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# How Did We Get Our Tax System? (And What Can That Teach Us About Reforming It?)

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## Abstract

"In celebration of the 30th compliance year of the Internal Revenue Code, I've compiled three articles covering the past, present, and future of America's tax system."

Posting about the history of American taxation from *In All Things* - an online journal for critical reflection on faith, culture, art, and every ordinary-yet-graced square inch of God's creation.

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## Comments

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> *"[I]n this world, nothing can be said to be certain, except death and taxes." Benjamin Franklin*

While we've talked about death a few times on iAt, we've strangely never gotten around to talking about taxes. Since this is surely a compelling topic for our readership, and since this is the subject matter of my highest degree (LL.M. in Taxation), I've been regularly pitching a tax-oriented topic at several of the last board meetings. Strangely, the iAt managing editor was less convinced about the compelling nature of this topic than I, but, after making many promises to keep this interesting and accessible, I got the go ahead. So, without further ado, and in celebration of the 30th compliance year of the Internal Revenue Code, I've compiled three articles covering the past, present, and future of America's tax system. It may not be first on your list of topics to read about, but it's one of the most tangible ways that the federal government affects the daily lives of its citizens, so I encourage you to follow along.

From the outset, you might be wondering why I'm quoting Benjamin Franklin at the top of the article before then claiming that we're only completing the 30th compliance year of our tax system. The answer is that taxation in Franklin's time was mostly about duties and tariffs.[1] The United States didn't have an income tax until the Civil War, and, even then, that tax was ruled unconstitutional, delaying a personal income tax until the ratification of the 16th Amendment in 1912. The taxes levied under this new authority were first gathered into one place and named the "Internal Revenue Code" in 1939. The Code was substantially revised in 1954, and it was put into its modern form in 1986.

If you're following along at home, you might notice that we've settled into a nice little pattern of doing major tax code revisions roughly every 30 years. That means that we're due, and, if conversations from Washington are to be believed, changes may be coming soon. With that in mind, what can the last successful efforts at major tax reform teach us about the efforts underway today?

**High Rates and Big Holes: Why the Tax Code was Revised in the Past**

When it was first introduced, the income tax was almost like an excise tax (sometimes called a "sin tax") on wealth: it levied a small tax only on the wealthiest 1% of Americans.[2] However, the needs of World War I shifted government revenue streams from relying on tariffs to income taxes, and those needs only expanded through World War II and the Korean war.[3] Throughout this time, the tax base (number of people paying taxes) broadened significantly and tax rates rose significantly, with the top marginal rate at 91% in 1954.[4]

It might shock you to see that rates were this high; however, virtually no one paid taxes at that rate. For one, marginal rates are the taxes imposed on a certain amount of income, not all of a person's income.[5] More importantly, though, numerous exemptions, loopholes, and tax shelters meant that the effective rate (the amount people really paid) was much lower. This, in fact, laid the groundwork for how tax reform could come to be.

The success of the tax reform effort in 1986 was the result of a bipartisan compromise. Conservatives were pushing for lower tax rates, while liberals wanted to close loopholes. By seeking to do both, the Tax Reform Act of 1986 kept federal receipts relatively level while dramatically reshaping the tax code. This meant that the government was still

taking in a similar amount of money, but it was doing so in a more efficient, straightforward manner.

***Semper Reformanda*: What We Can Learn from Past Reforms**

Of course, the reforms of 1986 were short-lived. The American tax system is in some ways a well-oiled machine, but we've tended not to change the oil on that machine until it becomes so gunked up that we need an overhaul of the whole thing. While the 1986 Act reduced the number of tax brackets from 15 down to 4, that number has crept back up to 7. Similarly, some base-broadening measures have been scaled back, making the system more progressive, while new loopholes have appeared which expanded the difference between marginal and effective rates again.

So, if the system is due for an oil change, what lessons can we take from past experience to apply to potential reforms?

First, as mentioned above, federal receipts have remained at a relatively stable percentage of the country's wealth produced each year (GDP) since World War II. [6] While we could always agree to raise our tax rate above the historical 15-20% rate, it appears that this represents a pretty settled political bargain, meaning that the only thing that has shifted over time is who is paying those taxes, not necessarily how much is being taxed. In other words, tax reform is at least as much about *how* we tax as it is about *how much* we tax.

Second, effective tax rates have remained relatively constant since about 1960 (especially for those in the highest income brackets). This reflects a reality that higher marginal rates have usually come with corresponding and counterbalancing loopholes. If effective tax rates have remained relatively constant, there might be something to be said for cutting out many of the special deductions and credits to make the marginal rates more closely match the effective ("real") rates. The system would certainly be simpler, and, as we'll see in tomorrow's piece, simpler can mean higher compliance rates and more revenue, meaning we don't have to raise rates for the law-abiding folk to account for tax evaders.

Finally, if we want to be honest with ourselves, even if Congress were to do a fantastic job with overhauling the tax system, it will still likely unravel over time. If nature abhors a vacuum, bureaucracy abhors simplicity. The demands of unique circumstances and special interests will always vie for the ears of lawmakers, and the system will likely need significant reform in another 30 years, but we're arguably in a better system now than we were in 1986 or 1954 before that. We may need to overhaul the system, but there is hope that we know how to build a better machine each time, and positive change may come out of the reforms that Republicans have been promising this year.

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## Footnotes

1. that is, taxes on the import and export of goods ↩

2. The tax didn't apply until an individual taxpayer was making the modern equivalent of about $66,000, and it didn't exceed 1% of income until that individual made over about $440,000. ↩

3. An income tax is a reliable income stream for a nation suffering the trade upheaval that usually accompanies wartime, and war is one of the most expensive endeavors a nation can undertake. This is why we see the shift to reliance on the income tax heavily tied to the Civil War, World War I, World War II, and the Korean War. ↩

4. For a great historical survey of tax reform efforts through the mid 1980s, see John E. Witte's *The Politics and Development of the Federal Income Tax*. ↩

5. For a great illustration of what this means, see the IRS' tax tables. ↩

6. This is referred to in tax nerd circles as Hauser’s Law. ↩