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THE FEDERAL INDIVIDUAL INCOME TAX:

Revising the Rate and Bracket Structure

November 1959

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FOREWORD

This is the fourth in a series of Tax Foundation studies reviewing major areas of Federal taxation. The first, *Federal Excise Taxes,* was published in 1956; the second, *Are High Surtax Rates Worthwhile?,* in 1957; and the third, *Reexamining the Federal Corporation Income Tax,* in 1958.

The present study is an examination of the rate and bracket structure of the individual income tax. That structure needs revision in order to reduce inequities, to minimize distorting effects on economic decisions, and to promote economic growth. With the exception of income splitting there has been no essential change in the basic characteristics of the rate and bracket structure since 1942. In the meantime, inflation has substantially changed the real impact of the tax. Moreover, economic conditions have markedly changed since then, as have the objectives of public policy.

While many specific features of the tax law have been revised since World War II, and there has been one complete revision of the details of the Internal Revenue Code (1954), there has not been until 1959 any attempt at an overall reexamination and revision of the general features of the Federal revenue system. The general tax revision hearings being conducted in 1959 by the House Committee on Ways and Means may lead to such a general revision. The recent highlighting of our scientific and industrial race with Russia should provide an added stimulus to tax reform for the promotion of economic growth as well as to improve the equity of the tax system. The revisions in the income tax structure suggested in the present study are aimed at these objectives.

The basic research and drafting of this study was done by or under the direction of George Bishop, Senior Researcher. Grateful acknowledgment is made to the corporation tax executives and others, both in government and academic circles, who read drafts of this study and made many helpful suggestions.

The Tax Foundation, a non-profit organization, is engaged in research and public education on government education and taxation. Its purpose is to aid in the development of more efficient government at less cost to the taxpayer. It also serves as a national information agency for organized taxpayer research groups throughout the country.

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THE FEDERAL INDIVIDUAL INCOME TAX:

Revising the Rate and Bracket Structure

I. SUMMARY AND CONCLUSION

The rate and bracket structure of the Federal individual income tax needs to be revised in order to reduce inequities, to minimize distorting effects on economic decisions, and to promote economic growth.

Revision is badly needed because with the exception of income splitting there has been no essential change in the basic characteristics of the rate and bracket structure since 1942. In the meantime, the real impact of the income tax has been substantially changed, in an unplanned way, because of inflation. Moreover, the objectives of public policy have changed, and those that were most significant in moulding the rate and bracket structure of the income tax—redistribution and limitation of income—have lost their relevance. Other policy objectives, particularly the promotion of economic growth, have become of central importance and demand a revision of the rate and bracket structure of the income tax.

Revision of Rates and Brackets

The bracket structure of the income tax needs revision in order to make it conform more closely with general notions of equity and with the basic facts of income distribution. Considerations of equity and the nature of income distribution suggest that the relative sizes of the brackets should be made more uniform.

The present bracket structure fails to differentiate sufficiently among taxpayers in the initial brackets and among taxpayers in the topmost brackets. Under the present structure, two-thirds of all income taxpayers are subject only to the first bracket rate of tax. Equity would seem to justify further differentiation of marginal rates for these taxpayers.

At the top of the present structure differentiation of marginal rates stops at $200,000 for single persons and at $400,000 for married persons filing joint returns. There is a wide range of individual incomes above $200,000 which serves a useful economic purpose. The function of economic incentives at the top of the income scale should not be almost completely eliminated by a marginal rate of 91 percent on additional income.

Considerations of equity, revenue and economic effects, all lead to the conclusion that the highest bracket rates of the present structure should be reduced. A reduction of the highest bracket rates would promote economic growth and involve little, if any, revenue loss. It would reduce the distorting effects of the income tax, lessen pressures to provide "escape valves," and mitigate inequities under the present tax.

This study includes alternative rate and bracket structures to illustrate the kinds of revision needed in the present structure, namely, greater uniformity in the widths of taxable income brackets, greater differentiation of marginal rates in the initial and the topmost brackets, and reduction of the highest bracket rates.

The Tax Base

A general tax revision should also include further efforts to reduce inequities and favoritism in the tax law. However, it must be recognized that many of the most widely discussed so-called "leakages"—income splitting, the dividend credit, percentage depletion, the general treatment of capital gains—represent major features of the tax system all of which involve specific problems of tax policy and were adopted after due consideration and for good reason. They cannot be treated merely as cases of income inadvertently or unjustifiably removed from the tax base. These specific cases must be examined in the light of the special policy considerations which led to their adoption and the relevance of these policies today.

