



tax notesSM

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**SPECIAL
REPORT**
TAX ANALYSTS

**THE FAILURE OF U.S.
TAX POLICY: REVENUE AND
POLITICS**

by Sheldon D. Pollack

Sheldon D. Pollack, Ph.D., J.D., is assistant professor in the College of Business and Economics at the University of Delaware. The following is adapted from the introduction to his new book, *The Failure of U.S. Tax Policy: Revenue and Politics*, published by the Pennsylvania State University Press, (800) 326-9180.

In this book, Professor Pollack surveys federal income tax policy from the Civil War to the post-World War II era, with special attention to the 1980s and 1990s. He identifies the most important trends in American politics that account for the erratic pattern and instability of contemporary tax policy. Likewise, the sources of the excessive complexity of the tax laws are located in the political process. The author discusses how tax policy has become highly partisan of late — most particularly, in the wake of the Republican electoral victory in November 1994. The tax policy of the Clinton administration is also assessed. Finally, Pollack argues that the dominant model used by social scientists to describe the tax policymaking process fails to account for the most important developments in U.S. tax policy.

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[M]odern taxation or tax making in its most characteristic aspect is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned. Class politics is the essence of taxation.

— T. S. Adams (1927)

U.S. policymakers use the federal income tax for many diverse and often conflicting purposes — to raise revenue, manage the national economy, further partisan politics, and implement a wide assortment of public policies. Policymakers themselves are subjected to diverse and conflicting demands with respect to satisfying the revenue needs of the American state. In addition, policymakers have individual interests and goals, as well as partisan affiliations, which are expressed and satisfied through the tax bills they write. Our constantly changing, unstable, unpredictable, highly partisan, and extraordinarily complex tax laws reflect the fact that so much is attempted through the Internal Revenue Code.

In so using the income tax, congressional policymakers are simply following the rules of the "tax game" established by the overall structure of American politics and institutions. Within this "constitutional" structure, the tax code is transformed into a *political instrument*. This use of the income tax compromises its capacity to raise revenue and undermines the coherence of tax policy. The most important decisions in federal tax policy are made by partisan politicians acting within the context and confines of the American political system. This is to say that tax policy is a political story — one that ultimately must be told in political, rather than economic, terms.

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Politics and Revenue

First and foremost, a "revenue imperative" motivates federal tax policymaking. For two centuries, political elites have struggled to satisfy the revenue demands of the American state. Officials of any state must "negotiate" for revenue with the major social and economic interests of civil society. However, the American state was expressly designed through its original constitutional structure to deny the federal

government easy access to revenue. Furthermore, the prevailing liberal political culture has limited the capacity of state officials to "extract" revenue from civil society. Taxation, after all, is both one of the most important and coercive activities of the state and one of the dominant themes of American political liberalism has been the restriction of such coercive state powers.

Despite the limitations on the fiscal powers of state officials, the "traditional" sources of federal revenue (customs duties, excise taxes, the sale of public land, and the tariff) were generally adequate in financing the limited activities of the 19th-century American state. Nevertheless, certain deficiencies in the fiscal organization of the central state became apparent during crucial periods of American history, particularly during military crises, beginning with the Revolutionary War, the War of 1812, and the Civil War, and then again during the two world wars of the 20th century. It is during military conflicts that the revenue imperative is felt most keenly by government officials, who are forced to accommodate a dramatic increase in the revenue needs of the state.¹ During such periods of crisis, policymakers must search out and cultivate new sources of revenue and experiment with new and often radical policies. The U.S. income tax was such a wartime innovation — one that raised unprecedented revenue and at the same time radically altered the development of the American state. To a large extent, the great revenue brought in by the income tax made possible the expansion of the American state in the 20th century, the establishment of a social welfare state beginning in the 1930s, and the creation of a dominant American military organization.

Just as the revenue imperative has played a primary role in shaping American tax policy, so, periodically, have various ideological imperatives.

But just as the revenue imperative has played a primary role in shaping American tax policy, so, periodically, have various ideological imperatives. For instance, populism and radical egalitarianism inspired the politics behind the adoption of the federal income taxes of 1894 and 1913. Surprisingly, once the income tax was adopted and became institutionalized, these ideological movements tended to play a more minor role in the development of income tax policy, which fell under the sway of mainstream politicians who recognized that the great potential of the income tax was in the revenue that it would bring in for the

¹The connection between the great cost of military warfare and the development of the modern state has been well noted. See, e.g., Joseph A. Schumpeter, "The Crisis of the Tax State" (1918), reprinted in *International Economic Papers*, No. 4 (New York: Macmillan, 1954), 13: "The most important cause of the financial difficulties [of fourteenth- and fifteenth-century European monarchs] consisted in the growing expenses of warfare."

American state, and not in its capacity to redistribute wealth among social classes. Nevertheless, questions of "equity" and redistribution have pervaded the debate over income tax policy, often under the cover of partisan politics.

In a speech on the floor of the Senate during debate over the 1913 income tax, Henry Cabot Lodge of Massachusetts demonstrated how income taxation, even when justified in terms of the revenue it raises, continues to invoke deep-rooted "class" issues: "It will be an evil day for us when we enter on confiscation of property under the guise of taxation. What we want to do is raise money for the support of the Government. . . . But to have the Government undertake, for vindictive reasons, to punish a man simply because he has succeeded and has accumulated property by thrift and intelligence and character, or has inherited it honestly under the law, is entering upon a dangerous path. It would convert this tax from the imposition of a tax to a pillage of a class."² Over the next eight decades, tax policy never actually manifested the kind of overt class warfare that Senator Lodge so intensely feared. But tax policy has expressed a level of partisanship certainly no less intense than that which otherwise prevails in American politics.

