spur supply—would swamp these other mundane issues. Unfortunately, this upside-down view implies that tax policy mainly exists to serve as a macroeconomic policy tool rather than a means to finance government fairly and efficiently. Of course, macroeconomic policy cannot be the dominant purpose of tax policy. One can hardly imagine, for instance, a government collecting taxes merely so it can reduce them later. It collects them ultimately to pay for government, while recognizing that their timing and distribution have consequences as well.

The stage was now set for another swing in policymaking—a long series of budget policies centered almost entirely on deficit reduction and a temporary end of the reign of macroeconomic fiscal policy.

The Prelude to Reform: 1982 to 1984

Don't tax you, don't tax me, tax the man behind the tree.

—Senator Russell Long, D-Louisiana

The Reagan administration invested great effort in its 1981 proposals and claimed great success. Its core successes, however, were reducing tax rates, accelerating depreciation allowances, and increasing defense expenditures. Despite the rhetoric from both sides of the aisle, neither Congress nor the administration initially reduced other expenditures more than modestly, and most cuts were in subsidies to state and local governments. Moreover, the bidding war on the tax bill had added many extra and costly provisions. By the time the president signed the bill, almost all parties, and much of the public, knew that more had been bitten off than could be paid for.

As David Stockman, then Reagan's head of the Office of Management and Budget, later wrote, "After November 1981, the administration locked the door on its disastrous fiscal policy jail cell and threw away the key. The president would not let go of his tax cut. . . . The nation's huge fiscal imbalance was never addressed or corrected; it just festered and grew" (Stockman 1986, 13). Stockman admitted that, by 1982, he knew the Reagan Revolution was impossible and turned his attention to reducing the "national fiscal disaster."

Since the new administration had succeeded in getting many of its early policies enacted, it hesitated to put forward additional proposals that might expose some of the weaknesses of what had just passed Congress. In this sense, the Reagan administration acted little different from most

administrations. Still, the president's policy proposals had come mainly out of campaign promises, and the executive branch had yet to develop a major initiative. The legislative process, however, abhors a vacuum, and the next three years were to witness a shift in the direction of tax policy and in the source of new initiatives. Once again, tax policy would dominate the agenda, but in an unexpected way: the enactment of three major tax increases in consecutive years was a precursor to the most significant income tax reform in the nation's history. Indeed, legislative peacetime tax increases were almost unheard of after World War II.¹

The president and the White House rarely took the lead in working out the details of initiatives during those three years. Instead, real responsibility rested with the Republican Senate and with a commission designed to deal with the possibility that the Social Security program might not have enough funds to meet its obligations. Here Republican Senators Robert Dole, of Kansas, and Peter Domenici, of New Mexico, played a special role in their leadership positions in the Senate Finance Committee, the Senate Budget Committee, and, later, the Office of the Majority Leader.² Within the administration, political forces were more split: some proclaimed the need for further tax cuts and others worked to reduce the deficit. The administration waffled in its role. It did not want to take responsibility for any tax increases, but some deficit hawks were willing to increase taxes. The president's public position was that he opposed all taxes, though he eventually accepted many increases.

The Tax Increases Begin: 1982

Less than two months after the victories and celebrations of 1981, work was already afoot in the Senate Finance Committee, the Joint Committee on Taxation, the Treasury's Office of Tax Policy, and the Office of Management and Budget to find ways to reduce the looming federal deficit. In mid-1981, as had become the annual custom, both the administration and the Congressional Budget Office produced new estimates of a "mid-session" budget review. By late August, the deficit debate was renewed. On September 10, 1981, CBO officials testified before Congress that \$80 billion deficits (2.6 percent of the GDP) loomed for 1982 and that expenditure cuts of \$100 billion (3.3 percent of GDP) would be needed to balance the budget by 1984 (Berry and Dewar 1981). These CBO assumptions proved optimistic. Even before a recession hit

in late 1981 and made matters worse, both Congress and the administration began to admit that the budget imbalance needed to be corrected.³

On September 24, 1981, the administration came out with a fall initiative to cut the deficit, mainly through entitlement cuts, across-the-board cuts, and even some paring of defense appropriations. Measures also included about \$22 billion in tax increases over slightly more than two years. The proposals were never called "tax increases," but rather "revisions in the tax code to curtail certain tax abuses and enhance tax revenues" (OMB 1981). Senate Republicans, in particular Domenici, along with other members of the Senate Budget Committee, also began looking for ways to reduce the deficit and prepared legislation calling for tax increases of \$60 to \$80 billion over the next three years, along with numerous expenditure reductions (Edsall 1981; Tate 1981).

This congressional initiative stalled mainly over disputes about the size of the tax increase. At one point, President Reagan declared that he had "no plans for increasing taxes in any way," only to be contradicted by his press spokesman, who indicated that the president still planned to ask Congress for \$22 billion of tax increases (Bacon 1981). Senate Republicans who had put themselves on the firing line for suggesting tax increases were especially upset with the lack of support from the administration.

Still, by early 1982, the president's budget contained proposals—many first revealed in the fall of 1981—for increasing tax revenues by over \$20 billion per year, or more than half of 1 percent of GDP. These proposals included improved tax enforcement and revisions centered on business income, including a minimum tax for corporations and disallowance of some deductions taken before contracts were completed and payments to contractors were made. Almost all of the proposals were revenue raising rather than revenue losing.

The Initiative Switches to Congress

Since there was no strong presidential push behind these proposals, the public and press barely noticed them. Nonetheless, these proposals did signal some willingness on the administration's part to tackle the upcoming deficits. It fell to Congress, therefore, to take up the deficit-reduction gauntlet. In particular, Robert Dole, then chairman of the Senate Finance Committee, began the arduous task of grafting together a package of proposals that he could get through the Senate. He received technical assistance from the increasingly important congressional staff

of the Senate Finance Committee and the Joint Committee on Taxation and, within the administration, from the Treasury Department's OMB and the Office of Tax Policy. From this brain trust came the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

TEFRA's base included some of the president's proposals. But it went much further. The act emphasized compliance and collection procedures through expanded information reporting and increased penalties. For instance, only 60 percent of reportable capital gains was estimated to appear on individual income tax returns. Taxpayers were either negligent or noncompliant on the rest. TEFRA gave the Treasury permission to require brokers to report customers' gross receipts from selling capital assets. Withholding taxes on interest and dividends was also enacted, but later retracted. Life insurance company taxation was partially reformed. The act increased excise taxes and employment taxes for unemployment insurance. Other reforms related to leasing and Medicare coverage of federal employees (thus requiring them to pay Medicare tax).

A Reversal of Some 1981 Tax Cuts

TEFRA also began reversing some of the actions taken in 1981. While the 1981 tax act had allowed higher-income individuals greater opportunity to take deductions for deposits to individual retirement accounts, TEFRA restricted the benefits available to them from other pension plans. The 1982 act also reduced the tax benefits from investment. First, the value of investment tax credits was reduced slightly.⁴ Second, TEFRA repealed a scheduled increase in 1985 and 1986 of the generosity of depreciation allowances, which had already been made quite generous after 1981. Those additional allowances would have cost more than \$18 billion by 1987 (Joint Committee on Taxation 1982).⁵

Another slight reversal from the 1981 rhetoric turned up in the Highway Revenue Act of 1982. An increase in excise taxes on gasoline allowed the Department of Transportation to finance further work on the nation's highway and transit systems. Fiercely opposed at first to any mention of a tax increase (Stockman 1986, 139), President Reagan later allowed that some tax increases—for instance, highway taxes that might also be considered user fees—as well as increases in government expenditures could be enacted. The reality of running government programs intruded once again on those who wanted a tax policy process that ran in a vacuum and behaved as though taxes weren't part of the rest of the budget.

A Focus on Revenues

TEFRA 1982 turned out to be the first of many bills in the 1980s that reduced the deficit by increasing taxes more than by reducing or reforming expenditures. In part, this tax-and-spend approach was due to the nature of the budget process: the tax changes were often permanent, whereas expenditure cuts frequently rested on nothing more than promises to cut programs back in future years. In addition, many expenditure programs were still "off the table"—defense, which the president hoped to expand, and entitlements such as Social Security, which was funded by formulas and didn't have to be voted on from year to year.

Perhaps the most important reversal came from the president himself. Earlier in 1981, President Reagan reacted strongly against David Stockman's attempt to cut back on expenditures hidden in the tax code, even though cutbacks in tax expenditures can be shown to serve the same conservative purpose as direct spending cuts. In signing the 1982 bill, the president had begun accepting the first stabs at "enhancing revenues," eliminating tax loopholes and unintended benefits, favoring compliance measures, and curtailing tax abuse. This was a direct turnaround from his 1979 claim that the term, "tax expenditures," was "the new name government has for the share of our earnings it allows us to keep" (see Brownlee and Steuerle 2003, 158).

Of course, this was neither the first nor the last turnaround on taxes for the president. When campaigning for governor of California, he had spoken out against a state withholding tax and indicated that his feet were set in cement. Later, in 1971, he called an emergency session of the legislature and proposed withholding to deal with a budget crisis. At a press conference, a big noise was suddenly heard, and Reagan, ever the actor, quipped that the sound was the cement breaking around his feet. The press corps later sent him a pair of his own shoes set in cement, which Reagan proudly displayed in his Governor's office (Smith 1980, 162–63).

Social Security Reform: 1983

Social Security reform loomed large in 1983. From the beginning, many in the Reagan administration viewed Social Security as an overweight portion of the budget. Some considered disability payments too high; others thought spouses' and students' benefits too generous or unnecessary; and others viewed early retirement as an unaffordable option. Social

Security had also matured, and automatic built-in benefit increases and expansions in years of support (as people lived longer) more and more became subsidies to the middle class and the middle-aged rather than baseline security for an older, poorer, population. Moreover, monies in the system went out about as fast as they came in. Because they were not saved (as in the case of private pensions), many believed that the Social Security system reduced total saving and investment in the economy. However, early attempts in 1981 to try to cut benefits created a storm and failed miserably (Stockman 1986). Demagoguery was quite common on Social Security, and many considered programs for the elderly untouchable—the “third rail” of politics.

Part of the categorical failure, however, stemmed from bad planning and organization. During 1981, the administration held internal meetings on Social Security reform with political officials from the White House, the Department of Health and Human Services, and the Social Security Administration.⁶ On hand were many new political appointees with strong but sometimes unseasoned views on what was wrong with the system. The newcomers so distrusted the entire civil service that they prevented many of the executive branch's most talented analysts, even top guns at the Social Security Administration, from attending these meetings. The controversy that eventually enveloped some proposals made public reflected bad planning and poor design as much as the difficulty and sacredness of the Social Security issue.

Meanwhile, the broader Social Security issue continued to dog the administration. Increasingly, projections began to show that Social Security probably would not have enough funds to pay out benefits during the mid-1980s. (Social Security is required to pay benefits out of its own taxes and trust funds and cannot rely upon deficits. The trust funds were approaching zero, and benefits were projected to be greater than taxes.) In the September 1981 fall budget program, the president proposed establishing a bipartisan task force to develop a “permanent solution to the problems facing the Social Security system” by January 1983. This political compromise created a commission headed by Alan Greenspan. Once again, responsibility for studying the problem fell outside of the executive branch.

The Commission Tackles the Problem

The threat of no more benefit checks eventually forced the administration and Congress to seek compromise. At various times, still, it appeared that

the Commission could come to no solution whatsoever. In the end, however, both political parties accepted the commission's recommendations, which were put forward in tentative form when Senators Dole and Daniel Patrick Moynihan (D-NY) tried to reach some bipartisan consensus. Moynihan's recollection was that "If you really want to do these things, they are not that hard." He boasted, "It took us three years to decide to fix [Social Security]. But when we did, it took Bob Dole, Jim Baker, Barber Conable, David Stockman, Dick Darman, and me exactly twelve days . . . to do it" (Darman 1996, 116). Even then, the Commission's recommendations lacked detail, and much was accomplished in the back rooms by the various tax-writing committee staffs and the Joint Committee on Taxation, who, along with Treasury staff, filled in the blanks.⁷ The net effect of the enacted bill (known as the Social Security Amendments of 1983) was substantial. It would, for instance, increase Social Security revenues over expenditures by \$31.0 billion in fiscal year 1989 (OMB 1988, 4-4). A principal short-run change was to implement sooner (in the mid-1980s) the tax rate increases already scheduled through prior legislation. Thus, the 1983 legislation contained no permanent increase in tax rates. Employer and employee Social Security tax rates were set to level out at 15.3 percent, the same level as that previously scheduled for 1990 and beyond under the 1977 Carter administration reforms.

The Social Security Amendments of 1983 achieved other reforms. First, it required new federal civilian employees and employees of nonprofit organizations to join the Social Security system and to receive the same tax treatment as most other employees. Second, self-employed individuals would now pay roughly the same total tax rate as employees. Perhaps the most important tax reform was that Social Security benefits, long exempt from taxation, became partially taxable for higher-income beneficiaries. By the 1990s, these other tax changes increased revenues by almost \$24 billion on an annual basis, or about 0.4 percent of GDP (OMB 1988, 4-4). However, it was the gradual rise in the normal retirement age from 65 to 67 that most affected future recipients, especially the baby boom generation.

When it comes to taxes, the 1983 amendments in many ways marked a transition between an old and new world of Social Security—a new reluctance to rely on tax rate increases. On the one hand, between 1980 and 1990, the combined employer–employee tax rate rose from 12.26 to 15.3 percent of wages. This rate increase increased revenues by about \$70 billion annually in 1990, and, when the other tax amendments of

1983 were added to the scheduled increase, Social Security taxes rose by over \$85 billion per year. From that perspective, the 1980s look a lot like the previous four decades in that tax rates were to rise by roughly 3 percentage points per decade (in 1950, employer and employee tax rates together equaled 3.0 percent; in 1960, 6.0 percent; in 1970, 9.6 percent). However, by failing to enact any *new* permanent tax rate increases, the 1983 amendments presaged a long period in which tax rates were no longer counted on to cover future deficits. Indeed, President George W. Bush would later suggest the rate be cut to pay for deposits to individual accounts for retirement saving.

At least for the short run, the 1983 Social Security Amendments repeated the pattern of the major tax bill of 1982 in relying more upon the tax changes (including reductions in tax expenditures) than direct-expenditure decreases to reduce deficits (table 6.1).⁸ It is easy, also, to complain that the 1983 amendments were inadequate to deal with the long-term problems of Social Security—they were. But one striking difference between 1983 and the debate over Social Security in later Clinton and George W. Bush administrations was that politicians acted in the former case and not in the latter. Benefits, retirement age, and taxes were not so sacrosanct in 1983. Another interesting lesson is that the retirement-age increases scheduled in 1983 and begun after 2000 have gone on with almost no protest or little press notice, in some ways contradicting the assessment in the early 21st century that increases in the retirement age are political dynamite.

More Tax Increases and Deficit Reduction: 1984

In 1984, the administration's submitted budget again included net tax increases. One proposed novelty for the 1985 fiscal year was to cap tax benefits for employer-provided health benefits—a reform not only of tax policy, but of health policy. (This reform would appear in different guises several times, as part of tax reform in the later 1980s, as part of President Clinton's proposed health reform in the early 1990s, and as part of President George W. Bush's health reform in his 2007 budget submission.) The president, who once had rejected a similar proposal because he viewed it as a tax increase, now considered it unfair that a wage earner without certain benefits should pay substantially higher taxes than one with income in the form of such employee benefits as health insurance.

Table 6.1. Estimated Changes in Social Security Receipts and Benefit Payments Resulting from the 1983 Social Security Amendments

	Total 1983-1989 (\$ billions)	Total long-range cost effects (percentage of payroll)
Tax (and Coverage^a) Changes		
Accelerate tax rate increases on wages and salaries	39.4	0.03
Increase tax rate on self-employed	18.5	0.19
Cover new federal workers and all nonprofit employees	21.8	0.38
Prevent termination of state and local employees and accelerate collection of state and local taxes	4.2	0.06
Tax up to half of benefits for high-income employees	26.6	0.61
Subtotal for tax changes	110.5	1.27
Benefit Changes		
Raise normal retirement age to age 67	—	0.71
Delay benefit increases by six months	39.4	0.30
Other benefit changes	-1.4	-0.22
Subtotal for benefit changes	38.0	0.79
Total ^b	148.5	2.06

Source: Committee on Ways and Means (1990a, 28-29).

Notes: Social Security here includes Old Age and Survivors Insurance (OASI) and Disability Insurance.

a. Coverage changes primarily raise tax collections, although there are also some benefit increases.

b. Excludes changes in general fund transfers for military service credit and reimbursement from general fund for unnegotiated checks (total = \$17.7 billion for 1983-1989 and 0.03 percent of payroll for long-range costs).

A modest attack on tax shelters also climbed onto the president's agenda. This lead from an OMB document tells the story: "The administration proposes a number of changes that will curtail transactions that generate unintended tax benefits or form the basis for tax shelter schemes" (OMB 1984, 4-10). In other words, though increasing taxes might not be acceptable, increasing tax revenue by eliminating "unintended tax benefits" and "tax shelters" was acceptable to the administration. While the 1984 proposals only hinted at a moderate counterattack, tax shelters had gotten so out of hand that no one with political principles of any kind could ignore them by this point.

More detailed structural reform was also part of the 1984 package. Front and center was an effort to change how life insurance companies' income would be measured and taxed—one of many attempts in the 1980s to reform the taxation of financial institutions. By this time, too, the growth in the use of tax-exempt bonds for private purposes had become so great that curtailment was inevitable. The administration's proposals in response were modest: restrictions on tax-exempt leasing and state and local governments' use of nontaxable bonds to finance private industrial development.

The Budget Deficit Reality Sets In

Despite modest progress through budget legislation in 1982 and through Social Security reform in 1983, the pressure to bring the budget under control continued into 1984. In the contemporary period, as multiyear budgets have increasingly been used, most administrations feel it is necessary to show the deficit coming under control at some point within their forecasted budget window.⁹ By 1984, of course, many of the projected costs of the 1981 tax act had been incurred, but the shortfall in revenues created by the recession of 1981 to 1982 had deepened the deficit beyond those original predictions—which were considered optimistic even without a recession. In addition, Martin Feldstein, then chairman of the Council of Economic Advisers, pushed the administration to use realistic economic assumptions and to abandon its unfaithful mistress of budget projections, "Rosy Scenario." Chairman Feldstein also worked with David Stockman and others to get the administration to propose a "Contingency Tax Plan" under which a surcharge would be assessed if the budget deficit exceeded 2.5 percent of GDP.¹⁰

Despite these budgetary pressures, the administration gave little support in public to these tax increase proposals, especially the contingency tax plan. Excluding the contingency plan, other tax proposals put forward in early 1984 would increase net revenue by only a few billion dollars (a tiny portion of the budget deficit), and even those gains would be offset by proposals for tuition tax credits and tax breaks for businesses set up in low-income areas designated as "enterprise zones."

Congress entered this leadership vacuum with a vengeance. Once again led by Senator Dole, Congress eventually proffered dozens of tax changes under the Deficit Reduction Act of 1984 (DEFRA). Partly following the format of TEFRA 1982, Congress tried to improve tax compliance by extending information reporting to such items as state and local tax

refunds. Excise taxes on distilled spirits and other items were increased, numerous corporate transactions and sales of assets were made taxable, contributions and benefits under pension plans were further limited, and tax-exempt leasing was further restricted. The aggregate volume of some private activity bonds sold by state and local governments (e.g., certain industrial development and student loan bonds) was capped or limited.

Various tax shelters again came under fire. So-called "tax straddles," for instance, had become too popular for the legislature to ignore any more. This shelter allowed taxpayers to buy and sell rights to future commodities in a way that created roughly equal gains and losses—like flipping a coin and betting on both heads and tails. The taxpayer would then take losses on whichever "leg" of the straddle generated a loss, use that loss to offset other taxable capital gains, and then defer recognition of the "leg" with a gain to future years. DEFRA 1984 also placed some controls on the growing market for fictitious or "on-paper only" shelters that had no real investment or significant risk behind them.

By fiscal year 1990, DEFRA raised \$31 billion, or 0.5 percent of GDP, on an annual basis. While the revenue yield was not quite as large as TEFRA was in 1982, in many ways DEFRA went beyond the earlier act. DEFRA relied more on tax base reform and less on changes in tax compliance or the elimination of provisions enacted in 1981. Like the 1982 and 1983 bills, the emphasis was more on tax changes than on reducing direct expenditures. Tax expenditures remained politically easier to reform than many types of direct expenditures.

Lessons from the Period

As a whole, the period from 1982 to 1984 represented a historical turnaround in postwar tax policy and a stark contrast from 1981. Now revenue raising was at the top of the agenda. All in all, tax acts passed during these years had raised over \$108 billion—or nearly 2 percent of GDP—by fiscal year 1990. Other than excise taxes, however, there were no permanent increases in tax rates. Most reforms involved expansions of the tax base, improvements in tax compliance, and retrenchments of 1981 provisions.

Even with all these tax changes, however, the nation's fiscal house remained in disarray. Costly defense build-ups continued, and, by 1984, the 1981 individual tax-rate cuts had been fully phased in. The rosy

economic growth rates projected in 1981, moreover, had never materialized, and the nation was only in the second year of recovering from a deep recession. Deficits were large, and many of the 1982 and 1984 reforms were proving inadequate. All of this signaled that 1982 to 1984 was merely the dawn of a long and tortuous period of deficit reduction that would last until the end of the 1990s.

The movement of leadership on taxes from the White House to Congress from 1982 to 1984 signaled a broader lack of momentum with the executive branch. Even in the 1984 campaign, the administration seemed content to defend the actions it took in 1981. Consultants to the administration suggested its domestic agenda was bare.¹¹

The Formation of Liberal-Conservative Coalitions

Even before the end of 1984, several events signaled a need for major tax reform. For example, state and local governments increasingly used the federal exclusion from taxing interest on state and local bonds as an excuse to lend at below-market rates, even for private purposes—thus usurping the private lending market. Congressional attempts to stem this practice in 1980, 1982, and 1984 had proven ineffective. Increasingly, investment followed bureaucratic rules and flowed through networks of state and local government decisionmakers. As another example, installment sales—selling an asset but deferring taxes on capital gains by recognizing the gains in installments over time—were used to reduce current taxes. Many financial institutions became more important in the economy, but paid little federal tax on their income.

These medium-size problems might have been ignored longer or attacked through a more modest bill, perhaps on the order of the tax bills of 1982 or 1984, but for two major problems. First was the proliferation of tax shelters and tax arbitrage opportunities that had to be contained, and second was the increasing taxation of the poor and of families with dependents. The two distinctive liberal-conservative coalitions that eventually united behind tax reform developed largely in response to these issues.

Addressing Tax Shelters while Lowering Tax Rates

One major hemorrhage of the tax system demanded attention far beyond the measures enacted in 1982 and 1984. Tax shelters and tax arbitrage

were deterring growth, reducing public confidence in government, turning the civic exercise of filing tax returns into a prolonged headache, and decimating the ability of the Internal Revenue Service to administer the tax laws.¹² Often misled by advertising, many purchasers of tax shelters turned out to be middle-income savers sacrificing much higher yields in favor of only moderate tax saving. Even college students with little tax liability were investing in shelters, many centered on leveraged purchases of real estate or oil and gas. The system of financial intermediation was supposed to help direct saving toward optimal economic investment, but few people were looking for the investment with the highest economic return. They wanted the tax breaks! Along the way, billions in savings were being cast to shelter promoters and organizers, and many individuals actually lost money in their attempts to reduce tax liabilities.

The problem came into the spotlight in the large market for publicly offered shelters, often advertised directly on the newspapers' financial pages. Available information on partnership activity began to support reformers' concerns. Between 1965 and 1982, the number of partnerships reporting net losses grew from 229,000 to 723,000, while the number of partners in all partnerships grew from 2.7 million to 9.8 million. Net "losses" reported in oil and gas partnerships grew from \$128 million to \$13.2 billion, and in real estate from \$619 million to \$23 billion, thus providing substantial offsets to other income reported on tax returns. Together, oil and gas and real estate partnerships accounted for about 60 percent of all partnership losses. And the growth rate in sheltering was phenomenal. New public offerings of partnerships grew from \$38 billion in 1979 to \$64 billion by 1982 (Nelson 1985, 58–59).

Corporations also sheltered their income from tax, often through direct purchase of equipment leased to other companies. General Electric was an often-cited example because it aggressively pursued this course and reduced its tax liability to zero. General Electric would buy depreciable assets with generous cost-recovery provisions and investment credits, then lease them to companies that might be less profitable and unable to take full advantage of the incentives. Without compunction, many of these corporations achieving lower tax liability could correctly claim that many tax benefits were passed on to consumers or other companies through lower prices or reduced lease rates. However, the appearance of large and profitable corporations paying no tax at all was a public relations disaster.¹³ Whatever the economic justifications for low taxes on corporations, tax shelters were an unseemly way to get there.

Of course, simply going after tax shelters alone was not enough to fire up a coalition to attack the status quo on other fronts. However, the quest to level tax shelters helped form an important liberal-conservative coalition that would unite behind broad-scale tax reform.

In several respects, the core of this coalition had been around for years. Economists trained in traditional public finance principles had been taught how the unequal treatment of various sources of income led to inefficient patterns of investment and consumption. The literature on this subject stretches back to the birth of the income tax.¹⁴ The basis for broad-based taxation and traditional tax reform had been popularized in economics books and texts by scholars ranging from Henry Simons (1938) at the University of Chicago to Richard Musgrave (1959) at Harvard University to Office of Tax Analysis alumnus Joseph Pechman (1983) and Richard Goode (1976), who published their work at the Brookings Institution.

Eliminating individual and corporate income tax shelters while lowering tax rates gradually became a trade-off that many conservatives and liberals found palatable. Under this banner, a primary coalition for tax reform was formed and would eventually prove quite potent. Even opponents of reform could not comfortably argue for higher tax rates to support a growing tax-shelter industry that let many wealthy individuals and corporations go tax-free.¹⁵

The Turnaround on Taxation of the Poor and Families

Growth in income taxes paid by the working poor and households with dependents was the accidental by-product of a multidecade decline in the relative and real value of the personal exemption (see chapter 3). Because this decline affected most households with the most members, single heads of households and joint-return-filing couples with dependents ended up bearing much greater increases in taxes in the postwar era than had other households.

Almost by accident, the media latched onto some policy analysis I had performed that revealed the extent of the rise in family taxes.¹⁶ The *Wall Street Journal*, *Forbes*, and the *Washington Times*, among others, ran the story, and *USA Today* gave it the banner front-page headline. This publicity helped galvanize liberal and conservative politicians in both political parties. Quoting this research, for instance, Senator Moynihan argued strongly to increase the personal exemption in

a book on the family and, later, on the floor of the Senate (Congressional Record, June 10, 1986, p. S7151; Moynihan 1986). Representative Jack Kemp (R-NY) incorporated substantial increases in the personal exemption in his tax reform proposals. Perhaps most important, Bruce Chapman, who became director of planning and evaluation in the White House office, raised the issue with the president and claimed that without the research "there never would have been a presidential decision to double the personal exemption" (Bruce Chapman, letter to author, July 28, 1985). Thanks to Chapman, the president took a stand in favor of substantially increasing the personal exemption. Meanwhile, social conservatives, including some of the religious right, discovered tax policy.

This proposal quickly became the Reagan administration's principal initiative to help the "family."¹⁷ Family tax policy was on the agenda and would remain there for decades to come. The concern for the poor and for the family combined to inspire the formation of the second major liberal-conservative coalition that later would prove crucial to tax reform. Between 1982 and 1984, however, the coalition had nowhere to go because it had no way to pay for the changes it embraced.

The Debate Expands

The growing problems of the tax system catalyzed the development of widely varied tax proposals in the early 1980s. The proposals diverged on many points but raised the level of the tax reform debate and opened more political room for initiating a tax reform that would succeed.

Consumption Taxes and Flat Taxes

Many proposals went beyond traditional income tax reform. By the late 1970s and early 1980s, economists had revived interest in consumption or expenditure taxes as replacements for income taxes (see chapter 2). The Treasury's 1976 tax reform study, *Blueprints for Tax Reform*, offered both pure versions of income and consumption taxes as superior to current law. Although some consider consumption taxes to be the antithesis of income taxes, in fact a comprehensive consumption tax in many cases would work similarly to a comprehensive income tax.

Both taxes move toward uniformity of treatment, but in different ways. The comprehensive income tax ideally treats all income the same regardless of where it comes from or how it is spent. The comprehensive consumption tax, on the other hand, ideally treats all income spent for consumption the same, regardless of source or use. Thus, consumption tax advocates sought many of the same efficiency goals favored by comprehensive income tax enthusiasts, such as neutrality in the types of assets that might be purchased, but placed more emphasis on efficiency in the choice between saving (or consumption tomorrow) and consumption today, and less on the choice of work versus leisure.

One set of proposals receiving increased attention during the Reagan administration centered on a "flat tax"—which really turned out to be a consumption tax with two rates: a zero rate and a "flat," positive marginal tax rate. Whether applied to income or consumption, consideration of a flat rate tax is as old as economics itself. Indeed, Adam Smith proposed a proportional tax on income on the grounds of fairness. The application of progressive rates to the income tax—that is, average tax rates rising with income—had been a bone of contention since the enactment of an income tax in this country.

The new "flat tax" advocates had more in mind than eliminating multiple rates. They also objected to the various exclusions, deductions, and credits in the income tax. Their goal was similar to that of traditional income tax reform: broadening the base to get the rate as low as possible. In addition, they could advance another tax policy principle—simplification of the tax system—by both eliminating special provisions and applying a single tax rate. The flat rate would allow banks and other payers effectively to pay on behalf of individual taxpayers. For instance, if every individual receiving bank interest owes exactly 15 percent, the bank could pay the exact amount of tax without sending statements to individuals, and individuals would not need to report this income on their tax returns.

Almost all "flat tax" proposals at that time combined consumption taxation with flat rate taxation (see, for instance, Hall and Rabushka 1983). Of course, a flat income tax rate would have been possible as well, but it was generally not in the political mix, except as an abstract academic idea.¹⁸

Both flat rate taxes, with and without the consumption tax base, and consumption taxes, with and without the flat rate, have many merits and problems not examined here.¹⁹ But those outlined above were enough to keep the tax debate just below the boiling point.

Bradley-Gephardt, Kemp-Kasten, and Other Congressional Proposals

Between 1982 and 1984, congressionally developed proposals began to receive attention. Senator Bill Bradley (D-NJ), with Representative Richard Gephardt (D-MO) as a cosponsor, put forward the most important of these, known simply as "Bradley-Gephardt." Unlike most congressional bills, it was both detailed and grounded in technical realism.

Bradley's public leadership on tax reform had been well recognized, and for two unrelated technical reasons, his proposal received more attention than others. First, the proposal resurrected the notion of a comprehensive income tax—one that has a broader base and retains a progressive rate structure. Second, Bradley engaged experts and staff who could stitch together a proposal, yet not one that merely might look good on paper, but wouldn't work in practice. These technical experts helped especially in ensuring that the proposal would not increase the deficit during this time of fiscal stringency.²⁰ The analyses of the Joint Committee on Taxation gave the senator accurate revenue estimates and distributional tables, thus eliminating the problems other proposals faced when oversimplified promises ignored budgetary realities.

The Bradley-Gephardt proposal was followed by a slew of congressional bills favoring tax reform, including the so-called "Kemp-Kasten," "Roth-Moore," "Nickles-Siljander," and "DeConcini-Shelby" bills. Of these bills, Kemp-Kasten was to command the most attention for several reasons. When Jack Kemp got behind base broadening, he effectively put the supply-side wing of the Republican Party behind traditional income tax reform—an approach that wing had avoided in the 1981 rate cuts. A significant portion of all bills, moreover, contained identical elements, making it easier to create a coalition in favor of tax changes that lowered tax rates. Finally, Jack Kemp was a force in the Republican party who would later run for president, and the White House did not want to oppose him publicly.

Common Themes

Perhaps the only theme truly common to all tax proposals of this period was the exchange of lower rates for a broader base—a traditional theme, but one applied more consistently to labor income and uses of income than to capital income. Less consensus was obtained on other issues.

Tax-shelter and tax-arbitrage problems had not yet been solved, yet lower tax rates would make even dubious deductions less valuable. Some consumption tax proposals and congressional proposals, however, would have expanded rather than contracted the shelter market. In all of the proposals with progressive rates, and in some of the flat-rate tax proposals, there were efforts to reduce taxes on the poor and for families with dependents.

The Beginning of the Tax Reform Process—Almost

Amid this swirl of activity, in his January 1984 State of the Union address, President Reagan asked the Treasury Department to prepare “a plan for action to simplify the entire Tax Code” and to present specific recommendations to him by December 1984. Notice the nuances. Not even a proposal was required, simply a “plan for action,” whatever that was. The recommendations were to be made to him, not necessarily to the public, and were not to be released until after the 1984 election. Not exactly a mandate for major reform!

Using hindsight, many of the actors in tax reform claimed to have a strong idea of just what was to develop.²¹ At the time, however, the only sure thing was that the administration did not want a tax reform debate during the election. A number of members of Congress had even laughed during this part of the State of the Union address.

Lack of Direction

The president’s cautious statement gave little basis on which to proceed. In 1984, even the meaning of “reform” was contentious. The administration was still strongly defending its 1981 tax cuts while signing legislation in 1982 and 1984 that contradicted some of the 1981 effort. Many wanted to deepen the 1981 cuts. The flat-tax debate continued apace, and some felt that its time had finally arrived. Several members of the administration, such as OMB’s David Stockman, were trying to maintain congressional focus on deficit reduction and not be distracted by a tax reform that might be revenue neutral.

Opposition to a broad-based income tax on capital income included many high-level administration officials, especially some political

appointees within Treasury's Office of Economic Policy who identified themselves as "supply-side" economists. They knew that the investment credit, plus rapid depreciation, had already reduced the effective tax rate on many types of equipment to almost zero even before borrowing was taken into account. Many of them sought to maintain or even enlarge this negative tax rate, sometimes by "expensing" all capital purchases—writing off costs immediately rather than more gradually. Still others, such as Martin Feldstein, then chairman of the Council of Economic Advisers, were willing to keep an investment credit and vastly accelerated depreciation allowances even if they had to be supported with higher corporate rates. One argument they made was that investment subsidies favored new capital, and high corporate rates collected taxes from returns to capital that already existed. Of course, the logic of this argument can be used to favor ever-higher tax rates and investment credits.²²

A Plan

In March 1984, I returned to the Treasury Department from a sabbatical year of studying capital income taxation and other issues at the Brookings Institution. The role as economic coordinator of the tax reform work fell into my lap. However, the charge to study reform came with no instructions on what tax reform was to entail.²³

As noted, a temporary stalemate resulted from the debate in 1984, so some questioned whether the request for a study should be taken seriously. Several weeks after the president's address, the project had not really gotten off the ground. Sensing the many reasons for a void, I decided to put a plan of action on the table and proposed developing a comprehensive list of more than 20 major "modules" to be studied. These modules centered on such issues as itemized deductions, employee benefits, low-income exemptions and deductions, depreciation and investment credits, energy and minerals taxation, and international tax matters.

After the staff would develop options, each module would be taken to the secretary of the Treasury for approval to proceed, starting with non-capital income issues.²⁴ This gradual approach would help us move forward even while a major source of stalemate remained—whether to further reduce the tax on capital income or to move toward a consumption tax. Much of the early base broadening that was considered would be required under almost all income tax, consumption tax, and flat tax proposals.

My colleagues and I also decided to set tax rates at the end of the process. This would allow incremental decisionmaking on base-broadening issues and encourage Treasury Secretary Donald Regan not to reject proposals that would offend various constituency groups—since rejection at this early stage would prevent us from seeing just how much rates could be lowered with a broad-based tax. That tactic proved sound: the secretary's initial acceptance of eliminating some tax preferences for powerful constituencies (such as the middle- and higher-income elderly population) set the stage for accepting many other attempts to broaden the base. It also meant that no particular issue needed to be decided on grounds of progressivity since the system's overall progressivity would be determined later by adjusting the rate schedule. If the secretary decided to eliminate any particular subsidy, later rate adjustments would cancel out the distributional effects of that decision.²⁵

At the time of the Treasury study, tax reform's future was uncertain. The 1982 and 1984 experiences led me to coin a "hopper" theory of reform. The more good things that get into the hopper, the more good and the fewer bad things emerge in the legislation when Congress finally decides to act. This homespun theory meant that far more than an academic study was required. We ultimately wrote a "how to" manual on how changes could be implemented should Congress move toward drafting a bill. The need for such back-up analysis was plain. For example, simply stating that families with equal incomes should be taxed equally was not adequate. Instead, detailed rules for operating trusts and treating family-member income had to be developed.

Extremely important to the development of the tax reform package was support within the Office of Tax Policy by its three successive assistant secretaries. John E. (Buck) Chapoton had led the fight for base broadening in 1982 and 1984 and convinced the secretary to take on a broader reform effort for the 1984 study. The enthusiasm with which Ronald Pearlman took on the task after replacing Chapoton in mid-year 1984 allowed the reform effort to be comprehensive and rigorous; Pearlman solidly backed traditional reform principles and worked hard to keep the onslaught of special interests at bay. His replacement, Roger Mentz, also fought for traditional tax reform principles, often behind closed doors, as the Treasury's mandate by then was to work quietly and not to criticize publicly and possibly derail developments in Congress. The deputy assistant secretary in charge of the project, Charles McLure, was brilliant in his analysis and writing of much of the study.

Finally, to make the study as comprehensive as possible, we pulled every observation possible from the staff on ways in which the tax base was incomplete or overstated and every idea on how to fix these problems. Comprehensiveness, of course, meant attacking the small, often overlooked problems.

The second advantage of a comprehensive tax study was political. Comprehensiveness may tend to take more special benefits away from more people, but it has a positive side: the opportunity to convince the public that the reform effort was sincere. Tax reform would be an attack, not on particular groups or individuals, but a broad-based attack on inefficient and unfair preferences. Many taxpayers would only be willing to pay the price of tax reform if they believed that they were not being singled out to pay its cost.

The Debut

Although a comprehensive review of the tax code provided direction for the study, other important steps were crucial to its reception and the ensuing debate.

Establishing Principles and Constraints

Step one was setting forth principles and objectives to guide tax reform. The touchstones were fairness, efficiency, greater simplicity, lower tax rates, fair treatment of families and removal of income tax on the poor, and the elimination of favoritism toward one form of investment or consumption over another.

Two constraints on the reform process served these principles. First, a commitment to revenue neutrality meant that revenues would be neither greatly increased nor greatly decreased. Second, distributional neutrality meant that tax burdens among income classes would not shift significantly. Within income classes, on the other hand, reform favored—largely through reductions in tax rates—those benefiting least from special provisions. These revenue and distributional neutrality constraints were pursued largely to allow policymakers to concentrate on the tough choices necessary to reduce inequities and promote the efficient allocation of resources and not get diverted back to the never-ending fights about the size of government and amount of progressivity.

Collecting and Analyzing Data

Another formidable task remained: vast quantities of data needed to be assembled and analyzed.²⁶

Early on, it became clear that constructing distributional tables required fixing a thorny problem related to tax shelters. By limiting shelters, the tax base's top tier could be expanded. But most tax shelter losses were from partnerships or other unincorporated business, and claiming these losses lowered the taxpayer's adjusted gross income and "expanded income," the traditional measures used to classify taxpayers. This way of classifying tax shelter owners made them appear to be in low- or middle-income brackets, where by rights they didn't belong. For instance, someone with \$500,000 of wages would buy into a shelter that gave off \$495,000 of fake losses, so the shelter buyer would end up with a reported net "poverty-level" income of \$5,000. It was necessary to make sure that negative statements of taxable income from these shelters were not used to misclassify these owners within economic-income classes. We achieved this result primarily by imputing some level of economic income to individuals owning different assets and not allowing shelter ownership to, say, reduce a doctor's earnings of \$200,000 toward a total income of \$0.

Picking through the Options

The Treasury's proposals were more thorough, more developed, and more related to what IRS could administer than the congressional proposals that had developed by that time. Policymakers and congressional staff were not remiss. Rather, the executive branch is far more able to muster the needed personnel and expertise to develop major reform packages when many overlapping details are involved.

The congressional plans had many limitations, some of which were being worked out while the Treasury study was being developed. First, the plans were not comprehensive. None of the reforms dealt with abuses derived from entertainment deductions or deductions for "seminars" on cruise ships. Income shifting through children was ignored. Nor did these proposals touch on such complicated issues as multiperiod production (whereby deductions are taken before income is realized); deductions by banks carrying tax-exempt bonds; the taxation of life-insurance, property-insurance, and casualty-insurance companies; international tax issues; the windfall profits tax; tax penalties; and many other provisions. (For a

detailed comparison of proposals, see U.S. Department of the Treasury 1984, 169–83.)

Second, some congressional plans entailed revenue losses and often gave far more away at the top of the income distribution than to other tiers of taxpayers. The Kemp-Kasten proposal was a case in point. The giveaways in this proposal were so great for some capital income items that a significant deficit increase would have resulted. The Bradley-Gephardt proposal was much more forthright in meeting revenue and distributional constraints, though it too was far from comprehensive.

Staying on Course

Initial principles, constraints, data development, and comprehensiveness all helped determine the direction of the tax reform process. The goal of rate reduction, combined with the constraints of revenue neutrality and distributional neutrality, prevented the process from deviating too far from its original path. Here are a few examples.

- *Setting Aside the Consumption Tax Debate.* Although advocates of consumption taxes and of expensing for capital equipment opposed many features of tax reform, they never came up with viable alternatives, largely because such proposals would involve significant reductions in the tax base. In a revenue-neutral proposal, tax rates would have to rise to accommodate the loss in revenues from not taxing capital income. Of course, tax arbitrage opportunities were so intense at the time that, ignoring issues of how the transition would take place, the net cost might have been fairly moderate.²⁷ In any case, many consumption tax advocates were not willing to bite the political bullet and treat borrowing and lending consistently (e.g., if net interest was to be made nontaxable, then interest deductions would not be allowed). This would have constrained some of the revenue loss from any switchover at the time.
- *Abandoning Investment Policy through the Tax Code.* A major difficulty with the investment credit adopted in the early 1960s and the cost-recovery allowances in the Economic Recovery Tax Act of 1981 was that the same subsidy was applied to almost all equipment no matter how fast it depreciated. This one-size-fits-all cost recovery or depreciation schedule created incentives to buy one type of

equipment as opposed to another for tax rather than economic reasons—a terrible idea from the standpoint of industrial efficiency. Once the principles of equity and efficiency were adopted in tax reform, depreciating very different assets at the same rate was hard to justify, and a schedule more related to how long the asset would be used (its asset-life) had to be developed.


- *Abandoning Simplistic Supply-Side Objectives.* Absent base broadening, reducing tax burdens on the poor is nearly impossible in a revenue-neutral bill without increasing average marginal tax rates. In turn, these higher rates dampen incentives (a concern to supply-siders) and, in effect, tax capital income at a higher rate (a concern to those who want to lower the cost of capital). Two ways out of this dilemma are to reduce expenditures or, in the case of capital, to shift even more of the tax burden to labor. Another alternative is to broaden the tax base, but, in practice, the funds base broadening provides can almost always be used to reduce the cost of capital more if they are not spent on low-income individuals. In fairness, not all supply-siders opposed reducing taxes on low-income individuals. This group, like many others unfairly associated with a single narrow goal, was split. That said, the tax-reform objectives on the table in 1984 clearly contradicted the tenets of supply-side extremists whose theories require taxing the first dollars of income the most—hence, taxing low-income people more if that allows greater reductions in top rates and in the tax on capital income.

The stage was now set for full-fledged reform. Political and economic forces had come into alignment, and a process for engineering major tax reform had been established. The ball, so hard to shove up the hill, was now starting to roll down the other side. In the end, no one could stop it.

Tax Reform and Its Aftermath: 1985 to 1988

Who is the figure behind every great man, the individual who knows his ultimate secrets? A father confessor? Hell, no, the tax expert.

—Louis Auchincloss, *The Partners*

 On October 22, 1986, nearly two years after calling for tax simplification in the 1984 State of the Union address, President Reagan signed into law the most sweeping change ever in the income tax, the Tax Reform Act of 1986 (PL 99-514). The Treasury Department released its blueprint for action in November 1984. In May 1985, the administration put forward a revised version. In November 1985, the House Ways and Means Committee produced its draft; the Senate Finance Committee approved a separate measure in May 1986. Hammering out the differences through August, a conference committee produced a report that the House voted on and the Senate cleared in September.

Yet each stage of the process after the release of the Treasury report was similar: first, certain constituencies or policymakers were appeased by new giveaways, then estimates revealed significant revenue losses because of those giveaways, and, finally, new packages restored some revenues by scrambling to find new “reforms” that could be substituted for the ones abandoned.

Onward to Enactment

The new Treasury Secretary, James Baker—who had traded his White House chief of staff position with Donald Regan—led the team that developed the stage two president’s proposals. When the bill went to the

House Ways and Means Committee, Chairman Dan Rostenkowski (D-IL) took responsibility; in the Senate Finance Committee, Chairman Robert Packwood (R-OR) played that role. Each stage of that process was often acrimonious, with the initial givebacks usually to the higher-income groups threatened with the most base broadening. However, because of revenue and distributional concerns, those giveaways required compensating measures, too.

The additional revenue sources that ultimately paid for the giveaways fall mainly into four categories: higher tax rates, double taxation of certain forms of income, new base expansions, and complex backdoor provisions, including a new alternative minimum tax.

- *Higher tax rates* were achieved in several ways. A promised increase from \$1,000 to \$2,000 in the personal exemption was implemented over time rather than immediately. Some tax rates below the top rate were also raised. A proposed statutory tax rate of 25 percent for many middle-income individuals turned into a 28 percent rate by the time the bill passed, which relieved pressure to broaden the base in middle-income brackets.
- *Double taxation of income* was an especially popular way to amend the reform proposal. Proposed moves away from double taxation of corporate income were curtailed and then abandoned. Indexing of realized capital gains for inflation was eliminated, then replaced in the final bill with full taxation of all nominal gains, even those due to inflation. Proposals to index depreciation allowances for inflation were also removed. This full taxation of gains, however, greatly simplified the tax system, at least temporarily, and removed incentives for many types of arbitrage.¹
- *New base expansions* were few. Even the revenue pick-up from expanded capital gains taxation was modest since taxpayers now could realize fewer gains and hence avoid the new higher tax rates imposed only when gains were realized. This issue continued to haunt tax politics after the bill passed, and in later years, the provision for full taxation of realized gains was abandoned.
- *Complex, backdoor provisions* crept into the bill as it neared its final form. In many cases, these provisions sowed the seeds of policy dilemmas and debates to come. The Senate Finance Committee, for instance, created a fourth rate of 33 percent, and then called it something else—a “phase-out of the benefits of the personal exemption

and the bottom tax rate.” The upshot of this doubletalk was that the 33 percent rate created a so-called “bubble”—marginal tax rates fell at the highest income levels after rising in bubble fashion at preceding income levels until there were no more benefits to phase out (see figure 3.6).² Even more popular were increasingly complex means of imposing minimum taxes and limits on loss write-offs.³

- *The individual alternative minimum tax (AMT)*, adopted in 1986, was a backdoor provision that played an ever-increasing role as the nation moved toward the 21st century. Its complexity increasingly affected taxpayers because the exemption levels were not indexed for inflation or real growth in income. Under the AMT, taxpayers were usually required to calculate depreciation and other allowances in a second way. Some deductions and tax breaks were disallowed. Taxpayers calculated their tax using the regular tax base and rates and then again under a different base and different set of rates in the AMT. They essentially paid the higher of the two.⁴ In addition, a business alternative minimum tax forced businesses to pay tax on the higher of taxable income or income reported on financial returns, even when no special tax preference was involved. This requirement came about in reaction to the populist sentiment that corporations reporting positive financial income should pay tax on that income.⁵

What Did Tax Reform Achieve?

Despite setbacks, the political process only partially derailed the type of tax reform the original Treasury study brought forward. In general, Baker, Rostenkowski, and Packwood couldn't move far from the ground rules set when reform began. No one wanted to be known for blocking reform once it became clear that a system could be designed to lower rates and eliminate shelters, remove the poor from the tax rolls, help equalize treatment of individuals with equal income, and even coalesce conservative and liberal support. The tax policy process concentrated decision-making in the hands of Treasury Secretary Baker and the chairpersons of the tax-writing committees. Thus, at each stage of reform, failure would have been attributed primarily to each in turn—which gave each of them a strong incentive not to fail.⁶

The simple recognition of the basic purpose of a tax system must be listed as one of tax reform's major achievements. As the historian Elliot Brownlee writes, "It can be argued that, as a result of the bipartisan effort, the Tax Reform Act of 1986 advanced a process of restoring to federal taxation the sense of balance sought by the founders of the Republic. The act represented a major step in the elimination of tax-based privilege, while reaffirming the duties of citizenship" (Brownlee 1989, 1620).

The Tax Reform Act of 1986 became one of the most sweeping tax code changes in U.S. history. Certainly, it involved the largest reshuffling of incentives and priorities ever achieved in a roughly revenue-neutral act. The rest of this chapter examines in more detail what was achieved, what was left undone, and what new problems were created.

Progressive Taxation and Incentives for Lower-Income Workers

In the end, tax reform proved mildly progressive, at least at the bottom of the income scale (see table 7.1). It reduced the taxation of the poor and low-income individuals through three changes: (1) increases in the personal exemption from \$1,080 in 1986 to \$2,000 by 1989 for all taxpayers and their dependents; (2) increases in the standard deduction, which reduced taxable income for all taxpayers who do not itemize or declare interest payments, state and local taxes, or other allowed deductions; and (3) significant expansion, as well as indexing for inflation, of an earned income tax credit (EITC) for low-income workers with children.⁷

The placement of "family" issues on the tax agenda set in motion numerous other EITC and child credit tax relief efforts through the end of the century and beyond. The tax-reform drafters also made it easier to enact welfare reform a decade later since the growing EITC ensured that work-related subsidies, at least for some, would still be there even as welfare checks were being displaced. The net effect of these changes increased the incentive to work among those not currently working. At higher-income levels where the EITC was phased out, however, the effective marginal rate under the new law was higher than before, and incentives to work were reduced.⁸

As for broadening the tax base, older Americans were gently tapped. The elderly lost their "double" personal exemption and got a less valuable increase in the standard deduction instead. When the continued non-taxability of most Social Security benefits is taken into account, the

Table 7.1. Changes in 1988 Income Tax Liability under the Tax Reform Act of 1986

Income class (thousands of 1986 dollars)	Percentage change in income tax liability 1998	Average Income Tax Rate (percent)	
		Prior law	1986 act
Less than \$10	-65.1	1.6	0.5
\$10 to \$20	-22.3	5.7	4.4
\$20 to \$30	-9.8	8.3	7.5
\$30 to \$40	-7.7	9.5	8.7
\$40 to \$50	-9.1	11.1	10.1
\$50 to \$75	-1.8	13.3	13.1
\$75 to \$100	-1.2	15.7	15.6
\$100 to \$200	-2.2	19.3	18.9
\$200 and above	-2.4	22.8	22.3
Total	-6.1	11.8	11.1

Source: Joint Committee on Taxation (1987, 1718).

Note: These figures do not take into account certain provisions affecting individuals. Thus, total tax reductions are somewhat different from what is indicated in this table.

elderly still paid significantly lower taxes than other taxpayers with equal incomes, but the gap shrunk.