As estimated at current income levels, the revenue effects of the kind of tax revision suggested in this study would be substantial. However, the rapid growth of Federal receipts under prosperous conditions in recent years indicates the sizable growth possible in the future — budget receipts for 1960 are currently estimated to be $19 billion higher than in 1955. It is evident that merely holding the line on Federal expenditures will in the course of ordinary growth provide a more than ample margin for the kind of tax revision and reduction suggested in this study even without the substantial stimulus to economic growth that may be expected from these changes.

II. TAX POLICY AND THE INCOME TAX STRUCTURE

A. FORMATION OF THE PRESENT RATE AND BRACKET STRUCTURE OF THE INCOME TAX

The present structure of rates and taxable income brackets under the Federal individual income tax is a legacy of the depression of the 1930's and World War II. The depression resulted in a sharply progressive rate structure. In the late 1920's the top rate of the income tax was 25 percent; by 1936 the top rate had been raised to 79 percent (Table 1). Redistribution of income was then a central issue of tax policy.[1]

World War II produced another great change in the Federal income tax. Not only were rates further raised, but also the taxable income brackets were narrowed and the level of per capita exemptions was sharply reduced, making high rates applicable to much lower levels of income. In 1939 the top rate of 79 percent applied to taxable income in excess of $5 million; under the Revenue Act of 1942 the top rate of 88 percent was applied to taxable income in excess of $200,000. In 1939 only the "normal tax" of 4 percent applied to taxable income under $4,000; under the Revenue Act of 1942 the first bracket rate (combined normal and surtax rate) was 19 percent of the first $2,000 of taxable income (Table 1). For a married couple with two children exemptions were reduced from $3,300 in 1939 to $1,900 in 1942 (Table 2).

The rate and bracket structure of 1942 reflected the wartime disregard of the effects of taxation on incentives —patriotic motives could then be relied on to ensure a maximum productive effort. The 1942 structure also reflected wartime controls on wages, salaries and profits. In 1942, President Roosevelt, in a special message to Congress, said: "I . . . believe that in time of this grave national danger, when all excess income should go to win the war, no American citizen ought to have a net income, after he has paid his taxes, of more than $25,000 a year." While Congress did not go quite that far, it did push down and squeeze together the prewar tax structure to extract the maximum amount of revenue and to make the tax a kind of excess-income tax.

It is a remarkable fact that, except for income splitting, the present structure of taxable income brackets is exactly the same, and the present structure of rates is very nearly the same, as under the Revenue Act of 1942. The first bracket rate is now 20 percent on the first $2,000 of taxable income as compared with 19 percent under the Revenue Act of 1942. The top bracket rate is now 91 percent on taxable income in excess of $200,000; under the Revenue Act of 1942 the top rate was 88 percent on taxable income in excess of $200,000. The exemption for a married couple is now $1,200, exactly as under the Revenue Act of 1942.

The major difference between the present rate and bracket structure and that of 1942 is a result of the provision for income splitting adopted in 1948, which lowered the effective rates on married persons filing joint returns.[2]

Between the Revenue Act of 1942 and the Internal Revenue Code of 1954 (present rates have been unchanged since 1954) there were various changes in rates and flat percentage increases and decreases in tax. These changes, however, were superimposed on the 1942 rate and bracket structure, with the emphasis always on the *changes* that were being made under each Revenue Act, and with very little attention to the basic characteristics of the structure.

The emphasis in these changes tended to be on whose taxes were being increased or decreased the most. The pressure has been to make tax *increases* progressive or at least proportional, and then to make tax reductions relatively favorable to the low income groups. As Dan Throop Smith has expressed it:

> ". . . the pattern of individual income tax rates has been developed over the years as a succession of changes in a pre-existing rate structure. Instead of looking primarily at the end result, that is, at the new pattern of rates, the attention of the public is usually centered on the *changes* in rates, viewed by themselves. This fact is responsible, I suspect, for the extremely high rates in the upper brackets—rates which are not only repressive but appear to be excessive by almost all ethical standards except those based on extremes of equalitarianism."[3]

In 1944 and 1945 rates were raised to their wartime peak—23 percent in the first bracket and 94 percent in the top bracket. In 1946 three percentage points were taken off each bracket rate in the scale, and to the tax calculated at these reduced rates a further flat five percent reduction was applied.

In 1948 the flat five percent reduction in tax calculated at the "tentative" rates was increased to 17 percent on the amount of tax up to $400, 12 percent on the amount

[1] Cf. R. G. Blakey and G. C. Blakey, *The Federal Income Tax* (New York, 1940), Chapter XV.

