Reconstructing
The Federal
Tax System

A Guide to the Issues

January 1963

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FOREWORD

The present period is probably unique in the history of Federal taxation. There have been few times when the deficiencies of the Federal tax system have been as vigorously discussed. Seldom have hopes for tax reduction run as high. Never has the discussion of tax changes ranged over so many aspects of tax and fiscal policy.

While there is widespread agreement that substantial changes need to be made in the Federal tax system, there are important differences of opinion as to the measures that should be undertaken to improve it. To many the problem is simply one of reducing rates. Others would seek merely to make certain revisions or reforms in the present methods of taxing individual incomes. Still others believe that a basic overhaul of the entire system and the adoption of new forms of Federal taxation are needed.

The purpose of this study is to contribute to public knowledge and understanding of the issues involved in reconstructing the Federal tax system. No attempt is made in this study to formulate or propose a tax program. The objective of this study is simply to provide information that will help interested citizens and public officials to judge the alternatives in Federal tax revision.

This study does not analyze all of the issues which may enter the debates on tax changes. Many of the issues were reviewed in more detail in the Foundation's earlier studies of Federal Excise Taxes (1956), Are High Surtax Rates Worthwhile? (1957), Re-examining the Federal Corporation Income Tax (1958), The Federal Income Tax: Revising the Rate and Bracket Structure (1959), and Allocation of the Tax Burden by Income Class (1960).

The study is divided into three parts. Section I deals with the need for tax revision. Section II sets forth the criteria for tax revision. The remainder of the study (Sections III-VI) takes up in order the issues involved in revising the individual income tax, the corporation income tax, excise taxes, and other Federal taxes (principally estate and gift taxes and payroll taxes).

Tax Foundation wishes to acknowledge the assistance it received from Professor C. Lowell Harriss of Columbia University in the preparation of this study.

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

TAX FOUNDATION, INC.

January, 1963
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>FOREWORD</td>
<td>5</td>
</tr>
<tr>
<td>I. THE NEED FOR TAX REVISION</td>
<td>9</td>
</tr>
<tr>
<td>A. Changes in Economic Conditions and Policy Objectives</td>
<td>9</td>
</tr>
<tr>
<td>1. Depression-Induced Features Remain</td>
<td>9</td>
</tr>
<tr>
<td>2. Effect of World War II on the Tax Structure</td>
<td>9</td>
</tr>
<tr>
<td>3. Post-World War II Tax Changes</td>
<td>10</td>
</tr>
<tr>
<td>4. Inflation Has Made the Tax System More Burdensome</td>
<td>11</td>
</tr>
<tr>
<td>5. Rise in the State and Local Tax Burden</td>
<td>12</td>
</tr>
<tr>
<td>6. Heavy Cost of Defense in “Peacetime”</td>
<td>13</td>
</tr>
<tr>
<td>7. Change in International Economic Position of the United States</td>
<td>13</td>
</tr>
<tr>
<td>8. Economic Growth as a Major Objective of Public Policy</td>
<td>14</td>
</tr>
<tr>
<td>9. Relation of Budgetary and Economic Outlook to Tax Changes</td>
<td>14</td>
</tr>
<tr>
<td>10. Summary</td>
<td>14</td>
</tr>
<tr>
<td>B. Over-all Characteristics of the Federal Tax System</td>
<td>15</td>
</tr>
<tr>
<td>1. Weight of the Tax System</td>
<td>15</td>
</tr>
<tr>
<td>2. Complexity</td>
<td>15</td>
</tr>
<tr>
<td>3. Instability of Revenue Yield</td>
<td>16</td>
</tr>
<tr>
<td>4. Economic Effects</td>
<td>17</td>
</tr>
<tr>
<td>5. Distribution of the Burden</td>
<td>17</td>
</tr>
<tr>
<td>6. Inequities among Taxpayers in Essentially Similar Circumstances</td>
<td>19</td>
</tr>
<tr>
<td>7. Summary</td>
<td>19</td>
</tr>
<tr>
<td>II. CRITERIA FOR TAX REVISION</td>
<td>20</td>
</tr>
<tr>
<td>A. Revenue Adequacy</td>
<td>20</td>
</tr>
<tr>
<td>B. Fairness and Equity in the Distribution of Tax Burdens</td>
<td>20</td>
</tr>
<tr>
<td>C. Reducing Obstacles to Efficient Operation of the Economy</td>
<td>21</td>
</tr>
<tr>
<td>1. Importance of the Market Economy</td>
<td>21</td>
</tr>
<tr>
<td>2. Keeping Allocation Distortions at a Minimum</td>
<td>21</td>
</tr>
<tr>
<td>3. Use of Tax Measures for Specific Economic Effects</td>
<td>22</td>
</tr>
<tr>
<td>4. “Business” as an Object of Taxation</td>
<td>22</td>
</tr>
<tr>
<td>5. Enlarging the Freedom of Choice</td>
<td>22</td>
</tr>
<tr>
<td>D. Encouraging Economic Growth</td>
<td>22</td>
</tr>
<tr>
<td>E. Simplicity and Ease of Administration and Compliance</td>
<td>23</td>
</tr>
<tr>
<td>F. Summary</td>
<td>23</td>
</tr>
</tbody>
</table>
TABLE OF CONTENTS (Continued)

III. THE INDIVIDUAL INCOME TAX .................................................. 24
   A. The Rate and Bracket Structure ....................................... 24
      1. The Rate Structure and Equity .................................. 24
      2. The Rate Structure and Economic Effects ....................... 26
      3. Revenue Effects of Rate Revision ................................ 26
   B. The Tax Base .............................................................. 28
      1. Statutory Provisions .............................................. 28
      2. Exclusions ......................................................... 28
      3. Personal Deductions ............................................. 32
      4. Personal Exemptions ............................................. 34
   C. Tax Credits .............................................................. 36
   D. Reconstructing the Individual Income Tax ....................... 37
   E. Summary ................................................................. 38

