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Evolution of the Federal Tax System: 1954-1983

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The last quarter of a century, roughly the mid-1950s to date, has been a period of most frequent and dramatic changes in the Federal tax system. Most observers of the Federal tax scene apply three, or possibly four, criteria for evaluating proposed tax legislation. These are:

(1) Fairness or equity;

(2) Simplicity or understandability to the average taxpayer;

(3) Economic impact, including incentives or disincentives for savings, investment, and other types of economic behavior; and

(4) Efficiency of the change—whether it will accomplish its objective without creating undue administrative or compliance problems.

EARLY HISTORY

While we had brief experience with Federal income taxes in the 19th century, the "modern" income tax system traces its roots to 1913. There were several revenue acts during the next four decades, but the 1954 Act was by far the most important attempt by Congress to put our income tax laws together in a cohesive and logical package. Whether they succeeded or not is obviously debatable.

Once the 1954 Act was in place and we had a chance to live with it for a few years, Congress commenced a program of both substantive change and fine tuning, largely directed toward concerns about fairness or equity, which was translated into identifying perceived loopholes and unintended benefits and trying to eliminate them. This led to a series of revenue acts commencing in 1962 and extending for nearly 15 years, culminating in the Tax Reform Act of 1976. The principal acts falling into this period were the Revenue Acts of 1962 and 1964, the Tax Reform Act of 1969, the Revenue Act of 1971, and the Tax Reform Act of 1976.

The **Revenue Act of 1962** was the most significant piece of tax legislation to follow the 1954 changes. Its stated purposes were to: stimulate economic growth in the United States; improve our competitive position abroad; raise our standard of living at home; and improve the "equity" of our tax structure.

To accomplish the first objective, the investment tax credit was introduced into the Code. To achieve the latter, travel and entertainment expenses were restricted; bad debt provisions for financial institutions were reduced; changes were made in the taxation of foreign operations, including the taxation of Americans working abroad; depreciation recapture was adopted for depreciable assets other than real estate; and changes were made to improve compliance.

A major change in the corporate and individual rate structure occurred in the **Revenue Act of 1964**. The range in individual tax rates during the latter stages of World War II was 23% to 94%. The top rate came into play at $200,000 for a joint return. There was an overall ceiling on the total tax burden of 90% for 1944 and 1945, and ranging from 77% to 88% during the Korean War.

A rate structure ranging from 20% to 91% was in effect until 1964 when it was reduced to 16% to 77%, and to 14% to 70% commencing in 1965. These rates remained in place until the 1981 Act, except for temporary surtaxes in the late 1960s. The top corporate rate was reduced from 52% to 50% in 1964, and to 48% in 1965.

The **Tax Reform Act of 1969** was intended to be a substantive and comprehensive reform of our income tax laws. To a considerable extent, it was motivated by disclosures that a number of individuals with high levels of adjusted gross income ($200,000 or more) were paying little or no taxes.

The investment tax credit enacted seven years earlier was repealed. The increased tax revenues anticipated through repeal of the investment credit (over $8 billion over three years) and other "reform" measures were more than offset by the reduction in the tax burdens of lower income groups. The tax reform objectives were achieved largely through imposition of the tax preference system, another blow for simplification. Tax relief for lower income groups was achieved primarily through small rate reductions and increases in the standard deduction and low-income allowance. In addition, a top rate of 50% on earned income was adopted.

The stated purposes of the **Revenue Act of 1971** were to provide a balanced program of tax reductions for individuals and tax incentives for business. Key members of Congress expressed concern about high unemployment, the impact of inflation on taxes, the need to modernize productive facilities, and our declining level of exports.

One of the major provisions in the 1971 Act was restoration of the investment tax credit under a new name, "Job Development Investment Credit." To stimulate exports, the DISC approach was adopted. Individual tax reductions were created by increases in personal exemptions and the standard deduction. A stated reason for the individual changes was to alleviate the impact of inflation, sometimes referred to as *Ad Hoc* Indexation, or *Political* Indexation.

