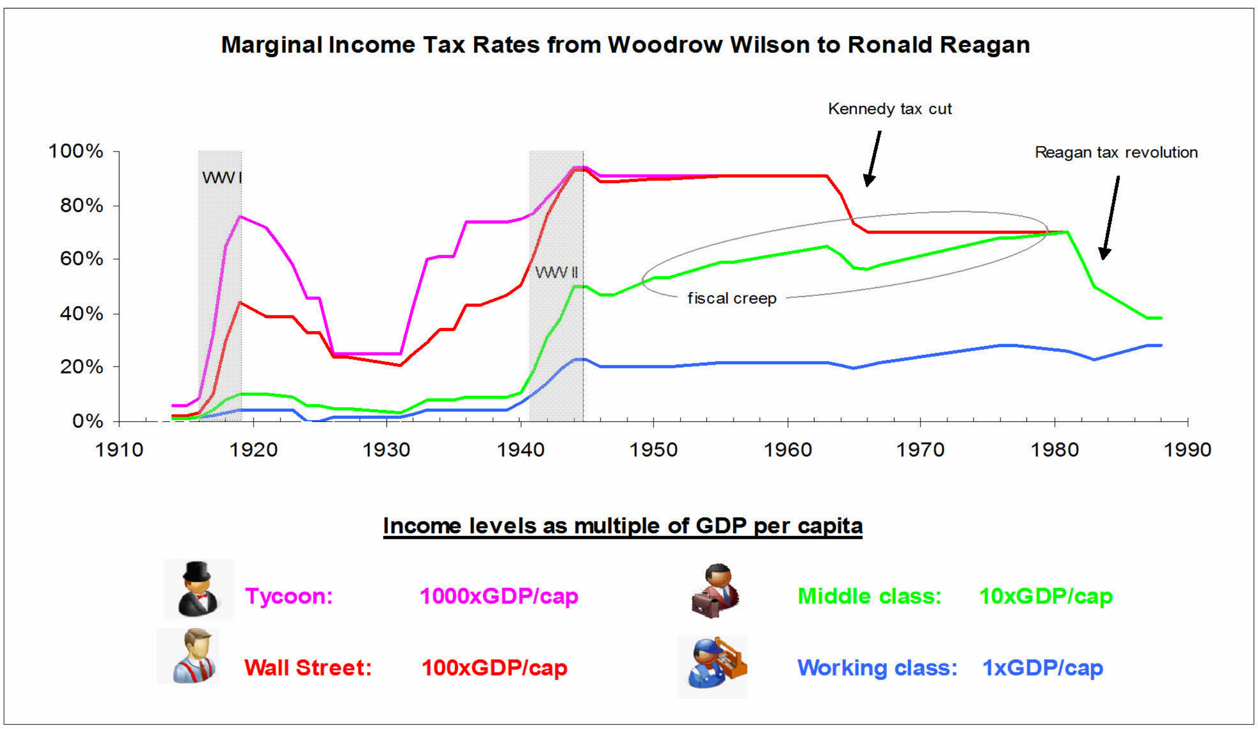
US Income Tax Rates – A Quick History

James Macdonald

Since the banking collapse of 2008 there has been much discussion of the likelihood of increased income tax rates, especially on the "underserving rich" such as bankers. Higher tax rates were certainly one of the legacies of the 1930s. In order to get a better picture of the political history of US income tax rates, I have constructed this chart which tracks marginal tax rates at four income levels which represent in a simplified and schematic way the four main social classes. These I have taken to be as follows:

- Plutocrats/tycoons – income in the tens of millions (in present day terms)
- Very wealthy/bankers – income in the millions
- Middle class – income in the hundreds of thousands
- Working class – income in the tens of thousands



The introduction of the income tax in 1913 was accompanied by a strong belief that the burden should be placed firmly on the mega-rich. This was a natural outgrowth of the intense public focus on the wealth of the tycoons of the gilded age – those "malefactors of great wealth" as they were called by Theodore Roosevelt. Highly progressive income tax rates were an intrinsic part of the attempt to undo their hold on the economy through anti-trust laws and other measures. The result was tax bands that rose to extraordinarily high multiples of average incomes. The highest rate of 7% in 1913 was paid only by those with incomes equivalent to 11,700 times GDP per capita. In other words there was a tax band (not visible in this chart) that applied only to people whose income would be the modern equivalent of over $500 million! In the meantime, even the very comfortably-off middle class paid no more than a token 1% of their incomes. This underlying principle of taxation, so alien to recent practice, was considered to be the norm for two generations.