IV. THE CORPORATION INCOME TAX .............................................. 39
   A. The Structure and Level of Rates .................................. 39
   B. The Tax Base ............................................................ 41
      1. Losses ................................................................ 41
      2. Depreciation ....................................................... 41
      3. Depletion ............................................................ 42
      4. Travel, Entertainment, and Related Expenses ............... 43
   D. Special Problems in Corporate Taxation .......................... 44
      1. Foreign Income .................................................... 44
   C. The Investment Credit ................................................ 44
   E. The Basic Issue of Taxing Business Firms ....................... 46

V. TAXES ON CONSUMPTION ....................................................... 48
   A. Taxes Imposed .......................................................... 48
   B. Proposals for Change ................................................ 49
   C. A Possible Expenditure Tax ........................................ 50

VI. OTHER TAXES: ESTATE, GIFT, AND PAYROLL .......................... 52
   A. Estate and Gift Taxes ............................................... 52
      1. Tax Base and Rates .............................................. 52
      2. Relations between Federal and State Taxes ................. 53
      3. Revision within the Federal Tax .............................. 53
   B. Payroll Taxes .......................................................... 53
LIST OF TABLES

TABLE

<table>
<thead>
<tr>
<th>Number</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Purchasing Power of the Consumer Dollar</td>
<td>11</td>
</tr>
<tr>
<td>2</td>
<td>1962 Equivalents of 1942 Incomes, Selected Levels of Income</td>
<td>12</td>
</tr>
<tr>
<td>3</td>
<td>Selected Income Tax Data for the Highest Income Taxpayers, 1929 and 1960</td>
<td>13</td>
</tr>
<tr>
<td>4</td>
<td>Federal Budget Receipts by Source, Fiscal Years 1954-1963</td>
<td>16</td>
</tr>
<tr>
<td>5</td>
<td>Effective Tax Rates on Adjusted Gross Income and Taxable Income on Returns with Itemized Deductions, with and without Alternative Tax, by Adjusted Gross Income Classes of $50,000 and Over, Income Year 1960</td>
<td>18</td>
</tr>
<tr>
<td>6</td>
<td>Federal Individual Income Tax Liability and Effective Rate of Tax on Net Income for a Married Couple, Two Children, Selected 1962 Levels of Net Income</td>
<td>24</td>
</tr>
<tr>
<td>7</td>
<td>Federal Individual Income Tax Rates, Selected Income Years, 1930-1962</td>
<td>25</td>
</tr>
<tr>
<td>8</td>
<td>Estimated Taxable Income and Tax Distributed by Taxable Income Brackets (Based on estimated 1962 taxable income)</td>
<td>27</td>
</tr>
<tr>
<td>9</td>
<td>Relationship of Personal Income to Reported Adjusted Gross Income and Taxable Income, Calendar Year 1960</td>
<td>33</td>
</tr>
<tr>
<td>10</td>
<td>Itemized Deductions and Exemptions in Relation to Adjusted Gross Income, by Adjusted Gross Income Class, 1960 (Returns with itemized deductions)</td>
<td>34</td>
</tr>
<tr>
<td>12</td>
<td>Comparison of Guidelines for Depreciable Assets under Bulletin “F” and New 1962 Treasury Rules, Selected Items</td>
<td>42</td>
</tr>
<tr>
<td>13</td>
<td>Taxation by Central Governments of Corporate Profits, Selected Countries</td>
<td>47</td>
</tr>
<tr>
<td>14</td>
<td>Consumption Taxes as Percentage of Government Tax Levies, Selected Countries, Fiscal Year 1960</td>
<td>49</td>
</tr>
<tr>
<td>15</td>
<td>Federal Excise Tax Rates on Selected Items, as of September 1, 1962</td>
<td>50</td>
</tr>
<tr>
<td>16</td>
<td>Federal Estate Tax Rates and Exemptions, Selected Years, 1929-1962</td>
<td>52</td>
</tr>
<tr>
<td>17</td>
<td>Old-Age, Survivors, and Disability Insurance Tax Rates, as of September 1, 1962</td>
<td>54</td>
</tr>
<tr>
<td>18</td>
<td>Federal Employment Tax Collections by Type, Selected Fiscal Years, 1940-1963</td>
<td>54</td>
</tr>
</tbody>
</table>

LIST OF CHARTS

CHART

<table>
<thead>
<tr>
<th>Number</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Federal Corporation Income Tax Rates, Calendar Years, 1913-1962</td>
<td>40</td>
</tr>
<tr>
<td>2</td>
<td>Private Capital Investment in Manufacturing, Calendar Years, 1950-1961</td>
<td>45</td>
</tr>
</tbody>
</table>
The need for tax revision is compelling. The present tax structure is in large part a legacy of the depression of the 1930's and of World War II. Since then economic conditions have changed profoundly. The objectives of public policy have also changed. Yet there has been little adaptation of the tax system. Nor, unfortunately, is there solid basis for expecting total tax loads to go down enough to bring relief automatically.

A. CHANGES IN ECONOMIC CONDITIONS AND POLICY OBJECTIVES

1. Depression-Induced Features Remain

During the 1930's a major goal of policy was to recreate employment opportunities. Modification — reform — of the social and economic structure also appeared as an important objective of those who made governmental decisions. Both goals shaped the tax system. There was much support for the view that taxes should redistribute income, burdening upper income groups heavily to provide benefits for the unemployed. The rates of the individual income tax in the range above $20,000 were increased drastically, the corporation income tax somewhat.

Influential men believed that the depression was due in part to underconsumption — or to oversaving in the sense that more was being saved out of income than was being spent to build new capital goods. Here was a source of more pressure for "soak-the-rich" taxes. The upper income groups and profitable corporations, it was argued, should be taxed heavily because they saved a relatively large portion of their income.

