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A PRELUDE TO THE FLOOD OF RED INK: FROM A STUDY OF COMPREHENSIVE TAX REFORM IN THE 1950S TO THE FEDERAL TAX REFORM OF 1962 IN THE UNITED STATES

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Abstract: The administration of John F. Kennedy enacted their first tax cut in 1962 that combined investment credit with several reform measures. Scholars have focused on how it passed through Congress as a tax cut; this paper illuminates how the reform measures, taken from the "one package" comprehensive tax reform plan discussed in the 1950s, was doomed. The Treasury Department and the House Committee on Ways and Means wanted to accomplish a comprehensive tax reform to make the federal tax system simpler, more equitable, and progressive. However, their compromise with Kennedy's economic advisers and vested interests killed their ideal tax reform.

Key words: "One package" comprehensive tax reform, the Treasury Department, Wilbur D. Mills.
JEL Classification Number: B3, H2, N00.

INTRODUCTION

On October 16, 1962, President John F. Kennedy signed into law the Revenue Act of 1962. This act provided a tax cut involving investment credits and several structural reform measures to offset revenue losses. In the statement upon signing the Revenue Act, Kennedy stated the effects of the tax cuts: on the one hand, in combination with the depreciation guideline reform enacted on July 12, 1962, investment credits would provide additional stimulus to investment in machinery and equipment, and give US firms more favorable tax treatment than their competitors in world markets; and on the other, structural reform measures would make the distribution of tax burdens fairer and

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offset revenue losses produced by investment credit and depreciation reform through reducing tax avoidance on incomes earned by individuals and corporations at home and abroad. Kennedy addressed that this act would not only stimulate economy, but also provide a greater measure of fairness in the federal tax system. Furthermore, he stated that it would make a good start on bringing the federal tax structure up to date and set up a favorable context for a comprehensive tax reform program that his administration intended to propose in 1963.[1]

This Kennedy's anticipation never realized. On January 24, 1963, the Kennedy administration finally proposed the comprehensive tax reform bill that provided huge cuts for individual and corporate income tax rates and structural reforms to broaden the tax base. The tax bill was proposed as a huge tax cut that aimed not only at stimulating consumer demand and investment, but also boosting progressivity, fairness, simplicity, and equity of the federal tax system.[2] When the bill was signed into law by Kennedy's successor, Lyndon B. Johnson, on February 26, 1964, it contained almost no structural reforms, while slashing individual and corporate income tax rates almost along with the original proposal. Consequently, the tax cut of 1964 did not achieve the original goal—making the federal tax structure fairer and more equitable—and was little more than a huge tax cut.[3] This result dissipated the possibility that the 1962 tax cut might catalyze the success in reforming the federal tax system in ways that the Kennedy administration expected.

This was definitely the result that the Kennedy administration replaced an emphasis regarding with their tax policies from the role of structural reform measures to the stimulating effect on economy of tax-cutting measures. In a 1961 message about their long-range tax reform, Kennedy stated that its major goal was to construct "a tax system that is more equitable, more efficient, and more conducive to economic growth" by "broadening the tax base and reconsidering the rate structure."[4] When the Kennedy administration ultimately proposed the resulting tax reform bill as a substantial tax cut on January 24, 1963, however, Kennedy stated that the intent of the tax reform bill originally proposed in 1961 was depreciation reform and investment credits that he had pledged would be only a first step toward the tax reform bill of 1963. In the same message, he argued that the tax reform proposal was crucial to achieve the goals to end the

[1] John F. Kennedy, *Public Papers of the Presidents of the United States, John F. Kennedy: Containing the Public Messages, Speeches, and Statements of the President, 1962* (Washington, D.C.: U.S. Government Printing Office, 1963), 787–788.

[2] John F. Kennedy, *Public Papers of the Presidents of the United States, John F. Kennedy: Containing the Public Messages, Speeches, and Statements of the President, 1963* (Washington, D.C.: U.S. Government Printing Office, 1964), 73–92.

[3] The Treasury Department, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1964* (Washington, D.C.: U.S. Government Printing Office, 1965), 36. Richard Goode demonstrates the particular result and effect that the tax reform of 1964 had on the individual income tax system. See Richard Goode, *The Individual Income Tax, 1st ed.* (Washington, D.C.: The Brookings Institution, 1964), 236.

[4] John F. Kennedy, *Public Papers of the Presidents of the United States, John F. Kennedy: Containing the Public Messages, Speeches, and Statements of the President, 1961* (Washington, D.C.: U.S. Government Printing Office, 1962), 291.

waste of unemployment and unused resources, to increase job and investment opportunities for improvement of productivity, and to lead the way to strong economic expansion and larger revenue yield.[5] Moreover, in a statement on economic issues prepared for the presidential campaign in 1964, Johnson stated that the Kennedy administration had enacted the most far-reaching tax reductions in history in 1962 to help industry modernize its facilities.[6] As a result, scholars discussing the tax cut of 1962 have evaluated that it was a significant step to the accomplishment of the tax cut of 1964—Walter Heller, the chairman of the Council of Economic Advisers (CEA) of the Kennedy administration, called a part of "the completion of the Keynesian Revolution"—that would be the largest income tax cut in US tax history until 1981.[7]

These scholars have generally focused on how the Kennedy administration could succeeded in accomplishing the 1962 tax reform as a tax cut. However, this paper first demonstrates its aspect on which few scholars have focused, namely, the legislative process of cutting down on structural reforms that turned the small tax increase bill proposed in 1961 into the tax cut of 1962. The Bureau of Budget of the White House (BOB) and the Treasury estimated that federal budget deficits would increase from the economic decline in 1960 and projects to expand social programs. Shortly after inauguration of Kennedy, his administration proposed the tax reform bill of 1961 as small tax increase involving investment credits and the reform measures. However, strong congressional opposition and lobbying from interest groups doomed the legislation of the latter in the proposed form. Thereafter, the tax cut of 1962 has been evaluated as a step to the accomplishment of the 1964 tax cut that was legislated for the first time after World War II in the face of federal budget deficits in 1964. Furthermore, in the 1970s and the 1980s, the administration of Richard Nixon, Gerald Ford, and Ronald Reagan used investment credit in congressional order to stimulate productivity and domestic economy, which resulted in expanding federal budget deficits. Consequently, the 1962 tax cut not only debuted tax-cutting measures as an economic policy preferred politically, but also opened the door to the era of federal deficits.

This explanation is similar to the argument of John F. Witte. Based on the incremental/pluralist theory, Witte argues that the basic purpose and legitimacy of tax policy—raising revenue equitably—has been jeopardized in the long run by domestic impulse

5 John F. Kennedy, *Public Papers of the Presidents of the United States, 1963*, 73–74, 79.

6 Office of the White House Press Secretary, "Presidential Statement #5 on Economic Issues: Further Tax Reduction," October 27, 1964, Historical Special Collection (HSC), Harvard Law School Library (HLSL), Stanley S. Surrey Papers (SSSP), Box 53, File No. 91-2D: Campaign, 1964.

7 Julian E. Zelizer, *Taxing America: Wilbur D. Mills, Congress, and the State, 1945–1975* (New York: Cambridge University Press, 1998); Iwan W. Morgan, *Deficit Government: Taxing and Spending in Modern America* (Chicago: Ivan R. Dee, Inc., 1995); Ronald F. King, *Money, Time, & Politics: Investment Tax Subsidies & American Democracy* (New Haven: Yale University Press, 1993); Cathie Jo Martin, *Shifting the Burden: The Struggle over Growth and Corporate Taxation* (Chicago: The University of Chicago Press, 1991); John F. Witte, *The Politics and Development of the Federal Income Tax* (The University of Wisconsin Press, 1985); Herbert Stein, *The Fiscal Revolution in America* (Chicago: The University of Chicago Press, 1969); Edward S. Flash, Jr., *Economic Advice and Presidential Leadership: The Council of Economic Advisers* (New York: Columbia University Press, 1965). As for Heller's explanation, see Walter W. Heller, *New Dimension of Political Economy* (New York: W. W. Norton & Company, Inc., 1966).

to represent broad and diverse sets of interests, to meet the political needs of decision makers, and to correct, adjust, and fine-tune the system which was facilitated by an incremental/pluralist process.[8] As for the tax cut of 1962, Witte argues that the faltering state of the economy, Kennedy's desire to take action to fulfill his platform for the presidential campaign in 1960, and Kennedy's economic advisers recommendation to restore the growth in productivity led the Kennedy administration to propose the investment credits with structural reform measures to offset revenue losses in 1961. However, the proposal immediately ran into stiff opposition from business communities, labor organizations, several industries. In response to their requirements and Congressional majority, the CWM and the Senate Finance Committee (SFC) recommended the elimination of most of reform measures. When passed the Senate, the tax bill took the form of tax cut with investment credit and further fewer structural reform measures. Then Witte concludes: "Even in this relatively modest bill, provisions pleasing to almost anyone could be found."[9]

This paper instead demonstrates the fact that Witte neglects; the investment credit and revenue-raising structural reforms appeared from different context, and the reduction of structural reform measures meant a significant failure for federal tax reform in the future. Since the 1950s, several tax experts, the Tax Analysis Staffs (TAS), a taxation bureau within the Treasury Department, and the Committee on Ways and Means (CWM) led by Wilbur D. Mills examined the defects of the federal tax system: the narrow tax base, excessively high tax rates, the inequality among both income brackets and types, and its weak progressive structure. In 1959, they agreed that the federal government should propose a "one package" comprehensive tax reform that would improve the tax structure by closing loopholes and lowering high tax rates without any revenue losses, at least in the early 1960s. When the Kennedy administration proposed the tax reform bill of 1961, several structural reform measures included in the bill departed from the agreed-upon tax reform plan not only as measures to offset revenue losses, but also as a step to accomplish a comprehensive tax reform that it would propose later. However, when Kennedy proposed his second tax reform program in January 1963, he addressed that investment credit and depreciation reform were significant accomplishments of the tax cut of 1962. The failure in legislating structural reform measures in 1962 resulted in impressing the public that the Kennedy administration ambitioned to carry out tax cut programs.

