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Introduction

In the United States since the 1930s, the Treasury Department and tax experts has attempted to accomplish a "one package" comprehensive tax reform program to create a simpler, fairer, and more equitable federal income tax system with sufficient ability to raise revenue.[1] Robert Murray Haig first introduced this idea, and Henry C. Simons, Carl Shoup, Stanley S. Surrey, and staff in the Treasury inherited and developed it.[2] However, their attempts to accomplish the kind of tax reform have always failed except in 1986. Instead, tax cuts and tax expenditures frequently utilized since the 1960s have undermined not only the ability to raise revenue, but also fairness and equity of the federal income tax system.

This paper picks up three episodes of federal tax reform—federal tax reform of 1964, 1978, and 1986—to demonstrate the effort of the Treasury, tax experts, and the administrations to accomplish their ideal tax reform, and the process in and for which they failed and succeeded. The attempts of comprehensive tax reform in the United States after World War II were fundamentally on the basis of the tax idea of Surrey—boosting horizontal and vertical equity, simplicity, fairness, and progressivity with no revenue losses. However, the tax cut in 1964—which "Keynesians" misused the ideas and attribution of Keynes—doomed the tax reform program that Surrey and the Treasury staff crafted. The result led Surrey and his colleagues in the Treasury to devise

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[1] Joseph J. Thorndike, *Their Fair Share: Taxing the Rich in the Age of FDR* (Washington, D.C.: The Urban Institute Press, 2013).

[2] W. Elliot Brownlee, "Tax Regimes, National Crisis, and State-building in America," in *Funding the Modern American State, 1941-1995: The Rise and Fall of the Era of Easy Finance*, ed. W. Elliot Brownlee (New York: The Woodrow Wilson Center Press and Cambridge University Press, 1996), 37-104.

the concept of "tax expenditure," originally conceived as the criterion to determine whether a particular policy objective should be pursued through direct government expenditures or tax preferences so as to accomplish their ideal comprehensive tax reform. In the late 1970s, although the administration of Jimmy Carter advocated reduction of tax expenditures increasingly used in the early 1970s, their attempt resulted in failure. Exceptionally, the administration of Ronald Reagan temporarily eased away from this path of tax preferences by implementing a comprehensive tax reform through cuts in tax expenditures in 1986.

Through examining the three episodes, this paper explores why these administrations succeeded or failed their tax reform efforts. From the late 1950s to 1960s, one southern Democrat Wilbur D. Mills, led the House Committee on Ways and Means (CWM), significantly contributed to take up comprehensive tax reform programs onto the legislative stage. However, the Congress in 1964 abolished most of loophole-closing measures due to fervent business and conservative opposition and Mills' inconsistent action. During the Carter presidency, Democratic and Republican leaders in Congress favored tax preferences for the higher-income brackets, and their approach prevailed. Their failure was because of the fact that the administrations proposed their tax reform program as tax reduction. In contrast, the Reagan administration made the only accomplishment of a comprehensive tax reform in 1986. They succeeded persuading Congress and opponents to loophole-closing reforms by invoking tax justice rooted in horizontal equity in ways of having been advocated by tax reform proponents such as Haig, Shoup, and Surrey, in exchange of conceiving the kind of economic efficacy that would result from lowering tax rates.

1. Tax Idea of Surrey and Keynes

The idea of comprehensive tax reform in the United States, which emphasizes fairness, simplicity, and equity, came from Germany, and was inherited by Edwin R. A. Seligman, Robert Murray Haig, and Carl S. Shoup. Through these public finance experts, tax law scholar Stanley S. Surrey learned this idea. He helped and led the attempt of the Treasury and the administrations after World War II.[3]

From the 1950s, Surrey kept emphasizing an accomplishment of the comprehensive tax reform to boost fairness, simplicity, horizontal and vertical equity, and progressivity. He thought federal income tax system had to contain better progressiveness and equity of the tax burden among the type and amount of income, and to smooth the rate structure without revenue losses.[4] Surrey viewed that preferential treatment for certain types of income brought about an overly narrow tax base, excessively high marginal rates, low effective rates, and an inequitable tax burden among types of income. Then he argued that the combination of a rate reduction and the elimination of upper-bracket differentials would materially improve the federal income tax system without revenue losses. With respect to the significant differentials between the lower- and middle-brackets, he believed that their elimination would likewise be far easier in the context of a general revenue revision involving compensating rate cuts, a

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[3] For Surrey's background, see, for example, Mirit Eyal-Cohen, "Preventive Tax Policy: Chief Justice Roger J. Traynor's Tax Philosophy," *Hastings Law Journal,* March 2008, Vol. 59; Erwin, N. Griswold, "A True Public Servant," *Harvard Law Review,* December 1984, Vol. 98, No. 2; "Stanley S. Surrey, 74; Taxation Law Expert," *The New York Times*, August 28, 1984.

[4] William Andrews, who was the Eli Goldston Professor of Law at Harvard Law School, described in retrospect the following: "This unity [of Surrey's thought and action] resulted partly from the single-mindedness of Stanley's concern for a fair, progressive tax system; wherever he was working and whatever he was doing, he was bound to be continuing the crusade for that objective." See William D. Andrews, "A Source of Inspiration," *Harvard Law Review,* December 1984, Vol. 98, No. 2, 332.

splitting of the first bracket, or increases in personal exemptions.[5] After Surrey was appointed to Assistant Secretary of the Treasury for Tax Policy in 1961, he began his work with those who had the same idea in the Treasury such as Seymour Harris, Harvey E. Brazer, and other staff.[6] Toward the same goal as Surrey envisioned, they emphasized broadening the tax base would boost progressivity and horizontal equity.

Surrey's tax idea had a similarity to that of John Maynard Keynes and his American contemporaries such as Alvin H. Hansen and Abba Lerner. In *General Theory*, Keynes argued that a low propensity to consume under highly developed capitalism would widen the gap between aggregate income and aggregate consumption, and this, in turn, would reduce the incentive for investment while increasing savings. Then, he suggested income tax reform aimed at redistributing income equally through the combination of capital levies such as capital gains taxation and estate and gift taxation to raise funds for government programs, and the reduction of taxes on income and consumption.[7] In *How to Pay for the War*, he sought to prevent inflation and the exhaustion of resources, to raise funds for government expenditure to prevent deflation and unemployment in the first recession that might come after World War II, and to prevent the aggravation of unequal income and consumption among the working class,

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[5] Stanley S. Surrey, "Summary Statement of Stanley S. Surrey for Hearings on Broadening The Tax Base, House Committee on Ways and Means November 16, 1959, The Federal Income Tax Base for Individuals," Undated, Historical Special Collection (HSC), Harvard Law School Library (HLSL), Stanley S. Surrey Papers (SSSP), Box 39, File No. 28-1: Ways and Means Committee, 1957-1960.

[6] As to the tax idea of Harris, see Seymour E. Harris, "Where Is the Money Coming From?" October 8, 1956, HSC, HLSL, SSSP, Box 14, File No. 40-5: Hon. Wilbur D. Mills, 1956-1959. As to Brazer's background, see, for example, "Harvey E. Brazer, 68, Professor of Economics," *The New York Times*, May 18, 1991; Faculty History Project of University of Michigan (http://um2017.org/faculty-history/faculty/harvey-e-brazer). As Surrey stated in retrospect, the Treasury and its staff fervently opposed the widespread use of the tax incentives. See Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973), vii.

