

Equity versus Efficiency and the U.S. Tax System in Historical Perspective

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The concept of tax justice in the United States has historically involved both social and economic factors. Americans have used the tax system to regulate economic privilege, and to restore equitable income and wealth distributions. Tax justice “American style” considers both horizontal equity (the equal taxation of equals) and vertical or progressive equity (the unequal taxation of unequals). It emphasizes the latter, however, measuring relative societal burdens against relative societal benefits and reflecting larger notions of social justice.

As the United States industrialized during the 19th century, and as concentrations of wealth increased, taxation’s role as a social instrument became more important. “The man of great wealth,” stated President Theodore Roosevelt, “owes a peculiar obligation to the State, because he derives special advantages from the mere existence of government” (1906, 27). The failure of the market economy in the 1930s prompted politicians and tax theorists to emphasize the morality of taxation. “The case for drastic progression in taxation,” argued economist Henry Simons, “must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely” (1938, 18–19). By the 1940s, distributive forms of tax justice had become so intertwined with federal tax policy that President Franklin Roosevelt proposed capping after-tax incomes at \$25,000.¹

Even into the 1950s, the case for steeply progressive taxation could be defended on ethical and moral grounds (Blum and Kalven 1953; De Jouvenel 1952).

Over the last two generations, however, the tax pendulum has swung from equity to efficiency concerns. Modern-day tax discussions avoid unsettling questions of relative burdens and benefits. In particular, they avoid considering taxation's potential for mitigating income and wealth inequalities, both of which have increased steadily since the early 1970s. Theorists, politicians, and the American public share responsibility for this trend, and among theorists, economists bear special culpability. Beginning in the 1950s, and accelerating in the 1970s, economists turned their attention from equity—particularly vertical equity—to efficiency and economic growth. To the extent that economists considered equity at all, they focused on how deviations from horizontal equity influenced efficiency.² They ceded professional jurisdiction over distributive equity to legal theorists and philosophers.³

The turn of economists away from progressive equity—in combination with a sustained period of stagnant economic growth, inflation, and public cynicism toward government—prompted the American people to support tax policies that emphasized efficiency rather than equity. This environment allowed tax-cutters to push through tax reforms that excluded equity considerations. In addition, it gave credence to the conservative supply-side notion that “if equity didn't matter, and only efficiency did, then taxes should be set only as to minimize distortions” (Steuerle 1999, 1593).

This chapter suggests that the American people still care about remedying “unlovely” income inequalities through taxation. They still perceive the moral and ethical power of taxes. At a time of heightened income and wealth inequalities—the social ills that historically have motivated considerations of redistributive taxation in the United States—we would do well to reconsider tax justice and its policymaking implications.

The first part of this chapter, “Theory versus Reality,” examines the history of tax justice in the United States. It describes a republican and liberal-democratic foundation to U.S. tax policies that supports progressive, ability-to-pay taxation. In addition, it evaluates how post-World War II tax theorists abandoned progressive equity in favor of efficiency. The theoretical turn from progressive tax equity precipitated the de-emphasis on redistribution as a policymaking construct. The second part,

“The Role of Economists,” emphasizes the divergence of tax justice as defined by theorists, on the one hand, and average taxpayers, on the other. It draws a connection between changes within the economics profession and the triumph of efficiency policies over equity policies. Moreover, it suggests that although American taxpayers endorsed lower marginal income tax rates beginning in the 1960s (and a flat tax in the 1990s), they did not necessarily endorse less progression. The last part, “Bridging the Divide between Equity and Efficiency,” bridges both the theoretical and practical gap, arguing that tax theorists have a professional as well as a civic obligation to consider the moral and ethical aspects of taxation.

Theory versus Reality: Tax Justice in the United States

“The public’s perception of tax equity,” Richard Musgrave has written, “can hardly be expected to coincide with . . . models as conceived by philosophers and economists” (1996a, 348). We seldom hear taxpayers clamoring for tax cuts on the basis of particular social welfare functions or the consequences of “deadweight loss” (situations where someone loses and no one gains). Neither do we hear politicians reveal that they have formulated their tax reforms from behind a Rawlsian veil of ignorance (Rawls 1971, 1974). Taxpayers and their legislators possess simpler, yet powerful, concepts of tax justice.

A historical examination of tax justice in the United States, from the founding of the republic to the present, reveals that Americans have perceived taxation as an instrument of social justice. They have favored tax policies that impose higher burdens, both absolutely and relatively, on high incomes and concentrated wealth than on low incomes.

This relatively simple conception of tax justice can result in tax policies that make little sense to economists and theorists. Consider corporate income taxes, for example. The American public perceives a direct connection between corporate income tax rates and corporate income tax payments (Sheffrin 1996). Economists, on the other hand, agree that corporations can shift the incidence of increased income tax rates toward workers (in the form of lower wages) and consumers (in the form of higher prices). The American public could be justified in arguing for higher corporate tax rates, however, if it desires improved progressivity. To the extent shareholders (a high-income cohort) bear the

burden of higher corporate income taxes (in the form of decreased dividends, for example), raising corporate income tax rates might improve progressivity. The history of taxation in the United States reveals similar examples of the public's simple but powerful understanding of tax justice.

*The Democratic (Small "d") and Republican (Small "r")
Underpinnings of U.S. Taxation*

The terms "Democratic" and "Republican" can refer to political parties. But they also reflect the founding ideals of the American republic, which permeate the history of both the nation and its tax system. These shared histories underscore a fundamental American paradox: the tension between political equality and individual liberty. The founding fathers mitigated this tension by balancing the ideal of Lockean liberalism—which emphasized private rights—with traditional republicanism or civic humanism—which emphasized public virtue.

Republican ideals helped create a tax system that taxed wealth and privilege despite a national aversion to infringements on individual liberty. From the beginning of the republic, federal and state legislators used taxation to restrict privilege (by taxing corporate charters, for example), and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry" (Brownlee 2000, 31). The ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth. Republican notions of tax justice tolerated persons who created wealth, but not those who inherited it. Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic.

The U.S. Constitution restricted the federal government from levying direct, nonuniform taxes, thereby limiting its ability to promote a distributive form of tax justice. States faced no such restriction and actively promoted social justice through taxation. State governments taxed property at a flat, *ad valorem* rate, believing that high-income individuals spent a larger share of their income on land and property than low-income persons did. Throughout the first half of the 19th century, states expanded their use of the general property tax to include tangible property (land, equipment, and household goods) as well as intangible property (cash, credit, stocks, and mortgages). By including

intangible property, states increased the percentage of taxes paid by wealthy citizens. Several states experimented with income taxes prior to the Civil War “with the avowed purpose of removing inequalities in the tax system,” and raising civic contributions from wealthy residents (Blakey 1914, 25). High-income individuals owed a debt to society. Their success depended on sustained economic and political order. High-income individuals created wealth, but they also benefited from the system in which they lived.

Social Forces and Progressive Taxation: Tax Justice from 1860 to 1945

Beginning in 1860 and continuing until the end of World War II, a series of national crises caused dramatic changes in the U.S. tax system. These changes reflected the influence of a democratization of politics, as well as an expansion of the American state. In the process, notions of tax justice evolved to include a progressive federal income tax.

The Civil War prompted the Lincoln administration to locate new sources of revenue beyond tariffs and excises. Northern Republican leaders believed that increasing consumption taxes would erode confidence in the national government. The administration sought an alternative form of financing that reflected the principle of ability to pay, and the Union government settled on the nation’s first federal income tax. The tax was modest by today’s standards, amounting to a flat rate of 3 percent on incomes above \$800. During the war, Congress lowered the exemption to \$600 and created an additional rate schedule. By 1865, individuals with incomes over the exemption and under \$5,000 paid a 5 percent tax, while those with incomes over \$5,000 paid 10 percent. Despite low statutory rates, the Civil War income tax doubled tax liabilities for the richest Northerners (Brownlee 2000).

At the end of hostilities, wealthy Americans demanded repeal of the income tax. It was a temporary wartime measure, not an experiment in public finance. So in 1872, Congress let the income tax expire. At the same time, Congress reduced wartime excises—a political move designed to induce nonwealthy Americans to accept the termination of the income tax, which was widely perceived to be a class-based tax. The federal government went back to relying on tariff revenues. State governments, too, reverted to less progressive tax systems. Although states raised property tax rates, wealthy residents evaded their tax obligations. State and local governments did not possess the administrative capacity

to identify noncompliance, much less prosecute it. They were forced to adopt a property tax they could collect easily with standardized assessment techniques and an emphasis on real estate. In the process, states reduced taxation of wealthy individuals relative to nonwealthy individuals, relying increasingly on more regressive forms of taxation.

Meanwhile, farm prices fell sharply between 1870 and the late 1890s. Farmers grew uneasy and launched a series of agrarian revolts that called for, among other things, social justice through tax reform. Republican tariff policies favored manufacturing and industrial interests over farmers and professionals. In the 1890s, the Populists in the West and South called for a progressive tax on corporate profits and high incomes to reallocate the tax burden toward corporate monopolies and wealthy shareholders. A progressive income tax, its proponents argued, could break inequitable concentrations of economic power.

When Democrats took control of Congress in 1893, Populists rushed progressive taxation onto the policy agenda. Many key Democrats, believing that taxation could realign the political parties along sectional lines, supported progressive taxation (Trilling 1980). In 1894, Congress passed the nation's second federal income tax. The new law exempted the first \$4,000 of personal income, taxed gifts, and inheritances, and levied a 2 percent tax on personal and corporate incomes. In late 1894, the American economist E. R. A. Seligman reflected on the social forces that animated the new income tax. "The democratic trend towards justice in taxation cannot be prevented here, as it has been impossible to prevent it in other countries" (Seligman 1894, 648). Popular notions of tax justice, Seligman argued, demanded progressive taxation as a means to remedy social and economic inequities.

Even before Congress could collect on the second federal income tax, the Supreme Court declared it unconstitutional. The Court's 1895 decision in *Pollock v. Farmers' Loan and Trust Co.* (158 U.S. 601) incited proponents of progressive taxation. According to one commentator, "the great majority of citizens" considered the decision "a radical reversal of long standing precedents and an unwarranted overthrow of the will of the people" (Blakey 1914, 25). Politicians from the two major parties could hardly ignore the public outcry for progression. Democrats included a progressive income tax in their 1896 presidential platform. And Republicans, though largely opposed to an income tax, enacted a temporary progressive estate tax and an excise tax on the sugar and oil trusts to finance the Spanish-American War.

