

Chapter Two

How We Got Here



The tax system is closely intertwined with American society; it not only reflects events of the day, but also shapes the society in which we live. It has broad effects – some intentional and some accidental, some short term and some long term. Over the years, many trends have contributed to the problems in our current system. To appreciate the Panel’s options for reform, it is useful to understand the broad historical outlines of the U.S. tax system.

Among the most important trends that have marked the federal income tax since its inception have been its ever growing reach; not only has it steadily affected increasing numbers of Americans, but it is now used to carry out a multitude of policy objectives that go well beyond merely collecting revenues needed to fund our government. And as the tax code has developed, little effort has been given to comprehensively examining the system to make sure that it is simple, efficient, and transparent.

There are already many comprehensive histories of the tax code, and this report does not attempt to duplicate, or even summarize, those works. Instead, this chapter highlights historical developments relevant to the Panel’s work.

For much of its history the United States did not have an income tax. Except for a brief period during and immediately after the Civil War, the nation relied almost exclusively on tariffs – taxes on imported goods – to support government functions. A lively constitutional debate, including a decision by the Supreme Court in 1895, weighed against the creation of an income tax.

But in 1913, the Sixteenth Amendment was ratified, ending all debate about whether an income tax was constitutional. A few months later, Congress enacted an income tax. At its inception, less than 1 percent of Americans paid the individual income tax. Most Americans were exempt from paying the tax because their income did not exceed a relatively high threshold, and even those who were subject to the tax paid at modest rates. By the 1920s, tax rates had increased and a majority of government revenue came from income taxes that helped fund what was still a small federal government.

The income tax was initially a “class tax” paid mostly by wealthy Americans. But during the 1930s, the federal government established withholding of payroll taxes in order to fund the new Social Security system, thereby creating a means to collect income tax from the many Americans who receive wages from an employer.

World War II created a pressing need for greater government revenues, and the income tax was greatly expanded to fill the shortfall. The threshold for paying taxes was dramatically reduced, subjecting millions of families to the income tax for the first time. At the same time, wage withholding was expanded to require employers to collect not only Social Security taxes, but also income taxes on employees’ wages. By the end of World War II, almost 75

percent of Americans were subject to the income tax, compared with only 5 percent in 1939. The income tax had been transformed from a “class tax” on the wealthiest Americans into a “mass tax” paid by most Americans to fund what had become a substantially larger federal government.

Unlike the aftermath of previous wars, such as the Civil War and World War I, when income taxes were either abolished or reduced, the end of World War II did not prompt the federal government to lower tax rates. Instead, the federal government continued to use receipts from the income tax to maintain much of its wartime size. The income tax remained a major factor in America’s economy, and unintended consequences became a hallmark of tax policy.

1913 Form 1040

During the war, the National Labor Relations Board followed an earlier IRS ruling that excluded employer-paid health insurance from income and exempted employer-paid health insurance from wage and price controls. As a result of this decision, employers looking to attract and keep talented workers made greater use of health insurance benefits and other non-cash wages. When World War II ended and price controls were removed, health insurance remained a tax-favored form of compensation for the vast majority of Americans. The decision to exclude health care benefits – originally made when the tax code affected only a small fraction of Americans – had far-reaching consequences, which are detailed later in this report.

Starting in the 1960s, another broad trend in tax policy accelerated: the use of the tax code to achieve policy goals other than raising government revenue. Rather than the largely unintended consequence of some earlier tax writing efforts, this trend reflected a deliberate intent. It strengthened throughout the 1960s and 1970s, with the creation of individual retirement accounts (IRAs) in 1974; the earned income tax credit (EITC), which provides low-income working Americans with a tax benefit, in 1975; and 401(k) retirement accounts in 1978.