[2] Other notable changes were the shift to a flat per capita exemption (Revenue Act of 1944) and the partial application of income splitting to heads of households (Revenue Act of 1951).

[3] "The Philosophy of Tax Policy," *1953 Proceedings*, National Tax Association, p. 541.

Table 1
FEDERAL INDIVIDUAL INCOME TAX: COMBINED NORMAL TAX AND SURTAX RATES
Income Years 1913-1959

Taxable Income[a]		Act of October 3, 1913	Revenue Act Of 1916	1917	1918, 1921		1921	1924	1926, 1928	1932	1934	1936, 1938
Over (Thousands)	Not Over	March 1, 1913-December 31, 1915	Income Year 1916	1917	1918	1919-1921	1922, 1923[b]	1924	1925-1931[c]	1932, 1933	1934, 1935	1936-1939
$ 0	$ 2	—	—	—	—	—	—	—	—	—	4%	4%
2	4	—	—	2%	6%	4%	4%	2%	—	4%	4	4
4	5	1%	2%	4	6	4	4	2	1½%	4	8	8
5	6	1	2	5	7	5	4	2	1½	4	8	8
6	7.5	1	2	5	14	10	5, 9	2	1½	5	9	9
7.5	8	1	2	6	14	10	9	4	1½	9	9	9
8	10	1	2	6	15	11	9	4	3	9	10	10
10	12	1	2	7	16	12	10	7	4	10	11	11
12	14	1	2	7, 8	17	13	11	7	6	11	12	12
14	16	1	2	8, 9	18	14	12	8	7	12	13	13
16	18	1	2	9	19	15	13	9	8	13	15	15
18	20	1	2	9	20	16	14	10	9	14	17	17
20	22	2	3	12	21	17	16	11	10	16	19	19
22	26	2	3	12	22, 23	18, 19	17, 18	12, 13	11, 12	17, 18	21	21
26	28	2	3	12	24	20	19	14	12	19	23	23
28	30	2	3	12	25	21	20	15	13	20	23	23
30	32	2	3	12	26	22	21	16	13	21	23	23
32	36	2	3	12	27, 28	23, 24	23	16, 17	14	23	25	25
36	40	2	3	12	29, 30	25, 26	24, 25	18, 19	15	24, 25	25, 28	25, 28
40	44	2	4	16	31, 32	27, 28	26, 27	19, 20	16	26, 27	28	28
44	48	2	4	16	33, 34	29, 30	28, 29	21, 22	17	28, 29	31	31
48	52	2, 3	4	16	35, 36	31, 32	30, 31	23, 24	18	30, 31	31, 34	31, 35
52	56	3	4	16	37, 38	33, 34	32, 33	25	19	32, 33	34	35
56	60	3	4	16	39, 40	35, 36	34, 35	26, 27	20	34, 35	37	39
60	66	3	5	21	41–43	37–39	36–38	27–29	21, 22	36–38	37, 40	39, 43
66	70	3	5	21	44, 45	40, 41	39, 40	30, 31	22	39, 40	40, 43	43, 47
70	74	3	5	21	46, 47	42, 43	41, 42	32	23	41, 42	43	47
74	76	3, 4	5	21	48	44	43	33	23	43	46	51
76	80	4	5	21	49, 50	45, 46	44, 45	34	23	44, 45	46	51
80	86	4	6	26	51–53	47–49	46–48	35–37	24	46–48	49	55
86	90	4	6	26	54, 55	50, 51	49–50	37, 38	24	49, 50	49	55
90	96	4	6	26	56–58	52–54	51–53	39-41	24	51–53	54	59
96	100	4	6	26	59, 60	55, 56	54, 55	42	24	54, 55	54	59
100	150	5	7	31	64	60	56	43	25	56	56	62
150	200	5	8	35	68	64	57	43	25	57	57	64
200	300	5, 6	9, 10	41, 46	72	68	58	44	25	58	58	66, 68
300	500	6	11	50	75	71	58	45	25	59, 60	59, 60	70, 72
500	1,000	7	12	54, 59	76	72	58	46	25	61, 62	61, 62	74, 76
1,000	1,500	7	13	65	77	73	58	46	25	63	63	77
1,500	—	7	14, 15	66, 67	77	73	58	46	25	63	63	77–79

(Continued)

Table 1 (Continued)