One change—full taxation of unemployment insurance benefits—complemented the tax reductions applied to low-income persons. Under old tax law, low-income unemployed persons received better treatment than low-income workers. Under the new law, the tax burden for low-income persons generally shrunk due to the increased EITC and higher level of tax-exempt income, but the unemployed had more incentive to work.⁹ Thus, lower (or negative for some EITC recipients) rates of tax on earned income and higher tax rates on unemployment income complemented each other to promote work.

Some comparisons reveal the magnitude of the overall changes in tax treatment of low-income workers. For a married couple with two dependents, the tax threshold excluding EITC was about \$7,980 for 1986, but rose to \$12,800 by 1988 under the new law. This new tax threshold was placed above the estimated federal poverty threshold of \$12,092 for the same year (U.S. Bureau of the Census 1990). If the EITC is factored in, the changes are significant. For instance, the average income tax rate (income taxes, less EITC, divided by income) at the federal poverty level for this type of family dropped from 3.3 percent in 1986 to negative 5.3 percent in 1988.

A Reversal of the Trend to Tax Low-Income Workers

From a historical perspective, the 1986 Tax Reform Act began reversing the trend of ever-higher taxes on low-income workers. Federal income tax rates on a family of four at one-half the median income, for example, were zero until 1960. Inflation and real growth then began to push families at one-half the median income into positive tax brackets, and legislated tax cuts before 1986 were not big enough to compensate for the tax hikes. By 1985, the average tax rate for this population reached 6.5 percent. Under the 1986 tax act, the average rate initially dropped to about 5 percent, but then rose again to 5.5 percent by 1990. Moreover, the 1986 act triggered a chain of events leading to higher credits for low-income workers in later years.

Put into perspective, tax reform raised the personal exemption to \$2,000 by 1989, but at that time it would have taken a personal exemption of almost \$7,500 to offset the same relative amount of income as the \$600 personal exemption did in 1948.¹⁰ In addition, Social Security tax increases continued almost unabated. For a family of four with taxable earnings from labor equal to one-half the median income, Social Security taxes and federal income taxes together accounted for 5 percent or less of income before 1960. By 1990, these taxes equaled 13 percent of income (figure 3.9). (Of course, benefits also rose over the years, and the distributional effect of taxes should not be considered in isolation.) An important point is that the lower taxes for low-income workers achieved in 1986 only modestly offset the increasingly higher taxes that the subset of these workers eligible for little or no EITC paid over time.

Rewarding Innovation and Productivity

Tax reform significantly improved the allocation of assets and investment within the economy. The government relinquished much of its role in determining which industries and types of business activity should be favored and which penalized. Effective tax rates across assets were made more equal in 1986, and money followed innovation instead of tax shelters. Table 7.2 presents estimates of effective tax rates on new or marginal purchases of assets for various asset types and categories. These calculations take into account both corporate and personal taxes on returns from these assets.¹¹

Table 7.2. Total Effective Tax Rates on Corporate Investment by Broad Asset Type and by Industry (Tax Reform Act of 1986) (percent)

	Old law	Treasury ^a	Administration ^a	House	Senate	New law
Total	38	34	30	40	39	41
Asset type						
Equipment and structures	29	33	25	38	37	39
Equipment	11	33	24	39	34	38
Structures	38	33	26	37	38	39
Inventories	58	35	44	47	47	48

Sources: Gravelle (1984, 1986).

Note: Calculations assume a 4 percent inflation rate and separate marginal tax rates for corporations, interest income, dividend income, and capital gains. Only effective tax rates on corporate investments are shown here, but the effective tax rates include both corporate and personal taxes. Investment is financed one-third by debt.

a. Calculations for Treasury and administration proposals assume that taxation of dividends on existing shares raises overall effective tax rates on capital.

Not shown in the table is another form of reduction in effective tax rates that is important to the economy but difficult to measure using traditional procedures. Investments are made not just in physical assets, but also in research, better management, and human capital. But for tax-accounting purposes, payments for these intangible forms of capital are difficult to calculate.¹² Lower rates allow more income to be retained by those dynamic firms.

Another group benefitting from reform was made up of new firms and firms that had not recently been profitable. These firms simply would not have enough taxable income to get the full benefits of tax breaks offered to their competitors. Some established firms with little income were also denied tax benefits if their business generated too little taxable income to allow full use of incentives for marginal investments.¹³

This discrepancy helps explain why some companies in basic industries wanted tax reformers to eliminate the investment tax credit. With a large carryover of unused investment credits from previous years, some industries felt at a competitive disadvantage with respect to new investment. Potential new firms, in turn, are always unrepresented in the political process for the simple reason that they don't yet exist.¹⁴

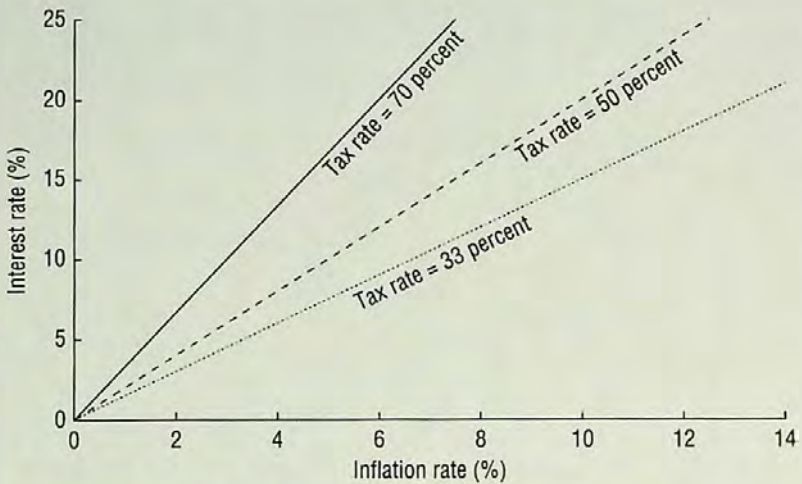
Investment in More Productive Assets

Because of its positive impact on the economy, restoring the market incentive to invest in productive assets was perhaps the major accomplishment of the tax bill. At the extreme, it had been profitable to back mediocre or even losing ventures if either the effective tax rate on equity-financed investments was negative or the after-tax real interest rate was negative (see table 5.1). The 1986 tax act took several important steps to reduce the probability that unproductive investment would be profitable after tax adjustments.

First, the investment credit was eliminated. As a result, so long as the investor wrote off no more than the real cost, acceleration of depreciation allowances by itself could never result in a negative tax rate on equity investments in depreciable assets. Expensing is equivalent under some conditions to a zero tax rate, so any acceleration less than expensing requires writing off the purchase price over time rather than immediately, thus making the resulting positive tax rate less valuable than expensing.

The act also lowered the marginal tax rate. At lower marginal rates, the tax consequences of any miscalculation of income are less important. In the case of interest, the failure to index for inflation means that taxpayers get to deduct more than the real interest costs. However, this extra deduction is less valuable at lower tax rates. (During this period, lower inflation rates also reduced the value of the extra deduction due to including the high inflation component in interest payments. Both lower rates and lower inflation contributed to investment in more productive capital. See figure 7.1.)¹⁵

The 1986 Tax Reform Act significantly reduced the money flowing into shelters that encouraged unproductive investment, just as it reduced other tax arbitrage opportunities by lowering tax rates and by making the effective tax rate positive for more types of equity investments. In addition, the act limited deductions from passive investments¹⁶ and restricted deductions for investment interest payments (e.g., payments associated with an investment account with a stock broker) in excess of investment income. These latter approaches, too, staunched the flow of scarce saving dollars into shelter investments. The sales pitches on financial pages for these now-beleaguered tax shelters soon dropped out of sight, and most taxpayers in the end had much simpler financial planning and tax returns simply because they no longer used these shelters.

Figure 7.1. Interest Rates Necessary to Prevent Unproductive Investments

Source: Author's calculations (see note 11 of this chapter).

The lessons for macroeconomic policy were powerful. Economic stagnation ruled when the combination of high inflation, high tax rates, and tax preferences led to profitable investments in unproductive assets (Steuerle 1985). The monetary and tax policy attack on this combination helped restore economic growth.

Lower Marginal (but Not Average) Tax Rates

As advertised, tax reform did lower the marginal tax rates individuals faced. Average individual rates also dropped. But, lest we lose perspective here, average corporate rates increased. Marginal rates for both individuals and corporations dropped without major revenue loss largely because the tax base expanded. Figures 3.8 and 3.9 show the drop in rates.

The distributional tables eventually presented in tax reform tended to exaggerate the extent of tax reduction, since they showed only the effect on individuals. Some considered this a ruse, since the increase in average corporate tax rates partly paid for the reduction in individual rates.

Because individuals bear the burden of the corporate tax, tax reform did not lower their taxes on net. The switch from individual to corporate taxes was really more the byproduct of an early Treasury decision to keep the top individual rate and the corporate rate close to each other. Then, too, the switch reflected the simple consequence of a reform more heavily attacking business than individual tax breaks.

The Treasury had argued from the beginning that it was seeking a distributionally neutral tax change, counting all provisions together. Once the individual rates were reduced, however, politicians could not help bragging about the tax cut they provided. All politicians' claims of giving something to the taxpayer should be appraised skeptically.¹⁷

Reduced Influence of Taxes on Consumer and Producer Choices

Lower marginal tax rates encourage better use of both time and money. The logic is simple: lowering rates reduces taxes' impact on the decisions of business managers and individual investors. While the 1986 tax reform eliminated numerous special preferences, deductions, and exclusions, many also survived. At the lower rate of taxation, however, the value of deductions was calculated at a rate of 33 percent or less for individuals and 34 percent for most corporate income instead of such rates as 50 percent (the former top individual rate) or 46 percent (the former rate applying to most corporate income). With lower marginal tax rates in effect, taxpayers became more likely to invest directly in equities or savings accounts. Before reform, large potential tax savings from various portfolio strategies subsidized the use of additional financial middlemen for nonproductive transactions. While there is no good estimate of savings lost to these additional transaction costs, the amount was probably substantial. For instance, many tax shelters ultimately used 80 percent or less of the money originally invested to purchase assets, with 20 percent or more going to brokers, salesmen, lawyers, and accountants. As tax savings fell relative to transaction costs after reform, taxpayers became more likely to avoid those additional costs by channeling saving more directly into investments requiring fewer middlemen.

Some Simplification

The 1986 Tax Reform Act simplified financial management in various ways. The reduced influence of taxes on economic decisionmaking made

life simpler for the saver and investor, who could now concentrate more on economic issues and less on tax issues.

Among the major simplifications the tax reform achieved was the virtual elimination of trusts for tax-planning purposes. Certain record-keeping and tax calculations became unnecessary for taxpayers no longer eligible for certain deductions. The increase in the standard deduction meant that far fewer taxpayers had to keep the records needed to itemize their tax returns. In addition,

- fewer individuals needed to keep track of medical expenses;
- sales tax receipts no longer had to be kept, nor did sales tax deduction calculations need to be made;
- less recordkeeping was required of those with employee business expenses, expenses related to producing investment income, and other miscellaneous itemized deductions;
- income averaging, second-earner expenses, political contribution credits, and dividend exclusions no longer had to be calculated; and
- capital gains became easier to calculate, and the game-playing induced by a capital gains preference was largely, if temporarily, eliminated.

Other Gains

Tax reform was so comprehensive in its scope that many improvements are given only scant attention in this book:

- the standard deduction for single heads of households¹⁸ was increased;
- the lower tax rates reduced the inequity between those who could still use deductions and those who could not;
- preferences for certain (intangible) oil and gas drilling costs and for state and local bonds used to finance private, rather than governmental, activity were limited in the alternative minimum tax;
- many industry-specific exclusions and deductions were limited or eliminated;
- tax subsidies for meals and entertainment associated with business were restricted;
- because of lower tax rates, reform lowered the federal subsidy to all state and local borrowing, not just the borrowing for private purposes that was more formally restricted;¹⁹ and

- other inequities were pared, such as for large prizes or awards, in-kind assistance for services rendered to educational institutions, and a few other types of formerly nontaxable income.

Summarizing the Gains

One measure of tax reform's success can be taken in its impact on tax expenditures. Remember that a basic thrust of traditional tax reform is to eliminate or cut back on expenditures hidden in the tax code so rates for individuals and corporations fall and personal exemptions for individuals increase.

With this in mind, John Witte (1991b), a political science professor at the University of Wisconsin, estimated that the Tax Reform Act of 1986 tightened 72 tax expenditures, while 14 tax expenditures were eventually repealed—a figure approximately equal to the total that had been repealed from 1913 to 1985. Of course, this can be contrasted to the proposals put forward in the original Treasury plan, which advocated repeal of 38 tax expenditures (Witte 1991b).²⁰ The largest income tax reform in U.S. history still could have been much larger. In another analysis, Thomas Neubig and David Joulfaian (1988) of the Treasury staff examined the reform's effect on tax expenditures. Figure 7.2 summarizes their estimates that tax reform produced the equivalent of an annual net reduction of \$193 billion in expenditures in the tax code for 1988.

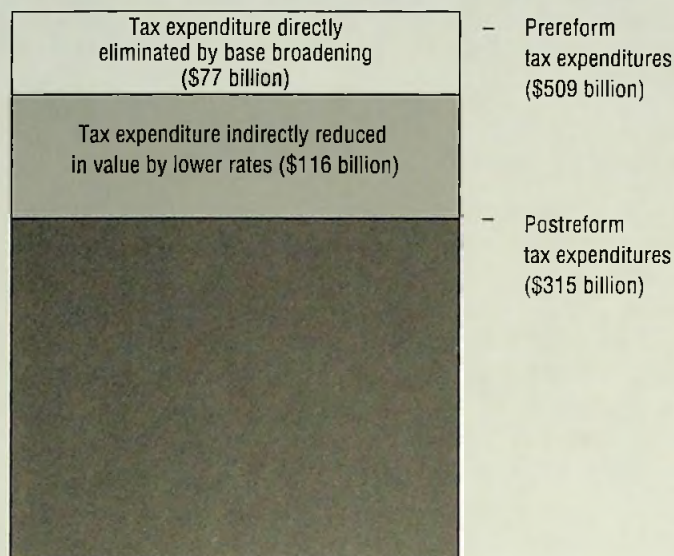
Failures of the 1986 Tax Reform Effort

As Witte suggests, despite the successes, a number of proposals were never actualized. Many inefficient and inequitable differentials in taxation remained, and new problems were created. These sources of neglect and failure would come to haunt tax policy deliberations not long after the major overhaul of 1986 passed.

Limited Base Broadening for Individuals

A major failure of the tax reform was that the base of taxable income for individuals, while expanded significantly, was still far smaller than it needed to be. As a result, tax rates remained high, as did losses of economic welfare arising from arbitrary distinctions between taxed and untaxed activities.

Figure 7.2. Total Tax Expenditures before and after Tax Reform
(at 1988 Levels of Economic Activity)



Source: Neubig and Joulfaian (1988).

Note: Details do not add up to total due to rounding.

Undue attention to the top rate had left insufficient attention to reducing other rates and to removing many middle-class preferences as a means to finance that exchange. Essentially untouched were most nontaxable employee benefits, nontaxable transfer payments, deductions of state and local taxes, and mortgage interest payments, which together make up most of the tax benefits granted to individuals.

Whether to treat the full taxation of capital gains as base broadening is debatable. In many cases, the failure to account for inflation meant that taxpayers (such as mutual fund owners) would be taxed on more than their real income when inflation increased asset values. Of more relevance here, any increase in tax rates on capital gains was significantly offset by a lower rate of realization. By some estimates, net taxes on capital gains decrease when rates increase in certain ranges. Other estimates predict a modest increase, but all conclude that a higher rate means fewer realizations.²¹ Thus, even though estimates may vary, they

all indicate that the extent of any base broadening for those reporting capital gains is limited because this discretionary tax can be avoided.

Some elements of tax reform are wrongly viewed as base broadening. The so-called phase-outs of "the benefits of the bottom brackets" and of the personal exemption, later called the "bubble effect," were simply disguised rate increases.

Lack of Indexing of Capital Income Measures for Inflation

When it drafted the 1986 tax bill, Congress ducked the problem of indexing capital-income measures to account for inflation. Accordingly, future changes in the inflation rate continued to wreak havoc on the effective tax rate applied to various forms of investment income. John Makin and Michael Allison (1986) estimated that inflation indexing in the mid-1980s effectively would have been worth several hundred billion dollars to the economy over time.²²

Although the failure to index creates significant economic problems, the implementation of indexing is difficult. The calculations, for instance, become quite complex for financial institutions and financial intermediation (Halperin and Steuerle 1988). The complexity of indexing was perhaps the major reason for its rejection in tax reform, and lower inflation rates since then have further sidelined the issue.

Other Neglected Issues

However comprehensive the Tax Reform Act of 1986, Congress failed to address many relevant tax issues. First, though the legislation contained important pension changes—notably to individual retirement accounts, rules regarding 401(k) plans, and the ways to integrate private pension plans with Social Security—pension policy was never examined holistically.

Second, though many scattered international tax issues were raised during tax reform, most enacted final provisions were not based on any thoroughgoing notion or acceptance of how international tax issues should be treated over the long run.

Third, to keep some preferences on the books, Congress quickly abandoned the plan to partially integrate corporate and individual income taxes as the original Treasury proposal suggested.²³ Riddling the new tax system, therefore, were many problems associated with taxing corporate income twice—the encouragement of debt rather than equity financing,

the legal problems of distinguishing between dividends and interest, and the discouragement of corporate (as opposed to noncorporate) ownership. Corporate integration would come to the fore again more than once before achieving mixed legislative success in 2003.

Little or No Decrease in the Cost of Capital

The Treasury had proposed a combination of changes that would have reduced the effective tax rate on capital investment—the rate that results when individual and corporate statutory rates are combined, while taking into account the effect of depreciation schedules, other preferences, and penalties. As tax reform worked its way through the political process, the effective tax rate on returns from capital investment was increased. This offset some of the gains from the more neutral taxation of different forms of capital investment. Table 7.2 shows estimates at the time that the 1986 law yielded a higher effective tax rate on capital income than the old law.²⁴

The net effect was moderate, and, as it turned out, reductions in the rate of inflation over time provided offsetting reductions in the cost of capital or effective tax rate.²⁵ Whether in the end the rate went up slightly or down slightly—as opposed to table 7.2, the estimates in figure 3.12 show a slight reduction—less was accomplished than could have been.

Interestingly, a common perception in 1986 was that business had succeeded in arm-twisting Congress to lower effective tax rates on capital, at least relative to the Treasury Department's initial proposals. That perception was wrong. True, some compromises helped certain types of investment escape taxation temporarily. But to get this gain, negotiators acquiesced to an effective tax rate increase on many structures and inventories and on the returns to invention and "ideas." The trade-offs generally increased the cost of capital because what had been abandoned (especially indexing) was worth more over time than what was gained (some faster write-offs of depreciation).

While some economic achievements were limited, researchers found that tax reform did not hugely affect aggregate investment or consumption (Slemrod 1990). The principal behavioral changes noted were improvements in the allocation of consumption and investment, such as the dramatic decline in the use of tax shelters. Still, whether due to reform or not, total investment and domestic saving increased after tax reform, and economic growth accelerated. This development was especially remarkable

since economic growth often slows after the economy has expanded for several years, as it had by 1986.

Backdoor Complications and Complexity

Political constraints on direct ways to broaden the tax base meant more and more revenues to finance rate reduction had to come in through the back door. Congress not only failed to index the measure of capital income for inflation but failed to make appropriate adjustments for the continual decline in the real value of moving expenses and costs of child care that could be counted toward a deduction or a credit. These allowances had long ago been set in nominal terms and not adjusted for inflation. Congress also went further and increased taxes in a way that was complicated by design—partly to befuddle opponents, make costs difficult to calculate, and otherwise hide the manipulation of the tax code to achieve political objectives. Even when backdoor approaches are attempted for honorable distribution, equity, or appearance reasons, they often make the tax code more complex.

The Alternative Minimum Tax

The new alternative minimum tax arrived through the back door in unsightly garb. For individuals, the principal items denied deduction under the AMT (even though deductible under the regular tax) were personal exemptions, miscellaneous itemized deductions, and state and local tax deductions.²⁶ In effect, personal exemptions—say, for taking care of a dependent—were treated as if they were tax shelters! Even though miscellaneous itemized deductions were subject to abuse, some were legitimate and had been pared already in the regular tax. And, while state and local taxes might be considered payments for services received from states and localities, Congress did not need to reduce or eliminate the state and local tax deduction in such a complex manner or through the back door. Lesser items were also needlessly complex: a tiny adjustment to normal depreciation allowances might have provided the same revenue gains as the contorted alternative calculation of depreciation allowances under the AMT.

Interest Payments

Various forms of interest payments were also limited in needlessly complex ways in the 1986 reform. Personal interest payments on automobile

loans and credit card balances were no longer deductible. On the other hand, mortgage interest was (and is) deductible for up to \$1 million of debt on a primary mortgage and \$100,000 on a second mortgage, but only for a taxpayer's first and second residences.²⁷ An effect of this new design was to encourage taxpayers to move from house to house as the primary mortgage on one house was paid off or the house increased in value. A reason for the high separable limits and the separation of consumer interest was that President Reagan had earlier sworn that the home mortgage deduction would remain untouched.

International Income

The taxation of international income became extraordinarily complex and the bane of tax accountants. Some complexity resulted from the drive to achieve a revenue target rather than a target based on principles. On the other hand, some complexity was simply unavoidable: attributing costs and income to various affiliates and subsidiaries operating in multiple jurisdictions at different exchange rates is necessarily complicated. The simple lack of a consensus on how to tax and measure the income of multinational companies and their owners also boggled the process.²⁸ The difficult issue of transfer pricing—how to account for intracompany transfers of know-how and other items—grew in importance over the years as well, although this likely would have occurred to some extent with or without tax reform.

How Complexity Arises: An Example

The treatment of minors' income illustrates how tax reform increased equity and simplified tax planning but complicated tax filing unnecessarily. To simplify the taxation of trusts, the initial Treasury plan tried to reduce tax-motivated transfers of wealth to children through trust instruments.²⁹ Reducing these incentives and requiring children who had received sizable financial transfers to pay tax on the income from those assets at the tax rate of the parent (rather than at their own lower rates) would have greatly simplified planning and removed many wasteful transactions.

Also proposed—and this would have avoided some of the resulting complexity—was that minors be allowed to retain their own personal exemption. In typical cases, then, only capital income in excess of the

new personal exemption of \$2,000 would be taxed. At an interest rate of 5 percent, for instance, this would require \$40,000 in assets or more—an amount likely to be reached only through sizable transfers from parents, guardians, or other taxpayers.

As reform wound through Congress, however, various giveaways in other parts of the tax code resulted in a shortfall of revenues. Some congressional tax analysts noted that on pure equity grounds there was little justification for allowing personal exemptions for a dependent twice—once to the head of household or parent, and once to the dependent. They then proposed eliminating this second personal exemption and leaving only a small standard deduction.

This amendment to the Treasury approach to taxing trusts significantly increased the complexity of filing tax returns. The additional personal exemption for minors was not fundamentally a matter of equity but of simplicity. The amended rule meant that hundreds of thousands of children with only modest assets had to file tax forms. To add to the complexity, some income was taxed at the child's rate and some at the parent's rate.

In this classic case, the political system simply accorded too little weight to the value of administrative efficiency and simplification. Children with moderate wage income from a summer job (which ate up their small standard deduction) needed to file and pay tax at their parents' rate on a few dollars of interest from a small checking or saving account. Without doubt, after 1986, many children with income and their parents violated this provision, often without knowing it.

The Aftermath to Tax Reform, 1987–1988

For two years after President Reagan signed the 1986 tax reform package, legislative activity was notably muted. Many tax practitioners, hard-pressed to absorb all the changes, felt that the tax code should be left alone. Some tax reform advocates, such as Secretary of the Treasury Baker, also feared a counter-attack against reform and did not want to open up tax reform issues that had just been settled.

In addition, the economy performed remarkably well during the years after tax reform. All the predictions of a reform-driven downturn turned out to be false. Instead, the economy grew at 3.4 percent in 1986 while reform was being anticipated, then at 3.4 percent in 1987 and 4.2 percent

in 1988 (Economic Report of the President, February 2002, table B-4). As this growth combined with the slow descent of Department of Defense spending as a percentage of gross domestic product after its 1986 peak, the nominal deficit declined from \$221 billion in FY 1986 to \$150 billion in FY 1987 (OMB 1990, A-281). This remarkable drop temporarily spared politicians from tackling the nagging issue of debt and deficit policy.

A strong economic performance, the lack of a crisis, and the desire to "leave the tax code alone" reinforced perhaps the strongest political tendency in 1987 and 1988—to delay major decisionmaking until after the 1988 election. Yet, even in this environment, not all tax legislation could be avoided. Legislation in 1987 and 1988 consisted of modest attempts to reduce the size of the deficit mingled with deficit-neutral attempts to change social policy.

The Deficit Reduction Act of 1987

In 1987, there initially was little appetite for enacting any major tax legislation after the three years of intense political battle leading up to tax reform. Nonetheless, under the Gramm-Rudman-Hollings budget rules then in effect (named after Senators Phil Gramm [R-TX], Warren Rudman [R-NH], and Ernest Hollings [D-SC]), the deficit would have to be reduced through legislation or the president would be required to sequester funds from most government agencies. The latter course of across-the-board cutbacks was so arbitrary and excluded so many saner options that most observers viewed it as impossible to implement. The political momentum to comply with the rules, moreover, was weak, and Congress could always vote to avoid them.

By late 1987, the economy itself was to puncture this complacency with a nosedive in the stock market. On October 19, the Dow Jones average dropped 508 points in one day to a level of 1,739—a drop that followed a decline the previous week of 235 points. On a percentage basis, this one-day drop of 22.6 percent far exceeded the 12.8 percent drop of October 28, 1929 (*Wall Street Journal*, October 20, 1987, p. 1). The lingering fear that inaction in 1929 had contributed to the Depression made swift corrective action politically necessary. The monetary authorities immediately added liquidity to financial markets by increasing the money supply and lowering interest rates, while the White House and the Treasury Department moved quickly to ensure passage of a

deficit-reduction package. The momentum to "do something" in a crisis often is more important politically than what is done: in this case, a potential downturn was fought not by Keynesian fiscal stimulus through higher deficits, but by the opposite, deficit reduction, to remove fears in financial markets that the government budget was out of control.

The resulting Omnibus Reconciliation Act of 1987 was achieved largely through a chaotic bargaining session involving congressional leaders, committee heads, and members of the administration. Despite the political inertia of early 1987, the act turned out to be the largest of those enacted and sustained in the 1987–89 period, if measured by the amount of revenues involved.

The conferees' main goal in those uncertain times was to minimize political damage by making tax changes that individual taxpayers would scarcely notice. To wit, the only significant items finally passed that affected individuals' income taxes directly were the simplification of the mortgage interest limits and an increase from 80 to 90 percent in the current year's tax liability that individuals must pay during that year (rather than by April 15) to avoid penalties. The latter move, like many taken to reduce the deficit for a short period, had almost no long-run effect on revenues. It simply speeded up payments slightly.

Under the 1987 act, businesses were to bear increased burdens, both financial and transactional. The changes entailed modest reform in a few cases, such as improved reporting of income related to installment sales and to contracts not yet completed. Attempts were made to tax corporations more by deterring corporate conversions into forms that reduced tax liability,³⁰ placing limits on carry-over losses after an ownership change, and cutting back on corporations' allowable deductions for dividends other corporations pay. Closing loopholes created in the 1986 act also brought in significant revenues.³¹

All in all, the 1987 act raised between \$14 billion and \$16 billion in each fiscal year from 1989 through 1992, or about 0.3 percent of GDP in years with deficits ranging from 3.0 to 3.4 percent of GDP. On net, the 1987 act could be considered tax reform in that it did broaden the tax base (OMB 1990, 4–4). Also, the deficit decrease achieved through tax increases significantly exceeded any decrease achieved through cuts in expenditures. Following the deficit reduction tradition that marked the 1980s, the tax committees delivered while the expenditure committees did not.

The Election Year of 1988

Action to reduce the deficit all but stopped in the election year of 1988, with one exception. The Technical and Miscellaneous Revenue Act of 1988 provided technical corrections to and minor simplifications of the 1986 tax reform bill, extensions of expiring provisions, special-interest concessions, and restrictions on the use of life insurance sold mainly to defer tax on investment income. It also contained a special tax break for those purchasing U.S. savings bonds spent for educational purposes. The last item was advocated by then-Vice President George H. W. Bush, but, like many social tax expenditures backed by Republicans, received substantial bipartisan support, including that of Senator Ted Kennedy (D-MA), whose staff was quite active in drafting the legislation.³²

Social Policy Changes

The future of tax policy was defined by effective tax changes implicit in social policy as much as by direct tax changes. In 1988, Congress attempted to expand social programs in a pay-as-you-go, or deficit-neutral manner—where, say, an increase in social spending had to be covered by tax increases or cuts in other social spending. One such change, the Family Security Act of 1988, raised a small amount of revenues to expand welfare programs by crimping the availability of the dependent-care tax deduction for children age 13 to 15 and by requiring taxpayer identification numbers, first required for dependents age 5 and over in 1986, to be extended to even younger ages. This led to a significant reduction in the number of dependents falsely claimed on tax returns (OMB 1990, 4-6 to 4-7).³³ The revenue gain of this last change was substantial relative to the small administrative change involved. Cutbacks in other welfare benefits paid for much of the rest of the change, as did mandates that states require a certain percentage of welfare recipients to work—a harbinger of welfare legislation in the 1990s.

Catastrophic Health Insurance for the Elderly

A much more elaborate attempt to extend social policy was made through the Medicare Catastrophic Coverage Act. In early 1987, the president

proposed modestly expanding Medicare benefits.³⁴ Congress quickly decided to take advantage of this crack in the door and moved to expand Medicare benefits more extensively. The final act, initially passed in 1988, expanded catastrophic benefits for the elderly by approximately \$7 billion in the first year or two and later by large multiples of that amount. The cost was to be covered in large part by a surtax on the income of the elderly, with rates rising over time from 15 to 40 percent or more of income tax liability.

By 1989, the act was repealed, partly because its design embodied a failed concept of tax policy. In enacting catastrophic health care legislation for the elderly and disabled, Congress pursued worthwhile objectives without devoting adequate attention to their financing and administrative costs. This series of enactments provided important lessons to future Congresses on using the tax code to back up social policy changes. As we shall see, in the early part of the 21st century, Congress imposed another tax on the elderly to pay for part of another health benefit expansion, but it avoided the use of a direct income tax surtax.

The act's rapid repeal also illustrated the continued power of elderly constituents. In a furor, some attacked the car of House Ways and Means Chairman Dan Rostenkowski with such signs as "Seniors for Repeal of the Catastrophic Act." One elderly woman even threw herself on the car's hood (*Chicago Tribune*, August 18, 1989). Though Rostenkowski escaped on foot, any inclination toward making the elderly population pay for additional benefits—at least in the short run—was thwarted.

Two related errors proved fatal. First, Congress had lost sight of what had become "ordinary" medical expenses. Second, collecting an additional premium or surtax for the Medicare system through the income tax system would have tied both systems into knots and created fundamental administrative problems. The first error led to the second by forcing Congress to find some means of paying for not just extraordinary, but many ordinary, expenses.

The real lesson from the 1988 experience is that there is no substitute for getting things right the first time. In the case of catastrophic care, the financing side should have been given weight at least equal to the benefit side from the beginning. Congress cannot, or at least should not, continually impose new administrative complexities on taxpayers and the IRS simply to achieve a relatively minor benefits-redistribution goal. Grafting a monthly benefit system onto an annual collection (income tax) system also made little sense.

In the end, perhaps the 1988 Medicare legislation simply filled a void—giving Congress something to do in an election year when it was clear that the Reagan era was ending and most presidential candidates, Republican and Democratic, were promising or at least implying that they would have a softer touch when it came to social issues. Indeed, under the next president, George H. W. Bush, domestic spending increased significantly, but despite his initial intentions, tax increases were not left off the table.

“No New Taxes?” 1989 to 1992

We do not have, and never had, and could not have a “voluntary” tax system.

—Donald C. Alexander, former commissioner of the Internal Revenue Service

The first year under a new president is often considered a honeymoon period with a high probability for legislative success. Yet when the new president of the same political party succeeds a popular two-term maverick, the ante is high. George H. W. Bush pledged to be both different than his predecessor, yet more Reagan-like than Reagan himself: he campaigned for both a “kinder, gentler” nation (than under whom, perhaps Reagan?) and “no new taxes.” These campaign promises left him open to restoring discretionary spending to higher levels in the previous administration and avoiding tax increases either to cover the costs or deal with the large deficit problem that remained at the end of the 1980s.

Initial Inaction on the Deficit

After the election, both the executive and legislative branches of government essentially agreed to defer decisionmaking on getting the long-term budget under control. On the tax front, initial efforts were put into the small Omnibus Budget Reconciliation Act of 1989, which increased taxes about \$3 billion to \$5 billion per year or less than one-tenth of 1 percent of the gross domestic product (OMB 1990, A-50 to A-51). Some small excise and social insurance tax increases were enacted, new legislation

sped up some corporate payments, a generous give-away for employee stock ownership plans (ESOPs) was cut back, and the corporate minimum tax calculation was simplified somewhat.¹

At year's end, skepticism reigned. Years of budget games had left a sour taste in all participants' mouths. Many in Washington believed that most tax and expenditure changes within the deficit agreement were "smoke and mirrors" or, at best, temporary speed-ups in revenues or slowdowns in expenditures. Despite three years of supposed deficit-reduction activity, the amounts involved were small enough that the deficit remained a significant problem. The failure to stick with deficit reduction during the prosperous late 1980s slowed the march toward low deficits. Yet the deficit had fallen from a peak of 4.9 percent of GDP in fiscal year 1983 to about 4.3 percent in fiscal years 1984 to 1986, to 3.1 in 1987 and 2.4 by 1989 (2002, tables B-1 and B-82). Since 1981 tax cuts were still being implemented in 1984, this progress was significant. However, at the end of a historically long period of economic expansion, this deficit was still fairly high, and, as it turned out, this recession-free period was ending.

A Turn Back to Deficit Cutting

By early 1990, the deficit began widening once again relative to the size of the economy. On the heels of the higher-than-normal economic growth rates of 1987 and 1988 came subnormal growth rates as 1990 approached. A federal bailout due to the wholesale crash of the savings and loans industry only exacerbated these deficit increases. By mid-1990, a recession hit. Lower growth rates, in turn, translated into decreased revenues and increased outlays for social safety-net programs. The final deficit figure for fiscal year 1990 was 3.0 percent of GDP, and for fiscal year 1991, the estimated deficit rose closer to 3.6 percent.

To the credit of both the president and Congress, an agreement was reached to try to reduce the deficit by \$500 billion over five years. Work toward compromise began not long after President Bush finally abandoned his "no new taxes" campaign pledge. President Bush also intimated that he would accept further sizable cuts in defense expenditures as a percentage of GDP, which in most years since World War II had been the primary way either to pay for domestic policy expansion or reduce the deficit. Democratic leaders quickly backed him, including Dan Rostenkowski, chairman of the Ways and Means Committee, as did many Senate Repub-

licans. Many House Republicans were more reluctant, and a House revolt led by Newt Gingrich led to temporary defeat in October 1990.

Measured simply in terms of reducing the deficit, the budget summit between the executive branch and Congress must be labeled a success. The scheduled rise in U.S. debt relative to national income could not continue forever, and the summit led to annual deficit reductions of 1 to 2 percent of GDP. Both Congressional Budget Office and Office of Management and Budget figures initially projected that deficits would decline relative to the size of the economy—though not for the first couple of years.²

Any thought of euphoria over these moderate budgetary gains would be quickly dissipated. The initial projections were optimistic because, as is usual in this type of budget exercise, it was assumed that no new emergencies would arise. But by mid-1991, OMB would raise five-year deficit estimates by over \$200 billion to account for further losses due to guarantees of saving and loan deposits and the now-established fact of recession (OMB 1991, 1). Moreover, even though intermediate-term deficits would eventually shrink, longer-term problems, especially financing for Medicare and Social Security in future decades, stubbornly remained.³ In effect, the day of reckoning for longer-term budgetary problems was simply delayed, even though most of the deficit reduction was real and the package was one of the largest in peacetime history.

By far the most important impact of the 1990 agreement was not what it did immediately to taxes and expenditures but what it prevented in the future. The 1990 agreement laid down the budget rules—the Budget Enforcement Act—that guided much of budget policy for most of the 1990s. These rules limited various expenditure increases significantly and required putting tax and entitlement spending on a pay-as-you-go (PAYGO) basis. Under PAYGO—which will be examined in more detail below—bills containing increases in entitlements or other mandatory spending or decreases in revenues would face procedural objections to consideration unless accompanied by offsetting entitlement cuts or revenue increases.

A Lack of Guiding Principles

The 1990 budget agreement contained the most important tax or budget changes since the Tax Reform Act of 1986. Like the 1986 act, securing the president's early backing helped ensure enactment. Once he became

committed, failure would have reflected badly upon him, as well as upon Democratic leaders who had pushed hard for deficit reduction and derided him for his pledge not to increase taxes. Outside this common element, the two bills were developed in very different ways.

Except for reducing the deficit by a target of almost \$500 billion over five years, almost no guiding tax principles or expenditure goals accompanied the 1990 budget proposal. There was a call to bargain over deficit reduction, but with no administration or congressional blueprint. Even the \$500 billion target was set with no particular ceiling on government's long-term debt or future interest payments. In this vacuum of principles, negotiators often embraced the normal political pull to enact the least politically offensive changes possible.

The president separately pushed hard for a capital gains tax cut, but not with the stated purpose of eliminating the double taxation of income or encouraging saving in an efficient and equitable way. Thus, those bargaining over an agreement had few guidelines for deciding which taxpayers or expenditure recipients should bear the costs of deficit reduction, and who should receive even more tax breaks, such as a capital gains tax reduction, along the way.

By way of contrast, the 1986 tax reform proceeded from principles—in particular, equal treatment of equals and efficiency. These principles made it easier to lay out which tax expenditure programs could be reduced or eliminated. The principles also limited other changes from being jammed through the tax system. Distributional constraints established early kept the focus trained on the real targets of the 1986 legislation. These constraints helped channel congressional energy into very specific traditional tax-reform goals. In 1990, tax changes lacked such momentum and direction.

Not surprisingly, a bargaining process guided by few principles led to surprises and unexpected obstacles. For instance, the Bush administration was taken aback when the Joint Committee on Taxation began to prepare tables of one tentative agreement's distributional effects. These tables showed that the tentative agreement would require a greater percentage reduction in after-tax income from lower-income than from higher-income households. Although these tables can mislead, they nonetheless helped to mobilize opposition, especially among a coalition of those advocating on behalf of the poor and Democrats and Republicans who opposed any tax increase. Together, this coalition temporarily defeated the initial agreement struck by the leaders of both parties.

With no conceptual or political groundwork laid, the choices among tax and expenditure programs often seemed more arbitrary than necessary. The amount of an increase in consumption or income taxes normally bore little relation to energy and health policies, government incentives and disincentives, or tax policy principles. And with some exceptions, expenditure program cuts were based neither on simplicity nor efficiency.

Sources of Deficit Reduction

Despite these limitations, the Omnibus Budget Reconciliation Act of 1990 (PL 101-508) ranked among the largest and most successful acts in the entire deficit-reduction period from 1982 to 1997. Once again, the tax-writing committees did much of the work. Outside of defense cuts, the final agreement followed the pattern of the deficit-reduction bills of 1982, 1984, and 1987. Excluding interest savings and deficit cuts "promised" in the bill but left for future Congresses to enact, table 8.1 shows that almost 50 percent of total deficit reduction came from taxes, fees, and premiums—that is, higher charges rather than lower outlays or direct expenditures. Cutbacks in gross domestic expenditures, on the other hand, totaled only about 7 to 17 percent of the package. (The principal difference between these calculations and those presented in official budget documents is that here fees and premiums are treated within a broader category of "taxes, fees, and premiums," instead of as negative outlays.) Factoring in some expenditure increases, the cuts in domestic expenditures accounted for only 7 percent of the total deficit reduction. Another 10 percent came from attempts to regulate prices and payment levels to service providers, particularly those paid through Medicare and Medicaid.

Strictly speaking, cutbacks in gross domestic expenditures may not even have added up to the small amounts noted. Many increases in user-related taxes and user fees went directly into trust funds (such as for highways) and not into general revenues. Since trust funds are generally saved to be spent later, this accounting tactic meant that some gains likely were temporary, as future Congresses spent any build-up in funds.

Despite limited success in reducing spending directly, the 1990 agreement was generally able to control spending. How? The 1990 budget rules eventually *slowed the growth rate* in domestic discretionary expenditures,

Table 8.1. 1990 OBRA Budget Agreement: Slicing the Pie
(billions of dollars)

	Total	Percentage
Taxes, fees, and premiums	181.0	48.9%
Net change, income tax base provisions	-15.4	
Income tax base erosion (-27.4) ^a		
Income tax base expansion (12.0)		
Income tax rate increases ^b	40.2	
Employment payroll tax increases	41.5	
IRS enforcement and penalties	11.2	
Excise tax increases, not user-related ^c	42.1	
User-related taxes and fees ^d	61.4	
User-related excise taxes ^e (27.0)		
User fees (19.4)		
Other premiums, contributions for pensions, health, and housing programs (15.0)		
Net cutbacks in gross domestic expenditures	27.2	7.3
Attempts to regulate prices or expenditures	37.4	10.1
Defense cuts first three years + estimated carryover to fourth and fifth years ^f	124.8	33.7
Total, current legislation	370.4	100.0
Other		
(Promises ^f mainly fourth and fifth year defense/domestic cuts)	57.6	
Interest savings	68.5	
Total	496.5	

Source: Author's calculations based on Congressional Budget Office preliminary estimates of the Deficit Reduction Reconciliation Conference Agreement, October 1990.

- a. Includes \$18.2 billion progressivity offset and \$9.1 billion in miscellaneous tax incentives.
- b. Includes \$11.2 billion personal income tax rate increase, \$10.8 billion personal exemption phaseout, and \$18.2 billion limit on itemized deductions.
- c. Assumes no increase in transportation spending because of new motor fuels taxes.
- d. Ignores increases in user-related activities (e.g., new air traffic control) because of new user-related taxes and fees.
- e. Assumes that half of motor fuel taxes are put in trust funds, half are treated as general revenues.
- f. Assumes that defense cuts in first three years yield half of savings committed for fourth and fifth years (i.e., half of \$115.2 billion), even without major changes, and that the other half represents new "promises" under revised budget procedures.

mainly by constraining new domestic spending proposals. In other words, the 1990 agreement was a precursor to a period of limited discretionary spending increases and little new entitlement legislation.

When it came to taxes, the 1990 budget act did little to expand the corporate or individual income tax bases. Weary of that route after taking it throughout the 1980s, Congress looked elsewhere for revenues. In fact, excluding "progressivity enhancements" for low-income individuals, the bill created new special preferences for oil and gas development and other activities that, collectively, almost offset the revenues picked up from a few base expansions, such as another round of tax changes paid by insurance companies. Although the tax reform dam still held, new holes were chiseled and new leaks developed. Tax legislation through the rest of the decade would follow the 1990 abandonment of 1980s-style reforms.

A significant source of new funds came from significant attention to revenues and fees within pay-as-you-go programs and trust-funded programs. Employment payroll taxes were increased by raising employer fees to cover unemployment insurance, by subjecting a bigger share of wages (up to \$125,000) to the Hospital Insurance (HI) share of the Social Security tax, and by expanding Social Security and Medicare tax coverage for some state and local employees. User fees within expenditure programs increased over \$19 billion; user-related excise taxes (such as those designated for highway and airport trust funds) increased \$27 billion; and higher premiums for Medicare, pension guarantees in the Pension Benefit Guaranty Corporation, and various financial programs raised about \$15 billion.⁴

Many excise-tax increases generated only limited controversy. Not so for luxury tax increases for furs, jewelry, private airplanes, expensive cars, and especially boats. Partly because the enactment took place during the economic downturn, the luxury boat industry was already hurting, and it quickly launched a counteroffensive, arguing that the tax especially hurt laborers in that industry. While luxury taxes had been prevalent in World War II, most had been abandoned or allowed to dwindle in importance over time. Economists justified the previous cutbacks by arguing that picking on one item of consumption or another is not efficient, even if the goal is to tax those with high levels of income or consumption. At the time of the 1990 agreement, however, Congress was merely looking for items that it thought would generate the least opposition.

Family and Children's Issues

Many tax improvements for families and children made the 1990 Budget Act more progressive, but at a cost: many child-related bells and whistles were relatively uncoordinated, further complicating the taxation of low-income individuals. The legislation imposed most rate increases at the top and granted further tax breaks to low-income individuals. This victory for low-income advocates was only partly in response to the political debate over the budget package and distributional effects documented in Joint Committee on Taxation tables. The residual momentum needed to launch change came from both liberals and conservatives who gave new status and attention to family and children's tax issues after the personal exemption doubled and the earned income tax credit was expanded in the Tax Reform Act of 1986. After the mid-1980s, "family tax issues" were in the limelight, and both political parties fought over who was most "pro-family."

During the 1988 presidential campaign, then-candidate George H. W. Bush pushed his own "pro-family" tax agenda by pledging to try to enact a "child credit."⁵ This would be only the first of many Republican efforts to enact or increase child credits. President Bush's credit was to apply only to workers with children.⁶ Eventually, this proposal was translated into a large addition to the EITC. The president also demanded a supplement for young children, and, as a conservative attempting to focus the benefits on stay-at-home parents, he further required that those receiving credits for work-related child care expenses not be eligible for the supplement. Senator Lloyd Bentsen, as Democratic chair of the Senate Finance Committee, added yet another wrinkle—a supplement for low-income workers with children who pay out of pocket for health insurance.

The president and many Republicans ended up joining Democrats in supporting an increase in the EITC, partly because analysis showed that an increase in the EITC was much more efficient than an increase in the minimum wage to bolster moderate-income families. Minimum-wage increases help not just primary workers, but many secondary workers, including spouses and teenage dependents, who often do not reside in low-income families. Moreover, minimum-wage increases can have a negative impact on employment. Thus, some analysis showed that the EITC changes better targeted low-income households, and

this gave some reprieve to Republicans wishing to show that they were not indifferent to the needs of low-income families while opposing minimum wage increases.

The bill also made clear for the first time that subsidies for low-income individuals would move well beyond tax relief. With the old EITC, "tax" relief was already "refundable"—that is, payments would be made even if the amount of credit exceeded income taxes otherwise owed. Until enactment of a child credit many years later, no other provision in the income tax allowed individuals to receive more money when filing tax returns than was paid in. But some argued that such relief was not really "refundable" if one also took account of Social Security taxes (the Social Security tax rate was 15.3 percent of wages by then and the EITC was equal at most to 15 percent of wages). With the 1990 act, that argument lost its meaning. Now the EITC rate would clearly yield more for low-income taxpayers than income or Social Security taxes would take away. In sum, this milestone made clear that the EITC is an expenditure, not simply a tax reduction, even though the IRS administers it. Indeed, the refundable part is treated as a direct expenditure in official budget documents. At the same time, like any benefit, new sources of cheating arose now that more money was at stake. For the first time, individuals found it worthwhile to claim earnings from work even when they had none. The EITC also became a more controversial item for other reasons: its design all but forced low-income workers to use paid tax preparers since their tax forms were more complex than those of many middle-income taxpayers.

The budget document labeled the EITC changes, along with a few others, as "progressivity offsets" against some increases in excise taxes on low- and moderate-income individuals. Near the end of the legislative process, Congress played games to enhance the appearance of progressivity. Analysis showed that if the EITC were adjusted for household size as originally proposed, families with incomes just above the federal poverty level would benefit more from that change than those at or below the poverty line. Households with more members and only a tiny bit more income looked better off than smaller families in the new distributional tables only because there was no adjustment for family size (e.g., a large family with \$12,000 of income looks better off than a small family with \$11,000 if family size is not taken into account). Rather than target the money where it was most needed, Congress scrapped most of

the adjustments for family size and increased the basic credit equally for all families.

Bubbles, Bangles, and Beads

Meanwhile, at the top of the income distribution, President Bush's effort to decrease the capital gains tax was rejected, and tax rates for high-income individuals were increased modestly.

Recall that in the compromises leading to the 1986 tax reform, Congress created a "bubble" in the tax-rate schedule. Taxpayers in successively higher income levels paid a tax rate on their last dollar earned of 15, 28, 33, and 28 percent again.⁷ The bubble was removed—sort of.

To maintain the revenues from the bubble, however, two related proposals were enacted as partial substitutes. First, a bangle—itemized deductions would be limited by 3 percent of the extent to which adjusted gross income exceeded \$100,000, with some exceptions. For most affected taxpayers, this translated into nothing more than an increase in the marginal tax rate of 0.93 percent.⁸

Next, a bead—the value of the personal exemptions would also be phased out at higher income levels. The conferees decided to complicate matters further by making the phase-out rate dependent on the number of personal exemptions. For a family of four, this translated into an increase in marginal tax rates of 2.13 percent, and for a family of two, 1.06 percent.⁹

Legislators prided themselves on their handiwork, however Byzantine. Believing they had met some arbitrary standard to which the public had acquiesced (e.g., a maximum statutory tax rate), Congress delighted in circumventing the declared standard both in 1986 and now here again in 1990. In certain high-income ranges, the maximum tax rate was now 31 percent, plus 0.93 percent through reduction in itemized deductions, plus some additional percentage for the phase-out of the personal exemption (e.g., 2.13 percent for families of four). The bottom line? This part of the package raised taxes on higher-income individuals by about \$40 billion over five years. A major reason was that at the very top of the income distribution—long after the former bubbles, the new bangles, and the beads were no longer relevant—the 31 percent rate replaced the old top rate of 28 percent. The ultimate goal of the majority of conferees—

to confine income tax increases to a limited few in the upper part of the income distribution—was reached, no matter that the means was abysmally complicated.

Something Old and Something New— a New Set of Budget Rules

Like so many tax policy changes, the 1990 agreement imitated past actions. Once again, Congress returned to the same funding sources tapped in previous years. For instance, the act attempted to increase revenues through additional IRS enforcement. Another attempt was made to rely on Social Security taxes, although the revenues raised were modest compared with substantial tax increases of the past. Even delaying indexing of individual tax brackets was included in a House version, but later dropped.

In many ways, the collapse of Communism triggered the anticipated defense cuts in the bill. Defense spending as a share of GDP would continue on its long-term decline since World War II, with the exception of temporary build-ups during the Korean conflict, the Vietnam War, and the early 1980s.

The 1990 budget agreement, however, did make a fundamental change in budget policy. This policy limited future congressional actions and provided impetus for reducing the deficit by simply letting revenues grow with the economy, yet without committing to new tax cuts or expenditures beyond the huge automatic increases in entitlement programs. One related legislative consequence was to stall major tax-reduction or expenditure-increase legislation until near the end of the Clinton administration. Another legislative consequence was the near-guarantee that any major budget legislation after the 1990 agreement would require the participation of the tax-writing committees.

