HISTORY OF U.S. TAX SYSTEM

The federal, state, and local tax systems in the United States have been marked by significant changes over the years in response to changing circumstances and changes in the role of government. The types of taxes collected, their relative proportions, and the magnitudes of the revenues collected are all far different than they were 50 or 100 years ago. Some of these changes are traceable to specific historical events, such as a war or the passage of the 16th Amendment to the Constitution that granted the Congress the power to levy a tax on personal income. Other changes were more gradual, responding to changes in society, in our economy, and in the roles and responsibilities that government has taken unto itself.

Colonial Times

For most of our nation's history, individual taxpayers rarely had any significant contact with Federal tax authorities as most of the Federal government's tax revenues were derived from excise taxes, tariffs, and customs duties. Before the Revolutionary War, the colonial government had only a limited need for revenue, while each of the colonies had greater responsibilities and thus greater revenue needs, which they met with different types of taxes. For example, the southern colonies primarily taxed imports and exports, the middle colonies at times imposed a property tax and a "head" or poll tax levied on each adult male, and the New England colonies raised revenue primarily through general real estate taxes, excises taxes, and taxes based on occupation.

England's need for revenues to pay for its wars against France led it to impose a series of taxes on the American colonies. In 1765, the English Parliament passed the Stamp Act, which was the first tax imposed directly on the American colonies, and then Parliament imposed a tax on tea. Even though colonists were forced to pay these taxes, they lacked representation in the English Parliament. This led to the rallying cry of the American Revolution that "taxation without representation is tyranny" and established a persistent wariness regarding taxation as part of the American culture.

The Post Revolutionary Era

The Articles of Confederation, adopted in 1781, reflected the American fear of a strong central government and so retained much of the political power in the States. The national government had few responsibilities and no nationwide tax system, relying on donations from the States for its revenue. Under the Articles, each State was a sovereign entity and could levy tax as it pleased.

When the Constitution was adopted in 1789, the Founding Fathers recognized that no government could function if it relied entirely on other governments for its resources, thus the Federal Government was granted the authority to raise taxes. The Constitution endowed the Congress with the power to "…lay and collect taxes, duties, imposts, and excises, pay the Debts and provide for the common Defense and general Welfare of the United States." Ever on guard against the power of the central government to eclipse that of the states, the collection of the taxes was left as the responsibility of the State governments.

To pay the debts of the Revolutionary War, Congress levied excise taxes on distilled spirits, tobacco and snuff, refined sugar, carriages, property sold at auctions, and various legal documents. Even in the early days of the Republic, however, social purposes influenced what was taxed. For example, Pennsylvania imposed an excise tax on liquor sales partly "to restrain persons in low circumstances from an immoderate use thereof." Additional support for such a targeted tax came from property owners, who hoped thereby to keep their property tax rates low, providing an early example of the political tensions often-underlying tax policy decisions.

Though social policies sometimes governed the course of tax policy even in the early days of the Republic, the nature of these policies did not extend either to the collection of taxes so as to equalize incomes and wealth, or for the purpose of redistributing income or wealth. As Thomas Jefferson once wrote regarding the "general Welfare" clause:

> To take from one, because it is thought his own industry and that of his father has acquired too much, in order to spare to others who (or whose fathers) have not exercised equal industry and skill, is to violate arbitrarily the first principle of association, "to guarantee to everyone a free exercise of his industry and the fruits acquired by it."

With the establishment of the new nation, the citizens of the various colonies now had proper democratic representation, yet many Americans still opposed and resisted taxes they deemed unfair or improper. In 1794, a group of farmers in southwestern Pennsylvania physically opposed the tax on whiskey, forcing President Washington to send Federal troops to suppress the Whiskey Rebellion, establishing the important precedent that the Federal government was determined to enforce its revenue laws. The Whiskey Rebellion also confirmed, however, that the resistance to unfair or high taxes that led to the Declaration of Independence did not evaporate with the forming of a new, representative government.

