

SOCIAL POLICY, SUPPLY-SIDE, AND FUNDAMENTAL REFORM: REPUBLICAN TAX POLICY, 1994-2004

By Chris Edwards

Chris Edwards is the director of tax policy at the Cato Institute, Washington. This report is a chapter in an upcoming Cato Institute book to be published in March 2005, *The Republican Revolution 10 Years Later: Smaller Government or Business as Usual?*

Cutting individual income taxes has been an important Republican policy objective in every session of Congress during the last decade, says Edwards. Tax cuts, he argues, have provided a strong unifying goal in a diverse party whose elected members include social conservatives, defense hawks, libertarians, and others.

Edwards asserts that Republicans promised tax cuts in the 1994 Contract With America, and they delivered substantial cuts in 1997, 2001, and 2003. This article looks at the tax proposals in the Contract and provides a chronology of Republican tax policies since 1995. Edwards sorts the good news from the bad news in a decade of GOP tax policy.

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I. The Contract With America

The Republicans came to power in 1995, following tax increases under President Bill Clinton in 1993, President

George H. W. Bush in 1990, and President Ronald Reagan in 1982, 1984, and 1987. House Republicans were eager to reestablish the GOP as the tax-cutting party in the tradition of Reagan's 1981 tax cut. The Contract included the following tax proposals:

- a \$500 child tax credit for families with incomes up to \$200,000;
- marriage penalty tax relief;
- new "back-ended" individual retirement accounts with \$2,000 annual contribution limits, dubbed "Roth IRAs" when enacted in 1997;
- a 50 percent capital gains tax rate cut for individuals and corporations, plus indexing to ensure that inflationary gains were not taxed;
- investment tax cuts in the form of inflation indexing for depreciation and capital expensing for the first \$25,000 of equipment purchases;
- a modest increase in the estate taxation exemption; and
- various social policy tax breaks, including refundable tax credits for adoption and elderly care, and a cut in Social Security benefits taxation.

The overall size of the cuts in the Contract was modest compared with the 1981 Reagan tax cut. The Contract cuts were scored at \$370 billion over seven years and \$704 billion over 10 years.¹ The largest single cut was the child tax credit, which would save taxpayers \$182 billion over seven years.

The Contract's social policy tax cuts, including the child tax credit and marriage penalty relief, were populist measures to aid particular constituencies. The supply-side tax cuts — including the capital gains tax cut, expanded depreciation deductions, and new IRAs — were designed to reduce taxes on savings and investment and boost economic growth. The Contract's social policy and supply-side tax proposals dominated the Republican tax agenda for the rest of the decade.

Aside from those tax cuts, the Contract proposed that Congress pass a balanced budget amendment (BBA) to the Constitution that included a 60 percent supermajority requirement for tax increases. The BBA was brought up for vote in the House and Senate several times, but fell slightly short of passage. In January 1995, the BBA passed in the House by a vote of 300-132.² In the Senate, Robert

¹Joint Committee on Taxation, JCX-4-95, February 6, 1995, www.house.gov/jct/pubs95.html.

²CQ Almanac, 1995, p. 2-34.

Byrd, D-W.Va. led the charge against it. It was opposed by 34 members, falling a single vote short of passage. Six Democratic senators who had voted for the BBA in 1994 switched their vote to “no” in 1995.³ After the budget went into surplus in 1998, momentum in Congress for a BBA dissipated.

II. Republican Tax Policy Year by Year

1995: Upon assuming control in the House, Republicans quickly began to move tax cuts through the chamber. Newt Gingrich championed a tax cut package of \$353 billion over seven years that included the Contract’s proposals within a plan to balance the budget by 2002. But House Republicans immediately met resistance from Republican moderates in the Senate, including Budget Committee Chair Pete Domenici, R-N.M., and Finance Committee Chair Bob Packwood, R-Ore. The resistance to tax cuts by some important Senate Republicans, particularly Domenici, was to be a continuing problem for House tax-cutters the rest of the decade.

Ultimately, Congress passed a slimmed down version of the Contract tax cuts valued at \$245 billion over seven years.⁴ The tax cuts came within a budget reconciliation package that also cut spending substantially compared to the baseline. Cuts included \$270 billion to Medicare over seven years, \$182 billion to Medicaid, and \$190 billion to nondefense discretionary spending.⁵

President Clinton’s February budget had proposed a continuation of large deficits throughout his five-year budget projection. The administration proposed that the fiscal 1995 deficit of \$193 billion remain essentially unchanged, and they projected a deficit of \$194 billion for fiscal 2000.⁶ But under continued GOP pressure, Clinton changed course and introduced a revised budget plan in June that would balance the budget over 10 years.⁷ As *Congressional Quarterly* noted on Clinton’s move toward the GOP budget position in 1995: “Clinton’s embrace of a balanced budget itself was a huge shift from the stand-pat stance he and Democrats took” after the 1993 budget deal.⁸

Nonetheless, the differences between Clinton and the Republicans on the budget were too large for an agreement to be reached. Clinton vetoed the GOP budget and tax package, resulting in high-profile government shut-downs in November and December, and a budget stalemate for the year.⁹

1996: In 1996 Clinton moved further toward the GOP budget position by agreeing to the goal of balancing the budget by 2002, not within the longer time frame he had proposed. But on taxes, it was the GOP that compromised. After the prior year’s tax cut defeat, Republicans scaled back their proposal and the House and Senate

agreed to a budget resolution that included room for \$122 billion in tax cuts over six years. As it turned out, a substantial tax cut did not make it through Congress, and the year ended with only a small package of business tax cuts being enacted that were tied to a minimum wage bill. While this was the year that President Clinton declared in his State of the Union address that the “era of big government is over,” Clinton would not support a deal that made substantial cuts to spending or taxes.

Nonetheless, there were some bright spots for tax policy in 1996. Staunch tax-cutter Bill Roth, R-Del., was now at the helm of the Senate Finance Committee. Also, Congress released a report by the National Commission on Tax Reform and Economic Growth that had been established by Republicans in 1995 and chaired by Jack Kemp.¹⁰ The report endorsed replacing the income tax with a low-rate, pro-savings flat tax. Another bright spot in 1996 was the presidential campaign of Steve Forbes, who gained a lot of support with his proposal for a Dick Armey-style flat tax. During his presidential campaign, Bob Dole proposed a 15 percent income tax rate cut. Dole’s proposal indicated the popularity of tax cutting, but he was unfortunately a poor salesman for tax reduction policies.