The new pay-as-you-go budget rules sorted different programs into different "baskets." All "discretionary" spending was divided into either defense, international, or domestic baskets, each subject to a spending cap. Any increases in spending above specified allocations had to be balanced by at least an equal spending decrease in that basket. If the basket's spending cap was exceeded, then all programs within that basket had to be cut back through a presidential sequester, that is, a proportional reduction in funds to get back under the cap. Trade-offs could not be made using budget resources outside the basket; nor could increased spending in one

discretionary basket be paid for by decreasing spending in a different basket. These changes greatly limited the power and leeway of expenditure committees. Even after these baskets were combined years later, the committees still could not finance changes by increasing revenues except when the rules were set aside.

In 1990, revenues, tax expenditures, and such "mandatory" entitlement programs as Social Security and Medicare (which are mainly under the jurisdiction of the tax-writing committees) were also lumped together in one huge basket. Spending on that basket was capped. Congress could make trade-offs within or between revenues and mandatory programs only if the net effect on the deficit was zero, at least during the period for which calculations were made. Broad expenditure or tax reform could be engineered only by going through the tax-writing committees.

The turn toward pay-as-you-go financing effectively created pressure for many expenditure committees to use internal fee and collection mechanisms as a means to increase spending. This intensified pressure on federal programs to move toward "benefit" financing—that is, raising such fees and premiums as user fees for parks, roads, bridges, and medical care. More broadly, the act entrenched pay-as-you-go financing within the congressional budget-making process. For a good part of the 1990s, most program expansions could not even be brought up on the floors of Congress unless a payment mechanism was attached. Some economists, including those who tend to favor benefit taxation, transparency in government, and rules that make clear that there is no "free lunch" in government legislation, would say that the move toward a more explicit connection between spending and payment is a good thing.¹⁰

Extremely important from a macroeconomic policy standpoint, the 1990 act redefined deficit targets. No longer targeted were changes in the size of the deficit, no matter what the cause. As long as the law doesn't change, the argument went, additional deficit reduction isn't required during recessions or crises, as it was through the latter half of the 1980s under rules that were enacted but then usually bypassed as impractical. By the same token, the strong push against growth in discretionary programs did not extend to the automatic growth in entitlement programs or in tax subsidies that behave like entitlements because they, too, require no annual appropriation. In effect, the unlevel playing field between discretionary and entitlement spending was tilted even more against discretionary spending.

Other Tax Actions

The 1989–1992 period saw a considerable slowdown from the flurry of tax activity marking the 1980s. One reason for the slowdown was Congress's sheer weariness from the many changes and battles of that earlier period. Another was that many Bush appointees, such as James Baker, who had moved on to become Secretary of State but was still a close advisor of the president on domestic matters, remained committed to the 1986 reforms. A third reason was the "no new taxes" pledge of the new president, who was loath to contradict himself except when the demand for deficit reduction and the need to compromise with a Democratic Congress forced him to act in 1990. Interestingly, taxes had increased many times under President Reagan, who was not held to such a tight standard and perhaps enjoyed residual credibility as a tax-rate cutter from his 1981 pronouncements and successes.

This surface calm notwithstanding, many smaller enactments mostly fell below the radar of the public and the press. The tax-writing committees worked ceaselessly. For instance, tax extensions by then had become the order of the day for such high-ticket items as research and development tax credits and targeted jobs credits that expire periodically. Many of these credits resembled expenditures that had to be periodically renewed and gave advocates and lobbyists plenty to debate as long as they weren't made permanent. Permanency, however, weakens review, so there is much debate over whether it reflects better policy. One possible compromise would have been to renew such provisions for five years or so, but politics quickly dictated shorter extensions.

Suppose, for instance, that \$100 million a year is sought. The cost of extending a provision for only one year would be counted in a five-year budget estimate as \$100 million, but a five-year extension would "cost" \$500 million. Politicians and lobbyists often decided to take what they could get and live to fight again another day. This gave many experts trouble even estimating reasonable future deficits under differing notions of "current law." Does current law really end or "sunset" various credits or is continual extension the norm?

The Energy Policy Act of 1992 provided another example of the ambiguity in budget-making during this period. It rewarded energy companies and some environmentalists alike with the subsidies they wanted. For example, the alternative energy investment credit was made permanent and some tax preferences for depletion and other costs of

independent-oil producers, gas producers, and royalty owners were removed from the reach of the alternative minimum tax. Small energy bills like this seldom involved enough money—whether effective in terms of bang-per-buck or not—to affect total energy consumption and production measurably.

Two presidential vetoes in 1992 revealed how acrimonious tax policy-making had become. For much of the post-war period, tax bills had been bipartisan and obtained significant support from both parties. In his 1992 State of the Union message, President Bush reported that the economy was faltering and challenged Congress to give him, by March 20, a stimulus bill that included such items as a new investment tax allowance, a credit for first-time home purchases, and a reduction in the capital gains tax rate to 15.4 percent. Congress met the deadline but gave the bill a Democratic twist with capital gains relief mainly for those below the top tax-rate bracket. The president vetoed the bill without waiting to read the details—marking the first veto of a tax bill since 1943. Ironically, a major reason for the Franklin D. Roosevelt veto was that Congress had extended capital gains treatment to timber harvests; a major reason for the Bush veto was that Congress failed to grant more generous capital gains relief to the higher tax-rate taxpayers.

Also in 1992, another bill was vetoed. This bill contained items the Bush administration desired (such as extensions of expiring provisions, the establishment of enterprise zones, and a repeal of most luxury excise taxes passed in 1990), but it added tax increases, such as a major reform of the taxation of securities dealers, a denial of deductibility for club dues, and some removal of estate tax cuts. So, after nearly 50 years of no presidential vetoes on tax bills, two occurred in one year—perhaps telling examples of the breakdown of bipartisanship in tax legislation.

Unfinished Business

So much attention had been paid to the deficit in the 1980s that it became a handy excuse for dodging other social issues. Although the 1990 act reduced the deficit yet again and put financing for some programs on a better footing, it dealt with only a few of the thousands of spending and tax expenditure programs on the books. Some programs that were left alone worked and some did not. The AMT juggernaut started to build up steam. Created in 1986, more and more people fell into its clutches

as their incomes rose with economic growth, while its exemption level remained constant and was not adjusted even for inflation. No politician openly embraced this bracket creep, but no Democrat or Republican wanted to pay the cost of fixing it. "Not just yet" started to become the rallying cry of AMT reform.

It is the combination of expenditure and tax programs that makes the federal government effective or ineffective. The cost of the expenditure programs, less the revenues collected through the tax programs, equals the budget deficit—the "dissaving" of the U.S. government. Financing this dissaving by floating government bonds at one level can simply be considered one more governmental program. Modest and incomplete fixes to this bond-based financing program could hardly be considered a panacea for society's other ailments: it did not clean up the environment, better educate our children, increase our inventiveness, reduce the crime rate, improve health coverage, or adapt our defense policy to 21st century demands.

Despite these microeconomic concerns, the years 1989 through 1992 saw successes that cannot be ignored. The Cold War ended and the Iraqi invasion of Kuwait was quashed. The 1990 budget agreement was the most notable domestic achievement, though the political costs were high. Despite careful political attention to limiting who was affected, the press had no trouble identifying some losers and generating conflict around them, as well as on President Bush's reneging on his campaign promise for no new taxes. Whether this turnaround cost President Bush a close election in 1992, or the short 1990 recession did him in, his son as presidential candidate and president would later draw some political lessons from his father's experience. But first we must turn to President Clinton, who ended up using the tools of the 1990 agreement to become a true budget hawk.

Clinton and the New Democrats: 1993 to 1996

As a cop, the IRS has to balance customer service and law enforcement . . . The agency's motto could be: "We're your friend. But if you push that friendship too hard, we'll ruin your life and throw you in jail."

—Chris Bergin, *Tax Analysts*

Bill Clinton campaigned as a new Democrat and successfully played to voter concern over the recession and the state of the economy—and the general perception that President George H. W. Bush was doing little about it. The Democratic Leadership Council claimed that the modern "Third Way" approach to governing began with Clinton's 1992 campaign.¹ Regardless of labels, that the former left now favored a moderate government somewhere between left and right became the implied message. Clinton would later declare, as a corollary, that "the era of big government is over."

Political metaphors, however, do not make policy. Candidate, and later president, Clinton floated many proposals, attempting to appease almost every constituency through government. There was no personal pain that he didn't feel, some quipsters would say. His initial campaign promise to cut taxes for the middle class was soon dropped or at least deferred, although he did follow through with threats to increase taxes for upper-income taxpayers. That campaign political promises cannot always be fulfilled because of budgetary constraints is hardly a new issue—witness President George H. W. Bush's reversal on taxes a few years earlier. But two deputy assistant secretaries for tax analysis during the Clinton years argue forcefully that the administration, particularly Robert Rubin, chair of the National Economic Council (1993–1995) and later Treasury Secretary (1995–1999), continually demanded adherence at least to the budget and

deficit-reduction goals that began in the campaign.² Early on after the election, the Clinton team decided to try to fulfill one of its campaign pledges for fiscal austerity—\$500 billion in a deficit-reduction package on top of the one that had been enacted in 1990. That decision essentially put the middle-class tax cut on the back burner.

Clinton's strategy as a campaigner and as president was not simply to respond positively to almost all constituencies, but also to indicate that there was little the Republicans wanted that he did not want, too, at least in some general way. This approach clearly limited his ability to develop simple and efficient tax policy. By the same token, Clinton was able to stick to many of his budget goals by making all these new programs and proposals modest in size, often adding more to tax and budget complexity than to revenue or deficit drains.

Besides the goal of lower budget deficits or even surpluses, there were two other areas where Clinton's approach to policy was fairly consistent. As a new Democrat, he favored both free trade and further help for the poor—but not in the form of traditional welfare *per se*. Free-trade proposals had only modest direct impact on tax policy, but aid to the poor, like deficit busting, would profoundly influence tax policy developments.

Early Action on the Deficit

President Clinton, in his quest to be a different type of Democrat, wanted to show he would do something about the economy, and budget policy became his best vehicle. His administration decided early on to bear down mainly on the deficit. Several reasons led him to defer dealing with other promises. Big reforms of health and welfare could not be designed overnight. Having watched how President George H. W. Bush was hurt by his inaction during the economic downturn in 1990 and 1991, Clinton understood the political perils of ignoring the economy. Lurking in the background was another reason for deficit-cutting—the baby boomers' inexorable march toward retirement and the lack of societal saving for that day.

Perhaps most important, Democrats had been chastising and blaming Republican presidents Reagan and George H. W. Bush for deficits ever since the tax cuts in 1981. Although the origins of the deficit were far more complicated, particularly the persistent growth of entitlement spending,

the Democrats set themselves up to deliver on deficit reduction, with a special focus on using taxes to achieve that goal.

Finally, significant deficits still existed, and path dependency—or at least resorting to familiar ways of dealing with the deficit, whether adequate for the long-term or not—was to act as a major determinant of tax policy development. By now, Congress had ample experience with big deficit-reduction packages, particularly from 1982, 1984, 1987, and 1990, so this newest venture was in keeping with its practice of enacting a significant deficit-reduction bill about every three years.

With that said, it was still fairly unique for a president to begin the first year of his first term by taking something away from people. In the Easy Financing era, Kennedy, Johnson, and Nixon sought tax cuts and spending increases early on. Carter started off with a moderate tax cut, while Reagan and, later, George W. Bush initiated their presidencies with big ones. Even George H. W. Bush waited a year before engaging in significant deficit reduction. In terms of political strategy, a contrast between Clinton and his predecessor raises the interesting question of whether, if a political price has to be paid to garner some control over the budget, it is better to pay up front.

The Omnibus Budget Reconciliation Act of 1993

Despite many differences in political philosophy with his predecessor, the new president's first budget enactment was remarkably similar to the 1990 agreement negotiated by Bush. When all was said and done, the Omnibus Budget Reconciliation Act of 1993 reduced deficits by about the same amount in nominal dollars as had the 1990 act. Congress in both years aimed to reduce the deficit by \$500 billion over five years, and despite some game-playing in both acts through such devices as temporary changes that would "sunset" after five years, most of the deficit reduction was real. When calculated in inflation-adjusted dollars, or as a percentage of GDP, of course, the 1993 act was smaller than the 1990 act.

As president-elect Clinton prepared to take office in January 1993, his transition team was busy sculpting the theory that would be called "Clintonomics"—which eventually claimed that economic growth in the 1990s was due to the team's deficit reduction effort. Treasury Secretary Lloyd Bentsen and National Economic Council Chairman Robert Rubin reasoned that the performance of the stock and bond markets was in part governed by financial analysts' collective opinions. They believed that

impressing these analysts with a sacrifice-oriented deficit-reduction plan might not only increase the supply of saving available for private investment, but lower interest rates and lift the country and the markets out of their malaise (Waldman 2000, 40). The short-term danger from a Keynesian perspective, of course, was that a deficit-reduction strategy could also sink the country back into recession and bite into the 8 million new jobs the president had promised in his campaign (Woodward 1994, 83–85). Of course, long-term deficit reduction was increasingly viewed as positive for saving and growth, and even short-term negative effects through Keynesian-style contraction in demand were called into question.³

Rubin, later Clinton's Treasury Secretary, recalls a crucial pre-inaugural meeting on January 7. On the way in, chief political advisor George Stephanopoulos indicated to Rubin that if Clinton decided on a significant deficit reduction target, he couldn't follow through on his middle-class tax cut and various domestic proposals. At the meeting, the president-elect responded to the data he was given on the deficit and made the decision then and there. Deficit reduction, Clinton said, had become the "threshold" issue. It was what the country needed "to get the economy back on track" (Rubin 2003, 119).

However it happened, the president chose deficit reduction over his campaign promise of a tax cut—the promise of halving the deficit in four years collided with the promise of middle-class relief. Health care reform, an "end to welfare as we know it," and other campaign initiatives would also have to wait. Further, the administration believed a successful deficit-reduction effort could make such ambitious undertakings more affordable down the road.

Eventually, even the title of the Clinton-supported budget act was the same as that enacted under President George H. W. Bush, except for one digit. On the expenditure side, the Omnibus Budget Reconciliation Acts of 1990 and 1993 each tried to rein in health spending through additional controls, particularly on Medicare payouts. And both bills continued reducing defense expenditures as a percentage of GDP, justified in part by a peace dividend at the Cold War's end.

On the tax side, elected officials tried to dodge political fallout in both bills by restricting the number of taxpayers impacted by tax increases. Democrats were more willing to achieve this goal through higher tax rates on those at the top of the income distribution—though those were the same people hit by some of the Bush tax bill changes.

If Bush could raise the top rate from 28 to 31 percent (with some reduction for those facing the 33 percent bracket bubble), Clinton could increase it further to 39.6 percent—in part by adopting a “surcharge” of one-tenth over and above a new 36 percent rate. The corporate rate (for income over \$10 million) was also raised in 1993 from 34 to 35 percent.

Under President George H. W. Bush, the Social Security Medicare or Hospital Insurance tax base was decoupled for the first time from the tax base applying to the old age and disability portions (OASDI) of Social Security, which had been set at \$53,400 (indexed for inflation). The Hospital Insurance cap for the tax base was raised to \$125,000 in 1990; by 1993, it was eliminated altogether.

Excises (such as those for motor fuels) were also increased modestly again. The 1993 motor fuels tax increase, however, was a substitute for a far more ambitious Clinton proposal to impose a broad-based energy tax, which Congress rejected. Even the motor fuels tax increase raised consternation since, unlike a pure benefit tax, the money would not be earmarked for spending on highways or items used by those paying the tax. The politically disastrous 1990 tax on such luxury goods as furs and boats was shelved. The luxury boat industry essentially won its campaign, complaining that this tax on the relatively wealthy would wipe out middle-class jobs in the boat-making industry.

Although not much attention was paid to base broadening, some preferences were pared. Business meals and entertainment deductions were cut back. The argument against the cutback—that it was a true cost of business to those in sales—largely ignored the additional income provided tax-free to the beneficiaries of the meals and entertainment. The possessions tax credit, a special tax break that applied mainly to Puerto Rico, was reduced and redirected toward providing a tax subsidy for employing workers.

The 1993 act also expanded the maximum taxable portion of Social Security benefits from 50 to 85 percent. While most seniors would be still exempt from the tax, over time, their numbers would dwindle since the threshold (\$44,000 for joint returns and \$34,000 for single returns) for paying the 85 percent rate was not indexed for inflation or income growth. This latest move on the taxation of Social Security benefits, including the lack of indexing, mirrored the cutbacks in after-tax benefits set forth in the 1983 Social Security amendments. It challenged once again the notion that Social Security was the untouchable third rail of politics. That said, budget rules then in place forced the unusual

requirement that the extra revenues from this tax change not be placed in the Social Security trust fund. Instead, the Hospital Insurance trust fund was chosen as the recipient, partly because its revenues were scheduled to fall short of benefits paid long before the same applied to Social Security.⁴

The legislation also ensured that the alternative minimum tax juggernaut, taxing more and more people over time, would not be slowed. The AMT tax rates, therefore, were increased at the same time as the statutory rates in the regular tax. Revenues from the unpopular and unwieldy AMT were simply too hard for Congress to pass up. In the confusing arithmetic of the AMT, making sure the two sets of rates rose in lock step ensured that raising the higher regular or statutory tax rate generally would not reduce significantly the number of AMT filers. (Recall that taxpayers subject to the AMT calculate their taxes in two ways and pay the higher of the two resulting sums.) Fixing the AMT would again be left for future leaders to solve.

Like the 1990 act before it, the 1993 act expanded the earned income tax credit. While Republicans in 1990 had accepted an EITC expansion in lieu of increases in the minimum wage, 1993 expansions were justified by the argument that the credit should be adjusted for household size. Thus, households with two or more children would receive additional help relative to a one-child household (which was held harmless). Another argument for this EITC expansion was that some compensation should be provided to low-income households to offset the excise-tax increases.

The net effect in 1993 was to give more to low-income families, leave the middle class more or less untouched, and zap the rich. According to the tax historian Elliot Brownlee (1996, 137), "Clinton stressed the point that tax increases enacted by Congress on families who earned more than \$200,000 would raise 80 percent of the new tax revenues imposed." The Clinton administration also stressed that, except for the gas tax, the tax increases affected only the top 2 percent of income recipients. Yet polls showed that close to 50 percent of the public thought the 1993 act increased their taxes, a continual source of frustration and puzzlement to Clinton political appointees who thought they had targeted their tax increases to the rich.⁵ Robert Rubin (2003, 153) put some of the blame for the Democratic losses in the 1994 election "debacle" to the "mis-characterization of our deficit reduction as tax increase on the middle class, which proved extremely hard to shake."

Further girding tax-based "family" policy, the 1993 act extended a modest EITC to single workers (without dependents) earning \$9,000 or less, apparently to give single persons and absent fathers a stake in the wage subsidy. However, the expansion was modest, partly because of the expense and partly because of the potential for large marriage penalties.

Throughout this dance of legislation, Clinton did not pursue broad-based tax reform in the mold of 1986. In fact, the president "favored the traditional politics of offering tax benefits to specific interests, groups, and classes, rather than a base-broadening strategy" (Brownlee 1996, 138–39). Lloyd Bentsen, Clinton's first Treasury Secretary, was no fan of broadening the tax base; nor was the president's National Economic Council about to forgo the use of special provisions in the tax code to promote its domestic agenda. If it couldn't make headway by increasing direct expenditures, then it would try to come in the tax-cutting door.

Claiming Credit for the 1993 Changes

Although easy to exaggerate, political backlash almost always trails attempts to cut spending or raise taxes, and it seriously dogged Clinton and his congressional allies after passage of the 1993 act. In this instance, the lack of any major new benefits for the middle class made matters worse. A number of elected officials lost reelection bids in 1994 because they sided with the tax-raising president. One notable example was Congresswoman Marjorie Margolies-Mezvinsky of Pennsylvania, who had been elected for only one term and was persuaded to cast the deciding vote for the president's 1993 tax bill in the House. Meanwhile, the anti-tax Republicans gained ground with the claim that Clinton had passed the largest peacetime tax increase in history. Of course, they were counting only nominal dollars and ignoring its size relative to the economy (for example, Reagan's 1982 tax increase and many of the Social Security tax increases were much larger as a percentage of GDP). The voter response was likely also a rebuke of big government (see the discussion below about the failed health reform initiative).

As time progressed and the economy expanded, deficits fell. President Clinton increasingly claimed credit for these economic developments, his mettle now tested as a new Democrat. The realignment of the political parties on matters of budget discipline was now complete. Democrats fully accepted the mantle of fiscal conservatism in practice as well as in word—a shift that had started in 1981 with their objections to the Reagan

tax cuts. (Given both parties' approach to large entitlements, of course, one can question whether there were any fiscal conservatives for the long-term.) By the end of Clinton's eight years, in fact, many Clinton stalwarts listed the success in reducing the deficit as the primary measure of his administration's success. Ironically, even though President George H. W. Bush had presided over a larger deficit-reduction package, he never tried to claim similar credit.

The Clinton administration was also accorded most of the public credit for increasing the EITC in the 1990s, even though the EITC reforms enacted on Bush's watch were more generous than the reforms on Clinton's. But Bush and his colleagues made less fanfare of them. Clinton's claim to credit was further enhanced by a technical point easily ignored by historians and political pundits who haven't done their homework: some EITC increases President Bush signed into law were only phased in during the Clinton years.⁶ When the EITC came under increasing congressional assault by Republican Congress members, such as Ways and Means Chairman Bill Archer, the Clinton administration countered by citing the past bipartisan support, including that of George H. W. Bush and Ronald Reagan.

The Health Reform Debacle

After passage of the 1993 Budget Reconciliation Act, the Clinton administration revved up its efforts on the largest and most important domestic reform initiative it would launch during its first term—health reform. Tax policy figured centrally in Clinton's health policy reform initiative, exemplifying once again the unavoidable entanglement of tax and social policy. Ira Magaziner, Clinton's health care policy adviser, anticipated that health reform would entail a substantial tax increase, to which then-Ways and Means Chairman Dan Rostenkowski objected. Magaziner initially proposed adopting a national value-added tax (VAT) of \$60 to \$80 billion. Treasury Secretary Bentsen partially supported the plan, as he tended to like the VAT. He had earlier supported a BTU tax on energy consumption because he felt it opened the way to a broader value-added tax. However, once the prospect of middle-class voter backlash set in, the administration proposed only modest direct financing of health care reform—a 75-cents-per-pack tax increase on cigarettes and a 1 percent income-tax surcharge on large businesses that failed to provide health

insurance through proposed pools of insurance buyers. Some administration members thought much higher direct taxes would be necessary to pay for this reform (Brownlee 1996, 138).

Postmortems on the Clinton health care proposal abound. Many conservatives believe the Clinton reform failed because a massive health care bureaucracy with controls emanating from Washington was as politically unpalatable as the tax increases the administration abandoned. Many liberals trace failure to the doorsteps of special interests—especially in the burgeoning health care industries.⁷ Critics also derided Congress for catering to both health care providers and consumers.⁸ Fearing political repercussions, the administration began promising something for everyone—the uninsured or inadequately insured, those needing portable health insurance, the elderly, large businesses that might already be insuring their employees, small business, and so on. Somehow all these pipers had to be paid.

Some might also claim that the attempt to legitimately pay for the change—as opposed to the traditional postwar tradition of paying for major change through increases in the deficit—derailed health reform. But that critique belies why tax reform succeeded in 1986. Perhaps the movement from an easy financing era to one where budgetary discipline tended to require pay-as-you-go financing translated into tough sledding for any major new initiative. Or the two divergent objectives of achieving health coverage for all and reducing the growth of health costs may have been difficult to pull together in a way that could appeal to the public.

Health reform also failed because of a badly organized political process and a fatally flawed design (see for instance, Skocpol 1994). The health reform proposal percolated within the confines of the White House, where political considerations kept trumping fiscal realities. In effect, the new fiscal constraints were not heeded early enough in the health reform process. The ever-rising influence of health costs on the budget simply had to be addressed—and the public convinced of the necessity for action—before any health reform achieving the more populist notion of universal coverage could succeed.

Health and Taxes

Tax policy permeates health policy both on the financing and subsidy side. The largest income tax subsidy in the tax code, as measured by forgone revenues, is the exclusion from taxation of health insurance

benefits provided through employers. Add in other tax subsidies—in particular, the exclusion from state and local tax and Social Security tax for compensation paid in the form of health insurance—and the revenue loss exceeded more than \$100 billion per year by the early 1990s, rising to more than \$200 billion for 2006.⁹ Most major health reform proposals affecting the nonelderly aim to modify or replace this provision for two reasons: it is inefficient because it encourages excess costs (the biggest subsidy goes to those who buy the most expensive insurance covering the most items), and it is inequitable because benefits rise significantly as one becomes richer. The Clinton health care proposal sought indirectly to redirect some of those forgone revenues to finance some of the proposed changes.

Major health reform usually requires reassessing many other taxes and tax breaks—from the tax exclusion noted above to Medicare and other taxes required to fund government health care for the elderly. These taxes have to be integrated or, short of that, the financing and operation of any new government system for the nonelderly and another for the elderly (Medicare) must at least be coordinated. By the early 1990s, government health care spending at all levels averaged over \$5,000 per family; a high rate of growth on such a large base meant that newly available government revenues increasingly were being directed toward health care.

In this political and budgetary milieu, mandates on employers to provide insurance and additional cost controls emerged temporarily triumphant in the ill-fated health care proposal. Whatever the merits of mandates and cost controls, they tend to hide costs from individuals. The administration had boxed itself in. Congress, however, balked at cost controls and even mainstream business, such as those represented by the Business Roundtable, balked at aspects of the employer mandates. Since the administration assumed that large employers already providing health insurance to their workforce would buy into a mandate, their reaction was a heavy blow. After all, the already insured were constantly cross-subsidizing the uninsured who did not cover their share of hospital and other costs. Employers, however, feared the government controls would follow a mandate. For instance, what qualifies as adequate insurance under a mandate has to be determined. Even attempts to buy off businesses with subsidies for retiree health costs were not adequate to win them over.

A major debate over these mandates was how to account for them in the government budget—should they be viewed as a tax or simply

treated as regulations that did not flow through the budget? After long and rancorous wrangling, and despite intense lobbying from the White House, the Congressional Budget Office determined that the mandate as designed would be counted as a government receipt (Reischauer 1994).¹⁰ Thus, those who looked at government receipts as equivalent to taxes and a measure of government's size concluded that this health reform would significantly increase the government's interference in the economy. For many, this decision was a sign that health reform was in its dying days.

Finally, the health care reform process may have lost support by giving too little attention to principles as opposed to such goals as "greater health insurance coverage." For instance, while the administration indicated that it wanted a progressive proposal, the final plan design was not progressive. The proposed employer mandate would have applied in large measure to low- and moderate-income employees since employees indirectly bear the costs (in lower wages) of employer mandates. Employees with access to charitable care or welfare would have ended up paying more and having less after-tax income if they had to bear the full cost of the insurance in lower wages, while forfeiting free services.¹¹

The proposal also abandoned the principle of equal justice or equal treatment of equals. By subsidizing only the uninsured, the proposed plan effectively gave a preference to a person with \$30,000 of income and no insurance over someone with \$30,000 of income who had already bought insurance. To make matters worse, regardless of the need and income of individual employees, different types of employer subsidies were proposed on the basis of employer size or the average wage of the employer group. Once again, a \$20,000 worker in one firm would generate a subsidy; an equal-income employee elsewhere would not. The Treasury's Tax Policy Office fought for a more rational approach that recognized issues of horizontal equity, but lost. Trying to appear to appease all constituencies only added to the White House revenue dilemma, so one solution was to subsidize only a visible portion of moderate-income households—such as those without insurance or those who worked only in small firms.

One major lesson is clear: major expenditure reform in areas like health care are as much matters of tax and revenue policy as anything else, and these matters cannot be treated as secondary or ignored until too late.

The Contract with America: 1995–1996

In the 1994 mid-term elections, Republicans succeeded in taking over both houses of Congress, in part because of public discontent with the 1993 tax increases and the failed health reform effort. Winning the House of Representatives for the first time since 1952, many Republicans had run on a platform outlined in a new “Contract with America”—a political and legislative strategy crafted largely by new House Speaker Newt Gingrich of Georgia. The “contract” featured many nontax provisions, including term limits on elected officials and the removal of some Congressional perks. Its tax provisions centered on “family tax policy” and on relief for the taxation of capital. Promises were made to grant tax credits for adoption expenses, home care for the elderly, and, most importantly, children. Also high on the social priority list was marriage tax relief in the income tax—removing situations where a couple paid more tax because they married and now filed a joint return. Meanwhile, Republicans also pledged to fight for extending capital gains relief, expanding cost-recovery allowances, eliminating the taxation of income from new capital investments, and eliminating the estate tax for many taxpayers. Under the contract, the costs of physical capital assets would be expensed or written off immediately, not simply for those who put up their own money, but for those who borrowed and did not save. Such a scenario potentially could have repeated the situation in the early to mid-1980s that led to the proliferation of tax shelters.

The Contract with America was full of ideas that eventually were enacted into law, but during the two years immediately following its introduction, a stalemate ensued when it came to taxes. Numerous battles erupted between the Democratic president and the Republican Congress—largely over tax cutting. When the president and the Congress could not strike a compromise on the fiscal 1996 budget, the government shut down. Congress could not muster a two-thirds majority to override the president, and the president vetoed and threatened to veto the budget bills that Congress did concoct. Meanwhile, in absence of a budget resolution, Congress refused to increase the debt ceiling so that the Treasury could sell debt to finance the deficits the government was running. Even the traditional trick of a continuing resolution—allowing the government temporarily to continue operating as usual in absence of a budget—was sent forward with riders and amendments that the president said he could not accept.

Eventually, a modest shutdown became unavoidable. Nonessential government workers were sent home, and a few functions ceased, including the operation of national parks—to the ire of vacationers. Dire actions, such as stopping Social Security checks, were dodged. The Treasury played a variety of games to avoid narrowly a default on debt, which might have precipitated a further meltdown of financial markets.

Eventually, a public outcry led to compromises that allowed the government to operate. President Clinton pinned much of the blame for the shutdown on the Republican Congress. Bolstering his claim was Speaker Gingrich's stance that he did not care if the government were shut down because nobody would miss it. The leader of the Republicans in the Senate, Bob Dole, on the other hand, worked strongly behind the scenes to prevent things from being pushed over the brink.

Modest Tax Action in 1995 and 1996

Despite this budget stalemate and brief government shutdown, the legislative process stuck fairly tightly to the pay-as-you-go budget rules first enacted in 1990 and extended in 1993. Of course, the budget rules did not stop the newly Republican Congress from aggressively pursuing significant tax proposals.

In January 1995, House Speaker Newt Gingrich and Bill Archer (R-TX), who had replaced Rostenkowski as House Ways and Means Committee Chairman, proposed an array of tax cuts for middle- and upper-income families following closely upon the Contract with America. Under the American Dream Restoration Act, the authors proposed a \$500 per child tax credit for families earning up to \$200,000, "marriage penalty" relief through a new income tax credit for two-earner married couples, and tax-free contributions to "American Dream Savings Accounts" (similar to IRAs) that could be used for certain housing, educational, and medical expenses, as well as retirement savings. Additionally, under the Job Creation and Wage Enhancement Act, Gingrich and Archer proposed to halve the tax rates on capital gains, index gains for inflation, and allow the deductibility of losses on the sale of principal residences.

Despite the substantial scale of the proposed cuts, the Contract with America made no attempt at base-broadening or broader tax reform, whether in the form of an income or consumption tax. Enough lawmakers voiced warning over the deficit size and voted down—at least temporarily—the tax proposals in the Contract with America (Brownlee 1996, 140–41).¹²

Reacting to the Republican takeover of Congress and its attempt to set the national agenda, the Clinton administration also proposed its own version of a child tax credit and an expansion of IRA accounts, as well as a tax deduction for tuition (U.S. Department of the Treasury 1995). In addition, Clinton proposed a college tax credit large enough to pay for the first two years of college at most community colleges.

The Clinton political strategy after the 1994 elections generally followed this push for new expenditures and entitlements. The president would do it through the tax system so he could argue he, too, was for tax cuts, while claiming budget responsibility by limiting costs to below what the Republicans proposed. In general, tax policy principles such as horizontal equity and efficiency did not come into play, partly because equal-costing rate reductions (often the most equitable and efficient way to cut taxes and distribute the benefits) appeared small when divided up across the population. Small rate cuts also could not generate the same type of publicity as "new" programs, so they lost out to new forms of credits or deductions.

Clinton supporters also argued that Republican tax cuts would be unfair. Rubin (2003, 162) notes that Speaker Gingrich helped the administration win the public battle in 1996 by planning to "to cut Medicare by \$270 billion and reduce taxes by a similar amount, in a way that primarily favored the affluent . . . an issue with special political force." We have already noted that most tax cuts in a social welfare state are likely to cut back on net redistribution once expenditures are viewed along with taxes; here pieces of the Gingrich plan made that connection obvious and politically exploitable.

During 1995 and 1996, Republicans floated many broad tax reforms, but all to little consequence. Such proposals took the form of a national sales tax or a flat tax (Brownlee 1996, 142–50). Sen. Richard Lugar (R-IN) and Rep. Archer proposed a national sales tax with a single rate of 16 percent on everything except food and medical expenses with the goal of "eliminating the IRS" and the income tax. Also resurrected were versions of a 1980s flat-tax proposal that would apply a single rate of consumption tax to both individuals and corporations (Hall and Rabushka 1983). In general, the flat taxes proposed were consumption taxes, not income taxes—equivalent technically to a value-added tax (using what is called the subtraction method) with a deduction for wages.

Although the broad reform proposals were largely ignored, many smaller proposals the president and Republicans pushed were later to

pass (demonstrating, once again, the “hopper” theory that what gets put in the hopper often eventually comes out). One bill worthy of note was called the Taxpayer Bill of Rights 2. Although much of this bill reduced or amended penalties and interest applied to various activities, it also established the Office of the Taxpayer Advocate. Since then, the Taxpayer Advocate has increasingly served as an intermediary between the public and the IRS in tax controversies and independently advocated for a simpler tax code.

Throughout the 1990s, tax legislation, appropriations, and internal decisionmaking changed the IRS. In particular, after it grew to handle deficit-reduction measures in the 1980s, the IRS was cut back, and the paring accelerated in Clinton’s second term. Meanwhile, a very large portion of the staff covering criminal activities moved to drug and other enforcement—avoiding the pure tax cheats and concentrating on individuals for whom tax cheating was only a portion of their crimes.¹³

The largest tax bill at the end of Clinton’s first term was the Small Business Job Protection Act of 1996, which gave small businesses and savers numerous benefits, including an increase in the amount of assets that could be “expensed”—deducted immediately rather than depreciated. For other assets, the depreciation lives were reduced, making deductions available sooner. Some pension changes were enacted. In particular, an individual retirement account deduction was allowed for spouses who did not work.

In keeping with the spirit of the budget resolutions, Congress “paid for” these changes through other budget offsets. Some special employee or pension benefits—a \$5,000 exclusion for employees’ death benefits and the ability to average lump-sum retirement distributions over five years to fend off large, one-year increases in marginal tax rates—were repealed. The biggest revenue offset was a cutback in the availability of “possessions” tax credits—credits of special value to companies that do business in Puerto Rico and other U.S. possessions. On balance, from 1995 to 2006, this bill increased revenues by \$5 billion (Joint Committee on Taxation 1996, 414).

Finally, one part of this small business act was devoted to trying to improve compliance or reduce availability of the EITC to unintended recipients. For instance, taxpayers who deducted losses on their tax returns usually had assets generating those losses; under the bill, they could no longer deduct certain losses from adjusted gross income in calculating whether their income was low enough to make them eligible for the EITC.¹⁴ Congress increasingly identified improving EITC compliance as a goal, and many initiatives followed.

Welfare Reform in 1996

Once again, social policy was never far from the tax policy agenda. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) created the Temporary Assistance for Needy Families (TANF) block grant, replacing the Aid to Families with Dependent Children (AFDC) (Gallagher et al. 1998). It turned over to states much responsibility for administering welfare.

The enactment of a welfare-reform measure broke a trend. The Clinton administration had been largely either unsuccessful or uninterested in systematic program reform. Health reform failed, the proliferation of special tax provisions stymied tax reform base broadening, Social Security reform never got off the ground, and compromise muddled most policy changes. Although perhaps the norm, this type of policymaking heightens tax complexity and often leads to incongruity among measures—whether through higher hidden tax rates, unintended marriage penalties, difficulty in filing and planning, or other problems.

Welfare reform was perhaps the only major systemic reform of the Clinton era, although it was hardly simple and was highly contentious. Indeed, several of the administration's top welfare policy officials resigned in frustration or protest just before or just after the bill was signed.¹⁵ But President Clinton was in a bind: he had promised welfare reform as part of his 1992 campaign but still had not been able to fashion a plan. Now, four years later, a very activist Republican House of Representatives felt that it knew something about the subject, too, and would take President Clinton at his word that he was willing to "end welfare as we know it." By ending the entitlement to cash assistance, the 1996 welfare act became a landmark. This reform also significantly contributed to a new federalism by expanding the flexibility of states to structure their own programs (although significant movement in this direction had already occurred through waivers the Department of Health and Human Services granted).

The bill fixed federal TANF payments through a block grant formula tied to 1994 spending levels in the states. Since 1994 federal spending was generally higher than in 1996, the bill actually increased federal transfers to states temporarily. However, as a result of the fixed nature of welfare spending under reform, states would have to bear almost all the costs of any expansion. In addition, Congress structured the program so states had to reduce caseloads over time to get the maximum federal funds. For their share of money, states also had to meet certain "maintenance of

effort" requirements with respect to their spending but generally could spend less than they had spent in recent years. The governors also pushed for and got their extra federal money up front; since welfare caseloads were declining but, at least initially, spending was not, the extra money needed to be channeled somewhere. Much ended up as child care benefits and additional assistance for the smaller groups that remained on welfare.

As in the period before welfare reform, the 1996 law did not integrate this type of child care benefit with the more universal dependent care credit available to those with positive income tax liabilities. Thus, to get many child care benefits, one had to sign up at the welfare office or have enough income to pay income tax. Many families fell into the fissures between these two approaches

Key to understanding welfare reform is the evolution of the earned income tax credit. Under welfare reform, total funds available to low-income individuals did not change much, at least from a historical perspective. Though the new welfare program set time limits on welfare receipt and penalized states that did not get larger percentages of beneficiaries to meet work requirements, the block grants were still equal to or greater than federal AFDC entitlement spending. But, by 1996, the monetary value of the EITC had far exceeded that of AFDC or TANF (see figure 3.4). In many ways, the availability of an increasingly generous EITC made pushing people off the welfare roles easier.

After welfare reform, the labor force participation rates of former AFDC recipients and, in particular, low-income women with children, grew significantly. These changes can be traced to welfare reform, state efforts, the expanding economy, and to the EITC. Regardless of which causes were most important, the rewards for working—especially in the stronger economy—had expanded greatly relative to the benefits of not working (see, for instance, Michalopolous and Berlin 2001).

Continued Deficit Reduction

Whatever else might be said about tax legislation between 1993 and 1996, deficits continued to drop. What was legislated (in particular, the 1993 budget agreement) became less significant than what was not legislated. Neither political party could enact new expensive programs, whether tax cuts or new health or other expenditure benefits. After 1994, power was

balanced, albeit because of the irreconcilable agendas of the new Republican House and the Democratic president.

Meanwhile, the economy picked up steam, and the first hints of the revenues available from a so-called "new" economy—led by technology advances and a stock market bubble—appeared before the 1996 presidential campaign. This virtuous cycle of more revenues and fiscal restraint in new legislation would be reinforced as the economic expansion gathered momentum and revenues rose along with the rapid growth in capital gains and stock options.

The long period from 1982 to the late 1990s, when concern over deficit reduction drove budget policy, was about to end, at least temporarily—but not before debate erupted over what to do with a surplus, an economic debate unfamiliar to many young and middle-age voters.

The “New” Economy: 1997 to 2000

The avoidance of tax may be lawful, but it is not yet a virtue.

—Lord Denning

In the 1996 presidential campaign, both Republican candidate Bob Dole and Democratic President Bill Clinton accused each other of having presided over the “largest tax increase” in the peacetime history of the nation. Dole applied the appellation to Clinton’s 1993 tax increases; Clinton referred to the tax increases in 1982, when Dole chaired the Senate Finance Committee. Neither would take credit for what had been one of the major legislative feats of each of their careers—pulling a large deficit-reduction package through a reluctant Congress. Though both packages contained unpopular tax increases, those increases were still modest in size relative to the overall level of tax collections. But it was campaign time—time to promise more, not to acknowledge that government’s past and future costs must be covered by taxes.

Voters reminded President Clinton of his 1992 presidential campaign promises for tax cuts. He renewed those vows, asserting that the deficit had taken precedence in his first term. With his second White House victory, he finally turned to those old promises, in part to prevent congressional Republicans from controlling the agenda. After all, Republicans would hand him some form of tax cut, and he wanted to shape it—not just approve it.

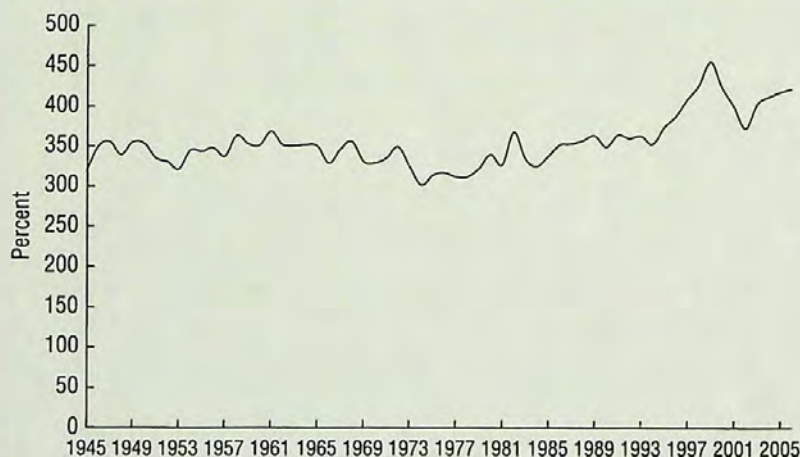
By 1997, the economy was on a roll. The last recession had hit seven years ago, in the middle of President George W. Bush’s term in office. Additionally, asset valuations were skyrocketing; the decline in real estate

values from the early 1980s to the mid-1990s subsided and real estate took off to join a continuing, longer-term, stock market spurt. Amid the soaring prices there was a telltale danger sign: total household net worth (largely driven by growth in both stock and real estate values relative to gross domestic product) exceeded its all-time high (see figure 10.1). But in 1997, few knew how to measure of this “new economy” despite the rising euphoria. True, technology stocks seemed to be touched by Midas, but no large real wage gains had registered yet, and deficits had become moderate, ending at 1.4 percent of GDP for fiscal year 1996 (CBO 1997, 18).

The Taxpayer Relief Act of 1997

With voters sending mixed messages and scant evidence to explain the new economy—or even whether it was new—contradictions riddled budgetary politics. As a consequence, Congress and the president reached a clumsy compromise that, at least on paper, provided deficit-increasing tax relief

Figure 10.1. Net Household Worth as a Percentage of GDP, 1945–2006



Source: U.S. Federal Reserve, Flow of Funds Data, <http://www.federalreserve.gov/releases/Z1/Current/data.htm>, tabel B.100, line 41 and BEA data on GDP.

GDP = gross domestic product

and overall deficit reduction at the same time. The package had the stated goal of balancing the budget, which meant that the expenditure reductions had to outweigh the tax reduction.

Those expenditure cuts once again took the form of caps on discretionary spending. Partly due to the emphasis on this and related legislation, from fiscal year 1997 to fiscal year 1999, discretionary defense spending fell from 3.3 to 3.0 percent of GDP, and domestic discretionary spending, from 3.1 to 3.0 percent. These reductions were smaller than those of the first Clinton administration (in fiscal year 1993, the comparable starting figures were 4.5 percent of GDP for defense and 3.4 percent for domestic discretionary spending). Most gains on the nondiscretionary side of the budget came from further constraints on the growth in Medicare cost. These expenditure reductions turned out to be temporary; within a few years, there were turnarounds or reversals in all major categories—defense, other discretionary spending, and Medicare.

At the time, however, the expenditure cuts paved the way for the first significant tax cuts since 1981. Although far less dramatic than the tax cuts in 1981 (and those to come in 2001), cuts under the Taxpayer Relief Act of 1997 totaled some \$28 billion per year by the time most were phased in. By fiscal year 2000, the net cost was about 0.3 percent of GDP; for the 10 years after passage, the total cost was about \$300 billion (JCT 1997, 545).

The Child Credit

A new child tax credit—at \$500 per child by 1999—stood out as the big-ticket item in the new tax relief bill, accounting for more than 60 percent of the 10-year cost (JCT 1997, 512). The credit was not indexed for inflation, so its relative value would decline over time absent new legislation. Promised by the Republicans as part of their Contract with America, the Democrats had reason to favor a credit as well. A credit for children would be fairly progressive compared with the dependent exemption since the credit's value would not rise with income.¹ As proposed and adopted, in fact, the credit was made more progressive by not being extended to higher-income families.²

At the same time, the credit finally enacted was "nonrefundable"—that is, taxpayers who owed no income tax could not receive it. There was a small exception for larger families—a fairly complicated exception that would play out more fully when debate over expanding the credit reemerged in 2001.³

The child credit became a prominent new feature in the U.S. tax scheme. Some of its origins can be traced to a refundable \$1,000 tax credit proposed to the National Commission on Children in 1990 as a partial alternative to cash assistance and as a way to counteract disincentives to work and marry (Juffras and Steuerle 1991).⁴ The Commission, along with its chair, Democratic Senator Jay Rockefeller (D-WV) had backed this provision with gusto (National Commission on Children 1991).

Some characteristics of the child credit can be contrasted with three other primary provisions aimed at families with children. While a credit reduces taxes paid, the nonrefundable dependent exemption (or personal exemption for dependents) reduces taxable income. The earned income tax credit also reaches low- to moderate-income families only if they have earnings from work or self-employment, but, unlike the child credit, it is refundable for low-income families and phases out for middle-income families. The EITC had already been expanded significantly in 1986, 1990, and 1993, which provided part of the political motivation for doing something "new" like a child credit rather than simply expanding it once again. Finally, the child credit can be contrasted with the non-refundable child care tax credit, which offset some workers' child care expenses.

This new child credit cannot be defined strictly in tax terms and must also be compared with grants on the expenditure side of the budget in programs such as cash assistance and food stamps. These expenditure programs phase out as the beneficiary's income rises, creating systems that penalize work and saving. In contrast, the child credit (even as later amended) typically is not available until a certain income level is attained and, at the same time, phases out much more slowly and is more broadly available for the middle class. Recall that the higher burden placed on families with children motivated the mid-1980s family tax reform efforts. That extra burden, in substantial part, was a middle-class issue addressed through this credit, along with earlier expansions of the personal exemption and the EITC. The child tax credit also comes into play as income rises and as the expenditure programs and earned income tax credits phase out. Thus, the child tax credit potentially helps reduce the work disincentives and palliates the marriage penalties that arise from these other programs.

Any refundable portion of an EITC or child credit is counted in the federal budget as a direct expenditure, not as a tax cut. The arbitrary parsing out of pieces of each program into tax-reduction and direct-

expenditure "baskets" may be appropriate from an accounting point of view, but it also demonstrates how inseparable tax and expenditure policy are.

Social Policy and New Tax Subsidies for Education

The second biggest item in the bill provided various tax benefits related to education—both credits proposed by President Clinton and savings incentives suggested by Republicans. Either a HOPE or Lifetime Learning Credit would offset a modest amount of educational expense for families at all but the highest income levels. The first was modeled partly on the Georgia HOPE scholarship and alluded to President Clinton's birthplace of Hope, Arkansas. The basic concept, though complicated, provided that a HOPE credit could equal up to \$1,500 per student for the first two years of college, while a lesser lifetime learning credit could be spread over more than two years. Other education boosts came from an income-tested deduction for some student-loan interest; allowable withdrawals from individual retirement accounts (IRAs) without penalty if used for undergraduate postsecondary, vocational, or graduate education expenses; the expansion of state-sponsored prepaid tuition and state savings plans; and a new deduction on deposits to education IRAs (even though the "R" in "IRA" stands for retirement).

The broader education establishment considered these various provisions a mixed blessing. The proposals were not designed to meet any particular target such as helping the neediest students or increasing enrollment in higher education. On the other hand, it *was* additional money, so few educational lobbyists opposed the measures. Moreover, some of the new tax-credit benefits were available to students attending junior colleges—a group generally passed over as most direct aid flowed to those attending costlier and more prestigious colleges. Indeed, according to Waldman (2000, 179), the Taxpayer Relief Act used the tax code to create a *de facto* entitlement that paid for nearly all community college tuition—"the biggest single investment in college education since the G.I. Bill." However, there was a drawback: many low-income persons with no tax liability could not use the credit.

Educational aid was already a complicated thicket, and this act only added to the underbrush. Deciding which educational subsidy to take was difficult, and new measures made it even harder for parents, students,

and educational establishments to sort through the many options. As one of Clinton's later Treasury Deputy Assistant Secretaries, Len Burman (1997), quipped, "Even with all of these new incentives, one is missing: the 'hope to learn how to do your taxes' credit."

Like so many other items proposed in the 1990s, these credits served a purpose far removed from the principles that inform education policy or tax policy. The administration wanted to propose tax provisions that would somehow be "better" than the rate reductions many Republicans proposed. "Better" here meant more visible (and, hence, more politically marketable as something new) to the public, as well as lower in cost and more progressive. Whether the credits embodied such principles as equal treatment of equals or efficiency (e.g., in providing educational assistance) was not a primary consideration.

The maneuverings of both Republicans and Democrats in this bill can be explained by their unison under banners of smaller government (at least in appearance) and deficit reduction. In this world, tax expenditure increases and tax cuts were deemed acceptable; direct expenditure increases were not and were harder to get through the budget process in any case (see Toder 1998, 2000). The Republicans in Congress wanted to put forward a tax cut no matter what. For the administration, the trick was to tuck expenditures and subsidies into the tax system, make proposals that might have more populist appeal than simple rate reductions, and claim greater deficit reduction than the Republicans—all at the same time. Thus, a \$500 educational credit sounded better than a tax-rate reduction from, say, 25 to 23 percent. The administration also emphasized social expenditures in lieu of the House Republicans' pitch for business or investment tax breaks. And, finally, Clinton's team argued that its approach would cost less than its political adversaries' tax cuts.

Provisions for Savers and Investors

Along with sizable social tax expenditures, the 1997 legislation embraced several other types of tax relief. For instance, the act raised the ceiling on the estate tax from \$625,000 in 1998 to \$1 million in 2006. At the same time, removing an additional complex calculation of depreciation under the corporate alternative minimum tax provided modest relief by simplifying and aligning this calculation with the regular income tax. In addition, the research tax credit and work opportunity tax credits were extended once more.

