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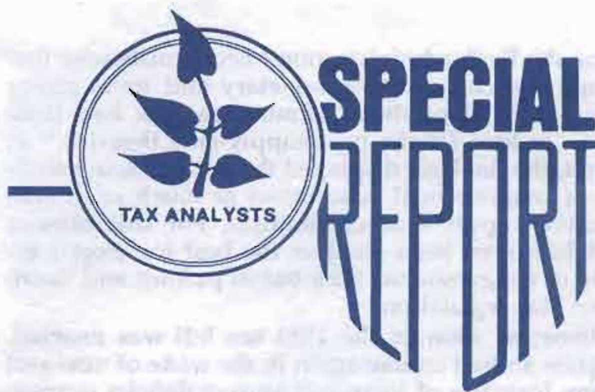

FAREWELL TO TAX REFORM: THE 1993 TAX ACT IN HISTORICAL PERSPECTIVE

by Sheldon D. Pollack

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This article discusses the Revenue Reconciliation Act of 1993, signed into law one year ago by President Clinton, in light of developments in tax policy during the 1980s. The author concludes that the 1993 act evidences a general return to the patterns of tax policymaking that prevailed prior to the enactment of the most significant tax legislation in the postwar era — the Tax Reform Act of 1986. Professor Pollack suggests that the politics surrounding the 1993 act indicate that tax reform in 1986 was an aberration, rather than a new and lasting trend in tax policy.

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"Fundamental reform almost always runs the risk of making things worse."
— Dan Rostenkowski, chairman, House Ways and Means Committee (1993)

Introduction

During the 1980s, the revenue laws of the United States were revised, reformed, and restructured to a greater extent than during any other period since the enactment of the modern federal income tax in 1913. As University of Chicago law professor Daniel Shaviro put it: "Just as China in the 1960's has perpetual revolution, so the United States in the 1980s has perpetual income tax legislation."[1] The fury of tax legislation culminated in the most significant tax bill in the history of the federal income tax — the Tax Reform Act of 1986.[2] However, no less than six other major tax bills were enacted during the 1980s, and the onslaught has continued unabated into the 1990s.

On the one-year anniversary of the Revenue Reconciliation Act of 1993[3] (signed into law by President Clinton on August 10, 1993), this article considers the politics and substance of the act in light of developments during the 1980s. Tax legislation during the 1980s revealed little coherence or direction as it continually shifted directions, following an erratic, cyclical course that seemed to lead nowhere. Furthermore, by the end of the decade, the historic tax reform efforts of 1986 had begun to unravel as traditional patterns of congressional tax policymaking began to re-emerge. This trend was evidenced in the ill-fated tax legislative efforts of 1990 and 1992, as well as in the 1993 tax bill. The politics behind these tax bills is examined within the historical context of the peculiar pattern of tax policymaking that emerged during the 1980s.

The 1980s: A Deluge of Tax Legislation

The single most significant defining characteristic of tax legislation enacted during the 1980s was the sheer magnitude of the enterprise. This deluge of tax legislation undermined the ability of the Internal Revenue Service to administer the federal income tax. To date, the IRS still has been unable to draft all the many regulations mandated by Congress to implement the new tax statutes and faces an enormous backlog of regulations to be written — with some 589 IRS "regulations projects" in progress as of February 28, 1994.[4] Likewise, the capacity of the federal courts

[1]Daniel Shaviro, "Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980's," 139 *U. Pa. L. Rev.* 1 (Nov. 1990).

[2]Pub. L. No. 99-514, 100 Stat. 2085.

[3]Pub. L. No. 103-66, 107 Stat. 312.

[4]*The Wall Street Journal*, Apr. 20, 1994, p. A1.

to adjudicate and dispose of the increasing number of disputes litigated between the government and taxpayers was severely strained during the 1980s. As of September 30, 1993, the U.S. Tax Court still faced a backlog of 42,074 cases, down from 54,135 three years ago, but considerable nonetheless.[5] For its part, the private tax bar still struggles just to keep up with the flood of new and increasingly complex tax statutes and regulations.

The 1980s began with significant ideologically driven tax legislation. In the summer of 1981, Ronald Reagan brought together a bipartisan conservative congressional coalition that enacted the Economic Recovery Tax Act of 1981 (ERTA).[6] During the 1980 presidential campaign, Reagan had endorsed in principle a tax rate reduction proposal first introduced by Sen. William V. Roth Jr., R-Del., and Rep. Jack Kemp, R-Mo., in 1977 during the Carter presidency. The so-called "Kemp-Roth I" proposal called for a 33-percent rate reduction for individuals and three percentage points for corporations. In the spring of 1981, newly elected President Reagan introduced his own legislative proposal for slightly milder tax rate reductions styled on Kemp-Roth. However, even this more modest proposal for rate reduction, supported by a popular president who had just won a clear and convincing electoral victory ousting the incumbent, ran into stiff opposition in Congress. Tax rate reductions implemented through ERTA were less than those of Kemp-Roth or even those contained in the original legislation proposed by the Reagan White House.[7] Nevertheless, they still constituted the most significant tax rate reductions (for both individuals and corporations) in the history of the U.S. income tax.[8]

The 1981 tax bill had its intellectual origins in the so-called "supply-side" economics, which came to dominate conservative economic thought during the late 1970s and early 1980s, especially among certain White House advisers during the Reagan years and, later, among staffers of Vice President Dan Quayle during the Bush administration.[9] Economists who had championed conservative monetary and fiscal policy during prior Republican administrations had little faith in or love for the new supply-side theories.[10] In the end, the final bill displayed the nonpartisan handicraft of congressional committees as much as of conservative supply-side economists. For this reason, ERTA has often been cited as the best (or worst) example of congressional pork-barrel politics and "anti-reform" tax legislation.[11]

Almost as soon as the 1981 tax bill was enacted, Congress shifted course again in the wake of new and gloomy forecasts of increased budget deficits purportedly attributable to the ERTA tax rate cuts. Led by Republican leadership in the Senate, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[12] and soon after, the Deficit Reduction Act of 1984 (DEFRA).[13] These tax bills collectively increased revenues by $50 billion and "reformed" a good many of the supply-side economic policies of ERTA right out of the tax code.