1997: Political winds changed in 1997 with both Congress and the president determined to reach a budget deal to reduce the deficit to zero by 2002. Compromise was greatly aided by the booming economy, which was flooding Washington with tax revenues and sharply improving budget projections. In January 1995, the Congressional Budget Office baseline put the fiscal 2002 deficit at \$322 billion.¹¹ By January 1997, the CBO projected that the fiscal 2002 deficit would be \$188 billion. By the summer, it was clear that the deficit would be even smaller than that. (By September 1997 the projection for fiscal 2002 was a surplus of \$32 billion, with about half the improvement since January resulting from the August budget deal and half from the improving economy and other factors.)¹²

A balanced budget deal including cuts to baseline discretionary spending and Medicare of \$196 billion over five years was signed into law in August. Many of the budget savings were never to materialize because Congress soon started breaking spending caps with “emergency” supplemental bills and other techniques.¹³ The budget deal represented a small positive step toward fiscal control, but it was mainly the strong economy that balanced the budget, not the 1997 budget deal. As the booming economy caused tax revenues to soar, the *Congressional Quarterly* joked in 1997: “Clinton and the

³*Id.*

⁴JCT, JCX-53-95, November 16, 1995.

⁵CQ *Almanac*, 1995, pp. 2-30, 2-33.

⁶*Budget of the U.S. Government, FY 1996* (Washington: Government Printing Office, 1995), p. 173.

⁷CQ *Almanac*, 1995, pp. 2-21, 2-28.

⁸CQ *Almanac*, 1997, p. 2-18.

⁹CQ *Almanac*, 1995, p. 2-21.

¹⁰National Commission on Tax Reform and Economic Growth, “Unleashing America’s Potential,” January 1996, www.empower.org/kempcommission/kempcommission_toc.htm.

¹¹Congressional Budget Office, “The Economic and Budget Outlook, FY 1996-2000,” January 1995, www.cbo.gov/Pubs.cfm.

¹²CBO, “The Economic and Budget Outlook, An Update,” September 1997, Table 12.

¹³CQ *Almanac*, 1997, p. 2-27. In 1998, Congress busted the prior year’s caps with a \$21 billion supplemental bill and other spending increases. See CQ *Almanac*, 1998, p. 2-117.

Republican Congress were in a hurry to seal their deal before the budget balanced itself."¹⁴

As a twin bill to the 1997 budget law, the Taxpayer Relief Act of 1997 (TRA1997) was signed into law by President Clinton in August. TRA1997 was expected to save taxpayers \$95 billion over 5 years and \$275 billion over 10 years, representing a smaller cut than the House had proposed in 1995.¹⁵ Nonetheless, TRA1997 included versions of most of the Contract proposals, including a \$500 child tax credit, a cut in the capital gains tax rate from 28 percent to 20 percent (18 percent for investment holdings of five years or more), Roth IRAs, and modest estate tax reforms.

1998: After the 1997 tax cut and budget deal, the pendulum swung back to the left on fiscal issues. President Clinton and moderate Senate Republicans resisted calls for further tax and spending cuts. But the House was not giving up the fight yet. Under the leadership of Budget Committee Chair John Kasich, R-Ohio, the House passed a budget plan that included \$101 billion of spending and tax cuts over five years.¹⁶ Kasich had a tough fight securing passage because some House Republicans saw the budget caps from the prior year's budget deal as a spending floor, and they were not interested in any further restraint.¹⁷

Kasich was one of the dwindling number of true believers in smaller government among the Republican revolutionaries. Many members gave up on spending reforms a year or two after the GOP took control of Congress in 1995. The elimination of the deficit in 1998 greatly weakened interest in spending restraint. But for Kasich, "Balancing the budget was never really the goal for me . . . [instead it] was a very effective rallying cry to move the troops to be able to reduce the power of government," as he noted in 1998.¹⁸

In the Senate in 1998, Budget Chair Domenici, Appropriations Committee Chair Ted Stevens, R-Alaska, and other deficit hawks and big spenders killed plans for tax and spending cuts after a bitter fight with Senate conservatives. Hard-charging John Ashcroft, R-Mo., led the attack against Domenici's budget plan and pushed for a large tax cut. Ashcroft said that he was elected to "cut taxes, cut government, and cut the debt."¹⁹ Ultimately, the Senate moderates prevailed, happy to sit on their laurels from the prior year's budget deal and eschew any further reforms.

One of the political dynamics in 1998 was that as large budget surpluses began to appear, conservative Republicans realized that it would be crucial to get the excess funds off the table with big tax cuts, or the excess would be spent on expanded federal programs. President Clinton's plan was to fence off the emerging surpluses to foil any further GOP tax-cutting efforts. He did so by arguing

that there was no money for tax cuts because the government must "save Social Security first." Clinton's rhetoric was politically effective, but it was empty: The administration did not introduce a serious plan to save Social Security, nor did the administration embrace any of the Social Security reform plans that were being introduced in Congress by members of both parties.

The large differences between the House and Senate budget plans could not be reconciled, and Congress passed no budget resolution in 1998 for the first time since 1974, when the modern budget rules were instituted. The lack of a budget, and President Clinton's opposition, meant that no tax cuts were passed in 1998.

The only bright spot for tax policy in 1998 was the Internal Revenue Service Restructuring and Reform Act. The law was enacted after two rounds of congressional hearings that highlighted gross IRS mismanagement and the aggressive tactics the agency used in enforcement actions against small businesses and other taxpayers. The IRS legislation was put together following recommendations of the bipartisan National Commission on Restructuring the IRS, led by Sen. Bob Kerrey, D-Neb., and Rep. Rob Portman, R-Ohio. The bill's new protections for taxpayers were modest but certainly a step in the right direction.

1999: The tax policy pendulum swung back to the right in 1999 with strong momentum for tax cuts developing in both the House and Senate. Congress passed a substantial 10-year \$792 billion tax cut bill, which included a 1-percentage-point cut in individual income tax rates, marriage penalty relief, a capital gains tax cut, an increase in IRA contribution limits, a phased-in repeal of the estate tax, and other business, education, and health-care tax cuts.²⁰ The tax cut was vetoed by President Clinton in September.

