

**The Evolution of Policy Ideas:  
Tax policy in the 20<sup>th</sup> century**

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*The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than commonly understood. Indeed the world is governed by little else. Practical men, who believe themselves exempt from any intellectual influence, are usually the slaves of some defunct economist. John Maynard Keynes*

*Academic economists discussing policy issues sometimes sound as though they are, in effect, advocating that the way world works should be changed to fit the conditions assumed in their models. Richard Bird*

*Economists are the most economical about ideas. They make the ones they learned in graduate school last a lifetime. John Kenneth Galbraith*

This analysis traces the evolution of ideas about one of the most important policies facing any state: taxation. The paper will demonstrate that elite ideas about tax policy have changed dramatically over the past century and that these ideas have had enormous consequences for the development of the modern state. I invoke the term 'evolution' intentionally. This paper will argue that actor's ideas are fundamentally rooted in their experience. Specifically, I will show that one era's experiences with taxation policy become the foundation upon which new ideas about policy develop. In short, there is an iterative, interdependent, and dynamic relationship between policy makers ideas, political institutions and substantive public policies. Understanding ideas, institutions and policies in this evolutionary context allows us to get beyond the quite useless debate that aims to separate ideas and interests as *independent variables* (Goldstein and Keohane 1993). Instead, I argue that ideas and interests are interdependent variables. Indeed, as Mark Blyth compellingly argues, one cannot make sense of one without the other (Blyth 2001).

In this paper I attempt to show how policy ideas (problem solutions), beliefs

(interpretations), values (basic normative preferences), and interests (material self-interest) are related to one another in a dynamic and interactive process that can be described in terms of policy evolution: Successful policy ideas are institutionalized and thus become the foundation upon which actor's beliefs are construed. Over time, the new institutional context thus provides the foundation upon which new idea, new problems and new solutions evolve. By this I do not mean to suggest some kind of banal Darwinistic survival of the fittest logic in which institutions are seen as competing genotypes. Rather, I suggest that institutions can be seen as an important part of the environmental or ecological context in which humans live, interact and adapt. Humans, however, are unique in the physical world because they can consciously change the environment or ecology. They/we can do this most obviously by changing institutions. (Though we also dam rivers, cut canals, build superhighways, and destroy our forests.)

Specifically, this analysis demonstrates that in each major epoch of 20<sup>th</sup> century, quite different policy ideas have dominated the thinking of fiscal policy makers. The institutionalization of these differing ideas has had enormous consequences for the development of the modern state. In each era, policy makers ideas evolve out of policy maker's experiences with their extant revenue systems but then became the foundation for the next generation of tax policy reforms. I understand history as a dynamic process and thus the very policy solutions initiated in one era create new opportunities and problems that form the foundation for new policy ideas in the next era. Policy ideas are not abstract value or ideological judgements which are simply floating around, waiting to used by entrepreneurial policy activists. Instead, substantive historical experience in time 1 substantially shape policy elite s ideas about policy options in time 2. In this sense the current epoch of tax reform is no different from the tax reform epochs of previous

decades.

This paper first gives a brief overview of this history of modern taxation. The emphasis here is to show how the ideas about what made for 'good' tax policy emerged in the context of both the changing structure of advancing capitalism *and* the political demands placed on policy makers. In short, new ideas became possible - even necessary - as the economy changed and revealed new sources of revenue which simply could not exist in a pre-modern economy. These new revenue sources, in turn, made possible new levels of government involvement in the economy which, in turn, shaped what policy makers and interest group activists understood to be possible and desirable.

Next, the paper examines the politics of tax reform in the United States in the 1980s focusing on the historic Tax Reform Act of 1986 (TRA '86). The point here is both to see how the idea for this historic act grew out of the concrete and specific abuses of the tax system that had evolved up to this point (in no small part due to Reagan's own policies in his first administration) and to show that once passed, the TRA '86 acted as an ideational rallying point (if not template) for similar tax reforms around the world. Here we see that the belief about what is possible critically shapes what is desirable. The final section offers an overview of the evolution of tax policy internationally. Once the US demonstrated that this kind of tax reform was possible, this idea spread across the world with remarkable force and power. While the details of tax reforms actually implemented of course vary from country to country, the patterns are astonishingly similar. I also argue that though 'globalization' has been a useful symbolic tool in the struggle for tax reforms, it cannot in itself explain the outcomes witnessed so far and wide.

## **The Origins of Modern Taxation**

Over the last 100 years, the ways in which states have raised revenues has been transformed. At the close of the last century revenue systems were not really *systems* at all. They were instead a collection of disparate excises, charges, duties and taxes on an amazing array of items and services — everything from men's hair powder, to windows, to salted cod. These various taxes were highly inefficient, easy to avoid, inequitably applied and did not generate very much revenue. In 1900 no state collected more than ten percent of GDP from all of the literally hundreds of revenue sources combined.

As the new century dawned, new political forces came to the fore demanding voting rights for the working classes AND fairer distribution of tax burdens. Indeed, taxation quickly became a major battleground of both economic interests and ideology. In traditional tax systems the poor bore much heavier tax burdens than the rich. But, as unions, as well as working and middle class parties mobilized, their political representatives increasingly demanded that taxes be used as instruments to change the maldistribution of income and wealth brought about by capitalism. Indeed, the very origins of what we now call modern tax policies (that is, efficient, universal and equitable taxes) was seen as a partial solution to the growing problem of inequality in modern society (Pechman 1983; Waltman 1985; Witte 1985; Weber and Wildavsky 1986).

Responding to these demands, income and profits taxes were introduced in a number of industrializing countries. In all cases, these taxes were in fact quite minor in revenue terms and were to be paid only by the very richest individuals and companies. They were often therefore often referred to as class taxes (Waltman 1985).

It would not be accurate, however, to simply view the introduction of progressive taxation

as the product of the raw exercise of political power. In fact, progressive taxes were introduced in a number of cases *before* the right to vote had been extended to the lower classes (eg. Japan, Germany, Sweden). Instead, this era marked a broad shift in social values in a number of industrializing countries. For many bureaucratic/fiscal elites, the idea of taxing profits and the income of the industrialists was seen as a policy solution (idea) which would both raise revenues and be 'fair.' (Sabine 1966; Stein 1969; Rodriguez 1980; Ishi 1993).

