



# JOINT ECONOMIC COMMITTEE

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## CONSTANT CHANGE: A HISTORY OF FEDERAL TAXES

*The first in a series on tax simplification and reform*

The current tax code is the product of an ongoing legislative process influenced both by shifts in the philosophy of taxation and by growth in understanding the economic implications of taxation. The result is an extraordinarily complex code that is frequently at cross-purposes with itself. This report highlights the major trends in the U.S. tax system since the beginning of the income tax, and especially over the last several decades, to illustrate how we arrived at the current tax system. Such an historical perspective on the tax system is crucial for understanding the motivations of features of the current code and evaluating proposals for simplification and reform.

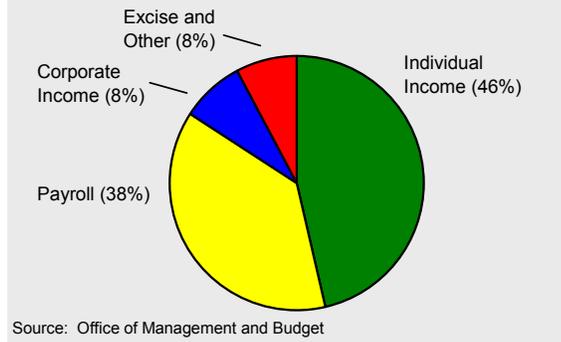
- **The Rise of the Income Tax.** When introduced into law following the ratification of the 16<sup>th</sup> Amendment in 1913, the income tax directly affected only one percent of the population. With the Great Depression and World War II, however, the number of households paying income taxes shot from four million to 43 million.
- **Mid-Century Experimentation: Tax Cuts to Smooth the Business Cycle.** In the 1960s, policymakers began experimenting with lowering taxes to smooth the traditional economic cycle of boom and recession. The underlying thinking was that increasing consumers' disposable income at precisely the right time could dampen temporary economic declines or speed recovery.
- **The Beginning of Modern Tax Policy: Reagan's 1981 Tax Cut.** The Reagan tax cut of 1981 marked an important new direction in tax policy. That tax legislation put emphasis on lowering marginal rates that discourage work and saving and took special steps – such as the establishment of Individual Retirement Accounts – to reduce the income tax's implicit double taxation of saving and investment. The idea that saving and investment lead to capital formation, a driver of long-run growth, is a basic principle of modern economic thinking.
- **The 1986 Tax Reform Act: A Mixed Bag.** The Tax Reform Act of 1986 (TRA86) was a watershed attempt at wholesale reform marked by both impressive achievements and notable failures. While TRA86 significantly reduced individual and corporate tax rates and deductions, a renewal of double taxation on saving marred those central accomplishments. Moreover, the 1986 reform substantially complicated tax compliance for businesses through complex new inventory and international tax rules and an expanded Alternative Minimum Tax.
- **Tax Policy Since 1986.** The primary achievement of the 1986 tax reform – lowering personal tax rates and reducing the number of brackets – was lost during the 1990s. However, in a positive reversal of a 1986 policy, recent changes have relieved some saving from double taxation by expanding saving opportunities like IRAs. Recent capital gains and dividend tax rate reductions have promoted investment as well. Unfortunately, the *ad hoc* nature of many post-1986 tax changes and the increasing use of the code for social policy have increased tax complexity.

Current tax code complexity reflects a cumulative history of changes motivated by shifting philosophies and priorities. While some of these priorities – such as low rates and a low saving burden – have been rightly pursued and should continue to guide tax policy, constant change without comprehensive reform has made the code ripe for major simplification.

## CONSTANT CHANGE: A HISTORY OF FEDERAL TAXES

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**Where Does Federal Tax Revenue Come From?**  
(Federal tax receipts, FY 2002)



result is an extraordinarily complex code that is frequently at cross-purposes with itself. This report highlights the major trends in the U.S. tax system since the income tax's beginning, and especially over the last several decades, to illustrate how we arrived at the current tax system. Such an historical perspective on the tax system is crucial for understanding motivations for features of the current code and evaluating proposals for simplification and reform.