In 1999, as in earlier years, Clinton feigned support for some tax cuts while blocking every actual Republican tax cut proposal. The president's tax policy in most years consisted simply of including an array of special interest tax breaks in his annual budget proposal to gain support from particular narrow constituencies. Clinton's budgets for fiscal 1999 and fiscal 2000 were typical, with many narrow tax breaks for education, health care, and energy efficiency.

Certainly, Republicans were just as guilty of supporting pro-complexity special interest tax breaks. The difference between the parties was that the Republicans also pursued supply-side tax cuts to reduce tax code inefficiencies, and they put a substantial effort into consideration of fundamental tax reform. By contrast, the Clinton administration did not seem to view the complex, high-rate income tax code as a problem worthy of much policy attention. Major tax reform was of little interest to the administration, other than to oppose GOP reform efforts.

2000: After the veto of 1999's all-in-one \$792 billion tax cut bill, Republicans changed their strategy. In 2000 they passed two separate and narrowly focused reconciliation

¹⁴CQ *Almanac*, 1997, p. 2-18.

¹⁵JCT, JCX-39-97, July 30, 1997, www.house.gov/jct/pubs97.html.

¹⁶CQ *Almanac*, 1998, p. 6-12.

¹⁷CQ *Almanac*, 1998, p. 6-9.

¹⁸CQ *Almanac*, 1998, p. 6-11.

¹⁹CQ *Almanac*, 1998, p. 6-6.

²⁰Entitled the Taxpayer Refund and Relief Act of 1999. See JCT, JCX-61-99, August 5, 1999, www.house.gov/jct/pubs99.html.

tax cut bills through Congress. A marriage penalty relief bill would have saved taxpayers \$90 billion over five years.²¹ It was passed with the support of 51 Democrats in the House and 8 Democrats in the Senate, but was vetoed by President Clinton. Similarly, the House and Senate passed a bill to repeal the estate tax with the support of 65 Democrats in the House and 9 Democrats in the Senate.²² The president promptly vetoed that tax cut bill as well.

2001: With a huge \$5.6 trillion 10-year budget surplus awaiting him, President Bush came into office promising a tax cut of \$1.6 trillion over 10 years.²³ His plan passed the House but got somewhat watered down in the Senate. Ultimately, a \$1.35 trillion bill passed Congress and was signed into law in June.²⁴ The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was the largest tax cut since 1981, and included an across-the-board reduction in the individual income tax rates. Because of budget rules in the Senate, the president could not get the cuts enacted permanently, and they expire at the end of 2010 unless Congress acts to extend them.

The main elements of EGTRRA were:

- phased-in reduction of individual income tax rates from 15, 28, 31, 36, and 39.6 percent to 10, 15, 25, 28, 33, and 35 percent, respectively;
- phased-in increase in the child tax credit from \$500 to \$1,000;
- marriage penalty relief in the form of adjustment of the standard deduction and the 15 percent tax bracket;
- phased-in reduction in estate taxes with a one-year repeal in 2010;
- eight narrow education tax breaks, including education IRAs;
- phased-in expansion of contribution limits for traditional and Roth IRAs to \$5,000; and
- substantial pension liberalization.

EGTRRA's rules regarding when particular tax cuts phase in and phase out over time were absurdly complex. That resulted from the modern congressional practice of beginning tax bill considerations with an overall dollar value first, then trying to fit as many cuts as possible into the legislation under the dollar ceiling. Unfortunately, the excessive focus on the dollar value of tax changes has made nearly every tax bill in recent years very complex. The focus on dollars comes at the expense of designing tax changes that simplify the tax code and improve its efficiency. But despite the complexity, the 2001 tax bill packed a lot of reform punch as a generally supply-side package of rate cuts and pro-savings provisions.

²¹JCT, JCX-79-00, July 19, 2000, www.house.gov/jct/pubs00.html.

²²CQ *Almanac*, 2000, p. 18-2.

²³Office of Management and Budget, *A Blueprint for New Beginnings: A Responsible Budget for America's Priorities* (Washington: Government Printing Office, February 28, 2001), pp. 186, 194.

²⁴JCT, JCX-51-01, May 26, 2001, www.house.gov/jct/pubs01.html. This is the 11-year revenue change, fiscal 2001 to fiscal 2011.

2002: With concern about the economy in the wake of the 2001 recession, Congress enacted the Job Creation and Worker Assistance Act of 2002 in March. The act's main provision allowed businesses to expense, or immediately write off, 30 percent of the cost of eligible equipment in the year of purchase, on a temporary basis. The 10-year value of that investment tax cut was \$16 billion, within an overall tax cut bill of \$29 billion.²⁵

While the dollar value of the tax cut was small, partial expensing represented an important step toward converting the income tax to a consumption-based tax system. Consumption-based tax systems, such as the Dick Armey flat tax, would allow full expensing of capital purchases (in place of depreciating purchases over time). Expensing would greatly simplify the tax code and would spur investment by removing taxation on the normal returns to new capital purchases. The 30 percent expensing provision in the 2002 tax bill was later increased to 50 percent in the 2003 tax bill. However, the future of that reform is uncertain because the Bush administration has proposed to allow it to expire at the end of 2004.

2003: With President Bush's leadership, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) to cut taxes by \$350 billion over 10 years.²⁶ The centerpiece of JGTRRA is a reduction in the maximum capital gains tax rate from 20 to 15 percent, and the maximum tax rate on dividends from 35 percent to 15 percent. The dividend tax cut was a long time coming, as tax policy experts have been concerned about the distortionary effects of the excessive taxation of dividends since at least the 1930s.

JGTRRA included the following tax cut provisions:

