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Inputs to Tax Policy-Making: The Supply-Side, the Deficit, and the Level Playing Field

Thousands of issues swirled in the whirlwind of tax policy-making in the Reagan era, and any effort to sort them out must inevitably be hampered by differences in perspective on their relative importance, their impacts, and even their definitions. Taxonomy and classifications can differ. After some reflection, however, it seems to me that most of the important issues can be categorized into three major forces that shaped the making of tax policy during the decade.

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First, tax policy in the 1980s was profoundly affected by the "supply-side" view popularized in the late 1970s by Arthur Laffer, Jude Wanniski, and Representative Jack Kemp. They pointed out that high personal marginal tax rates encourage taxpayers to stay home from work, enter the cash or barter economy, engage in tax shelters, or rearrange financial affairs to avoid paying tax. A reduction in the rate of tax would then have feedback effects that increase the tax base and mitigate the fall in revenue. Some define *supply-side* by the view that tax rate reductions have these advantageous feedback effects, and others define it by the extreme view that the tax base rises by more than the tax rate falls. In the latter case, the government could actually collect more revenue by lowering the rate of tax (see the papers in Meyer 1981). Whatever its definition, however, the supply-side clearly propelled policymakers into the Economic Recovery Tax Act of 1981 as well as the additional marginal rate reduction of the Tax Reform Act of 1986.

Second, the 1980s have been characterized by persistent large government deficits. Some point to the large tax cuts of 1981 as the "cause" of these deficits, while others condemn the failure to reduce spending. Whatever "caused" these persistent government deficits, however, they undoubtedly reshaped the making of tax policy after 1981. Up to this point, inflation in an unindexed tax system continually pushed taxpayers into higher brackets, increased real revenues automatically, and allowed Congress to enact successive tax "reduction" legislation. Tax policymakers simply did not have to worry about obtaining enough revenue (see, e.g., McLure 1990a). I will emphasize the importance of the indexing provisions of the 1981 act as the beginning of an era that instead has a perennial shortfall in revenue. The current process of tax policymaking is very different because of it.

Third, although I appeal to a rather broad definition, the *level playing field* evolved during this period to encompass notions of fairness, economic efficiency, and even simplicity. Some companies and individuals were observed to pay high effective tax rates, while others with the same income paid little or no tax at all. Economists pointed to these differences as a source of resource misallocation and economic inefficiency in production, a view that I call the *efficiency version* of the level playing field. Others simply viewed these differences as unfair, a view that I call the *equity version* of the level playing field. This view relates to *horizontal equity*, the equal treatment of those with the same income, in contrast to the *vertical equity* treatment of those with different incomes. Under either version of the level playing field, there was growing support for the idea that government should get out of the business of deciding which investments are most productive. This idea was certainly voiced earlier, but not until the 1980s was it assimilated, digested, and accepted.[1] It became a driving force in the tax increases of 1982–84, the Tax Reform Act of 1986, and beyond. (See, e.g., *The President's Tax Proposals* 1985.)

1. See the papers in the Summer 1987 issue of the *Journal of Economic Perspectives*.

I organize discussion around these three headings primarily because, as I will argue, they were wholly new forces in the field of tax policy-making. Certainly, other perennial issues were important during this period as well, and I take this opportunity to note topics *not* covered in this paper. Since I emphasize the domestic economy, readers interested primarily in foreign repercussions should see Grubert and Mutti (1987) or McLure (1990b). Those interested in the politics of tax reform should see Witte (1985), Stewart (1991), or Conlan, Wrightson, and Beam (1990). For the effects of the budget process on tax policy, see Rudder (1983) or Merrill, Collender, and Cook (1990). On issues of complexity, see McLure (1990a).

Also, since I emphasize the economic thinking of policymakers during debates about proposals, I do not discuss the actual effects of tax changes. For the effects of the 1981 act on the distribution of tax burdens, see U.S. Congressional Budget Office (1987), U.S. House of Representatives (1990), and Lindsey (1990). For many other economic effects of the 1986 act, see U.S. Department of the Treasury (1987) and all the papers in Slemrod (1990).

Details of the tax laws themselves can be found in various publications of the U.S. Congress and the Commerce Clearing House. Details of the arduous process toward just one piece of legislation, the 1986 act, can be found in Birnbaum and Murray (1987) and Conlan, Wrightson, and Beam (1990). Since this one chapter must cover legislation throughout the 1980s, it cannot do justice to these details. Instead, I will discuss selected issues, especially as they relate to the supply-side, the deficit, and the level playing field. Primarily, however, I will argue that it is most unusual to have the phenomenon of three such wholly novel developments shaping policy in one decade.

3.1 Some Relevant Background

To imagine the debate around the turn of the century about the proposed Sixteenth Amendment's direct tax on incomes, one only need consider the current debate about a possible tax on value added: the new tax would be a powerful source of revenue even at low rates and might allow considerable growth of government if imposed at higher rates. Table 3.1 outlines a history of just the top marginal income tax rate, the additional tax paid if a person in the highest income bracket were to earn one more dollar. This top rate starts at only 7 and then 15 percent, but it jumps significantly at the First World War and again near the Second World War. Remarkably, the table shows that the top personal marginal tax rate from 1944 until 1964 was over 90 percent.

Since this paper is supposed to discuss what prompted tax policy changes since 1980, it will address the specific question, What prompted the dramatic reduction in personal marginal tax rates from a top 70 percent rate in 1980 to a top 33 percent rate by 1988? One easy, and probably correct, answer is to point out the increasing popularity around 1980 of the supply-side view that high marginal tax rates can stifle incentives to work and invest. This review of

Table 3.1 The Top Federal Marginal Personal Income Tax Rate in the United States

Years	Top Rate (%)	Years	Top Rate (%)
1913–15	7	1946–51	91
1916	15	1952–53	92
1917	67	1954–63	91
1918	77	1964	77
1919–21	73	1965–67	70
1922–23	58	1968	75.25
1925–31	25	1969	77
1932–35	63	1970	71.75
1936–39	79	1971–81	70
1940–41	81	1982–86	50
1942–43	88	1987	38
1944–45	94	1988–	33

Source: Tax Foundation (1988, table C36). For some surcharges and special rules, see the notes to Tax Foundation (1988).

Note: From 1944 to 1963, when the top marginal rate exceeded 90 percent, maximum effective rate limitations kept the total tax as a fraction of taxable income (the average tax) below 90 percent. This cap varied between 77 percent (1948–49) and 88 percent (1952–53). Also, these top bracket rates include surcharges of 7.5 percent in 1968, 10 percent in 1969, and 2.5 percent in 1970. They exclude the minimum tax (enacted in 1969) and the 50 percent maximum rate on earned income (enacted in 1971).

prior history, however, turns the question on its head. The inverted question is much more difficult, and perhaps unanswerable. What in the world prompted tax policymakers during the twenty-year period from 1944 until 1964 to enact personal marginal tax rates *over 90 percent?*

For two reasons, the top rate is a misleading indicator of the overall impact of the tax. First, the revenue impact of the income tax depends much more on the taxation of middle brackets than on the taxation of just the top bracket. Pechman (1987, 375) shows that 96.7 percent of tax returns in 1980 (paying 68.7 percent of the tax) were in brackets below $50,000 of adjusted gross income. Second, the link between rates and revenues is broken by exemptions, deductions, and a host of special provisions. Pechman estimates that "in 1947 only about 40 percent of personal income was subject to tax; this rose to 50 percent in 1969 and then declined to 45–47 percent between 1971 and 1984" (p. 66). For both these reasons, the total federal individual income tax after 1947 was never more than 11.3 percent of personal income, a high that it reached in 1981.

Table 3.2 shows more detailed information about the personal income tax between 1947 and 1985. The first column repeats the top bracket rate, from table 3.1 above, and the second column shows the tax as a percentage of personal income. For the years shown, this ratio hit a low of 7.0 percent in 1949, rose to 10.2 percent in 1952, and fell below that level for the next fifteen years. It then reached highs of 11.2 in 1969 and 11.3 in 1981. The third column shows

Table 3.2 Personal Income Tax Rates and Revenues

Year	Top Bracket Rate %	Tax as % of Personal Income	Tax as % of Federal Receipts
1947	91	9.5	46.5
1948	91	7.4	44.0
1949	91	7.0	42.8
1950	91	8.1	36.7
1951	91	9.4	41.5
1952	92	10.2	46.7
1953	92	10.1	46.5
1954	91	9.1	45.7
1955	91	9.4	43.9
1956	91	9.7	43.2
1957	91	9.7	44.5
1958	91	9.3	43.6
1959	91	9.9	46.3
1960	91	9.6	44.0
1961	91	9.9	43.8
1962	91	9.9	45.7
1963	91	10.1	44.7
1964	77	9.3	43.2
1965	70	9.0	41.8
1966	70	9.3	42.4
1967	70	9.8	41.3
1968	75.25	10.8	44.9
1969	77	11.2	46.7
1970	71.75	10.1	46.9
1971	70	9.6	46.1
1972	70	9.5	45.7
1973	70	9.8	44.7
1974	70	10.2	45.2
1975	70	9.5	43.9
1976	70	9.8	44.2
1977	70	9.9	44.3
1978	70	10.4	45.3
1979	70	10.6	47.0
1980	70	11.1	47.2
1981	70	11.3	47.7
1982	50	10.4	48.2
1983	50	9.7	48.1
1984	50	9.7	44.8
1985	50	9.8	45.6

Source: Pechman (1987, 313–14, 346, 370) and Steuerle and Hartzmark (1981, 160).

Note: From 1944 to 1963, when the top marginal rate exceeded 90 percent, maximum effective rate limitations kept the total tax as a fraction of taxable income (the average tax) below 90 percent. This cap varied between 77 percent (1948–49) and 88 percent (1952–53). Also, these top bracket rates include surcharges of 7.5 percent in 1968, 10 percent in 1969, and 2.5 percent in 1970. They exclude the minimum tax (enacted in 1969) and the 50 percent maximum rate on earned income (enacted in 1971).

the personal income tax as a percentage of total federal receipts. For virtually all the years shown, this fraction varied only between 41 and 48 percent, reaching its high in 1982. The relative stability of the personal tax, however, masks the falling corporate tax share and the rising payroll tax share of federal receipts.

Thus, the top 90 percent personal rate was perhaps not viewed as such a problem: it was good for the perception that rich people paid plenty of tax, but less than one-tenth of 1 percent of taxpayers ever had to pay at that rate. Virtually anyone with that much income would be doing something to avoid that bracket. With the benefit of hindsight, however, this logic dovetails perfectly with the supply-side view that high rates are counterproductive by inducing changes in behavior. Incentives clearly were stifled for those allowed to keep less than a dime out of a dollar's extra effort. In particular, Ronald Reagan tells of making movies during this period with over a 90 percent top bracket: "So we all quit working after four pictures and went off to the country" (Stockman 1987, 11). The perceived success of the Kennedy-Johnson cut in the top rate from 91 to 70 percent in 1964 was a major factor in the subsequent effort in 1980 to cut the top rate to 50 percent.

Another important feature of the prior tax code was that inflation and not just real growth would push poor households onto the tax roles and middle-income taxpayers into higher brackets. Minarik (1985, 37) shows that, from 1965 to 1980, the marginal rate on a family with the median income increased from 17 to 24 percent while that on a family with twice the median income increased from 22 to 43 percent. Inflation did not increase the marginal rate of those already in the top bracket, but it did increase their tax as a fraction of income (see Steuerle and Hartzmark 1981). As a result, legislators always seemed to find themselves with surplus revenue that could be used for some combination of increased spending or decreased taxes: "In the seven-year period from 1975 through 1981, eight of the eleven major revenue measures (73 percent) enacted by Congress were estimated by the Treasury Department to lose revenues in the first three fiscal years after enactment, with an average revenue loss of $27 billion" (Merrill, Collender, and Cook 1990, 37).

Very little rate reduction occurred from 1965 to 1980, so the primary form of tax reduction was through additional credits or deductions. Special Analysis G of the U.S. Budget documents the growth of "tax expenditures," the revenues lost from special tax provisions that might have been direct expenditures instead. Without these tax expenditures, personal tax revenues would have been 50 percent higher in 1974, almost twice as high in 1984, and over twice as high in 1986. Tax expenditures sometimes exceeded 45 percent of direct federal outlays (but the 1986 act cut them to 34 percent of those outlays).

This is not to say that the government often had a surplus, for the money was most often spent or returned to taxpayers before it was ever collected. The point is that revenues were always projected to rise until a future year in which a surplus was expected. Table 3.3 shows, from 1976 to 1989, the deficit or

Table 3.3 CBO Baseline Budget Deficit (−) or Surplus (+) for Fiscal Years, as a Percentage of GNP

Report Date	Prior Year	Current Year	First Year	Second Year	Third Year	Fourth Year	Fifth Year
1976[a,c]	−2.9	−4.7	−2.8	−1.6	1.6	1.8	1.8
1977[c]	−3.9	−2.8	−2.2	−.7	.5	1.7	2.7
1978[c]	N.A.	N.A.	−1.7	−.4	.9	2.0	2.8
1979[d]	−2.4	−1.8	−1.9	−1.1	.2	1.2	2.4
1980	−1.2	−1.8	−.8	−.6	.0	.0	.1
1981[b,d]	−2.2	−2.1	−2.2	N.A.	N.A.	N.A.	N.A.
1982	−2.7	−4.2	−5.1	−5.4	−5.4	−5.6	−5.4
1983	−4.2	−6.6	−6.1	−6.0	−6.0	−6.0	−5.9
1984	−6.4	−5.7	−5.3	−5.4	−5.7	−5.9	−6.3
1985	−5.2	−5.6	−5.2	−5.2	−5.1	−5.2	−5.3
1986	−5.4	−5.0	−4.0	−3.4	−2.8	−2.1	−1.7
1987	−5.3	−4.0	−3.6	−3.2	−2.5	−1.9	−1.4
1988	−3.4	−3.4	−3.5	−3.1	−2.8	−2.5	−2.1
1989	−3.2	−3.0	−2.6	−2.4	−2.2	−2.0	−1.7

Source: Merrill, Collender, and Cook (1990). For their source, Merrill et al. refer to various issues of the CBO's *Economic and Budget Outlook.* Total deficit includes off-budget items.

Note: NA = not available.

[a]Average of path A and B forecasts (5 and 6 percent GNP growth assumptions).

[b]Calendar year 1981–82 GNP estimated as average of published range.

[c]Fiscal year GNP estimated as 25 percent of prior and 75 percent of future calendar year GNP forecasts (50 percent of prior and future calendar years used for fiscal year 1976).

[d]Calculated by subtracting outlays from revenues, both as a percentage of GNP.

surplus from the past year and the current year and the projected deficit or surplus for the next five years. In the late 1970s, the current deficit was always projected to turn into a surplus within those five years. The quote given above makes clear that a tax reduction such as the 1981 act was not necessarily unusual, except perhaps for the extent of the rate cut. The act included indexing after 1985, however, so that inflation would no longer push taxpayers into higher brackets. The result is a fundamental shift in the nature of the policy problem, as shown in table 3.3: after 1981, the budget is always projected to remain in deficit. Until the row for 1986 (the 1987–91 projection), those deficits were even expected to rise as a fraction of GNP. As a consequence, "in the following seven years of 1982 through 1988, fourteen of the seventeen major revenue measures (82 percent) were estimated to raise revenue in the first three years after enactment, with an average revenue gain of $15 billion" (Merrill, Collender, and Cook 1990, 37). Thus, 1981 represents a watershed year in the making of tax policy, from an era of constantly projected surpluses to one of constantly projected deficits. As discussed below, the making of tax policy would never be the same.

Policymakers used the excess revenue during the postwar period, not just to

offset bracket creep in the personal tax system, but to provide additional investment incentives in the corporate tax system. In 1954, Congress first introduced accelerated methods of depreciation such as double-declining-balance or sum-of-the-years'-digits. Then, in 1962, the Treasury issued "Guidelines" with a 30–40 percent shortening of previously suggested Bulletin F lives, and the Congress enacted the first investment tax credit (ITC) for equipment. In 1971, the Asset Depreciation Range (ADR) permitted a 20 percent reduction from the Guideline lifetimes. Some acceleration was perhaps intended to offset the reduction in real allowances caused by increasing inflation, but still the corporate income tax fell from 30.3 percent of federal revenue in 1954 to 12.5 percent in 1980. The 1981 act further reduced depreciation lifetimes with the Accelerated Cost Recovery System (ACRS), and the corporate income tax fell to 10, 8, and 6 percent of federal revenues in 1981, 82, and 83, respectively (Pechman 1987, 370).[2] Thus, the postwar period reflects a falling ratio of observed corporate taxes to profits, or the "average effective tax rate," from 51 percent in 1960 to 24 percent in 1985 (Auerbach and Poterba 1987, 6).

A more forward-looking measure of investment incentives is the "marginal effective tax rate," the ratio of expected future taxes to expected future income from a hypothetical marginal investment. One such measure, shown in the bottom row of table 3.4, fell from 48 percent under 1960 law, to 37 percent under 1980 law, to 26 percent under the 1981 act. This measure includes *all* taxes on the expected income from the investment, such as corporate taxes, property taxes, and personal income taxes. However, other calculations from King and Fullerton (1984) indicate that the effective rate from just property taxes and personal taxes in 1981 would be 35 percent. In other words, the corporate tax system under 1981 law provides a net *subsidy* in the sense that its elimination would cause an *increase* in this total effective tax rate from 26 to 35 percent. This subsidy results from the combination of accelerated depreciation, the investment tax credit, and interest deductions at a statutory corporate rate that exceeds the average of the rates at which recipients are taxes on interest income.[3]

Of course, this subsidy is not uniform across all investments of all firms, and therein lies an important problem. The 1960 calculations, before the investment tax credit was enacted, show effective tax rates of 59 percent for equipment and 45 percent for buildings or inventories. By 1980, with the ITC, these were 18 percent for machinery, 41 percent for buildings and 47 percent for inventories. In the calculations of King and Fullerton (1984, 252) for just prop-

2. Note that the 1981 act did not reduce the statutory corporate tax rate. Also, Auerbach and Poterba (1987) show that accelerated depreciation and other legislated changes account for less than half the decline in corporate tax revenues since the mid-1960s while reduced profitability and other factors account for the rest.

3. King and Fullerton (1984) also show how inflation raises this effective tax rate through depreciation allowances based on historical cost and through taxation of nominal capital gains and lowers the effective tax rate through deductions for nominal interest at a rate that exceeds the average rate of recipients. The net effect of inflation is mixed.

Table 3.4 **Marginal Effective Tax Rates in the United States (%)**

	1960 Law	1980 Law	1981 Act	1986 Act
Asset:				
Machinery	59.3	17.6	−5.5	38.9
Buildings	45.0	41.1	30.2	43.1
Inventories	45.6	47.0	47.0	42.8
Industry:				
Manufacturing	58.8	52.7	43.5	51.1
Other industry	38.4	14.6	.7	31.3
Commerce	42.4	38.2	27.5	39.5
Source of finance:				
Debt	−3.6	−16.3	−31.9	5.5
New share issues	96.5	91.2	84.9	74.7
Retained earnings	73.1	62.4	53.4	59.6
Owner:				
Households	65.3	57.5	48.2	54.4
Tax-exempt institutions	−.9	−21.5	−37.6	5.5
Insurance companies	37.6	23.4	11.2	36.3
Overall	48.4	37.2	26.2	42.1

Source: King and Fullerton (1984, 244, 255, and 261). Column 4 is from Fullerton and Karayannis (1993). Calculations assume a 10 percent pretax rate of return, a 6.77 percent rate of inflation, and sufficient tax liability for the firm to use all available credits and deductions. These rates include the net effect of all corporate taxes, property taxes, and personal taxes on the income from a marginal investment in the corporate sector.

erty taxes and personal taxes in 1980, the effective rate for machinery is 34 percent. Thus, even by 1980, the corporate tax system was providing a net subsidy for machinery. Under the fully phased-in version of the 1981 act, assuming enough tax liability that all credits and deductions could be used, the total effective tax rate on machinery was a *negative* 5.5 percent (table 3.4). The corporate subsidy was so large that it more than offset positive property taxes and personal taxes on corporate-source income.[4]

As discussed more fully below, the 1981 act was intended to provide more investment incentives for capital formation that, in turn, would enhance future productivity. The familiar course for such incentives was to apply them primarily to equipment. But the 1981 act carried this logic to such an extreme that the effective tax rate on machinery was −5.5 percent, the rate on buildings was +30 percent, and that on inventories or land was still +47 percent. Averaged over these assets, as shown in table 3.4, an investment financed by new share issues faced a marginal effective tax rate of +85 percent, and one financed by debt faced −32 percent. As a consequence, some equipment-

4. Even if the firm did not have enough tax liability to use all credits itself, the "safe-harbor leasing" feature of the 1981 law allowed it to lease equipment from another firm that could use the credit, at a rental price that passed through the benefit of the credit.

intensive or debt-intensive firms were paying little or no tax in the early 1980s, while other firms such as retailers were paying high effective tax rates.[5]

Many economists pointed out that these differences would lead to misallocations of resources and a lower value of output than if the same amount of tax were collected in a more uniform manner. Others simply thought it unfair that some firms with positive income were paying no tax. These investment incentives were the building blocks of tax shelters, and they were sometimes used by high-income firms and individuals to avoid paying any tax at all. Calls were heard for a "level playing field" that would subject all firms and all types of investment to more similar effective tax rates. The development and impact of such ideas will be examined below.