While the U.S. relies on estate and payroll taxes in addition to income taxes, the focus of this report will be on corporate and individual income taxes, the main generators of revenue for general government operation and the largest sources of complexity in the tax system. (See the above chart for contributions of each tax to government revenues.)

### The 16<sup>th</sup> Amendment and the Rise of the Income Tax

Before the ratification of the 16<sup>th</sup> Amendment in 1913 gave the federal government the power to levy an income tax, the U.S. government raised revenue primarily through tariffs and excise taxes on items such as liquor and tobacco. Following ratification, Congress created an income tax featuring a seven percent top rate, with only the richest one percent of individuals paying this tax. Although Congress sharply raised tax rates during World War I and again during the Great Depression, the proportion of people facing the income tax remained quite small. However, the demands of World War II prompted Congress to extend the reach of the income tax to the masses. Between 1939 and 1945, the number of households subject to the income tax shot up from four million to 43 million.

### Mid-Century Experimentation: Tax Cuts to Smooth the Business Cycle

Although it was necessary to raise taxes to pay for the war, increasing taxes during the Depression was an economically disastrous strategy that reflected poor knowledge of the

### The Payroll Tax's Great Depression Origins

Congress enacted the *Social Security Act of 1935* during the middle of the Great Depression and two years later created a distinct *payroll tax* system to fund it. Payroll taxes currently provide financing for Social Security – Old Age, Survivors, and Disability Insurance (OASDI) – and part of Medicare. The tax was introduced at a rate of one percent on all payrolls (wages and salaries), payable by both employers and employees, for a total rate of two percent.

The current payroll tax is 15.3 percent of wages, on paper split evenly between employer and employee. Economists of all stripes agree, however, that the employee bears the employer portion of the tax in the form of lower wages. The first 12.4 percent of the payroll tax is levied on payroll income up to a cap, which was \$87,000 in 2003. Due to this cap, the payroll tax would be considered regressive (i.e. a tax under which lower-income individuals face a higher average tax rate than higher-income individuals) if it stood alone. That regressivity is offset, however, by Social Security benefits that replace a much higher fraction of earnings for low-earners than for high-earners. The Social Security system taken as a whole, including its payroll tax financing mechanism, is actually quite progressive.

effects of taxes on the economy. Benefiting from an improved understanding of economic theory, policymakers after 1950 began to view tax cuts as a way to boost personal disposable income and consumer spending, thereby smoothing the business cycle. Accordingly, the 1960s saw a modest drop in the top tax rate to 70 percent from over 90 percent, as well as experimentation with investment tax credits that reduced tax liability for companies using earnings to make investments. Despite several tax cuts during the 1970s and relatively stable real incomes, inflation pushed millions of workers into higher tax brackets and reduced the value of exemptions and deductions.

### **The Beginning of Modern Tax Policy: Reagan’s 1981 Tax Cut**

With the passage of the *Economic Recovery Tax Act of 1981*, two major themes emerged that would dominate federal tax policy in the following decades: reducing *marginal tax rates* that discourage work and investment, and reducing the *bias against saving* inherent in any income tax. The Act reduced the top individual tax rate from 70 percent to 50 percent and indexed all brackets for inflation. This legislation also reformed business depreciation rules to encourage investment by allowing firms to deduct more quickly the cost of investment from their tax liability.

#### *Marginal Tax Rates Emphasized*

The idea that a person’s *marginal* tax rate has important effects on economic decision-making was not

#### **Marginal versus Average Tax Rates**

A person’s *marginal* tax rate is the tax rate that person would pay on an additional dollar of income earned or received beyond his current income. In an income tax system where tax rates increase with income, the marginal rate is the rate corresponding to a person’s top income tax bracket. For example, if the first \$10,000 of income is taxed at 10 percent and the second \$10,000 is taxed at 20 percent, a person who earned \$15,000 would be in the 20 percent bracket facing a 20 percent tax rate on an additional (marginal) dollar of income.