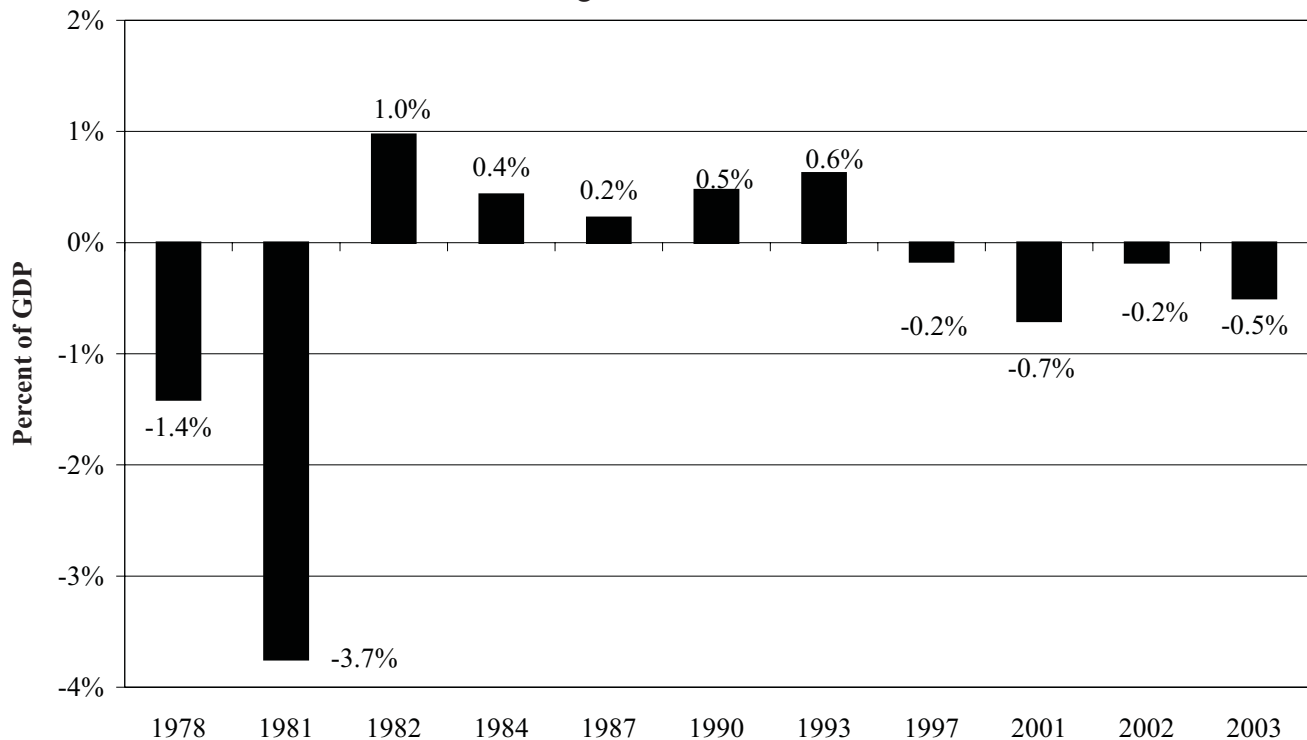
- reduced the maximum dividend and capital gains tax rates to 15 percent;
- the phased-in tax rate cuts from the 2001 tax law were made effective immediately;
- increased capital expensing for business equipment from 30 percent to 50 percent; and
- increased small business expensing from \$25,000 to \$100,000.

Like the tax cuts enacted in the 2001 tax law, the capital gains and dividend cuts from the 2003 law will expire later in the decade unless they are extended by Congress. And, as noted, the 50 percent capital expensing provision is scheduled to expire at the end of 2004. Most economists would agree that adopting temporary tax changes that phase in and phase out over time is a poor way to make tax policy. Recent tax changes have created planning difficulties for investors, businesses, and other taxpayers that will reduce the positive economic effects of the reforms. A priority for 2005 should be to revisit the Bush tax cuts and enact them permanently.

²⁵JCT, JCX-13-02, March 6, 2002, www.house.gov/jct/pubs02.html.

²⁶JCT, JCX-55-03, May 22, 2003, www.house.gov/jct/pubs03.html.

Figure 1
Major Tax Bills Compared
 Revenue Effects During the First Five Years as a Percent of GDP



Source: Author's calculations based on various CBO reports. The years shown are the years since 1978 that Congress enacted major tax bills. (The Tax Reform Act of 1986 was scored as having a minimal net revenue impact). The analysis uses the official five-year estimates at the time of enactment of each bill.

III. Ten Years of GOP Tax Policy: Good News

A. Individual Taxes Were Cut

As a result of the 1990s economic boom and the tax rate increases of 1990 and 1993, tax revenues soared from 18.1 percent of gross domestic product in fiscal 1994 to 20.9 percent by fiscal 2000, which ties the record high share of GDP set in 1944.²⁷ The 2001 recession and Bush tax cuts reduced revenues to 15.8 percent of GDP by fiscal 2004. Nonetheless, even if President Bush's 2001 and 2003 tax cuts are made permanent, revenues are expected to rise to more than 18 percent of GDP later this decade.²⁸ That rise is expected to occur partly because of a growing

economy and partly because of a rapid increase in alternative minimum tax payments. Because the AMT is not indexed for inflation, it will hit an increasing number of taxpayers in future years. If made permanent, the CBO estimates that the 2001 and 2003 tax cuts would reduce federal revenues by about 1.7 percent of GDP annually by 2014.²⁹

