

BRACKETS: A HISTORICAL PERSPECTIVE

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ABSTRACT—This Article surveys the history of the U.S. income tax system from 1913 to the present, examining changes in the structure of the graduated rates system over the past 100 years, using inflation-adjusted dollars. By connecting these changes to key events in the history of the United States, the Article contextualizes modifications Congress has made to the income tax over time as well as the current debate surrounding several proposals for reform. First, the Article demonstrates that the rate structure has become more flat (with lower rates and fewer brackets than in the past), compressed (with less graduation, steeper jumps between brackets, and less penetration of the rate schedule into the income strata), and complex (with the proliferation of tax expenditures) over time. Second, the Article reveals that the structures that would result from two of the tax reform proposals being discussed in the popular media resemble historical rates and brackets. Because these proposals for tax reform have analogs in earlier versions of the income tax, the Article argues that analysis of economic data from prior periods may help inform tax policy and identifies an agenda for future research.

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INTRODUCTION

The U.S. Income Tax celebrated its 100th anniversary in 2013. It is customary under such circumstances to revisit significant events in the history of an institution and to provide some context for the changes that have occurred over time. This Article is descriptive; it examines and compares the rate structures in effect during the past one hundred years, using inflation-adjusted dollars, and depicts these changes in graphic format. Part I describes the compression and flattening of the progressive rate structure. It describes the changes in the top and bottom marginal rates for ordinary income, the personal exemption and standard deduction, and the number of brackets and their progression into the income strata, noting that the bracket structure has become flatter, more compressed, more complex, and less transparent over time. This Part also contextualizes the major modifications in the rate structures by connecting them to key events in the history of the country. Part II notes the resemblance between historical rate structures and those that would result from implementation of two current proposals for reform, outlining recent empirical research on progressive rate structures based on historical data. It then examines the “millionaire surtax” in light of analogous tax rate structures from the history of the income tax. The Article then concludes, describing an agenda for further study.

I. THE COMPRESSION AND FLATTENING OF THE PROGRESSIVE RATES STRUCTURE

A. Nominal Versus Inflation-Adjusted Brackets

The income tax is progressive; higher tax rates are imposed on higher¹ levels of an individual's income. To calculate taxable income, we identify an individual's adjusted gross income,² subtract the standard deduction (or itemized deductions, subject to certain limitations)³ and the personal exemption.⁴ We then segregate ordinary income from capital gains and apply different rates to each successive tranch of ordinary income.⁵ Capital gains are subject to a separate rate schedule under I.R.C. § 1(h).⁶ Historically, in enacting income tax legislation, Congress has denominated in fixed dollar amounts the income levels to which the different tax rates would apply. Figure 1 sets forth in nominal dollars the taxable income levels to which the successive rates would be applied for 1913, 1963, and 2013. In the 1960s the exemption amounts appear to be lower, the rates appear to be much higher, and there are more brackets (twenty-four different rates instead of seven) applied across the income spectrum.⁷

¹ In general, higher rates are applied to higher levels of income, but from 1988 to 1990 a lower rate (28%) was applied to the top income bracket, while the middle bracket was taxed at a higher rate (33%). *U.S. Federal Individual Income Tax Rates History, 1862–2013 (Nominal and Inflation-Adjusted Brackets)*, TAX FOUND., <http://taxfoundation.org/article/us-federal-individual-income-tax-rates-history-1913-2013-nominal-and-inflation-adjusted-brackets> (last updated Oct. 17, 2013).

² Adjusted gross income is reached by subtracting above-the-line deductions listed in § 62 (relating primarily to business expenses and other key investments made to generate income over time) from gross income, defined in § 61. I.R.C. §§ 61–62 (2012).

³ *Id.* § 63.

⁴ *Id.* § 151.

⁵ *Id.* § 1.

⁶ Space constraints limit the inclusion of a capital gains analysis. Most of the taxpayers that would be reporting capital gains are in the top quintile of income. See *The Distribution of Major Tax Expenditures in the Individual Income Tax System*, CONGRESSIONAL BUDGET OFFICE (May 29, 2013), <http://www.cbo.gov/publication/43768> (“[The] CBO estimates that more than 90 percent of the benefits of reduced tax rates on capital gains and dividends will accrue to households in the highest income quintile in 2013, with almost 70 percent going to households in the top percentile.”) See also Benjamin H. Harris, *Capital Income by Tax Treatment*, 127 TAX NOTES 573, 573 (2010) (based on a simulation model). For the other four quintiles, wages are the primary source of income (which are taxed at ordinary income rates), retirement assets are often held in tax-deferred vehicles such as IRAs and § 401(k) plans (which defer tax on income saved for retirement, but charge ordinary rates on that income as it is drawn down), and their main capital assets are primary residences, which on sale currently enjoy the exclusion of the first \$250,000 in capital gains for an individual and an exclusion of up to \$500,000 in capital gains for a married couple under I.R.C. § 121.

⁷ *Historical Individual Income Tax Parameters*, TAX POL'Y CENTER, URB. INST. & BROOKINGS INSTITUTION (Apr. 10, 2013), <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543>; *Historical Standard Deduction*, TAX POL'Y CENTER, URB. INST. & BROOKINGS INSTITUTION (Apr. 1, 2013), <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=171&Topic2id=30&Topic3id=39>; *U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

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FIGURE 1: NOMINAL BRACKETS
(PERSONAL EXEMPTION, STANDARD DEDUCTIONS,
AND RATES FOR BRACKETS IN NOMINAL DOLLARS)

Nominal Brackets	1913		1963		2013	
Personal Exemption	\$3000		\$600		\$3900	
Standard Deduction	N/A		\$60		\$6100	
Total PE + SD (0% Bracket on Gross Income)	\$3000		\$660		\$10,000	
Rates on Taxable Income	Rate	On Taxable Income of	Rate	On Taxable Income of	Rate	On Taxable Income of
1 st Bracket	1%	\$0–\$20,000	20%	\$0–\$2000	10%	\$0–\$8925
2 nd Bracket	2%	\$20,000–\$50,000	22%	\$2000–\$4000	15%	\$8925–\$36,250
3 rd Bracket	3%	\$50,000–\$75,000	26%	\$4000–\$6000	25%	\$36,2550–\$87,850
4 th Bracket	4%	\$75,000–\$100,000	30%	\$6000–\$8000	28%	\$87,850–\$183,2550
5 th Bracket	5%	\$100,000–\$250,000	34%	\$8000–\$10,000	33%	\$183,250–\$398,350
6 th Bracket	6%	\$250,000–\$500,000	38%	\$10,000–\$12,000	35%	\$398,350–\$400,000
7 th Bracket	7%	Over \$500,000	43%	\$12,000–\$14,000	39.6%	Over \$400,000
8 th Bracket	N/A	N/A	47%	\$14,000–\$16,000	N/A	N/A
24 th Bracket	N/A	N/A	91%	Over \$200,000	N/A	N/A

Nominal brackets mask some of the dramatic changes that have been made to the bracket structures, however, because they do not account for inflation. When the dollar amounts for the brackets,⁸ the standard deduction⁹ and the personal exemption¹⁰ are adjusted for inflation,¹¹ comparisons can be made between these parameters over the one-hundred-year period. The income tax has undergone a dramatic transformation over time.

⁸ Nominal brackets for the calendar years 1913 through 2013 were obtained from the Tax Foundation. See *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. The nominal brackets were then adjusted for inflation to reflect 2013 dollars based on the average Consumer Price Index for All Urban Consumers (CPI-U) published by the Department of Labor, Bureau of Labor Statistics for each year. The consumer price index represents changes in prices of all goods and services purchased for consumption by urban households. The CPI-U index value has been calculated every year since 1913. See generally BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, BLS HANDBOOK OF METHODS ch. 17 (2007), available at <http://www.bls.gov/opub/hom/pdf/homch17.pdf> (providing a detailed overview of the Consumer Price Index). An inflation calculator is available from the Bureau of Labor Statistics. See *CPI Inflation Calculator*, BUREAU LAB. STATS., U.S. DEP'T OF LAB., http://www.bls.gov/data/inflation_calculator.htm (last visited June 1, 2014). Since the initial research was performed, the Tax Foundation has posted its own set of inflation-adjusted brackets using other methodologies.

⁹ In 1944, when the standard deduction was introduced, it was set at 10% of adjusted gross income up to a maximum of \$1000. Individual Income Tax Act of 1944, Pub. L. No. 315, § 9, 58 Stat. 231, 236. In 1964, Congress introduced a minimum standard deduction of \$200 plus \$100 for each exemption, up to a maximum of \$1000. Revenue Act of 1964, Pub. L. No. 88-272, §141(a), (c), 78 Stat. 19, 23. The historical values for the standard deduction from 1970 through 2013 were obtained from the Tax Policy Center and adjusted for inflation throughout the Article to reflect 2013 dollars based on the average CPI-U published by the Department of Labor, Bureau of Labor Statistics for each year. *CPI Inflation Calculator*, *supra* note 8; *Historical Standard Deduction*, *supra* note 7.

¹⁰ The historical values for the personal exemption were obtained from the Tax Policy Center and adjusted for inflation throughout the Article to reflect 2013 dollars based on the average CPI-U for each year published by the Department of Labor, Bureau of Labor Statistics. *CPI Inflation Calculator*, *supra* note 8; *Historical Individual Income Tax Parameters*, *supra* note 7.

¹¹ Many methods may be used to adjust for inflation. See Jim Chen, *The Price of Macroeconomic Imprecision: How Should the Law Measure Inflation?*, 54 HASTINGS L.J. 1375, 1403–29 (2003) (describing the strengths, weaknesses, and differences between the Consumer Price Index published by the Department of Labor Bureau of Labor Statistics and the Implicit Price Deflator published by the Department of Commerce Bureau of Economic Analysis). However, Congress has, by statute, specifically authorized the Commissioner of Internal Revenue to use the CPI-U to index the income tax brackets for inflation. See I.R.C. § 1(f)(5). The Internal Revenue Code does authorize other indices for other inflation adjustments. See Chen, *supra*, at 1406–07. For example, the Internal Revenue Code authorizes the use of the Implicit Price Deflator for adjusting the phaseout of tax credits for production of electricity for renewable energy and production of alternative fuels. *Id.* at 1407; see also I.R.C. §§ 43(b)(3)(B), 45(e)(2)(B).

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FIGURE 2: PERSONAL EXEMPTION, STANDARD DEDUCTION, AND RATES FOR BRACKETS IN INFLATION-ADJUSTED DOLLARS

Inflation-Adjusted Brackets	1913		1963		2013	
Personal Exemption	\$70,593		\$457		\$3900	
Standard Deduction	N/A		\$4568		\$6100	
Total PE + SD (0% Bracket on Gross Income)	\$70,593		\$5025		\$10,000	
Rates on Taxable Income	Rate	On Taxable Income of	Rate	On Taxable Income of	Rate	On Taxable Income of
1 st Bracket	1%	\$0–\$470,620	20%	\$0–\$15,226	10%	\$0–\$8925
2 nd Bracket	2%	\$470,620–\$1,176,551	22%	\$15,226–\$30,452	15%	\$8925–\$36,250
3 rd Bracket	3%	\$1,176,551–\$1,764,826	26%	\$30,452–\$45,678	25%	\$36,2550–\$87,850
4 th Bracket	4%	\$1,764,826–\$2,353,101	30%	\$45,678–\$60,904	28%	\$87,850–\$183,2550
5 th Bracket	5%	\$2,353,101–\$5,882,753	34%	\$60,025–\$76,130	33%	\$183,250–\$398,350
6 th Bracket	6%	\$5,882,753–\$11,765,505	38%	\$76,130–\$91,356	35%	\$398,350–\$400,000
7 th Bracket	7%	Over \$11,765,505	43%	\$91,356–\$106,582	39.6%	Over \$400,000
8 th Bracket	N/A	N/A	47%	\$106,582–\$121,808	N/A	N/A
24 th Bracket	N/A	N/A	91%	Over \$1,522,595	N/A	N/A

Using the inflation-adjusted dollars set forth in Figure 2, it becomes apparent that the initial income tax¹² was low, relatively flat, and applied only to very-high-income taxpayers. The first \$3000 of gross income, approximately \$70,600 in 2013 dollars, were exempt. The legislation imposed a “normal” tax of 1% on taxable incomes of up to \$20,000 (or \$470,620 in 2013 dollars), and an additional “surtax” at graduated rates of 1% to 6% on higher levels of income.¹³ This seven-bracket progressive rate structure extended very far into the income spectrum, with the top rate of

¹² Act of Oct. 3, 1913, Pub. L. No. 63-16, § 2, 38 Stat. 114, 166–81.