It is no surprise, then, that World War I was paid for (insofar as it was not financed by borrowing) by taxes falling on the very rich, with rates on the tycoon class reaching 77%. By contrast, even in 1918, middle class tax rates were no higher than 10%.

This tax-the-rich principle was not abandoned by the conservative Republican administrations of the 1920s. There was a "peace dividend" in the form of tax reductions for all, and especially for highly taxed tycoons. However, the income tax burden remained firmly placed on the super-rich.

It is scarcely surprising, then, that FDR continued the tradition. The "money changers" were not merely to be chased from the high temple of civilisation, as he declared in his inaugural speech; they were also to be relieved of their undeserved riches. His tax rises of the 1930s raised marginal rates more or less to World War I levels, with plutocrats taxed at up to 79%.

It was World War II that started to change the picture. World War I was paid for largely by the very rich. World War II was so expensive that it had to be paid for by everyone. The separate tax concept of the "tycoon" disappeared once the merely very wealthy were taxed at the same marginal rates.

The first question that springs to mind when looking at the post-war era is: Where is the peace dividend? In contrast to World War I, there was no reduction of tax rates at all after World War II. The answer is that there was a peace dividend, but it took the form of increased social spending, not of reduced taxation.

Equally striking is that the principle of taxing the super-rich at punitive rates outlived the war. The Republican administration of the 1950s did nothing to lower the 90%+ rates that had been introduced in the 1940s. Surprisingly, perhaps, it was the Democrats who first reduced the top rates in the mid-60s. The "Laffer curve" had not yet been invented, but already that idea that very high rates might be counterproductive was starting to seep in.

The big story after World War II was the increasing tax burden on the middle class. This occurred through a process of inflation and "fiscal creep" (visible in the slowly rising green line) rather than rising marginal rates. JFK's tax reductions attempted to address this concern, but fiscal creep subsequently undid his work and more. When the 70% top tax bracket was introduced in 1965, it applied only to incomes over 28 times GDP per capita. By 1981, even those with incomes 8 times GDP per capita had moved into the 70% bracket. It was this process that made possible the Reagan revolution. The fortunate "wall-streeters" and "tycoons" saw their tax rates carried down on a wave of middle class revolt.

The tax burden on the working class rose sharply in WWII and has remained more or less stable since then. It did not go up in parallel with middle class tax rates, nor has it gone down. The result is a massive compression of tax rates since 1980. However, it is worth bearing in mind that this is only a chart of marginal tax rates, and makes no allowance for deductions and allowances which are more significant at lower income levels.

What does the future hold in the light of this history? I can imagine three scenarios:

- One possibility is that we have been living through an aberrant period of tax rate compression and are about to see a return to the sharply differentiated rates of earlier decades. Certainly the current political and economic climate would support such a trend. Could we have a re-enactment of the 1930s tax rises on the super-wealthy, with confiscatory tax rates for incomes over $1 million (or even $500,000, given Obama's views on "reasonable" income levels for bankers)?

- However, another message of the chart is that each crisis has tended to bring a wider group into the tax net because only in this way can large sums be raised. The First World War demonstrated the need to tax the very wealthy as well as tycoons. The Second World War demonstrated the need to tax the middle class and the working class. The current crisis is likely to raise everyone's taxes, not just the wealthy.

- In some ways the chart appears to show an inexorable trend towards a flat tax. First the tax rate of the "wall-streeters" rises until it reaches that of the tycoons, and the two groups merge. Then the middle class tax rate rises until it reaches that of the super-wealthy, and they merge. On this basis, the next wave would see the working class tax rate rise until it merges with the middle class and the super-wealthy.

However, history rarely moves in straight lines, and I suspect that we are in for a major detour here. Given the combination of the likely rise in public debt to crisis levels and the current political climate, the most likely outcome would seem to be a general tax rise on the whole population made politically palatable by sharply higher tax rates on the very wealthy – in other words a rerun of the 1940s.

It is also worth noting that the rise in income taxes on the wealthy during the Depression was not immediate. It was the chronic nature of the unemployment that gradually shifted the political climate to the left. Hoover started the process of raising tax rates in 1932 as the Depression began to appear intractable and the electorate became increasingly desperate. The more optimistic mood after FDR's election allowed FDR to stay with Hoover's rates for a while. However, the mood soured as unemployment refused to come down. It was the increasingly radical tone of the mid-1930s that forced FDR to move to the left for his re-election campaign, and tax rates were accordingly raised in 1936.

In other words, if you want to predict the direction of tax rates, look at the unemployment statistics as well as the public financial accounts.

June 2009