During the confrontation with France in the late 1790's, the Federal Government imposed the first direct taxes on the owners of houses, land, slaves, and estates. These taxes are called direct taxes because they are a recurring tax paid directly by the taxpayer to the government based on the value of the item that is the basis for the tax. The issue of direct taxes as opposed to indirect taxes played a crucial role in the evolution of Federal tax policy in the following years. When Thomas Jefferson was elected President in 1802, direct taxes were abolished and for the next 10 years there were no internal revenue taxes other than excises.

To raise money for the War of 1812, Congress imposed additional excise taxes, raised certain customs duties, and raised money by issuing Treasury notes. In 1817 Congress repealed these taxes, and for the next 44 years the Federal Government collected no internal revenue. Instead, the Government received most of its revenue from high customs duties and through the sale of public land.

The Civil War

When the Civil War erupted, the Congress passed the Revenue Act of 1861, which restored earlier excises taxes and imposed a tax on personal incomes. The income tax was levied at 3 percent on all incomes higher than $800 a year. This tax on personal income was a new direction for a Federal tax system based mainly on excise taxes and customs duties. Congress quickly acknowledged certain inadequacies of the income tax and thus none was collected until the following year.

By the spring of 1862 it was clear the war would not end quickly and with the Union's debt growing at the rate of $2 million daily it was equally clear the Federal government would need additional revenues. On July 1, 1862 the Congress passed new excise taxes on such items as playing cards, gunpowder, feathers, telegrams, iron, leather, pianos, yachts, billiard tables, drugs, patent medicines, and whiskey. Many legal documents were also taxed and license fees were collected for almost all professions and trades.

The 1862 law also made important reforms to the Federal income tax that presaged important features of the current tax. For example, a two-tiered rate structure was enacted, with taxable incomes up to $10,000 taxed at a 3 percent rate and higher incomes taxed at 5 percent. A standard deduction of $600 was enacted and a variety of deductions were permitted for such things as rental housing, repairs, losses, and other taxes paid. In addition, to assure timely collection, taxes were "withheld at the source" by employers.

The need for Federal revenue declined sharply after the war and most taxes were repealed. By 1868, the main source of Government revenue was derived from liquor and tobacco taxes. The income tax was abolished in 1872. From 1868 to 1913, almost 90 percent of all revenue was collected from the remaining excises.

The 16th Amendment

Under the Constitution, Congress could impose direct taxes only if they were levied in proportion to each State's population. Thus, when a flat rate Federal income tax was enacted in 1894, it was quickly challenged and in 1895 the U.S. Supreme Court ruled it unconstitutional because it was a direct tax not apportioned according to the population of each state.

Lacking the revenue from an income tax and with all other forms of internal taxes facing stiff resistance, from 1896 until 1910 the Federal government relied heavily on high tariffs for its revenues. The War Revenue Act of 1899 sought to raise funds for the Spanish-American War through the sale of bonds; taxes on recreational facilities used by workers, and doubled taxes on beer and tobacco. A tax was even imposed on chewing gum. The Act expired in 1902, so that Federal receipts fell from 1.7 percent of Gross Domestic Product to 1.3 percent.

While the War Revenue Act returned to traditional revenue sources following the Supreme Court's 1895 ruling on the income tax, debate on alternative revenue sources remained lively. The nation was becoming increasingly aware that high tariffs and excise taxes were not sound economic policy and often fell disproportionately on the less affluent. Proposals to reinstate the income tax were introduced by Congressmen from agricultural areas whose constituents feared a Federal tax on property, especially on land, as a replacement for the excises.

Eventually, the income tax debate pitted southern and western Members of Congress representing more agricultural and rural areas against the industrial northeast. The debate resulted in an agreement calling for a tax, called an excise tax, to be imposed on business income, and a Constitutional amendment to allow the Federal government to impose tax on individuals' lawful incomes without regard to the population of each State.

By 1913, 36 States had ratified the 16th Amendment to the Constitution. In October, Congress passed a new income tax law with rates beginning at 1 percent and rising to 7 percent for taxpayers with income in excess of $500,000. Less than 1 percent of the population paid income tax at the time. Form 1040 was introduced as the standard tax reporting form and, though changed in many ways over the years, remains in use today.