¹³ JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 78 (1985).

7% applied to taxable income in excess of \$500,000 (or \$11,765,505 in 2013 dollars).

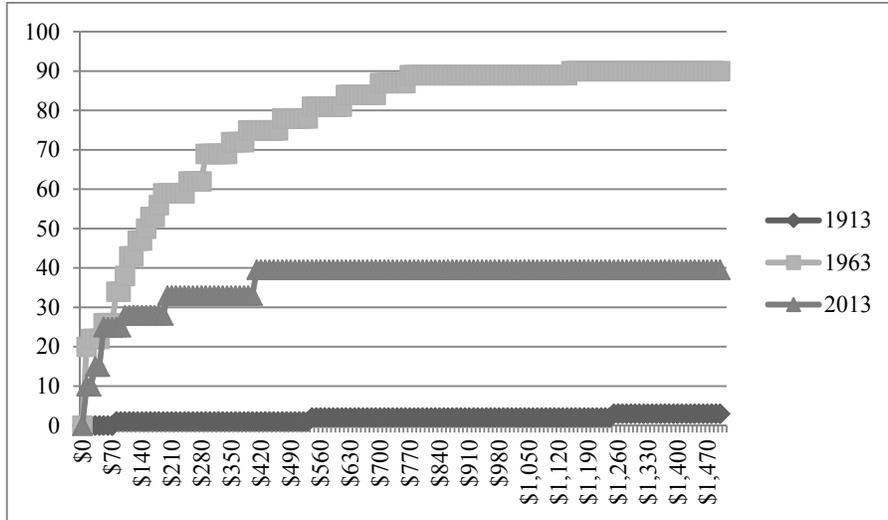
By 1963, the mid-century mark, however, the income tax had transformed from a “class tax” to a “mass tax” with a significantly broader base.¹⁴ The personal exemption, to which a standard deduction had been added, exempted the first \$660 in income from taxation, the equivalent of \$5025 in 2013 dollars. The rate structure had also become far more progressive, applying twenty-four different rates across the income strata, beginning with a steep bottom rate of 20% applied to taxable income up to \$2000 (\$15,226 in 2013 dollars). The top rate of 91% was applied to income above \$200,000 (\$1,522,595 in 2013 dollars).

In 2013, the standard deduction and the personal exemption excluded the first \$10,000 of gross income. Seven brackets, 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% were applied to successive tranches of income, with the 10% bottom rate applied to taxable incomes up to \$8925, and a top rate of 39.6% applied to taxable income above \$400,000 in 2013 dollars. The three different rate structures are depicted in Figure 3, to facilitate comparison.¹⁵

¹⁴ STEVEN A. BANK, KIRK J. STARK & JOSEPH J. THORNDIKE, *WAR AND TAXES*, at xiv, xix n.12 (2008) [hereinafter BANK ET AL.] (citing Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 *BUFF. L. REV.* 685, 686 (1989)).

¹⁵ There are a number of simplifying assumptions that have been applied throughout this Article to promote comparison, to ensure consistent treatment of the tax parameters over time, and to facilitate graphing the changes in the parameters. First, the Article focuses on taxpayers filing as unmarried individuals. Initially, each individual was liable for tax on his or her own income tax without respect to whether the person was single, married, or the head of a household. Today, the progressive rates are applied to different levels of income based on a taxpayer’s filing status as an unmarried individual, a married couple filing jointly, a married couple filing separately, or an unmarried individual acting as the head of a household. *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. Second, in depicting the bracket structures in Figure 3, the Article assumes that above-the-line deductions have already been taken into account to calculate adjusted gross income. Third, for Figure 3 and Figure 10, *infra*, the Article assumes that the standard deduction is taken, since less than 30% of taxpayers itemize. See Benjamin H. Harris & Daniel Baneman, *Who Itemizes Deductions?*, 130 *TAX NOTES* 345, 345 (2011). Finally, the phase-outs for the personal exemption under I.R.C. § 151 are ignored, the Alternative Minimum Tax under I.R.C. § 55 is not taken into account, and credits are not applied.

FIGURE 3: BRACKET STRUCTURES FROM 1913, 1963, AND 2013
 APPLIED TO ADJUSTED GROSS INCOME IN 2013 DOLLARS (THOUSANDS)



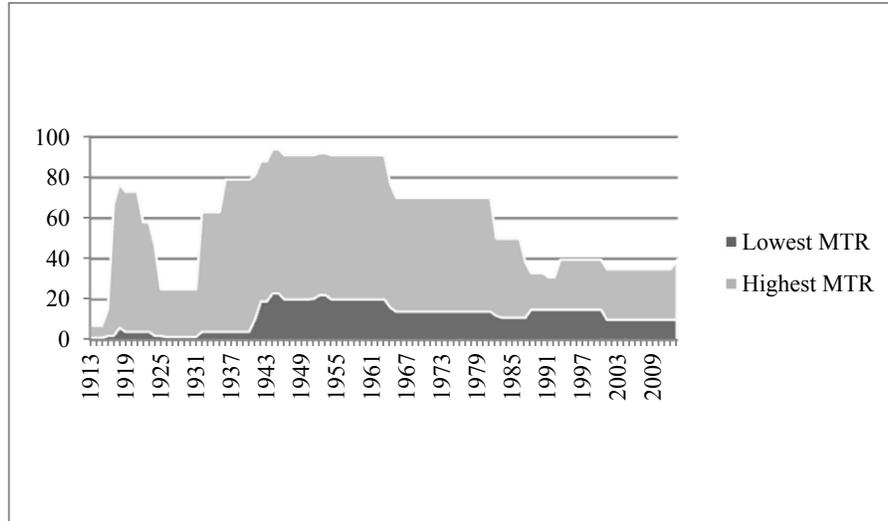
During the first half century, the income tax structure transformed from a relatively low and very modestly progressive tax levied only on the wealthiest classes to a broad-based tax that included virtually all wage earners and imposed highly progressive rates across the income spectrum. During the last half century, however, the rate progression has contracted significantly, with the income tax becoming more flat and the bracket structure becoming more compressed. The following sections clarify these trends by focusing on the following tax parameters: the changes in the top and bottom rates on ordinary income, the capital gains rate, the zero rate (the amount of income on which no income tax is paid due to the personal exemption and standard deduction), the number of brackets, and the income levels at which the top and bottom rates were applied. These sections also connect changes in the parameters to key events in the history of the United States over this period.

B. Changes in Rates on Ordinary Income and Capital Gains

The first parameter to examine is the rates themselves. Figure 4 depicts the top and bottom marginal rates for an unmarried individual over the 100-year period the income tax has been in force.¹⁶

¹⁶ U.S. Federal Individual Income Tax Rates History, supra note 1.

FIGURE 4: TOP AND BOTTOM MARGINAL TAX RATES 1913–2013



The top marginal tax rate provides some indication of the degree to which the income tax has varied over time. Initially the income tax was a “class tax”;¹⁷ the rates were very modest and applied only to households with the highest incomes, impacting only 2% of the population.¹⁸ As mentioned above, the first income tax statute provided for a seven-bracket structure of gradually increasing rates starting at 1% and extending to 7%, and was levied on only the highest income taxpayers.¹⁹ The days of low rates and high exemptions were short lived, however. The United States soon prepared to enter World War I and Congress raised income tax rates

¹⁷ BANK ET AL., *supra* note 14, at xiv.

¹⁸ *Id.* at 52; WITTE, *supra* note 13.

¹⁹ See *supra* notes 12–13 and accompanying text.

sharply to increase revenues for military mobilization.²⁰ By 1918, the top marginal rate was 77%.²¹

After World War I, when the postwar economic boom of the “Roaring Twenties” had yielded budget surpluses,²² Congress reduced rates,²³ with the top rate of 25% levied on taxable incomes of \$100,000 (approximately \$1.31 million in 2013 dollars) or more.²⁴ The 1929 stock market crash heralded the onset of the Great Depression; bank failures, price deflation, unemployment, foreclosures, and a 50% drop in industrial output²⁵ reduced

²⁰ Congress passed the Revenue Act of 1916 in preparation to enter the war. BANK ET AL., *supra* note 14, at 53–55. The Act cut the personal exemption by half, increased the number of brackets to fourteen, brought up the bottom rate to 2%, and doubled the top rate, imposing a tax of 15% on incomes over \$42,744,404 (in 2013 dollars). See Revenue Act of 1916, Pub. L. No. 64-271, § 1(a)–(b), 39 Stat. 756, 756–57; BANK ET AL., *supra* note 14, at 54; *Historical Individual Income Tax Parameters*, *supra* note 7; *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. When the U.S. actually entered World War I in 1917, Congress again raised income tax rates sharply, increasing the number of brackets from seven to fifty-six, with the top marginal rate set as high as 67%, and reducing the personal exemption from \$3000 (approximately \$64,117 in 2013 dollars) to \$1000 (approximately \$18,200 in 2013 dollars). See War Revenue Act, Pub. L. No. 65-50, § 3, 40 Stat. 300, 301 (1917); BANK ET AL., *supra* note 14, at 57–68. In 1918, finding that the revenues were short of the sums needed to fund the war, Congress again increased rates, bringing the top marginal rate to 77%, applied to incomes in excess of \$1 million (\$15,427,616 in 2013 dollars). See Revenue Act of 1918, Pub. L. No. 65-254, § 211(a), 40 Stat. 1057, 1064–65; BANK ET AL., *supra* note 14, at 69–79.

²¹ Revenue Act of 1918, Pub. L. No. 65-254, § 211(a), 40 Stat. 1057, 1064–65.

²² In 1921, President Warren Harding appointed Andrew Mellon, the Pittsburgh banker and industrial magnate, one of the wealthiest men in the country, as Secretary of the Treasury. JOSEPH J. THORNDIKE, *THEIR FAIR SHARE: TAXING THE RICH IN THE AGE OF FDR* 12 (2013); WITTE, *supra* note 13, at 88. Mellon reduced top rates from wartime highs, acting upon the view espoused in his book, *Taxation: The People's Business*, that high taxes led to tax evasion or avoidance and had a negative impact on labor supply by undermining incentives to work. WITTE, *supra* note 13, at 89; see also ANDREW W. MELLON, *TAXATION: THE PEOPLE'S BUSINESS* 12–13 (1924). Mellon was a fiscal conservative; he reduced taxes throughout the 1920s because the country had experienced actual budget surpluses after World War I. See BANK ET AL., *supra* note 14, at 81.

²³ WITTE, *supra* note 13 at 91–93; see The Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227. The Revenue Act of 1921 reduced the top marginal rate from 73% to 58%, charged on incomes of \$200,000 or more (approximately \$2.77 million in 2013 dollars). 42 Stat. at 233, 237; *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. The Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253, reduced both normal rates and surtaxes, bringing the number of brackets down to forty-three and reducing the highest marginal tax rate to 46%, which was charged on incomes of \$500,000 or more (approximately \$6.8 million in 2013 dollars). By 1925, the top rate, 25%, was levied on incomes in excess of \$100,000 (approximately \$1.3 million in 2013 dollars). The bottom rate was reduced to 2%, charged on incomes up to \$4000 (approximately \$53,250 in 2013 dollars). 43 Stat. at 264–67; *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. The exemption increased from \$1000 (approximately \$13,600 in 2013 dollars) in 1924 to \$1500 (approximately \$20,000 in 2013 dollars) in 1925. *Historical Individual Income Tax Parameters*, *supra* note 7; 43 Stat. at 272.