Before these attitudes became important, however, major tax changes had been made in an effort to check the drop in revenues — a decline of almost 50% from 1930 to 1932. The Revenue Act of 1932 effected one of the largest peacetime tax increases in history. It added a variety of selective excises. Individual income tax rates were raised sharply — the first bracket rate from 11½% to 4% and the top rate from 25% to 63%. Personal exemptions were lowered from $3,500 to $2,500 for a married couple. The long-established earned income credit was eliminated. The corporation income tax was raised from 12% to 13¼%. The estate tax was increased tremendously, and a gift tax was adopted.

Further increases were enacted in 1934, 1935, 1936, and 1938. The top rate of the individual income tax went to 79%, the corporation rate to 19%. A tax on the undistributed profits of corporations (1936 to 1939) was intended, among other things, to raise dividend payments and thereby personal tax payments. Technical changes, especially those reducing deductions for depreciation, also increased the effective burdens. The top estate tax rate, which had been 20% until 1932, became 70% in 1935.

Nevertheless, it was the excises that produced most of the additional revenue. Excises accounted for 19% of Federal tax collections in 1930 and 34% in 1939. Payroll taxes for social insurance, enacted in 1935, began to bring revenue in 1938; in 1939 they yielded $740 million. Many other changes in tax laws and administration were made in this period. Decisions were made under a variety of pressures, often to meet emergencies and with little firm knowledge of the results.

2. Effect of World War II on the Tax Structure

Rate Increases

World War II intensified the pressures on the personal income tax — to get dollars to pay for defense
and, in contrast to the goals of the depression, to curb private consumption. To get large increases in total yield, broad extension of the tax on the vast bulk of the public was required. The first bracket rate went from 4% in 1939 to 23% in 1944. At high income levels rates were raised almost to the arithmetical limit, 94%, so not much for the revenue as for the feeling that if the ordinary man’s tax went up — and if wage and salary controls were imposed — greater burdens ought to be put on the prosperous. Moreover, an excess profits tax on corporations supplied added reason—for limiting large personal incomes.

While Congress did not go so far as President Roosevelt’s recommendation to limit after-tax income to $25,000, it did push down the levels at which the high rates became effective. The top rate, which applied to taxable income in excess of $5 million in 1939, applied to taxable income in excess of $200,000 beginning in 1942. The whole bracket structure was compressed. In 1940 the 66% rate was imposed at $200,000 of net income; the 1944 law made a 65% rate effective at $26,000. Where a 13% rate applied in 1939 at $14,000, the 1944 rate was 50%.

Broadening the Scope of the Income Tax

The exemption for a married couple was reduced from $2,500 in 1939 to $1,000 in 1944, a period during which the purchasing power of the dollar fell 21%. This drastic reduction in the “real” level of personal exemptions made the income tax a true “broad-based” levy. In 1939 individual income tax returns covered only 5%, but in 1945 around 75% of the population. Two other noteworthy wartime changes were the adoption of withholding on wage and salary income and the optional standard deduction.

Corporation and Excise Tax Increases

The corporation income tax rate applicable to most profit was raised to 40% in 1942. An additional excess profits tax took most of what remained of corporate net income. Corporation taxes produced $16 billion in 1945 as compared with $1.2 billion in 1939; after-tax profits rose less than $4 billion.

The selective excise tax system was broadened to cover new commodities and services, and rates were raised — to restrict consumption as well as to raise revenue. Shortages and rationing limited the growth of excise tax revenues, which amounted to $4.5 billion in fiscal 1944, compared with $1.8 billion in 1939. Estate and gift tax rates went up by one-tenth in 1940 and by varying amounts in 1941.

Actions Taken in Emergency

Wartime changes were made under conditions of extreme emergency. Some, especially the big rate increases, were assumed to be temporary. Much the largest effect of the war on the tax structure was on the individual income tax. From chiefly a “rich man’s” tax, it became one imposed on nearly every worker. From 1939 to 1945 its yield rose from 1% to 10% of personal income.

3. Post-World War II Tax Changes

Relatively Small Rate Reductions

Some tax reduction followed the end of fighting. In 1945 individual income tax rates were cut by about one-fifth and the aggregate corporate tax by about 31% (including repeal of the excess profits tax). Individual income tax burdens were again reduced in 1948 by about 21% as a result of a small cut in rates, an increase in exemptions from $500 to $600 per person, and by the split-income provision for married couples. On the other hand, the long-delayed increases in social security payroll taxes began in 1950.

Korean Increases

The Revenue Act of 1950 raised individual income taxes simply by cutting back on percentage reductions of about one-tenth which had applied to statutory rates since 1948. In 1951 Congress raised rates by about one-tenth through the income ranges which include most taxpayers. The corporation rate, which had been 38% in 1949, was raised to 32%, and an excess profits tax was added. Some excises were lifted.

These Korean period tax increases were originally scheduled to expire at the beginning of 1954. The individual income tax increases and the excess profits tax did end on schedule, but reductions of the corporation rate and of most of the excises have been postponed every year. The rates of the individual income tax still in effect in 1963 remain those of the immediate post-war schedule — merely three percentage points lower in each bracket than the peak World War II rates.

The 1954 Internal Revenue Code

In 1954 an over-all revision of the Internal Revenue Code was accomplished. It was designed to remove obsolete materials, clarify ambiguities, and rearrange provisions in more logical order. Its sponsors also sought to make substantive changes which would remove inequities and reduce barriers to the expansion of production and employment. Yet the total of changes did not constitute a re-examination of the Federal tax structure nor of major tax policy problems. The range of substantive matters dealt with was relatively narrow. Tax rates were not at issue.