Since the adoption of the modern 20th-century income tax in 1913, both of the major national political parties have had their own unique visions of how the burden of income taxation should be imposed upon and shared among the citizenry. As distinct from economics and public finance, which are generally concerned with the aggregate level of tax revenue extracted from the private sector to support the public sphere, partisan tax policy is often little more than a veiled attempt to shift the incidence of taxation from one particular social or economic class to another. This is evidenced by the often-heard demand that the income tax (as well as other taxes, such as estate and inheritance taxes) be used to effect a redistribution of wealth among social classes. Similarly, the attempt to shift the burden of taxation onto the "wealthy" would seem to be the primary political impetus behind the corporate-level income tax, as well as that behind increasing the rates at which the corporate income tax is imposed. There is great uncertainty regarding who actually bears the economic burden of corporate taxes. But ideological impulses, rather than sound economic theory, have more often informed policy with respect to the taxation of the business corporation in the United States. The claims made to defend or castigate such policies reflect and express partisan political rhetoric as applied to the federal income tax. Sadly, this constitutes a good deal of what passes for "tax policy" in the United States.

Tax policy has also accommodated a "functional" nonpartisan use of the income tax by elected representatives intent upon currying favor with constituents as well as implementing social and economic policies

²*Congressional Record*, 63d Cong., 1st sess. (August 28, 1913), 50, pt. 4, 3840.

through the tax laws. As the role of Congress changed during the 20th century, so too did its use of the federal income tax. The member as "ombudsman" introduces amendments to the income tax that are intended to protect and enhance the economic well-being of local interests and constituents. As such, the income tax code becomes an effective vehicle for politicians, Democrats and Republicans alike, looking to curry favor with the home district. At times, this amounts to little more than political grandstanding; at other times, it produces "special-interest" provisions buried within the arcane language of the income tax code. The latter explains why the tax committees are such attractive assignments for congressmen and why the leading members of the tax committees have such full coffers at election time.

In the decades following World War II, American tax policy has also been shaped by a very distinct and particular vision — one traditionally enunciated by tax academics and professionals. Tax experts share a faith that the ideal income tax can be achieved through "tax reform." Their understanding of what is demanded by tax reform constitutes a distinct worldview — one that is dominant among the executive and congressional staffs charged with formulating policy initiatives and drafting tax legislation. In this way, the principles of tax reform have influenced the kind of tax proposals that are advanced and the kind of choices offered to policymakers by their own professional tax advisers. This often puts the congressman's professional advisers in conflict with his own basic motives and interests as a politician. Most of the time, the political impulses of congressional policymakers prevail, but occasionally the interests of these politicians and the worldview of the tax experts converge. This was most apparent in 1986, when congressional policymakers realized that tax reform could constitute a viable and convenient political issue. As a result of the momentary convergence of interest of tax professionals and policymakers, the tax code was restructured under the Tax Reform Act of 1986 according to the general dictates of the movement for tax reform.

These many disparate uses and ideological imperatives that drive the politics of the income tax have resulted in an unstable and internally inconsistent tax policy. The incoherence and complexity of the tax code can be attributed to much the same source — a "pluralist" tax policymaking process that accommodates nearly every organized economic interest at once, almost always preserving prior tax policies while constantly grafting new and often contradictory policies onto the same tax code through "incremental" development. The instability of federal tax policy is attributable to the American political system itself — a system of divided and shared powers, institutional fragmentation, and structural incoherence. And while instability has marked tax policy for decades as contemporary political coalitions (and their attendant tax policies) have come and gone, it was particularly intense during the 1980s, when federal tax policy dramatically shifted direction several times — first following the broad dictates of supply-side economics in 1981, then tax reform in 1986, and, by the end of the decade, no clear direction at all.

The major tax bill enacted in 1993, during the first year of the Clinton administration, seemed to signal a return to pre-1986 patterns of tax policy. But any such movement came to a screeching halt in 1994 with the electoral triumph of the Republican Party in Congress. The new Republican tax policy codified during the first 100 days of the 104th Congress evidenced the high degree of partisanship underlying contemporary tax policy, as well as the continued volatility and lack of principle underlying the enterprise as a whole.

Revenue and the Income Tax

For decades the U.S. income tax has been the single most important source of revenue for the federal government, providing an extraordinarily fertile and stable means of financing the activities of the American state. Revenue derived from the federal income tax (corporate and individual combined) has increased from \$28 billion in 1913 (the first half year of the tax) to \$34 billion in 1945, during the height of World War II, to \$560 billion in 1990, to a projected \$781 billion for fiscal year 1996. In 1914, the federal income tax provided 7.37 percent of total receipts of the federal government; by 1985, the figure was 54 percent. In 1950, revenue from the federal income tax constituted 66 percent of federal receipts from all sources. Federal receipts from all forms of taxation (income, excise, estate, etc.) reached \$1 trillion for the first time in 1990. The individual income tax alone raised \$543 billion in 1994.³

Income taxation would be of paramount importance to the American state if only on account of this immense revenue that it raises. A modern income tax makes possible a state's institutional development because it provides a viable means to tap the great wealth produced by modern, advanced market economies. Income taxation is both an exercise of and prerequisite to a modern state. A successful income tax is conceivable only within the context of an advanced market society such as that which had emerged in the United States and Great Britain by the turn of the century; at the same time, only a well-developed state is capable of administering and enforcing the kind of income tax that will generate such massive revenue. The sig-

³Federal receipts from all forms of taxation (income, excise, estate, etc.) reached \$1 trillion for the first time in 1990. As a percentage of gross domestic product (GDP), receipts from the individual income tax increased dramatically during World War II, declined after the war, and remained relatively constant (in the range from 8 to 9 percent of GDP) thereafter. Revenue from the corporate income tax has declined steadily from 30 percent of federal revenue in the early 1950s to a fairly constant 20 to 25 percent in the 1960s to the current figure, which hovers at or below 10 percent. This is partly on account of the increase in other taxes, such as social security. See House Committee on Ways and Means, *Overview of the Federal Tax System*, 103d Cong., 1st sess. (Washington, D.C.: Government Printing Office, 1993); *Statistical Abstract of the United States* (Washington, D.C.: Government Printing Office, 1985), table 488, 307.

nificance of the state's capacity to "extract" revenue from civil society to sustain its own institutional development has been described by historian Dall Forsythe as follows: "'Extraction' is an ugly but necessary term that neatly summarizes the complex strategies governments adopt to assure themselves adequate flows of revenue. . . . [R]ulers cannot develop a central state apparatus without some degree of capacity to extract revenues from the subject population of a nation."⁴ It was the federal income tax that provided the 20th-century American state with the capacity to extract revenue from the private economy to finance two worldwide military campaigns and (along with the social security wage tax) the modern social welfare state. If, as Edmund Burke once declared, the "revenue of the state is the state," then surely the U.S. income tax has been at the heart of the 20th-century American state.