The capital gains debate could not be avoided in this round of legislation—Republicans had long sought to reduce the rate of tax on capital gains. Yet the issues are complex. Those who favor capital gains relief often point to (1) the double taxation of income first taxed as corporate income and then, if retained within the firm to increase stock value, taxed again when stock is sold; (2) the extent to which capital gains merely represent inflation; and (3) limited revenue loss from lower rates since individuals tend to realize more gains when tax rates go down. Those opposed point to (1) the heavy concentration of capital gains among the richest taxpayers; (2) the extent to which capital gains tax rates for the rich are lower than middle-income taxpayers' rates on wages; (3) the transactional complexity of taxing capital gains at rates different from other income; and (4) the tax-shelter opportunities created by capital gains relief, especially when people borrow to buy assets.⁵

In 1997, Congress essentially gave up on reconciling these arguments and translating them into a coherent tax bill. Instead, it imposed six new, lower tax rates that, when combined with existing taxes on capital gains, created 12 rates to sort through (7.5, 8, 10, 14, 15, 18, 20, 25, 28, 31, 36, and 39.6 percent) (Burman 1997). Which rate applied depended on the taxpayer's normal tax rate, the sale year of the assets, and the asset holding time before being sold. A special rate and even more complex rules applied to real estate holdings, where account must be made of an asset's depreciation for tax purposes.

The act also provided generous allowances for IRA deposits. One new break especially deserves note. Congress created a Roth individual retirement account with much more generous income limitations than traditional IRAs, so many people ineligible for traditional IRA tax breaks could use the Roth IRA instead. In part, this meant abandoning the policy that IRAs would be available to higher-income taxpayers only if they had no employer-provided plan. For tax year 2006, for instance, a married couple with an employer-provided plan could deduct some contributions made to a regular IRA if their income was below \$62,000, but some Roth IRA contributions could be made up to an income limit of \$160,000.⁶

A Roth IRA allows no deduction up-front, so a taxpayer putting money into a Roth IRA rather than a regular IRA pays more tax to the government initially. The advantage to the taxpayer? All interest and all withdrawals are tax-free forever. Thus, a teenager putting aside money today in a Roth IRA and eventually bequeathing it to her children could

avoid tax on all capital income on that IRA for more than three-quarters of a century.

The Roth IRA became especially appealing in the politically charged budget process because in its first few years this tax break was actually counted as a tax increase. Despite very large long-term costs, estimators indicated that revenues initially rose when individuals put deposits into Roth IRAs because they would forgo deductions for deposits to a regular IRA. Congress made matters worse by letting individuals switch money already in traditional IRAs into Roth IRAs and pay a tax up front. Of course, taxpayers choosing that option believed it would more than pay for itself with later tax savings. This rollover provision was especially inimical to good budget policy since, for the most part, there was not much additional savings at stake.⁷ Such tax games go against the notion of providing subsidies for saving, since no additional saving is required.

Generally speaking, tax-cutting legislation is backed up by revenue estimates for the first 3, 5, or 10 years only. Yet losses from Roth IRAs will stretch out over many decades and are therefore unaccounted for in these estimates. In a more typical retirement plan, such as a traditional IRA, the government recognizes many of the associated losses up front but gets revenues back as individuals spend down their retirement accounts.⁸ Budget-wise, then, Roth IRAs are about as back-loaded as tax provisions can get, and their impact on the budget will not be fully felt for a long time. About the time that the nation's retirement and health systems for the elderly are placing strains on the nonelderly, many elderly individuals will escape paying tax on income from their Roth IRAs. As we shall see, Congress, following its usual path of copying and expanding its actions, made this the first of many Roth-like proposals for back-loading the cost of retirement and saving incentives.

Other Tax Changes

Excise taxes on airplane tickets were extended but also modified in the 1997 tax legislation. A major battle ensued among the airlines over charging excise taxes on a per-passenger basis versus a per-dollar-value-of-ticket basis, the latter of which favored lower-cost airlines. A new compromise was reached that based the charges on both the price and number of flight segments.

Finally, to Congress's credit, the 1997 bill did contain some tax simplifications. Examples included eliminating some filing requirements for

charitable gifts over \$10,000 and simplifying the audit procedure for partnerships. Another simplification forgave capital gains tax (for up to \$500,000 of gains for couples) on sales of most owner-occupied homes. The old law was fraught with problems: it discouraged people from downsizing at retirement; the IRS had significant problems enforcing the capital gains tax on home sales; and home-owning taxpayers almost never had the data to calculate correctly the gains they made on their homes.⁹ Most of the simplification provisions were restricted to uncontroversial provisions and had a minor impact on revenues.

IRS Restructuring

As in his first term, President Clinton signed the most significant tax legislation for that term in the first year following the election. However, congressional tax-writing committees were far from idle in the succeeding years of his second term.

One resounding debate over the IRS and tax administration solidified into legislation in 1998. This followed several years of complaints mounted against the IRS, its antiquated computer system, and the too-often erroneous advice tendered to taxpayers who called for help. The debate went from red to white hot as Congress began dealing with constituent complaints about the extent to which the IRS harassed taxpayers. The Senate Finance Committee held four days of hearings, after first combing the country for cases of significant abuse (IRS 1998).

While some IRS workers apparently did abuse their positions, the hearings proved to be more bark than bite. Although IRS staff numbers hovered around 100,000 per year, the countrywide search for sensational examples turned up very few clear-cut cases of ineptitude or abuse. Close analysis by the General Accounting Office released many months after the hearings indicated that almost none of the cases trotted out at the hearings involved abuse and that proof of significant IRS wrongdoing was simply not evident (Donmoyer 2000).

A common complaint voiced at the hearings concerned IRS seizures of assets, which are quite rare. A typical seizure might involve a small employer who not only failed to pay taxes owed on his or her own income, but collected withholding taxes from employees and failed to turn them over to the IRS. Thus, the employer stole from other taxpayers' accounts and cheated the government. The Senate Finance Committee also blamed

the IRS for a raid that the IRS had not even organized; rather, a local enforcement agency dealing with nontax issues had launched it.

Whatever the merits of their anecdotal findings, the 1998 Senate Finance Committee hearings prompted added momentum toward a major restructuring of the IRS. This overhaul came about not only through legislation, but also through administrative efforts. For the first time, the head of a major information technology corporation, rather than a lawyer or accountant, was appointed Commissioner of Internal Revenue in 1997 in the hope of moving the Service more fully into the computer age. Charles O. Rossotti came to the IRS from American Management Systems, where he had been chairman of the board.

The Internal Revenue Service Restructuring and Reform Act of 1998 added numerous protections, abated some penalties and interest costs, required more disclosures to taxpayers, and, perhaps most important, led to the revamping of the IRS organizational structure over the succeeding months and years (JCT 1998; Price Waterhouse Coopers 1998). The act created a new IRS Oversight Board to oversee the agency in its administration of the laws, gave the Taxpayers' Advocate Office greater independence, and replaced the IRS geographic administrative units with operating units serving particular groups of taxpayers, such as small businesses.

Despite this partially successful reform of the IRS, many defects and problems remain. First, even after numerous efforts and good intentions over many years, the IRS still has not modernized many parts of its information systems. This can be traced in part to the lack of resources devoted to hiring skilled information technology staff for years prior to the reform. Considering it is one of the most complex agencies in the world, there must be highly trained people internally who can determine its software and hardware needs.¹⁰

Second, the agency is still not equipped to monitor, analyze, or gather adequate data on charitable deductions, housing tax credits, enterprise zones, health subsidies, research credits, energy production incentives, or the many hundreds of other programs it administers. No one knows who benefits from many of these programs, their administrative costs, the number of filing errors in each, and so forth. In this information vacuum, programs are more difficult to run well, congressional program objectives are harder to meet, and policymakers lack the research they need to improve the programs over time. While the IRS may never be given the resources to carry out the fuller policy analysis of these programs that

the public deserves, it should at least have people assigned to ensure more data is collected and programs are monitored sufficiently.

The agency became much less aggressive about auditing returns after Congress's public attack. Code section 1203 of the Restructuring and Reform Act of 1998 listed 10 categories of misconduct—often called "deadly sins" by IRS personnel—for which an IRS employee could be fired. From the time of the hearings to 2002, audit rates plummeted, as did levies, liens, and seizures, actions that IRS personnel now saw as threatening to their careers (Murphy and Higer 2002; Plumley and Steuerle 2003).¹¹ A huge backlog developed in efforts to collect known tax debts and the concerned tax community began to fear that IRS enforcement—particularly on hard-to-detect items such as self-employment income—was practically nil (Burman 2003).¹² By 2003, however, Congress did an about-face and hammered the IRS to bump up its audit rate, albeit only with a 3 percent budget increase. The fear was that cheating was expanding as taxpayers realized their chance of being caught was low.

Some caution is called for, however, in interpreting a longer-term trend toward declining "audit" rates (of which the falloff in the late 1990s was an aberration, though in the same direction). The IRS still computer-matches paper documents payers (such as banks) prepare with the income taxpayers declare.¹³ Direct physical contact with taxpayers plummeted—affecting mainly areas where information matching is not possible, as with charitable contributions, business income, and self-employed independent contractors.

In sum, the IRS reorganization improved the agency's technology, gave taxpayers additional layers of protection, and reduced its divisions' inefficiencies. But the IRS is still incapable of analyzing or even reporting many of the policy programs it administers, its information system is still inadequate, its lines of responsibility are still confused, and it faces a fickle Congress when it comes to its audit and collection functions.

Trade and International Issues

In a world increasingly global and dependent upon trade, international issues have naturally come to the forefront of tax debates. Those discussed here are perennials that take on new urgency in the early 21st century as the globalization of production and markets accelerates.

Subsidies for Exports

In the Foreign Sales Corporation (FSC) Repeal and Extraterritorial Income Exclusion Act of 2000, Congress attempted to tackle one part of the exceedingly complex issue of how to tax income U.S. companies earn abroad. Knotty complexities arise because different countries impose different tax regimes, characterized by differing tax rates and tax bases. Because income and sales are often taxed both in the country of origin and in the country of receipt, laws and treaties attempt to limit double taxation and ensure the home country collects some of the tax revenues. The United States generally grants a tax credit for foreign taxes paid on income earned abroad. Concurrently, income a foreign company earns from foreign operations is subject to U.S. tax mainly when dividends are paid to the U.S. individual. Many other countries use a "territorial" system in which the country where the income is earned determines and collects most of the corporate tax on income earned abroad.

Eligible foreign sales corporations, many of which are owned by a U.S. company but located outside the United States, exist mainly to secure partial exemption from income tax for sales profits made abroad. In these cases, the production itself is usually done (sourced) in the United States and the FSC is just a paper conduit. The World Trade Organization (WTO) Dispute Settlement Panel found that the FSC provisions were a prohibited export subsidy, in violation of U.S. treaties with foreign countries. Generally, corporate income taxation is taxed at the source country—that is, where the production takes place—and, by the treaty, corporate income stemming from goods produced for export is not supposed to be assessed at a lower tax rate than profits from goods produced for domestic consumption. On the other hand, consumption taxes are not based on where the product is produced but where it is consumed. Accordingly, the treaty allows rebates of the withholdings of a consumption tax, such as a value-added tax, to the extent that the produced items have been exported.

U.S. politicians from both political parties have often argued that they wanted to grant some type of tax relief to companies producing for export the same way that European countries rebate value-added taxes (VAT). These politicians also argue that they want to keep production at home, so they want to forgive domestic producers from income tax on goods produced for export the same way they would defer or forgive tax on these companies if they located their plants abroad and then deferred or

avoided U.S. tax. The WTO, however, backs a treaty regime that had long been pushed for by the United States that tries to keep companies neutral as to whether they produce for export or not.

Notably, the FSC provisions had replaced a 1971 Domestic International Sales Corporation subsidy that had also been declared in violation of the treaty much earlier. Accordingly, in 2000, Congress repealed this FSC subsidy as well but then substituted a new exclusion for extraterritorial income. In short order, U.S. trading partners opposed it as an illegal export subsidy, thus rekindling the dispute first ignited in 1971. Congress continually struggles with how to deal with this issue, and corporations remain split over how to allocate these types of subsidies.

There are no easy answers here. Direct export subsidies will continue to be declared illegal. An imperfect answer to this problem is to keep government as lean as possible so that tax rates are low. Then there is less gain in using lower tax rates abroad. If subsidies must be provided, then to meet treaty obligations, they probably must be done in an even-handed way—that is, given to all companies whether for export or not. In 2004, Congress found a very inadequate replacement for its subsidy scheme, providing lower tax rates for “industrial corporations” only, even though the definition of “industrial” was almost impossible to determine. Not surprisingly, by 2007 the new chairman of the Ways and Means Committee Charles Rangel (D-NY) would suggest eliminating the 2004 subsidy as part of a reform that would lower corporate tax rates.

Tax Shelters and Foreign Income

Foreign tax shelters also came under scrutiny in the late 1990s (see chapter 3). The tax advantage of establishing offices (but seldom producing) in tax havens through foreign companies and subsidiaries became increasingly contentious, and efforts by the Treasury and the IRS to improve reporting from accounting, law, and other professional firms—an effort that stretched into the next administration—were often stymied by opponents who claimed that such reporting would be burdensome and difficult. A related dispute in 1994 and 1995 had dealt with Americans becoming expatriates to avoid capital gains income tax and estate tax on income earned or wealth accumulated in the United States. Here, too, for the most part, the administration could do little to tax these persons upon expatriation. Some opponents seemed to base their arguments on the notion that all taxes were bad, so any way of avoiding them, even if

it was on the boundary of what was legal, was all right. In this environment, shelters and the use of tax havens continued to grow into the early part of the next century.

Social Security Surpluses and Savings Accounts

Due to a confluence of good luck and budget discipline, by 1998, the federal government, for the first time in decades, was beginning to project budget surpluses under current law. Clinton's 1998 State of the Union address was intended partly to persuade the electorate that, despite the projected bounty, the country ought to stay the course of fiscal discipline, which he claimed had begun in 1993 (Waldman 2000). Congressional Republicans warned that they would seek to return any surpluses as tax relief, boasting that "it would be gone before it arrived." After six years of budget discipline, both parties were ready to open government's coffers somewhat to constituencies' demands. They had already wriggled out from under the pay-as-you-go budget rules (largely enforced since 1990) when, in 1997, they passed a large transportation bill that the president felt compelled to sign.

The budget bulge continued and ever-larger surpluses were projected. Meanwhile, reduction in federal debt lowered interest payments, and this compound effect sparked even more positive projections. By the end of the 1990s, the debate extended to what to do if the federal debt was entirely paid off—for instance, what types of assets the monetary authorities might have to buy and sell when they wanted to change the money supply if there were not enough federal bonds to do the job. Forecasts got rosier still as the economy strengthened. The nation moved toward its longest peacetime expansion without a recession, and people saw the value of their wealth soar. Technology and Internet stocks boomed and new theories held that such stocks should be valued on their growth in sales even when there were no profits (a tenuous argument, to say the least). Increasingly sweeping generalizations about the "new" economy and what it all meant colored the debate on taxes and spending.

Some forces behind the budget surpluses were entirely predictable. Demographically, most baby boomers were still working, and the largely retired baby bust population of the Depression and World War II was too small to swell the ranks of the elderly, so Social Security tax payments temporarily grew relative to benefits being paid. But other budget

boosters were unexpected. Wage growth was higher than anticipated, and the growth in the value of many stocks, particularly technology stocks, prompted extraordinarily high levels of capital gains realizations relative to the size of the economy. Stock options were also being realized by corporate executives. Moreover, the Medicare constraints enacted in 1997 were holding down costs better than projected, at least initially.

An often-contradictory debate sprang up over what to do with these unexpected surpluses. Within the divided government, many Republicans eschewed more spending, while many Democrats abhorred more tax cuts. A major contest arose over who was more likely to "save the Social Security surplus." In Washington-speak, this meant avoiding a deficit calculated apart from any savings taking place in the Social Security trust fund. Historically, government saving in Social Security was more than offset by government dissaving or deficits in the rest of the budget—leaving a net deficit even as unfunded promises to future retirees built up. Most Social Security taxes had not been saved in the trust funds throughout most of the program's history but instead were spent immediately to pay for benefits. Nonetheless, from the enactment of the 1983 amendments (see chapter 6) until enough baby boomers retire (about 2017), Social Security is taking in slightly more in taxes than it is paying out each year (Social Security and Medicare Boards of Trustees 2007).

In this confusing debate, neither party ever made clear what a policy of "saving the Social Security surplus" would mean once the program started running huge deficits. But that did not stop Republicans and Democrats from competing over who could do it better. Initially, the goal meant moving toward a positive non-Social Security budget surplus (that is, a unified budget surplus in excess of the Social Security surplus) at some point down the road—say, in 10 years. But as the budget numbers began looking rosier and rosier, running these types of surpluses right off the bat became a possibility so long as no significant tax cuts or major expenditures were enacted in 1999 or 2000. The administration and some House and Senate members also began hailing temporary Medicare surpluses as funds that should be "saved."¹⁴

Both the Treasury and the White House toyed with ideas of Social Security reform. However, the attention garnered by President Clinton's impeachment basically derailed any attempt at major reform late in his second term. The president's national economic adviser, Gene Sperling,

indicated that this was one of the real disappointments of Clinton's second term.¹⁵ Nonetheless, a positive outcome of the partisan fight was greater budget stringency. A government divided proved to be a fiscally prudent government, at least as measured by deficits (see Liebman et al. 2002).

Individual Accounts and USA Accounts

No serious discussion of Social Security is complete without mentioning the debate over whether to establish accounts in which government taxes (particularly Social Security taxes) would be deposited in individual retirement accounts similar to IRAs or 401(k) plans.¹⁶ This issue's implications for tax policy are enormous since establishment of such accounts would fundamentally alter the ways taxes are used to meet retirement needs.

For almost seven decades, federal tax policy has mainly supported two pillars of retirement. First is the Social Security system, largely financed on a pay-as-you-go basis, through which the Social Security taxes of workers largely go immediately to pay benefits to retirees. Second is a voluntary private system subsidized by tax policy, which favors saving for retirement over other forms of saving—usually by allowing deferral of tax on any earnings or compensation deposited to pension or retirement accounts, as well as on income earned on those deposits. This income is taxable only when withdrawn. In this tradition, retirement plans and pensions are favored by the delay of taxation, but the system provides no grants or similar direct subsidies. The Roth-type savings accounts discussed earlier differ in excluding (rather than deferring) capital earnings from tax, but likewise do not rely on grant-like subsidies.

By the late 1990s, analysts had begun to consider whether Social Security taxes should be deposited directly in "individual accounts," as was being done increasingly in other countries. Although the issue need not be partisan, advocates from some think tanks that label themselves as conservative, or libertarian (such as the Cato Institute), put their voices together with some successful members of the financial services industry to make individual accounts—and a simultaneous attack on traditional Social Security—into a crusade. But some from other think tanks that label themselves as Democratic or liberal combined with labor representatives to conduct a counter-crusade to hold that traditional Social Security was almost sacrosanct. Loathe to tap Social Security funds, President Clinton proposed instead in early 1999 that modest deposits

to "USA accounts" be made but financed out of general revenues and kept separate from Social Security.

Political implications aside, individual-account and USA-account proposals have many common elements. Either would establish a pillar that is a hybrid of the existing two pillars. Mandated taxes still have to be used (whether income or Social Security taxes). Unlike Social Security, these dollars would be deposited into accounts for individuals under both scenarios. In many cases, the individual does not need to do anything—the tax money is deposited on his or her behalf—but in others, the individual may have to provide some matching money.

One distinction is worth noting. USA accounts were dressed up as an income-tax credit, rather than an expenditure credit—in other words, a tax cut rather than an increase in expenditures. President Clinton had not relinquished his use of the income tax code to try to deliver his programs.

Proponents of these two types of accounts mainly differed not on whether such accounts by themselves might add to retirement security, but on the source of financing. Clinton, for instance, wanted to use non-Social Security money whereas many others (including the next President, George W. Bush) only talked about redirecting to the accounts a share of the Social Security taxes already collected. Under the second approach, other Social Security benefits are usually pared to help deal with the loss of Social Security revenue. But the first approach faces a similar budget constraint, since the money must come from somewhere—either a new mandate, additional taxes, or reduced expenditures. Advocates of both approaches at the end of the Clinton administration remained vague on which expenditures would be cut or which taxes increased.

A final issue is whether deposits to these accounts should be made disproportionately higher for moderate-income individuals than for better-off taxpayers; both political parties have now bought into this idea at some level. (A commission formed by the succeeding Republican president, George W. Bush, would have had subsidies to the accounts higher as a percentage of earnings for taxpayers whose income was lower.)

Although rhetoric in the individual account debate has often been highly charged, the money involved actually totals only a tenth or so of promised expenditures for elderly programs. In fact, focus on this issue so skewed the debate on the elderly budget that it was difficult to address many other serious issues, such as Social Security antipoverty effectiveness and possible

discrimination against single heads of households (Steuerle and Favreault 2003). The point for tax policy is that mandated saving accounts are a very different and new way of using tax dollars to subsidize retirement—one that has been already adopted by many countries around the world and one that would come up again in future Social Security reform debates (see chapter 11).

The Community Renewal Tax Relief Act of 2000

The Community Renewal Tax Relief Act of 2000, signed into law by President Clinton on December 21, 2000, after the election of his successor, deserves attention as a prime example of how legislators try to use tax policy to serve communities.

Ever since the advent of enterprise zones in the 1980s, policymakers have looked to market-based initiatives to spur growth by granting special favors to particular places or regions. Although such programs were often thought of as help for poor communities, Congress has attempted to subsidize some communities in almost every state. In the Clinton administration, “empowerment zones,” “renewal communities,” and “new markets” partially replaced enterprise zones. Empowerment zones were first authorized in the 1993 and 1997 tax acts. The 1997 act cost \$32 billion over 10 years, with annual costs rising to \$5 billion by 2009.

The 2000 community renewal act designated 40 areas to be “renewal” communities. They would receive wage credits, extra deductions for purchases of depreciable assets, and no capital gains tax for qualifying assets. Nine new “empowerment” zones were created. New tax credits were allowed for qualified equity investments in low-income communities through the acquisition of stock or a partnership interest in a selected community development entity (CDE). The bill allowed states to float more private-activity bonds and increased the amount of low-income housing tax credits that states could issue.

As in the case of earlier enterprise zones, the subsidies were a potpourri, and their impacts were hard to track. The Government Accountability Office was assigned to make assessments in 2004, 2007, and 2010. Its 2004 report, not surprisingly, noted that “the lack of tax benefit data limits the ability of HUD and USDA to administer and evaluate the programs” (GAO 2004). As previously noted, the IRS for the most part simply does not gather much data on such programs, making it exceedingly hard to

know how much of this \$30 billion is misappropriated or effective, much less what proportion goes to lawyers, bureaucrats, and other intermediaries. Indeed, a very large question—how much benefit inures at all to the targeted communities, particularly their poorer constituents—remains unanswered.¹⁷ For instance, the new markets tax credits are more generous than more universal capital gains relief and wage credits already available. Apparently trying to mimic the low-income housing tax credits, the new credits provide a significant share of the up-front cost (perhaps 25 percent) of an investment.

Any time tax subsidies are allowed on one side of a street or community boundary and not on the other, however, issues of efficiency and equity arise. Geographically based subsidies such as those in the 2000 act could possibly catalyze a community to deal with its problems (see Steuerle 1992). But equity is not served when subsidies to those in particular geographic regions are favored over more broadly available wage subsidies aimed at the poor, wherever they may live. The few studies that have been done on enterprise, empowerment, renewal, and new markets zones and communities call into question their effectiveness. (See for instance, Papke 1993 and 2000.)

Century's End

It is hard to discern any defining principles or rules behind tax policy over the second Clinton term. The divided government rarely evoked such tax policy principles as efficiency, equal justice, or simplicity. The domestic policy focus was on deficit reduction, and the administration dictated almost no large domestic initiatives, especially after the failure of health reform in Clinton's first term and the 1994 Republican takeover of the House of Representatives. For President Clinton, deficit reduction was valuable in its own right, and it was his way of fighting tax cuts he considered unjust or unaffordable. He fought off big tax cuts with the veto.

Where Clinton accepted tax cuts, they often provided more redistribution from the rich to the poor than other across-the-board alternatives. Clinton also favored smaller cuts if they were a way of creating new programs that had middle-class appeal, such as educational subsidies. Perhaps the most interesting new development of these sanguine "new economy" years was the evolving recognition that something should be done to reform Social Security and the parallel debate on alternative ways to

subsidize private pensions through different types of tax breaks or mandated saving that went into individual accounts.

Although Clinton's tax increase in 1993 was designed to maintain alternative minimum tax revenues, Clinton proposed some relief in his final budget, fiscal year 2001. His proposal would have provided \$33 billion of AMT relief over 10 years to appease the "soccer moms"—the swing voters who came out in force in the 1994 election to return congressional power to the Republicans (OMB 2002, 410). His proposals removed the AMT treatment of personal exemptions and the standard deduction as if they were tax shelters (effectively disallowing them). Len Burman, then deputy assistant secretary for tax analysis at the Treasury, recalls how "nobody disputed the facts that the AMT was horrible tax policy and that it was going to affect millions of taxpayers in a few years. But the Treasury/White House position for a long time was that it mostly affected higher-income people and was therefore a Republican problem."¹⁸ Swayed by stories about the AMT impact, Clinton agreed to Treasury's request for the budget item, accepting the advice of Secretary Lawrence Summers over Gene Sperling, his White House national economic adviser. Of course, the budget was only half serious: no one expected the Republican Congress to back the president's proposals in an election year.

By the end of the Clinton presidency, Congress had tasted modest tax cutting and wanted more. Temporary surpluses put that goal within reach, and the way was paved for the next president to take those surpluses and spend them on his own priorities—which would turn out to be major tax cuts but, again, without fixes to items like the AMT.

Bush II and Compassionate Supply-Side Conservatism: 2001 to 2005

In the time of the Emperor Vespasian, the government provided urinals in the streets of Rome, and charged a fee for their use . . . His son asked the emperor whether the additional receipts should be considered a tax increase or a reduction in government expenditures. To this the emperor made his famous reply . . . "Non olet" . . . [or] "It doesn't smell" . . . [or] "It's all money, and it doesn't matter which side of the ledger you put it on."

—Herbert Stein

The early 21st century held many parallels to the early 20th. Progress in new medical wonders, cell phones, and ever-faster Internet connections rivaled the mechanical and energy revolutions a century earlier. Each discovery and development made it plain that a "new economy" was displacing the old, and during presidential elections at both junctures, euphoria reigned.

Good times as the new millennium rolled in invited the belief that predicted federal budget surpluses could be spent before they even arrived. In 2000, neither George W. Bush nor his rival, Vice President Al Gore, suggested making budgetary sacrifices today to make the nation or world better tomorrow. During the campaign, promises trumped probity. The next generation of taxpayers would cover the costs—whether immediate tax cuts or continually rising shares of national income spent on Social Security retirement and enhanced Medicare benefits.

Taking a leaf from President Clinton's 1992 campaign image as a new Democrat, George W. Bush called himself a new type of conservative, a compassionate conservative who favored higher spending on Medicare and education coupled with sizable tax cuts. Further borrowing from Clinton, he co-opted many of the other party's ideas by declaring, "I'm for that, too . . . only in a better form." As few can forget, his contest with Al Gore ended in a dead heat and Republicans could not declare

victory until the Supreme Court passed judgment on the Florida ballot recount.

Tax Cutting Again

For many Republicans, George W. Bush's victory signaled a return to the halcyon days of Ronald Reagan, at least on the tax front. Supply-side economics was back in vogue, though not as fully as critics contended. Reductions in tax rates dominated both the domestic debate in 1981 and—in rhetoric and dollars—the new president's domestic policy in 2001, not to mention much of the rest of his tenure. Even the new homeland security initiative took a distant back seat, at least in terms of dollars.

The administration downplayed budget concerns. According to Bush's first Secretary of the Treasury, Paul O'Neill, budget-minded people like himself and the chairman of the Federal Reserve Board, Alan Greenspan, fought a losing battle. The latter had even asserted that without ensuring that debt targets could be met, "that tax cut is irresponsible fiscal policy" (Suskind 2003, 162).¹ *Déjà vu!* Just as in 1981, White House predictions proved too optimistic, partly because a recession soon followed. And, once again, White House political appointees prevented the Treasury from redesigning tax proposals to avoid the problems that dog attempts to convert loose campaign promises into policy—in this case, deepening deficits and growing dependence upon the alternative minimum tax.

Several of the administration's early tax cuts were phased in. One reason, never publicly stated, was the growing budgetary squeeze discussed in the past few chapters. Budget politics in Washington had become like a game of "chicken"—not just over current activity but also how to control the future. One side played the game by building expenditure increases far into the future, the other by promising tax cuts.

The game transcends partisanship. The reinforced instinct of both parties, given budget rules and the public's addiction to politicians' promises, is to get what you can while you can. In short, the winners in budgetary politics are those who promise easy gratification now but leave the bills to future policymakers. Although politicians always fight over whether to increase spending or reduce taxes to pay for programs, the game was taken to a new level as more and more future revenues were put on the table.

In 2001, the temporary budget surplus delayed the time when constraints on future expenditures and taxes would deprive government of flexibility. Temporarily, politicians could drive faster in this game of chicken and schedule even more long-term giveaways. Admittedly, opponents of big government hoped that tax cuts would eventually squeeze expenditures just as built-in expenditure growth can strangle tax cuts. For example, as noted, the tax cuts of 1981 exacerbated the budget shortfalls of the 1980s and 1990s and perhaps eventually precipitated cutbacks in discretionary spending, along with temporary reductions in Medicare growth. For now, that was only theory. In practice, the administration decided not to engage in a fight on the expenditure side of the ledger; instead, it attempted new expenditure giveaways, including new benefits for farmers and a large increase in health benefits for senior citizens.

What did the administration believe would be the effect of reduced surpluses or, as soon became an issue, higher deficits? O'Neill quotes Vice President Dick Cheney as arguing in late 2002 that "Reagan proved deficits don't matter" (Suskind 2003, 291). While the context of that statement seems to have been in backing further tax cuts rather than higher expenditures,² it became emblematic of the widespread lack of attention to budgetary discipline in President Bush's first term.

The 2001 Tax Cuts: An Emphasis on Tax Rates

In early 2001, it was clearly the tax cutters' turn. The primary economic initiative President Bush advanced was a tax cut aimed mainly at reducing tax rates. Naturally, Congress appended bells and whistles, but the administration succeeded in getting final legislation that still emphasized rate reductions. The Economic Growth and Tax Relief Reconciliation Act of 2001 cut average rates for taxpayers at all income levels and cut marginal rates for about 62 percent of taxpayers.³ Although rarely portrayed as such, marriage penalty relief and the elimination of the estate tax were essentially selective rate reductions. The final legislation also dropped the "first" or "bottom" rate from 15 to 10 percent, thus reducing the marginal tax rate that applied to people moving into the regular tax system after having paid no taxes. Many moderate-income workers already were facing an additional effective marginal tax rate of 21 percent as higher income meant that their EITC benefits phased out, so the 5 percentage point drop in their statutory income tax rate eased that transition.

Going by the public-finance book, reductions in tax rates are usually more efficient than other approaches to tax reduction. President Bush's economic advisers bought into this logic, contending that such cuts create greater parity among taxpayers with equal incomes than do new special deductions, credits, or preferences—all of which are basically new expenditures administered by the tax authorities instead of by direct-spending agencies. Moreover, with lower rates, remaining deductions or exclusions are worth less, and the tax system as a whole distorts individuals' choices less. Of course, whether rates are really cut over the long haul depends on whether the tax cut is eventually financed with other tax increases or with expenditure cuts.

If one ignores this all-important budget issue, by emphasizing rate cuts, Bush's tax cutters may have been more in line than Clinton's with traditional tax principles, such as efficiency and horizontal equity. However, their reluctance to try to broaden the tax base and their willingness to favor new preferences, especially in other tax bills, put the Bush administration back in the same camp as the Clinton administration when it came to paying little heed to traditional tax policy principles.

Progressivity and the Integration of Taxes with Spending

The tax cuts enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 exemplify the difficulty in treating taxes and expenditures separately in a tax bill. Consider the debate in 2001 over the cut's progressivity.

Unlike the 1981 Reagan tax cut, the Bush administration proposal (excluding for now the estate tax and the alternative minimum tax) gave a significantly larger percentage tax cut to those at the bottom than at the top. In the 1970s, such a proposal would have been considered reasonable. Then, inflation-driven bracket creep usually ushered in tax increases for those in the broad middle-income band in a way that was proportional to current taxes. Consequently, tax cuts that were proportional, or more than proportional, would maintain progressivity overall when laid against the inflationary tax increases.

The complication, of course, is that when tax cuts are not offset by tax increases something eventually has to give on the expenditure side. Viewed this way, few tax cuts are likely to be progressive. For example, consider a cut in a regressive tax like Social Security, which taxes the poor at a higher rate than the rich. The poor may still be worse off after

the cut if they eventually lose more in expenditures than they gain in tax cuts.

Under a more inclusive measure of progressivity, most attempts to shrink the modern welfare state reduce net redistribution (ignoring effects related to efficiency and growth).⁴ After all, expenditures are much more evenly split than collected taxes in dollar terms (and are sometimes even aimed only at low-income households). If redistribution is the only goal, fewer taxes usually mean relatively less of it. It doesn't necessarily matter whether government is bloated, society wants to move away from communism or socialism, excess revenues flood in unexpectedly, inefficiency rises exponentially as government grows, or whether slimming down government enhances overall economic growth.

When the 2001 tax cuts are compared with the tax increases of the 1990s, the progressivity debate plays out in different ways. Designed to minimize political fallout, most modern statutory tax increases (e.g., 1990 and 1993) target only a few people, usually at the top of the income scale. Judged by how much the rich pay relative to the middle class, that makes the increases progressive. Now consider tax cuts, such as those in 2001, that reduce taxes for a broader spectrum of households—including those spared significant tax increases in previous years. The combined effect of the increases and cuts over time may be a more progressive system. (Of course, the calculation of net change in progressivity over time also requires accounting for such factors as bracket creep in the individual and alternative minimum taxes, and Social Security tax changes.)

Partly because of the ways these dynamics interacted, the Congressional Budget Office found little net change in the tax system's progressivity as a whole over most of the postwar period (see figure 3.7). The primary exceptions are at the bottom and very top of the income distribution, as discussed below.

A significant part of the 2001 progressivity debate centered on how to extend the tax cut benefits to those at the bottom of the income scale. Partly because tax cuts in 1986, 1990, and 1993 eliminated the tax liabilities of so many lower-income people, the only way to give them some share of benefits in 2001 was through expenditures. The 2001 bill did that in the end by making the child credit partially refundable. President Bush had proposed increasing the child credit from \$500 to \$1,000 only for those who pay taxes, but the final bill phased in the credit for those with incomes above \$10,000, whether they paid taxes or not. The budget counts the refundable portion of credits (EITC and child credit) as expenditures

even though the IRS administers them. In short, the distributional fight over progressivity in 2001 could not be resolved within the tax system alone: both sides of the budget had to be aligned.⁵

Table 11.1 shows the combined distributional impact of the 2001 through 2006 income tax cuts (largely dominated by 2001 changes) for taxpayers in 2006. The table does the same for the year 2010, when all provisions are supposed to be phased in. The table also includes the expenditure increases from raising the child credit for taxpayers and nontaxpayers

Table 11.1. Distribution of Income Tax Change under the 2001–2006 Tax Cuts

Cash income percentile	AVERAGE FEDERAL TAX RATES					
	2006			2010		
	Before tax cuts	After tax cuts	Difference (after–before)	Before tax cuts	After tax cuts	Difference (after–before)
0–10	4.8	4.7	–0.1	4.6	4.5	–0.1
10–20	3.3	3.0	–0.3	3.8	3.3	–0.5
20–30	6.4	5.0	–1.4	7.2	5.6	–1.6
30–40	10.9	8.8	–2.1	11.6	9.5	–2.1
40–50	14.5	12.3	–2.3	15.1	13.0	–2.1
50–60	17.8	15.8	–2.0	18.1	16.3	–1.8
60–70	19.7	17.8	–2.0	20.5	18.6	–1.8
70–80	21.2	19.2	–2.0	21.9	20.1	–1.7
80–90	23.4	20.8	–2.6	24.2	22.3	–1.9
90–100	29.9	26.9	–3.1	29.9	27.0	–2.8
All	23.8	21.3	–2.5	24.1	21.8	–2.3
Addendum						
90–95	25.5	22.7	–2.8	26.2	24.6	–1.6
95–99	27.6	24.9	–2.7	28.1	26.4	–1.7
Top 1 percent	34.2	30.7	–3.5	33.5	29.0	–4.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes: Data are for calendar years. Baseline is pre-EGTRRA law. Tax cuts include individual income tax provisions in EGTRRA, JCWA, JGTRRA, WFTRA, AJCA, TIPRA, and PPA.

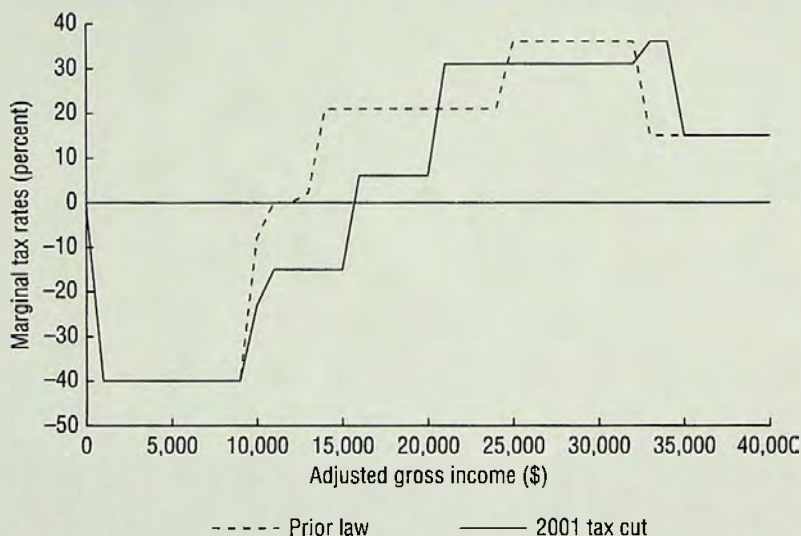
Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

Federal tax includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax.

alike. The reduction in the effective tax rate (and the corresponding percentage change in after-tax income) is fairly significant for all brackets above the 30th percentile of the income distribution. Below that, where tax rates are already negative (counting the EITC and child credit expenditures), the reduction in the effective tax rate is less dramatic. For the lower half of the income distribution, the child credit provides the most benefits of any of the multiple tax changes.

The child credit demonstrates again the importance of considering both tax and expenditure programs when determining an appropriate combined marginal tax rate schedule. Figure 11.1 shows marginal tax rates for a married couple with two children in 2010 under prior tax law and after the 2001 legislation passed.⁶ The figure reflects rates from the regular income tax and the EITC. At about a bit above \$25,000 of income, the marginal rate under prior law jumps up to 36 percent. This combined marginal rate derives from a 21 percent tax rate for those whose EITC was being reduced as income rose, combined with the 15 percent marginal tax rate applied to the lowest-income tax bracket. By

Figure 11.1. Marginal Rates for Married Couples with Two Children in 2010: Prior Law vs. 2001 Tax Cut



Source: Sammartino, Steuerle, and Carasso (2001).

making the child credit partially refundable or available to some who paid no income tax, phasing out the EITC at a higher starting point for married filers, and creating a 10 percent bracket, the final bill helped lower marginal tax rates for many taxpayers near the bottom of the income scale. As in 1990 and 1993, the net change for lower-income individuals derived primarily from the expenditure portion of the bill in the form of refundable credits.⁷

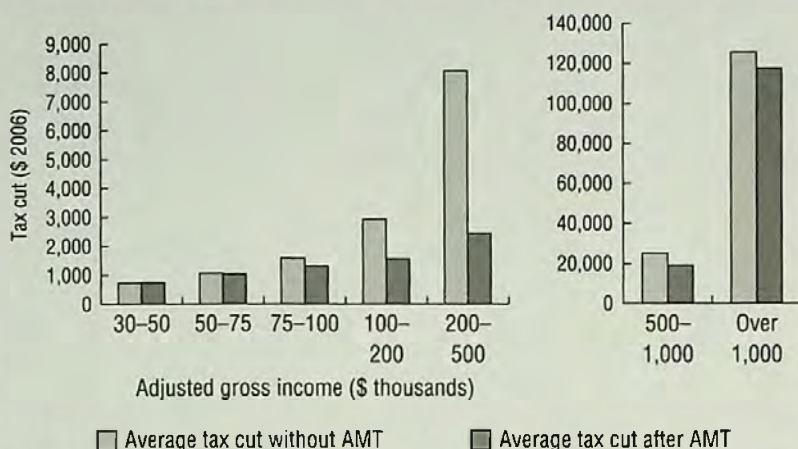
The refundable credit approach to enhancing the progressivity in 2001 evolved partly from debates over how to reduce fairly high work disincentives and marriage penalties—as seen in the high marginal tax rates—among those who did not earn enough to owe income tax (see Bull et al. 1999; Ellwood and Liebman 2000; Feenberg and Rosen 1995; Rosen 1987; Sammartino, Steuerle, and Carasso 2001; Sawhill and Thomas 2001).⁸ With significant growth in low-income relief in recent years, more than a third of households now pay no net income tax. Hence, refundable credits become the only way in a tax bill to allocate some share of a cut to low-income households or to deal with their marginal tax rates, work disincentives, and marriage penalties.

Of course, further coordination across programs would better address these issues. As noted, adjusting refundable credits is really about expending funds.⁹ Given precedent and jurisdictional boundaries among congressional committees and executive branch departments, however, refundable credits are the only expenditures coordinated to any extent with taxes and, at least in a tax bill, the only viable way the tax-writing committees have found to reach low-income Americans.

Estate Taxes and the Alternative Minimum Tax

Two changes in the 2001 legislation simultaneously mitigated and enhanced the statutory income tax rate reductions for higher-income taxpayers. First, the 2001 act substantially increased the number of taxpayers subject to the alternative minimum tax (AMT): AMT rates were not lowered though statutory tax rates were reduced, thus limiting any net tax cut. For instance, if a household formerly had a regular tax liability of \$20,000 under standard calculations and a total liability of \$19,000 under the AMT, reducing the regular tax liability to \$18,000 left the household paying \$19,000, effectively halving the tax cut.

As figure 11.2 shows, the AMT offset to the 2001–2006 rate reductions hit taxpayers with \$100,000 to \$500,000 of income hardest. Tax-

Figure 11.2. The Effect of the AMT on the 2001–2006 Tax Cuts in 2010

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

payers in even higher income classes are almost immune from the AMT because their statutory tax rates are high enough to keep them on the regular tax ladder. Table 11.2 shows the remarkable number of taxpayers, including nearly all middle-income families with children, who will be paying the AMT by 2010 as a result of the 2001 legislation (and subsequent legislation, most of which did not affect 2010 liability). As we shall see, this predicament haunted legislation throughout the Bush administration.

Although the near wealthy get a much lower tax break, on net, because of the AMT, a second change would make the wealthiest taxpayers much better off—the complete phase-out of the estate tax by 2010. The law imposes a tax on money left to estates only of the wealthiest decedents, who thus would benefit most from its removal. This change concentrates tax reduction on the highest income group much more than most previous tax cuts, including those of Ronald Reagan. If the effects of this change were also calculated in the distributional tables just presented, almost half of all the tax cuts would go to the very highest income groups.

The phase-out of the estate tax has divided America's wealthiest income classes. Bill Gates, Sr., the father of the nation's wealthiest person,

Table 11.2. AMT Projections

Characteristic	AMT PARTICIPATION RATE (PERCENT) ^a		
	Current Law		Pre-EGTRRA Law
	2006	2010	2010
Tax filers by cash income (thousands of 2006\$)^b			
Less than 30	—	—	—
30–50	—	3.0	2.9
50–75	0.2	17.1	13.1
75–100	0.7	49.9	26.1
100–200	4.8	80.4	32.0
200–500	50.9	94.3	54.2
500–1,000	49.3	72.2	22.6
1,000 and more	31.4	38.8	19.1
Tax filers by number of children^c			
0	1.9	16.8	3.9
1	2.7	32.4	16.0
2	5.0	42.0	34.0
3 or more	7.4	48.4	50.3
Tax filers by filing status			
Single	0.9	3.8	1.7
Married filing jointly	5.1	47.9	22.2
Head of household	1.3	17.0	14.5
Married filing separate	5.7	47.4	17.6
Married couples, 2 or more kids, \$75,000 < AGI < \$100,000			
	0.8	88.6	86.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes: — = less than 0.05 percent.

a. Includes returns with AMT liability on Form 6251, with lost credits, and with reduced deductions. Tax units who are dependents of other tax units are excluded from the analysis.

b. Taxpayers are defined as returns with positive income tax liability net of refundable credits.

c. Tax units with negative cash income are excluded from the lowest income class. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

d. Number of children is defined as number of exemptions taken for children living at home.

spoke for thousands of other wealthy individuals who signed a petition to oppose the estate tax's repeal. He argued that that the super rich have an obligation to share their large gains with other members of society. On the other side are such economic titans as heirs to the Gallo wine and the Mars candy fortunes (Gates and Collins 2002a; Weisman 2003). One prominent pro-repeal family, the Blethens, who own *The Seattle Times*, rallied more than 75 newspapers nationwide to run "death tax" ads, and their company created and runs the web site <http://www.deathtax.com>. Pollsters working for the anti-estate tax contingent bragged that labeling the estate tax the "death" tax worked wonders on swaying fence sitters to adopt their views.

Note that the wealthy are not taxed on their estates except to the extent they transfer funds to their families or other persons. After all, through a charitable deduction, they can still largely give to people other than a select group of heirs and even build their legacy, while giving the government nothing. The political divide among the very wealthy over the estate tax thus partly mirrors a divide over one's social obligation to give to charity if one has great wealth. That helps explain why the second wealthiest person in America, Warren Buffett, opposed removing the estate tax—he had decided to give most of his wealth to charity. Those who believe that society loses when the wealthy settle huge sums on their kids naturally find little merit in perpetuating dynastic status.

Poll data reveal interesting aspects of the wealthy class's political leanings. Compared with the past, by 2000, a much smaller percentage of the wealthy still identified themselves as Republican, abandoning a long-standing political stronghold (Brooks 2000; Connelly 2000; Starobin 1998). Past income tax rate reductions had possibly shrunk their stake in further tax cuts, a keystone of Republican dogma. Then, too, newer wealth has accrued in such fields as technology, health, entertainment, and law, where well-heeled professionals tend to be more positive about government's role.

This novel political realignment notwithstanding, the 2001 tax cuts gave only moderate cuts to the near wealthy relative to the wealthy. For the former, increases in the alternative minimum tax offset most of their tax cuts. The poor and lower-middle class won some benefits, but the very rich received the greatest tax rate reduction or the highest increase in their after-tax incomes and will benefit even more if the estate tax is permanently eliminated.

Terrorism, Economic Slowdown, and Revenue Shortfall

The collapse of the World Trade Center towers remains the most enduring image of 2001—an inexplicable act of terrorism. Before the attack, economic projections indicated that, even with the passage of tax cuts, the nation's budget would continue to run surpluses at least until baby boomers started retiring in droves. President Bush claimed that his 2001 tax cut would consume only a portion of the surplus, leaving enough to bank the temporary Social Security surplus (see the debate in the Clinton administration on this topic in chapter 10) and to address unforeseen contingencies.¹⁰ Not long afterward, however, his optimistic surplus projections had to be abandoned. A modest economic slowdown combined with a slump in stock prices produced an unprecedented fall in revenues.

The terrorism threat combined with the economic slowdown, however, to give Congress and the president excuses to throw budgetary caution to the wind. The pay-as-you-go budget rules, which had survived in tattered form since 1990, were now routinely shoved aside, and spending rose to meet new needs, real and perceived. Generous farm subsidies and defense increases unrelated to forestalling terrorism passed handily, while some social spending bills simultaneously received expensive boosts. One Congressional Budget Office study indicated that the fiscal 2003 deficit increased by about \$70 billion thanks to discretionary spending alone.¹¹

The administration wanted to show it was still concerned about the economy. Once again, tax cuts were its chosen vehicle, even though the cumulative shortfall in revenues was ballooning. The end result was the passage of the Job Creation and Worker Assistance Act of 2002. The act provided additional temporary unemployment assistance, extended tax relief to New York City in the wake of the terrorist attack, and renewed some expiring provisions. Among these were the "Work Opportunity" tax credit, the "Welfare to Work" tax credit, and a deduction for clean-fuel vehicles. In terms of revenue impact, a special depreciation allowance for purchases of certain equipment topped the heap (Joint Committee on Taxation 2002b).

Accelerated Depreciation or "Partial Expensing" of Asset Purchases

Eager to provide an economic stimulus, both Republicans and Democrats supported this new immediate deduction or expensing option for

some portion of physical capital expenses.¹² This super acceleration of depreciation allowances proved popular on both sides of the aisle because it immediately provided more money to businesses than it eventually cost the U.S. Treasury.

Getting deductions up front is one way of reducing effective tax rates. Think of it as getting a zero-interest loan from the government on taxes otherwise due.¹³ Such deductions also have a sizable impact on cash flow to the firm. Take a simple example of an asset costing \$1,000 that is normally written off over five years. When a business adds an up-front 30 percent write-off of costs to an existing depreciation allowance of one-fifth of value, the first-year deduction rises from \$200 to \$440. Yet, this interest-free loan does have to be repaid to the Treasury coffers, and though the firm deducts \$240 extra in the first year, it deducts \$240 less in following years (for instance, \$96 of deduction will be forgone in the second year).¹⁴

Many advocate accelerating depreciation to reduce taxes on capital income. In particular, some consumption tax advocates embrace any argument for expensing or moving toward writing off 100 percent of cost in the first year since this is the first step in transforming the income tax to a consumption tax. But those who like to pump money into the economy temporarily to stimulate growth may be the happiest of all: the cash infusion they get is large relative to the eventual revenue loss. In effect, supply-siders (who want to lower effective marginal tax rates), consumption tax advocates (who want to expense investment), and the Keynesians (who want to get more money into people's hands) all have reasons to support the temporary partial expensing of physical capital investment.

Unfortunately, these camps have paid little attention to the problems known to plague the payback period. Encouraging firms to move capital investment into the qualifying period, for instance, could slow down capital investment later. Moreover, if a temporary incentive lasts three years, firms might play games as the expiration date nears. For this reason, the incentive could *shift* investment into that three-year window rather than *increase* it over time, thus causing an economic slowdown after the third year. An even bigger problem arises if the next time the economy seems to be losing steam, business slows down investment more quickly while waiting for a new depreciation incentive that would not apply to purchases bought before its announcement.

While there are pros and cons to discretionary fiscal policy, a classic argument against it holds that Congress waits too long to provide

incentives. Legislators can't get the timing right. With accelerated depreciation, not only do several months pass between the discovery of a downturn and congressional action to start the incentive, but Congress also sets the end of the incentive years in advance, long before anyone knows what state the economy may be then. In short, both removing and activating incentives fall prey to bad timing.

Two additional costs of this type of incentive bear mention. First, the incentive thwarts innovation because it usually helps established businesses more than start-ups, which seldom have enough taxable income to exploit the extra deductions. In 1986, tax reformers argued that rate cuts beat old-style accelerated depreciation because depreciation favors established firms with taxable income from old investments over new firms and because new temporary allowances add to tax accounting complexity.

The Extraordinary Additional Revenue Shortfall

Between January 2001 and November 2003, the Congressional Budget Office's revenue projection for fiscal year 2003 dropped by about \$450 billion.¹⁵ In one fell swoop, revenues as a percentage of gross domestic product fell from an all-time high of 20.4 to 16.5, the lowest level since 1959. The CBO projections indicated that the decline in economic growth forced receipts down by \$144 billion. Among the causes, capital gains realizations fell precipitously: capital gains distributions from mutual funds alone dropped by about 80 percent, while fewer stock options, less incentive pay, and so forth temporarily reduced the share of income by the taxpayers paying the highest tax rates. Still, the tax bills accounted for only about a third of the total fall-off, so the economic slowdown was not fully to blame.