Need for Additional Revision Recognized

The scope of the job remaining was suggested by the statement of the three main objectives of a 1955 study.
of Federal tax policy by the Joint Committee on the Economic Report:

1. "What should be the focus of tax policy, both from the standpoint of short-run stabilization and long-run growth?

2. "What is the impact of Federal taxation on the distribution of real income and levels of consumption, the amount and character of private investment, managerial efforts and incentives?

3. "The third part of the study deals with a number of specific tax issues. Those which we believe are the most important from an economic standpoint include the capital gains tax, the treatment of natural resources, depreciation, excises, taxation of small business, corporate income, deferred compensation, individual exemptions and deductions, foreign income, estate and gift taxes, and intergovernmental relations."

Many technical revisions were made in 1958, but substantive revision of the tax structure was not attempted. In 1959 the Committee on Ways and Means undertook a new investigation with still broader aims than those of the 1955 study. This investigation was described as aiming at "the immediate objective ... of reduction in tax rates without sacrificing revenues required for responsible financing of Government."

The House Committee produced no report on its extensive 1959 hearings. No general program was prepared and considered publicly by Congress or the Executive in 1960, 1961, or 1962. The Revenue Act of 1962, the result of a year and a half of consideration, reduced somewhat the tax on business though adding to the burden of foreign operations and making a variety of other changes. The Administration has promised a plan for fundamental changes in 1963.

4. Inflation Has Made the Tax System More Burdensome

The purchasing power of the dollar has fallen by about half since 1940 (Table 1). Price inflation has changed the tax burden substantially—and yet surreptitiously and unevenly for different groups of taxpayers.

Decline in the "Real" Value of the Personal Exemption

Inflation, for one thing, reduced the "real" level of personal exemptions (Table 11, page 35). In 1939 the exemption for a married couple was $2,300—more than the average personal income per family. In 1961 the exemption for a married couple was $1,200. Expressed in 1939 dollars, the 1961 exemption amounted to only $563; since 1939, therefore, the married couple exemption has been cut in real terms by 78%. The real value of the credit for dependents declined by one-fourth despite the dollar increase from $400 to $600.

As a reflection of the drastic reduction in exemptions and the rise in income, the individual income tax base (i.e., taxable income) rose from 10% of total personal income in 1939 to 43% of total personal income in 1960, an increase of 330%. Indeed, more of the tremendous increase in income tax yield is attributable to the reduction of exemptions than to the increase in statutory tax rates. Thus in 1939 the total individual income tax bill amounted to about 12% of taxable income. In 1960 the comparable tax bill was about 23% of taxable income. In other words the over-all effective rate of tax on taxable income went up 90%. In real terms personal income rose 158%, less than one-half as much as the 330% increase in the portion taxed.

Income Moved to Higher Tax Brackets

Inflation moved taxable, as distinguished from real, income into higher tax brackets. In this way inflation raised the effective rate of taxation. In 1949 about 26% of all taxable income was in brackets above the first, in 1960 over 36%. The amount of income in the first bracket increased 121% from 1949 to 1960; in contrast, the amount subject to higher bracket rates rose over 250%. The difference in these increases resulted in part from real economic growth, but in larger measure from inflation.

In 1948 a family with an income equal to average family personal income for that year ($4,800) and three exemptions would have paid a tax on 58% of its income;
Table 2
Income Required in 1962 to Equal 1942 After-Tax Purchasing Power
Selected Levels of Income

<table>
<thead>
<tr>
<th>Adjusted Gross Income in 1962</th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Single person</td>
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<tr>
<td>$2,000</td>
<td>$3,840</td>
</tr>
<tr>
<td>$3,000</td>
<td>$5,770</td>
</tr>
<tr>
<td>$7,500</td>
<td>$14,700</td>
</tr>
<tr>
<td>$10,000</td>
<td>$20,250</td>
</tr>
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</table>

(a) Amount of money income required in 1962 for a taxpayer to be as well off after taxes and the depreciation of the dollar as in 1942.

In 1960 a family with three exemptions and an income equal to average personal income ($7,700) paid tax on 67% of its income. Table 2 shows, for several income groups, the money income required in 1962 for taxpayers to have the same after-tax purchasing power as in 1942.

Increase in Real Burden of Corporation and Other Taxes

Inflation also added, again somewhat surreptitiously, to the weight of corporation taxes. Some of the result has come from the fixity of the surtax exemption at $25,000. More important is another factor — the basing of depreciation on historical cost in figuring operating expense. As a result of inflation the amount deducted as depreciation expense falls below the cost of replacing the productive capacity. Although the wage increases required by inflation were deductible expenses, important increases in the dollar costs of capital goods were not allowed as expenses. Studies in the late 1950's concluded that in relation to replacement cost, historical cost depreciation understated production cost by $6 to $8 billion each year. Consequently, in terms of the cost of replacing the productive facilities, taxable income was overstated.3

Inflation has also raised the real burden of the estate and gift taxes, partly because the exemptions have remained fixed and partly because the increases in property values have fallen into higher and higher brackets. For some of the excises which are specific rather than ad valorem, however, inflation has reduced the real tax burden. Thus the rise in the cigarette tax from 6 cents to 8 cents per package since 1939 has been less in percentage terms than the rise in the over-all level of prices. The weight of numerous excises has risen at approximately the same rate as the level of prices.

Effects Difficult to Identify and Evaluate

Along with growing real income, inflation has raised Federal revenues. It has thereby eased the financing of expenditure growth without requiring explicit consideration of boosts in tax rates. A partial offset, however, has been the increase in cost of government operation due to inflation. If the tax burden increases resulting from inflation had been more widely recognized, tax-rate reduction as an alternative to expenditure increases might have received greater consideration.