The Income Tax as a Political Instrument

An examination of the vast body of the Internal Revenue Code from a broad historical perspective reveals that the drive for revenue has been the single most important force behind the adoption and subsequent expansion of the income tax. However, similar examination of the congressional politics-as-usual through which the federal tax laws are made indicates that a significant portion of income tax policy is dedicated *not* to raising revenue, but rather to implementing public policies that effectively reduce federal revenue. During periods of peace and domestic tranquillity, revenue is but one among many concerns pursued by federal policymakers — and not always the dominant or overriding one at that.

For instance, the income tax is used by American policymakers as an easy, albeit crude, means for manipulating private economic and social behavior. Through taxation, a state is able to alter the allocation of goods and services that otherwise results from the unrestrained expression of human wants and desires. In this way, the income tax establishes a broad system of economic incentives and disincentives through which the state can direct, and thereby subtly control, a wide sphere of private economic and social activity. Liberal capitalist states that otherwise maintain relatively free markets and adhere to general principles favoring a minimum of governmental intrusion into private economic matters routinely use income taxation to direct the private economic sphere, although few so extensively as the United States. Since the American state is particularly lacking in the institutions and powers of centralized planning and economic management found elsewhere among the Western industrial democracies and Japan, political elites here have found taxation to be one of the best means at their disposal for implementing macroeconomic policy. For this reason, taxation has become an important, if not the primary, fiscal tool of the American state.

⁴Dall W. Forsythe, *Taxation and Political Change in the Young Nation, 1781-1833* (New York: Columbia University Press, 1977), 1.

In the years following World War II, political elites, labor, and capitalists all came to regard the income tax as a means for stimulating long-term investment and the accumulation of capital. "Beginning with the Employment Act of 1946, the federal government undertook to oversee the economy and maintain a stable business climate through macroeconomic stabilization policies that involved the income tax structure among other tools."⁵ This consensus (which solidified during the administration of John F. Kennedy) was informed by a "neo-Keynesian" faith in the central government's capacity to manage the national economy for purposes of long-term growth, job creation, and prosperity for capital and labor alike. As political scientist Ronald King puts it: "Public finance increasingly became an arena devoted to government efforts at non-zero-sum macroeconomic regulation, and taxation was thus transformed into an instrument promising class coordination, not polarization."⁶ Federal tax policy has reflected this undoubtedly overly optimistic belief that the federal government can manage the national economy through the tax laws. Walter Heller, economist and member of Kennedy's Council of Economic Advisers, observed this "important truth" in declaring that "the tax system is more than a revenue-raising device, it is an instrument of national policy."⁷

⁵Cathie J. Martin, *Shifting the Burden: The Struggle Over Growth and Corporate Taxation* (Chicago: University of Chicago Press, 1991), 18. Martin's interesting study focuses upon the ways in which the corporate income tax was turned into a system of deductions and credits "to create incentives to stimulate savings and investment." She also focuses upon the politics behind the decline of the corporate income tax as a source of federal revenue from the 1950s to the 1980s (i.e., "shifting the burden" away from corporate taxpayers). However, Martin cannot really prove that this trend amounted to shifting the burden (or incidence) of taxation from the wealthy to the middle class, since it remains uncertain who bears the economic cost, or incidence, of the corporate income tax.

⁶Ronald F. King, *Money, Time, and Politics: Investment Tax Subsidies and American Democracy* (New Haven: Yale University Press, 1993), 121. This is the central theme of King's important interpretation of the development of postwar income tax policy. See also Barry P. Bosworth, *Tax Incentives and Economic Growth* (Washington, D.C.: Brookings Institution, 1984), 5: "The neo-Keynesian or neoclassical synthesis — bringing together long-held views of the determinants of supply and Keynesian views on the need to manage aggregate demand — has provided the framework for the discussion and conduct of economic policy for the last several decades. . . . On the demand side, fiscal and monetary policies were aimed at moving actual output closer to potential and avoiding the fluctuations that had been so costly in the past. On the supply side, new tax incentives and an accommodative monetary policy were major elements of an effort to encourage new investment."

⁷Quoted in King, *Money, Time, and Politics*, 268. Three decades later, this observation seems trite; textbooks take it as a given fact of tax policy. See, e.g., Joseph A. Pechman, *Federal Tax Policy*, 5th ed. (Washington, D.C.: Brookings Institution, 1987), 5: "Taxation is a major instrument of social and economic policy. It has three goals: to transfer resources from the private to the public sector; to distribute the cost of government fairly . . . and to promote economic growth,

(Footnote 7 continued on next page.)

So for decades now the federal income tax has been used (for better or worse) as an "instrument" for managing the national economy. Federal policymakers in Congress and the White House routinely use the income tax to implement a wide array of public policies. Some of these are broad national public policies. Others are narrow provisions inserted into the tax laws strictly for the benefit of "special interests" — many of which, not surprisingly, are located in the home district of some member of Congress with a strategic seat on one of the tax committees. Nevertheless, though special interests often prevail in influencing tax policy decisions, this is only one side of the story, one greatly exaggerated in journalistic accounts of tax politics, as well as in the general public's perception of how Congress works. But whether used to implement broad national economic policy or to benefit narrow special interests, the income tax is an important tool of federal policymakers in making public policy.