Taxable Income[a] Over	Not Over	Revenue Act of 1940	1941	1942	1944	1945, 1948, 1950	1951	1951	Internal Revenue Code of 1954
(Thousands)		Income Year 1940[d]	1941	1942, 1943[e]	1944, 1945	1946-1950[f]	1951	1952, 1953	1954-1959
$ 0	$ 2	4%	10%	19%	23%	20%	20.4%	22.2%	20%
2	4	4	13	22	25	22	22.4	24.6	22
4	6	8	17	26	29	26	27	29	26
6	8	10	21	30	33	30	30	34	30
8	10	12	25	34	37	34	35	38	34
10	12	14	29	38	41	38	39	42	38
12	14	16	33	42	46	43	43	48	43
14	16	19	36	46	50	47	48	53	47
16	18	22	39	49	53	50	51	56	50
18	20	25	42	52	56	53	54	59	53
20	22	28	45	55	59	56	57	62	56
22	26	31	48	58	62	59	60	66	59
26	32	34	51	61	65	62	63	67	62
32	38	37	54	64	68	65	66	68	65
38	44	40	57	67	72	69	69	72	69
44	50	44	59	69	75	72	73	75	72
50	60	48	61	72	78	75	75	77	75
60	70	51	63	75	81	78	78	80	78
70	80	54	65	78	84	81	82	83	81
80	90	57	67	81	87	84	84	85	84
90	100	60	68	83	90	87	87	88	87
100	150	62	69	85	92	89	89	90	89
150	200	64	70	87	93	90	90	91	90
200	300	66, 68	71, 73	88	94	91	91	92	91
300	500	70, 72	75, 76	88	94	91	91	92	91
500	1,000	74, 76	77, 78	88	94[g]	91[g]	91[g]	92[g]	91[g]
1,000		77–79	79–81	88	94[g]	91[g]	91[g]	92[g]	91[g]

[a] Prior to 1934 the entire net income was subject to surtax; for 1934 and subsequent years net income less personal exemptions and credits for dependents was subject to surtax. For the purpose of this table in years prior to 1934 the normal tax rates were added to the surtax rates by including in "taxable income" for normal tax the exemptions for a married couple with one child and adding the normal tax rate in the closest corresponding surtax income bracket. For 1948 and subsequent years the tax on joint returns is computed on half of the taxable income and then multiplied by two.

[b] The tax for 1923, computed at these rates, was reduced 25% by credit or refund under the Revenue Act of 1924.

[c] Normal tax rates for 1929 were reduced by one percentage point by Joint Resolution of Congress, No. 133, approved by President December 16, 1929.

[d] In 1940 there was a defense tax of 10% of the normal tax and surtax (limited to 10% of the excess of net income over the sum of the normal tax and surtax).

[e] In 1943 there was also a Victory tax of 5% of income in excess of $624 less certain credits (see footnote h to Table 2).

[f] Tentative rates. The tax computed at these rates was reduced by 5% for 1946 and 1947. For 1948 and 1949 the total normal tax and surtax were reduced by 17% of tax up to $400, 12% of tax from $400 to $100,000 and 9.75% of the excess over $100,000. For 1950 the reductions were 13%, 9% and 7.3% respectively for these amounts of tax.

[g] The maximum effective rates of the income tax on net income were as follows: 1944 and 1945, 90%; 1946 and 1947, 85.5%; 1948 and 1949, 77%; 1950, 80%; 1951, 87.2%; 1952 and 1953, 88%. Under the Internal Revenue Code of 1954, the maximum is 87% of taxable income.

Source: Treasury Department.