²⁴ The Revenue Act of 1926 lowered the bottom marginal rate to 1.5%, to be applied to incomes of \$4000 or less (approximately \$52,600 in 2013 dollars); the top marginal rate of 25% was applied to incomes as high as \$1.5 million or more. Revenue Act of 1926, Pub. L. No. 69-20, § 210(a), 44 Stat. 9, 21. This twenty-three-bracket rate structure was maintained through 1931. *U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

²⁵ HOWARD ZINN, *A PEOPLE'S HISTORY OF THE UNITED STATES* 386–93 (1999).

tax revenues significantly.²⁶ Within two years the earlier surpluses had turned into massive deficits.²⁷ Congress restored income tax rates to their immediate postwar levels,²⁸ setting the top marginal rate at 63%.²⁹ President Franklin Roosevelt was initially hesitant to raise rates further,³⁰ but by 1934 he argued that the revenue system had “done little to prevent an unjust concentration of wealth and economic power.”³¹ He pushed Congress to reverse that concentration with the Revenue Act of 1935,³² bringing the top rate to 79%. With the onset of World War II, Congress increased rates each year to support military mobilization, cover the costs of war, and suppress inflation.³³ The top marginal rate reached its apex at 94% in 1944.³⁴

In the first decade and a half following the war, Presidents Harry Truman and Dwight D. Eisenhower struggled with Congress to keep taxes high; their goals were to combat inflation, repay the war debt, balance the budget, and cover the costs of Cold War conflicts.³⁵ They opposed and periodically vetoed revenue acts that reduced rates significantly or benefited the wealthy preferentially.³⁶ To override Truman’s vetoes, Congress constructed the requisite majority by offering tax benefits to

²⁶ THORNDIKE, *supra* note 22, at 30.

²⁷ *Id.* at 33.

²⁸ When postwar budget surpluses turned into massive deficits with the deepening of the Great Depression, Secretary of the Treasury Andrew Mellon reversed course, overseeing sharp increases in marginal income tax rates, reversing the tax cuts he had spearheaded during the prior decade. WITTE, *supra* note 13, at 96.

²⁹ The Revenue Act of 1932 returned the income tax to the fifty-six-bracket structure, with the lowest marginal tax rate, 4%, charged on incomes up to \$4000 (approximately \$68,000 in 2013 dollars) and the highest marginal tax rate, 63%, charged on incomes in excess of \$1 million (approximately \$17 million in 2013 dollars). The earned income tax credit was eliminated. The Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169.

³⁰ WITTE, *supra* note 13, at 100.

³¹ *Id.*

³² *Id.* at 100–02. Called by detractors the “Wealth Tax of 1935” and the “Soak the Rich Tax,” the Act imposed a surtax on incomes of \$50,000 (approximately \$838,000 in 2013 dollars) or more. BANK ET AL., *supra* note 14, at 108; THORNDIKE, *supra* note 22, at 131; WITTE, *supra* note 13, at 100–01; *see* Revenue Act of 1935, Pub. L. No. 74-407, §101, 49 Stat. 1014, 1014–15; *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. The Revenue Act of 1935 created a structure with thirty-three brackets, adding a surtax to incomes of \$50,000 (approximately \$838,000 in 2013 dollars). The lowest marginal tax rate of 4% was charged on incomes of \$4000 (approximately \$67,000 in 2013 dollars) or less, and the highest marginal tax rate, 79%, was charged on incomes of \$5 million (approximately \$83.8 million in 2013 dollars) or more. *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. The personal exemption remained at \$1000 (approximately \$17,000 in 2013 dollars). 49 Stat. at 1014–15; *Historical Individual Income Tax Parameters*, *supra* note 7.

³³ BANK ET AL., *supra* note 14, at 95–107; WITTE, *supra* note 13, at 114–23. The income tax was used to reduce demand. By taxing wages and other income at high rates, consumers had less disposable income and consequently, fewer dollars were chasing limited goods. *See* WITTE, *supra* note 13, at 115.

³⁴ Individual Income Tax Act of 1944, Pub. L. No. 315, pt. I, sec. 3–4, § 11–12, 58 Stat. 231, 231–32.

³⁵ *See* WITTE, *supra* note 13, at 133, 137, 140, 151.

³⁶ *Id.* at 133–34.

special interest groups,³⁷ a process that was to be repeated regularly with future tax legislation, increasing the size and complexity of the income tax.³⁸ With the commitment of troops to the Korean Peninsula, Congress reversed their rate cuts and restored a top rate of 90%.³⁹ Following the Korean War, the Revenue Act of 1954⁴⁰ reduced rates to prewar levels and provided for all of the income tax statutes to be codified to manage the increasing complexity needed to track new forms of income, new tax units, income from foreign sources, and the proliferation of tax expenditures.⁴¹ Following codification, there were no new income tax statutes for eight years.⁴²

By the mid-century mark, tax policy had shifted away from concerns about equal sacrifice, ability to pay, the incidence of the government benefits and burdens, and the importance of reducing federal deficits and eliminating federal debt.⁴³ Instead, policymakers began to use the income tax as an economic tool to spur growth.⁴⁴ President John F. Kennedy

³⁷ See *id.* at 134 (noting that the proposed bill offered extra exemptions for the blind and the elderly).

³⁸ *Id.* at 142–43.

³⁹ See BANK ET AL., *supra* note 14, at 113–14.

⁴⁰ Pub. L. No. 83-591, 68A Stat. 3 (1954). The lowest marginal rate was 20%, charged initially on taxable incomes of up to \$2000 (approximately \$17,000 in 2013 dollars). The highest marginal rate was 91%, charged on incomes of \$200,000 or more (approximately \$1.7 million in 2013 dollars). 68A Stat. at 5. Because the nominal brackets were not indexed to inflation, however, the rate structure was subject to “bracket creep,” the imposition of higher rates on lower and lower levels of real income. By 1962 the bottom rate of 20% applied to incomes of \$15,000 or less in 2013 dollars, and the top rate applied to incomes of \$1.5 million or more in 2013 dollars.

⁴¹ WITTE, *supra* note 13, at 149. Social Security, unemployment insurance, and health insurance were all new forms of income that required additional rules to be developed for taxing them. New entities, such as holding companies, closely held corporations, partnerships and tax-exempt organizations, required new tax rules; corporations received income from abroad and new mechanisms for tracking that income and levying taxes were needed. *Id.*; see also Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson’s Quest*, in BUSINESS TAX STORIES 207, 208, 213 (Steven A. Bank & Kirk J. Stark eds., 2005) (describing the need for the development of a fully theorized partnership tax to manage the massive shift to the partnership form by businesses seeking to avoid the excess profits tax during World War II and to address the subsequent games that businesses had developed to shift income and loss between partners, to convert ordinary income to capital gains, and to convert capital losses to ordinary losses).

⁴² *Id.* at 150.

⁴³ While Kennedy had initially, like his predecessors, argued in favor of a balanced budget, he settled for avoiding deficit growth. David Greenberg, *Tax Cuts in Camelot?*, SLATE (Jan. 16, 2004, 11:00 AM), http://www.slate.com/articles/news_and_politics/history_lesson/2004/01/tax_cuts_in_camelot.html (“At first Kennedy balked at [Chief Economist Walter] Heller’s Keynesianism [and proposal of a tax cut to spur demand]. He even proposed a balanced budget in his first State of the Union address. But Heller and his team won over the president. By mid-1962 Kennedy had seen the Keynesian light, and in January 1963 he declared that ‘the enactment this year of tax reduction and tax reform overshadows all other domestic issues in this Congress.’”). Kennedy agreed to run budget deficits so long as they did not exceed those reached during the Eisenhower era. WITTE, *supra* note 13, at 159.

⁴⁴ WITTE, *supra* note 13, at 159.

proposed tax cuts to increase demand,⁴⁵ and President Johnson delivered them, in part to garner support for his Great Society programs.⁴⁶ The Revenue Act of 1964 reduced rates significantly, bringing the top rate down from 90% to 70%.⁴⁷ The next decade and a half, there were few significant modifications to the income tax rate structures.⁴⁸

In 1981, under the Reagan Administration, income tax rates were reduced dramatically again, with the top rate dropped from 70% to 50% under the Economic Recovery Tax Act of 1981 (ERTA).⁴⁹ ERTA also authorized Treasury to index the brackets for inflation.⁵⁰ The Tax Reform Act of 1986 then, over the course of five years, brought top marginal rates down further, taxing income between approximately \$35,000 and \$86,000 and incomes over \$176,000 (all in 2013 dollars) at a marginal rate of 28%.⁵¹ The reduction in rates during the Reagan Administration sharply

⁴⁵ Greenberg, *supra* note 43 (“After his election, his advisors, led by chief economist Walter Heller, urged a classically Keynesian solution: running a deficit to stimulate growth. . . . In Keynesian theory, a tax cut aimed at consumers would have a ‘multiplier’ effect, since each dollar that a taxpayer spent would go to another taxpayer, who would in effect spend it again—meaning the deficit would be short-lived.”).

⁴⁶ BANK ET AL., *supra* note 14, at 128. Even as U.S. military involvement escalated in Vietnam, Johnson resisted requesting tax increases to cover the additional costs of the Vietnam War, because he felt that this might undermine his “Great Society” programs, requiring the public to choose between “guns” and “butter.” Johnson was correct; when he ultimately did make the necessary request, the tax increase is thought to have compromised both the war effort and his social programs. *Id.* at 126, 136.

⁴⁷ Revenue Act of 1964, Pub. L. No. 88-272, § 111(a), 78 Stat. 19, 21. Initially, the twenty-five-bracket structure had a bottom rate of 16% charged on incomes of \$3700 or less (in 2013 dollars) and a top rate of 77% charged on incomes of \$1.48 million or more. In 1965, the bottom rate changed to 14%, levied on incomes of \$3600 or less (in 2013 dollars), and the top rate—set at 70%—was levied on incomes initially of \$728,000. By 1972, the 14% rate was charged on incomes of \$2700 or less and the highest rate, 70%, was levied on incomes of \$549,000 or more. *U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

⁴⁸ See *U.S. Federal Individual Income Tax Rates History*, *supra* note 1 (noting that the brackets and rate structures remain the same during this period). During this period Congress most frequently used tax expenditures to reduce the impact of inflation and the high marginal rates, such as with the Tax Reform Act of 1969, or to stimulate the economy, as with the Tax Reduction Act of 1971. See WITTE, *supra* note 13, at 165–220. The impacts of inflation during this period and the changes that resulted from indexing the brackets to inflation in 1981 are discussed in detail *infra* at Part II.D.

⁴⁹ Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 101, 95 Stat. 172, 179.

⁵⁰ ERTA, § 104, 95 Stat. at 188–90; see also W. ELLIOTT BROWNLEE, *FEDERAL TAXATION IN AMERICA: A SHORT HISTORY* 150 (2d ed. 2004) (noting that although ERTA was passed in 1981, indexing was not utilized until 1985).

⁵¹ Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096; *U.S. Federal Individual Income Tax Rates History*, *supra* note 1. By 1988, when the Act had been fully phased in, there were three rates in place. The bottom marginal tax rate was increased to 15% and applied to incomes up to \$17,850 (\$35,150 in 2013 dollars), the middle marginal rate of 28% was applied to taxable incomes between \$17,850 and \$43,150 (\$35,150 and approximately \$85,000 in 2013 dollars). The structure next imposed a “bubble tax rate” of 33%, applied to income between \$43,150 and \$89,560 (approximately \$85,000 and \$176,400 in 2013 dollars). All income exceeding \$176,400 (in 2013 dollars) was subject to a reduced rate of 28% again. *U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

increased budget deficits and contributed to the federal debt.⁵² During the Clinton administration Congress raised rates and expanded the bracket structures to reverse the growing deficits, setting the top rate at 39.6%.⁵³ This, combined with PAYGO,⁵⁴ a budgetary process that required that all new budget proposals be revenue neutral, yielded budget surpluses.⁵⁵

In general, the highest marginal rates have corresponded with periods in which the U.S. has been at war or facing sharp revenue losses from economic recession.⁵⁶ Congress diverged from this pattern⁵⁷ in 2001.⁵⁸ Despite U.S. military engagement on two fronts, Afghanistan and Iraq, Congress reduced rates in 2001⁵⁹ and 2003,⁶⁰ setting the top rate at 35%,

⁵² BROWNLEE, *supra* note 50, at 150–51. From 1981 to 1988 the federal debt increased from approximately \$1 trillion to \$2.6 trillion (approximately \$2.557 trillion to \$5.125 trillion in 2013 dollars). *Historical Debt Outstanding—Annual 1950–1999*, TREASURYDIRECT, http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo4.htm (last updated May 5, 2013).