The many provisions in the tax code not dedicated to raising revenue enact a curious assortment of social and economic policies, often in a rather haphazard fashion. This is the source of much of the incoherence found in the tax code. Old policies are seldom repealed by the "incremental" policymaking that prevails in the tax arena; new policies (very often at cross-purposes to the old) are simply grafted onto the tax code. This instrumental use of the federal income tax is a relatively recent phenomenon of the postwar period. While the great revenue-raising potential of the modern income tax was almost immediately recognized by political elites during the wartime fiscal crisis of World War I, it took several decades more for congressional policymakers to comprehend the great possibilities of the income tax as a nonpartisan tool for serving constituents. But since World War II, Congress has perfected the art of policymaking through the income tax laws.

At the same time, a distinctly partisan use of the federal income tax reflects the fact that early in the history of the nation the major political parties cultivated their own very distinct fiscal and tax policies. During the first decades of the 19th century, this was evidenced by the split between Federalists and Jeffersonian Republicans, a split in substantial part occasioned by deep-rooted ideological differences over tariff policy. Later in the 19th century, the parties were divided over the fundamental question of an income tax. Ever since, Democrats and Republicans have disagreed on the substantive issues of income tax policy and on the overall structure of the tax system, with

stability and efficiency." See also John K. McNulty, *Federal Income Taxation of Individuals*, 4th ed. (St. Paul, Minn.: West Publishing Co., 1988), 1-2: "The income tax serves several functions in addition to financing federal government expenditures. It also allocates resources, encourages or discourages certain kinds of economic and social behavior, redistributes wealth, stimulates or stabilizes economic growth, helps maintain our federalism, and helps solve some specific social problems such as pollution and urban decay."

Republicans generally favoring lower and flatter tax rates since the 1860s. In the 1920s, Warren Harding's treasury secretary, Andrew W. Mellon, was instrumental in cultivating the Republican Party's first income tax policy and rhetoric, both of which were resurrected intact during the 1994 congressional elections. None of this should come as much of a surprise. Differences over tax policy simply reflect the dominant partisan cleavage of the day.

The many provisions in the tax code not dedicated to raising revenue enact a curious assortment of social and economic policies, often in a rather haphazard fashion.

While there are fundamental differences in the visions of tax policy that prevail among Republicans and Democrats, congressional policymakers share a nonpartisan inclination to implement their respective policies through the income tax. Democrats have traditionally favored such policies as offering tax credits for low-income earners and for housing for the poor, encouraging employee stock ownership plans (ESOPs) and retirement plans through tax preferences, limiting executive compensation, and providing preferential tax treatment for employer-provided health insurance and pension plans. Republicans pursue a similarly wide range of social and economic policies through the tax code: income tax cuts, preferential tax treatment for capital gains, tax-favored economic "enterprise zones" as a cure for urban blight, and various tax credits and expenditures aimed at encouraging savings, investment, and the accumulation of capital. The list goes on and on. The very first week that he was elected Speaker of the House of Representatives, Republican Newt Gingrich proposed (apparently in all seriousness, but what later was described by Gingrich himself as a "dumb idea") a tax credit for the "poor" to enable them to purchase laptop computers.⁸ More absurd proposals have found their way into the tax code.

Conservatives who otherwise extol the virtues of "voluntary" private action, fiscal responsibility, and governmental noninterference in the private social and economic spheres showed great eagerness in the 1980s to use the tax laws to implement their favored social and economic policies. Condemning the institutional approaches of New Deal liberalism, conservatives find the tax code a convenient alternative vehicle for public policymaking — assuming that governmental controls imposed through tax credits and tax preferences are somehow less coercive than programs relying upon direct budgetary outlays and enforcement through administrative agencies other than the Internal Revenue

⁸Testimony of Speaker of the House Newt Gingrich before a joint meeting of the House Ways and Means and Senate Finance Committees, January 5, 1995, as reported in "104th Congress: The First 100 Days," *N.Y. Times*, January 6, 1995, A20, col. 1.

Service. In many respects, the most significant difference between the tax policies of congressional Democrats and Republicans lies in the particular interests they choose to protect through the tax laws. Both sides of the political spectrum appear equally enamored of the electoral benefits derived from using the tax code to provide nonpartisan constituency service to the home district. The resulting tax policy has left the tax code riddled through and through by a dizzying array of tax credits, preferences, and deductions.

A number of factors contributed to the general increase in this use of the federal income tax to make public policy. First, the development of an American social welfare state during the 1930s greatly increased the overall magnitude of all public policies pursued by the federal government. Perhaps it was inevitable that some of these new policies would find their way into the federal tax code; more than a few did. Second, the tax legislative arena, as compared to that of budgeting and appropriations, proved to be generally more accessible and hospitable to the personal interests, ambitions, and goals of individual congressmen. It simply proved politically easier to provide constituents with benefits through the tax code than through direct budgetary expenditures.⁹ On top of this, the overall rise of interest-group politics and the related decline in political parties following World War II left individual congressmen relatively free to pursue special-interest tax provisions on behalf of their constituents. The post-Watergate "reforms" of the congressional committee hierarchy only contributed to this trend, since they radically altered the political arena within which tax policy is made — in particular, weakening the control over the tax legislative process formerly exerted by the chairman of the House Ways and Means Committee. As a result, congressional policymakers were increasingly able to use the tax code as a vehicle for satisfying their own individual political goals and aspirations. Few in the legislative branch seem to have much interest anymore in protecting the integrity of the tax code or the interest of the Treasury in revenue.