3.2 The Supply-Side

It was 1974 when Arthur Laffer first drew his famous curve on a napkin in a Washington restaurant.[6] Its logic is amazingly simple. Government revenue must be zero at a tax rate of 0 percent, and revenue must also be zero at a tax rate of 100 percent since nobody would bother to work or earn other forms of income subject to tax. If any revenue is raised between tax rates of 0 and 100 percent, there must be an intermediate rate at which revenue is maximized. The counterintuitive implication is that there must also be a range over which a higher tax rate reduces revenue. Even more surprising, perhaps, is that this result was not already well known and well understood by everyone interested in tax policy.

The principle economic reason given for this result was that taxpayers react by changing their *supply* of taxable labor or capital, a terminology that was useful in distinguishing this microeconomic orientation from the previous macroeconomic orientation of tax cuts designed to stimulate aggregate *demand.* To academic economists, however, the presentation of the idea had a number of problems. First, of course, the idea was not exactly new: "High taxes, sometimes by diminishing the consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to government than what might be drawn from more moderate taxes" (Adam Smith [1776] 1975, bk. 5, chap. 2). Second, economists were quite familiar

5. If the corporate investment is financed by stocks and bonds sold to a tax-exempt institution, the total effective rate in table 3.4 is −37 percent. Presuming that the corporation can use all excess credits and deductions on the marginal investment against its tax liability on intramarginal investments, the positive corporate tax is more than offset by the ITC, accelerated depreciation allowances, and interest deductions at the statutory corporate rate, with no subsequent tax on the exempt recipient of the interest and dividends.

6. "Dining with Wanniski and Richard Cheney, Rumsfeld's deputy, Laffer tried to explain how higher tax rates can produce less revenue. . . . When Cheney seem mystified, Laffer impulsively grabbed a napkin and drew a curve, demonstrating the variable relationship between tax rates and revenues. Thus was born what Wanniski popularized in his writings as the Laffer Curve" (Evans and Novak 1981, 63).

with the idea that economic outcomes were determined by the interaction of both supply and demand. Third, Laffer and other early champions did not just point out the existence of the downward-sloping range of the curve but also claimed that "we are well within this range at present" (Laffer 1977, 79). Fourth, they emphasized the effect of lower tax rates on actual labor and capital supply, at least initially,[7] rather than on financial arrangements and other tax avoidance behavior that can be used to reduce one's tax base.[8]

An unfortunate result was that these surface issues were easily attacked. It was quickly shown that the curve did indeed exist within preexisting economic models with both demand and supply behavior but that "reasonable estimates of an aggregate labor supply elasticity and of an overall marginal tax rate are both low enough to suggest that broad-based cuts in labor tax rates would not increase revenues" (Fullerton 1982, 20). Use of this preexisting model found that the revenue-maximizing tax rate was in the 70–80 percent range. Such responses address the extreme claims, perhaps, but not the more subtle and important points of the supply-side movement. What we learned ultimately from this movement is that tax rate reductions may have large effects on the tax base through means other than actual labor or capital supply.[9]

Indeed, the quote from Adam Smith should be suggestive. Two hundred years ago, when most government revenue was obtained from tariffs, a particularly high rate would not necessarily discourage imports; it would just shift them to an untaxed form. Similarly, high rates of tax may do little to actual labor supply, but they may shift it to an untaxed form such as "receiving income as fringe benefits, devoting expenditures to tax deductible items, and participating in the underground economy" (Browning 1989, 52). Use of a model with these three behaviors found that the revenue-maximizing tax rate was in the 50–60 percent range.

Tax avoidance can take additional forms as well. In 1985, the president's Council of Economic Advisers called for lower marginal tax rates that would reduce the incentive to hold tax-free municipal bonds, to take advantage of the deductibility of state and local taxes by shifting more activity into that govern-

7. Representative Jack Kemp, e.g., said, "The case that I'm making is that this tax system is biased against innovation, against investment, against savings, against work. There's such a tax on labor and capital that it's causing in part the deficit" (*New York Times,* 30 November 1980).

8. In addition, some of the initial jargon was simply wrong, suggesting that the peak of the curve is "the point at which the electorate desires to be taxed" and where "revenues plus production are maximized" (Wanniski 1978, 98).

9. Another lesson from more recent literature is that the effect of a tax rate change depends greatly on what is done with the revenue. If extra revenue is used to provide cash or the equivalent back to taxpayers, then work effort necessarily falls. The taxpayer does not really lose any income, so the change in relative price makes him substitute from work into leisure. True supply-siders believe that most government programs *do* provide cash or private goods. Instead, however, the revenue may be spent on something that bears no relation to choices about private goods and leisure (where economists say that the public good is "separable" in utility). The relative price of leisure falls, so the substitution effect makes an individual work less, but he has less income to spend on private goods and leisure, so the income effect makes him work more. On net, labor may either rise or fall.

ment sector, to take business deductions for travel, meals, and entertainment, to use fringe benefits as a form of compensation, to take deductible charitable contributions, to use interest-deductible debt rather than equity to finance an investment, to earn tax-free "imputed" net rents from owner-occupied housing, to search out legal tax shelters, and to engage in illegal tax evasion (see U.S. Council of Economic Advisers 1985).

After some rate reduction was completed, Lindsey (1990) found that tax cuts for lower brackets had positive feedback effects on revenue but did not pay for themselves. However, he found that high-bracket taxpayers (those earning more than $200,000) brought so much more activity into the tax base that they ended up paying more tax rather than less. In other words, the use of his model found that the revenue-maximizing tax rate was in the 40–50 percent range.

For these reasons, and with the value of hindsight, it might be said that the *supply-side* movement was entirely mislabeled. This terminology emphasizes actual labor supply, which for most people is not very adjustable, and it thus gave traditional thinkers an easy target. Supply-siders were branded as extremists even before they got a chance to list these other more adjustable behaviors as additional reasons that a tax cut could raise revenue. Moreover, the *supply-side* label did not convey their more central message, namely, that economic growth would be aided by shrinking the size of government.

It did not help that the supply-siders themselves were ambiguous. In intellectual circles, they tried to explain the myriad ways in which rate reduction can have positive feedback effects on revenue, but, in the popular press, these complex arguments always seemed to get reduced to the claim that people work more and revenues rise. Others besides Laffer and Wanniski helped feed this misunderstanding, partly in order to bring attention to their cause. A "wake-up call" was needed to put the issue before the people and convince policymakers that taxes had any such incentive effects at all. Jack Kemp was quoted as saying, "Frankly, it is my belief that at lower, more efficient rates of taxation, we'll get more revenue" (*New York Times,* 30 November 1980), and candidate Reagan said, "Even the government winds up getting more money at the lower rates."[10] As Murray Weidenbaum (1988, 19) wrote, "Supply-side economics has made a useful positive contribution in moving the issue of incentives . . . to the front page of our newspapers." The problem with this ambiguity was that then they had to deal with the consequences:

> Journalists and academics continued to declare that there was not a scrap of evidence for supply-side economics. When pressed on this matter of evidence, it always turned out that they meant there was no evidence that tax-rate reductions would pay for themselves in each bracket. Since Reaganomics was not based on the Laffer Curve, they either did not know what

10. This quote was used on a 1981 broadcast of "All Things Considered," on National Public Radio, entitled "Tax Less, Work More" (no. 81311).

they were criticizing or pretended not to know in order to hold on to their strawman. (Roberts 1984, 133)

As noted above, the cut in the top rate might have paid for itself, but not across-the-board cuts in all marginal rate brackets.

These problems with the initial presentation of supply-side ideas may have been the source of weak academic support, but problems with inflation were definitely the source of strong public support. Increases in the Consumer Price Index (CPI) were substantial:

Year	% Change CPI	Year	% Change CPI
1976	5.8	1979	11.3
1977	6.5	1980	13.5
1978	7.6		

Source: U.S. Council of Economic Advisers (1990, 363).

In fact, inflation was a factor in two supply-side precursors of 1978. In California, inflation had been increasing nominal assessed values, with the result that property taxes would rise even with no change in the tax rate, until a popular uprising passed Proposition 13 to limit these automatic tax increases. In addition, inflation had been increasing nominal selling prices and therefore taxes on capital gains. President Carter did not recognize the shifting political winds, perhaps, until a popular uprising passed the Steiger Amendment to convert his proposed capital gains rate *increase* into a capital gains rate *decrease.*[11]

Inflation was having at least two other important effects on taxes. First, it was pushing taxpayers into higher brackets, increasing personal marginal tax rates through "bracket creep." One response was the Kemp-Roth plan of 1977, H.R. 8333, also known as "10–10–10" to summarize its three successive years of 10 percent cuts in all marginal tax rates. However, rate reduction would not offset the effect of inflation on low-income households that had become taxable. Second, inflation was reducing the real value of depreciation allowances, increasing the cost of capital, and decreasing investment incentives. The response to this problem was the Conable-Jones plan, H.R. 4646, also known as "10–5–3" to summarize its three depreciation lifetime categories for all assets: ten years for structures, five years for equipment, and three years for light vehicles.

These proposals each represented massive tax reductions, at least relative to the then current unindexed tax system that was projected to turn a 2.4 percent of GNP deficit into a 2.4 percent of GNP *surplus* (in table 3.3 above, the row

11. At the time, the top bracket was 70 percent, and the capital gains exclusion was 50 percent, but the "alternative tax on capital gains" allowed a 25 percent rate on the first $50,000 of net capital gains. In January, the *President's 1978 Tax Program* (U.S. Department of the Treasury 1978) proposed repealing the alternative tax and thus raising the top capital gains rate to 35 percent. The enacted legislation instead raised the exclusion, to 60 percent.

for 1979). Each was motivated in part by supply-side considerations. For different reasons, however, each was actually a very traditional piece of legislation.

As described above, the entire postwar period had seen frequent income tax "reduction" legislation.[12] The Kemp-Roth plan was a bit larger, perhaps, and it provided rate reduction in contrast to the more common practice of adding new credits and deductions. But inflation was greater than normal, and bracket creep had sent marginal rates to all-time highs. Thus, despite supply-side rhetoric, even 10–10–10 could be viewed as another ad hoc offset to inflation. In particular, it was traditional legislation in that it did not propose indexing to *end* the continuing cycle of bracket creep and tax "reduction."

Similarly, as described above, depreciation had been accelerated in 1954, 1962, and 1971. In 1980, inflation was higher than usual, so the proposed acceleration in allowances was higher than usual. Again, the Conable-Jones 10–5–3 plan was traditional legislation in that it did not propose to index depreciation allowances in a way that would guarantee a certain real value of depreciation whatever the rate of inflation. According to David Stockman (1987, 62), it did not even arrive with any supply-side rhetoric: "Conable and his Ways and Means Committee Republicans had consolidated their own coalition. It was an awesome assembly of business lobbies and trade associations representing everything from autos to real estate, steel, and zinc smelters. . . . The old guard was much more comfortable with this approach than with the supply-side marginal rate reduction plan." For related reasons, this business tax cut did not jibe with the populist message of the personal tax cuts: "Kemp and the supply-side purists did not like it, viewing it as just another tax shelter for established big corporations that would be little or no help to up-and-coming entrepreneurs, the future hope of the capitalist system who above all wanted a quick drop in taxation of 'unearned' income" (Evans and Novak 1981, 99).

In addition, these proposals were not designed according to any particular careful theory, supply-side or otherwise. There was no special reason for three successive 10 percent rate cuts, except that it spread out the cost, and no special reason for that particular total percentage cut, except that it was big. The special appeal was the simplicity of the numbers, 10–10–10. It was something that the man on the street could understand. Even for an area as arcane as business depreciation provisions, the simplicity of 10–5–3 had appeal.[13]

Thus, the proposals had several things going for them. Inflation was at an all-time high, the budget was projected to go into surplus, the simplicity was appealing, there was a popular antitax uprising, *and* a new supply-side theory

12. In contrast, the postwar period also saw frequent Social Security tax *increase* legislation.

13. As David Brockway pointed out to me, "10–10–10 is not something you generate out of a computer." Also, "they were running out of corporate tax base, so eventually the bubble would burst. . . . If anything is devoid of intellectual content, it's 10–5–3."

provided some intellectual (if ambiguous) underpinnings. For many traditional legislators, however, the extreme version of the supply-side view may have worked against the proposal. Few in Congress gave any credence at all to the idea that the rate cut would pay for itself.

The proposals had much more going for them in 1980, however, when candidate Reagan came on board. Ronald Reagan was a natural opponent of high taxes and big government, and his campaign pushed the populist message of the supply-side. He garnered populist support with 10–10–10 and courted business support with 10–5–3. Despite their differences, both these proposals were tax cuts, both would help offset inflation, and both were proposed by Republicans. Why choose between them? Reagan was more interested in the personal rate cut, but both these odd bedfellows were adopted by the Republican platform. The landslide election of 1980 certainly appeared to be a strong mandate for tax reduction.

After the election, Ronald Reagan collected into his administration several different kinds of appointments. The White House was dominated by moderate Republicans such as James Baker and Richard Darman, while the Treasury Department included some extreme supply-siders such as Norman Ture and Paul Craig Roberts. The budget director, David Stockman, was a bit of a half-breed. He professed to be an ardent supply-sider, but he never believed that the tax cuts would pay for themselves. Rather, he believed in the importance of smaller government for greater productivity and economic growth. He quickly calculated that the cost of the two tax cuts together was "staggering" (Stockman 1987, 64), but he had a two-part plan. First, since the proposal still did not include indexing, a few years of inflation would help undo some of the cost. Second, "the prospect of needing well over $100 billion in domestic spending cuts to keep the Republican budget in equilibrium appeared more as an opportunity than as a roadblock" (p. 74).

As we shall see, indexing was added to the proposal before it was passed, and actual spending cuts were small compared to the remaining deficit. The more immediate problem, however, was the administration's February 1981 economic forecast: "When you added the supply siders' assumption of 5.2 percent real growth [for 1982] to Weidenbaum's 7.7 percent inflation, you got a mountain of money GNP—and phantom tax revenues" (Stockman 1987, 106–7). Thus, it was "Rosy Scenario" who convinced policymakers that they could afford the big tax cut.

Although the Senate had gone Republican in 1980, the tax cuts were still far from a sure thing. Many legislators viewed the size of the personal tax cut as irresponsible. In the first place, Democrats were naturally opposed to the tax and spending cuts, and, in the second place, traditional Republicans agreed with George Bush's campaign quote that supply-side was "voodoo economics." Both these groups were more inclined toward the business tax cuts, and Democrat Lloyd Bentsen even had his own similar accelerated depreciation scheme in the Senate Finance Committee. The personal rate cuts were of no interest to

business leaders and lobbyists but of great interest to the new president still in his honeymoon period. The two proposals were married in the White House, as corporate executives agreed to support Kemp-Roth in exchange for White House support of the Accelerated Cost Recovery System (ACRS), a modified version of Conable-Jones that reduced structure lifetimes from thirty to forty years to fifteen years, equipment lifetimes to five years, and light vehicles to three years.

Democrats were still balking, and the White House eventually agreed to cut the first year of the personal rate reduction from 10 to 5 percent, delay it for a year, and add a couple of "ornaments" designed to attract support from particular sources.[14] Many observers said afterward, however, that such compromises were not necessary. The Democrats were reeling not only from electoral defeats but also from successive legislative defeats on Stockman's spending cuts. Southern "Boll-Weevil" Democrats had formed a viable coalition with Republicans, and other Democrats were shrinking in fear of the next election. One insider told me that "the Republicans could have crammed in twice the cuts and still got the vote, but they only bit off as much as they thought they could chew." When the president was shot on 30 March, anything he wanted could have sailed right through. The Democratic leadership promised a tax bill by July.

Meanwhile, the professional tax staffs in both the Treasury Department and the Joint Tax Committee were analyzing the proposals, and it was soon clear that the combination of the investment tax credit and accelerated depreciation allowances would be even more generous than simply allowing businesses to "expense" immediately the full cost of the investment. In my interviews, these insiders said that they knew that the outcome would be a host of administrative problems related to tax shelters, the leasing of equipment, the churning of real estate, and corporations without enough tax liability even to make use of the allowable credits and deductions. Besides, in their judgment, it just seemed "wrong." Among other issues, it raised the specter of providing more investment incentive to an older taxable firm than to a struggling new high-tech firm that was not yet taxable.

The Treasury had two responses. First, they designed "safe-harbor leasing" so that a taxable firm could buy the equipment, lease it to an untaxed firm that had really wanted to make the investment in the first place, and then charge a rent that passes the tax benefits through to the untaxed firm. The result, we would see later, was that many large profitable corporations could zero-out their tax liability, which caused significant perception problems even if these firms were passing through the tax advantages by receiving reduced rents for the equipment. Second, in June, the Treasury proposed a reduction in the gen-

14. Up to this point, the administration was trying to keep "clean" a bill that would balance the budget by 1983 (using the "Rosy Scenario"). Although these changes started them down the road toward a "dirty" bill, the cost of the ornaments was offset by the lower first-year rate cut.

erosity of ACRS.[15] The result in this case was "Lear-Jet Weekend." Corporate executives flew to Washington from all over the country to point out that their support of the personal rate cuts was dependent on full White House support of their business tax cuts. By Monday, the full depreciation plan was restored.[16]

Along the way, the administration's tax plan had been named after Barber Conable (R., New York) and Kent Hance (D., Texas). It has been amended by a second-earner's deduction, an estate and gift tax reduction, a higher ceiling on Individual Retirement Accounts (IRAs), and a credit for oil royalty owners. But the Democrats were not just sitting on their hands. All tax legislation is required by the Constitution to begin in the House of Representatives, and the House was still controlled by the Democrats. The new chairman of the House Ways and Means Committee, Dan Rostenkowski, wanted to put his own stamp on the bill. Democrats were nervous about the third year of 10 percent personal rate cuts, so they came up with an alternative of their own. They saw enough of the supply-side argument that they viewed as sensible the cut in the top rate from 70 to 50 percent, so they made it immediate rather than phased over three years. To try to rationalize the depreciation scheme, they offered straight expensing of equipment. To attract particular other constituencies, they added significant cuts in the estate and gift tax, a larger oil royalty credit, an IRA for those who already have pension plans, a cut in the corporate tax rate from 46 to 34 percent, and other sweeteners. The Republicans countered by adding several of these ornaments plus additional provisions for indexing and for all-savers' certificates. The result was the "bidding war" of summer 1981 (see Rudder 1983; and Witte 1985). Sweeteners were added *both* to the administration's bill and to the Democratic alternative in attempts to bid support away from the other. The bills were fundamentally very similar, so the struggle really amounted to whose name would be on the bill to win. At this point, all semblance of responsible policy-making went out the window. Several observers thought that the result was nothing other than a "feeding frenzy."[17]

The resulting bill, passed in August, had not just three years of personal rate cuts and the Accelerated Cost Recovery System (ACRS). It had safe-harbor leasing, expanded IRAs and Keogh accounts, all-savers' certificates, estate and gift tax cuts, a second-earner deduction, an incentive stock option, a larger employee stock option plan (ESOP), an oil royalty owner's credit, a research and development (R&D) incremental tax credit, a child-care credit, deductions for charitable contributions of nonitemizers, an increase in the homeowners'

15. Double-declining-balance was reduced to 150 percent declining balance, while utilities and industrial structures were given longer lives.

