Chapter 1

Showdown

The clerk will call the roll for final passage . . .

It is twenty minutes past midnight on the morning of Wednesday, May 7, 1986, and the Senate Finance Committee has been working almost nonstop since early the previous morning. Under the glare of television lights, the twenty powerful senators seated around the semicircular hearing table show signs of fatigue. Some droop back in their chairs, others lean forward, propping their heads in their hands. Committee Chairman Bob Packwood's high forehead glistens with sweat, and his eyes are dark and sunken. Next to Packwood, the committee's ranking Democrat, Senator Russell Long—son of legendary Louisiana populist Huey Long and a Washington legend himself—wears dark glasses to protect his eyes from the lights.

Despite the late hour, the marble-lined committee room is packed to the doors with people, and guards are stationed at the entrance to stop more from pushing in. Deputy Treasury Secretary Richard Darman sits near the front of the room, facing the senators, his brown hair combed straight back and his face stone-serious. Surrounding him are the staffs of the Treasury Department, the congressional Joint Committee on Taxation, and the Finance Committee. Reporters sit cheek-by-jowl around two tables not far from the door, and the remainder of the room is filled with lobbyists—lots of lobbyists.

There is a sort of hierarchy to the tax lobbyists who swarm about the

Dirksen Senate Office Building on this spring night. Those with seats in the committee room tend to be mostly notetakers. They are the lobbyists' front guard, the younger lawyers and legal assistants whose job it is to get up at sunrise and stand in long lines to make certain they secure seats in the crowded committee room. Other less eager and more highly paid notetakers fill a large auditorium two floors below. The auditorium is wired for sound, and the lobbyists listen to the proceedings while munching on take-out pizza and Dunkin' Donuts. The room has been occupied by too many people for too long, and it smells faintly like a gymnasium. A few of the lobbyists smoke and play poker at a table on the auditorium stage; others doze in the back. The room is at once raucous and somber; it has the strange aura of a wake.

In the hallway outside the committee room, more lobbyists stand nervously, like so many expectant fathers crowded into the waiting room of a maternity ward. These hallway loiterers include the top ranks of Washington's tax lobbying world—men and women who are paid $200, $300, even $400 an hour to influence legislators and preserve tax benefits worth millions of dollars to their anxious clients. They lean against the walls and talk among themselves, trading bits of gossip. "Did you hear?" says one. "They changed the effective date for the investment credit." The whispered message travels quickly down one side of the long hallway and echoes back up the other. A few of the lobbyists huddle around the back door of the committee room, hoping to catch a senator coming in or going out, hoping for one last chance to make a pitch before the vote. The desperation in their voices makes it clear that *big* money is at stake. Their expensive suits and shiny Italian shoes give this hallway its nickname: Gucci Gulch.

Until two weeks ago, most of these lobbyists were still betting that tax reform would never happen. It was too bold, they thought, too radical. It proposed wiping out a multitude of special-interest tax breaks in return for sharp cuts in tax rates. That would be a boon to the great mass of people who pay their taxes each year without taking advantage of these deductions, exclusions, and credits. But it would be a disaster for the many business interests and high-income individuals who have come to depend on tax favors from Congress. It is those groups, the lobbyists thought, who control Washington. They have the power, the money, and the influence. They are the ones who hire lobbyists.

Then again, the lobbyists were wrong about President Reagan. They thought he would never back a tax-overhaul effort that stepped on the toes of countless Republican business constituents. But he did. And they were wrong about the Democratic House: Defying everyone's predictions, the House too approved a sweeping tax-reform bill shortly before Christmas the year before. Nevertheless, until just two weeks ago, the lobbyists were still betting that the Finance Committee would bury the effort. The committee, after all, was the lobbyists' best friend. Its members were the authors of countless tax breaks that aided favored constituents; they were the recipients of millions of dollars in campaign contributions from groups determined to defeat reform. The conventional wisdom in Washington was that this Senate committee would certainly send tax reform to its grave.

But in the early morning hours of May 7, all bets are off. Something strange has been happening in the back rooms of the Dirksen Building over the past two weeks. Working privately, out of the public eye, Chairman Packwood and a handful of his committee members have undergone a remarkable conversion. They have prepared a reform plan even more radical than the one passed by the Democratic House: a plan that cuts back a wide swath of special-interest tax breaks and lowers the top statutory tax rate to 27 percent, the lowest of any major industrialized nation. It is without a doubt the most significant reform in the history of the income tax. It removes millions of low-income workers from the income-tax rolls, eliminates most tax shelters and ensures that profitable corporations and wealthy people pay at least some tax. If enacted, it would affect the lives and pocketbooks of virtually every American.

The clerk slowly calls out the names of the senators:

Senator Dole.

The dark-eyed legislator from Kansas is the majority leader of the Senate, and his vote strongly influences other Republicans on the committee. He has been critical of tax reform in the past, arguing that it does nothing to help ease the nation's biggest problem—a huge budget deficit—but he is caught up in the momentum of the past two weeks. "I want to thank the chairman for this historic effort," he says, "and I vote aye."

Senator Roth.

Senator Danforth.

As the clerk calls out the names of the Republicans, moving along the table from the most senior to the most junior member, it gradually becomes clear that all of them, even those who have been hostile to the bill all along, are voting aye.

"There, that's good work," whispers Dole to the chairman, as all eleven Republicans vote for the unprecedented tax measure.

Then come the Democrats:

Senator Long.