[7] John M. Keynes, *The Collected Writings of John Maynard Keynes, Volume 7: The General Theory of Employment, Interest and Money* (Macmillan: Cambridge University Press, 1973), 94-95, 372-373.

capitalists, and the wealthy. To accomplish these goals, Keynes advocated boosting progressivity sharply by the exempt minimum and a tax increase mainly on middle- and high-income classes, and a general capital levy.[8] Keynes' tax idea also emphasized vertical and horizontal equity, progressivity, countercyclical tax flexibility, and the financing ability of government through the income tax system. In the United States, Keynes idea spread through his American contemporaries.[9]

2. The 1964 Defeat of Comprehensive Tax Reform Proposal

The story of the 1964 tax reform began with the research of the Treasury and its cooperation with the CWM in the 1950s. In the late 1950s, the Treasury and the CWM determined to began their work to complete the unfinished business of the administrations of Harry S. Truman and Dwight E. Eisenhower until 1954: Reforming the defects of the federal income tax system that constructed during World War II—lower personal exemptions and a steep and high rate structure a narrowed tax base that favored recipients of unearned income and relatively higher-income classes.[10] Representative Wilbur D. Mills (Democrat-Arkansas), an accomplished and politically talented member of the CWM, significantly contributed to this movement. Through his activity in several congressional committees in the 1950s, Mills concluded that the

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[8] John M. Keynes, *How to Pay for the War* (London: Macmillan, 1940), 34-51.

[9] Abba P. Lerner, *The Economics of Control: Principles of Welfare Economics* (New York: Macmillan, 1947); Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York: W.W. Norton & Company, Inc., 1941).

[10] As to the tax regime structured during the wartime, see W. Elliot Brownlee, "Tax Regimes, National Crisis, and State-building in America" in *Funding the Modern American State,* ed. W. Elliot Brownlee, 88-96; Carolyn C. Jones, "Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax during World War II," *Buffalo Law Review* 37 (1989), 685-737. As for the details of the federal tax system structured by tax reform programs until 1954, see U.S. Congress, Joint Economic Committee, *The Federal Revenue System: Facts and Problems, 1961* (Washington, D.C.: U.S. Government Printing Office, 1961).

single package of comprehensive tax reform would provide a fairer, simpler, and more equitable and progressive income tax system that could raise more total revenues, keep the federal budget roughly in balance over the years, and create an atmosphere of equal opportunity for steady economic growth and expansion.[11]

After Mills assumed the chairman of the CWM in 1958, the CWM, cooperating with the Treasury, held hearings to discuss the specific measures of such tax reform from November 16 to December 18 in 1959.[12] Through the series of hearings, the CWM led by Mills and the Treasury succeeded in making tax experts, economists, and congressmen known how necessary a comprehensive tax reform was to be accomplished. After Kennedy took the office on January 20, 1961, the Treasury, led by Surrey, Harris, and Brazer, began their work to craft the comprehensive tax reform proposal based on the discussion of the CWM and the Treasury in the late 1950s. When the Treasury drafted the original tax reform bill in 1961, their idea prevailed in the Kennedy administration. Advisers of the administration and the Treasury agreed to the proposal a coherent package tax reform combining base-broadening reforms with rate reductions, at least until 1963.[13]

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[11] "Keep the Income Tax but Make It Fair," *U.S. News & World Report*, July 27, 1956; Louis Cassels, "This Man Shapes Your Tax Bill," *Nation's Business*, March 1956.

[12] "Program of Panel Discussion in General Revenue Revision, 1959," September 8, 1959, National Archives College Park (NACP), Record Group (RG) 56, Office of Tax Policy: Subject Files (OTPSF), Box 68, File Folder #55: Tax Legislative Program for 1959-1960, Mills Subcommittee, 1959-1962. As for this series of hearings, see U.S. House of Representatives, Committee on Ways and Means, *Tax Revision Compendium of Papers on Broadening the Tax Base,* vol.1-3 (Washington, D.C.: U.S. Government Printing Office, 1959).

[13] Arthur Okun to Robert Solow and Joseph Pechman, "Tax Meeting of November 24," November 25, 1961, John F. Kennedy Library (JFKL), Walter W. Heller Personal Papers (WWHPP), Box 22, File: Tax Cut 4/61-11/61; "A Summary of the Views of Tax Consultants Eckstein, Goode, Pechman, and Shoup on the Tax Reform Issues Discussed at the Treasury Department on June 10, 1961," October 26, 1961, HSC, HLSL, SSSP, Box 59, File No. 208-3A: Consultants Prof. Seymour Harris, 1961-1962; Robert Solow to

However, they failed in accomplishing their tax reform program in 1964. One of reasons for this failure was the pressure from the Council of Economic Advisers (CEA) and economists for Kennedy. They have been called "Keynesian" economists. However, their tax idea was absolutely different from that of Keynes, and even Surrey's thought. Based on the concept of "full-employment budget," they argued that the "full-employment budget surplus" should be offset by "fiscal dividends" through tax cuts or increases in government expenditure, even if actual budget was deficit.[14] From 1961 to 1962, the CEA and several economists such as Paul Samuelson and Robert Solow persistently persuaded Kennedy of the importance of deliberate deficit financing through tax cuts to prevent economic decline. Economist outside the administration and business interests supported CEA's argument.[15]

In addition to the series of tax cut arguments, the change of economic and political conditions vanished the administration's original tax reform program.[16] Especially, in 1962, criticism against the administration increasingly spread among Republicans and businesses. At that time, tax cut turned into a measure appealing to the Kennedy administration for both political and economic reasons.[17] They also expected that it

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Walter W. Heller, Kermit Gordon and James Tobin, "Tax Reform in 1962," April 24, 1961, JFKL, WWHPP, Box 22, File: Tax Cut 4/61-11/61.

[14] This concept means the difference between the balance of the actual budget and of the full-employment budget, which is the notion assumed when an economy is at full employment.

[15] Cathie Jo Martin, *Shifting the Burden: The Struggle Over Growth and Corporate Taxation* (Chicago: The University of Chicago Press, 1991); Herbert Stein, *Fiscal Revolution in America* (Chicago: The University of Chicago Press, 1969).

[16] As to the details about the changes of political and economic conditions, see Arthur M. Schlesinger, Jr., *A Thousand Days* (Boston: Houghton Mifflin Co., 1965), chapter 23.

[17] Based on the full-employment budget, the CEA could have chosen government expenditure increases as a measure to stimulate economy. However, the political complex required an approach to expansionary policy that would not be rejected on grounds that it necessarily meant bloated budgets. See Walter W. Heller, *New Dimension of Political Economy,* (New York: W.W. Norton & Company, Inc., 1966), 113.

would keep the Democratic tradition while avoiding conflict with business.[18] Therefore, they recommended that the administration should propose their tax reform program as a net tax cut and divided it into two parts: the permanent rate cuts and simple tax-cutting measures would take effect first; and controversial base-broadening reform measures should take effect one year later to alleviate the predictable opposition (the two-stage approach).[19] Although the Treasury and Mills were not in favor of this approach, they finally accepted it after the negotiation with the CEA.[20] The Treasury and Mills abandoned their ideal tax reform with hoping that the two-package approach would make the eventual adoption of tax reform much more likely. The tax reform program, when proposed in January 1963, did not take the revenue-neutral and coherent form. It took the form of two-stage tax cut. The administration's proposal primarily emphasized the purpose of stimulating consumption and investment, while stating structural reform measures to boost progressivity, fairness, simplicity, and horizontal and vertical equity.[21]

Nevertheless, businesses, Republicans, and several newspapers fervently attacked the proposed structural reform measures.[22] Their opposition mainly focused on the

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[18] Arthur M. Schlesinger, Jr. to John F. Kennedy, "Tax Cut," July 17, 1962, JFKL, WWHPP, Box 22, File: Tax Cut 6/62-7/62.

[19] Walter W. Heller to John F. Kennedy, "Where We Stand on Budget and Tax Policy Decisions," June 9, 1962, JFKL, WWHPP, Box 22, File: Tax Cut 6/62-7/62.

[20] Robert A. Wallace, "Possible Compromise on Tax Package," November 19, 1962, JFKL, Record of Department of Treasury Microfilm Print Outs (RDTMPO), Roll 40, Folder 2 of 2, File: Asst. Secy. of Treasury (Robert A. Wallace), Troika, September–December 1962.

[21] *Public Papers of the Presidents of the United States, John F. Kennedy: Containing the Public Messages, Speeches, and Statements of the President, January 20 to November 22, 1963,* 73-92.