16. Although double-declining-balance was restored, it was delayed until after 1985. Lives would be shortened immediately, but depreciation would be 150 percent of declining balance in 1981–84, 175 percent in 1985, and 200 percent thereafter. Each depreciation schedule is laid out in a table, and each involves switching to straight line or sum-of-the-year's-digits at the optimal point in the life of the asset.

17. The logic "was that of the alcoholic: One more couldn't hurt, given all that had gone down already" (Stockman 1987, 248). See also McLure (1990a).

capital gains exclusion, a deduction for adoption expenses, a new exclusion of foreign earned income, and many other special provisions.

To be sure, many of these proposals had been kicking around for some time and had good tax policy arguments supporting them. Many did not. The point here is not to debate the arguments for and against each provision but to note the process by which they were all combined in one bill. No attention was paid to the long-run revenue consequences of the two main provisions, let alone all these additional provisions. Especially given the nature of the bidding war, all observers thought that the bill was pure politics. There was virtually no economic input to the process. Stockman (1987, 278) notes that "supply side theory was, well, as relevant as love at an orgy."

Of the professional economists I interviewed who were involved in this process, almost all said that economic analysis may have had an impact only on some small aspects of the legislation. They pointed out that certain assets were moved from one depreciation category to another on the basis of economic estimates of useful service lives. Also, safe-harbor leasing was suggested as a way to provide the same economic incentives to both taxable and untaxed firms. And the second-earner deduction had been suggested by economist Joe Pechman years before as a way to lessen the perverse incentive effects of the marriage penalty. Here was a modest proposal that was targeted directly at the logic of the supply-side. Given the higher earnings of the family's primary worker, the secondary worker faced a high initial marginal tax rate *and* a more adjustable labor supply decision. Since the second-earner deduction cuts the tax of just the more responsive secondary worker, it is more likely to have a large positive feedback effect on revenue.

These economists all agreed with the noneconomists that the big decisions were pure politics, however. First of all, if the peak of the Laffer curve were really as low as 40 percent, then a pure supply-side rate cut would apply only to the top brackets. No supply-side response would be expected from a low-income taxpayer's reduction in rate from 14 to 11 percent. In addition, the depreciation scheme was pushed by the business lobby, while economists were pushing alternatives such as expensing or the "first-year-recovery" proposal of Auerbach and Jorgenson (1980).[18] Moreover, the ideas that *had* been put forward by economists were ignored. Economists had pushed the value-added tax (VAT), a proposal that spelled electoral defeat for Al Ullman, the former chairman of the House Ways and Means Committee. Economists had pushed the idea of a consumed-income tax, a proposal that was ignored by all politicians except Gary Hart.[19] Economists had pushed the integration of corporate and

18. Instead of indexing later depreciation allowances, this proposal would avoid the effects of inflation by providing a deduction in the first year of the life of each asset that would be equivalent in present value to real economic depreciation.

19. Under a consumed-income tax, each taxpayer would file an annual return that measures consumption by including all forms of income and then deducting all forms of savings. As discussed below, a deduction for net saving means the inclusion of net borrowing.

personal income taxes, another idea that was totally ignored in the political process.[20]

Despite these arguments, I think that it is possible to take the exact opposite position, namely, that economic considerations determined the big issues while politics decided relatively small issues such as the provisions added during the bidding war. These staff economists are correct that they had more impact on the details of this legislation than on its fundamental form. In several important respects, however, *other* economists from the academic and private sectors had a *prior* impact on the nature of the legislation. It is more difficult to see the indirect role of economists whose writings get sifted through colleagues and the media before entering the political marketplace of ideas, but these impacts were crucial nonetheless.

First, whatever the validity of particular claims made at the time, the supply-side is inherently an economic concept. The main point of the supply-side is that incentives matter, and that point was ignored or forgotten as previous politics had raised marginal tax rates to over 90 percent. It was economic ideas that first suggested these rates be brought back down again. The Kemp-Roth bill might not have been available for consideration but for supply-side economics.

Second, economic analysis deals not only with incentives but also with the distribution of tax burdens. While incentive considerations suggested reducing the top marginal tax rate, distributional considerations suggested reducing rates for low-income taxpayers as well. Here, economists and politicians were in agreement that the tax cut should not be only for high-income households. In fact, bracket creep had been raising the taxes of low- and middle-income taxpayers more than it had been raising the taxes of those already in the top bracket.

Third, many economists had been pointing out the perverse effects of inflation not only through bracket creep but also in reducing the real value of depreciation allowances, raising capital gains taxes, and exaggerating the real effects of interest paid and received. Although most economists might have preferred to index depreciation allowances for inflation, Feldstein (1981, 38) supported 10–5–3 by noting that, "for moderate rate of inflation and real discount rates, the acceleration proposal and full indexation are quite similar." Much economic analysis was devoted to the problem of insufficient savings and investment, and this analysis provided much impetus to the final bill's expanded IRA, reduced capital gains rate, and R&D credit. Politics merely determined the right time to insert these provisions, some aspects of their form, and a few other provisions like ESOPs.

20. Businessmen like to talk about double taxation, but not integration. Yet Ullman wanted to pay for integration by imposing a VAT. As David Brockway, talking with me, remembered it, "Politically, this is ludicrous: impose a sales tax in order to cut tax for business. It just reflects the haywire political compass of the Democrats. At least the supply side had a focus."

Finally, it is an economic argument that underlies the indexation of tax brackets for inflation, the provision that perhaps unexpectedly turns out to have the biggest effect of all.

3.3 The Deficit

Concern about the revenue impact of the Economic Recovery Tax Act of 1981 (ERTA) began "immediately if not sooner." Some legislators knew even as they voted for the bill that it would soon have to be fixed.[21] For example, on 14 September 1981, the *New York Times* reported that

> Mr. Moynihan, a Democrat and New York's senior Senator, voted for the Administration's tax legislation this summer—both in committee and on the Senate floor—but maintained in an interview that he really supported only certain parts of that bill. He gave it his vote, he explained, "because it was that or nothing."
>
> Asked to specify how he would revise the tax bill, Mr. Moynihan said he was not ready to provide details, other than to say he would cut the $750 billion, five-year cost of the Administration's bill by approximately $250 billion, or one-third.

Even the administration, as part of the "September offensive" directed primarily at spending cuts, proposed $22 billion of what was for the first time euphemistically called "revenue enhancement." But the primary problem developing during this period was the deepening recession. The "Rosy Scenario" of February 1981 may or may not have been overly optimistic from the beginning, but now the economic forecasts repeatedly had to be revised downward. According to David Stockman's mea culpa (1987, 369), "The failed September Offensive had been aimed at reducing the 1984 deficit by $75 billion. Now the deficit estimate had increased by an order of magnitude—to $150 billion. We were suddenly faced with the stark reality of what had been hidden from the beginning. Our sweeping fiscal plan had led straight into the jaws of triple-digit deficits."

Because the budget plan covered only the years through 1985, the apparent problem was still simply the size of the ERTA tax cut. Much discussion ensued about whether to delay the second year's 10 percent rate cut or to abort the third year's additional 10 percent cut. Policymakers still had not recognized the long-run implications of bracket indexing, scheduled to start after 1985. Without indexing, they could have avoided any legislation to raise taxes. By just waiting a bit longer, inflation would have raised taxes for them. The budget problem, although severe, would have been only temporary.

Since supply-side theory recommended that marginal tax rates be reduced,

21. The Economic Recovery Tax Act of 1981 passed by a vote of 238 to 195 in the House and 89 to 11 in the Senate.

it might also be thought to recommend that rates stay reduced. Yet indexing was not put into the 1981 legislation by any supply-sider such as Arthur Laffer, Jude Wanniski, Jack Kemp, or even Ronald Reagan. It was inserted late in the summer of 1981 by Republicans Bill Gradison in the House and Bill Armstrong in the Senate. The administration did not even want indexing. As Congressman Gradison remembers it, the administration tried to renege on a deal that indexing would be added to Conable-Hance, the administration's bill in the House, if Armstrong managed to get it into the other version of the bill in the Senate.[22]

Then, at the height of the bidding war, despite his administration's earlier opposition, President Reagan used indexing to great advantage in selling his "bipartisan" package (since Conable-Hance was named after members of both parties) over the "Ways and Means" (Democratic) plan. On 27 July, he went on national television with an oversize chart (reproduced here as figure 3.1) showing that, although the "Ways and Means" plan gave larger cuts initially, taxes would subsequently rise. With indexing, the "bipartisan" tax cut would remain a tax cut.

This figure demonstrates vividly the single most unusual feature of the 1981 legislation. Prior tax cuts were temporary. Not only was the 1981 tax cut the biggest in U.S. history; it was permanent.[23] It was not the size of the deficit as much as this permanence that so greatly affected all subsequent tax policymaking.

During the course of the next year, additional policymakers came to realize that revenue must be raised. Within the administration, some began seriously to discuss a $100 billion tax increase, and others began to resign.[24] The form of the tax increase, however, was still subject to debate. Democrats favored repeal of the third year's rate cut; as Rostenkowski said, "I see it as repealing something that taxpayers have never enjoyed—as opposed to taking money right out of their pockets with heavy consumer taxes" (*Washington Post,* 10 May 1982). The Republicans leaned toward excise taxes, user fees, greater enforcement, and generally anything that appeared less as a tax. Asked whether the new tax bill represented a turnaround from the philosophy of last year's supply-side tax cut, Senate Finance Chairman Bob Dole said, "We're

22. As Stockman tells it, "'Armstrong doesn't have the votes on the Senate floor,' the Senate's best vote-counter told Jim Baker. 'We'll bury indexing in an hour'" (1987, 275). Then, after indexing was voted into the Senate bill by 57 to 40, "Conable insisted that tax indexing be incorporated in Conable-Hance II. Both Don Regan and I fought that one, but Conable and his GOP colleagues persisted. We solved the impasse by delaying the effective date of tax indexing until 1985" (p. 281). While true supply-siders would favor both the rate cut and indexing, fiscal conservatives in the administration may have feared the sheer size of the rate cut and viewed bracket creep as a way to reduce it. The budget was defined as a three-year problem (1982–84), however, so any cost after 1985 was irrelevant.

23. Policymakers at the time used nominal terms to describe the 1981 act as the biggest tax cut in U.S. history and the 1982 act as the biggest tax increase in U.S. history.

24. Paul Craig Roberts resigned as assistant secretary of the Treasury in January 1982, and Norman Ture resigned as undersecretary in June (see also Regan 1988, 184).

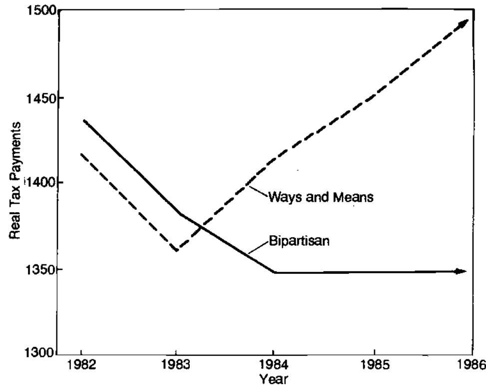

Fig. 3.1 Keeping taxes down—$15,000 wages
Source: Roberts (1984).

not trying to make a U-turn; we're just trying to avoid going over the cliff" (*Washington Post,* 16 August 1982).

One unusual feature of this bill is that, instead of beginning in the House of Representatives, as is required by the Constitution, it essentially began in the Senate Finance Committee. Chairman Dole circumvented the constitutional restriction by latching onto a minor tariff bill that *had* passed the House. His committee could then produce a virtually new bill and go straight to a conference with House members to work out the "differences." An immediate question is why Rostenkowski did not cry bloody murder at this constitutional outrage. After all, one might think that the Democrats would want to help undo the Republican tax cut of 1981. The answer is that Rostenkowski was in on the plan. He wanted a bill in 1982, but many on his Ways and Means Committee did not. In many ways, the House was more supply-side oriented than the Senate. Since its members faced election more often, the House was more susceptible to swings in the public mood such as the ongoing antitax revolt. Rostenkowski could simply pick conferees that agreed with him, negotiate with the Senate, and avoid ever taking on his full committee (see also McLure 1990a).

In its final form, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised $98.3 billion over three years. Given the flap over news accounts of major corporations that were paying no tax, it repealed the safe-harbor leasing provision of the 1981 act. Mostly, it took little nicks at many features of the law. It added to the individual alternative minimum tax (AMT), increased the floor for deductible medical expenses and casualty losses, taxed more of unemployment benefits, reduced deductions for some mineral companies, required capitalization and amortization of construction period interest and property taxes, amended the completed contract method of accounting, accelerated corporate estimated tax payments, limited the use of tax-exempt

industrial development bonds, restricted allowable pension contributions and benefits, and amended provisions for foreign income, life insurance companies, and unemployment taxes. It added excise taxes on airport use, communication, and cigarettes.[25]

Its two largest provisions, however, were modifications to depreciation and compliance. Calculations such as those in table 3.4 above began to show that the combination of ACRS and ITC was considerably more generous than expensing, especially since the rate of inflation had fallen. Inefficiencies and inequities would result from high effective tax rates for some assets and negative effective tax rates for others. Thus began the development of the "level playing field." In this case, tax increases had some political appeal by targeting those receiving extra benefits. Note that the calculations in table 3.4 reflect the fully phased-in version of the law, with double-declining-balance, scheduled to begin after 1985. The 1982 act simply made permanent the 150 percent method that ERTA had specified for 1981–84. It also decreased the basis for depreciation deductions by half the investment tax credit. According to economists doing the calculations, these changes were designed to leave benefits approximately on par with expensing.

The compliance provisions included various income reporting responsibilities and increased penalties, but also the first withholding on interest and dividends, at a 10 percent rate. Wages and salaries had been subject to withholding for years, so it might be natural to think that interest and dividends could be subject to similar rules. Wages and salaries were no longer a major compliance problem, while interest and dividends were often not reported. Any significant administrative problems had been considerably reduced by the coming of computers to the banking and brokerage industries. But this provision raised a terrific outcry from banks and depositors, largely through Senator Bob Kasten's write-in campaign. It was repealed the next year.

Perhaps most striking about TEFRA and other subsequent efforts to raise revenue is not the provisions that they included but one possibility that they excluded. They did not repeal bracket indexing. Another look back at table 3.3 above reveals that, whereas the 1979 five-year projection showed a surplus as large as 2.4 percent of GNP, the 1982 projection showed a deficit as large as 5.4 percent of GNP. The result is that tax increase legislation took the hard road, with bills every year from 1982 to 1985.

At the time of passage, the revenue effects of each bill were projected a few years ahead. More recently, however, the Office of Management and Budget (OMB) has estimated the past effects of each bill through 1990, relative to the law in effect before ERTA. These "static" estimates ignore possible behavioral responses. As shown in table 3.5, prior law would have increased revenues dramatically throughout the 1980s, but the 1981 bill reduced revenues by at

25. Commerce Clearing House (1981, 1982, and 1984) publications provide details and explanation of the three tax bills enacted in those years.

Table 3.5 Changes in Budget Receipts, Fiscal Years 1982–90

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Receipts under laws in effect 1/1/81	650.8	656.0	749.4	821.3	822.5	873.9	1,002.6	1,088.2	1,167.3
Changes due to:									
ERTA (1981)	−35.6	−82.6	−136.8	−168.5	−170.3	−207.5	−264.4	−290.9	−322.8
TEFRA (1982)		17.3	36.0	40.7	39.2	49.2	57.3	55.7	57.2
Social Security (1983)		5.3	15.5	31.2	30.5	39.7	70.3	85.2	105.1
DEFRA (1984)			.9	9.3	9.3	16.0	25.4	27.7	31.0
TRA (1986)							−8.9	−24.4	−20.3
Technical corrections (1987)							11.4	16.9	18.7
Total receipts	617.8	597.5	666.4	736.8	734.0	776.4	908.7	975.8	1,057.6

Note: These figures are taken from selected rows of table 3 in Stewart (1991). Rows for administrative action and other small legislative changes are omitted here, but they are reflected in the last row for total receipts.

Stewart's explanation: "The first row of figures is an estimate of the amount of revenue that would have been generated in each fiscal year if no change to tax law had been made in the 1980s. Other rows gives estimates of the revenue gains or losses for that fiscal year attributable to the relevant change in tax law. For instance, if there had been no changes to federal tax law during the decade, then the federal government is estimated to have received $1167.3 billion in revenues during FY 1990. The net effect of the 1981 ERTA is estimated to be a loss of revenues during FY 1990 to the order of $322.8 billion. The net effects of changes to the 1981 ERTA itself are reflected in the estimates for the relevant subsequent tax laws; for example, the effects of rolling back the accelerated depreciation provisions of the ERTA that occurred in 1982 are reflected in figures for TEFRA."

Stewart's source: "Budget of the United States, FY 1982–1990. These are estimates provided in the annual budget documents, therefore they are subject to frequent revision. Therefore, these figures should be taken to represent ballpark figures, rather than hard-and-fast estimates."

least $200 billion per year after 1987. Then the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised revenue, by $50 billion per year after 1987.

Later sections of this paper discuss how ambiguities in prospective revenue estimates cause problems for debate about proposed tax changes, but these ambiguities apply even to retrospective estimates for past tax changes. Since nobody really knows how the economy would have evolved under prior tax law, the OMB estimates in table 3.5 simply apply the old law to actual economic magnitudes to get prior law baseline revenues for comparison with actual revenues. In contrast, Lindsey provides one attempt to estimate how various economic magnitudes would have been different under prior law. Without some of the incentive-induced increases in the tax base, revenues under old law would not have been as high as in these OMB estimates. Thus, "ERTA cost less than one-third as much as implied by the naively calculated direct effect estimate" (Lindsey 1990, 74).

Meanwhile, demographic trends were playing havoc with the pay-as-you-go Social Security system. Payroll tax receipts would be sufficient to cover retirement benefit payouts while the baby-boom generation was still working but might not be sufficient after that population bulge was retired. In 1983, a "bipartisan" commission reached an agreement to restore the long-run health of the beleaguered system, through moderate increases in current payroll taxes and transfers from general revenue to build a temporary "surplus" in the trust fund. The effect starts small, as shown in table 3.5, but grows to $100 billion per year by 1990.

The next large tax increase was the Deficit Reduction Act of 1984 (DEFRA, to rhyme with TEFRA). It was raising only $25 billion per year by 1988, but it required many more pages than any of the previous bills. Just a list of the table of contents gives some idea of its breadth: tax changes affecting individuals, tax provisions affecting business, foreign sales corporations and foreign tax provisions, private foundations and exempt organizations, leasing, retirement plans and other employee benefits, tax shelters and related transactions, straddles, life insurance provisions, estate and gift taxes, tax-exempt obligations, administration and compliance, and excise taxes. Each of these chapters has twenty or thirty subheadings.

Among other changes, DEFRA raised the depreciation lifetime for structures from fifteen to eighteen years. Another bill the next year raised this life to nineteen years.

Legislators during this period were forced by the deficit to raise taxes, and they were forced by political realities to raise taxes on somebody who was "hiding" some special deal buried in the tax law. The general approach was to scour the tax code for provisions that were obscure rather than blatant. Policymakers could not increase rates or hit a popular personal deduction, but they could hit a "loose" provision that had been allowing some rich person to avoid paying tax (see Minarik 1897, 1359). Thus, tax policy came to be made

in a fashion that is the *exact opposite* from the previous era. Up until 1981, Congress could return excess tax revenue, and undo the projected surplus, by granting new special exemptions or deductions. After the rate cuts and indexing of ERTA, Congress needed to undo the projected deficit by deleting such special provisions. Thus, deficit reduction also leveled the playing field.

Tax reformers such as Stanley Surrey and Joe Pechman had for years decried the practice of opening new loopholes that erode the tax base and create unfair disparities in the taxation of otherwise similar individuals. The basic political and economic forces were not in their favor, however, until the 1981 bill provided the logical extreme of such practices. It was the reductio ad absurdum of opening loopholes. But the sleeper was the indexing provision, as it would force policymakers thereafter to close loopholes instead.