One of the problems with the new income tax law was how to define "lawful" income. Congress addressed this problem by amending the law in 1916 by deleting the word "lawful" from the definition of income. As a result, all income became subject to tax, even if it was earned by illegal means. Several years later, the Supreme Court declared bootleggers and others who earned income through illegal activities to avoid paying taxes could not use the Fifth Amendment. Consequently, many who broke various laws associated with illegal activities and were able to escape justice for these crimes were incarcerated on tax evasion charges.

Prior to the enactment of the income tax, most citizens were able to pursue their private economic affairs without the direct knowledge of the government. Individuals earned their wages, businesses earned their profits, and wealth was accumulated and dispensed with little or no interaction with government entities. The income tax fundamentally changed this relationship, giving the government the right and the need to know about all manner of an individual or business' economic life. Congress recognized the inherent invasiveness of the income tax into the taxpayer's personal affairs and so in 1916 it provided citizens with some degree of protection by requiring that information from tax returns be kept confidential.

World War I and the 1920's

The entry of the United States into World War I greatly increased the need for revenue and Congress responded by passing the 1916 Revenue Act. The 1916 Act raised the lowest tax rate from 1 percent to 2 percent and raised the top rate to 15 percent on taxpayers with incomes in excess of $1.5 million. The 1916 Act also imposed taxes on estates and excess business profits.

Driven by the war and largely funded by the new income tax, by 1917 the Federal budget was almost equal to the total budget for all the years between 1791 and 1916. Needing still more tax revenue, the War Revenue Act of 1917 lowered exemptions and greatly increased tax rates. In 1916, a taxpayer needed $1.5 million in taxable income to face a 15 percent rate. By 1917 a taxpayer with only $40,000 faced a 16 percent rate and the individual with $1.5 million faced a tax rate of 67 percent.

Another revenue act was passed in 1918, which hiked tax rates once again, this time raising the bottom rate to 6 percent and the top rate to 77 percent. These changes increased revenue from $761 million in 1916 to $3.6 billion in 1918, which represented about 25 percent of Gross Domestic Product (GDP). Even in 1918, however, only 5 percent of the population paid income taxes and yet the income tax funded one-third of the cost of the war.

The economy boomed during the 1920s and increasing revenues from the income tax followed. This allowed Congress to cut taxes five times, ultimately returning the bottom tax rate to 1 percent and the top rate down to 25 percent and reducing the Federal tax burden as a share of GDP to 13 percent. As tax rates and tax collections declined, the economy was strengthened further.

In October of 1929 the stock market crash marked the beginning of the Great Depression. As the economy shrank, government receipts also fell. In 1932, the Federal government collected only $1.9 billion, compared to $6.6 billion in 1920. In the face of rising budget deficits, which reached $2.7 billion in 1931, Congress followed the prevailing economic wisdom at the time and passed the Tax Act of 1932, which dramatically increased tax rates once again. This was followed by another tax increase in 1936 that further improved the government's finances while further weakening the economy. By 1936 the lowest tax rate had reached 4 percent and the top rate was up to 79 percent. In 1939, Congress systematically codified the tax laws so that all subsequent tax legislation until 1954 amended this basic code. The combination of a shrunken economy and the repeated tax increases raised the Federal government's tax burden to 6.8 percent of GDP by 1940.

The Social Security Tax

The state of the economy during the Great Depression led to passage of the Social Security Act in 1935. This law provided payments known as "unemployment compensation" to workers who lost their jobs. Other sections of the Act gave public aid to the aged, the needy, the handicapped, and to certain minors. These programs were financed by a 2 percent tax, one half of which was subtracted directly from an employee's paycheck and one half collected from employers on the employee's behalf. The tax was levied on the first $3,000 of the employee's salary or wage.