The most common means of enacting public policy through the tax code is through tax preferences of one sort or another. Such tax preferences are now often referred to as "tax expenditures" to emphasize the extent to which they are functionally equivalent (at least in respect to the net effect upon the Treasury) to direct expenditures or outlays. The concept of tax expenditures was first formally introduced to budget analysis by the Treasury Department in 1968. Subsequently recognized in the Congressional Budget and Impound-

⁹One main difference between the tax arena and that of appropriations is that an appropriations bill must first clear a subcommittee with pertinent technical expertise and jurisdiction over the bill before it reaches the appropriations committee, whereas a comparable tax expenditure proceeds directly out of the tax committee. For a summary of other relevant differences between the tax and appropriating processes, see Thomas J. Reese, *The Politics of Taxation* (Westport, Conn.: Quorum Books, 1980), 198-201.

ment Act of 1974, tax expenditures are defined there as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."¹⁰

Tax expenditures grant relief from taxation on specific terms, with the express intention of altering the behavior of those who wish to claim the benefit of such exemption, deferral, or tax credit. Thus, rather than "loopholes" — a term that suggests a glitch or tax benefit unintentionally conferred by Congress upon taxpayers (or at least those astute enough to recognize them) — tax expenditures are preferences intentionally adopted precisely to allow taxpayers to escape some measure of taxation by complying with the dictates of the particular favored policy. Of course, there also are genuine loopholes in the tax code — unintended tax benefits derived from the intersection of different provisions of the tax code that, when combined by tax attorneys, produce significant tax advantages. Some of the more clever (and perfectly legal) tax shelters devised during the 1970s and early 1980s would fall into this category.¹¹

Notwithstanding the relatively recent awareness of the importance of tax expenditures in the budgetary process, the use of sanctioned tax preferences in the political process was already understood by the 1950s and common by the 1960s. Congressional policymakers, as well as those in the White House, routinely offered tax incentives to specific groups, interests, or classes of individuals, with the goal of promoting social and economic policies favored by such policymakers, as well as satisfying constituents. When tax preferences are used by members of Congress for purposes of constituency service, the class of taxpayers who benefit may be so narrow as to consist of a single individual — as is the class of taxpayers affected by the "transition rules" for new tax legislation.¹²

Because policymaking through tax expenditures is relatively easy and generally conducive to the political and electoral needs of representatives in Congress, it has become a common mode of congressional policymaking. As a result, the revenue-raising capacity

¹⁰Congressional Budget and Impoundment Act, Pub. L. No. 93-344, sec. 3(a)(3), 88 Stat. 298, 299 (1974). For a comprehensive discussion of the political process of legislating tax expenditures, see Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973); see also Stanley S. Surrey and Paul McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985), and Pechman, *Federal Tax Policy*, 355-63.

¹¹It is not as easy as many would think to define a "tax shelter." See, e.g., Calvin H. Johnson, "What's a Tax Shelter?" *Tax Notes*, Aug. 14, 1995, p. 879.

¹²For a discussion of such narrow tax preferences granted to individuals in the transition rules to the Tax Reform Act of 1986, see Donald L. Barlett and James B. Steele, "The Great Tax Giveaway," *Phila. Inquirer*, April 10, 1988; see also Lawrence Zelenak, "Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?" *44 Tax L. Rev.* 563 (1989).

of the tax code has been undermined by special tax preferences generated by the political process, and no end to the practice is in sight. Stanley Surrey and Paul McDaniel calculated that the volume of government "spending" through tax expenditures increased by 179 percent from fiscal year 1974 to fiscal year 1981.¹³ The tax expenditure spending spree continued even after 1981, notwithstanding the success of tax-reform efforts in 1986. A recent study by the General Accounting Office estimated that tax expenditures totaled almost \$402 billion in 1993 and will continue to increase annually by 4 percent.¹⁴

The instability, incoherence, and great complexity of contemporary tax policy can be traced to a number of factors.

Every tax expenditure represents a discrete departure from a pure revenue-driven tax policy. As tax reformers like to remind us, the cumulative effect of all the many tax expenditures, credits, exemptions, deferrals, and other tax preferences has been to "erode" the revenue-raising capabilities of the federal income tax. According to President Clinton's budget originally proposed for fiscal year 1997, the revenue loss attributable to federal income tax expenditures will be \$544 billion — a 4.1 percent increase over 1996.¹⁵ To the extent that the income tax succeeds in redirecting social and economic behavior toward preferred activities enshrined in the tax code, it becomes less capable of raising revenue. In turn, the revenue loss attributable to the increase in tax expenditures increases pressure for higher overall tax rates. For this reason, the distinctive characteristic of the postwar federal income tax has been high marginal tax rates with an abundance of tax preferences provided by congressional policymakers eager to alleviate the burden of such rates as they apply to favored constituents. This proliferation of tax expenditures has even led some to question whether the federal income tax can continue as the primary source of federal revenue.¹⁶

During the 1950s, the revenue loss attributable to the use of the federal income tax for such instrumental political purposes was much less critical. Congressional policymakers enjoyed the luxury of unprecedented, sustained economic prosperity during the immediate postwar era. Buoyed by the effect of long-term inflationary trends and the strong economy, federal

policymakers enjoyed a constantly increasing source of revenue attributable to so-called "bracket creep." The relative stability of institutional structures and partisan politics in Congress contributed to the persistence of this pattern of tax policymaking throughout the 1960s and into the 1970s. At that time, the postwar economic boom began to stall out, denying policymakers the luxury of the automatic tax increases to which they had become accustomed. Then, in 1981 the income tax brackets were indexed for inflation, and policymakers were forced to confront serious revenue constraints. This fiscal restraint, along with the enormous budget deficits that followed in the wake of the 1981 tax act, had a profound impact upon tax policymaking in the 1980s and 1990s, when the rules of the "tax game" were radically altered. While it is unclear whether any substantive changes in tax policy are attributable to the ongoing budget shortfalls, the structures and processes of federal tax policymaking have changed dramatically in the face of a heightened revenue imperative.