By the early 1900s, Republicans—from insurgent reformer Senator Bob LaFollette to party leaders Theodore Roosevelt and William Howard Taft—endorsed progressive income taxation. Previously confined to the West, Midwest, and South, the public clamor for a federal income tax crossed sectional boundaries and moved into northeastern urban centers. Middle-class and professional propertied Americans resented their rising tax burdens while wealthy individuals escaped paying their fair share. Personal and corporate income taxes as well as transfer taxes, the middle class believed, could produce a fairer tax distribution. Even high-income and conservative groups supported federal income taxation. They saw the adoption of a progressive income tax as one way to stave off more radical calls for industrial democracy (Stanley 1993). In 1909, Congress submitted the Sixteenth Amendment to the states for ratification. Many Republican leaders believed that the amendment would fail (Blakey 1914; Brownlee 2000; Hull 1948). And, in fact, it got off to a rocky start, with New York, Massachusetts, and other powerful states rejecting it immediately. However, the amendment prevailed, and in 1913, it became law.

The third federal income tax featured only a moderate degree of progression. It taxed personal and corporate incomes at a “normal” rate of 1 percent, and it included a graduated surtax up to 6 percent for individual taxpayers. It provided exemptions of \$3,000 for singles and \$4,000 for married couples, effectively excluding all but the very wealthiest Americans.⁴ Despite its modest scope, the new law was a symbol of democracy, exemplifying the movement for greater social justice in an industrialized nation. Cordell Hull (D-TN) called the income tax a triumph, “the one great equalizer of the tax burden and therefore a tremendous agency for the improvement of social conditions” (1948, 71). Progressive income taxation complemented both the popular will and a growing consensus among tax theorists. “The tendency in all countries and among both the theorists and the masses,” wrote economist Roy Blakey, “is strongly in the direction of graduated or progressive taxation, and the present income tax is distinctly in harmony with this tendency” (1914, 33). The reaction of wealthy Americans to income taxation paid tribute to its power. Henry Cabot Lodge called it “confiscation of property under the guise of taxation” and “the pillage of a class” (Witte 1985, 77). Although the federal income tax before World War I was hardly confiscatory, President Wilson’s wartime revenue acts substantiated these charges.

The Wilson administration greatly expanded the federal income tax. The Revenue Act of 1916 raised income tax rates to 15 percent, and preserved the high exemptions. It created a graduated federal tax on estates over \$50,000, increased the corporate income tax rate to 2 percent, and subjected munitions manufacturers to a 12.5 percent excess-profits tax. Wealthy Americans complained that the Wilson administration was explicitly pursuing a redistributive program of “soaking the rich,”⁵ and they were right. By war’s end, personal income tax rates ranged from 15 to 77 percent. Estate tax rates rose to 25 percent. The corporate income tax ranged from 30 to 65 percent, and the excess-profits tax accounted for nearly two-thirds of federal tax revenues during World War I. Although personal exemptions fell to \$1,000 for singles and \$2,000 for married people, the income tax remained a class-based tax. The richest 1 percent of Americans paid 80 percent of federal income tax revenues collected in 1918. This cohort paid effective tax rates that topped 15 percent, up from 3 percent in 1916 (Brownlee 2000).

The Wilson administration’s soak-the-rich mentality was hardly in advance of public opinion. Efforts to expand the power of the income tax began immediately after its enactment. A small but growing number of politicians, theorists, and citizens recognized that income taxation could do more than supplement existing forms of revenue; it could replace them. Moreover, an expanded progressive income tax could redistribute wealth, which had grown more concentrated between 1913 and 1916 (Williamson and Lindert 1980).

Other Americans were less sanguine regarding the leveling effects of progressive taxation. Wealthy individuals and corporate America objected to the wartime tax program. When President Wilson proposed doubling existing rates in 1918, critics of the class-based tax system took to the stump during that year’s congressional elections. They sold their anti-tax message through populist appeals for smaller government. Their efforts paid off, and Republicans regained control of Congress. In 1920, the White House also fell to Republicans, and Warren Harding promised a “return to normalcy.”

Harding, with the help of a Republican Congress, made good on his promise. Treasury Secretary Andrew Mellon directed tax reforms that sharply reduced personal and corporate tax rates. The top marginal individual rate fell from a wartime high of 77 percent to 58 percent in 1921, and 25 percent by 1928. Congress reduced the estate tax rate to 20 percent, and increased the exclusion to \$100,000, exempting all but one-half of 1 percent of decedents. Congress also eliminated the excess-profits tax,

a symbol of economic justice. In addition to rate cutting, Republican Congresses undermined progressive taxation by punching loopholes in the Internal Revenue Code. The 1920s witnessed the creation of the preferential tax treatment of capital gains, the oil and gas depletion allowances, and the exclusions for employer contributions to pensions and life insurance plans. In conjunction with reduced statutory rates, these new loopholes lowered effective tax rates on wealthy taxpayers, from 15.8 percent in 1920 to 7.4 percent by 1926 (Brownlee 2000).

Andrew Mellon, despite endorsing certain tax dispensations, perceived the necessity of preserving a semblance of tax justice. He persuaded corporations and wealthy Americans to support progressive taxation, if only in principle. Mellon believed that keeping tax schedules graduated (albeit flatter) could mitigate radical demands for restructuring the capitalist system. Mellon and his fellow corporate liberals preserved progressivity in the estate tax, and retained wartime corporate income tax rates. Moreover, at Mellon's behest, Congress enacted a reduced tax rate for "earned" income. Thus, although Mellon and the Republican leadership dulled the redistributive sting of progressive income taxation, they preserved its message of social justice.

The Great Depression, especially its protracted nature, reversed the course of federal taxation. In an effort to balance the budget, Herbert Hoover endorsed higher taxes on the rich. The 1932 Revenue Act raised the top marginal rate for individuals from 25 to 63 percent, and increased exemption levels only slightly. It also increased estate taxes by reducing the exclusion to \$50,000 and raising the rate from 20 to 45 percent. Although Hoover initiated the process, Franklin Roosevelt committed the federal government to soak-the-rich taxation.

Partly to deflect criticism from the left, but largely because he believed in progressive, ability-to-pay taxation, Roosevelt launched a series of radical tax reforms beginning in 1935 (Brownlee 1996, 2000; Lambert 1970).⁶ Roosevelt went before Congress personally to rail against "accumulation[s] of wealth," which he felt should be tapped through more progressive taxation (Blum 1959). The 1935 Revenue Act looked much like Roosevelt's original proposal, which the press dubbed the "Wealth Tax." It increased the top marginal rate for individuals to 77 percent, made the estate tax more progressive, taxed intercorporate dividends, and created a graduated tax on corporations.

In 1936, Roosevelt pushed the progressive envelope further. He proposed, and Congress passed, a graduated undistributed-profits tax. In addition, between 1934 and 1937, Roosevelt and Treasury Secretary

Henry Morgenthau conducted a war against tax loopholes and evasion.⁷ The most celebrated case involved former Treasury Secretary Andrew Mellon, whom the Treasury Department alleged owed over \$3 million in back taxes and penalties. The Board of Tax Appeals found Mellon innocent of tax evasion in 1937, yet required him to pay \$400,000. The Board made an example of Mellon and publicized the inequities of tax loopholes. The publicity gave Roosevelt the platform he needed to ask Congress to create the Joint Committee on Tax Evasion and Avoidance. Congress granted the new committee authority to name taxpayers who exploited tax avoidance techniques, and that same year, the Roosevelt administration presented Congress with a list of 67 high-income tax evaders. Consequently, Congress passed the Revenue Act of 1937, restricting the most egregious loopholes (personal holding companies, deductions for corporate yachts and secondary estates) and closing others (tax preferences for nonresident taxpayers). Together, the 1936 and 1937 Revenue Acts raised effective tax rates on the nation's wealthiest individuals to above 15 percent for the first time since World War I.

Roosevelt, bolstered by his legislative successes as well as signs of economic recovery, pursued his tax reforms for 1938. Proposals included raising the undistributed-profits tax, eliminating the exemption for federal, state, and local bonds, and creating a graduated tax on capital gains. Business leaders and wealthy taxpayers responded by lobbying Congress for tax reduction. Aided by the recession of 1937–38, these tax protestors convinced Congress that Roosevelt's tax policies had precipitated the economic downturn. The economy needed tax cuts, not tax reform. The 1938 Revenue Act weakened the undistributed-profits tax and eliminated the graduated corporate income tax. Furthermore, in 1939, Congress abolished the undistributed-profits tax. Roosevelt lamented the turn away from progressive taxation, but the reversal was hardly permanent. America's entry into World War II and subsequent wartime revenue demands meant greater reliance on progressive federal income taxation.

Growth versus Equity: The Modern Federal Income Tax, 1945 to 1964

World War II produced a mass-based income tax. In 1939, the Treasury Department collected federal income taxes from 4 million individuals. By 1945, reduced personal exemptions increased the number of income taxpayers to 43 million. The new income tax contained steeply progressive rates, ranging from 22 to 94 percent (Moody 1998), and it generated

a near majority of all federal tax receipts. In 1939, the federal income tax yielded just \$892 million, only 13.6 percent of federal tax receipts. By 1944, it produced \$19.7 billion, or 45 percent of all federal tax revenues (Moody 1998).

The broad-based, revenue-buoyant income tax ushered in an “era of easy financing” whereby politicians could enact both tax reductions and new expenditure programs (Steuerle 1996). As an instrument of policy, the new federal income tax could help reverse recessions and curb inflation by cutting and raising taxes, respectively. “Nothing like this was possible in, say 1930 or 1938,” observed the Committee for Economic Development (CED), “because there were not large amounts of taxes to cut” or raise. “Before current tax payments and withholding were introduced [two other wartime alterations] there was no way in which a tax cut could have a *quick* effect on individuals’ available incomes” (CED 1954, 28, emphasis in the original). Despite a general recognition of the tax system’s potential utility, neither experts nor policymakers fully understood the new fiscal instrument. What effect would it have on the widely anticipated postwar inflation? To what extent would it smooth business cycles? Without an accurate sense of how the mass-based income tax might influence the postwar economy, experts and politicians disagreed on its application. To what extent should the tax system stimulate capital investment, technological development, and entrepreneurial activity? How far should the income tax go in redistributing wealth?

To complicate matters, analysts considered these issues while the economics profession was undergoing a theoretical transformation. Fiscal theory, as much as fiscal practice, had broken from its moorings to classical economics, and both were speeding in the direction of Keynesianism. With the Great Depression a living memory, New Deal economics had avoided taxing consumption and instead taxed saving (Brinkley 1995; Hawley 1995; Stein 1990), resulting in a tax policy that emphasized progressive rates.

