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# Income Tax Rhetoric (or Why Do We Want Tax Reform?)

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# FORUM

## **Income Tax Rhetoric (or Why Do We Want Tax Reform?)**

*To the editors:*

### **I. INTRODUCTION: OUR PRESENT FOCUS ON TAX REFORM**

The 1992 presidential election is over but the United States economy still faces hard times. Each man who hoped to lead us promised to revive our sick economy, and each cure promised included a strong dose of tax reform. At no time during the campaign or the transition did anyone seem to ask: Can tax reform actually increase employment, lower the deficit, reverse our trade imbalance, or provide any other boost out of the recession? Why do Americans accept the notion that economic recovery requires tax reform? We did not always think this way. Why does it seem so natural now? Furthermore, is it good for our politics to focus so much on constant tax reform?

### **II. TAXATION PRIOR TO THE INCOME TAX**

There was a time when the average citizen thought very little about the process of financing our government. How was America financed in this earlier period and how did that method shape our political debates?

Our received history is that, prior to 1913, U.S. revenue was raised by a series of excise taxes; that is, sales taxes on such things as alcohol, tobacco, and firearms. In this received history, we are told that, except for some odd events in the western territories, taxation in the United States was always a process of free giving by a free people in support of democracy. In this version of our history, income taxation becomes the final expression of Americans' faith in, and support of, our government. This faith and support is then shown by the success of our self-reporting system.

The actual history of revenue raising in the United States is much more bloody than our received history. For example, we are rarely confronted with the fact that, for many years, one major revenue source was the sale of Indian lands and another was the excise tax on the sale of slaves. We spend little time discussing how troops were used to enforce excise taxes on alcohol and firearms. In our true history, Americans spent many years letting others pay our taxes before picking up the tab ourselves.

### **III. IMPOSITION OF THE INCOME TAX AND INCREASED INTEREST IN TAXATION**

How was the shift of taxation from the "other" to the citizen accomplished? From the time that the income tax was enacted in 1913

until 1942, the tax was laid on a very small percentage of the population. Less than five percent of American citizens even had to file an income tax return. As a result, the income tax remained hidden from the majority of the public, just as today few people in the United States understand that we continue to pay excise taxes. During this early period, most citizens had no understanding of the role of the income tax in federal revenue raising. In fact, the way that the tax was laid made it look as if its primary goal was wealth redistribution. At least the very high progressive rates laid on a very small population seemed like a wealth distribution mechanism. In fact, those high rates were undercut by significantly lower tax rates for transfers of property. For example, there was no tax on appreciation when property passed under a will. Furthermore, there was no tax on gifts and there was a much lower rate of tax on capital gains. The result was that the tax worked well for everyone. The upper classes did not pay very much in tax and the lower classes were told that the tax was in effect a success tax, that those who benefited most from their stay in the United States would have to give back the most to the United States.

World War II changed the way that Americans were sold on the income tax. During this period, the tax became part of the war effort, like victory gardens. The idea of wealth redistribution remained part of the rhetoric of income taxation; however, the tremendous benefits for property transfers also remained, thereby undercutting actual progressivity.

In the 1950s, victory gardens disappeared but the income tax did not. Instead, the income tax went from a class tax to a mass tax as almost every worker became required to file, even if some did not have to pay. In this period of American history, taxation became equated with citizenship and the right to government services. Increased interest in the entire subject of taxation also began in this era.

#### IV. THE RISING BELIEF THAT TAXATION CAN ALTER THE ECONOMY

In the 1960s and 70s the rhetoric of taxation expanded as Americans were told that the income tax could help boost the economy. When President Kennedy entered office at the time of an economic downturn, he introduced several tax changes meant to lower overall taxes on investments. The stock market shot up at the time of these changes, thereby proving to many people that taxation could be used as a means of economic recovery. Was this true? It is difficult to know because the same measures have been used since the Kennedy administration and have not always produced the same results. However, the belief that taxes could increase economic activity and should be the centerpiece of a president's economic program was established at this time.

As a result of this belief, Presidents Johnson, Nixon, Ford and Carter all made tax changes part of their economic agendas. Typically, in time of economic stress, increased benefits were provided for new investments, new machinery, equipment and real estate; but, in general, these benefits did not include reduced rates. Further, most hidden benefits for property transfers were left the same or increased. Thus, the ideal of progressivity remained, while the wealthy continued to receive significant relief from the progressive rates.