This deficit-driven policy-making has advantages and disadvantages. Many of those interviewed think that it puts far too much emphasis on revenue considerations rather than other policy considerations. Some "good" tax policy changes might actually lose revenue. If so, they can't get enacted. On the other hand, given all the "good policy" reasons of Surrey and Pechman for closing various loopholes, deficit-driven policy-making might well create better policy. Indeed, the whole point of the indexing provision was to put fiscal discipline into the tax policy-making process. Congress should be run like a corporation for which raising funds must be recognized as costly and spending funds must be demonstrated as worthwhile.

At least two books and many articles have been written in attempts to explain how the Tax Reform Act of 1986 was able to reverse previous practice, take on the special interests, close loopholes, and provide true reform (see, e.g., Birnbaum and Murray 1987; and Conlan, Wrightson, and Beam 1990). It was indeed important legislation. But the direction of tax policy-making had really changed by 1981. As we shall see in the next section, the many diverse and arcane base-broadening provisions of the 1986 act were very similar in nature to the earlier revenue-raising provisions of 1982–85.

3.4 The Level Playing Field

Various political and economic forces were still coming at the tax code from different directions, to be sure, but they were beginning to push it together instead of pulling it apart. Perhaps four developments were most important. First, supply-side theory continued to affect tax policy. Calls were heard for a "flat tax" that would put all taxpayers together in the same low tax bracket with absolutely no deductions other than those needed to define income. Since total federal individual tax revenues were about 11 percent of personal income, one naive approach would simply define a broad tax base equal to personal income, tax it at 11 percent, and get at least the same revenue. The low rate would be a tremendous boost for incentives to work and to save. A problem, of course, is

that some components of personal income would be difficult to tax. Also, this extreme version of a flat tax would greatly increase the burden on poor and low-income taxpayers while greatly reducing that on high-income taxpayers. A "modified flat tax" (on consumed income) with a large personal exemption and a single tax bracket of 19 percent is fully described in Hall and Rabushka (1983).

Second, the tax system had become inordinately complex. In addition to complaints from taxpayers in all kinds of situations, there were estimates from economists that

> the average compliance time comes to 21.7 hours, valued at $231, and $44 in additional expenses, for a total of $275 per household. Applying the reweighted averages to an estimated 97 million taxpaying units in 1982 yields aggregate estimates of 2.13 billion hours and a total resource cost of $26.7 billion. This cost is approximately 1.4 percent of aggregate adjusted gross income, and more than seven percent of total federal and state income tax revenue. (Slemrod and Sorum 1984, 465)

This is only an average. Since most taxpayers took less than twenty-one hours to fill out the short form for a return with the standard deduction, other taxpayers must have had to take much more than twenty-one hours. Many had to fill out ten or twenty forms just for one return. In contrast, a modified flat tax such as that in Hall and Rabushka could be filed once a year on a postcard.

Third, public confidence in the tax system was further undermined by reports about corporations and high-income individuals paying no tax. In October 1984, Robert McIntyre and his Citizens for Tax Justice calculated the average effective tax rate for 250 large profitable corporations in years 1981–83. He found that 128 paid *no* federal income taxes in at least one of these three years and that seventeen paid no taxes in all three years. For example, "The single biggest gainer from the 1981 legislation was Ronald Reagan's former employer, General Electric. GE earned $6.5 billion in pre-tax domestic profits over the three years, paid not one cent in federal income taxes, and claimed tax refunds of $283 million in taxes paid before Reagan took office" (McIntyre 1984, 2). Many of these companies used safe-harbor leasing to avoid paying tax, but the repeal of safe-harbor leasing in 1982 did not come fast enough to avoid the attention to other problems with the corporate tax brought by the intense media coverage of this report.

For individuals, the U.S. Department of the Treasury (1985) examined the 1983 returns of taxpayers with "total positive income" over $250,000 per year and found that 64 percent reported "losses" from partnerships, subchapter S corporations, rental and royalty activities, farms, and businesses. Of this entire high-income group, 11.4 percent had tax liability that was less than 5 percent of income. Another 9.8 percent had effective tax rates between 5 and 10 percent, and 32.0 percent had tax rates between 10 and 20 percent. The public

decided, correctly, that such a system was just not fair. Thus, the "horizontal equity" version of the level playing field meant that taxpayers in the same economic circumstances ought to have to pay the same tax.

Fourth, economists both in and out of academe were calculating marginal effective tax rates of the sort shown above in table 3.4, with huge disparities between different types of assets or financing. Perhaps the major source of these differences was the investment tax credit (ITC) that was available for equipment but not for other investments of the firm. To economists, these disparities did not present a problem of equity, for no one ought to be concerned with the "fair" treatment of a machine relative to a building. Equity is an issue only among individuals. In equilibrium, individuals must be earning the same net-of-tax rate of return on a machine as on a building because otherwise they would invest more in the favorable asset until net returns *were* equalized. Instead, the problem was one of economic efficiency. If net returns were equal and effective tax rates were not, then the differences must show up in gross rates of return on these assets. Thus, some assets must be more productive, to cover a high effective tax rate, while other assets could be less productive and still yield the same net rate of return to the investor. The tax system was "distorting" the allocation of resources, as it encouraged *more* investment in the asset that was *less* productive.

Even with a fixed total stock of capital, according to this argument, total output would increase by taking investment away from the asset with the low gross rate of return and putting it into the asset with the high gross rate of return. Moreover, just such a reallocation would be induced by leveling the relative tax treatment of different assets. It was sometimes difficult for economists to explain this efficiency version of the level playing field, however, so they did not always object to the perception of inequity created by disparate treatments of different assets or firms.[26]

This efficiency argument rejects implicit industrial policy, the notion that government knows better than private firms what assets are the most productive. But the investment tax credit was not always conceived as industrial policy. In 1964, it was primarily a temporary macroeconomic tool used to stimulate aggregate demand. The ITC was repealed in 1969 and reintroduced in 1971. Perhaps it made sense to limit a temporary ITC to equipment, where stimulus could have immediate effect, and to exclude buildings, where lags might delay the effect of the stimulus until after the need was long gone. This logic was lost, however, when the ITC became permanent in 1975. It then

26. The confusion of these two concepts is interesting in itself. I would have expected economists to emphasize efficiency arguments for a level playing field and others to voice the equity arguments. Certainly members of Congress were heard discussing the equitable treatment of different assets or firms. But these comments may have been directed at the lay public. In the interviews for this paper, a surprising number of noneconomist policy-makers described very accurately in their own words the economic efficiency argument for a level playing field.

became a microeconomic tool that influenced not just the amount but also the type of investment.

This free-market approach of economists should not be oversold as a driving force for tax reform. At best, the gains in economic efficiency would be small for all taxpayers. More certainly, the cost of lost credits would be large for particular taxpayers. Also, the playing field could never be completely level as long as owner-occupied housing retained its untaxed treatment. Besides, Congress was not about to reject the government's influence over the allocation of resources. Provisions of the tax code were *intended* to influence homeownership, charitable contributions, retirement savings, corporate research and development, pollution control, and other worthy causes. Instead, the point is simply that such provisions had been overextended through the years. Shelter organizers were able to attract investors to projects that had little or no economic return, only tax advantages. It was merely a happy coincidence for economists that their view about the inefficiency of disparate effective tax rates seemed to mesh with the more populist view about the inequity of disparate effective tax rates. It was clear that investments were misallocated, simply because so many high-income individuals and corporations were paying no tax.

Several issues of perennial interest to tax reformers are distinctly absent from the list given above of developments affecting this new climate for tax reform. In particular, this list excludes the classic argument that loopholes for the rich should be closed in order to restore the "intended" degree of progressivity given by the graduated marginal rate structure (see Musgrave 1987; and Pechman 1990). The list excludes consideration of revenue. It excludes perennial (and therefore "traditional") arguments about the remaining effects of inflation on the measurement of taxable income and the double taxation of corporate-source income. Senator Bill Bradley was probably the first member of Congress to grasp the new climate for tax reform. In his first term as senator, he devoted considerable energies to fashioning a comprehensive tax reform plan, cosponsored with Representative Dick Gephardt and introduced as the Fair Tax Act of 1982. He considered the classic arguments for tax reform and rejected them. He did not propose further indexation for inflation or integration of corporate and personal taxes. He decided not to try to close loopholes in a way that would raise the aggregate burden of high-income taxpayers. Indeed, he decided not to raise revenues at all or even to change the distribution of tax burdens. The reasons for such a strategy may seem obvious now, namely, lower marginal rates, less complexity, more similar tax burdens for those in the same income group, and a more efficient allocation of resources. But consider how his colleagues must have wondered at the time. If this proposal does not change the amount of tax paid in total or by any particular income group, then why bother? Put bluntly, "Simplification for the sake of simplification is to beat your brains out and go through the whole process and then end up without a

dime's dent in the deficit" (Senator Packwood, quoted in the *Washington Post*, 30 November 1984).

The Bradley-Gephardt proposal was a modified flat tax in the sense that it would eliminate a long list of "loopholes," broaden the base, and reduce marginal tax rates to only three tax brackets of 14, 26, and 30 percent. Major personal deductions were retained, such as home mortgage interest, charitable contributions, and state and local income and property taxes, but they applied only against the 14 percent rate. The return would not fit on a postcard, but filing would be simpler because many taxpayers would use the enlarged standard deduction. Other forms were eliminated altogether. Taxes would rise for shelter abusers and fall for others. The plan would repeal the ITC and reduce the corporate rate to 30 percent but leave corporate taxes unchanged.

There seemed to be much discussion of modified flat rate proposals, but nobody seemed to know quite how to forge the right coalition. The Bradley-Gephardt plan was not taken too seriously. Yet the Reagan reelection campaign was apparently afraid that Walter Mondale would endorse Bradley-Gephardt and steal the issue for the Democrats. Given the president's long-standing desire to reduce marginal tax rates, they decided to preempt the Democrats in the February 1984 State of the Union address by having him order the Treasury Department to conduct a "study" that would not be due until after the election. Then, as it turns out, Mondale never got close to endorsing Bradley-Gephardt.

The ensuing debate involved several years, many interesting personalities, and umpteen versions of tax reform. Besides Bradley-Gephardt and the Republican plan called Kemp-Kasten, the public had opportunities to examine the Treasury proposal, the President's proposal, Rostenkowski's "staff option," the House bill, Senate Finance Committee Chairman Bob Packwood's staff option, and the Senate bill as well as the final conference agreement signed as the Tax Reform Act of 1986. The political interactions of these policymakers and their various proposals have been fully described elsewhere (see Birnbaum and Murray 1987; and Conlan, Wrightson, and Beam 1990), so I will try to touch on a few issues of particular interest.

Because of the political ploy of ordering a "study" to be completed after the election, tax experts at the Treasury Department were given a rare opportunity to craft a very apolitical document. White House officials did not even want to know what was in it. Within this ivory tower environment, economists had an unusual say in the formulation of the plan. For this reason, many other economists were surprised that Treasury economists did not propose a consumed-income tax that would allow a deduction for all savings and expensing of all investment. It would reduce the cost of capital, set all marginal effective tax rates to zero, and remove problems measuring real income. McLure and Zodrow (1987, 40–41) list several reasons for rejecting a consumed-income tax, but the most compelling is that it would have to include all borrowing in

the tax base.[27] The public was simply not ready to accept the idea of paying a tax on borrowed funds that did not even represent income to the taxpayer (see Regan 1988, 206). Instead of including all borrowed funds, a consumed-income tax could disallow all interest deductions, but public acceptance of this idea was no easier.

Even within an income tax, some economists in the Treasury wanted to allow expensing for investment. Without including borrowing in the tax base or disallowing interest deductions, however, expensing would make marginal effective tax rates negative: for a debt-financed investment, the firm would get to deduct both the value of the asset and the normal return on it. Expensing by itself would cost considerable revenue and not fix problems with shelters.

Thus, the decision was made to design a more comprehensive income tax base. The Treasury followed the new logic of tax reform insofar as it wanted a plan that was revenue neutral, distributionally neutral, and simpler, one that would equalize the tax treatment of individuals in the same income group (the equity version of the level playing field) and equalize the tax treatment of different types of investment (the efficiency version of the level playing field). Among other provisions, the Treasury proposal would have eliminated percentage depletion, expensing of intangible drilling costs for oil and gas, expensing of many expenditures in multiyear production, the exclusion for most employee fringe benefits, the deduction for state and local taxes, and the entire minimum tax. It would have substantially increased the personal exemption.

As in Bradley-Gephardt, the original idea was to be revenue neutral for individuals and for corporations considered separately. When all the tough choices were made about which credits and deductions to eliminate, these constraints initially led to three personal rate brackets of 16, 28, and 37 percent. This result was a bit of a disappointment since lower rates had been hoped for. When the same process of base broadening was conducted on the corporate side, enough new revenue was generated to reduce the corporate rate all the way to 28 percent. This base broadening included the repeal of the investment tax credit and a depreciation scheme that was based on economists' estimates of real economic depreciation (Hulten and Wykoff 1981).

Officials in the Treasury had two major problems with this outcome. First, Secretary Don Regan had an aesthetic problem. He thought that the personal rates of 16, 28, and 37 percent were cumbersome. He wanted something simple and catchy like the earlier Kemp-Roth 10–10–10 or the Conable-Jones 10–5–3. "Give me 15–25–35," he ordered. Second, attorneys in the Treasury had a legal problem. With a rate as low as 28 percent, the corporate tax might become a shelter that allowed high-income individuals to incorporate them-

27. See n. 19 above. The taxpayer must be consuming all income and all borrowed funds, minus any monies put into various forms of savings and investment. Thus, the inclusion of borrowed funds would be offset immediately by a deduction if they were used to make an investment.

selves, pay the 28 percent rate, and avoid the higher 37 percent personal rate. The corporate rate and the top personal rate needed to be closer together. The obvious solution to both problems was to lower the personal rates to 15–25–35 and make up the revenue by raising the corporate rate to 33 percent.[28]

Thus was born the proposal to shift $150 billion of burden over five years from individuals to corporations. The Treasury had an aesthetic problem and a legal problem, operating in a relatively apolitical environment. The solution was a political master stroke. All subsequent versions of tax reform retained a similar shift of at least $100 billion over five years, for good political reasons. It allowed tables of estimated distributional effects to show a tax cut for *every* personal income group, even in the revenue-neutral bill. Otherwise, the table would have to show some tax increases to offset any group that received even a small net tax cut. Everybody knew that individuals somewhere bear the ultimate burden of corporate income taxes, but most simply ignored it.[29] Besides, as pointed out earlier, the corporate tax had fallen from 30 percent of federal revenue in 1954 to 6 percent of federal revenue in 1983. Perhaps this trend had gone too far.

Would President Reagan recommend a corporate tax increase of this magnitude, after just pushing the largest corporate tax decrease in history? For the success of tax reform, the device was brilliant, like Nixon going to China. On the other hand, it is not clear whether Reagan confused the cut in the corporate rate with the increase in the corporate burden. The day after praising the Treasury plan in his 1985 State of the Union address, Reagan was interviewed by the *Wall Street Journal* (8 February 1985): "The president said he hadn't studied the plan in sufficient detail to realize that it sought an increase in the relative tax burden on business. Moreover, he suggested that taxes on corporations are merely passed on to individuals anyway. 'Someday,' he said, 'I would hope that we could arrive at a tax structure that would recognize that you can't tax things, you only tax people.'"

Following Bradley-Gephardt, the U.S. Department of the Treasury (1984) proposal adopted the new logic of tax reform. It was revenue neutral, distributionally neutral, and leveled the playing field. Unlike Bradley-Gephardt, however, it did not eschew traditional tax reform issues. It addressed the integration of corporate and personal taxes by providing firms with a deduction for 50 percent of dividends paid. It addressed the problem of inflation in measuring real income by providing indexation of interest, depreciation, and capital gains.

28. Note that the corporate rate could have been raised without affecting the overall corporate burden, e.g., by allowing more accelerated depreciation. By this time, the Treasury experts were wedded to the idea of a tax on comprehensive economic income, however. Given the "ideal" tax base, a higher rate necessarily meant a higher burden. For more discussion of the reasons for this shift, see McLure (1986, 1643).

29. The distributional burdens of corporate tax changes are estimated by Feldstein (1988).

Some of these provisions made the proposed law more complex rather than simpler.

Moreover, these problems with inflation simply do not have the same kind of effect as bracket creep. With fixed nominal tax brackets, *any* rate of inflation would keep raising taxes as a percentage of income by continuously pushing individuals into ever higher brackets. Thus, the indexing of brackets in the 1981 bill was crucial to the subsequent making of tax policy in of deficits. These other problems are different. Inflation does reduce the real value of depreciation deductions, and it thus takes the effective tax rate to a new higher level. However, a constant rate of inflation does not *keep* raising the effective tax rate beyond that level. Similarly, the taxation of purely nominal capital gains and nominal interest raises real taxes to a higher level. In these cases, an increase in the rate of inflation will increase the tax, but a decrease in the rate of inflation will decrease the tax. Any given level of inflation could be offset by ad hoc adjustments such as accelerated depreciation or an exclusion for part of capital gains.

Thus, the point of these additional forms of indexing in the Treasury proposal was to account automatically for variations in the rate of inflation. The effective tax rate would be invariant to the rate of inflation, only with indexing for depreciation, interest, and capital gains. It was a traditional economist's type of reform, of no interest to Congress or constituents.

In fact, economists have long wondered why businesses do not show more interest in these forms of indexation. After all, the increase in later years' depreciation deductions to account for inflation would raise the present value of allowances and thus reduce the cost of capital. While businesses would rather have indexation than nothing, the relevant choice is usually between indexation and acceleration. For a given revenue cost, acceleration provides deductions that are earlier and more certain. Businesses see indexation as a provision that could subsequently be repealed by Congress, thus providing lower benefits than were expected at the time of investment. Moreover, traditional accounting practices are dominated by nominal magnitudes. Accountants are uncomfortable with deductions that are uncertain in nominal terms, even if they are more certain in real terms. Similarly, businesses showed little interest in the deduction for dividends paid.

For better or worse, these traditional reform provisions for indexing and integration did not survive the new climate for reform. The 50 percent dividend deduction was cut to 10 percent by the president's proposal, delayed by the House bill, and dropped by the Senate bill. Interest indexing was deemed unworkable and did not appear in any version beyond the Treasury plan. Capital gains indexing was modified by the president's proposal and dropped thereafter. Finally, depreciation indexing was retained by the president's proposal, cut by the House, and dropped by the Senate (see the details given in exhibit 3.1).

The Treasury proposal was also criticized for raising the cost of capital. Even though the corporate rate was reduced from 46 to 33 percent and allow-

Exhibit 3.1

Depreciation indexing, a case study in policy-making

The basic economic argument for depreciation indexing is that policy should decide the level of tax revenue and investment incentives, without interference from changes in the rate of inflation. The Accelerated Cost Recovery System enacted in 1981 was intended, in part, to offset the extraordinarily high rates of inflation at the time. But, when inflation fell dramatically, accelerated allowances were *more* generous than required to offset inflation. Indexing would maintain the real value of deductions whatever the rate of inflation.

At the Treasury in 1985, I might have expected noneconomist policymakers to reject these arguments, but I did not expect trouble from economists as well. Once interest indexing was rejected as unworkable, economists at the Joint Tax Committee argued that the system would be unbalanced with one and not the other. The advantage of deducting inflation-bloated interest payments was approximately offset by the disadvantage of deducting inflation-eroded depreciation allowances. The Treasury countered that, if they were in the same tax bracket, the lender's extra tax would exactly offset the borrower's benefit, so depreciation should be considered separately. The economists responded that lenders were generally in lower tax brackets than borrowers.

Rostenkowski's staff option ignored depreciation indexing, but the Treasury came up with a partial plan that indexed allowances for 80 percent of the extent to which the rate of inflation exceeded 5 percent. It had no estimated revenue implications since projected inflation was less than 5 percent, but Congress was still uninterested. We prepared all the economic arguments for indexing, with all the charts and graphs, and drove to Capitol Hill to meet with the Ways and Means task force on depreciation headed by Richard Gephardt. We never got to discuss it. When the issue arose, Gephardt simply said that Rostenkowski had talked on the phone with James Baker while we were driving over. Baker had made a plea for this partial indexing plan, and Rostenkowski had agreed to 50 percent of inflation over 5 percent. It was a done deal.