In short, elite views on taxation were also evolving. Modern capitalism resulted in enormous economic wealth and inequalities, they argued, and given this reality taxes could be levied according to the taxpayer's "Ability To Pay" (Stein 1969; Musgrave and Musgrave 1980; King 1983; Witte 1985).

As World War I broke out, the Ability to Pay principle was taken to some remarkable extremes. Total War as it was sometimes called, was extremely expensive. In other words, the fiscal needs of the state expanded enormously just as the new tax ideas had been institutionalized. Thus, in addition to the traditional means of financing war (debt) the state now had new tools which were both financially quite lucrative and politically legitimate. Thus, new "Excess Profits Taxes," "War Preparedness Taxes," and "National Defense Levies" were implemented as 'temporary' taxes.<sup>1</sup> In many countries, these taxes quickly became the major sources of national government finance even though they were paid only by corporations and by fewer than five percent of society's richest citizens.<sup>2</sup>

The institutionalization of progressive and corporation taxes in this era had enormous implications for subsequent developments in taxation policy - and indeed for the development of the modern welfare state as a whole. First, these new taxes produced enormous revenues.

Secondly, the basic assumptions about how taxes could legitimately be raised had by now shifted. Taxes, it was now clear, should be used as an instrument of economic redistributive policy.

During the 1920s, the very high marginal wartime tax rates were rolled back. But in no cases did fiscal policy makers attempt to abandon the principle of Ability to Pay. By now the belief that taxation policy could be used as an instrument of redistribution in modern society was no longer seriously questioned. Clearly there was much disagreement over how progressive taxes should be, but not even the American financier Andrew Mellon who became Secretary of the Treasury under Hoover argued against the principle of progressivity - he simply argued that they should not be *as* progressive as they had become during the war years.<sup>3</sup> By now progressive taxes were an integral part of the tax system as a whole - to repeal them would violate commonly held values about social equity.... especially in view of the fact that the revenues from these taxes would necessarily have to be replaced through regressive taxation.

Once again, it was not simply politicians and demagogues who struck on the idea that progressive taxes could be expanded to help the maldistribution of wealth and income in society.<sup>4</sup> The following table offers insight into the tax policy elite's thinking in the mid-1930s. Unfortunately, we do not have any survey data which would reveal the attitudes of tax policy professionals in earlier eras, but all of the case studies this author has been able to find as well as the biographies of policy makers of the era indicate that attitudes had changed remarkably of the previous generation. (Walton 1928; Snowden 1934; Keynes 1936; Blough and Shoup 1937). We see clearly here that the majority of economists favored progressive taxes generally and specifically favored taxes that placed a heavier burden on 'unearned' income (See Table 1 below.) Note for example that in 1934 only 12-13% felt that there should be a retail sales tax but fully

66% believed that capital income should be taxed at a higher rate than ordinary (earned) income. Moreover, fully 92% believed that the Federal government should impose inheritance taxes and 98% believed that the federal government should tax corporate profits. Perhaps most telling, 60% believed that tax rates on unearned (capital) income should be higher than tax rates on earned (wage) income. As this table clearly shows, these views are dramatically at odds with the views of tax policy professionals later in the century.

**Table 1 ---- Here**

**From Class Tax to Mass Tax**

World War II changed the tax policy climate dramatically. Once again, the costs of fighting this war were enormous, and it was clear to all concerned that no one would be able to escape massive increases in their tax burden. Between WWI and WWII the economy in had evolved. As more and more people moved from agriculture to industry, more and more incomes were being paid in cash by employers in weekly paychecks. This new political economy opened the door to new ideas about taxation.

Though clearly intended originally as taxes on the rich, Treasury officials also saw the enormous revenue potential of income taxes. Specifically, revenue officials in countries as dispersed as the US, Sweden, Japan and Germany began to realize that income could be withheld by employers and paid directly to the government even before the worker collected it in his weekly check. Thus the idea of a Pay as You Earn (PAYE) system was born. Such a system had

enormous financial advantages to the state. With this system employers could effectively act as revenue collectors for the state and the state would not have to wait for the monies until the end of the fiscal year. Moreover, with this new system massive increases in government revenues could be politically and morally justified with income and profits taxes. It was 'fair' to tax income, as long as everyone paid. Given the now common egalitarian values among elites it was even more 'fair' if the rich paid a higher percentage of their income than the poor.<sup>5</sup> Thus marginal tax rates on the wealthy were pushed up to extraordinary levels at the same time that tax thresholds<sup>6</sup> were substantially lowered such that now even modest income earners would contribute to the war effort directly with each paycheck.

Simply put, the Idea was to convert what once was a 'class tax' into a 'mass tax.' Whereas until the end of the 1930s income taxes were still paid by only the very richest in society, by the end of the war at least 60% of income earners were now paying this tax. These changes massively increased the revenue raising capacity of central governments in Europe and America. Tax revenues as a share of GDP nearly doubled in most countries between 1930 and 1945.

Taken together the revenue reforms of the 1930-1945 era transformed the politics of taxation in all industrial democracies. By steeply increasing tax rates on companies and the very wealthy at the same time that they extended the income tax net downward, central/national governments became responsible for both redistributing wealth and income across classes and generations. As we shall see below, the structural fact of high tax revenues and high tax rates now provided a new foundation upon which new policy ideas could evolve.

## **Taxation as an Economic Tool: The Carrot and the Stick**

At the close of the war, voters and interest groups alike expected governments to roll back taxes to somewhere near pre-war levels. This, of course, did not happen. Instead, all western democratic governments held on to the high levels of taxation that the war had made politically possible. Even where conservative parties gained majorities in Parliament, tax rates were not pulled down substantially.<sup>7</sup> Why were taxes not rolled back when the war was over? The key is that by the end of the 1940s there was a widespread consensus (belief) among policy elites that the state now had a meaningful and appropriate role in managing the capitalist economy.<sup>8</sup> With this belief, a new policy idea emerged: Instead of reducing rates across the board, the government could direct investment in socially and economically desirable ways by offering tax incentives to corporations and wealthy investors.