Tax changes motivated by non-tax economic or social policy goals became so commonplace that, beginning in 1974, provisions in the tax code to promote these goals were tracked in a “tax expenditure budget.” A tax expenditure is a tax incentive that provides special tax treatment to a particular type of activity. Many of these tax incentives could have been structured as a direct government spending program. Either way, it costs the government money to provide benefits, which must be financed with higher taxes elsewhere. Over the past several decades, the number and estimated cost of tax expenditures has grown considerably.

Even when Congress and the Administration corrected certain problems in the tax code, they often created other problems at the same time. For example, in 1981, Congress passed and President Reagan signed a tax bill that indexed tax brackets for inflation, ending what was called “bracket creep.” Bracket creep occurred when inflation pushed up taxpayers’ wages. Because tax brackets were not adjusted for inflation, this amounted to an inflation-aided tax hike every year, even if a taxpayer’s purchasing power stayed the same or actually fell. Furthermore, lawmakers were able to spend the proceeds from these higher taxes without having to actually vote to increase rates.

PERSONAL INCOME-TAX RETURNS FILED FOR THE CALENDAR YEAR ENDED
DECEMBER 31, 1920 DISTRIBUTED BY INCOME CLASSES.

INCOME CLASSES		NUMBER OF RETURNS
\$ 1,000 TO	\$ 2,000	2,671,950
2,000 "	3,000	2,569,316
3,000 "	4,000	894,539
4,000 "	5,000	442,557
5,000 "	6,000	177,147
6,000 "	7,000	112,444
7,000 "	8,000	74,511
8,000 "	9,000	51,211
9,000 "	10,000	40,129
10,000 "	11,000	29,984
11,000 "	12,000	24,370
12,000 "	13,000	19,388
13,000 "	14,000	16,089
14,000 "	15,000	13,739
15,000 "	20,000	44,531
20,000 "	25,000	23,729
25,000 "	30,000	14,471
30,000 "	40,000	15,808
40,000 "	50,000	8,269
50,000 "	60,000	4,785
60,000 "	70,000	3,006
70,000 "	80,000	1,969
80,000 "	90,000	1,356
90,000 "	100,000	977
100,000 "	150,000	2,191
150,000 "	200,000	590
200,000 "	250,000	307
250,000 "	300,000	166
300,000 "	400,000	169
400,000 "	500,000	70
500,000 "	750,000	98
750,000 "	1,000,000	25
1,000,000 "	1,500,000	19
1,500,000 "	2,000,000	3
2,000,000 "	3,000,000	4
3,000,000 "	4,000,000	3
4,000,000 "	5,000,000	-
5,000,000 AND OVER		4
TOTAL		7,259,944
* RECAPITULATION *		
JOINT RETURNS OF HUSBANDS AND WIVES, WITH OR WITHOUT DEPENDENT CHILDREN, INCLUDING HUSBANDS WHOSE WIVES, THOUGH LIVING WITH THEM, FILED SEPARATE RETURNS		
		3,775,261
WIVES MAKING SEPARATE RETURNS FROM HUSBANDS		
		77,558
MEN, HEADS OF FAMILIES		
		474,574
WOMEN, HEADS OF FAMILIES		
		132,181
ALL OTHER, MEN		
		2,256,565
ALL OTHER, WOMEN		
		503,690
COMMUNITY PROPERTY		
		40,115
TOTAL		7,259,944

Internal Revenue Service, Statistics of Income, 1920

While fixing the bracket creep problem, the 1981 tax bill also included various narrowly tailored tax incentives, and these special interest provisions, including further benefits for real estate investment, helped drive greater use of tax shelters. By 1982, one poll showed that 86 percent of Americans believed that most higher-income people got out of paying much of their taxes by hiring tax accountants and lawyers who showed them how to use loopholes in the tax law, while lower and middle-income people simply took the standard deduction and paid what they owed.

In his 1984 State of the Union address, President Reagan called on the Treasury Department to prepare a plan to overhaul the entire tax code. After two years of analysis, debate, and bipartisan compromise, President Reagan signed the Tax Reform Act of 1986. The 1986 Act reduced the top marginal individual tax rate from 50 percent to 28 percent and increased the standard deduction. The top corporate tax rate was reduced from 50 percent to 34 percent.