Traditional Republican fiscal and monetary policy could be pursued through executive action (albeit, only with a good deal of cooperation from the Federal Reserve Board). However, supply-side economics could be enacted only through amendments to the tax laws that must be approved by the legislature. This proved to be particularly problematic for Republicans who controlled the White House throughout the 1980s, but had much less sway over Congress. To the extent that the tax code became the vehicle for enacting the

[5]"Fewer Tax Battles Clog Courts," *The Wall Street Journal*, Feb. 2, 1994, p. A1.

[6]Pub. L. No. 97-34, 95 Stat. 172.

[7]The original Reagan proposal called for 10-percent rate reductions in each of three successive years, retroactive to January 1, 1981. That would have amounted to an overall 27-percent rate reduction for individuals. ERTA included rate reductions of 5, 10, and 10 percent over three successive years, effective beginning October 1, 1981. This amounted to a 23-percent rate reduction; however, the full effect of ERTA rate reductions was offset by subsequent legislation.

[8]The tax rate cuts proposed in 1963 by President John F. Kennedy and enacted after his death in March 1964, reduced the top marginal tax rate from 91 to 70 percent — a 23-percent reduction. The lowest tax rate was reduced from 20 to 14 percent; middle-income rates were reduced by smaller amounts.

[9]During the Reagan years, perhaps the most ardent supply-side economist was Paul Craig Roberts, who was economic adviser to Kemp in 1975 and later became Assistant Secretary of Treasury under Reagan. His account of the "rise" of the supply-siders is found in Paul Craig Roberts, *The Supply-Side Revolution* (Cambridge: Harvard University Press, 1984). The most vigorous advocate of supply-side principles during the Bush administration was neo-conservative William Kristol, Chief of Staff of the Office of the Vice President. For a discussion of Kristol's role in the administration, see Jacob Weisberg, "The Veep's Keeper," *The New Republic*, Mar. 12, 1990, p. 10.

[10]For instance, supply-side economics was criticized by Herbert Stein, former chairman of the Council of Economic Advisers under Presidents Nixon and Ford, in *Washington Bedtime Stories: The Politics of Money and Jobs* (New York: The Free Press, 1986), p. 123; *see also* Herbert Stein, "Here We Go Again," *The Wall Street Journal*, Apr. 29, 1993, p. A14 ("[T]here are still people who believe that the supply-side prescription worked, or would have worked if followed more rigorously. . . . In any case, after 1981 the deficit grew, saving declined and there was no significant revival of long-run output and productivity.").

[11]*See, e.g.,* John F. Witte, "The Tax Reform Act of 1986: A New Era in Tax Politics?" 19 *American Politics Quarterly* 438, 441 (Oct. 1991), p. 443 ("The 1981 Economic Recovery Act (ERTA) stands as the most strident *anti-reform* bill."); Shaviro, note 1 *supra*, p. 108 ("[M]ost supporters of tax reform would agree [that ERTA] was almost pathologically bad special interest legislation.").

[12]Pub. L. No. 97-248, 96 Stat. 324.

[13]Pub. L. No. 98-369, 98 Stat. 494.

conservative policy agenda, White House Republicans were rendered dependent on a largely unsympathetic Democratic Congress. The dilemma of supply-side economics during the 1980s was that the White House was at the mercy of congressional politics beyond its control. In the end, this proved fatal to the cause.

During the second Reagan administration, tax policy took an altogether unpredictable change of course as an ideological movement for tax reform supplanted both supply-side economics and revenue concerns as the driving force behind the legislative process. Tax reform had been "in the air" for decades. In his January 1963 State of the Union Message, John F. Kennedy had proclaimed tax reform the highest domestic policy priority of his administration: "I am convinced that the enactment this year of tax reductions and tax reform overshadows all other domestic problems in this Congress."[14] However, in the 1980s, the movement for tax reform attained a previously unknown level of political success.

Ironically, the campaign for tax reform in the 1980s was instigated by a president hardly known for his interest in reform politics. Reagan unintentionally initiated the campaign when, in his 1984 State of the Union address, he called on the Treasury Department to study the feasibility of tax reform and simplification:

> Let us go forward with an historic reform for fairness, simplicity and incentives for growth. I am asking [Treasury] Secretary Don Regan for a plan for action to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly.[15]

This was a little like telling lions to eat meat. Treasury had been working on significant tax reform proposals for decades, and little encouragement was needed to stimulate further efforts. Reagan thereby set in motion a two-year struggle for reform of the tax laws, culminating in the enactment of the Tax Reform Act of 1986. Contrary to all expectations, tax reform became the centerpiece of domestic policy in the second Reagan administration.

By most accounts, the 1986 act was the most comprehensive and significant tax legislation enacted in the history of the federal income tax.[16] By virtue of the sheer volume of the revisions and amendments to the tax laws it implemented, the 1986 act was the most massive restructuring of the federal income tax in its 80-year history, dwarfing by far the last major overhaul of the tax code in 1954. Equally significant, the 1986 act came closer than any tax bill ever to emerge from the congressional tax committees (purportedly the bastion of special interests) to codifying the reformist's vision of the ideal tax code.

The intellectual underpinnings of the movement for tax reform that prevailed in 1986 can be traced to the seminal writings in the 1930s of University of Chicago economist Henry Simons, whose influence is still exerted through the tax "experts" in the administrative state who share a common academic training and ideological perspective largely informed by Simons' vision of tax reform. That vision of tax reform follows directly from Simons' conception of "economic income," which has been widely embraced by academics, tax experts, as well as the U.S. Supreme Court, and incorporated in substance into the tax code as the basis for "taxable income." Tax reform derived from Simons' economic model would strip the tax laws of all special provisions, expenditures, and loopholes, in favor of a so-called "comprehensive income tax base." A triumph of such a notion of tax reform would inflict the most radical changes to the tax code as it has evolved since 1913.