The logic of "Keynesian" economic management had by now become widely accepted in most advanced capitalist nations. In other words, economists increasingly came to believe that government could and *should* effectively manage the capitalist economy. [T]his regulation, however admirable, Galbraith wrote, will work only if the magnitudes are great enough to count. Taxes must be appreciable in relation to income if they are to affect incomes and therewith demand (Galbraith 1978: 238) It did not take major intellectual leaps, then, to conclude that the government might also be able to influence micro economic outcomes. Tax policy was seen as a major instrument with which to accomplish this end. Economic policy officials quickly realized that the tax structure could be manipulated to provide incentives for a wide range of economic activities. In effect, governments now were in a position to impose a deal on capital: If you invest in places, times, or activities that we determine, you will pay lower taxes. If you chose to ignore

our incentives, you pay higher taxes. It is important to note that these extraordinarily high marginal tax rates built up during the war were not created in order to allow public policy makers to manipulate or direct private investment. But once these rates had been institutionalized it became easy to see how they could be used for new purposes. In short, changes in the tax structure brought on by the War became the foundation for new 'ideas' after the war. These ideas, moreover, were adopted quite easily in part because of the experience of policy makers and economists during the war when governments were actively involved in directing and shaping the private economy in order to make it more effective for fighting the enemy. After the war social and economic pressures did not of course disappear.<sup>9</sup>

Tax policy thus quickly became a major instrument of social and economic management. Tax incentives could be (and were) used to effect decisions about where to invest, when to invest, and what to invest in (Howard 1997). There were far too many complicated incentive mechanisms developed in various nations to discuss here: They ranged from general investment tax credits, to inventory, to reserve funds, to special depreciation allowances, to tax deductions for investments in particular regions, products, and companies. But it is important to note that all countries engaged in these micro-manipulations of the economy via the tax code irrespective of party, ideology, and level of economic wealth. Even before the war, economists were engaged in a debate about how, when and which taxes could be the most effective instruments of public policy (Blough and Shoup 1937). By the end of the war mainstream economists rarely doubted that taxes could be used as instruments of what they called Social Control. The real questions were which instruments were best and which were less so (Martin 1989).

There was, moreover, a considerable amount of international sharing of ideas and specific

policies over how to most effectively use the tax code to affect desired social and economic ends (Hansen 1969).<sup>10</sup> Tax advisors (from rich industrialized countries, at least) frequented a large number of international conferences on tax and fiscal policy. It is difficult to know exactly how effective these conferences were, of course, but there is no question that the very point was for tax policy experts to get together to share information on fiscal theory, policy experiences, implementation issues and politics.<sup>11</sup> A number of studies were produced, for example, that examined what tax expenditures worked and what others did not work in the experience of participating countries (cf. Confederation of British Industries 1965; Hansen 1969; Tanzi 1969)

Whatever the specific mechanisms used in different countries, and irrespective of whether they were always used effectively or efficiently (which they were not), there was by now widespread agreement that governments could and should use their tax systems as instruments of economic policy: that tax incentives could affect the timing, structure and shape of investment and other private economic decisions (cf. Hansen, 1969). Under the extant fiscal regime (high marginal taxes combined with generous tax incentives and strict capital controls regulating the export of capital) the belief had now become widespread that capitalists and their money could be used to promote the ends of society as a whole. At the same time, many believed that this carrot and stick approach helped reduced uncertainty in the marketplace and contributed to the postwar economic miracle. As Christopher Howard points out, for example, because tax expenditures were seen as off budget expenditures, advocates enjoyed the luxury of accenting the program's benefits and ignoring its costs without fear of serious challenge (see also King 1983; Howard 1997:178). This regime was a centerpiece of the post-war compromise between capital and labor in all western industrial democracies (Steinmo 1993). The now dominant definition of a "good"

tax system was one that promoted social equity and allowed governments to influence private economic outcomes in publicly determined ways (Bird 1980; Sandford 1993).

Certainly there were those who continued to argue that high taxes damaged economic performance. But, as a number of empirical studies have indicated, there was very little empirical evidence that could be used to support this proposition. For most of the post-war period there has simply been no correlation between tax burdens and economic performance (cf. Ferleger 1993; Barro 1991). There was by now, at any rate, a widely held belief that the state could promote social equity and economic growth simultaneously.

### **Rethinking Tax Policy    The Origins of Tax Reform**

By the 1960's and 70's, taxes were increasingly seen by political leaders as low cost (politically) solutions to virtually every problem. In country after country - under both left and right governments - policy makers invented a dizzying array of tax policy instruments. It would take volumes to simply catalogue the astonishing number of tax instruments enacted in the 1960s through to the early 1980s that were designed to promote or support different types of economic activity within the OECD.<sup>12</sup>

Ironically, the very tax incentives introduced to promote economic growth in this era tended to exacerbate the political dilemma facing virtually all OECD nations. Whether tax incentives had the general economic effects their sponsors claim or not, they clearly had the specific effect of complicating tax codes, making it easier for sophisticated taxpayers to avoid paying taxes and, finally, radically reducing taxes for *some* taxpayers. Consequently, reports of

huge corporations and multi-millionaires (and even American Presidents) who payed little or no taxes became virtually commonplace throughout the OECD. In short, tax policies justified with reference to the goal of promoting economic growth, had the direct effect of undermining another widely accepted goal for tax policy - equity. Taxes were increasingly felt to be unfair.<sup>13</sup>

Tax policy makers also grew increasingly concerned with the revenue consequences of expanding tax expenditures. The American case was perhaps the most dramatic, by the 1980's the total revenue loss from tax expenditures to the Treasury exceeded the total revenues brought in by the Federal Income Tax (Witte 1983). In other words, other taxes had to be raised in order to pay for tax expenditures.