World War II

Even before the United States entered the Second World War, increasing defense spending and the need for monies to support the opponents of Axis aggression led to the passage in 1940 of two tax laws that increased individual and corporate taxes, which were followed by another tax hike in 1941. By the end of the war the nature of the income tax had been fundamentally altered. Reductions in exemption levels meant that taxpayers with taxable incomes of only $500 faced a bottom tax rate of 23 percent, while taxpayers with incomes over $1 million faced a top rate of 94 percent. These tax changes increased federal receipts from $8.7 billion in 1941 to $45.2 billion in 1945. Even with an economy stimulated by wartime production, federal taxes as a share of GDP grew from 7.6 percent in 1941 to 20.4 percent in 1945. Beyond the rates and revenues, however, another aspect about the income tax that changed was the increase in the number of income taxpayers from 4 million in 1939 to 43 million in 1945.

Another important feature of the income tax that changed was the return to income tax withholding as had been done during the Civil War. This greatly eased the collection of the tax for both the taxpayer and the Bureau of Internal Revenue. However, it also greatly reduced the taxpayer's awareness of the amount of tax being collected, i.e. it reduced the transparency of the tax, which made it easier to raise taxes in the future.

Developments after World War II

Tax cuts following the war reduced the Federal tax burden as a share of GDP from its wartime high of 20.9 percent in 1944 to 14.4 percent in 1950. However, the Korean War created a need for additional revenues, which, combined with the extension of Social Security coverage to self-employed persons, meant that by 1952 the tax burden had returned to 19.0 percent of GDP.

In 1953 the Bureau of Internal Revenue was renamed the Internal Revenue Service (IRS), following a reorganization of its function. The new name was chosen to stress the service aspect of its work. By 1959, the IRS had become the world's largest accounting, collection, and forms-processing organization. Computers were introduced to automate and streamline its work and to improve service to taxpayers. In 1961, Congress passed a law requiring individual taxpayers to use their Social Security number as a means of tax form identification. By 1967, all business and personal tax returns were handled by computer systems, and by the late 1960s, the IRS had developed a computerized method for selecting tax returns to be examined. This made the selection of returns for audit fairer to the taxpayer and allowed the IRS to focus its audit resources on those returns most likely to require an audit.

Throughout the 1950s tax policy was increasingly seen as a tool for raising revenue and for changing the incentives in the economy, but also as a tool for stabilizing macroeconomic activity. The economy remained subject to frequent boom and bust cycles and many policymakers readily accepted the new economic policy of raising or lowering taxes and spending to adjust aggregate demand and thereby smooth the business cycle. Even so, however, the maximum tax rate in 1954 remained at 87 percent of taxable income. While the income tax underwent some manner of revision or amendment almost every year since the major reorganization of 1954, certain years marked especially significant changes. For example, the Tax Reform Act of 1969 reduced income tax rates for individuals and private foundations.

Beginning in the late 1960s and continuing through the 1970s the United States experienced persistent and rising inflation rates, ultimately reaching 13.3 percent in 1979. Inflation has a deleterious effect on many aspects of an economy, but it also can play havoc with an income tax system unless appropriate precautions are taken. Specifically, unless the tax system's parameters, i.e. its brackets and its fixed exemptions, deductions, and credits, are indexed for inflation, a rising price level will steadily shift taxpayers into ever higher tax brackets by reducing the value of those exemptions and deductions.

During this time, the income tax was not indexed for inflation and so, driven by a rising inflation, and despite repeated legislated tax cuts, the tax burden rose from 19.4 percent of GDP to 20.8 percent of GDP. Combined with high marginal tax rates, rising inflation, and a heavy regulatory burden, this high tax burden caused the economy to under-perform badly, all of which laid the groundwork for the Reagan tax cut, also known as the Economic Recovery Tax Act of 1981.

The Reagan Tax Cut

The Economic Recovery Tax Act of 1981, which enjoyed strong bi-partisan support in the Congress, represented a fundamental shift in the course of federal income tax policy. Championed in principle for many years by then-Congressman Jack Kemp (R-NY) and then-Senator Bill Roth (R- DE), it featured a 25 percent reduction in individual tax brackets, phased in over 3 years, and indexed for inflation thereafter. This brought the top tax bracket down to 50 percent.