The Treasury Department worked more closely, in some ways, with the Republican Senate and managed to get depreciation indexing into Packwood's staff options. Senator Danforth, a Republican on the Finance Committee, got it taken out altogether. Even later, the issue had some appeal to Deputy Treasury Secretary Richard Darman, but not for economic reasons. He simply saw it as a way to reduce the cost of capital with most of the revenue cost outside the five-year budget window. Darman had become known for a certain sleight of hand, so I even tried suggesting to him that we support the right policy for the wrong reason: by slowing down allowances but indexing at the same time, we could *reduce* the cost of capital and *raise* revenue in the five-year budget period. Still it didn't fly.

ances were indexed, the ITC was repealed and asset lives lengthened.[30] Typical were the comments of the Chamber of Commerce (1984, 1): "This increased tax wedge on capital income would reduce capital investment and, consequently, harm economic growth rates, reduce U.S. international competitiveness and exacerbate the federal deficit. . . . [It] constitutes a reversal of the pro-growth policies inaugurated in 1981."

Finally, all these "modified flat tax" proposals could be criticized for offering false rate reduction. Consider, for example, a world where all compensation is always paid 80 percent as wages and 20 percent as fringe benefits and where wages are subject to a tax rate of 50 percent. A revenue neutral reform could then broaden the tax base to include all fringes and reduce the tax rate to 40 percent. Yet it would have absolutely no effect. If the ratio of fringes to wages is fixed, as assumed, then 40 percent of compensation is paid in tax before the reform as well as after. The rate reduction is more effective if fringes are fixed as work effort responds. The overall effect depends on the flexibility of all tax advantages such as fringe benefits, interest deductions, and charitable contributions.

Thus, the release of the Treasury proposal in November 1984 was accompanied by acclaim from many economists and traditional reform advocates, alarm from businesses and capital formation advocates, and yawns from the general public. Senator Bob Packwood, the chairman of the Finance Committee, said, "I sort of like the tax code the way it is" (*Washington Post,* 30 November 1984). Secretary Regan quickly noted that his proposal "was written on a word processor. It can be changed" (*Washington Post,* 8 December 1984).

The next most crucial step in the progress toward tax reform was the January 1985 job switch by Donald Regan and James Baker. It put an advocate of tax reform next to the ear of the president and a savvy politician in charge of the main tax reform effort. The president did not really need to be convinced, however, as he was always in favor of lower tax rates. With some misgivings, the administration decided to make tax reform the primary domestic policy initiative of Reagan's second term. So the new Treasury secretary Baker and Deputy Secretary Richard Darman set about trying to make the proposal more acceptable. Besides reducing the traditional reform provisions for indexing and integration, they provided better investment incentives through acceleration of depreciation allowances. They restored tax breaks for oil and gas, fringes, and some other popular benefits. In order to keep the personal rates at 15–25–35,

30. The marginal effective tax rate in the corporate sector was 29 percent under 1985 law and would rise to 43 percent under the Treasury proposal, as estimated by Fullerton (1987). Considering components separately, the 29 percent rate would rise to 41 percent with just interest indexing, would rise to 40 percent with just repeal of the ITC, would fall less than 1 percent with just the full taxation of real capital gains, would fall to 28 percent with just the deduction for half of dividends, and would fall to 27 percent with just the personal rate cuts. It would *rise* to 30 percent with just the corporate rate cut because the reduced tax on equity is more than offset by the reduced advantage of nominal interest deductions. Under the same assumptions, this effective tax rate is 34 percent under the president's proposal.

they recouped some revenue through a tough additional minimum tax. Then a last-minute computer snag left the new proposal still significantly short of revenue. Thus was born the "windfall recapture tax" proposal to raise $56 billion over the five-year budget period. The logic was that firms had already made investments to earn income that they had expected would be taxed at the 46 percent rate, so the reduction to a 33 percent rate provided an unexpected windfall that could be recaptured. On the release of the president's proposal in May 1985, this provision caused the biggest stir. It was viewed as a retroactive tax and therefore unfair.

When I was asked to speak to various groups about the tax reform process, I used to bring with me a balloon that I would underinflate to fit in the palm of my hand. "The revenue needed for neutrality with current law is like the air in this balloon," I would say, "and each of the other demands on the tax system is a constraint, like pressing on one part of the balloon." When I pressed one part of the balloon, I got a bulge sticking out somewhere else. The pressure to reduce rates to 15–25–35 created in the Treasury proposal a bulge in the form of "economic" depreciation allowances that were viewed as inadequate to provide basic incentives for capital formation and competitiveness. The pressure to accelerate those allowances in the president's proposal just pushed the bulge somewhere else, primarily in the form of the windfall recapture tax.

Dan Rostenkowski, chairman of the House Ways and Means Committee, accepted the president's challenge to push tax reform. Actually, he thought that it was based on solid Democratic principles of fairness: it would take the poor off the tax roles, remove shelters for the rich, and raise corporate taxes. Democrats could hardly reject such suggestions. Then, in the committee markup during the fall of 1985, Rostenkowski was under considerable pressure to restore several tax breaks, primarily state and local tax deductions. He also dropped the recapture tax. The result was a major bulge in personal tax rates, with the top bracket reduced only to a 38 percent rate. The House bill also did not provide the full $2,000 exemption that was viewed as important to take those below the poverty line off the tax roles. Finally, it shifted $140 billion over five years from individual to corporate taxes.

House Republicans objected, and they managed to stop the entire bill on a procedural rule. The primary domestic policy initiative of the president's second term was killed by lawmakers in his own party. It was resurrected only when President Reagan traveled to Capitol Hill. He encouraged Republicans to keep tax reform alive and vote for this bill by promising to *veto* it if adequate changes were not made in the Senate. H.R. 3838 limped through on a voice vote in December.

Robert Packwood, Republican chairman of the Senate Finance Committee, had no real interest in taking up tax reform at all. Quotes given above indicate that he liked the existing tax code, saw no point in simplification for its own sake, and had greater concern about the deficit. However, he could not let the Republican president's major domestic policy initiative die on his doorstep. He

made up yet another set of staff options for the Finance Committee deliberations. In order to suppress the personal rate bulge and the corporate tax bulge, Packwood's staff options suggested disallowing deductions for business payments of excise taxes. But the air of the balloon was simply pushed out into a new bulge. This veiled increase in excise taxes was preferred to the increase in corporate taxes by some lawmakers, but it violated accepted practices of measuring net income by the difference between gross income and legitimate business expenses such as excise taxes paid. It did not survive the markup. Moreover, senators on the committee were quick to restore many tax breaks that they themselves had devised in past years, from municipal bonds to natural resources. The coup de grâce was an accelerated depreciation scheme for "productivity property" that allowed lawmakers to pick and choose which assets in which industries were to be deemed "productive" enough to warrant special treatment. The revenue cost was not as big a problem as the symbol: this concept flew in the face of the entire spirit of tax reform that would level the playing field and leave profit-maximizing firms with the task of deciding which were the best investments. It was business as usual, a depreciation scheme written by Charls Walker and Ernest Christian, the same corporate lobbyists who had devised the earlier ACRS in 1981 and even ADR in 1971.

With a revenue hemorrhage on his hands, Chairman Packwood decided to stop the markup. On Friday, 18 April, Packwood had his famous two-pitcher lunch with Chief of Staff Bill Diefenderfer at the Irish Times. They discussed the impending death of tax reform, a possible minimalist strategy of closing a few loopholes to get some rate reduction, and an alternative, more dramatic strategy. What would really make tax reform attractive, they reasoned, would be *very* low rates. If the top rate were only 25 percent, for example, then maybe taxpayers would not mind losing a few deductions. What would it take to get rates that low? Joint Tax Committee Chief of Staff David Brockway was asked to devise a new plan altogether. He returned with no state and local tax deduction, no mortgage interest deduction, and no charitable contribution deduction but a top rate of 25 percent.

This plan became the starting point for a "core" group of seven senators who showed some interest. They "spent" a point or two of rate reduction to add back most of those key, popular personal deductions. Since the low top rate created a huge tax cut for high-income brackets, and since the bill was intended to be approximately distributionally neutral, they accepted other changes that would raise the tax on high-income individuals such as the full taxation of nominal capital gains and the disallowance of some "passive losses." These hits were not easy to take, but finally the balloon was starting to assume a round shape.

The Finance Committee ended up with a 27 percent rate, an income range over which the benefits of exemptions and the lower 15 percent rate bracket were phased out by a 5 percent surcharge, and a unanimous 20 to 0 vote for tax reform. The full Senate passed it 97 to 3. The conference with the House

required enough revenue-losing modifications to require a top rate of 28 percent. With the 5 percent surcharge over the phase-out range, the maximum marginal rate was actually 33 percent. The president signed the bill on 22 October 1986.

3.5 Some Final Remarks

The Tax Reform Act of 1986 was a very intricately constructed package of provisions, each of which depended on the others. The original "supply-side" idea of greater incentives gave the motivation for lower rates, but the era of "deficits" implied that these rate reductions must be paid by base broadening and a "level playing field."

Plenty of criticisms were leveled at the legislation, but mostly they were attempts to take some of the interwoven provisions without others. "We like the lower corporate rate, but we don't like the slower allowances." As this oversimplified example makes clear, you can't have one without the other. In particular, many complaints were heard about the full taxation of nominal capital gains. Certainly, there are good reasons for a capital gains exclusion or at least for indexing in order to tax only the real capital gain. But this imperfect provision was a necessary price of the package since it was the only way to keep the percentage tax cut in the top income group *down* to one digit. Even then, lower-income groups received smaller cuts. Similarly, neither the minimum tax nor the passive loss rule would be needed in a perfect system, but they were needed to achieve this reform. They raised revenue from existing shelters of high-income taxpayers, and they help prevent new shelters, as discussed below.

Others point to the anomaly that the marginal tax rate increases from 15 percent, to 28 percent, to 33 percent, but then falls back to 28 percent for the highest-income taxpayers. It does not seem fair to tax the richest at a lower rate than those less rich. However, while the marginal tax rate is important for the incentive to earn one more dollar, it has little to do with equity. Fairness is best measured by taxes paid as a fraction of income, the average tax rate. Since the first block of income is untaxed, someone in the 15 percent marginal rate bracket has a tax that is less than 15 percent of total income, and someone in the next 28 percent bracket has a tax that is less than 28 percent of total income. The stated purpose of the 5 percent surcharge in the penultimate income group is to "phase out" the benefits of the untaxed block of income and the 15 percent rate block of income, bringing the total tax *up* to 28 percent of total income. As soon as the average tax rate hits 28 percent, the 5 percent surcharge ends, and the taxpayer is back down to a 28 percent marginal rate. In other words, the average tax rate is always less than 28 percent until reaching the highest income level, where every dollar is taxed at 28 percent.[31]

31. This provision is similar to the maximum effective rate limitation of 1944–63, which capped the average tax rate below the 90+ percent top marginal tax rate (see table 3.1 above).

Still, why try to claim that the top rate is 28 percent instead of admitting the 33 percent rate and just extending it out to all taxpayers above a certain income level? In the first place, senators did *not* grant that the top rate was really 33 percent. Yes or no, they would ask, is it possible for anyone's tax to exceed 28 percent of their taxable income? No. In the second place, when senators were trading off key deductions against each percentage point of tax rate, as it increased from 26 to 27 and then to 28 percent, they were told that a 1 percent increase in the top bracket would raise about $30 billion over five years. In contrast, extending an official 33 percent rate bracket to those few taxpayers above the phase-out range would raise only about $25 billion over five years. It made no sense to these senators to enact a 5 percentage point increase in the top rate to raise $25 billion when a 1 point increase in the top rate would raise $30 billion.[32]

Another question is whether Congress went too far in attacking shelters, the "whipping boy" of tax reform. First, rate cuts would make shelters less attractive simply by reducing the tax saving from sheltering a dollar at the margin. Second, longer lives for both equipment and structures would chip away at the basic building blocks of which shelters are constructed. Third, the capital gains rate hike would make the conversion of ordinary income into capital gains income irrelevant. Fourth, at-risk rules were tightened. Fifth, the passive loss rule was designed specifically with shelters in mind. Finally, the tough new alternative minimum tax would keep any taxpayer from overusing what was left of any tax shelter arrangement. Was this overkill? In combination, these features are guaranteed to stop pure shelter arrangements.[33] And, once a shelter is stopped, each additional hit is no longer relevant. The passive loss rule may be important in preventing pure shelter arrangements, but it acquires little long-run revenue because virtually nobody goes so far as to pay it.

Although more taxpayers were induced to use the standard deduction instead of itemizing, these antishelter and other provisions helped keep the final bill far from a "simplification." But that goal was a bit of a red herring anyway. (For an opposing view, see McLure [1990a]). Uninformed taxpayers thought that simplification meant having two rate brackets instead of eleven, although calculating taxable income is a much tougher job than using taxable income in the rate tables to figure the tax. Also, the media used "simplification" to summarize *other* aspects of tax reform.[34] Simplification was primarily important to the extent that the average taxpayer thought that high-income individuals

32. Current estimates of the U.S. Congressional Budget Office (1990) suggest that a 1 percentage point increase in the 28 percent rate would raise $50 billion over five years while the extension of the 33 percent rate would raise $40 billion over five years.

33. McLure (1990a, 92) calls this the "vampire approach" to dealing with tax shelters: "In order to be safe when dealing with a vampire, one drives a stake through the heart, hangs a cross around the neck, places a mirror over the eyes, and fills the coffin with wolfsbane."

34. For example, the *Wall Street Journal* of 8 February 1985 repeatedly refers to the "Treasury's tax-simplification plan" and then defines the concept as "drastic tax-rate reduction for individuals and businesses coupled with elimination of a host of tax preferences."

were *using* complexity to avoid their fair share of tax. With nice simple digits like 10–10–10, 10–5–3, or 15–25–35 appearing throughout the decade, one might think that a reform needs to be, not simplification, but simple minded.

The first theme of this paper is the supply-side logic of personal marginal rate reductions. Rates were reduced not just in 1981 but again in 1986. President Reagan was able to leave office with the top marginal rate less than half what it was when he started. Some economic effects of these changes are analyzed in papers appearing in Slemrod (1990). Important associated effects on the distribution of tax burdens are not discussed much here, but evidence on the 1981 changes is debated in U.S. Congressional Budget Office (1987), U.S. House of Representatives (1990), and Lindsey (1990).

The second theme of this paper is the impact of deficits on the process of tax policy-making. Lawmakers now pay much attention to estimates of revenue impact. For a number of reasons, it seems like too much attention. First, each revenue estimate is only an estimate. It is an imperfect best guess made by an arbitrarily assigned estimator who uses old data, a set of arbitrary assumptions, and error-prone computer calculations. A different estimator could easily make other reasonable assumptions and get a different answer. Second, these revenue estimates are always relative to existing law, as if that were some valuable standard against which to judge all changes. There is *nothing* absolute about current law, for that is why changes are being considered in the first place. An example is the way that any indexing proposal appears to lose billions of dollars, relative to the tyranny of current law, when in fact inflation under current law might be *raising* billions of dollars of revenue more than was intended (see McLure 1986, 1645). Third, other good reasons to enact some tax change may be overwhelmed by the estimate of a revenue loss, given the difficulty of reducing each dollar of deficit. Fourth, the process has established five-year budget periods of absolute importance. Four years doesn't matter, or six years, or any kind of present value calculation. The process becomes incredible when minute details of several small provisions that each add $200 million of revenue are combined to pay for a big provision that costs tens of billions, with a reasonable error of plus or minus one or two billion.

These criticisms are quite valid, but what is the alternative? The process absolutely needs some kind of discipline. As Senator Pat Moynihan of the Finance Committee puts it, "Everyone is entitled to his own opinion, but not his own facts" (Birnbaum and Murray 1987, 275). There is no free lunch, and policymakers need a common language for communicating about the necessary trade-offs among alternatives. Indeed, the tax reform process really started working properly only when the "core" group of senators came out of their closed room not just with a new low-rate proposal but with a rule that amendments themselves must each be revenue neutral. Any lawmaker who wants some tax break must, for the first time, recognize its cost in terms of some other added tax. For another example, consider the differences in legitimate estimates of the revenue impact of a change in the capital gains rate. These

estimates are not even the same sign, let alone the same magnitude. When the rate was raised in 1986, the revenue estimate was positive. Later, other estimates showed that a reduction in the capital gains rate would raise revenue. Either is possible, but not both. The government cannot raise revenue by raising the capital gains rate and then raise more revenue by lowering it again. The procedures to provide and use revenue estimates can undoubtedly be improved, but, in the era of deficits, their importance is here to stay.

The last theme of this paper is the level playing field. Certainly, the equity version of the level playing field had a role in making sure that individuals in the same income group could not end up with very different tax burdens owing to shelters. This more populist version just happened to support the efficiency version that called for more equal marginal effective tax rates on different assets. Such calculations were popular in the early 1980s, but Merrill (1987) discusses several reasons that these economic models were of only limited importance to the actual policy debate. One such model, however, was used not only in academic research to evaluate alternative proposals in the early 1980s (see Fullerton and Henderson 1984) but also within the Treasury department to evaluate successive reform options in 1985–86 and later as the basis for calculations appearing in the *Economic Report of the President* in 1987 (pp. 87–90) and again in 1989 (pp. 92–93).

Looking over the decade of tax policy in the making, a question frequently asked is whether the Tax Reform Act of 1986 (TRA) was a reversal of the Economic Recovery Tax Act of 1981. When asked this very question, most interviewees responded immediately, "Yes, it was a reversal." Where ERTA accelerated depreciation and expanded the ITC, the 1986 act slowed down depreciation and repealed the ITC. One bill greatly reduced corporate taxes; the other greatly increased them. Then, after further reflection, or prompting from the interviewer, most added, "Well, I suppose that personal rate reduction was one aspect similar in the two bills." A significant minority of interviewees responded immediately, "No, it was not a reversal." Some thought that debates about both ERTA and TRA had an unusual concern with the structure of taxation (e.g., indexing) and not just revenues.[35] Others pointed immediately to the similarity of the rate reduction.[36]

To the extent that TRA did reverse ERTA, via depreciation allowances and corporate taxes, the reversal did not start with the 1986 bill. The more im-

35. Before Congress on 18 February 1981, in support of ERTA, Reagan said that "the taxing power of government . . . must not be used to regulate the economy or bring about social change." The same logic applied to TRA and the level playing field.

36. This question is addressed specifically by Fullerton and Mackie (1989). They measure the efficiency effects of both ERTA and TRA by using a simulation model that incorporates the intertemporal distortion of higher taxes on capital and the interasset distortion of differing effective tax rates. They find that, if one adopts the "new view" (that personal taxes on dividends are unimportant disincentives), then the reduced tax on capital in ERTA is more important for overall efficiency. But, if one adopts the "old view" (that personal taxes on dividends are important investment disincentives), then the level playing field and additional rate reduction in TRA are more important.

portant bill as a watershed in tax policy-making was the Economic Recovery Tax Act of 1981. The powerful forces of "supply-side" thoughts about incentives and rate reduction began with the 1981 bill. Indexing of brackets and the resulting "era of deficits" started with the 1981 bill. And the process of using the tax code to encourage or reward particular economic activities through various tax provisions culminated in the 1981 bill. Forever after, projected deficits (shown in table 3.3 above) required that these provisions be cut back or repealed. This new era of tax policy was in effect as of August 1981, but its first products were not evident until TEFRA in 1982 and DEFRA in 1984. These bills closed loopholes, slowed depreciation, and started to level the playing field. By 1986, in these respects, the Tax Reform Act of 1986 was simply more of the same.

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2. *Charls E. Walker*

I believe that the "why" (or the politics) of federal tax policy in the 1980s can best be explained in terms of three fundamental factors: (1) significant swings in what I call the *pendulum* of U.S. tax policy; (2) still another demonstration of the convention political science wisdom that presidents of one party can

often achieve policy goals that presidents of the other party cannot, goals that appear on the surface at least to be contradictory to the party's philosophy, culture, and/or constituencies; and (3) the emergence of a huge, politically intransigent federal deficit.