The Louisiana lawmaker, his sunglasses now laid aside, also gives a nod to Chairman Packwood, who is sitting to his right. Long chaired the committee for fifteen years before the Republicans took control of the Senate in 1981, and he labored hard to enact many of the tax incentives that the tax-reform bill now threatens to eliminate. But he too has become a reformer. "Like Senator Dole, I want to congratulate the chairman for the fantastic work he's done on this bill, and I vote aye," he says.

The clerk calls the names of the Democratic senators in order of seniority, and again only ayes are heard. By the time the voting gets to Senator Bill

Bradley of New Jersey, one of the most junior members of the committee, there still has not been a single dissent. The former basketball player has a proud, almost smug look on his face when his name is called. He authored a version of tax reform four years ago; he is, as Senator Packwood will later say, the "godfather" of reform. He pauses a moment and nods his head approvingly before answering aye.

The last two Democrats cast their votes, and a flush comes over Chairman Packwood's face. His dramatic proposal is not only going to win, it is going to win unanimously. No one expected that. No one thought that his committee—of all committees—could muster even a majority for such a radical bill, much less unanimous support. The chairman is the last to vote, and as he does, tears begin to well up in his eyes. He gives a slow, solemn aye.

Senator Chafee rises quickly to his feet and begins to applaud the chairman. Other senators and staff aides follow suit. Even the lobbyists in the back of the room, unable to avoid the sweep of sentiment, join in the applause. Packwood grabs the hands of Dole and Long and thrusts them into the air in a show of victory. Then he looks down at his desk, choked with emotion.

In the hallway outside, and in the auditorium two floors below, there is mostly silence. A few groans are heard. Many of the lobbyists have clients who will lose hundreds of thousands, millions, even billions of dollars as a result of that 20–0 vote. The same questions buzz through their heads: How did it happen? Why did so many special interests go down in flaming defeat? How could the usual ways of Washington be turned on their head?

As they listen to the applause, many of the lobbyists are still confused by the remarkable turn of events. But one thing is clear to all of them: In the early hours of the morning of May 7, tax reform completed its transformation from the impossible to the inevitable.

The income tax was enacted three quarters of a century ago in an attempt to bring fairness to the tax system. At the close of the nineteenth century, the government raised all of its revenue from tariffs and excise taxes, which placed a heavy burden on low-income Americans. "If taxation is a badge of freedom," stormed income tax advocate William Jennings Bryan in a fiery 1894 House debate, "let me assure my friend that the poor people of this country are covered all over with the insignia of freedom."

Bryan fought for an income tax, but was thwarted in 1895, when the Supreme Court ruled that the levy was unconstitutional. The debate raged for nearly two decades, but in 1913 the Sixteenth Amendment to the Constitution was ratified and the income tax became law.

The idea was to tax people according to their ability to pay, and income was considered the best measure of that ability. From the start, however, Congress made exceptions to that basic principle, allowing special treatment for income that was used for certain purposes or that came from certain sources.

Payments for mortgage interest and state and local taxes, for instance, were made deductible by the 1913 law. Farmers were allowed immediate write-offs for their equipment investments in 1916. Charitable contributions were made deductible in 1917. Military benefits were excluded in 1918. The special tax treatment of capital-gains income earned from the sale of assets, such as securities or real estate, was enacted by Congress in 1921. Employers' contributions to pension funds were excluded from taxable income in 1926. The list of special deductions, exclusions, and credits grew and grew, as Congress, acting at the behest of various interest groups, found more and more reasons to make exceptions to the original principle of the income tax.

Tax rates were boosted to help finance World War I and again to finance World War II. After the wars, Congress was slow to lower the rates, choosing instead to give back money through ever more tax breaks. The steady erosion of the income tax base became a landslide in the late 1970s and early 1980s. High rates of inflation increased the tax burden on individuals and businesses in various subtle ways, and as a result, the clamor for special tax breaks reached a furious pitch. In 1981, the Reagan administration and Congress bowed to these pressures and enacted a tax bill that not only cut tax rates, but also included the biggest package of tax breaks for business in history. By 1984, even Trappist monks were petitioning Congress for special treatment, asking that they be allowed to use the lucrative investment credit. "We'd like to have it," said Father John Baptist, bookkeeper of the Trappist Abbey in Lafayette, Oregon, "because everyone else has it."

Many of these tax preferences were enacted with the best of intentions. They were supposed to provide "incentives," promoting laudable social or economic goals, but the sheer volume of the breaks became a menace. As the list expanded, the code became like a giant Swiss cheese with too many holes. It was on the verge of collapse.

The astonishing dimensions of the problem were illustrated in a pamphlet published each year by the Joint Committee on Taxation. It listed federal "tax expenditures"—a term devised to show that tax breaks were really no different than direct government spending. In page after page of small type, the pamphlet showed the many ways in which the code deviated from the principle of taxing all income equally, the many ways in which the government "spent" its revenue through tax breaks.

The list included tax credits for people who paid for child care or made contributions to political candidates. There were deductions that allowed people to escape taxes on the portions of their income that went to pay medical bills, adoption expenses, or losses from theft. And there were various types of income that were simply excluded from taxation altogether, such as employer-paid fringe benefits, interest earned on life insurance, military disability payments, interest on municipal bonds, and ministers' housing allowances.

For businesses, the tax breaks were more complex. Tax experts agreed that a firm's legitimate business expenses should be subtracted from its revenues before arriving at the income subject to tax. But the definition of legitimate business expenses could be bent and twisted, and with the assistance of armies of tax lobbyists, Congress had found countless ways over the years to do just that. Oil and gas companies, for example, were able to write off certain costs of drilling successful wells in one year, even though the wells would produce oil or gas for many years—a ploy that saved the industry more than $14 billion a year in taxes. As an additional incentive, the law also allowed oil and gas firms to deduct a percentage of their gross income. Manufacturers, similarly, were able to save taxes by writing off investments in heavy equipment over five years, even though the equipment might last fifteen years or longer. Banks were allowed to deduct the money they put into "bad-debt reserves," even though those reserves were far larger than the amounts of money the banks actually lost to bad debts.