[22] In 1961, Congressional opposition to Surrey's appointment was intense. The oil and gas industry, the mining industry, the savings-and-loan associations, and an army of others who benefited from tax preferences raised a storm of protest. Surrey's reception before the SFC was particularly hostile, with Chairman Harry Byrd (Republican-Virginia) indignantly accusing him of harboring a low opinion of the

restraint of itemized deduction, the repeal of dividend credit and exclusion, and the restraint of preferential treatment for capital gains. These criticisms against reform measures were on the ground of their idea that this tax reform program unfairly impose excessive tax burden on higher-income classes, investors, and homeowners.[23] In the face of fervent opposition, Mills, who had been one of the imminent proponents of comprehensive tax reform, turned his attitude into a tax-cut proponent.[24] Consequently, most loophole-closing provisions were abandoned or gutted by the CWM and the SFC. The tax reform program was legislated in 1964 as the largest tax cut until 1981 with huge rate cuts in the individual and corporate income taxes and almost no reform measures—the so-called "Kennedy-Johnson tax cut."[25] The original impetus for tax reform had vanished.

The defeat of the comprehensive tax reform in 1964 left two legacies on federal tax and fiscal policy. The first was the idea that deliberate deficit-finance through tax reduction would stimulate consumer demand or investment, expand economy, and result in increasing tax revenues. The tax idea of comprehensive tax reform proponents was more similar to the idea of Keynes, Hansen, and Lerner than that of "tax cut" proponents nowadays mentioned as "Keynesians." However, their effort ended up in failure, and the tax cut argument finally won. Kennedy's economic advisers repeatedly

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nation's legislators. See Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (New York: Random House, 1987), 14.

[23] "5 Per Cent Tax Deduction," *The Washington Post*, February 14, 1963.

[24] Herbert Stein, *The Fiscal Revolution in America*, 449-450. Stein cited Mills' Statement from U.S., Congress, House, *Congressional Record,* 88th Cong., 1st Sess., 1963, Vol. 109, pt. 13, 17908-17909.

[25] The Treasury Department, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1964* (Washington, D.C.: Government Printing Office, 1965), 36. Richard Goode demonstrates the particular result and effect that the tax reform of 1964 had on the individual income tax system. See Richard Goode, *The Individual Income Tax, 1st ed.* (Washington, D.C.: The Brookings Institution, 1964), 236.

applauded the tax cut as having contributed to economic expansion in 1964 and resulting in increasing tax revenues.[26] Then, ignoring the real thought of Keynes, the victorious CEA and other economists promoted the popularity of the Kennedy–Johnson tax cut as a part of “the completion of the Keynesian revolution,” despite the fact that it had little to do with the true ideas of Keynes and his American contemporaries.

Secondarily, the 1964 tax cut produced the idea that any comprehensive tax reform should contain rate reductions and be proposed as a net tax reduction. Surrey, staff in the Treasury, and even Mills had never argued that a comprehensive tax reform should be a tax reduction before the administration proposed the tax reform program in 1963. However, Mills acted inconsistently and changed his attitude in the legislative process. Mills changed his argument regarding with a comprehensive tax reform. Remembering the legislative process and result of the Kennedy–Johnson tax cut, Mills thereafter argued that every comprehensive tax reform program should include tax reductions to pass it through Congress.[27]

3. The Concept of Tax Expenditures and the Criticism Against “Keynesianism”

“Keynesian” won the main stream of the federal tax policy by the enactment of the Revenue Act of 1964. When it turned out the Treasury would be very likely to be defeated, however, they attempted to make use of the result of the 1964 tax cut as a representation that they had decided to arrest the gradual erosion of the tax base through

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[26] Walter W. Heller to Lyndon B. Johnson, “Economic Impact of the Tax Cut,” June 2, 1964, JFKL, WWHPP, Box 23, File: Tax 6/63.

[27] Wilbur D. Mills, “Remarks before the American Institute of Certified Public Accountants, Washington, D.C.,” October 16, 1968, The Hendrix College Archives (HCA), Wilbur D. Mills Papers Collections (WDMPC), Box 644, File 3.

special preferences and privileges for certain groups of taxpayers.[28] Surrey and new director of the OTA, Gerald M. Brannon, mainly directed this attempt inside the Treasury. In order to accomplish this goal, they devised the concept of "tax expenditures" to recognize tax preferences the same as government expenditures—though this term would never be used until 1967 publicly—in 1965. Brannon suggested that this concept would be useful to judge whether or not a certain government expenditure or tax preferences would be a good idea.[29]

Along with his suggestion, Surrey obtained the viewpoint that any tax preferences designed to further a specific and desirable social goal should be tested whether or not it would be really possible to achieve it more efficiently, directly, and fairly than through government direct expenditure programs.[30] Surrey clearly thought that taxes foregone because of a desire to benefit a particular activity or to induce certain activities were "monies spent." Surrey recognized in particular the preferential treatments mainly favored higher-income taxpayers such as capital gains tax and dividends credits and exclusion as such. In contrast, as to programs for education, pollution, manpower training, research and development, Surrey favored the non-tax approach because the benefits from tax preferences might be misdirected to taxpayers who did really not need them, or withheld from those whose low incomes kept them from being taxpayers at

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[28] "Remarks of the Honorable Henry H. Fowler, Under Secretary of the Treasury, at the Fourteenth Annual Midyear Conference of the Tax Executives Institute, Mayflower Hotel, Washington, D.C., Monday, March 2, 1964, 7:30 P.M., EST: A Turning Point in Tax Policy," March 3, 1964, NACP, RG 56, OTPSF, Box 69, Folder #96: Tax Policy (1964-1965).

[29] Gerald M. Brannon, "Statement of Treasury Policy on Tax Credits," March 30, 1964, NACP, RG 56, OTPSF, Box 69, Folder #96: Tax Policy (1964-1965).

[30] "Remarks by the Honorable Stanley S. Surrey Assistant Secretary of the Treasury before the Tax Executive Institute Shoreham Hotel, Washington, D.C. 6:30 P.M. EST, Sunday, March 7, 1965: The Function of Tax Policy," Undated, NACP, RG 56, OTPSF, Box 69, Folder #96: Tax Policy, 1964-1965.

all.[31] The Treasury continued researching this concept with expectation that it would make clear the importance of the distinction who really needed help or not to avoid wasting tax revenue that instead could be used directly to finance a constructive program to those who would most need it. In addition, they thought tax reform programs based on a research based on this concept would provide the federal tax system with the ability to produce revenue for government programs for those who really need it in as fair, equitable, and simple way as possible.

This establishment of tax expenditure concept wedded to the criticism against deficit financing of "Keynesian" and the convergence of the power of purse onto Congress in the 1970s. The administrations of Lyndon B. Johnson and Richard M. Nixon faced with exacerbation of federal deficits and inflationary pressure. This situation bore the criticism against the juxtaposition of the "Keynesian" amendment of a "fiscal constitution"—the prevailing rules guiding fiscal choice legally and non-legally––and democratic political process of the United States. The pre-Keynesian fiscal constitution expected expenditures to be financed from taxation. However, it was contended that "Keynesian" broke this expenditure-taxation nexus, and replaced the old constitution with a new one that cyclical fluctuations in economic activity was to be damped by using government to control aggregate macroeconomic variables. This replacement of a fiscal constitution presumed that policy decisions should be made by a small and enlightened group of wise people in a rational government—the "presuppositions of Harvey Road." In the United States, it was contended that

[31] Treasury Department, "Remarks by the Honorable Stanley S. Surrey, Assistant Secretary of the Treasury at the Financial Analysts Federation Conference, Washington Hilton Hotel, Washington, D.C., Tuesday, October 5, 1965, 12:30 P.M. EDT: The Role of Tax Policy in the Great Society," Undated, NACP, RG 56, OTPSF, Box 69, Folder #96: Tax Policy, 1964-1965.