⁵³ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,202(a)(2), 107 Stat. 312, 461.

⁵⁴ Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, 1388-581 to -582 (1990). Under PAYGO, to the extent that a new spending or tax program would decrease government revenues, Congress was required to cut another spending program, or to raise taxes. *The Budget Process: What Is PAYGO?*, TAX POL'Y CENTER, URB. INST. & BROOKINGS INSTITUTION, <http://www.taxpolicycenter.org/briefing-book/background/budget-process/paygo.cfm> (last updated July 12, 2007).

⁵⁵ BROWNLEE, *supra* note 50, at 191.

⁵⁶ See BROWNLEE, *supra* note 50, at 3–5. The top marginal tax rates were as high as 77% in the last year of World War I (1914–1918), 79% during the Great Depression, 94% during the last two years of World War II (1939–1945), 92% during the last two years of the Korean War (1950–1953), and 91% during the Cold War and in the early years of the Vietnam War (1950–1973). *U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

⁵⁷ BANK ET AL., *supra* note 14, at xvi (“Unwilling to risk domestic achievements, or fearful of eroding support for an unpopular war, [U.S. Presidents] have shrunk from the tough decisions that wars invariably demand. Eventually, however, they all accepted the hard realities. Whether ardent tribunes of fiscal sacrifice (like Franklin Roosevelt) or reluctant champions of fiscal responsibility (like Lyndon Johnson), they all accepted the need for some sort of homefront sacrifice, as both an economic and moral necessity.”).

⁵⁸ *Id.* at 168. Bank, Stark, and Thorndike suggest that the traditional pay-as-you-go war financing was swept aside for three reasons. First, the shift to an all-volunteer armed services force has made war less visible to the public and consequently resulted in fewer calls for shared sacrifice than have been made in the past. Second, during the early part of the Bush era, Congress pushed to lower top rates as a Pigouvian mechanism to encourage economic growth. Bank, Stark, and Thorndike argue that the Republican deficit hawks, who would otherwise be concerned about rising deficits, lost political ground to the “growth hawks,” Congress members who believed that tax cuts that spurred economic growth would ultimately yield higher tax revenues. Third, because the Federal Reserve has used monetary policy to keep inflation low, economists have eschewed the use of the income tax to reduce inflation’s caustic effects. *Id.*

⁵⁹ The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38, reduced taxes significantly, particularly for higher income households. See 115 Stat. at 41–44. Approximately three months after EGTRRA was signed into law, terrorists attacked the World Trade Center and Operation Enduring Freedom was initiated in Afghanistan within a few months afterward. BANKS ET AL., *supra* note 14, at 150–52. While Congress debated suspending or moderating the rate reductions under EGTRRA, the tax cuts were implemented without modification. See *id.* at 153.

and it maintained those low rates during the Great Recession.⁶¹ Congress reversed this course in 2012, restoring the top rate previously in effect under the Clinton Administration, 39.6%.⁶²

An examination of top rates across the 100-year history reveals that the rate schedule has flattened over the last thirty years. Currently, top rates are significantly lower than both the mean, 59%, and the median, 67% for the period.⁶³ At the same time the bottom rates, applied to the first dollars of income, have risen and then declined. The bottom tax rates applied to the first dollars of taxable income have ranged from a low of 1% in 1913 to a high of 23% during World War II. The mean for the initial rate over the 100-year period is approximately 11.8% and the median is 14%. In 2013, the bottom rate on taxable income was 10%.⁶⁴

C. Changes in the Zero Bracket (the Personal Exemption Plus the Standard Deduction)

To get a full picture of the rate structures, however, the impact of the personal exemption and the standard deduction must be taken into account.⁶⁵ The personal exemption and standard deduction effectively impose a zero percentage tax rate on the first dollars of gross income, creating a “zero bracket.”⁶⁶ Figure 5 depicts inflation-adjusted levels for the personal exemption and standard deduction for an unmarried individual.

⁶⁰ In 2003, the U.S. began war on a second front with Operation Iraqi Freedom and within three months of the beginning of that war, a second set of tax cuts under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) were signed into law. BANK ET AL., *supra* note 14, at 153–57. JGTRRA authorized rate reductions for each bracket, added a 10% bracket for the first dollars of income, and taxed certain dividends at capital gains rates. JGTRRA, Pub. L. No. 108-27, §§ 104–105, 302(a), 117 Stat. 752, 754–55, 760–64.

⁶¹ *U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

⁶² American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(b), 126 Stat. 2313, 2316 (2013).

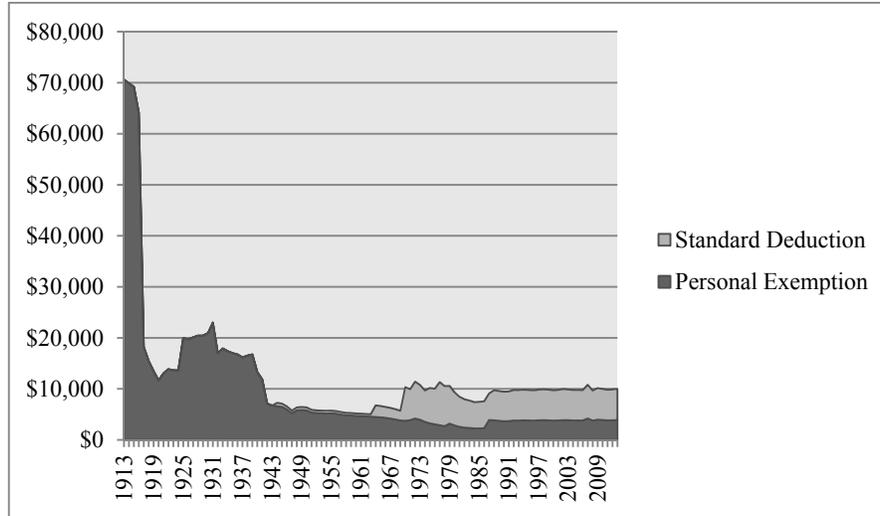
⁶³ *See U.S. Federal Individual Income Tax Rates History*, *supra* note 1.

⁶⁴ *Id.*

⁶⁵ Because approximately 70% of taxpayers do not itemize, the diverse impacts associated with claiming itemized deductions and estimating the impacts of § 67 and § 68 on those deductions have not been explored. *See Harris & Baneman*, *supra* note 15.

⁶⁶ Nominal and inflation-adjusted numbers for the personal exemption and standard deduction were obtained from the Tax Policy Center. *See Historical Individual Income Tax Parameters*, *supra* note 7; *Historical Standard Deduction*, *supra* note 7.

FIGURE 5: INDIVIDUAL PERSONAL EXEMPTION AND STANDARD DEDUCTION (IN 2013 DOLLARS)



Initially, at the inception of the income tax in 1913, the personal exemption was very large, equal to approximately \$70,600 in 2013 dollars. A comparison of the exemption to the average and median incomes for that period provides additional perspective on the expansiveness of the initial exemption. From 1913 through World War II, average incomes in the United States ranged between \$11,000 and \$25,000.⁶⁷ Average income did not reach levels approximating the current level of approximately \$50,000 until the mid-1980s.⁶⁸ Congress lowered the personal exemption significantly at the beginning of World War I from \$3000 in 1916 (approximately \$64,100 in 2013 dollars), to \$1000 in 1917 (approximately \$18,200 in 2013 dollars).⁶⁹ While the personal exemption lost nearly half of its value from inflation by 1920, Congress raised the exemption to \$1500 (nearly \$20,000 in 2013 dollars) in 1925.⁷⁰

⁶⁷ Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913–1998*, 118 Q. J. ECON. 1, 8–9 (2003) (data updated to 2012 dollars may be found at *Tables and Figures Updated to 2012 in Excel Format, September 2013*, Table A0, available at <http://elsa.berkeley.edu/~saez/TabFig2012prel.xls> (last visited June 1, 2014)).

⁶⁸ *Id.* at 10. Cf. U.S. Census Bureau, Table H-5, Race and Hispanic Origin of Householder—Households by Median and Mean Income: 1967 to 2012 (2012), available at <http://www.census.gov/hhes/www/income/data/historical/household/> (identifying the *mean household* income as \$71,274 and the *median household* income in the U.S. as \$51,017 for 2012). *But see Country Profile, United States*, UNDATA, <http://data.un.org/CountryProfile.aspx?crName=United%20States%20of%20America> (identifying average income in the United States for 2011 as \$47,882, the Gross Domestic Product per capita).

⁶⁹ *Historical Individual Income Tax Parameters*, *supra* note 7.

⁷⁰ *Id.*

Throughout the Great Depression, Congress maintained the personal exemption at a level roughly between \$15,000 and \$23,000 in 2013 dollars, reducing it significantly only to broaden the tax base during World War II.⁷¹ Throughout the war, Congress lowered personal exemptions, increased rates,⁷² and imposed a 5% Victory Tax on the first dollars of gross income.⁷³ As a greater segment of the population entered the workforce during World War II, Congress layered the personal exemption with the standard deduction to expand the zero percent rate for the first dollars of gross income.⁷⁴

The income tax was further transformed from a class tax to a mass tax with the mandate for employers to withhold taxes on wages.⁷⁵ Prior to that time, the lack of a broad enforcement mechanism rendered the payment of income tax largely voluntary.⁷⁶ By withholding tax at the income source, Treasury could more effectively collect tax from a tax base that had expanded significantly during the war.⁷⁷ This mechanism also increased the value of collections; delayed receipts meant reduced receipts because high inflation eroded the value of the tax liabilities⁷⁸ between the time the income was earned and the time the tax was collected.⁷⁹

⁷¹ BANK ET AL., *supra* note 14, at 95.

⁷² The United States Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, reduced the personal exemptions, increased individual income tax rates, and imposed a 5% Victory Tax with a 1.25% rebate following the war. 56 Stat. at 802–03, 827–28, 884, 886–87. Roosevelt argued that at a time of national crisis, shared sacrifice was needed. *See* WITTE, *supra* note 13, at 116. The expansion of the tax base was justified by an increase in progressivity. Roosevelt suggested that anyone earning over \$25,000 (approximately \$357,300 in 2013 dollars) in income would use that income to purchase unnecessary luxury goods. *See id.* at 116–17. Roosevelt also proposed the enactment of an excess profits tax to prevent war profiteering, stating, “not a single war millionaire would be permitted as a result of the war disaster.” *Id.* at 111.

⁷³ The Revenue Act of 1942 had increased the tax base from 13 million to 28 million taxpayers and the Victory Tax broadened the tax base by another 22 million, shifting the tax burden to the lower and middle income classes. *See* WITTE, *supra* note 13, at 117.

⁷⁴ The Individual Income Tax Act of 1944 provided for a percentage standard deduction equal to 10% of an individual taxpayer’s adjusted gross income, up to a maximum of \$500. Individual Income Tax Act of 1944, Pub. L. No. 315, § 9, 58 Stat. 231, 236.

⁷⁵ Current Tax Payment Act of 1943, Pub. L. No. 78-68, § 1622(a), 57 Stat. 126, 128–37; *see* BANK ET AL., *supra* note 14, at 103. Withholding mechanisms had been developed to collect Social Security and had proven successful. BANK ET AL., *supra* note 14, at 100. Congress fought against Roosevelt’s proposal to grant the government the power to direct employers to withhold taxes at the source, however. *Id.* at 100–03. Ultimately Congress traded authorization to employ withholding (a change that would impact lower income wage earners for the indefinite future) for forgiveness of much of the tax liability of 1942 (which had been borne primarily by the wealthier classes). *Id.*

⁷⁶ The author owes this insight to Professor Bill Quirk. *See* BANK ET AL., *supra* note 14, at 98–99.

⁷⁷ *Id.* at 100.