1. TAX REFORM BILL BEFORE KENNEDY'S INAUGURATION

After WWII, financing government expenditures through taxation was an urgent subject in federal fiscal operations. The increases in outlays for national defense, health, labor, and welfare significantly expanded federal government expenditures. In the late 1950s, however, the Department of Labor and the Department of Health, Education

[8] John F. Witte, *The Politics and Development of the Federal Income Tax* (The University of Wisconsin Press, 1985), xxii, 369–370.

[9] *Ibid.*, 158.

and Welfare began formulating welfare, labor, and other social policies to deal with problems such as unemployment, the elderly, or the poor. Although the administration of Dwight Eisenhower attempted to restrain federal expenditures, the administration of John F. Kennedy planned to propose programs such as public works, the expansion of Aid to Dependent Children, and a vocational training and reeducation program that would increase federal government expenditures.[10] It was therefore important to create an income tax system that provided steady revenues to stabilize federal fiscal condition.

The amount of tax revenue from individual and corporate income—the main sources of revenue in the federal tax system—fluctuated with economic conditions.[11] The federal income tax system after WWII had contained plenty of tax preferences, which had not only narrowed the individual income tax base, but also favored higher-income classes.[12] The narrow tax base created a high nominal rate structure (20–91 percent). The amount of personal exemptions declined since the federal income taxation was introduced in 1913.[13] In 1960, however, the proportion of income deductions to total the amount of adjusted gross income for taxpayers in the under $2,000 tax bracket was 12.2 percent, but that for those above $500,000 was 21.5 percent.[14] Total amount of adjusted gross income of all of taxpayers in 1959 was $335.1 billion, but these provisions curtailed taxable income to $167.9 billion, tax liability to $39.9 billion, and overall effective rate to 23.3 percent. In short, the federal income tax system at the time provided preferential treatment to higher-income tax brackets and for unearned income compared to lower-income tax brackets and earned income, despite the fact that it had become more important since the 1950s to not only raise stable revenues and deal with the increase in taxpayers who received salaries, wages, and income from assets through the federal income tax system, but also capture them more accurately.

To manage the fiscal issues, the TAS researched possible areas in which intensive consideration of them might well yield practical suggestions for improvement and simplification of the tax structure.[15] The report drafted on July 22, 1958 enumerated the tax reforms concerning capital gains, tax-exempt interest, percentage depletion, income averaging, travel and entertainment expenses, exclusions, medical deductions, fringe benefits, and treatment of the elderly.[16] The research of the TAS in 1958 led to a confidential report, "Suggested Outline for Tax Study" drafted on March 9, 1959, proposing three principle areas to study. The first area, the "economic effects of taxes," highlighted

[10] John F. Kennedy, *Public Papers of the Presidents of the United States, 1961*, 43–51.

[11] Bureau of Budget, *The Budget of the United States Government for the Fiscal Year, Ending June 30, 1962* (Washington, D.C.: U.S. Government Printing Office, 1961), 979.

[12] U.S. Congress, Joint Economic Committee, *The Federal Revenue System: Facts and Problems, 1961* (Washington, D.C.: U.S. Government Printing Office, 1961), 1–6, 10.

[13] It granted $3,000 for the single in 1913, but was reduced to $600 in 1948 and had been kept this standard.

[14] Internal Revenue Service, *Statistics of Income: Individual Income Tax Returns, 1960* (Washington, D.C.: U.S. Government Printing Office, 1961), 66.

[15] In 1961, the name of the TAS changed to the Office of Tax Analysis (OTA).

[16] "Areas of Possible Tax Reform and Simplification," July 22, 1958, National Archives College Park (NACP), RG 56, Office of Tax Policy: Subject Files (OTPSF), Box 68, File Folder #56: Suggestions for TAX REFORM Submitted to Treasury for Comment, 1959.

personal income tax, corporate income tax, gift and estate taxes for analysis considering (1) incentives, saving, mobility, and demand, (2) horizontal and vertical equity, (3) capacity to produce revenues, (4) cyclical flexibility, (5) effectiveness in resource allocation, and (6) distribution of tax burden. The second area concerned the "tax base," in line with the criteria of the first area, to weigh the merits of the various exclusions, deductions, and exemptions that made the tax base so much narrower than personal income from which it could have derived. The third area, "tax rates," argued that the two areas should consider the total amount of rate reductions possible as a result of broadening the tax base, and how to distribute the tax burden among the various tax and income groups.[17]

While the Treasury progressed with its research, the CWM, led by Wilbur D. Mills as of January 7, 1958, began studying and discussing tax issues. Jere Cooper, the former chairman of the CWM, stated that the hearings "will be utilized as a source of information in order to obtain a revenue system which is fair, equitable, neutral in impact between similar dollars of income, responsive to changes in economic conditions, and capable of compliance and administration with a minimum of taxpayer and governmental effort, and which will at the same time produce the needed revenues for the Government."[18] On February 15, 1959, Mills argued that tax reduction in the near future should wait until budget surpluses could be accurately foreseen, while stating that the existing tax system had contributed to industrial operations at less than full capacity, and affected employment, economic stability, and growth because the situation the United States was "part peacetime and part wartime" due to the Cold War. Referring to tax revisions to add specific tax preferences as "tax erosion," he argued that eliminating unjustifiable tax differentials and preferences and lowering tax rates for everyone was the hallmark of a comprehensive tax reform program.[19] In addition, on May 18, 1959, Mills stated that the comprehensive tax reform revision had to occur without sacrificing revenues required for responsible government financing.[20] In addition, as the representative of the CWM, Mills argued for a comprehensive tax reform that would enable a more responsive, equitable, and fair tax system for both economic stability and growth, and adequate tax revenues to finance federal government programs.

The CWM, cooperating with the Treasury, held hearings to discuss the specific measures of a comprehensive tax reform program that could meet the criteria above from

[17] "Suggested Outline for Tax Study," March 9, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

[18] "Chairman Jere Cooper of the Committee on Ways and Means Releases a Further Announcement Relative to the General Tax Revision Hearings Scheduled to Begin January 7, 1958," September 11, 1957, HSC, HLSL, SSSP, Box 39, File No. 28-1: Ways and Means Committee, 1957–1960.

[19] "Address of Chairman Wilbur D. Mills, Committee on Ways and Means, U.S. House of Representatives, before the Ninth Annual Mid-Year Conference of the Tax Executive, Shoreham Hotel, Sunday Evening, February 15, 1959," February 15, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

[20] "Chairman Wilbur D. Mills, Committee on Ways and Means, House of Representatives, Announces Committee's Plans for Study Aimed at Revision of Federal Tax System," May 18, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

November 16 to December 18 in 1959. The CWM invited a number of tax experts from colleges and universities, research organizations, business, labor, and agriculture.[21] Before this series of hearings concluded, the CWM drafted a report, "Tax Policies for Economic Growth," to outline the expected tax reform proposal. As for the individual income tax rate structure, it recommended (1) reducing marginal rates on personal income, (2) revising the income tax brackets and rates, especially in the lower-income scale to create a more progressive structure, and (3) splitting the lowest bracket and taxing the lower part at lower rates to improve both equity and built-in flexibility. Its proposed rate revision would include base-broadening measures, such as (1) eliminating exclusions, exemptions, tax credits, and special dispensations according to income source and industry, (2) increasing deductibles for capital losses, and (3) redefining capital gains to prevent the conversion of ordinary income into capital gains for tax reasons. As for corporate income taxation, it recommended (1) reducing corporate tax rates while tightening definitions of business expenses and net income, (2) liberalizing depreciation allowance by revising the calculations for useful life while taxing gains from the sale of depreciable assets as ordinary income, and (3) eliminating the tax bias against equity financing in favor of debt financing. The CWM recognized that these measures would meet the principles of a sound tax system that would generate sufficient revenues to finance all necessary government expenditures and contain contra-cyclical tax flexibility,[22] tax people equally both horizontally and vertically, be as simple as possible for the government and the taxpayer, and be as neutral as possible in its effects on private economic decision-making. They argued that the tax revision would remove impediments to efficiency and growth, improve the productivity of capital, release or restore incentives to personal effort, and increase savings and risk-taking. Finally, the CWM concluded that every recommended tax reform would have to be coordinated with other simultaneous changes in the tax structure as a single package of constructive tax reform to create a tax system with contra-cyclical tax flexibility, horizontal and vertical equity, simplicity, and neutrality toward the economy.[23]

However, it seemed to take a long time to propose the tax reform plan. The consensus among those testifying about tax reform was loss apparent. In the panel discussion, some experts believed that several provisions of the existing law gave undue advantage to particular groups or activities, while others were just as convinced that they were

[21] "Program of Panel Discussion in General Revenue Revision, 1959," September 8, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962. As for this series of hearings, see U.S. House of Representatives, Committee on Ways and Means, *Tax Revision Compendium of Papers on Broadening the Tax Base*, vol. 1–3 (Washington, D.C.: U.S. Government Printing Office, 1959).