I shall deal with these factors out of order, starting first with the budget crunch. Don Fullerton has provided a good discussion of this factor in his background paper, so my remarks shall be supplemental and deal primarily with the politics of tax policy.

Tax Policy to Raise Revenue

Inasmuch as the fundamental purpose of a nation's tax system is to provide revenue, it may seem strange to single out this factor for special treatment with respect to the 1980s. The point is not that revenue raising is not essential but rather that it came largely to drive tax policy in the United States after 1981. The (misnamed) Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was a valiant if only partially successful effort to bring down the mounting federal deficit that emerged as a result of the spending and tax policies of the early Reagan years. Fullerton has given us a good blow by blow on TEFRA.

Perhaps the most important aspect of the emergence of revenue impact as the major driving force in tax policy—at least to "outsiders" (both outside and *within* the Congress) trying to affect policy—was that the professional revenue estimators on the staff of the Joint Committee on Taxation (JCT) (and, to a lesser extent, at the Treasury's Office of Tax Analysis [OTA]), and the members to whom they responded, became of overwhelming importance in any debate over specific tax provisions.

In one instance involving a Walker Associates client during the debate on and markup of TEFRA, we were almost certain that our proposed substitution for a very tough provision (from the client's standpoint) would at least be revenue neutral. The JCT reported otherwise, and we were not allowed to look into the staff's "little black box" and examine the assumptions and analysis that blew our proposal out of the water. The fundamental merit of our proposal was not even debated; we were killed by a staff revenue estimate. That is *not* good tax policy, and it is *not* fair.[1]

Is there an answer to this problem? In my judgment, the revenue estimators have much more power than they should have in our democratic system. It is the members who legally possess final power over revenue estimates (as my friend Russell Long demonstrated in the capital gains fight of 1978). One solution would be to emulate public policy in other difficult, technical areas and

1. The JCT staff has finally been more forthcoming—at least on one issue. It recently shared with the world at large its assumptions and analysis on revenue estimates during the recent capital gains debate. That's progress—although I think that the JCT staff estimates of the revenue impact of a capital gains cut are still too conservative, especially if scored on an overall macroeconomic basis.

transfer revenue estimating to an outside panel of carefully selected nongovernment economists—short of that, to set up a "National Academy of Science"–type nonpartisan panel of experts to review and critique the JCT and OTA revenue-estimating procedures. Neither of these steps seems to be even remotely close to the horizon.

Three other political points about tax policy and the budget crunch should be noted before I turn to the other two factors affecting tax policy in the 1980s. One involves decision making in Congress, the second relates to the basic forces to which Congress was responding, and the third shows how a voter uprising can quickly force Congress to reverse an earlier unpopular tax decision.

During his years as chairman of the Senate Finance Committee, Russell Long did all that he could to promote tax decisions on a collegial, consensus basis. This approach had a great deal going for it, especially during years in which, more often than not, we operated under divided government, with all its inherent difficulties. Partisan factors tend to be minimized under this approach.

But, when the new chairman of the committee, Bob Dole, began his effort to push through TEFRA in 1982, collegiality was thrown out the window. I don't say this to be critical of Bob Dole. I haven't talked to him about it, but I suppose that he simply wanted to get the job done, quickly, and without a lot of talk—perhaps Russell can enlighten us on that. In any event, the eleven Republicans on the committee would meet in private caucus, Dole would cut a deal, and the group would emerge (in most instances) as a solid phalanx, in effect telling the Democratic members, "Take it or else." It worked. But, not only did it make tax legislation less "fun," it also probably helped move us toward the excessive partisanship that finally emerged this fall in the efforts to construct an effective deficit-reduction package. If that's so, it's too bad. We direly need ways to make divided government work well today, as it did during the years of Eisenhower and even Nixon.[2]

My second political point involves the frequently made statement that the passage of TEFRA in a congressional election year proves that the need to bring down a mounting deficit can be a driving force in tax policy, causing members to vote against their constituents' desires. Not so. TEFRA passed, not because of the emerging deficit per se, but because the media convinced

2. This is neither the time nor the place to discuss the basic factors that have led to the budget fiasco of 1990. But I must note that the *Economist* seemed to me to be on the right track when it recently noted (after calling the summit agreement a "mouse") that one of the basic problems is that the U.S. system of government was invented 200 years ago and might not be quite suitable for the present—or at least need some significant changes. I strongly agree. The Founding Fathers, for good reasons at the time, insisted on checks and balances and a weak executive. Now that we have moved so far toward that type of plebiscite democracy that the Founding Fathers distrusted, with members voting more and more their constituents' desires even when they know they're wrong, the chief executive needs more power in the budget arena. Once he sends up his budget, he's technically "out of play" (unless he can motivate voters directly through his bully pulpit and congressmen through persuasion or political pressure), until what might be one final continuing

the voting public that the sky-high interest rates and collapsing stock market of 1981–82 were *caused by* the deficit—staunch the red ink, and the pain of ultra high borrowing costs and shrinking net worth would disappear.

If this view is correct—and you know that it is—then we can understand why nothing other than an inadequate weapon known as Gramm-Rudman-Hollings was used to attack the deficit until 1990, when George Bush decided (too late?) that he had better reconfigure his lips and get deficit reduction moving or else he would seriously injure his prospects for reelection in 1992. And, sad to state, when he made that move last May, and since that time, the "non-pain" federal deficit has continued to rise, thus dooming the chance to get a solid deficit-reduction plan voted by Congress only shortly before the 1990 election. As one member said in speaking against the first package, "Are we supposed to vote for legislation which includes our own death warrants?" Good question.

A second reason that TEFRA passed Congress in an election year is that it primarily hit corporations, not individuals. The biggest individual revenue raiser in the legislation was mandatory withholding of income taxes on interest and dividends—a provision on which, as noted below, Congress quickly turned tail. To be sure, everyone "knows" that people, not institutions, ultimately bear all taxes, but that knowledge seems to count for little in the political arena. In Russell's famous dictum of tax reform—"Don't tax you; don't tax me; tax that fellow behind that tree!"—the "fellow behind that tree" is frequently a faceless corporation.

My third political point about TEFRA is the just-noted and, to some, astonishing reversal of Congress on the TEFRA provision to force withholding of taxes on interest and dividends. That reversal didn't surprise me at all, and I doubt that it surprised Russell; we had gone through almost exactly the same thing in 1962. Withholding had passed the House as part of John Kennedy's "tax reform" efforts, but it went down the tube in the Senate (and Congress) as a result of a very effective (but dishonest) publicity campaign mounted by the U.S. Savings and Loan League. As executive vice president of the American Bankers Association at the time, and fresh out of the Treasury, I refused to join the league in the campaign—partly because the ads were dishonest, partly

resolution appears before him—a measure that he must sign or literally bring the government to a halt.

I'm not sure that I favor the line-item veto; it will not help in the crucial area of entitlements, could give an LBJ-type president huge power in bringing congressmen "around," and might impair national security policy when and if an overly "dovish" man or woman (e.g., George McGovern) occupies the presidency at a time when new weapons systems need to be developed. At the least, however, the president should have restored to him the recession and impoundment powers taken away in the Budget Control Act of 1974. Furthermore, can we not come up with some innovative but politically acceptable methods for the president, representing all the people, to exercise at least some control over growth of entitlements? I refer that tough question to Charles Schultze and David Stockman.

because I knew that they would kill withholding without the presence of organized banking's fingerprints.[3]

There are millions upon millions of voters who own savings accounts, receive dividends, and so on, and they detest the idea of withholding. The sponsors of withholding in 1982 like to blame the bankers and savings and loans (S&Ls) for the repeal of the provision in 1983. The banks and S&Ls might have speeded the process, but permanent withholding was not in the cards from the start. In fact, the banks and S&Ls did the politicians a favor by helping force its repeal *before* it could go into effect.

Events in 1989 demonstrate that powerful taxpayer uprisings can still carry the day and force reversals of earlier legislation. Cases in point are the provision of the Tax Reform Act of 1986 (TRA) that affected employee benefit programs (sec. 89), reversed as a result of a voter uprising (mainly small businesses), and the catastrophic health provisions enacted in 1988, shot down in flames by the elderly only a year later.

All in all, a revenue-driven tax policy can make life miserable for almost all parties—legislators, Treasury officials, interest groups, lobbyists, the whole crowd. Only the revenue estimators seem to prosper and perhaps be happy at such times.

The Tax Policy Pendulum

Let me begin to illustrate what I mean by the tax policy pendulum by quoting the final examination question on tax policy for my graduate students at the University of Texas at Austin last semester:

> In enacting the Tax Reform Act of 1976, Congress tried to move the tax system toward its image of "fairness" by raising taxes on business and on high-income individuals who enjoyed large capital gains. Only two years later, Congress passed the Revenue Act of 1978, which did just the opposite by cutting corporate tax rates, making "permanent" the investment tax credit, and—by means of the Bill Steiger/Russell Long amendment—slashing taxes on capital gains.
>
> Less than a year later, in the summer of 1979, Representatives James R. Jones (who had authored the House version of the 1978 bill) and Barber Conable, accompanied by such Senate worthies as Lloyd Bentsen, Gaylord Nelson, Bob Packwood, Jack Danforth, and Jack Heinz, introduced the "10–5–3" capital cost recovery bill, which, if passed, would cut corporate tax

3. Those of us who like to think of ourselves as politically astute frequently quote taxi drivers to make our points—and, indeed, it was a New York taxi driver who made the telling comment on withholding to me in 1962. When he found that I spent considerable time in Washington on legislative matters, he said, "Do you know what that damn John Kennedy is trying to do to me—and, to think, I voted for the guy?" "No," I replied. "What is that damn Kennedy trying to do to you?" "He's trying to pass a law that will take some of my money out of my savings account." "But don't you realize that you owe that money as taxes to Uncle Sam?" His response was short and telling: "Like hell I do!"

liabilities in half within five years. In less than six weeks, over 300 House members and some seventy-five senators had signed onto the legislation. Its significant features were enacted in 1981 as part of President Reagan's Economic Recovery Tax Act.

Finally, in 1986, Congress passed a Tax Reform Act, which repealed the investment tax credit; lengthened depreciation guidelines; eliminated the preferential tax on capital gains; sharply limited the individual retirement account provisions passed originally in 1981; and greatly reduced the attractiveness of "tax shelters."

Explain.

(Oh, how I hated that type of question in my graduate days. "Explain," indeed!)

What were student answers that I did not accept? That federal tax policy is simply and for no good reason unpredictable, swinging erratically with no discernible pattern. Or that Congress acted with uncharacteristic good sense and courage in 1976 and again in 1986, repulsing the greedy "Gucci Gulch" lobbyists in order to make the tax system "fair." Or, vice versa, that the good sense and courage was demonstrated in the 1978 and 1981 bills. None of these answers gained a passing grade.

The answer that I did accept was that the "pendulum" of U.S. tax policy had repeated past performance, making a one and a half swing from the "fairness" objective, which is fueled by voters' unhappiness with what they view as an unfair and oppressive federal income tax—to tax policy oriented toward economic goals—and back to "fairness" again. Let me explain in terms of my personal experience with U.S. tax policy.

Although my presence on the Washington scene runs back almost four decades, my direct concern with taxes began only in 1961, when the Treasury moved administratively to liberalize certain depreciation guidelines and John Kennedy proposed the investment tax credit (ITC) to Congress. Interestingly, JFK's call for the ITC "to get the country moving again" (one of his major campaign themes) and to enhance U.S. "international competitiveness" (yes, even then) was opposed by both the labor and the business communities. The American Bankers Association was a major exception; we applauded and worked for the ITC; I personally testified for it before Congress. Congress somewhat reluctantly approved it in 1962.

These first steps toward what I would call a *pro-capital formation* tax policy (which might now be called *supply-side*), strongly oriented toward economic goals, were followed by what was surely a major "supply-side" proposal in early 1963, when JFK called for slashes in both business and individual taxes, the latter closely resembling the Kemp-Roth tax cut of the late 1970s. The tax measure was bogged down in the Senate Finance Committee at the time of JFK's assassination, but LBJ broke it loose, and Congress enacted the bill in 1964.

The point here, as related to the pendulum of tax policy, is that the original JFK macro tax cut had also included a large number of "tax reform" measures

(defined solely in terms of "fairness"), in the image of, and prepared by, the dean of all such "reformers," Treasury Assistant Secretary Stanley Surrey.[4] The "reform" portion of JFK's proposal collided with the growth section, and, not surprisingly, growth won. After all, JFK had indeed promised "to get the country moving again." Add to that the skill and pragmatism of his Treasury team of Doug Dillon and Joe Fowler and the recognition by Council of Economic Advisers (CEA) Chairman Walter Heller and his associates that tax policy for growth was indeed important—well, economics won, and "reform" lost. As Russell will recall, JFK promptly dropped the reform elements from his package when they showed signs of dragging the whole bill down.

JFK could do this, without major political damage, because the "tax reform" crowd at the AFL-CIO, along with Stan Surrey and his disciples, would doubtless be sullen, but not really mutinous. Here we get close to the final factor in 1980s tax policy that I shall discuss below—what a president of one party can do that a president of the other cannot. More important in this instance, however, was the fact that, in 1963–64, the public was not nearly so unhappy with the federal income tax system as it later became. Bracket creep was still far down the road, tax shelters had not become a national scandal, and stories about big corporations or millionaires paying little or no federal taxes were not as yet front-page news.

By the time I took my second seat at the Treasury in January 1969—indeed, I should say that at almost *precisely* the time I took it—public unhappiness with the income tax almost exploded. Outgoing Democratic Treasury Secretary Joe Barr had done his successors the "favor" of telling Congress that many multimillionaires or even billionaires were paying little or no federal income taxes. At the same time, Stan Surrey's comprehensive swan song tax reform proposal was publicly released (rather than privately handed to us).[5]

The news of millionaires paying little or no federal income taxes rocketed around the country. A staffer told me that the Treasury received more gripe mail about income taxes in February 1969, following the Barr revelations in January, than in all of 1968. The ranking Republican on the House Ways and

4. I use quotation marks when referring to "tax reform" because, as Webster tells us, "reform" means "to amend or improve by change of form or removal of faults." "Tax reform" that makes a system "fairer" (in someone's image) by, e.g., raising taxes on saving and investment may cause the economy to falter and unemployment to rise—a policy that can surely be viewed as "unfair." Unfortunately, in my view, the "fairness" gang captured the high rhetorical ground a long time ago. When those in the media speak of "tax reform," they are almost always buying "fairness" as reform's sole ingredient. A strong case can be made that, in a fundamental sense, the Kennedy-Johnson tax measures of 1961–1964, the Jones-Steiger-Long bill of 1978, and the Economic Recovery Tax Act of 1981—all strongly pro–capital formation, pro-jobs, pro-growth, and pro-competitiveness—deserve the label *reform* no less than the 1969, 1976, and 1986 tax acts.

5. LBJ, who could be devious, had promised AFL-CIO head George Meany that, if organized labor would support his proposal for a 10 percent income surtax in the spring of 1968, he would send a true "tax reform" proposal to Congress before he left office in January 1969. Surrey worked hard and long and brought forth an ambitious plan, but LBJ kept it bottled up—until only a few days before Richard Nixon was sworn in.

Means Committee, a fine politician and wonderful human being named John Byrnes, prepared a hard-hitting, pro-"tax reform" speech for delivery about that time, but shared it in advance with Committee Chairman Wilbur Mills—only to find that Wilbur in effect stole his speech and gave it first!

I believed all along that the "tax reform" pressure might die out, as it usually had in the past—until 15 April. When the typical taxpayer got to the bottom of his return and saw that he had to add LBJ's surtax to what he already considered a tax bill much too high—he exploded again. As a result, during 1969, Treasury officials and staff, tax committees and staff, and many others worked night and day to produce the Tax Reform Act of 1969, up to that time the shining example of "tax reform" defined in terms of fairness.

Wonder of wonders—that bill was largely put together in a Republican treasury (drawing, of course, from Stan Surrey's plan) and was signed by none other than Richard Nixon. Nixon could succeed where JFK could not—another example of my third element of tax policy, discussed below.

Tax policy swung back toward the goal of economic growth only two years later, a move ushered in by the recession of 1970. With the economy weak, inflation mounting, and convertibility of the dollar into gold becoming harder to maintain, Nixon announced his New Economic Policy in August 1971. In addition to cutting the link between gold and the dollar and a wage-price freeze, the president asked Congress for restoration of the ITC, which had been repealed in the "tax reform" flurry of 1969, and statutory approval of a new depreciation system known as the Asset Depreciation Range (ADR).[6] These two actions, both of which Congress approved, provided the United States with a creditable and fairly competitive capital cost recovery system.[7]

The tax policy pendulum moved little in the first half of the 1970s, but, by

6. Earlier, in 1965, the ITC had been "suspended." Congress quickly reactivated it in 1966 as investment spending dropped sharply.

7. Once in a very long while, a tough legislative goal can be achieved with a single argument presented on a single piece of paper; such was the case with the restoration of the ITC and the enactment of ADR in the fall of 1971. Sophisticated financial/political reporters had told me, "Walker, you'll never get both ITC and ADR. Which will you settle for?" Sounding perhaps more optimistic than I really felt, I simply said, "Just you watch—it's a piece of cake!"

Educating Congress with respect to international competitiveness was the key (just as it is likely to be a big part of the next swing of the tax policy pendulum back to economic goals). Treasury tax staff had prepared what was in effect a "present value" table of the capital cost recovery systems in Japan, Western Europe, and the United States. The AFL-CIO, then very powerful in Congress, had swung from its traditional free trade position toward protectionism, and Congress was uptight about foreign competition and the "export of jobs." Our capital cost recovery table showed that, even if both the ITC and ADR were approved, our system, in competitive terms, would still fall far short of the Japanese and Western European systems. Representative James Burke, who had been the AFL-CIO stalking horse in introducing a blatantly protectionist tax bill known as the Burke-Hartke Act, said in executive session of the Ways and Means Committee, "I'm with Charly on this. He's convinced me that we need both of these measures." Russell may recall our successful use of the table later in his committee.

Nothing at all was said about whether these business tax cuts were or were not fair. The members, reflecting their constituents concerns, were much more interested in jobs, growth, and competitiveness.

1976, "tax reform" was again center stage, culminating in the Tax Reform Act of 1976. Work on the measure began in the summer of 1975, under new Ways and Means Committee Chairman Al Ullman and before a much-expanded group. According to reports from reliable sources, AFL-CIO President George Meany had insisted that the House Democrats "stack" the Ways and Means Committee by adding some eleven or twelve members, from the traditional twenty-five to thirty-six or thirty-seven. The goal was to get a comprehensive "tax reform" bill. The main result was agony for Al Ullman, for the expanded committee was ideologically split right down the middle. Consensus, or even near consensus, was impossible.

Nevertheless, Al Ullman pushed ahead and ultimately succeeded in obtaining passage a year later of the Tax Reform Act of 1976. Perhaps its most spectacular "reform" was to attack the alleged problem of nontaxation of capital gains at death by requiring the original basis of inherited property to be carried over to the heir. Once middle America's farmers and small businessmen found out about this action, they rose up (as with withholding in 1962), and the provision was repealed even before it went into effect.

Then came the first of two spectacular swings in the tax policy pendulum: the passage of the Jim Jones–Bill Steiger–Russell Long–devised Revenue Act in 1978; the overwhelming congressional endorsement of "10–5–3" when introduced in the summer of 1979; and the ultimate passage of the Economic Recovery Tax Act of 1981 (ERTA), which gave the United States one of the most competitive capital cost recovery systems in the industrial world.

How to explain this swing of the pendulum? There were several factors. Business groups and some academics in the early 1970s had begun to warn that the United States faced a capital shortage, and various studies tended to point in that direction. Senators Lloyd Bentsen and Bill Brock mounted hearings to study the issue, concluding that a problem did indeed exist. Brookings undertook such a study, and it is with the reporting of that study to the House Ways and Means Committee that I began to feel that the tide was beginning to turn in the direction of a pro-capital formation policy.