Keynesian policymakers based on the presuppositions had created bureaucratic policymaking process and neglected the important fact that any policy choices had emerged from democratic politics in Congress.[32]

This criticism required the reform of the federal budgetary procedure that would be controlled in the democratic policy-choice process in Congress. To the critics, the existing budgetary procedures had made a decision regarding taxation in isolation from decisions about expenditure. This argument spread the recognition that the existing budgetary procedures generated a bias toward expanding spending and budget deficits. This growing recognition inspired and informed the Congressional Budget and Impoundment Control Act of 1974 that intended to give Congress a tighter grip on the nation's purse strings.[33] The act created a Budget Committee for each house. These committees were given the task of setting overall targets for revenues, expenditures, and the resulting deficits or surplus. The act also instituted the Congressional Budget Office (CBO) that was obliged to help the work of the Budget Committees, reviewed the amount of tax expenditures, and investigated tax reform programs to reduce unnecessary tax expenditures in cooperation with the Joint Committee on Taxation of Congress (JCT). Under the new act, the CWM and the SFC were required to work on the legislation of tax code with considering the level of revenue that each Budget Committee had targeted, and the research of the CBO and the JCT. Furthermore, the act forced administrations to pay more attention to the intentions of Congress than before.

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[32] James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, Inc., 1977), 21-22, 77-105.

[33] James M. Buchanan and Richard E. Wagner, *Democracy in Deficit*, 156. As to the detail of the Congressional Budget and Impoundment Control Act of 1974, see Committee for Economic Development, *The New Congressional Budget Process and the Economy* (New York: Committee for Economic Development, 1975).

4. The Second Defeat of Tax Reform in 1978

These institutional changes certainly strengthened the power of Congress to control federal tax policy. In the 1970s, however, it did not contribute to the fiscal consolidation of the United States, or an accomplishment of a comprehensive tax reform. The remarkable story is the attempt of the administration of Jimmy Carter that began in 1977. Carter felt a strong campaign commitment to reform the federal tax system that he had called a "disgrace to the human race" and "a welfare program for the rich." Carter criticized the existing federal tax system as a regressive one that let the total tax burden shift toward the average wage earner and called for lower taxes on low- and middle-income families and a shift of the tax burden to the wealthy and corporations. He also thought that the nation was ready for comprehensive, total tax reform. His plan was to eliminate hundreds of tax loopholes and greatly reduce tax rates.[34] In addition, Carter expressed his desire to complete the tax reform effort without any significant loss of revenue.

After Carter took office, the Treasury, led by the Secretary Michael Blumenthal and Assistant Secretary for Tax Policy Lawrence Woodworth, began publicly discussing the tax reform provisions under consideration. Inside the administration, several members of the White House Domestic Policy Staff (DPS) worked for devising administration's tax reform program. Executive Director of the DPS Stuart Eizenstat and a member Robert Ginsberg led the effort of the group. In Congress, the CWM led by Al Ullman (Democrat-Oregon) and the SFC chaired by Russell Long (Democrat-Louisiana) also considered provisions that the tax reform should include.

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[34] Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch*, 15.

Through discussion with Ullman and Long in the early 1977 in order to outline which the purpose and the provisions the tax reform program should include, the Carter administration found that they were in favor of using tax preferences. Ullman favored the expansion of tax preferences such as employment tax credits that would encourage firms to hire new workers, in ways of benefitting indirectly lower- and middle-income taxpayers. However, the administration did not favor Ullman's proposal in terms of the effect that might increase tax expenditure for businesses and higher-income taxpayers. Based on their research, Blumenthal and Eizenstat, recommended Carter not to support this measure because of the expected loss of tax revenue, and inequitable effect on taxpayers and on the complexity of federal tax system.[35] They feared that such kinds of proposal might make administration's tax reform program perceived to further complexify the bureaucracy because it would increase complexity of the demand on the Internal Revenue Services (IRS). Thus, they urged Carter to stick with his original intention, and press for congressional action with as little change as possible.[36]

With considering demands of the congressmen, several staffs inside the White House thought that the work of planning tax reform program should be coordinated with interests of each agency inside the administration. Bert Lance, Carter's first director of the Office of Management and Budget (OMB), worn Carter that past experience suggested the operating agencies of the executive branch should be enemies of tax reform because each of them would view loopholes as vitally important to their programs and constituents. In the meantime, he emphasized that the plans for

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[35] Stuart Eizenstat to Richard Hutcheson, "Congressman Ullman's Employment Tax Credit Proposal," January 31, 1977, Folder: 2/5/77 [1], Container 5, Office of the Staff Secretary Files (OSSF), Presidential Files (PF), Jimmy Carter Library (JCL).

[36] Mark Siegel to Jimmy Carter, "Ullman's Tax Proposal," January 31, 1977, Folder: 2/5/77 [1], Container 5, OSSF, PF, JCL.

consultations with the public should be appropriate and necessary because reform proposals laid out cold before the CWM as an administration's package had not been legislated. Furthermore, Lance was concerned that other major administration policy initiatives regarding with energy and welfare reform would be developed with tax elements that might be inconsistent with the tax reform package. He then argued that this would need to be coordinated through the Economic Policy Group (EPG).[37] Eizenstat and Ginsberg also recommended that Carter should involve his principal economic advisers such as the CEA and the EPG at the outset of the project in helping the Treasury block out the general areas of tax reform to be considered.[38]

Woodworth and the Treasury staff intensively worked to design the tax reform program to be coordinated with the other administration's programs.[39] The Treasury intended to eliminate the special preference for capital gains and was taking a hard look at some of the more egregious personal deductions and business tax preferences. The first Treasury's tax reform program that Blumenthal sent Carter in May 1977 contained measures for simplification, capital gain taxes, rate reduction, taxation of foreign income and capital formation.[40]

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[37] Bert Lance to Jimmy Carter, February 10, 1977, Folder: 2/15/77 [1], Box 7, OSSF, PF, JCL. For the detail and membership of the EPG, see W. Carl Biven, J*immy Carter's Economy: Policy in an Age of Limits* (Chapel Hill: The University of North Carolina Press, 2002), 40-45. The EPG included Charles Schultze, the chairman of the CEA, Lance, and Blumenthal. Lance's deputy, James McIntyre, replaced Lance later.

[38] Stuart Eizenstat and Robert Ginsburg to Jimmy Carter, "Secretary Blumenthal's Memorandum Re Organizing for Tax Reform," February 11, 1977, Folder: 1/20/77-5/31/77, Box FI-28, FI 10, WHCF, SFE, JCL.

[39] Lawrence Woodworth (through W. Michael Blumenthal) to Jimmy Carter, "Relationship of Energy Program to Tax Reform," April 1, 1977, Folder: 1/20/77-5/31/77, Box FI-28, FI 10, WHCF, SFE, JCL.

[40] W. Michael Blumenthal to Jimmy Carter, "Possible Tax Reform Program," Undated, Folder: 5/19/77 [2], Container 21, OSSF, PF, JCL.

To Eizenstat and Ginsberg, however, their proposal had some serious concerns. They evaluated that the Treasury did not review all of existing tax expenditures the federal tax system contained. Rather, the Treasury made a number of ad hoc political judgments as to which reform measures would be acceptable to the Congress such as substitution of a general credit for the existing $750 personal exemption. There was also an apparent hesitancy to go after the travel and entertainment expense deductions and the remaining tax shelters. The Treasury's proposal also considered the integration of the corporate and individual income taxes. However, since corporate shares were disproportionately held by the wealthy, almost all forms of integration would be heavily weighted in favor of upper income taxpayers. Furthermore, the form of integration being considered by Treasury had been criticized in the past for encouraging the payment of dividends to shareholders, thereby reducing business investment of retained earnings—that kind of criticism might strengthen business arguments for retention of the existing capital gains preference as a countervailing incentive for the retention and investment of earnings. Eizenstat and Ginsberg viewed that these provisions were adverse to the intention of the administration and Carter.