[22] The Report described contra-cyclical tax flexibility meant the ability of generating substantial surpluses under boom conditions to offset the inevitable and beneficial deficits occurring in periods of decline in business activity.

[23] "Tax Policies for Economic Growth," December 17, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #56: Suggestions for TAX REFORM Submitted to Treasury for Comment, 1959.

Table 1. Annual Rates of Growth of Real Gross Domestic Fixed Gapital Formation, 1948–57

(percent)

Country	1948-50	1950-53	1953-57	1948-57
OEEC total	10.0	4.8	7.9	7.3
Selected Countries				
France	5.3	1.2	9.6	5.8
Germany	-	8.5	9.7	9.2
Italy	5.3	9.4	8.6	8.1
Netherlands	6.3	3.2	8.5	6.2
Sweden	4.6	4.4	4.0	4.3
United Kingdom	6.6	3.5	5.7	5.1
United States	5.7	1.5	3.6	3.4

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, "Affirmative Brief for President's Recommendation for Investment Tax Incentive Credit," April 28, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H.R. 10650 (Section 2)—Investment Tax Credit.

essential to tax fairness and to promote desirable economic or social objectives.[24] On the last day of panel discussion, Mills stated that it would be necessary for the CWM, the Joint Committee on Internal Revenue Taxation (JCIRT), and the Treasury, "before any plan can be developed, to review and analyze the various suggestions which have been made to us and give the Committee the benefit of their views as to their feasibility and practicability." He added: "It will not be possible for the staffs to complete this analysis in the remainder of this Congress, thus it will not be possible for the Committee on Ways and Means, itself, to give specific consideration in 1960 to any broad proposals of tax revision based on these discussions."[25] Fred C. Scribner Jr., Under Secretary of the Treasury in the Eisenhower administration, told Mills: "We concur in your view that this analysis by the staffs will necessarily take time."[26] Douglas H. Eldridge of the TAS also conveyed to Scribner that to propose an inventory of suggestions for tax revisions "at that time would seem very unwise."[27] Thus it was decided that creating and proposing the measures be put off until after Kennedy's inauguration.

2. ECONOMIC CONDITIONS AND THE ARGUMENT TO STIMULATE INVESTMENT

The recession of 1960–61 after the discussion of future tax reform and the presidential campaign in 1960 challenged the plan to propose a comprehensive tax reform bill. The American economy often fluctuated in the late 1950s. From 1955 to the third quarter of 1957, new investments for machinery and equipment increased excessively, which developed mechanization and automation. However, these investments declined sharply from the fourth quarter of 1957, leading to a decline in economic activity. Though economic activity and industrial production recovered from second quarter of 1958 to the end of 1959, it again declined from 1960 to the first quarter of 1961.

Meanwhile, there was the problem with fixed capital formation in the United States.[28] As Table 1 shows, the growth rate of real gross domestic fixed capital formation in the United States was substantially lower than that in selected European countries and OEEC total. The reasons behind it were the leveling off or actual decline in business expenditures on plant and equipment, and the increase in depreciation and obsolescence of existing stock. Other countries, in contrast to the United States, had been lowering the average age of their fixed capital. The lower increase in fixed investment raised the issue of the balance of payments. Higher prices for American products compared to those of other countries such as France, West Germany, and Japan, and the slowdown of industrial production led to deterioration in the balance of trade and the U.S. position in the export market.[29] Both long- and short-term capital continued flowing outward due to the lower short-term interest rate and the movement of U.S. firms to foreign countries through private direct investments. The balance of transfer deficit also expanded through an increase in foreign military expenditures and foreign economic assistance.[30] These problems related to the balance of payments ultimately led to the outflow of gold and an unstable dollar value.

Senator John F. Kennedy and his economic advisers during the presidential election

[24] Fred C. Scribner, Jr. to Wilbur D. Mills, December 18, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

[25] "Closing Statement of Chairman Wilbur D. Mills, Committee on Ways and Means, at the End of Five Weeks of Panel Discussions on Tax Reform," December 18, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

[26] Fred C. Scribner, Jr. to Wilbur D. Mills, December 18, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

[27] Douglas H. Eldridge to Fred C. Scribner, Jr., "Draft of the 'Tax Policies for Economic Growth'," December 21, 1959, NACP, RG 56, OTPSF, Box 68, File Folder #56: Suggestions for TAX REFORM Submitted to Treasury for Comment, 1959.

[28] Office of Tax Analysis, "Affirmative Brief for President's Recommendation for Investment Tax Incentive Credit," April 28, 1961, NACP, RG 56, Office of Tax Policy: Legislative History Files (OTPLHF), Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

[29] United Nations, *Statistical Yearbook* (New York and Geneve, 1961), 66–68; Nasrollah S. Fatemi, Thibaut de Saint Phalle, and Grace M. Keeffe, *The Dollar Crisis: The United States Balance of Payments and Dollar Stability* (Madison: Fairleigh Dickinson University Press, 1963), 38, 54.

[30] *January 1961 Economic Report of the President and the Economic Situation and Outlook*, 423–424; Nasrollah S. Fatemi et al, *The Dollar Crisis*, 152–153; Pizer, S. and Culter, F., "Expansion in U. S. Investments Abroad," *Survey of Current Business*, Vol. 42, No. 8, August, 1962, 20.

in 1960 aimed to solve these economic problems. Some eminent economists, led by Paul A. Samuelson and James Tobin, helped to draft Kennedy's platform. For instance, in a meeting regarding the outline of the campaign's economic platform on August 3, 1960, Samuelson indicated that the platform had to suggest returning to fuller utilization of unemployed or underemployed human and capital resources as one of most important paths to higher growth.[31] They did not prefer easy money because of the balance of payments problem. Thus, the economists stressed the expansion of both private and public capital formation through tax reform such as accelerated depreciation or investment allowance.[32] In addition, businesses argued for a measure to stimulate investments in machinery and equipment in the same period.[33]

In line with these arguments, Kennedy's Taxation Task Force led by Stanley S. Surrey began devising measures to stimulate private investment from 1960.[34] Their tax policy report released on December 31, 1960 rejected accelerated depreciation because they regarded it as a measure benefitting only larger firms that could afford these investments. Instead, they recommended a measure enabling corporations to deduct a percentage of the investment in new plant and equipment during the year in excess of its current depreciation deduction (the excess over depreciation allowance approach).[35] After Kennedy took the office, the OTA and the Tax Legislative Counsel (TLC) in the Treasury began writing the details of the investment credit bill, preferring the excess over depreciation allowance approach to the "across-the-board approach" that could apply to certain percentages of investment expenditures.[36] E. Cary Brown and Richard A. Musgrave, working with both the Treasury and the Council of Economic Advisers (CEA), also recommended the excess over depreciation allowance approach.[37] This recommendation was aimed to benefit and provide some of the available financing techniques to smaller firms, as most did not have access to the security markets and could not obtain

[31] Attendances were John K. Galbraith, Seymour E. Harris, and Samuelson.

[32] Paul A. Samuelson to Archibald Cox, "August 3 Meeting of Galbraith-Harris-Lester-Samuelson with Senator Kennedy," August 8, 1960, HSC, HLSL, SSSP, Box 127, File No. 91–2D: Investment Credit (Tax Incentive 1), 1960–1961.

[33] Imrie de Vegh, "The Economic Problem of the Sixties," August 19, 1960, HSC, HLSL, SSSP, Box 127, File No. 91-2D: Investment Credit (Tax Incentive 1), 1960–1961.

[34] Task Force included Mortimer Caplin, Richard Musgrave, Norman Ture from the Joint Economic Committee, Cary Brown, and Adrian DeWind who was a New York attorney who had specialized in tax matters and who had served as the Chief Counsel on the House Ways and Means Subcommittee on Internal Revenue Administration in 1951–52. In February 1961, Surrey assumed Assistant Secretary of the Treasury for Tax Policy, and Caplin became the Commissioner of the Internal Revenue Service.