The **Tax Reform Act of 1976**, over three years in the making, was intended to review the entire tax structure to eliminate perceived abuses and unintended benefits. Extensive hearings were held on tax shelter schemes, the treatment of foreign source income, the regulation of tax professionals, and many administrative provisions.

When completed, the Act contained such things as:

☐ Capitalization of construction period interest and taxes;

☐ Recapture of depreciation on real property;

☐ Strengthening the maximum tax on preferences;

☐ Restrictions on DISC (incremental approach); and

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- ☐ Tougher rules on foreign tax credits for foreign oil and gas operations.

Another part of the 1976 Act was the elimination of many so-called deadwood provisions that had accumulated in the Internal Revenue Code over many years. Nearly 150 sections of the Code were repealed and major deletions were made in 850 others.

Following the 1976 Reform Act, Congress began to show more concern about economic issues and the impact of the tax system on savings and investment. The next two major pieces of legislation were the **Revenue Act of 1978** and the Economic Recovery Tax Act (ERTA) of 1981. Both of these tax bills made significant changes intended to encourage savings and investment, to recognize the impact of inflation on the tax system, and generally to stimulate the economy.

The centerpiece of the 1978 Act was the major reduction in capital gains taxes. Ironically, the capital gains changes originated from proposals made by the Carter Administration that would have increased the level of taxation. Congress quickly rebelled over this proposal, as well as a number of others recommended by the Administration, and the final product went in the other direction. From a theoretical top rate of nearly 50% on long-term gains, the maximum rate dropped to 28%.

Aside from the capital gains changes, individual tax reductions were accomplished through widening tax brackets and changes in the zero bracket amount, formerly called the standard deduction.

At the business level, the corporate tax rate was reduced from 48% to 46% with a graduated structure from 17% to 46% up to $100,000 of taxable income. The investment tax credit was liberalized, and the rate (10%) made "permanent," and increased incentives were enacted for rehabilitating older structures. The minimum tax on tax preferences for individuals was changed by removing capital gains as a preference item and subjecting them to a new alternative minimum tax in place of the add-on scheme previously applicable.

ECONOMIC RECOVERY TAX ACT OF 1981 (ERTA)

From a conceptual viewpoint, ERTA was probably the most important piece of tax legislation we have seen in a quarter of a century. It was the first major tax bill under the Reagan Administration. It made dramatic changes in our system for cost recovery, investment incentives, overall tax rates, recognition of inflation, and estate and gift taxes. As its title suggests, its principal objectives were to create incentives for economic development and to reduce or eliminate disincentives for savings and investment.

The Act started with a fairly simple program proposed by the Administration that would have reduced individual taxes over a three-year period by roughly 30% and stimulated business investment through a new cost recovery system, essentially the so-called 10-5-3 approach.

With a Republican-controlled Senate and a Democratic-controlled House, however, consideration of the Administration proposals quickly evolved into a political bidding contest. The finished product went far beyond the initial proposals and, even though ultimately backed by the President, it probably went beyond what he and his top advisors really wanted.

Among other things, ERTA:

- ☐ Reduced the top individual rate to 50% on all types of income and the entire rate structure by about 25% over three years;
- ☐ Indexed individual tax brackets commencing in 1985;
- ☐ Created a new cost recovery system (ACRS) for depreciating business assets;
- ☐ Permitted a tax credit for "incremental" research and development expenditures; and
- ☐ Provided major reduction in estate and gift taxes.

Even though its principal business provisions were slanted toward encouraging capital investment, business groups generally, both capital and labor intensive, rallied behind the program and actively supported it. This was caused in large part by the President's personal appeal to leading business groups, and broadly based support was generated.

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA)

The driving force behind the 1982 Act was concern over rising Federal deficits. This led to the reexamination of major portions of ERTA and a redirection of tax policy toward loophole closing and eliminating perceived abuses.