Ultimately economists and tax policy makers began to question the very propriety of the use of the tax code to accomplish government's goals. A key figure in this change was Stanley Surrey, Assistant Secretary of the Treasury for Taxation from 1960-1968. Surrey argued, quite reasonably, that if the government wished to subsidize some specific activity or industry, it ought to do it publically - through the normal spending process - not through offbudget (ie. out of sight) mechanisms like tax expenditures (see Surrey 1973). At first, Surrey's arguments against using tax incentives instead of direct government spending were taken as theoretically plausible, but politically improbable. This was not because his arguments were logically flawed, but instead few believed that Congress would ever pass the kinds of reforms Surrey was advocating.

In sum, both tax policy experts in government and many on the political Left became increasingly skeptical of tax expenditures (loopholes) because they were seen as giveaways to the rich, that were ineffective as policy tools, they cost ever larger sums to the Treasury, and they were outside normal public scrutiny. What was once thought to be a very 'good idea' - was

becoming increasingly discredited as bad after all.

### **The New Politics of Taxation**

A sea change in the political climate swept the western world in the 1980's. It is clearly outside the scope of this short paper to analyze all the sources and consequences of this ideological shift - but I believe its manifestation in tax policy provides important insights into the broader phenomenon. In many ways, it can be argued that tax policy was the leading edge in this new political tide.

It would be wrong to suggest that Ronald Reagan came to power in 1981 with a clear mandate from the people. Many factors contributed to his electoral victory including the Iranian hostage crisis, disaffection with the previous administration, and the continuing economic crisis facing the United States. It is clear, however, that Ronald Reagan came to power with an agenda - he wanted to cut taxes and balance the Federal budget (Pechman 1987; Conlan, Wrightson et al. 1990). What it meant to cut taxes was still somewhat unspecified: Whose taxes should be cut, and by how much, were still issues to be decided. How he would reduce the deficit, it turned out, was even less clearly worked out.

During his electoral campaign, Reagan campaigned vociferously on behalf of the overtaxed middle class. On June 25, 1980, he specifically promised that if he was elected, he would introduce an across the board 30% cut in personal income tax rates. Few knew what this would mean in reality, but it sounded good. What happened next surprised virtually everyone. As if taking a page from Andrew Mellon's 1924 book, Reagan advanced the counterintuitive

argument that cutting taxes would actually stimulate growth and therefore increase revenues taken in by the state. Following this logic, Reagan thus introduced the most sweeping tax cut in modern American history.<sup>14</sup> The total value of this Economic Recovery Tax Act was to reduce government revenues by over \$750 billion dollars over the next five years.

The immediate consequence of the 1981 tax reform was the massive increase in the public deficit. The Federal government's annual deficit grew from \$40 billion in 1979 to \$207 billion by 1983.

By the mid-1980's the inefficiency and inequity of the American tax system had become so obvious and pervasive that even the authors of the system were embarrassed. Public Interest groups like Citizens for Tax Justice, Common Cause and a host of others had become incensed with the increasingly common revelations that multi-millionaires and mega-corporations were paying less in taxes than the people who cleaned their houses and offices (Minarik 1990, pp.159-179). Reflecting what was becoming an increasingly common view among tax policy experts, Henry Aaron and Harvey Galper, two widely respected fiscal economists with the Brookings Institution described the American tax code in 1986 in the following way:

The U.S. tax system has become a swamp of unfairness, complexity and inefficiency. The accumulation of credits, deductions and exclusions designed to help particular groups or advance special purposes conflict with one another, are poorly designed and represent no consistent policy. The tax system causes investors to waste resources on low-yield investments that carry large tax benefits while high-yield investments without such benefits go unfunded. The result is a shrunken tax base that requires needlessly high rates on wages, salaries and other taxable income. Overall the system undermines the faith of citizens that tax burdens are shared fairly (Aaron and Galper 1986:1).

In the end, however, as the gross abuses of the system became more and more

commonplace in the media, the demand for tax reform became harder and harder for Republicans to ignore. Worried that the Democrats would use the unfairness of the tax system as a bludgeon against them in the next election (1984) several Republicans began to argue for tax reform as well. The Treasury Secretary was thus charged with the responsibility to examine a proposal for tax reform that the administration could call its own.

The detailed twists and turns that tax reform politics took over the next year have been the grist of many excellent books on American politics and policy making (cf. Conlan, Wrightson et al. 1990). I shall not recount these stories here.

Though many pundits predicted at the time that tax reform of this magnitude would surely fail, the particular combination of forces came together in a way not unlike the Nixon visits China phenomenon (Minarik 1990:169). After many, many twists and turns, the 1986 Tax Reform Act, (TRA) eventually made it through Congress and was signed by the President. Truly, what eventually passed was remarkable. Tax rates were lowered for most individuals and corporations and this was financed largely by the elimination of hundreds of tax expenditures/loopholes. Though marginally regressive, the distribution of these cuts was mostly proportional to income. It could scarcely be argued that the new American tax system was fair, it almost certainly was more fair than the one it replaced.

It is important to remember, however, that the American tax system was improved *in comparison to the tax system since 1981*. When we remember that the tax code had become radically more inefficient, complex and unfair than it had been only five years earlier, the marvel of the 1986 tax reform loses some of its sheen. In short, the 'idea' of tax reform - meaning lowering rates and cutting many loopholes - grew on the foundation of policy elites' experience with the

abuses of the old tax system. Fiscal policy experts and tax policy makers alike now began to abandon the belief that taxes could be effectively used for redistributive policy ends as well as instruments with which the government could effectively direct private investment. Why did they abandon this long held belief? Because their experiences with tax system over the past several decades had taught them that even if tax expenditures might be a good idea in principle, in reality they too often were misused and unfair.

### **Table 2 here**

The table above, from a recent study by Joel Slemrod, compares the opinions of tax economists in 1934 and 1994. It shows that the economists today have far more skeptical attitudes toward government intervention and redistributive policy than they did in the 1930s'. Specifically, economist in 1994 are much more likely to favor regressive taxes (presumably because they are more economically neutral) and less likely to favor progressive taxes on capital and corporate income. These data, moreover appear to confirm McClure's conclusion in his 1984 essay *The evolution of tax advise and the taxation of capital income in the USA*.