[35] Taxation Task Force, "Tax Policy for 1961: Contents, Listing, of Matters Covered, Brief Summary of Recommendations, Detailed Discussion of Recommendations," December 31, 1960, John F. Kennedy Library (JFKL), Papers of John F. Kennedy, Pre-Presidential Papers, Transition Files (JFKTRAN), Task Force Reports 1960 (TFR1960), Box 1072, File: Taxation Task Force Report.

[36] "Alternative Approaches to an Investment Incentive Allowance," Undated, HSC, HLSL, SSSP, Box 127, File No.: 91-2A, File: Investment Credit (Tax Incentive 1), 1960–1961.

[37] E. Cary Brown and Richard A. Musgrave to Stanley S. Surrey, "Choices on Investment Credit Approach," February 24, 1961, HSC, HLSL, SSSP, Box 127, File No.: 91–2A, File: Investment Credit (Tax Incentive 1), 1960–1961.

term loans. Those days, they used lease financing to obtain capital equipment.[38] The Treasury finally recommended an investment credit with the excess over depreciation allowance approach to meet the economic advisers' and businesses' requests.

The Task Force simultaneously recommended retrieving $2 billion in offsetting funds by closing certain minor loopholes that were either long on the Democratic agenda or thought not to be very controversial.[39] The economic decline from 1960 to 1961, the BOB estimated, would turn the consolidated budget in fiscal 1961 from a surplus of $0.8 billion to a deficit of $2.3 billion.[40] They thus argued for a combination of the investment credit and some of the reform measures discussed since the 1950s.

3. PROPOSAL OF THE TAX REFORM BILL 1961

The Kennedy Administration proposed their first tax reform bill in its "Special Message to the Congress on Taxation" on April 20th, 1961.[41] The first section, "Tax incentive for modernization and expansion," recommended the investment tax credit taking a "three-step-scale-excess" approach,[42] in addition to several restrictions on the application of investment credits.[43] This measure would involve a $1.7 billion revenue loss. The second part, "Tax treatment of foreign income," recommended reforms to foreign income taxation,[44] estimated to raise $ 250 million in tax revenue. The third section, "Correction of other structural defects," proposed reforms to the treatment of dividends

[38] Kenneth W. Bergen to Stanley S. Surrey, January 18, 1961, HSC, HLSL, SSSP, Box 127, File No.: 91-2C, File: Investment Credit (Tax Incentive 1), 1960–1961.

[39] Taxation Task Force, "Tax Policy for 1961: Contents, Listing, of Matters Covered, Brief Summary of Recommendations, Detailed Discussion of Recommendations," December 31, 1960, JFKL, JFKTRAN, TFR1960, Box 1072, File: Taxation Task Force Report.

[40] Bureau of Budget, *The Budget of the United States Government for the Fiscal Year Ending June 30, 1963* (Washington, D.C.: U.S. Government Printing Office, 1962), 8.

[41] John F. Kennedy, *Public Papers of the Presidents of the United States, 1961*, 292–300.

[42] It would provide (1) 15 percent of all new plant and equipment investment expenditures in excess of current depreciation allowances, (2) 6 percent of such expenditures below this level but in excess of 50 percent of depreciation allowances, with (3) 10 percent on the first $5,000 of new investment as a minimum credit.

[43] The contents were as follows: (1) Investment credit would be taken as an offset against the firm's tax liability up to an overall limitation of 30 percent in the reduction of that liability in any one year, (2) It would be available to the investment expenditures for new plant and equipment with a useful life of 6 years or more in the United States after January 1st of 1961, and (3) Investments by public utilities other than transportation would be excluded, as would be investment in residential construction including apartments and hotels.

[44] The contents were as follows: (1) Taxation on each year American corporations on their current share of the undistributed profits realized in the year by subsidiary corporations organized in economically advanced countries, (2) The elimination of tax deferral privileges for the profits earned by the operation in the "tax haven" countries, (3) Taxation on the income derived through foreign investment companies in the same way as income from domestic investment companies, (4) Termination of the total tax exemption in those days accorded the earned income of American citizens residing in economically advanced countries, limitation of this exemption to $20,000 for those residing in the less developed countries, and termination of the exemption of $20,000 of earned income accorded those citizens who stayed abroad for 17 out of 18 months, and (5) Termination of the exclusion from the estate tax accorded real property situated abroad.

and interest (increasing revenue by $1,050 million),[45] measures related to expense accounts (increasing revenue by $250 million),[46] and measures for capital gains on the sale of depreciable business property (increasing revenue by $200 million).[47] As a whole, the tax reform bill would raise an estimated $50 million in tax revenue.

The investment credit proposal had two purposes. On the one hand, it aimed to improve productivity, reduce production costs, promote economic growth, and improve the balance of payments.[48] On the other hand, the three-step-scale-excess approach in the investment credit proposal would significantly reduce inequity among corporations. In 1958, while the percentage of corporate returns under $25,000 was 83 percent of all taxable corporations, this income class accounted for only 7 percent.[49] It was estimated that financing investments was more difficult for firms in this income class than for large corporations. Therefore, a credit of 10 percent on the first $5,000 of new investment as a minimum targeted firms under $25,000, such as small and new businesses in need of new investments to modernize plant and equipment. It was expected that a majority, especially new and growing firms, would be induced to invest through a tax credit of 15 percent of all new plant and equipment investment expenditures in excess of the current depreciation allowance. The 6 percent credit for firms whose new investment expenditures were between 50 and 100 percent of their depreciation allowances was designed to incentivize depressed or risk-averse firms that knew they could not yet achieve the 15 percent credit.[50] The investment credit proposal was therefore designed to correct both the domestic economy by encouraging investments by small, new, and growing businesses and the problem of the balance of payments.

The measures to reform foreign income tax treatment and to correct other structural defects were significant. From the viewpoints of the Kennedy administration, "a sound tax system is essential if we are to carry out our defense program and provide the public services which are so necessary in our present society." They believed that the existing tax structure, however, "contains a number of provisions which grant special treatment to certain types of taxpayers." Their objective "should be to remove these tax preferences in any case where they are not clearly justified." "These changes, while making

45 On the treatment for dividends and interest, two measures were proposed as follows: (1) 20 percent withholding rate on corporate dividends and taxable investment type interest, and (2) The repeal of the exclusion from income of the first $50 of dividends received from domestic corporations and a 4 percent tax credit against of dividend income in the excess of $50.

46 The contents were as follows: (1) The disallowances in full of a tax deduction for the cost of business entertainment and the maintenance of entertainment facilities such as yachts and hunting lodges, and (2) The restrictions on the deductibility of business gifts, expenses of business trips combined with vacations, and excessive personal living expenses incurred on business travel away from home.

47 The items were as follows: (1) The elimination of the treatment for the gains from the disposition of depreciable assets as capital gains to the extent which depreciation had been deducted for such property by the seller in previous years, (2) Permitting only the excess of the sales price over the original cost to be treated as a capital gain, and (3) Treatment for the remainder as ordinary income.

48 C. Douglas Dillon to Wilbur D. Mills, August 2, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

49 Joint Economic Committee, *The Federal Revenue System: Facts and Problems, 1961*, 28.

50 John F. Kennedy, *Public Papers of the Presidents of the United States, 1961*, 293.

a beginning toward the comprehensive tax reform program mentioned above, will provide sufficient revenue gains to offset the cost of the investment tax credit and keep the revenue-producing potential of our tax structure intact."[51] Additionally, the OTA and the TLC thought that the removal of preferential provisions "will result in a broader tax base which will make it possible to reduce the present tax rates for all taxpayers without a loss of revenue."[52] Surrey was also in favor of a base-broadening tax reform rather than rate-cuts or additional preferential treatment to create a more progressive structure and to improve both vertical and horizontal equity of the federal income tax system that had mainly favored unearned incomes and higher-income brackets, and to smooth the rate structure without revenue losses.[53] According to the Treasury's staff, "as a first step toward the goal of greater uniformity and equity in our tax system, the adoption of these reforms would serve as a prelude to the more extensive tax reform which should follow later."[54] In short, this tax reform bill was not necessarily crafted based on Keynesian theory. Revenue-raising reform measures were taken from the "one-package" comprehensive tax reform plan discussed in the late 1950s, and they were unexpectedly combined with the investment credit proposed by Kennedy's economic advisers before his inauguration.

4. DEFECTS IN THE FEDERAL TAX STRUCTURE RELATED TO THE 1961 TAX REFORM BILL

The coherent package constructive tax reform aimed to provide countercyclical tax flexibility, horizontal and vertical equity, simplicity, and economic neutrality, though it was ultimately divided. This section reviews the defects in the tax structure of concern to the Treasury to clarify why the specific measures in the tax reform bill of 1961 were chosen along these principles.

Foreign Income Taxation. The Kennedy administration believed that these provisions created the balance of payments problem. Since the 1950s, federal corporate income tax law granted US corporations operating through foreign subsidiaries some

[51] *Ibid.*, 297.