⁷⁸ Between 1941 and 1943, inflation rose by 25%. WITTE, *supra* note 13, at 120. Shifts to military production had reduced the availability of consumer goods and scarcity drove prices upward. *Id.* at 114. Expansion of the military and war production workforce increased income and demand for goods, fueling inflation. *Id.* Congress looked to the income tax as a means to cool demand and slow inflation by reducing the amount of cash available for consumption. *Id.* at 115. By collecting taxes on a broad tax

Following World War II through the late 1960s, inflation further reduced the aggregate value of the personal exemption and standard deduction, which reached an all-time low of approximately \$5000 (in 2013 dollars) in 1963. In 1969, however, Congress gave the standard deduction a boost and when combined with the personal exemption, the zero bracket was extended to the first \$1625 (approximately \$10,360 in 2013 dollars) of income for an unmarried individual.⁸⁰ Congress periodically updated the standard deduction and personal exemption to maintain this zero bracket over the next decade.⁸¹ Ironically, while ERTA indexed the brackets for inflation in 1981, it did not index the standard deduction and personal exemption; these two parameters were finally indexed to inflation with the Tax Reform Act of 1986.⁸² From 1982 to 1986 inflation eroded the value of the standard deduction and personal exemption to approximately \$7500 (in 2013 dollars).⁸³ Finally, the Tax Reform Act of 1986 set the standard deduction at \$2540 and personal exemption at \$1900 yielding a zero bracket on the first \$4440 (or approximately \$9100 in 2013 dollars) and provided for both parameters to be indexed for inflation.⁸⁴ From 1986 forward the standard deduction and personal exemption have together maintained a zero bracket set at between \$9000 and \$11,000 (in 2013 dollars).⁸⁵ The mean value for the personal exemption plus the standard deduction during the 100-year period is \$12,738, and the median is \$9804 (both in 2013 dollars).⁸⁶

D. Number of Brackets

In comparison to prior years, the current income tax system has a paucity of brackets. During the first thirty years, the federal income tax contained as many as fifty-six brackets, yielding both a greater degree of progressivity and more gradual rate increases. The number of brackets has ranged as high as fifty-six during the two world wars and as low as three in

base at the time the income was earned, the government reduced consumer purchasing power and dampened consumer demand. BANK ET AL., *supra* note 14, at 99.

⁷⁹ BANK ET AL., *supra* note 14, at 99.

⁸⁰ Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 801–802, 83 Stat. 487, 675–76.

⁸¹ See *Historical Individual Income Tax Parameters*, *supra* note 7; *Historical Standard Deduction*, *supra* note 7.

⁸² The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, provided for the personal exemption and standard deduction to be adjusted for inflation annually. 100 Stat. at 2100–03.

⁸³ See BROWNLEE, *supra* note 50, at 133.

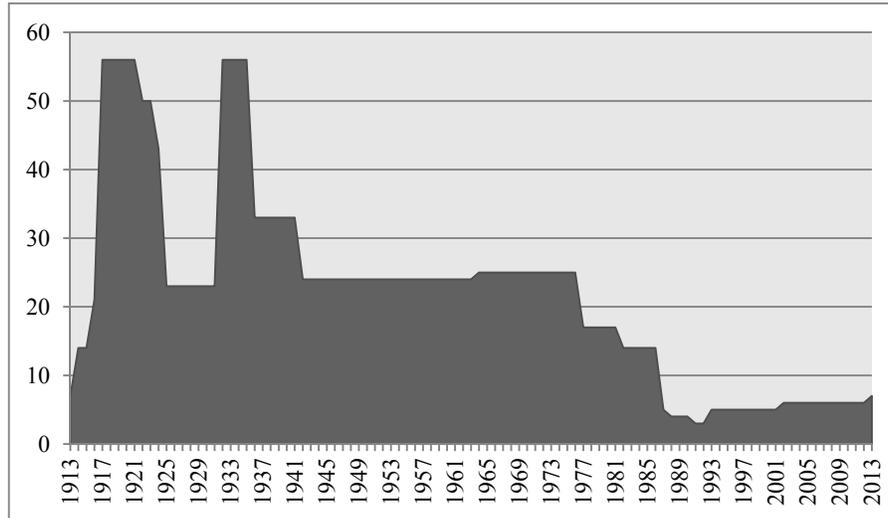
⁸⁴ The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, provided for the personal exemption and standard deduction to be adjusted for inflation annually. 100 Stat. at 2100–03.

⁸⁵ See *Historical Individual Income Tax Parameters*, *supra* note 7; *Historical Standard Deduction*, *supra* note 7.

⁸⁶ See *Historical Individual Income Tax Parameters*, *supra* note 7; *Historical Standard Deduction*, *supra* note 7.

1991 and 1992. Figure 6 tracks the number of brackets that have been in effect over the full period the income tax has been in place.⁸⁷

FIGURE 6: TOTAL NUMBER OF TAX BRACKETS 1913–2013



Prior to World War II, the initial rates levied on taxable income were modest. The bottom rates started at 1% to 4%, the rate increases between brackets were small (no greater than 4%), and the brackets themselves (the tranches of income subject to each rate) were broad. During World War II, Congress reduced the number of rates and increased the step up in rates between brackets. After the initial rate, set at 23% on the first dollars of taxable income, the rate schedule progressed in increments of 1% to 5% to the top rate of 94%.⁸⁸

In contrast, the Tax Reform Act of 1986 dramatically reduced the number of brackets to four, applying only three different rates. The first three rates were set at 15%, 28%, and 33%. These rates were applied to progressively higher tranches of income up to \$176,000 (in 2013 dollars). A lower rate of 28% was applied to taxable income in excess of \$176,000.⁸⁹ The rate structure progressed steeply against middle class taxable income and was flat at higher levels.

In 1992, under President Clinton, Congress expanded the rate structure to increase progressivity, setting a top marginal rate at 39.6%.⁹⁰ In 2001, under President George W. Bush, Congress reduced the rates set under

⁸⁷ See *U.S. Federal Income Tax Rates History*, *supra* note 1.

⁸⁸ *Id.* (years 1944 and 1945).

⁸⁹ Tax Reform Act of 1986 (TRA 1986), Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096–98.

⁹⁰ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,202, 107 Stat. 312, 461.

President Clinton, bringing the top rate down to 35%, and creating an additional 10% bracket for the first dollars of taxable income.⁹¹ This rate structure has remained in place, with the restoration of a top rate of 39.6% in December of 2012.⁹²

E. Bracket Penetration

The penetration of the bracket structure into the income stream has varied wildly. For the first fifty years of the income tax, the bracket structure extended much more deeply into the income strata. During the Great Depression and just prior to entry into World War II, the U.S. established top rates of 79% and 81% for incomes in excess of \$5 million (approximately \$78–\$82 million in 2013 dollars).⁹³ In contrast, in 2013, the top marginal rate of 39.6% was applied to taxable income in excess of \$400,000.⁹⁴ Figure 7 depicts the income levels at which the top marginal rates were applied over the 100-year period.⁹⁵

⁹¹ See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 104–105, 117 Stat. 752, 754–55; Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41–42.

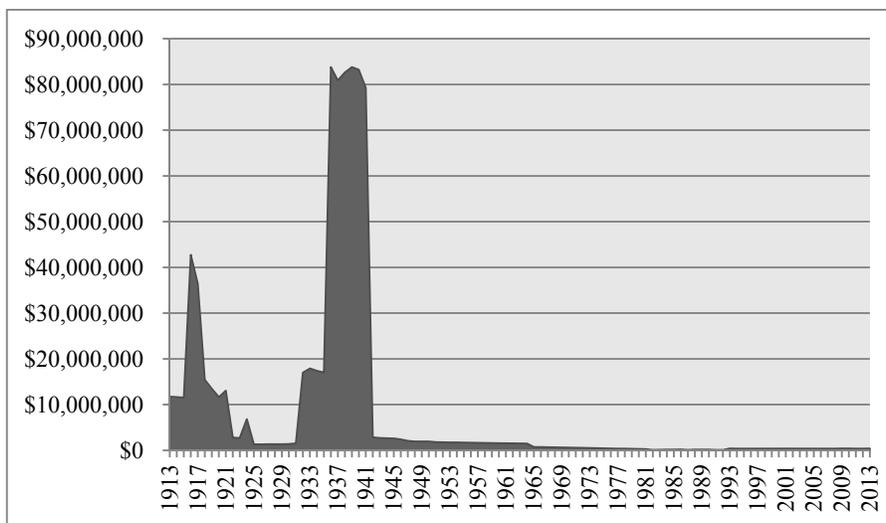
⁹² American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(b), 126 Stat. 2313, 2316 (2013). The Act applies a 10% rate on the first \$8925 of taxable income, a 15% rate on the next \$27,325, a 25% rate on the next \$51,600, a 28% rate on the next \$94,400, a 33% rate on the next \$215,100, a 35% rate on the next \$1650, and 39.6% on taxable income in excess of \$400,000. See *U.S. Federal Income Tax Rates History*, *supra* note 1.

⁹³ See *U.S. Federal Income Tax Rates History*, *supra* note 1 (years 1940 and 1941).

⁹⁴ *Id.*

⁹⁵ See *U.S. Federal Income Tax Rates History*, *supra* note 1.

FIGURE 7: TOP MARGINAL TAX RATES AND LEVEL OF INCOME AT WHICH TOP MARGINAL TAX RATES APPLIED 1913–2013



Congress made dramatic adjustments to the brackets in 1942, applying a top rate of 88% to \$200,000 of taxable income (approximately \$2.86 million in 2013 dollars).⁹⁶ While these progressive rate structures remained in place for three decades after the end of World War II, inflation compressed the rate structures.

From 1913 to 1981, Congress denominated the brackets, the income levels to which different marginal tax rates would apply, in dollar amounts. Because Congress did not provide for those sums to be adjusted annually for inflation, higher rates were forced onto taxpayers at lower and lower levels of income, a phenomenon known as “bracket creep.”⁹⁷ For example, from 1946 through 1963 the rate structure was not altered significantly. In 1946 the top tax rate, 91%, was levied on taxable income of \$200,000 (approximately \$2.39 million in 2013 dollars).⁹⁸ By 1963 the 91% top rate still applied to incomes of \$200,000, but those dollars were worth only about \$1.52 million (in 2013 dollars) because of inflation.⁹⁹ Similarly, between 1964 and 1981 Congress did not amend the rate schedule significantly, but inflation continued to take its toll. In 1965, the top marginal rate was 70%, applying to incomes of \$100,000 (approximately \$740,000 in 2013 dollars) and higher.¹⁰⁰ By 1981, the top bracket was

⁹⁶ *See id.*

⁹⁷ BROWNLEE, *supra* note 50, at 126–27.

⁹⁸ *U.S. Federal Income Tax Rates History*, *supra* note 1.

⁹⁹ *Id.*

¹⁰⁰ Revenue Act of 1964, Pub. L. No. 88-272, § 111(a), 78 Stat. 19, 21; *U.S. Federal Income Tax Rates History*, *supra* note 1.

largely unchanged, but the 70% rate applied to taxable incomes of approximately \$278,000 in 2013 dollars.¹⁰¹ This inflationary shift of top rates onto lower levels of income was paralleled in every bracket and impacted every taxpayer.¹⁰² Each year higher rates were imposed on taxpayers at lower levels of income.

Bracket creep also provided Congress with “easy” money.¹⁰³ By failing to index the brackets to inflation, Congress effectuated an increase in rates without having to pass a new tax statute.¹⁰⁴ Bracket creep and the erosion of earning power also appears to have driven significant demand for tax expenditures, preferences in the form of exclusions, exemptions, deductions, credits, deferral provisions, and special rates.¹⁰⁵ Tax expenditures, in turn, gave Congress the means to move their social policy goals forward and to provide favorable tax treatment to special interest groups without having to go through the budgetary process.¹⁰⁶ In 1967, Assistant Secretary of the Treasury Stanley Surrey began to assemble a tax expenditure budget to identify these forms of “spending” occurring through the tax code and to express his concerns about their inefficiency, unfairness, growing magnitude, and distortionary impact.¹⁰⁷ Under President Nixon, Congress introduced the Alternative Minimum Tax to attempt to restore vertical equity.¹⁰⁸ President Jimmy Carter sought to attack the source of the problem, spearheading broad-based tax reform to roll back tax preferences for the wealthy, but these efforts failed.¹⁰⁹ Between

¹⁰¹ The 70% marginal rate applied to incomes of \$108,200 in 1965. *U.S. Federal Income Tax Rates History*, *supra* note 1.

¹⁰² BROWNLEE, *supra* note 50, at 133.