The 1981 Act also featured a dramatic departure in the treatment of business outlays for plant and equipment, i.e. capital cost recovery, or tax depreciation. Heretofore, capital cost recovery had attempted roughly to follow a concept known as economic depreciation, which refers to the decline in the market value of a producing asset over a specified period of time. The 1981 Act explicitly displaced the notion of economic depreciation, instituting instead the Accelerated Cost Recovery System, which greatly reduced the disincentive facing business investment and ultimately prepared the way for the subsequent boom in capital formation. In addition to accelerated cost recovery, the 1981 Act also instituted a 10 percent Investment Tax Credit to spur additional capital formation.

Prior to, and in many circles even after the 1981 tax cut, the prevailing view was that tax policy is most effective in modulating aggregate demand whenever demand and supply become mismatched, i.e. whenever the economy went in to recession or became "over-heated". The 1981 tax cut represented a new way of looking at tax policy, though it was in fact a return to a more traditional, or neoclassical, economic perspective. The essential idea was that taxes have their first and primary effect on the economic incentives facing individuals and businesses. Thus, the tax rate on the last dollar earned, i.e. the marginal dollar, is much more important to economic activity than the tax rate facing the first dollar earned or than the average tax rate. By reducing marginal tax rates it was believed the natural forces of economic growth would be less restrained. The most productive individuals would then shift more of their energies to productive activities rather than leisure and businesses would take advantage of many more now profitable opportunities. It was also thought that reducing marginal tax rates would significantly expand the tax base as individuals shifted more of their income and activities into taxable forms and out of tax-exempt forms.

The 1981 tax cut actually represented two departures from previous tax policy philosophies, one explicit and intended and the second by implication. The first change was the new focus on marginal tax rates and incentives as the key factors in how the tax system affects economic activity. The second policy departure was the de facto shift away from income taxation and toward taxing consumption. Accelerated cost recovery was one manifestation of this shift on the business side, but the individual side also saw a significant shift in the enactment of various provisions to reduce the multiple taxation of individual saving. The Individual Retirement Account, for example, was enacted in 1981.

Simultaneously with the enactment of the tax cuts in 1981 the Federal Reserve Board, with the full support of the Reagan Administration, altered monetary policy so as to bring inflation under control. The Federal Reserve's actions brought inflation down faster and further than was anticipated at the time, and one consequence was that the economy fell into a deep recession in 1982. Another consequence of the collapse in inflation was that federal spending levels, which had been predicated on a higher level of expected inflation, were suddenly much higher in inflation-adjusted terms. The combination of the tax cuts, the recession, and the one-time increase in inflation-adjusted federal spending produced historically high budget deficits which, in turn, led to a tax increase in 1984 that pared back some of the tax cuts enacted in 1981, especially on the business side.

As inflation came down and as more and more of the tax cuts from the 1981 Act went into effect, the economy began a strong and sustained pattern of growth. Though the painful medicine of disinflation slowed and initially hid the process, the beneficial effects of marginal rate cuts and reductions in the disincentives to invest took hold as promised.

The Evolution of Social Security and Medicare

The Social Security system remained essentially unchanged from its enactment until 1956. However, beginning in 1956 Social Security began an almost steady evolution as more and more benefits were added, beginning with the addition of Disability Insurance benefits. In 1958, benefits were extended to dependents of disabled workers. In 1967, disability benefits were extended to widows and widowers. The 1972 amendments provided for automatic cost-of-living benefits.

In 1965, Congress enacted the Medicare program, providing for the medical needs of persons aged 65 or older, regardless of income. The 1965 Social Security Amendments also created the Medicaid program, which provides medical assistance for persons with low incomes and resources.

Of course, the expansions of Social Security and the creation of Medicare and Medicaid required additional tax revenues, and thus the basic payroll tax was repeatedly increased over the years. Between 1949 and 1962 the payroll tax rate climbed steadily from its initial rate of 2 percent to 6 percent. The expansions in 1965 led to further rate increases, with the combined payroll tax rate climbing to 12.3 percent in 1980. Thus, in 31 years the maximum Social Security tax burden rose from a mere $60 in 1949 to $3,175 in 1980.