Inflation had another influence. A sense of rising income brought a feeling of prosperity and undoubtedly reduced individual and business concern about high taxes and high government spending. Normal incentives for economy gave way to the toleration of looseness and what may now seem nearer folly than wisdom.

Inflation affected some taxpayers relatively much more than others. Although these differential effects are difficult to measure statistically, they are unquestionably important. The executive and managerial group (in government, business, and non-profit organizations), the leaders in the professions and the arts, and most members of the upper income groups, were hit especially hard. Their incomes did not increase sufficiently to offset the combined effects of inflation and progressive taxation. These two forces were like a scissors, lopping off real income at the top of the scale.

In marked contrast, however, after-tax money incomes increased faster than prices at the lower levels; real income after taxes increased for those families at subject to the steeply progressive rates. Thus per capita personal income increased from $700 in 1929 to $2,200 in 1939, an increase of over 200%. On the other hand, after-tax incomes of the highest income taxpayers on the average fell substantially even in current dollars (Table 3).

5. Rise in the State and Local Tax Burden

One notable feature of post-World War II public finance has been the growth of state and local taxes. In 1929 state and local taxes amounted to 6.8% of net national product. In 1946 this ratio was 5.5%. Thereafter, the total state and local tax bill rose to around 9% of a much larger net national product. State-local taxes, including those for unemployment benefits, rose from $11 billion in 1946 to about $42 billion in 1961.

3 If tax rates were, perhaps, 10%, no serious concern might arise over the purely tax effects of depreciation on the basis of historical cost and inflation at a low rate. When inflation is very rapid, perhaps 2% a month, and tax rates are high, some recognition must be given. Inflation in the United States has been large enough, and tax rates high enough, to make the problem serious but not so clearly urgent as to compel action.
They seem likely to rise further, even in relation to national output. Federal tax revision, therefore, must take into account the revenue pressures on state and local governments. The spread of state withholding, and the practice of patterning state laws after the Federal income tax, raise additional considerations in Federal tax revision.

6. Heavy Cost of Defense in “Peacetime”

In 1929 expenditures for national defense constituted about 1% of the gross national product (GNP). Customs receipts alone almost paid defense costs. After World War II, defense expenditures fell to 5% of GNP. Then during Korean hostilities, they rose to about 15%; military costs went up less than GNP in the late 1950’s, but they are now around 9% of GNP.

Defense costs amount to nearly as much as all the revenue from the individual income tax. They already strain the Federal budget — in times of “peace.” If threats to free-world security were to force increases in military spending on a scale comparable to that of the Korean crisis, could the present tax structure meet the needs? The safety margin is uncomfortably small. A revenue system continuously strained to meet non-emergency needs is inadequate for an economy which may be forced to meet the greater needs which international challenges may bring.

7. Change in International Economic Position of the United States

Through most of the 1930’s, World War II, and the immediate postwar period, the United States had a comfortable balance of international payments. Gold seeking safety came here from other lands. Imports to this country were held down by low incomes in the thirties, then by World War II, a war which also raised demand for U.S. output. After the war the rest of the world wanted to buy more here than this country bought abroad. Some of the gap was filled by lend-lease, some by outright gifts, and some by loans.

Over the last decade, however, and for varied reasons, total payments to foreigners have exceeded receipts from foreigners in most years. Debts to foreigners have built up, and gold has left. Deficits in the balance of payments continue.

Insofar as the tax system contributes, directly and
indirectly, to the imbalance in U. S. payments, or can be modified to help correct imbalances, such effects need to be considered in tax changes. The tax system has long had provisions designed to foster business abroad, or to avoid discouraging it. To some extent, certainly, exports from this country have been encouraged by policies which help American companies develop foreign operations. The total effects of tax policies, however, are subject to debate. Although present tax arrangements may be basically satisfactory, they call for continuing examination in the light of balance-of-payments needs.

8. Economic Growth as a Major Objective of Public Policy

The U. S. economy has a most impressive record of accomplishment, but many leaders are urging the public to try to find, and then adopt, policies which will raise the rate of growth. Economic growth, of course, is not an end in itself. But it does influence profoundly man's ability to achieve his many and varied purposes in life. In any short period an economy may be able to increase its output by using its resources more fully. For the longer run, however, reliance must be placed on the accumulation of more productive capacity and the increase in productivity.

When taxes and government spending were relatively low, they probably had only moderate influence on the over-all growth rate. Today, however, taxes are so high that they inevitably influence economic progress. Yet, when most of our present tax structure was built, encouraging economic growth was an objective that received little or no explicit attention.

9. Relation of Budgetary and Economic Outlook to Tax Changes

Tax rate reduction is the key element in Federal tax revision. Budgetary deficits, however, have appeared in most recent years and seem virtually certain for the near future. Will not tax reduction enlarge the deficits? Are not deficits year after year undesirable? Although the issues involved are among the most complex of economics, some major elements are clear enough.

The immediate effect of tax reduction in early 1963 would be to increase a budgetary deficit which already is well in excess of 1% of GNP. At least for the short run such an increase in the deficit — as distinguished from a cut in tax rates themselves — would probably stimulate business. Production and national income will rise by somewhat more than the cut in taxes. The rising income will in turn increase tax payments. It has been estimated that about 30% of an initial tax reduction will come back to the Treasury within a year or so, although the actual amounts depend on a variety of factors.

Tax reduction which is not matched by expenditure reduction, i.e., a tax reduction which enlarges the Federal deficit, can for a time stimulate an economy which has idle productive capacity. When business can readily increase the output of goods and services, a Treasury deficit does not present the inflationary threat which is to be expected when the economy is operating at practical capacity.

The "shot-in-the-arm" advantages of tax reduction, however, can scarcely justify permanent reduction with endless and large deficits. But substantial tax reduction is needed for the longer run. It is the kind of tax changes which will reduce the depressants on capital accumulation, incentive, and efficiency. By speeding economic progress, such fundamental tax changes would lead to growth in receipts by the Treasury.