[52] R. A. Klayman, "Remarks on President's Tax Message," April 19, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

[53] Stanley S. Surrey, "Summary Statement of Stanley S. Surrey for Hearings on Broadening The Tax Base, House Committee on Ways and Means November 16, 1959, The Federal Income Tax Base for Individuals," Undated, HSC, HLSL, SSSP, Box 39, File No. 28–1: Ways and Means Committee, 1957–1960. Before taking the position in the Treasury, Surrey had already developed an intellectual commitment to closing loopholes in the income tax. In 1989, in response to an interviewer's question regarding his selection of Surrey for the Shoup mission, Shoup recalled how hostility to tax preferences shaped his choice of colleagues: "My own prejudices determined the selection of the members of the Tax Mission, and if Surrey had been an advocate of tax preferences, I might not have asked him to join the mission." M. Ramseyer, Carl S. Shoup, "Japanese Taxation: The Shoup Mission in Retrospect: An Interview," *The Japan Foundation Newsletter 1989*, vol. 16 (4), 5–6.

[54] R. A. Klayman, "Remarks on President's Tax Message," April 19, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

preferential treatment for their tax liabilities. Profits earned abroad through foreign subsidiaries were subject to United States tax only when they were returned to the parent company in the form of dividends. The number of firms operating through foreign subsidiaries thus increased since the 1950s, especially in tax havens such as Switzerland, Bermuda, the Bahamas, and Liechtenstein. This provision provided tax advantages to US firms operating through overseas subsidiaries with lower income taxes that were not available to companies operating solely in the United States. These firms attempted to exploit the multiplicity of foreign tax systems and international agreements to reduce their tax liabilities significantly, both at home and abroad, and to maximize their accumulated profits.[55] A number of investment companies created abroad also contributed to the capital outflow from the United States. Additionally, many American investors made proper use of this deferral in their foreign investments.

Treatment of Dividends and Interest. While federal income tax law contained a combination of withholding and voluntary reporting on wages and salaries under the individual income tax, income from dividends and interest were not withheld. This provision resulted in substantial tax evasion on this type of income, especially on interest.[56] As the higher income brackets usually received these incomes, it was patently unfair to salary and wage earners who therefore bore a larger share of the tax burden. According to the TAS, "Recipients of dividends and interest should pay their tax no less than those who receive wage and salary income, and the tax should be paid just as promptly. Large continued avoidance of tax on the part of some has a steadily demoralizing effect on the compliance of others,"[57] and that "this has been a source of weakness in our tax system to which the Congress and the Treasury have given attention over the years."[58]

Federal income tax law also excluded the first $50 of dividends received from domestic corporations from income and a 4 percent credit toward dividend income in excess of $50. These preferential treatments for income from dividends were introduced in 1954 to alleviate double taxation at the corporation and shareholder stages, and to encourage capital formation through equity financing. However, the revenue losses from these provisions were spread over a large volume of outstanding shares rather than concentrating on new shares, thus diluting their stimulus effects and resulting in relatively little increases in the supply of equity funds and a relatively slight reduction in the cost of equity financing. Table 2 shows that the amount of equity financing had not increased much and accounted for less than 10 percent of total corporate funds. The TAS, the IRS, and some members of the Joint Economic Committee (JEC) of Congress

55 John F. Kennedy, *Public Papers of the Presidents of the United States, 1961*, 294–295.

56 According to the estimation of the Treasury, the amount of unreported dividend was $900 million in 1958, and of unreported interest was $3–4 billion. And the Treasury estimated that the amount of loss of tax revenue was $300 million due to unreported dividend, and $500–800 million due to unreported interest. Tax Analysis Staff, "Dividend and Interest Reporting," January 17, 1961, NACP, RG 56, OTPSF, Box 68, File Folder #61: Tax Reform, 1961–1962.

57 John F. Kennedy, *Public Papers of the Presidents of the United States, 1961*, 297.

58 Tax Analysis Staff, "Draft Material on Tax Program," February 1, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

Table 2. Souces of Corporate Funds, 1949–1959

(Percentage distribution)

	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
Tax rates	21-38	23-57	28.75-80.75	30-82	30-82	30-52	30-52	30-52	30-52	30-52	30-52
Source of Corporate Funds											
Internal sources	96.1	47.1	48.0	57.8	64.8	89.2	52.9	58.0	65.9	85.7	57.6
Retained profits	50.3	29.4	25.3	24.0	26.0	28.4	21.7	21.9	20.9	19.9	17.1
Depreciation and Amortization	45.8	17.6	22.7	33.8	38.8	60.8	31.2	36.1	44.9	65.8	40.5
External long-term sources	27.7	9.5	19.7	30.5	25.0	28.8	17.1	23.2	28.2	35.5	18.3
Stocks	10.3	3.8	6.8	9.7	7.6	9.5	5.4	6.7	8.2	11.7	7.0
Bonds	21.3	4.5	9.1	15.9	15.8	17.1	8.4	9.8	16.7	19.2	8.1
Other debts	-3.9	1.1	3.8	4.9	1.6	2.3	3.4	6.7	3.3	4.6	3.2
Short-term sources	-23.9	43.4	32.3	11.7	10.2	-18.0	30.0	18.8	6.1	-20.8	23.9
Bank loans	-11.0	4.8	9.8	5.2	-0.3	-5.0	7.4	4.6	0.7	-7.8	4.0
Trade payable	-1.9	19.9	6.8	8.8	1.3	-0.9	10.9	11.5	5.6	-4.9	11.9
Federal income tax liabilities	-14.2	16.5	10.9	-10.0	2.0	-14.0	7.6	-3.5	-5.2	-7.8	4.5
Other	3.2	2.3	4.8	7.8	7.2	1.8	4.2	6.3	4.9	-0.3	3.6
Total sources	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: *The Federal Revenue System: Facts and Probrems, 1961*, pp. 32–33.

cooperated since 1955 and submitted a report to the JEC, pointing out that, "Stockholders do not base their decisions with respect to stock purchases on the basis of pretax corporate earnings per share, but rather on the basis of after-tax earnings available for distribution. Accordingly, shareholders take full account of the corporate income tax in determining the price they offer for a corporation's stock."[59] Finally, these dividend provisions created unequal tax burdens.[60] The dividend credit and exclusion disproportionately benefitted the middle- and high-income tax brackets, increasing inequity and eroding the income tax structure's progressivity.

Expense Accounts. Deductions for expense accounts also led to tax evasion at the individual and corporate levels. Many firms and individuals devised means of deducting a large proportion of personal living expenses as business expenses, resulting in a significant loss in federal tax revenues. According to a study by the Audit Division of the IRS (AD), it was customary in many industries to give gifts to customers and purchasing agents as well as to government employees such as highway inspectors and police officers. Income tax law at that time allowed deductions for these expenses against taxable income if it was necessary for the business. However, taxpayers very often failed to comply with the examining officer's request to provide the donees' names. In many of these cases taxpayers claimed that the amount of each gift was nominal though the total amount might have been substantial. These conditions made it extremely difficult

[59] Joint Economic Committee, *The Federal Revenue System: Facts and Problems, 1961*, 30.

[60] In the tax message on April 20th, it was estimated that about 80 percent of dividend income accrued to 6.5 percent of taxpayers whose incomes exceed $10,000 a year, while only about 10 percent of it accrued to those with incomes below $5,000. Similarly, by 1961, dividend income had sharply risen, accounted for about 1 percent of all income from all sources for those taxpayers with incomes of $3,000 to $5,000. But it constituted more than 25 percent of the income for those with $100,000 to $150,000 of income, and about 50 percent for those with incomes over $1,000,000. John F. Kennedy, *Public Papers of the Presidents of the United States, 1961*, 297–299.

Table 3. Entertainment Expenditures and Revenue Effect of Proposed Legislation

(In millions of dollars)

Item	Estimated total expenditures	Disallowed		Revenue Estimates
		Percent	Amount	
Eliminate comletely				
Tickets	50	100	50	20
Club dues	130	100	130	52
Hunting lodges	15	100	15	6
Working ranches	25	100	25	10
Fising camps	10	100	10	4
Resort properties	15	100	15	6
Yachts or boats	25	100	25	10
Other similar facilities	10	100	10	4
Total	280	100	280	112
Eliminate partly				
Food and beverages -- entertainment	400-1,000	25	100-250	40-100
Conventions	300	10	30	12
Gifts	200	20	40	16
Apartments and suites	20	20	4	2
Airplanes	100	10	10	4
All other	200	20	40	16
Total	1,220-1,820		224-374	90-150
Grand total	1,500-2,100		504-654	202-262

Source: D. H. Leahey to Stanley S. Surrey, "Estimated Revenue Effect of Limitation of Entertainment Expenditures," March 29, 1961, NACP, RG 56, OTPLHF, Box 12, File Folder #18B: H. R. 10650 (Section 4)-Disallowance of Certain Entertainment, etc., Expenses.

to determine proper expenses from pseudo-business expenditures. The use of expense accounts to avoid taxes cost the federal budget \$1.5–2.1 billion annually. Thus, the AD requested new legislation to deal with this problem.[61]

The proposal related to expense accounts aimed to eliminate abuses in this area by disallowing tax deductions for expenditures on entertainment, facilities, gifts, club dues, food and beverages, and travel. Table 3 shows the revenue effect of the proposed legislation, demonstrating that this would fully eliminate deductions for some entertainment expenditures judged by the IRS as unnecessary for business, and partial exclusion to expenditures that were more difficult to judge in terms of necessity.[62]

Capital Gains on the Sale of Depreciable Business Property. Under federal income tax law, gains and losses arising from the sale or exchange of depreciable property held over 6 months were subject to special treatment. Where the total gains from such

[61] D. J. Barrow to Michael A. Waris, Jr., "Substantiation of Business Gifts," March 28, 1961, NACP, RG 56, OTPLHF, Box 12, File Folder #18B: H. R. 10650 (Section 4)—Disallowance of Certain Entertainment, etc., Expenses.