Macroeconomic policy in the postwar period looked very different. The Keynesian-influenced “new economics” considered saving a virtue, not a vice. It addressed postwar anxieties regarding pent-up consumer demand and inflation (CED 1946 and 1948; Shere 1948; Tobin 1949). Moreover, it pursued fiscal policies that produced full employment (Gurley 1952; Noyes 1947). Consequently, postwar tax policy de-emphasized progressive taxation and promoted capital investment for wealthy taxpayers and corporations. It met aggregate demand with increased supply.

Postwar tax programs—conservative and liberal, Republican and Democratic—emphasized economic growth through tax reduction (Groves 1944; Lutz 1947; Paul 1947). Excessive tax rates created economic inefficiencies and dried up private investment. Moreover, high marginal tax rates stifled economic growth by discouraging work effort and reducing productivity. High tax rates also prompted taxpayers (both individual and corporate) to lobby for tax preferences. Lower tax rates could promote saving and investment, stimulate the economy, and discourage tax avoidance. For many postwar tax reformers, tax cuts were inherently good, a policymaking panacea. According to Roswell Magill of the right-leaning Tax Foundation, “lower tax rates would be the most important step that could be taken to promote all of the broad objectives of tax reform. It would provide a tax climate more favorable to economic growth. It would lessen the extent of inequities that exist in the tax system. It could mean a more reasonable use of the principle of progression. It would reduce interference with the free market allocation of economic resources” (Magill 1959, 96). Tax cuts meant progress, equity, and efficiency.

The widespread appeal of lower marginal tax rates suggested that the U.S. income tax system after World War II would exhibit flatter rates. But progressive taxation proved resilient, and the top marginal income tax rate for individuals remained above 90 percent throughout the 1950s. Moreover, the top corporate rate—as high as 77 percent from 1950 to 1953—never fell below 52 percent. Calls for tax cuts to stimulate the economy were met by equally vociferous calls to preserve progressive, ability-to-pay taxation.

For 20 years after World War II, tax policies that promoted economic growth on the one hand and progressive equity on the other vied for preeminence. The contest between growth and equity involved experts, politicians, and the public. Three distinct groups of postwar tax reformers debated the trade-offs between growth and equity: conservatives or “anti-taxers,” “supply-side” liberals, and “demand-side” liberals.

Conservatives advocated tax cuts. Taxes distorted the free market. They reduced private investment, threatened the capitalist system, and financed wasteful government spending. Taxes created a tax-and-spend cycle of higher tax burdens, and bigger expenditure programs. The tax-and-spend philosophy, moreover, produced deficits. “We have our highest peacetime taxes,” conservative Carl Curtis (R-NE) argued. “Yet, in spite of all those tax receipts, the Fair Deal is running an annual deficit

of over \$5,000,000,000" (1950, 8329). A year later, the Republican National Committee warned that Democratic tax-and-spend policies would "further cheapen the dollar, rob the wage earner, impoverish the farmer, and destroy the savings, insurance and investments of millions of people" (Shafer 1951, A3987).

The conservative economic vision accomplished tax cuts alongside expenditure cuts. It preached fiscal prudence. "Be nifty and thrifty in fifty," Robert Rich (R-PA) exhorted his colleagues in the House of Representatives (Rich 1950, 8331). Taxes should raise only enough revenue to finance the most essential government services.

According to postwar conservatives, taxation—especially progressive taxation—was socialistic. Redistributive tax policies fostered class discrimination, and threatened tyrannies of the majority. Political economist F. A. Hayek wrote, "Once it is admitted that a majority has a right to impose upon minorities burdens of a kind which the majority does not bear itself, there is little reason [to doubt] that this will be used only for discrimination against the rich" (1956, 271). Progressive taxation, by jeopardizing individual liberties, contradicted the founding principles of the U.S. republic.

In the context of the Cold War, progressive taxation adumbrated communism. Like communist Russia, it challenged democratic institutions and portended revolution. The Communist Manifesto, anti-taxers were quick to point out, advocated a progressive income tax and the abolition of inheritances. The expansive reach of the postwar federal income tax would dry up private investment, as Marx had predicted, and destroy capitalism. For many postwar conservatives, the communist invasion was already underway. In 1947, Harold Knutson (R-MN) railed against the subversive influence of progressive taxation: "For years we Republicans have been warning that the short-haired women and long-haired men of alien minds in the administrative branch of government were trying to wreck the American way of life and install a hybrid oligarchy at Washington through confiscatory taxation" (Jones 1988, 294). Karl LeCompte (R-IA) issued a call to arms against excessive taxes. "Continued use of the taxing power," he warned, "will destroy the very things, the very weapons, we must use against the threat of communism" (1953, A104). For conservatives, the power to tax was the power to destroy.

Conservative forces engaged in a protracted effort during the 1950s to limit Congress' ability to levy progressive taxes. They offered constitutional

amendments and congressional resolutions designed to amend, reform, and repeal the Sixteenth Amendment.⁸ This decade-long effort encapsulated the conservative critique of taxation in the postwar period. “Its purpose and effect,” explained Chauncy Reed (R-IL), “are merely to eliminate in large measure from our system of taxation its socialistic features” (1955, 1002). Limiting the taxing powers of Congress would safeguard “liberty” and “freedom” (Gwinn 1950, A304–5).

In their effort to reduce progression within the federal income tax and to promote private investment, conservatives supported certain tax preferences. They defended low taxes on capital gains. They supported the income-splitting joint return. And they endorsed depletion allowances and accelerated depreciation. Conservatives, like their liberal counterparts, knew that tax subsidies operated like spending subsidies. They also knew that spending from the tax side of the budget helped conservative constituents more than it helped liberal constituents. For one thing, conservative constituents generally reported more taxable income, and thus benefited to a greater degree from tax deductions. For another, conservative constituents were more likely to report unearned income on their tax returns, and thus utilized tax subsidies for unearned and investment income.

Conservatives did not endorse all loopholes. They appreciated the effect loopholes had on tax progression, but they also understood that tax preferences distorted economic activity and the free market. Tax subsidies were patently unfair; moreover, they helped some taxpayers, but not others. If only for political reasons, conservatives endorsed efforts to close particularly egregious tax apertures. Conservatives also realized that tax subsidies reduced federal revenues. Closing loopholes could raise revenue, which, in turn, could help balance the budget, pay down debt, cut federal spending, and reduce tax rates.

Like conservative tax reformers, supply-side liberals supported reduced taxes on high incomes and corporate America. Unlike the anti-taxers, however, this tax reform cohort did not seek tax reduction for the sake of shrinking the size of government or saving the country from an insidious communist invasion. Nor did it endorse tax loopholes to carve out special privileges for the rich. Rather, it believed that tax cuts stimulated the economy, enhanced employment, and induced growth. Targeted tax incentives for business and capital investment benefited the economy. Excessive tax rates on high-income individuals distorted economic behavior, reduced work effort, and discouraged entrepreneurship.

Excessive taxes on business were worrisome as well. Corporations grew slowly under the burden of heavy tax rates. Higher corporate taxes could destroy the ability of American industry to compete in world markets, and corporate America fueled these fears. In 1953, U.S. Steel told Congress that the excess-profits tax (levied from 1950 to 1953) amounted to “a destructive tax, dishonestly named. It [was] not a tax upon excessive profits. It [was] an excessive tax upon normal profits, on business efficiency, on industrial growth, and on public service” (Colmer 1953, A600–1). Tax cuts were needed to save American industry.

Supply-side liberals desired as few barriers to growth as possible. They espoused what economist Herb Stein termed “domesticated” Keynesianism, a form of Keynesianism akin to its original British formulation—that is, one less concerned with structural economic weakness than with economic stimuli and recovery (1990). While the first generation of American Keynesians (Mariner Eccles, Mordecai Ezekiel, and Alvin Hansen) concerned itself with distribution and consumption in a period of economic depression and war, the second generation worried about investment and production during a period of prosperity and peace. These supply-side liberals advocated economic policies that facilitated growth in an efficient manner. Spreading the tax burden throughout the income distribution and carefully using targeted tax incentives could provide the least distortive fiscal policy stimulus. “A broadly based income tax with as few special provisions as possible,” tax scholar Walter Blum suggested, “is most compatible with the kind of economic growth most people desire, and the kind in which we will have the least wastage of investment” (1955, 246). Cutting tax rates could also lead to fewer tax inequities by reducing the incentive to punch loopholes in the tax code.

Supply-side liberals did not advocate tax cuts simply for the sake of economic growth.⁹ They perceived social and economic benefits flowing from tax reduction. An enlarged economic pie could benefit all income levels. “An ever-expanding economy could produce undreamed-of abundance and material gain for all classes,” argued Leon Keyserling, chairman of President Truman’s Council of Economic Advisers. “Business could expect higher profits, labor better wages, farmers larger incomes, and, above all, those at the bottom of the economic scale could experience a truly decent life” (Hamby 1973, 300). To the extent tax cuts served up more generous helpings of the economic pie, supply-side liberals pursued them aggressively.

Tax cuts were also in the interest of national security. In the context of the Cold War, they were essential if America was to meet and exceed Soviet economic growth. The strength of the U.S. economy reflected the strength of capitalism and of democracy. Determining who was “winning” the Cold War was measured as much by aggregate rates of economic growth as by the number of nuclear warheads. Fears over the Soviet economic juggernaut peaked in the latter half of the 1950s. Important economic indices suggested the Soviets were about to declare victory on the economic battlefield. Between 1953 and 1958, the Soviet economy grew between 7 and 8 percent annually, eclipsing the growth rate of the U.S. economy, which averaged a comparatively sluggish 1.5 percent over the same period.

The strong Soviet economy, in turn, financed military and technological advances. In 1957, the Soviets successfully launched *Sputnik*, a scientific space satellite. Some Americans feared that if the Soviets could thrust an object beyond the earth’s atmosphere, they might also be able to launch an intercontinental nuclear missile to the United States. The specter of raining nuclear bombs prompted a national debate on “catching up” to the Soviets. Meeting the Soviet threat required a strong economy. According to supply-siders (and conservatives, too), the most efficient way to enhance economic growth was to reduce taxes on capital and investment income.

“Sputnik complexes” fueled the postwar preoccupation with economic growth and influenced the supply-side position on tax reform. For supply-side liberals, “reform” meant abolishing economically distorting tax preferences, but preserving, and even creating, tax subsidies that stimulated the economy. On the one hand, tax preferences could be economically inefficient, threaten the revenue viability of the new tax regime, and undermine taxpayer morale. On the other hand, supply-side tax reformers perceived far-reaching benefits to tax subsidies that enhanced economic growth.

