In recent years, Uncle Sam's annual cut of GDP has declined significantly

Revenue BREAKDOWN

BY KARL RHODES

During the fiscal year that ended Sept. 30, 2012, the federal government spent $3.5 trillion. It raised $2.4 trillion in revenue, primarily by taxing individuals and corporations, and it closed the resulting budget gap by borrowing $1.1 trillion. During the past four years, deficit spending has added more than $5 trillion to the national debt, more than all the deficits and surpluses (adjusted for inflation) from 1987 through 2008 combined.

This fiscal picture scares taxpayers and policymakers alike, but American fiscal challenges are nothing new; the struggle to pay Uncle Sam's bills is as old as the United States. It reflects a variety of conflicts, real or perceived: small government versus big government, poor people versus rich people, and ultimately, current taxpayers versus future taxpayers.

One hundred years ago, federal spending accounted for about 2 percent of gross domestic product (GDP). The United States funded its operations with tariffs and a few excise taxes, mostly on alcohol and tobacco. Those taxes were regressive because merchants passed them on to average consumers. The federal government "tried to put some tariffs on imported things that only rich people would buy, but many tariffs were imposed on things that everybody would buy," says Joe Thorndike, director of the Tax History Project for Tax Analysts, a nonprofit organization that publishes research on tax issues.

To make the tax system somewhat less regressive, the United States established an income tax in 1913. The tax was graduated from 1 percent to 7 percent, but it applied only to the wealthiest people. The low rates and high income threshold ($450,000 in today's dollars) generated little revenue, Thorndike says. "It was really a symbolic tax designed to say, 'Hey, you know what? We are going to make rich people pay their fair share.'"

The new tax earned its stripes during World War I after its top rate jumped from 7 percent to 77 percent. The war was expensive, and it disrupted the international trade that generated the tariffs that were paying most of the bills. "Tariffs never again went back to their predominance in the revenue system," Thorndike notes. "Income taxes and excise taxes became the foundation of federal finance."

The individual income tax helped the United States repay its World War I debt fairly quickly, even after prohibition corked alcohol taxes, which had become an important revenue source. The federal government regained its fiscal fitness during the 1920s as spending fell from 23 percent of GDP in 1919 to about 3 percent of GDP in 1928.

Just as outlays were approaching their historical peacetime average of 2 percent of GDP, the nation plunged into the Great Depression. Income tax revenues plummeted, and the federal government started looking for ways to fund President Franklin D. Roosevelt's New Deal programs. Congress established an excise tax on gasoline in 1932 that provided more than 6 percent of revenues in its first full year. The nation also repealed prohibition, and alcohol taxes accounted for nearly 13 percent of revenues by 1936. Government spending spiked above 10 percent of GDP, by far the highest peacetime level at that point in American history. So tax receipts fell woefully short, and borrowing funded more than half the budget in 1936.

During the Great Depression, excise taxes remained the largest source of federal revenue, but the new payroll tax to fund Social Security quickly provided the second largest revenue stream. This one-two punch made the overall tax system more regressive. Roosevelt tolerated regressive taxes because they brought in a lot of money, but he also wanted to create at least the appearance of a progressive tax system, and tinkering with tax brackets was a high-profile way to do that. The top individual income tax bracket had fallen

to 25 percent during the Coolidge administration, and Roosevelt persuaded Congress to push it back up to 79 percent. That top rate, however, applied only to annual income above $5 million (equivalent to $81 million today). John D. Rockefeller Jr. was the only taxpayer in that bracket, according to Mark Leff, a history professor at the University of Illinois at Urbana-Champaign and author of *The Limits of Symbolic Reform*, a history of New Deal taxation.

Revenue for War

"IT TAKES TAXES *and* BONDS," according to a propaganda poster that featured Uncle Sam trying to balance the "war budget" during World War II. Taxes and deficit spending skyrocketed to unprecedented levels to fund the war. Federal borrowing peaked at 30 percent of GDP in 1943, a year when government expenditures accounted for 43 percent of the U.S. economy.

Roosevelt and Congress raised corporate taxes and individual income taxes dramatically and kept excise taxes high. By 1944, the federal government claimed 94 percent of Rockefeller's marginal income, and he was no longer alone in the nose-bleed bracket because the income threshold for the upper crust had fallen from $5 million to $200,000. Roosevelt and Congress also raised taxes substantially on low- and middle-income people. In the bottom bracket, for example, people who earned $2,000 or less paid 23 percent. Revenues from the individual income tax exploded from $1 billion in 1939 to $17 billion in 1945. Excise taxes remained high as well, but during World War II, individual and corporate income taxes became the foot soldiers of federal finance. For the first time in American history, the United States achieved a progressive tax system from top to bottom.