Essentially, TEFRA took back many of the benefits of ERTA. It provided the Internal Revenue Service a new arsenal of weapons to seek compliance with existing tax laws. It attempted to address abuses involving corporate mergers and acquisitions and employee retirement plans. Its dominant objective, however, was to generate tax revenues.

Among other things, TEFRA:

- ☐ Reduced medical and casualty loss deductions;
- ☐ Expanded the alternative minimum tax system;
- ☐ Reduced benefits from ACRS and the investment tax credit;
- ☐ Repealed safe harbor leasing;
- ☐ Tightened rules for completed contract method;
- ☐ Enacted changes in tax rules for mergers and acquisitions;
- ☐ Made major changes in pension programs;
- ☐ Reduced possessions' corporation benefits, primarily Puerto Rico;
- ☐ Increased taxes on certain life insurance companies; and
- ☐ Adopted several provisions intended to improve compliance with tax laws, including greater penalties for underpayment of tax, increased information reporting, withholding on payments of dividends and interest.

Contrary to strong business support for the 1981 Act, the development of TEFRA divided the business community. The net result was that most business groups were ineffective in opposing major changes that were adverse to their interests.

In the final analysis, the President again put his neck on the line and, through his personal persuasion, prevailed upon Congress to pass a package that I suspect he and many of his top advisors did not really like. However, the size of anticipated budget deficits led to the enactment of many provisions that are distasteful, to say the least, to major segments of the taxpaying population.

Finally, while the reductions under ERTA were divided roughly 80%-20% between individual and business taxpay-

ers, increases under TEFRA went in the other direction. More than half of the benefits under ERTA for business were repealed by TEFRA.

GRADING 25 YEARS OF TAX LEGISLATION

We noted earlier the criteria that are usually applied to evaluate tax proposals. If we use them to grade the bills we have discussed earlier, either separately or collectively, and on a scale of 1 to 10, I would give Congress no better than a "6." Some bills were better than others, but none deserve very high marks. ERTA probably rates an "8."

With respect to "equity and fairness," assuming we can agree on what those terms really mean, some areas of abuse have been modified or eliminated over the last 25 years. For example, it is more difficult today to structure flimsy tax shelter arrangements, where a taxpayer can achieve huge writeoffs in excess of his real investment, with little or no economic substance. It is more difficult for taxpayers with large amounts of economic income to completely avoid taxes.

The improvements in making the system more equitable have been achieved largely at the expense of much greater complexity. Income averaging, the preference tax system, complex rules governing charitable contributions and many other items that we can think of have made the system incomprehensible to millions of taxpayers. The phenomenal growth in tax return preparation services over the last quarter century is a clear indication of the fact that most taxpayers simply cannot cope with our complex tax system.

In this regard, a great deal of the complexities that have been created stem from the almost fanatical compulsion of the tax writing committees and staffs to try to achieve perfection and to anticipate every conceivable way that a provision might be avoided.

With respect to economic impact, the system still contains some bias against savings and investment, although it was better after the 1981 Act than 25 years earlier. Adoption of the ACRS system in 1981 and more cautious changes made earlier with the ADR tax depreciation system recognized to some extent the impact of inflation on business investment. By permitting more rapid recovery of cost, the risk of erosion of investment caused by inflation is reduced. The expansion of tax deferred investment vehicles, such as HR-10 plans and IRAs, is providing significant incentives for savings.

In my view, the most important change in our income tax structure over the last 25 years is the reduction in tax rates. This started on a modest scale in 1964, was continued when the maximum tax on earned income system was adopted in 1969, and reached fruition in 1981 with the reduction in the top individual rate and the top estate tax rate to 50%.

I have always felt that the greatest cause of artificial tax planning schemes and abusive tax shelters is high individual tax rates. When an individual has significant amounts of income subject to Federal taxation at a 70% rate or higher, he is less concerned about the economics and substance of an investment since he is investing one of his dollars to two of the government's.