An *average* tax rate, in contrast, is the overall rate at which a person is taxed on all his income, as opposed to the tax rate on just an additional dollar of income. In the tax system example above, a person earning \$15,000 would pay \$1,000 in taxes on his first \$10,000 of income and another \$1,000 in taxes on the remaining \$5,000 of income. The average tax rate is calculated by dividing his total tax payment of \$2,000 by his total income of \$15,000. This individual would thus face an *average* tax rate of 13.3 percent ( $2,000/15,000=13.3$  percent) but a *marginal* tax rate of 20 percent.

Average and marginal tax rates serve different functions in evaluating tax policy. While average rates are used to determine how different groups are impacted by a tax, marginal rates are important for determining how much taxes affect individuals’ work and saving decisions.

prominently embodied in tax legislation before 1981. Previous policymakers had recognized that lowering *average* tax burdens could have positive effects on the economy by providing individuals with more disposable income to spend. This 1960s-era thinking had given less attention to the importance of the marginal tax rate (see box). The marginal rate – which determines how much of each additional dollar of earnings a person keeps – is the rate that matters for a worker making a decision about whether to work extra hours, or a business deciding whether to invest in another machine. Before 1981, the highest federal rate was 70 percent – meaning that a person in the top income bracket was allowed to keep only 30 cents of every additional dollar earned after paying federal income taxes. By emphasizing marginal tax rate reduction, the 1981 tax cut encouraged more work and savings, ushering in a decade of sustained economic growth.

#### *Saving and Investment Encouraged*

Saving and investment, which lead to a higher level of capital in the economy, are important drivers of long-run economic growth. The 1981 tax cut promoted saving and investment by reducing the burden that a standard income tax imposes on saving. By collecting a tax both when a dollar is initially earned and again on

the investment income generated if it is saved, an income tax system penalizes saving through double taxation.

In recognition of the income tax system's bias against saving, the 1981 Act included provisions that relieved a portion of the double burden on saving and investment. One such provision, the Individual Retirement Account (IRA), allows individuals to save while avoiding double taxation. Earnings invested in a traditional IRA are taxed only once – upon withdrawal from the account. Other tax code changes allowed businesses to accelerate depreciation of their investments and provided tax credits for new investments – encouraging capital formation and thereby economic growth. Investment tax credits, accelerated depreciation, and IRAs all introduced elements of a consumption tax system into the traditional income tax.

### **The Tax Reform Act of 1986: A Mixed Bag**

The *Tax Reform Act of 1986* (TRA86) was a watershed attempt at wholesale reform, albeit a reform marked both by impressive achievements and by notable failures. The 1986 Act represented a compromise between those who wanted a broader tax base with a broader definition of income and those who wanted to reduce high marginal tax rates and their depressing effect on economic growth. The reform made important gains for economic efficiency by dramatically lowering tax rates – including a reduction in the top individual rate from 50 to 28 percent – and reducing the number of tax brackets. As discussed below, those achievements were marred by the introduction of new complexities into the tax code and a renewal of the income tax's bias against saving and investment.

#### *Some Progress on Simplification*

The 1986 reform made some progress on simplifying the tax code, but it also added considerable new complexity. The Act made some advances in simplicity for individuals, reducing the number of individual tax brackets from 14 to two (15 and 28 percent). Both the personal exemption and standard deduction were increased as well as indexed to inflation, relieving many lower-income individuals of the need to itemize or even file taxes at all. Additionally, complexities such as income averaging and deductions for consumer interest and sales taxes were eliminated.

Unfortunately, several features of the 1986 Act actually added significant new complexity to the tax code, offsetting many of the positive accomplishments. New rules governing IRAs complicated retirement planning for many individuals. At both the individual and business level, the Alternative Minimum Tax (AMT) – which requires many filers to calculate a second tax liability (and pay the greater of the two) – was revised and expanded. For businesses, new rules about inventory grossly complicated tax compliance. New international tax rules changing the timing of tax payments for certain types of foreign income also greatly added to tax complexity for businesses.