Supply-side liberals perceived tax cuts and tax reform as linked, especially when tax cuts and reduced loopholes spurred the economy. Following the lead of their “more liberal” brethren—the demand-side liberals—supply-siders recognized that closing tax loopholes could pay for rate reduction. Strategically, they believed they could enact tax cuts if they compromised on tax reform. That is, they believed that demand-side liberals would be more inclined to support supply-side tax cuts alongside fewer tax loopholes.

The supply-side group of liberal tax reformers included Wilbur Mills (chairman of the House Ways and Means Committee from 1958 to 1974); Walter Heller (future chairman of President Kennedy's Council of Economic Advisers); Herb Stein (director of research for the Committee for Economic Development and later chairman of President Ford's Council of Economic Advisers); Stanley Surrey (Harvard law professor and later assistant treasury secretary for tax policy under Presidents Kennedy and Johnson); Dan Throop Smith (Harvard economist and assistant treasury secretary for tax policy under President Eisenhower); Walter J. Blum and Harry Kalven Jr. (professors at the University of Chicago Law School and coauthors of *The Uneasy Case for Progressive Taxation*, the most articulate postwar critique of progressive taxation); and the Committee for Economic Development, the National Association of Manufacturers, and the Chamber of Commerce. Growth liberalism provided these tax reformers a platform on which to form a policy network of politicians, federal officials, academics, and expert researchers.

Demand-side liberals, like conservatives and supply-siders, believed in the stimulative effects of reduced taxation. However, demand-siders did not believe that high marginal tax rates necessarily threatened economic progress by distorting economic behavior, reducing work effort, or discouraging investment. Frank Clark (D-PA), for example, refuted the "fallacy" that excessive taxes jeopardized capitalism or democracy. He scoffed at the suggestion that "the crushing burden of taxation" would destroy "the whole incentive of the free enterprise system" (1959, 2488). Demand-siders acknowledged the damaging effects that could result from excessive taxes on executives, managers, and other high-income earners. They did not feel, however, that marginal tax rates of 90 percent necessarily jeopardized work incentives. "The evidence is overwhelming," economist Roy Blough reported, "that the business executive is putting a full measure of work and energy into his regular job" (1952, 37). Demand-side economist George Break wrote that "contrary to the frequently repeated injunctions of so many financial commentators, solicitude for the state of work incentives does not under current conditions justify significant reductions in the role of progressive income taxation." In fact, Break noted, income tax rates "could be raised considerably, especially in the middle and upper-middle income ranges, without lowering unduly the aggregate supply of labor." Tax-related work disincentives, he concluded, "like the weather, are much talked about, but relatively few people do anything about them" (1957, 549). According to

demand-siders, taxation was not the bane of the nation—the obsession with growth was.

Demand-side liberals explicitly criticized the supply-side “trickle-down” theory of economics. Tax cuts on wealth and capital did not lead inevitably to economic gains throughout the income distribution. What good was increased supply without sufficient demand? “It is well and good to worry about taxation effects on investment incentives when there is plenty of demand for goods and services and a lack of investment capital,” argued Robert Nathan, chairman of the Americans for Democratic Action. “But we should make sure now that there is enough demand to make investment profitable in the first place.” Demand created supply. “The way to increase investment,” Nathan emphasized, “is to increase consumption” (1954, 879). “Continued economic growth,” the AFL-CIO agreed, “will depend upon sustained and expanding levels of consumption” (Kassalow 1959, 518). Senator Russell Long (D-LA) argued for the demand-side economic vision during tax debates in 1954. “What we need at the present time is not more production but more buying power in the hands of the consumer to buy the products which are already being produced at a greater rate than they are being sold. . . . The problem,” Long emphasized, “is that of keeping the consuming and the productive powers in balance. At the present time there is no question whatever but that the problem is not in producing more washing machines, more automobiles, more television and radio sets, and so forth, but in selling the products of industry” (1954, 9172).

Supply-side liberalism was a cop-out, demand-side liberals argued. It diverted the discussion from difficult and unsettling issues such as income and wealth inequalities. “The usual liberal approach today,” lawyer Louis Eisenstein lamented, “is that if we can promote economic growth, if we can have a larger pie, all segments of society will necessarily have larger shares of that pie and we won’t have to worry about redistribution of income anymore” (1962, 4). The rising tide thesis was a by-product of what John Kenneth Galbraith identified as the general “decline of interest in inequality as an economic issue” (1958, 82). The great economic issue in postwar America was not equity, but economic growth. Bucking the trend, demand-side liberals attacked disparities between rich and poor in an affluent society.

The theorists among this liberal cohort articulated a moral and ethical defense of distributive justice. “Ethical conceptions,” not empirical analysis, argued economist Earl Rolph, “provide the fundamental defense

for equalitarian devices” such as progressive taxation (1950, 393). Tax policy alternatives, Harold Groves suggested, should be evaluated in terms of “the social significance of income” (1956, 27). These theorists drew on a long tradition in public finance that emphasized the social implications of fiscal economics, or what sociologist Rudolph Goldscheid (1917) and economist Joseph Schumpeter (1918) had called “fiscal sociology.” Taxes reflected and reinforced social norms. Appraising tax justice involved evaluating the relationship between a nation’s economic and social systems. It involved, above all else, appreciating a society’s moral and ethical code. When talking about the “equity of taxation,” fiscal theorist S. J. Chapman argued, “we are obviously talking ethics, and therefore the wants primarily dealt with must be adjudged not according to the value of their satisfaction in fact (positive value), but according to the value of their satisfaction in a moral scheme of consumption (normative value)” (1913, 34). Measuring tax justice involved appraising distribution, recognizing social-economic equality and inequality, and considering “the equity of the whole existing order” (Taussig 1921, 509).

Demand-side theorists emphasized tenets of public finance theory that taught tax justice, “along with [its] underlying image of a good society, cannot be resolved by considerations of economic efficiency alone” (Musgrave 1996a, 354). Equity considerations were essential to “good” taxation. “The equity of the tax structure,” Richard Musgrave told Congress during hearings on the Kennedy-Johnson tax cut in late 1963, “is an important end in itself. The ability of a people to institute a fair and equitable tax structure is a true test of social responsibility in a working democracy.” Tax reform, argued Musgrave, “is not only a matter of broadening the tax base so as to permit rate reduction to aid incentives.” Indeed, economic growth was salient to tax policy debates. So was social and economic equity. “Equitable distribution of the tax burden *is* important,” Musgrave emphasized. “This means an income tax law which defines income so that, in line with the demands of ‘horizontal equity,’ people in equal positions are treated in similar fashion. It also means that the tax burden, in line with considerations of vertical equity, should be distributed fairly among different income groups.” Musgrave acknowledged that his advocacy for progressive taxation might appear as “a matter more of political philosophy than economic analysis.” But that hardly lessened its power. All arguments for progressive taxation—economic, philosophical, moral—should inform the debates, “especially in the individual income tax, since the rest of the tax structure is regressive” (1963a, 2202).

Attacking tax loopholes complemented the demand-side strategy of shifting the tax burden away from low-income individuals. Demand-siders recognized that statutory rates could not—and perhaps should not—go any higher. But closing loopholes, nearly all of which benefited high-income individuals and corporations, would improve progressivity. If demand-siders could hold the line on statutory rates while removing tax privileges, they could shrink the distance between what taxpayers should have been paying and what they really were paying. In fact, demand-siders recognized that they could give ground on rate reduction if they accomplished enough loophole closing. They traded vertical equity for horizontal equity on the theory that improving horizontal equity could improve vertical equity enough to justify modest tax cuts.

Closing tax loopholes also raised revenue. The money generated from reducing tax leakages could pay down the public debt, balance the national budget, increase personal exemptions, improve national defense, and raise public expenditures. Perhaps more important, closing loopholes could pay for tax cuts, which provided demand-siders bargaining power. “If all the controversial points in the revenue act were resolved in favor of the revenue,” Harold Groves said, “the rates of personal tax could be reduced 25 percent” (1955, 243). Base broadening paved the way for tax reduction. It also enhanced the ability of the federal income tax to provide economic stability during periods of upswing and downswing. If Congress increased total income subject to tax, Randolph Paul explained, “we have more of a chance to decrease taxes because we have more income subject, generally, to tax and in addition we have a more sensitive income-tax structure, because the broader the base, the greater then will be the effect one way or the other of a change in the economic trend” (1955, 256).

Demand-side liberals succeeded in consolidating the wartime changes to the federal income tax and challenging efforts to carve out additional tax loopholes. Personal income tax rates never fell below 90 percent in the 1950s, and corporate income tax rates fluctuated between 52 and 77 percent. Demand-siders also demonstrated that progressive taxation promoted economic growth as well as social justice. Progressive equity, moreover, complemented democracy as well as capitalism. Tax loopholes, on the other hand, threatened both. They discriminated against the majority of taxpayers and distorted economic behavior. At a time when steep marginal income tax rates arguably justified tax favors to

strengthen the national economy, demand-side liberals kept progressive equity at the forefront of tax policymaking debates.

In their fight for progressive tax equity, demand-side liberals put together a coalition of reformers that included Senators Paul Douglas (D-IL), Al Gore (D-TN), Wayne Morse (D-OR), and Hubert Humphrey (D-MN); academic economists Otto Eckstein (Harvard University), Harold Groves (University of Wisconsin), and Richard Musgrave (Harvard University); economists Richard Goode of the Brookings Institution and Joseph Pechman of the Committee for Economic Development and, later, of the Brookings Institution; tax lawyers Louis Eisenstein, Randolph Paul, and Joseph Sneed; organizations such as the ADA and AFL-CIO; and “high-brow” publications such as *The New Republic* and *The Nation*.

A Postwar Tax Policymaking Consensus

The three groups of postwar tax reformers occupied different positions on the spectrum between growth and equity. Members from each group came together at certain points, however, to form a tax policymaking consensus that emphasized rate reduction and horizontal equity. They viewed the policymaking debate, perhaps in an oversimplification, as a trade-off between tax cuts and tax reform. They talked in terms of balancing progressivity losses in statutory tax rates, for example, with progressivity gains through fewer tax loopholes. Regardless of the theoretical accuracy of their rhetoric, postwar policymakers correctly recognized that linking tax cuts and tax reform could prove a winning combination both economically and politically. Closing loopholes paid for rate reduction. It broadened the tax base and provided additional opportunities for cutting taxes. Lower tax rates, in turn, reduced incentives to carve out new tax preferences. The practical and theoretical foundations of the postwar tax policymaking consensus animated tax discussions for the latter half of the 20th century. Broadening the tax base and lowering marginal tax rates provided the intellectual and political foundation for the most important episodes in postwar tax policymaking: the Revenue Act of 1964, the Tax Reform Act of 1969, and the Tax Reform Act of 1986. The tax policymaking consensus reinforced postwar economic imperatives.