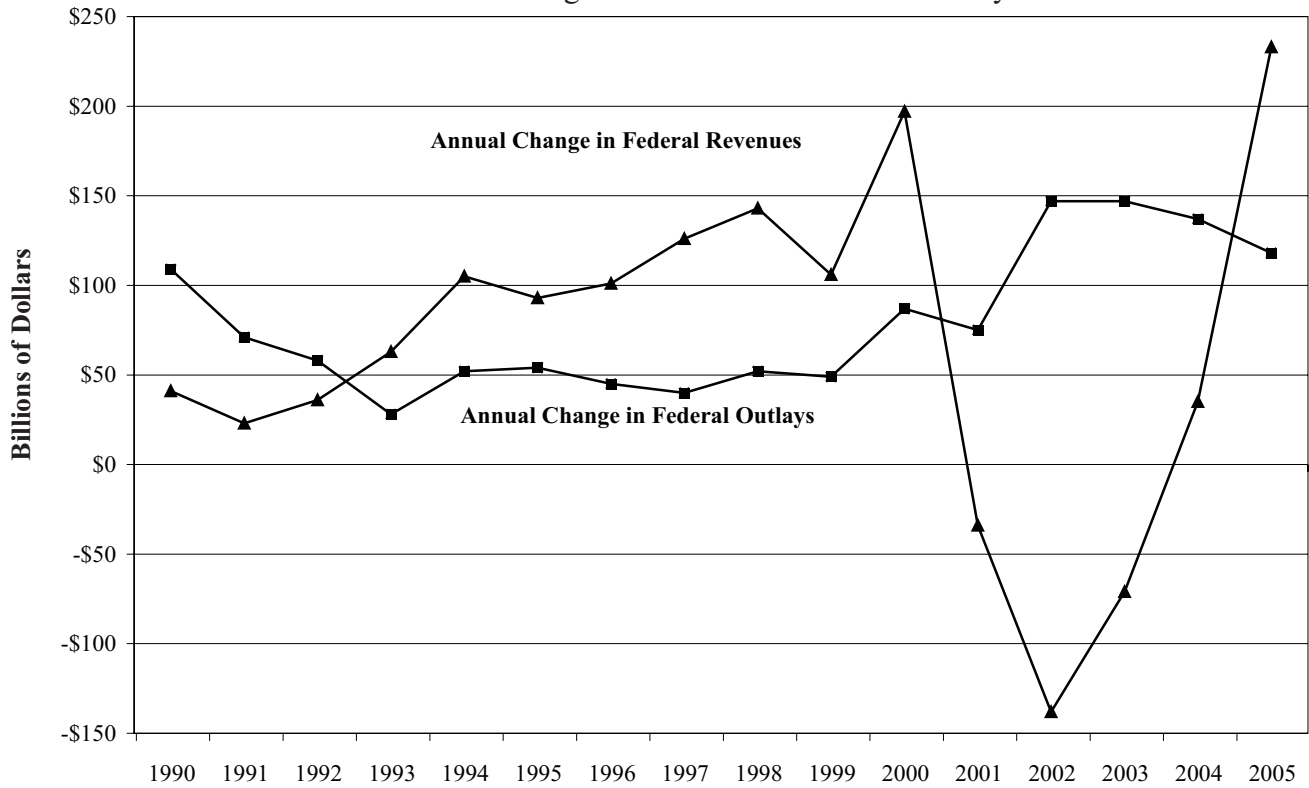
The highlights of the GOP's tax cuts include a modest cut in personal income tax rates, a cut in the top capital gains rate from 28 to 15 percent, and a cut in the top dividend tax rate from 39.6 percent to 15 percent. Also, Republicans have substantially cut taxes on savings. IRAs and pension vehicles have been liberalized, health savings accounts were created in 2003, and partial capital

²⁷Budget of the U.S. Government, FY 2005, Historical Tables, p. 34.

²⁸CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2005," March 2004, p. 3.

²⁹Id.

Figure 2
Federal Revenue Growth vs. Spending Growth
 Annual Change in Federal Revenues and Outlays



Source: Author calculations based on CBO data. Fiscal years. FY2005 is the CBO baseline estimate.

expensing was (temporarily) enacted. The crucial question is whether future Congresses will act to retain these pro-growth tax cuts.

B. GOP Created a Tax-Cutting Brand Name

Republican leaders in Congress worked hard during the decade to make sure that the GOP gained a brand name as the tax-cutting party. Leading tax cutters included Dick Armey (House Majority Leader, 1995-2002), Bill Archer (Ways and Means Committee Chair, 1995-2000), Bill Thomas (Ways and Means Committee Chair, 2001-present), William Roth (Senate Finance Committee Chair, 1995-2000), and John Kasich (House Budget Committee Chair, 1995-2000). Those important party leaders kept Congress focused on pro-growth cuts. In addition, some of those leaders and other members, including Sen. Richard Shelby, R-Ala., and Reps. Billy Tauzin, R-La., Phil English, R-Pa., John Linder, R-Ga., and Phil Crane, R-Ill., championed fundamental tax reform.

C. Bush Focuses on Supply-Side Tax Cuts

Before President Bush came to office in 2001, most GOP tax cutting efforts were focused on social policy breaks, particularly child tax credits and marriage penalty relief. To Bush's credit, he changed course and

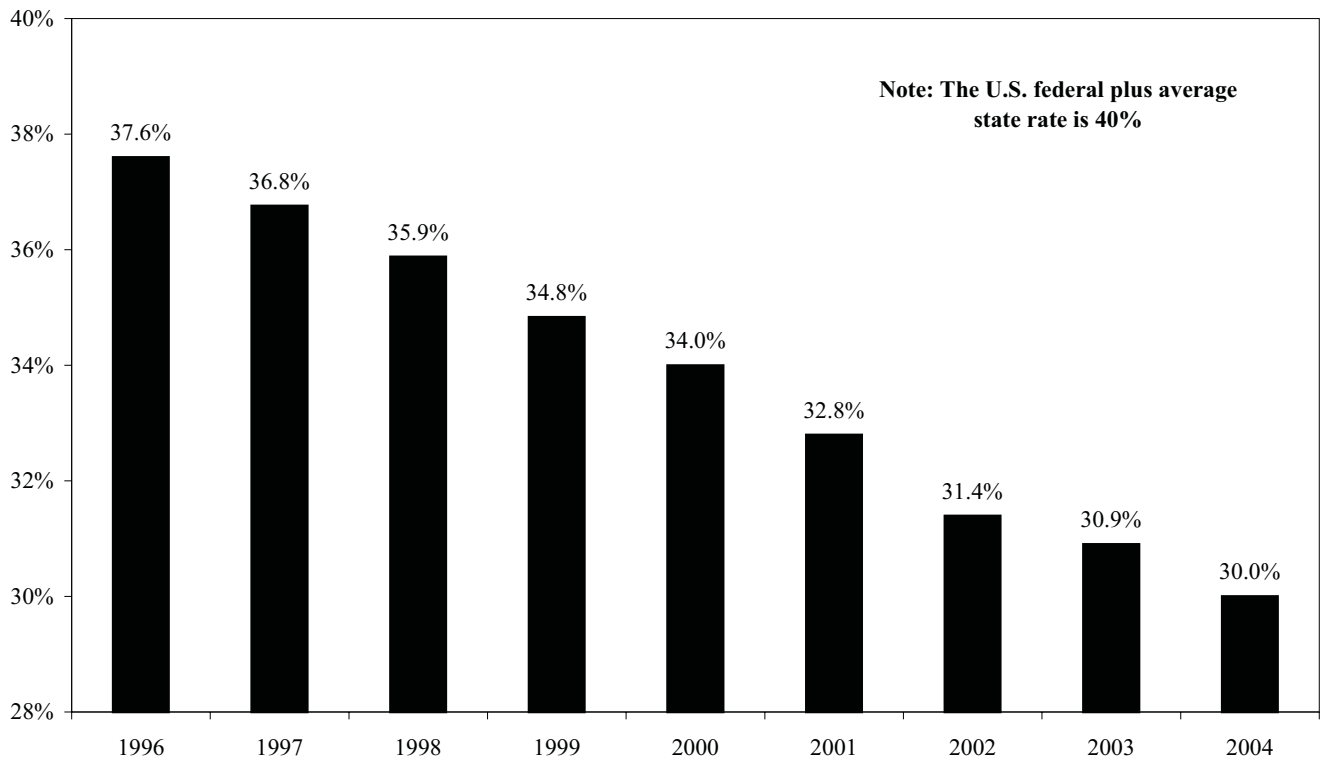
followed the supply-side tax advice of his two main economists, National Economic Council Chair Larry Lindsey and Council of Economic Advisers Chair Glenn Hubbard. While some of Bush's tax proposals have been narrow tax credit provisions, the bulk of his tax cuts have been pro-growth, pro-savings, and pro-investment.