#### **Marginal Tax Rates and Progressivity**

Progressivity refers to the extent that higher-income individuals pay a higher tax rate than do lower-income individuals. A tax system's progressivity depends on a number of factors, including the rate structure, the forms of income subject to taxation, and the availability of deductions and credits.

The *Tax Reform Act of 1986* represented the culmination of a trend toward lower marginal tax rates that began hesitantly in the 1960s and was reaffirmed in 1981. In the 22 years between 1964 and 1986, the top individual tax rate fell from 91 percent to 28 percent. Yet, tax system progressivity actually increased over this period of falling rates for two reasons: 1) higher-income individuals chose to take more of their compensation as taxable salaries rather than as non-taxed fringe benefits, and 2) tax base broadening resulting from elimination of many deductions.

### *Temporary Reversal on Saving*

Whereas the Reagan tax cuts of 1981 made important inroads in alleviating the tax system's double taxation of savings, the Tax Reform Act of 1986 negated this accomplishment by reducing saving and investment incentives. At the individual level, the 1986 reform placed new restrictions on the use of IRAs and also repealed the partial exclusion for capital gains, thereby increasing the tax rate on investments that increase in value. At the corporate level, the investment tax credit was repealed and less favorable depreciation rules were re-imposed, making new investment a less attractive proposition. While these changes reinstated much of the tax code's bias against saving and investment, this reversal would prove to be an aberration rather than a trend. Future amendments to the tax code would again move toward tax-neutral savings treatment, and nearly all major tax reform proposals would advocate adoption of a saving-friendly consumption tax base.

### **Since 1986: Fluctuating Rates and Steadily Increasing Complexity**

The prime achievement of the 1986 tax reform – lowering tax rates and reducing the number of brackets – was lost during the 1990s through a series of increases in both tax rates and the number of tax brackets. With tax hikes enacted under President George H. W. Bush in 1990 and President Bill Clinton in 1993, the top tax rate climbed from 28 percent to 39.6 percent while the number of tax brackets proliferated from two to six. Tax cuts in 2001 and 2003 brought the top marginal rate down slightly again. Two other trends during the 1990s – an increasing use of the tax code to achieve social policy objectives and an increase in tax preferences for saving – both contributed to increasing complexity in the tax code, as described below.

### *Social Policy in the Tax Code*

During the late 1980s and especially the 1990s, legislators made increasing use of the tax code to encourage or reward certain behaviors unrelated to the tax system's primary purpose of raising revenue in the most efficient, fair, and simple way. Certainly, social policy goals have long been pursued through the tax code. The corporate income tax, for example, contains an alternative fuel production credit, while both the individual and corporate sides contain incentives for the restoration of historic buildings. Yet, the growth in the 1990s of narrowly targeted tax provisions, especially on the personal side of the tax code, was remarkable. The Earned Income Tax Credit (EITC), available to workers who pay no federal individual income tax, expanded significantly between 1991 and 1996. The Tax Relief Act of 1997 established a child credit, two different education tax credits, and IRAs specifically for educational saving. Legislation in 2001 expanded the child credit and offered it even to those paying no federal income tax.

Many of the social objectives pursued through the tax system are surely worthy goals. Nonetheless, one must be aware that the use of credits, deductions, and exemptions instead of direct spending programs has undeniably complicated the code and made tax filing a more daunting task for the average tax filer.

### *Encouraging Saving and Investment ... Again*

The 1990s also saw a resumption of the battle against the double taxation of savings, albeit in a narrow, targeted way symptomatic of the trend toward using the tax code to encourage specific approved behaviors. Medical Savings Accounts were established to encourage saving for medical expenses, although in reality few people were eligible to participate. Saving

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In 2003, Congress took another important step toward relieving the double taxation of saving by reducing the individual tax rate on dividend income to 15 percent.