¹⁰³ *See id.* at 126–28. Brownlee dubs this period the “era of easy finance.” *Id.* at 107.

¹⁰⁴ *Id.* at 133.

¹⁰⁵ *Id.* at 129–30. Today, the largest tax expenditures for individuals include exclusion of employers’ contributions for employee’s health insurance and medical care, the net exclusion of contributions to employer-provided and individual pension plans and the deferral of gains under these plans, the deductibility of mortgage interest on owner-occupied homes, the exclusion of up to \$250,000 of capital gains on a primary residence (up to \$500,000 for a married couple), the deduction of state and local property tax for owner-occupied homes, the partially refundable child credit of \$1000 per child, the deduction for charitable contributions, the reduced tax rate on long-term capital gains, and the step-up in basis for capital gains at death. For businesses, the largest tax expenditures include the provision that allows for accelerated depreciation of certain types of machinery and equipment, and the deferral of income from controlled foreign corporations. *See Tax Expenditures: What Are the Largest Tax Expenditures?*, TAX POL’Y CENTER, URB. INST. & BROOKINGS INSTITUTION, <http://www.taxpolicycenter.org/briefing-book/background/expenditures/largest.cfm> (last visited June 1, 2014).

¹⁰⁶ BROWNLEE, *supra* note 50, at 129–30.

¹⁰⁷ *Id.* at 131–32.

¹⁰⁸ *See* WITTE, *supra* note 13, at 167.

¹⁰⁹ BROWNLEE, *supra* note 50, at 147.

1967 and 1984 the tax expenditure budget expanded from \$37 billion (\$258 billion in 2013 dollars) to \$327 billion (\$733 billion in 2013 dollars).¹¹⁰

The Economic Recovery Tax Act of 1981 (ERTA) brought bracket creep to a halt by requiring the tax tables to be adjusted annually for inflation based on the Consumer Price Index.¹¹¹ The progressivity maintained during and after World War II was never restored, however. For example, in 1981, before ERTA went into effect, the 49% rate was applied to incomes between approximately \$87,000 and \$106,000 in 2013 dollars, with higher rates of up to 70% imposed on higher levels of income.¹¹² In 1982 when ERTA went into effect, the top rate, 50%, was applied to incomes of \$100,000 (in 2013 dollars) and above.¹¹³ In other words, those with incomes below \$100,000 did not receive a significant reduction in rates that year.¹¹⁴ Taxpayers with incomes above \$100,000, however, received rate reductions of between 5% and 20%.¹¹⁵

Congress continued to compress the rate structures with the Tax Reform Act of 1986; after its initial three-year phase-in period, the rate schedule had little progression at all. By 1988, the rate on the highest level of income was 28%; it was applied to incomes between \$17,850 and

¹¹⁰ *Id.* at 132. The sums were adjusted for inflation to reflect 2013 dollars based on the average CPI-U published by the Department of Labor, Bureau of Labor Statistics for each year. *See CPI Inflation Calculator*, *supra* note 8.

¹¹¹ Pub. L. No. 97-34, § 104(a), 95 Stat. 172, 188–89. The provisions for inflation adjustments under ERTA and TRA 1986 contained one important exception, the Alternative Minimum Tax (AMT). The AMT was developed during the Nixon Administration to ensure that high-income taxpayers were not able to avoid paying income tax altogether through the extensive use of exemptions, deductions, and credits. WITTE, *supra* note 13, at 167; *see also* Tax Reform Act of 1969, sec. 301, §§ 56–58, Pub. L. No. 91-172, 83 Stat. 487, 580–86; STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 105 (Comm. Print 1970). The AMT applies a flat rate to a more comprehensive tax base for high-income taxpayers. *See* 83 Stat. at 580–86. While initially the tax was calculated separately and added to the tax calculated using the tax tables on ordinary income, the AMT was transformed into a separate, parallel system under the Revenue Act of 1978. *See* Revenue Act of 1978, Pub. L. No. 95-600, sec. 131, § 457, 92 Stat. 2763, 2781–82; *Historical AMT Legislation*, TAX POL'Y CENTER, URB. INST. & BROOKINGS INSTITUTION (Jan. 6, 2014), <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=195>. Consequently, a taxpayer earning income in excess of the threshold would have to calculate their income tax both under the normal system and under the AMT. *See* I.R.C. § 55 (2006); I.R.C. § 55 (1988). The failure to index the AMT for inflation meant that each year more middle class households were subject to the AMT, paid a flat rate between 21% and 28% on their incomes, and spent significantly more time calculating their total tax burden. In December of 2012, after spending years periodically “patching” the AMT to provide relief to middle income households, Congress finally modified the AMT to index the thresholds for inflation. *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §§ 101(a)–(b), 104, 126 Stat. 2313, 2316–17, 2320 (2013) (codified at I.R.C. § 55(c)(4)).

¹¹² *U.S. Federal Income Tax Rates History*, *supra* note 1.

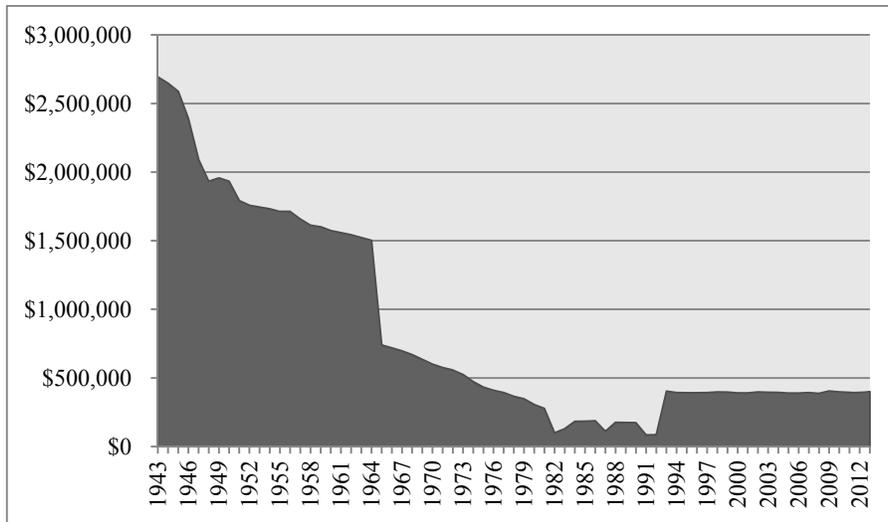
¹¹³ *Id.*

¹¹⁴ At that time, taxes were actually increased for taxpayers earning incomes of less than \$99,000 because the standard deduction and the personal exemption were not indexed for inflation and declined in value from 1981 through 1986.

¹¹⁵ *See U.S. Federal Income Tax Rates History*, *supra* note 1.

\$43,150 (between approximately \$35,150 and \$85,000 in 2013 dollars) and to incomes above \$89,560 (approximately \$176,000 in 2013 dollars).¹¹⁶ A 33% bubble rate that applied to incomes between approximately \$85,000 and \$175,000 (in 2013 dollars) recouped the benefits provided by the initial 15% rate. In 1991 and 1992 the top rate was 31% applied to incomes in excess of approximately \$85,000 in 2013 dollars.¹¹⁷ Figure 8 depicts the income levels at which the top marginal rates were applied over the last 70 years.¹¹⁸

FIGURE 8: TOP MARGINAL TAX RATES AND LEVEL OF INCOME (IN 2013 DOLLARS) AT WHICH TOP MARGINAL TAX RATES WERE APPLIED 1943–2013



The sharp changes in the slope of the line in Figure 8 for 1964, 1981, 1986, and 1992 correspond to tax legislation that modified the brackets and the rates. The gradual declines in the slope from 1943 through 1964 and from 1965 through 1981 depict the impacts of inflation; higher tax rates were increasingly applied to lower levels of income. From 1992 to the present, the rate structure has been relatively stable as a result of inflation indexing, with the taxable income level at which the top rate has been applied ranging between approximately \$387,000 and \$404,000 in 2013 dollars.¹¹⁹

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

F. Overview

The income tax has taken on a diverse array of forms over the past 100 years. Congress broadened the income tax base dramatically from 1913 to 1963 and applied sharply progressive rates against higher levels of income, reaching deeply into the income strata. To cover the costs of military mobilization during World Wars I and II and fiscal needs during the Great Depression, Congress expanded the rate schedule to include as many as fifty-six different rates ranging from 2% to 94%. These rates were applied against income brackets that extended so deeply into the income strata that the top rate was applied to income in excess of \$83 million (in 2013 dollars). When the United States entered World War II, Congress made the rate structures more steeply progressive, shifting to a twenty-four-bracket structure and applying the highest rate, 88%, against income in excess of \$2.8 million in 2013 dollars. During that period, Congress brought virtually every household into the ambit of the income tax through withholding at the source and a sharp reduction in the personal exemption and standard deduction. The lowest income taxpayers were paying a rate of 23% on their first dollars of taxable income. The executive and legislative branch justified this massive transformation toward sharper progressivity and a much more expansive base with calls for shared sacrifice. These rate structures remained in place for another twenty years. At the end of World War II, the executive branch resisted Congressional pressure to lower rates, instead emphasizing inflation management, federal debt reduction, balanced budgets, and the need to fund domestic programs and military engagement in Korea and Vietnam. The primary concerns of tax policy analysts throughout this period were efficiency (how best to collect revenue without distorting taxpayer behavior), equity (how best to distribute the burdens and benefits across the economic classes), and fiscal prudence (how to balance the budget and reduce the federal debt).

During the last fifty years, however, Congress has used the income tax as a tool to achieve economic growth, apparently eschewing its earlier goals. While the initial tax cuts were designed to increase consumer demand, for the past forty years Congress has repeatedly reduced the progression of rates and their penetration into the income strata to increase the supply of capital. By 1991 the rate schedule had flattened to three rates, with the top rate of 31% applied to incomes in excess of \$49,300 (approximately \$84,300 in 2013 dollars). While Congress has expanded the rate schedule during the Clinton, Bush, and Obama Administrations, the progressivity achieved during the first half of the 20th Century has never been restored and the federal debt has grown.

In addition, the structure has become far more opaque. From World War II to 1980, inflation reduced the real value of wages and forced lower income taxpayers into higher brackets. Lower real income and higher taxes increased demand for tax preferences (exemptions, exclusions, deductions,

credits, deferral, and special rates) that would help taxpayers shield their income. These tax expenditures have proliferated at a rapid pace,¹²⁰ creating more complexity,¹²¹ undermining horizontal and vertical equity,¹²² and reducing transparency.¹²³

II. HISTORICAL ANALOGS TO CURRENT PROPOSALS FOR TAX REFORM

The great variety of bracket and rate structures employed over the 100-year history of the income tax renders historical economic data an invaluable resource for economists and tax scholars. Because the structures that would result from a number of tax proposals currently being discussed in the media resemble historical tax structures, analysis of historical data may aid tax analysts in evaluating those proposals.

For example, historical evidence appears to contradict assumptions that tax cuts to top incomes will spur growth. The Congressional Research Service has noted that the highest periods of economic growth have correlated with more highly progressive tax rates.¹²⁴ Thomas Piketty, Facundo Alvaredo, Anthony Atkinson, and Emmanuel Saez have examined historical economic data from the United States and other countries throughout North America, Europe, Asia, and Australia and concluded that countries that cut top income tax rates significantly during the last quarter of the 20th Century did not achieve higher growth than countries that

¹²⁰ *Tax Expenditures: How Have They Changed over Time?*, TAX POL'Y CENTER, URB. INST. & BROOKINGS INSTITUTION, <http://www.taxpolicycenter.org/briefing-book/background/expenditures/change.cfm> (last updated July 20, 2009) (describing the increase in tax expenditures as a percentage of GDP).

¹²¹ STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 25–26 (1985).

¹²² See CONG. BUDGET OFFICE, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM* 8 (2013), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf. In a tax system with progressive rates, exclusions, exemptions, and deductions provide an upside-down subsidy, granting larger subsidies to higher income taxpayers than to those with lower incomes. Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 720–22 (1970); see also Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant?*, 56 NAT'L TAX J. 613, 622 (2003) (describing the size and the distributional impact of the home mortgage interest deduction).

¹²³ STAFF OF THE JOINT COMM. ON TAXATION, JCX-37-08, *A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS* 62–64 (2008).