Over the past twenty years there has been a marked shift in the concerns of academic tax experts from equity toward efficiency. This has been manifested in a shift in professional advise on tax policy. Whereas in 1960 a comprehensive income tax levied at progressive rates was the goal of most tax economists, consumption is not preferred by many in that profession, and graduated rates are less popular, even if the tax base is consumption, rather than income (McLure 1984 : 266)

## **World Tax Reform**

Once the Americans had reformed their tax system, other countries were remarkably quick to follow suit. One of the most respected economists in the international tax policy community, Vito Tanzi, describes the diffusion of these ideas as follows:

There is no question that the tax reform movement in the United States... has sent shock waves to other countries... [i]t provided the officials of other countries with both a challenge and an opportunity to introduce changes in their own tax systems. One does not exaggerate in stating that very rarely has the world seen so much interest in tax reform as in the past couple of years, and very rarely has there been such a convergence of views on at least some aspects of the tax systems that need to be modified (Tanzi 1987:5).

Cedric Sandford summarized the tax reforms passed across the globe in what he calls a movement...without precedent in fiscal history.<sup>15</sup> He suggests in his book, *Successful Tax Reform*, that even more remarkable than the widespread nature of tax reform, has been the similarity which justify its description as a movement (Sandford 1993:9,10). He lists the main features of this tax movement as follows:

Rates of personal income tax have been scaled back (particularly at the top end).  
 The number of steps in the income tax scale has been reduced.  
 The income tax base as been broadened. (Loopholes and exemptions are reduced.)  
 Reductions in income tax revenues have been finance by increases in other taxes (VAT, Social Security, etc.)  
 Corporate tax rates have been lowered and tax incentives for corporations have been correspondingly cut back. (Sandford 1993: 10-20)

The convergence of views was indeed remarkable. It is, of course, not surprising that Right-leaning governments, such as those in power in the U.S. and the UK at the time should favor tax reductions for the rich. But, these views were increasingly shared by key policy makers throughout the democratic world (and beyond) of virtually all political persuasions. In the last eight years, this author interviewed Ministry of Finance officials in seven OECD countries from

Australia and Japan to Sweden and Denmark. *In every single case*, I have heard a remarkably similar beliefs. This view is best summarized in the following statement made by former Swedish Minister of Finance, Kjell Olof Feldt: The very high level of progressive taxation just doesn't work.<sup>16</sup> Former Social Democratic Chancellor of Germany Helmut Schmidt takes this basic argument even further: The welfare state is such a good idea, but it has been driven to extremes by Sweden, by France, by Germany, by all the European countries. The public does not understand, he complains, there will be a need to reduce the burden of social services, reduce taxation and find new ways to produce goods in order to be competitive in the global economy (quoted in Yergin and Stanislaw 1998: 329).

Tables 2 shows one of the consequences of this tax reform process: Tax rates on upper income individuals and corporations have been drastically slashed. It is possible, however, that the cuts in tax rates are being distributed progressively in some countries. I have found no evidence, however, to suggest that this has happened. It appears instead, as Williams has noted in a survey of tax reforms in the EC conducted for the accounting firm Price Waterhouse:

At the same time as some disillusion was spreading about the efficacy of our main taxes, other pressures were building up . . . Our objective now is to be neutrality [sic], with taxes that do not penalize one person rather than another. They give [priority to] equality of opportunity rather than equality of result . . . A 'fair' tax is one which presents us with a 'level playing field' and does not concern itself with the quality of the teams (Williams 1991:24).

### **Table 3 Here**

Unfortunately, the enormous complexity of both tax systems and the stunning number of specific tax reforms introduced over the past decade make it impossible to provide a full

accounting of all tax changes introduced. Still, while there are some who may focus on a particular major piece of legislation (say, U.S. 1986, Sweden 1991, Germany 2000) and argue that this specific reform was neutral between income classes, virtually all analysts agree that the *cumulative* effects of the many tax policy changes introduced in OECD nations over the past decade and a half have made these tax systems less progressive (Boskin and McLure Jr 1990; Gravelle 1992; Björklund, Palme et al. 1995; Tanzi 1995). As Sandford admits, the first main blot on the tax reform movement has been its tendency to increase inequalities in income and in wealth (Sandford 1993:222).

It is also true, of course, that in recent years *the needs of capital changed as it became more internationalized*. The OECD described the effects of these new international pressures in the following way:

The increased openness of national economies has, in practice, made it more difficult to separate out domestic and international tax issues. When changes to national tax systems are made attention has increasingly to be paid to the international implication of any proposed modifications. This, in turn, may mean that the traditional criteria used to evaluate tax reforms have to be reconsidered. Policies which may have been appropriate in economies where exchange controls and other limitations on international transactions were prevalent may be neither feasible nor desirable once these non-tax barriers are removed (OECD 1991:14).

In short, by the 1980s the very structure of capital's interest had begun to change. Not only are modern corporations bigger in the global economy, they are also more interconnected and more interdependent. This also affects their tax policy interests. Firms that formerly would have been quite content with tax incentive policies that released them from paying taxes as long as they invested in domestic plants and equipment, no longer find these kinds of incentives appealing. In a largely insulated economy, manufacturing firms would be quite happy with accelerated

depreciation for capital investment, for example. But a global manufacturing firm, in contrast, prefers a lower tax rate with fewer incentives which lock in investment. The point here is that the more internationalized firms become, the less they are likely to prefer taxes that advantage domestic suppliers and/or consumers over those beyond national frontiers (Porter 1990 : 57).