[62] "Detailed Proposals to Implement the President's Recommendations in the Expense Account Area," Undated, NACP, RG 56, OTPLHF, Box 12, File Folder #18B: H. R. 10650 (Section 4)—Disallowance of Certain Entertainment, etc., Expenses.

sales or exchanges exceeded the total losses, the net gains were treated as capital gains, subject to tax at the maximum rate of 25 percent. Where losses exceeded gains, however, the net losses were treated as ordinary losses and thus fully deductible. The law treated depreciable property based on straight-line method calculations. However, the double-declining balance and sum-of-the years-digits methods applied for depreciable assets with useful lives longer than three years acquired after 1954.[63]

These provisions afforded a substantial tax advantage to taxpayers making extensive use of depreciable property to produce income compared to those with little dependence on depreciable property. Depreciation deductions were chargeable against income at ordinary income tax rates, while upon property disposal, the gains were taxed as capital gains at the maximum rate of 25 percent, though they could only have resulted from an accelerated reduction of the asset's value for tax purposes.[64]

5. THE OBJECTIONS TO THE INVESTMENT CREDIT BILL

Large businesses, including manufacturers, objected to the investment credit proposal. For instance, based on the fact that the economic growth rate was relative to the amount of depreciation allowances of economically developing countries, the National Association of Manufactures (NAM) argued that the lower depreciation allowance in the United States was the reason for the relatively slow economy. Additionally, the NAM maintained that promoting reinvestments in plant and equipment was more significant than promoting new investment.[65] The CWM then recommended that the Treasury modify the proposal, first arguing that the three-step-scale excess approach should be changed to adopt the across-the-board approach, claiming that industries with a high depreciation base, such as the steel and auto industries, would be excluded. Second, they recommended repealing the 30 percent limitation because it would inhibit small business investments in plant and equipment, while favoring investments in large firms and stable industries. Third, they argued that a revenue loss of $1.7 billion was not sufficient to provide investment incentives and so should be expanded by combining it with the depreciation rule reform. Finally, the bill adopted a "placed-in-service" rule making only investment expenditures for working plant and equipment eligible for a tax credit. However, the CWM argued that the rule might delay any immediate relief needed at that critical time, and recommended a "when-spent" rule wherein investment credits would apply at the time the business made investment expenditures. To respond to industry requirements, "the principal arguments made against the credit, i.e., that the plan was complicated and discriminatory would be eliminated."[66]

In response to these arguments, the OTA and the TLC revised the investment credit

[63] Joint Economic Committee, *The Federal Revenue System: Facts and Problems, 1961*, 71–73.

[64] *Ibid.*, 85.

[65] The American Economic Foundation, "Depreciation and National Economic Health," July 26, 1961, HSC, HLSL, SSSP, Box 128, File No.: 92–1A, File: Investment Credit (Tax Incentive 4), 1961.

[66] "Comments, Questions, and Attitudes of Committee Members Concerning the Investment Credit," June 8, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

bill. Surrey conveyed their plan to Secretary of the Treasury in the Kennedy administration, C. Douglas Dillon, in a memorandum on June 7, 1961. He initially suggested two plans for the credit structure: a credit of 10–12 percent on all investment in excess of 50 percent of depreciation, and a 7 or 8 percent across-the-board credit on all qualifying investment. In the end, they retained the 30 percent limitation in the bill. This provision aimed to insure that the investment credit would not consistently eliminate all tax liability for some tax brackets, as this would occur in many cases, for example, in many oil and mining companies whose tax liabilities were generally low relative to earnings because of the combination of other tax advantages. They maintained a possibility of extending the credit related to new property to used machine tools with a remaining useful life of six years for the purchaser. Moreover, the "when-spent" approach was adopted to recognize expenditures as made, or to allow the credit for all expenditures, including those made before 1961, on assets placed in service in 1961 and 1962.[67]

The CWM restarted discussions related to the investment credit bill based on the Treasury's suggested revision. On July 17, 1961, the CWM announced that it had tentatively adopted a proposal granting a credit for 8 percent of investment expenditures with certain limitations. Meanwhile, eligibility was limited to the machinery and equipment used in production in specific industrial activities to maintain the credit, reduce revenue loss, and cover the larger and most vital aspects of investment.[68] These changes would reduce revenue losses from the investment credit to an estimated $1.45 billion.

In addition, the Treasury reformed depreciation in 1962. Since the late 1950s, the Treasury had attempted to write a depreciation reform bill through the hearings held with the CWM to revise the useful life table for depreciable assets (Bulletin F) enacted in 1942. The useful lives of depreciable assets for tax accounting were determined through a negotiation between the IRS and a corporation, with Bulletin F used as a criterion in the negotiation. Although these were not binding, taxpayers allegedly encountered strong pressures on capital investments, and considerable difficulty in establishing the useful lives of their assets not listed in Bulletin F.[69] As a result, the Treasury proposed revisions to Bulletin F allowing for a contract of the useful lives in Bulletin F, and a simplified notation. It was estimated that this revision to the tax reform bill would further decrease federal revenues.

The tax reform bill passed through the House of Representatives on March 29, 1962 by a vote (219-196). The investment credit rate was reduced from 8 percent to 7 percent. The portion of public utility investments eligible for the credit was reduced from 1/2 to 3/7, reducing the effective rate for utilities from 4 percent to 3 percent. The limit on tax liability for a particular year that the credit would eliminate, formerly $100,000

67 Stanley S. Surrey to C. Douglas Dillon, "The Investment Credit—Policy Questions Which Are Being Reexamined As A Result of the Recent Hearings," June 7, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

68 Office of Tax Analysis, "Why the Investment Credit is Applied to Machinery and Equipment but Not Buildings," March 30, 1962, NACP, RG 56, OTPLHF, Box 15, File: Revenue Act of 1962—Briefing Material Prepared for the Secretary in Connection with His Appearance before SFC on April 2, 1962.

69 Joint Economic Committee, *The Federal Revenue System: Facts and Problems, 1961*, 88.

plus 50 percent of the tax in excess of that amount, was reduced to $25,000 plus 25 percent of the tax in excess of $25,000. These changes were estimated to reduce gross revenue losses from the investment credit for a full year to $1.175 billion.[70] The Senate Finance Committee added revisions to the House bill, including a reduction in the base amount of investment credits applied to all eligible investments, a rejection against the application of investment credits for reinvestments, repealing the investment credit for livestock, and adding a three-year carry-back for the unused investment tax credit. These revisions were estimated to reduce revenue losses to $1.020 billion, though accelerated depreciation would instead further reduce revenues by about $3.5 billion. Finally, revenue losses from the investment credit were reduced as a result of the changes in eligibility and limits for the credit.

6. OBJECTIONS TO THE TAX-PREFERENCES REFORMS

While working on revisions to the investment credit bill and depreciation, the Treasury added further structural reform measures to the proposal. The first was to eliminate or curtail preferential treatment for mutual banks and savings and loan associations, increasing revenue by $365 million. At first, this type of taxation had two issues. The first related to the "conduit principle" for mutual organizations, which taxed both income distributed to the members and the balance, retained earnings in excess of reserves for bad debts. In this way, income originating in a mutual organization would be taxed at either the individual or the company level. It was a more favorable treatment than for corporate income, which was taxed at both the corporate and stockholder levels. The second issues was related to the proper size of the bad debt deduction allowed these organizations, which was the lesser of either income before bad debt allowances or the excess of 12 percent of deposits at year end over surplus, undivided profits, and reserves at the beginning of the year. Commercial banks might also deduct interest paid to depositors and additions to reserves, but in their case bad debt reserves were limited to three times their average bad debt experience during any consecutive 20-year period since 1927, applicable to eligible loans.[71] Consequently, mutual savings banks and savings and loan associations added $3.2 billion to reserves and undivided profits considered available to pay bad debt losses while paying only $50 million in income tax between 1952 and 1958 under these preferential treatments.[72] As Table 4 shows, tax law favored mutual thrifts over commercial banks and firms subject to normal corporate income tax.