¹²⁴ THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R42729, *TAXES AND THE ECONOMY: AN ECONOMIC ANALYSIS OF THE TOP TAX RATES SINCE 1945 (UPDATED)* 10 (2012) (“The fitted values [annual real per capita GDP growth rate plotted against the top marginal tax rate and top capital gains tax rate] seem to suggest that higher tax rates are associated with slightly higher real per capita GDP growth rates. The top marginal tax rate in the 1950s was over 90%, and the real GDP growth rate averaged 4.2% and real per capita GDP increased annually by 2.4% in the 1950s. In the 2000s, the top marginal tax rate was 35% while the average real GDP growth rate was 1.7% and real per capita GDP increased annually by less than 1%.”).

maintained progressive income tax regimes.¹²⁵ Saez and Peter Diamond have used historical economic data since World War II to develop models of the impacts of income tax rate changes and concluded that imposing much more highly progressive rates, such as those in place since 1964, during the Johnson Administration,¹²⁶ and from 1981 to 1986, during the Reagan Administration,¹²⁷ would not dampen economic growth.¹²⁸ While critics claim that increased progressivity would be confiscatory and redistributive and that a more equal distribution of income would not be acceptable for most U.S. citizens,¹²⁹ top rates between 50% and 70% have not only been common during the 100 years of the income tax, but have prevailed during most of its history.¹³⁰

Similarly, other reform proposals are mirrored in the bracket and rate structures that have been employed in the United States in the past. For

¹²⁵ Facundo Alvarez, Anthony B. Atkinson, Thomas Piketty & Emmanuel Saez, *The Top 1 Percent in International and Historical Perspective*, J. ECON. PERSP., Summer 2013, at 3, 11; see also Thomas Piketty, Emmanuel Saez & Stefanie Stantcheva, *Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities*, 6 AM. ECON. J.: ECON. POL'Y 230, 232 (2014) (finding no apparent correlation between cuts in top tax rates and growth rates in real per capita GDP based on U.S. and international data). While the United States and the United Kingdom reduced top rates dramatically from 1970 to 2010, real GDP growth per capita did not vary significantly from that of other countries, such as France, Germany, and Denmark, that maintained much higher marginal tax rates. Thomas Piketty, Emmanuel Saez & Stefanie Stantcheva, *Taxing the 1%: Why the Top Tax Rate Could Be over 80%*, VOXEU.ORG (Dec. 8, 2011), <http://www.voxeu.org/article/taxing-1-why-top-tax-rate-could-be-over-80> (“[T]here is no correlation between cuts in top tax rates and average annual real GDP-per-capita growth since the 1970s. For example, countries that made large cuts in top tax rates such as the United Kingdom or the United States have not grown significantly faster than countries that did not, such as Germany or Denmark.”); see also, Peter Diamond & Emmanuel Saez, *Diamond and Saez: High Tax Rates Won't Slow Growth*, WALL ST. J. (Apr. 23, 2012, 7:14 PM) [hereinafter Diamond and Saez, *High Tax Rates*], <http://online.wsj.com/article/SB10001424052702303425504577353843997820160.html> (“For example, from 1970 to 2010, real GDP annual growth per capita averaged 1.8% and 2.03% in the U.S. and the U.K., both of which dramatically lowered their top tax rates during that period, while it averaged 1.72% and 1.89% in France and Germany, which kept high top tax rates during the period. While in no way does this prove that higher top tax rates actually encourage growth, there is not good evidence from the aggregate data supporting the view that higher tax rates slow growth.”).

¹²⁶ From 1965 to 1981, the top marginal rate was 70%, levied initially on taxable income of approximately \$728,000 (in 2013 dollars) or more. *U.S. Federal Income Tax Rates History*, *supra* note 1.

¹²⁷ From 1982 to 1986, the top marginal rate was 50%, levied initially on taxable income of \$99,000 (in 2013 dollars). *Id.*

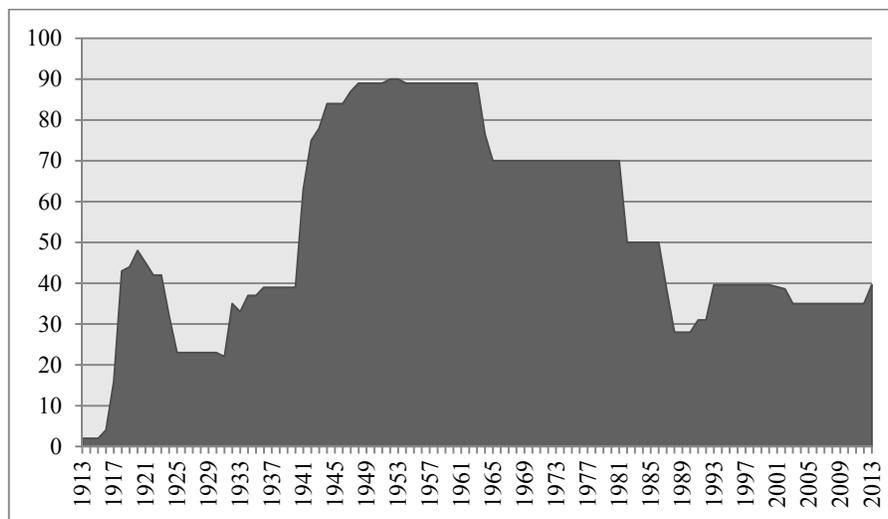
¹²⁸ See Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, J. ECON. PERSP., Fall 2011, at 165; Diamond & Saez, *High Tax Rates*, *supra* note 125 (“Indeed, according to the U.S. Department of Commerce’s Bureau of Economic Analysis, GDP annual growth per capita (to adjust for population growth) averaged 1.68% between 1980 and 2010 when top tax rates were relatively low, while growth averaged 2.23% between 1950 and 1980 when top tax rates were at above 70%.”).

¹²⁹ Aparna Mathur, Sita Slavov & Michael R. Strain, *Should the Top Marginal Income Tax Rate Be 73 Percent?*, 137 TAX NOTES 905, 912 (2012).

¹³⁰ The mean for the top rate is 59% and the median top rate is 67% for the 100-year period. See *supra* note 63 and accompanying text.

example, a recent proposal for reform involves a “millionaire tax,” imposing a surtax of 3.25%¹³¹ to 5.6%¹³² on incomes in excess of one million dollars. Congress has enacted far more highly progressive rate structures in the past. Figure 9 tracks the marginal rates applied to the millionth dollar of income over the period the income tax has been in effect.¹³³

FIGURE 9: MARGINAL RATES ON MILLIONTH DOLLAR



The enactment of a 3.25% surtax on incomes in excess of \$1 million would result in a top marginal rate of 42.85% and a 5.6% surtax would result in a top marginal rate of 44.2%¹³⁴ on taxable income of \$1 million or more. These rates would be well below the mean and not significantly above the median for the 100-year period the income tax has been in place.¹³⁵ The marginal rates that would result from the application of a millionaire surtax are not only unremarkable, but are actually more common than not. Furthermore, the higher marginal rates do not appear to have had an impact on economic growth.¹³⁶

¹³¹ Susy Khimm, *Millionaire's Surtax Would Hit the Top 1 Percent of Small Businesses*, WASH. POST WONKBLOG (Nov. 29, 2011, 4:07 PM), http://www.washingtonpost.com/blogs/wonkblog/post/millionaires-surtax-would-hit-the-top-1-percent-of-small-businesses/2011/11/29/gIQA09de9N_blog.html.

¹³² Janet Hook, *Democrats Propose New Tax on Top Earners*, WALL ST. J., Oct. 6, 2011, at A5.

¹³³ See *U.S. Federal Income Tax Rates History*, *supra* note 1.

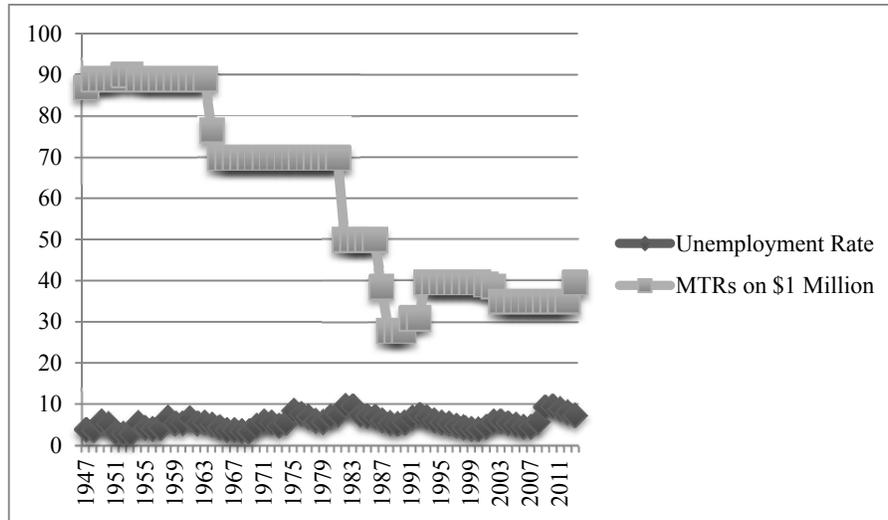
¹³⁴ In 2013 the top rate of 39.6% was applied to incomes in excess of \$400,000. *Id.*

¹³⁵ The marginal rate on incomes of \$1 million has averaged about 52.3%, with a median rate at about 42%. *See id.*

¹³⁶ During economic recession periods, the marginal rate on \$1 million has been as high as 90% and as low as 2%, with the mean falling at about 53% and the median at about 44.5%. During times of

Critics of the millionaire surtax argue that the imposition of the surtax would negatively impact employment¹³⁷ and that the surtax would harm small businesses.¹³⁸ Figure 10 compares the unemployment rate¹³⁹ to the marginal tax rate applied to incomes of \$1 million or more¹⁴⁰ for the period for which unemployment data is available, between 1947 and 2013.

FIGURE 10: UNEMPLOYMENT RATE AND MARGINAL TAX RATE ON \$1 MILLION 1947–2013



Unemployment rates do not appear to vary based on changes in the marginal tax rates on incomes of \$1 million. A closer examination of unemployment rates and tax rates for the past three decades, a period in

economic expansion the marginal rate on \$1 million has also been as high as 90% and as low as 2%, with the mean at 54.3% and the median at 44%. Economic contractions start at the peak of a business cycle and end at the trough: January 1913–December 1914, August 1918–March 1919, January 1920–July 1921, May 1923–July 1924, October 1926–November 1927, August 1929–March 1933, May 1937–June 1938, February 1945–October 1945, November 1948–October 1949, July 1953–May 1954, August 1957–April 1958, April 1960–February 1961, December 1969–November 1970, November 1973–March 1975, January 1980–July 1980, July 1981–November 1982, July 1990–March 1991, March 2001–November 2001, December 2007–June 2009. Economic expansions start at the trough of a business cycle and end at the next peak. *US Business Cycle Expansions and Contractions*, NAT'L BUREAU OF ECON. RES., <http://www.nber.org/cycles/cyclesmain.html> (last visited June 1, 2014).

¹³⁷ See Hook, *supra* note 132.

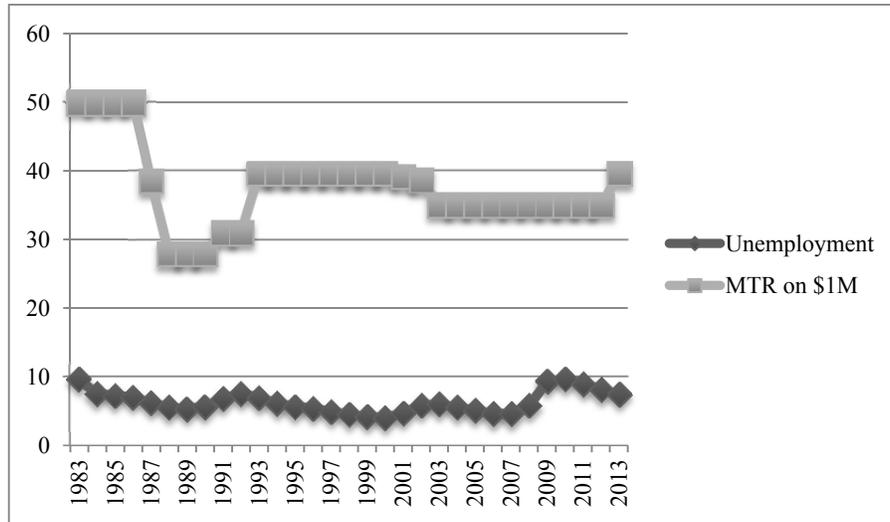
¹³⁸ See Khimm, *supra* note 131 (noting Congressman John Boehner's critique of the millionaire tax as a "job-killing tax hike on small businesses").