As we saw above, the tax policies of the 1970s and 1980s discredited the increased use of specific tax incentives. They appeared not to work *and* they substantially added to these political problems facing modern governments. Policy makers throughout the OECD thus were under dual, and in many ways contradictory, pressures with respect to tax policy. On the one hand, there was growing disenchantment with specific tax incentives from the Left. On the other hand, it was becoming equally obvious that both technological and policy changes were making it possible for capital and capitalists to place their money and investment in areas where they received the highest possible *after tax* return. As a result, policy makers began to see the multiple advantages of abandoning or severely restricting their use of taxation policy as an instrument of economic management. Table 3 shows the changes in basic tax rates facing companies around the globe. Interestingly, as Swank and Steinmo (Swank and Steinmo 2002) have shown, these rate reductions have not resulted in significant revenue losses to the treasuries. (see also Economist 2001)

#### **Table 4 Goes here**

How could it be that the consensus has shifted so dramatically in such a short time? The answer is clearly that governments *believe* they can no longer effectively manage or control

private economic decision makers through the tax system. A good tax system has moved from being one that explicitly introduced distortions into the capitalist market place to one that minimizes these distortions. In short, a good tax system, it is widely believed by the left and the right, keeps the government out of private economic decision making.<sup>17</sup>

### **What Happened to The Ability to Pay?**

The reader will remember that the original justification for reforming the tax system (in America as elsewhere) was that it had become so littered with tax expenditures/incentives/loopholes, that it was widely perceived as unfair by tax policy makers and tax payers alike. Also remember that by fairness citizens at least meant that the rich were not paying their fair share and the poor and middle classes had been increasingly been forced to pay too much in taxes (Svallfors 1997). What, it seems reasonable to ask, has become of this goal? The answer, bluntly put, has been that it is often downplayed or forgotten. Vertical equity has virtually been taken off the agenda.<sup>18</sup> "Common intellectual themes [of the tax reform movement]" report Boskin and McClure in their book, *World Tax Reform*, "included concern about the adverse incentive effects of high marginal tax rates and about distortions caused by differential tax treatment of economically similar activities, and a downplaying of vertical equity as a central objective of tax policy (Boskin 1990 :3, my emphasis).

As the OECD argued in 1989:

The pursuit of greater neutrality has been based on the growing acceptance of the fact that a proportional tax system is more likely to be optimal from an efficiency point of view than one which is graduated and selective. . . . Also, the idea of minimizing the impact of the tax structure on economic behavior has been a distinctly unfamiliar idea to many OECD governments until recently. Governments have often used the tax system deliberately to



outcomes. Governments, even Social Democratic governments, are moving to get out of the way. In short, tax reform means changing the character of the relationship between the state and the private economy: public authority is being yielded to private interests (see also Blyth 2001).

It is clearly the case that pro-market and state-interventionist ideas are now dominant, but it is not true that these ideas are new. Capital and the ideological Right have made these same arguments since the turn of the century. But up until recently, those who called for more socially and economically neutral tax systems have been overwhelmed by those who saw it as the legitimate responsibility of the state to try to shape both the distribution of income/wealth in society and to encourage certain kinds of economic activity over others. Reading the current economic literature on tax policy one might conclude that these new/old principles driving tax policy in the 1980's and 1990's have won because they are superior ideas: that the idea that taxes should be based on the principles of ability to pay and state management of the economy are simply intellectually bankrupt. Sandford puts it thus: *Above all, however, tax reform reflected a change in economic philosophy.* In most countries, certainly amongst the leaders, tax reform was part of a programme of pushing back the boundaries of the state... Disillusionment with the results of state intervention had led to a decline in belief in the efficacy of state intervention and a revival of belief in the efficacy of markets (Sandford 1993:20, emphasis in original). Similarly Richard Musgrave, one of the worlds most respected fiscal economists wrote in 1982:

While my generation of tax economists has placed much emphasis on equity, the younger generation is now stressing efficiency. The change.... may reflect the fact that efficiency considerations are more amenable to the exercise of technical tools, a practice that brings rewards to the young professional but may not be most helpful to a balanced view of reform. This shift in emphasis reflects, as well, changes in social values... (quoted in McLure 1984: 258)

It is not true that the tax policy changes that have occurred around the world over the past twenty years or so are purely the product of a new attack on the part of capital and/or the rich against the middle and lower classes. Instead, as this paper has attempted to demonstrate, it was equally the increased disaffection with extant tax systems and what they had become that opened the door to new thinking about taxation and tax policy. It was the horrible mess that many countries had made of their tax systems in the 1970's and early 1980's that created the disillusionment with taxes than some new systematic attack by forces on the Right. Both the Left and the Right, after all, contributed to building the increasingly complex, inefficient and inequitable systems that these countries had developed.

*Public* dissatisfaction with taxes in the early 1980's was rooted in the belief that the poor and the middle classes were paying too much and the rich and corporations were paying too little - ie. vertical equity. But *elite* dissatisfaction with taxes was more rooted in distrust of the efficacy of the tax expenditures that now littered the tax codes and the economic inefficiencies they created. In a fundamental sense, fiscal economists and Treasury/Finance officials grew increasingly skeptical of their political masters. It is not clear that tax policy experts believed tax incentives were by definition bad. But they clearly believed that they were wrongly used and misused by the political leadership. It would be better, they came to believe to have no (or very few) tax expenditures than to have a tax system littered with tax loopholes designed for the politically powerful.

Economic realities have clearly played a role in the specific character of the reforms witnessed in recent years. As I have tried to show, the realities of economic internationalization substantially contributed to the change in what tax policy makers thought was desirable. As Vito

Tanzi puts it, [t]ax competition from other countries may force some countries into choosing tax structures (and, perhaps, tax levels) that their policy-makers might consider less desirable than the ones they would have chosen if their economies had remained closed (Tanzi 1995: 134).

Rarely, however, do policy makers think in terms of if we only could have... Instead their thinking is fundamentally framed within the economic/intellectual climate in which they work. Just as in the 1930's when it seemed self-evident to economists that taxes should contribute to social justice, today it is self-evident to them that the state should level the playing field. The President of the American Economic Association T.S. Adams, put this point quite well in his address to his association in 1928: The dominating factor of economic interest in taxation determines to a large extent the role or place of idealism in taxation. Ideals are effective when they further the economic interest of powerful groups (Adams 1928:4).

Ideas about policy are formed in political, economic and institutional contexts. As we have seen, experiences with poorly designed and implemented tax policies helped shape politicians, economists and tax officials attitudes and beliefs about what reforms were necessary and desirable. This is because beliefs about what is desirable are constructed within the context of historical experience. What we want is fundamentally framed by what we can imagine achieving - - and what we can imagine achieving is informed by what we have done before. At the same time, policies are also framed in an economic context. In the present era, the context in which tax reform is constructed is one of increased international economic mobility. The result has been the growing conviction among policy makers that markets will outrun political boundaries no matter how well policies are designed.