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for educational expenses was encouraged through an Education IRA and the Section 529 Qualified Tuition Program. Roth IRAs were also introduced, providing a similar tax benefit as traditional IRAs but changing the timing of the tax payment from the time of distribution to the time the money is earned.

Although the 1986 reform taxed capital gains at the same rate as other income, the cause of eliminating saving disincentives in the tax code realized a minor victory when the capital gains tax rate was held constant in 1990 and in 1993 even as ordinary income tax rates increased. Between 1997 and 2003, Congress reduced the capital gains rate to its current level of 15 percent. The tax on capital gains is often the second or even third layer of taxation imposed on saved income. Accordingly, this tax is an important disincentive to saving and potential drag on efficient capital movement and economic growth. In 2003, Congress took another critical step toward reducing the double taxation of investment in corporate stock by reducing the tax rate on dividend income at 15 percent.

While all of these provisions represent important progress toward reducing the burden on saving, they simultaneously complicate tax and financial planning. The number of savings plans to choose from, the restrictive rules governing those plans, and the different tax rates for various income sources all add complexity and offer ripe targets for simplification agendas.

### **Where Do We Go From Here?**

The history of the income tax reveals several clear patterns in tax legislation over the last two decades. The Reagan tax cut of 1981 promoted two trends – lowering marginal tax rates and reducing the double taxation of saving – that have remained important tax policy considerations since that time. The Tax Reform Act of 1986, although affirming the importance of lower tax rates, temporarily reversed the effort to alleviate the tax burden on saving. Since 1986, the tax treatment of saving has improved, but complexity and tax rates have generally increased along with the targeted use of the tax code as an instrument of social policy.

Congress now faces important questions about the future of tax policy. How should future tax reforms further relieve the double taxation of saving? Can complexity in the tax code be relieved through incremental simplification efforts within the existing structure, or is fundamental reform necessary? If fundamental reform is the route chosen, what can be done to prevent the unraveling of reform as occurred in the aftermath of 1986? Future reports in this JEC series will explore these questions and consider how Congress can approach tax code changes from a consistent framework that incorporates the lessons of recent history.

### **Further Reading**

#### **Treasury Department's Fact Sheet on the History of the U.S. Tax System**

(Part of the Treasury Department's series of fact sheets on tax policy and history.)

<http://www.treasury.gov/education/fact-sheets/taxes/ustax.html>

#### **The Decline (and Fall?) of the Income Tax**

(A 1997 book by Michael J. Graetz on the history and politics of income taxation in the U.S.)

This report is the first in the **JEC Tax Simplification and Reform** series. This series addresses the growing bipartisan belief that the current tax code is broken and that opportunities exist for wholesale improvements. Future papers will explore topics including the difference between income and consumption taxes and issues in evaluating tax system fairness.

## Committee Publications

### JEC publications released this month:

- “Constant Change: A History of Federal Taxes,” September 12, 2003. First in a series of reports on tax simplification and reform.
- “Recent Economic Developments: The Economy Builds Momentum,” September 10, 2003. Reviews key economic data from the past month and indications for future economic growth.
- “Understanding Today’s Deficits,” September 3, 2003. Update of previous JEC report using new budget estimates made by the Congressional Budget Office.

### Other recent JEC publications include:

- “10 Facts about Today’s Economy”
- “New Possibilities for Financing Roads”
- “Prescription Drugs Are Only One Reason Why Medicare Needs Reform”
- “Health Insurance Spending Growth – How Does Medicare Compare?”
- “Medicare Beneficiaries’ Links to Drug Coverage”

### Recent JEC hearings include:

- “The Employment Situation,” September 9, 2003.
- “Technology, Innovation, and the Costs of Health Care,” July 9, 2003.
- “Transforming Iraq’s Economy,” June 11, 2003.

Copies of the above publications can be found on-line at the committee’s website at [jec.senate.gov](http://jec.senate.gov). Publications issued by the vice-chair and ranking member can be accessed via the same website.