Table 2

FEDERAL INDIVIDUAL INCOME TAX: EXEMPTIONS, CREDITS, TREATMENT OF DIVIDENDS, AND NORMAL TAX RATES

Income Years 1913-1959

Revenue Act	Income Year	Personal Exemptions and Credit for Dependents			Earned Income Credit				Treatment of Dividends	Normal Tax	
		Married Person[a]	Single Person	Credit for Each Dependent	Kind of Credit	Earned Net Income	Credit	Limit of Credit		On Taxable Income[b]	Rate
1913[c]	1913–1915	$4,000	$3,000	None	None				Exempt from normal tax	All	1%
1916	1916	4,000	3,000	do.	do.				do.	do.	2
1917	1917	2,000	1,000	$200	do.				do.	$0 –$2,000	2
										Over 2,000	4
1918	1918	2,000	1,000	200	do.				do.	0 – 4,000	6
										Over 4,000	12
	1919, 1920	2,000	1,000	200	do.				do.	0 – 4,000	4[d]
1921	1921–1923	2,500[e]	1,000	400	do.				do.	Over 4,000	8[d]
1924	1924	2,500	1,000	400	Against tax	All net income up to $5,000, whether earned or not, and up to $10,000 if earned.	25% of normal tax on earned net income.	25% of normal tax on entire net income.	do.	0 – 4,000	2
										4,000 – 8,000	4
										Over 8,000	6
1926, 1928	1925–1931	3,500	1,500	400	Against tax	All net income up to $5,000, whether earned or not, and up to $20,000 in 1925-1927 and $30,000 in 1928-1931, if earned.	25% of total tax on earned net income.	25% of normal tax on entire net income plus 25% of surtax on earned net income.	do.	0 – 4,000	1½[f]
										4,000 – 8,000	3[f]
										Over 8,000	5[f]
1932	1932, 1933	2,500	1,000	400	None				do.	0 – 4,000	4
										Over 4,000	8
1934	1934, 1935	2,500	1,000	400	Against net income	All net income up to $3,000, whether earned or not, and up to $14,000 if earned.	10% of earned net income.	10% of entire net income.	do.	All	4
1936-1938	1936–1939	2,500	1,000	400	do.	do.	do.	do.	Fully taxable	do.	4
1940	1940	2,000	800	400	do.	do.	do.	do.	do.	do.	4[g]
1941	1941	1,500	750	400	do.	do.	do.	do.	do.	do.	4
1942	1942, 1943	1,200	500	350	do.	do.	do.	do.	do.	do.	6[h]
1944, 1945	1944–1947	1,000[i]	500[i]	500[i]	None				do.	do.	3[j]
1948, 1950, 1951	1948–1953	1,200	600	600	do.				do.	do.	3[k]
Internal Revenue Code of 1954	1954–1959	1,200	600	600	do.				First $50 excluded from gross income[m]	do.	3[l]

[a] For the years 1916-1943 the personal exemption allowed to married persons was also allowed to heads of families. For 1948 and subsequent years an additional exemption of $600 is granted to persons over 65 and to the blind.
[b] Net income less personal exemptions, credit for dependents and, in 1934-1943, earned income credit.
[c] Tariff Act of October 3, 1913. Tax effective on income for last 10 months of 1913.
[d] Tax for 1923 was reduced 25% by credit or refund under Revenue Act of 1924.
[e] For net incomes in excess of $5,000, personal exemption was $2,000.
[f] Reduced by one percentage point for 1929 by Joint Resolution of Congress, No. 133, approved by President December 16, 1929.
[g] In addition in 1940 there was a defense tax of 10% of normal tax and surtax (limited to 10% of excess of net income over sum of normal tax and surtax).
[h] In addition in 1943 there was a Victory tax of 5% of income in excess of $624 less credits of 25% of the tax for single persons, 40% for married persons or heads of families, and 2% for each dependent, with maximum credits of $500, $1,000, and $100 respectively.
[i] Surtax exemptions, 1944 and 1945; in these years the normal tax exemption was $500 per taxpayer.
[j] Tentative rate reduced by 5% for 1946 and 1947.
[k] Tentative rate 1948-1950. Reductions for 1948 and 1949 were 17% of total normal tax and surtax up to $400, 12% of tax from $400 to $100,000, and 9.75% of tax in excess of $100,000; reductions for 1950 were 13%, 9%, and 7.3% respectively, for these amounts of tax.
[l] In the Internal Revenue Code of 1954 the 3% normal tax and the surtax rates were combined in a single set of rates.
[m] 4% of taxable dividends received after July 31, 1954, allowed as a credit against the tax otherwise due. The credit may not exceed 2% of taxable income in 1954, and 4% thereafter, or the amount of the tax due, whichever is less.

Source: Treasury Department.

of tax from $400 to $100,000, and 9.75 percent of the tax in excess of $100,000.

During the Korean War these reductions were eliminated and under the Revenue Act of 1951 rates were raised by 11 percent in the first bracket, and 11.75 percent in other brackets (but limited so that the increase in any individual total tax would not exceed 9 percent of taxable income less the tax under previous law).

In 1954 the Korean War tax increase expired and the rate schedule reverted to the immediate postwar rate schedule which was 3 percentage points lower in each bracket than the peak World War II rates, and nearly the same as the rate schedule under the Revenue Act of 1942.

In short, there has been no revision of the basic characteristics of the rate and bracket structure since 1942. Rate changes have been made under the pressures of the moment, but no fundamental revision of the rate and bracket structure has been attempted.