The 1982 Act, TEFRA, is obviously not my choice for the best tax bill of the century. With the possible exception of eliminating some abuses in the mergers and acquisition and retirement plan areas, I give TEFRA low marks by almost any criteria. The dominant motive behind TEFRA was purely and simply dollars. The Congressional budget committees directed the tax committees to raise $100 billion over three years, and that is precisely what they did, if you can believe the revenue estimates that attach to TEFRA's various provisions. I give TEFRA about a "3."

WHERE DO WE GO FROM HERE?

Debate on tax policy in the 98th Congress seems to be starting out on pretty much the same basis as 1982. Understandably, Congressional leaders are concerned about projected budget deficits in the $200 billion range and up, not only for fiscal 1984 but stretching well into the future.

The deficit arises because projected spending (around $850 billion for fiscal 1984) exceeds anticipated revenues (about $650 billion). It does not take a genius to note that it can be reduced by (1) increasing revenues, (2) decreasing expenditures, or (3) a combination of these. To the extent the budget deficit is not reduced, the government must borrow and this puts further pressure on the available capital in this country, where the government is already taking an increasingly large share in competition with the private sector.

While none of us likes to see large government deficits, particularly continuing indefinitely into the future, some believe that, when the economy is still relatively weak even though showing some signs of recovery, it may be better to live with deficits than to impose additional taxes on a fragile economy. Our main concern now should be to encourage the economy to grow, and to encourage people to save, so that more capital will be available at a reasonable price.

Congress is obviously faced with a real dilemma, and it will have to balance conflicting demands in attempting to come up with a solution which is the least bad of several undesirable alternatives. The end result is likely to be another round of tinkering with the tax system, much like that in 1982.

Since different tax changes affect different groups in different ways, we see great tension between different sectors of our economy. Small business vs. large business, labor vs. capital intensive, companies involved in research and high technology, particular problems of service industries—these often create conflicting demands for changes in our tax system. The somewhat uniform business backing for the 1981 Act seems a thing of the past, and we are likely to see greater stress on the tax legislative process further into the 1980s.

CREDIBILITY OF REVENUE ESTIMATES

We have noted that the dominant factor behind the 1982 Act, and probably 1983, is raising revenues. This leads to the question of how revenue estimates from tax changes are determined. This has been a controversial factor in tax legislative deliberations for many years and needs to be reexamined.

Basically, when a tax change is proposed, the staffs of the Treasury Department, Joint Tax Committee and, in some cases, the Congressional Budget Office, develop estimates based on the number of taxpayers affected, the volume of economic activity that might be involved, assumptions as to inflation and the rate of growth in a particular economic sector, and other factors. This results in a dollar figure relating to the particular change. Generally, this approach assumes no change in taxpayer behavior if the tax laws are changed.

Common sense suggests this is seldom a valid assumption. Traditional revenue estimates also generally don't consider secondary or tertiary effects—so-called feedback. A couple of examples illustrate this point.

In 1978, when capital gain reduction was under consideration, Treasury officials estimated that reducing capital gains taxation would reduce tax revenues by approximately $2 billion for 1979, the first full year of the reduction. Advocates of capital gain reduction argued that, if rates were reduced, the volume of transactions generating gains would increase, taxpayers locked into an investment would have greater incentive to liquidate their holdings and, on an overall basis, including additional commissions for securities dealers, tax revenues might increase. This is precisely what happened. Rather than a revenue loss for 1979 of $2 billion, recent analyses show that tax revenues from capital gains transactions *increased* by nearly $2 billion for 1979, and $700 million for 1980.

Another recent example involves an estimate of the tax effect of eliminating the current deductibility of intangible drilling costs (IDC) for oil and gas wells. Joint Tax Committee staff estimates indicate a revenue gain while a Price Waterhouse study of this issue came up with the conclusion, with which I fully agree, that eliminating the intangible drilling cost expensing election would probably cause a revenue loss. Elimination of current expensing of IDC would probably decrease exploration and drilling activities which would cause cutbacks in sales of goods and services for items used in drilling. Earnings and taxes of drilling workers would be cut back, and businesses providing drilling services would have lower profits which, in turn, would reduce their taxes.