At the height of the war, government revenues soared to slightly above 20 percent of GDP, and by 1950, they had fallen to slightly below 15 percent of GDP. Since then federal receipts as a percent of GDP have remained within that range. Through five wars, 10 recessions, 11 administrations, and countless tax code revisions, revenues rarely deviated much from their average of 18 percent. When 18 percent of GDP was not enough to pay Uncle Sam's bills, he borrowed the rest.

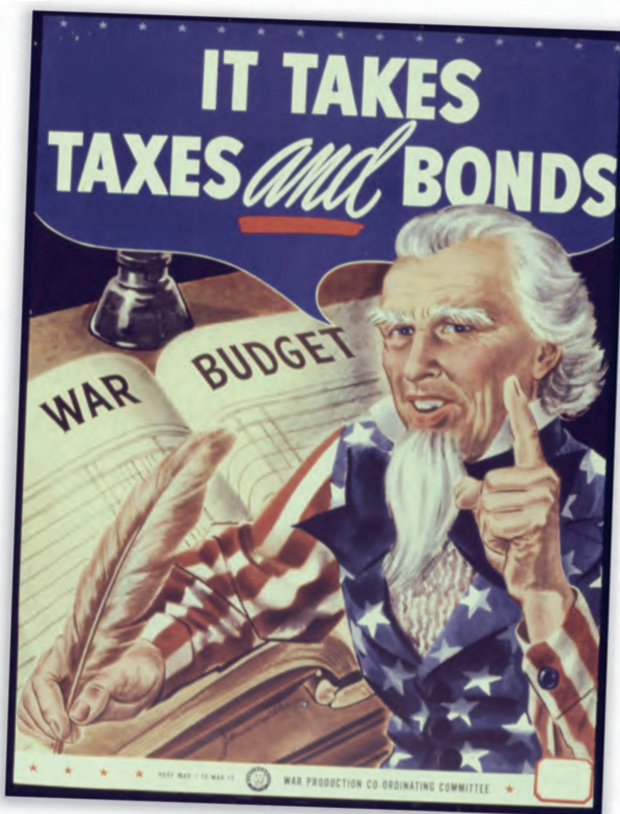
After World War II, pundits and politicians floated the idea of passing the nation's massive war debt to the next generation. "A lot of people at the time said, 'Hey, we did the fighting. It is not unreasonable to ask our kids to do some of the paying because we were securing their future,'" Thorndike says.

That argument faded as the economy expanded substantially during the Truman and Eisenhower administrations, reducing debt as a percent of GDP to a more manageable level. Taxes remained elevated, however, to fund growing social programs and the Cold War military buildup. By the end of the Korean War, federal spending briefly exceeded 20 percent of GDP — twice the level of Depression-era outlays. Federal spending rose to 20 percent again during the Vietnam War, and it has rarely dipped much below that level since then.

Bracketology

Throughout the Truman and Eisenhower administrations, the top individual income tax rate remained above 90 percent. "Although Eisenhower was not a great fan of those rates, he really didn't do anything to challenge them," Thorndike says. "I think he was not prepared to challenge the growth of the state. They were going to need a lot of money, and on top of that, he was a real budget-balancing fiend. He was willing to tolerate high taxes if it meant paying the bills."

Finally, the Revenue Act of 1964 (proposed by President Kennedy and signed by President Johnson to boost the economy) slashed the top income tax rate from 91 percent to 70 percent. Trade-offs between tax rates and tax revenues were not widely understood in 1964, but a marginal rate of 91 percent would have been well above the point where lowering the rate would generate more revenue. In the 1980s, President Ronald Reagan used this rationale to reduce the top rate from 70 percent to 28 percent. Even with such dramatic reductions in the top rate, individual income tax receipts remained roughly the same as a percent of GDP



POSTER: COURTESY OF THE NATIONAL ARCHIVES

Federal taxes and borrowing soared to unprecedented heights to fund World War II. Borrowing came down quickly after the war, but taxes never returned to pre-war levels.

from 1953 to 1996, under nine presidents (five Republicans and four Democrats).

With individual income tax revenues holding steady at about 8 percent of GDP for more than four decades, gradual growth in government spending was funded primarily by borrowing more money and by boosting payroll tax revenues from 1.8 percent of GDP in 1953 to 6.7 percent of GDP in 1988. (Payroll taxes are regressive, but the spending programs they fund are progressive on average.)

