Drew University

College of Liberal Arts

The Development of the Economic Recovery Tax Act of 1981

and

Its Implications for Income Distribution in the United States

A Thesis in Political Science

By

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Abstract

Income inequality in the United States has risen consistently over the past 40 years. This trend is characterized by income concentration in the top one percent of earners. Scholars have sought to pinpoint the primary causes of rising inequality often focusing on exogenous factors such as globalization and technological changes. This thesis, however, focuses on the ways in which domestic policy may have distorted income distribution, namely through tax policy. Given that the Economic Recovery Tax Act of 1981 was enacted precisely as the initial spike in top incomes occurred, it is explored as a policy that initiated the broader trend of rising inequality. It also is understood as one of the initial policies enacted under neoliberal ideological insights, which marks a notable change in policymaking away from interventionist policies. Through the use of qualitative and quantitative data, this paper traces the development of the Economic Recovery Tax Act of 1981 by reviewing the political and economic events, forces, and factors that led to its development and the rhetoric that accompanied its enactment. The conclusion offers evidence that this tax policy likely contributed to income concentration. In addition, this paper provides fruitful ground for further research regarding the relationship between tax policy and income distribution in the United States and, inherently, has implications for policymakers going forward.

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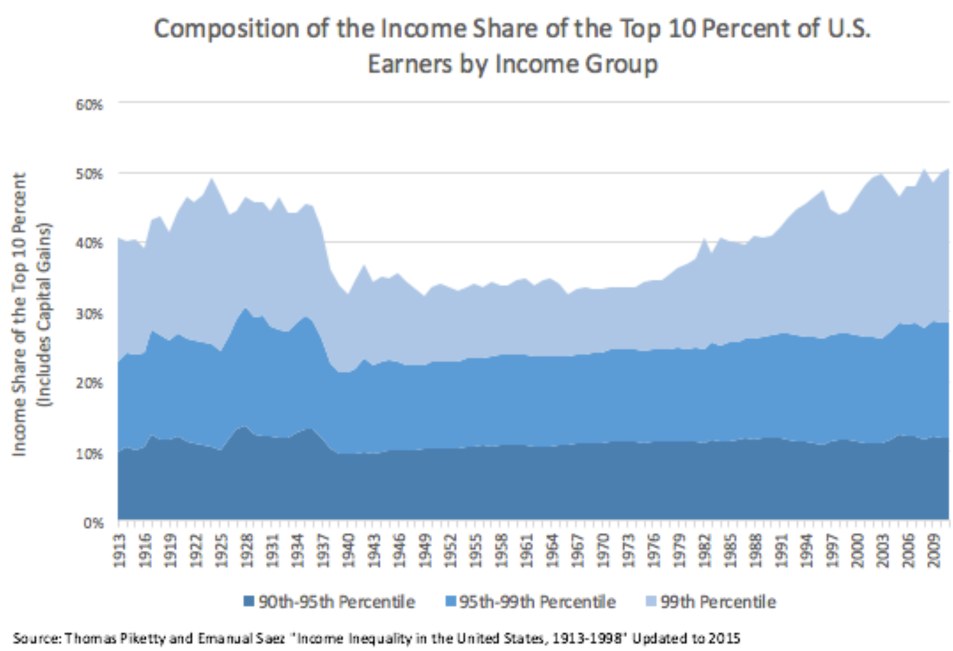
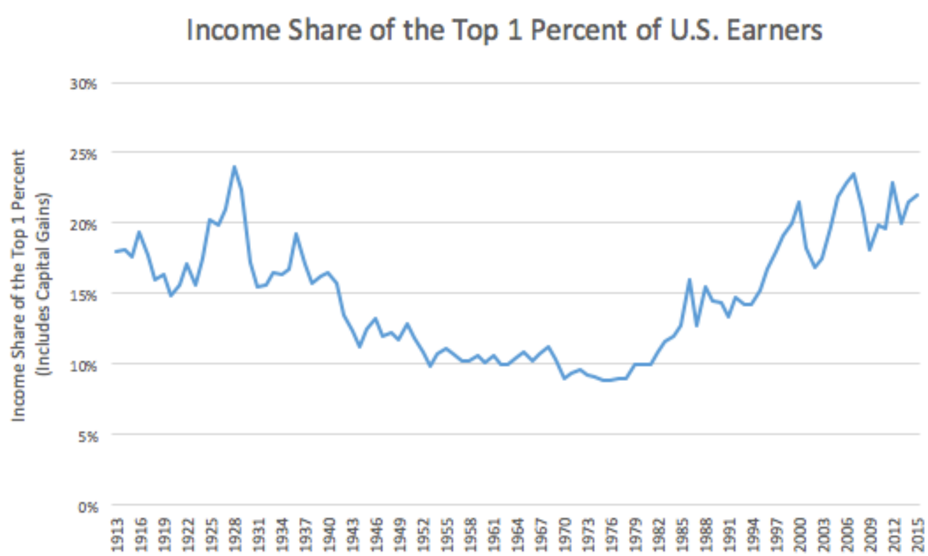
I. Inequality and Tax Policy

Income inequality in the United States has been rising consistently since the late 1970s. The rise in inequality is characterized by an unwavering upward trend which has included large surges in inequality during the 1980s. There is little evidence to suggest that this trend of growing inequality is reversing (Piketty and Saez 2003). This consistent rise in inequality primarily is a result of a growing gap in the income distribution, which has received scholarly attention since the 1990s. In recent years, this growing level of inequality has been drawing attention from the mainstream media, has directly and indirectly lead to populist movements such as Occupy Wallstreet, and is the underlying theme fueling the popularity of political figures such as Bernie Sanders.



An important feature of inequality in the United States is the large concentration of income at the very top of the income distribution. The earnings disparity is not between the top 50 percent of wage earners and the bottom 50 percent of wage earners.

Instead, the large gains in income are highly concentrated at the very top of the income distribution, specifically within the top 1 percent of income earners. Thomas Piketty and Emanuel Saez (2003) track the severe increases in inequality. The data these scholars compiled illustrate that the income share of the top 1 percent grew from 5 percent to 7.5 percent between 1970 and 1984. Between 1986 and 1988, their income share grew from 7.5 percent to 9 percent. Then in 1994, the income share of this same group grew from 9 percent to 11 percent (31-32). Overall, the income of the top 1 percent of income earners has increased from 8 percent to 18 percent between 1974 and 2007 (Hacker and Pierson 2010, 155). The gains in income have been even greater for the 0.1 percent. In the same period, their share of income has grown from 2.7 percent to 12.3 percent. Accordingly, the top .001 percent of income earners are generating 6 percent of national income (Hacker and Pierson 2010, 155).



Source: Thomas Piketty and Emanuel Saez, "Income Inequality in the United States, 1913-1998" Updated to 2015

The data illustrate that there was a critical event or change in the 1980s that initiated the rise in top incomes. Specifically, this trend seems to begin in 1981 and continue throughout the decade and beyond, so that the income share of the top 1 percent grew from less than 10 percent of total income to 15 percent of total income by 1988. Following the election of Ronald Reagan in 1980, there were a number of policies put into place that were fundamentally different from and, in many ways, in opposition to the type of policies enacted during the earlier post-war period. For this reason, analyzing policy changes that occurred around this period provides insight into what may have spurred the growth in inequality.

In the 1980s, historically unprecedented changes were made to the United States taxation structure. Notable pieces of tax legislation enacted during this decade were the Economic Recovery Tax Act of 1981 (ERTA), which included large across-the-board tax cuts and favorable treatment of capital, and the Tax Reform Act of 1986 (TRA), which included a major overhaul of the tax code. For the highest earners, the Economic Recovery Tax Act of 1981 and the Tax Reconciliation Act of 1986 reduced the income tax rate by over 40 percent. Additionally, the preferential treatment of capital gains and the incentivizing of capital accumulation were central tenants of ERTA. These central provisions signal a shift to policies that favor investment, risk, and accumulation. The treatment of non-wage, investment income evolved from being viewed as unproductive income during the early post-war period to being viewed as the foundation of a healthy economy. While both pieces of legislation are significant, the Economic Recovery Tax Act of 1981 is more pertinent to the distributional changes that occurred during this time because its development and provisions are indicative of the broader changes in policy-making that were to come. During the years following the enactment of ERTA, there are large surges in pre-tax income and post-tax income for the top 1 percent of income earners, which is a trend that has continued to persist to this day.

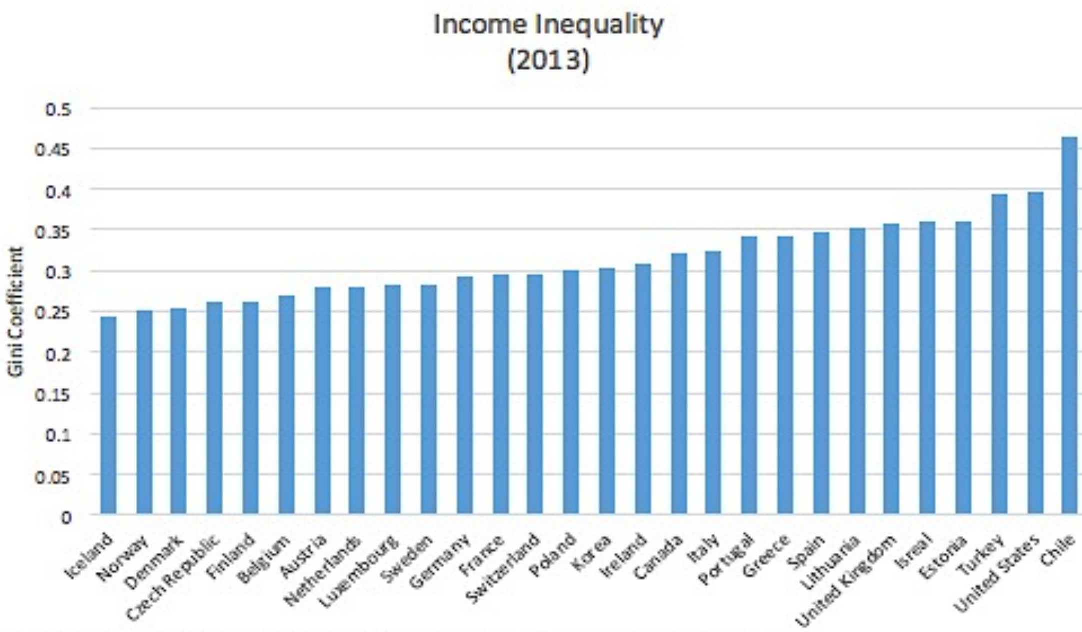
During the late 1970s and early 1980s, other policy changes also occurred in the United States that accompanied the changes in taxation. There was a renewal of the neoliberal ideology as the dominant policy-informing model, which was followed by a host of neoliberal policies. Neoliberalism is an ideology that emphasizes the efficiency of independent markets and seeks to reduce government involvement in economic affairs in order to maximize growth and efficiency (Albelda and Drago 2013, chapter 3). The policies that were implemented based on neoliberal insight during this time included liberalization of capital flows, deregulation of a number of sectors including finance, and changes in labor and regulatory policies. In addition, there was the development of "supply-side" policy, which also is aimed at promoting growth by creating policies that facilitate the accumulation of capital. The tax cuts discussed in the literature, most specifically the Economic Recovery Tax Act of 1981, were enacted based on the insights provided by neoliberal and supply-side economic models. The provisions of this legislation and the development of these provisions illustrate the changing political and economic thinking, which appears to have affected and continues to affect the allocation of income.