They were also concerned about the estimated cost the Treasury's reform proposal would create. The Treasury plan contained the revision of rate schedule from 14-70 to 13-50 percent. The integration of the corporate and individual income taxes would cost approximately $13.5 billion presently and increase in cost to about $25 billion by fiscal 1981. Eizenstat and Ginsberg evaluated the tax reform package based on the Treasury's recommendation would be extremely costly, and tilted largely in favor of tax reductions for the wealthy and business. They contended that the Treasury's preliminary proposal would have a minimal effect on administration's fundamental objective of tax reform—

boosting fairness, equity, simplicity, and progressivity of the tax system. Then Eizenstat and Ginsberg urged Carter to schedule a meeting with Woodworth and his principal assistants in order to instruct the Treasury to prepare proposals that would meet those objectives, as well as his insistence on making the political decisions on major issuers and options himself. They thought that the fact that Carter made the political decisions on that tax reform program himself would be better than having the Treasury make political judgments as to what would be acceptable to the Congress and watering down the reform proposals.[41]

Based on their evaluation of the Treasury's proposal, Eizenstat and Ginsberg designed their tax reform proposal basically along with Carter's statement. They emphasized that the tax reform should be comprehensive by a zero-based review and elimination of tax expenditures that principally tilted to favor upper-income taxpayers and enabled them to avoid bearing an equitable part of the overall tax burden. Removing the capital gains preference, tax shelters and business expense deductions such as those for first class travel and the "three-martini lunches," and preferential treatment for the Domestic International Sales Corporation (DISC) and foreign deferral provisions would be essential elements of achieving a credible tax reform effort. They argued that the repeal of preferential treatment for dividend and interest would tax equally the corporate shares disproportionately held by the wealthy. They expected that this tax reform plan would result in creating a fairer, simpler, and more progressive tax system. To them, achieving this tax system would make any taxpayers pay their fair

[41] Robert Ginsberg and Stuart Eizenstat to Jimmy Carter, "Tax Reform Meeting," May 16, 1977, Folder: 5/18/77, Container 21, OSSF, PF, JCL.

share, enable them to fill out his own return, and reduce the overall complexity of the tax system.[42]

The proposal of Eizenstat and Ginsberg included an element deviated from Carter's almost-revenue-neutral requirement. Eizenstat and Ginsberg thought that to meet it would be extremely difficult because the average taxpayer would probably not regard the tax reform effort very favorably if it did not reduce his taxes. They viewed that the Congress was likely to reduce taxes in the years ahead to offset the effects of inflation on the average taxpayers—inflation pushed taxpayers into higher tax brackets, even though their real income had not changed (bracket creep). The predicted that tax reductions would probably also be required to meet Carter's budget objective of keeping the federal sector at about 21% of GNP.[43] Eizenstat and Ginsberg thought that average taxpayer deserved a good-sized ($200-$300) tax reduction and that being able to promise that kind of a reduction would be essential to the success of their tax reform effort. At the same time, in order to keep the revenue loss within bounds, they thought it was necessary to reduce the existing $100 billion tax expenditures more than the Treasury recommended.[44]

However, changing budgetary, economic and political realities began urging Carter aides to begin reshaping the tax proposal. The most significant event was that the Congress watered down the administration's economic stimulus program proposed on

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[42] Robert Ginsberg and Stuart Eizenstat to Jimmy Carter, "Tax Reform Meeting," May 16, 1977, Folder: 5/18/77, Container 21, OSSF, PF, JCL.

[43] During the presidential campaign in 1976, Carter often mentioned the restraint of the size of federal budget in order to avoid flaring up inflationary pressure again. See Burton I. Kaufman and Scott Kaufman, *The Presidency of James Earl Carter Jr., 2nd ed., revised* (Lawrence: University Press of Kansas, 2006), 33-35.

[44] Robert Ginsberg and Stuart Eizenstat to Jimmy Carter, "Tax Reform Meeting," May 16, 1977, Folder: 5/18/77, Container 21, OSSF, PF, JCL.

January 31, 1977. The program included tax cuts incorporating $50 tax rebate and business tax reduction such as an increased investment credit and a wage credit. On May 16, however, the tax cut program turned out in the end to be relatively mild mainly due to the elimination of the rebate and an optional tax credit for business from the original proposal.[45] Joseph Pechman, one of the leading scholars on budget matters, and Alan Greenspan, chairman of the CEA for former president Gerald Ford, concluded the final bill turned out to be somewhat less stimulating that the tax-cutting measure the Ford administration had carried out.[46]

The Carter administration feared that the watered-down tax cut and its mild stimulus effect might weaken international position of the United States. Shortly after Carter took the office, the administration intensively attempted to persuade Japan and West Germany into acting as international economic leaders: To stimulate their domestic demand in order to increase their import from developing countries. Domestic economic expansion through the tax cut was the card to make them accept it. It was evaluated internationally that the resultant tax cut had less stimulating effect than the tax cut originally proposed. Then the Carter administration was situated to make the pressure on Japan and West Germany weaker than the administration actually wanted.[47]

In the face of these conditions, Schlutze became aggressive in proposing the larger revenue losses of administration's comprehensive tax reform program. He calculated

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[45] Congressional Quarterly, Inc., *Congressional Quarterly Almanac, 1977* (Washington, D.C.: Congressional Quarterly, Inc., 1978), 101-109.

[46] W. Carl Biven, *Jimmy Carter's Economy: Policy in an Age of Limits* (Chapel Hill: The University North Carolina Press, 2002), 198; Erwin C. Hargrove and Samuel A. Morley, *The President and the Council of Economic Advisers: Interviews with CEA Chairmen* (Boulder: Westview Press, 1984), 453.

[47] Takaharu Shimada and Seiichiro Mozumi, "Construction State and International Politics: The Relations and the Choices of Japan, the United States, and Germany over 'Locomotive Strategy'," in *Modern History of Japan's Public Finance I* (NIHON ZAISEI NO GENDAISHI I), ed. Eisaku Ide, (Tokyo: Yuhikaku, 2014), 277-299 (In Japanese).

that the shares of corporate taxes and excise taxes would fall by more than social insurance taxes would rise so that some increase in the ratio of personal taxes to gross national products would necessarily occur unless they would have a much larger tax reduction.[48] Carter finally accepted his recommendation, in addition to the tax-cut argument of Eizenstat and Ginsberg.

Carter required the Treasury led by Blumenthal and Woodworth to revise their tax reform program along with the intention of the DPS and the CEA in several ways. First, Carter required greater tax reductions for middle-income taxpayers so as to reduce the relative share of the overall tax burden borne by them, while maintaining the average taxes paid by individuals in the $50,000 and over brackets at about their present levels. Second, Carter required them to attempt to identify more tax preferences they could eliminate. He focused on reducing use of tax expenditures, especially those benefiting upper-income taxpayers, with lowering rate schedule for those who did not use them. Furthermore, Carter asked everyone involved in the tax reform effort to be very cautious in making public statements about the proposal, particularly those regarding any net revenue loss or rate reductions. He was concerned that continued discussion of these items would divert the attention of the public and the Congress from the difficult issue of tax reform to the easy one of tax cuts and rate reductions. Although it deviated from his original revenue-neutral requirement, Carter wanted to reform the federal income tax system simpler and more progressive through these measures. In other

[48] Charles Schultze to Jimmy Carter, “Taxes as a Percent of GDP,” June 3, 1977, Folder: 6/4/77 [1], Container 24, OSSF, PF, JCL.

words, he put greater importance on vertical equity than horizontal equity.[49] The Treasury agreed with these requests from Carter, and completed their drafting in July.[50]

The CEA nevertheless continued to recommend the administration and the Treasury that the tax reform program should involve more tax-cutting measures. Lyle Gramley, who was in charge of the critical area of economic forecasting, reported the Steering Committee of the EPG in late October 1977 that the pace of economic expansion was disappointingly slow in the third quarter. Real gross national products increased at an annual rate of 3.9 percent, with more than half of that growth occurring in government purchases. This outlook meant that the revenue loss of the tax reform program would conclusively be larger than the administration originally expected.[51] At that time, the CEA proposed the tax cut that targeted mainly businesses. Although Carter first disagreed with this argument because of the fear of inflation, he finally accepted the CEA's recommendation that the proposal should expand business tax cut.[52]

The Carter administration finally released the comprehensive tax reform program on January 21, 1978. It had tax reform elements that Surrey and "Keynesian" had argued in the early 1960s. The bill contained tax cut provisions aimed at giving relief to lower- and middle-income classes, but also reform measures to close loopholes benefiting upper-income classes and businesses such as "the three-martini lunch." The proposed tax reform included several measures to stimulate investment including

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[49] Jimmy Carter to W. Michael Blumenthal and Lawrence Woodworth, "Tax Reform," June 29, 1977, Folder: 6/29/77, Container 26, OSSF, PF, JCL.