Dozens of other methods, all perfectly legal, were used to keep from paying taxes on business income. There was no end to the diversity of tax-avoidance schemes that Congress, with the help of clever lobbyists and tax lawyers, could devise.

The accumulated effect of all these tax breaks was breathtaking. The Joint Committee on Taxation concluded that by 1987, tax expenditures would cost the government $450 billion a year in lost revenue—more than the total amount the government would collect that year in individual income taxes!

The tax system became dangerously unbalanced. Some activities were taxed at extremely high rates; others faced no tax at all. Economic decisions by people and businesses were distorted by these variations in tax, and the result was to create enormous inefficiencies in the economy. Money poured into those businesses and investments that were favored by the tax system, and avoided those that were not. The tax system became an impediment in the workings of the market.

At the same time, the uneven tax system created significant disparities among taxpayers. Those who were fortunate or clever enough to benefit from the many loopholes reaped large benefits; those who were not paid a stiff penalty. Roscoe Egger, the commissioner of the Internal Revenue Service during the first five years of the Reagan administration, summed it up this way:

> People were rapidly becoming disenchanted with the whole system. We began to see the emergence of tax protesters. Groups refused to file, backyard churches began to claim income as charitable contributions, tax shelters reached entirely different proportions. One couldn't fail to recognize that this was a reflection of deep-seated unhappiness with the entire tax system. By 1983 we even began to see people in the lower income levels, with incomes of only $18,000 or $20,000 a year, buying into phony tax shelters, private churches, master recordings, that sort of thing. They listened to this siren song and said, "Gee, everybody else is doing it. Why not me?"

Opinion polls showed that public dissatisfaction with the tax system was rising sharply and steadily. Horror stories about millionaires and large corporations that managed to pay no income taxes at all were commonplace. Many Americans began to perceive that the U.S. income tax was not very "progressive." It seemed that the average man on the street paid a higher portion of his income in taxes than the typical millionaire paid, rather than the other way around.

Public perceptions of the income tax changed drastically. A 1972 poll by the Advisory Commission on Intergovernmental Relations showed that Americans generally viewed the federal income tax as fairer than state income taxes, state sales taxes, or local property taxes. But by 1985, the federal tax was judged in the same poll to be the least fair, by a long shot.

In part, this dissatisfaction with the tax system had its roots in the inflation of the 1970s: As wages and salaries rose to keep pace with prices, middle-income Americans found themselves pushed into higher and higher tax brackets, even though their new, inflated incomes bought no more at the grocery store than their old ones did. But mostly, the dissatisfaction reflected a recognition of the proliferation of tax breaks.

Gary Hecht, an assistant school principal in New York City, expressed the sentiments of millions of taxpayers in a December 1984 discussion group conducted by *The Wall Street Journal*. "My feeling with the federal tax goes back to the same old story: The rich get richer, the poor stay poor, and the middle class gets poor too," he complained. "Because of the loopholes, this is going to constantly occur."

On tax day, April 15, 1985, Deputy Treasury Secretary Richard Darman gave a speech that highlighted the extent of the problem. Darman was the administration's top reform strategist, and he had a sharp mind that grasped both the politics and the substance of the issue.

> The overwhelming majority of taxpayers eat lunch without being able to deduct their meals as business expenses. They buy baseball or hockey tickets without being able to enjoy the luxury of business-related skyboxes. They talk on fishing boats, but don't take the tax deduction for ocean-cruise seminars. They strain to pay interest on their home mortgages and may take the tax deduction for their payments, but they can't quite figure out how others can invest in real estate shelters and get more back in tax benefits than is put at risk. They read that of those with gross income of over $250,000 before "losses," more than a fifth pay less than 10 percent in taxes; and of those with gross incomes over $1 million before "losses," a quarter pay 10 percent or less in taxes.

The phenomenal rise in tax shelters was a central part of the problem. These investments were structured to bunch several different tax incentives—interest deductions, rapid depreciation write-offs, low capital-gains rates, credits for rehabilitating buildings, credits for research and development—in ways that enabled investors to get several dollars in tax savings for every dollar they invested. Although precise figures are difficult to come by, tax-shelter sales are believed to have jumped from less than $2 billion in 1976 to over $20 billion in 1983.

Real estate partnerships were the most popular shelters. Under these schemes, investors made relatively modest contributions to a building project, and the tax-shelter partnership borrowed the rest of the money it needed. By deducting the interest and taking rapid depreciation write-offs, the partnership was able to show huge paper losses, which the investors divided among themselves and wrote off on their income tax returns. Thus, for an investment of only $10,000, a person in the 50-percent bracket might buy "losses" of $20,000 or more, saving $10,000 or more in taxes; and when the building was finally sold, the income would be taxed at the low capital-gains rate. It was an unbeatable deal—and perfectly legal.

These new tax schemes drastically altered the economics of the real estate business, making it possible for developers to build new office buildings even if the demand for office space was not strong. So-called see-through office buildings—structures with few tenants—became commonplace in cities like Houston, where the real estate market was driven by the desire for tax-sheltered investments rather than by the need for office space.