This shift in income to the very top of the distribution has numerous social, political, and economic consequences for the United States. It threatens the idea of equal opportunity, and ensures that there are unequal outcomes. The far-reaching effects of high income inequality have led to a number of questions regarding the origins of this pattern, its persistence, and ways in which to solve it. In order to understand the persistence of inequality and to properly formulate solutions, there must be a basic understanding of the origins of rising inequality in the United States following the post-war period. As evidenced by the graphical presentation of the trend, there was a critical juncture in the late 1970s and early 1980s which may have distorted the income distribution. For this reason, the primary object of analysis in the following discussion is the Economic Recovery Tax Act of 1981, and the various changes in the political climate, politics, and policy that contributed to its creation. In this analysis, the ERTA is understood as the initial piece of legislation that may have contributed to the redistribution of income to the top of the income ladder. An exploration of the creation of this legislation, its role in contributing to the election of President Reagan, and its various provisions shed light on both the changing political climate and the rise of neoliberalism as the primary policy-informing ideology.

Evidence of Tax Policy's Effect on Income Distribution

There were a number of changes that were made to the structure of not only the United States economy, but also the global economy during this period. Some argue that the broader changes to the global economy were the primary causes of top incomes rising. For example, scholars such as Autor, Katz, and Kearney (2008) and Gottschalk (1997) cite reasons such as changes in technology, trade and globalization, and returns to education as the primary drivers behind the bifurcation of the income distribution.

However, as noted by Alvaredo et al. (2013), there are a number of developed countries that have experienced similar changes, but not all have witnessed the rise in top incomes. In fact, there is quite a bit of variation in levels of inequality across high-income, Western countries. Therefore, the authors state, “different patterns of income inequality at the very top supports the view that institutional and policy differences play a key role in these transformations” (Alvaredo et al. 2013, 6).



Source: OECD (2017), Income inequality (indicator). doi: 10.1787/459aa7f1-en (Accessed on 15 February 2017)

One policy-related factor that has been explored by scholars as a possible cause for the variation in inequality is taxation. According to the literature there are a number of ways in which changes in the tax structure have been able to affect income distribution; these include changes in tax reporting behavior; changes in saving, labor, and compensation; and the allowance and even facilitation of income accumulation.

Hacker and Pierson (2010) assert, "[The] government actually has an enormous range of tools for affecting the distribution of earnings before taxes and benefits take effect" (169). The authors note that taxation is among the most effective ways that government can influence the distribution of income (Hacker and Pierson 2010, 182). They recall that the tax code was very progressive during the days of lower inequality with the top marginal tax rates fluctuating between 90 and 70 percent. The authors follow with the assertion that the changes in the tax code "account for roughly one-third of the total gains in income share for the top 0.1 percent in the last four decades" (Hacker and Pierson 184). Piketty and Saez (2003) argue that the decrease in the progressivity of the tax code since the 1980s combined with the possible repeal of the estate tax could lead to long-term distributional effects.

Bargain et al. (2015) also find that tax policy has an effect on income inequality. The authors suggest that "the size of the policy effect corresponds to 11% to 29% of the total change in income shares of different income groups" (Bargain et al. 2015, 1062). They state that the cumulative effect of tax reform between 1979 and 2007 had an impact on the incomes of the top .01% such that, of the 350% rise in their incomes, 18% of that increase can be explained by changes in taxation (Bargain et al. 2015 1075).

Alvaredo et al. (2013) establish the relationship between changes in the marginal tax rate and surges in top incomes by comparing the extent to which a host of developed nations reduced their top tax rate over a given period and the extent to which top incomes increased in each nation. They find that, for example, the United States reduced its top tax rate by 47 percent, which was followed by the 1 percent seeing an increase of 10 percent in their share of income (Alvaredo et al. 2013, 8). However, other nations such as Spain and Denmark which have not changed their top tax rates, or have done so to a limited extent, have seen little to no change in the income share of their 1 top percent of income earners (Alvaredo et al 2013, 8). Using data from OCED countries, the authors illustrate that there is a strong correlation between changes in the marginal tax rate and change in the income share of top earners. Feenberg and Poterba (2013) and Saez (2004) both note that, following the large tax cuts passed in the Tax Reform Act of 1986, there are significant surges in the incomes of the top 1 percent of earners. Similarly, following the Economic Recovery Tax Act of 1981 a few years earlier, there immediately was a spike in top incomes during the following years. Saez (2004) makes the claim that two percent out of the nine percent that the income share of the 1 percent has grown is a result of the changes in tax policies over the last several decades (Saez 2004, 149).

Feenberg and Poterba (1993) note that during the early 1980s, when the capital gains tax was lowered, there was a rise in realized capital gains. Saez (2004) asserts that the change in taxation laws led to the development of a completely different form of compensation. Saez states that wages at the very top have increased as a result of stock options, which are realized "only once every few years" (168). Accordingly, Saez (2004) and Alvaredo et al. (2013) assert that top incomes have high elasticities in regard to taxation, which means that top incomes are highly responsive to changes in the tax code. Saez (2004) recalls the change in per-dollar, after-tax income that resulted from the tax policy changes. In the 1950s and 1960s, one extra dollar would equal marginal gain of $.10 after taxes; then by the late 1980s, it rose to more than $.70 (118). He asserts that such a severe increase in the marginal tax rate results in changes in compensation and was a contributing factor to the rise in top incomes, especially top wage income. In Saez's (2004) analysis he asserts that the group that was most responsive to changes in the tax structure was the top 1 percent. Saez (2004) states, "the [income] elasticities increase sharply from .3 to 2.5 as we move up the wage income distribution" (161).

Alvaredo et al. (2013) add that the changes in the tax rates incentivized top earners to "bargain" for higher compensation (10). Saez (2004) notes that "the average real income of the top 1 percent has increased by 160 percent since the early 1970s [and]… it is striking to note that the top 1 percent incomes start increasing precisely in 1981, when marginal tax rates start going down. The jump in top incomes from 1986 to 1988 corresponds exactly to the sharp drop in that marginal tax rates from 45 to 29 percent" (142). Alvaredo et al. (2013) note that prior to the large tax cuts on top income earners, the "high marginal tax rates served" as a type of "surplus extraction," which curbed both pre-tax and post-tax inequality (10). Bryan and Martinez (2008) reference "The Great Compression" during the WWII period, which was a time when the government capped executives' compensation. This policy helped to limit inequality and, since it was repealed, executive compensation has grown. Bogenschneider (2015) notes that "the cumulative effects of regressive taxation on accumulated wealth are compounding and may, therefore, continue to increase relative inequality absent a structural shift in wages or other forms of income" (10).

Alvaredo et al. (2013) note that, contrary to the idea of supply side economics, which asserts that the economic growth spurred by the focus on capital accumulation will filter down to labor, there was not growth across the board following the implementation of these policies since the 1980s. Instead it seems as though the majority of growth has meant that "the increases in top 1 percent incomes now come at the expense of the remaining 99 percent" (10). Piketty (2014) notes that, in a study conducted by Emanuel Saez, Stefanie Stantcheva, and himself, they find that "elasticity with respect to luck – broadly speaking, the ability of executives to obtain raises not clearly justified by economic performance – was higher in countries where the top marginal tax rate was lower" (Piketty 2014, 512). He notes that the "optimal" tax rate for the highest income earners would be around 80 percent (512).

To reiterate, the concentration of income in the top 1 percent of earners is the defining characteristic of income inequality in the United States. The existing scholarship suggests that cross-country institutional and policy variations may explain much of the differences seen in levels of income inequality. One of the policies that has been explored by a number of scholars is taxation. Studies have found that changes in the tax structure have led to higher levels of inequality, which seem to result from a number of changes made in the tax code, instead of one specific provision. Therefore, a broad analysis of the Economic Recovery Tax Act of 1981 and its development will provide valuable insight into the general trend of income concentration in the United States since the early-1980s.

The Development of the Post-War Tax Structure

Prior to the World Wars, the taxation system in the United States differed in structure, purpose, and scope. The first income tax was levied during the Civil War, but was repealed thereafter (Pollack 1996). Then, in 1895, the Supreme Court determined in

Pollock v. Farmer's Loan & Trust Co. that the "direct" taxes proposed by the populist movement of the time were unconstitutional (Pollack 1996, 48). Less than two decades later, this ruling was overturned by the passing of the Sixteenth Amendment, which was followed by income tax legislation characterized by high personal exemptions and low marginal tax rates. From the early days of the peace-time income tax, it was not only a way to raise a relatively small amount of revenue, but it also served as a way to allay populist sentiments calling for greater equity (Pollack 1996).

Soon after, there was a fundamental change in taxation resulting from the World Wars and the Great Depression. It became necessary for the state to raise revenue in order to finance WWI and WWII. By the end of the Second World War, taxation changed from a way to promote equality and a source of revenue during wartime to what is often referred to as a 'mass tax' (Pollack 1996, 63). The taxing of the majority of Americans would be cemented with the Revenue Act of 1942 and, by 1945, more than 74 percent of Americans were paying income tax (Pollack 1996, 64). Pollack (1996) states, "revenue derived from the federal income tax has increased from $28 million in 1913 to $29 billion in 1945, during the height of World War II, to $587 billion in 1990, to a projected $781 billion for fiscal year 1996" (Pollack 1996, 10).

The shift in the nature of income taxation from a tax on the wealthy to a mass tax occurred following the Great Depression. In an attempt to end the Great Depression and prevent another from occurring in the future, the New Deal legislation was enacted. As is widely known, the New Deal legislation created a host of social welfare programs and regulatory policies designed to control business abuses, moderate cyclical effects, and prevent deep poverty. These policies applied during the Great Depression and thereafter followed the theoretical insights of economist John Maynard Keynes. His theory, typically referred to as Keynesian economics, suggests that instead of relying on the market to correct itself, the government should play a role in correcting the market in times of economic need and in moderating the negative effects brought about by the business cycle (Albelda and Drago 2013, 127). After the Great Depression, Keynesian theory was adopted by the Democratic Party; since the Democrats were in power for most of the post-war period, much of the policy created during this time was influenced by Keynesian insights. The institutional structure of the United States' government, by default, produces incremental policy-making that often is ideologically incoherent. Therefore, while much of the policies that were enacted in the post-war period draw from Keynes' ideas of government correction, there is never a purely Keynesian doctrine adopted. Since a number of Keynesian inspired policies were implemented following the Great Depression and World War II, by the 1940s, the majority of Americans were contributing into a larger federal structure that would characterize the post-war period. This period also happened to be the time during which there were relatively low levels of income inequality.

Previously, the federal government had limited involvement in matters of commerce, but by the 1940s, there was a general consensus that the federal government should assume an active role in directing the economy and producing equitable outcomes. More importantly, most of the public believed that structuring a strong economy while producing equitable outcomes was something that the government was capable of doing, which is a sentiment that eventually would change (Steinmo 2003, Michelmore 2012). Policies that were enacted during the post-war period included, but were not limited to, greater regulation, high and progressive taxation, income redistribution, and social security programs (Steinmo 2003). Taxation was a central tenant of the post-war policy regime due to the need to fund the social programs, the idea that taxes could be used as social and economic incentives, and the ability of the taxation structure to redistribute (Steinmo 2003). Pollack (1996) cites Ronald King, who stated, “Public finance increasingly became an arena devoted to government efforts at non-zero-sum macroeconomic regulation, and taxation was thus transformed into an instrument promising class coordination, not polarization” (12-13).