D. Tax Hikes Averted

Before the 1997 tax law, the six previous major tax laws either imposed tax increases (1982, 1984, 1987, 1990, and 1993) or were roughly revenue-neutral (the Tax Reform Act of 1986).³⁰ (See Figure 1.) In addition, the 1983 Social Security amendments increased taxes. Without the change in policy direction that resulted from the 1994 election, Congress may have continued along the path of tax increases that had dominated recent budget policies. Indeed, there were several efforts in the 1990s led by Democrats and liberal Republicans to increase cigarette taxes, gasoline taxes, and corporate taxes. Those were mainly averted. For example, President Clinton's fiscal

³⁰CBO, "Projected Federal Tax Revenues and the Effect of Changes in Tax Law," December 1998.

Figure 3
Average Top Corporate Income Tax Rate in the 30 Major Industrial Countries



Source: Author, based on KPMG data for the 30 OECD countries. Includes national and subnational taxes.

2000 budget sought a 55-cent-per-pack cigarette tax increase and proposed dozens of corporate tax increase provisions.³¹

E. Tax Revenue Gusher Not All Spent

The economic boom of the 1990s caused income taxes, capital gains taxes, and corporate profits taxes to pour into federal coffers. Figure 2 shows that revenues were rising by roughly \$100 billion every year. For a few years in the mid-1990s spending increases were limited to about \$50 billion per year, thus preventing the full gusher of rising tax revenues from being spent. Tax revenues as a share of GDP rose from 18.5 percent of GDP in fiscal 1995 to 20.9 percent in fiscal 2000.³² Yet as revenues rose, federal outlays fell from 20.7 percent of GDP to 18.4 percent during that same period. Most of the reduction was in defense, but even nondefense discretionary spending fell from 3.7 percent of GDP in fiscal 1995 to 3.3 percent by fiscal 2000. Alas, by 2004 President Bush and the Republican Congress had completely blown the

party's decent fiscal record of the 1990s. Massive spending increases in recent years pushed outlays back up to 20 percent of GDP by fiscal 2004.

F. Dynamic Scoring Partly Instituted

During the last two decades, tax debates in Congress have put an excessive emphasis on the revenue effects of legislation. That has unfortunately shifted the policy focus away from the effects that legislation might have on economic growth and tax complexity. To compound the problem, official revenue estimates, which are presented as if carved in stone, have often been inaccurate because they ignored the effects of tax changes on the macroeconomy.

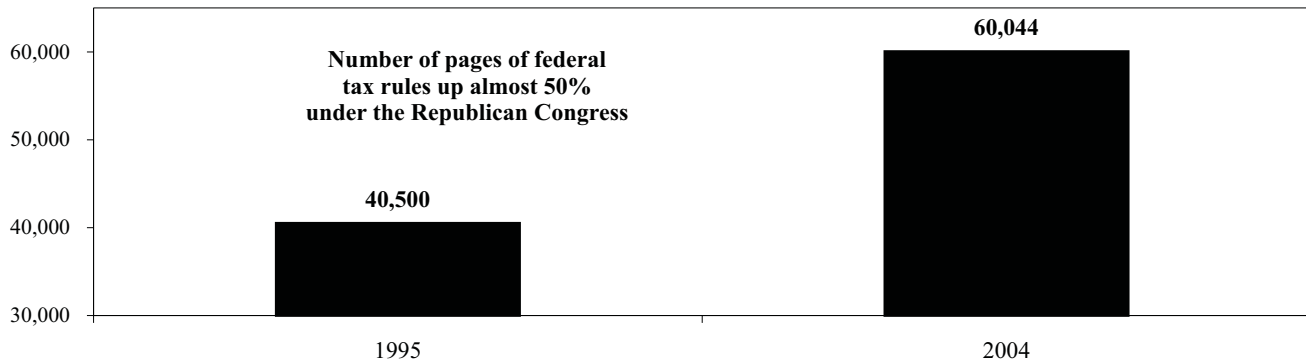
To address that problem, the Congressional Budget Office and Joint Committee on Taxation have begun to modernize their tax estimating apparatus by bringing macroeconomic modeling into the process.³³ One result should be to make revenue estimates more accurate.

³¹*Budget of the U.S. Government, FY 2005, p. 374.*

³²*Budget of the U.S. Government, FY 2005, Historical Tables, p. 52.*

³³For background, see David Burton, "Reforming the Federal Tax Policy Process," Cato Institute Policy Analysis no. 463, December 17, 2002.

Figure 4
Number of Pages of Federal Tax Rules
 (Includes the tax code, tax regulations, and IRS rulings)



Source: Number of pages in the CCH Inc. *Standard Federal Tax Reporter*.

Also, the greater focus on the economic effects of legislation should help sensitize Congress to the fact that tax changes are not just about gaining and losing money for the government budget; tax changes have serious consequences for economic growth and prosperity.

IV. Ten Years of GOP Tax Policy: Bad News

A. Corporate Taxes Have Not Been Cut

Aside from the temporary capital expensing provisions enacted in 2002 and 2003, corporate taxes have not been substantially cut since 1981. (The American Jobs Creation Act of 2004, which modestly cuts corporate taxes, was passed as this article was going to print.) While many Americans seem to believe that corporations are big winners under Republican governments, the GOP has not cut corporate taxes. That is unfortunate because the U.S. corporate income tax desperately needs to be cut and simplified to adjust to the realities of the increasingly competitive global economy.

U.S. policymakers have been asleep at the switch while nearly every other industrial country has cut its corporate tax rate in recent years. The combined federal and average state corporate tax rate is 40 percent, which is 10 percentage points higher than the average of our 30 major trading partners.³⁴ Figure 3 shows that the average corporate tax rate in the 30-member Organization for Economic Cooperation and Development plunged from 37.6 percent in 1996 to 30 percent in 2004.