#### V. THE PERSPECTIVE THAT PRESIDENT REAGAN BROUGHT TO TAX REFORM AND TAX RHETORIC

The nature of tax reform changed with the Reagan administration. In terms of taxation, President Reagan may well be the most significant United States president.

What was it about Ronald Reagan which made him the president who so severely changed American taxation? In order to understand this, we have to understand Reagan the man. Ronald Reagan is the only United States president who made the bulk of his fortune through salaried work. At the time, salaried work was subject to high income tax rates. All the other presidents in the United States became wealthy either before the income tax or in ways that subjected them to much lower rates. Reagan was the only president who failed to obtain almost any tax benefits.

Basically, the income tax, during President Reagan's life, was structured to protect people who inherited wealth, through low rates on the sale of property, low deferred rates on gifts, and no tax on inheritance. The tax also protected people who worked for low or middle class wages by placing them at low rates. However, the income tax hit very hard on the few people, like President Reagan, who earned very large salaries. Thus, President Reagan came to the White House with a personal history of higher taxation than any other United States president. I believe that it was this experience that shaped his tax policy.

#### VI. PRESIDENT REAGAN'S TAX REFORMS AND ANTI-TAX RHETORIC

Because President Reagan's personal experience involved very high tax rates and very few benefits, his response to the income tax is understandable. That response was to sharply decrease rates because, in his case, high rates actually meant higher taxes. However, President Reagan did not stop there. Coming into office at a time of economic recession, President Reagan also followed the pattern established by President Kennedy by creating tremendous incentives for investments in machinery, equipment and real estate. The result was that, at one point, Reagan's tax structure created a negative tax, that is, the tax savings for certain investments were actually higher than the cost of the

purchase. This negative tax rate has disappeared, but the amount of tax paid by the wealthy remains at a historic low.

#### VII. RESULTS OF PRESIDENT REAGAN'S TAX REFORMS AND TAX RHETORIC

The results of President Reagan's tax programs and the anti-tax rhetoric he employed can be seen as we face many of the problems of the Reagan era. Before President Reagan, tax rates were controlled through provision of special benefits which decreased an individual's actual tax burden. After President Reagan's tax reforms, rates are controlled directly, that is, they are lowered and raised in public where everyone can see, rather than through the manipulation of special benefits which are hidden from public view. This creates an interesting political problem: When people begin to equate tax owed with the rate imposed, the pressure to keep rates low is profound.

At this point, the United States has high deficits resulting from the decrease in revenue brought on by tax cuts. The U.S. also has a shift in the tax burden from the wealthy to the middle and lower classes. This shift becomes even more significant when income taxes are combined with other more hidden taxes, such as state sales taxes, federal excise taxes and social security taxes. However, because of President Reagan's anti-rate rhetoric, the country is also in a situation in which our low rates are almost impossible to raise.

In the past, we had low effective rates once incentives for property ownership were added into the equation. This created a situation in which Americans were accustomed to the idea of high rates although they paid their taxes based on lower rates. Now that lower rates have been introduced, Americans are resistant to an increase even if effective rates do not go up. We saw this, for example, when President Bush got skewered for raising rates from twenty-eight to thirty-one percent. The resistance to rate increases also comes from President Reagan's rhetoric which managed to convince the American public that high rates are the same as high taxes. This rhetorical device has created a situation in which our future presidents and candidates have a public relations problem. That problem is how to raise revenues without raising rates, how to develop a tax program for a public that has been conditioned to believe that a presidential candidate should have a tax program, and how to move at all, given the deficit (which creates a need for revenue raising) combined with a resistance to higher rates.

#### VIII. IS THERE A WAY OUT?

We are stuck in a rhetorical dilemma. Because the income tax touches so many Americans, there is a profound interest in how it works

and who it affects. Because of thirty years of rhetoric, we believe a president is not doing his job unless he uses the income tax system to manipulate the economy. Because of so many years of tax reform, almost every aspect of our system has been changed more than once, leaving us with a constant stream of tax reform. Is there a way out of this box?

Perhaps the best thing that any president can do in the face of these constraints is to be strong. He or she should refuse to engage in tax reform or to imply that tax reform is the way out of a sick economy and thus change the rhetoric that has haunted us for so many years. If we fail to stop reform, if we continue change for change's sake so that our presidents can appear as if they are doing something they "should" be doing, we will get much reform but nothing else and a lot of time and energy will waste away.

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