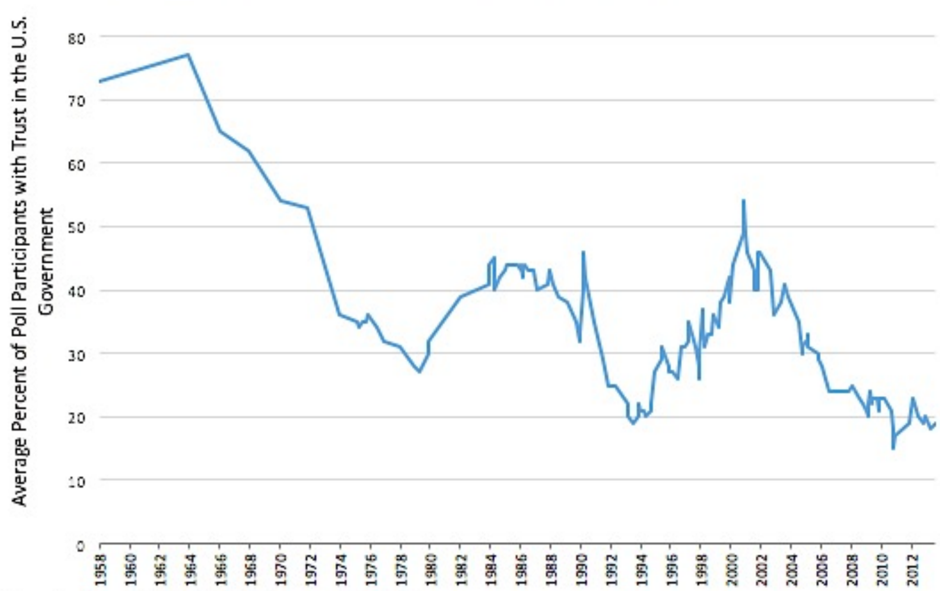
The adoption of this perspective is most obviously illustrated by the Great Society program enacted under Lyndon B. Johnson. This program enacted in 1965 called for government action on a number of pressing social and economic items including “aid to education…development of depressed regions, [and] a wide-scale fight against poverty” to name a few (“Lyndon B. Johnson”). While Johnson was a Democrat, the Keynesian insights were not limited to the Democratic party. The mentality that the government had the duty to work as a force of its own within the economy and trust in the government’s ability to do so was present to varying degrees in both political parties. In fact, despite the Republican tendency to favor the classical or neoclassical approach, in 1971, Richard Nixon stated that he was “a Keynesian in economics” (Chicago Tribune 1). During his Presidency, Nixon even introduced a Family Assistance Plan that would extend cash assistance benefits to working poor families (PBS). These policies and others that were enacted during the post-war period tried to ensure a fair balance of power between capital and labor and shared economic growth. This led not only to anti-poverty programs and social insurance, but also led to a proliferation of business-specific, and wide-ranging regulatory policies, which rapidly increased during the mid-1970s. This further expanded the size, scope, and complexity of the state.

By the late 1970s and early 1980s, there was a swift shift in the intellectual approach to governing and policy making as a result of two primary factors that gained force roughly around the same period. The first factor was the unfavorable economic conditions of the late 1970s, which contributed to public unrest and feelings of disenchantment with the federal government. The second factor that largely facilitated the shift in thinking was the well-funded agenda to disseminate neoliberal thinking that favored the reduction of the size and activities of government, which provided apathetic American voters with an alternative to the reigning doctrine.

II. The Anti-Government Crusade

During the 1970s, there was high, persistent inflation coupled with low economic growth, known as stagflation, and rising unemployment (Prasad 2012). In light of the proliferation of regulation and worsening economic conditions, there was growing disaffection with the government across most political factions. For the general public, the post-war “mass tax” increasingly became a larger and larger burden during the period of high inflation as a result of “bracket creep” and, for the business community, the ominous government presence in most matters of the market was unfavorable. In addition to a multitude of economic grievances, trust in the government for social and political reasons had been rapidly declining. Nixon's Watergate scandal was a vital force propelling public trust to new lows.

Decline in U.S. Public Trust in Government (1958-2014)



Source: Pew Research Center "Public Trust in Government 1958-2015"

The stirring of these anti-government sentiments led to both populist and business-oriented movements to limit the imposition of government into each's respective economic realm. This was representative of a broader trend that was occurring to limit government's role. This trend gained traction as the government continued to implement a greater number of policies and regulations. The general movement called for a change away from government involvement in the economy and toward both a greater focus on the market's growth potential and a greater trust in the market to dictate where capital was to flow. As opposed to trust in the government, the neoliberal theory is rooted in greater trust in the market to ensure growth and job creation and to decide the distribution of capital and the balance of power within the economy. The first major piece of legislation that sharply redirected economic policy toward a neoliberal approach to fiscal policy was the Economic Recovery Tax Act of 1981. This legislation consists of provisions that directly respond to the discontent expressed by the business community and the public. Overall, the legislation rather explicitly conveys the newfound trust in the private sector and the general estrangement with the public sector.

While the creation of ERTA sometimes is characterized as an exclusively populist success, the discussion of a movement towards lower taxation and less government involvement would be incomplete if the more powerful actors involved in the broader movement were excluded. It also would be incorrect to characterize the general shift towards liberalized economic policies to be solely a result of powerful interests. The interaction between public dissatisfaction and business's ability to frame and disseminate information through think tanks and policy institutes, in a way that resonated and was congruent with the frustrations of the public, provided the foundations for major policy changes.

The Rise of the Business Community

Following the implementation of numerous regulations during the 1970s, there was a concerted effort by the business community to change the ideological paradigm from the post-war government-interventionist policies in which the legislation of the 1960s was firmly rooted, to a market- oriented policy approach (Akard 1992 and Pollack 1996). This market-oriented approach followed the implementation of a number of costly regulations that were put into place. Between 1965 and 1975 there were "more than 25 major pieces of federal legislation enacted," all of which increased regulation. Due to the proliferation of this legislation, between 1970 and 1975, there was a subsequent increase in "federal regulatory personnel," from 9,707 to 52,098 individuals (Akard 1992, 601). This increase also led to higher expenditures, according to Akard (1992), who states that the federal government multiplied its regulatory spending by five during this period (Akard 1992). The incurring of additional costs as a result of this proliferation of regulation was not limited to the government; higher costs also affected businesses whose ability to maximize profits suffered due to the overarching government presence. Additionally, in contrast to earlier legislation that was enacted prior to the 1970s, the later regulatory legislation was not industry-specific. The new regulations largely affected all industries (Akard 1992). These changes helped ignite the political organization of various factions within the business community who shared the opinion that the government was weighted unfairly against general business interests. This point is especially poignant when one notes that there were originally a greater number of labor political action committees (PACs) and lobbyists in the early 1970s, and by the late 1970s, the number of business PACs and lobbying firms largely out-numbered them. For example, "the number of corporate PACs increased from under 300 in 1976 to over 1,200 by the middle of 1980" (Hacker and Pierson 2010, 176)

Numerous accounts have cited the success of the business community during the 1970s and 1980s at mobilizing public support around a number of conservative agenda items. This success was a result of the business community's ability to cohesively streamline information and capitalize on the public discontent with government, resulting from events such as Watergate and high inflation. Conservative think tanks such as the Heritage Foundation, the American Enterprise Institute, and the Manhattan Institute were funded by wealthy private investors such as Charles Koch, Joseph Coors, and Edwin Noble as a way to offer an intellectual alternative to the Keynesian-influenced economic policy that had led to high taxation, robust social programs, and increased regulation (Alexander and Jacobsen 2008). Through these think tanks, the business community was able to disseminate to the public information regarding the neoliberal approach to governance.

The business community not only created policy think tanks for the purposes of influencing the public and the government, but also involved themselves directly in politics (Akard 1992). For example, there was no business organization with greater influence than the Business Roundtable, which still exists to this day. The Roundtable was notable during this time because it was considered to be an atypical business organization due to the noteworthy composition of its members and the scope of its activities (Akard 1992). The Roundtable consisted of the CEOs of most major corporations and took a more active role in disseminating ideological views (Akard 1992, 602). This and other business-oriented groups would form coalitions to promote their interests. Akard (1992) notes, "This combination of the Business Roundtable, broad-based business groups, and ad hoc coalitions formed a powerful organizational base for pro-capital political mobilization by the end of the 1970s" (603). Issues for which they pursued these pro-business changes in legislation included regulation, taxation, and labor (Akard 1992).

In the area of taxation, an especially influential coalition of business organizations was the Carlton Group. This coalition of business interests consisted of members of other pro-business groups such as affiliates of the Business Roundtable, the American Council for Capital Formation, the Committee for Effective Capital Recovery, the NAM, the USCOC, and the NFIB. The Carlton Group was founded in 1975 and expanded in 1980 through the inclusion of the American Business Conference (Akard 608). The purpose of the group was to meet in order to streamline business positions on taxation in particular. The group was invited by Representative James Jones (D-OK) and Representative Barber Conable (R-NY) who served on the House Ways and Means Committee to discuss ideas for taxation that would allow for greater growth. The ideas that were brainstormed in this meeting would eventually become the foundations for supply-side tax legislation, which would be adopted only a few years later (Akard 608). Through this, the business community developed the ideas for the accelerated cost recovery provision, which incentivizes the purchasing of capital with the goal of increasing productive activity. The wide-spread increase in productive activity, in theory, would increase growth. The cost recovery prescription that was created by this group eventually would be included in the final Economic Recovery Tax Act legislation. Akard (1992) states, “The Carlton Group lobbied for the ACRS proposal from early 1979 until its passage as part of the Economic Recovery Tax Act in 1981” (608).

The Development of the Populist, Anti-Tax Reaction

Due to the fact that the public was vocal regarding their disaffection with the current system of taxation, the changes in the 1981 tax legislation at times are characterized as the product of successful grassroots effort. However, it is unlikely that the movement toward lower taxes was an exclusively grassroots movement, although a number of scholars such as Prasad (2012) view it in this light. It is unlikely that it was solely a grassroots movement because tax policy is a type of policy that is often considered to be an 'electoral blind spot' due to the complexity of the legislation (Hertel-Fernandez and Skocpol 2015, 237).

For example, there were systems within the tax system that proved difficult for Congressional members to reconcile with such as Alternative Minimum Tax, which was created to ensure that households that received preferred types of income such as capital gains paid a minimum level of tax (Tax Policy Center). It originated in the 1960s as an add-on tax after it was reported that high income individuals paid no tax, and it was changed to the alternative minimum tax in the Revenue Act of 1978 (Tax Policy Center). Pollack (1996) notes that, in the 1960s, legislators just "grafted [the ATM] into the 'regular' federal income tax regime," which he concludes gave the public the perception that tax evasion was being combatted, while simultaneously appearing to give preferential treatment to various forms of income (Pollack 1996, 78).

Due to congressional avoidance of political trade-offs, there frequently have been conflicting systems and covert provisions in the tax system. In addition to this complex nature of taxation, the tax code changes quite frequently. In the 1960s, there were five pieces of tax legislation enacted: the Revenue Act of 1962, the Revenue Act of 1964, the Tax Adjustment Act of 1966, the Revenue and Expenditure Control Act of 1968, and the Tax Reform Act of 1969 (Tax Policy Center). This was in addition to much of the public experiencing changes in their tax bracket as a result of bracket creep. Therefore, it is not impossible, but improbable, given the complex and mercurial nature of tax policy, that the strength and success of the tax reform movement was solely or originally a grassroots effort.