America's high corporate tax rate creates many problems. It causes U.S. companies to lose out in global markets to foreign businesses that face lower tax burdens. It also causes the American economy to lose

investment to countries with more inviting tax climates. The high rate has also encouraged companies such as Enron to structure elaborate transactions to avoid corporate taxes.³⁵ Other U.S. firms have reincorporated abroad in low-tax countries to avoid the uncompetitive U.S. tax rules on foreign investment.

To reduce such tax avoidance, U.S. policymakers have proposed and enacted several pieces of antishelter legislation in recent years, but those Band-Aid fixes just make the tax code more complex and more uncompetitive. A more fundamental response to global tax competition is needed. The U.S. corporate tax rate needs to be cut sharply, and policymakers should consider replacing the corporate income tax with a consumption-based cash-flow tax.³⁶

B. Individual Tax Rates Are Too High

Today's top individual income tax rate of 35 percent is higher than the 28 percent rate achieved in the late 1980s. George W. Bush's tax cuts have not fully reversed the tax rate increases of George H. W. Bush in 1990 and Bill Clinton in 1993. The top tax rate is economically very important because of the concentration of small businesses, entrepreneurs, and investors in that rate bracket. Also, the income affected by the top tax rate is the most mobile of all income — as the rate increases, reported income tends to disappear.³⁷

A related problem is that the overall income tax code is too progressive or steeply graduated. For example, the

³⁵For a thorough discussion, see Chris Edwards, "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax," Cato Institute Policy Analysis no. 484, August 14, 2003.

³⁶*Id.*

³⁷For a summary of the literature, see Chris Edwards, "Economic Benefits of Personal Income Tax Rate Reductions," Joint Economic Committee, April 2001.

³⁴Chris Edwards, "The Corporate Income Tax and the Global Economy," Cato Institute *Tax & Budget Bulletin*, no. 18, September 2003, as updated to 2004. Based on data from KPMG.

average federal income tax rate (income tax liability divided by adjusted gross income) for those earning over \$200,000 was 26 percent in 2002.³⁸ By comparison, the average tax rate of households earning between \$50,000 and \$100,000 was 11 percent. Thus, the income tax is very vertically unequal. To increase fairness and equality, and to spur economic growth, the top statutory tax rates should be substantially reduced.

C. Tax Complexity Has Increased

Tax complexity has increased substantially during the past decade. Figure 4 shows that the total number of pages in the tax code, regulations, and related IRS rules increased almost 50 percent between 1995 and 2004. Table 1 provides a variety of other indicators showing that tax complexity has increased under the Republican Congress. Tax forms and IRS instruction books are longer, there are more different tax forms, Americans are spending more money for tax preparation services, and the number of narrow tax breaks, or loopholes, has increased.

Despite occasional calls for tax simplification by members of Congress from both parties, when it comes to actually writing tax legislation, members usually support provisions that increase complexity. Members of Congress seem addicted to narrow tax credits, special deductions, and complex income limitations. For example, the Taxpayer Relief Act of 1997 contained 11 narrow education tax breaks for such items as student loan interest, a tuition tax credit, and an education IRA.³⁹ Each item has complex requirements related to income, eligibility, and administration.

In 2001 the Joint Committee on Taxation issued a 1,300-page report on simplifying the tax system that had been requested by Congress.⁴⁰ Despite the report's many useful recommendations, including eliminating the individual and corporate alternative minimum taxes, Congress ignored it. Yet complexity continues to get worse each year. The AMT problem, for example, is expected to explode as the number of individuals paying that complex add-on tax increases from 3.7 million in 2004 to 30 million by 2010.⁴¹

D. High Deficit Creates Big Tax Threat

While President Bush and Congress have passed some important tax cuts in recent years, they have let federal spending and the resulting budget deficits explode in size. Taxpayers face a big threat because future congresses and presidents may use the deficit as an excuse to raise taxes, as President Clinton did in 1993. Federal outlays rose 29 percent under President Bush between

³⁸Internal Revenue Service, "Individual Income Tax Returns: Preliminary Data," 2002, *SOI Bulletin*, Winter 2003-2004, p. 6.

³⁹JCT, JCX-39-97, July 30, 1997.

⁴⁰JCT, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, JCS-3-01 (Washington: Government Printing Office, April 2001).

⁴¹JCT, JCX-55-03, May 22, 2003.

Table 1
Rising Tax Complexity

Item	Initial Year	Recent Year
a) Total pages of federal tax rules	1995 40,500	2004 60,044
b) Number of IRS tax forms	2000 475	2004 529
c) Number of income tax loopholes for education and training	1994 16	2004 28
d) Percent of taxpayers using paid tax preparers	1995 50%	2003 62%
e) H&R Block U.S. tax preparation revenues	1996 \$740 million	2003 \$1.9 billion
f) Hours Americans spend filling out tax forms	1995 5.3 billion	2004 6.5 billion
g) Pages in Form 1040 instruction book	1995 84	2003 131
h) Average time to complete Form 1040 and Schs. A, B, D.	1995 21.2 hours	2003 28.5 hours
Source: Author, based on a) CCH Inc. Includes tax code, regulations, and IRS rulings. b) IRS, Tax Forms and Publications Division. c) Author's count of official "tax expenditures." d) National Taxpayers Union. e) H&R Block. Annual reports for various years. f) Office of Management and Budget, "Information Collection Budget." g) National Taxpayers Union. h) National Taxpayers Union.		

fiscal 2001 and fiscal 2005.⁴² That big-spending policy was remarkably irresponsible and short-sighted — both economically and politically — because the resulting deficits will create political pressure to let the 2001 and 2003 tax cuts expire, which would wipe out Bush's primary fiscal achievements.

V. Fundamental Reform

The biggest Republican tax policy failure of the past decade has been the inability to move ahead with fundamental tax reform, despite high-level support in Congress. Consider this statement by Bob Dole and Newt Gingrich in the foreword to the 1996 report of the National Commission on Tax Reform and Economic Growth:

The current tax system is indefensible. It is overly complex, burdensome, and severely limits economic opportunity for all Americans. We made clear on the very first day of the 104th Congress that our top priority would be to change the status

⁴²CBO, March 2004, p. 3.

quo and to bring fundamental change to America. And we agreed that there is no status quo that needs more fundamental changing than our tax system.⁴³

Despite that top-level call for change, Dick Arme's leadership, the efforts of leading think tanks, and the enthusiasm of many citizens for reform, legislation to overhaul the tax system was not moved through the House or the Senate.