Revenue estimating is not an exact science, whether under the traditional static approach or considering feedback and other changes that might occur if tax changes are enacted. Since estimated revenue effects are given such importance by Congressional committees, however, I hope that a better method of estimating can be developed.

PROSPECTS FOR THE 1980s

There is more concern today about the complexity of the tax system than I have ever seen. The frequency of changes as well as their magnitude makes it almost impossible for even highly skilled tax professionals to keep current. This creates almost insurmountable problems for the Internal Revenue Service and Treasury Department who must interpret and administer these changes through regulations and rulings. The backlog of regulations projects is nearly 500, and the Chief Counsel's Office at the IRS is losing ground.

Congress is beginning to show interest in broad conceptual changes in the tax system, rather than continuing to tinker with the income tax rules. There is growing support for the proposition that our present income tax system, as the major source of Federal revenues, has outlived its usefulness. A broadly based income tax system, with a single rate (sometimes called a flat tax) or a smaller number of progressive rates, has generated a great deal of rhetoric and in time may receive serious consideration.

The Bradley-Gephardt approach, now called the "Fair Tax" system, has probably received more attention than other flat tax proposals. The Fair Tax bill would materially broaden the income tax base by eliminating most deductions and credits. However, payments by individuals for home mortgage interest and taxes, charitable contributions, state income taxes, and contributions to IRAs and Keogh plans would continue to be deductible. A 14% tax rate would apply to this broadened tax base. A surtax of 12% would apply to adjusted gross income (AGI) in excess of $25,000 ($40,000 on joint returns), and 16% on AGI over $37,500 ($65,000 on joint returns).

Because of the structure of the tax, itemized deductions such as contributions, mortgage interest, and state income and property taxes would generate tax benefit only at the basic 14% rate.

Corporations would pay a flat rate of 30%, and many existing deductions, credits, and exemptions available to business entities would no longer be allowed.

The Bradley-Gephardt approach is cleverly constructed. By retaining deductions for homeowners' mortgage interest and taxes and charitable contributions, it tries to avoid the political land mines that other flat tax proposals are likely to encounter. Charitable institutions and real estate and construction groups are powerful adversaries against any tax proposals that would jeopardize their interests.

The alternative of moving toward a consumption tax will have to be explored seriously before this decade is over. With anticipated continuing high deficits and the need for a broader and more stable tax base, a consumption tax has a lot of appeal. The two types being discussed most frequently are (1) a transactional tax like a value-added or national sales tax and (2) an annual determination of total consumption, to be taxed under a graduated rate structure. This latter approach was suggested by the Ford Administration Treasury team in its "Blueprints for Basic Tax Reform," issued over six years ago.

The major political factors arguing against Federal consumption taxes generally relate to the redistribution of tax burden among taxpayer groups and shifting toward a more regressive tax system. These problems can be answered to some extent by the way the tax is structured, but there remains a strong perception of regressivity about any consumption tax. This will create significant political problems whenever such an approach is seriously proposed.

We have tinkered with the income tax system long enough and have tried to use it to accomplish objectives that it cannot solve effectively. It is time for a change. With all of the traumatic problems we are likely to have in switching to a new type of tax structure, whether consumption-oriented, fair tax, or flat tax, I firmly believe that is the direction tax policy should take in the next decade.

About the Author

WILLIAM C. PENICK recently retired as Senior Partner–Legislative Tax Policy for Arthur Andersen & Co., in Washington, D.C. Mr. Penick serves on the Board of The Tax Council and is a member of Tax Foundation's Tax Advisory Group. He has been involved in tax policy matters with the American Council for Capital Formation, the American Enterprise Institute, and the American Institute of Certified Public Accountants.

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