With that said, during the 1970s, there was a growing notion that the tax structure was unfair. The middle class was among those who lacked sufficient resources to fully take advantage of the tax code. Therefore, they felt as though they were bearing much of the tax burden. Added to the sense of unfairness was the fact that the high levels of inflation were causing “bracket creep” (Prasad 2012, 354). Bracket creep is a result of inflation; when inflation causes incomes to rise, it pushes taxpayers up into the next tax bracket. Bracket creep was problematic due to the fact that the incomes of taxpayers were rising in nominal terms rather than in real dollar value, which resulted in a higher tax rate on an unchanged or even lower level of income. During this time, income taxes were growing at twice the rate of “food, housing, and transportation” (Michelmore 2012, 720). Since inflation reached all-time high levels during the late 1970s, bracket creep was felt poignantly among the public. This combination of events led to a number of popular movements to cut taxes. As early as 1971, millions of taxpayers had joined grassroots organizations to encourage tax reform. There were over two million individuals that had joined roughly 2,300 protest organizations by this time (Michelmore 2012, 715). In 1973, a group of organized anti-tax advocates in California staged a Boston Tea Party reenactment in protest of rising property taxes (Michelmore 2012, 713). As inflation continued to rise, popular movements gained momentum.

III. Politics and Origins of ERTA

Partisan Struggle for Issue Ownership

As movements for tax reform developed, so did liberal and conservative factions. These factions were related to the Democratic and Republican struggle for ownership over the issue of taxation. On one hand, liberal activists such as George Wiley pushed for tax reform, while still maintaining the support for welfare programs. As early as 1966, he drew attention to tax benefits that were enjoyed exclusively by corporations and the wealthy, leaving out average American families. Wiley created the Movement for Economic Justice and, within that organization, created the Tax Justice Project in 1973 (Michelmore 2012, 717). In contrast to the left-wing or liberal perspective, which viewed corporate tax evasion as the reason for the burden on the "average" taxpayers, many middle class Americans increasingly viewed themselves as losing money because of social and economic programs rather than as the beneficiaries of them (Michelmore). Therefore, their strongest grievance was not in regard to the ultra-wealthy, but rather in regard to those individuals receiving government benefits who they believed were unjustly taking their money. This feeling of carrying the burden of social programs was especially poignant in regard to welfare programs for low-income households (Michelmore 2012, 710).

There was political rhetoric that developed in the 1940s regarding the type of people who benefited from social welfare programs. Despite the fact that many welfare programs were beneficial to the sustainment of the middle class, individuals who benefited from welfare programs were typically characterized as "prostitutes," "irresponsible parents," and "bums" who used government benefits for "luxuries" such as seafood, drugs, and alcohol (Michelmore 2012, 712, 720). Many saw social programs as ineffective, and the opposition to these programs grew as economic conditions failed to rebound. Taxpayers viewed the social welfare system as the driver of higher taxation (Michelmore 2012). Given that the robust welfare programs such as the New Deal and the Great Society were Democratic programs, the Republicans quickly capitalized on the waning support for these and similar programs. Since taxation is a policy blind-spot, middle class taxpayers failed to recognize that there were welfare programs embedded in the tax structure that heavily benefitted their demographic. These tensions only increased in the post-civil rights era, which was when Nixon successfully took advantage of the tense political climate of the time and crafted "the silent majority." This assignment of much of the white middle class as the "silent majority" also was a decisive factor in the Democratic and Republican struggle for ownership over the issue of taxation.

As it became more apparent that the general opinion was leaning toward changes in taxation, both the Democratic and Republican parties fought for ownership. In other words, both parties sought to assimilate the issue of taxation into each of their respective platforms. The Democrats intended to gain the support of tax reform advocates on the left by focusing on the sentiment that the tax system was weighed in favor of the rich as Wiley suggested. An initial step taken by the Democratic side to assert ownership over taxation was executed by Lyndon B Johnson's administration. In 1969, the Treasury Department under this administration compiled a list of what were called "tax millionaires," or individuals who were able to utilize the tax system in such a way that they paid minimum or zero taxes (Michelmore 2012, 714). Following the release of this list, the Democratic Party continued to try to attract the "anti-corporate welfare" taxpayers (Michelmore 2012, 715). The way in which the Democrats sought to reconcile their pro-welfare policies and tax cuts was by assuring voters that, once all of the perceived unfair loopholes were closed, the welfare programs would be able to be paid for with the money of high income and wealthy individuals instead of the middle class (Michelmore 2012).

In addition, during the 1972 presidential campaign, Democratic nominee George McGovern attempted to capitalize on the anti-corporate sentiment. He did so by stating that it is unfair for the tax burden to be on the middle class while the wealthy are able to avoid paying a basic level of taxes. He failed at his effort to make tax fairness part of his platform, but continued to try to frame taxation as a Democratic issue. He and other Democratic congressmen planned National Tax Action Day in April of 1973, in which there was an effort to bring attention to loopholes in the tax system (716).

Despite the leftist movements for tax reform and the Democratic Party's attempt to assert issue ownership, the Republican Party ended up the victor in this struggle. This failure is frequently attributed to the Democratic Party's association with robust welfare programs, which had become inextricably linked to taxation and, worst of all, high inflation. The Democrats ceased to try to own the issue of taxation. At this point in time, the public lacked the faith in the Democrat's approach to governing and in the government's ability to deal with matters of the economy. This only encouraged anti-tax sentiment even further given that the decrease in taxation would sharply limit the government's capacity (Michelmore 2012).

From the beginning, the Republican party had the upper hand in this fight for issue ownership since they had earned the reputation for sound economic policy. This occurred despite initial hesitation by some traditional conservative members to incorporate tax cuts into the Party's platform, which historically consisted of balanced budgets, lower spending, and greater consumer savings. Initially, Richard Nixon, like many traditional Republicans, was against the idea of tax reform in the form of tax cuts, especially because he sought to extend a new welfare program to the middle class. The political pressure he received from the Republican party changed the direction of his administration. By the time reelection came around, Nixon was in favor of utilizing the issue of taxation for his campaign (Michelmore 2012). He was advised by Buchanan to make a decisive blow to McGovern's attempt to absorb anti-tax reformers; he advised that Nixon "force the Democrats to 'choose between the working class… and the welfare class,'" effectively dividing the Democratic Party's base (Michelmore 2012, 721).

It was around this time that the beginning of the fundamental shift in Republican policy towards taxation occurs, which was largely due to the popular approval of recent California tax movements. However, at this time, the Republican party was still far from where it would be less than a decade later. While there were shifting tides, Nixon was still functioning within institutions that favored interventionist policies. Even when there was rising inflation in 1971, Nixon still sought to maintain the Keynesian balance between business and labor (Alexander and Jacobsen 2008). Alexander and Jacobsen

(2008) state, “Nixon not only refrained from attacking labor, he even announced that he was a Keynesian too” (Alexander and Jacobsen 2008, 293). While Nixon came around to the idea of tax reform, he did not push for the type of major tax reform the would be enacted under the Reagan administration.

Once the majority of Republicans were on board, the Party succeeded in establishing ownership over the issue of taxation by framing the economic issues of the time as a result of the Democratic Party’s choices. The rhetoric on taxation played on the frustrations of the middle class caused by the civil rights movement, the war on poverty, and social welfare, which was concurrently framed as a program through which the middle class funded illicit and irresponsible activity (Michelmore 2012, 721). Through the use of rhetoric such as Reagan’s sentiments about “welfare queens,” the Republicans shaped the discourse around social spending (Alexander and Jacobsen 2008). The rhetoric continually utilized by the Republican party and their ability to frame both tax cuts and reduced social expenditures as an issue of hard work and fairness allowed them to form a winning coalition.

As a result, the conservative movement that was gaining traction was able to not only frame social spending as a burden that was falling on the middle class and causing inflationary effects, but it also was able to frame welfare programs as creating disincentives for work because of both the tax burden and the free rider effects of social spending. The Republicans successfully argued that the high level of government spending was the primary reason for high inflation and that government welfare was a disincentive to work, which caused individuals to be unproductive. The Republicans framed this “unproductiveness” as the reason for the slow growth of the economy (Béland and Waddan 2015). By creating a rational argument for the causes of stagflation, appealing to the public’s frustrations with high taxes, and affirming the belief that welfare was creating a free rider system in which the burden fell upon the working class, the Republicans easily won issue ownership.

The evolution of Republican ownership of the issue of taxation is important for understanding the Reagan Tax Cuts, specifically the Economic Recovery Tax Act of 1981, and the current ideology of the Republican Party. Some scholars say that this policy was transformative for the Republican Party because it changed the party’s association from fiscal conservatism to a party of tax cuts (Prasad 2012, 353). While that is true, this policy marked an even greater shift. The ERTA was the initial policy of the neoliberal policy regime that was to be implemented and consolidated throughout the next several decades, which would ultimately debilitate the government’s ability to intervene in certain economic matters such as income distribution.

Ideological, Intellectual, and Political Support for ERTA

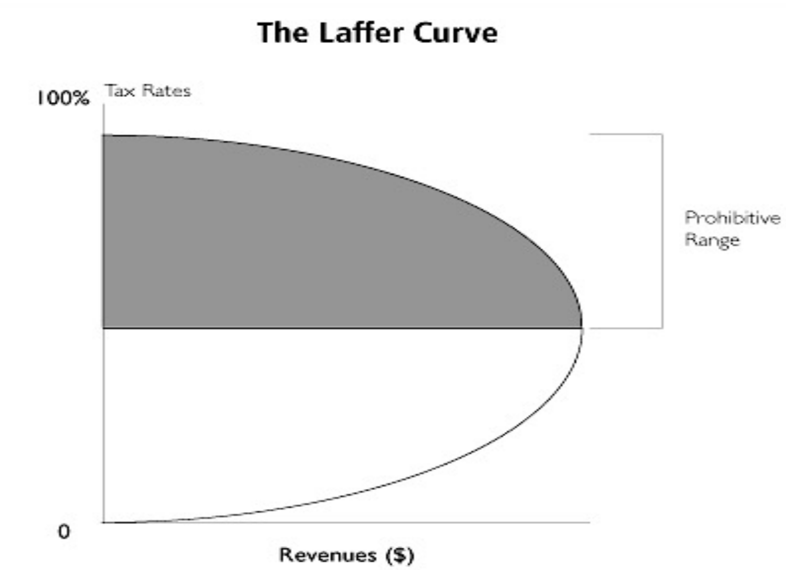
The development of the 1981 tax legislation has its origins rooted in a number of political, ideological, and intellectual arguments and assumptions. There are three concepts, specifically, that were integral to the development of the tax cuts. The most fundamental concept is taken from Treasury Secretary Andrew Mellon, who was the initial champion for reducing post- WWI taxation levels during the 1920s. This was a part of the neoliberal thinking of Mellon, which shaped the Republican economic ideology throughout the 20^{th} Century. The more contemporary influences on Reagan’s

1981 tax legislation included the Laffer Curve, a theoretical model developed by Arthur Laffer, and the Kemp-Roth tax proposal, proposed in 1977, which was largely based on the logic of Laffer (Prasad 2012). The intellectual argument provided by Laffer provided the substance needed to support the type of large-scale tax cuts that Kemp and Roth originally would propose in the later 1970s. These tax cuts eventually would be included in the ERTA. Following the development of tax movements and the passage of tax legislation in various parts of the country such as California's Proposition 13, which was a 1978 "ballot measure that dramatically reduced and limited property taxes," Reagan seized this opportunity to make tax cuts a central tenet of his campaign (Berman and Pagnucco 2010, 358). His approach to tax cuts was informed by these key insights.