The total revenue drop was extraordinary—close to 4 percentage points of GDP. Of this, about 1 percentage point was due to the drop in GDP itself and the rest to the drop in average tax rates. Meanwhile, state and local revenues plummeted. Counting expenditure increases, the total drop in the government's surplus (or increase in the deficit) outstripped the total drop in national output. This was a level of "stimulus," as measured by change in government cash flow, that defied any historical standard and economically would be almost impossible to repeat in any downturn for the near future.

Still More Stimulus in 2003

In mid-2002, the economy picked up steam again, only to slow modestly late in the year through the first part of 2003. More important, however, was that the unemployment rate did not fall once economic growth resumed.

Correctly or not, many attributed the political defeat of President George H. W. Bush in 1992 to his lack of a strong domestic policy to combat the 1990 recession. Paying heed, the administration of the younger Bush was determined not to take this slowdown sitting down—even though the economy clearly was already back on a modest growth path. Amid this crisis, the U.S. invasion of Iraq in 2003 complicated the political and economic picture.

For the third year in a row, a tax cut emphasizing lower rates and reduced capital costs topped the domestic agenda. First, the administration proposed accelerating some tax cuts enacted in 2001—in particular, the rate reductions and child credit. Second, its biggest new initiative was relief from the double taxation of corporate income. Income that was taxed once at the corporate level would no longer be subject again to tax when paid out as dividends and capital gains. Third, the administration initially designed initiatives to simplify some complex retirement plan and saving provisions, but soon expanded that effort into a tax-cutting one that would dramatically increase opportunities to put money in individual and retirement accounts. Indeed, these tax-simplification proposals soon morphed into something resembling a consumption tax on the individual receipt side, but not the deduction side. That is, they would have allowed almost all deposits to saving accounts to receive the treatment formerly confined mainly to tax-favored retirement accounts.¹⁶ However, interest deductions would still be allowed—adding immensely to the huge arbitrage opportunities created when receipts of interest and other income are not taxed, but payments of interest and other income outflows are deducted (Steuerle 2003d). Most of these savings proposals were ignored by Congress in 2003, but some were tucked into other bills for later consideration or resubmitted in the next year's budget.

After the first phase of the war in Iraq, the military demand on the budget did not recede. Defense demands were large, as were calls for humanitarian assistance and money to restore order and help the Iraqi economy recover. Although the economy shifted out of recession, the budget offices

continued to show a downward slide in revenues even as spending grew in early 2003. Partly because of the deteriorating budget, some Senate Republicans balked at the cost of the administration's proposed tax cut and joined with Democrats to draft a more affordable package.

In the end, the Jobs and Growth Tax Relief Reconciliation Act of 2003 adopted the following provisions, with a variety of expiration dates to hold down cost. The dates, along with an estimate of the cost of extension to 2013, are shown in parentheses (Gale and Orszag 2003a):

- Temporary increase in the alternate minimum tax exemption (2004, \$244.5 billion)
- Expanded (50 percent write-off) depreciation for corporations (2004, \$170.5 billion)
- Lower dividends and capital gains tax rates (2008, \$164.9 billion)
- Increased child tax credit (2004, \$56.9 billion)
- Expanded 10 percent bracket (2004, \$46.4 billion)
- Tax breaks for married couples (2004, \$26.5 billion)
- More favorable depreciation rules for small business (2005, \$12.5 billion)

This act copied or repeated elements of recent legislation. Much of the cost in 2003 and 2004 derived largely from accelerating various rate reductions, child credits, and tax breaks for married couples already scheduled in 2001. At the same time, real reform of the alternative minimum tax was deferred, though an increase in its exemption level provided some temporary relief.

Although it accelerated most of the 2001 tax cuts, Congress refused to accelerate the increased expenditure associated with the (refundable) portion of the child credit that would go to those paying no tax.¹⁷ Despite the modest size of this proposal, it fueled considerable debate over progressivity. So did interaction between the 2001 and 2003 tax acts. By 2003, most of the 2001 cuts that affected low- and middle-income taxpayers had already been phased in, so by accelerating the remainder of the income tax cuts, the 2003 act concentrated benefits mainly among higher-income taxpayers. Of course, in the long run, accelerating changes has little effect on distributional estimates, so the child credit debate mainly symbolized larger philosophical differences about tax policy. (See table 11.1 for the combined effect of the 2001 through 2006 tax cuts by income class.)

Congress and the president also used the 2003 act to expand the temporary investment provision (see above) of the 2002 legislation (Joint Committee on Taxation 2003). Taxpayers would be allowed to write off a larger minimum amount of investment up to \$100,000,¹⁸ and all businesses could now expense or write off 50 percent (compared with 30 percent under the 2002 legislation) of capital investments. First year deductions for an investment of \$1,000 in five-year equipment now rose to \$600 from \$240 under normal law and \$440 under temporary allowances in the 2002 legislation. While the provision was temporary and not later extended, such large write-offs again favored established profitable businesses with profits from other activities.

The 2003 legislation offered individuals relief from the taxation of their dividends and capital gains. The president proposed extending this individual relief only for income that had already been taxed once at the corporate level and specifically not for never-taxed corporate income. This back-door attack on tax shelters would have necessitated accounting changes but—had it not been abandoned—would have furthered both equity and efficiency. After all, if the greatest gains from lowering tax rates come—as supply-siders would have it—from reducing the highest rates of tax, then revenues spent on reducing the high rate that results from double taxes improve general welfare much more than removing taxes on individuals whose income would be taxed at best only once.

Instead, capital gains and dividends were taxed at a reduced maximum rate of 15 percent (5 percent for some moderate-income individuals). Since capital gains had already been taxed at a maximum rate of 20 percent before the 2003 legislation, most of the revenue loss applied to dividends that had formerly been subject to tax, the same as wages.¹⁹ Clearly, some revenue loss went toward reducing a double tax on income; however, where no corporate tax was paid, the bill guaranteed that capital income would never be subject to a rate above 15 percent and then only when realized as dividends or capital gains. Among the winners, it would turn out, were managers of hedge funds and private equity firms who took their management fees as partnership shares of gains taxed at a 15 percent rate. This controversial consequence would not be fully debated until 2007 (Fleischer forthcoming; Steuerle 2007).

The long-term direction for tax policy remained largely uncertain. The many legislative sunsets set guaranteed future arguments over what should be extended, and large sums were at stake. Simply extending the provisions of the 2001 and 2003 acts alone would more than double

the 2004–2013 cost of the tax bills (Concord Coalition 2003; Gale and Orszag 2003).²⁰ Such sunsets make it hard for businesses and individuals to plan their financial affairs and for budget analysts at places like the Congressional Budget Office to project the government's fiscal position under current law.²¹ Indeed, exactly what is current law under these circumstances?

The 2003 Medicare Act

Compassionate conservatism returned in late 2003 with the passage of a bill establishing drug benefits as a part of Medicare. At the time, the CBO estimated the 10-year cost of the bill at \$395 billion, but the cost in the second 10 years was expected to be around \$1 trillion. Perhaps a better measure of the cost is the predicted annual costs of \$48 billion or 0.36 percent of GDP for 2006, rising to 1.2 percent of GDP in 2025 and to 2.0 percent in 2055 (Board of Trustees 2007). Democrats did not complain about the cost so much as the small benefit level. Of course, neither political party indicated how it would pay for the benefit.

Besides putting long-term strain on the budget and taxes, the bill also had a significant side effect. The Joint Committee on Taxation (2003a) estimated that by 2013 costs would increase by \$4.6 billion annually simply because some employers would drop tax-favored health coverage for retirees once the government started providing drug insurance. Congress adopted an employer subsidy aimed at stemming the loss, but budget scorekeepers viewed it as less than fully effective. Moreover, the design of the employer subsidy violated principles of tax policy, such as efficiency and equity. It was made nontaxable—thus adding to its subsidy value, but only for profitable businesses with sufficient taxable income. In effect, this subsidy discriminated against nonprofitable businesses, nonprofit organizations, and governments by providing them less subsidy for maintaining retiree coverage.

A less-noticed part of the bill created a new income-based premium on high-income Medicare recipients beginning in 2007. Recalling the last time that it tried to impose an extra fee or tax on Medicare recipients (1988, see chapter 7), Congress significantly delayed the implementation date and made the tax conditional upon signing up for part B of Medicare (mainly covering the cost of doctors and tests) (Gould 2003). Of course, almost everyone signs up for part B since the government so heavily sub-

sidizes it, and individual premiums for it alone normally represent only 25 percent of its total costs.

Instead of having the IRS collect the money, Congress turned the table to require the IRS to furnish the information on income to Medicare, which would then deduct the extra fee from Social Security checks along with the flat premium all pay for getting part B coverage. Ways and Means Committee Chairman Thomas's long-run hope may have been that this provision would push the higher-income elderly closer to buying more of their insurance from the private market and thus make them more cost conscious; however, such a strategy raises the issue of whether healthier people would opt out of Medicare and thus make the cost of insurance for remaining Medicare recipients higher. Whether this tax approach is feasible to administer remains to be seen, and its political ramifications will grow with the size of the new fee. Indeed, the monthly premium paid in 2006 was \$88.50 in 2006 for everyone, but in 2007, single tax filers with over \$200,000 in annual income pay \$161.40 a month, rising to \$414.10 a month by 2016 (Board of Trustees 2007, 172). Some other higher-income households with incomes between \$80,000 and \$200,000 will also see a hefty increase.

Separate from Medicare, a new health savings account (HSA) for those under age 65 created even more controversy. Taxpayers and their employers are allowed to deposit up to \$2,600 for singles and up to \$5,150 for families tax-free into an HSA. These consumers must also purchase a high-deductible health insurance policy covering only catastrophic or high-expense health costs. The money in the accounts then may be withdrawn tax-free, now and in the future, to cover the noncatastrophic health costs not covered by insurance. Unused balances also accrue interest in the account tax-free. The extra savings incentive, of course, favors higher-income taxpayers over those in lower tax brackets. At retirement age, moreover, the accounts may be used as a kind of IRA. Withdrawals for nonmedical expenditures are taxed as income, but, unlike IRAs, they are not subject to the penalty that applies to such withdrawals at younger ages.

HSAs are the most generous tax benefit accorded any type of employee benefit anywhere. They are better than health insurance because the money does not have to be spent on health care and can accumulate tax-free. They are better than deposits to retirement plans because the money can be withdrawn more easily and can be spent tax-free on health.

The policy argument behind HSAs, as well as some of their related predecessors, such as medical savings accounts (MSAs), was that people

who pay directly for some health care costs (as with high deductibles) are more cost conscious than those for whom insurance covers all costs. Thus, this logic goes, HSAs drive down costs and deter overconsumption. Still, the initial argument for HSA tax benefits was simply that costs covered through health insurance and cost covered out of pocket should be taxed similarly. By the time Congress finished, the legislation actually provided more benefits overall to HSA-type health plans.

HSAs have also generated controversy over how their benefits are distributed. Critics question whether HSAs will mainly favor high-income people looking for another tax break for saving and whether healthy and wealthy employees will demand high-deductible policies, driving up premiums on more comprehensive insurance and ultimately, threatening its viability. Some voice concern that a \$5,000 deductible is tantamount to no insurance for people with low incomes, so these individuals would have little incentive to buy into HSA policies (Burman and Blumberg 2003). Proponents, on the other hand, argue that employers, especially if they are small or cannot afford comprehensive insurance, might find HSAs an attractive way to help employees buy a low-cost health plan, thereby increasing national health insurance coverage. Moreover, by making people more cost conscious, the new system might constrain cost growth and thus reduce the number of uninsured.

The simple fact is that no one likes any method of containing medical costs—not imposing costs on individuals, not relying on intermediaries like health maintenance organizations (HMOs), not ratcheting up government controls on prices and quantities, as is done partially under Medicare. But somebody has to make those decisions. Learning toward the first approach, HSAs are merely one more patch. And, par for the course in the 2003 health reforms, government tried to buy its way out of the problem even though the long-term health budget was already unsustainable.

Onward to the 2004 Election

The major tax issue in 2004 was the same as it had been for the previous three years—whether the tax cuts of 2001 were appropriate and should be continued. The administration had come close to proclaiming the cuts as its major domestic policy, and even the wars with Iraq and Afghanistan

and the uncovered cost of the Medicare drug bill did not dampen the tax-cutting enthusiasm.

The American Jobs Creation Act of 2004

Perhaps the most significant tax legislation in 2004 came about because of Congress's repeated efforts in previous decades to enact an income-tax preference for items produced for export—efforts that eventually had been declared illegal under our treaties by the World Trade Organization (WTO). The WTO demanded Congress remove the preference it granted through the exclusion for extraterritorial income (ETI), enacted in 2000, which replaced the subsidy for foreign sales corporations (FSC), in turn a replacement for the 1971 domestic international sales corporation (DISC) subsidy (chapter 10). Loath to raise taxes along the way, Congress created a new subsidy that almost no one could support—a preference for “industrial” goods and services produced in the United States, whether for export or not. Trying to return revenues to approximately the same companies bearing the tax increase produced this crazy provision after almost all alternatives (including it) had been rejected as needlessly complex and unfair. The administration, meanwhile, was in a bind: for treaty reasons, it needed to go along with the repeal of the ETI, but it did not like the replacement and lobbied against it.²²

What was so difficult about the new special preference, which eventually came in the form of a lower tax rate for industrial goods and services produced in the United States? It was next to impossible to define “industry” or to determine the exact proportion of a good or service that was produced in the United States or abroad. Lobbyists tried to make sure that the companies they represented were defined as industrial. Among others, the motion picture business succeeded in being defined as industrial, though an amendment excluded pornographic film-making. Reportedly, many IRS agents applied for the job of reviewing which movies would and would not qualify under the amendment.

Congress did worry a bit about real tax reform. It made the definition of children a bit more uniform for breaks ranging from the child tax credit to the dependent deduction. And it added a new penalty on businesses for “failure to disclose” certain transactions the IRS was likely to consider as tax shelters.

A Remarkable Period of Fiscal Giveaways?

From 2001 to 2004, the president and Congress embraced fiscal policies that were unique in the nation's history. The turnaround from surplus to deficit was the greatest in U.S. history for so short a period (with the exception of the Civil and World wars). Had the president's full time in office ended then, he would have been only the second president in the 20th century to preside over increases in defense spending and domestic spending, as well as decreases in revenues, all measured as a percentage of GDP. And the other was Herbert Hoover, who had to deal with the Depression.

Policy simply could not continue for long in that direction. But the president and members of Congress were running again for office. The previous president presiding over large tax cuts, Ronald Reagan, had moved beyond tax cutting in his first year to deficit reduction and Social Security reform in later years and to tax reform in his second term. Would this precedent hold for the new president? Or would he be boxed in by the pressures of the war in Iraq and a Congress with many members who had never had to legislate anything but lower taxes and increased benefits for taxpayers?

The End of the Two Santa Claus Era: Bush II's Second Term

We don't pay taxes. Only the little people pay taxes.

—Leona Helmsley, wife and heiress to a real estate tycoon

At the beginning of his second term, President George W. Bush was confident. Although he had again only squeaked by in the election—this time the outcome had hinged on the state of Ohio—he felt that he had proven in his first term how to assert control over the national political agenda. Moreover, he still had a Republican Congress, now with some years of experience behind it, and a majority of the public expressed trust in his leadership of the country after September 11. At his first press conference after the election, he stated that “I earned capital in the campaign, political capital, and now I intend to spend it.”¹

Early on in his new term, President Bush decided to embark on two major domestic initiatives, both affecting taxes: Social Security reform and rewriting the tax code. He also remained committed to sustaining the 2001 tax cuts; this required extending most of its provisions, since they had various scheduled expiration dates (usually 2010). Well before the 2006 election, however, both of these major initiatives failed dramatically. Furthermore, the mid-term election that year resulted in a shift of power to the Democrats in both houses, jeopardizing his 2001 cuts.

What happened? Certainly the increasing dissatisfaction with the conduct of the war in Iraq made the president vulnerable. Continuing stories of political ineptitude and corruption certainly did not help and detracted attention from the president's initiatives: lobbyist Jack Abramoff's buying of Congressional votes; House Majority Leader Tom Delay's “K Street

project,” under which Republican legislators would deal only with Republican lobbyists, who, in turn, would contribute to the party for their access; Federal Emergency Management Agency Director Michael D. Brown and the inept handling of Hurricane Katrina; and Vice Presidential Chief of Staff Lewis “Scooter” Libby’s indictment for lying to a grand jury over an investigation into the leaking of the name of a CIA worker. At the same time, no historian could fail to note the difficulty faced by any “lame duck” president during his second term.

Yet much more was in play. In their second terms, President Reagan had managed tax reform, while President Clinton combined with Congress to produce welfare reform. And neither of these presidents could claim immunity during their second terms from scandals surrounding them. Unlike his predecessors, however, President Bush in his first term had almost never asked Congress to take any unpopular budgetary action. For instance, unlike President Reagan in his first term, President George W. Bush had largely refused to increase taxes through base broadening to pay for other things he wanted, including greater budget balance.

Consider the longer-term impact of the almost total lack of fiscal discipline on legislators’ habits. After abandoning budget disciplinary rules in 1997 and operating almost solely on the giveaway side of the budget—increasing expenditures and cutting taxes—many in Congress on both sides of the aisle had *never* enacted a bill that took away anything significant from anyone.

By the time Bush’s second term rolled around, nonetheless, the budget had become so tight that there was little room to maneuver. During the previous term’s slide from surplus to deficit, two Santa Clauses (see Wanninski 1974) had coexisted—one favoring fewer taxes and the other, more spending. Now though, there was not enough money left to promise more presents to the public from one Santa Claus, let alone two.

Social Security Reform

Early in his first term, President Bush established a Social Security panel composed of eight Republicans and eight Democrats to put forward a plan to deal with Social Security. He set ground rules that included establishing personal saving accounts and not increasing taxes—not even to pay for those accounts. This created an inexorable arrangement whereby the accounts had to be paid for out of existing Social Security taxes, which,

in turn, reduced the revenues available to finance basic Social Security benefits. Indeed, the White House vetted all the members of the panel first to make sure they had at least some sympathy for personal accounts. This generated animosity with Democrats who claimed the panel was stacked, despite having as one chair former Democratic Senator Daniel Patrick Moynihan.

The attacks on September 11, 2001, however, quickly pushed Social Security reform to the back burner. The rapid movement from surplus to deficit did not help matters: reformers could no longer finance a transition out of the surpluses seen at the turn of the century. A transition was especially important for personal saving accounts, since the government would need to finance both annual deposits to the accounts for current workers and benefits for current retirees, only gradually reducing basic benefits for future retirees as their accounts built up. And it did not help that the panel's final report contained three options, each with its own complexity. One option, put forward by Moynihan, really did not aim to bring the system into balance but simply let some recipients buy personal accounts through a reduction in the basic benefits they would otherwise receive.

The panel did face up to the government's traditional budget and actuarial accounting, but this brought to light the tough choices it faced. Outside the panel, radical political advocates of personal accounts suggested benefits could be maintained or increased in the future and future Social Security deficits eliminated without any pain. They claimed, for instance, that while other reforms used benefit cuts or tax increases, they had a third way. Some members of Congress taking the stance that only benefit cuts or tax increases could remove Social Security deficits were labeled the Pain Caucus.² The panel, however, struggled constantly with paying for its changes. Many adjustments proposed under the panel's principal options, therefore, were painful because deficits would increase for years to come to pay for the accounts, while reductions in benefits for future retirees were required to bring the system into long-term balance.

By the time of publication, Moynihan and many others had concluded that the report was going nowhere. The AARP, among others, had conducted a vigorous attack on the establishment of personal accounts. The president failed to win the support of many Republicans and almost no Democrats. In December 2002, when the panel finally issued its report, it landed with a thud. The White House barely gave it notice.

Two years later, at the beginning of his second term, the president decided to move Social Security reform back out of the hinterlands and give it top priority. The impetus for reform had grown every year, with dramatic changes in the labor force predicted to begin in 2008, when the majority of baby boomers first become eligible for benefits. Each and every year of the Bush administration, moreover, the Trustees of Social Security had pronounced the future shortfalls in the Social Security trust funds and the need to take action sooner rather than later. Most importantly, after his 2004 victory, the president needed a new major initiative to capture the national policy agenda, and he embarked on a “60 day” campaign (which turned out to be more than 60 days) around the country to push for reform with the American people.

The president this time indicated much more flexibility and a willingness to bargain with those who might not favor personal accounts as a means to get the system into long-term balance. He made a significant gesture in that direction in early 2005 when the White House released statements favorable to a major reform labeled progressive price indexing.³ This reform would allow benefits for lower-income retirees to continue growing over time in line with real wage growth, but would restrict benefit growth at higher incomes by requiring benefits above a base amount to grow only with inflation.

The White House hoped that this progressive way of dealing with potential benefit cuts would make a bipartisan effort more likely. Because it still refused to abandon its goal of adding personal accounts to Social Security, however, its messages became ambiguous about what might or might not be acceptable as a compromise. No complete plan for reform was ever released, partly because the president’s strategy to create a bargaining situation never materialized. Some Democrats, sensing their strength, demanded personal accounts be taken off the table entirely before they would even begin negotiations. Of course, they largely ignored President Clinton’s offer of a type of personal account, albeit one that involved an addition to Social Security financed out of income tax revenues.

Although he had tried harder this time than in his first term, the president never succeeded in getting the support he needed—even from many Congressional Republicans, who feared any reform effort was a losing political issue. By the end of 2005, the writing was on the wall, and Social Security moved back into the hinterlands.

The President's Advisory Panel on Tax Reform

Meanwhile, another systemic reform effort moved forward on its own trajectory. On January 7, 2005, President Bush established a bipartisan panel to advise him on options to reform the tax code to make it simpler, fairer, and more conducive to economic growth. The panel held a dozen public meetings around the country. Numerous people were called to testify (including me). The panel members then tried to meet to discuss their conclusions but faced a major hurdle. If a majority met, by law, the meeting had to be open to the public. The committee, therefore, openly divided into two groups small enough to allow private discussions. A consequence, according to panel member and former Representative Bill Frenzel, was that there simply was neither enough time nor ability to consolidate the separate efforts of the two groups when they reconvened.⁴ In the end, the panel offered not one but two options for reform.

In its final report dated November 1, 2005, the panel noted that nearly 15,000 changes had been made to the tax code since the tax reform passed in 1986—equal to more than two changes per day. While each change had a rationale to defend it, together they undermined the integrity of the code. The panel members also stated that they “unanimously recommended two options” to reform the tax code (if it is possible to unanimously support two substantively different options). Perhaps more correctly, they stated that either option was preferable to current law. Unfortunately, as can be seen in the Social Security panel, options do not help elected officials make the tough decisions.

One option was called the Simplified Income Tax Plan, the other the Growth and Investment Tax Plan. Both would have substantially expanded the tax base, converted some deductions toward credits that tend to be more progressive, combined 15 different saving incentives into three saving plans, reduced the double tax on corporate profits, and simplified a number of procedures and calculations (table 12.1). They differed mainly in that one plan continued to tax capital income, albeit at a fairly low rate, and the other made the income tax closer to a consumption tax, although even it would have taxed interest and other capital income at a 15 percent rate.

The panel did not get everything right, and consequently, no one supported all its recommendations. Its proposal for simplifying tax incentives for saving, for instance, would have maintained very large tax savings opportunities for taxpayers who merely transfer their assets from

Table 12.1. Options for Tax Reform

		How the Tax Code Would Change	
		Simplified income tax plan	Growth and investment tax plan
Provisions	Current law (2005)		
Households and Families			
Tax rates	Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative minimum tax	Affects 21 million taxpayers in 2006, 52 million taxpayers in 2015	Repealed	
Personal exemption	\$3,200 deduction for each member of a household; phases out with income	Replaced with family credit available to all taxpayers: \$3,300 credit for married couples, \$2,800 credit for unmarried taxpayers with child, \$1,650 credit for unmarried taxpayers, \$1,150 credit for dependent taxpayers; additional \$1,500 credit for each child and \$500 credit for each other dependent	
Standard deduction	\$10,000 deduction for married couples filing jointly, \$5,000 deduction for singles, \$7,300 deduction for heads of households; limited to taxpayers who do not itemize		
Child tax credit	\$1,000 credit per child; phases out for married couples between \$110,000 and \$130,000		
Earned income tax credit	Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child is \$2,747; with two or more children is \$4,536	Replaced with work credit (and coordinated with the family credit); maximum credit for working family with one child is \$3,570; with two or more children is \$5,800	
Marriage penalty	Raises the tax liability of two-earner married couples compared to two unmarried individuals earning the same amounts	Reduced; tax brackets and most other tax parameters for couples are double those of individuals	

Other Major Credits and Deductions

Home mortgage interest	Deduction available only to itemizers for interest up to \$1.1 million of mortgage debt	Home credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about \$227,000 to \$412,000)
Charitable giving	Deduction available only to itemizers	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses
Health insurance	Grants tax-free status to an unlimited amount of premiums paid by employers or the self-employed	All taxpayers may purchase health insurance with pretax dollars, up to the amount of the average premium (estimated to be \$5,000 for an individual and \$11,500 for a family)
State and local taxes	Deduction available only to itemizers; not deductible under the AMT	Not deductible
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income	Taxpayers can claim family credit for some full-time students; simplified savings plans

Individual Savings and Retirement

Defined contribution plans	Available through 401(k), 403(b), 457, and other employer plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts "prepaid" or Roth-style)
Defined benefit plans	Pension contributions by employers are untaxed	No change
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs—subject to contribution and income limits	Replaced with Save for Retirement accounts (\$10,000 annual limit) available to all taxpayers

(continued)

Table 12.1. Options for Tax Reform (*continued*)

Provisions	Current law (2005)	How the Tax Code Would Change	
		Simplified income tax plan	Growth and investment tax plan
Education savings plans Health savings plans	Section 529 and Coverdell accounts MSAs, HSAs, and Flexible Spending Arrangements	Replaced with save-for-family accounts (\$10,000 annual limit); would cover education, medical care, new home costs, and retirement saving needs; available to all taxpayers; refundable saver's credit available to low-income taxpayers	
Dividends received	Taxed at 15% or less (ordinary rates after 2008)	Excludes 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Taxed at 15% or less (higher rates after 2008)	Excludes 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax-exempt municipal bonds)	Taxed at ordinary income tax rates	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Taxed at three different levels, depending on outside income; marriage penalty applies	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than \$44,000 in income (\$22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	

Small Business

Tax rates	Typically taxed at individual rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%)
Recordkeeping	Numerous specialized tax accounting rules for items of income and deductions	Simplified cash-basis accounting	Other small businesses taxed at 30%
Investment	Accelerated depreciation; special small business expensing rules allow write-off of \$102,000 in 2005 (but cut by 75% in 2008)	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	Business cash flow tax

Large Business

Tax rates	Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%	31.50%	30%
Investment	Accelerated depreciation under antiquated rules	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	Deductible	No change	Not deductible (except for financial institutions)
Interest received	Taxable (except for tax-exempt bonds)	Taxable	Not taxable (except for financial institutions)
International tax system	Worldwide system with deferral of business profits and foreign tax credits	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Applies second tax system to business income	Repealed	

one account to another or, in the income tax plan, who borrow to buy tax-favored assets but really do no net saving. However, as with the Social Security reform debate, most public attacks on the plans centered not on legitimate concerns but on identifying the losers. The press did not even wait for lobbyists to respond; it immediately knew how to go for the jugular and sell controversy. For instance, the panel suggested limiting the home mortgage interest deduction and converting it to a credit. The press reports immediately attacked the panel as unrealistic for asking for any sacrifice from any homeowners—and often failed even to acknowledge that more households would probably gain than lose by such a change.

The panel also dodged a big issue that made its recommendations a bit unrealistic. It was asked to make revenue-neutral options, but the president required the panel to include full and permanent extension of his earlier tax cuts in its definition of revenue neutrality. As in the case of the Social Security panel, the preconditions did not sit well either with the Democrats who opposed the cuts or with budget hawks who would not want to spend enormous energy enacting tax changes without getting the budget in order. Thus, unable to address the longer-term budget issues facing the country, the panel left open whether their suggested fixes would last very long.

Once again, by the time the report was issued, the possibility of tax reform had already been abandoned.

Enactments from 2005 to 2006

Despite its inability to undertake major reform, Congress still enacted numerous small to moderate tax provisions in President Bush's second term. The Tax Reform Commission's note on the 15,000 changes since 1986 indicates just how thoroughly the tax system has effectively become like the expenditure system. More provisions now expire and come up for regular, if not annual, consideration.⁵ In addition, legislators now grant hundreds of special interest provisions—"rifle shots," "earmarks," or whatever else one wants to call them—through the tax code changes, not just through direct spending appropriations.

The largest revenue changes mainly involved extensions of provisions that had been enacted previously but only temporarily. For instance, in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA, signed in May 2006) Congress extended and raised alternative minimum tax

(AMT) exemptions (costing \$18 billion for fiscal year 2007), and extended through tax year 2010 the expiration date for the lower 15 percent capital gains and dividend tax rate established in 2003. Soldiers and Katrina victims also received a number of new tax breaks, although there was little or no consideration of whether direct spending choices could be more fairly and efficiently offered.

Lobbyists had a big hand in other legislation during this period, having enormously expanded their ability to draft and write legislation, often without consideration or formal study by the executive branch or congressional agencies on the potential effectiveness of what might be enacted. What is disturbing is not the vital and important role of lobbyists; it is their usurpation of the role of staff whose job is to vet different policy options according to such basic principles as fairness and efficiency. Take, for instance, the Energy Policy Act of 2005.

This act, which cost about \$11 billion over the 11 years from 2005 to 2016, did little to enhance energy policy. The administration itself later admitted a willingness to remove some special subsidies for oil producers, whose profits had soared during the various oil crises of the first part of the 21st century. The 2005 act did shower favors on all sorts of industries and interests: a shorter depreciation for natural gas pipelines, an extended eligibility for a credit for producing ethanol, a modification of the rules for nuclear decommissioning costs, a faster amortization of geological expenditures related to oil, a credit for investment in clean coal facilities, a solar investment tax credit, and an alternative motor vehicle credit.

In the end, there was no coherent energy policy. There was no ultimate goal of energy independence or pollution abatement, no significant tightening up on gasoline consumption, no call to sacrifice to achieve a long-term goal, and certainly no studies comparing benefits to costs for all the actions undertaken and ignored. There was some money to produce and some to conserve, but the money was very small relative to what a significant energy policy would entail. I do not mean to imply that all provisions were bad; sometimes incentives do work, and producers are often stymied by existing laws and need clarification to move forward. Tough decisions also have to be made over whether, when, and how to open up federal lands and offshore areas for production. Still, the sum of the bill's parts, often determined by the appeals of interest groups and their lobbyists, did not an energy policy make.

Perhaps more representative of an act that dealt with problems and achieved some good is the Pension Protection Act of 2006. Several forces

combined to make this act possible. One was the rising problems facing the Pension Benefit Guaranty Corporation (PBGC), which guarantees some benefits for employees in traditional pension plans. Currently, many plans still have insufficient assets to cover liabilities if the firms declare bankruptcy. At the time of the bill's passage, the PBGC's own liabilities were growing relative to its assets, and employers were threatening to shut down their plans. The act strengthened the PBGC modestly and moved some plans closer toward full funding. Although there remains much controversy over the PBGC (since it effectively transfers money from taxpayers to the employers and employees who negotiate the most risky plans) something had to be done. At least one former Treasury official who was intimately involved concluded that the net impact was to reduce significantly the risk that pension plans would be underfunded in the future (Warshawsky 2007b). In this particular case—unlike many other enactments during this period—the Treasury was more involved from the beginning in designing options thought to be for the public good.

Another issue was the hang-up among the courts in determining whether certain types of pension plans, called cash balance plans, discriminated against older employees. While most courts did not find these plans discriminatory, one court did on the theory that younger employees accrued more interest over time than older employees who got the same benefit and pay for the same job. The bill resolved that employers could offer cash balance plans.

Some provisions received widespread bipartisan support. In particular, a growing consensus developed that employees were more likely to save if they were offered plans in which deposits were automatically taken out of their paychecks unless they opted out. Such opt-out clauses can be contrasted with more traditional clauses, where employees "opt in" to have their employer deduct their contributions. Although the idea was hardly new, and in theory employers might have been able to adopt such plans, they still feared lawsuits without additional legal protection. Moreover, just prior to the enactment of the bill, a retirement security project at the Brookings Institution and Georgetown University's Public Policy Institute engaged employer groups and H&R Block, among others, and concluded that deposits were indeed higher under opt-out approaches—largely because employees were driven by the forces of inertia.⁶ The law made clear that such plans would be allowed.

Another provision permanently extended a saver's credit, which subsidizes retirement plan deposits by modest-income taxpayers. The credit,

however, has always been relatively ineffectual, in part because its maximum benefit amounts are largely symbolic. If taxpayers' incomes are too low, they have no tax against which to apply the credit, and if their incomes are too high, they are phased out of eligibility. The credit, therefore, has very modest costs relative to pension policy as a whole (about \$1 billion per year). Additional provisions of the act attempted to reform multiemployer funding (e.g., for union employees who work for multiple employers), clarified insurance product tax issues, and moderately bumped up the maximum income level for which tax-preferred contributions could be made (Warshawsky 2007a).

Like the energy bill just examined, much of the act responded to built-up pressures from many outside interest groups and their lobbyists. There was often little analysis of whether each provision, usually of modest size, represented good retirement or tax policy. The act also contained many nonpension provisions, such as the permanent extension of 529 plans for higher education saving incentives channeled through states (which, in turn, contract out with private intermediaries). These plans skew educational subsidies to upper- and upper-middle-income families who can take advantage of saving well in advance for their children and grandchildren.

Although the data suggest the solvency of traditional pension plans has increased, this development is likely due to several factors (Watson Wyatt 2006). Corporate funding contributions did increase, but interest rate assumptions also increased, thereby reducing estimates of future liabilities in an accounting sense only. A rise in asset prices also contributed to the improvement of the funding status of plans, but higher asset prices imply lower, not higher, future returns. In the end, the act may have achieved some good on a number of fronts, but it never aimed at any major objective, such as improving the retirement benefits of the very large portion of the population that retires with scarce retirement assets. Nor did it seek to improve significantly the distribution of retirement tax breaks so that those with moderate incomes received a more even share. In sum, much of the pension act represented patchwork onto a system without any overarching vision for what a better system might be.

A contrast might be made between this pension reform and the more renowned Employee Retirement Income Security Act of 1974 (ERISA). The earlier bill aimed to increase the extent to which plans funded the benefits they promised, attempted to reduce discrimination against lower-wage employees, and vested benefits earlier in employees' careers. Furthermore, ERISA is sometimes credited with increasing by hundreds of billions of

dollars the amount held in retirement and pension accounts and funds. By way of contrast, the Joint Committee on Taxation effectively concludes through its revenue estimates that there will be only modest changes in the additional money put into pension accounts because of the 2006 legislation. If the act would stimulate substantial additional deposits, the Treasury would lose substantial revenues in earlier years because of the simultaneous reduction in the compensation subject to tax.

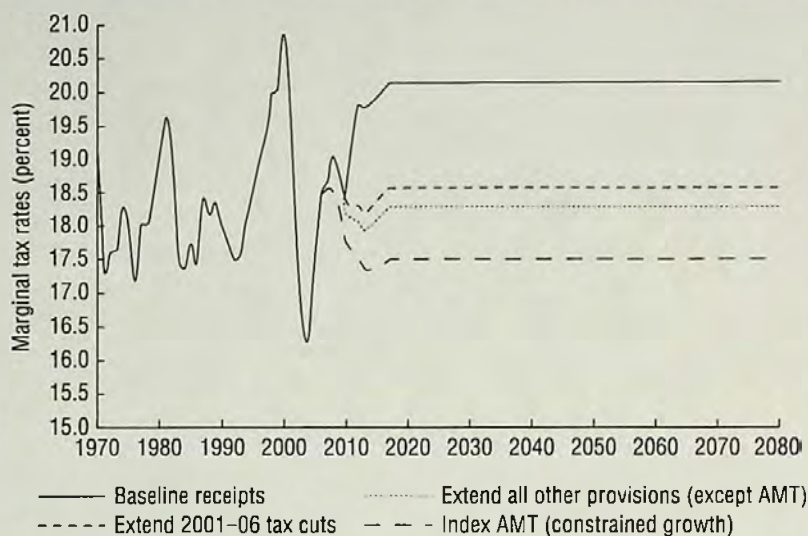
Explaining the difference in congressional attitude is not hard. Congress felt much more bound by revenue constraints in the more recent period, so it wanted to do something without having much impact on the budget (although the bill loses almost nothing in the first few years, losses amount to about \$15 billion by 2015). The 1974 bill was mainly drafted by non-partisan staff with comments from lobbyists; many parts of the 2006 bill were drafted by lobbyists with comments from nonpartisan staff. Our elected officials were much less afraid of reform, including reform that would identify “losers” in 1974; by 2006, they remained at best in a patch-work mood, with a primary goal of identifying no losers.

The Tax Cuts: A Historical Comparison

Tax cuts turned out to be the primary domestic legislative change fostered under the George W. Bush presidency.⁷ They also turned out to be a major item of contention as the 2008 presidential election got underway. It is worth a moment, therefore, to examine how they fit into the larger historical picture of revenues and the budget issues that will dog legislators for years.

Figure 12.1 shows taxes as a percentage of gross domestic product with and without extensions of the 2001 to 2006 tax cuts. The 2001 cut, as finally enacted, turned out to be a bit smaller than what the president had initially proposed, but the 2002 and 2003 cuts increased those amounts, sometimes by moving up the phase-in dates, sometimes by adding such provisions as an additional exemptions for dividends and capital gains.

A traditional way of making sense out of the long-term change in legislation is to look at costs (as a percentage of GDP) in a year when the provisions in question are fully implemented, or assumed to be implemented. Examining this particular tax reduction this way is hard because its implementation was very disjointed: Congress scheduled most breaks to

Figure 12.1. Projected Federal Receipts if the Tax Law Remains Constant

Source: Steuerle, Carasso, and Reynolds (2007). Authors' calculations based on projections by the Congressional Budget Office, *The Budget and Economic Outlook, FYs 2008-17*.

be eliminated after 2010 or 2013, enacted some changes for only a few years, and failed to index the child tax credit or the AMT exemption level for inflation. Still, roughly speaking, when fully implemented, the estate and gift tax repeals cost about 0.4 percent of GDP per year; the tax rate reduction on dividends and capital gains, about 0.2 percent; other extensions (such as the research and development credit and various energy credits), about 0.4 percent; and the broad income-tax provisions—in particular, cuts in tax rates, marriage penalty relief, and child credits, 0.9 to 1.0 percent. Of course, all this assumes that the AMT is allowed to constantly increase taxes. A fix in the AMT ranging from just indexing some parameters for inflation to outright repeal could add costs anywhere from 0.5 to 1.1 percent of GDP. Thus, the total cost can add up to 3.0 percent of GDP, but also significantly less. For instance, if Congress would pay for all AMT changes, not let the estate tax be repealed, and reduce the cost of some extensions, the cost as a percentage of GDP is closer to half that total.⁸

How does this figure compare with tax increases and decreases historically? The biggest increases of the 20th century helped finance World War II and the Korean conflict, while the biggest decreases came in their wake. Since then, total federal revenues as a percentage of GDP have remained remarkably constant. The Reagan tax cut of 1981—often evoked by both proponents and opponents of the Bush cut—would have been about 6 percentage points of GDP, if fully implemented. Thus, relative to the economy, the initial Reagan cut was more than twice as big as the initial Bush cut. But, if one adds up all the tax cuts in Bush's first term, accounts for changes in the AMT to prevent it from increasing revenues dramatically, and compares that package with the full array of tax cuts and increases in Reagan's first term—there were almost no offsetting increases under Bush—the two are much more in line.⁹

Besides asking how much a cut will cost over the long term, comparing new cuts with preceding years' tax changes also provides perspective. The Reagan tax cuts, for instance, were about the same size as the effective tax hikes in the years preceding the cuts. A large portion of those hikes can be traced back to the substantial bracket creep in the late 1970s, when annual inflation rates sometimes exceeded 10 percent. The increases in marginal tax rates during this earlier inflationary period were especially large for families at about twice the median income (see figures 3.8 and 3.9).

To give some context to the Bush tax cuts, it should be noted that revenues as a percentage of GDP also rose prior to the 2001 tax cut. In fact, if state and local taxes are counted, they rose to a peacetime apex (see chapter 3). One moderate factor was the tax rate increases enacted in 1993 under Clinton's budget reform, but even more important were large increases in realizations of capital gains and stock options during the stock market bubble at the end of the 1990s. Also, many upper-middle-income and richer families—especially two-earner couples in which both spouses had higher-than-average wages—moved into higher brackets. Finally, average tax rates rose because of the continuing trend, started in the late 1970s, toward a more unequal distribution of income.

The years immediately preceding and following 2001 were unusual when it came to taxes. At first, the Bush cuts appeared simply to reduce the highest peacetime average tax rate (for all receipts) ever, attributable in large part to the revenue spikes of the late 1990s. However, capital gains realizations and taxes paid by higher-income taxpayers fell tremendously in 2002, which added to the losses due to an economic slump. This development might suggest that the tax increases of the late 1990s may have

been temporary, as opposed to the increases of the late 1970s, which would have been permanent absent legislation.¹⁰ In any case, by 2004, the country had quickly moved from peak to trough, witnessing the lowest level of federal receipts as a percentage of GDP since 1950—due as much to economic factors as legislative ones. Individual plus corporate income taxes combined reached the lowest level since 1942. This calculation, though, ignores other taxes, particularly the Social Security tax.

After another couple of years, receipts moved back to their historic averages. By 2007, total federal receipts had risen again by almost 2 percentage points to a level as high or higher than most postwar years. Once again, continuing growth in the inequality of income and the corresponding tendency for income to shift toward taxpayers in higher tax brackets drove rates higher.

In sum, the 2001 Bush tax cut, by itself, was large. If the 2001 to 2006 tax cuts are considered in isolation from the economy, assumed to be extended permanently, and combined with a halt in alternative minimum tax growth and an extension of other expiring provisions, the cuts could add up to as much as 3 percentage points of GDP. But a final figure that large is highly unlikely. Bush himself indicated he wanted the additional AMT revenues but not the AMT. At the end of the day, tax collections remained close to the narrow range of average tax rates typical of the post-World War II period.

From a broader budgetary perspective, under President Bush discretionary spending and defense spending both increased as a percentage of GDP, taxes were cut as a percentage of GDP, and he promoted and got adopted the biggest entitlement expansion since 1965, and the biggest ever unaccompanied by any additional revenue sources. By mid-2007, he had vetoed only two bills (over stem cell research in 2006 and Iraqi war funding in 2007)—in contrast to more than 2,500 for his predecessors (Kosar 2007).¹¹ Whether the tax cuts themselves were too large in isolation, therefore, may not be the relevant question; instead, one should ask whether the combined budget changes made sense either economically or politically.

Toward the Future

The combination of deficit concerns and demands on the nation's health and retirement systems likely will continue to be the dominant force behind tax policy throughout the first part of the 21st century. Other forces,

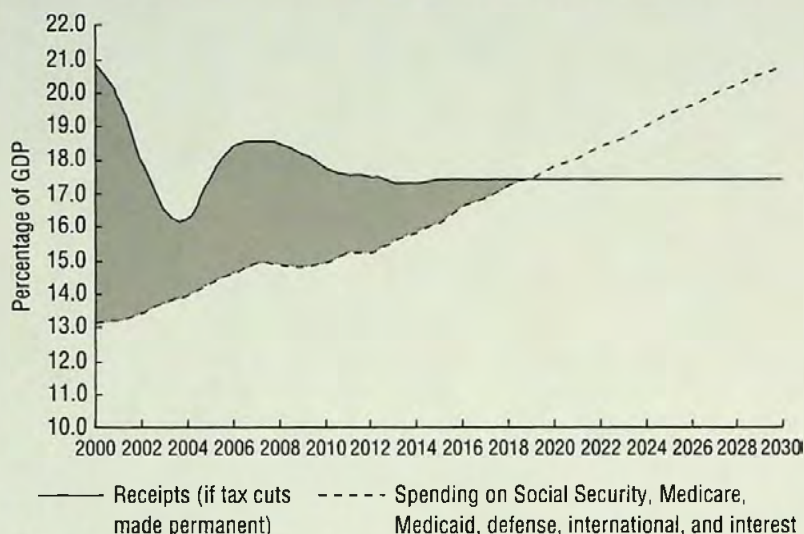
including the demands of the international order, are also powerful and far less predictable. If we have learned one thing for certain, it is that tax policy is the handmaiden of budget policy.

For elected officials, Republican and Democratic, George Bush's second term represented an attempt to turn in the opposite direction from his first term or, perhaps more broadly, from the period since 1997, when Congress started abandoning tighter budget rules and declared a holiday from fiscal discipline. During his first term, large surpluses, a recession, and a terrorist attack made tax cuts and expenditure increases politically irresistible. Trying to capture the national agenda through systemic reform in the second term was a complete failure. Too many elected officials and political appointees simply had never learned to operate on any but the giveaway side of the ledger. Temporary deficit reduction in the second term was a bit more successful, largely because failure to enact much that was new allowed revenues to swell, at least temporarily, as incomes became more unequal.

Continued health cost growth and the imminent retirement of the baby boomers will force many tough choices, likely to be reflected in legislation over many years. Meanwhile, the worldwide aging of societies will fundamentally change economies in unpredictable ways. Elected officials will have to worry about how to pay for promises that now extend at higher levels, to larger shares of the population, further into the future. Not politics but simple arithmetic tells us that future presidents and Congresses will also have to restore some slack to the budget so they can do anything new, whether due to crisis or simple change in voter demand.

My own calculations show that maintaining the tax and expenditure promises in place near the end of the Bush presidency, while balancing the budget, will leave nothing for any domestic policy other than retirement and health by sometime between 2015 and 2020. The impossibility of such a scenario means we will see either cutbacks in retirement and health program growth, higher revenues, or, as is likely the case, both. Figure 12.2, therefore, is less a trajectory of future spending and revenues than a representation of the unsustainable expectations, even in the short run, that government officials have set up.

As the first baby boomers moved toward retirement in 2008, programs were already feeling the pressure. Programs for children, including such tax subsidies as child credits, are on a trajectory of relative decline. Although the government expects more than \$609 billion more in real revenues in another decade, only a sliver goes to children (Steuerle et al. 2007).

Figure 12.2. The Current Squeeze

Source: Steuerle, Carasso, and Reynolds (2007). Authors' calculations based on data from CBO Budget Outlook (January 2007) and OASDI and HI-SMI Trustees Reports (2006).

Like any tale ending in the present, this chronology must end without a climax.¹² One sure expectation is that tomorrow will bring the unexpected. In the final chapter, I turn to implications of this tale of an ever-whirling and contradictory tax policy where left and right agree mainly on one thing: using the tax code to change the behavior of people and control the direction of government.

13

Who Won?

Finality is not the language of politics.

—Benjamin Disraeli

Has “good” or “bad” tax policy won out in the contemporary period? The history outlined in this book makes it difficult to give a simple answer. It does make it possible to reflect broadly on the success or failure of advocacy groups in influencing policy, and to see how competing tax theories intertwined to produce contemporary tax policy—a tax policy that, for all its warts, still managed to finance a stable government and a thriving economy. The ebbs and flows of tax policy also force us to reflect less on whether it achieves any particular ideal and more on how the president and Congress respond to extraordinary demands and continually changing democratic sentiments.¹ Although I have tried to write this story in a way that respects your ability as reader to draw your own conclusions, I will end with one of mine: that good policy is dependent, more than anything, upon a good policy *process* that is broadly based on principles, gives them each their due even when they compete, and leaves adequate flexibility for future voters to respond to the needs of their own time. First, however, let us recap the most important tax-policy trends of recent decades.

The 1950s—Codification of the Modern Income Tax System

The adoption of the Internal Revenue Code of 1954 codified or recodified many practices, regulations, and laws that had evolved previously, including exclusions from tax that had derived from IRS practices and regulations but had never formally been approved by legislation. Progressives and traditional tax reformers exerted strong influence during this period.

The Congresses and presidents of that period essentially institutionalized big domestic government by taking the essential first step: even as defense spending fell, they maintained the build-up in taxes originally enacted to finance World War II and then the Korean conflict. Business interests and those promoting capital formation (at that time largely focused on physical capital, such as plant and equipment) attained moderate success—some acceleration of depreciation allowances and the maintenance of a corporate tax rate well below the top individual rate. After the Korean conflict, average federal tax rates never fell nor rose much relative to gross domestic product—a story that remains true today. Meanwhile, by backing Social Security tax rate and benefit increases, President Eisenhower provided a Republican imprimatur to this system; for the succeeding half-century, the political parties competed over who would provide the next best benefit increase for the elderly.

The 1960s—Macroeconomic Issues to the Fore

President Kennedy was the first president effectively to advocate using tax policy primarily for nonrevenue purposes—a development that has had repercussions ever since. Although British economist John Maynard Keynes had pushed for more activist fiscal policy in the 1930s, it took three decades for a macroeconomic rationale to drive U.S. tax legislation (that is, tax cuts that led to higher deficits now become acceptable if they spurred demand or spurred new investment). While Keynesian theory technically touted expenditure increases as the best way of stimulating demand, U.S. macroeconomic policy centered largely on tax cuts—in particular, on rate cuts and investment credits. During the Kennedy round of tax cutting, congressional leaders gave the administration a choice between promoting traditional tax policy principles, such as equity and

efficiency, and cutting taxes to spur the economy—but not both. It chose tax cuts.

In terms of the long-term sustainability of the budget, it didn't matter whether, as the Keynesians claimed, the Kennedy tax cuts generated the additional growth by which they were justified. Even if the tax cuts spurred no additional growth, or failed miserably and reduced it, in the long term, revenues would still rise with the economy. If long-term budgets had been projected at that time, the future would have shown rising future surpluses under the law prevailing then. That is, relative to a base of expenditures that were largely fixed, growing future revenues eventually became larger than the current level of expenditures, allowing Congress to enact new expenditures or tax cuts over time. Only later would nondiscretionary retirement and health programs become so large and contain such large built-in growth that future budgets would be imbalanced even without new legislation. Once this policy took hold, even higher economic growth provided little reprieve, as retirement and health programs were designed to grow faster as the economy grew faster—hence maintaining a wedge between their growth path and that of slower-growing revenues.

The 1970s—Coping with Stagflation

Escalating inflation and slower economic growth dampened enthusiasm for Keynesian policy. The combination of high tax and inflation rates provided incentives for individuals and businesses to direct their investments toward less productive capital—a major cause of the stagnation that accompanied the higher inflation (stagflation).² Tax policy adjustments were varied, but one thing was consistent: as inflation drove up average and marginal tax rates, legislated tax cuts came in ever-greater numbers but still could not keep up with tax increases due to inflation. In fact, the decade's most significant tax changes—the steep increase in marginal tax rates on individual income for upper-middle classes and the large percentage increases in local and state real estate taxes—were not legislated directly but were driven by high inflation. In the former case, inflation led to significant bracket creep and, in the latter, inflation caused property values to soar, partly because of huge tax-arbitrage opportunities for property secured by borrowing.³ In terms of macroeconomic policy, economists and government officials increasingly turned toward monetary policy, although not until the end of the decade did the Board of Governors

of the Federal Reserve System, under Paul Volcker's leadership, began to rein in ever-rising inflation.