Despite the increased payroll tax burden, the benefit expansions Congress enacted in previous years led the Social Security program to acute funding crises in the early 1980s. Eventually, Congress legislated some minor programmatic changes in Social Security benefits, along with an increase in the payroll tax rate to 15.3 percent by 1990. Between 1980 and 1990, the maximum Social Security payroll tax burden more than doubled to $7,849.

The Tax Reform Act of 1986

Following the enactment of the 1981, 1982, and 1984 tax changes there was a growing sense that the income tax was in need of a more fundamental overhaul. The economic boom following the 1982 recession convinced many political leaders of both parties that lower marginal tax rates were essential to a strong economy, while the constant changing of the law instilled in policy makers an appreciation for the complexity of the tax system. Further, the debates during this period led to a general understanding of the distortions imposed on the economy, and the lost jobs and wages, arising from the many peculiarities in the definition of the tax base. A new and broadly held philosophy of tax policy developed that the income tax would be greatly improved by repealing these various special provisions and lowering tax rates further. Thus, in his 1984 State of the Union speech President Reagan called for a sweeping reform of the income tax so it would have a broader base and lower rates and would be fairer, simpler, and more consistent with economic efficiency.

The culmination of this effort was the Tax Reform Act of 1986, which brought the top statutory tax rate down from 50 percent to 28 percent while the corporate tax rate was reduced from 50 percent to 35 percent. The number of tax brackets was reduced and the personal exemption and standard deduction amounts were increased and indexed for inflation, thereby relieving millions of taxpayers of any Federal income tax burden. However, the Act also created new personal and corporate Alternative Minimum Taxes, which proved to be overly complicated, unnecessary, and economically harmful.

The 1986 Tax Reform Act was roughly revenue neutral, that is, it was not intended to raise or lower taxes, but it shifted some of the tax burden from individuals to businesses. Much of the increase in the tax on business was the result of an increase in the tax on business capital formation. It achieved some simplifications for individuals through the elimination of such things as income averaging, the deduction for consumer interest, and the deduction for state and local sales taxes. But in many respects the Act greatly added to the complexity of business taxation, especially in the area of international taxation. Some of the over-reaching provisions of the Act also led to a downturn in the real estate markets, which played a significant role in the subsequent collapse of the Savings and Loan industry.

Seen in a broader picture, the 1986 tax act represented the next to the last installment of an extraordinary process of tax rate reductions. Over the 22-year period from 1964 to 1986 the top individual tax rate was reduced from 91 to 28 percent. However, because upper-income taxpayers increasingly chose to receive their income in taxable form, and because of the broadening of the tax base, the progressiveness of the tax system actually rose during this period.

The 1986 tax act also represented a temporary reversal in the evolution of the tax system. Though called an income tax, the Federal tax system had for many years actually been a hybrid income and consumption tax, with the balance shifting toward or away from a consumption tax with many of the major tax acts. The 1986 tax act shifted the balance once again toward the income tax. Of greatest importance in this regard was the return to references to economic depreciation in the formulation of the capital cost recovery system and the significant new restrictions on the use of Individual Retirement Accounts.

Between 1986 and 1990 the Federal tax burden rose as a share of GDP from 17.5 to 18 percent. Despite this increase in the overall tax burden, persistent budget deficits due to even higher levels of government spending created near constant pressure to increase taxes. Thus, in 1990 the Congress enacted a significant tax increase featuring an increase in the top tax rate to 31 percent. Shortly after his election, President Clinton insisted on and the Congress enacted a second major tax increase in 1993 in which the top tax rate was raised to 36 percent and a 10 percent surcharge was added, leaving the effective top tax rate at 39.6 percent. Clearly, the trend toward lower marginal tax rates had been reversed, but, as it turns out, only temporarily.