The ideological framework informing the Economic Recovery Tax Act of 1981, which can be understood as a market idealist vision that has been most vigorously pursued by the Republican party, has its contemporary origins in the early 20th Century. This ideological assertion about the way in which the world works is based on neoliberal assumptions. The development of this ideology, in its contemporary form, is frequently attributed to Andrew. W Mellon who was the Treasury Secretary under President Warren Harding (Pollack 1996). Following the conclusion of World War I, Mellon sought to restructure the tax code as to return it to its pre-war format (Pollack 1996). In an address to Congress in April of 1921, Harding stated, "I know of no more pressing problem at home than to restrict our national expenditures within the limits of our national income, and at the same time measurably lift the burdens of war taxation from the shoulders of the American people" (Pollack 1996 citing Harding 58). Up to this time, while there were higher taxes to fund the war effort, taxes were not used as a means to redistribute income or fund social programs. Widespread support for more active federal government policies, which requires the type of increased state revenue that can only be derived from a robust individual tax structure, did not develop until the mid-1930s (Pollack 1996).

The overarching idea of Mellon was to reduce the capacity of the federal government, which had grown as a result of the war, and to return to the kind of free-market paradigm to which the United States had adhered up to that point in history. For this reason, Mellon referenced his proposal as returning to “tax normalcy” (Pollack 1996, 58). The origins of this ideological stance are important because it sets precedent for the type of legislation the Republicans sought to pursue. As will be discussed below, the tax cuts enacted under Mellon are cited by Representative William Roth (R-DE), one of the key actors who created the large individual tax cut, as a successful example of lowering taxation for the improvement of economic conditions. Given the political climate at the time, this argument was important. By the end of the 1970s, even Democratic President Jimmy Carter stated that “government cannot solve our problems,” illustrating the movement toward Mellon’s neoliberal perspective across the entire political spectrum (Alexander and Jacobsen 2008, 286).

Intellectual support for the tax legislation was provided by Arthur Laffer an economics professor who was working at University of Chicago at the time (Laffer). Some consider Laffer’s model to be a form of credible intellectual support for the type of supply-side tax cuts and incentives embedded in the 1981 tax legislation, while others note its political utility. Either way, Laffer’s theoretical framework was integral to the development of ERTA. In 1974, Arthur Laffer created what is known as the Laffer Curve. The Laffer Curve is an economic model depicting optimal tax rates along a curve. Along this curve, tax revenue decreased to suboptimal levels at both high tax rates and low tax rates. The idea was that high tax rates served as a disincentive to work and caused low productivity. Since productivity was low, individuals earned less income and there was less money raised through income taxation. The bottom half of the curve was a bit more intuitive. When taxes were too low, the government would not raise a sufficient level of tax revenue. To sum it up, when tax rates were too high or too low, the government would not raise the optimum level of tax revenue, but this could be corrected by raising or reducing tax rates (Prasad 2012).



Arthur Laffer. *The Laffer Curve*. 1974. "The Laffer Curve: Past, Present, and Future." *The Heritage Foundation*. 1 June 2004.

Arthur Laffer explains his concept in an article for the conservative think tank, the Heritage Foundation. He states, "If the existing tax rate is too high—in the 'prohibitive range' shown [above]—then a tax-rate cut would result in increased tax revenues. The economic effect of the tax cut would outweigh the arithmetic effect" (Laffer). As discussed, there was general consensus among the business community and the public that taxes were too high; accordingly, the logic then followed that lowering taxes would have the effect of creating more revenue (Prasad 2012). As will be discussed further, the extent to which the ERTA reduced the federal government's capacity through the revenue limitations it created provides evidence that the logic of the Laffer Curve was little more than a political tool.

When Laffer debuted this diagram in 1976, few took this idea seriously. While there were many economists who were in favor of the more general shift toward neoliberalism, most questioned the veracity of the Laffer Curve. Some went as far as to refer to Laffer as a "propagandist" (Prasad 2012, 369). However, Laffer found an ally in Jude Wanniski who was an associate editor of The Wall Street Journal. In 1978 Wanniski published an article entitled, "Tax, Revenues, and 'The Laffer Curve,'" which not only helped to spread the idea of the Laffer Curve, but also coined the term (Laffer). Wanniski advised that the Republican Party needed to concern itself less with deficits and matters of fiscal soundness and adopt a pro-tax cut platform as a way to garner political support (Michelmore 2012). Wanniski also introduced this concept to Congressman Jack Kemp who would later reach out to president Ford in an attempt to outline a plan for Republican consolidation of the issue (Prasad 2012).

Prior to Reagan's presidential campaign and presidential election, there were several congressional members working toward tax cuts. The most notable actor in this Republican push was Representative Jack Kemp (R-NY). Originally, Kemp had been pushing for business tax cuts around 1974, but the evolution of populist anti-tax movements redirected his efforts. Inspired by the logic of Arthur Laffer, Kemp was convinced that a broad tax cut would be the best way to address the current economic climate (Prasad 2012). Kemp and his fellow congressman, William Roth, attempted, but failed, to pass legislation with a 30 percent cut for individuals in 1977. This would be the predecessor to the individual tax cuts inserted in the Economic Recovery Tax Act of 1981 (Prasad 2012, 358). This legislation is referred to as the Kemp-Roth tax cuts, both in its original form and in its ERTA form. Kemp's plan involved the following: "Let the Democrats be the party of deficit spending. We are the party of lower taxes. Let the Democrats be the party of quick fixes and more government jobs. We are the party of private enterprise. Let the Democrats be the party of inaction. We are the party of a sound dollar" (Prasad 2012, 356).

Kemp and Roth were able to take advantage of a unique time in policymaking history. Watergate changed the way legislation was introduced. For much of the post-war period, tax legislation was dictated by Representative Wilbur Mills (D-AR) who was the chair of the Ways and Means Committee, which is the committee in the House that possesses jurisdiction over tax policy (Pollack 1996). According to Pollack (1996), some of the reforms that occurred following Watergate affected "most particularly the Ways and Means Committee and the seniority system" (Pollack 1996, 165). This opened up room for what are considered "policy entrepreneurs" such as Kemp and Roth. Since the tax legislation process no longer was dictated by the senior congressional members, and more specifically Mills, the policy making process now allowed for Jack Kemp and

William Roth to introduce their, at first, radical tax proposal. This proposed tax plan eventually would be the central component of the Economic Recovery Tax Act of 1981.

William Roth, one of the co-sponsors of the Kemp-Roth individual tax cuts, illustrates the ideological shift that was occurring in his article about the individual tax cuts contained within the Economic Recovery Tax Act of 1981. In this article, he explains the ideological foundations of the Kemp-Roth tax proposal. In the process of justifying the large tax cuts, Roth addresses the issue of unfairness, which was a major motivation behind the public support for tax cuts. As mentioned, there was a political struggle for issue ownership, which included the ability of the parties to define what fairness meant. The Democrats put forward an image of fairness as one of equity, while the Republicans offered a take on fairness that defined it as an adversarial issue between hard work and free riding. The approach offered by Roth was extremely successful because, at this point in history, many middle class individuals felt that they were working hard and playing by the rules, but also felt that they were losing economic and political ground to individuals who were taking advantage of government protections. He states that if it had not been for the tax cuts the “average” family would pay $1,500 more in taxes annually (Roth 1990).

Roth argues that the problem with the critics of the tax cuts is that they do not actually have a problem with taxation, but in reality have a problem with individuals making different levels of income. Roth states that “This is the ‘equality of outcomes’ concept of fairness, in contrast to the ‘equality of opportunity’ concept of fairness to which most Americans adhere” (Roth 1990, 61). He follows this observation with the assertion that income redistribution will cause economic decline and lower the standard of living in the United States. He also states that supply side taxation cuts are necessary to “provide tax incentives for investment, entrepreneurship, and risk” (Roth 1990, 61). In accordance with the fiscal proposal from Reagan that calls for the private allocation of resources, the logic behind Kemp-Roth tax cuts as explained by Roth calls for a trust in free markets and a disregard of redistribution as a goal of tax policy and as a responsibility of government (Roth 1990).

The ideology presented by William Roth is congruent with Ronald Reagan’s own positions. Ronald Reagan consistently had been a proponent for reducing government spending and cutting welfare programs. Reagan also was in favor of cutting taxes, but much of his early rhetoric focused on topics such as “welfare queens” (Michelmore 2012, 726). Following the growing popularity of tax reform, Reagan and other politicians took note and adjusted their positions on the issue. This was especially true following California’s tax protest in 1977 and the popular passing of Proposition 13 in 1978. Reagan was quick to incorporate taxation as a result of these measures and, by 1978, tax cuts were a central focal point of his campaign (Prasad 2012). Having been rejected by the Ford administration, the tax legislation proposed by Roth and Kemp was utilized as a policy framework that would be enacted if Reagan were to win (Prasad 2012). During this period, there was a swift transition in the Reagan campaign strategy. Prasad notes than an “observer” stated ‘pushing tax reform for blue-collar workers has replaced flogging welfare recipients’ (Prasad 2012, 361).

Jack Kemp would prove to be an influential actor in the Republican Party, eventually running alongside Senator Bob Dole (R-KS) as Republican Vice Presidential nominee in the 1996 Presidential election. Early on, Reagan recognized his potential (Jack Kemp Foundation). As Reagan took note of the support for tax cuts, he made them, and Jack Kemp, a key part of his campaign. Reagan recognized Kemp as a key player because of his leadership in what would eventually become the Economic Recovery Tax Act of 1981 having cosponsored the original individual tax cuts with Roth. In addition, some accounts assert that the decision to integrate Kemp into Reagan's campaign was a strategic move to prevent Kemp from becoming a possible threat (Prasad). Following the presentation of the Kemp-Roth tax cuts, Reagan invited Kemp to work with him on the campaign trail. Kemp's main position was to encourage the support for the tax cuts. In trying to reconcile his proposed tax policy with Republicans' distain for budget deficits and its possible impact on inflation, Kemp offered the supply side theory of income tax cuts to which the Laffer Curve is part-in-parcel. Kemp states, "'cutting tax rate of income has a supply-side effect because it rewards additional saving relative to additional consumption. Since the former increases productivity and the latter lowers prices, it is absurd to say that cutting tax rates is inflationary'" (Quoted in Prasad 2012, 362).

Business interests were skeptical about the individual tax cuts. The business community was against such large tax cuts for individuals. They were worried that the individual tax cuts originally proposed by Kemp and Roth could result in even higher inflation. In order for Reagan to convey his support for business, his campaign created the Business Advisory Panel consisting of business advisors, which frequently did not see eye to eye with the campaign (Prasad 2012, 366). A business lobbyist and head of the Business Roundtable, Charles Walker, referred to the individual tax cuts and the Laffer Curve as “political rhetoric” (Prasad 2012, 366). Despite Reagan’s desire to cut some of the business benefits out of the ERTA legislation, all of the individual and business cuts were present in the final tax proposal (Prasad 2012). The Reagan campaign and the Republicans that were on board with his plan tried to allay the fears of the business community by explaining the effects of the tax cuts on the deficit as follows: “spending restraint would reduce the deficit; lower taxes on savings would increase the propensity to save; and …accelerated depreciation schedules would lead to higher business savings” (Prasad 2012, 368).

Although many Republicans, business interests, and economists were skeptical about the models that were proposed, the Republican party recognized the opportunity to act in the face of popular approval for tax reductions and unchanging stagflation, which was responsible for much of the public’s discontent. In prior years, Republicans such as Nixon were unconvinced that the policies would work, but also knew that something needed to be done in order to improve economic conditions (Prasad 2012). Despite the concerns about inflationary and deficit enlarging effects, business interests ultimately accepted the individual tax cuts because of the popular and, thus, congressional support it generated for the larger ERTA, which included highly favorable provisions for businesses (Akard 1992, 608).