Oil and gas partnerships also attracted investors seeking to hide from the tax collector, and there were other, more exotic, tax shelters as well: cattle-feeding shelters, equipment-leasing shelters, boxcar shelters, billboard shelters, videotape shelters, even llama-breeding shelters. In Girdletree, Maryland, Bill Lilliston set up the Chincoteague Bay penny-oyster shelter, a scheme that he promised would reduce taxes, prevent prostate problems, and improve potency all at the same time. In California, a group of dentists invested thousands of dollars in jojoba beans, hoping to take large deductions during the three years it takes to determine whether a plant is female and could therefore bear more beans. The jojoba scam prompted an angry complaint from California Representative Fortney "Pete" Stark: "We shouldn't be giving tax breaks to anything that takes three years to figure out its sex."

The ultimate effects of this tax-shelter mania were dramatically illustrated in a 1985 study prepared by the Treasury Department for House Ways and Means Democrat J. J. "Jake" Pickle of Texas. The study showed that in 1983 alone, about thirty thousand taxpayers with earnings exceeding $250,000—including three thousand millionaires—paid less than 5 percent of their income in taxes. Little wonder that people felt the progressive tax was a fraud.

Expense-account living also irked the average taxpayer. People saw that their neighbors with well-paid accountants could find dozens of creative ways to beat the system. These clever taxpayers would deduct their Mercedes, their expensive meals, their country club dues, even their vacations. Ski resorts in places such as Vail, Colorado, offered "investment seminars." After a long day on the slopes, skiers could drop by the seminars, fix a cocktail, and watch a videotape telling them how to make tax-shelter investments; they could then deduct the trip as an investment expense. The average taxpayer was, in effect, subsidizing ski trips for investors who wanted to learn more about escaping taxes!

Confidence in the tax system was further undermined by the fact that U.S. corporations were paying an ever-smaller share of the nation's tax burden. Over three decades, the corporate contribution to government revenues had plummeted from 25 percent in the 1950s to just over 6 percent in 1983; the 1981 tax bill brought the corporate tax near extinction. "It's like Alice's Cheshire Cat," joked Van Doorn Ooms, chief economist for the House Budget Committee. "Everything's gone but the grin."

The decline in corporate taxes was highlighted in 1982 when a controversy broke out over the so-called lease-a-tax-break law, a provision in the 1981 tax bill. The scheme had been hatched by the Treasury Department, working in conjunction with a group of business lobbyists, and was designed to ensure that the generous new business breaks in the 1981 bill would help those companies that most needed them—companies suffering losses and therefore not paying any taxes. The provision allowed profitless companies to sell their tax breaks to profitable companies in a transaction known as a "safe-harbor lease."

Although it may have been sound in theory, the safe-harbor-leasing arrangement proved to be a political disaster in practice. The new law led to a frenzy of strange tax deals that outraged the public and their representatives in Congress: Global Marine reportedly sold tax benefits on oil rigs worth $135 million to Hilton Hotels. Ford Motor sold IBM the tax breaks on its entire $1 billion 1981 investment program, reportedly for a price of between $100 million and $200 million. Occidental Petroleum sold benefits on $94.8 million in investments, LTV sold breaks on $100 million in equipment, and Chicago & North Western sold tax benefits on $53 million worth of locomotives, freight cars, and other property. In each case, both the buyer and the seller benefited, and all at the taxpayers' expense.

The furor in Congress over the tax-break sales was swift and sharp. The safe-harbor-leasing provision was repealed, but not until after the affair had burned itself well into the public psyche.

An even bigger flap over corporate taxes was sparked in early October 1984, when a little-known public-interest lawyer named Robert McIntyre dropped a bombshell. Sitting at his computer in a cluttered little office in Washington, the scruffy McIntyre spent endless hours combing through the annual reports of the largest corporations of America. He calculated each company's domestic profit and how much federal income tax each actually paid. His result: 128 out of 250 large and profitable companies paid *no federal income taxes* in at least one year between 1981 and 1983. Seventeen of the companies paid no taxes in all three years.

The McIntyre list included the best-known names in corporate America: General Electric, Boeing, Dow Chemical, Lockheed, and others. In a particularly embarrassing revelation, the study showed that among the corporate freeloaders was W. R. Grace & Company, whose chairman, J. Peter Grace, had headed a commission for President Reagan that concluded that wasteful government spending was "sending the country down the tubes for future generations of Americans."

"Americans are wondering why the federal government is incurring the largest deficits in history even while they are paying the highest taxes ever," said McIntyre when his report was released. "This study documents one important answer: the demise of the corporate income tax."

The study made instant news. In Los Angeles, the *Herald Examiner* overlooked the American League play-offs to make this its banner headline: 128 BIG FIRMS PAID NO FEDERAL INCOME TAXES. A story in *Rolling Stone* magazine shouted in big bold letters: EARN A BILLION! PAY NO TAXES! Conservative columnist James J. Kilpatrick complained of "corporate welfare" and "AFDC: aid for dependent corporations." A labor leader at a rally in New Jersey held up a package of General Electric lightbulbs and said they had cost him more money than GE's entire contribution to the cost of government. And on national television, Democratic Senator Robert Byrd of West Virginia told of a woman in Milwaukee, "the mother of three children, who in 1983 earned $12,000. On that income she paid more in taxes than Boeing, GE, DuPont, and Texaco, all put together."

Other analysts had documented the decline in corporate taxes before, but never before had anyone named names. In the public mind, it became a powerful indictment of the income tax. "It's a scandal when members of the Fortune 500 pay less in taxes than the people who wax their floors or type their letters," McIntyre said.