The second measure was concerned with mutual fire and casualty companies, raising revenue by $50 million. The tax provisions provided to these companies enabled them to avoid or alleviate their tax liabilities. Many of these companies, organized on a

[70] "Ways and Means Committee Action on Investment Credit," March 23, 1962, HSC, HLSL, SSSP, Box 128, File No.: 92-2A, File: Investment Credit (Tax Incentive 5), 1962.

[71] Tax Analysis Staff, "Issues in the Taxation of Mutual Savings Institutions," January 22, 1960, NACP, RG 56, OTPSF, Box 68, File Folder #55: Tax Legislative Program for 1959–1960, Mills Subcommittee, 1959–1962.

[72] Tax Analysis Staff, "Mutual Savings Banks and Savings and Loan Associations," January 19, 1961, NACP, RG 56, OTPSF, Box 68, File Folder #61: Tax Reform—1961–1962.

Table 4. Allocation of Total Income of Insured Commercial Banks, Mutual Saving Banks and Savings and Loan Association, 1952–1958

(Dollar amounts in billions)

Item	Commercial banks		Mutual savings banks and savings and loan associations			
			Mutual savings banks		Savings & loan associations	
	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution
Total income	20.3	100.0	5.9	100.0	9.0	100.0
Payments to depositors and stockholders	9.6	47.4	5.1	86.3	6.5	72.5
Federal income tax associations	5.9	29.2	0.015	0.2	0.035	0.4
Additions to reserves and undiv. Profits	4.8	23.4	0.8	13.5	2.4	27.1

Source: Treasury Department, Tax Analysis Staff, "Mutual Savings Banks and Savings and Loan Associations," January 19, 1961, NACP, RG 56, OTPSF, Box 68, File Folder #61: Tax Reform 1961–1962.

mutual or reciprocal basis, were taxed under a special formula that did not account for their underwriting gains, resulting in an inequitable distribution of the tax burden among the various types of companies.[73] The OTA thus emphasized eliminating tax avoidance related to foreign insurance and reinsurance.[74]

Third measure was related to taxation on cooperatives, with two measures proposed to restrain benefits for cooperatives and patrons. At first, all earnings should be taxable to either the cooperatives or their patrons, assessing the patron on their allocated earnings as patronage dividends or refunds in scrip or cash. Secondly, the withholding principle should apply to patronage dividends or refunds, thus increasing revenue by \$35 million.[75] Taxation on cooperatives also created problems, in that substantial income from certain cooperative enterprises, reflecting business operations, was not taxed at either organization or member-level, leading to inequity between cooperatives and competing businesses. This inequity resulted from court decisions deeming patronage refunds (the payment or distribution to patrons) non-taxable. Where patronage refunds were not paid in cash, cooperatives could retain earnings on which they paid no tax. While the Treasury held that recipients should report patronage refunds not paid in cash as income in the year in which they were received if they resulted from business transactions, patrons normally deferred reporting non-cash patronage refunds as income until the refunds were redeemed in cash.[76]

The Treasury and the CWM addressed proposals to close these loopholes in the late 1950s, and the Treasury had already begun devising the proposals by this time. However, the Treasury postponed their proposal until 1962 because the Treasury and the CWM could not reach an agreement through the hearings in the late 1950s. From the

73 *Public Papers of the Presidents of the United States, John F. Kennedy, 1961*, 300.

74 Tax Analysis Staff, "Taxation of Fire and Casualty Insurance Companies," January 18, 1961, NACP, RG 56, OTPSF, Box 68, File Folder #61: Tax Reform—1961–1962.

75 Tax Analysis Staff, "Cooperatives," January 23, 1961, NACP, RG 56, OTPSF, Box 68, File Folder #61: Tax Reform—1961–1962.

76 Ibid.

Treasury's point of view, it was necessary to offset the extra revenue loss from depreciation reform. Based on changes in the foreign policy situation and the consequent expansion of federal budget expenditures, Dillon wrote in a letter to Mills that "I would urge that your final consideration of this legislation provide an approximate balance in over-all revenue effect, preferably through the addition of further revenue raising measures implementing the President's recommendations on closing loopholes including a possible revision of the special tax provisions relating to mutual savings banks and savings and loan associations, or if need be through a small reduction in the 8 percent level of the investment credit, or perhaps through some combination of both."[77] In addition, the TLC insisted that it would be very difficult for the Treasury to propose these changes later if they were excluded from the bill.[78] The Treasury proposed these reforms to fulfill the original purpose as a step toward later comprehensive tax reform proposals, and to offset revenue losses from the investment credit and depreciation reform.

Despite the reductions in revenue losses created by the investment credit, the tax reform bill was enacted as a tax reduction as a whole since some parts of the reform were eliminated or curtailed. the most damaging modifications were removing the repeal of the dividend credit and its exclusion on the House floor, and curtailing withholding dividends and interest. Just after the tax reform bill was proposed in 1961, this portion generated intense opposition from organizations representing manufacturers, finance institutions, and investment companies fearing that it would result in discriminatory double taxation and discourage equity financing while making debt financing more attractive.[79] Businesses, especially manufacturers such as Twin Disc Clutch Company and the American Mining Congress, opposed reforms to foreign income taxation.[80] Henry Rothschild commented on business account reforms, which would reduce the internal corporate funds on which most corporations had relied for investments, argued that the deductions for business accounts were "so deeply embedded in our way of life that it cannot be legislated out of existence as a deductible business expense without the most

77 C. Douglas Dillon to Wilbur D. Mills, August 2, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

78 Tax Legislative Counsel, February 14, 1962, NACP, RG 56, OTPLHF, Box 11, File Folder #15C: H. R. 10650 (Section 2)—Investment Tax Credit.

79 Office of Tax Analysis, "Summary of the Hearings conducted by the Ways and Means Committee on the President's Tax Message: Repeal of Dividend Credit and Exclusion; Incidental Remarks on Tax Withholding Proposals," May 11, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #9: The Revenue Act of 1962: Summaries of Hearings Held by the Ways and Means Committee, 1961.

80 For instance, Twin Disc Clutch Company, many of whose subsidiaries operated in tax havens such as Liechtenstein and Switzerland, argued that this measure would be detrimental for American firms to meet foreign competition and for the benefits they gave to U.S. domestic economy, on the ground (1) That the profits earned in tax havens actually benefited the U.S. Internal Revenue because earnings remitted to U.S. parents or associates were subject to taxation under federal income tax law, and (2) That the excess of foreign source dividend inflow over investment outflow during the past ten years amounted to about $8.6 billion. The American Mining Congress opposed this proposal on the ground that taxation on undistributed profits would withdraw the tax incentive for capital investments granted by foreign countries. J. B. Schubeler to Wilbur D. Mills, "Administration Proposals on Foreign Source Income Taxation," June 8, 1961, NACP, RG 56, OTPLHF, Box 12, File Folder #14D: Revenue Act of 1962—General, March, 1962–May, 1962.

far-reaching implications," and that "to put forward a general disallowance bill may discredit the entire program."[81] Advertising and hotel companies fervently opposed reforms to expense accounts, arguing that this measure had an adverse effect on many businesses depending on business entertainment and conventions, and that it would add to unemployment in the hotel and restraint businesses. The Advertising Association emphasized that the proposal would restrict promotional activity through entertainment expenditures. Additionally, the Chamber of Commerce alleged that it would increase production costs and give an added advantage to foreign competitors in the American market who faced no such limitations.[82] The proposal related to mutual banks and savings and loan associations was opposed by their representative associations for fear that it would impose discriminatory tax liabilities on the grounds that the authorized commercial bank rate was 4 percent, and the typical savings and loan rate was 4 $^{1}/_{4}$ percent.[83] The Kennedy administration had to deal with unemployment and increase both domestic sales and exports to improve economic conditions, and thus had to avoid any negative impact to employment or the economy.

Economic conditions and the CWM's schedule provided additional obstacles to the passage of reform measures. In a memorandum for Mills on August 2, 1961, Dillon commented that though "the importance of vigorous growth of our producing capacity has been enhanced by the additional demands imposed by world situation, domestic tool orders by American industry are lagging in part because of uncertainty regarding the timing of the enactment of the investment credit."[84] Meanwhile, after Surrey met with Frank Ikard, a member of the CWM, Surrey conveyed to Dillon, "as Mr. Ikard pointed out, in 1962 Mr. Mills and the Committee [CWM] have every excuse not to consider these special bills in view of the very heavy schedule of the Committee."[85] Businesses had secured some net profits through the provisions the Treasury wanted to reduce or abolish. There was an additional urgency to pass the investment credit bill to resolve the Treasury's balance of payments problem, and to increase domestic economic growth rates through investments for Kennedy's economic advisers. These conditions finally led the Treasury to compromise and reduce reform measures given the political and economic situation. Consequently, as Table 5 shows, the tax reform bill was legislated as a tax reduction bill at the cost of accomplishing reform measures

[81] V. Henry Rothschild to Stanley S. Surrey, "The Quiet Business Lunch, and Entertainment Generally," March 28, 1961, NACP, RG 56, OTPLHF, Box 12, File Folder #18B: H. R. 10650 (Section 4)—Disallowance of Certain Entertainment, etc., Expenses.