B. NEED FOR REVISION OF THE RATE AND BRACKET STRUCTURE

There are three main reasons why the rate and bracket structure needs revision. First, as shown in the previous section, the rate and bracket structure needs attention because it has been substantially unchanged in statutory terms since 1942. At the same time the real impact of the rate structure has changed very substantially, and in an unplanned way, because of inflation. While the rates are nearly the same, and the taxable income brackets are exactly the same, as under the Revenue Act of 1942, the impact of the structure has moved down the "real" income scale because the level of consumer prices has risen 77 percent since 1942.

For example, while a married person with an income of $3,000 paid a tax of $269 in 1942, a married person with a 1959 income greater to the extent of the increase in consumer prices over 1942 ($5,310), would pay a tax of $716. While consumer prices increased by 77 percent, his tax would have increased by 166 percent.

To be as well off after taxes and the depreciation of the dollar as in 1942, people in 1959 need incomes greater than the increase indicated by the consumer price index. These income equivalents are shown in Table 3. The combined effect of inflation and progressive tax rates is most evident for single persons. Single persons require an income approximately double the 1942 incomes to be as well off in 1959 after taxes and the depreciation of the dollar. At very high income levels single persons require an income nearly three times as great as in 1942 to be as well off in 1959. This reflects the progressivity of the rate structure. For as prices and money incomes rise, people become subject to higher marginal tax rates. Thus, the progressive rate structure magnifies the effect of inflation.[4]

Married persons require an income greater by some 80 to 90 percent than in 1942 to be as well off in 1959. This is little more than the increase in the consumer price index over the period. There is little difference between the increase in equivalent incomes and the in-

[4] No attempt is made here to examine the question of over-all economic growth and whether, on the average, people may actually be better off after taxes and the depreciation of the dollar. The point is rather that inflation has meant effective, but unplanned, tax increases with a differential impact varying with size and type of income and family position.

Table 3
1959 EQUIVALENTS OF 1942 ADJUSTED GROSS INCOMES[a]

1942 Adjusted Gross Income	1959 Equivalent Income			Percent Increase 1959 Over 1942		
	Single Person	Married Couple No Children	Married Couple Two Children	Single Person	Married Couple No Children	Married Couple Two Children
$ 2,900	$ 3,690	$ 3,813	$ 3,743	84%	91%	87%
3,000	5,540	5,618	5,613	85	87	87
5,000	9,378	9,222	9,233	88	84	85
7,500	14,444	13,709	13,723	93	83	83
10,000	19,998	18,174	18,190	100	82	82
15,000	32,283	27,002	27,058	115	80	80
25,000	57,625	44,405	44,499	130	78	78
50,000	134,864	88,005	88,018	170	76	76
100,000	285,856	178,376	178,506	186	78	79

[a] Adjusted gross income required in 1959 for a taxpayer to be as well off after taxes and the depreciation of the dollar as in 1942.
Source: Calculated by Tax Foundation.

crease in consumer prices for married persons because the introduction of income splitting in 1948 largely offset the effect of the progressivity of the rate structure in magnifying the effect of inflation.

It is evident that inflation has been as much of a tax as if the statutory rates themselves were substantially above what they were in 1942. For the same statutory rates are applicable to the same *money* incomes, but because of inflation high rates are now applicable to much lower "real" incomes.

The second major reason why the rate and bracket structure of the income tax needs revision is that policy objectives and economic conditions have changed greatly over the last two decades, and the present structure reflects objectives and conditions of the past rather than of the present and the future.

As noted in the preceding section, the present income tax structure reflects the pre-World War II efforts to redistribute income and the wartime objective of controlling incomes. These past justifications of the existing rate and bracket structure have largely lost their relevance. We are no longer at war, and an essential part of public policy is to depend upon the free market and the free play of individual incentives to guide the allocation of our resources; we cannot, as in wartime, rely on government controls and directives. Moreover, there has in fact been a great change in the distribution of income which has removed much of whatever grounds may have existed in the past for redistribution of income. This change has included a decline in the shares of upper income groups in total income, a decline "which for its magnitude and persistence is unmatched in the record . . ."[5]

It is notable that *Statistics of Income* data show that for individual returns with incomes of more than $100,000, average income per return was less in 1956 than it was in 1939, and substantially less than in 1916.[6] In so far as rates running up to more than 90 percent have been designed to put a limit on high incomes, that purpose has been more than accomplished.

[5] S. Kuznets, *Shares of Upper Income Groups in Income and Savings*, National Bureau of Economic Research, New York 1953, p. xxxvii.

[6] Average income on returns with incomes of over $100,000 amounted to $159,000 in 1957, $211,000 in 1939, and $280,000 in 1916 (adjusted gross income in 1957; net income in 1939 and 1916). In 1957 there were 22,936 returns with incomes of more than $100,000 or 0.04 percent of all returns filed. For further analysis and discussion of these data, see *Are High Surtax Rates Worthwhile?*, Tax Foundation Project Note No. 41.