A failure to control expenditures, however, can lead to an expansion in spending which outruns the revenue increase produced by growth of national income. Repeated deficits would discourage the progress toward tax modernization which is needed for the longer pull. If there were ever a vicious circle, it would be one of rising Federal expenditures which discourage the tax reduction that would help the economy grow; the depression in the growth rate by retarding the increase in revenue would in turn delay the tax reconstruction which would aid growth. Most observers believe that tax changes made now should be those best designed to aid long-run growth even if they are not so clearly best for stimulating the economy in the next few months. The reduction in tax rates which is consistent with responsible finance for 1963 and 1964 may be much below what would be the appropriate goal for 1970.

10. Summary

The need for reconstruction of the Federal tax system grows out of a combination of developments which have not yet been reflected in tax laws. (1) The economy has moved from deep depression and yet retains tax provisions adopted, not necessarily wisely, to meet depression emergencies. (2) Drastic increases in tax rates, reductions in exemptions, and other elements enacted to pay for a big war remain in effect 17 years after the end of fighting. (3) Inflation gradually increased the burden of taxes, but more so for some people than for others; these burden increases and shifts have not yet been considered explicitly as part of tax "legislation." (4) State and local taxes have gone up. (5) Defense costs remain heavy. The tax system was not designed to meet such apparently endless strains. It has little margin for meeting added revenue needs which would grow out of a serious, but by no means inconceivable, turn for the
Federal taxes are obviously heavy. The system which imposes them is complex. It has other important, but less obvious, features — the “flexibility” or instability of its revenue yield, the economic effects, the way in which the total burden is distributed over the public, and the inequities that exist among different taxpayers.

1. Weight of the Tax System

Including social insurance and highway user taxes, the total Federal tax bill in the 1963 fiscal year will amount to $101 billion or about one-fifth of the net national product. Of this total, $16 billion represents contributions for social insurance; the personal income tax accounts for about $48 billion; the corporate profits tax amounts to about $21 billion; and all the other taxes will bring $16 billion.

The personal income tax took about 11% of personal income in 1962, and the corporation tax took almost half of corporate profits. Payroll taxes for social insurance alone were more in 1962 than total Federal taxes 20 years earlier — during a war year. Excises and other taxes amounted to 3% of 1962 net national product.

State and local taxes in the 1961 calendar year amounted to over $42 billion or nearly 9% of net national product. The total tax bill — Federal, state, and local — in the year to July, 1962 was about 30% of net national product.

An estimate of the distribution of the total tax burden by income class indicates that for the vast majority of families the total tax burden amounts to about one-fourth of their share in the nation’s total net output (net national product). This exceeds even the peak levels of World War II and Korean fighting.

The total weight, even after the biggest reduction possible, will remain much higher than anyone would like. The structure of the system to raise that revenue, however, can take any of several forms. The choices made in...

Despite the budget deficit probable in 1963, tax reduction of moderate amount would in itself create no immediate inflation threat. Over the longer run carefully devised tax changes would contribute to responsible budgetary policy but, of course, are no substitute for wisdom in restraining expenditure.

B. OVERALL CHARACTERISTICS OF THE FEDERAL TAX SYSTEM

deciding on the structure will have major effects on the economy.

2. Complexity

The Internal Revenue Code is a document of over 900 pages. The administrative regulations run to thousands of pages and millions of words. Court cases add a voluminous source on tax law, and occasionally a treaty is negotiated. In addition thousands of pages of Congressional hearings and reports bear on the meaning and interpretation of the law. And every year more statutory law, regulations, and judicial decisions pile up. No wonder that an army of tax lawyers and accountants is necessary to help the taxpayer, both corporate and individual, thread a way through this tangle of laws and regulations.

Complexities are so great and so interrelated that revision of the law becomes ever more involved and difficult. More and more groups come to have a special interest in detailed provisions. Each group musters some Congressional support and, properly, demands attention. The multiplicity of interests impedes decision in Congress. Furthermore, the complexity of many important features is so great that informed public opinion about them is impossible.

Much of the complexity is a result of effort to prevent avoidance and evasion induced by high tax rates. Much, however, reflects a determination to deal equitably with special situations which are not taken care of under general rules. To a degree, therefore, complexity represents a cost of trying to deal fairly with different taxpayers. Nevertheless, greater rationality in some fundamentals of the tax system would aid in reducing complexity. And significant cuts in the higher rates of tax would reduce the need for some of the special provisions which now make the law so complex.

Despite the vast complexity, however, the present law may in one sense be too simple for some taxpayers. Not only is their tax withheld in full, but the amount finally due is calculated for them by the Internal Revenue Service. Never seeing the income involved and perhaps not appreciating how much tax they bear, such taxpayers can hardly be expected to be aware of the significance and cost of government — or of the expansion of government spending. The tax consciousness of untold numbers of taxpayers will be lower as a result.
3. Instability of Revenue Yield

The yield of the Federal revenue system is unstable. Fluctuations during the business cycle are substantial; views about the desirability of such wide revenue swings differ.

The $12.4 billion deficit of fiscal 1959 was followed by a $1.2 billion surplus. Spending changed only a little. Obviously, therefore, Federal revenues increased dramatically, but not because of changes in the tax law. Except for payroll tax increases, the last general revision in Federal taxes went into effect in 1954. Since then changes in Federal budget receipts have been due largely to fluctuations in business activity.¹

Budget receipts increased by 13% in fiscal 1956, a result of a rapid recovery from the recession of 1954 plus some inflation (Table 4). In the fiscal year 1958, as a result of recession, total budget receipts fell by 3% and corporation tax receipts fell by over 5%. In 1960, as GNP rose about 4%, total budget receipts rose by almost 15%, and corporation tax receipts by 24%. When business activity dropped off later, however, total budget receipts fell 0.1% for in fiscal 1961 (and some effect was still evident in fiscal 1962). It is notable, however, that individual income tax receipts actually rose in fiscal 1961 by 13½% — and by almost 10% more in fiscal 1962 even though the rate of economic recovery was disappointing.