If Henry Simons provided the classic definition of income for purposes of the income tax, setting in motion the movement for a comprehensive income tax base, the dominant theorists of tax reformism in the postwar generation were Stanley S. Surrey of Harvard Law School (and later, Assistant Secretary of the Treasury in the Kennedy administration) and economist Joseph A. Pechman of the Brookings Institution. The enduring vision of tax reform first enunciated by Simons is the credo of vertical and horizontal equity in pursuit of a comprehensive tax base. The legacy of Surrey and Pechman is found in their substantial contribution toward refining this orthodoxy of the tax expert: broadening the tax base to include previously excluded or exempt sources of income, eliminating unjustifiable preferences and tax expenditures, and reducing erosion of the revenue-raising capacity of the tax laws and other sources of leakages of tax revenue, while simultaneously closing the vast array of special tax loopholes bestowed on favored special interests.

In 1986, due to an unusual array of circumstances, this vision of tax reform unexpectedly became the theoretical foundation for a political coalition with just enough broad-based support to prevail against the typically stronger, more focused special interests. The story of how special interests so often succeed in the political arena of tax policy by exerting intense pressures in regard to those issues most significant to them is well-known.[17] It is generally difficult to mobilize the "public" or any broad interest with regard to policies

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[14]John F. Kennedy, "Annual Message to the Congress on the State of the Union," (Jan. 1963), *Public Papers of the Presidents: John F. Kennedy, 1963* (Washington: Government Printing Office, 1964), p. 13.

[15]Ronald Reagan, "Address Before a Joint Session of the Congress on the State of the Union," (Jan. 25, 1984), *Public Papers of the Presidents: Ronald Reagan, 1984* (Washington: Government Printing Office, 1986), p. 87.

[16]Eugene Steuerle has called it "[T]he most comprehensive reform of the U.S. tax laws ever undertaken." C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* (Washington: The Urban Institute Press, 1992), p. 1; *see also* Witte, note 11 *supra*, p. 4 ("TRA can only be viewed as a remarkable legislative accomplishment and by far the most radical example of peacetime tax reform in history.").

[17]The classic account of how special interest group politics influence the legislative process remains Stanley S. Surrey, "The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted," 70 *Harv. L. Rev.* 1145 (1957); *see also* James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do It* (New York: Basic Books, 1989), pp. 72-89.

that have only marginal and dispersed effects, whereas narrow interests are easily mobilized and quite willing to act at great expense when issues most salient to them are at stake. The story of how the academic vision of tax reform triumphed, however briefly and incompletely, is much less familiar.

What most significantly distinguished tax reform in 1986 from the incremental policymaking that dominated during periods of politics as usual was the extraordinary origins and reformist ideology behind this legislation. Ironically, at the very moment that tax reform took as its goal the most abstract, ideological vision, it was supported by a strong and viable political coalition. This unusual convergence of theory and praxis resulted in an unpredicted political success, which suggests that, contrary to the theorists of incrementalism, tax policy has come to be made at the national level through a complicated interplay of diverse forces, some tied to the politics of interest groups, but others quite clearly informed by the reformist's vision of the political order.

Ironically, as proponents of this particular vision of tax reform achieved their greatest success in 1986, the already arcane tax laws grew even more complex. The 1986 act added new complexity to the tax code precisely as it sought an aesthetically purer income tax regime. Tax reform provisions enacted in 1986 contributed additional complexity as tax policymakers (first congressmen in their statutes, and later tax experts in their administrative regulations) drew increasingly subtle distinctions between what is allowed and what is disallowed under the tax laws. This contributed to the increasing complexity that has pervaded the tax code.

One consequence of excessive complexity in the tax laws is that it stimulates periodic demands for simplification of the federal income tax. Tax simplification has been championed by politicians, academics, bureaucrats, and even at times the tax bar itself. Simplification is less a theoretical problem for tax practitioners and more a practical matter of coping with a system of rules and regulations spiraling out of control. For the politicians who are ultimately responsible for the excessive complexity, tax simplification provides an ideal theme for currying favor with constituents who are forced to grapple annually with the mind-numbing complexities of the tax code. And for the tax bureaucracy, tax simplification is a means to enhance taxpayer "self-compliance" with the tax laws, and thereby maximize revenue for the U.S. Treasury.

The two most significant aspects of the 1986 act — tax reform and the related increase in the complexity of the tax laws — remain its impressive, albeit dubious legacy. Notwithstanding the success of tax reform in 1986, within only a few short years, the prior patterns of tax policymaking were reasserted as proclamations of the "triumph" of tax reform proved greatly premature. There is little agreement even now among scholars as to how to explain both the radical, if only temporary, success of tax reform and the subsequent return to the traditional patterns of tax policymaking. Despite the unravelling of the historic tax legislation in 1986, tax reform still must be considered an important political force in the tax policymaking process as it remains a shared ideology of so many of the tax experts in the bureaucracy and among the tax academics who, if relatively powerless themselves, provide the theoretical underpinnings for much of the political debate over tax policy.

Tax policy dominated American politics during the 1980s as it never had before. Eugene Steuerle of the Urban Institute has appropriately characterized the 1980s as the "tax decade."[18] Unfortunately, postwar tax policy has also been an inherently flawed enterprise — in the words of Stanley Surrey: "Tax legislation has become a catch-as-catch-can affair that produces complexities, unfairness, conflicting moves in all directions, almost mindless provisions . . . ."[19] Surrey wrote those words in 1981, before the great deluge of tax legislation of the 1980s. Since then, the income tax code has been further used and abused, pulled and pushed, all to serve an assortment of contradictory political interests, instrumental economic goals, and ideological motives. The result has been "a pattern of erratic tax policy over the past dozen years."[20]

If tax policy has been erratic, it also has been cyclical. Today's reform is often perceived tomorrow as a "loophole." Tax policies stripped out from the tax code in prior legislation may be resurrected only years later as some new "reform." (The investment tax credit, for example, seems to have unlimited political lives.) Even worse than cyclical, tax policy has developed in a long-term pattern of incremental policymaking marred by occasional radical departures. If American tax policy has been more stable over time than that of some other nations — arguably, Great Britain — its own distinctive flaw is found in having no direction at all. Or more properly, whatever direction tax policy may take in the short term, regardless of how strong the apparent commitment to such policy, political coalitions and support seem to melt away, with the course of tax policy effortlessly reversed by the next emergent coalition.