At a hearing in July 1975, the late Joe Pechman told Ways and Means that Brookings—where Joe was then director of economic studies—had engaged a distinguished panel of experts, which had concluded that the United States would have no capital shortage problem in the future provided that we do two things: restore full employment and convert the federal deficit into a surplus. Whereupon Representative Bill Frenzel, a "legislator's legislator," all-around fine person, and world-class "doodler," dropped his pencil and exclaimed, "What did you just say?" Joe repeated his statement and asked, "Does that conclusion surprise you, Congressman?" Frenzel replied, "Surprised? I'm flabbergasted. You have just convinced me that we have a very big capital formation problem!"

By 1975, when Joe testified, the various studies and discussions of a capital shortage were having a decided impact on public opinion. Seventy-eight per-

cent of the nation's "thought leaders" polled by the Opinion Research Corporation (ORC) believed that there was a looming investment shortage and that, "over the next ten years or so," it would be "somewhat serious" (30 percent), or "very serious" (8 percent). Even more significantly, an identical 78 percent of the federal legislators polled by the ORC came to the same conclusion. Moreover, by a ratio of 50 to 38 percent, federal legislators stated that existing tax laws hurt capital formation. By 1976, according to the Cambridge Report, 60 percent of the general public believed that there was "a problem with raising the dollars needed for business investment."

So, understandably and inevitably, the tax policy pendulum began to swing from "tax reform for fairness" to "tax reform for jobs, growth, and competitiveness." The American people, and therefore Congress, had concluded that the U.S. economy was not performing up to snuff and that the tax system had a great deal to do with that. The result was the strongly pro-capital formation tax bills of 1978 and 1981. And, since pro–capital formation tax legislation means reducing the hit on saving and investment, tax "benefits" (as scored by the Joint Tax Committee) can be said to flow to the upper-income rather than to the lower-income citizens. The answer on this to the "tax reform by fairness" crowd is that there is nothing "fair" about rising unemployment and lagging growth in living standards. What "tax reformers" refer to in pejorative terms as *trickle-down* economics (still a favorite of the *Washington Post*) can also be called *capital formation* economics, which almost everybody agrees is essential to achieving higher per capita income and thus expanding living standards.

In speaking to groups about this phenomenon, I was prone to say that, in the 1970s, capital formation became "as American as apple pie"—until my friend George Will returned from a trip to California and told me of a sign on a fast-food place advertising "kosher burritos." Now what, asked George, could be more American than kosher burritos? What indeed! I changed my line. In the 1980s, capital formation became as American as kosher burritos. But, alas and alack, the pendulum was soon to swing back again, and with great vigor, culminating in the Tax Reform Act of 1986 (TRA).

I have a love-hate relationship with that legislation. I "love" the low individual and corporate rates, something I never thought I would see in my lifetime. But I "hate" the more than $150 billion, five-year "hit" on capital formation that in effect paid for those low rates (plus other "goodies" distributed by this "revenue-neutral" legislation). Worst of all, of course, was repeal of the ITC. That action, coupled with lengthening of depreciation guidelines, raised the capital cost of investing in new equipment by 41 percent, when viewed from the standpoint of the investor, and by 13 percent, when viewed from the standpoint of the user, which includes depreciation. For the entire period after 1981, the relevant figures are 90 percent and 23 percent, respectively.[8]

8. See the testimony of Mark Bloomfield before the House Ways and Means Committee (101st Cong., 2d sess., 5 March 1990).

From an economic standpoint, worse tax action for a nation whose capital costs had already been driven too high by the upward pressure of the huge federal deficit on domestic real interest rates can hardly be imagined. John Paulus, then chief economist for Goldman Sachs, wrote in the *Washington Post* that the tax bill would have been near perfect—for Japan. Martin Feldstein was also very critical of the anti-capital formation parts of the legislation. Our purpose today, however, is to discuss not the wisdom of the decade's tax policy but how it happened.[9]

The 1986 TRA was partly the result of the tax policy pendulum swinging back toward "tax reform for fairness," for the American people by 1985 had become very angry with the federal income tax. Not only did they crave simplicity in order better to understand the system as a whole as well as to stay away from the tax preparer, but they were also furious with reports of rich individuals and big corporations who paid little or no taxes. Still, such unhap-

9. Still, I cannot resist taking substantive issue with Fullerton. I believe that his statement that "Treasury I" would have "leveled the playing field" of tax policy for business investment omits an aspect of tax neutrality that is crucial to promoting capital formation. While it is indeed true that equality of tax rates on the income from all three types of business investment (structures, equipment, and inventories) will tend to result in what the economists call *efficient* allocation of resources *in the present*, the existence of an income tax inherently promotes misallocation of resources *over time*. We know that the personal income tax is in effect a double tax on saving; it taxes the income from which saving is generated and at the same time taxes the proceeds of such saving. And we add to this double tax on saving still a third layer, a tax on corporations. The result—as is widely recognized—is a tax system that promotes consumption and is biased against saving and investment.

By raising taxes on the latter, TRA in fact made the playing field more uneven. The bias of the income tax can be eliminated by substituting a consumption tax, such as a value-added tax (VAT), for the business income tax or by moving the latter toward a consumed income tax by cutting back on the taxation of saving and investment. Given the political inevitability of the corporate income tax, this was the policy route that we took with ERTA in 1981—and, from the standpoint of economic progress, a very good route in my book.

When we "corporate lobbyists" conceived of "10–5–3" in 1979 (actually, it was more the creation of Representative Jim Jones, based on an earlier business group proposal known as "10-5"), we wanted to bring the tax treatment of investment on equipment as close to theoretical expensing as possible, as under a neutral VAT. Given the high discount rates that existed at the time, we hit very close to our target period. As interest rates fell, however, the combination of short depreciation lives and a 10 percent ITC shifted the rate to a theoretically negative level, to what might be called a "subsidy" for tax-paying corporations (or those who temporarily took advantage of "safe-harbor leasing").

But I do not apologize for this "subsidy." As DeLong and Summers (1991) tell us so convincingly in a study covering a cross section of nations, investment in equipment is indeed the key to stronger economic growth in mature economies and to more rapid development in less-advanced economies. DeLong and Summers conclude that investment of 1 percent of gross domestic product (GDP) in equipment is associated with a third of a percentage point increase in the overall growth rate of overall GDP—a very substantial rate of return.

To me, the case for expensing all business investment is strong, and it is even stronger for expensing investment in *productive* equipment—and I would risk a theoretical "tax subsidy" to that end. If that is industrial policy, then so be it.

Incidentally, Fullerton is dead wrong when he says that JFK's original ITC was not conceived as industrial policy but was intended as a temporary macroeconomic tool used to stimulate aggregate demand. Just the opposite was true (if the public statements of JFK and his aides are to be believed—as well as private statements to me and others).

piness had not in the past broken out so strongly as to support so massive a revision of the tax law (a trillion-dollar crap shoot, as Dave Stockman said to me). Indispensable to the whole process was the presence in the White House of a popular *Republican* president who was really dedicated to getting individual tax rates down, even at the cost of raising the very corporate tax burden that for many years he had condemned as an unnecessary and unwise appendage to our federal tax system.[10]

This, of course, brings us to the final factor conditioning U.S. tax policy in the 1980s.

What Presidents of One Party Can Do That Those of the Other Cannot

The most often cited example of a president of one party leading the effort to achieve a difficult and perhaps politically divisive policy goal is, of course, Nixon's successful effort to establish relations with Communist China during his first term. Conventional political wisdom—and I think it is correct—is that liberal Democrat Hubert Humphrey, if victorious in 1968, would have faced a difficult if not impossible task in that regard. The probability is that he would have been roundly attacked and solidly opposed by the Republican Right, a group that had "no place else to go" when Nixon moved and—to repeat the phrase—became sullen but not mutinous. What has not been sufficiently recognized is that this same U.S. political characteristic applies to other politically divisive policies, including tax policy.

For example, in the late 1950s, we Republicans in the Eisenhower Treasury wanted to mount a campaign in Congress for a pro-growth, pro-capital formation, "supply-side" cut in income taxes of individuals and corporations. But the Democratic leadership in Congress said, in effect, "*no way*"—in no way

10. As late as February 1983, Ronald Reagan told a group of businessmen in Boston that the corporate tax was (my words) a dumb, lousy tax and ought to be eliminated. As both he and I have said thousands of times, "Corporations don't pay taxes; people do. And the fact is that the corporate tax is a hidden tax of the worst type, for nobody knows who really pays it. We ought to get rid of it." The press responded to this statement with great relish. But the tempest died quickly when (as George Will put it) Reagan's aides made it crystal clear that he was *not* speaking for his administration. Fullerton has noted Regan's statement in 1985 that reflected his earlier position—but this was before Don Regan had much of an opportunity, as the new chief of staff, to convince the president that "the higher business taxes would just hit those companies paying too little now."

Interestingly enough, Ronald Reagan has some pretty heavy academics backing him up. My favorite quote in this respect comes from Arnold Harberger, viewed by many as the foremost academic expert on the corporate income tax. At a conference in 1983, he said, "There is no sound *economic* underpinning for the corporation income tax. The tax originated because corporations are legal persons—but so too are three-year-olds, eighty-five-year-olds, manic depressives, blonds, and idiots. Why select out this particular class of legal person as the object of special (and harsh) taxation? There is no respectable *economic* answer to this question." The conclusion must be that the corporate income tax is a bad tax. I am therefore puzzled as to why so many economists (and lawyers) devote many hours of study and effort to bringing internal "rationality" to the tax. Even if *all* rates were equalized on *all* investment *all* the time, it would still be a bad tax that exists almost solely for political reasons.

was it possible for a Democratic Congress to agree to the tax reductions on upper-income individuals and corporations that such a proposal would have to include. But, lo and behold, that's precisely what John F. Kennedy proposed in 1961–63 and a Democratic Congress approved in 1962 and 1964.

Even so, as already noted, JFK had to drop "tax reform" from his proposal; even a Democratic Congress was not going to buy that. Eight years later, however, a Republican Treasury devised—and a reluctant Nixon approved—what up to that time was the high-water mark in "tax reform." To be sure, the Tax Reform Act of 1976 was enacted by a Democratic Congress, and I cannot for the life of me remember why Gerald Ford did not veto the legislation. But, by the "tax reform" standards of 1969 and, later, 1986, it was pretty weak tea.

There is little doubt that the 1986 act would not have had a snowball's chance in you-know-where if it had not been conceived by a Republican Treasury and accepted and pushed by a popular and highly articulate Republican president. Not that the Reagan imprimatur was enough—each of what I call the "four horsemen" of the TRA could be said to have been indispensable to success: Reagan; Baker/Darman at the Treasury (together they make up one horseman); Ways and Means Chairman Danny Rostenkowski; and Senate Finance Chairman Bob Packwood, who, with his top aide, pulled it all together (as Fullerton points out) over a bucket of beer.

The indispensability of these other three horsemen notwithstanding, it was a Ronald Reagan production from beginning to end. To drive this point home, can anyone conceive of Jimmy Carter pulling off the same victory? Indeed, Carter entered the White House declaiming that the U.S. income tax system was a disgrace and that he would do something about it. When he finally sent up his "tax reform" proposals in 1978, they were decidedly weak, with the major recommendation to raise taxes on capital gains. Congress did precisely the opposite, and very little of Carter's "tax reform" passed.

Conclusion

Martin has told us not to look at the future, and, although I have taken a peek or two, I have largely abided by his wish. But there are of course important lessons to be learned from the 1980s experience as we proceed through the 1990s. But I supposed that's another subject for another conference.

Reference

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3. *Russell B. Long*

The late John F. Kennedy used to keep a chart in the Oval Office of the White House. It showed the decline of the national debt as a percentage of the gross national product under Truman and Eisenhower. Then, during my years as chairman of the Senate Committee on Finance, I insisted on obtaining from the Treasury an updating of that information.

Here is what it showed. Our net federal debt was 118 percent of the gross national product in 1945. Under Truman and Eisenhower, it declined to 46 percent, less than half. Then, under Kennedy, Johnson, and Nixon, it declined to 25 percent, less than one-quarter of what it was in 1945.

To be sure, the debt grew in terms of dollars. But, in terms of its relation to the gross national product (which represents what we have with which to pay both the debt and the interest), it was cut to less than one-quarter. What had caused that?—(1) economic growth, which included (2) increased productivity, (3) high employment, (4) population increase, and (5) inflation. The increases in those factors greatly offset the small annual increase in the national debt to cause the ratio to go steadily down.

During the Kennedy-Johnson years, we saw how fiscal policy—using tax cuts and tax credits along with lower rates—could be used to promote economic growth. Then, during the Carter administration, Senator Bill Roth started making speeches advocating a 30 percent cut in tax rates—10 percent a year each year for three years. In those speeches, he emphasized the experience of the Kennedy-Johnson tax cut. Toward the end of the Carter administration, Republicans began to coalesce behind the Kemp-Roth 30 percent tax cut proposal.

When President Reagan came into office, he recommended a first-year tax cut of about 5 percent (the same magnitude as the Finance Committee bill we had recommended in 1980). But he went far beyond that to recommend a further tax cut of another 10 percent in rates to take effect in 1982 and a third tax cut of still another 10 percent to take effect in 1983. All this was to be incorporated into one gigantic tax cut bill, known as ERTA, the Economic Recovery Tax Act.

Why did he recommend such huge tax cuts? We need go no further than to note that, in his campaign, he had recommended a 30 percent across-the-board cut in rates, spread evenly across three years—the Kemp-Roth bill.

As the former chairman of the Committee on Finance, I was proud of the part I played in passing the Kennedy-Johnson tax cut, which had been the largest tax cut up to that time and had worked very well. At a minimum, I felt that I had to vote to give President Reagan's bill a try.

As the bill progressed through the committees and the floor of both Houses, it picked up amendments to make it an even greater tax cut than the president had advocated. Why were the add-on amendments accepted?

Well, it is rather difficult for an administration (asking for the largest tax cut in history) to insist that other suggestions, such as indexing the tax code to eliminate the so-called bracket creep, should not also be tried. That is especially the case with regard to items that the president has been known to endorse in previous years.

Part of the income tax package leveled the top rate on personal income taxation to 50 percent, and we provided that 60 percent of a long-term capital gain would be excluded from taxation. Thus, the top rate for a "long-term" capital gain was reduced to an overall rate of 20 percent.

Did it bother me that we might be cutting taxes too deeply? Not particularly. In previous years, I had voted for large tax cuts and for needed tax increases. On two different occasions, I had gone to sitting presidents, President Johnson as well as President Nixon, and urged them to recommend suspending or repealing the investment tax credit (ITC) because it appeared to be overheating the economy. At the presidents' recommendation, we had twice repealed and subsequently reenacted the investment tax credit.

But I was not prepared for the series of events that transpired during the next few weeks. When the first stage—the 5 percent tax cut—went into effect in October 1981, the stock market started going down rather than up. The economy—which had been booming since Ronald Reagan took office—turned downward.

The economy was on its way into a recession. Why? It was explained to me this way. First, various gurus and economic thinkers on Wall Street such as Henry Kaufman thought that the massive tax cuts would lead to huge deficits. Second, they believed that the huge deficits would be inflationary. Third, they reasoned that the inflation would require high interest rates. And, fourth, they concluded that the high interest rates would make it impractical to build the new plants and equipment on which we were relying.

This would prevent the economic boom that we had predicted. Their logic was compelling. By my lights, that was not a difficult problem to overcome. It was my view that the president should be persuaded to "stretch out" the tax cuts as long as need be. That should restore confidence and achieve the desired degree of economic expansion.

When I explained my theory to Republican Senator Bob Dole, the new chairman of the Finance Committee, he suggested that the two of us should call on President Reagan so that I could explain my suggestion. (Incidentally, I was not alone in this thinking. Charls Walker was reported to be thinking along the same lines. He will tell you that there were a lot of other highly regarded advisers of President Reagan's who agreed.)

The president received us graciously, but, when I tried to explain my recommendation, Ronald Reagan took over the conversation, and I hardly had a chance to get more than a few words in edgewise. Ronald Reagan was determined to stay the course. And he did.

Then, after a few months, we saw the deficit getting out of hand. I was in-

vited to sit with what was later known as "the Gang of Seventeen." We were asked to recommend revenue increases and spending cuts that could lead us to a balanced budget. The Gang of Seventeen failed because then Speaker "Tip" O'Neill (ably represented by Dick Boland) would not agree to cut back on Social Security—not even the cost-of-living adjustment (commonly referred to as the COLA).

If you were not going to cut in the area of Social Security, then it made no sense to cut in the smaller entitlement areas like government retirement, railroad retirement, and other lesser entitlement programs. For lack of savings in the entitlement areas, the Reagan administration was not interested in pushing for a "budget-balancing" package that had no hope of balancing the budget.

Without the spending cuts, Ronald Reagan was not willing to advocate—or sign into law—the tax increases that he would have considered under other circumstances. So the tax suggestions went down the drain with the spending cuts.

Thereafter, as responsible Americans far and wide spoke out for a tax increase, Bob Dole seized the initiative and put together TEFRA, the Tax Equity and Fiscal Responsibility Act. This was heralded as a measure to close tax loopholes and achieve greater tax uniformity.

It was a significant tax increase, and it became law. Bob Dole's TEFRA took away from business about half the benefit of Ronald Reagan's ERTA bill.

Meanwhile, we passed a five-cent tax increase on gasoline. Then came the Social Security Rescue Package. This measure found ways to shift more general revenues into the Social Security fund. It made the Social Security fund solvent temporarily by adding to the national debt.

The more logical part of the Social Security package was that, in future years, the Social Security taxes were to be increased to bring in more revenue. A couple of years later, the deficit-reduction package repealed most of what was left for business in ERTA. Neither of those bills touched the rates. Now add all that together, and you have a lot of tax increases.

Then came the so-called Tax Reform Act of 1986. It took away a great number of deductions and used the revenue to reduce the rates. Much was said about the fact that 7 million relatively low-income taxpayers were removed from the rolls. However, the big item of controversy was the repeal of capital gains.

In general terms, we reduced taxes for about 70 percent of individual taxpayers and sought to make it back by raising taxes on corporations. That latter objective, paying for the individual tax reductions by increasing taxes on corporations, was not achieved—not in full at least.

The reason was that corporations found ways to reduce tax liabilities—such as obtaining capital by borrowing money rather than by selling stock. This led to very thin margins of equity in some corporations. That, in turn, made companies more vulnerable in the case of temporary adversity.

The lower rates had to do a lot of good. But much of that good was merely by terminating the stifling effect of income tax rates that were too high.

Well, here we are. We are still stuck with a capital gains tax on transactions many of which are not income at all in a real sense. We have had very large deficits for every year after the ERTA tax cut went into effect.

And, after ten years under Presidents Reagan and Bush, the debt, as a percentage of the GNP, is now back to where it was toward the end of the Eisenhower administration. In terms of fiscal and monetary prudence, America has lost the ground it gained under Kennedy, Johnson, and Nixon.

We have a situation that must be turned around. It will take time. But eventually the people will learn that to put our income tax rates much higher than we have now is self-defeating. It stifles the economy and retards economic growth.

If large amounts of additional revenue are needed, we should turn to a tax on consumption, as our friends in Europe have done. That may take several years to do, but it will happen because it makes sense.

Summary of Discussion

Murray Weidenbaum began the discussion by agreeing with Walker that politicians of one party can change policy in a way that politicians of the other party often cannot. He recalled that President Reagan was considering whether to include in his initial tax proposal a recommendation to lower the top tax bracket from 70 to 50 percent, and he asked what the response to that recommendation would be. His advisers said that the Democrats would lambaste them as the party of the rich, but, if this recommendation were not included in the administration proposal, then they likely would put it in themselves because it is a good idea. Reagan said that he would let the Democrats twist his arm and then reluctantly go along with it, which is what Weidenbaum believed had actually happened. Weidenbaum added that one fundamental flaw with the Joint Tax Committee's revenue estimates is that they were static; in other words, a tax change designed to quicken the growth rate is estimated to have no effect on revenue through a faster growth rate.

Rudolph Penner thought it was interesting that neither Walker nor Long made any mention of the journalistic crusade of the supply-siders in the late 1970s and early 1980s as an important factor in the original tax cuts.