The 1986 Act broadened the tax base by repealing more tax preferences than had been eliminated in all tax legislation enacted between 1913 and 1985, including the long-term capital gains exclusion, the investment tax credit, the two-earner deduction, state and local sales tax deductions, and the deduction for credit card interest. Deductions for passive losses, medical expenses, business meals and entertainment, and miscellaneous expenses also were limited. These changes and others made by the 1986 Act simplified the tax code, broadened the income tax base, allowed for lower marginal tax rates, and curtailed the use of individual tax shelters.

While the 1986 Act was a historic event, it did not produce a lasting transformation of the tax system. The 1986 Act left in place or added various complicated tax benefits, including such items as exclusions for employer-provided fringe benefits, state and local tax deductions, tax-deferred annuities, new mortgage interest deduction rules, and complicated rules for determining alternative minimum tax liability. Many point to the 1986 Act as the high point of contemporary tax reform – and they may well be right – but its limitations suggest that truly sweeping comprehensive reform faces formidable political obstacles.

The reforms of the 1986 Act were intended to create a simpler, more stable, and pro-growth federal income tax system based on lower rates and more uniform taxation of all sources of income, while retaining a progressive tax rate structure. But since 1986, the promise of a more simple and sustainable system has been undone. Throughout the 1990s, income tax rates rose, and many special individual and business tax provisions were enacted, narrowing the tax base. The piecemeal addition of these new benefits was shaped by new budget rules aimed at forcing lawmakers to limit the scope of tax legislation. Rather than limiting the number of new provisions, however, the budget rules led to a greater use of phase-outs, restrictions, and eligibility criteria that compounded the complexity of the tax code.

During the 1990s, the EITC was revised to account for family size and was extended to cover low-income single workers with no children. A higher level of Social Security benefits became subject to tax, and a complicated three-tier system was enacted for calculating how much would be taxed. On the business side, Congress increased the corporate tax rate from 34 percent to 35 percent and either created or extended a number of special provisions for the energy sector, low income housing, research and development, and tax-free employee fringe benefits.

In 1997, Congress again enacted new tax credits for children and for education. A new type of retirement vehicle – called a Roth IRA – was created along with a new education savings account. Joining the medical savings accounts created in 1996, these accounts were the first of a slew of new provisions to promote savings, each with its own rules and limitations. The piecemeal addition of savings incentives with complicated rules made it increasingly hard for ordinary Americans to navigate the system while still allowing for well-advised taxpayers to take advantage of the code's many loopholes.

A number of significant changes to the tax code have been made in the last few years. Tax relief passed in 2001 lowered individual tax rates, doubled the child tax credit, raised limits for retirement plan contributions, provided marriage penalty relief, and introduced a deduction for college expenses and yet another education savings account. Two years later, further tax relief was signed that reduced the taxation of both dividends and capital gains to a uniform top rate of 15 percent, and increased the amount of depreciation or expensing that companies could take for business purchases. All of these provisions – rates and others – are temporary and expire over the next six years, substantially undermining the durability of the tax code and the certainty taxpayers need for planning.