Needless to say, McIntyre generated considerable irritation in corporate America. "His whole study is a pile of bunk," groused John R. Mendenhall, vice president for taxes at Union Pacific, which showed a slim 3.5-percent effective tax rate in the study. And even Whirlpool, which had the highest effective tax rate on McIntyre's list at 45.6 percent, was not particularly happy about the publicity. "It's a double-edged sword," explained Robert Kenney, the company's tax counsel. "We owe it to our shareholders to take legitimate and legal means to keep down taxes."

For McIntyre, who was trained by consumer advocate Ralph Nader, the publicity was ample return for the hours he spent deciphering corporate reports. He too was a lobbyist of sorts, working for a labor-funded group called Citizens for Tax Justice, which promoted the closing of corporate loopholes. Unlike the lobbyists who represented big business and other wealthy interests, he did not dine at plush, expense-account restaurants, nor did he spend much time buttonholing members of Congress. His $38,000 salary was a mere fraction of the much larger sums earned by his corporate lobbying foes.

No matter. In the tax debates ahead, Bob McIntyre's one-man report would turn out to be more influential than all the firepower the corporate lobbyists could muster.

The goal of tax reform was to eliminate or curtail as many tax expenditures as possible. To be sure, not all tax breaks could be eradicated: Some were politically immovable; others served critical social functions. But the tax code was badly in need of a housecleaning, and tax reform was intended to give it just that. Reform also promised a trade-off: Tax breaks for the few would be replaced with lower tax rates for everyone.

As appealing as the concept sounded, however, few in Washington thought it could be done. The groups with an interest in the existing tax system were well-organized and ready to defend their breaks at a moment's notice; the populace who stood to benefit from lower rates was unorganized and diffuse. Furthermore, Congress was a slow and cumbersome institution that usually made only piecemeal, incremental changes. Tax reform proposed something very different: a radical revamping of the entire tax structure. There was a tremendous inertia in Congress that resisted any such sweeping change. As a result, the conventional wisdom in Washington held that tax reform was destined to lose, and the conventional wisdom had plenty of history to back it up.

Tax breaks, after all, had always been part of the currency of Congress. Politicians liked to give them out; they did not like to take them back. The seventy-three-year history of the income tax had been a story of steady erosion in the tax base, with more and more loopholes being added and few being taken away. Indeed, the very structure of American government, with its checks and balances, argued against the success of such a bold plan. The American revolution had been fought largely over the question of who should have the power to tax: the King's appointed governors or the popularly elected legislatures. By putting the authority to tax into the hands of the legislature, the Constitution ensured that our tax system would become and remain a political potpourri. A parliamentary government might be able to fashion radical tax-reform legislation in the executive branch and be assured of its success in the loyal parliament, but the American system subjected such bills to the tugs and twists of 535 members of Congress, each with strong political interests to protect.

Idealists had tried with little success to eliminate loopholes almost from the day the income tax was enacted. One man even died trying: In 1956 Randolph Paul, a former Treasury tax expert, collapsed in the midst of telling a congressional hearing that the Eisenhower administration was using the tax code to stimulate business rather than just to collect revenue.

President John F. Kennedy also tried to launch an attack on the tax code and appointed Harvard law professor Stanley Surrey, an outspoken critic of tax breaks and incentives, to the Treasury's top tax post. Congressional opposition to Surrey's appointment was intense. The oil and gas industry, the mining industry, the savings-and-loan associations, and an army of others who benefited from the nation's cheesecloth tax system raised a storm of protest. Surrey's reception before the Senate Finance Committee was particularly hostile, with Chairman Harry Byrd of Virginia indignantly accusing him of harboring a low opinion of the nation's legislators. "You think that some of these tax laws were sneaked through Congress without the knowledge of a great many congressmen," Byrd charged. The senator assured Surrey that they were not.

In the face of such opposition, Kennedy's reform efforts wilted. His first tax bill, signed in October 1962, was designed to jump-start the economy rather than reform taxes. It included a huge new investment credit that subsidized the purchase of business equipment and became one of the biggest tax expenditures in the code, resulting in billions of dollars of lost revenue to the Treasury each year. The bill also contained a new provision, added by Congress, that created a deduction for lobbying expenses. Kennedy's second tax bill, introduced in early 1963, attempted to combine sharp cuts in tax rates with an array of Surrey's loophole-closing measures. Virtually all the loophole-closing provisions were abandoned or gutted, either by the Ways and Means Committee in the House or by the Finance Committee in the Senate.

The closest Congress ever came to enacting a broad reform of the income tax was in 1969. The measure got its start in early January of that year, thanks to Treasury Secretary Joseph Barr, who held the top Treasury post for only twenty-seven and a half days at the end of the Johnson administration. Shortly before leaving office, Barr testified on Capitol Hill of an impending "taxpayers' revolt," spurred on by increased public awareness of tax inequities. To ensure the fulfillment of his prophecy, he unveiled alarming Internal Revenue Service figures showing that 155 people with incomes over $200,000 had managed to pay no income taxes at all in 1967. The list, he said, included twenty-one millionaires.

That disclosure prompted a torrent of press coverage and a blizzard of indignant mail to members of Congress. The new president, Richard Nixon, was no friend of reform, but he immediately came under heavy pressure to embrace tax overhaul. After a long debate, a bill was crafted that repealed the investment credit, ended or curtailed a number of other tax breaks, and cracked down on tax-exempt foundations.

But the reforms of the 1969 bill were short-lived; subsequent legislation reopened most of the closed loopholes. In 1971, for instance, Congress voted to reinstate the investment credit and also approved new and more generous business investment write-offs, as well as a new tax break for export companies.