The Limits of Tax Policy

As described above, there are significant incentives for politicians to use the federal income tax for purely instrumental political purposes. This politically motivated use of the federal income tax is but one consequence of the lack of institutional resistance to interest-group pressures; an unstable and inconsistent tax policy is another. In addition, the simultaneous efforts to raise revenue, make public policy, serve special interests, and direct the national economy through the federal income tax all leave tax policy without any singular purpose or body of unified and coherent organizational principles.¹⁷ It has also made American tax law an incredibly complicated affair. Stanley Surrey, assistant secretary of Treasury during the Kennedy administration, once described contemporary tax legislation as "a catch-as-catch-can affair that produces complexities, unfairness, conflicting moves in all directions, almost mindless provisions."¹⁸ Amazingly, Surrey wrote those words before the great deluge of tax legislation enacted during the 1980s, wherein the complexities, conflicting moves, and mindless provisions proliferated beyond anything previously experienced or imagined.

The instability, incoherence, and great complexity of contemporary tax policy can be traced to a number of factors. First, American political institutions designed to restrain the coercive powers of the federal government have simultaneously introduced conflict into the legislative process. As constitutional scholar Edwin Corwin once observed, the separation of powers built into the structure of national political institutions by the U.S. Constitution proved to be an invitation to 200

¹³Surrey and McDaniel, *Tax Expenditures*, 6.

¹⁴General Accounting Office, "Tax Policy: Tax Expenditures Deserve More Scrutiny" (GAO/GGD-AIMD-94-122) (June 3, 1994).

¹⁵Budget of the United States Government, Fiscal Year 1997 (submitted to Congress by President Clinton, March 19, 1996), "Analytical Perspectives," chap. 5 ("Tax Expenditures").

¹⁶See, e.g., Michael J. Graetz, "Can the Income Tax Continue to Be the Major Revenue Source?" in *Options for Tax Reform*, ed. Joseph A. Pechman (Washington, D.C.: Brookings Institution, 1984).

¹⁷That interest-group politics generally lacks coherence and principle is a major theme of Theodore J. Lowi, *The End of Liberalism* (New York: W. W. Norton, 1969).

¹⁸Stanley S. Surrey, "Our Troubled Tax Policy," *Tax Notes*, Feb. 2, 1981, p. 179.

years of conflict. This separation of the executive and legislative functions has similarly contributed to the instability and incoherence of contemporary American tax policy. Major tax policy initiatives tend to originate with the executive branch, but tax legislation is very much a product of a congressional policymaking process dominated by a relatively small number of key players on the House Ways and Means and Senate Finance Committees. The divergence of interests between the executive and legislative branches, even when these are controlled by the same national party, is evidenced in the final legislative product and is one notable source of the incoherence of contemporary tax policy.

During the periods of stability between so-called critical elections and realignments, American tax policy has floundered.

Second, the pluralist structure of American political institutions affords private interests considerable access to public policymaking. It is generally recognized that on account of this pluralist structure, federal policymakers have been highly accessible (or, more pessimistically, susceptible) to the entreaties of private interests located outside the formal processes of government. The input of constituents, special interests, so-called public-interest groups, as well as the media, is felt most intensely in congressional committees. The pressures from these various interests play an important role in shaping tax policy outcomes, securing enactment of special provisions, or merely in vetoing some executive initiative adverse to their interests, thereby robbing tax policy initiatives of any overall perspective or ideological coherence. The tax code becomes a collection of disparate and often contradictory provisions as congressional policymaking degenerates into this peculiar brand of tax — “pork-barrel” politics.

There have been moments in political time when broad national partisan coalitions have emerged and overwhelmed this congressional “politics-as-usual” — such as during the first years of the New Deal, immediately following Lyndon Johnson’s triumph in 1964, in the years following Ronald Reagan’s overwhelming and decisive electoral victory in 1980, and during the opening days of the 104th Congress, following the Republican victory in the 1994 midterm elections. During these rare moments of consensus, broad tax policy initiatives have prevailed. However, such moments of tax policy consensus have turned out to be temporary and invariably short-lived. Notwithstanding the apparent strength of commitment to a particular political alliance at some given moment, coalitions melt away quickly and the course of tax policy shifts once again. During the periods of stability between so-called critical elections and realignments, American tax policy has floundered.

Thus, the fundamental problem of contemporary tax policymaking is that it seldom has any overall direction and is simply too accessible to too many private inter-

ests at once. This is a direct consequence of the constitutional structure of American politics. Political scientist John Witte has observed that the “inability of the [tax] system to resist change create[s] a policy morass that is perpetuated by its own structure.”¹⁹ The underlying problem of American tax policy then relates to the failings of American politics and cannot simply be blamed upon the failure of individual “politicians” or “special interests” that are said to control congressional policymaking — as reformers so hold. The limits of American tax policy reflect the fragmented structure of the American political system out of which it originates. Ironically, efforts in the early 1970s to “reform” the hierarchical organization and legislative procedures of Congress only exacerbated the problems of tax policy by further weakening the institutions of decisionmaking.

Elected representatives must eventually confront the political reality of an electorate with an apparently insatiable appetite for “public goods” that at the same time harbors a deep-rooted intolerance for the levels of taxation sufficient to support its own proclivities. This creates a dilemma for elected officials subject to the mixed pressures of the democratic politics within which the tax regime is located. Popular resistance to tax increases is strong within the political culture, and these sentiments are translated into political commands by the electoral process that dominates the political system.²⁰ At the same time, the dynamics of American electoral politics creates strong incentives for congressional policymakers constantly to offer up greater quantities of public goods (as well as tax expenditures) for the benefit of constituents, thereby increasing overall pressure for higher taxes.²¹ Over the long run, the “electoral connection” compels congressional policymakers to adopt ever more tax preferences and budget expenditures and concurrently avoid raising taxes to finance all the many policies that are now commonly referred to as “revenue losers.” Indeed, there is enormous political pressure to *reduce* taxes even in the face of significant budget shortfalls — a lesson learned all too well by President Clinton. Clin-

¹⁹John F. Witte, *The Politics and Development of the Federal Income Tax* (Madison: University of Wisconsin Press, 1985), 20.