In short, both the apparent failure of the political structure to make efficient and fair use of

tax policy and the realities of globalization have ultimately shaped what policy elites now believe can be done *and what ought to be done*.<sup>20</sup> Whereas in the first seven decades of this century, there was a widespread consensus that taxes *should* be used as a social policy instrument that had an essential function in redistributing income and wealth in capitalist democracies, today there appears to be a growing consensus (among elites, at least) that taxes *should* not be used for these purposes. This new consensus is not simply the product of a shift in political power from the Left to the Right. Instead it comes about through the evolution of ideas about tax policy: Economists and tax policy makers no longer believe that they can effectively manage the economy through tax manipulations. Indeed, they have instead moved to the belief that if government gets involved, the politician's incentives will drive them to create tax policies that are fundamentally destructive to an efficient capitalist economy.

## **Conclusion**

The very size of the modern welfare state today is a direct product of tax policy choices that were made in earlier eras by policy makers whose attention was clearly focused elsewhere. This is not to suggest that the size of the modern welfare state is either an accident or the product of a conspiracy. Rather, policy choices operate in an evolutionary manner: Policy choices made in one era clearly shape the context (ecology) in which future tax policy choices are made. Political leaders anticipate - they are the agents which carry or bring forward new policy ideas. These ideas may be new policy solutions which have become available due to previous policy choices, or they may be older ideas which have been more or less dormant for a period. In either case, policy ideas are seen as *problem solutions* - a kind of rational probabilistic calculation

linking problems with potential solutions. New ideas come to the fore because a) older ideas are discredited by experience, b) a new political/economic context opens up new opportunities for innovation or c) the political balance of power shifts, thus those that are advantaged by certain policy ideas are able to push their agenda over others.

Ideas and the policies they imply are of course not neutral: They advantage some interests over others. One cannot disaggregate ideas from interests as if they were separate and *independent* variables (as one might in a simple regression model) because ideas and interests are both interactive and interdependent. It is tempting to argue, for example, that the recent trends towards lower marginal tax rates for capital and high income earners witnessed around the world is a direct result of globalization. But a more careful analysis of the evolution of this policy arena reveals that it was more the negative experience economists and policy makers had with high marginal tax rates in the 1970-1990's and to the growing belief that policy makers could not be trusted to implement tax policies either fairly or efficiently - that helps explain this new turn in tax policy evolution. To be sure the boogie man of Globalization and the threat of capital exit in the late 1980s and 1990s, provided a powerful justification for tax policies which tax economists and tax policy advisors had long wanted to make - but when looks more closely at the timing of the reforms and the arguments laid out in their behalf, it is difficult to argue that it was international competition the 'made us do it.'

**Table 1**  
 Tax Professionals Opinion: 1934  
 Responses to Tax Policy Questions: Figures refer to % answering Yes

Question	% Yes
In general, should there be free trade with only incidental tariffs?	61
Should there be a special tax on unearned increment of land values?	62
Should inheritance taxes be by the federal government?	92
Should there be higher income tax rates for unearned (ie. capital) income?	66
Should all future federal, state and local government securities that are issued be fully taxable as to income?	96
Should there be a net income tax on corporations?	98
Should insurance business be taxed in a different way than general incorporated business?	73
Should railway and public utility business be taxed in a different way than general incorporated business?	55
Should there be a general retail sales tax at the federal level?	13
Should there be a general retail sales tax at the state level?	12

Source: Slemrod, 1995 Table 1.

**TABLE 2**  
 Tax Professionals Opinion: 1934 and 1994  
 Responses to Tax Policy Questions: Figures refer to % answering Yes

Question	% Yes 1994 Survey	Difference between 1934 and 1994
In general, should there be free trade with only incidental tariffs?	91	0.3
Should there be a special tax on unearned increment of land values?	22	-40%
Should inheritance taxes be by the federal government?	72	-20%
Should there be higher income tax rates for unearned (ie. capital) income?	7	-59%
Should all future federal, state and local government securities that are issued be fully tax able as to income?	61	-25%
Should there be a net income tax on corporations?	70	-28%
Should insurance business be taxed in a different way than general incorporated business?	28	-45%
Should railway and public utility business be taxed in a different way than general incorporated business?	24	-29%
Should there be a general retail sales tax at the federal level?	33	+20%
Should there be a general retail sales tax at the state level?	91	+58%
Should there be a general retail sales tax at the local level?	56	+56%

Source: (Slemrod 1995: Table 1)

**Table 3**  
**Top Marginal Rates of Central Government**  
**Personal Income Tax**  
**1976, 1986, 1992, 1997**  
**Selected OECD Countries**

Country	1976	1986	1992	1997	reduction 1997 -1976
Australia	65	57	47	47	17
France	60	65	57	57	3
Germany	56	56	53	53*	3
Ireland	77	58	52	48	29
Italy	72	62	51	51	22
Japan <sup>1</sup>	75	70	50	50	25
New Zealand	60	57	33	33	27
Norway <sup>1</sup>	48	40	23	23	35
Sweden <sup>1</sup>	57	50	20	25	32
United Kingdom	83	60	40	40	43
United States <sup>1</sup>	70	50	31	39	31
<b>Unweighted Average</b>	<b>63.4</b>	<b>56.3</b>	<b>42.8</b>	<b>42.4</b>	<b>21.0</b>

<sup>1</sup> Countries with income tax at lower levels of government. Typical rates in 1992 being flat: Canada 17; Finland 16; Norway, 28; Sweden, 31; progressive: Japan 5-14; United States 2-14.

\*Top Personal Tax rate to be reduced to 42% in 2005. <sup>2</sup>1976 and 1986 figures refer to personal income tax only; 1992 includes social security contribution now levied on same basis as income tax. <sup>3</sup> In 1976 only, an additional 15 percentage points for investment income above a threshold. <sup>4</sup>Reduced to 48 per cent in 1992 budget. <sup>5</sup>Increased 39 percent in 1995.<sup>5</sup>

Source: Sandford, 1993: p. 12./ OECD Tax Database, 1998.