Congressional resistance to tax reform was symbolized by Senator Russell Long, who chaired the Finance Committee from January 1966 to December 1980. Scion of one of the nation's most colorful political dynasties, Long saw the tax code as his tool for changing society. He had no interest in reform. A wise student of human behavior, Long realized the losers from tax overhaul would make far more noise than the winners. "When we proceed to shift the taxes around so that one set of taxpayers pays a lot more taxes and somebody else pays a lot less taxes, the people who benefit from it do not remember it very long," Chairman Long said in 1976. "They tend to feel that it should have been that way all the time, and the people who are paying the additional taxes resent it very bitterly." On another occasion, the wily Louisiana Democrat gave an even more cynical assessment of reform. "I have always felt," he said, "that tax reform is a change in the tax law that I favor, or if it is the other man defining tax reform, it is a change in the tax law that he favors."

Reform-minded legislators attempted an end run past Long in 1975 and enacted legislation that cut back the oil depletion allowance, one of the largest and least-justified breaks in the tax code. But even then, Long succeeded in undermining the reformers' victory, restricting the change to the major oil companies and leaving the generous break intact for the prosperous independent producers in his state and elsewhere. Another failed attempt at reform was made in 1976, when the House passed a bill with a tough anti–tax-shelter provision, only to have it dropped by the Senate. (Ironically, the attempt to shut down tax shelters was stopped partly through the efforts of Senator Packwood of Oregon, who ten years later made a similar provision the foundation of his own tax-reform bill.)

Tax reformers breathed one last gasp in 1977 and 1978, during the presidency of Jimmy Carter. Carter made tax reform a cornerstone of his election campaign, calling the existing tax system "a disgrace to the human race" and "a welfare program for the rich." In an interview with *Fortune* magazine, the president said he thought the nation was "ready for comprehensive, total tax reform." While not divulging details, he said his plan would "eliminate hundreds of tax breaks and greatly reduce the tax rate." After taking office, Carter's treasury secretary, Michael Blumenthal, began publicly discussing some of the provisions under consideration, and they did indeed sound bold and sweeping. He floated the idea of eliminating the preferential treatment of capital gains, for example.

The response of interest groups to Carter's trial balloons was fierce and swift, and the administration's resolve was indeterminate. In the fall of 1977, Carter aides said they were "reshaping" the tax proposal to reflect changing budgetary, economic and political realities. When the plan was finally unveiled in January 1978, Carter's grand rhetoric boiled down to a few exceedingly modest reforms, such as cutting back on the "three-martini-lunch" deductions for business meals and entertainment. Even those modest measures were quickly ripped apart by Congress.

The bill finally enacted in 1978 was a complete renunciation of the Carter proposals and of any notion of tax reform. It included a host of new tax benefits. The Senate proved to be particularly generous, voting to expand many existing tax breaks and adding numerous new provisions targeted to help farmers, teachers, Alaskan natives, railroads, record manufacturers, the Gallo winery of California, and two Arkansas chicken farmers.

The defeat of President Carter's tax-reform efforts signaled a new era in tax policy, the triumph of a broad coalition of business lobbyists who came together under the rubric of "capital formation." These lobbyists argued that the best medicine for the faltering U.S. economy was to create new tax breaks for businesses and investors. They championed a provision in the 1978 law that enhanced the preferential treatment of capital-gains income, bringing the top tax rate on gains income down to 28 percent from the existing rate of 35 percent or more. Reformers complained that the special treatment for capital gains was unfair and fueled the growth of tax shelters, but the capital-formation coalition said the tax break would encourage investment and promote economic growth. The economy was in trouble, they argued, and lower capital-gains taxes were a solution. Tax reform was clearly out; "capital formation" was in. The influence of special interests in Congress had reached new heights.

The symbol of this new era was an elite group of Washington business lobbyists who in 1978 began meeting each Tuesday morning for breakfast at the Sheraton-Carlton Hotel in downtown Washington. Known among themselves as the "Carlton group," they were the cream of Washington tax lobbyists—highly paid representatives of the largest corporations and the most influential business organizations in America. They developed into a virtual fourth branch of government, devising new tax schemes that would eventually become the law of the land.

It was this pinstriped-suited group that gave birth to the biggest business tax break ever adopted—the accelerated cost recovery system, a loophole so large that it allowed many big, profitable corporations to slip through without paying a penny in corporate tax.

The reputed father of the Carlton group was a man named Charls E. Walker, an expatriate Texan who pronounced "corporate" like "carpet," and who became the slow-walking, smooth-talking embodiment of the capital-formation crowd. Walker, who was deputy treasury secretary under Nixon, ran a lobbying firm that represented dozens of major industrial clients, from the Aluminum Company of America to the Weyerhaeuser Company. All of them invested heavily in equipment, and all sought ways to reduce the tax burden on their investments. To provide research to back up his efforts, Walker also ran an organization known as the American Council for Capital Formation.

In Walker's view, encouraging business investment in equipment was the most important goal of tax policy. He told acquaintances that he viewed capital investment the way Mark Twain viewed good bourbon: "Too much is barely enough." He felt there should be no tax on corporate investment; indeed, he apparently had no qualms about outright tax subsidies for investment, and that is what his generous tax write-off scheme amounted to for some. His clients were the heart of smokestack America, and their power in the economy was declining rapidly, as foreign manufacturers grew more competitive and as the U.S. economy turned more toward services. His job was to get government to help halt that decline.