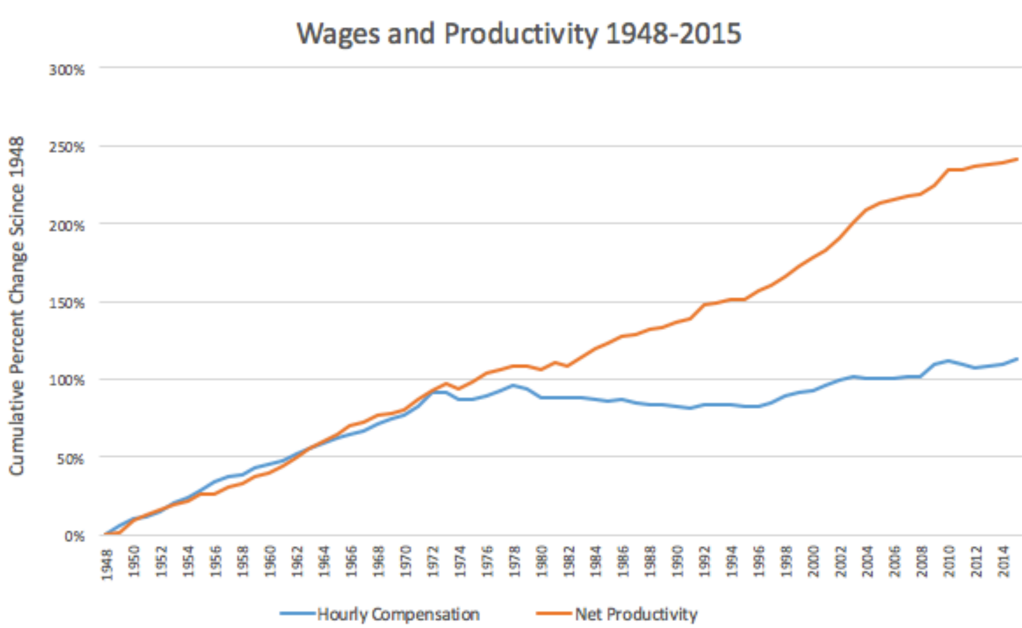
Through the creation of a coalition, which included business interests and frustrated taxpayers, Reagan was able to secure the Republican Presidential nomination and, eventually, win the general election. The tax plan was no small part of this process. In his acceptance speech at the Republican National Convention, Ronald Reagan appealed to this coalition. He addressed the elderly by noting that inflation reduces the real dollar value of their social security and retirement income. He addressed his broader public base by stating, "We will remind them that government programs exist at the sufferance of the American taxpayer and are paid for with money earned by working men and women" (presidency.ucsb.edu). He also addressed the business community by stating his plan to "include improvement in business depreciation taxes so we can stimulate investment in order to get plants and equipment replaced…" (Presidency.ucsb.edu). Reagan would follow through with his tax promises through the Economic Recovery Tax Act of 1981 which would be the largest tax cut in history.

IV. The Passage and Effects of the Economic Recovery Tax Act

Legislative Process and Democratic Support

Reagan won the 1980 election by a large margin. In the Electoral College Reagan received 489 electoral votes relative to Carter, who received 49 votes. Reagan also won the popular vote by 10 percent (PBS "The Election of 1980"). While the election did not give Republicans control of both the Executive and Legislative branches, it did result in the Republicans having control of the Senate and a larger minority in the House of Representatives. In the House, the Republicans held 192 seats, while the Democrats held on to 243 seats (History. House. Gov 97th Congress).

Following the election of Reagan and a new wave of Republican congressional members, the Reagan administration produced their budget proposal for the coming years. In the administration's proposal, it states that the tax cuts follow the neoclassical rationale that there are trade-offs between leisure and consumption. In the report, the administration makes clear that the post-war economic arrangements have caused the scale to tilt too far towards leisure. The report asserts that these arrangements were an impediment to the growth of the economy. This idea is based on classical assumptions about the trade-off between work and leisure. The proposal states, "the business and individual tax cuts are proposed as a means of increasing economic growth. The marginal rate reduction is designed to encourage work in place of leisure and saving in place of consumption, as well as to reduce inefficient—and unproductive—tax avoidance behavior" (7). A look at the historical data on productivity, however, shows no such diminishing of productivity, but it does show that wages have failed to keep pace with the growth.



Source: EPI analysis of data from the BEA and BLS (see technical appendix of Understanding the Historic Divergence Between Productivity and a Typical Worker's Pay for more detailed information)

In Reagan's budget proposal, there are a number of references to the ominous predictions calculated by the Congressional Budget Office about the coming years' economic growth, inflation, unemployment, and interest rates. The proposal states that the CBO's numbers are "based on historical experience" and "the postwar experience" more specifically (U.S. Senate 1981, 10). In the midst of offering an alternative path as a way to avoid the projected dismal economic conditions, the budget proposal places the blame of high inflation on the wages of labor. The report states that "since labor costs account for roughly three-quarters of total business costs, wage increases that outrun productivity put strong upward pressure on prices" (U.S. Senate 1981, 10). Although the administration expressed their concern with the inflationary effects of rising wages, they continued onward with the tax cuts despite the fact that tax cuts also increase the amount of money in circulation, which increases inflation.

As far as taxation and social spending are concerned, the Reagan agenda was executed as promised. The individual, business, and capital tax cuts were enacted, which are discussed later in further detail. Reagan followed through with his campaign promises and scaled back social welfare programs, even though Democrats had already been moderately reducing social program expenditures for those programs that mostly benefitted minority individuals and families (Alexander and Jacobsen 2008). Of the money used for the tax cuts, 70 percent was taken from social welfare programs for the poor, while other social welfare programs such as Social Security and Veterans Affairs stayed largely intact (Michelmore 2012, 727).

Since there still was a Democratic majority in the House, Reagan did not achieve all of his administration's intended goals. Despite this, the ERTA made it through Congress relatively swiftly. There were a number of reasons for the Democratic party's compliance with the Economic Recovery Tax Act, which included their attempt to incorporate this issue into their platform because of their awareness of the public's changing positions. The attempt of the Democratic party to gain issue ownership provides evidence that the party was aware of the burgeoning anti-tax campaign that was forcefully gaining ground among the general public and special interest groups. Therefore, their awareness of the public and private sector's discontent with taxation was affirmed by the victory of Reagan, given that his campaign was founded upon an anti-tax and anti-government movement. In addition, there were provisions included that appealed to Southern Democrats, which helped to strengthen the tax coalition Republicans were seeking to build.

Most accounts support the notion that Democrats were not going to be able to put up much of a fight given the current political climate. The sense that the Democrats were not going to win the taxation battle was reinforced by the development of special interest watchdogs monitoring congressional positions on taxation. Overall there was a sense that Democrats "should not be on the 'wrong side' of public sentiment on tax policy" (Béland and Waddan 2015, 181). In addition, beginning in the mid-1970s, the anti-government mentality introduced a new wave of Democratic leaders who would be considered more moderate than their post-war predecessors. In 1976, these new Democratic congressional members had shot down a proposal for a robust consumer protection agency (Akard

1992). Given consumer protections and greater regulations were cornerstones of post-war Democratic policy-making, the rejection of this legislation by new Democrats was illustrative of the broader shifts occurring.

The changing consensus again was indicated by the 1978 Revenue Act that was proposed and enacted by President Carter. These tax cuts, while far from the radical tax cuts enacted in 1981, also were informed by the sense that government should have a reduced role, which was a notion that would inform American policy making going forward (Berman and Pagnucco 2010). As many note, there was confusion and conflict within the Democratic party about the future economic plan of the party. The political and economic conditions had made it clear to the Democrats "that they could no longer 'tax and spend' in a manner tolerable to both middle- and low-income supporters" (Alexander and Jacobsen 2008, 286). Therefore, without economic direction, with an awareness of the public's position, and given the appearance of a new wave of moderate Democrats, the party had very little leverage to challenge the proposed tax policy. As a result of this, the legislation was introduced in the House in July of 1981 and, on August 13, 1981, it became law (Congress.gov).

Notable ERTA Provisions

The most notable changes spurred by the Economic Recovery Tax Act were made to the individual tax rates. These individual cuts were inspired by the Kemp-Roth tax legislation that originally was proposed in 1977 (Pollack 1996). The Kemp-Roth cuts were more dramatic than the final provisions included in the ERTA bill having "called for a 33 percent reduction in the tax rate for individuals and a reduction in the corporate

rate of 3 percentage points" (Pollack 1996, 88). William Roth himself defends this idea of "across-the-board" tax cuts having been proven effective by citing the tax cuts enacted by Kennedy and Mellon (Roth 1990, 60). The final ERTA legislation instead called for an incremental reduction in the individual income tax rate. In October 1981, the individual rate was to be reduced by 5 percent; in July 1982, it was to be reduced by 10 percent; in July of 1983, it was to be reduced by another 10 percent (Delaney 1981, 1267). Ultimately, most individuals received a tax cut of 23 percent. In addition, the maximum individual tax rate was reduced by 28 percent starting January 1, 1982, which lowered the top marginal tax rate from 70 percent to 50 percent (Delaney 1981). There were many pieces of tax legislation enacted during the 1980s, but the other more notable tax legislation was the 1986 Tax Reform Act. This legislation further reduced the top marginal tax rate to 28 percent (Béland and Waddan 2015, 181). Therefore, during Reagan's presidency, the top income rate was reduced by 60 percent dropping from an initial 70 percent in 1980 to 28 percent by 1986.

Additionally, the ERTA contained another significant feature, which was especially relevant for individuals given, at that point in time, the discourse concerning unfair taxation. The tax act "indexed" tax brackets to inflation through the use of the Consumer Price Index (CPI) (Delaney 1981). This indexing of income was important given the high rates of inflation that characterized the 1970s and resulted in bracket creep, which was a major grievance aired by the public. The results of this inflation indexing were the successful negation of bracket creep and a permanent impact on the way in which tax revenue was to be raised. This impact would make increasing tax rates and government revenue exponentially more difficult, politically speaking.

While many of the provisions of ERTA eventually were changed or repealed, the decision to index income brackets to inflation has remained. While it does create a more transparent and fair tax system in some respects, there were other motivations beyond fairness behind this change. During the time when interventionist policies were the norm in the United States, bracket creep that resulted from inflation and unindexed tax brackets provided a steadily increasing income flow. This was primarily beneficial for the Democratic party given that they had created a coalition partially on the basis of social spending. Pollack (1996) recognizes that "conservative Republicans had long favored indexing specifically as a means to deny Congress access to such easy financing for its expenditures" (93). This change towards indexing also meant that in order for Congress to raise additional revenue, there would have to be deliberate votes on raising taxes, which constituents typically find unpalatable. Previously, Congress held the ability to continue spending and cutting taxes because of the bracket creep (Pierson 1995). This was a politically neutral, if not favorable, way of managing the budget. This change to indexed brackets and its persistence illustrates the permanent shift away from a government-moderated economy and the shift towards a market-driven economy, which partially was achieved by creating budgetary limits.

The changes in this tax legislation also affected capital gains tax, which resulted in a decrease in the top rate from 28 to 20 percent in "the maximum effective tax rate applicable to long-term capital gains" (Delaney 1981, 1267). The alternative minimum tax for these preferred types of income was lowered from 25 to 20 percent by the ERTA (Tax Policy Center, Delaney 1981). Additionally, the ERTA increased the amount of capital gains from $100,000 to $125,000 that could be subject to a one-time exclusion for taxpayers that were 55 (Delaney 1981, 1267). The estate tax rate was reduced from 70 percent to 50 percent for “estates having taxable value of $5 million or more” (Delaney 1981, 1268). There also was an expansion of the unified credit to the extent that tax experts noted that “only .3 percent of all estates will be subject” to taxation (Delaney 1981, 1268).