[50] W. Michael Blumenthal to Jimmy Carter, "Tax Reform," July 15, 1977, Folder: 7/15/77 [1], Container 31, OSSF, PF, JCL.

[51] W. Carl Biven, *Jimmy Carter's Economy*, 199.

[52] Erwin C. Hargrove and Samuel A. Morley, *The President and the Council of Economic Advisers*, 495.

sizable rate cuts of individual and corporate income taxes.[53] The reform program provided a $25 billion net tax reduction, larger number than the Treasury had argued ($20 billion), that Schultze and Eizenstat favored. However, Ullman favored a smaller amount of tax reduction. Then, the administration chose to downplay this aspect of the tax reform proposal, emphasizing instead opposition to existing tax loopholes favoring business and to any liberalization in the capital gains tax. When he unveiled the reform program, Carter's grand rhetoric boiled down to a few exceedingly modest reforms. The reform proposal emphasized its effect of boosting simplification, equity—rather vertical than horizontal aspect—and progressivity, and stimulating capital formation.[54]

However, the final bill "bore almost no resemblance to what Carter had proposed."[55] Before Carter proposed the tax reform, Long and Ullman had asked the administration not to send the Congress a comprehensive tax reform program in 1978. They were not interested in taking up controversial legislation in a congressional election year. The coalition, consisting of unified Republicans and Democrats in the CWM, scuttled and sharply scaled down reform measures for eliminating and reducing tax expenditures the administration strongly desired to accomplish, such as itemized deductions and capital gain taxes. Rather, they resulted in adding several new tax preferences, such as a new tax deduction for charitable contributions, to the CWM's bill. Another reason for their opposition to the administration proposal was that they viewed it would hurt the middle-income class. In the committee's panel, Barber Conable

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[53] For the detail of administration's tax reform proposal, see Congressional Quarterly, Inc., *Congressional Quarterly Almanac, 1978* (Washington, D.C.: Congressional Quarterly, Inc., 1979), 225-226.

[54] Ben W. Heineman, Jr., and Curtis A. Hessler, *Memorandum for the President: A Strategic Approach to Domestic Affairs in the 1980s* (New York: Random House, Inc., 1980), 259.

[55] Congressional Quarterly, Inc., *Congressional Quarterly Almanac, 1978*, 218.

(Republican-New York) summarized the feelings of the coalition: "The proposals have a lot of appeal in terms of simplification and structure, provided we don't stick it in the ear of the middle class…I'll support doing away with them as long as it isn't a redistribution gimmick."[56] With Daniel Rostenkowski (Democrat-Illinois) and Joseph Waggonner, Jr. (Democrat-Louisiana), on April 20, 1978, Ullman went to the White House to tell Carter that the tax reform proposal was in serious jeopardy. They recommended Carter: "scale down the proposals or face a substantial defeat." Ullman told Carter directly after the meeting that the CWM required a re-evaluation of the whole package. Waggonner, more conservative than Ullman, viewed that there was no constituency in the Congress or the country for the tax reform proposal.[57]

While the administration debated whether it should adjust its goals to practical reality, the wave of "tax revolt" was spreading in the country.[58] Despite this crescendo of activity, the administration did nothing, and the CWM on reconsidering the tax bill in July, shelved the administration proposals. The committee report dropped most of the administration's base-broadening reforms, while restructuring its tax-cutting elements by retaining the personal exemption at a higher level and gearing more marginal rate reductions to the middle-class group. The bill increased the capital gains exclusion, cut the maximum effective rate on capital gains, and indexed capital gains to inflation. Since the coalition was concerned about deficits, the bill provided a smaller tax cut ($16.1 billion) than the administration requested by elimination the proposed general

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[56] Congressional Quarterly, Inc., *Congressional Quarterly Almanac, 1978*, 227.

[57] Ibid., 226.

[58] Isaac W. Martin, *The Permanent Tax Revolt: How the Property Tax Transformed American Politics* (Stanford: Stanford University Press, 2008); Arthur O'Sullivan, Terri A. Sexton, and Steven M. Sheffrin, *Property Taxes and Tax Revolts: The Legacy of Proposition 13* (Cambridge: Cambridge University Press, 1995).

tax credit and the existing $35 credit. After adding several minor revisions on the floor, the House approved the committee bill.[59]

The SFC proved to be particularly generous, voting to expand many existing tax breaks and adding numerous new loopholes targeted to help farmers, teachers, Alaskan natives, railroads, record manufacturers, and so on. The final Senate bill was estimated to reduce income taxes by $29.1 billion. This result the tax cut effect tilted toward upper-income taxpayers. Carter almost vetoed because he felt he had been double-crossed and the final bill contained more tax loopholes than the existing federal tax code did. The CEA persuaded Carter that a veto of the bill might have brought greater fiscal restraint, more unemployment and mild less inflation in 1979. They repeatedly kept describing how the economy needed tax cut.[60] Carter conclusively signed the tax bill on November 6, but with no statements of approval.[61]

It is evaluated that the defeat of Carter's tax reform proposal signaled a new era in tax policy, the triumph of a broad coalition of business lobbyists who came together under the rubric of "capital formation." These lobbyists argued that the best medicine for the faltering American economy was to create new tax breaks for businesses and investors. They championed a provision in the 1978 reform that enhanced the preferential treatment of capital gains income, bringing the top tax rate on gains income down to 28 percent from 35 percent. Tax reformers persistently complained that the special treatment for capital gains was unfair and fueled the growth of tax shelters. However, the capital-formation coalition maintained that the tax break would encourage investment and promote economic growth. The economy was in trouble, they argued,

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[59] Congressional Quarterly, Inc., *Congressional Quarterly Almanac, 1978*, 219.
[60] Erwin C. Hargrove and Samuel A. Morley, *The President and the Council of Economic Advisers*, 495.
[61] Congressional Quarterly, Inc., *Congressional Quarterly Almanac, 1978*, 219.

and lower capital-gains taxes were a solution. As a result, "tax reform was clearly out; capital formation was in." The influence of special interests in Congress had reached new heights.[62]

4. Exceptional Victory in 1986[63]

Tax policy history of the administration of Ronald Reagan began with the Economic Recovery Tax Act (ERTA) that became law in August 1981.[64] When legislated, ERTA consisted of huge cuts in both individual and business income taxes more than Reagan had required. In the legislative process, both party made their bill with a spectacular array of tax shelters and restored indexation.[65] Reagan expected, invoking the result of the Kennedy-Johnson tax cut of 1964, that it would accelerate capital formation, enhance American economy, and consequently increase federal tax revenues.[66] As a consequence of the deepening recession and substantial increases in defense outlays, however, each successive projection of the budget deficit unexpectedly increased after it was legislated.[67] Then, while tackling mandatory entitlement spending,

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62 Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch*, 16.

63 The elaboration of this section heavily relies on W. Elliot Brownlee, *Federal Taxation in America: A Short History, New Edition* (Washington, D.C.: Woodrow Wilson Center Press, and Cambridge: Cambridge University Press, 2004).