For Walker, promoting investment tax breaks was also good business. As a child in tiny Graham, Texas, he had sometimes slept on the porch when the family was able to rent out his room in their hotel for a night. But as a Washington lobbyist, he learned to live luxuriously. He was, in his own words, "a very diminutive millionaire," who could garner as much as $7,500 a speech, and who served on four corporate boards. He traveled in a large black limousine and smoked cigars nearly as large, called "Ultimates."

In 1980, Walker initially threw his support to fellow Texan John Connally, who was making a futile attempt for the Republican nomination for the presidency. But when Ronald Reagan won the nomination, Walker joined his team. He was asked to become Reagan's adviser on tax policy, and he jumped at the chance.

At the time Walker joined the campaign, Reagan's tax policy was the brainchild of two congressional Republicans who were leaders in the so-called supply-side movement, Representative Jack Kemp of New York and Senator William Roth of Delaware. The Kemp-Roth proposal was a tax cut for individuals known as "10-10-10"—a 10-percent tax reduction across the board in each of the next three years. Walker helped convince candidate Reagan to embrace another set of numbers: 10-5-3. Those figures represented the accelerated write-off scheme fashioned by the Carlton group. The plan would enable businesses to "depreciate," or write off, the entire cost of a building in only ten years—compared with thirty years under existing law; to write-off investments in equipment and machinery in five years—compared with ten under existing law; and to write off cars and trucks in just three years, compared with three and a half under existing law. It was an extraordinarily rich tax break, worth hundreds of billions of dollars to business.

Why did Reagan accept such a costly scheme on top of his own tax cuts for individuals? "He didn't know what he was doing," Walker later speculated; but Walker certainly knew, and the payoff for his clients was enormous.

Once elected, the president kept his campaign promise to corporate America. He continued to push for Walker's 10-5-3 plan, as well as for Kemp-Roth's 10-10-10. Only once did the administration show signs of wavering on the massive business tax break: In June of 1981, the Treasury Department began to worry that the tax cuts were too big and would exacerbate the budget deficit. In response, the White House considered cutting back the proposed depreciation schedules, but Walker and company showed they could still flex their muscles. In an event later dubbed the "Learjet weekend," corporate chieftains from across the country raced into Washington to protest any diminution in the 10-5-3 plan. The Treasury quickly backed away from its concerns and even added a few new sweeteners to keep business on board.

In the end, the 1981 tax bill, called the Economic Recovery Tax Act (ERTA), served as proof of the new power of the advocates of business loopholes. It not only included a revised version of 10-5-3, it also lowered the top tax rate on capital gains yet again to 20 percent from 28 percent. A congressional "bidding war" between Democrats and Republicans to see who could be more generous to whom added even more special giveaways. The Carlton group had triumphed.

In the 1980s, tax reform seemed even more unlikely than it had in earlier decades. Accompanying the rising influence of business lobbyists was the proliferation of political action committees (PACs), which dispensed campaign contributions. From 1974 to 1984, PAC spending on congressional campaigns increased nearly tenfold. PAC giving to congressional candidates totaled $12.5 million in 1974 and soared to $104 million in 1984. Some of the biggest beneficiaries of this largesse were members of the tax-writing committees. Nearly $3.5 million of PAC money flowed into the coffers of fifty-six tax-committee members in the first half of 1985 alone. With so much money going into their campaign chests, members of Congress became more beholden than ever to narrow interests.

Changes in the way Congress operated also stood in the way of tax reform. A decade and a half before, Congress was controlled by committee chairmen and a few leaders in both parties. Wilbur Mills, for example, held the pen for all legislation that was written by the Ways and Means Committee during his fifteen-year reign as chairman. In the 1980s, however, Congress was more democratic, and members were more independent of their leaders. Congressional subcommittees had proliferated. There were no longer just a few key power centers; power was spread throughout both chambers. The administration could not simply cut a deal in a back room with a handful of important members; it had to negotiate with a Congress full of independent thinkers and minor potentates.

The yawning budget deficit also appeared to work against reform. Supply-side guru Arthur Laffer, a California professor, had convinced President Reagan and others that the 1981 tax cuts would cause a surge in economic growth strong enough to eliminate the deficit. Instead, the economy slid into recession and the huge tax cuts helped create the biggest peacetime budget deficits the United States had ever known. Republicans had complained about $60 billion deficits in the Carter administration; but under the Reagan administration those deficits soared to more than $200 billion a year, and they showed no sign of coming down. The deficits were clearly the nation's number-one economic problem, and tax reform, as envisioned by Senator Bradley in 1982, offered nothing to reduce them. It was to be "revenue neutral," raising neither more nor less revenue than the current tax system. Tax reform seemed to be a sideshow, a distraction from the real problem. Furthermore, the small reform successes of the past had occurred in bills that cut taxes. Barber Conable, a long-time Republican member of the Ways and Means Committee and a keen observer of Congress, predicted reform could only occur when overall taxes were being lowered. "Tax reform must be bought," he insisted. But with burgeoning budget deficits, the idea of "buying" reform by cutting revenues was unthinkable.

Moreover, the men who had their hands on the levers of the tax-writing system in Washington—Finance Chairman Bob Packwood, Ways and Means Committee Chairman Dan Rostenkowski, Treasury Secretary Donald Regan, and later, Treasury Secretary James Baker—were scarcely reformers. They all helped fashion the 1981 tax bill, and they all had done their part to create and preserve the tax breaks that riddled the existing system. They could hardly be expected to champion an effort to rid the code of special-interest tax breaks.

Bob Packwood was the unlikeliest reformer of the group. Again and again during his nearly two decades in the Senate, Packwood had proved his commitment to maintaining and expanding the vast web of social and economic incentives in the tax code. He was the author of countless provisions benefiting special interests, a man whom lobbyists felt they could count on to defend their tax breaks against the threat of a sweeping reform.