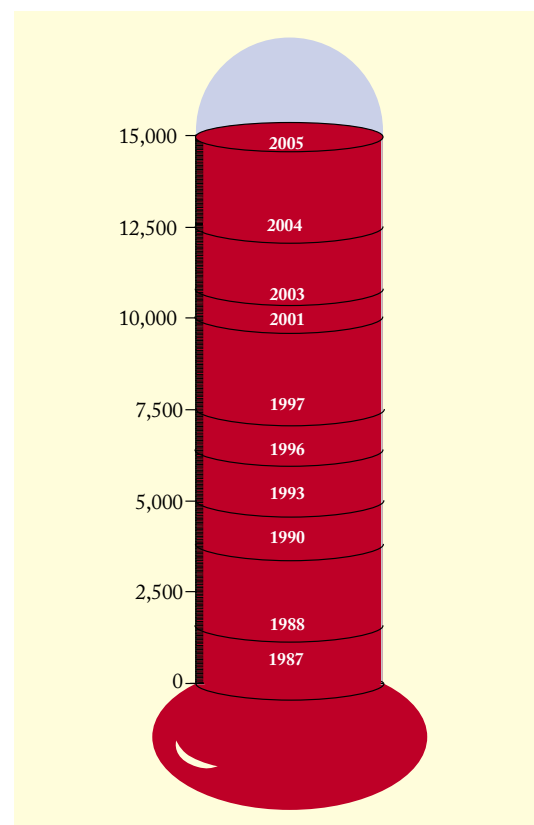
Just last year, Congress enacted a “use it or lose it” tax holiday to encourage multinationals to bring back previously untaxed foreign earnings, and a special tax deduction targeted at domestic manufacturing. The manufacturing deduction is another example of a provision that is targeted at a specific type of activity, but that creates complexity for everyone. The provision allows businesses to deduct net income from the sale of goods, software, and film and sound recordings if they are manufactured or produced within the United States. To take advantage of the benefit, businesses need to allocate all of their receipts and expenses between those activities that are eligible for the preference and those that are not. Provisions like these are also difficult to administer. One witness observed that the prohibition on movies with sexually explicit content places IRS agents in the awkward position of screening movies to determine whether they qualify for the deduction.

Even as the Panel was conducting its deliberations, lawmakers continued to enact additional tax breaks for certain industries. Yet again, greater value was placed on creating targeted tax breaks than on establishing broad-based provisions that would apply to all businesses.

Today, our tax system bears little resemblance to the simple, low-rate system promised by the 1986 reform effort. Since 1986, there has been nearly constant tinkering – more than 100 different acts of Congress have made nearly 15,000 changes to the tax code, as shown in Figure 2.1. A number of new credits, deductions, and exemptions have been extended or layered on top of long-standing incentives in the tax code for such goals as encouraging savings, charity, and homeownership. A growing maze of tax rules and incentives target narrow classes of individuals; phase-outs, contribution limits, and complicated eligibility criteria circumscribe the scope of older programs. Changes in the global economy, including increasingly sophisticated financial instruments, the free flow of capital across borders, a globally competitive marketplace, and the expanding role of intangible assets in producing business income, have also made it harder to establish the rules required to accurately measure tax liability and fairly enforce the income tax.

Our tax code is in dire need of reform. Not only has it failed to keep pace with our growing and dynamic economy, frequent changes have made it unstable and unpredictable. History demonstrates that in the absence of a concerted effort to reform the tax system, it will become more complex and ungainly. Meaningful reform requires a comprehensive and forward-looking examination of our tax system. The Panel has been presented with a historic opportunity to do just that. The following chapters describe the Panel's findings, along with proposals designed to put our country on a path towards a better tax system for current and future generations.

Figure 2.1. Tax Law Changes Since 1986



Box 2.1. International Trends

A wave of tax reforms has swept across the world in the last two decades. Since the United States reformed its tax system in 1986, almost every major developed economy has engaged in fundamental tax reform. The Panel heard that a common theme of these reform efforts was an attempt to lower tax rates and broaden the tax base.

Some countries have adopted flatter personal income tax systems by reducing the number of tax brackets in their systems. A number of countries in Eastern Europe – including Estonia, Georgia, Latvia, Slovakia, and Russia – have adopted a single uniform rate for taxing personal income. Other countries, such as Finland, Norway, and Sweden have moved towards dual personal income tax systems under which wage income is taxed at progressive rates and capital income (dividends, interest, etc.) is taxed at a single low rate. Countries have also lowered their corporate income tax rates and provided other tax relief for capital income. Finally, almost all developed economies and many developing ones have adopted a modified sales tax known as a value-added tax, or VAT.