²⁰For example, the grassroots, populist antitax movement that began in California with Proposition 13. For a discussion of antitax politics, see Susan B. Hansen, *The Politics of Taxation: Revenue Without Representation* (New York: Praeger, 1983), chap. 7, and David O. Sears and Jack Citrin, *Tax Revolt: Something for Nothing in California* (Cambridge: Harvard University Press, 1982). Much the same antitax sentiment was expressed in the 1977 Kemp-Roth proposal, as well as the politics leading up to the 1981 tax act. Antitax rhetoric heated up again during the fall of 1994, when conservative Republicans made tax cuts a central campaign theme.

²¹James Buchanan describes this dynamics as follows: “[T]hose citizens and their legislative agents who enjoy the current benefits of spending without paying current taxes impose costs on all taxpayers who will be around in future periods.” James M. Buchanan, “Clarifying Confusion About the Balanced Budget Amendment,” 48 *Nat’l Tax J.* 347, 350 (1995).

ton was forced to offer his own tax-cut proposals in an effort to quiet the thunder of Republicans in the wake of their significant electoral successes in the 1994 mid-term elections, during which tax-reduction rhetoric ran rampant. Political incentives lead politicians to postpone paying the piper for as long as possible; budget deficits are the direct and inescapable consequence.

Accordingly, the overall operative tendency is for members of Congress (as well as the executive) to increase expenditures and thus aggravate the demand for revenue beyond what the federal income tax can readily accommodate within the limits imposed by the prevailing democratic/populist politics — at least, absent the extraordinary national unity occasioned by a military crisis. This has suggested to some an inherent structural defect in the democratic/liberal state, rendering it incapable of adequately financing its own activities.²² Whether this constitutes a “structural deficit” is a matter open to serious debate. Certainly the “Deficit” has become a constant presence looming over and influencing the course of contemporary American politics.²³ Even still, both the Republican and the Democratic Parties exert strong political pressure to reduce taxes, rather than raise them. The tension between the state’s pressures for revenue and the citizenry’s appetite for public goods imposes a peculiar (and perverse) dynamic on American tax policymaking.

In less open and democratic politics, political elites may escape this dynamic altogether, encountering fewer barriers and obstacles to the pure pursuit of revenue — perhaps even enjoying the outright unrestrained freedom to plunder their own societies. The sad history of the former Soviet Union suggests that political elites in control of an authoritarian state, unrestrained by popular controls, will extract the maximum wealth from civil society, even to the point where private economic activity is suppressed to the obvious detriment of the state itself. Pursuit of the state’s wealth at the expense of civil society may be self-destructive in the long run, but the political elites who for decades dined on caviar and vodka in Moscow did not worry about the long run. They left behind an economy and society ravaged and decimated by the

Soviet state itself. However, in the Western liberal democracies, political elites are continually subjected to popular controls exerted through electoral politics and the open expression of public opinion. Electoral competition and public opinion impose a significant degree of popular control over elected political elites and render them in some way accountable to the citizenry.²⁴ The need for American political elites to raise revenue for the state is tempered by such electoral pressures and controls, exerted through the peculiar arrangement of American political institutions operating within the traditional liberal political culture.

One of the most significant achievements of American constitutionalism has been to devise and put in place structures and procedures that effectively restrain the federal government from imposing arbitrary, exploitative, and onerous controls over the private sphere. The prevailing democratic electoral politics has generally limited the capacity of the state to maximize its revenue at the expense of civil society. The power of the liberal state to tax, like all the other coercive powers of the state, has for the most part been contained within constitutionally prescribed boundaries. This has effectively prevented American political elites from behaving as bona fide “revenue predators.”²⁵ However, the same institutional arrangements and democratic politics have also contributed to a fragmented and internally inconsistent tax policy. This is the real “structural” problem of contemporary American tax policy.

A Decade of Erratic Tax Policy

The many failings of contemporary American policymaking regarding the income tax seemed to come to a head in the 1980s, when (in the words of Eugene Steuerle of the Urban Institute) a “pattern of erratic tax policy” prevailed.²⁶ The tax legislation of the 1980s reflected the inability of the political system to adopt a single coherent tax policy to the exclusion of all others. In the 1980s, policymakers seemed intent upon accommodating nearly every organized political and economic interest — if not in the same tax bill, then

²²This is James O’Connor’s premise, derived from his neo-Marxist perspective, that there is an inherent tendency of the liberal democratic state to spend beyond its fiscal capacities. James O’Connor, *The Fiscal Crisis of the State* (New York: St. Martin’s Press, 1973).

²³Joseph White and Aaron Wildavsky described the looming presence of the budget deficit in American politics as follows: “Now we are living in the era of the budget. . . . Virtually all other issues are discussed and decided in terms of the impacts on the deficit.” Aaron B. Wildavsky and Joseph White, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and Los Angeles: University of California Press, 1989), xv-xvi. The politics of the budget deficit is the focus of a new study, John H. Makin and Norman J. Ornstein, *Debt and Taxes* (New York: Random House, 1994); see also James D. Savage, *Balanced Budgets and American Politics* (Ithaca, N.Y.: Cornell University Press, 1988).

²⁴The seminal statement of this view of electoral politics is found in Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Row, 1950), chap. 22. Robert Dahl built upon Schumpeter’s theme, arguing that elections ensure that “political leaders will be somewhat responsive to the preferences of some ordinary citizens.” Robert A. Dahl, *A Preface to Democratic Theory* (Chicago: University of Chicago Press, 1956), 131.

²⁵The reference is to Margaret Levi’s “theory of predatory rule,” which holds that “rulers are predatory in that they try to extract as much revenue as they can from the population.” Margaret Levi, *Of Rule and Revenue* (Berkeley and Los Angeles: University of California Press, 1988), 3. Notwithstanding the significant insights of Levi’s theory, the conclusion here is that it is not particularly useful in describing or predicting the actions or motives of American policymakers with respect to the politics of the U.S. income tax.