This peculiar pattern of tax policy can be traced to such factors as the successes and failures of various partisan political campaigns instigated by the White House, the rising tide of interest group politics that informs the traditional congressional policymaking, the emergence of a semi-autonomous tax bureaucracy, as well as the development and "reform" of the internal hierarchical organization and legislative procedures of Congress. Political scientist John Witte has written that the "inability of the [tax] system to resist change create[s] a policy morass that is perpetuated by its own structure."[21] To this extent, tax policy reflects the in-

[18]Steuerle, note 16 *supra*, p. 1.

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

[20]Charles A. McLure, Jr., "The Budget Process and Tax Simplification/Complication," 45 *Tax L. Rev.* 25, 28 (1989). McLure, an economist by training, played an important role in formulating tax policy in Treasury during the 1980s.

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

coherent and fragmented structure of the American political system out of which it originates.

The 1990 Budget Deficit-Reduction Agreement

There was continual tax legislating in the latter half of the 1980s as well, although much of it consisted of technical corrections to the 1986 act itself. Most important, the difficult issues of the budget deficit were never addressed, neither on the revenue side nor with respect to expenditures. "Revenue-neutrality" was adopted as the framework for post-1986 policymaking, but that may have only added to the difficulty in solving the underlying problem by creating the illusion that a solution had been reached. Post-1986 tax legislation simply failed to confront the persistent, endemic gap between revenue and expenditures — a gap that was widening by the close of the decade.

> ***The 1990 act evidenced the beginning of the retreat from 1986 tax reform policy.***

By 1990, with the economy beginning to slide into recession, the federal deficit became an ever greater concern. The deficit as a percentage of GNP had fallen from a peak of 6.3 percent in 1993 to some 3.4 percent in 1988, rose again to 4.1 percent for fiscal year 1990, and was estimated to be 5 percent by the close of 1990.[22] Propelled by its inability to persuade Congress to impose further spending cuts on federal expenditures, by the summer of 1990 the Bush administration entered into ill-fated negotiations with Democratic congressional leadership in an effort to reach reconciliation over budget cuts and increases in tax rates.

The 1990 budget negotiations adopted a target of $40.1 billion in deficit reduction for fiscal year 1991 and a total of $500 billion spread over five years. However, there was no overall principle or economic worldview that guided the negotiations.[23] In many respects, this reflected the president's own lack of convictions in the area of tax policy — other than a pragmatic preference not to raise taxes. This same instrumental, nonideological approach was apparently shared by Bush's chief negotiator, OMB Director Richard Darman. Both the 1990 budget agreement and Darman became symbols for conservatives, reflecting what they perceived as the Bush administration's lack of commitment to "true" conservative (Reaganite) principles. The administration's lack of principle also permitted the congressional tax committees to maintain control over the negotiations, much to the detriment of the president's position.

The tax legislation that emerged from the negotiations, the Omnibus Budget Reconciliation Act of 1990,[24] reflected this nonideological perspective. Some effort was made to increase revenue through increases in "user fees," a 10-cents increase in the gasoline tax, excise taxes on liquor and cigarettes, and income tax rate increases, with only modest cuts in expenditures included in the total package. Most deficit reduction was attributable to tax increases, and not reductions in expenditure. It is noteworthy that the notion of tax reform that prevailed in 1986 was nowhere to be found in the 1990 budget negotiations. Rather than marking a new trend in tax policymaking, the 1990 act evidenced the beginning of the retreat from 1986 tax reform policy.

The attempt to raise revenue through user fees and excise taxes on such "luxury" items as furs, jewelry, and boats proved to be largely unsuccessful as the demand for such goods turned out to be far more inelastic than what conferees had apparently assumed — as if they actually contemplated such things. The luxury tax was finally repealed in 1993 with respect to all such items, other than automobiles with a purchase price in excess of $30,000. Budget negotiators in 1990 introduced other ill-conceived measures as well, such as the phase-out of personal exemptions, the benefit of the 15-percent tax bracket, and the reduction of certain itemized deductions above threshold levels of adjusted net income (AGI). Such tax policy gimmicks rely on sleight of hand to disguise what are in substance increases in marginal tax rates.[25] A similar game had been played in 1986 with the so-called "bubble" — really a 5-percent surtax on income above threshold levels of AGI. The bubble duped no one into believing that the highest tax rate was only 31 percent, although it did confuse many into believing that tax rates were lower for the wealthy than for the middle class (confusing effective tax rates with marginal tax rates).

> ***The 1990 act illustrates how a decade of intense tax policymaking ended adrift and with no clear direction evident.***

The 1990 act illustrates how a decade of intense tax policymaking ended adrift and with no clear direction evident. Neither Democrats nor Republicans favored the final bill, and there was only modest success in closing the budget deficit. Even more important, the episode left the Bush administration in full retreat on tax policy. Bush himself was eventually forced at the 1992 Republican National Convention in Houston to recant his political heresy of having raised taxes pursuant to the 1990 budget summit agreement, but by then it was too late.

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[22]The figures are cited in Steuerle, note 16 *supra*, p. 173.

[23]Steuerle, note 16 *supra*, p. 175.

[24]Pub. L. No. 101-508, 104 Stat. 1388-1400.

[25]Once a taxpayer has crossed the threshold for the "phase-out" of personal exemptions, which begins at $100,000 for a single taxpayer, as well as the threshold for the phased-in reduction in the enumerated deductions, which begins at $150,000 for the same single taxpayer, the effective marginal tax rate for the 1993 tax year is really 34 percent, and not the statutory 31 percent.

After 1990, the commitment of Republicans in the White House and in Congress against tax increases hardened. Nevertheless, they certainly had supported their share of tax increases throughout the 1970s and 1980s. Likewise, Republicans had consistently supported a wide range of social and economic policies enacted through the tax code, such as reducing federal income tax rates, preferential tax treatment of capital gains, tax-favored economic "enterprise zones" as a cure for urban blight, and the use of tax credits and expenditures to induce investment, the accumulation of capital, and all sorts of favored social behavior.