The 1980s—Tax Reform and Lower Rates

While the tax revolt against higher real estate and income taxes (largely due to 1970s inflation) played out at the state level mostly in the late 1970s, at the federal level, it was embodied in the Reagan Revolution. In 1981, President Reagan signed legislation lowering individual income tax rates by 23 percent and further accelerating cost recovery for depreciable assets. The 1981 act also retained an investment credit as the primary tax incentive for physical capital investment. Although some cite 1981 as the beginning of an era, it was really the end—the last major attempt to substantially cut taxes or increase expenditures until two decades later. Outside of the tax cuts in 1981 and the roughly revenue-neutral Tax Reform Act of 1986, almost all significant tax changes for the rest of the decade—indeed, until well into the 1990s—were driven by budget demands to raise revenue.

The period from 1982 to 1987 stands out as a unique period of reform, when the income tax went through more base broadening and traditional tax reform than at any other time in its history. The Tax Reform Act of 1986 represents the most significant traditional tax reform in the history of the income tax—by one measure, over \$200 billion of tax expenditures annually were exchanged for lower rates. But much more than the promotion of traditional reform principles was at play: President Reagan's opposition to high tax rates also seriously influenced the reform. The acceptance of business tax reform with lower rates and fewer investment incentives for equipment and plant in many ways reflected the movement from an economy based on physical capital to one in which human capital, technology, and information had become dominant.

The 1990s—Tax Policy Principles Take a Backseat to Budget Fights

The 1990s is one of the hardest periods to characterize. Almost all battles in previous decades—over high tax rates, progressivity, capital gains taxation, the use of the tax code for macroeconomic and nonrevenue purposes—were reengaged. Politically, the arguments became shriller.

How to deal with the large deficits remaining from the 1980s defined tax policy debate for most of the decade, until the temporary surpluses in the late 1990s turned the question on its head. Thus, deficit-reduction and surplus-reduction efforts bracket the decade.

In the early 1990s, statutory tax rate increases fell primarily on the top earners in the income distribution. In the mid-1990s, however, top earners saw their share of tax payments grow along with their significant gains in income, capital gains, and stock options instead of legislated tax increases. Tax subsidies became especially popular with both political parties, and social spending and expenditure policy were implemented more and more through the tax code—symbolized, for example, by the growth in the earned income tax credit and the child credit.

The Early 2000s—Domestic Policy as Defined by Tax Cuts

President George W. Bush and Congress began this period with tax rate cuts as his primary domestic policy initiative. At first, tax cuts were suggested as a way to spend what appeared to be a potentially large surplus. Later, as the surplus evaporated and the deficit rose significantly, they were sold as a stimulus. The emphasis was clearly on supply-side considerations, with individual rate reductions and reduced taxes on capital income accounting for the vast majority of the cost of legislation from 2001 to 2006. The flagship for the period, the 2001 act, focused on cuts in the top rates—the very rates that had seen tax increases in the 1990s—but, more broadly, the act reduced tax rates on most earners across the income spectrum. Tax cuts remained the primary domestic policy response to almost everything, including a terrorist attack, wars in Afghanistan and Iraq, a recession, a temporary stock market plunge and significant recovery, a parallel dramatic fall and rise in revenues, and, finally, the ever-more ominous approach of the baby boomer retirement starting in 2008. The period was also unique in all of American history in terms of the combined size of its tax cuts, defense spending increases, domestic discretionary spending increases, and entitlement expansion.

Although it is still too early to see through the haze of the first decade of the 21st century, some trends can be perceived. Family policy increasingly became the focus of groups attempting to reform the tax code, refundable child credits being the latest manifestation of their success. Traditional

reform made some shuffling sounds with little real legislative success—a delayed response to the latest wave of tax shelters, a tax reform commission, congressional demands to cut the tax gap between what taxpayers owed and what they paid, and attempts to reform the AMT. A decline in average tax rates in the decade's early years was attenuated by the continued trend toward a more unequal distribution of income (and the higher average rates that accompany it) and the AMT's expansion. Neither source is dependable for the future—nor should we want to depend on them. The fiscal future was threatened not so much by tax cuts per se, but by their combination with new spending initiatives for defense, homeland security, drug benefits, and many other items, and, more importantly, the scheduled increase in health and retirement costs in the upcoming years and decades. Indeed, this issue has been so pressing that the Comptroller General of the United States, as head of Congress's General Accountability Office, began traveling the country with representatives of liberal and conservative think tanks on a "Fiscal Wake-Up Tour."

The Tenacity of Tenuous Tax Theories

Figuring out whether good tax policy transpired over these past decades depends on how you define "good tax policy." Do you adhere to the arguments of those who want to use the tax code for revenue-raising, economic, or social policy purposes? Do you accept the traditional arguments for a broad base and low rates? Do you favor income taxes over consumption taxes or some blend of the two? Do you want to limit the use of the tax code to conduct expenditure policy? Do you tend to be Keynesian, supply-side, pro-capital formation, or none of the above? Or do you simply support lower taxes on capital gains and estates no matter what? Each camp has won some battles and lost some. No camp has really laid down its swords in defeat, and each reasserts itself whenever tax policy climbs back on the agenda.

Traditional Tax Reformers

The legislative heyday of traditional tax reformers was from 1982 to 1987, when both broad-based tax reform efforts and budget bills attempted to tax different sources of income or consumption more equally, as well as to treat more equally individuals with equal incomes. Some traditional

tax reformers seem to maintain hope that the type of large-scale reform that occurred in 1986 can and will occur again, even if only intermittently. Many of the principles these reformers favor—efficiency, equal justice or equal treatment of equals, and simplicity—should hold regardless of the government's size, the progressivity of the tax system, the level of capital taxation, or the extent of macroeconomic fiscal policy employed.

Traditional tax reformers do not easily fit into the conservative or liberal camp. In the past, their type of reform was often associated with progressives, yet some of their strongest adherents were such conservative economists as Henry C. Simons at the University of Chicago. While this traditional tax reform approach has always had some sway, lately it has operated mainly in the background. For the Clinton administration, reducing the budget deficit or enhancing progressivity almost always carried more weight than traditional tax principles, such as equal justice or efficiency.⁴ For the George W. Bush administration, lower rates were the overriding goal. President George W. Bush did tentatively approach traditional tax reform through a panel, but the two optional paths it offered received little political support in the administration or Congress.

Still, almost all major tax bills, even those that provide tax breaks to special interest groups, contain many provisions aimed at creating equal justice, reducing disparities in taxation, and simplifying taxes. Thus, even when the net change in any particular bill could be considered antireform, traditional tax principles keep rearing their heads because such issues as equal justice cannot be avoided entirely. For example, when an interest group achieves some favor for its type of energy production, usually all producers of that type of energy are subsidized in an equal way that still encourages the most efficient producer among them.

Tax Expenditure Theorists

All modern presidents have used the tax code to enact new subsidies, whether for business or social policy. These subsidies often could have been designed as direct expenditures, as they essentially served the same purpose: a cash bonus for a taxpayer performing the favored actions. But then they would have been counted as contributing to larger government through higher outlays rather than to smaller government through lower taxes. Some opponents of tax expenditures go so far as to say that exceptions for items like medical expenses or charitable contributions are inconsistent with a pure tax system. However, few people today accept

such a pure version of tax expenditure theory, where all income would be taxed with no exceptions.

Tax reform in 1986 successfully replaced many tax expenditures with lower rates, but the cuts applied mainly to business incentives. Since 1986, the number of tax expenditures has again grown, though mainly in the arena of social and middle-class entitlements (see figure 3.3). The full impact of ever-expanding tax breaks has been attenuated by lower rates, which has made the "expenditure cost" of many of these breaks less than they would have been otherwise.

Certainly, winners from the proliferation of tax breaks and expenditures include all those special interests—rich, middle-class, and poor alike—who got their provisions enacted along with other legislation. The crafting of large bills allows each member of Congress to put in one or more items that favor campaign contributors or home constituencies—a less-than-pretty part of democracy, although hardly confined to tax legislation. Many people lose on net simply because, in a world of special interest legislation, they don't get their share.

Consumption Tax Theorists

Consumption tax theorists usually adhere to traditional tax principles but would tax equally those with equal consumption rather than those with equal incomes. Many theorists are willing to preserve progressivity in the tax system as a whole (Bradford 1984, 1996a, 1996b; McCaffery 2003; Shaviro 2004; Tax Reform Commission 2005; Zodrow 2007). Perhaps their strongest argument is that, among equal earners, levying higher taxes on those who save more is unfair. That is, equal-earning savers and non-savers pay the same tax on their earnings, but only the savers pay additional tax on the income from their saving. This raises the question of what to do with those who do not consume all their income and wealth during their lifetimes and, thus, have some of their income go untaxed until and unless their children or grandchildren consume out of their inheritance. Some economists would accept an inheritance or estate tax as a means of taxing equally individuals with equal lifetime incomes or endowments, even though they would tax only consumption while the individual is alive.⁵

Consumption tax advocates and theorists of all types face large hurdles in promoting their views. For example, some especially do not like the way that the current income tax system favors owner-occupied housing over other forms of capital investment.⁶ Attacking tax breaks for owner-

occupied housing, however, does not resonate well with the public, as President George W. Bush's tax reform panel discovered. Politically, it is difficult to change the treatment of debt as consumption tax theory requires—either by denying deductions for interest payments or counting borrowing as a taxable event. Further, a pure consumption tax would remove incentives for pension saving by treating the return from all types of saving the same way. But does removing retirement plan incentives make sense in an economy where a large proportion of the population already saves little for retirement? Although some, such as the antitax lobbyist Grover Norquist, argue that recent tax breaks for capital income move toward a consumption tax, others suggest just the opposite: since borrowing is still favored, these special tax breaks reward game-playing more than saving.

Another issue is whether a consumption tax is simpler and more easily administered because it does not tax capital income. Depreciation does not need to be calculated for tax purposes but is still required for financial purposes, thus limiting any accounting simplification. Bankman and Schler (2007) debate whether enforcement is easier: hiding \$100 in assets spent for consumption, for instance, might result in reducing one's consumption tax base by \$100, whereas hiding a 5 percent return from those assets reduces the income tax base by only \$5.

Another major obstacle stems from the backdoor income taxes derived from the phase-out of such benefits as the EITC, Food Stamps, and college aid (Steuerle 2007). If these programs continue to base eligibility on income, then the nation still effectively taxes income, and it still needs reporting systems on the income individuals receive. Simply switching from an income to a consumption tax would reinforce the awkward result in current law—a combined tax and expenditure system that rewards saving by those who are well-off but penalizes saving by those with low or moderate incomes.

A compromise between consumption and income taxation would be to replace only some of the income tax with a consumption tax.⁷ The Treasury Department under the administration of President George H. W. Bush suggested a version of this approach. Some tax economists and lawyers (Graetz 1997) suggest adopting a value-added tax (VAT) for the vast majority of the population, with a moderate income tax rate of, say, 20 to 25 percent only for those with incomes above \$75,000 or \$100,000.⁸ This compromise would deliver most middle-income people from the more complicated world of filing income tax returns (VATs are enforced

at the corporate or business level) and remove any tax on their capital income. However, two additional issues arise with this compromise. One is whether grafting yet another tax system, such as a VAT, onto the income tax and Social Security tax systems would be worthwhile administratively. Another is whether the compromise would hold and income taxes slowly expand to more and more taxpayers (for instance, if real bracket creep is allowed to draw more of taxpayers back into the income tax system).

The Keynesians

This activist group achieved their peak influence in the 1960s. Still, even in the 1970s, Keynesians wielded significant power, and both Republicans and Democrats pushed for tax cuts to stimulate the economy. Given the nature of politics, however, a temporary surtax in 1968–70 is the only noted example in U.S. history where a tax increase was advocated on Keynesian grounds to dampen demand (arising from Vietnam war expenditures).

In 1981 and 2001, Presidents Reagan and George W. Bush respectively pushed tax cuts without much regard for the economic cycle—although, in both cases, a succeeding recession allowed them to claim excellent (almost Keynesian, although they would never use the word) timing for their tax cuts. By the same token, the tax increases proposed from about 1982 to 1997 almost fully ignored Keynesian arguments; they were designed mainly for deficit reduction, regardless of the economic cycle.

Still, the Keynesians continue to reassert themselves, especially when growth slows or turns negative. Pushed in 2003 to do some “dynamic scoring”—showing how lower rates might lead to greater economic growth through supply-side effects—the Congressional Budget Office and the Joint Committee on Taxation released the results of several models that included some Keynesian demand effects. These models showed some short-run stimulus from tax cuts but also long-run losses to the economy if the higher deficit was not brought under control.

Even when abandoned in the United States, Keynesian policy is frequently pushed abroad. The Clinton and George H. W. Bush administrations, for instance, often jawboned Japan to deal with its economic slowdown by lowering taxes and pumping more money into the economy.⁹

Adherents to Keynesian theory are not the only ones who have argued for Keynesian policy. President George W. Bush’s administration often asserted that its early 2001, 2002, and 2003 tax cuts were fortuitously timed

to fight the recession that began later in 2001 and to boost otherwise inadequate growth.¹⁰ The 2001 tax cut even included an early one-time tax rebate that added considerably to tax-return filing errors (IRS 2002)—a move that had nothing to do with changes in incentives but a lot to do with typical Keynesian pump priming.

Counter-cyclical fiscal policy—larger deficits when the economy slows and smaller deficits when it grows—now reigns even without new or activist tax legislation. One reason is that government was much smaller when Keynes originally pushed for more discretionary action. The current government, though, is so large that fiscal responses, such as significantly lower taxes in economic downturns, occur automatically and without legislation. With monetary policy reacting quickly in the short run, automatic fiscal stabilizers doing their work, and discretionary and automatic expenditure policy meeting new needs, discretionary Keynesian tax policy—even when applied—is often one of the players with fewer chips at the table. Meanwhile, downturns have been less severe in recent decades, so less response is required.

The push for more discretionary stimulus, however, is unending. One telling sign of how much the stimulus argument has become politicized and oversimplified is that seldom, if ever, do advocates estimate the “right” amount of stimulus needed ahead of an economic downturn or the appropriate deficit level under alternative circumstances.¹¹ The argument for more stimuli in 2002 and 2003, when deficit increases (from both automatic and discretionary policy) were already larger than the falloff in GDP, exemplifies attempts to shoot without a target. Of course, the administration mixed and matched Keynesian arguments to buttress its basic supply-side approach, so perhaps no one could have expected it to set a Keynesian target.

One doesn’t need to be a Keynesian to favor spending and taxation that would make fiscal policy counter-cyclical. One might simply want to give people some reprieve from taxes in bad times or respond to needs when they are greatest, regardless of any larger macroeconomic effect. Few political advocates, however, make improving the automatic side of the system a priority, though doing so would answer numerous criticisms of Keynesian fiscal policy, such as Congress’s inability to make discretionary changes fast enough to respond to the economic cycle’s ups and downs. Thus, much of Keynesian advocacy is more political than economic—an attempt to “do something” when there is a downturn. That political need is not likely to go away.

Supply-Side Theorists

Like some Keynesians who never found an economic condition that more tax cuts could not help, some supply-side theorists never discovered a lower tax rate that could not boost the supply of capital and labor—never mind the untoward effect on the deficit and government's absorption of private saving. Many supply-siders emphasize the top rate of taxation, and here they have won many major battles. The top income tax rate dropped from 90 percent after World War II to 70 percent under President Kennedy, to between 28 and 33 percent under President Reagan; then it was raised toward 40 percent under President Clinton and lowered to 35 percent under President George W. Bush.

Economic theory holds that distortions from tax rates increase with the square of the marginal tax rate, so high rates really matter in supply-side theory. If high marginal tax rates are a priority for supply-siders, therefore, one wonders why their intensity does not shift more from the top income group. Those with very low earnings continue to face staggeringly high effective marginal tax rates of 50, 70, even 100 percent or more as their food stamps, Medicaid, child care, earned income tax credits, and housing allowances are phased out. High penalty rates also apply to many who receive educational aid. The 2001 tax legislation did adjust marginal rates at some low-income levels, but only in the income tax system, not in the expenditure and welfare systems.

Although it cannot be proven, supply-siders' extraordinary emphasis on the very top rate of tax paid by the highest-income taxpayers—and not on the high rate paid by other taxpayers—derives as much from politics as economics. The economic excuse is that only the tax rate at the top is almost always marginal—that is, it applies to the last dollar of income earned, which is where incentives are said to matter. Other rates are likely to be "inframarginal" for at least some taxpayers (e.g., the tax rates on the first \$50,000 earned by a taxpayer with \$80,000 of income). Quite simply, some of the rich fight hard for tax relief and often finance research organizations and interest groups with friendly views toward lowering their taxes. Enhancing that push, politicians and the public intuitively grasp what it means to lower the top rate from, say, 50 to 40 percent but find it more difficult to focus on a drop in an intermediate rate, say from 25 to 20 percent, much less on multiple calculations of how phasing out various benefits creates a very high effective tax rate on additional income.

Although supply-siders often favor preferences for capital income as a backdoor way of reducing capital income tax rates toward zero, they generally agree with tax expenditure theorists in opposing other preferences in the tax code. Since many preferences are also favored by their tax-rate-cut allies—middle-class conservatives, social conservatives, and just plain vanilla tax cutters—supply-siders have been less successful in countering these preferences.

Capital Formation Reformers

Capital formation reformers have won their fair share of battles. From the 1950s through the early 1980s, they successfully pushed for accelerations in depreciation allowances, along with the enactment of an investment tax credit in the early 1960s. Then, in the 1986 tax reform, these investment incentives were essentially abandoned in exchange for lower tax rates. The lower rates roughly offset the loss of preferences and helped keep the cost of capital from rising much.

Inflation played an important role in helping capital formation advocates win some early battles both directly and indirectly. When inflation increased in the 1950s through the 1970s, politicians offered capital incentives, partly to offset inflation's pernicious effect on the value of depreciation allowances. Afterward, declines in the inflation rate during the last two decades of the 20th century increased the value of many depreciation allowances, thus lowering the cost of capital without legislation (appendix table A.5). Capital formation reformers also succeeded in temporarily obtaining an allowance to write off (rather than depreciate) 30 percent (in 2002 legislation) and 50 percent (in 2003 legislation) of the up-front cost of capital purchases.

Arguably, some depreciation rates are now higher in our technology-based economy, and established allowances have failed to keep pace with this change. This leaves some of the debate over depreciation open. Still, few people lobbying for more accelerated allowances consistently embrace more scientific measures of depreciation. Political goals of capital interests advocates are seldom aligned with the economic theories they tout when convenient. Fearing that some assets could turn out to be too favorably treated relative to others, capital formation reformers prefer not to develop systematically, for all assets, information on how long depreciable assets remain in service and whether allowed depreciation matches the economic decline in value.¹²

Many capital formation advocates side with consumption tax reformers, focusing on expensing—or immediately writing off—purchases of physical capital rather than depreciating them over time. But capital formation advocates usually ignore the problem of interest deductions, effectively offering large tax breaks to those who ultimately save little because they simultaneously acquire assets and debt. Generally speaking, with a true consumption tax, either borrowing is added to the tax base or interest deductions are not allowed.

Capital Gains Advocates

Capital gains advocates are in favor of paying reduced taxes when capital assets are sold. A major measure of these advocates' success is that in the early part of the 21st century, capital gains tax rates were as low as they had been for over 50 years. The full taxation of capital gains, enacted as a compromise of the Tax Reform Act of 1986, did not last long. But the realization of gains is often a portfolio choice to sell one asset and buy another. Higher rates of realization of gains when capital gains rates are reduced proves little about whether more saving or work actually occurs. Think of the taxation of capital gains as a toll charge: with lower tax rates, more individuals are willing to pay the toll to diversify their portfolios. In fact, relief on capital gains already accrued helps make spending that income cheaper than continued saving.¹³

The issue of capital gains taxation is one of the most vexing in all of tax theory (Burman 1999; Kleinbard 2007). When aggregated over several decades, capital gains approximately equal the sum of gains due to inflation plus increases in the value of corporate stock due to retained earnings, which are already subjected to corporate tax (Halperin and Steuerle 1988). Hence, in aggregate, it may not be necessary to tax individuals' capital gains to tax capital income—assuming that the law and regulations can limit the constant attempts to convert ordinary income to capital gains income.

Aggregate analysis of total capital gains in the economy does not tell the full story. Most capital gains, and subsequently most of the benefits of capital gains tax breaks, go to people with very high incomes—that is, the winners in the economic system. The losers, on the other hand, rarely get to deduct the full value of their losses, whether due to inflation or other causes. Yet another complication is that interest deductions are allowed for money borrowed to buy or hold onto assets—often yielding a

negative tax rate on net income from saving when interest deductions at a high rate combine with gains at a low rate. Some large corporate buy-outs are encouraged in part by the combination of high debt, for which interest payments are fully deductible, and capital gains, for which low rates of taxation apply.

Those with substantial capital gains from successful investments want more than a reprieve from double taxation of inflation or corporate earnings already taxed. This can be seen in President George W. Bush's initial proposal in 2003 to remove the double tax on either dividends or capital gains if the income was already taxed at the corporate level, which ironically would have removed some of the justification for a capital gains preference. Congress, however, extended dividend and capital gains relief even to income never taxed at the corporate level.

Some people recognize little or no gains despite substantial accruals during their lives. If the estate tax were eliminated, many highly successful people would pay no individual tax on income accrued until death and only a 15 percent tax on gains realized during their lives (their heirs might eventually pay tax on realizations). Even the 15 percent rate is exaggerated since the deferral of paying that tax on gains accrued over the years is quite valuable relative to a 15 percent rate paid on accrued gains every year. In the end, corporate taxes, not individual taxes, have been the major source of taxation of the capital income of the nation's richest people. Corporate taxes, too, have fallen in importance over time.

The Progressives

Supporters of using the tax code as a social policy tool have been a sustained force for more than a century. Early on, they fought for a fairly progressive income tax and for the removal of tariffs. Since then, no major tax bill has passed without some debate about its progressivity. Even Andrew Mellon, Secretary of the Treasury and architect of large income tax rate cuts after World War I, favored progressive taxes (Brownlee 2004; Thorndike 2003).

As historians note, progressivity means different things in different periods. As detailed throughout this book, it is usually measured inconsistently in public discussions of government policy. "Progressive" taxation often means that the average tax *rate* goes up with income. For expenditures, progressivity is usually measured by whether poorer people get more *absolute dollars* or benefits.¹⁴ If progressivity is defined as

redistribution from richer to poorer members of society, however, then the combination of taxes and expenditures determines progressivity, and even tax systems with lower tax rates on the rich can still support redistribution. In any case, what should matter most is the overall distribution of taxes and benefits, not how they play out in each and every program.

The top statutory income tax rates have generally fallen since World War II. Is that evidence that progressives have lost the battle? Not really. For the vast majority of the population, Congressional Budget Office calculations do not show much change in overall progressivity, at least as measured by effective or average tax rates from the late 1970s on (see figure 3.7). There are two exceptions. The rate on lower-income households has dropped substantially to a negative number if the EITC and the child credit are counted—both of which are paid in various degrees to some households that pay no direct tax. Meanwhile, at the very top of the income distribution, the CBO also shows a modest drop.

How can this be? While tax legislation has emphasized cuts over increases in recent decades, the cuts and increases were not applied in equal measure to the same people. Tax increases in 1990 and 1993 were concentrated at the top, whereas tax decreases from 2001 to 2006 were shared with middle- and low-income taxpayers, even if opponents claimed the shares were insufficient.

Consider, more generally, the combined effect on progressivity of a tax increase followed by a tax cut.¹⁵ Many members of the progressive movement argue that an increase should not include any additional tax on the poor and that a larger percentage tax increase should apply at the top. They also hold that a tax cut should give lower- and middle-income classes an increase in aftertax income at least proportionate to the increase the rich receive. For those who pay no taxes at all, this can only be achieved through additional expenditures. If such cuts and increases were to take place continually, the net result would be an ever-more progressive tax system (counting refundable credits). Indeed, in 1990 and 1993, additional expenditures (or tax cuts) were given to the poor even while other taxpayers faced tax increases; some poor also shared in the tax cut of 2001. In sum, the progressives did not win all of these battles, especially over the distribution of tax cuts. But when cuts and increases are considered together with automatic changes in the system (such as bracket creep), they won enough battles to maintain roughly the same progressivity in the federal tax system throughout most of the post-1980 period.

Warren Buffett, the world's third richest person at the time, made an interesting play on the progressivity issue in 2007 during a fundraiser for Senator Hillary Clinton, arguing that he only paid a tax rate of about 17.7 percent on his income—"less than our receptionists do, or our cleaning ladies, for that matter."¹⁶ He essentially claimed that his tax rate on items like dividends and capital gains was lower than their tax rate on wages. But two issues complicate his analysis. First, it is clear that Buffett, like many of the rich, recognizes hardly any of his income (in his case, from gains in stock value), and a higher tax rate on realized income would hardly make a dent in the effective rate on all his income. On the other hand, he may pay a significant amount of corporate taxes (although, again, many rich leveraged investors do not).

If we turn from the top to the bottom of the income scale, progressives who specifically advocate for the poor have done modestly well. Thanks to increases in the EITC and refundable child credits, average or effective tax rates for the lowest-income working families with children have fallen significantly. The refundable EITC and child credit make tax rates negative for some low-income working families. Of course, most of these credits are expenditures, and the right way to measure progressivity is to measure changes in taxes and expenditures together. No part of the government produces such statistics, although social expenditures to the middle class have expanded significantly over most of the postwar period, largely but not solely due to benefits for retirees.

The future of the distribution of taxes, of course, is uncertain. Just as lower statutory rates tend to increase income realized, rather than sheltered or deferred from tax, higher rates may reduce realizations. As noted, the rich control their effective taxes in part by deferring income from being taxed—for instance, by simply not selling their stock as it grows in value. Meanwhile, the distribution of more income to the top has tended to increase tax rates, such as on corporate income or on individuals receiving certain types of stock options, but those higher rates could be overturned (or magnified) if income became more (or less) equal in the future.

At the same time, many reductions enacted from 2001 on will expire without further extension. The estate tax repeal is scheduled for the year 2010 only. The capital gains and dividend tax cuts are also scheduled to expire in 2010. While many reductions not expected to survive are concentrated at the top of the income distribution, Democrats controlling Congress in 2007 have indicated little interest in removing recent

middle-income tax cuts, such as the expansion of the child credit or the standard deduction.

New Challenges and Old

This chapter began by noting that reform of the policymaking process is especially needed at this point in the nation's history. What should not, and in many ways cannot, continue is the way tax and budget policy has been made recently. Principles matter, even if reform cannot be defined simply by adherence to one principle or approach to the exclusion of others. Since 1986, principles have played only a modest role in crafting tax legislation. Instead, the legislative and the executive branches have continually put forward internally inconsistent choices, trying in vain to please all constituencies. Our government institutions risk losing their credibility and effectiveness as such traditional principles of equal justice, efficiency, and simplification are neglected in the blind pursuit of political needs and singular priorities, however worthy. Helped by pollsters skilled at making private greed appear like public need, even the White House, Treasury, and tax-writing committees have increasingly used the tax code to serve special interests instead of the common good.

If the tax policy process stands in need of an overhaul, the budget process requires a whole new vehicle. It is simply too engaged in giving away the future today—before that future has even arrived. Health and retirement policies set in motion decades ago leave little money today for discretionary programs that benefit working families and children or meet other societal needs. Tax provisions like Roth IRAs increasingly remove further discretion for decades into the future. No wonder the public feels that it has such little control over its government: elected officials retired and long dead have determined most of the ways tax dollars are spent today.

The Retreat from Tax Principles

Bills today are introduced, and often enacted, through a process of almost random reactions to pressures from interest groups and lobbyists. The problem is not that such efforts have no redeeming value. Along with money for campaigns, lobbyists proffer expertise that, however biased,

may also be essential to understanding the needs of particular groups and constituents. Lobbyists obtain access by representing powers that legislators cannot ignore and also by mastering the knotty path of tax legislation—one reason those former members of Congress, former congressional and Treasury tax experts, and even former presidential candidates now commonly join lobbyists' ranks. The problem, of course, is that the modern tax policy process gives lobbyists so much heed that disinterested parties—including nonpartisan staffs at places like the Treasury, the Joint Committee on Taxation, the Congressional Budget Office, and the Government Accountability Office—often cannot be heard amid the din. Sometimes these staffs are so muzzled that their knowledge and analyses are denied to the public so as not to politically offend anyone.

Adding further to this retreat from principles, the tax code is now riddled with social and individual expenditures, which often promote the unequal and inequitable treatment of equals, distort investment and consumption choices, and boost administrative and enforcement costs for taxpayers and the IRS. In the 1960s and 1970s, attacks on using the tax code for subsidies and expenditures came largely from progressives concerned about business's tax preferences and the distribution of the tax burden. Then, in 1986, when the choice of lower rates was finally offered in exchange for removing or reducing various tax breaks, many conservatives happily and temporarily joined the ranks of those progressives advocating "base broadening" to achieve lower rates. Today, however, the budget for tax subsidies and expenditures consists in no small part of middle-class entitlements for individuals (see figure 3.2) that neither progressives nor conservatives are eager to eliminate. In no small sense, then, the problems of multiple programs inconsistently serving multiple middle-class constituents in fairly arbitrary ways has carried over from the expenditure to the tax side of the budget.

In this milieu, most tax programs—whether subsidies for education, health, pensions, the poor, enterprise zones, commerce, housing, charity, political campaigns, or anything else—are treated *ad hoc*, not as components of a larger policy mosaic. Moreover, even a well-considered program based on a good idea can be inefficient or unfair in practice if its details and implementation are not carefully weighed or evaluated. And this has often been the case with these programs, especially when they are considered *ad hoc*.

Among the most slighted principles in recent years is simplification. Joel Slemrod of the University of Michigan estimates that resources spent

on income tax filing alone equal about 10 percent of the total income from tax collections.¹⁷ Even these estimates, probably the best available, do not fully account for the true cost of filing to the taxpayer, since they place no additional economic costs on the psychological aggravation associated with performing frustrating paper work.

This is not an argument for removing every program and subsidy from the tax code. Occasionally, taxes can be used successfully for macro-economic and social purposes. For instance, programs like wage subsidies, where reporting of wages for tax purposes is essential, might be more easily administered by the IRS than by another agency. However, there is little excuse for the inequities, inefficiencies, and complexities associated with the AMT,¹⁸ layers upon layers of capital gains taxation rates, dozens of complicated retirement and saving subsidies (see appendix table A.2), multiple child credits and allowances, contradictory energy and environmental subsidies, uncoordinated and undirected educational subsidies, and the crazy quilt of sunset clauses applied to tax provisions, to mention only a few. Things have simply gotten out of hand as both major political parties have essentially abandoned traditional tax reform principles.

The Modern Budget Dynamic: Spend It First

Improving tax policy requires minding the budget. In general, budget issues trump tax issues—after all, taxes exist to finance government activity. Yet the lack of budgetary discretion given to elected officials makes governing and legislating much harder. The evidence is overwhelming and reflected in the shrinking share of the budget that is discretionary and subject to annual appropriations.

The name of the game in Washington, D.C., and most state capitals today is to spend money before somebody else does. Unlike the past, lawmakers do not limit themselves to the money currently in hand: whatever economic growth might provide for years or decades to come is now fair game. Thus, retirement and health programs are now scheduled to absorb almost all future revenue growth, and if the economy grows faster, then they also automatically grow faster to maintain their grip on a rising share of resources. Rather than get the budget under control, tax-cutters have joined advocates of program expansion in this dangerous game of spending future revenues before they arrive. Rather than retract untenable promises already made, elected officials compete to make even more unsustainable promises.

Hard as it is to prove, spending ahead in this way has become the most glaring economic problem with federal tax, spending, and budget policy. And there is no end in sight. The implicit inefficiency is obvious when guesses about the population's future needs are assigned priority over tomorrow's actual needs. This practice is equivalent to dictating to our children a list of what they can and cannot consume for decades to come. Thus, we treat future voters as if they are adolescents who cannot be trusted to make wise decisions for themselves, who will not have the sense to vote for the increases in Social Security benefits or for the cuts in income taxes we think they will need.

Some dismiss this concern. For instance, advocates of maintaining built-in growth in Social Security benefits contend that we can always change the law later, and the tax-cut advocates point out that lawmakers can always raise taxes again. To be sure, some aspects of current law will be overturned, but that prospect is no basis for making expensive promises that may not be fulfilled. Nor is it fair to many people who count on the promised program benefits or tax breaks.

The bottom line is that so much scheduling of benefit increases on one side and scheduling of future tax cuts on the other takes democracy away from its citizens even as it puts the budget on a collision course. Why let that happen? Why not let tomorrow's voter decide whether taxes should be cut or spending increased tomorrow?

Strengthening Governmental Processes and Institutions

Neither of these two major fiscal problems—the lack of principled tax policy development and the long-range budgetary quagmire—is going to evaporate without dedicated champions. Further, waiting for a selfless Congress will not fix the tax policy and budget processes. A solution requires, first and foremost, an agreement by a large and influential group of elected officials to take action, backed up by strengthened institutions and rules of process. Neither is sufficient by itself. The way to tax reform in 1986 was paved by an agreement between major figures in both parties that something had to be done, along with reform proposals initially modeled by Treasury and Joint Committee on Taxation staff who were allowed to proceed on the basis of principles. The wrenching march toward smaller deficits from the mid-1980s to late 1990s, in turn, was made possible again by bipartisan agreement that

action had to be taken, backed up by modestly successful pay-as-you-go budget rules.

While there is no single way to create a climate that will support traditional tax and budget principles, there are ways to strengthen the governmental institutions and processes responsible for taxation and the budget so they are prepared when reform opportunities arise:

- The *IRS* first must admit that it does a very poor job at examining the effectiveness of the tax programs and policies it administers, then strengthen its tracking and accountability procedures. For almost every program and subsidy it administers, the agency should assemble data and perform studies on compliance, the distribution of program benefits, and at least minimal measures of effectiveness, such as who gets what. Unfortunately, even after its touted modernization around the turn of the last century, the agency still does not even profile the beneficiaries of a multitude of tax breaks, ranging from charitable contributions of appreciated property to enterprise and empowerment zones.¹⁹
- The *Treasury*, in turn, has an obligation to furnish the public with information on various tax policy programs—their successes *and* their failures. There was a day when Treasury testimony more forthrightly listed the problems with any proposal backed by members of Congress, even at the risk of offending them. Somebody has to do the job of representing public rather than private interests, and it should be the Treasury, especially since most other executive branch departments are organized to try to appease groups associated with the more narrow functions they serve.²⁰ The Secretary of the Treasury also needs to take a stand that—barring the president's direct interventions—appointments to the Treasury are his or hers to make, not that of some political appointee in the White House.
- The *Office of Management and Budget (OMB)* must be restored to preeminent status within the executive branch, with the capability to deal with broad, crosscutting budget issues. Its small and inadequate economics staff must be built up to the size of the Office of Tax Analysis in the Treasury or the Congressional Budget Office. It must develop capabilities for modeling and examining as a unified whole programs for health, pensions, the elderly, community aid, and so forth—cutting across agencies and avoiding arbitrary distinctions between direct expenditure subsidies and tax subsidies. Like

the Treasury, OMB should be known for issuing public studies on what works with programs and what does not. These studies must be separate from those that are put forward to support the presidential agenda.

- The *Ways and Means* and *Senate Finance Committees* must restore and strengthen the tradition of bipartisan, internal meetings and retreats on issues of important national concern. They must also set up internal processes that ensure more time is spent on obtaining input from the researchers and staff, including their own *Joint Committee on Taxation*, who do not represent any particular interests other than the public. They must also give greater weight to rules that require analysis of complexity and IRS enforcement capability before bills are voted upon.
- Finally, the *congressional budget committees* should be empowered to enforce rules that only through future legislation can any program increase in cost beyond some initial short period—say, four years. Sunset clauses, which require a program to end unless extended by further legislation, should be used to actively force periodic reconsideration of programs. Absent broader reform, triggers need to be put in place to restrict growth when it reaches an unsustainable level (Penner and Steuerle 2007). Rules should prevent hiding the cost of what is meant to be a permanent program by only paying for the first three years. The moderate success of the 1990 budget rules, extended through much of that decade, helped balance the budget temporarily, but those rules are now inadequate because they applied only to growth in spending through new legislation, not to the built-in growth of old legislation. Since entitlements are more dominant now than in the 1990s, the old rules simply do not cover a large enough portion of the budget. New budget rules must be set up that go beyond those adopted in the past and that apply to current programs.

The Opportunities

On a note of optimism, I see two major opportunities for real reform arising—one in the tax arena and one in the budget. The first will come, one hopes, because the American system's roots are still embedded in principles. The second is far more certain; it will be forced by events,

sooner or later, since more has been promised for the future than can possibly be delivered. From a fiscal standpoint, September 11th and Hurricane Katrina made clear that there must be enough fiscal slack to meet the costs of unexpected crises.

After leaders take a long vacation from any fundamental principle, they occasionally return to it in lawmaking. On the tax front, the time once again may be ripe to give attention to the virtue of simplicity. So much growth is now programmed into the AMT that a counterreaction could be the horse on which broader reform rides. By itself, AMT simplification may be politically hard to sell when other principles need attention. AMT reform, moreover, would do little or nothing for low-income and many middle-income taxpayers. But ignoring AMT's perverse effects on tens of millions of taxpayers will be harder still. For that reason and despite the failure of a tax reform panel to generate momentum in 2005, a wide-reaching reform package advanced by a president eventually may be the only way out of this tax dilemma.

The grand budget compromise that must take place is between those who would allow retirement and health programs to continue to grow without bound and those who would continually prescribe tax cuts into the future. Each side has the right to appeal to voters to move government in one direction or the other, but each also has an obligation to deal with the budget disaster foreordained if both continue simultaneously. What will force action is the need to maintain other programs dealing with education, jobs, community development, the environment, and so on—discretionary programs now discriminated against in the current budget process and slated to all but disappear if current trends continue. Of the hundreds of billions of dollars in additional revenues expected over coming years, for instance, children would get almost nothing (Carasso, Steuerle, and Reynolds 2007). The solution is not to seek some exact mixture of entitlement spending and taxes that will please all present and future voters but to decide these issues by elections over time. Thus, prudence requires that budget rules constrain both current policy and policymaking.

A Final Note

This book began by noting that elected officials are using tax policy more than ever to change taxpayers' behavior. It ends by pointing out major forces that are changing the policy world's ground rules, often for the

worse, and that must be addressed head on. That said, no single conclusion can or should be drawn about the future direction of tax policy.

Tax policy is not monolithic. Rather, it is a labyrinth of programs exerting influence in almost every sphere of life. It remains inseparable from the broader budget process. Without question, too much is attempted. The tax system is inefficient and, in many respects, inequitable. Should we strive to align the system with the principles that we embrace as a nation and to make taxation easier to understand, comply with, constructively criticize, and improve? Of course. Even if Americans do not categorically agree on an ideal tax policy, our democratic system still allows us to separate the reasonable from the unreasonable and the just from the unjust. And we can contain the demands of special interests when they are excessive if we stop appeasing them at every turn, while boosting the influence of agencies set up to serve the public interest.

Our history of failures is also a history of hope. When the U.S. tax system gets truly out of whack, the political system responds. When high-income taxpayers or profitable corporations were perceived to be dodging tax in the late 1960s, policymakers tried to get them to pay a fairer share. Tax shelters proliferating through the 1970s and early 1980s were reined in during 1982 and 1984, then more thoroughly in the Tax Reform Act of 1986. Even the newer types of tax shelters springing up in the late 1990s and early 2000s have come under increased congressional and Treasury scrutiny. When the budget deficits ballooned in the early 1980s, budget and tax bills in the mid-1980s and 1990s gradually brought deficits to a bearable level, however oblivious lawmakers were to the impending budgetary impacts of the baby boom generation's retirement.

True, many of those problems could have been anticipated and avoided in the first place. And some of the fixes were not well designed—witness the runaway growth and complexity of the AMT over recent years. But the U.S. democratic system is nothing if not resilient, and its adaptive mechanisms still work. Perhaps the story of the U.S. tax policy process is simply part of democracy's broader story: it is prone to waste, bureaucracy, cronyism, and borderline corruption when no wolf is at the door, but it is good at handling emergencies and responding to powerful forces. Despite its limitations, it has managed to sustain what is still the longest lasting democracy in the world.

Not everyone will agree with this bittersweet conclusion, but one point is unambiguous: tax legislation's day has arrived. With the tax system providing not only the resources to support government spending but a

quarter to a third of all subsidies (through tax breaks rather than direct expenditures), future elected representatives have no choice but to loosen and re-tie the tax-policy ropes. Besides, Congress and the public have an insatiable appetite for new legislation, so we may as well try to channel that energy in a productive direction. A moratorium on new tax provisions requires today's politicians to assume that yesteryear's elected representatives got it all right in the first place. Fat chance!

No matter how much poorly designed tax policies stand as evidence that getting it "right" is difficult, when good policies are enacted and revisions well-timed, they remind us that political honesty, tenacity, and integrity can help create a better, more efficient, and equitable system. The powerful dynamic of the democratic process remains at play in tax policy no less than in the rest of our civic, political, and economic lives. Edmund Burke deserves the last word here: issues of taxation and finance reside at the very heart of debates over liberty and government.²¹

APPENDIX

Table A.1. Total Federal, State, and Local Tax Receipts, 1929–2006
(Amounts in billions of dollars)

Year	Gross domestic product	Federal Individual Income Tax		Social Security and Railroad Retirement Taxes		Federal Corporate Profits Tax		Other Federal Taxes ^a	
		Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
1929	103.6	1.20	1.16	0.0	0.00	1.2	1.16	1.3	1.25
1930	91.2	1.00	1.10	0.0	0.00	0.7	0.77	1.1	1.21
1931	76.5	0.50	0.65	0.0	0.00	0.4	0.52	1.0	1.31
1932	58.7	0.30	0.51	0.0	0.00	0.3	0.51	0.8	1.36
1933	56.4	0.40	0.71	0.0	0.00	0.5	0.89	1.6	2.84
1934	66.0	0.50	0.76	0.0	0.00	0.6	0.91	2.2	3.33
1935	73.3	0.60	0.82	0.0	0.00	0.8	1.09	2.3	3.14
1936	83.8	0.70	0.84	0.0	0.00	1.3	1.55	2.6	3.10
1937	91.9	1.30	1.41	0.8	0.87	1.3	1.41	2.8	3.05
1938	86.1	1.20	1.39	0.8	0.93	0.9	1.05	2.5	2.90
1939	92.2	0.90	0.98	0.8	0.87	1.3	1.41	2.6	2.82
1940	101.4	1.00	0.99	0.8	0.79	2.6	2.56	2.9	2.86
1941	126.7	1.60	1.26	1.0	0.79	7.3	5.76	3.8	3.00
1942	161.9	4.20	2.59	1.2	0.74	11.1	6.86	4.5	2.78
1943	198.6	16.00	8.06	1.4	0.70	13.6	6.85	5.3	2.67
1944	219.8	16.90	7.69	1.4	0.64	12.5	5.69	6.5	2.96
1945	223.1	18.60	8.34	1.4	0.63	10.2	4.57	7.7	3.45
1946	222.3	16.40	7.38	1.8	0.81	8.6	3.87	10.2	4.59
1947	244.2	18.80	7.70	2.2	0.90	10.7	4.38	9.5	3.89
1948	269.2	18.10	6.72	2.2	0.82	11.8	4.38	9.3	3.45
1949	267.3	15.40	5.76	2.2	0.82	9.6	3.59	9.2	3.44
1950	293.8	17.40	5.92	3.2	1.09	17.2	5.85	9.5	3.23
1951	339.3	25.40	7.49	3.9	1.15	21.7	6.40	10.2	3.01
1952	358.3	30.20	8.43	4.4	1.23	18.6	5.19	11.3	3.15
1953	379.4	31.30	8.25	4.6	1.21	19.5	5.14	12.0	3.16
1954	380.4	28.10	7.39	5.7	1.50	16.9	4.44	10.8	2.84
1955	414.8	30.50	7.35	6.5	1.57	21.1	5.09	11.9	2.87
1956	437.5	33.90	7.75	7.0	1.60	20.9	4.78	12.9	2.95
1957	461.1	36.00	7.81	8.4	1.82	20.4	4.42	13.6	2.95
1958	467.2	35.50	7.60	8.5	1.82	18.0	3.85	13.2	2.83
1959	506.6	38.50	7.60	10.3	2.03	22.5	4.44	14.4	2.84
1960	526.4	41.80	7.94	12.4	2.36	21.4	4.07	15.6	2.96

State and Local Taxes ^b		Total Tax Receipts		State and Local Income Tax Receipts		Total Individual Income Tax Receipts	
Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
6.1	5.89	9.8	9.46	0.1	0.10	1.3	1.25
6.4	7.02	9.2	10.09	0.1	0.11	1.1	1.21
6.2	8.10	8.1	10.59	0.1	0.13	0.6	0.78
6.1	10.39	7.5	12.78	0.1	0.17	0.4	0.68
5.7	10.11	8.2	14.54	0.1	0.18	0.5	0.89
5.9	8.94	9.2	13.94	0.1	0.15	0.6	0.91
6.2	8.46	9.9	13.51	0.1	0.14	0.7	0.95
7.0	8.35	11.6	13.84	0.2	0.24	0.9	1.07
7.8	8.49	14.0	15.23	0.2	0.22	1.5	1.63
8.1	9.41	13.5	15.68	0.2	0.23	1.4	1.63
8.3	9.00	13.9	15.08	0.2	0.22	1.1	1.19
8.6	8.48	15.9	15.68	0.2	0.20	1.2	1.18
9.5	7.50	23.2	18.31	0.3	0.24	1.9	1.50
9.6	5.93	30.6	18.90	0.3	0.19	4.5	2.78
9.9	4.98	46.2	23.26	0.3	0.15	16.3	8.21
10.2	4.64	47.5	21.61	0.4	0.18	17.3	7.87
10.4	4.66	48.3	21.65	0.4	0.18	19.0	8.52
11.3	5.08	48.3	21.73	0.4	0.18	16.8	7.56
13.0	5.32	54.2	22.19	0.5	0.20	19.3	7.90
14.7	5.46	56.1	20.84	0.6	0.22	18.7	6.95
15.7	5.87	52.1	19.49	0.7	0.26	16.1	6.02
17.7	6.02	65.0	22.12	0.8	0.27	18.2	6.19
19.6	5.78	80.8	23.81	0.9	0.27	26.3	7.75
21.0	5.86	85.5	23.86	1.0	0.28	31.2	8.71
22.3	5.88	89.7	23.64	1.0	0.26	32.3	8.51
23.3	6.13	84.8	22.29	1.1	0.29	29.2	7.68
25.4	6.12	95.4	23.00	1.3	0.31	31.8	7.67
28.3	6.47	103.0	23.54	1.6	0.37	35.5	8.11
30.4	6.59	108.8	23.60	1.7	0.37	37.7	8.18
31.7	6.79	106.9	22.88	1.8	0.39	37.3	7.98
35.5	7.01	121.2	23.92	2.2	0.43	40.7	8.03
38.7	7.35	129.9	24.68	2.5	0.47	44.3	8.42

(continued)

Table A.1. (Continued)

Year	Gross domestic product	Federal Individual Income Tax		Social Security and Railroad Retirement Taxes		Federal Corporate Profits Tax		Other Federal Taxes ^a	
		Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
1961	544.7	42.70	7.84	12.7	2.33	21.5	3.95	16.2	2.97
1962	585.6	46.50	7.94	13.7	2.34	22.5	3.84	17.6	3.01
1963	617.7	49.10	7.95	16.3	2.49	24.6	3.98	18.2	3.84
1964	663.6	46.00	6.93	17.1	2.43	26.1	3.93	19.1	3.71
1965	719.1	51.10	7.11	18.1	2.36	28.9	4.02	19.2	3.84
1966	787.8	58.60	7.44	25.8	2.87	31.4	3.99	18.4	3.78
1967	832.6	64.40	7.73	29.1	2.92	30.0	3.60	19.2	3.37
1968	910.0	76.40	8.40	32.6	3.58	36.1	3.97	21.0	2.31
1969	984.6	91.70	9.31	37.9	3.85	36.1	3.67	22.5	2.29
1970	1,038.5	88.90	8.56	39.4	3.79	30.6	2.95	23.3	2.24
1971	1,127.1	85.80	7.61	43.6	3.87	33.5	2.97	25.4	2.25
1972	1,238.3	102.80	8.30	49.4	3.99	36.6	2.96	26.0	2.10
1973	1,382.7	109.60	7.93	64.2	4.64	43.3	3.13	27.2	1.97
1974	1,500.0	126.50	8.43	73.3	4.89	45.1	3.01	27.1	1.81
1975	1,638.3	120.70	7.37	76.7	4.68	43.6	2.66	29.8	1.82
1976	1,825.3	141.20	7.74	85.0	4.66	54.6	2.99	30.2	1.65
1977	2,030.9	162.20	7.99	94.1	4.63	61.6	3.03	33.6	1.65
1978	2,294.7	188.90	8.23	108.8	4.74	71.4	3.11	34.8	1.52
1979	2,563.3	224.60	8.76	128.5	5.01	74.4	2.90	35.8	1.40
1980	2,789.5	250.00	8.96	141.9	5.09	70.3	2.52	45.4	1.63
1981	3,128.4	290.60	9.29	169.9	5.43	65.7	2.10	62.4	1.99
1982	3,255.0	295.00	9.06	181.4	5.57	49.0	1.51	54.0	1.66
1983	3,536.7	286.20	8.09	193.9	5.48	61.3	1.73	57.0	1.61
1984	3,933.2	301.40	7.66	219.5	5.58	75.2	1.91	60.8	1.55
1985	4,220.3	336.00	7.96	242.5	5.75	76.3	1.81	59.9	1.42
1986	4,462.8	350.10	7.84	263.9	5.91	83.8	1.88	58.3	1.31
1987	4,739.5	392.50	8.28	281.3	5.94	103.2	2.18	61.0	1.29
1988	5,103.8	402.90	7.89	314.6	6.16	111.1	2.18	66.1	1.30
1989	5,484.4	451.50	8.23	336.6	6.14	117.2	2.14	66.2	1.21
1990	5,803.1	470.20	8.10	363.3	6.26	118.1	2.04	70.3	1.21
1991	5,995.9	461.30	7.69	380.1	6.34	109.9	1.83	80.5	1.34
1992	6,337.7	475.30	7.50	398.0	6.28	118.8	1.87	83.5	1.32

State and Local Taxes ^a		Total Tax Receipts		State and Local Income Tax Receipts		Total Individual Income Tax Receipts	
Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
41.6	7.64	134.7	24.73	2.8	0.51	45.5	8.35
45.2	7.72	145.5	24.85	3.2	0.55	49.7	8.49
48.3	7.82	156.5	25.34	3.4	0.55	52.5	8.50
52.2	7.87	160.5	24.19	4.0	0.60	50.0	7.53
56.5	7.86	173.8	24.17	4.4	0.61	55.5	7.72
61.3	7.78	195.5	24.82	5.4	0.69	64.0	8.12
66.0	7.93	208.7	25.07	6.1	0.73	70.5	8.47
75.0	8.24	241.1	26.49	7.8	0.86	84.2	9.25
84.1	8.54	272.3	27.66	9.8	1.00	101.5	10.31
92.6	8.92	274.8	26.46	10.9	1.05	99.8	9.61
103.3	9.17	291.6	25.87	12.4	1.10	98.2	8.71
118.5	9.57	333.3	26.92	17.2	1.39	120.0	9.69
130.1	9.41	374.4	27.08	18.9	1.37	128.5	9.29
140.0	9.33	412.0	27.47	20.4	1.36	146.9	9.79
151.1	9.22	421.9	25.75	22.5	1.37	143.2	8.74
172.5	9.45	483.5	26.49	26.3	1.44	167.5	9.18
192.1	9.46	543.6	26.77	30.4	1.50	192.6	9.48
208.9	9.10	612.8	26.71	35.0	1.53	223.9	9.76
222.9	8.70	686.2	26.77	38.2	1.49	262.8	10.25
238.5	8.55	746.1	26.75	42.6	1.53	292.6	10.49
264.0	8.44	852.6	27.25	47.9	1.53	338.5	10.82
281.9	8.66	861.3	26.46	51.9	1.59	346.9	10.66
311.0	8.79	909.4	25.71	58.3	1.65	344.5	9.74
350.7	8.92	1,007.6	25.62	67.5	1.72	368.9	9.38
376.3	8.92	1,091.0	25.85	72.1	1.71	408.1	9.67
398.9	8.94	1,155.0	25.88	77.4	1.73	427.5	9.58
434.7	9.17	1,272.7	26.85	86.0	1.81	478.5	10.10
467.2	9.15	1,361.9	26.68	90.6	1.78	493.5	9.67
501.0	9.14	1,472.5	26.85	102.3	1.87	553.8	10.10
531.2	9.15	1,553.1	26.76	109.6	1.89	579.8	9.99
556.6	9.28	1,588.4	26.49	111.7	1.86	573.0	9.56
594.7	9.38	1,670.3	26.35	120.4	1.90	595.7	9.40

(continued)

Table A.1. (Continued)

Year	Gross domestic product	Federal Individual Income Tax		Social Security and Railroad Retirement Taxes		Federal Corporate Profits Tax		Other Federal Taxes ^a	
		Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
1993	6,657.4	505.50	7.59	414.8	6.23	138.5	2.08	88.0	1.32
1994	7,072.2	542.70	7.67	442.0	6.25	156.7	2.22	102.7	1.45
1995	7,397.7	586.00	7.92	465.7	6.30	179.3	2.42	99.2	1.34
1996	7,816.9	663.40	8.49	490.4	6.27	190.6	2.44	99.2	1.27
1997	8,304.3	744.30	8.96	524.4	6.31	203.0	2.44	107.5	1.29
1998	8,747.0	825.80	9.44	562.2	6.43	204.2	2.33	115.4	1.32
1999	9,268.4	893.00	9.63	599.3	6.47	213.0	2.30	122.0	1.32
2000	9,817.0	999.10	10.18	638.3	6.50	219.4	2.23	125.7	1.28
2001	10,128.0	994.50	9.82	662.0	6.54	164.7	1.63	123.6	1.22
2002	10,469.6	830.50	7.93	674.9	6.45	150.5	1.44	122.6	1.17
2003	10,960.8	774.50	7.07	692.1	6.31	197.8	1.80	121.7	1.11
2004	11,712.5	801.40	6.84	724.1	6.18	244.5	2.09	129.6	1.11
2005	12,455.8	927.90	7.45	767.0	6.16	326.4	2.62	136.5	1.10
2006	13,246.6	1,060.0	8.00	815.7	6.16	388.5	2.93	145.2	1.10

Source: Bureau of Economic Analysis, NIPA Tables, various years (Tables 1.1, 3.2, 3.3, 3.5, 3.6, 3.7, 5.10)

a. Includes federal estate taxes, gift taxes, and custom duties plus employer contributions for federal unemployment tax, railroad unemployment insurance, and federal worker's compensation. Excludes federal nontaxes.

b. Includes all state and local receipts from taxes and licenses. Excludes nontaxes, receipts from contributions to social insurance and receipts from federal grants-in-aid.

