BRACKETS: TAKING A HISTORICAL PERSPECTIVE

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This paper examines the history of the U.S. income tax system from 1913 to the present, focusing on the system of graduated rates. The paper compares the structure of the current system to the structures in effect during the 100 preceding years, using inflation-adjusted dollars. Several observations quickly emerge that are not currently part of the broader discourse about the income tax.

First, the paper matches the changes in these structures to several other data sets, including the distribution of the tax burden among the population according to income and the size of the federal budget. The paper identifies the kinds of public goods and services those tax dollars have procured as the tax structures have changed and the federal budget has grown.

Second, the paper describes the ways the rate structure has changed over time, in terms of rates, the number of brackets, the graduation of those brackets and their penetration into the income strata. The top marginal rate, currently 35%, is well below its historic high; the top marginal rate during the 1940s was 94%. The current system also has a stark paucity of brackets in comparison to prior years, with a total of seven brackets, including the zero rate bracket created by the personal exemption and standard deduction. The early years of the federal income tax contained over ten times that number of brackets. In previous decades, the brackets also extended into the income strata much more deeply. Currently, the top marginal rate is applied to taxable income in excess of $380,000. In the earliest years of the tax code the top rate was applied to incomes that exceeded $33 million (in inflation adjusted dollars) and during WWII, the top rate was applied to incomes in excess of $82 million (in inflation adjusted dollars). Until the Kennedy administration, the top rates were applied to incomes that exceeded $1.5 million (in inflation adjusted dollars). In short, the rate structure has flattened significantly in the last 40 years. The paper describes the economic policy theories and decisions driving these changes over time.

Finally, the paper explores the impact of these changes as a matter of political economy. The paper examines the impact of the marginal rate increases on households within each bracket and what those tax dollars would otherwise buy, based on household expenditure data from the U.S. Census. In the past, the size of the increases in rates between brackets has been much smaller and those increases have been more evenly distributed throughout the income strata rather than centered on the middle class. In contrast, the increases in rates in the current system are most steep (a ten percent increase on the next dollars of income) for unmarried individuals earning $45,000 of gross income and couples married filing jointly earning $90,000 of gross income. The dollars of income a household earns in excess of $45,000 in gross income are the dollars middle class households use to buy a home, rear children, and finance a college education. These

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investments benefit not only these households, but also the broader economy. This suggests that the current system punishes the middle class preferentially and may purchase public goods at a price that exceeds their benefit, given the impact that alternative purchases households in these brackets generally make and the extent to which they procure not only their own economic well-being, but contribute to the U.S. economy. The paper also explores the impact of grouping high-level wage earners, such as doctors and lawyers, with households whose incomes are many times that level and with individuals with incomes that are derived primarily from capital rather than labor. The paper argues that by increasing the number of brackets, extending their reach into higher levels of income, reducing the marginal rate increases in between brackets, particularly for the middle class, and increasing the rates on capital gains, the resulting system would be more effective at raising revenue, improve overall welfare, and provide for long-term growth in the economy.