**Table 4**  
**Basic rates of corporate income tax of central government, 1986-1995**

	1986	1991	1995
Australia	49	39	33
France	45	34/42	33
Germany	56	50/36	45/30
Greece	49	46	35/40
Japan	43	38	38
New Zealand	45	33	33
Sweden	52	30	28
United Kingdom	35	34	33
United States	46	34	35

Source: OECD 1997, *Taxing International Business: Emerging Trends in APEC and OECD Economies*, pg. 63.

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## Endnotes:

1. There were several different types of "excess profits" taxes used in these years in these countries. They are far too complicated to explain here, but in each case an attempt was made to tax all, or nearly all, the profits made as a result of the hostilities.
2. In 1918, income and profits taxes contributed 44.8 percent of total state and local government revenue in Sweden. In the same year, the income and profits taxes contributed 63.1% the federal government's ordinary receipts in the U.S.. In Britain these taxes contributed 64.9% of total tax revenue in 1920.
3. In what would several decades later be called supply side economics, Mellon argued that cutting taxes on the rich would leave them with more money to invest. This in turn would stimulate the economy, put more people to work and, in the end, generate even more revenues for the state (Mellon 1924). Needless to say, others were skeptical, but Congress was anxious to pass out tax cuts and quickly moved to accommodate Mellon's plan (Adams 1928; Walton 1928).
4. See, for example, (Eberstein 1929; Keynes 1933; Strachey 1933; SOU 1936; SOU 1936; Blough and Shoup 1937; Haas 1937; Benham 1942; Genberg 1942; Shirras and Rostas 1942).
5. In the American case the government employed a public relations firm to help propogandize these ideas. A very popular slogan, for example, was "Taxes to beat the Axis" see (Jones 1996).
6. The income at which the individual begins to pay income tax.
7. In most cases the wartime "Excess Profits" duties and taxes were scaled back and/or folded into more permanent corporate profit tax systems.
8. Assar Lindbeck, undoubtedly one of Sweden's most influential and powerful economist in Sweden since Gunnar Myrdal wrote in 1970, for example, "One can look in any elementary economics textbook today and see that we have the possibility through monetary and fiscal policy to maintain total demand in the economy exactly at any point that we wish" (Lindbeck 1970: 20). Today Professor Lindbeck, is chair of the Nobel Prize in Economics Committee and is an ardent neo-classical economist.
9. Tax expenditures have had a long history, of course, and were not invented during these years. What was different here was the growing belief that tax expenditures could be effective instruments of public management rather than simply political prizes offered to the powerful.
10. Of course, the character and structure of these tax expenditures could differ quite dramatically between nations. I have argued elsewhere that the variation in tax expenditure policies is best explained as a product of variations in state institutional structures (Steinmo, 1986). The U.S., for example, tended to write very specific tax incentives designed to benefit specific (politically powerful) industries, firms and individuals. Other countries designed broader (and less complicated) incentive mechanisms which could be used by anyone who invested in the ways determined by the government. Two of the countries which perfected these incentive mechanism the most were Germany and Sweden.
11. See, for example, the publications of the International Fiscal Association, Cahiers De Droit Fiscal International, from 1939 forward (on the WEB at <http://www.vuw.ac.nz/~holmesk/cahiers.html>). Or international conference publication put out by the Brookings Institution.
12. For an attempt at such a catalogue see (McDaniel and Surrey 1985).

13. See Pechman and Okner, 1969: 7 in praise of the Carter Commission report on the Canadian Tax System.
14. In order to pass a huge tax rate cut, the administration offered to add literally hundreds of tax expenditures to the tax bill to sweeten the package (Stockman, 1986:44). What started out as a side deal here and a side deal there, however, ended up becoming an avalanche.
15. Vertical equity implies progressivity (that fair taxes should tax those with greater ability to pay *more* than those with lesser abilities to pay). Horizontal equity, in contrast, refers to treating those with equal incomes equally - often irrespective of their ability to pay.
16. Interview with author, May 1988.
17. Vito Tanzi surveys the recent literature and suggests that changes in the international economy are so profound that there are serious doubts about whether capital taxation can continue to exist at all.

For example, Roger H. Gordon has asked, Can capital income taxes survive in open economies? In the same spirit, Jack M. Mintz asked, Is there a future for capital income taxation? For Guttorm Schjelderup, the fear is that capital mobility may lead to capital flight from high to low tax countries in such large amounts that it deprives a nation of its tax base and, as a consequence, its welfare system (Tanzi 1995).

Tanzi goes on to argue that it is especially small open countries that are the most vulnerable:

Similar fears have been expressed by other authors, including Frenkel, Razin, and Sadka. These fears are related to the taxation of capital in all countries but acquire special urgency in small countries. Small countries may find it particularly difficult to maintain high tax rates on capital income, and some of them may be tempted to become tax havens for foreign capital, thus making it more difficult other countries to maintain their tax rates. As Razin and Sadka have put it, No capital income tax, whatsoever, can be efficiently imposed by a small open economy if capital flight to the rest of the world cannot be stopped. Of course, for capital to move out of a given country the net-of-tax rate of return in the rest of the world must be lower than that in the country. The idea that especially small countries will be exposed to the effects of deep integration on capital taxation is a recurrent theme in the literature on international taxation (Tanzi 1995).

18. Vertical equity usually implies that those with greater incomes should pay a larger share of their income in taxes.
19. Comparative data on effective tax rates by income class is extraordinarily difficult to attain or even compile. This author has examined the shift in tax burdens in four countries (Britain, Sweden, Germany, the US and Japan) and found that tax rates among 'middle class' families have not changed dramatically over the past ten years, but taxes paid by the very poor have gone up as a percentage of their income and taxes paid by the very rich have gone down as percentage of their income in each case.
20. It is interesting to note that there has been a recent flurry of academic writing among political scientists that appears to argue that tax policy makers do not have to respond to internationalizing incentives by calling taxes and/or redistributing the tax burden. Apparently, however, elite policy makers have not read these analyses (cf. Garrett 1996; Garrett and Lange 1993; Waltman 1985).