It is widely recognized today that a major goal of public policy must be promotion of a high rate of economic growth. A high rate of economic growth will be essential in the future to maintain a growing defense effort and at the same time meet the needs of a rapidly growing population. It is also widely recognized that one of the necessary steps in promoting economic growth is a revision of the income tax. In 1956 the Joint Committee on the Economic Report, after a lengthy study of the Federal tax system, concluded that "Federal tax policy should encourage the balanced growth of the economy and the most efficient use of our economic resources." The Committee also pointed out that

> "Elimination of growth-distorting features from the tax system would entail a thoroughgoing revision of the Internal Revenue Code. While the magnitude of such an undertaking is recognized as formidable, the rewards in terms of a more dynamic and better balanced economy warrant that a start be made."[7]

Finally, the rate and bracket structure of the income tax needs revision in order to mitigate its distorting effects on economic activity. When taxpayers may keep as little as nine cents out of an additional dollar of income, the tax rates clearly leave little room at the top of the income scale for monetary inducements to guide the direction of individual efforts and investments. Yet under a free enterprise system, it is monetary incentives that, in general, provide the best guides for the direction of economic activity. Moreover, with rates going up to 91 percent, there are large differentials as between reportable income and income excluded by law, between deductible and nondeductible expenditures, and between income fully subject and income not fully subject to the ordinary rates.

In summary, the rate and bracket structure of the income tax needs revision to improve its equity, to reduce its distorting effects, and to adapt it to present day conditions and policy objectives.

While some attention is given here to the problems of defining income for tax purposes, and of the relation of the tax base to reportable income, this study is concerned primarily with revision of the rate and bracket structure of the income tax.

[7] *Federal Tax Policy For Economic Growth And Stability*, Joint Committee on the Economic Report, Senate Report No. 1310 (1956), pp. 6, 9.

III. THE "BRACKET" SYSTEM

A. NATURE OF THE BRACKET SYSTEM

Under the bracket system all taxpayers are subject to the same tax rate on the first $2,000 (or other given amount) of taxable income; all with more than $2,000 of taxable income are subject to the same rate on the next $2,000 of their taxable income; and so forth. Thus each individual's taxable income is broken down into slices or brackets to each of which a different "marginal" rate applies. The term "marginal" is applied to these rates because, as the individual's income increases, he becomes subject to higher rates only on the *additions* to his taxable income. The term "marginal" is contrasted with "effective" rates which refer to the percentage of tax to total taxable or net income.

This appears to be the simplest system for providing progression in income tax rates. Under it a taxpayer cannot have his income after tax reduced by an increase in income which makes him subject to a higher tax rate.

Because the bracket system directly uses marginal rates, these rates tend to be emphasized in discussions of the income tax and of changes in it. The "effective" rates have to be calculated; they are not shown on the usual income tax forms; and they may be stated on the basis of different income concepts. Thus the average person can scarcely be expected to be aware of effective rates of tax, other than possibly his own.

The emphasis on marginal rates may tend to intensify the effects of the income tax on incentives to work and invest. For the marginal tax rates can tell the taxpayer immediately (apart from changes in deductions) how much his income after tax will be changed as a result of a change in his income before tax. It is the marginal rates which are relevant to the taxpayer in making a decision that will change his income.

B. THE ROLE OF EXEMPTIONS

Personal exemptions may be regarded as a kind of initial tax bracket in which the tax rate is zero. The size of exemptions is an important element in the bracket structure because exemptions enter directly into the determination of taxable income (taxable income equals adjusted gross income less personal deductions and exemptions).

Exemptions serve several purposes: (1) they remove from tax certain minimum amounts of income, sometimes said to represent a subsistence standard of living; (2) they provide a means of differentiating among taxpayers in different family positions; and (3) they serve administrative convenience by removing the application of the income tax to very low income taxpayers.

It is often argued that exemptions should be high enough to cover the "necessities of life." No one, however, has attempted to specify exactly what the necessities of life amount to. Congress has in fact very sharply reduced the size of the personal exemption at the very time that the cost of the necessities of life was rising. Thus the exemption for a married couple was reduced from $2,500 in 1938 to $1,500 in 1941 and $1,000 in 1944. In 1948 the exemption for a married couple was raised to $1,200, where it has remained ever since.

Even if a clear dividing line were possible between necessities and luxuries, the use of the personal exemption on this ground alone would imply that government programs fall on the luxury side of the line. When two-thirds of Federal expenditures go for national security expenditures, such an implication cannot be justified.