A clear majority of tax reformers favored tax cuts. Supply-side liberals supported tax reductions that stimulated the economy, while

demand-siders sanctioned most stimulative cuts. Conservatives, unless compromised by unbalanced budgets, worked to reduce excessive taxation. Support for targeted tax incentives aimed at enhancing economic growth garnered less support in the early postwar years. However, an extensive lobbying effort on behalf of supply-side liberals, in combination with the perceived necessity of meeting the Soviet economic threat, delivered both liberal and conservative endorsements for growth-oriented tax subsidies.

Finding support for reform was harder. The two liberal factions agreed generally on the need to eliminate inequities in the tax code, but they differed on the margins. These distinctions often involved the relative importance of growth versus equity. Demand-side liberals criticized the income tax treatment of capital gains, for example, because the provision discriminated against earned income in favor of investment income. Supply-siders, on the other hand, welcomed certain tax subsidies, particularly those for investment income, which they believed could promote economic growth. Despite their policy emphases, the two liberal factions found enough common ground to trade modest tax cuts for modest tax reform in the postwar period. On those occasions when the two liberal groups supported the same legislative measure, they formed a formidable alliance. But it was a precarious alliance, particularly for demand-side liberals. Without support from their liberal brethren, demand-side liberals had nowhere to turn. If supply-siders decided to abandon equity concerns, the demand-side agenda for achieving progressive equity would stall. Or if they decided to endorse horizontal equity only insofar as it helped them accomplish tax reduction, the policy "trade-off" between losses in vertical equity and gains in horizontal equity could yield substantial progressivity losses.

Conservatives made the alliance between the two liberal cohorts more precarious. If conservatives refused to budge on the horizontal-equity side of the equation, or if they forged an alliance of their own with supply-side liberals (around their shared affinity for promoting investment, for example), demand-siders would again be left on the losing end of the battle for progressive equity. Demand-side liberals walked an uncertain path. Conservatives generally accepted the Swiss-cheese nature of the federal income tax because it resulted in a less progressive tax system. But conservatives also recognized that tax loopholes distorted free-market operations and business decisions. In addition, conservatives disparaged the idea of using the tax code to achieve social and

economic goals other than revenue collection. Also, conservatives recognized that loopholes were blatantly unfair; they could not afford to ignore all discriminations in favor of wealthy taxpayers. Thus, they supported limited tax reforms.

In order to achieve progressive equity, demand-side liberals needed more than “limited reform.” They needed to politicize tax policymaking, publicize tax inequities, and lead a taxpayer revolt against tax loopholes. However, neither the political culture nor political institutions would allow it. The official government institutions of tax policymaking—the House Ways and Means Committee and the Senate Finance Committee—consciously eschewed politics and demagoguery during postwar tax policy debates. In particular, the Ways and Means Committee, under the direction of Wilbur Mills (D-AR), cultivated an aura of impartiality around tax policymaking. Mills relied on his own expert knowledge of the tax code, as well as the expertise of an influential network of tax professionals and economists both inside and outside government (Zelizer 1998). The numerous tax hearings Mills convened throughout the 1950s and 1960s were forums for neutral, technocratic, and objective tax policy discussions. Ostensibly, they accomplished a comprehensive, impartial, nonpartisan review of the federal taxing process.

Unfortunately for demand-siders, these tax discussions also focused on supply-side tax policies. Tax reform characterized by technocratic, impartial, expert, or numbers-driven discussions subordinated class politics and philosophical questions of tax justice. The supply-side emphasis on economic growth and efficiency overwhelmed concerns regarding income and wealth inequality. To the extent the tax-writing committees discussed redistributive tax policies, they condemned them as threats to the economy’s incentive structure. The aggregate economic benefits of taking from the rich and giving to the poor were difficult to quantify. But demonstrating the effects on capital formation that flowed from an investment tax credit, for example, could be determined readily through empirical analysis.

Postwar tax reform involved objective considerations. Determining appropriate levels of vertical equity, on the other hand, required making value judgments. It was a matter of taste. “If A’s income is twice B’s,” economist Herb Stein posited in 1959, “should A’s tax be twice B’s, or one and one-half times or three times as large? Intuitive standards of equity,” Stein counseled, “seem to throw no light on questions of ‘How much’ ” (1959, 114). Reaching consensus on degrees of vertical equity in

the rate schedule was indeterminate and should be avoided as a matter of policy. Subjective considerations of progressive equity belied the aura of impartial precision that Mills and his network of supply-side tax reformers cultivated. Moreover, debating progressive equity from the standpoint of tax rates threatened to disturb the tacit compromise among the members of the postwar tax policymaking consensus regarding the incremental reduction in tax rates. Demand-siders enjoyed some success debating progressive equity from the standpoint of tax loopholes. Their success, however, derived more from their ability to characterize tax loopholes as deviations from horizontal equity than from their ability to engage supply-siders and conservatives in a discussion over how tax loopholes undermined progression.

The concept of horizontal equity generated more agreement than discord. Horizontal equity amounted to “the first, basic rule of taxation” (Stein 1959, 110). Everyone could agree on the principle of taxing equals equally. It was hard to imagine someone arguing for the *unequal* taxation of equals. Yet, postwar tax reformers allowed exceptions to the rule. Businesses could deduct “ordinary and necessary” expenses, but individuals could not. Farmers who raised four-legged livestock for purposes of “draft, breeding, or dairy” paid taxes at a special rate of 25 percent on the sale of their livestock; farmers who raised and sold two-legged poultry, meanwhile, paid taxes according to the more penal graduated rate schedule. In addition, working parents with 12-year-old children received a tax deduction for child-care expenses, but identically situated working parents with 13-year-old children did not.

In the end, debates over horizontal equity, like debates over vertical equity, amounted to value judgments and were equally subjective. They prompted as much disagreement among tax reformers as debates over vertical equity because the participants rightly perceived the two principles as linked. Improvements in horizontal equity could improve vertical equity. Conversely, creating new loopholes could reduce progressivity.

Ostensibly, all three tax-reforming groups stood the same chance of accomplishing their distinct vertical-equity goals in the battle over horizontal equity. Demand-siders faced a stacked deck, however. Not only were “tax-cutting provisions . . . hard to dislodge,” but they also “tend[ed] to fan out and bring other tax reductions in their wake” (Hellerstein 1963, 22). Each additional subsidy further undermined progressive equity, which, in turn, justified still more subsidies. Demand-side liberals were left fighting a losing battle. It was only a matter of time before their

agenda for progressive equity was overwhelmed by the combination of tax politics and the supply-side agenda of economic growth and efficiency.

Growth: Declaring Victory

In 1953, Walter J. Blum and Harry Kalven Jr. published the most careful study of progressive taxation to date. They acknowledged the weaknesses of graduated rates: High marginal tax rates yielded little revenue; progressivity complicated the tax system, both structurally and administratively, and it created economic inefficiencies, encouraged tax evasion, promoted “political irresponsibility,” stifled incentives for risktaking, and overtaxed saving (Blum and Kalven 1953). Ultimately, Blum and Kalven offered a “stubborn but uneasy” case for progressivity. Like Simons 20 years earlier, they reconciled the adverse consequences of progression with its “ethical or aesthetic” effects on income and wealth inequality.

By the end of the 1950s, the case for progressive taxation had become less stubborn and more uneasy. In fact, the debate between growth and equity ended in the early 1960s with growth emerging triumphant. Post-war supply-side anxieties about the stagnant U.S. economy finally compelled legislators to enact deep tax cuts. The rate cutting that began with the 1964 Revenue Act and continued for the next 22 years represented a triumph of economy and efficiency over equity. Richard Musgrave observed this trend firsthand. During a Treasury Department consultants’ meeting in 1963, Musgrave lamented that President Kennedy’s tax reform package emphasized growth while subordinating equity. “I am bothered by the Administration’s failure to emphasize the importance of the equity objectives in the whole reform issue,” Musgrave stated. “To argue for base broadening as needed merely to permit rate cuts (required on incentive grounds), and not urge it on equity grounds, is a pretty weak position from which to defend the reform case. One cannot but note a change in flavor, in this respect, between the tax messages of ’62 and ’63” (1963b). Horizontal equity, the “first, basic rule of taxation,” was being used to accomplish tax cuts, not tax fairness.¹⁰

Supply-side liberals within the Kennedy administration convinced the president to support stimulative tax policies primarily for their effects on the economy. Kennedy lobbied for a controversial investment tax credit in 1962. In 1963, he argued for across-the-board cuts in personal and corporate income taxes, reduced capital gains taxes, and accelerated

depreciation. The Kennedy proposal became the Kennedy-Johnson tax cut of 1964. It represented the triumph of “growthmanship” and Keynesian countercyclical policies. Cutting taxes while the budget was in deficit could stimulate economic growth. Some liberal supply-siders peddled the comforting assumption that the rising tide would lift all boats: poverty could be eliminated without significant redistribution of wealth. Rather than reslicing the economic pie, policymakers could enlarge it. Tax cuts could benefit everyone.

For demand-side liberals, the 1964 tax bill was cause for less celebration. They perceived the wisdom of using taxation as a countercyclical tool, but they were discouraged by the subordination of progressive equity to economic growth and efficiency. The 1964 tax cuts signified a definitive policy turn away from progressive, ability-to-pay taxation. Gone was the conflation of social justice and tax reform. Gone, too, was the conceptualization of tax justice as a moral and ethical construct. In its place emerged a single-minded emphasis on taxation’s economic effects.

Economy and Efficiency: Falling Rates and Relative Burdens, 1964 to 1999

The years 1964 to 1999 witnessed significant declines in the U.S. income tax system’s statutory progressivity. The 1964 Revenue Act cut individual rates by an average of 20 percent, with the top rate falling from 90 to 70 percent and the bottom rate from 20 to 14 percent. The Tax Reform Act of 1969 reduced the maximum rate on wage and salary income to 50 percent. The Economic Recovery Tax Act of 1981 decreased individual income tax rates by 23 percent over a period of three years, and reduced the rate on unearned income from 70 to 50 percent. The Tax Reform Act of 1986 finished the business of rate cutting. It lowered the top rate to 33 percent, and consolidated the rate schedule to three brackets (15, 28, and 33).¹¹ In 1992 and 1993, Congress raised the top statutory rate—but only slightly—to 39.6 percent.