¹³⁹ *Labor Force Statistics from the Current Population Survey*, U.S. DEP'T OF LAB., BUREAU OF LAB. STAT., http://data.bls.gov/timeseries/LNU04000000?years_option=all_years&periods_option=specific_periods&periods=Annual+Data (last visited June 1, 2014) (providing the unadjusted unemployment rate from 1947–2013).

¹⁴⁰ See *U.S. Federal Income Tax Rates History*, *supra* note 1.

which Congress has actively used the income tax as a tool to spur growth, establishes no clear relationship between the two parameters. Figure 11 examines more recent data, comparing the unemployment rate¹⁴¹ to the marginal tax rate applied to incomes of \$1 million or more¹⁴² from 1983 to 2013.

FIGURE 11: UNEMPLOYMENT RATE AND MARGINAL TAX RATE ON \$1 MILLION 1983–2013



While unemployment declined from 9.6% to 5.3% during the Reagan era, when tax rates on incomes of \$1 million were dropped from 50% to 28%, unemployment declined from 7.5% to 4.0% from 1992 to 2000, when the top marginal rate was increased to 39.6%.¹⁴³ Furthermore, from 2001 to 2010, when Congress reduced the top marginal tax rate to 35%, unemployment steadily rose to the previous high of 9.6%.¹⁴⁴ While these comparisons are rudimentary, they suggest that there is no clear relationship between unemployment and the marginal tax rates applied to top incomes. If tax rates do impact employment levels, the relationship appears to be obscured, and possibly swamped, by other factors.¹⁴⁵

¹⁴¹ See *Labor Force Statistics from the Current Population Survey*, *supra* note 139.

¹⁴² See *U.S. Federal Income Tax Rates History*, *supra* note 1.

¹⁴³ *Labor Force Statistics from the Current Population Survey*, *supra* note 139; *U.S. Federal Income Tax Rates History*, *supra* note 1.

¹⁴⁴ *Labor Force Statistics from the Current Population Survey*, *supra* note 139; *U.S. Federal Income Tax Rates History*, *supra* note 1.

¹⁴⁵ Other factors impacting unemployment during this period include rising inequality, wage stagnation, inflation and monetary policy, globalization of trade, and offshoring of jobs. See JOSEPH E. STIGLITZ, *THE PRICE OF INEQUALITY: HOW TODAY’S DIVIDED SOCIETY ENDANGERS OUR FUTURE* 84–

Concern about the impact of the income tax on small businesses has arisen from a belief that small businesses drive new job growth.¹⁴⁶ The most recent economic literature suggests, however, that it is not small businesses, but *new* businesses, startup enterprises, that are responsible for private sector job creation.¹⁴⁷ Existing research on the impacts of tax on small business entry and exit provides little guidance on how tax might impact entrepreneurship, unfortunately.¹⁴⁸ Note that the only startups directly impacted by a millionaire surtax would be those generating incomes in excess of \$1 million during the first year of operation, the period in which they are net job creators.¹⁴⁹ Given that startups are not generally profitable for their first several years,¹⁵⁰ they would not likely feel any direct impacts from a millionaire surtax. If concerns about enacting a millionaire surtax are based on fears that job growth will be slowed, then research should be focused on the factors that impact the development of startup enterprises.¹⁵¹

CONCLUSION: A RESEARCH AGENDA

During the first fifty years the income tax has been in effect, the primary concerns of policymakers were efficiency (how best to collect revenue without distorting taxpayer behavior), equity (how best to

85, 238–40 (2012) (describing the rise in unemployment from a decline in aggregate demand and tracing that decline to reduced consumption from wage stagnation, increasing inequality, and monetary policies to keep inflation low); *see also* LINDA LEVINE, CONG. RESEARCH SERV., RL32292, OFFSHORING (OR OFFSHORE OUTSOURCING) AND JOB LOSS AMONG U.S. WORKERS (2012), *available at* <http://www.fas.org/sgp/crs/misc/RL32292.pdf> (describing rising worker displacement from changing technology, globalization, and outsourcing of labor to offshore companies).

¹⁴⁶ TIM KANE, KAUFFMAN FOUND., THE IMPORTANCE OF STARTUPS IN JOB CREATION AND JOB DESTRUCTION 6 (2010), *available at* <http://www.kauffman.org/what-we-do/research/firm-formation-and-growth-series/the-importance-of-startups-in-job-creation-and-job-destruction>.

¹⁴⁷ John C. Haltiwanger, Ron S. Jarmin & Javier Miranda, *Who Creates Jobs, Small vs. Large vs. Young* 28–29 (NBER Working Paper Series, Working Paper No. 16300, 2010), *available at* <http://www.nber.org/papers/w16300.pdf> (“Firms that are over 10 years old and have more than 500 workers account for about 45 percent of all jobs in the U.S. private sector. In turn, we show that these large, mature firms account for almost 40 percent of job creation and destruction. The share of jobs created and destroyed by different groups of firms is roughly their share of total employment. An important exception in this context is the contribution of firm startups. Firm startups account for only 3 percent of employment but almost 20 percent of gross job creation.”).

¹⁴⁸ WILLIAM GALE & SAMUEL BROWN, SMALL BUSINESS, INNOVATION AND TAX POLICY: A REVIEW 29–33 (2013), *available at* <http://www.brookings.edu/~media/research/files/papers/2013/04/small%20business%20tax%20policy%20gale/small%20business%20tax%20policy%20gale.pdf>.

¹⁴⁹ KANE, *supra* note 146, at 5 (“A closer analysis presented here indicates that net job growth in the United States comes from firms less than *one* year old, formally defined as startups. Since the [Business Dynamics Statistics] uses annualized data, . . . it stands to reason that the [transition from when the number of jobs created equals the number destroyed occurs] at the three- to nine-month point after firm founding.”).

¹⁵⁰ GALE & BROWN, *supra* note 148, at 33.

¹⁵¹ *See, e.g., id.* at 29–33; Haltiwanger et al., *supra* note 147.

distribute the burdens and benefits across the economic classes), and fiscal restraint (how best to balance the budget and reduce the federal debt). Since 1964, however, the income tax has increasingly been used as a Pigouvian tool to spur economic growth. Efficiency has been pursued at the expense of equity,¹⁵² as well as fiscal prudence. Whether this is an appropriate trade-off depends on whether the income tax is an effective mechanism for producing growth. This was the key question in 1964¹⁵³ and it remains a key question today. Unfortunately, most tax policy analysis is not directed to answering this question.

A number of economists have taken issue with the way tax policy analysis is performed, arguing that too often it is incomplete.¹⁵⁴ To determine whether the government should take an action, policymakers frequently employ cost-benefit analysis, which requires them to evaluate the benefits and costs associated with taking an action and weigh them against the benefits and costs of not taking the action.¹⁵⁵ Typically, on matters of tax policy, however, once economists have argued that a tax policy action will have costs, the analysis ends.¹⁵⁶ The actual efficiency

¹⁵² See Emmanuel Saez, *Striking It Richer: The Evolution of Top Incomes in the United States* (Updated with 2012 Preliminary Estimates) (Sept. 3, 2013) (unpublished manuscript), available at <http://elsa.berkeley.edu/~saez/>. Professor Saez's manuscript is an update to an article by the same title published in 2008. See Emmanuel Saez, *Striking It Richer: The Evolution of Top Incomes in the United States*, PATHWAYS, Winter 2008, at 6, available at https://www.stanford.edu/group/scspi/_media/pdf/pathways/winter_2008/Saez.pdf.

¹⁵³ When the Kennedy Administration proposed lower rates to spur demand and stimulate a flagging economy, Richard Musgrave, a Harvard economist and tax policy advisor, cautioned that "any departure from equity must have clear justification in terms of probable effectiveness with regard to growth." WITTE, *supra* note 13, at 159.

¹⁵⁴ See, e.g., Neil H. Buchanan, *What Is Wrong with Incomplete Tax Policy Analysis*, DORF ON LAW (Mar. 22, 2012, 1:08 PM), <http://www.dorfonlaw.org/2012/03/what-is-wrong-with-incomplete-tax.html>; Paul Krugman, *Too Much Faith in Models*, *Capital Taxation Edition*, N.Y. TIMES (Mar. 27, 2014, 2:05 PM), http://krugman.blogs.nytimes.com/2014/03/27/too-much-faith-in-models-capital-taxation-edition/?_php=true&_type=blogs&_r=0 ("[T]he case for zero or low taxation of capital income rests on very strong, very unrealistic assumptions—basically perfectly rational intertemporally optimizing agents, with dynasties behaving as if they were infinitely lived individuals. Question those assumptions, and the whole case falls apart. Don't take my word for it—read Peter Diamond and Emmanuel Saez, who also point out that the intertemporal optimizing model of saving is in fact rejected by lots of evidence. . . . [T]he economic case for not taxing capital rests on a stylized model that we know does a bad job of capturing real behavior; the case for taxing capital rests on considerations of equity and concerns about excessive concentration of wealth that are very much grounded in real world observation."); see also THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 32 (Arthur Goldhammer trans., 2014) ("To put it bluntly, the discipline of economics has yet to get over its childish passion for mathematics and for purely theoretical and often highly ideological speculation, at the expense of historical research and collaboration with the other social sciences. Economists are all too often preoccupied with petty mathematical problems of interest only to themselves. This obsession with mathematics is an easy way of acquiring the appearance of scientificity without having to answer the far more complex questions posed by the world we live in.")

¹⁵⁵ JONATHAN GRUBER, *PUBLIC FINANCE AND PUBLIC POLICY* 206 (3d ed. 2011).

¹⁵⁶ *Id.* Buchanan suggests training, and, ironically, the incentive structures are what have caused economists to falter in making reliable economic predictions, such as the financial crisis that led to the

losses in employing a tax are not calculated, the value of the governmental activity that tax buys is not evaluated, and the direct effects, the current and future costs of maintaining the status quo, are not assessed.¹⁵⁷ While during most of the 20th Century the dearth of economic data made empirical research challenging, if not impossible,¹⁵⁸ today robust data sets are available¹⁵⁹ and technological advances facilitate their analysis.¹⁶⁰ It is incumbent on tax policy analysts to examine existing data, to provide explanations for deviations from expected outcomes, and to evaluate policy failures. Only by examining historical data, evaluating the actual performance of predictive models, and incorporating lessons learned, can tax scholars enhance their capacity to predict economic outcomes.

Great Recession. Neil H. Buchanan, *Why Are So Many Economists So Unable to Help with the Ongoing Economic Crisis? Understanding What the Economics Profession Rewards and Penalizes*, VERDICT (Feb. 17, 2012), <http://verdict.justia.com/2012/02/17/why-are-so-many-economists-so-unable-to-help-with-the-ongoing-economic-crisis>. He argues that economists are trained and evaluated on their ability to generate sophisticated mathematical models that are divorced from real world economic problems, and to direct their research away from inquiries that are practical, policy focused, or empirical. Buchanan also cautions that the profession has abandoned its mission of evaluating economic problems accurately and with integrity in favor of “ignor[ing] or distort[ing] reality [to achieve] ideological ends.” *Id.* Others, such as Robert Samuelson, who reported on the U.S. economy throughout the Great Inflation, another significant failure in U.S. economic policy, have argued that economists’ dismissal of history and historians’ failure to grasp fundamental economic concepts has undermined any comprehensive analysis of the period from 1965 to 1979. ROBERT J. SAMUELSON, *THE GREAT INFLATION AND ITS AFTERMATH* 42–45 (2008).

¹⁵⁷ See Buchanan, *What Is Wrong with Incomplete Tax Policy Analysis*, *supra* note 154.

¹⁵⁸ PIKETTY, *supra* note 154, at 11–12.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 19–20.