The major purposes of exemptions today are to take account of differences in family positions (number of dependents), and to serve administrative convenience.

The present uniform per capita exemption is probably the simplest way of achieving these purposes. However, the law has also gone further in providing different statutory rates for different family positions. The split income provision of 1948 provided a different effective set of rates for married persons using a joint return, even though the device of dividing taxable income by two, calculating the tax on half the income, and then multiplying this tax by two, makes it possible to use the same set of statutory rates as for single persons. The Revenue Act of 1951 went one step further by providing a separate set of rates for heads of households. With the improvements in the "short form" and the mechanical and electronic methods of handling these forms, administrative convenience is of less significance today than it has been in the past. Improved techniques of collection and administration have made it possible, as demands on the Federal budget have made it necessary, to turn the income tax into a broad-based levy paid by nearly all of the population. In 1939 income tax returns accounted for only about 12 percent of the population;[1] today they account for about 94 percent of the population.

[1] S. Kuznets, *Shares of Upper Income Groups in Income and Savings*, National Bureau of Economic Research, New York 1953, p. 252.

C. RELATIVE IMPORTANCE OF EXEMPTIONS, RATES AND BRACKETS IN DETERMINING PROGRESSIVITY AND REVENUE YIELD

At low and middle income levels it is primarily the exempions that determine the degree of progressivity and the relative tax burdens on different taxpayers. Even at their present low level of $600 per capita, exemptions plus the relatively wide first taxable income bracket ($4,000 on joint returns) result in over two-thirds of income taxpayers being subject only to the first bracket rate of 20 percent. Thus, a married person with two children and an income of $3,000 is subject to the same rate on an additional dollar of income as a married person with two children and an income of $7,000. The proportion of total exemptions to taxable income is the determining factor in the relative tax burdens of most taxpayers at the low and middle income levels.

The revenue yield of the income tax is to a large degree governed by the level of exemptions and the first bracket rate. It must be remembered that the first bracket rate applies to the first $2,000 ($4,000 on joint returns) of *every* taxpayer's income regardless of the size of his total income. In 1957, the latest year for which data are available, the amount of income subject to the first bracket rate was about $108 billion out of total taxable income amounting to $153 billion. The first tax bracket in 1957 accounted for about 61 percent of the total yield of the income tax. The breakdown of taxable income and tax yield by taxable income brackets in 1957 is shown in Table 4.

The relative importance of the first bracket is further emphasized by examining the revenue contribution of the *increments* in the rates in the higher brackets, i.e. the

Table 4

TAXABLE INCOME AND YIELD FROM BASIC AND PROGRESSIVE ELEMENTS OF THE FEDERAL INDIVIDUAL INCOME TAX[a] INCOME YEAR 1957

Taxable Income Bracket	Taxable Income[b]	Rate Schedule	Tax At Basic Rate[c]	Tax From Progressive Element of Rate[d]	Total Tax
(Thousands)	(Millions)	(Percent)	(Millions)		
$ 0– 2	$107,627	20	$21,525		$21,525
2– 4	24,027	22	4,805	$ 480	5,286
4– 6	7,071	26	1,414	424	1,838
6– 8	3,529	30	706	353	1,059
8– 10	2,158	34	432	302	734
10– 12	1,576	38	315	284	599
12– 14	1,227	43	245	282	528
14– 16	948	47	190	256	446
16– 18	758	50	152	227	379
18– 20	534	53	107	176	283
20– 22	435	56	87	157	244
22– 26	658	59	132	257	388
26– 32	664	62	133	279	412
32– 38	430	65	86	194	280
38– 44	288	69	58	141	199
44– 50	209	72	42	109	150
50– 60	240	75	48	132	180
60– 70	145	78	29	84	113
70– 80	105	81	21	64	85
80– 90	75	84	15	48	63
90–100	50	87	10	34	44
100–150	152	89	30	105	135
150–200	69	90	14	48	62
Over 200	211	91	42	150	192
Total	$153,184		$30,637	$4,585	$35,222

[a] Detail will not necessarily add to totals because of rounding.
[b] Excludes capital gains subject to alternative tax. The taxable income in each bracket is the sum of the segment of income in that bracket on all returns. Thus the taxable income in the first bracket is the sum of taxable income up to $2,000 (after income splitting on joint returns) on all returns whatever the size of total income on the return.
[c] First bracket rate (20%).
[d] Difference between first bracket rate and the rate in each higher bracket.
Source: Calculated from Treasury Department data.