"On taxes, I'm as predictable as the sun rising," Packwood told *The New York Times* before taking over the Senate Finance Committee in early 1985. His statement was irrefutable. He had always been, in his own words, "a big credit man." He had peddled tax credits for parents who sent their children to private schools; tax credits for child-care expenses; tax credits for solar energy, wind energy, ocean energy, even biological-waste energy. "I sort of like the tax code the way it is," Packwood admitted shortly after the Treasury Department unveiled a plan for a comprehensive overhaul of the tax system.

Packwood's words were sweet music to those lobbyists battling to keep tax benefits, and they paid the piper generously. During his first year and a half as Finance Committee chairman, the senator received nearly $1 million in campaign contributions from PACs—far more than any other member of Congress. The money poured in from investment banks, insurance companies, auto companies, real estate companies, drug companies, steel companies, the carpenters' union, the food workers' union, the bricklayers' union, airlines, law firms, the American Hospital Association, the American Dental Association, liquor associations—in short, from almost every organization with an interest in preserving the existing tax system.

If Packwood seemed an unlikely champion of tax reform, so too did Treasury Secretary Donald Regan. The silver-haired former chairman of Merrill Lynch was the very picture of corporate America. He was one of the many executives who chanted the mantra of "capital formation." During his years on Wall Street, Regan frequently jetted to Washington to push for big-business tax benefits. His firm also aggressively marketed a type of tax shelter known as "straddles," even though the IRS had raised questions about their legality. When Jimmy Carter was considering his own ill-fated tax-reform plan, Regan was quick to criticize. He was particularly contemptuous of reports that the president was planning to limit the special break for capital-gains income. "The market is going down," he said in 1977, "and the administration is trying to kill off one of the few tax preferences coming to the individual investor, so why should he bother to take risks?"

When Regan became Treasury secretary in 1981, his tax philosophy seemed clear. He remained true to that philosophy, serving as the point man in the administration's efforts to enact the biggest corporate handout in history.

James A. Baker III, the White House chief of staff who later swapped jobs with Regan, was also an unlikely reformer. A Texas lawyer, he became Treasury secretary in 1985 largely because the job of secretary of State—his top choice—was not available. Despite his training as a lawyer, Baker had no abiding interest in tax policy and at times seemed to have no interest in policy at all. His first love was politics, and he viewed everything through that prism. He encouraged the president to call for a tax-reform "study" in early 1984, largely because he feared the Democrats might make reform an issue in the presidential campaign. But he also listened closely to the advice of Republican pollster Richard Wirthlin, who said the public would be skeptical of any effort to "reform" the tax system and would probably view it as a tax increase in disguise.

The largest gulf between Baker and tax reform was filled with oil. Baker was a Texas aristocrat, and like many wealthy natives of the Lone Star state, his roots ran deep into the reservoirs beneath the tumbleweed plains. His interest in oil was not only financial; it was cultural, societal—oil ran in his blood.

The problem was that oil and tax reform were like oil and water. The oil industry had been a major beneficiary of tax loopholes since 1918, when generous depletion allowances were first enacted to help drillers. Any legislation that did not cut back on the generous oil and gas tax breaks could hardly be called reform, but any legislation that did cut back those cherished breaks would be inimical to Baker.

Dan Rostenkowski, the big, blustery Democratic chairman of the House Ways and Means Committee, shared the Treasury secretary's preference for politics. Raised under the tutelage of Chicago machine-boss Mayor Richard Daley, he too was no reformer. He joined the Ways and Means Committee in 1964 not because of a deep interest in taxes, but because the panel at the time had the power to determine which committees Democratic House members would be allowed to sit on. With his training in ward politics, Rostenkowski knew that the power of patronage reigned supreme.

Rostenkowski became chairman of the tax-writing committee in 1981, and his first year in the job was a trial by fire that marked him as anything but a reformer. Confronted with President Reagan's effort to force a Republican tax bill through the House, Rostenkowski responded by "sweetening" his version of the bill with even more tax preferences in order to buy support. In the bidding war that followed, Democrats and Republicans both handed out tax breaks in a desperate grab for votes. The Democrats—and Rostenkowski—lost, but in the process, Rostenkowski found himself backing a tax bill with business tax breaks so generous that even business lobbyists were stunned. "This is nothing short of astounding," said a surprised Richard Rahn, chief economist for the Chamber of Commerce of the U.S.A. "If you'd told me a few years ago that the Democrats would propose this, I would have said you were out of your mind."

President Reagan also was, in many ways, an unlikely tax reformer. He had always thought the reformers' notion of tax expenditures was a "liberal myth." The government had no inherent right to a taxpayer's money, he reasoned; therefore, forgoing taxes on any portion of that money could hardly be considered the same as government spending.

The president also had a natural antipathy for the corporate income tax. Speaking to a group of businessmen in Bedford, Massachusetts, during January of 1983, he shocked his political advisers by saying that "there really isn't a justification" for taxing corporations at all. "The elimination of the corporate tax," he said, was "something we ought to look at." The incident sparked immediate retractions from his aides in Washington, but the inadvertent comments were a clear reflection of the president's feelings. They certainly did not suggest that, nearly three years later, he would triumphantly sign a tax bill that closed dozens of loopholes and raised corporate taxes by $120 billion over five years—the biggest corporate tax increase in history.

But in one very fundamental way President Reagan was a natural advocate of tax reform; he had a passionate desire for lower individual tax rates. He had vivid memories of his days as a young Hollywood actor,