During this period, excise tax receipts contracted from 2.7 percent to 0.7 percent of GDP, and corporate income tax proceeds shrank from 5.7 percent to 1.9 percent of GDP. Companies may be able to pass some corporate taxes on to employees and customers, making corporate taxes less progressive. But the interplay between corporate income taxes and individual income taxes over the years suggests that shareholders, especially owners of private companies, do pay a large portion of corporate taxes. When the top individual rate was higher than the top corporate rate, owners paid themselves lower salaries to shelter their earnings inside corporations, notes David Kautter, managing director of the Kogod Tax Center at American University. To discourage this strategy, Congress came up with an "accumulated earnings tax." The distortion reversed itself in 1987, when the top individual rate dropped below the top corporate rate, and owners started paying themselves higher salaries, often as bonuses at the end of the year. The Internal Revenue Service tried to stop this practice by instituting the concept of "reasonable compensation." The rates finally converged at 35 percent in 2003.

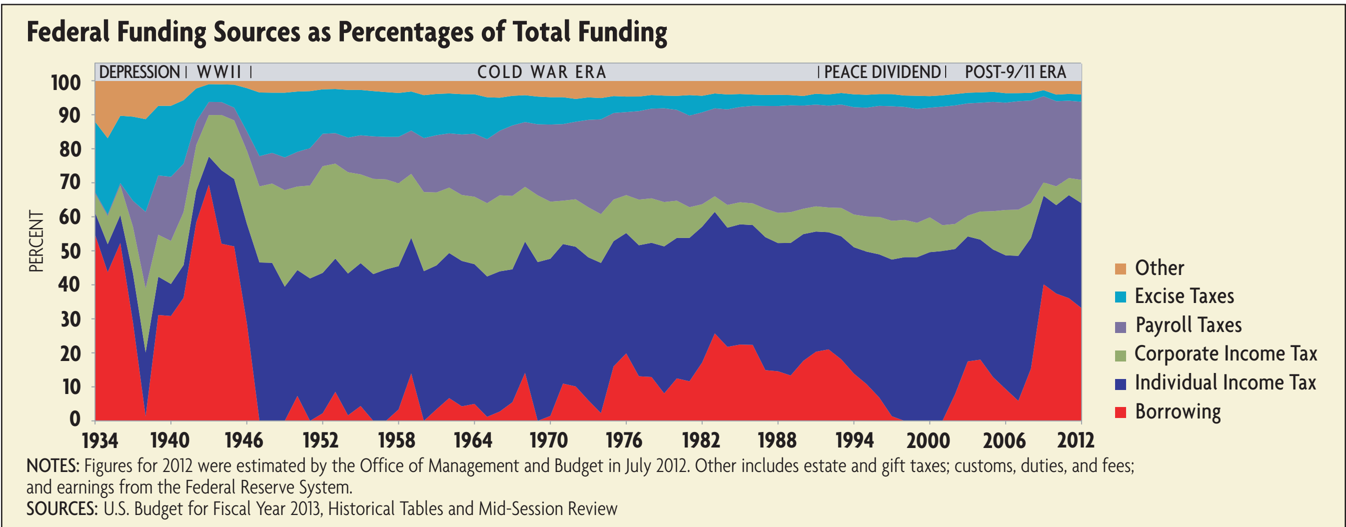
As corporate and individual tax rates came closer, many small and midsize business owners converted their companies to S corporations or limited liability entities to retain legal protections while getting rid of board meetings and other activities that the IRS requires of full-fledged corporations. These conversions shifted a lot of corporate income tax revenue into the individual income tax category.

"Right now the focus is on getting the corporate rate down and broadening the base by eliminating deductions and other preferences," Kautter says. "But if tax reform creates a spread between corporate and individual rates, you will see a return to tax shelters and corporate structures."

Unsoaking the Rich

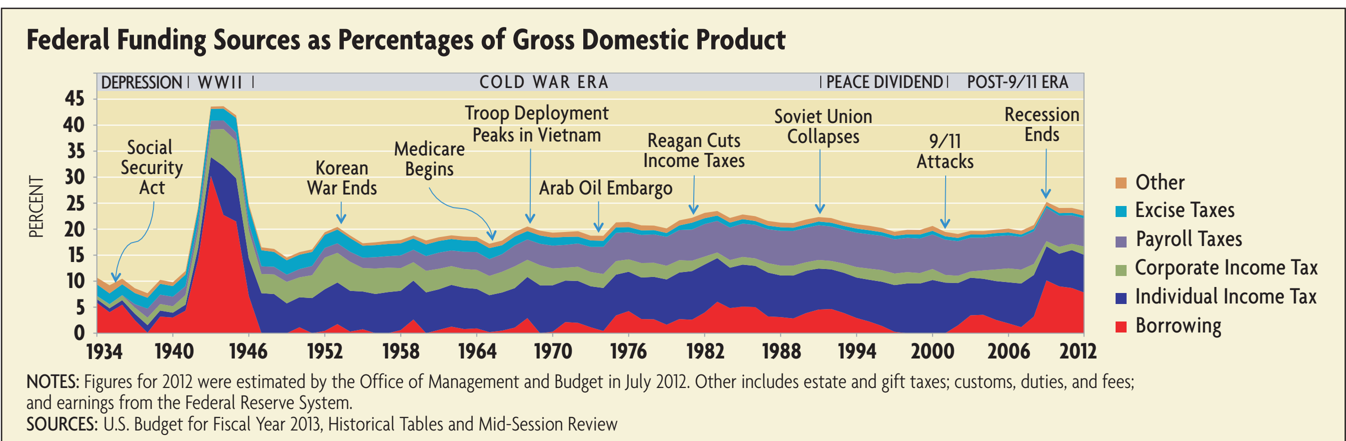
Tax tinkering that began in the 1960s appeared to make the federal tax system significantly less progressive. But a study