Both sides of the political spectrum appear equally enamored by the electoral benefits to be derived from using the tax code to provide nonpartisan constituency service to the home district.

Conservatives who otherwise extol the virtues of "voluntary" private action, fiscal responsibility, and governmental noninterference in the private social and economic spheres, have shown great eagerness to use the tax laws to implement social and economic policies. Condemning the institutional approaches of New Deal liberalism, conservatives found the tax code a convenient alternative vehicle for public policymaking — assuming that governmental controls imposed through tax credits and expenditures are less coercive than programs relying on direct budgetary outlays and administrative agencies (other than the IRS). In many respects, the most significant difference between the postwar tax policy of congressional Democrats and Republicans has been in the substance of the particular policies that they choose to write into the tax laws. Both sides of the political spectrum appear equally enamored by the electoral benefits to be derived from using the tax code to provide nonpartisan constituency service to the home district. An implicit agreement was reached among congressional Democrats and Republicans in the postwar era sanctioning such use of the tax laws. The resulting tax policy has left the tax code riddled through and through by a dizzying array of tax credits and tax expenditures.

The extent to which the use of tax expenditures to make public policy has penetrated American politics was illustrated by an incident during the waning months of the Bush administration. In September 1992, for the second time in as many years, Congress enacted a bill guaranteeing employees the right to take unpaid leave from their jobs for certain medical and "family" reasons. The Family and Medical Leave Act required employers with 50 or more employees to grant 12 weeks of unpaid leave for the care of a new or adopted child or on account of a serious family illness. Soon after the bill passed both houses of Congress, Bush vetoed the bill, just as he had when the prior version was sent to his desk in 1990. The president's veto was sustained in the House.[26]

What is so revealing about this political game was this Republican administration's response to the traditional Democratic approach of implementing public policy through mandates imposed on the private sector. Rather than rejecting outright any such role for government in regulating the private workplace, as one might expect of traditional conservatives as well as mainstream Republicans, the Bush administration proposed an alternate plan of tax credits intended to encourage private businesses to voluntarily adopt a similar family leave program.

The White House plan, which was never formally introduced as a legislative proposal, was undoubtedly motivated by political concerns.[27] Nevertheless, the White House's response also revealed the readiness of conservatives to resort to tax policy to enact a social policy that they opposed on ideological grounds and for which no convincing case for federal intervention had been made in the first place. The White House conjured up some new tax credits to be added to the existing arsenal as a cure for this newly discovered social "problem." Much the same dynamics was revealed in the initial Republican response to President Clinton's recent health care plan, which provides for significant governmental intervention into the private sector and mandates imposed on employers. The Republican leadership of Congress initially proposed in response to the Democratic administration's traditional New Deal initiative an alternative plan of tax credits and deductions for employer-provided medical insurance.[28] Democrats in Congress proposed their own alternative plans, most of which consisted of offering tax deductions for the cost of medical insurance and adopting everyone's favorite, the tax-preferred spending account — this time for medical expenses (akin to an IRA, but with back-end withdrawals permitted for medical expenses).

Tax Legislation in 1992

Prereform patterns of tax policy had been reasserted during the Bush administration in the absence of any strong countervailing commitment by the White House to supply-side economics and the exhaustion of the

[26]The Family and Medical Leave Act originally passed the House by a 241-161 vote, with 37 Republicans supporting the program, and later passed the Senate. Bush's veto of the bill was sustained in the House by a comfortable margin. The bill was eventually signed into law by President Clinton on February 5, 1993.

[27]The proposal was introduced at the suggestion of James Baker III, immediately following his reappointment as White House Chief of Staff in 1992. Apparently, it was intended to demonstrate new resolve and direction from the White House in the face of the sagging Bush reelection campaign. Given the timing and the outcome of the 1992 election, it should come as no surprise that nothing more was heard of the Republican tax credit proposal.

[28]For a discussion of the peculiar evolution of the Republican response to the Clinton health care plan, see Ruth Shalit, "Republicans and Health Care," *The New Republic*, Feb. 14, 1994, pp. 19-22.

movement for tax reform. After 1990, the Bush administration had no tax policy of its own to stand on. The strategic political decision to repudiate the very premise of the 1990 budget agreement (accepting higher taxes in exchange for modest budget cuts) left the administration with no direction for future tax policy. As a result, when initiatives commenced in Congress for a new tax bill in the spring of 1992, the White House became more of an observer, at best responding to congressional initiatives, rather than itself asserting control over the tax policy arena.

The result was a tax bill that passed the House on July 2, 1992, following all the well-established patterns that had led to the budget crisis in the first place. Imposing little in the way of budget cuts, the House bill offered up some $2.5 billion in additional federal funding for social programs (explicable in the wake of the recent urban disturbances in Los Angeles) as well as a 50-percent exclusion for capital gains on "urban enterprise zone assets" held for five years. The Senate passed its own modified version of this urban aid tax package on September 29, 1992. This bill signaled the formal abandonment of the principles that moved both tax reform in 1986 and supply-side tax policy in 1981. The bill represented a retreat to the more comfortable days of tax policymaking in the 1960s — the only thing missing was the revenue. Congressional policymakers had been denied the luxury of the automatic, nonlegislated revenue increases previously provided by so-called "bracket creep," but ended in 1981 when indexing of tax brackets was adopted by ERTA.

During conference, Chairmen Dan Rostenkowski, D-Ill., of the House Ways and Means Committee and Lloyd Bentsen, D-Texas, of the Senate Finance Committee attempted to strip down the bill to render it palatable to President Bush. Even still, the Senate conferees persisted in retaining two revenue-raising provisions (tax increases in all but name) originating in the Senate amendments — making permanent the phase-out of personal exemptions and limitations on itemized deductions enacted in 1990. Estimates put the price tag on the Senate bill at $36.6 billion, as compared with $19.6 billion for the House version. In October, both the House and Senate passed the conference committee's bill (a $27 billion compromise), notwithstanding Bush's open threat of a veto. The veto finally came on November 4, 1992 — one day after Bush had been defeated in his bid for re-election. Lacking congressional will or support for a veto override, the bill was laid to rest. However, following Bush's stunning electoral defeat, the empty legacy of his administration in the area of tax policy was the reputed 1990 budget agreement and the president's veto of the 1992 tax bill.