The top corporate income tax rate also fell during this period, from 52 percent in 1963 to 38 percent by 1994. Decreases in the corporate tax rate resulted in declining corporate income tax revenues as a percentage of federal receipts. In 1964, the corporate income tax made up 20.86 percent of federal tax revenues. By 1997, it had fallen to 11.7 percent, up from a low of 6.16 percent in 1982 (Moody 1998). The taxation of another form of capital—property—also declined during this period.

Both the corporate income tax and the property tax, long-standing symbols of tax justice, assumed minor roles in a postwar tax system that emphasized lower rates and pro-growth policies. In fact, according to one study, without accounting for any shifting of the corporate income, property, or payroll taxes, the tax burden on capital income declined by nearly 50 percent from 1966 to 1985 (Pechman 1985).

While taxes on capital income fell, taxes on labor income increased. Lower- and middle-income groups experienced higher marginal tax rates because of rising payroll taxes (Bakija and Steuerle 1991). From 1964 to 1990, the combined employee/employer payroll tax rose from 7.25 to 15.3 percent. The maximum taxable earnings increased as well, and the portion of tax receipts from payroll taxes grew from 19.5 to 36.8 percent (Moody 1998).

Meanwhile, the personal exemption declined dramatically, both as a percentage of personal income and the poverty level. In 1948, the personal exemption equaled 27.2 percent of personal income. By 1960, it had fallen to 19.8 percent, and by 1986, to 6.2 percent (Bakija and Steuerle 1991). Periodic increases in the standard deduction for married couples did not offset declines in the personal exemption, and tax-exempt thresholds remained well below the poverty line for nearly the entire period—1964 to 1986. The 1986 tax law increased tax-exempt thresholds, and removed over six million individuals from the income tax rolls by raising the standard deduction and personal exemption, and by liberalizing the Earned Income Tax Credit (EITC) (Conlan, Wrightson, and Beam 1988). Additional increases to the EITC in 1990 and 1993 raised the tax-exempt threshold still further. These increases, however, occurred during a period of rising payroll taxes on low-income workers as well as dramatic changes in welfare policy; the EITC expansions merely offset increased regressivity and retrenchment in other areas of the tax-transfer system (Ellwood 2000; Ventry 2000).

Low-income taxpayers also faced deteriorating wages. Beginning in the early 1970s, real earnings reversed their post-World War II upward trend and approached stagnation. For the next two decades, earnings inequality accelerated, creating a “hollowed out” earnings distribution with large percentages of workers at the top and bottom of the distribution, and smaller percentages in the middle (Levy and Murnane 1992). Income inequalities widened throughout the 1990s, with explosive growth in earnings and capital gains at the top of the distribution and modest growth at the bottom (Cohen 2000). Indeed, the entire period

from 1968 to 1998 was characterized by increased income inequality. Census Bureau data indicate that shares of before-tax family income decreased for families below the 80th percentile in the income distribution, with the poorest 20 percent of families losing the most ground. By comparison, the share of income for the top 20 percent of families increased by an average of 14 percent, with the richest 5 percent receiving a 33 percent increase (Cohen 2000).¹²

The tax system contributed to this trend by taxing higher levels of income at reduced rates (Gramlich, Kasten, and Sammartino 1993; Pechman 1985, 1990; Slemrod 1992; U.S. Census Bureau 1992). From 1980 to 1997, effective income tax rates declined for the wealthiest Americans. According to the Internal Revenue Service, the richest 1 percent of taxpayers experienced an effective income tax rate of 34.5 percent in 1980. By 1997, that rate had fallen to 27.6 percent. Effective tax rates during the same period also fell for the top decile of taxpayers, from 23.5 to 21.4 percent (Bartlett 1999). Although wealthy taxpayers paid a larger percentage of total federal income taxes in 1997 than in 1980, income and wealth inequalities also increased. From 1983 to 1998, the after-tax income share for the wealthiest 20 percent of taxpayers increased by 5 percent, and by 16 percent for the richest 5 percent. Meanwhile, the after-tax income shares for all other households decreased (Cohen 2000). Thus, both the before-tax and after-tax distributions of income and wealth became more unequal.

The policy trends of the last 40 years have created a tax system that appears much less just from the standpoint of the republican/democratic tradition, which emphasized progressive, ability-to-pay taxation. Why have Americans accepted such a system?

The Role of Economists: Explaining the Rate Changes, 1964 to 1999

Unlike previous changes to the U.S. tax system, the transformation that began in 1964 was not the result of war, politicians, or social movements. Rather, it largely reflected changes within the economics profession and its influence within the tax policymaking process.¹³

Postwar economists de-emphasized progressive equity. The question they faced was not whether a corporation should be allowed to retain profits or whether the tax system should redistribute wealth. Rather, the

question concerned whether high marginal tax rates prevented businesses from maximizing growth or an entrepreneur from maximizing aggregate welfare. Although some economists vigorously resisted these trends, their arguments for tax reform based on moral and equity considerations became difficult to sustain once the economics profession shifted its focus to efficiency gains and losses. The profession de-emphasized what it considered value judgments on relative degrees of equity for more “reliable” measurements on the efficiency effects of tax subsidies and implicit taxation. Supply-side economists extended the argument, suggesting that equity considerations were irrelevant; economists and policymakers should concentrate solely on minimizing tax distortions.

As the economics profession gained status in postwar America, economists sold their expert, efficiency-minded advice to policymakers and presidents.¹⁴ Government economists peddled a particular kind of advice. According to Charles Schultze, chairman of President Carter’s Council of Economic Advisers, government economists served as spokespersons for economic principles and especially as “partisan advocate[s] for efficiency” (Schultze 1982, 62). During the 1950s, when the U.S. economy slowed relative to that of the Soviet Union, calls for increasing economic efficiency resonated with particular clarity. Economists used efficiency arguments to advocate across-the-board cuts in personal and capital income taxes throughout the 1960s. Encouraged by the stimulatory effects of the cuts, economists turned to rate reduction again in the 1970s. And when the U.S. economy could not shake the paralysis of stagflation, economists played the efficiency card once more. In the process, they reduced taxes on capital income and high-income taxpayers to postwar lows. Their efforts resulted in a flatter, less-progressive tax system that favored corporations and high-income individuals.

Economic research justified these dramatic transformations. Public finance theory had held for generations that the least distorting tax-transfer system (one with a marginal tax rate of zero) involved lump-sum transfers whereby taxpayers paid a fixed amount of taxes or received a fixed amount of subsidy. However, such a system required that tax officials know more than they possibly could about the ability of every taxpayer to pay. Theorists and policymakers were forced to use other observable proxies to measure ability to pay. Like income, however, these proxies created efficiency losses involving a range of individual decisions about work effort, saving, and risk taking. Tax theorists struggled to

create an efficient tax system with second-best strategies and asymmetric information—that is, until Peter Diamond and James Mirrlees ushered in the “optimal tax” tradition (Diamond and Mirrlees 1971a, b; Mirrlees 1971). According to the two theorists, the optimal second-best tax system contained relatively flat marginal tax rates through most of the income range and declining marginal tax rates at the top. Overall, an optimal tax system achieved progression because average rates rose with income, with the marginal rate remaining higher than the average rate through most of the income range. Other theorists extended the optimal tax model and argued that the highest-earning individual (the most able person in theory) should encounter a marginal tax rate of zero (Phelps 1973; Seade 1977). Still others advocated negative rates on the highest-income earners (Stern 1982; Stiglitz 1982). Indeed, Diamond and Mirrlees’s findings created a race to the bottom of the rate scale. Researchers fiddled with calculations to see how much equity could be sacrificed in the interest of efficiency. By the early 1980s, tax “efficiency” in some circles meant the same thing as tax “equity.” Under these assumptions, equity had to be sacrificed for equity’s sake.

Optimal tax theory hardly initiated the postwar penchant for cutting taxes. However, it swept the economics profession, in part because economists had been “thinking along the same lines,” and “were concerned with the development of models of optimal second best taxation” (Sandmo 1999, 179). Even economists who did not consider themselves optimal tax adherents absorbed many of its suppositions and used them to advocate stimulative tax cuts. It is impossible to ascertain the extent to which the optimal tax tradition has influenced individual economists over the last generation. It is safe to say, however, that modern-day economists have inculcated its concern for reducing distortions. We can observe these influences and hypothesize about their effects on policy by comparing two relatively under-appreciated tax-policy opinion polls.

The first survey, conducted in 1934 and administered by the Tax Policy League, polled public finance professors in the country’s leading universities (Walker 1935). The second poll, conducted in 1994 and administered by the National Tax Association (NTA), asked American and Canadian members of the NTA to respond to many of the same questions found in the 1934 survey (Slemrod 1995, 1999). Comparing the survey results indicates that modern-day economists express less interest than their predecessors do in wielding the tax system as an instrument of social justice.

A larger percentage of economists in 1934 supported progressive income taxation for individuals. One hundred percent of surveyed economists in 1934 favored a "graduated personal income tax," compared with 80 percent in 1994. A significant number of economists in 1934 believed so strongly in the power of progressive personal income taxation that 45 percent of respondents favored abolishing all taxes except the federal personal income tax. By contrast, the 1994 response rate was 12 percent.

Economists in 1934 also favored transfer taxes and opposed sales taxes at higher rates. Ninety-two percent of respondents in 1934 and 72 percent in 1994 supported federal inheritance taxes, while 90 percent in 1934 favored a separate tax on gifts, compared with 70 percent in 1994. On sales taxes, not a single respondent in 1934 favored a general retail sales tax at the local level, compared with 56 percent of respondents in 1994. Support for a general retail sales tax at the state and federal levels was equally low in 1934 (12 and 13 percent, respectively) and comparatively high in 1994 (91 and 33 percent, respectively).

The largest professional difference between economists in 1934 and 1994 involves their attitude toward the taxation of capital income. Sixty-six percent of respondents in 1934 favored taxing "unearned (i.e., capital) income" at higher rates than earned income, compared with 7 percent in 1994. Attitudes toward property and business taxes reinforced these preferences. In 1934 and 1994, respectively, 62 percent and 22 percent of respondents thought there should be "a special tax on [the] unearned increment of land values." With respect to business taxes, 98 percent of respondents in 1934 supported a net income tax on corporations, compared with 70 percent in 1994. In addition, economists in 1934 preferred higher taxes for industries believed to possess excessive power, including banks (54 percent), insurance companies (73 percent), and railroads and public utilities (55 percent). Economists in 1994 expressed much less support for these discriminatory taxes (27, 28, and 24 percent, respectively).

The change in tax policy preferences among economists over the last 50 years influenced commensurate changes in the nation's tax system. The economics profession was also instrumental in changing the attitudes of American taxpayers toward the "proper" structure of the U.S. tax system. To some extent, economists altered popular notions of tax justice by educating legislators and taxpayers on the negative economic effects of high marginal tax rates.