Federal Funding Sources as Percentages of Total Funding



NOTES: Figures for 2012 were estimated by the Office of Management and Budget in July 2012. Other includes estate and gift taxes; customs, duties, and fees; and earnings from the Federal Reserve System.
SOURCES: U.S. Budget for Fiscal Year 2013, Historical Tables and Mid-Session Review

Federal Funding Sources as Percentages of Gross Domestic Product



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by Thomas Piketty of the Paris School of Economics and Emmanuel Saez of the University of California, Berkeley found that this conclusion applied primarily to the top 1 percent of taxpayers, especially the top 0.01 percent.

Their analysis of average federal tax rates from 1960 to 2004 indicated that the overall federal tax system became dramatically more favorable for the top 1 percent while maintaining roughly the same level of progressivity at all other income percentiles. Taxation, however, was extremely confiscatory for the top 0.01 percent in the first decade that they studied. These super-rich people carried an average federal tax burden of nearly 75 percent of their total income in 1970. That rate fell to less than 35 percent by 2004.

The Congressional Budget Office (CBO) documented the same trends in its study "Trends in the Distribution of Household Income Between 1979 and 2007." Overall, the study found that the federal tax system was about as progressive in 2007 as it was in 1979, but since average tax burdens decreased across the board, the income-equalizing effect of federal taxes declined from 10 percent in 1979 to about 7 percent in 2007. The CBO also noted that federal taxes declined substantially more for the wealthiest 1 percent of households.

President Barack Obama's proposal to raise taxes on only the richest taxpayers could satisfy the short-run need to generate more revenue "without crimping the economy," says Roberton Williams, a senior fellow at the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution. "But in the long term, that does not do enough to close the budget deficit. We have to go much deeper than just the rich. We have to come down further in the income distribution to make a serious dent in deficits."

In the long run, the federal government cannot close even half of the budget gap by tweaking the existing tax system, Williams adds. Instead, the United States needs to implement comprehensive reform or "something extra" such as "a broad-based consumption tax."

Generational Struggle

The past few years of fiscal policy have been strikingly different than the previous five decades of fiscal policy, partly because political entrenchments seem deeper and partly because recovery from the recession of 2007-09 has been relatively weak and slow.

Wars, bailouts, and stimulus programs have pushed federal spending substantially higher (22.8 percent of GDP in 2012), while Obama's payroll tax cuts and extensions of President George W. Bush's tax cuts, among other factors, have pulled revenues substantially lower (15.8 percent of GDP in 2012). To bridge this gap, the United States has been borrowing at levels the Government Accountability Office calls "unsustainable over the long term." Even so, Thorndike of Tax Analysts does not expect a grand compromise on taxes to emerge anytime soon. "Tax reform happens when it has to, not when it should. We are not at a 'has to' point yet," he concludes. "I think it will happen when the financial markets determine that the path we are on is not sustainable. I don't think that regular voters or even politicians are ever going to come to that realization on their own."

Perhaps fiscal policymakers, most of them baby boomers, will strike a deal to balance the budget and reform entitlement programs, but paying down the national debt of $11.4 trillion may become more of a generational struggle than a tax-bracket battle. Boomers are showing every sign of transferring the national debt to their children and grandchildren — not to pay for a global conflagration, such as World War II, but to fund Social Security, Medicare, and Medicaid.

"Defeating the Nazis bought future generations a world without a hegemonic European fascist power. That was probably a good deal," Thorndike says. But the next generation will be paying back money borrowed primarily to fund entitlement benefits for baby boomers. "We are really asking our kids to pay for us — not for the world we are building for them." Such thorny questions about equity have no easy answers but will have to be tackled head on to address the country's mounting fiscal problems. **RF**

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