In terms of the favorable business provisions, there was a shift from a system of cost recovery that was based on profits made from capital to a system of “accelerated cost recovery,” which allowed for the “expensing” of capital put into “service” that very year (Delaney 1981, 1268-69). Therefore, companies could receive tax deductions just from purchasing capital. According to the CBO report published in September 1981, the provisions for capital cost recovery were projected to amount to $1.5 million in 1981, $9.6 million in 1982, $16.8 million in 1983, and eventually reach $52.8 million by 1986 in federal tax expenditures (U.S. Congressional Budget Office 1981, erratum 72). This, in certain cases, led to virtually useless capital accumulation.

There also was the creation of the “safe harbor lease,” which allowed corporations who had no taxable income to sell their capital cost recovery deductions to other corporations (Pollack 1996, 91). Pollack (1996) notes that this system, in effect, could create a “negative tax rate;” however, this was quickly repealed following public outcry after a number of high profile sales. For example, Ford sold IBM $1 billion in tax benefits for $100 to $200 million (Pollack 1996, 91-92). In addition, the act offered tax incentives for, specifically, private companies to conduct research. Another provision in the ERTA “reinstated some of the benefits, under a concept of incentive stock options,” which had been previously removed through the 1976 tax legislation (Delaney 1981, 1269). The scholarly work of Piketty and Saez notes how the development of income earned through the channel of stock options has greatly led to an increase in top incomes.

The Effects of ERTA

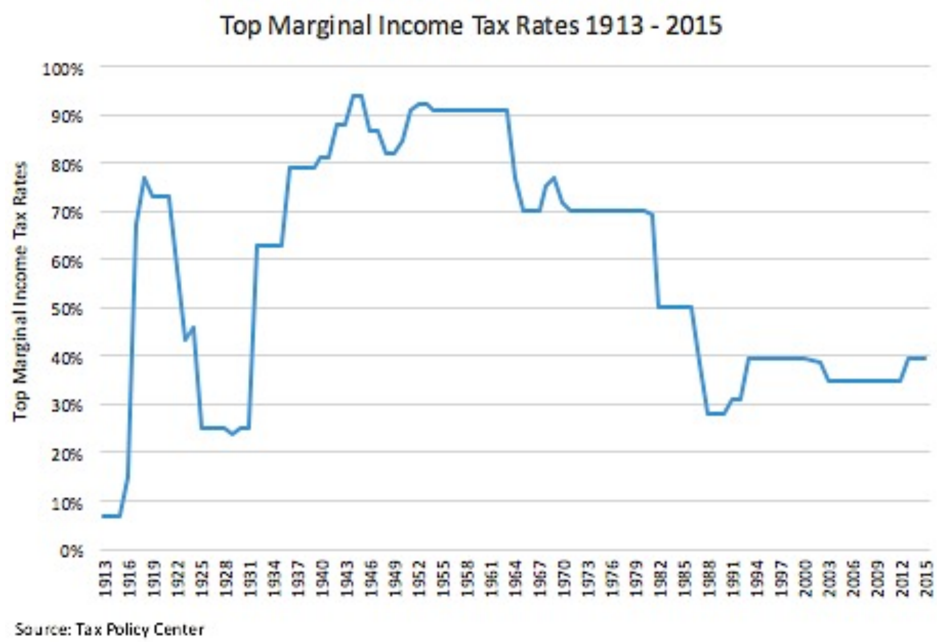
The Economic Recovery Tax Act of 1981 consisted of the “largest tax cut in American history” (Prasad 2012, 351). As reviewed, the tax policy was largely informed by the notion of supply-side economics in which “the overriding principle was that economic investment and capital formation would be stimulated through incentives resulting from lower marginal income rates” (Pollack 1996, 89). Pollack (1996) suggests that this led to “a significant political battle over ideologically driven tax policy” (88). This ideologically driven tax policy would be the first of many policies, which would take a market-oriented and supply-side approach. The tax policy was part of a broader change in the dominant ideological regime, which Reagan successfully ushered in during the 1980s. This has, for the most part, remained the dominant policy-informing paradigm in the contemporary American political economy. Reagan’s Fiscal Budget Proposal of 1980 stated, “the President’s budget proposals involve a fundamental shift in priorities – from nondefense to defense spending and from government to private allocation of resources” (1980 Budget Proposal). The Reagan administration followed through with their proposed course of action. In 1981, interest payments and defense spending were equal to 30.1 percent of federal expenditures, but by 1987, the same items were equivalent to 41.9 percent of federal expenditures (Pierson 1995, 152).

Following the ERTA, the deficit increased from 40 billion dollars in 1979 to 207 billion dollars in 1983 (Steinmo 2003, 217). In addition, over the following five years, the ERTA resulted in a revenue loss of $750 billon (Béland and Waddan 2015). Prasad (2012) refers to the ERTA as “the most central blow to state capacity that the American state has ever experienced” (353). Whether or not it was the intention of Reagan to, in fact, “starve the beast” the legislation in the ERTA did just that.

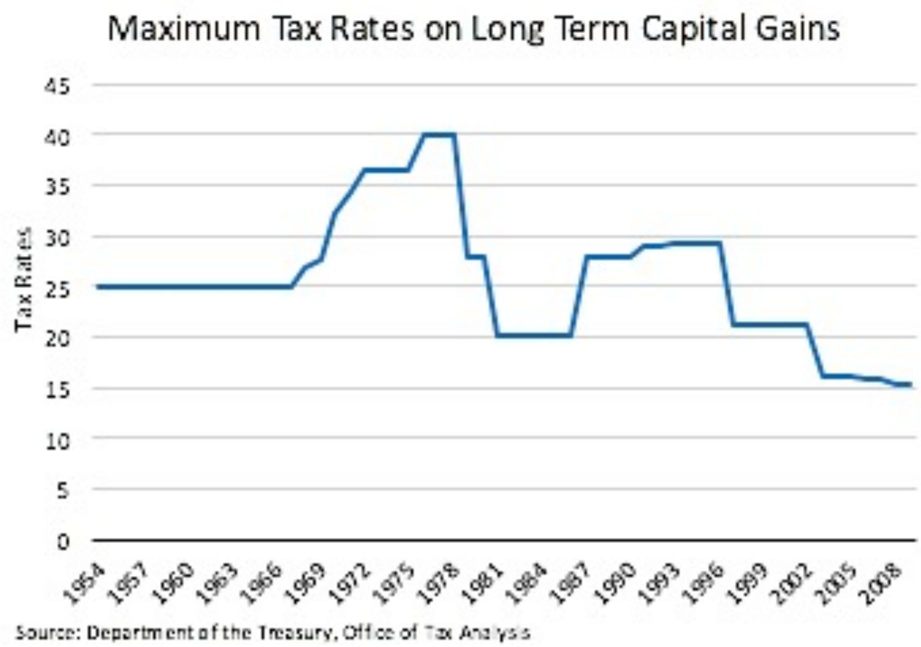
The Economic Recovery Tax Act was not notable for just reducing high rates, but broadly reducing all rates, which is the reason that this legislation had such a large impact on federal revenues. As Roth mentions, taxpayers received a break of 1500 dollars each, on average. On an individual level, this is not a large sum of money. However, when there is a reduction of this size enacted on such a broad scale, the capacity of the government is severely restricted. In addition, not only was there a mass tax cut, but this already extreme reduction in state capacity was solidified through the indexing of income to inflation, which cut off the flow of consistent increases in tax revenue. While the idea of corporate welfare frequently has been the focus of left-wing critique of the United States’ taxation system, the reductions for the wealthy were not the only provisions included in ERTA that may have impacted equity. Many developed nations technically have less progressive taxation structures, but lower levels of inequality.

Keeping the size and structure of the reductions in mind, the Economic Recovery Tax Act was able to affect inequality in primarily three ways. Both the general reduction of taxes across the board and, just as importantly, the indexing of inflation had the effect of limiting the spending ability of the federal government. This is key because, prior to inflation indexing, the tax structure allowed for a steady stream of revenue to flow into the federal government, which allowed for the maintenance of new and growing social programs such as those that were a part of the Great Society. Looking at other nations, one finds that the United States, relatively speaking, spends a small amount on programs and typically shies away from providing overarching social security benefits with the exception of old-age benefits. Following the enactment of the ERTA, this ability of government to fund programs was severely limited especially in the face of the Reagan administration's plan to simultaneously increase defense spending. In an article for the CATO Institute, John Samples (2012) reported "discretionary domestic spending dropped about 14.2 percent during Reagan's first year."

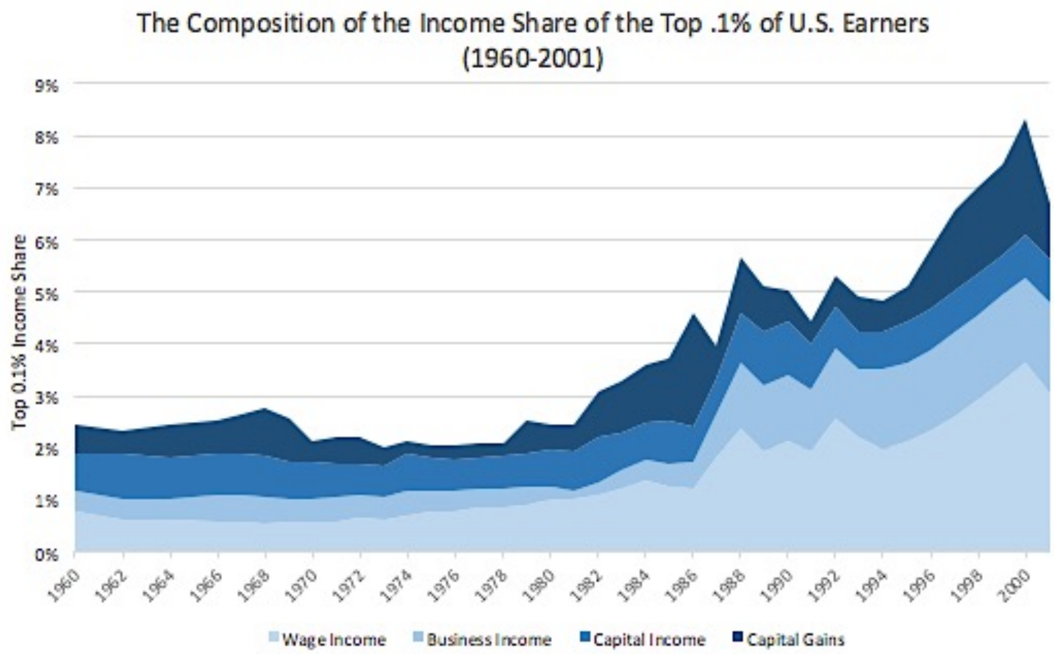
Although the post-war period policy making environment allowed for the creation of government funded programs and social safety nets, for most of the nation's history, the U.S. typically has refrained from creating overarching welfare programs. The typical social welfare approach pursued by the United States has a basic goal of ensuring a minimum level of subsistence through redistribution. For this reason, there is a gradation within the United States' tax code, which is understood as tax progressivity. Very obviously, those with higher incomes pay greater taxes, while those with lower incomes pay little to no tax. It is through this channel that the US manages to curb some of the inequality. Therefore, in the post-war period the highest income tax rate was 90 percent and was lowered to 70 percent. In addition, during this time, capital gains were treated as normal income given that those who earn capital gains typically have higher incomes. Both of these policies changed with the enactment of the Economic Recovery Tax Act of 1981. As reviewed, the top marginal rate was markedly decreased and capital gains received preferential treatment.