Charls Walker responded that the role of the extreme supply-siders was overplayed by the press. The basic economic policy group around Ronald Reagan during the 1980 campaign was not economists Arthur Laffer and Jude Wanniski but rather George Shultz [former secretary of the treasury and later secretary of state], Arthur Burns [former chairman of the Federal Reserve Board], Alan Greenspan [former chairman of the Council of Economic Advis-

ers and later chairman of the Federal Reserve Board], economist Milton Friedman, Walter Wriston [chairman of Citicorp], Jim Lynn [former director of the Office of Management and Budget], Representative Jack Kemp, and Walker himself. This team felt "almost to a man" (Kemp excluded) that the Kemp-Roth tax cut of "10–10–10" should be extended at least over a five-year period instead of a three-year period. Someone wrote Reagan's speech at the Republican convention to include the phrase "three-year cut." But the economic policy group met less than three weeks later in Los Angeles, and Greenspan told Reagan that it would be much easier to reach the goal of reducing both spending and taxes to 18–20 percent of GNP after five years if they could extend the Kemp-Roth plan from three years to five years. Reagan said, "I don't care," and they all "nearly fell out of their chairs."

Thereafter there was debate within the group, with Kemp on one side and most of the other members on the other side. They were moving toward backing away from the three-year approach when Reagan got into trouble talking about some other issues, and the economic policy group decided (in putting together an economic policy speech after Labor Day) that they couldn't back away. But the basic idea of the economic plan constructed by this group was *not* that the tax cuts would pay for themselves but that there had to be a concomitant cut in the rate of growth of federal spending. The press played it up as purely a "supply-side off a napkin thing," even though Laffer was not even a participant in the deliberations.

Weidenbaum noted that Laffer was on the economic policy group, but *Walker* stated that Laffer either did not attend or did not say anything. *Martin Feldstein* added that William Roth had been talking about a "10–10–10" tax cut for quite a number of years before Roth had ever heard of Laffer or supply-side economics.

Robert Litan said his understanding was that Laffer and other supply-siders had had a major intellectual influence on Kemp. Since Walker indicated that Kemp was on the panel and was staunchly defending the three-year rather than the five-year program, the role of the suppler-siders should not be understated. *Walker* confirmed that it was Kemp who had the reference to a three-year plan included in Reagan's speech.

Russell Long addressed the question of President Reagan's political motivation for supporting tax reform in the mid-1980s. Long felt that Senator Bill Bradley and others were attracting a lot of publicity by talking about tax fairness and tax reform and that it looked as though it might be a problem for the Republican party if the Democrats made much headway on the issue. Also, some of the Republicans on the Senate Finance Committee were interested in tax reform, so it seemed to Long that Reagan decided that he ought to "get out front" on the issue. Long believed that, when a politician thinks some legislation is going to pass, it is often better to "bend with the wind and go along" because then one has some influence on what happens. If one tries to stop the

law, then things could happen that would hurt the people one is representing. He always felt that, after the storm had passed, people would decide to restore special capital gains tax provisions in order to encourage economic growth.

Weidenbaum said that the decision made in January 1984 to encourage tax reform was a political decision based on fear on the part of James Baker [White House chief of staff] and others that Democratic presidential candidate Walter Mondale would join the flat tax bandwagon of Bradley and Representative Dick Gephardt. Thus, the president said a few lines in his State of the Union message that directed the secretary of the Treasury to undertake a study and report back in December 1984. In fact, Reagan had no great relish for tax reform except for lower tax rates.

David Stockman discussed several crucial facts that he believed ruled tax policy for most of the 1980s. First, as late as early 1981, a 30 percent tax rate cut had a very small constituency in Congress. There was no great support for it in the Democratic party, and, even in the Republican party, only a minority of the "backbenchers" like Kemp and Stockman were in favor of it. Nevertheless, the policy was being developed at a time when the inflation rate was running at 10 or 11 percent, and there was a group of more orthodox members of Congress who saw the 10–10–10 tax cut as simply a politically attractive form of temporary indexing. Stockman remembered Alan Greenspan making the argument strongly to the skeptical middle-of-the-road Republicans that a 10 percent rate cut in this environment was basically going to keep the real tax rates constant, so they would not be taking a major fiscal risk.

What happened in reality was that the monetary policy being implemented at the same time lowered inflation dramatically faster than anybody expected, so that, by the fall of 1983, the inflation rate was running about 3 percent on an annual basis. As a result, the 10–10–10 tax cut became a far deeper fiscal cut in terms of the real revenue base of government.

Second, since there was not a strong constituency for this tax change in the Republican party, when the fight really got serious in committee, a compromise had to be made between the middle-of-the-road tax indexers and the supply-side rate cutters. To get the tax bill out of the Senate Finance Committee, it had to be agreed that there would be a vote on the Senate floor about indexing. Stockman remembered Senator Bob Dole saying that the indexing provision would be easily defeated on the floor and that this is the way we can get an 18-to-3 committee vote in favor of the bill before it went to the floor. However, indexing passed, and the unexpectedly large real rate cut in 1981–83 was locked in permanently in 1985 by the indexing.

The revenue impact of indexing was far beyond what anybody expected. Today, people are always looking at five-year budget projections, and the natural question is why didn't anybody think about the long-term revenue impact at the time. That was in the early days of long-term budgeting, however, and

almost everybody looked at one-year budget projections, and nobody took five-year projections seriously.

The third crucial fact is that, even with indexing and the rate cut, the tax bill would not have passed in 1981 unless all the other tax policy constituencies were accommodated. So the 10–5–3 capital depreciation schedule was married to the bill, the estate tax was dismantled over four or five years, there were huge savings and IRA incentives included, anything that the oil and gas industry could imagine was added, and so on. The tax bill that was signed into law in 1981, under the economic conditions that actually materialized by 1986, cut the revenue base by 5 percent of GNP when the back-loaded features of the bill were fully in force. So, in August 1981, the government cut a gaping 5 percent of GNP hole in its revenue base, bringing it down to 17 percent of GNP. This was relative to spending of 23 or 24 percent of GNP under the defense and domestic policy conditions of the time.

Stockman recapitulated his view that everything that happened to tax policy after 1981 was driven by the near impossibility of our political system coping with a 5 percent of GNP hole in the fiscal balance. The hole was slowly closed in the 1982 act, the 1983 act, and the 1984 act, so, by the time they got to 1986, the hole was only 4 percent rather than 5 percent. However, it was that fundamental, shocking imbalance that drove almost the whole economic and fiscal policy story, in Stockman's view, in the 1980s.

Feldstein noted that Stockman's calculation of a revenue loss of 5 percent of GNP was a static estimate with no behavioral response because it was based on the economy as it actually worked out. The supply-siders would argue that, without that tax cut, there would have been less GNP growth and thus less revenue, so the actual cut is smaller than the 5 percent. *Stockman* and *Feldstein* agreed that the actual cut was not much smaller, however.

William Poole commented that the unexpectedly rapid decline in inflation was importantly affected by the unexpected appreciation of the dollar. He thought that this appreciation had been a result of three separate factors. First, monetary policy became substantially more disciplined, and expectations of inflation and actual inflation came down. Second, economies abroad turned much weaker than expected. Most people did not foresee the Latin American debt crisis a couple of years in advance, and the European economies turned soft as well. Finally, the investment incentives in the 1981 tax law increased the attractiveness of investment in the United States by increasing the after-tax rate of return, and this brought capital to the United States, which aided in the appreciation of the dollar.

Penner questioned the emphasis on indexing as the cause of so much lost revenue. Before indexing was in force, Congress regularly offset the extra inflation tax by cutting tax rates, although not always the rates that affected the people who were hurt by inflation. He thought that one of the remarkable things about the last twenty-five years is that, through all the swings of the tax

pendulum that Walker discussed, the overall federal tax burden had been almost a divine constant of between 18 and 20 percent of GNP. Every time the ratio had risen to 20 percent, there had been a reaction, and it had gone back down.

Feldstein said that Penner's point raised the question of whether there would have been discretionary tax cuts in the mid-1980s, despite the increasingly large budget deficits, if the indexing had not been in place.

Feldstein recalled that he had debated the merits of the 10–10–10 tax cut as an approximation to indexing with Walker and others back in the late 1970s and had argued very much against it. There was no question that, given the inflation forecast of the time, the two proposals were approximately equal, but Feldstein thought that there was too much uncertainty about that forecast. He also liked the idea of indexing per se and instituting a permanently indexed system rather than accomplishing a one-time tax cut and then having inflation push people up into higher brackets again.

Feldstein asked the group how indexing came to be an accepted idea. He remembered trying to persuade Representative Barber Conable of the virtue of indexing, and Conable visited Canada to see how indexing was working there and came back to say that it was terrible and that he was firmly opposed to the idea. Eventually, Conable was a big advocate of indexing, and Feldstein wondered how that pendulum on indexing shifted and why it did not include capital gains or depreciation.

Weidenbaum thought that William Fellner at the American Enterprise Institute was instrumental in starting the discussion, not by directly influencing the media or Capitol Hill, but by influencing the people who influence both the media and the Hill.

Feldstein said that he and Fellner and a few others were part of a group that met with Conable occasionally when he was the ranking minority member of the Ways and Means Committee. When that group advocated indexing, however, Conable was very resistant, and there was no general support for the idea.

Stockman said that the more cynical explanation of the increased interest in indexing is the political fight in the Republican party between the young backbenchers and the middle-of-the-road traditional Republicans. People like Conable and Representative Bill Gradison repaired to indexing as an alternative to a "radical, experimental, dangerous" 30 percent rate cut. The idea for indexing had been around for a long time, but this was the source of the political momentum. *Long* said that, once people started asking about bracket creep before civic clubs and in similar settings, it was very hard to defend the other side.

Feldstein asked why the indexing of capital gains was never accepted, even though it should be subject to the same kinds of arguments. *Walker* responded that the people who were pushing capital gains tax changes from the outside believed that they could get indexation almost any time because both sides of the aisle in Congress think it is a good idea. Thus, they have not pushed for

indexing as the centerpiece of capital gains tax changes to the exclusion of a "real" differential capital gains cut.

Feldstein returned to another topic raised by Stockman, the reason that so many additional items were added to the basic 10–10–10 tax cut. Feldstein contrasted Stockman's argument that the only way to pass the tax cut was to add 10–5–3 depreciation and so on with Long's argument that people felt that the tax cut would be approved so they might as well add a lot of other ideas that had been around.

Long responded that there had been a similar situation about add-on arguments when they were working on the Kennedy tax cut bill in 1963 and 1964. At one point, they realized that they had added so much extra baggage on top of the investment tax credit that they had to kill some of these extra provisions or abandon the bill. He thought that, if someone in the Reagan administration had "read the riot act" to the right group in Congress, much of the objectionable language could have been dumped out.

Stockman explained that, while the administration bill was being considered, there was an alternative bill emerging in the House (the Conable-Hance bill) that was an attempt to avoid a "competitive political auction" on tax cuts. That was going to be a consensus bill that did not have all the cuts that the administration wanted but that would also not lead to a competitive bidding contest between the Democrats and the Republicans in the House. The White House was trying to decide whether to support the consensus bill, but they had just won the big fight on the budget on the House side (the Gramm-Latta bill), and they felt that they had the ability to push through their own bill and therefore did not have to compromise. The Democrats were smarting badly at that point because they had just lost the first strategic level domestic policy fight in the Congress in thirty years (again, Gramm-Latta), so they were not overly interested in compromising either. On 4 June 1981, the decision was made by the White House not to embrace the bipartisan Conable-Hance bill but to go for their own bill. The bill was loaded up in the House Ways and Means Committee, and, by the time it got to the floor, "everything that had ever been thought of by any tax constituency in the last thirty years" was in the bill. Because it happened in the House first, the Senate couldn't help carrying the junk across the Capitol from the House into the Senate bill.

Stockman felt that he had misspoken earlier by saying that these additions were needed to get a bill passed. The real explanation is that the process turned into a competitive political auction, both bills were loaded with extra features, and there were "no shuckers to do the shucking" when the conference bill was put together because all the steps had been endorsed with huge votes in both houses. There are times when strategic decisions are made that affect the course of events, and to go for a competitive bill rather than a compromise in the House was the key decision made in early June 1981.

Harry Reasoner argued that one of the most disastrous features of the 1981 tax act was the subsidization of real estate investment. That contributed to mis-

allocation of capital, to vast overbuilding, to the savings and loan crisis, and to other adverse economic impacts throughout our economy. He wondered whether anyone at the time the legislation was passed believed there was an economic justification for it or whether anyone expressed concerns.

Weidenbaum answered that the 1982 *Economic Report of the President* included a table that showed the combined effects of the investment tax credit and 10–5–3 depreciation rules producing negative tax rates on some assets, but that was after the fact.

Stockman argued that there was a strong case for encouraging plant and equipment investment and that the powerful real estate lobby simply jumped into the action. So 10–5–3 was really a marriage of convenience between a powerful real estate lobby and the original case for accelerated depreciation of plant and equipment.

Feldstein added that most public finance economists did not understand at the time how much the tax shelter industry could accomplish with the new tax law. Only after the fact did economists learn what the combination of extreme leverage (no cash in the deal) and those kinds of depreciation rates could produce.

Walker thought that the revenue impact of these add-on provisions for the 1981 tax act was being overstated. He thought that the three big revenue impacts were the personal income rate cut (10–10–10), the new depreciation schedule (10–5–3), and the indexing of personal tax rates. The 10–5–3 cut was married to the 10–10–10 cuts as a compromise between those who defined supply-side tax cuts solely in terms of individual tax cuts and those who said that capital cost recovery is important in the business community. So those two items were what the Reagan task force recommended and basically what the Treasury Department eventually proposed.

Geoffrey Carliner asked why the political system was unable to solve the problems in the 1980s that it had been able to solve before. In other words, why was it unable to restore the rough fiscal balance of previous decades?

Feldstein responded that an important difference in the 1980s was indexing. Once indexing was on the books, there were not the automatic tax increases that had occurred in past decades.

Long felt that, since President Reagan had led the charge for the big tax cut, he did not relish the idea of working to repeal some of the things he had proudly signed into law. Long understood that, commenting that Reagan had not had as much experience as Long had at reversing his position. Long joked that he had voted *for* the investment tax credit three times and *against* it three times. He felt that flexibility is not a bad thing when the situation requires it.

Weidenbaum said that he, Baker, and others had constructed a package of excise tax increases that Dole was going to introduce in early 1982.

Stockman confirmed that the package was arranged in January 1982 because the administration was about to have to present the first $100 billion deficit in history and nobody wanted to send that up to Capitol Hill. They were about to

print the budget, but the Chamber of Commerce and the business lobbies fought the taxes, and they "died by noon." The budget had to be printed that same afternoon, so they invented prospective management savings to reduce the budget deficit. Today, a triple-digit deficit is nothing, but in those days it was close to fiscal treason.

The management savings were made up on the spot, but they had an important legacy. They were ridiculed on the Hill until it came time to put the TEFRA (Tax Equity and Fiscal Responsibility Act) package and budget together later in 1982. Then those savings were adopted as part of the "three-for-one" deal, in which there was supposed to be three dollars in spending cuts for every dollar in taxes raised by TEFRA. Those management savings were "out of this world" and could not have been achieved by anybody, but, two years later, the president and the Republican right wing decided that Congress had engaged in a great act of treachery by adopting the TEFRA tax increases and not producing the expected spending cuts. These particular spending cuts were never real cuts anyway. This was another aspect of why the government could not deal with the 7 percent fiscal hole: after a while, people began to believe things that were not true about the opportunities for change that existed.

William Niskanen said that, in the spring of 1981, many economists testified that the tax cuts would be wildly inflationary. This was the basis of the charge that the Reagan program was incoherent because, while monetary policy was presumed to reduce inflation, the tax cuts were presumed by economists of both parties to be inflationary.

Niskanen asked the group about two contingent tax proposals that did not pass. In June 1981, Representative Jim Jones, then head of the House Budget Committee, proposed that the third year of the tax cut be made contingent on Stockman delivering on his $44 billion "magic asterisk." Niskanen felt that this proposal was appealing from a public choice point of view because it provided a continuing incentive to both the administration and Congress to agree on $44 billion of further spending cuts. Why did the administration reject this idea so abruptly?

A different contingent tax proposal was suggested by the administration in the winter of 1983, in which they proposed a contingent tax increase if Congress made spending cuts. Niskanen thought that that was a bizarre proposal and wondered what its origin was.

Feldstein responded that the conditional tax increase with which he was involved was in the budget that was submitted in early 1983. The supply-siders and others were forecasting so much economic growth that the deficit was going to go away, and they argued that, if taxes were raised in 1983, that would kill the recovery. So the president's budget in the beginning of 1983 said that there would be a tax increase if there was not sufficient growth in 1984 to shrink the deficit to whatever the targets were. But this proposal never had the support of Baker in the White House or of the Treasury, so it was never pushed in Congress and died along the way.

Stockman said that the conditional tax increase was proposed because it seemed unacceptable within the administration to propose a budget that pointed the country toward the first permanent $200 billion budget deficit policy. It was easy to describe the idea internally in the administration, but, when the budget became public and reporters started asking about the contingent tax, nobody knew what it was. Sooner or later, someone said, maybe it's a flat tax, and that became part of the vocabulary of the fiscal debate over the course of the year, and eventually, as Bradley and the flat-taxers turned up the heat, there was the Treasury study in early 1984. The administration became hooked on the idea as a result of having to describe a contingent tax that was put in to help clean up the numbers but really had no content.

Walker thought that Jim Baker and Richard Darman [deputy White House chief of staff] were deeply concerned about the deficit in the summer of 1984 and earlier and wanted to do something about it. He said that Darman was accused in the campaign of 1984 of having a secret tax plan in the closet, and Walker believed that it was true. Walker believed that, if Baker and Darman had stayed in the White House in the first year of Reagan's second term, then there would have been serious consideration given to what Darman called a "big fix" on fiscal policy. However, Donald Regan was chief of staff in the White House by then, and he did not have a very good understanding of either the political or the economic issues involved. So the personality changes made a large increase in taxes (say 2 percent of GNP) absolutely impossible. Such an increase is not possible through nickel-and-dime tax changes or through the income tax because the revenue from the income tax comes mainly at the expense of the middle class, which is the driving political force in the country. The remaining possibility is a broad-based consumption tax, not just because it is a consumption tax, but because it raises so much revenue.

Walker said that the politics of tax increases started to change when Walter Mondale told the Democratic Convention in August 1984 that both he and Reagan knew that taxes would have to be increased but that Mondale would say so and that Reagan would not. At his next press conference, Reagan said that he was against raising taxes until federal spending was down to the lowest possible level relative to GNP. In other words, he did not close the door to the idea. However, it became clear that Mondale had made a big political mistake, so, by the time the campaign ended, "no tax increase" had become dogma as far as the president, and later Regan, was concerned. Over the next several years, it became basic Republican policy. Walker felt that the United States now has a plebiscite democracy that is giving the people exactly what they want—low taxes *and* high spending.

James Poterba shifted the discussion to the distributional politics of the tax burden. Looking back over the decade, he was struck that the 1981 changes were very beneficial to those at the top of the income distribution and that the 1983 Social Security reform moved in the same direction by putting higher tax burdens on low-income earners. However, if one consolidates the corporation

tax changes into the 1986 tax reform, that represents a reversal by putting higher burdens on those at the top of the income distribution. And the 1990 discussions of taxes on yachts, planes, and millionaires suggest that we have come full circle on this topic.

Walker felt that the Democrats were now considering a strong populist approach as a political strategy, in contrast with Stockman's remark after the 1978 tax act passed that the country is no longer concerned with how income is distributed but with how it is created. This partisan debate had received a big push in the previous three or four months as a result of the debate on the budget and the capital gains proposal. Walker also cited David Broder's recent column on the Op-Ed page of the *Washington Post* in which Broder said that the "fairness" issue would not work politically because the real concern of the American people is not the taxes that rich people pay but the taxes that they pay themselves.

Long agreed that tax rates should not be so high as to be counterproductive. He held that view in terms of the personal income tax as well as the corporate income tax, and he felt that the tax code should not go beyond the point at which it will really reduce economic activity. He believed that, as long as low-income people are doing better, middle-income people are doing better, and those in all walks of life are doing better, it is very important to keep accumulating capital and making investments. At some point we have to be in favor of creating more wealth even if it doesn't come in with quite the distributional pattern we would like.

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