The upward trend is no less striking than the short-run instability. Budget receipts in 1963 (after allowing for changes in classification of the "highway" excises) will be over $25 billion higher than in 1955, the first year in which essentially the present tax rates became fully effective.

¹ The apparent drop in excise tax receipts in fiscal 1957 and 1958 was due primarily to the transfer of highway user tax receipts to the highway trust fund established in 1956.

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### Table 4

**Federal Budget Receipts by Source**

**Fiscal Years 1954 — 1963**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total budget receipts</th>
<th>Individual income tax</th>
<th>Corporation income tax</th>
<th>Excise taxes</th>
<th>Customs</th>
<th>Net employment taxes</th>
<th>Estate and gift taxes</th>
<th>Miscellaneous receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954</td>
<td>$64,420</td>
<td>$29,942</td>
<td>$21,101</td>
<td>$9,945</td>
<td>$542</td>
<td>$283</td>
<td>$934</td>
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<td>1955</td>
<td>$60,209</td>
<td>$28,747</td>
<td>$17,861</td>
<td>$9,131</td>
<td>$585</td>
<td>$579</td>
<td>$924</td>
<td>$2,381</td>
</tr>
<tr>
<td>1956</td>
<td>$67,850</td>
<td>$32,188</td>
<td>$20,840</td>
<td>$9,292</td>
<td>$682</td>
<td>$322</td>
<td>$1,161</td>
<td>$2,689</td>
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<tr>
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<td>$35,620</td>
<td>$21,167</td>
<td>$9,055</td>
<td>$735</td>
<td>$328</td>
<td>$1,365</td>
<td>$2,293</td>
</tr>
<tr>
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<td>$68,550</td>
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<td>$20,704</td>
<td>$8,612</td>
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<td>$2,633</td>
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<td>$17,309</td>
<td>$8,504</td>
<td>$925</td>
<td>$321</td>
<td>$1,333</td>
<td>$2,804</td>
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<td>$77,763</td>
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<td>$21,494</td>
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<td>$1,606</td>
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<tr>
<td>1961</td>
<td>$77,659</td>
<td>$41,338</td>
<td>$20,954</td>
<td>$9,063</td>
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<td>(b)</td>
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<td>$3,344</td>
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<td>1962</td>
<td>$81,360</td>
<td>$45,541</td>
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<td>$1,125</td>
<td>(b)</td>
<td>$2,090</td>
<td>$2,845</td>
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<tr>
<td>1963</td>
<td>$85,900</td>
<td>$47,500</td>
<td>$21,300</td>
<td>$9,800</td>
<td>$1,320</td>
<td>(b)</td>
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<td>$3,499</td>
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<table>
<thead>
<tr>
<th>Year</th>
<th>Amount in millions</th>
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<tr>
<td>1957</td>
<td>+4.0</td>
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<tr>
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<td>-2.9</td>
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<tr>
<td>1959</td>
<td>-0.9</td>
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<tr>
<td>1960</td>
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<td>1961</td>
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<td>1962</td>
<td>+4.8</td>
</tr>
<tr>
<td>1963</td>
<td>+5.6</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage change over preceding year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>-1.1%</td>
</tr>
<tr>
<td>1956</td>
<td>+10.4%</td>
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<tr>
<td>1957</td>
<td>+8.2%</td>
</tr>
<tr>
<td>1958</td>
<td>-8.2%</td>
</tr>
<tr>
<td>1959</td>
<td>-13.8%</td>
</tr>
<tr>
<td>1960</td>
<td>+16.6%</td>
</tr>
<tr>
<td>1961</td>
<td>-11.0%</td>
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<tr>
<td>1962</td>
<td>+10.7%</td>
</tr>
<tr>
<td>1963</td>
<td>+11.2%</td>
</tr>
</tbody>
</table>

(a) Not of refunds and transfers.
(b) Beginning with fiscal 1961 the unemployment tax was transferred to the unemployment trust fund, so that net budget receipts no longer contain employment taxes.
(c) As estimated in the Review of the 1963 Budget (November 13, 1962).

Source: Bureau of the Budget.
4. Economic Effects

The economic effects of the Federal tax system are subject to much controversy. The full effects develop only after many years as individuals and businesses learn what is involved and arrange their affairs accordingly. Extensive studies have failed to demonstrate clearly the size and the significance of the effects today. Comparison with what would develop if the structure were different must involve troublesome uncertainty. But there is evidence to support important conclusions.

Stabilization Effects

The instability just noted is one of the “automatic stabilizers” which have been credited with helping stabilize the private economy since World War II. The amount of any net stabilizing is debatable. Nevertheless, the forces of cumulation which tend to develop during cyclical contractions and expansions are moderated somewhat by opposing movements of income tax payments. By 1962, however, some economists who had welcomed this feature were calling attention to what seems to be a serious defect. The increase in tax obligations puts an unwelcome brake on economic expansion before reasonably full employment is reached. As income rises from recession levels, the high and progressive tax rates withdraw more and more from the flow which would finance additional consumption and investment.

Amount and Types of Investment

The economic effects of Federal taxes include significant change in the balance, the proportion, and the nature of private consumption and investment. Taxation diverts resources from private to governmental use. The diversion may be done with relatively little distortion of the composition of private activities. The present Federal tax system, however, alters the pattern of the allocation of productive resources and of consumption.