The Revenue Reconciliation Act of 1993

With the election of a Democratic president in 1992, all the elements for a full-fledged return to the traditional, prereform tax politics were in place. This was manifested in the proposals introduced during the first few months of the new Clinton administration, as well as the tax legislation ultimately enacted in August 1993.

In January 1993, several unusual tax proposals were raised by the administration — some perhaps more seriously than others. Of these proposals, only one was actually included in the president's economic program announced in his February 1993 State of the Union address — the reinstitution of the investment tax credit into the tax code. The rest were never formally set out in concrete proposals. However, the very fact that they were raised at all evidences much about the direction of tax policy in the 1990s.

During the 1992 presidential campaign, candidate Clinton had committed himself to some form of an investment tax credit. The investment tax credit was said to be necessary to "jump-start" the stagnant economy. As should have been anticipated, the first hints in 1992 of the president's support for an investment tax credit had the undesirable effect of inducing businesses to delay their scheduled purchases so as to reap the significant tax benefits to be derived from the proposed tax credit. It is doubtful whether the benefits derived from the Clinton administration's proposed version of the investment tax credit would have outweighed the cost attributable to the distortions that it would inflict on capital markets.

In another short-lived trial balloon floated in early January 1993, Clinton expressed interest in eliminating the long-sacred doctrine of exempting from taxation the gains inherent in a taxpayer's property that are recognized at death.[29] While death causes an otherwise taxable transfer of the taxpayer's assets to his estate (a separate taxpayer as well as separate legal entity), the long-standing policy has been to forgive the recognition of built-in gain in the property, giving the estate and beneficiaries a "stepped-up" tax basis equal to the fair market of the property on the date of death. This tax preference, one of the last of the great loopholes still left in the tax code after 1986, means that heavily appreciated assets can be transferred from generation to generation without the need to ever pay income tax on the built-in gain. This provision has irked tax reformers for decades. It also is a tempting source of additional revenue — calculated to be as high as $46 billion a year. (Treasury calculated that repeal of this exclusion would bring in $28 billion in additional revenue in 1993; the Congressional Budget Office concludes that repeal would yield $17 billion over five years.)

This loophole was almost closed pursuant to the Tax Reform Act of 1976. That bill included a provision whereby property acquired from a decedent would take a "carryover" tax basis equal to the decedent's basis immediately prior to death. This would have allowed for deferral of tax on the built-in gain, but would have prevented avoidance of tax altogether. However, the effort to close this tax loophole provoked such strong, organized resistance that the effective date of the new provision was first delayed until 1978, and then repealed altogether prior to ever becoming operative.

The very first hint in 1993 of another attempt to repeal this exclusion immediately generated strong op-

[29] *See, e.g.*, "Clinton Suggestion of Possible Capital Gain Tax Upon Death Stirs Ire Among Powerful Interests," *The Wall Street Journal*, Jan. 5, 1993, p. A16.

position — even without any formal written proposal ever being introduced by the administration. Aside from the political barriers to enacting the proposal, there are real administrative difficulties in changing a tax principle that has been followed for seven decades, even if the principle is inconsistent with the general scheme of the rest of the tax regime.

In 1992 campaign rhetoric, Clinton also had promised that his administration would collect an additional $45 billion over a four-year period from foreign corporations doing business in the United States. It was asserted that additional revenue could be raised by limiting techniques purportedly used by foreign corporations to understate their U.S. income, thereby reducing their U.S. income tax liabilities. As all tax attorneys know quite well, U.S. taxable income can be reduced through the manipulation of costs charged for various sales, exchanges and/or the performance of services between foreign and U.S. business owned and controlled by the same parent. Such techniques are referred to as "transfer pricing." The U.S. tax code requires that such prices between related entities be set at an "arm's length" standard. Despite finding foreign corporations an easy political target in the search for additional revenue during the budget crisis, no such proposals emerged in the president's 1993 revenue package, most likely because of the difficulty in crafting and enacting such provisions, as well as the political fallout from foreign trading partners who unsurprisingly object to such measures.

All these proposals reveal much about the direction that tax policy is taking in the 1990s. First, all of these legislative reforms merely reintroduce proposals from prior decades. The investment tax credit was first introduced in 1962, suspended briefly in 1966, terminated in 1969, reinstated in 1971, and finally abandoned pursuant to the Tax Reform Act of 1986 as an "abuse" with no economic justification. Likewise, the attack on the exclusion of gain recognized at death is an old theme of reformers attempting to prevent any income from escaping from a comprehensive income tax base. Apparently, the short memory of the public permits this kind of repackaging of timeworn proposals as new "reforms," and this pattern of tax policymaking (so prevalent in the 1960s and 1970s) is still very much intact.

During the 1992 presidential election campaign, candidate Clinton had indicated numerous times that revival of the tax bill and dealing with the budget deficit would be one of the highest priorities of his administration. During the months following his election and prior to inauguration day, President Clinton reiterated his campaign commitment to address the deficit, but also continued to assert that his administration would actually lower taxes on the "middle class." However, economic realities soon caught up with campaign rhetoric, as new projections of an increasing budget deficit forced the retraction of this pledge even prior to taking office. By then, it was already evident that the dynamics of congressional politics would dictate that the deficit shortfall would be addressed by the new Democratic administration through tax increases, rather than through significant reductions in expenditures. The Republican administration just departing from the White House had been unable to advance the latter position through the congressional legislative process — partly because it is largely controlled by Democrats, but as much because Congress as a political institution is overwhelmingly oriented toward increasing spending, rather than reducing expenditures. Just as higher tax rates became the cornerstone of the 1990 budget agreement negotiated between President Bush and Congress, so too would they dominate the proposals that emanated from the White House in 1993.

In his State of the Union on February 17, 1993, President Clinton formally set forth his new economic program to Congress.[30] The Clinton plan heralded a massive retreat to pre-1986 tax policy. Much of the "new" economic package consisted of an odd assortment of recycled tax incentives, preferences, credits, and rate increases. This hodgepodge of proposals set the stage for the political debate that continued for the next six months.