64 This tax cut was based on the so-called "Kemp-Roth" proposal. See, e.g., John F. Witte, *The Politics and Development of the Federal Income Tax* (Madison: The University of Wisconsin Press, 1985), 209-211, 216. Reagan's popularity, especially strengthened by the assassination attempt, strongly supported the legislation of ERTA. Congress could not resist the momentum. See, e.g., Charls Walker, "Summary of Discussion," in *American Economic Policy in the 1980s*, ed. Martin Feldstein (Chicago: The University of Chicago Press, 1994), 224-225; Donald T. Regan, *For the Record: From Wall Street to Washington* (San Diego: Harcourt Brace Jovanovich, 1988), 163-170.

65 W. Elliot Brownlee, *Federal Taxation in America*, 150.

66 Ronald Reagan, "Taxes, October 18, 1977," in *Reagan, In His Own Hand*, ed. Kiron K. Skinner, Annelise Anderson, and Martin Anderson (New York: The Free Press, 2001), 274-277.

67 Between 1980 and 1984, the federal deficit rose from 2.8 percent of GDP to 5.0 percent of GDP, implying that more than half the deficit had been there when Carter left office. See Martin Feldstein,

the Reagan administration quietly initiated a new proposal for several tax increases in September 1981, describing them as "revisions in the tax code to curtail certain tax abuses and enhance tax revenues."[68]

The Reagan administration began attempting to cooperate with the Congress for success in tax increases. The administration's first attempt was to cooperate with the SFC led by Robert Dole (Republican-Kansas). In 1982, a number of supply-siders at the Treasury, including Paul Craig Roberts and Norman Ture, left the administration.[69] In the face of the situation that to implement tax increases were unavoidable to consolidate the federal budget, Reagan agreed with the less visible and less universal forms of tax increases that cut in tax expenditures. The loophole-closing reforms encountered resistance in the Congress from conservative Republican. Then, Reagan made a long speech to the nation on economic affairs and emphasized that closing off special interest loopholes would promote simple fairness for every American, especially those in lower income brackets.[70] As a result of these movements, the Reagan administration succeeded in enacting three tax reforms that combined tax increases with structural reform. The first and third of them, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and several tax reform measures as a part of the Deficit Reduction Act of 1984 (DEFRA) took the form of tax increase in order to reduce the large deficits that resulted from ERTA. They succeeded in closing tax loopholes, some of which was

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"American Economic Policy in the 1980s: A Personal View," in *American Economic Policy in the 1980s*, Martin Feldstein, ed., 47-48.

[68] W. Elliot Brownlee, *Federal Taxation in America*, 152-153.

[69] For the detail, see Donald T. Regan, *For the Record*, 171-184.

[70] W. Elliot Brownlee, *Federal Taxation in America*, 153-154.

created by ERTA. In both cases, Congress managed to approve complex tax bills that increased tax revenues without increasing any tax visible to most voters.[71]

While the Reagan administration had worked on these tax and budget reform measures, several movements toward the forth tax reform program had begun. In 1982, a member of the SFC Senator Bill Bradley (Democrat-New Jersey), inspired by Surrey's earlier reform program, and Congressman Richard Gephardt (Democrat-Missouri) introduced a broadening-base tax reform proposal with a top individual income tax rate of 30 percent. Bradley was convinced that the idea made economic sense, and that Democratic sponsorship of such reform would have voter appeal. He drew effectively on the advice of experts of the CBO and the JCT. The White House political officials were concerned at that time that the Democrats would take the lead on tax reform and make it major issue in the 1984 campaign. In this context, Reagan first suggested a plan to simplify the tax code and make it fairer for all Americans in his 1983 State of the Union address in a low-key.[72] During 1983, Secretary of the Treasury Donald Regan and his staff paid serious attention to the adoption of a lower, flatter tax rates and significant broadening of the income base by eliminating the special privileges enjoyed by the few.[73]

The increased weight of political considerations in 1984 stimulated the motive of tax reform. Public confidence in the fairness of the federal income tax code was rapidly

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[71] William A. Niskanen, *Reaganomics: An Insider's Account of the Policies and the People* (New York: Oxford University Press, 1988), 76-84.

[72] W. Elliot Brownlee, *Federal Taxation in America*, 153-154; Richard Darman, *Who's in Control? Polar Politics and the Sensible Center* (New York: Simon & Schuster, 1996), 118-119; William A. Niskanen, *Reaganomics*, 86.

[73] Donald T. Reagan, *For the Record*, 196-207.

eroding. Public opinion began to push Reagan toward base broadening.[74] However, until the election campaign in 1984 concluded, the result of discussion and research regarding with the tax reform had been kept secret in the Treasury. The Treasury did not allow any officials outside the Treasury to review the developing plan, and monopolistically developed their research during the campaign in 1984. After the DEFRA was approved and a new Secretary of the Treasury for Tax Policy Ronald Pearlman was appointed, the Treasury developed an exceptionally coherent set of reform proposals rapidly.[75] It was made possible by shielding any information from Congress, the press, other members of the administration, and the experts.[76] By the time of the 1984 elections, they had completed and submitted to Regan a far-reaching set of proposals, "Treasury I."[77]

During several weeks after the presidential election, the details of tax reform plan began to leak. After the Treasury plan was published, interest groups loudly protested. However, it also picked up broad supporters, from Republicans and Democrats, both conservative and liberal press and think tanks. The best explanation of Regan's approval of this plan was "that the OTA staff, under the pressure of time and without an outside review, was in a position to present him with an all-or-nothing choice." The Treasury staff succeeded in avoiding a technical review and interference of tax specialists in the OMB and the CEA and the judgment of other cabinet members. It protected their tax

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[74] Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch*, 11-13.

[75] Inside the Treasury, the economic coordinator of the project, C. Eugene Steuerle, Assistant Secretaries for Tax Policy John E. Chapoton and Pearlman, and Deputy Assistant Secretary for Tax Analysis Charles E. McLure worked on this task.

[76] W. Elliot Brownlee, *Federal Taxation in America*, 161-162; William A. Niskanen, *Reaganomics*, 87.

[77] It is said that "Treasury I" implemented Henry Simons' theory of comprehensive income taxation. W. Elliot Brownlee and C. Eugene Steuerle, "Taxation," in *The Reagan Presidency: Pragmatic Conservatism and Its Legacies,* ed. W. Elliot Brownlee and Huge D. Graham (Lawrence: University Press of Kansas, 2003), 169-170.

reform program and a major feature advocated in the initial Reagan's address from their calling and pressure for revising the program.[78] Treasury I was revised into "Treasury II." Reagan favored it because it included a further lowering of the top tax rate.[79]

On May 28, 1985, Reagan finally announced his tax proposals for fairness, simplicity, efficiency, and compassion, to remove the obstacles to growth and unlock the door to a future of unparalleled innovation and achievement. The speech appealed to both the spirit of enterprise capitalism and a sense of tax justice rooted not in the vertical equity of progressive taxation but in the horizontal equity of a tax that provided uniform treatment to broad categories of taxpayers.[80]

Reagan and his administration succeeded in obtaining supports for the tax reform proposal. During the tour of barnstorm, Reagan and his speech to sell the tax reform was greeted by enthusiastic and affectionate crowds.[81] In the face of his popularity, the leaders of the congressional tax-writing committees decided to become advocates of comprehensive tax reform. Rostenkowski, who chaired the CWM at that point, determined to put the nation on notice that he and the Democratic party were reformers. This meant the nation would see the bipartisan cooperation. With the support of the top House tax-writer, tax reform had a chance.[82] Behind the scenes, Rostenkowski countered the lobbyists representing those who would lose from Treasury II. Reagan urged Republicans to support Rostenkowski's bill if a Republican version could not win CWM endorsement, and threatened them that he would veto any bill with a maximum

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[78] William A. Niskanen, *Reaganomics,* 91.

[79] W. Elliot Brownlee and C. Eugene Steuerle, "Taxation," 171.