This has two effects. First, this not only allows, but promotes income concentration, which supply-side advocates would consider to be capital accumulation. Frequently, supply-side economics is called trickle-down economics because there is a notion that the accumulated capital will be invested into businesses, the market, and so forth resulting in an increase in growth. The benefits from the growth will eventually make their way down to the middle and working class through wages. However, while there may be studies that have been able to illustrate an increase in growth following the supply-side policies, there are few that have supported the notion that supply side policies have had the trickle-down effect. Instead, there has been a consistent trend in earnings going to the top of the income distribution.

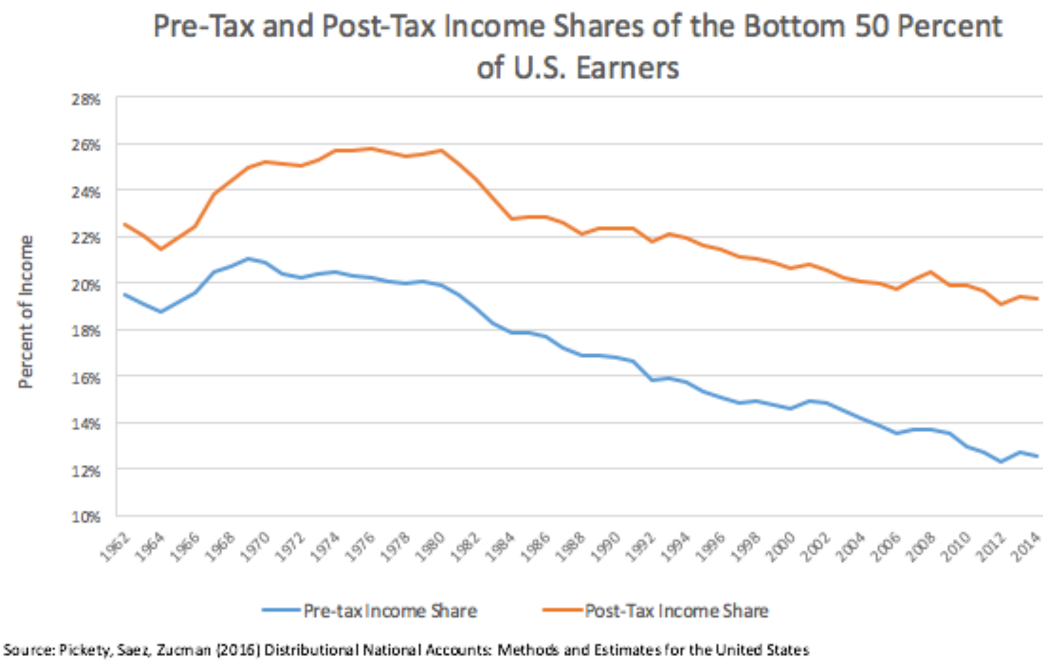


Putting this in the context of the 1981 tax cuts, the idea was that the reduction in tax rates would provide top earners with a greater ability to invest, which would be further incentivized by the preferential treatment of capital gains. Ultimately, the income does become concentrated and invested for a select few who have the resources, access, and financial prowess to invest. As investors make returns on their extra income gained from the reduction in marginal tax rates and are able to make these returns at a lower taxation rate because of preferential treatment of capital gains, the income or capital continually concentrates.



Source: Thomas Piketty, Emanuel Saez, "How Progressive if the U.S. Federal Tax System? A Historical and International Perspective"

This is further exacerbated by other supply-side ideas pursued by the Reagan administration, Republicans, and some Democrats. As has been explored by a number of scholars, the effects of tax policy are felt in both the long and short term, especially since many of the breaks were factored in over a number of years. Given the nature of these changes and their permanence, the long term trend would be a continuation of the shorter term trend, which would be the facilitation of capital accumulation. The graph shown above depicts the sharp increase in capital gains income for the top .1 percent beginning precisely around 1981. While the other income channels also start to increase during this time, the capital gains income show the most obvious growth. Simultaneously, we see average wages stagnate despite Reagan's assertion that rising wages were causing inflation. Eventually, there is an apparent bifurcation as top incomes rise and productivity increases, yet wages stagnate and eventually begin to decline in real terms.



There is also something to be said about the lowest income earners having to pay no taxes. As previously mentioned, the tax system in the United States is not uniquely regressive; in fact, the United States' tax structure places a relatively low burden on low-income citizens. This is in contrast to other nations that have higher levels of taxation, but also larger welfare states. The reduction in low income earner's taxes creates a system in which the lowest earners are not contributing and, therefore, are regarded as not entitled to the benefits of government programs. This turns the notion of free-riders that Reagan and the Republicans were pushing through their rhetoric into a reality, ultimately making low income households undeserving of government programs. In addition, the reduction in their taxes ensures that there is a reduction in the government's ability to spend on programs that would likely benefit low and middle income earners the most. These tax cuts also took place in the context of a broader reduction in overall progressivity, which directly means that the ability of the tax code to have a moderating effect on top incomes and to have a redistributive effect overall is significantly weakened.

While the establishment of causality is beyond the scope of this project, there is evidence to suggest that the Economic Recovery Tax Act of 1981 contained provisions that may have contributed to changes in the income distribution. Not only did the act reduce the spending ability of the federal government by cutting taxes across all levels, it also reduced the progressivity of the federal government's redistribution mechanism, which was further reduced in the tax legislation of 1986. In addition, the indexing of incomes to inflation ensured that the government's spending ability would be permanently limited.

Additionally, while much of this tax legislation was repealed or amended, a number of key elements ensured that the trend that began with ERTA continued. The indexing of tax rates to inflation made tax raises difficult, especially for the purposes of social spending. Consequently, from 1981, there was very little chance that the government would be engaging in social spending to the degree of the Great Society or to the extent that other nations with similar characteristics, but that value equity, invest in social programs ("Social Spending Is Falling in Some Countries, but in Many Others It Remains at Historically High Levels"). In addition, the preferential treatment of capital gains and the sharp decreases in top marginal tax rates were not quickly repealed. The maximum capital gains tax remained at 20 percent until the late 1980s and the top income tax rate was not raised until the 1990s. Therefore, the changes that remained were those that may have contributed to income concentration.

The graph of the income of the top 1 percent of earners is clearly affected by a major change in 1981. Given that this was the first major item on the Reagan agenda to be passed and enacted, it is not surprising that we see that immediate spike in top incomes which seemed to have opened the flood gates. This was followed by an unwavering trend of rising top incomes, which coincides with the unwavering allegiance to neoliberal ideological insights by both the Republican and Democratic parties and the permanent limitations on federal government revenues that resulted from the marked decreases in tax rates and the indexation of taxes to inflation.

V. Conclusion

While the Economic Recovery Tax Act of 1981 is important in its own right, its significance is not limited to the contents of the provisions. The ERTA was the first piece of major legislation enacted to reduce the size and involvement of the federal government. The policy changes that occur during the 1980s resulted from the public and private discontent with the government. This disengagement with the government developed during the 1970s in response to poor economic conditions and political events that fostered mistrust. The anti-government sentiment that was pervasive throughout not only the business community, but also the general public resulted from unfavorable economic conditions of the time and a distrust of government in light of the Watergate scandal, the Vietnam war, and recent civil rights legislation. Simultaneously, the business community, tired of costly regulation and taxation, launched an effort to disseminate neoliberal and supply-side ideas as an alternative ideology to the reigning interventionist perspective. Once the public was aware of an ideological alternative, less government and free markets, the path was paved for ideologically driven policies to reduce the size of government. These groups wanted the government to be hands-off in regard to matters of the economy, business, and redistribution. The result of this sentiment was the election of Ronald Reagan. The election of Reagan and the policy goals pursued by his administration were indicative of a critical shift in the approach to governing that was occurring.

Ronald Reagan was the ideal candidate for the time. He had a long history of criticizing the welfare state and government spending on social programs. The dismal performance of the government provided him with the foundation to seize the Republican nomination. His stance on a number of positions, which included his plans to carry out large tax cuts and his promise to middle class Americans that they would stop paying for welfare, resonated within the political and economic climate of the time. His incorporation of key political actors such as Representative Jack Kemp also helped to improve the political viability of his campaign. Reagan carried the spirit of the anti-government campaign into the White House with him, instigating policy changes that were reflective of this notion. According to Reagan's budget proposal, he planned to reduce the government's role in economic matters, calling for private redistribution and a reduction in taxes across the board, while increasing defense spending. His first major policy, in effect, would unravel a sizable amount of the large federal taxation structure that had accumulated during the post-war period. This first step toward reducing government involvement was the Economic Recovery Tax Act of 1981.

While facilitating the growth of income inequality may not have been the intended effect of the Economic Recovery Tax Act of 1981, there is evidence to suggest that this tax policy contributed to changes in income distribution. Following the enactment of this legislation, there is an immediate spike in capital gains, and over the following years, there is substantial growth in wage income, business income, and capital income for top earners indicating that there may have been a long term impact given the accumulative effects of lower taxes. When one reflects on the political climate in which Reagan rose to power and on the premise of his campaign, the idea that his policies contributed to greater inequality becomes quite feasible.

The public wanted the government to lower their taxes and to cease funding "illicit" activities through social welfare programs, and Reagan rose to power partially through the use of his rhetoric about "welfare queens." During his campaign, this would eventually develop into a discourse about taxation and the unfair burden on the hard working middle class. Additionally, the private sector wanted the government to reduce their involvement in matters of business by reducing taxation and regulation, which was a part of the government's attempt to create a mutually beneficial economic arrangement between business and labor. Accordingly, in his article about his proposed tax cuts, William Roth explained how redistribution was detrimental to the economy and called for the market to allocate income. This discourse was both a symptom of and a factor that contributed to the broader movement that was occurring.

The Economic Recovery Tax Act of 1981 addressed a number of grievances expressed during the 1970s by indexing tax brackets to inflation, limiting discretionary government spending, and reducing the redistributive effects of tax and federal policies. Following neoliberal insights, this policy attempted to reduce the federal government's involvement in economic matters. Through this legislation, there was a tangible shift in the dominant policy-informing ideological thought consisting of both neoliberal and supply-side ideas. While the neoliberal ideas were not dominant during the post-war years, they also were not new. In fact, the consensus that government could and should help alleviate poverty, reduce inequality, and moderate effects of the market did not exist until after WWII and the Great Depression.

This exclusion of government from matters of distribution was typical of policy that characterized the pre-war and inter-war periods in the United States. During this time, top incomes earners also earned a widely disproportionate share of income. Therefore, it follows that when there was a return to this sort of policy, a noticeable spike in inequality occurs, which spurred the ascent of top incomes to pre-war levels. Both under Mellon's neoliberal insights in the 1920s and the current reigning neo-liberal paradigm today, the income share of the top 1 percent reached 20 percent of total income.

Using the insight provided in this paper, further research on this topic may seek to prove causality between this legislation and the growth in inequality. Scholars also may attempt to assess the impact on inequality of a number of neoliberal legislative initiatives that developed during this time. The development of studies that assess the causal impact of legislation on inequality not only would contribute to the discipline's understanding of the United States' high levels of inequality, but also may deepen the understanding of what causes and reduces inequality globally.

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