In his speech, Clinton revealed what was already quite obvious — that his economic agenda would include a significant increase in the marginal tax rate for individuals. The president reiterated his support for a proposal that had been championed by congressional Democrats since 1990 — a so-called "millionaires' surtax." In the president's proposal, this was transformed into a 10-percent surtax imposed on taxable income in excess of $250,000.

Beginning with the resurrection of the investment tax credit, the Clinton revenue proposals exemplified little that was new — and a good deal that can be seen only as tinkering at the margins of the tax code. Proposals nominally referred to as incentives for "capital investment and economic growth" consisted of retroactively extending and making permanent the tax credits for research and development expenditures, employer-provided education assistance, low-income housing, and targeted jobs. A diluted version of a plan for 50 "enterprise zones" wherein would apply special tax incentive credits also was included by the president.[31] A new capital gains exclusion for 50 percent of the gain

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[30]President Clinton's budget proposal was initially submitted to Congress in this address on February 17, 1993. The revenue proposals were stated by the Treasury Department in its "Summary of the Administration's Revenue Proposals," released on February 25, and by the Office of Management and Budget in "A Vision of Change for America," released on February 17. A more detailed description of the White House tax proposals is found in the "Summary of the President's Revenue Proposals" (Mar. 8, 1993) as prepared by the Staff of the Joint Committee on Taxation.

[31]Enacting new Subchapter U, found at new sections 1391 *et seq.* of the Internal Revenue Code. The provision provides for a general business tax credit for certain wages paid to "qualified zone employees." This new "empowerment zone employment credit" is considerably less than what was proposed by Jack Kemp, and hence, will surely be denounced as inadequate by such supporters as it inevitably fails to reverse the half-century decline of American cities and/or countless other social and economic problems.

recognized on the sale of certain "small business stock" was provided as a stimulus for capital investment.[32] This provision returns tax planning for capital gains preferential rates to the repertoire of the tax lawyer as it effectively reduces the capital gain rate for sales of qualified stock to 14 percent — which, when coupled with the increases to the individual rate, makes for significant new tax shelter possibilities.

Also introduced into the Clinton proposals with virtually no fanfare or public notice (and later enacted with little attention) was a curious provision allowing for the deferral of gain on the sale of publicly traded securities where the proceeds are reinvested (or in tax parlance, "rolled over") in a "specialized small business investment company."[33] Such a company is provided for under the Small Business Investment Act of 1958.[34] These specialized small business investment companies are generally firms that invest in businesses owned by "disadvantaged" individuals (minorities, disabled individuals, veterans, and women). Thus, this provision effectively inserted specialized treatment of taxpayers into the tax code based on "politically correct" classifications. Perhaps even more interesting, the proposal was inserted into the Clinton tax bill entirely at the instigation of a single member of Congress, Rep. William Jefferson, D-La., through a successful personal lobbying crusade undertaken apparently while sharing a 15-minute airplane ride with the president.[35]

Revenue-raising provisions of the 1993 act added up to little more than increasing marginal tax brackets. Proposed rate increases included the following: a new maximum tax bracket of 36 percent for individuals with income above $115,000 ($140,000 for married couples filing joint returns), with the aforementioned 10-percent surtax applicable to taxable income above $250,000 (resulting in a top rate of 39.6 percent); a maximum tax rate of 35 percent on corporate income over $10 million (representing a 1-percent increase); and preservation of the 55-percent maximum tax rate on gifts and estates (scheduled to decline to 50 percent under prior law).

Other provisions proposed limitations on, or the outright elimination of, several long-standing business deductions. While somewhat ideologically driven and largely aimed at business, these proposals were essentially driven by a more pragmatic consideration — the search for revenue. For instance, the business deduction for meals and entertainment would be further reduced to 50 percent (having previously been reduced to 80 percent). Employee deductions for moving expenses were cut back, and other provisions eliminated altogether business deductions for dues paid for membership in any social or athletic club and lobbying expenses. Most provocatively, corporate deductions for non-performance-based executive compensation in excess of $1 million were disallowed by the 1993 act.

One of the most controversial proposals in the president's program was a provision providing for a broad energy tax — the Btu tax. As might be expected, this new tax provoked immediate opposition from congressional delegations from the gas- and oil-producing states.[36] Equally controversial among revenue-raising provisions was the president's proposal to tax up to 85 percent of the Social Security benefits for those with income and benefits exceeding the current law thresholds of $25,000 for single individuals and $32,000 for married couples filing jointly.

These proposals, many of which can be traced directly to campaign promises made during the 1992 presidential election, served as the initiative for the debate over tax policy that dominated domestic politics over the course of the first six months of the Clinton administration. Tax policy was the first serious political battle of the administration (as reform of the nation's health care system had been put on the backburner at that time). The president started the ball rolling in 1993 for tax legislation, although once in motion, the executive branch played a secondary role in determining the specifics as to what actually became law. Once the initiative was begun, congressional "politics as usual" generally took over in shaping the outcome with respect to particular issues. The president's initiative fit well within the mold of traditional postwar tax policy and incremental policymaking, and it presented little to offend the traditional congressional politics (other than the Btu tax). While the budget deficit continued to loom over tax policymaking, there simply was no "extraordinary" source of popular will or countervailing political force in 1993 to overcome the congressional-based politics that molded the executive's initiative.

Beginning in early 1993, the House Ways and Means Committee took up consideration of the president's initiative.[37] Even while already facing the serious problems that ultimately led to his indictment by federal authorities, Committee Chairman Rostenkowski still remained firmly in control of tax

[32]New section 1202.

[33]New section 1044.

[34]Section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993. 15 U.S.C. section 661 *et seq.* The Small Business Administration has announced that there are 103 specialized small business investment corporations that qualify for this new tax provision. "More Than 100 Firms Are Investment Vehicles Under Capital Gains Provision," *DTR*, Nov. 29, 1993, p. G-1.