[82] "Summary of the Hearings conducted by the Ways and Means Committee on the President's Tax Message: Expense Accounts," May 19, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #9: The Revenue Act of 1962: Summaries of Hearings Held by the Ways and Means Committee, 1961.

[83] "Comments on Statements Made by Representatives of the Mutual Savings Industry, Part 4, Hearings before the Senate Finance Committee on H. R. 10650," April 12, 1962, NACP, RG 56, OTPLHF, Box 13, File Folder #20: H. R. 10650 (Section 6)—Mutual Savings Banks & Savings & Loan Associations.

[84] C. Douglas Dillon to Wilbur D. Mills, August 2, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #15B: H. R. 10650 (Section 2)—Investment Tax Credit.

[85] Stanley S. Surrey to C. Douglas Dillon, "Special Tax Bills," December 27, 1961, NACP, RG 56, OTPLHF, Box 11, File Folder #14A: Revenue Act of 1962—General, 1961–1962.

Table 5. Comparison of Revenue Effect of Tax Reform in 1962

(In millions of dollars)

	Treasury proposal in 1961	Treasury proposed changes in 1962	House	Senate
Investment tax credit	-1,700	-1,450	-1,175	-1,020
Capital gains on depreciable property	200	180	100	100
Withholding on dividends and interest	600	650	650	240
Expense accounts	250	250	125	60
Mutual banks and savings and loan associations	-	365	200	205
Mutual fire and casualty companies	-	50	40	35
Cooperatives	-	35	35	35
Foreign items	250	310	145	140
Repeal of the dividend credit and exclusion	450	475	-	-
Miscellaneous provisions	-	-	-	-35
Total	50	865	120	-240

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, "Estimated Increase in Receipts, Fiscal Year 1962, from Revenue Raising Provisions of the Tax Program under Different Assumptions as to Effective Date," April 1, 1962, "Estimated Revenue Effect of H.R. 10650, When Changes Are Fully Effective, Without Taking Accout Its Stimulative Effects on the Economy," March 27, 1962, "Estimated Revenue Effect of H.R. 10650," September 27, 1962, NACP, RG 56, OTPLHF, Box 11, File Folder #1: Budget Figures Revenue Effect of Tax Program, 1961–1962.

expected to act as the next step toward larger tax reform bill.

7. CONCLUDING REMARKS: AFTERMATH OF TAX REFORM 1962

While the tug-of-war for the tax cut of 1962 was ongoing, the Kennedy administration had worked on crafting their second tax reform program. Soon after Kennedy's inauguration, the Kennedy administration led by the Treasury and Surrey planned its proposal along with the 1959 agreement.[86] In 1962, however, owing to the change of the political and economic conditions surrounding the Kennedy administration, the CEA recommended that the tax reform bill should be proposed as net tax reduction as an economic stimulant with taking the "two-stage approach": making tax cuts first and tackling reform later.[87] Other economists helped the CEA or business community agreed with the CEA's position.[88] In the end of 1962, while the Treasury and the CWM compromised, the Kennedy administration adopted the CEA's recommendation. Consequently, however, the tax reform bill was enacted in 1964 as a tax cut with huge rated cuts and almost no base-broadening elements that the Kennedy administration originally had proposed, which left most defects of the federal tax system. Then, there was no one who maintained that the 1961 tax reform bill originally had two purposes: To stimulate

[86] Stanley S. Surrey, "Preliminary Statement of Tax Reform Program for 1962," April 22, 1961, JFKL, Walter W. Heller Personal Papers (WWHPP), Box 22, File: Tax Cut 4/61–11/61; *Public Papers of the Presidents of the United States, John F. Kennedy, 1961*, 290–291.

[87] Walter W. Heller to John F. Kennedy, "Where We Stand on Budget and Tax Policy Decisions," June 9, 1962, JFKL, WWHPP, Box 22, File: Tax Cut 6/62–7/62.

[88] Paul A. Samuelson and Robert M. Solow to John F. Kennedy, "The Final Decision August Look at the Case for an Immediate Tax Cut," August 10, 1962, JFKL, WWHPP, Box 22, File: Tax Cut 8/62; Walter W. Heller to John F. Kennedy, "Business Economists on the Economic Outlook and Tax Policy," July 12, 1962, JFKL, WWHPP, Box 22, File: Tax Cut 6/62–7/62.

economy and to provide a step to a fairer and more equitable federal tax system. The resulting 1962 tax reform was ultimately enacted as a tax cut that killed both the 1959 agreement and its original purpose of structural reform, and neutralized comprehensive federal tax reforms.

This eventuality created federal fiscal issues later on. From the late 1960s to the 1970s, budget deficits accumulated persistently through expanded government expenditures while inflationary pressure grew. In the early 1970s, with regard to the effect of "bracket creep," federal tax policy took the enviable form of returning revenues to voters in the form of tax cuts.[89] The argument that tax cuts would stimulate the economy and finally increase tax revenues had been dominant up to 1980s.[90] By following the tendency in the 1970s, the administration of Ronald Reagan implemented the tax cut of 1981 by invoking the results of the 1964 tax cut. However, in reality, it resulted in explosively increasing federal deficits. In the early 2000s, through combining substantial growth of spending with five separate tax cuts by invoking the result of the 1964 tax cut when signing the cut in 2001, the administration of George W. Bush left a massive amount of debt.[91] After the global financial crisis in 2007–2008, the federal government attempted to plug the gaps caused by lost revenues with deficit spending and issuing debt. By 2015, federal accumulated debt reached $18.12 trillion, or 101.8 percent of gross domestic product.[92]

While shifting to austere trend by restraining direct government expenditure in the face of the growth of federal deficits and debt from the 1970s, the expanding use of tax expenditures, the so-called "Hidden Welfare State," fueled this change.[93] In the 1970s, federal tax policy mainly provided tax-cutting measures such as investment credits and tax preferences, to return revenues to voters and to stimulate consumer demand, productivity, and job opportunity.[94] Although the Tax Reform Act of 1986 was intended to broaden the tax base and introduce revenue-neutral tax reform, the administration of Bill Clinton increased tax expenditures several times in preference to direct social

[89] Eugene C. Steuerle, "Financing the American State at the Turn of the Century," in *Funding the Modern American State, 1941–1995: The Rise and Fall of the Era of Easy Finance*, ed. W. Elliot Brownlee, (Washington, D.C.: Cambridge University Press and Woodrow Wilson Center Press, 1996), 409–444.

[90] U.S. Congress, Joint Economic Committee, *The Mellon and Kennedy Tax Cuts: A Review and Analysis*, 97th Congress, 2nd Session, 1982 (Washington, D.C.: U.S. Government Printing Office, 1982), 27.

[91] George W. Bush, "Remarks on Signing the Economic Growth and Tax Relief Reconciliation Act of 2001," June 7, 2001, Online by Gerhard Peters and John T. Woolley, *The American Presidency Project* (http://www.presidency.ucsb.edu/ws/index.php?pid=45820&st=&st1=).

[92] Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2017* (https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/hist.pdf), Table 7.1.

[93] Sven Steinmo, *The Evolution of Modern States: Sweden, Japan, and the United States* (New York: Cambridge University Press, 2010); Michael B. Katz, *The Price of Citizenship: Redefining the American Welfare State, Updated Edition* (Philadelphia: University of Pennsylvania Press, 2008); Jacob S. Hacker, *The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States* (New York: Cambridge University Press, 2002); Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton: Princeton University Press, 1997).

[94] Dennis S. Ippolito, *Deficits, Debt, and the New Politics of Tax Policy* (New York: Cambridge University Press, 2012), 92–111.

expenditures in the 1990s. Five-time tax cuts of the Bush administration mainly benefited corporations and the wealthy, while curtailing the federal government's ability to finance its direct expenditures and deteriorating the equity and progressivity of the federal income tax system.[95] However, the Congressional Budget Office demonstrated that tax expenditures unfairly favors higher-income brackets relative to lower-income brackets.[96] Suzanne Mettler renamed the "Hidden Welfare State" the "Submerged State," which has consumed a considerable amount of the tax revenues available for programs for low- and middle-income classes while hiding how it provides benefits from the public.[97] The resulting 1962 tax cut not only hindered tax reform that might have alleviated later federal fiscal problems, but also stands as a story about how the government shirked its tax-related fiscal responsibility under the belief that economic growth, conventionally believed to increase tax revenues, would sufficiently finance government.

[95] Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes, 4th ed.* (Cambridge, Mass.: The MIT Press, 2008); Eugene C. Steuerle, *Contemporary U.S. Tax Policy, 2nd ed.* (Washington, D.C.: The Urban Institute Press, 2008); W. Elliot Brownlee, *Federal Taxation in America: A Short History, 2nd ed.* (New York: Cambridge University Press, 2004).

[96] Congressional Budget Office, *The Distribution of Major Tax Expenditures in the Individual Income Tax System* (http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf, 2013).

[97] Suzanne Mettler, *The Submerged State: How Invisible Government Policies Undermine American Democracy* (Chicago: The University of Chicago Press, 2011).