Note: Projected 2006 levels for Social Security and railroad retirement taxes, other federal taxes, and state and local taxes based on 2005 levels as a constant ratio to GDP.

State and Local Taxes ^a		Total Tax Receipts		State and Local Income Tax Receipts		Total Individual Income Tax Receipts	
Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
622.5	9.35	1,769.3	26.58	126.2	1.90	631.7	9.49
662.2	9.36	1,906.3	26.95	132.2	1.87	674.9	9.54
687.6	9.29	2,017.8	27.28	141.7	1.92	727.7	9.84
720.9	9.22	2,164.5	27.69	152.3	1.95	815.7	10.44
755.8	9.10	2,335.0	28.12	164.7	1.98	909.0	10.95
795.4	9.09	2,503.0	28.62	183.0	2.09	1,008.8	11.53
838.2	9.04	2,665.5	28.76	195.5	2.11	1,088.5	11.74
885.8	9.02	2,868.3	29.22	217.3	2.21	1,216.4	12.39
907.1	8.96	2,851.9	28.16	223.1	2.20	1,217.6	12.02
921.7	8.80	2,700.2	25.79	200.8	1.92	1,031.3	9.85
978.0	8.92	2,764.1	25.22	204.5	1.87	979.0	8.93
1,068.1	9.12	2,967.7	25.34	225.1	1.92	1,026.5	8.76
1,162.8	9.34	3,320.6	26.66	250.9	2.01	1,178.8	9.46
1,236.6	9.34	3,646.0	27.52	275.2	2.08	1,335.2	10.08

Table A.2. Personal Income Excluded from Adjusted Gross Income
(in billions of dollars)

Year	NET NONTAXABLE GOVERNMENT TRANSFERS						NET NONTAXABLE LABOR-RELATED INCOME												Total Net Exclusions from AGI		Personal income
	OASDI and Railroad Retirement (a)		Medicare (b)		Other Nontaxable Transfers (c)		Pension and Profit Sharing		Health Insurance		Other Labor Compensation		Other Statutory Exclusions		Other Net Differences						
Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI				
1948	-0.2	-0.1	0.0	0.0	9.4	4.5	0.7	0.3	0.4	0.2	0.9	0.4	3.3	1.6	11.5	5.49	26.1	12.4	209.8		
1949	-0.1	0.0	0.0	0.0	10.2	4.9	0.7	0.3	0.6	0.3	1.0	0.5	2.7	1.3	10.5	5.08	25.5	12.3	207.1		
1950	-0.3	-0.1	0.0	0.0	12.7	5.5	1.0	0.4	0.7	0.3	1.0	0.5	1.6	0.7	9.7	4.24	26.5	11.6	229.0		
1951	0.3	0.1	0.0	0.0	9.2	3.6	1.6	0.6	1.0	0.4	1.2	0.5	2.8	1.1	12.7	4.91	28.7	11.1	258.0		
1952	0.3	0.1	0.0	0.0	9.3	3.4	1.7	0.6	1.1	0.4	1.3	0.5	3.6	1.3	16.4	5.96	33.8	12.3	275.4		
1953	1.2	0.4	0.0	0.0	9.0	3.1	1.9	0.6	1.3	0.5	1.5	0.5	3.6	1.2	17.3	5.94	35.8	12.3	291.9		
1954	1.2	0.4	0.0	0.0	10.2	3.5	1.8	0.6	1.5	0.5	1.5	0.5	3.9	1.3	17.1	5.81	37.2	12.6	294.5		
1955	2.1	0.7	0.0	0.0	10.2	3.2	2.2	0.7	1.7	0.5	1.7	0.5	3.9	1.2	15.6	4.94	37.4	11.8	316.1		
1956	2.5	0.7	0.0	0.0	10.5	3.1	2.3	0.7	2.1	0.6	2.0	0.6	4.2	1.2	16.7	4.92	40.2	11.8	339.6		
1957	3.6	1.0	0.0	0.0	11.5	3.2	2.6	0.7	2.4	0.7	2.2	0.6	4.4	1.2	19.4	5.41	46.1	12.9	358.7		
1958	4.7	1.3	0.0	0.0	14.3	3.9	2.2	0.6	2.7	0.7	2.3	0.6	4.5	1.2	22.4	6.08	53.2	14.4	369.0		
1959	5.6	1.4	0.0	0.0	13.2	3.4	2.7	0.7	3.0	0.8	2.5	0.6	4.8	1.2	19.2	4.89	51.0	13.0	392.8		
1960	5.5	1.3	0.0	0.0	13.7	3.3	2.6	0.6	3.4	0.8	2.7	0.7	5.2	1.3	24.5	5.95	57.5	14.0	411.5		
1961	6.9	1.6	0.0	0.0	15.9	3.7	2.4	0.6	3.7	0.9	2.8	0.7	5.3	1.2	24.0	5.59	61.0	14.2	429.0		
1962	8.1	1.8	0.0	0.0	15.1	3.3	2.4	0.5	4.2	0.9	3.1	0.7	6.2	1.4	27.6	6.04	66.7	14.6	456.7		
1963	7.8	1.6	0.0	0.0	15.9	3.3	2.4	0.5	4.6	0.9	3.3	0.7	6.7	1.4	28.0	5.83	68.6	14.3	479.6		
1964	8.1	1.6	0.0	0.0	16.4	3.2	2.7	0.5	5.2	1.0	3.6	0.7	7.6	1.5	27.1	5.27	70.7	13.7	514.6		

1965	9.8	1.8	0.0	0.0	17.0	3.1	3.2	0.6	5.9	1.1	3.9	0.7	9.1	1.6	26.1	4.70	75.1	13.5	555.7
1966	8.8	1.5	-0.4	-0.1	17.6	2.9	3.4	0.6	6.4	1.1	4.5	0.7	12.4	2.1	30.1	4.98	82.7	13.7	603.9
1967	8.8	1.4	2.4	0.4	20.9	3.2	3.3	0.5	6.9	1.1	4.9	0.8	15.0	2.3	34.9	5.38	97.0	15.0	648.3
1968	11.4	1.6	2.8	0.4	24.1	3.4	3.6	0.5	8.4	1.2	5.6	0.8	17.1	2.4	33.3	4.68	106.4	14.9	712.0
1969	10.8	1.4	3.4	0.4	27.7	3.6	3.5	0.5	9.9	1.3	6.0	0.8	17.8	2.3	39.6	5.08	118.7	15.2	778.5
1970	15.1	1.8	3.7	0.4	34.3	4.1	3.1	0.4	12.1	1.4	6.4	0.8	18.0	2.1	49.8	5.93	142.4	17.0	838.8
1971	18.6	2.1	4.2	0.5	41.5	4.6	2.8	0.3	13.7	1.5	6.7	0.7	18.2	2.0	55.1	6.09	160.7	17.8	903.5
1972	20.5	2.1	4.5	0.4	46.0	4.6	3.0	0.3	16.2	1.6	7.2	0.7	17.8	1.8	53.0	5.34	168.2	16.9	992.7
1973	25.9	2.3	3.1	0.3	49.1	4.4	4.3	0.4	18.3	1.6	7.9	0.7	18.1	1.6	58.9	5.30	185.7	16.7	1110.7
1974	28.6	2.3	5.1	0.4	60.2	4.9	5.0	0.4	21.1	1.7	8.9	0.7	22.2	1.8	68.0	5.56	219.1	17.9	1222.6
1975	35.7	2.7	7.6	0.6	85.2	6.4	5.3	0.4	25.5	1.9	10.1	0.8	24.4	1.8	94.4	7.07	288.2	21.6	1335.0
1976	41.2	2.8	10.1	0.7	87.1	5.9	6.1	0.4	32.0	2.2	11.9	0.8	26.1	1.8	92.2	6.25	306.8	20.8	1474.8
1977	46.1	2.8	12.4	0.8	85.1	5.2	8.3	0.5	38.8	2.4	14.4	0.9	28.6	1.8	103.5	6.34	337.1	20.6	1633.2
1978	48.8	2.7	13.8	0.8	88.7	4.8	12.7	0.7	46.0	2.5	16.9	0.9	33.2	1.8	111.2	6.05	371.3	20.2	1837.7
1979	52.3	2.5	15.8	0.8	95.7	4.6	14.3	0.7	52.6	2.5	19.3	0.9	38.9	1.9	119.3	5.78	408.1	19.8	2062.2
1980	63.0	2.7	20.6	0.9	114.3	5.0	14.0	0.6	61.0	2.6	21.4	0.9	43.6	1.9	139.7	6.05	477.6	20.7	2307.9
1981	73.9	2.9	23.0	0.9	124.7	4.8	5.2	0.2	71.7	2.8	22.3	0.9	60.5	2.3	193.8	7.48	575.0	22.2	2591.3
1982	84.2	3.0	28.9	1.0	126.0	4.5	-1.0	0.0	82.6	3.0	22.3	0.8	96.1	3.5	237.6	8.56	676.7	24.4	2775.3
1983	90.6	3.1	33.5	1.1	136.0	4.6	-8.4	-0.3	91.5	3.1	23.0	0.8	117.0	4.0	251.9	8.51	735.1	24.8	2960.7
1984	79.9	2.4	37.3	1.1	126.8	3.7	-3.6	-0.1	100.3	3.1	24.7	0.8	137.7	4.2	313.8	9.54	816.9	24.8	3289.5
1985	75.7	2.1	39.2	1.1	135.0	3.7	-6.4	-0.2	110.0	3.1	28.1	0.8	154.8	4.4	358.7	10.17	895.1	25.4	3526.7
1986	77.9	2.1	40.9	1.1	142.9	3.8	-29.1	-0.8	117.4	3.2	31.8	0.9	162.1	4.4	325.3	8.74	869.2	23.4	3722.4
1987	75.5	1.9	44.2	1.1	130.9	3.3	-29.9	-0.8	126.2	3.2	36.0	0.9	107.4	2.7	336.0	8.51	826.3	20.9	3947.4
1988	70.8	1.7	44.4	1.0	142.5	3.4	-43.6	-1.0	142.3	3.3	39.9	0.9	120.7	2.8	324.8	7.64	841.8	19.8	4253.7
1989	71.3	1.6	50.6	1.1	158.5	3.5	-57.0	-1.2	158.6	3.5	43.1	0.9	134.6	2.9	378.4	8.25	938.1	20.4	4587.8
1990	74.0	1.5	59.8	1.2	173.0	3.5	-65.5	-1.3	176.9	3.6	47.8	1.0	160.6	3.3	453.5	9.30	1080.2	22.1	4878.6

(continued)

Table A.2. (Continued)

Year	NET NONTAXABLE GOVERNMENT TRANSFERS						NET NONTAXABLE LABOR-RELATED INCOME												Personal income
	OASDI and Railroad Retirement (a)		Medicare (b)		Other Nontaxable Transfers (c)		Pension and Profit Sharing		Health Insurance		Other Labor Compensation		Other Statutory Exclusions		Other Net Differences		Total Net Exclusions from AGI		
	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	Amt	%PI	
1991	88.8	1.8	64.1	1.3	195.4	3.9	-69.0	-1.4	192.8	3.8	50.0	1.0	175.8	3.5	496.3	9.83	1194.2	23.6	5051.0
1992	96.3	1.8	75.9	1.4	216.9	4.0	-73.9	-1.4	215.7	4.0	53.6	1.0	182.3	3.4	503.2	9.38	1270.0	23.7	5362.0
1993	102.3	1.8	84.3	1.5	235.0	4.2	-69.9	-1.3	234.3	4.2	55.4	1.0	191.6	3.4	480.1	8.64	1313.1	23.6	5558.5
1994	91.5	1.6	95.1	1.6	245.8	4.2	-81.4	-1.4	246.0	4.2	54.9	0.9	221.8	3.8	495.2	8.47	1368.8	23.4	5842.5
1995	89.8	1.5	105.2	1.7	260.8	4.2	-95.6	-1.6	252.3	4.1	53.3	0.9	243.4	4.0	483.3	7.86	1392.5	22.6	6152.3
1996	88.7	1.4	119.5	1.8	270.2	4.1	-118.4	-1.8	252.9	3.9	53.1	0.8	273.9	4.2	436.2	6.69	1376.1	21.1	6520.6
1997	82.3	1.2	125.6	1.8	267.3	3.9	-136.8	-2.0	256.9	3.7	52.6	0.8	300.2	4.3	389.0	5.63	1337.1	19.3	6915.1
1998	77.6	1.0	120.0	1.6	280.8	3.8	-139.3	-1.9	267.6	3.6	51.6	0.7	344.1	4.6	300.3	4.05	1302.8	17.6	7423.0
1999	62.0	0.8	117.6	1.5	297.6	3.8	-171.6	-2.2	294.1	3.8	52.3	0.7	367.5	4.7	229.4	2.94	1248.9	16.0	7802.4
2000	53.3	0.6	123.0	1.5	312.2	3.7	-174.8	-2.1	331.4	3.9	55.9	0.7	401.4	4.8	201.9	2.40	1304.3	15.5	8429.7
2001	63.2	0.7	142.6	1.6	346.5	4.0	-208.3	-2.4	353.3	4.0	58.6	0.7	422.7	4.8	540.4	6.19	1719.1	19.7	8724.1
2002	77.2	0.9	157.4	1.8	356.3	4.0	-178.6	-2.0	386.5	4.4	62.4	0.7	439.5	4.9	604.4	6.81	1905.1	21.4	8881.9
2003	82.6	0.9	169.8	1.9	383.5	4.2	-197.1	-2.2	423.4	4.6	66.7	0.7	467.2	5.1	532.6	5.81	1928.7	21.0	9163.6
2004	79.1	0.8	189.0	1.9	429.1	4.4	-243.1	-2.5	469.7	4.8	70.8	0.7	519.7	5.3	340.1	3.49	1854.4	19.1	9731.4

Sources: Bureau of Economic Analysis, *National Income and Product Accounts*, tables 3.6, 3.12, 6.11, 7.19. *Survey of Current Business*.

Note: BEA would not release the latest numbers for imputed interest to persons from pensions. They are estimated as maintaining their 2001 level for 2002–2005. These estimates affect the pensions and profit sharing figures for 2002–2005.

Table A.3. Tax Exempt Levels of Income by Filing Status and Number of Dependents, 1948–2006

Year	Per capita personal income	Single		Joint			Head of Household	
				0	2	2	2	2
		Without EITC	With EITC	Dependents without EITC ^a	Dependents without EITC + CTC	Dependents with EITC + CTC	Dependents without EITC + CTC	Dependents with EITC + CTC
1948	\$1,431	\$667	\$667	\$1,333	\$2,667	\$2,667	\$2,000	\$2,000
1954	1,814	667	667	1,333	2,667	2,667	2,000	2,000
1960	2,276	667	667	1,333	2,667	2,667	2,000	2,000
1966	3,072	900	900	1,600	3,000	3,000	2,300	2,300
1972	4,729	2,050	2,050	2,800	4,300	4,300	3,550	3,550
1978	8,255	3,200	3,200	5,200	7,200	7,533	5,200	6,930
1981	11,266	3,300	3,300	5,400	7,400	8,634	5,300	7,515
1984	13,915	3,300	3,300	5,400	7,400	8,783	5,300	8,315
1986	15,466	3,560	3,560	5,830	7,990	9,575	5,720	9,063
1988	17,358	4,950	4,950	8,900	12,800	15,110	10,250	13,940
1990	19,500	5,300	5,300	9,550	13,650	16,296	10,900	15,066
1991	19,923	5,550	5,550	10,000	14,300	17,437	11,450	16,179
1992	20,870	5,900	5,900	10,600	15,200	18,548	12,150	17,217
1993	21,356	6,050	6,050	10,900	15,600	19,187	12,500	17,841
1994	22,176	6,250	7,179	11,250	16,150	21,098	12,950	18,887
1995	23,078	6,400	7,356	11,550	16,550	22,362	13,250	19,387
1996	24,176	6,550	7,546	11,800	16,900	23,672	13,550	19,884
1997	25,334	6,800	7,803	12,200	17,500	24,386	14,000	22,090

(continued)

Table A.3. (Continued)

Year	Per capita personal income	Without EITC	With EITC	Joint			Head of Household	
				0 Dependents without EITC ^a	2 Dependents without EITC + CTC	2 Dependents with EITC + CTC	2 Dependents without EITC + CTC	2 Dependents with EITC + CTC
1998	26,880	6,950	7,990	12,500	17,900	27,796	14,350	26,319
1999	27,933	7,050	8,114	12,700	18,200	28,204	14,600	26,706
2000	29,855	7,200	8,274	12,950	18,550	28,684	14,850	27,144
2001	30,572	7,450	8,863	13,400	19,200	31,739	15,350	29,860
2002	30,805	7,700	9,156	13,850	19,850	33,210	15,900	30,706
2003	31,469	7,800	9,300	15,600	21,700	39,700	16,150	33,379
2004	33,102	7,950	9,485	15,900	22,100	40,200	16,450	33,928
2005	34,493	8,200	9,740	16,400	22,800	41,000	16,900	34,620
2006	36,312	8,450	10,041	16,900	23,100	41,867	17,450	35,525
% Change								
1948–2006	2438%	1167%	1405%	1168%	766%	1470%	773%	1676%
1948–1986	981	434	434	337	200	259	186	353
1986–2006	135	137	182	190	189	337	205	292

Sources: Author's calculations based on data from the U.S. Department of Commerce (1986, 1990); the Internal Revenue Service, individual income tax returns, various years; the *Green Book*, BEA NIPA table 2.1; and Urban-Brookings Tax Policy Center, Tax Facts, "Individual Income Tax Brackets: 1945–2007."

Single filers were not eligible for the EITC until tax year 1994. The Child Tax Credit (CTC) was unavailable before tax year 1998.

Per capita personal income for FY2006 estimated using BEA NIPA table 2.1 data from the first three quarters.

a. Joint filers without children are ineligible for CTC and ineligible for the EITC at the tax entry threshold.

Table A.4. Average and Marginal Combined Federal Income and Employee Social Security and Medicare (FICA) Tax Rates for Four-Person Families, 1955–2006

Year	One-Half Median Income			Median Income			Twice Median Income		
	Income (\$)	Average combined tax rate	Marginal combined tax rate	Income (\$)	Average combined tax rate	Marginal combined tax rate	Income (\$)	Average combined tax rate	Marginal combined tax rate
1955	2,460	2.0	2.0	4,919	7.4	20.0	9,838	11.6	22.0
1956	2,660	2.0	2.0	5,319	8.0	20.0	10,638	12.0	22.0
1957	2,744	2.3	2.3	5,488	8.4	20.0	10,976	12.3	22.0
1958	2,843	2.3	2.3	5,685	8.6	20.0	11,370	12.4	22.0
1959	3,035	2.5	2.5	6,070	9.5	20.0	12,140	12.9	22.0
1960	3,148	3.2	23.0	6,295	10.1	20.0	12,590	13.3	22.0
1961	3,219	3.5	23.0	6,437	10.2	20.0	12,874	13.3	22.0
1962	3,378	4.3	23.1	6,756	10.5	20.0	13,512	13.6	26.0
1963	3,569	5.6	23.6	7,138	11.1	20.0	14,276	14.1	26.0
1964	3,744	5.7	19.6	7,488	9.9	18.0	14,976	12.8	23.5
1965	3,900	5.8	17.6	7,800	9.3	17.0	15,600	12.2	22.0
1966	4,171	6.9	18.2	8,341	10.8	19.0	16,682	13.2	22.0
1967	4,497	7.7	19.4	8,994	11.2	19.0	17,988	13.5	22.0
1968	4,917	8.4	19.4	9,834	12.7	20.4	19,668	15.1	26.9
1969	5,312	9.4	19.8	10,623	13.4	20.9	21,246	16.0	27.5
1970	5,583	9.5	19.8	11,165	12.7	19.5	22,330	15.2	25.6
1971	6,088	9.9	20.2	12,176	12.6	19.0	24,352	15.1	28.0
1972	6,404	9.6	20.2	12,808	12.7	19.0	25,616	15.4	28.0

(continued)

Table A.4. (continued)

Year	One-Half Median Income			Median Income			Twice Median Income		
	Income (\$)	Average combined tax rate	Marginal combined tax rate	Income (\$)	Average combined tax rate	Marginal combined tax rate	Income (\$)	Average combined tax rate	Marginal combined tax rate
1973	6,855	10.7	21.9	13,710	14.1	19.0	27,420	16.4	28.0
1974	7,485	10.0 ^a	21.9	14,969	14.2 ^a	22.0	29,938	16.9 ^a	33.0 ^a
1975	7,924	10.0 ^b	32.9 ^b	15,848	14.8	22.0	31,696	17.5	32.0
1976	8,658	10.5	22.9	17,315	15.1	22.0	34,630	18.1	32.0
1977	9,362	9.5	22.9	18,723	15.6	22.0	37,446	19.0	36.0
1978	10,214	10.8	25.1	20,428	16.3	25.0	40,856	20.0	39.0
1979	11,256	11.2	22.1	22,512	17.0	30.1	45,024	20.3	37.0
1980	12,166	12.2	24.1	24,332	17.6	30.1	48,664	21.5	43.0
1981	13,137	13.5	24.4	26,274	18.4	30.4	52,548	22.9	42.5
1982	13,810	13.2	22.7	27,619	17.8	31.7	55,238	21.9	39.0
1983	14,591	13.2	21.7	29,181	17.1	29.7	58,362	20.9	35.0
1984	15,549	13.2	20.7	31,097	17.0	28.7	62,194	20.7	38.0
1985	16,389	13.6	21.1	32,777	17.4	29.1	65,554	21.0	38.0
1986	17,358	13.8	21.2	34,716	17.6	29.2	69,432	21.4	38.0
1987	18,543	12.3	22.2	37,086	16.1	22.2	74,172	20.0	35.0
1988	19,526	12.7	22.5	39,051	16.8	22.5	78,102	19.5	28.0
1989	20,382	12.8	22.5	40,763	16.9	22.5	81,526	19.7	28.0
1990	20,726	12.8	22.7	41,451	17.0	22.7	82,902	19.8	28.0
1991	21,526	12.7	22.7	43,052	17.0	22.7	86,104	20.3	29.5

1992	22,126	12.2 ^b	35.8 ^a	44,251	16.8	22.7	88,502	20.1	29.5
1993	22,581	12.0 ^b	36.6 ^b	45,161	16.8	22.7	90,322	20.1	29.5
1994	23,506	11.0 ^b	40.3 ^b	47,012	16.8	22.7	94,024	20.2	29.5
1995	24,844	11.2 ^b	42.9 ^a	49,687	16.9	22.7	99,374	20.3	29.5
1996	25,759	10.6 ^b	43.7 ^b	51,518	17.0	22.7	103,036	20.4	29.5
1997	26,675	10.7 ^b	43.7 ^b	53,350	17.0	22.7	106,700	20.4	29.5
1998	28,031	8.7 ^{b,c}	43.7 ^{b,c}	56,061	15.6	22.7	112,222	19.9	29.5
1999	29,991	9.8 ^{b,c}	43.7 ^{b,c}	59,981	15.5	22.7	119,962	20.5	29.5
2000	31,335	10.6 ^{b,c,d}	22.7 ^{b,c}	62,670	15.7	22.7	125,340	20.9	34.5
2001	31,639	7.5 ^{b,c}	43.7 ^{b,c,e}	63,278	14.4	22.7	126,556	20.3	34.5
2002	31,186	5.4 ^{b,f}	28.7 ^{a,c,f}	62,372	14.2	22.7	124,744	19.4	33.5
2003	32,547	3.4 ^{b,f}	28.7 ^{b,c,f}	65,093	13.0	22.7	130,186	17.7	31.5
2004	33,056	3.4 ^{b,f}	23.7 ^{b,c,f}	66,111	13.0	22.7	132,222	18.1	31.5
2005	35,156	4.2 ^{b,f}	23.7 ^{b,c,f}	70,312	13.3	22.7	140,624	18.5	26.5
2006	36,291	4.2 ^{b,f,g}	23.7 ^{b,c,f}	72,583	13.3	22.7	145,165	18.6	26.5

Sources: Department of the Treasury Office of Tax Analysts (1998) and Tax Policy Center.

a. Reflects one-year rebate under P.L. 94-12, including income related phaseout for the twice-median income family.

b. Includes effects of the Earned Income Tax Credit (EITC), assuming two eligible dependents.

c. Includes effects of Child Tax Credit enacted in the Taxpayer Relief Act of 1997.

d. Sample expanded by 28,000 households. If calculated by old method, would've been \$62,228.

e. Includes effects of \$600 rebate given as part of EGTRRA.

f. Includes effects of Child Tax Credit expansion as part of EGTRRA.

g. Reflects adjustment for inflation based on CPI-W.

Note: Median income is for a four-person family. All calculations are for a married couple and income is assumed to be earned by one spouse. Itemized deductions are assumed to equal 23 percent of income through 1986 and 18 percent of income thereafter.

Table A.5. Marginal Effective Tax Rates on Capital Income, 1953–2006 (percent)

Year	Corporate firm level	Corporate total	Noncorporate	Owner- Occupied	U.S. Total
1953	63	70	37	-1	58
1954	50	57	23	-1	43
1955	51	58	24	-1	44
1956	53	60	25	-1	46
1957	55	61	27	-1	48
1958	55	61	26	1	47
1959	52	58	25	1	45
1960	49	55	23	1	42
1961	49	55	22	1	42
1962	42	48	17	1	35
1963	41	47	16	1	34
1964	38	44	14	0	31
1965	37	42	13	1	29
1966	37	42	14	1	30
1967	40	45	17	1	33
1968	44	50	20	3	37
1969	52	58	28	5	45
1970	48	54	26	5	42
1971	43	50	21	5	38
1972	44	51	21	5	38
1973	43	51	21	5	38
1974	48	55	25	7	42
1975	51	56	27	11	44
1976	46	53	23	7	40
1977	41	49	23	6	40
1978	50	58	26	10	46
1979	47	57	29	11	45
1980	51	60	33	15	48
1981	37	48	24	12	38
1982	35	43	22	9	35
1983	39	46	20	8	34
1984	38	44	20	7	33
1985	38	44	20	7	33
1986	38	45	19	6	33
1987	35	44	22	4	33
1988	35	43	22	4	33

Table A.5. *(Continued)*

Year	Corporate firm level	Corporate total	Noncorporate	Owner- Occupied	U.S. Total
1989	34	43	22	4	33
1990	33	42	22	3	31
1991	32	41	22	3	30
1992	32	41	22	3	30
1993	33	42	22	2	31
1994	32	41	22	2	30
1995	32	42	22	2	31
1996	32	42	22	2	31
1997	31	41	23	2	31
1998	31	41	22	2	30
1999	30	40	23	2	30
2000	31	41	23	2	31
2001	32	41	22	2	30
2002	30	39	21	2	29
2003	27	32	18	2	23
2004	30	35	21	2	36
2005	34	41	23	2	30
2006	34	41	23	2	30

Source: Gravelle (2004). Estimates updated for 2005 by Jane Gravelle. Estimate for 2006 based on note to author that, due to the lack of any significant legislation, little change should be expected from 2005 to 2006.

Acronyms

ACRS	accelerated-cost recovery system
AFDC	Aid to Families with Dependent Children
AGI	adjusted gross income
CBO	Congressional Budget Office
CDE	community development entity
CRS	Congressional Research Service
CTC	child tax credit
DEFRA	Deficit Reduction Act of 1984
DISC	domestic international sales corporation
EEC	European Economic Community
EITC	earned income tax credit
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001
ERISA	Employee Retirement Income Security Act of 1974
ERTA	Economic Recovery Tax Act of 1981
ETI	extraterritorial income exclusion
EU	European Union
FSC	foreign sales corporation
GAO	Government Accountability Office
GDP	gross domestic product
GNP	gross national product
HI	Hospital Insurance (under Medicare)
HSA	health savings account

IRA	individual retirement account
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
JGTRRA	Jobs and Growth Tax Relief Reconciliation Act of 2003
MSA	medical savings account
NTJ	<i>National Tax Journal</i>
OASDI	Old Age, Survivors, and Disability Insurance (Social Security)
OBRA	Omnibus Budget Reconciliation Act (various years)
OMB	Office of Management and Budget
OTA	Office of Tax Analysis (Treasury)
OTP	Office of Tax Policy (Treasury)
PRWORA	Personal Responsibility and Work Opportunity Reconciliation Act of 1986
TANF	Temporary Assistance for Needy Families
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
VAT	value-added tax
WTO	World Trade Organization

Glossary

Adjusted gross income (AGI). A measure of an individual taxpayer's net income used in calculating personal income taxes, but before itemized deductions are taken. As a creature of the tax code, the components of the AGI have changed over the years as the tax law has changed.

Airport and Airway Trust Fund. A trust fund established in 1970 and financed by aviation excise taxes and dedicated to funding public investments in the air transport system. A substantial portion of the funding for the Federal Aviation Administration (FAA) comes from the trust fund.

Alternative minimum tax (AMT). A supplemental income tax originally intended to ensure that high-income filers do not take undue advantage of tax preferences to reduce or eliminate their tax liability. The primary items of "preference," however, are for state and local tax deductions, personal exemptions, and miscellaneous itemized deductions—not items normally thought of as preferences or shelters. Increasingly, this complicated tax applies to middle-class families, in part because its exemption was not indexed for inflation.

Average effective tax rate. A widely used measure of tax burdens, particularly corporate tax burdens. Basically, it is a ratio of a taxpayer's nominal tax liability to income. The calculation does not deal with the eventual incidence of the tax.

Base broadening. A term applied to efforts to expand the tax base, usually by removing deductions, exclusions and other preferences that are unrelated to measuring the tax base correctly. A broader base means that an equal level of revenues can be raised with lower tax rates or that more revenues can be raised at the same rates.

Bracket creep. The movement of taxpayers into higher tax brackets with higher tax rates. Under a progressive tax system, individuals are pushed into higher tax brackets as their incomes increase. In the early 1980s, tax rate schedules were indexed for inflation so that general price increases would not cause bracket creep. More recently, some analysts have expressed concern about real income growth causing bracket creep.

Capital cost recovery. Income tax features intended to allow businesses to deduct over time the costs of tangible capital assets that are used to produce income. It is similar to a depreciation allowance, except that "depreciation" usually conveys that the timing of the write-off will be related to change in value over time. (See *depreciation*.)

Capital gains taxation. A tax on increases (or decreases) in the value of assets such as corporate stock, real estate, or a business. Such taxes are usually assessed only when gains are "realized" by sale or exchange. Unrealized gains generally are not taxed on the grounds that it would be difficult to estimate the assets' value, and it could force the liquidation of assets to pay the tax. Taxation upon realization, however, leads to certain distortions and creates opportunities for tax shelters.

Carryover of basis. Transfer of basis value to a person to whom assets are transferred. The basis of an asset equals its cost, with some adjustments for items like depreciation. When an asset is sold, the realized gain equal sales price less basis (e.g., General Motors stock bought for \$1,000 and sold for \$3,000 has a basis of \$1,000 and a gain of \$2,000). Capital gains accrued at death are not only forgiven from tax in the decedent's estate, but the heirs get to treat their "basis" in the inherited assets as equal to the value at the death of the decedent (in the example, the heirs get to treat \$3,000 as their basis even though no one ever paid tax on the \$2,000 of gains). With carryover of basis, the heirs would be required to keep the original basis of assets left by a decedent (\$1,000 in the example). Under current law, beneficiaries of gifts from donors still alive must

carry over basis. Also, under legislation passed in 2001, the estate tax is temporarily eliminated and replaced with carryover of basis for people dying in 2010.

Charitable deductions. Deductions allowed for gifts to charity. Since 1917, individual federal taxpayers have been allowed to deduct gifts to charitable and certain other nonprofit organizations. Corporations are also allowed a deduction under a stricter limit. Among other reasons, the deduction was intended to subsidize the activities of private organizations that provide viable alternatives to direct government programs.

Child care credit. A benefit in the form of a credit for child care expenses incurred by some taxpayers deemed to be gainfully employed or students. A separate exclusion is available for some employer-provided child care.

Counter-cyclical policy. Fiscal (or monetary) policy that moves counter to economic cycles, such as tax cuts in a time of recession. Traditionally, fiscal incentives have been associated with the macroeconomic theories of John Maynard Keynes.

Deficit-neutral. A term applied to bills or proposals that neither increase nor decrease the deficit. For instance, a tax increase equal in value to an expenditure increase would be revenue neutral.

Depreciation. A measurement of the declining value of assets over time because of physical deterioration or obsolescence. In practice, tax depreciation is calculated by a set of deductions, usually over a code-specified "useful life," through which the full cost of an asset can be written off. Accelerated depreciation means a speed-up in deductions so that more can be taken in earlier years.

Distortion. Changes in behavior due to taxes, government benefits, monopolies, and other forces that interfere in the market. Typical tax distortions are changes in the amount of work or saving that would occur because of tax avoidance.

Double taxation of dividends. A controversial feature of the many tax systems that have both corporate and individual income taxes, whereby

corporate profits are taxed once at the corporate level and then again when these profits are distributed to shareholders as dividends.

Earned income tax credit (EITC). An income tax credit for low-income workers, originally enacted in 1975, and now one of the largest antipoverty programs in the federal budget. Unlike other tax credits for individuals, the EITC is refundable. (See *refundable*.)

Enterprise zones. Geographically targeted tax, expenditure, and regulatory inducements used by state and local governments since the early 1980s and by the federal government since 1993. While they differ in their specifics, all the programs provide development incentives in an attempt to encourage private investment and increase employment opportunities.

Estate tax. The taxation of large estates at the time of the owner's death. In 2003, the tax applied to the largest 2 percent of estates (those worth at least one million dollars). Special provisions apply to farms and small businesses, and there is a complete exemption or deduction from the estate tax for assets transferring to spouses or charity. The tax is scheduled to be phased out by 2010, but then to be reinstated the following year.

Flat tax. A proposal for fundamental tax reform that would replace the income tax system with a flat-rate tax on businesses and individuals. Most flat tax proposals are designed to be consumption rather than income taxes, and most are really not "flat" because they grant an exemption at least for the first dollars of earnings.

Foreign tax credit. A credit that allows U.S. residents to subtract foreign income taxes paid from the U.S. income tax due on income earned abroad.

Gramm-Rudman-Hollings law. A law enacted in 1985 that required budget deficits be brought down to specified amounts and the budget be balanced by 1991. If Congress did not enact legislation to do so, automatic spending cuts would be triggered. In 1990, this legislation was replaced with the more politically attainable goal of achieving specific size deficit targets as part of broader budget reconciliation bills.

Health savings account (HSA). A special tax-favored account for deposits made to cover present and future health care expenses paid by the individual. Both the health expenditures and interest earned in the account are tax free so long as funds are used to pay for medical expenses. Enacted in 2003 as part of legislation providing drug benefits as part of Medicare, the tax preference is only available if the individual purchases a health insurance policy with a large deductible.

Highway trust fund. A federal trust fund, created in 1956, that finances highway construction and certain other federal spending on transportation. The fund keeps its revenues and outlays segregated from the rest of the federal budget.

Homeowner preference. Income tax provisions that favor investments in owner-occupied housing. The mortgage-interest deduction and the property-tax deduction are two of the largest measured tax expenditure items. In truth, the real preference is for the nontaxation of the “rental” stream of income available to a homeowner (compare, for instance, a renter having a savings account with a homeowner who puts the saving into a purchasing a home).

Indexation of the tax system. Measures that prevent bracket creep by “indexing” such items as personal exemptions and the brackets in the tax rate schedules for inflation. For instance, with 5 percent inflation, a personal exemption of \$1,000 would be raised to \$1,050. More broadly, the term applies to all efforts to adjust measures of income relative to some index, such as reducing capital gains subject to tax by the amount to which those gains are inflationary, rather than real. (See *bracket creep*.)

Low-income housing credit. A federal tax credit designed to encourage the acquisition, construction, or rehabilitation of housing for low-income families, and one of the few tax mechanisms for low-income housing support.

Marginal tax rate. The additional tax that would be paid on an additional dollar of income. It is a measure of the effect of the tax system on incentives to work, save, and shelter income from tax. Provisions such as the phase out of tax credits can cause marginal tax rates to differ from statutory tax rates.

Out year. In budget parlance, a future year beyond the period over which budget costs are tallied (in recent years, after a 5- or 10-year period over which costs are estimated).

Pay-as-you-go and caps. Provisions in the 1990 Budget Enforcement Act law that replaced Gramm-Rudman-Hollings (see above). Spending subject to appropriation was made subject to a separate series of annual caps. Pay-as-you-go rules covered the rest of the budget: mandatory spending and revenues could not together increase the deficit in any bill when pay-as-you-go rules were enforced.

Real income. Income that is not due to inflation. Real income is usually calculated by subtracting inflationary income (e.g., capital gains due to inflation) from nominal income.

Refundable. Payable to taxpayers (usually as a refund) even if they have no tax liability. Most credits and deductions are not refundable, although they often may be used to offset liability not just in the current year but also from past or future years. (See *earned income tax credit*.)

Rent-seeking. The search for extraordinary profits or returns due, for instance, to scarcity, monopoly, asymmetry of information, or segmentation of market demand into different price-sensitive categories.

Revenue-neutral. A term applied to tax bills or proposals that pay for themselves over some budget period by having tax increases equal in value to tax decreases. (See *deficit-neutral*.)

Stagflation. The combination of stagnant growth and high inflation, associated in the United States largely with the 1970s.

Standard deduction. An allowance for a minimum amount of deductions that may be taken in lieu of itemizing deductions on a tax return. Typically, taxpayers with small amounts of potential itemized deductions, such as charitable contributions, mortgage interest, or state and local taxes, choose to take the standard deduction instead. In 2001, about two-thirds of returns claimed the standard deduction.

Tax arbitrage. Profiting from the different tax treatment of different assets, firms, or tax regimes in different countries, sometimes when there is no economic reason for the transactions. The most common form of tax arbitrage is borrowing and deducting the interest to buy tax-preferred assets (even when on a before-tax basis the arbitrager pays more in interest than he receives in return on the asset).

Tax expenditures. Spending programs channeled through the tax system. The size of the "expenditure" is approximated by different measures of the revenue losses. These tax provisions generally grant special tax relief to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. What counts as a tax expenditure is often disputed.

Taxpolicycenter.org. The website of the Urban-Brookings Tax Policy Center, established to provide nonpartisan analysis of key tax issues.

Tax Policy Center microsimulation model. A microsimulation model developed by the Tax Policy Center and based on data from the IRS Statistics of Income public use files. The model is used to estimate how proposals affect revenue, the distribution of tax burdens, and incentives to work and save. It is very similar to the models used by the Treasury Department, the Joint Committee on Taxation, and the Congressional Budget Office.

Tax shelters. A popular term applied to investments that take advantage of preferences in the tax system; more generally, any arrangements undertaken to minimize taxes. (See *tax arbitrage*).

Value-added tax (VAT). A general tax on all goods and services based on the value each firm adds to a product (rather than, say, gross sales). Although not required, almost all value-added taxes are based upon consumption, not income (e.g., they allow complete write-offs, rather than depreciation, of capital expenses). Designed to raise large amounts of revenue while minimizing a number of economic distortions, it is almost universal among developed countries other than the United States.

Notes

CHAPTER 1

1. One former deputy assistant secretary for tax analysis at the U.S. Treasury claimed that “tax policy is an extraordinarily poor instrument for rapid reaction to short-term policy problems” (Burman 2002).

2. This quotation stands at the entrance to the IRS main building in Washington, D.C.

3. That portion of the EITC that is paid to households without tax liability is technically treated in the budget as a direct expenditure. However, the EITC was passed as part of tax legislation, and the IRS administers it.

4. Note that I am not suggesting that this set of tendencies always *must* apply, simply that it does apply to modern tax policymaking.

5. New software, of course, has reduced the amount of increased cost. In fact, some change might not have been tolerated were it not for the new software.

6. See, for instance, Brownlee (2004), who also stresses that most major changes in the tax system have come in times of emergency. World War II stands out in this regard (see chapter 3). Joseph Thorndike (2004) suggests such changes “were orchestrated by political leaders wielding cogent arguments about social justice.”

CHAPTER 2

1. “It looks, in fact, very much as if both parties had in mind some kind of Law or Rule of *fair play*” C. S. Lewis (1943, 17) (cited in Steuerle 2002a).

2. The rest of the quote is “Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist” (Keynes 1936).

3. For a more elaborate treatment of two equity principles—horizontal and vertical equity—see Steuerle (2002a, 253–84). We have given little attention here to some of

the more complex issues, such as how one tries to measure who are equals and what compromises are required to deal with nonmarket transactions, such as the returns from equity ownership of one's home.

4. "Horizontal equity is the command that equals be treated equally" (Kaplow 1989, 139).

5. On the subject of vertical equity, economist Harley Lutz (1945, 70, 82) states, "There is no just or progressive tax rates scale. Every such scale is the product of guesswork and of political and fiscal expediency. And where expediency is the basis of policy, it is easy to lapse into injustice."

6. Steuerle (2003a) takes up the issue of integrating taxes and expenditures in determining overall progressivity.

7. See Cohen, Steuerle, and Carasso (2002) for a detailed analysis of just how progressive Social Security may be once it also accounts for such issues as differential mortality rates among groups of recipients. As it turns out, Social Security would redistribute little without disability insurance, as higher mortality rates among lower-income groups tend to offset a progressive schedule for paying benefits relative to lifetime taxes paid.

8. Altruism may be required if taxpayers incur net losses to themselves to support some broader gain to society, as when the defense expenses paid by one generation of taxpayers are valuable mainly to the next generation.

9. Note that the aggregate net income in society may be unchanged when one person loses a dollar and another gains a dollar in a tax/transfer scheme.

10. For a much broader discussion of the individual equity principle, see Steuerle (2002a). I find it useful to discuss individual equity separately from efficiency and the efficiency implications of benefit taxation because the equity argument lays underneath some of the rationale for "choice" programs, vouchers, and those aspects of social insurance programs that try to relate benefits to taxes.

11. This split can be traced back to Adam Smith, who argued that "individuals ought to contribute to the support of the government, as nearly as possible, according to their respective abilities [ability to pay taxation]; that is, in proportion to the revenue which they respectively enjoy under the protection of the state [benefit taxation]" (Smith 1904, 310, brackets mine).

12. Note that this issue, often called "adverse selection," comes up mainly in areas like health and primary and secondary education. For a further discussion of the many pluses and minuses of vouchers that provide choice, see Peterson et al. (2000).

13. See, for instance, Pechman (1971, chapter 3).

14. The CEA's role has waned with the increased number of economists in the departments of government and with the strengthening of the Economic Policy Council. While the Office of Tax Analysis has the greatest number of public finance economists assembled anywhere in the executive branch, the CEA still maintains a strong connection with academia, and its three advisers often come from there. The Congressional Budget Office, however, now has more public finance economists than any agency in the executive branch, which reflects the shifting of power between the two branches of government.

15. As noted, the Joint Committee on Taxation handles the revenue-estimating responsibility for changes in the law in Congress, while the Congressional Budget Office is in charge of estimating long-run receipts under current law.

16. Some of this book's reviewers have commented that the Ways and Means staff has become more partisan since the early 1980s.

17. As more preferences began to be granted to lower-income individuals, moreover, the political dynamic between liberals and conservatives began to change as well.

18. This condition is among those examined to determine if a switch to consumption tax enhances efficiency.

19. For example, if a person earning \$10 million and consuming \$1 million were to pay \$2 million in income tax (assuming much income escapes tax), the consumption tax rate would have to be 200 percent of the \$1 million of consumption to generate equal revenues. Again, if government lives with promises of future revenues when the taxpayer or her heirs finally consume the income, then it forgoes the initial collection, assesses a much lower rate, and counts on getting its money down the road.

20. If the saver saves because her discount rate is less than the rate of return on the investment, then she also has access to some additional "income" even on a present-value basis.

21. When an estate tax is attached to a tax on earnings, it is equivalent to a tax on lifetime income. In a sense, it is an income tax with an accounting period of a lifetime rather than a year. See Steuerle (1980).

22. Much of their income may already avoid income taxation if it comes in the form of unrealized capital gains on their assets.

23. Alternatively, they would require that if saving were to be deducted from the tax base, then borrowing would be added to it.

24. As Herb Stein (1988, 135–36) explains, President Nixon was not advocating an activist policy but simply that it would be folly to raise taxes in a recession.

25. Elliot Brownlee suggests in a note to me that arguably some progressives (e.g. Roosevelt, Brandeis, and Morgenthau) were also supply-siders (see also Brownlee 2004). They believed that progressive redistribution would stimulate competition, economic growth, and tax revenues.

26. I suppose I take the scoring issue more personally. In January 2003, while a candidate for the position of director of the Congressional Budget Office, a lead *Wall Street Journal* editorial attacked me as "not an agent for change" on the grounds that I would not adequately "score" feedback effects that made tax cuts less expensive than their initial costs. To be fair, it is the tendency of some extreme supply-siders to engage in personal attacks, as well as argue that tax cuts wouldn't cost anything, that gives the theory its bad reputation.

27. A sanguine but well-articulated view of the supply-side revolution and its various historical claims can be found in Bartlett (2003).

28. A very good summary of different approaches to consumption taxation, as well as some of the pluses and minuses, can be found in Rosen (1999, chapter 20).

29. Two taxes are not necessarily more distorting than one. The resolution depends upon both the combined tax rate achieved and how the two tax bases are related. For instance, the existing corporate income tax creates a bias in favor of debt, an issue separate from whether it leads to a higher rate on corporate capital.

30. The basis value of the underlying assets are "stepped up" to market value at death, so that an heir immediately selling an inherited \$100 asset that originally cost \$10 would calculate gains as \$100 minus \$100 of "stepped up" basis, or \$0.

31. The law attempts to limit this game-playing to prevent net negative declarations of income, but there are ways around these limitations. For instance, one can borrow against one's house and take mortgage interest deductions while never recognizing any investment income, or one can use negative investment income from one set of transactions to offset positive income from others.

32. The estate tax is more progressive in taxing top wealth holders, but it collects only a small fraction of what the income tax raises.

33. Early supporters of the income tax argued that their tax would "not touch the wages and salaries of ordinary people, but would instead attack the unearned profits and rents of monopolists. Thus they firmly believed that the income tax could itself contribute to an assault on monopoly power. . . . Democratic party leaders such as [William Jennings] Bryan . . . added income taxation to tariff reform as a central party cause" (Brownlee 1989, 1616).

34. Sales taxes do attempt to restore some progressivity by exempting food or other items, but the method is crude and still taxes the poor on other items of consumption. Exemptions may be easier to administer with income taxes.

35. As we will see, advocates of a pure flat tax generally want to displace the progressive income tax with a flat tax that raises no more revenue. But whether they could hold the line causes even some conservatives pause when considering whether to join the flat rate parade. For instance, a progressive tax with rates up to 35 or 40 percent may be harder to increase than an equal-revenue flat rate tax with a rate of 20 percent.

36. IRS regulations or rules, rather than the code itself, sometimes provided the effective exclusions from tax.

37. Of course, the net impact on progressivity of any expenditure provision cannot be examined in isolation. The higher rates necessary to support the exclusion may still leave the overall system progressive.

38. Cordes (2002) makes the case for "corrective taxes" as an instrument of social policy. On a different tack, Cavanaugh (2003) goes so far as to argue that "political equality" requires shifting the tax burden onto the wealthy.

CHAPTER 3

1. Total tax collections at both federal and state and local levels, however, were moving up by 2007, indicating that they again may soon approach their previous peak as a percentage of GDP.