The successful effort to cut taxes in 1964 was largely a campaign of economists and did not enjoy a groundswell of popular support. In fact, for the five years preceding the 1964 tax cut, Americans expressed more satisfaction with the income tax system than in any other five-year period after World War II. In response to a Gallup poll question asked almost every year from 1947 to 1998 (“Do you consider the amount of federal income tax that you have to pay as too high, too low, or about right?”), 48.8 percent of respondents in the years 1959 to 1964 felt their federal income tax burden was “too high,” much lower than the average response rate of 57.5 percent for the period 1947 to 1998. Meanwhile, 42.4 percent surveyed felt it was “about right,” well above the 50-year average of 36.7 percent (Gallup 1972, 1998, 1999).

After the 1964 tax cut, however, the tax-cutting penchant of economists appeared contagious. Oddly, public enthusiasm for tax cuts seemed only loosely correlated to statutory tax rates. In the three polls conducted after 1964 (1966, 1967, and 1969)—that is, after rates were cut 20 percent—57 percent of those surveyed indicated their federal income taxes were too high, a significant jump from the five-year period preceding the 1964 tax cut (Gallup 1972). Examining taxpayer attitudes over the longer run is even more revealing. For the years 1947 to 1964, when the top marginal tax rate never dropped below 90.0 percent, 54.9 percent of respondents considered their federal income tax burden too high. From 1965 to 1998, when the top marginal income tax rate plummeted from 90.0 to 39.6 percent, a *higher* percentage of those surveyed, 60.6 percent, indicated that they paid too much in federal income taxes (Gallup 1998). From 1965 onward, American taxpayers expressed less satisfaction with the federal income tax although rates fell steadily. Something besides high tax rates (or in addition to high tax rates) fueled the public’s anti-tax sentiments.

While taxpayers followed economists along the path of rate reduction beginning in the 1960s, they diverged from prevailing economic wisdom in recent years. Public opinion polls in the 1990s indicated that a majority of taxpayers supported tax reforms that would significantly reduce progressivity. In December 1995, 50 percent of respondents to a national Gallup poll supported a flat tax with a large exemption for low-income workers (Gallup 1996). A January 1996 poll found similar support (51 percent) for a flat-tax system that did not explicitly include a low-income exemption (Gallup 1997). Furthermore, by March 1999, a clear majority of respondents (65 percent) favored a flat tax with an

unspecified exemption (Bartlett 1999). Professional economic opinion, by comparison, did not support a flat tax: only 28 percent of respondents endorsed a flat tax in the 1994 NTA poll (Slemrod 1999).

Have Americans abandoned progressive equity? Hardly. Americans have merely lost confidence in the income tax system to uphold progressive rates. Over the last 30 years, their worst fears have come true: corporations and high-income taxpayers have avoided their tax obligations while average taxpayers have been left to pay the bill. In January 1969, Acting Treasury Secretary Joseph Barr told Congress that 154 of the richest Americans paid no taxes in 1967 and warned of a grassroots “taxpayer’s revolt.” Congress responded by enacting a “minimum tax” in 1969, but public concern over loopholes that favored the rich and big business persisted. During the 1970s, while a select group of taxpayers reaped huge economic benefits from tax shelters, the majority of Americans saw more of their income subject to taxes and their after-tax income decline in value because of inflation. Although statutory income tax rates dropped during this period, bracket creep, rising payroll taxes, and higher state and local income taxes increased the marginal rate paid by the majority of Americans.

By the late 1970s, Barr’s warning appeared prophetic. Beginning at the state and local levels and spreading to the federal level, taxpayers “revolted.” In California, voters passed Proposition 13, an amendment to the state constitution restricting the property tax and requiring a two-thirds vote in each house of the state legislature to pass any new taxes. Proposition 13 spawned similar tax revolts in other states (O’Sullivan, Sexton, and Sheffrin 1995). These tax reform movements fed off a larger anti-government phenomenon that included Republicans and Democrats, conservatives and liberals—a movement that rejected the rising costs of government, as well as the ineffectiveness of social programs, inadequate public services, and unresponsive legislatures at all levels of government. It reflected a well-documented cynicism toward government that revealed a simple but powerful political expression: the burdens of citizenship outweighed the benefits. Americans found expression for their cynicism by reconsidering one of the most obvious public burdens, taxation.¹⁵

Public support for a flat tax can be viewed as part of the process of reconsidering benefits and burdens and, some say, indicates public displeasure with progressive taxation (Mitchell 2000). The evidence presented in this chapter suggests otherwise, however. Public support for

the flat tax reflects frustration with the existing tax system's inability to uphold statutory progressivity, and demonstrates the belief that a flat tax would produce a more just income and wealth distribution. In the eyes of average taxpayers, a flat tax with no dispensations could produce more progression than an income tax full of loopholes.¹⁶

Public discontent with income tax burdens throughout the period from 1947 to 1998 was not a function of marginal tax rates. The lowest percentage of public approval with the income tax in the postwar period correlated with periods of low marginal tax rates. Alternatively, the highest percentage of public approval with the income tax system correlated with periods of high marginal tax rates. Additional poll data indicate that Americans believe progressive tax rates produce a just distribution of the tax burden. A 1983 poll conducted by the Advisory Commission on Intergovernmental Relations asked, "Which *one* of the changes would be the single most important change that would make the nation's tax system more fair?" (emphasis in the original). Forty-nine percent of respondents checked the box, "Make the upper-income taxpayers pay more," three times the percentage for the second-place vote-getter, "Make business firms pay more even if it reduces the number of jobs" (ACIR 1986). Similarly, respondents to a 1993 Gallup poll indicated overwhelmingly that neither high-income nor business taxpayers paid enough taxes. Seventy-five percent of those surveyed thought both upper-income individuals and large corporations paid too little in taxes (Gallup 1994).

Americans still believe in using tax policy as an instrument of social justice. In the 1960s and 1970s, economic efficiency arguments facilitated public acceptance of income tax reduction. Marginal tax rates of 90 percent, and even 70 or 50 percent, appeared excessive and a likely source of tax evasion. Most American taxpayers, however, accepted rate reduction not because they desired subordinating equity to efficiency concerns. Rather, they believed improving efficiency could also improve progressive equity and by extension, tax justice. Closing loopholes was supposed to pay for more progressive equity, not less.

Bridging the Divide between Equity and Efficiency

Although considerations of equity still resonate with American taxpayers, tax theory and tax policymaking currently downplay equity as an orienting principle. This last section examines the consequences of subordinat-

ing equity to efficiency in modern-day tax discussions and considers the benefits of reinserting equity into the debate. It also evaluates whether theorists are justified in separating efficiency concerns from equity concerns. The section concludes by suggesting that bridging the divide between the two principles would result in tax policies more consistent with widely shared perceptions of tax justice.

When designing (or redesigning) a tax system, participants should agree on the pattern of effective tax rates before they consider the tax instrument that will uphold these rates (Musgrave 1996a). This process encourages both the public and policymakers to consider acceptable levels of burden and benefit in relation to widely understood concepts of justice. Presently in the United States, the formula is backwards; that is, most tax reformers (legislators and economists especially) consider tax forms first and sets of rates later. In fact, many tax reformers purposely obscure the resultant pattern of effective rates. Flat-tax proponents, for example, fail to mention that their proposals will tax Bob Gates's forty-thousandth dollar of income at the same rate as Bill Gates's ten millionth dollar. They concentrate, instead, on how their proposals might reduce complexity, minimize tax evasion, or reduce the size and power of the Internal Revenue Service—all commendable concerns, but not the value-based considerations that preoccupied previous generations of tax reformers. The usual results are an empty and misleading public debate, deficient tax policies, and a cynical citizenry.

Refocusing the debate on the desired pattern of effective rates would undoubtedly make some people uneasy by raising questions about societal norms and values. However, reinserting distributive justice and competing levels of progression into the policymaking mix would restore a much-needed degree of morality into the public discourse over taxes.

Evaluating the desired distributive effects of taxation would impel policymakers to consider tax and expenditure programs as part of an integrated budget policy. Viewing tax burdens (or benefits) in isolation presents only a partial picture of relative government benefits and burdens. Both taxes and expenditures influence distribution; it does not matter, practically speaking, whether the tax side or the expenditure side impacts individuals. Thus, Musgrave (1996a) suggests viewing equity in terms of net benefits and burdens, an approach that provides policymakers with a better understanding of how individual tax policies (as well

as expenditure policies) interact with the rest of the tax-transfer system and therefore helps them determine an equitable pattern of effective tax rates.

Economists have resisted considering equity too seriously, arguing that they “have no special competence in determining which distribution of resources is appropriate” (Heckman 1997, 327–28). In the interest of scientific rigor and gaining “some relative advantage to non-economists” (Steuerle 1999, 1593), the profession has avoided what it considers the “naïve and dogmatic set of judgments” required “to decide on the kinds and extent of inequality” that should prevail (Stigler 1952, 285). Economists divorce their professional duties from their duties as citizens, leaving society’s pedestrian equity concerns to their citizen selves rather than their professional selves. “Since we get our notions of equity from the community,” George Stigler wrote, “we can hardly play a large role in the community’s choice of policies with respect to income distributions” (1982, 65). In the end, many economists seem untroubled that the “separation of efficiency and equity creates a void that often leads to neglect of the distribution/redistribution question entirely” (Heckman 1997, 332).

Both in theory and practice, the divide between efficiency and equity is not as wide as many economists would have us believe. When economists measure efficiency, they assume given and various levels of income distribution. To the extent economists prioritize certain efficiency outcomes, they also prioritize the levels of distribution associated with those outcomes. The very meaning of a given efficiency outcome depends on the initial distribution of resources. Maximizing aggregate welfare “depends on tastes, on what people want, on what they value. But what they value depends on what they have to begin with” (Calabresi 1982, 90) and, it follows, on what they end up with. On a more practical level, economists consider equity outcomes every time they evaluate competing costs and benefits of public policies.

By de-emphasizing equity, economists fail to fully use their professional training. Economics “emphasizes understanding and quantifying relationships and determining how well various measures work, such as in identifying who are equals and who are not” (Steuerle 2000, 692). Competing equity schemas are as pertinent to tax policymaking as competing consumption desires, particularly when equity preferences are viewed as “revealed preferences” analogous to other consumption preferences that cannot be neglected by economists (Steuerle 2000, 692).