The large dependence on income taxes, when their rates are so high and progressive, affects the balance between saving and investment on the one hand and consumption on the other. The highest rates of the individual income tax fall with greatest effect on income that would be available for saving and investment. The high corporate income tax impinges particularly on earnings which would otherwise be available for investment. Heavy taxes not only limit the volume of funds available for investment. These very high tax rates also cut the prospective (net) after-tax return on investment, thus discouraging venturesome activity.

The tendency to discourage investment is reinforced by the effect of historical cost depreciation in limiting funds available for replacement of capital equipment.

Taxes have another distorting influence on investment; various tax provisions favor the channeling of new savings through institutions — pension funds, savings institutions, and life insurance companies — whose investments are restricted to relatively conservative forms. Therefore, the tax law tends to restrict the supply of funds for risky undertakings, both directly and indirectly.

Special Tax Provisions and Their Effect on Resource Allocation

Numerous special tax provisions — including what are sometimes called “loopholes” — lower the tax barriers against certain kinds of economic activity. Other special features create above-average tax burdens on some types of economic activity. Payroll taxes add to the employer’s cost of using labor. Estate taxes bear heavily on large accumulations of wealth and encourage the use of long-term trusts. The depletion provisions encourage the extraction of oil and other natural resources. The exemption of state and local bond interest reduces the cost of state and local capital financing. Deductibility of charitable contributions stimulates philanthropy.

The direction or the general tendency of such results is usually clear. The size of the results, however, and their net significance for the country, are usually open to debate. Even those provisions which represent deliberate and considered efforts by Congress to influence the economy in some particular way need occasional re-examination. Circumstances change. The practical significance of most features depends heavily upon the height of the tax rates involved. Features which had rather little importance before tax rates soared can now affect the economy in ways deserving of careful study. Another point also follows: A cut in tax rates would reduce the importance of these details of the tax structure.

5. Distribution of the Burden

As shown above, the over-all burden of the tax system is heavy. But the burden is greater on some families than on others. A recent Tax Foundation study showed that the distribution of the total Federal tax burden by family income classes was clearly progressive over $10,000. For 1958, the total tax burden (excluding social insurance) amounted to 9.6% of total income for families with incomes under $2,000, and 28.6% for all families with incomes over $15,000.

Note 45, Allocation of the Tax Burden by Income Class (New York: The Foundation, 1960). The text of the study, of course, explains the problems involved in estimating how much of the tax on corporation income, payrolls, and estates is paid by families at different income levels. Some uncertainty must remain.

“Total income” as used in this study is defined broadly as equivalent to the family’s share in net national product. The income classes, however, refer to “family personal income.”
For the individual income tax alone, progression is much steeper. The burden of this tax in 1958 rose from 1.8% for families with incomes under $2,000 to 16.3% for families with incomes over $15,000. The data did not permit a breakdown of the "$15,000 and over" income class. At the higher income levels, of course, the burden of the individual income tax (as well as the imputed burden of the corporation income tax and the estate tax) would be much higher.

But are high tax rates effective, or, as is sometimes said, more often an illusion? Even the highest personal income and estate tax rates are anything but a sham. They touch thousands of taxpayers. They influence more economic activity than can be determined.

The difference between the statutory rates (ranging from 20% to 91%) and the effective rates actually paid on total reported income is largely accounted for by personal exemptions, personal deductions, and the ceiling rate on capital gains. These differences are shown in Table 5. For taxpayers not utilizing the alternative tax on capital gains, effective 1960 rates on total reported income (adjusted gross income) in the highest income classes ranged from 34% to 51%. These rates are lower than those which might be expected from an inspection of the rate schedule. However, when exemptions and deductions are taken into account, the effective rates on these same income classes range from 42% to 82% of total net taxable income (column (3) of Table 5). Returns utilizing the alternative tax ceiling of 25% on long-term gains showed effective tax rates almost as high for incomes from $50,000 to $150,000. At the highest level the tax was 58% of taxable income.

Furthermore, of course, the marginal rates which do actually apply are appreciably higher than the averages shown in Table 5. And it is the marginal rates which will have most influence on decisions.

For individual returns without significant amounts of capital gains, the average effective rate on joint returns with total (adjusted gross) incomes over $400,000 in 1960 was 80%; that on single person returns with incomes over $200,000 was 81%. The high rates of the individual income tax are obviously far from mere "window dressing."

Moreover, the progressivity of the individual income tax is hardly less sharp than the statutory rates would suggest. The actual, effective rates vary from zero to over 80%. For taxable returns the over-all ratio of income tax liability to income in 1960 was 13% on adjusted gross income, and 23% on taxable income. From

<table>
<thead>
<tr>
<th>Adjusted gross income class (thousands)</th>
<th>Number of returns with normal tax and surtax only</th>
<th>Effective tax rates (percent) on taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns with normal tax and surtax only</td>
<td>Adjusted gross income</td>
<td>Taxable income</td>
</tr>
<tr>
<td>$ 50 - under $100</td>
<td>54,131</td>
<td>33.5</td>
</tr>
<tr>
<td>100 - under 150</td>
<td>5,188</td>
<td>41.0</td>
</tr>
<tr>
<td>150 - under 200</td>
<td>1,219</td>
<td>44.4</td>
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<td>200 - under 500</td>
<td>978</td>
<td>45.7</td>
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<tr>
<td>500 - under 1,000</td>
<td>103</td>
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</tr>
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<td>1,000 and over</td>
<td>45</td>
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<td>$ 50 - under $100</td>
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<td>200 - under 500</td>
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<td>620</td>
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</tr>
<tr>
<td>1,000 and over</td>
<td>250</td>
<td>47.4</td>
</tr>
</tbody>
</table>

(a) Alternative tax was imposed in those cases where there were excess of long-term capital gains over short-term capital loss, but only if the alternative tax 25% long-term capital gains was less than the regular normal tax and surtax.

Source: Treasury Department, Statistics of Income.