[80] Ronald Reagan, "Address to the Nation on Tax Reform," May 28, 1985, Online by Gerhard Peters and John T. Woolley, *The American Presidency Project* (http://www.presidency.ucsb.edu/ws/index.php?pid=38697&st=&st1=).

[81] Donald T. Regan, *For the Record*, 281-283.

[82] Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch*, 96.

rate higher than he originally proposed. Their efforts bore fruit: enough bipartisan support for the House to pass a reform bill on December 16, 1985.[83]

In the SFC, the chairman Robert Packwood (Republican-Oregon) made crucial efforts in keeping reform alive. He, up for reelection in 1986, who was had turned his attitude into a tax reformer by Reagan's leadership. He did not want to take the blame for the death of tax reform. After long weeks in which it looked like tax reform would in fact perish in the SFC, Packwood adopted a bold, alternative plan the staff of the JCT suggested. He concluded that the only way to win the support of the SFC was to lower the top individual income tax rate below the rate proposed by the House.[84] With Bradley's support, he and his staff drafted a plan that lowered the corporate rate from 36 percent in the House bill to 33 percent and retained only two rates for individuals: 15 and 25 percent. The plan proposed abolishing all deductions for mortgage interest, consumer interest, and charitable contributions. The plan obtained support within the SFC. The SFC made only a few changes. In May 1986, Packwood's bill won unanimous support from the SFC. Then, in his weekly radio address, Reagan urged Republicans and Democrats to unite to move this legislation through Congress as fast as possible. In response to Reagan's address, the bipartisan support engineered by Packwood and Bradley moved the bill quickly through the Senate, which adopted it on June 24, 1986.[85]

The House and Senate bills contained key elements of agreement and significant differences. Both bills provided benefits for lower-income classes through sharp

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[83] W. Elliot Brownlee, *Federal Taxation in America*, 168-169.

[84] Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch*, 208; Timothy Conlan et al, *Taxing Choices*, 163-165.

[85] W. Elliot Brownlee, *Federal Taxation in America*, 170-71.

increases in the personal exemption, the standard deduction, and the Earned Income Tax Credit (EITC). As to differences, the House bill closed many corporate loopholes but was less aggressive in eliminating the tax preferences for individuals. In contrast, the Senate bill made sweeping reforms on the individual tax code but left more corporate tax breaks unchallenged. The top rates on both individuals and corporations were lower in the Senate bill that in the House bill—32 versus 38 percent for individuals and 33 versus 36 percent for corporations.

Rostenkowski and Packwood struck much of the final deal in private, removed from the direct pressure of the contending interests. Rostenkowski, impressed by public enthusiasm for lower rates, agreed to accept rates very close to those proposed by the Senate. Under the Gramm-Rudman-Hollings Act (GRH) of 1985, any policymakers were supposed to avoid creating additional deficits by tax reform.[86] Therefore, in their negotiations, Rostenkowski and Packwood implemented the goal of revenue neutrality: Paying for the rate reductions by sacrificing some of their favorite tax expenditures, while preserving or establishing several tax preferences.[87] In September, the conference committee approved the deal. With the support of the House Republicans, the Congress approved the conference version. Reagan finally signed the legislation into law on October 22.

This tax reform picked both winners and losers for the first time since World War II. The losers in 1986 were the many individuals, corporations, and industries for which the loss of tax preferences was greater than their gains from the reduction of the top tax

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[86] For the detail of GRH, see, e.g., Howard E. Shuman, *Politics and the Budget, 3rd ed.* (New Jersey: Prentice Hall, 1992), 286-288; Robert D. Reischauer, "Taxes and Spending under Gramm-Rudman-Hollings," *National Tax Journal,* vol.43, no.2, 224.

[87] William A. Niskanen, *Reaganomics*, 100-101.

rates. The biggest losers were those that sold tax shelters and some traditional Rust Belt industries. Among businesses, the biggest winners were investment bankers, high-technology industries, service industries, and some multinational firms. The act helped financing cuts in individual income taxes by raising corporate taxes by nearly $120 billion over the next five years. A bipartisan group of political entrepreneurs had successfully championed an approach to tax reform never previously associated with either of the two major parties: focusing reform of the income tax on broadening its income base and creating a more uniform—a more horizontally equitable—tax. Both the Reagan administration and many Democratic liberals welcomed the act because of the way it moved toward eliminating tax-based privilege. Reagan, Bradley, and Regan believed that bringing down marginal tax rates to promote economic efficiency in the face of the sluggish growth of national productivity. Democratic liberals put more emphasis than them on taking poor people off the tax rolls by increasing the personal exemption and increasing the EITC.

Concluding Remarks

This study proposes several points in and for which the attempt of comprehensive tax reform exceptionally succeeded in 1986, while those of 1964 and 1978 failed. First of all, congressmen, especially Republicans, had not usually been so much interested in tax reform as the Treasury and the administrations. The result of tax reform 1964 indicates that the fact that the Democratic chairman of a committee had the power and desired to accomplish a comprehensive tax reform was insufficient to legislate controversial reforms. The case of tax reform 1978 showed that it was so difficult to persuasive the chairmen of the tax-writing committees who would not intend to protect

intensively the reform proposal. In both of these cases, Republicans and business interests were not convinced the administration's proposal. On the 1986 tax reform, in the process of policymaking, leaders of two tax-writing committees were significantly interested in the accomplishment of tax reform. Popularity of Reagan at that time made it impossible for Congress to deny considering the tax reform program. Therefore, they allied and negotiated with both Republicans and Democrats in their committee. It was crucial for any administrations to convince both Republicans and Democrats.

Secondarily, Congress did never pass the comprehensive tax reform proposals that largely deviated from a coherent revenue-neutral reform due to arguments from policy architects outside the Treasury such as the CEA, the OMB, the DPS, and the EPG. The Kennedy administration proposed comprehensive tax reform as a huge tax reduction that took the two-stage approach. The tax reform proposal in 1978 was also proposed as a tax cut that carried the banner of "capital formation," while containing the measures that restricted tax preferences benefitted upper-income taxpayers and businesses. In both cases, anti-reformers attacked reform measures from the standpoint that there were those who would lose their benefits in spite of the fact that the tax reform proposal was a tax cut that would have benefited taxpayers and stimulate the growth of economy. In the case of the 1986 tax reform, the Treasury avoided interference from the outside, and kept crafting their tax reform proposal in secret. It enabled Reagan to announce administration's tax reform proposal as a coherent tax reform aimed parallel at boosting fairness, growth, and simplicity. In the legislative process, congressmen managed to elaborate their tax reform proposals involving no revenue losses by giving all taxpayers both beneficial and detrimental provisions in the face of huge deficits. The Reagan administration could succeed in accomplishing comprehensive tax reform by taking the

coherent and resultant revenue-neutral form that both winner and loser could receive some benefits at the cost of existing benefits they had enjoyed at that time. In sum, it was crucial for any administrations to emphasize coherent and revenue-neutral aspects, resulting in increasing economic efficacy.

Thirdly, the administrations that emphasized the importance of vertical equity and progressivity failed in accomplishing comprehensive tax reform. When both 1964 and 1978 tax reform was proposed, the administrations of Kennedy and Carter emphasized that structural reforms should have the effect of boosting vertical equity and progressivity. In particular, Carter did not so much referred to the importance of horizontal equity. In contrast, while avoiding asserting the effect of improving vertical equity and progressivity, only the Reagan administration emphasized that their comprehensive tax reform program would boost horizontal equity. The Reagan administration obtained agreements from Republicans and Democrats in ways of combining rate cuts and broadening-base measures. The Democrats supported the measures that would benefit lower-income classes and base-broadening measures. Republicans favored rate reductions and announcement about the economic effect, convincing them of the restriction and elimination of tax expenditures. In sum, the exceptional success of the Reagan administration stemmed from the fact that they hid the effect of base-broadening reforms on vertical equity and progressivity behind horizontal equity, fairness, simplicity and economic efficiency.