Within months of coming to power in 1995, Republicans began holding congressional hearings on fundamental tax reform, and many members introduced tax reform legislation. Most plans proposed replacing the individual and corporate income taxes with a simpler and more efficient consumption-based system. One leading reform idea was the consumption-based flat tax introduced by Dick Arme in June 1994, which was modeled on a 1981 plan by Hoover Institution economists Robert Hall and Alvin Rabushka. Following Arme's lead, Steve Forbes campaigned for president in 1996 with a flat tax as the centerpiece of his platform. Tax reform was so popular that even moderates, such as Sen. Arlen Specter, R-Pa., and liberals, such as Richard Gephardt, D-Mo., had their own flat tax plans (Specter's was a derivation of Hall-Rabushka; Gephardt's was a not-very-flat income tax).

A competing reform idea is replacement of the income tax with a national retail sales tax. Sen. Richard Lugar, R-Ind., introduced his retail sales tax plan in April 1995. He was followed by Ways and Means Chair Bill Archer, who wanted to "rip the income tax out by its roots" and replace it with a sales tax. Another reform idea is the pro-savings "USA Tax" proposal, currently championed by Rep. Phil English, R-Pa. Many articles and books during the 1990s examined the economic growth and simplification advantages of consumption-based taxation, including early studies by the Cato Institute.⁴⁴

Despite all the support for fundamental tax reform inside and outside the beltway, it has not happened yet. Why not?

- **Splits among tax reformers.** Nearly all the major tax reform plans of recent years, including the flat tax, retail sales tax, and the USA Tax proposal, have been economically similar in that they all rely on a savings-exempt or consumption-based structure. However, the reform plans have differed on key design features, such as the point of collection and the treatment of imports and exports. Those differences have been substantial enough to hold up agreement on a common Republican tax reform plan.
- **Big business has not gotten on board.** Corporations spend millions of dollars lobbying to gain narrow tax breaks and to defend against narrow tax in-

creases. But most companies put little effort into supporting fundamental tax reform. Part of the problem is that the last major tax "reform" bill — the Tax Reform Act of 1986 — imposed a substantial tax increase on corporations. Thus, businesses are justifiably concerned that "reform" means an increase for them. Nonetheless, corporations should consider that the past decade of lobbying for narrow provisions has got them little: The corporate tax is more punitive than ever. The corporate tax legislation passed in 2004 contains only limited reforms and does not solve major problems with the corporate tax. Big businesses need to rethink their strategy and work toward common reform goals that would benefit companies in all industries, such as an overall corporate tax rate cut.

- **Social engineering undercuts reform.** A good deal of the GOP's tax policy focus during the past decade has been on narrow social policy tax breaks. That focus diverted energy from consideration of fundamental tax reform, and it has made reform harder to achieve because narrow breaks create new constituencies against reform. For example, families with children may now be against any simple and neutral tax reform plan if it takes away the recently enacted \$1,000 child tax credit. Both parties deserve blame for social engineering in the tax code. While the mortgage interest deduction and other special breaks were in the code before the Republicans took control of Congress, the GOP's tax policies in some cases have made reform harder to achieve.⁴⁵
- **Fewer Americans are paying income tax.** Since the 1980s, Congress has steadily reduced the constituency for tax reform by taking millions of moderate-income Americans off the tax rolls. Expansion of the earned income tax credit in 1990 and 1993, the child tax credit, the new 10 percent tax bracket, and other provisions have had the effect of zeroing out income tax liability for millions of families. By 2003, 60 million of 150 million U.S. households (39 percent), did not pay a dime of federal income tax.⁴⁶ While it is good that many Americans have achieved tax freedom, the problem is that that has created a large group with a strong interest against any tax reform that asks them to pay even a simple low-rate tax.
- **Democratic opposition to reform.** In the 1980s, tax reform was a bipartisan concern with prominent Democrats and liberal think tanks offering reform proposals. Former Sen. Dennis DeConcini of Arizona and Rep. Leon Panetta of California, both Democrats, first introduced versions of the Hall-Rabushka flat tax plan in Congress in early 1982,

⁴³National Commission on Tax Reform and Economic Growth, "Unleashing America's Potential," January 1996, www.empower.org/kempcommission/kempcommission_toc.htm.

⁴⁴See, e.g., Laurence J. Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes With a Sales Tax," Cato Institute Policy Analysis no. 193, April 15, 1993.

⁴⁵However, it is also true that the GOP's tax rate cuts and pro-savings changes have made tax reform easier because they move the tax code toward a low-rate consumption-based system.

⁴⁶JCT, JCS-8-03, December 22, 2003, p. 30.

months after Hall and Rabushka crafted their proposal.⁴⁷ In 1985 the Brookings Institution's Henry Aaron and Harvey Galper proposed a comprehensive consumption-based tax plan.⁴⁸ But on becoming the minority party in the 1990s, the Democrats have become very reactionary on tax policy. They have focused their energy on throwing darts at Republican tax reform plans, while offering no reform alternatives of their own. For tax reform to move ahead, it may be necessary for some forward-thinking Democrats to get on board the tax reform movement.

⁴⁷Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford: Hoover Institution Press, 1995), p. 47.

⁴⁸Henry Aaron and Harvey Galper, *Assessing Tax Reform* (Washington: Brookings Institution, 1985). Aaron and Galper called their plan a "cash flow income tax." The plan would have combined a personal consumed-income tax, a business cash-flow tax, and a tax on estates and gifts.

VI. Conclusion

Despite the hurdles, one can bet that serious tax reform will come back onto the agenda in Washington. The last decade of tax debates has shown that both tax cuts and major tax reform ideas are popular with the general public. Tax cutting continues to be important to the electoral success of the Republican Congress.

Dynamics in the tax system will also raise the profile of reform. Tax complexity continues to spiral upwards and the AMT will soon be hitting 30 million American households. Those dynamics may spur a tax revolt and demands for a major tax system overhaul. Also, the federal corporate income tax is headed for a train wreck while other countries continue to cut their statutory rates, and investment capital becomes ever more globally mobile.

The tax reform ingredient that is missing right now is a new generation of Republican leaders to build on the efforts of Bill Archer, Dick Armey, and other reformers of the 1990s.