²⁶Charles A. McLure Jr., “The Budget Process and Tax Simplification/Complication,” 45 *Tax L. Rev.* 25, 28 (1989).

eventually over time through their constant tinkering with the tax code. During the decade, the tax-policymaking process was particularly open and accessible to pressures from outside the formal legislative process and generally was unrestrained by fiscal reality or the inherent limits of public policy. For example, tax legislation enacted in 1981 slashed taxes and revenues, both out of ideological conviction (i.e., supply-side economics) and to appease pro-business constituents within the Republican Party. In sharp contrast, the Tax Reform Act of 1986 represented the greatest success of tax professionals in their quest to achieve a more perfect tax code through "tax reform." In this respect, the spirit of the 1986 bill was very much at odds with that of the 1981 legislation. In a matter of only five years, federal tax policy entirely reversed course — and this under the tutelage of the very same president.²⁷

The many failings of contemporary American policymaking regarding the income tax seemed to come to a head in the 1980s.

Not only is contemporary American tax policy unstable, but the tax laws have also become incredibly complex on account of the overuse of the income tax laws for instrumental political purposes. American tax laws are by far the most complex of all the Western industrial nations. One of the purported goals of tax reformers in 1986 was to strip out the many tax preferences and expenditures that contribute so much to the excessive complexity of the enterprise. However, the already arcane tax laws actually grew more complex precisely because the 1986 act sought an aesthetically purer income tax regime; policymakers (first Congress through its statutes, and then "tax experts" through their administrative regulations) drew increasingly subtle distinctions between what is allowed and what is disallowed under the tax laws. This constant overlegislating, so aptly described by law professor Bayless Manning as "hyperlexis,"²⁸ threatens to swamp the tax code with the accumulated weight of such subtle distinctions.

While the reform of excessive complexity has emerged as a perennial issue on the tax policy agenda,

²⁷Witte has pointed out the irony of President Reagan's political support for both the 1981 and 1986 tax acts: "Ronald Reagan thus has the unique historical position of supporting both the largest tax reform and the largest antitax reform legislation in the history of the United States." John F. Witte, "The Tax Reform Act of 1986: A New Era in Tax Politics?" 19 *Am. Pol. Q.* 438, 443 (1991).

²⁸The term was coined to define "a pathological condition caused by an overactive law-making gland." Bayless Manning, "Hyperlexis: Our National Disease," 71 *Nw. U. L. Rev.* 767 (1977). Manning went on to describe and lament the consequences of hyperlexis: "Statutory codes, such as those in the fields of commercial law and taxation, are becoming ever more particularistic, longer, more complex, and less comprehensible. We are drowning in law."

the tax laws themselves have continued to grow ever more complex, becoming a serious consideration for taxpayers and practitioners who must cope with a system of rules and regulations spiraling out of control. However, for the politicians who are ultimately responsible for the excessive complexity, tax simplification provides an attractive political theme for currying favor with constituents. Indeed, it is unclear whether policymakers have any real interest in simplifying the tax laws. To paraphrase a theme made familiar in the literature on Congress by political scientists Morris Fiorina and David Mayhew, the interests of policymakers may very well be served best by acting in Congress to increase the complexity of the tax laws and, at the very same time, campaigning for reform and simplification before their constituents in the home district.²⁹

The Failure of U.S. Tax Policy

The political importance of the federal income tax goes beyond the interest-group politics exerted in Congress. The tax laws and political institutions constitute a unified "tax system," a steering mechanism for the liberal state through which political institutions exert control over civil society and the private economic sphere. If the income tax is used as a tool of the American state to regulate and control private interests, the relationship runs both ways, since private interests also use the open and porous tax-policymaking process to shape and define public policy to their own interest. For those who can read its arcane language, the tax code provides a virtual architectural blueprint of the American state.

The structures of the political system impose conflicting demands upon tax policymakers — impelling them *both* to raise revenue and to implement policies that are functionally equivalent to direct budgetary expenditures (i.e., tax expenditures). As a result of the diverse and conflicting roles of policymakers and the related uses of the federal income tax to serve the conflicting functions thrust upon them, the tax laws have in recent decades become increasingly unstable, incoherent, and excessively complex. When the income tax is used by policymakers to implement public policies and to cull favor with local constituents, Treasury is inevitably deprived of revenue. These conflicting demands made upon the federal income tax account for the internal inconsistency, incoherence, instability, and excess complexity that has plagued contemporary American tax policymaking. In this way, the failure of tax policy is a problem central to contemporary American politics, but not one easily solved by the political process to which it is inextricably tied.

²⁹The reference is to the proposition, set forth by political scientists Morris Fiorina and David Mayhew, that politicians will constantly rail against the "bureaucracy," though their political interest lies in creating the very same. See Morris P. Fiorina, *Congress: Keystone of the Washington Establishment* (New Haven: Yale University Press, 1977), and David R. Mayhew, *Congress: The Electoral Connection* (New Haven: Yale University Press, 1974).

Since Republicans scored their victory in the November 1994 election, the federal income tax has come under heavy attack. As the legitimacy of the federal income tax came to be increasingly questioned, all sorts of radical statements in favor of abandoning it became common fare. Perhaps the most significant were proposals to abandon the income tax altogether and replace it with some form of a "flat" consumption-based tax. Despite all the political rhetoric and bragadocio in favor of such reforms of the income tax, there is considerable institutional resistance to such a wholesale assault upon the federal income tax. The income tax has become so deeply entrenched and intertwined with the development of the American state over the last eight decades that any threat to the more than \$700 billion of revenue it raises should be looked

at skeptically. "Radical tax reform" threatens so many political interests and runs counter to so much of what motivates American policymakers that such is unlikely to succeed politically (even if the merits are genuine).

Still, it must be said that with tax policy set in flux during the 104th Congress, legislative proposals that seemed entirely beyond the realm of political reality only months ago are now prominently on the policy agenda. But only one thing is certain. Radical tax reform is sure to be a persistent political theme so long as the income tax is used as a political instrument by both political parties. And so the policymaking of the federal income tax remains at once a perplexing and revealing enterprise — one reflecting and ultimately undermined by the structure of American politics.

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