Attempts to partition off equity from efficiency when considering tax policies also ignore the relationship between horizontal and vertical equity. Gains and losses in horizontal equity can, respectively, increase and decrease vertical equity. Moreover, efforts to improve horizontal equity can improve both equity and efficiency, respectively, by taxing equals equally and by reducing distortions caused by taxation.

The lingering resistance among economists to consider equity alongside efficiency involves a professional ethos that purports objectivity and rejects ideology. However, economics itself comprises an ideology by putting its faith in the competitive market economy, and by favoring policies and behaviors that reinforce the values of competition and efficiency. The free markets, within which consumers theoretically evaluate efficiency gains and losses, “are not really free,” legal scholar Neil Duxbury has argued. “Rather, they are markets within which the economically powerful are able to dominate the economically weak. To express a preference for such markets is arbitrarily to uphold the legitimacy of existing power relationships” (1995, 404). With the recognition that economics reflects a system of values, maintaining a distinction between efficiency and equity based on scientific rigor becomes indefensible.

Evaluating equity alongside efficiency recognizes the inherent sociopolitical inputs of taxation. “Tax policy is a product of politics,” economist Randall Holcombe suggests. “A complete understanding of tax policy requires an explicit recognition of the political environment within which tax policy is made” (1999, 397). It requires an evaluation of both social and economic equity. Although many economists are reluctant to recognize it, they are well positioned to evaluate the political and sociological variables associated with competing tax policies and systems. The economics profession resides “at the boundary where efficiency and value considerations are difficult to keep apart” (Musgrave 1996b, 257). Perhaps economics is destined to play only a supporting role to politics in the formation of tax policy (Holcombe 1999). But it shouldn’t. Perhaps, too, the tools of economic analysis “can provide only limited guidance” with respect to the distribution of taxes (Sheffrin 1996, 324). But they don’t have to. If economists can “transcend what is usually defined as economics” (Musgrave 1985, 13), they will once again be able to apply their valuable analytical and empirical skills to creating a tax system more in line with the realities of tax policymaking and more reflective of tax justice as defined by the group that matters most in a democracy—the taxpayers.

Conclusion

Tax theorists like to say that horizontal equity provides the one basic rule of taxation on which everyone can agree. Nonetheless, vertical equity, not horizontal equity, animates the history of tax justice in the United States. Whether in the form of the property tax, the progressive income tax, or the estate and gift tax, Americans have preferred tax policies that regulate concentrations of wealth and privilege. Similarly, whether in the form of high exemptions, lower rates for earned income, or refundable tax credits for the working poor, Americans have desired a tax system that favors low-income individuals. This is not to say that lawmakers would (or should) consider raising marginal income tax rates to approximate levels of the 1940s or 1950s. It does suggest, however, that policymakers and theorists should facilitate public debates over progressive tax equity. Moreover, it indicates that policymakers and theorists should be explicit about what various tax schedules and tax systems mean—economically as well as morally—for all income classes.

Within the last 20 years, tax experts have adjusted their models to better simulate real-life tax policymaking. They assign greater weight to the social cost of income and wealth inequality, for example, and they allow for more egalitarian social welfare functions. While experts have become slightly more amenable to equity considerations, the taxpaying public has become more sensitive to efficiency concerns, particularly the costs of high marginal tax rates. Nevertheless, tax theory and tax practice remain separated. “Optimal taxation” for economists and tax theorists still subordinates equity to efficiency. “Optimal taxation” for the majority of taxpayers, on the other hand, sacrifices efficiency for the sake of equity and emphasizes progressive tax policies. Public perceptions of tax justice may have evolved with respect to specific tax policy instruments and the relative importance of efficiency concerns, but American taxpayers still prefer tax policies that reinforce egalitarian, progressive forms of equity.

NOTES

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1. For Roosevelt’s proposal to impose a 100 percent tax on all incomes above \$25,000, see Treasury Department, Division of Tax Research, Memorandum for the Secretary, “A Supertax on Individual Incomes above \$25,000,” May 1942; and Roy Blough,

“Comments from Harriss, Hewett, and Slitor on Super-Tax on Individual Incomes above \$25,000,” May 5, 1942; both documents in the Records of the Office of Tax Analysis/Division of Tax Research, Box 54, General Records of the Department of the Treasury, Subject Files, Record Group 56, National Archives, College Park, Md.

2. Vertical and horizontal equity are not mutually exclusive, of course. Improvements in horizontal equity can result in improvements in vertical equity, while losses in horizontal equity can create losses in vertical equity. Throughout the history of taxation in the United States, theorists, policymakers, and the public have recognized these relationships. For purposes of this chapter, however, unless otherwise indicated, “equity” is defined as the opposite of “efficiency” and indicative of societal norms involving morality, ethics, and social justice.

3. Not all modern-day economists ignore issues of equity and distribution. The welfare economics tradition, for example, makes distribution issues central to its analysis, and the optimal tax tradition measures equity issues alongside efficiency issues. Both groups of theorists, however, de-emphasize the social value of equality, theoretically as well as empirically.

I should emphasize that this chapter could not have been written absent previous research on tax equity and income distribution. Several contributions deserve especial comment: Slemrod’s individual research and a series of conferences on progressivity (Slemrod 1983, 1992, 1996, 2000; Slemrod and Bakija 2000); Blank (1997), Danziger and Gottschalk (1995), Ellwood (1988), and Wolff (1995, 1998) on income distribution and wealth inequality; Pechman (1985, 1990) and Bakija and Steuerle (1991) on progressivity trends, and Steuerle’s numerous written and professional efforts to increase progressivity at the bottom of the income distribution; Atkinson (1975, 1983) and Sen (1973, 1992) on liberal welfare economics and inequality; and the entire career of Musgrave (1959, 1989, 1992, 1996a). Despite these important contributions, economists generally consider equity issues as (1) qualitative matters about which their profession should say little; (2) measurable variables that, although important, should be subordinated to efficiency concerns when there exists an observable trade-off; or (3) salient only when they contribute to further efficiency gains.

4. Only 1.5 percent of households paid an income tax in 1913, and only 2 percent paid income taxes on average from 1913–1915 (Brownlee 2000; Witte 1985).

5. As Brownlee has shown, the term “soak-the-rich” taxation was a contemporary designation used in both the United States and England by critics of progressive taxation (Brownlee 2000).

6. For Roosevelt’s New Deal tax programs, see Lambert (1970), Leff (1984), Witte (1985), and Brownlee (1996). Of the four, only Brownlee and Witte perceive the radical nature of Roosevelt’s pre–World War II tax policy, and only Brownlee sees a commitment to soak-the-rich taxation. Lambert emphasizes Roosevelt’s moral commitment to ability-to-pay taxation, but does not consider New Deal tax policies as radical. Leff, for his part, sees only hollow, symbolic victories for the American people in New Deal taxation; Roosevelt’s tax reforms were all bark, no bite, according to Leff.

7. The balance of this paragraph relies heavily on Brownlee (1996).

8. For the legislative efforts to limit the taxing powers, see H.R. 8545, Ralph Gwinn (R-NY), *Congressional Record*, March 24, 1954, p. 3804; H.J. Res. 16, Frederic Coudert Jr. (R-NY), *Congressional Record*, January 5, 1955, p. 49; H.J. Res. 608, Ralph

Gwinn (R-NY), *Congressional Record*, April 23, 1956, p. 6809; H.J. Res. 171, Russell Keeney (R-IL), *Congressional Record*, January 1, 1957, p. 791; S.J. Res. 25, Everett Dirksen (R-IL), *Congressional Record*, January 1, 1957, p. 404; H.J. Res. 67, Noah Mason (R-IL), *Congressional Record*, January 3, 1957, p. 90; H.J. Res. 218, Overton Brooks (D-LA), *Congressional Record*, February 2, 1957, p. 1508; H.J. Res. 232, Clare Hoffman (R-MN), *Congressional Record*, February 2, 1957, p. 2062; H.R. 12879, Gerald Flynn (D-WI), *Congressional Record*, June 29, 1960, p. 15040.

9. The liberal supply-siders of the 1950s and 1960s should be differentiated from the conservative supply-siders of the 1970s and 1980s. The former group pursued policies that stimulated economic growth, but they also recognized the economic and social benefits of stability in the form of a progressive income tax, welfare transfers, unemployment insurance, and farm subsidies. The latter group of supply-siders pursued economic growth to the near exclusion of economic stability (except to the extent lower taxes stabilized investment planning for businesses and high incomes). They argued for reduced taxes on capital income, and they attacked programs that provided stability during economic upswings and downswings, such as the progressive income tax and welfare payments.

10. Musgrave was not alone in suggesting that the Kennedy administration had abandoned equity in advocating the tax bill. Economist Joseph Pechman, for one, noted, "In the hullabaloo over the tax reduction, the tax reform part of the package has been virtually forgotten" (1963, 20).

11. For practical purposes, TRA 86 created two tax brackets (15 and 28 percent). The 33 percent "bubble" bracket applied to only a narrow band of income.

12. The trend toward increased income inequalities between 1968 and 1998 stands in stark contrast to the period from 1947 to 1968. During this period, shares of before-tax income for families below the 80th percentile increased, while shares of before-tax income for the richest 20 percent of families decreased (Cohen 2000). Although researchers have discussed the effect of taxes on after-tax income inequality by comparing pre-tax income distributions with after-tax income distributions, they have spent less time trying to understand the effect of taxes on before-tax income distributions. It would be worth studying the relationship between taxes and before-tax income inequalities for each of the two distinct periods (1947–1968 and 1968–1998), particularly because decreases in before-tax income inequalities seem to be correlated to periods of high marginal tax rates while increases in before-tax income inequalities seem to be correlated to periods of low marginal tax rates.

13. The evidence presented in this section challenges George Stigler's conclusion that economists "exert a minor role and scarcely detectable influence on the societies in which they live" (1982, 63).

14. For government economists as political actors, see Stein (1986) and Nelson (1987).

15. According to a May 1999 poll conducted by the Council for Excellence in Government, many Americans still perceive an imbalance between government burdens and benefits. Forty-six percent of respondents felt they paid too much in taxes for what they received from government, while only 19 percent considered their taxes a fair price for the benefits they received. Cited in Bartlett (1999).

16. Slemrod and Venkatesh (1999) conclude similarly that Americans believe a flat tax would improve progressivity. Slemrod and Venkatesh also argue that most tax-

payers misunderstand the distributive effects of flat-tax proposals. My research supports these conclusions. Consider, for example, that a January 1996 Gallup survey revealed that 51 percent of respondents believed a flat tax would help middle-class Americans (Gallup 1997). The majority of flat-tax plans, however, most certainly redistribute tax burdens from wealthy taxpayers to everyone else, including the middle class.

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