2. Note that state and local taxes had reached slightly higher levels during 1932 and 1933. They were then eclipsed by federal tax increases, especially during World War II and its immediate aftermath.

3. Most economists consider taxes on inputs to other businesses (turnover taxes) to be inefficient since, among other problems, they penalize firms that are not vertically integrated enough to handle various stages of a production process (and, hence, must buy inputs from outside the firm, thus generating an additional tax).

4. The Excise Tax Reduction Act of 1965, Public Law 89-44.

5. With retirement plans, the exclusion from current income operates as a deferral of both the wage income put aside and the earnings on the retirement plan deposits.

Employer contributions and most employee contributions and the earnings on those deposits are taxed only when finally withdrawn. The value of exclusion is equivalent to the nontaxation of the normal return to the plan assets if the taxpayer is in the same tax bracket at the time of withdrawal as at the time of deposit. Newer Roth individual retirement accounts and 401(k) plans, still relatively small in size, operate differently: they do not allow the investor an up-front deduction or exclusion, but, in return, the earnings on these plans are not taxed.

6. The growing taxation of some Social Security benefits has recently slowed, even reversed, the negative effect of Social Security on the income tax base.

7. The value of home-ownership is enhanced because the homeowner effectively gets nontaxable income by owning rather than renting. Consider the tax that is saved by owning rather than investing that equity in the bank, paying tax on the interest, and then renting a similar home. Thus, compare a taxpayer who owns a house worth \$100,000 and one who rents and keeps \$100,000 in a bank earning interest. The latter has higher taxable income because of the taxable interest payments on the bank deposits.

8. For taxable returns, the credit-equivalent amount rose. For all returns, credits rose from \$7.2 billion in 1975 to \$50.6 billion in 2006.

9. In figure 3.1, the income of nontaxable individuals cannot be separated from nonreported income and certain reconciliation items, including possible changes in compliance, and error terms. Hence, they are reported as one number.

10. In theory, one cannot add up tax expenditures exactly. Each is estimated as if all other tax provisions are unchanged. A simple example shows the type of problem that can arise with addition. If a taxpayer with \$10,000 in income has \$10,000 in deductible charitable contributions and \$10,000 in deductible mortgage payments, then each set of deductions alone might suffice to make her nontaxable. Each deduction estimated separately would have a positive value, but if one were stacked on top of the other, the second would entail no benefit at all to this taxpayer and no cost to the government.

11. As always, there are exceptions. General tax credits of a modest amount were available only briefly from 1975 through 1978. Also, as discussed, those who have additional sources of nontaxable income, such as Social Security, may exceed minimum tax-exempt levels of income.

12. These credits have both refundable and nonrefundable components. The refundable component is treated as a federal outlay because it goes to an eligible family in the form of a refund regardless of whether that family owes tax or not. The nonrefundable component is treated as a tax expenditure because it only gets counted against actual tax liability, if any. However, the net effect is very similar to a federal outlay and makes the credits comparable to other federal programs for lower-income families.

13. The crazy quilt pattern for the child credit in the chart reflects the temporary nature of some increases, as well as how these increases were reflected in withholding and other adjustments during each year.

14. This calculation takes into account the 2001 and 2003 tax cuts that increased the standard deduction for joint filers.

15. Technically, reductions in tax are counted in the budget as tax reductions, and only the amount of credit paid that does not offset taxes (the refundable portion) is counted as spending.

16. For a discussion of the many problems associated with adjusting poverty measures for inflation, see Ruggles (1990) and Burtless et al. (2000). Among the many issues are in-kind benefits and taxes that are not taken into account when measuring the number of those below the poverty line.

17. We will use the term to apply to both phenomena. There are some who believe that inflation should not be allowed to raise tax rates, since individuals' real circumstances have not changed, but that a tax system over time should impose ever-higher tax rates as people become richer in real terms. Applying the term "bracket creep" to average rates rising with average real income does not mean I am making a judgment as to whether tax rates should change in this manner. I am simply asserting as a factual matter that a population can "creep" up in "brackets" with real, as well as inflationary, growth in income.

18. See "Individual State Income Tax Rates, 2000–2006" at <http://taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=406>.

19. Of course, tax rates also affect behavior by changing the amount of after-tax income left to the taxpayer. A taxpayer, for instance, may work more to cover the shortfall. However, other "income" effects derive from what the government does with the money. For instance, it can make transfers to others by collecting the tax, and those who get the additional transfers may decide they can now consume what they want without working as hard.

20. Filers include some (but not all) nontaxable returns—for instance, those who file for refund of all withheld taxes. For more details on the distribution and progressivity of the tax burden, see chapter 2 in Slemrod (1994).

21. Fullerton and Rogers (1993) develop a very interesting analysis of the distribution of lifetime, rather than annual, taxes. They find that the distributional effects of taxes are likely to be muted over the long term. Unfortunately, there is no long-run data set on lifetime incomes and tax regimes with which to compare generations as fully as one might like.

22. Separate income and Social Security tax calculations can be found at <http://www.taxpolicycenter.org>.

23. In 1981, when inflation was still at a peak, the value of tax deductions for private interest paid was \$61 billion or 2 percent of GNP more than tax payments made on private interest received. Technically, interest paid equals interest received on a worldwide, not domestic, basis. See Steuerle (1985b, 52, 56) for details of this calculation.

24. See Jorgenson and Yun (2001) for a time series of effective tax rates on business assets from 1970 to 1996.

25. One explanation may be that labor bears some or much of the corporate tax burden—an issue we do not pursue further.

26. See Steuerle (1985b). A few paragraphs here obviously cannot substitute for what is conveyed in that book. Tax arbitrage was not the only problem created by inaccurate accounting for income in an inflationary era. As discussed in later chapters, I was privileged to serve as the economic coordinator of the tax reform project that led to the Tax Reform Act of 1986. That reform, along with monetary policy, was significantly responsible for moving investment to more productive assets and allowing for the two long growth intervals of the 1980s and 1990s. While stagflation is less of an issue in most developed nations at the time of this writing, the problem can arise again, and it still affects many middle-income nations.

27. Again, for a thorough review of tax arbitrage, theory and practice, see Steuerle (1985b).

28. The rate of payment on the short sale is essentially the increase in value of the asset that must be delivered down the road. The rate of return on the long purchase is simply the return on the owned asset.

29. Not all interest on borrowed assets is deductible. For instance, for years after 1986, Congress placed limits on borrowing to purchase consumer durables and on secondary mortgages in excess of \$100,000. A taxpayer can usually figure out a way, within limits, to borrow against the right type of asset to finance tax arbitrage activities.

30. For instance, under the LIFO (last-in, first-out) method of accounting, a firm is allowed to deduct first the cost of items purchased last. This provides a form of adjustment for inflation, but no inflation adjustment is made to reduce the amount of interest paid.

31. This was the case in the Enron collapse in 2001, though the tax enticement was not the only factor at play. See Gravelle (2003).

CHAPTER 4

1. Gradually, this rule would be eroded. First, from its inception, Medicare insurance was to be financed only partly through the Social Security tax; non-hospital payments would be met through general revenues. Later, Social Security benefits were made subject to income taxation, and the revenues from those additional taxes were transferred to both the Social Security and Medicare trust funds.

2. The economist E. Cary Brown was one who sounded this alarm.

3. In retrospect, the 1950s look to be a period of substantial overall growth, despite the recessions in July 1953 to May 1954 and August 1957 to April 1958. Recessionary periods are recorded by the National Bureau of Economic Research (2003).

4. Herbert Stein provides further explanation for the neglect of equity principles in the Kennedy tax cut: "The only possibility of holding the net tax cut to the neighborhood of \$3 billion was to accompany the rate reduction with major revenue-raising 'reforms' or 'loophole-closings.' Indeed, this was the Treasury's intention. But each of these reforms would be unpopular with someone. The loopholes were not in the tax law by accident; someone had wanted them there and the Congress agreed. Once the President had proposed and promised rate reduction, and described it as terribly important, where would be the compulsion on Congress to enact the reforms? It could only be in the sentiment for balancing the budget. But this sentiment was not strong enough for the task. Therefore, the administration, having opened the door, was led unavoidably to large net tax reduction" (Stein 1969, 411).

5. In many economic models, the new incentive would lower the price required for output, thus hitting old capital with a reduced valuation in the market.

6. One reason was that shorter-lived capital could receive multiple investment incentives over the period of time that longer-lived capital would receive only one investment credit.

7. Personal statement to author.

8. The measure of total domestic spending is total government outlays less spending on defense, international affairs, and interest on the debt.

CHAPTER 5

1. The mathematics of the proposal was that rates would be reduced each year to 90 percent of their previous level. Hence, taxes would be reduced to $0.9 \times 0.9 \times 0.9$, or 72.9 percent of their original level. The proposed reduction in taxes was actually 27.1 percent (100 percent minus 72.9 percent), not 30 percent.

2. A fascinating aspect of the California law is how it now discriminates against new homeowners, including migrants from other states. They are not protected against the tax increases, thus leading to different taxes on individuals who own similarly valued property in the same locality.

3. In comparing notes as to why they favored reform, Senator Bradley (D-NJ) stated, "Mr. President, you came to this [tax reform] because you were an actor who paid at the 90 percent rate; that's why you want a lower rate. . . ." (Birnbaum and Murray 1987, 26).

4. The exemption might move some taxpayers into lower brackets. In the example, a taxpayer with \$15,200 of income would move down to the 20 percent bracket if the exemption were raised from \$5,000 to \$5,300.

5. In the Treasury Department, the Office of Tax Analysis forms the economic arm of the Office of Tax Policy, which is in charge of the administration's tax policy efforts. The Office of Tax Analysis estimates the receipts of the U.S. government and the revenue costs of tax proposals, prepares tax studies for both Republican and Democratic administrations, and develops models and data files to examine the impact of tax changes. The OTA also performs economic analyses of proposals. Those who wanted it to show low costs for favored proposals often misunderstood the Office's insistence that the integrity of the cost estimation function be maintained.

6. Shelters would be encouraged further by the maintenance of higher tax rates, which increase the value of the deductions.

7. The net reduction in tax is actually about 23 percent rather than 25 percent. Taxpayers' liabilities were reduced, first to 95 percent of their original level, then to 90 percent of the new level, and then to 90 percent of the previous level. Thus, excluding other economic changes such as inflation, taxpayers' burdens ended up at 77 percent of their original level.

8. These calculations do not even include the additional \$10 billion in tax reduction that would have taken place with indexing for real growth over and above inflation.

9. Inflation can raise the average tax rate by pushing a larger share of income into the higher marginal tax rate brackets.

10. Tax preferences may lead to no higher return for individuals buying the preferred assets, as before-tax rates of return fall for the preferred assets or rise for the nonpreferred ones. Steuerle (1985b) deals with the unlikelihood that such a full equilibrium can be attained, largely because many capital income taxes are based upon discretionary realizations.

11. See table 7.1 under the column, "old law."

12. The calculation assumes that tax preferences (credits and accelerated depreciation) are designed to provide a tax break that is available regardless of actual inflation, interest rates, and return from the asset. Tax preferences here are assumed to offset a tax rate of 46 percent (the corporate rate in 1981) times a 6 percent real rate of return, or 2.8 percent. Then the taxpayer can make a net profit if the real rate of return from

the asset (in the example, a negative 9 percent) and the after-tax interest payments ($14 \text{ percent} \times [1 - 0.46]$) are offset by the tax preferences, plus the additional tax write-off on the real losses (0.46 times the negative 9 percent), plus the inflationary increase in the value of the asset.

13. If the government wants to provide incentives for certain equipment purchases, a strong economic argument can be made to apply that incentive equally to corporations with and without tax liability. Nonetheless, the appearance of corporations buying and selling tax liabilities called into question the fairness of the underlying tax structure.

14. It is not clear how much importance Stockman attached to the point at the time. His recollections can be found in Feldstein (1994, 226), Feldstein's recollections in Feldstein (1994, 48–49), while Anderson's were from personal conversations with the author. Note also that the lower rates of inflation were one consequence of the recession that also lowered expected revenues through lower real economic growth; so some blamed the recession in general for the deficits.

15. Technical review will always be performed, but it almost never results in change of any significance. Indeed, the change is as likely to go in one direction as the other.

16. A secondary debate was whether the Treasury's Office of Tax Analysis adequately took into account so-called "feedback" effects from growth in the economy that derived from tax reductions. As it turns out, OTA did nothing more than prevent double counting and force the presentation of consistent numbers. The "Troika" had to make projections of substantial economic growth under the president's plan in order to show small deficits in future budgets. The feedback effect, therefore, was already in the numbers by being built into the economic assumptions. By assuming that growth would be 4 percent per year with enactment of the president's program, rather than, say, 3 percent, additional receipts of tens of billions of dollars for the government were projected.

Misleading attacks on OTA were to last throughout the 1980s and were printed repeatedly in such places as the editorial pages of *The Wall Street Journal*. One attack associated OTA and CBO with the Kremlin.

The strange irony was that OTA never had control of measuring these "feedback" effects, whereby lower taxes led to economic growth that, in turn, led to higher tax collections. It merely had control of the machinery to make revenue estimates consistent with assumptions on the state of the economy. Supply-siders and others who wanted to show feedback effects simply needed to present to the public two sets of economic assumptions—one with the policy they favored and one without. Revenue, as well as expenditure effects, would have followed.

17. Social Security presents a classic example. The benefits paid to each generation of workers were purposely designed to increase over time by a formula that adjusted payments to growth in wages. Barring the complications of demographic cycles and changes in rates of inflation, wages usually grow as fast as the economy—thus, so do benefits. Added to this wage adjustment was usually a constant retirement age that meant that larger and larger shares of one's life would be spent in retirement. Through such devices, Social Security's level of existing benefits relative to the economy would grow in absence of legislation. New legislation could increase benefits further as a share of national income, but decreasing those benefits was argued to go against a social contract by "cutting" (growing) benefits.

18. The fault lay not just with the politicians. Many academic researchers fail to get involved in detailed structural issues, partly because they are ignorant of the many details

of tax and expenditure law and often cannot incorporate such details into their simple models of the economy. In a deceptive way, issues become defined as unimportant because they are absent from researchers' economic models.

CHAPTER 6

1. In 1985, John Witte noted that until the early 1980s, "The only legislated peacetime tax increases in U.S. history have been the Revenue Act of 1932, a slight one-year increase later in the 1930s, and a relatively modest and mostly administrative increase in 1982" (Witte 1985, 249).

2. Senator Dole was chairman of the Senate Finance Committee from 1981 to 1985, Senate majority leader from 1985 to 1987 and 1995 to 1996, and Senate minority leader from 1987 to 1995.

3. Perhaps an even earlier catalyst for action was the public "discovery" of new deficits after the CBO released its summer update of the Economic and Budget Outlook in 1981. That document was issued just before the Reagan tax cuts were enacted.

4. The amount of expenditure to be depreciated was adjusted partially for the size of the investment credit. If a taxpayer spent \$100 on an asset and received a \$10 credit, a new basis adjustment only allowed depreciation on \$95 of the asset's value.

5. For discussion of change in the ACRS system of depreciation, see Joint Committee on Taxation (1982, 39–40).

6. I represented the Treasury Department at some of these meetings.

7. For instance, the Commission compromise called for taxing benefits above a certain income level but did not come to terms with the need to phase in that requirement so that earning one additional dollar did not suddenly cause tax liability to rise by hundreds or even thousands of dollars.

8. Expenditure reductions, in fact, were confined almost entirely to a six-month delay in benefit increases and to the gradual phase in, between 2000 and 2022, of a higher normal-retirement age (67). This last adjustment had been long expected, but was still far less than adequate to compensate for cost burdens of greater human longevity. From 1983 to 1989, tax increases provided almost three-fourths, or \$110.5 billion, of the \$148.5 billion of changes in Social Security receipts and payments (see table 6.1). Over the long term, the tax increases covered almost 62 percent of the total reduction in the Social Security deficit. However, the taxation of benefits, as noted, could be said to lower net benefits.

9. Of course, the future move toward balance within the budget window may be temporary. For instance, a deficit may be seen to fall as a percentage of GDP after 5 or 10 years but rise again once the retirement of baby boomers raises spending for elderly programs.

10. See Steuerle (1996) and Carasso and Steuerle (2002), where this surtax is discussed in more depth.

11. Stuart Spencer, a California political consultant, met with key political strategists to map Ronald Reagan's second campaign. As he would later say, "The problem is we've been talking to everybody at the White House over the past few days and the Reagan administration fired all its bullets very early and very successfully in the first two years. . . . The most striking thing I discovered is that they don't have a goddamn thing in the pipeline. They don't have an idea" (Mayer and McManus 1988).

12. To see how far these shelters extended by the mid-1980s, Susan Nelson of the Treasury Department and I initiated some studies with the IRS to see who was investing in these tax shelters.

13. For a discussion of some of the most egregious examples of corporate tax sheltering and how they were publicized, see Birnbaum and Murray (1987, 9–11).

14. For a detailed discussion of the historical development of the American income tax and the role of equity principles, see Witte (1985).

15. Birnbaum and Murray (1987, 186) discuss the formation of this coalition in a related way: "Reform was also achieved because it combined goals that were important to both political parties. Ending loopholes for the privileged had long been the desire of some Democrats. But the 1980s also saw the emergence of a new wing of the Republican party that was crucial to tax reform's success—the supply-siders, whose influence grew dramatically after President Reagan's election and who were passionately committed to lowering tax rates. These activist-conservatives had no deep interest in closing loopholes, but if that was the only way to pay for lower rates, they were willing to go along. By combining with the older Democratic reformers, they created an impressive bipartisan coalition."

16. By happenstance, my research was the original source of this movement. Rudolph Penner (later director of the Congressional Budget Office, but then at the American Enterprise Institute) asked me to write an article on the taxation of households of different sizes, long a neglected topic, as part of a book on taxation of the family. My earlier work on changes in the tax base led to this work on the decline in the value of the personal exemption and the resulting conclusion that worst hit were households with children.

17. It is also likely that my research on taxation of the family was accepted because it was published under the auspices of the American Enterprise Institute, where Rudolph Penner, the editor, then resided. Earlier research on the taxation of the poor had not received a similar reception. One of the more unfortunate aspects of policy-related research is that it tends to get labeled as acceptable to conservatives or liberals depending upon which research institute publishes it.

18. As a technical matter, a flat income tax involves a few major shifts from a flat consumption tax; in particular, investment in depreciable capital would be written off over time rather than expensed or written off immediately.

19. For a more elaborate treatment of these issues, see Steuerle (1985b), Boskin (1996), Aaron and Gale (1996), and Zodrow and Mieszkowski (2002).

20. Credit here goes mainly to Joseph Minarik, then at the Urban Institute, and Randall Weiss and James Wetzler, then at the Joint Committee on Taxation, with Gina Depres leading the Senator's own staff efforts.

21. See, for instance, former Secretary of the Treasury Donald Regan's comments in Regan (1988, 202–3) and further discussion in Brownlee and Steuerle (2003, 166–67).

22. One dilemma for those favoring investment incentives was where to stop. For instance, should effective tax rates be allowed to be negative? A consumption tax would maintain tax rates at zero. Because of tax arbitrage, an investment credit system might maintain a positive tax rate for equity investments and a negative tax rate for investments purchased with borrowed dollars.

23. Former Treasury Secretary Donald Regan once commented that President Reagan never really advised him on how to spend his tenure as secretary. "To this day, I have never had so much as one minute alone with Ronald Reagan! Never has he, or

anyone else, sat down to explain to me what is expected of me, what goals he would like to see me accomplish, what results he wants" (Regan 1988, 38–40).

24. The Treasury Department group involved in discussing these modules with the secretary included the assistant secretary for tax policy, John E. (Buck) Chapoton and, later, Ronald Pearlman; the deputy assistant secretary for tax analysis, Charles McLure; the assistant secretary for economic policy, Manuel Johnson; the undersecretary of the Treasury, Beryl Sprinkel; commissioner of the internal revenue, Roscoe Egger; deputy secretary, Tim McNamar; assistant secretary for legislative affairs, Bruce Thompson; assistant secretary for public affairs and public liaison, Alfred Kingon; and Thomas Dawson and Chris Hicks, who worked as close aides to the executive secretary (Birnbaum and Murray 1987).

25. In many ways, this approach was parallel to academic research, which stressed that different types of tax systems should be compared on a revenue- and sometimes distributionally neutral basis.

26. The success of this effort was due in large part to the efforts of Susan Nelson of the Office of Tax Analysis, who initiated an effort to insure that the data sets being developed could properly account for many of the changes being proposed.

27. See Gordon and Slemrod (1987) and the update, Gordon, Kalambokidis, and Slemrod (2002).

CHAPTER 7

1. Each indexing of various items has a different complexity associated with it. See Halperin and Steuerle (1988).

2. This debate, too, carried forward to later years. Amendments were made in 1990 in the structure of the top rate, but once again, Congress attempted to impose those rate increases through the back door.

3. The means by which the Joint Committee performed distributional analysis also supported the political tendency to deal with some issues through the back door—through increases in minimum taxes and limitations on write-offs of "passive" losses and interest payments. When limits were imposed on the extent to which business losses could be taken or when minimum taxes were imposed, the Joint Committee imputed these increases in taxes almost entirely to high-income individuals. While this imputation method mainly attacked shelters, it also drew under its wings a number of business owners who were not high income and had legitimate losses.

4. Technically, the AMT equaled the difference between the AMT calculation and the regular tax when the former was higher, and zero when the former was lower.

5. Citizens for Tax Justice, a labor-backed, Washington-based organization, had significant influence here through the publication of tables relating tax liability to financial income. Tax Analysts, a nonprofit publisher, had performed similar calculations over the years.

6. Birnbaum and Murray (1987) and Conlan et al. (1990) chronicle the eventual support and sometimes conversion to reform and base-broadening of each person in charge at each stage.

7. When fully phased in, the expansion and the indexing together raised the maximum credit (from \$550 in 1986 to \$874 in 1988), while the credit did not phase out completely until income exceeded \$18,576 (IRS 1988, 145).

8. For further discussion of issues surrounding the EITC, see Steuerle and Wilson 1987; Steuerle 1990c; Hoffman and Seidman 1990; Dickert, Houser, and Scholz 1995; and *National Tax Journal Special Issue: The Earned Income Tax Credit* 2000. The EITC also has income effects: increases in income that could lead to decreases in labor supply for those receiving the credit. In any comprehensive bill, one also needs to examine the income (and substitution) effects throughout the income distribution. Thus, increases in income for EITC recipients are paid for by decreases in income and higher tax rates for other taxpayers in a revenue-neutral bill.

9. Many unemployed are married to employed workers, and most are not unemployed for the entire calendar year. Hence, the drop in earnings due to temporary unemployment may increase the probability of receiving an EITC for part-year work or work by a spouse.

10. Increases in the standard deduction offset only a part of the decline in the personal (taxpayer and dependent) exemption, mainly for smaller households that did not make much use of the dependent exemption.

11. The marginal rates used are effectively averaged across individuals by weighting each taxpayer relative to the amount of interest, dividends, or capital gains received. Different marginal rates are used for capital gains, interest, dividends, and so forth. A constant debt/equity ratio for corporate investments is also assumed. For further details, see Gravelle (1984, 1986).

12. Charles R. Hulten and James W. Robertson (1984) found that high-technology industries within manufacturing experienced higher average effective tax rates during the 1970s than other manufacturing industries. Note that limits on loss write-offs arise in part because the tax system is based on realizations, so that losses can be realized even while gains are deferred. For further discussion, see Auerbach (1988) and Kaplow (1994). Hulten and Robertson also treat the case where there would be no limit on use of incentives, even by firms owing no tax.

13. In some cases, this limitation could be offset through carry-back of current-year tax losses and credits to offset income and taxes in previous years.

14. Here is an example of how discrimination among assets worked under the old law. At a zero inflation rate, an asset generates output valued at about 31 percent of the initial price of the asset over two and a half years if it depreciates at 10 percent per year and yields about a 4 percent real return over and above depreciation. Yet under old law, tax deductions and credits could offset income equal to 80 percent of purchase price over the same period. Since the income from the asset is less than half of the allowed offsets, only the established firm with existing flows of taxable income could make immediate full use of the deductions and credits. The new law reduced some of the disparities between new and established firms. After passage, deductions in the first two and a half years only offset income up to 56 percent of the purchase price. Thus, while discrimination against new business was not eliminated, it was lessened considerably.

15. It is apparent that negative after-tax interest rates can induce investment in unproductive capital. When borrowing takes place, the investor must receive a return from the investment that is greater than or equal to the after-tax interest rate. If the after-tax real interest rate is positive and real, then the after-tax return from the investment (calculated without regard to the borrowing) must be higher than the effective interest rate, hence also positive in real terms. Otherwise, the borrower-investor will not earn enough to pay the after-tax interest rate. However, when the after-tax interest rate is negative in

real terms, the investor may profit personally from investment in an unproductive asset, that is, one with a negative real rate of return. While investors would still tend to invest in assets with higher rates of return, different assets have different amounts of risk. With a negative after-tax interest rate, investment in assets with little perceived or actual risk may become competitive on a risk-adjusted basis. For instance, if commodities are expected without much risk to increase in price with inflation, some saving may be diverted to the wasteful storage of commodities. The corporate manager may also be induced to invest in fairly riskless assets that almost surely would not have been purchased if the after-tax interest rate were positive.

16. An investment is "passive" if the taxpayer does not materially participate in the conduct of the activity. Limited partnerships are presumed to be passive, as are most rental activities. Most activities in which the taxpayer provides substantial services are not defined as passive.

17. Of course, if the paring of tax expenditures was counted as a reduction in expenditures, then, in a sense, average tax rates did fall and were paid for by the reduction in the expenditures.

18. This approval was based partly on my earlier research showing how different family groups had been affected over time.

19. "Changes in the 1980s, and especially in the Tax Reform Act of 1986, have reduced the size of the federal subsidy to state and local borrowing, but improved the relative allocation of benefits to those governments rather than to high-income investors" (Break 1991, 527).

20. Also, according to Witte (1989, 11), "Treasury I called for the outright elimination of 38 of the approximately 105 tax expenditures on which we have long-term data. To put this in context, in the prior history of the income tax, we had only eliminated 13 tax expenditures, once permanently enacted."

21. The debate on the relationship between tax rates and capital gains realizations has not been settled. See Auten and Clotfelter 1982; Feldstein, Slemrod, and Yitzhaki 1980; Lindsey 1988; Minarik 1984; and Office of Tax Analysis 1985. The debate is explained well and in an unbiased fashion in Auten and Cordes 1991.

22. Their estimates actually compare the new tax law with the original Treasury Department proposal, but relate much of the gain in welfare—an economist's way of measuring inefficiency—to the indexing provisions of the former proposal. At 4 percent inflation, the present value of welfare gains in 1973 dollars would have been \$131 billion for the new tax law and \$393 billion for the Treasury proposal. At 7 percent inflation, the corresponding numbers are \$63 billion and \$505 billion. As inflation increases from 4 to 7 percent, most of the relative gains are due to inflation indexing under the Treasury proposal.

23. A corporate deduction, rising eventually to 50 percent of dividends paid out of previously taxed earnings, was proposed in Treasury I. Treasury II (the president's proposal) lowered the proposed deduction to 10 percent. The Ways and Means Committee phased in this lower 10 percent deduction over 10 years, and the Senate Finance Committee abandoned integration completely. The Treasury would put forward another study of integration in 1992, and yet another version would pass in 2003 after being amended from a proposal by President George W. Bush.

24. Another table, reflecting the view that a lower tax rate on dividends has no effect on total tax rates on capital income, was calculated by Yolanda Kodrzycki and can

be found in Steuerle (1990, 151). The “new” view that dividends do not matter is that once income has already been taxed in the firm, paying the tax on dividends is a toll charge that ultimately must be paid. However, this table shows essentially the same change in effective tax rates by the time that tax reform was over.

25. The calculations are also sensitive to the way that one assumes that investors project future inflation rates. Table 7.1 was produced mainly to show differentials among bills and types of assets at that point in time; for that purpose, differences across time were less important. Figure 3.12 focuses more on differences across time and uses slightly different assumptions about expected inflation, derived more from a consistent survey than from a weighted average of past inflation rates.

26. Even the much simpler alternative minimum tax in prior law was prone to much error and resulted in understatement of tax on at least 32.6 percent of returns (IRS 1985, table 10).

27. Mortgage interest on these homes, however, is not deductible on mortgage debt amounts above the original purchase price of the residences plus the cost of major improvements. A proposed but later defeated exception was to allow the excess mortgage if debt was incurred for educational or medical purposes. Technically, secondary mortgage interest is not deductible at all against the alternative minimum tax unless the money is used to make capital improvements.

28. The common practice—where corporate income was taxed on the basis of the source while interest, dividends, and other payments were taxed on the basis of residence of the recipient—has a long history that is embodied in both law and tax treaties, although it results in inconsistent treatment of income from equity versus income from debt.

29. Here I was fortunate to be able to work with Victor Thuronyi, one of the most important contributors to the early tax reform work of the Treasury and the person who led much of the effort to reform the taxation of minors. We had concluded that this was the best way to reduce wasteful tax planning through trusts.

30. Subchapter “C” corporations pay corporate tax; those organized as subchapter “S” corporations are treated more like partnerships.

31. These included estate tax deductions for sales of employer stock to an employee stock ownership plan (ESOP), a requirement that certain publicly traded partnerships be treated like corporations, and limitations on the use of net operating loss carry-forwards (NOLs) following ownership change of a loss corporation.

32. Background information on the hearings on this subject can be found at Joint Committee on Taxation (1988).

33. Required reporting of taxpayer identification numbers for dependents age 5 and over was first required in the Tax Reform Act of 1986 (Public Law 99-514, Title XV, subtitle C, section 1524).

34. According to some participants, the proposed expansion was partly a response to “Iran-gate.” The administration was seeking a proposal to move attention away from selling arms to Iran and the misallocation of those funds to the Nicaraguan rebels. An expansion of benefits, proposed by then-Secretary of Health and Human Services Otis Bowen, was suddenly chosen to provide the necessary vehicle. Whether true or not, the proposal filled a vacuum in domestic policy and proposals coming out of the White House.

CHAPTER 8

1. There was also an extension of what has been labeled "completed contract" reform, which largely related to the time period in which payments made under contracts would be made taxable.

2. Assuming compliance with the discretionary spending caps in the 1990 Budget Enforcement Act, federal debt as a percentage of GDP was projected at the time to rise from 44.6 percent of GDP in 1990 to 49.7 percent by fiscal year 1993, then fall to 45 percent by fiscal year 1996 (Congressional Budget Office 1991, 98). Getting the budget under control still had a way to go.

3. The conferees had available information showing that under typical assumptions, the Old Age and Survivors and Disability Insurance (OASDI) program in Social Security was expected to continue accumulation in the Trust Fund until peaking in 2014. After that, it would draw down a large accumulated trust fund, which at the time was projected to last until 2043. After 2043, OASDI would have to increase payroll taxes, cut benefits, or be subsidized by general revenues to avoid bankruptcy. Medicare Hospital Insurance (Part A) was expected to exhaust its trust fund as soon as 2003. See the 1990 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds and the 1990 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund. There were modest changes in Social Security taxes in 1990—mainly in the tax base for Hospital Insurance—but these affected the calculations only slightly, with bankruptcy for Hospital Insurance to come later in the same decade. Later reports altered the projected dates of exhaustion. See the annual reports from various years for more information.

4. Closely related to the movement toward pay-as-you-go programs was the reform of governmental credit systems. In many cases, the reform charged the private sector for the value of the government insurance provided. In addition, budget accounting rules required greater up-front recognition of the real cost of these guarantees down the road. Charging taxpayers directly for services and for the value of government guarantees had already achieved some momentum in the 1980s, but this was the first budget bill to give these efforts such prominence relative to changes in the income tax. Again, those who like benefit taxation favored this type of action.

5. The campaign promise was partly an attempt to offer an alternative to Democratic Candidate Michael Dukakis's support of bills to provide monies directly to states to establish day care programs for young children.

6. The credit was to be made available only to workers, but "worker" was not defined in the campaign. Still at the Treasury Department in early 1989, I deliberately interpreted the "work" requirement to imply a phase-in schedule identical to the one in the earned income tax credit, in the hope that for administrative simplicity the two might be combined. As the process evolved, that is exactly what happened.

7. The suspect 33 percent bubble between the two 28 percent brackets grew out of an attempt to proclaim a top marginal rate of 28 percent while actually imposing a higher rate by phasing out the personal exemption and the "benefits" higher-income taxpayers received for being in a 15 percent bracket for some income rather than a 28 percent bracket for all income. At one point, the conferees for the 1990 budget agreement agreed to get rid of the bubble. Speaker Dick Gephardt angled for a deal of a top rate of 33 percent and a reduction of the capital gains tax rate to 20 percent, but the Senate Majority Leader Mitchell would not agree. In the end, rather than raise the top rate to 33 percent, they

combined the 33 percent rate and the 28 percent rates into a single top rate of 31 percent. Because of the amount of income in the 28 percent bracket, the change actually raised revenues.

8. The calculation is as follows: an additional dollar of income reduces itemized deductions by 3 cents. At a tax rate of 31 percent, this provision increases taxes by 0.93 cents for each additional dollar of income. The tax rate, however, applies to adjusted gross income rather than taxable income—that is, income after deductions.

9. For a joint return with income between \$150,000 and \$272,500, personal exemptions were phased out at a rate of 2 percent for each \$2,500 by which the taxpayers' income exceeded the threshold amount. In effect, assuming a personal exemption of \$2,150 and a base level of income of \$132,150 in 1991, additional income produces an increase in taxable income of $(0.02 \times \$132,150) / \$2,500$ for each exemption. For four exemptions and a taxpayer in the 31 percent tax bracket, the net tax burden increases by $4 \times [(0.02 \times \$2,150) / \$2,500] \times 0.31$, or 0.0213 percent.

10. Economists from the "public choice" school would almost certainly find themselves in that camp. Some in this school believe that government employees and elected officials have an incentive to always expand government and that, to control this leviathan, rules and often constitutional limitations must be put in place. However, one does not have to belong to that school to favor a balanced approach to expenditure and tax legislation that forces taxpayers to recognize that they must pay for government actions one way or the other.

CHAPTER 9

1. The DLC asserts, "Starting with Bill Clinton's presidential campaign in 1992, Third Way thinking is shaping progressive politics throughout the world. Inspired by the example of Clinton and the new Democrats, Tony Blair in Britain led a revitalized New Labour party back to power in 1997. The victory of Gerhard Schröder and the Social Democrats in Germany the next year confirmed the revival of center left parties . . ." See "About the Third Way" (June 1, 1998) at http://www.ndol.org/ndol_ci.cfm?kaid=128&subid=187&contentid=895. The term, in fact, has a much longer history and often referred to various middle-way approaches, such as between laissez-faire capitalism and socialism.

2. Personal comments to the author from Leonard Burman and Eric Toder.

3. Among the many issues involved are the reactions of monetary policy and the extent to which short-term deficit reduction is necessary to convince financial markets of the seriousness of the effort. Finally, if a budget is to be balanced over a long cycle, then deficit reduction is often best achieved as an economic expansion makes headway. See, for instance, Blanchard (1985) on deficits and time horizons.

4. Alan Cohen, then at the Treasury Department, is credited with suggesting this allocation as a means of staying within the budget rules.

5. Note to author from Eric Toder, deputy assistant secretary of the Treasury for tax analysis under President Clinton.

6. I personally would go to conferences where increases in EITC benefits post-1992 would all be credited to Clinton with nary a mention of the Bush increases.

7. Health reform also showed the growing power of interests to influence public perception. Commercials showing "Harry and Louise" having to give up health insurance

they liked, as well as diagrams showing an extraordinary labyrinth of new proposed health bureaucracy, were highly effective in turning the public against the plan.

8. In recent history, no complex systematic reform has ever been designed in the White House, mainly because it seldom has the knowledge and capability to deal with all the policy and administrative issues involved. The emphasis on personal loyalty, moreover, often keeps crucial information off the table. Meanwhile, plan designers become wedded to their own logic, so that when the White House takes on the role of initial designer, it cannot objectively critique its own design. That was especially true for the Clinton proposal, since the First Lady was supposedly in charge.

Meanwhile, in Congress, the organizational problem is as bad, if not worse. If the debate is over the size of a single parameter, such as a tax rate, members might not reach the most efficient or equitable solution, but they can find one that is workable and manageable mainly because they usually take a given structure and tweak it here and there. However, if too many committees and individual power brokers try to redesign a basic structure with many interlocking parts, they often make contradictory and unsustainable decisions. Given a strong proposal—that is, a workable base from which to build—the congressional staff can be put to better use in modifying, not merely taking apart, a reform effort.

9. Author's estimates for Social Security and state and local income tax expenditures. The official tax expenditure budget only counts the loss of federal income tax due to the tax subsidy (see OMB 2007, 289). This estimate shows that income tax expenditures on the exclusion of employer contributions for medical insurance premiums and medical care will grow \$240 billion by 2012. Again, however, there is also substantial loss to Social Security tax collections and to state income tax collections.

10. Whether revenues should be counted as taxes is another matter. Robert Reischauer, head of CBO at the time, claimed, "the 'T' word has not crossed my lips" (Tax Analysts' Calendar 1997).

11. At minimum wage levels, of course, the employee could not bear the cost in the form of lower wages. This may also have contributed to employer opposition. Here the effect can be considered similar to a minimum wage increase (see Holahan et al. 1994).

12. See also Pollack (1996, chapter 5), for more detail on the Republican proposals as laid out under the "Contract with America."

13. After an initial increase in the IRS workforce between 1982 and 1993, there was a significant decline in IRS personnel. Particularly between 1996 and 2000, enforcement and processing personnel were reduced by about a third while taxpayer service personnel more than doubled during that time. By almost every measure (both inputs and outputs), IRS enforcement of the tax laws outside of computer-generated document-matching programs declined for many years, but particularly starting about the mid-1990s to the beginning of the new century (see Plumley and Steuerle 2002).

14. If a household's AGI was \$20,000 without the losses, but \$10,000 once losses were counted, the taxpayer would essentially lose eligibility for the EITC because the \$20,000 income level was too high to be eligible for any credit (though the \$10,000 level was not).

15. Peter Edelman, Wendell Primus, and Mary Jo Bane were assistant or deputy assistant secretaries of the Department of Health and Human Services.

CHAPTER 10

1. One must be careful to distinguish the political from the economic argument. Ignoring differences in family size, it is possible to design a credit with a rate schedule that would exactly match an exemption with another rate schedule. An equal-cost credit is only more progressive than an exemption if the rate schedule is assumed to be fixed.

2. For more on the reemergence of tax expenditures as a tool of social policy, see Howard (2002).

3. For families with three or more children, the act allowed the credit to offset not just income tax, but the employee share of FICA or Social Security and Medicare payroll taxes minus earned income tax credit. In a sense, then, for some taxpayers, the credit was refundable up to the amount of Social Security tax paid. Interpreted differently, one might argue that the credit was nonrefundable if the income and Social Security tax were considered together. The provision required many calculations, however, to get a small amount of money to a few people.

4. We had proposed this credit to the Commission partly as a way of reducing taxes for lower-income workers and partly as relief from the types of work and marriage disincentives in welfare.

5. For details on many other issues surrounding capital gains, see Burman (1999).

6. Limits on the amount deductible were phased in between \$52,000 and \$62,000 for the traditional IRA and between \$150,000 and \$160,000 for the Roth IRA.

7. Technically, the additional tax paid up front could represent additional saving since the after-tax value of the account was enhanced down the road.

8. During parts of 2002 and 2003, Michael Boskin, former chair of the Council of Economic Advisors under President George H. W. Bush emphasized that there was a large stock of taxes due the government under the traditional IRAs and pension plans (Boskin 2003). He stressed that this might help pay for the deficit. Later critiques (see, for instance, Auerbach et al. 2003) noted among other things that much of this revenue was already accounted for in estimates of deficit, and that there were no surprises. Then Boskin admitted an error in his calculations that treated inconsistently money coming into and going out of pension plans.

9. The proposal followed upon research by Leonard Burman, Sally Wallace, and David Weiner (see Burman et al. 1997).

10. The IRS for years was unable even to hire computer science majors because its pay was so low and its systems so antiquated that working there became a dead-end career move for the highly talented (see Steuerle 1986c).

11. The emphasis on the "10 Deadly Sins" in the IRS Restructuring and Reform Act of 1998 also led to further consequences, such as low output and collection rates.

12. At the time of the Senate Finance Hearings, IRS levies were at 14 per million of population, seizures at close to four per million, and liens at about two per million. Just two years later, these numbers dropped to about two levies and one lien per million and practically no seizures (see Plumley and Steuerle 2003).

13. For example, 1099 forms are used for such items as interest, dividends, or payments from pension plans.

14. The Medicare surplus is of much shorter duration than the Social Security surplus. Expenditures in Part A of Medicare (Hospital Insurance) are scheduled to exceed taxes much sooner than in Social Security. Of course, a large share of Medicare's Part B (Supplemental Medical Insurance) is mainly financed out of general revenues anyway—implying that Medicare expenditures as a whole already exceed Medicare taxes (see Social Security and Medicare Boards of Trustees 2007).

15. Personal communication with the author.

16. To access papers and reports on the subject, see the Retirement Project page on the Urban Institute web site at <http://www.urban.org/retirement>.

17. Congress passed the new markets tax credit (NMTC) legislation as part of the Community Renewal Tax Relief Act of 2000 in December of 2000 with the intent of generating \$15 billion in new private sector equity investments into for-profit “community development entities” that serve low-income urban and rural communities.

18. Personal communication with the author.

CHAPTER 11

1. The mechanism being discussed was a “trigger.”

2. I doubt seriously that the vice president believed that any and all deficits do not matter, but the statement seems to discount the possibility that the costs of higher deficits could lead to bigger, not smaller, government, as bills became due.

3. See Kiefer et al. (2002). Major reasons that not all taxpayers saw their marginal rates cut were that many remained in the 15 percent bracket and that others remained at the same marginal tax rate under the AMT.

4. For greater discussion of these issues, see Steuerle (2002a, 2003a).

5. What made this particular compromise possible was that the tax-writing committees of Congress have jurisdiction over these particular programs (both the nonrefundable tax and the refundable spending portions of the credits).

6. This is the same average tax rate that applied under the 2003 legislation, which merely accelerated the point at which the lower rates applied.

7. See Burman, Maag, and Rohaly (2002) for the details of how the 2001 tax cuts affected families with children.

8. The final act included a provision that was close to an option first put forward by Sawhill and Thomas (2001).

9. The compromise in the 2001 legislation allowed some refundability starting at \$10,000—close to the income level where the EITC was fully phased in. The administration itself had proposed increases in child credits and a new 10 percent tax bracket so that positive income tax rates would not be faced below about \$32,000. At this income level, the EITC would have fully phased out (i.e., its 21 percent phase-out rate would not combine with the lowest tax rate in the income tax rate schedule). In general, the 2001 legislation lowered marginal tax rates and reduced marriage penalties for many low-income individuals, although they were raised for others.

10. From 2002 to 2011, the tax relief was estimated to make up only 29 percent of the baseline surplus projected at that time (see OMB 2001, 499).

11. See Steuerle (2003b). The author's calculations are based on data from the Congressional Budget Office's "The Budget and Economic Outlook: An Update" (August 2003).

12. This subsection is taken largely from Steuerle (2002b).

13. In some economic models, an immediate 30 percent write-off of capital expenses is equivalent to a reduction in the effective rate of tax on that capital of about 22 percent, from approximately 35 to 27.4 percentage points. The calculation is provided by Alan Auerbach (note to author).

14. Without any special expensing provision, the law allowed year-to-year write-offs for "five-year" equipment of 20, 32, 19.2, 11.52, 11.52, and 5.76 percent. With 30 percent expensing, the write-offs change to 44, 22.4, 13.44, 8.064, 8.064, and 4.032 percent. With 50 percent expensing (made available in 2003), the write-offs become 60, 16, 9.6, 5.76, 5.76, and 2.88 percent. Six years of deductions are required for five-year equipment because the equipment is assumed to be put into commission at mid-year.

15. Portions of this section are taken from Steuerle (2002f).

16. The proposals also would convert new forms of saving into Roth-like vehicles where there is no up-front deduction (hence, saving on near-term budgetary costs) and no taxation of income from capital in the accounts.

17. The refundable portion was already being phased in at 10 percent. Congress refused to accelerate to 2003 the 15 percent rate at which refundability was eventually allowed.

18. The special exemption also phased out at \$400,000 rather than \$200,000 of income.

19. Also, some capital gains rate reductions lead to increases in capital gains realizations, thus reducing the revenue impact. This was especially true for temporary reductions in tax rates.

20. The Concord Coalition bases its estimates mainly upon Gale and Orszag (2003).

21. Economic modelers also are left in a quandary as to defining what is permanent and temporary tax policy.

22. I myself received a call from a member of the Council of Economic Advisers who found this to be a crazy tax provision.

CHAPTER 12

1. "Political capital" was a favorite metaphor of his: before his first election as president, for instance, he mused about his father's inability to use his "political capital" adequately.

2. The author served with some of these members on an earlier bipartisan commission known as the National Commission on Retirement Policy, organized by the Center on Strategic and International Studies.

3. This proposal is associated most closely with Robert Pozen, who had been a member of President George W. Bush's earlier commission.

4. Personal comments to the author. Bill Frenzel felt that this requirement seriously undermined the ability of the committee to grapple with issues and test ideas, even bad ones, among themselves and the staff.

5. This trend can be positive to the extent that it invites regular review and negative to the extent that it makes planning more difficult.

6. See, for instance, Choi et al. (2002) and Duflo, Ester, et al. (2005). Note also that the author was an advisor to the project.

7. Portions of this section and the two succeeding sections are taken from Steuerle (2001a).

8. The calculations are the authors based upon various data from Burman et al. (2007) and the CBO (2007).

9. It is not quite that simple. The Reagan individual tax rate brackets were not indexed for years before 1985, so there was some bracket creep between 1981 and 1984. Also, in 1982, Congress passed a bill that halted implementation of some of the long-term changes built into the Reagan tax cut, and in 1983 and 1984, it also increased taxes. In the case of the Bush tax cuts, just the opposite happened: more tax cuts were enacted in 2002 and 2003. Then again, the Bush tax cuts still are not permanent. A final verdict on which president presided over the larger set of tax cuts may never be possible.

10. Once one moves up in brackets because of inflation, one generally does not move back down. But tax increases due to unusually high levels of stock valuation relative to GDP are likely to be temporary. The reemergence of unusually high asset values, in stock and real estate, by 2007, leaves open the question of whether that source of revenues can continue in the long term.

11. Kosar (2007) lists 37 for Clinton, 44 for George H. W. Bush, 78 for Reagan, 31 for Carter, and so on. President Bush's streak was the longest since Thomas Jefferson, who was the only two-term president not to issue a veto.

12. Continuing developments can be followed at <http://www.taxpolicycenter.org>, a joint center run by the Urban Institute and the Brookings Institution.

CHAPTER 13

1. While the most radical single changes to the tax system seem to occur only during crises (Brownlee 1996; Pollack 1996), the sum of all the incremental changes over the decades can lead to fairly radical change as well. Even unattended changes can make huge differences over time: bracket creep after World War II brought substantial portions of the population into the income tax.

2. Steuerle (1985b) suggests that the way we account for income inaccurately in an inflationary world has real effects that lead to stagflation. For instance, when interest rates rose with inflation, the after-tax interest rate still was often negative. As an example, for a taxpayer in a 33 percent tax bracket, interest rates might rise to 12 percent when inflation was 9 percent, but the after-tax interest rate would be minus 1 percent. Thus, property did not have to produce any income as long as borrowing rates were negative. On the other hand, to create positive after-tax interest rates required the Federal Reserve to push up interest rates an extraordinary amount, which could lead to recession (and did when the Federal Reserve finally took such a tough stance).

3. The interaction of inflation and taxes led to shifts in relative values of real estate versus stock (Steuerle 1985b).

4. Politics may be a different matter. It seems clear, for instance, that the Clinton administration felt that small rate reductions would not have the same appeal as special

tax breaks to various constituencies and that it would be more likely to lose the budget battle if it simply offered smaller or more progressive tax rate reductions as an alternative to the larger rate reductions (see Brownlee 1996, 138–39).

5. In many cash flow versions of a consumption tax, it is usually argued that the extraordinary returns to capital, but not the ordinary returns, would be taxed.

6. In a number of economic models, this is one of the larger sources of inefficiency arising from the income tax.

7. Among the issues raised in the conversion to a consumption tax is how much various groups might win or lose. Hassett and Hubbard (2001) suggest that such a fundamental change would do less damage than previously thought to home prices and stock market valuations, while Douglas Holtz-Eakin (2001), in the same volume, finds big effects on the housing stock.

8. Graetz was also instrumental, as a deputy assistant secretary, in writing the Treasury study noted here.

9. Japan's interest rates were already so low that there was also a question of whether monetary policy would have any effect.

10. For example, the Bush administration's chairman of economic advisors, N. Gregory Mankiw, was quoted as saying, "But I also believe that if you cut taxes, that's going to stimulate consumer spending and bring you back toward full employment" (*National Tax Journal* 2003).

11. These include the leading economists at major universities. A major exception was Herbert Stein (1969), who addressed issues of balance over the economic cycle with concepts like the full employment budget surplus.

12. The General Explanation of the Tax Reform Act of 1986 states that "The Secretary, through an office established in the Treasury Department, is authorized to monitor and analyze experience with all tangible depreciable assets, to prescribe a new class life for any property (other than real property) when appropriate, and to prescribe a class life for any property that does not have a class life" (Joint Committee on Taxation 1987, 103). Lack of cooperation by some industries and lobbying by others quickly led to the elimination of this office established for depreciation analysis.

13. As in so many cases when capital gains issues are involved, issues become complicated by the availability of borrowing, which also makes it possible to consume out of accrued income without ever paying a tax on it.

14. Some progressives argue that, in the case of a tax cut, one should measure progressivity by whether the percentage change in after-tax income is greater in lower income classes. Thus, a proportional drop in the after-tax income of all income classes would be roughly proportionate rather than progressive or regressive. One does not, however, usually hear them consistently argue that a proportionate expenditure increase should increase the after-tax income of all groups proportionately—that is, that a neutral program of educational spending would grant someone with \$1 million in after-tax income a grant of \$100,000 as long as someone with \$10,000 got \$1,000. Or, changing this example slightly, they do not argue that this educational change would be "progressive" if the poorer person now got \$1,001.

15. If the tax increase is plus 10 percent of existing tax rates, then the tax decrease would need to be about minus 9 percent of existing tax rates (i.e., 9 percent of rates that are now 110 percent of where they used to be) to restore the original structure.

16. Tom Bawden, "Warren Buffet Says Rich Should Pay More Taxes," *Times Online*, June 27, 2007 (http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article1995931.ece).

17. Communication with author, 2007.

18. Nina Olson (2004), the national taxpayer advocate, lists the AMT as the top problem facing taxpayers in her annual report to Congress.

19. This relief is greater than that provided to cash contributions since the appreciation in the value of the property is forgiven tax altogether, up to certain income limits.

20. One example was the Transportation Department's efforts in the late 1990s and early 2000s to convince state and local governments to take advantage of a tax shelter—essentially involving tricks like selling their subway systems and then leasing them back—even though the Treasury believed this was done in a way that was illegal.

21. See Edmund Burke's speech "On American Taxation."

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