[35]The interesting story of how this provision was inserted into the Clinton economic package, with virtually no lobbying or support in either the Congress or White House, is recounted in Eugene Carlson, "How a Small-Business Group Found a Niche in Tax Bill," *The Wall Street Journal*, May 26, 1993, p. B-2.

[36]Sen. David Boren, Democrat of Oklahoma, led the opposition to this proposal that eventually was its demise. *See, e.g.*, Kirchheimer and Zeidner, "Btu Tax in Jeopardy After Key Senate Democrats Defect," 93 *TNT 109-1* (May 21, 1993).

[37]The president's tax proposals were introduced in the House on May 4, 1993, as H.R. 1960, and thereafter, subject to a mark-up by the Ways and Means Committee. The legislation was later passed by the House on May 27, 1993, as part of the Budget Reconciliation Bill of 1993, as H.R. 2264.

policymaking in the House.[38] In a display of remarkable party coherence, Republicans opposed the entire package, ironically leaving it to Democrats on Ways and Means to direct the course of mark-up. The Clinton administration, for its part, was accused of too-quickly abandoning its commitment to such provisions as the investment tax credit and the Btu tax, as well as accepting a lower corporate tax rate — leaving those Democrats on the Ways and Means Committee who supported the president's proposals bitter over his apparent willingness to compromise with interested parties. In the end, the executive initiative was compromised in response to pressures from important regional interests capable of penetrating congressional decisionmaking, as well as the institutional pressures and interests of Congress and its members.

> ***The politics surrounding the 1993 act lend support to the proposition that tax reform in 1986 was merely an aberration, a temporary departure from the traditional politics that otherwise dominate tax policy.***

Much the same dynamics were evidenced in the Senate's consideration of the 1993 tax bill. The tendencies uniquely characteristic of the Senate since the 1960s were exerted in mark-up by the Senate Finance Committee. However, in the end, the Senate followed the House bill, with only several notable departures. First, the Senate accepted the president's proposal for a 36-percent maximum tax rate for individuals, but broke with the president and House in applying the 10-percent surtax to net capital gains. The Finance Committee also took the position that the rate increase be implemented as of the effective date of the tax bill (to be achieved through a blended annual rate), and not retroactively to January 1, 1993, as the House version made it. Few original initiatives came out of the Senate mark-up, the expectations being a proposal for the repeal of the so-called "stock-for-debt" exception for the recognition of income on the cancellation of indebtedness, as well as a new Indian Investment and Employment Tax Credit. Also notable was the strength of Senate resistance to the Btu tax. An alternative proposal emerged from the Senate in favor of a 4.3-cents-per-gallon increase in the federal gasoline tax, which ultimately prevailed in the final bill.

Once the Senate passed its own bill, negotiations shifted to the conference committee mark-up. Agreement was quickly reached with respect to tax rate increases, with incremental increases acceptable to Democrats in both Houses. Disagreement continued over the effective date of such tax increases, the Btu tax, the viability of the enterprise zone initiative as originally proposed by Clinton, and the House's proposed expansion of the earned income tax credit.[39]

Conference committee negotiations were notable in that the leadership of the Finance Committee had devolved to Sen. Daniel Patrick Moynihan, D-N.Y., with Bentsen's "promotion" to the executive branch as Secretary of Treasury. This probably gave some greater control over the legislative process at this stage to Rostenkowski, the more experienced Ways and Means chairman — although the senator from New York cannot be said to be lacking in political savvy.[40] On most key points, the House version prevailed. For example, Moynihan publicly swore that individual tax rate increases would not be retroactive to January 1, 1993 — they were nonetheless. In addition, the House and Rostenkowski prevailed in placing limitations on the section 936 possessions tax credit (which is relatively important to Moynihan's New York constituency with its strong ties to Puerto Rico — the main beneficiary of the development resulting from the credit), and the amortization of acquired intangibles. While it might be too strong to conclude that the House was the "winner" in conference committee or that Rostenkowski's seniority was the significant difference in determining the outcome over any particular issues, nevertheless, on most significant issues, the House bill prevailed.

As was the case with the House and Senate versions of the bill, floor voting on the bill that emerged after weeks of compromising in conference committee, followed unusually strict party lines (with Senate Republicans held firmly in line by Senate Republican Leader Robert Dole, R-Kan., as they had been in the Finance Committee by Ranking Minority Member Robert Packwood, R-Ore.). The final vote in the Senate ended in a tie and was decided by Vice President Gore in his capacity as president of the Senate. That came one day after the House had passed the bill by the narrow margin of 218 to 216. The Revenue Reconciliation Act of 1993 was signed into law by President Clinton on August 10, 1993.

A Final Assessment

In many respects, the politics surrounding the enactment of the 1993 tax bill exemplified the same political trends that had characterized the 1990 bill. The perpetual budget crisis continued to play a crucial role in orienting tax policymaking in 1993. Likewise, while executive initiatives served as the basis for tax legislation, congressional politics and interests dominated the tax policymaking process in 1993, much as it had in 1990. Both the 1993 and 1990 acts (as well as the 1992 bill) represented a marked retreat from the vision of

[38] For an interesting account of both the chairman's legal problems and political strengths, see "Rostenkowski's Woes Spotlight the Decline Of House's Old School," *The Wall Street Journal*, July 23, 1993, p. A1.

[39] Kirchheimer and Hope, "Rosty To Float Combination Btu and Gas Tax; Conferees 'Halfway There' on Revenue Provisions," *93 TNT 154-1* (July 23, 1993).

[40] "Taking Over Finance Panel in Senate, Moynihan Faces Test: Can He Lead?" *The Wall Street Journal*, Dec. 11, 1992, p. A14.

tax reform that had shaped the 1986 act, reversing the movement for lower tax rates and broadening of the tax base that had characterized the 1986 reform legislation.

The politics surrounding the 1993 act lend support to the proposition that tax reform in 1986 was merely an aberration, a temporary departure from the traditional politics that otherwise dominate tax policy. Much the same can be said for the politics of tax rate reduction that was witnessed in 1981. In the end, neither supply-side economics nor the enthusiasm of tax reform was anywhere to be found in 1993. That future tax policy should reflect either of these two important trends of the 1980s is highly unlikely.

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