The Taxpayer Relief Act of 1997 made additional changes to the tax code providing a modest tax cut. The centerpiece of the 1997 Act was a significant new tax benefit to certain families with children through the Per Child Tax credit. The truly significant feature of this tax relief, however, was that the credit was refundable for many lower-income families. That is, in many cases the family paid a "negative" income tax, or received a credit in excess of their pre-credit tax liability. Though the tax system had provided for individual tax credits before, such as the Earned Income Tax credit, the Per Child Tax credit began a new trend in federal tax policy. Previously tax relief was generally given in the form of lower tax rates or increased deductions or exemptions. The 1997 Act really launched the modern proliferation of individual tax credits and especially refundable credits that are in essence spending programs operating through the tax system.

The years immediately following the 1993 tax increase also saw another trend continue, which was to once again shift the balance of the hybrid income tax-consumption tax toward the consumption tax. The movement in this case was entirely on the individual side in the form of a proliferation of tax vehicles to promote purpose-specific saving. For example, Medical Savings Accounts were enacted to facilitate saving for medical expenses. An Education IRA and the Section 529 Qualified Tuition Program was enacted to help taxpayers pay for future education expenses. In addition, a new form of saving vehicle was enacted, called the Roth IRA, which differed from other retirement savings vehicles like the traditional IRA and employer-based 401(k) plans in that contributions were made in after-tax dollars and distributions were tax free.

Despite the higher tax rates, other economic fundamentals such as low inflation and low interest rates, an improved international picture with the collapse of the Soviet Union, and the advent of a qualitatively and quantitatively new information technologies led to a strong economic performance throughout the 1990s. This, in turn, led to an extraordinary increase in the aggregate tax burden, with Federal taxes as a share of GDP reaching a postwar high of 20.8 percent in 2000.

The Bush Tax Cut

By 2001, the total tax take had produced a projected unified budget surplus of $281 billion, with a cumulative 10 year projected surplus of $5.6 trillion. Much of this surplus reflected a rising tax burden as a share of GDP due to the interaction of rising real incomes and a progressive tax rate structure. Consequently, under President George W. Bush's leadership the Congress halted the projected future increases in the tax burden by passing the Economic Growth and Tax Relief and Reconciliation Act of 2001. The centerpiece of the 2001 tax cut was to regain some of the ground lost in the 1990s in terms of lower marginal tax rates. Though the rate reductions are to be phased in over many years, ultimately the top tax rate will fall from 39.6 percent to 33 percent.

The 2001 tax cut represented a resumption of a number of other trends in tax policy. For example, it expanded the Per Child Tax credit from $500 to $1000 per child. It also increased the Dependent Child Tax credit. The 2001 tax cut also continued the move toward a consumption tax by expanding a variety of savings incentives. Another feature of the 2001 tax cut that is particularly noteworthy is that it put the estate, gift, and generation-skipping taxes on course for eventual repeal, which is also another step toward a consumption tax. One novel feature of the 2001 tax cut compared to most large tax bills is that it was almost devoid of business tax provisions.

The 2001 tax cut will provide additional strength to the economy in the coming years as more and more of its provisions are phased in, and indeed one argument for its enactment had always been as a form of insurance against an economic downturn. However, unbeknownst to the Bush Administration and the Congress, the economy was already in a downturn as the Act was being debated. Thankfully, the downturn was brief and shallow, but it is already clear that the tax cuts that were enacted and went into effect in 2001 played a significant role in supporting the economy, shortening the duration of the downturn, and preparing the economy for a robust recovery.

One lesson from the economic slowdown was the danger of ever taking a strong economy for granted. The strong growth of the 1990s led to talk of a "new" economy that many assumed was virtually recession proof. The popularity of this assumption was easy to understand when one considers that there had only been one very mild recession in the previous 18 years.

Taking this lesson to heart, and despite the increasing benefits of the 2001 tax cut and the early signs of a recovery, President Bush called for and the Congress eventually enacted an economic stimulus bill. The bill included an extension of unemployment benefits to assist those workers and families under financial stress due to the downturn. The bill also included a provision to providing a temporary but significant acceleration of depreciation allowances for business investment, thereby assuring that the recovery and expansion will be strong and balanced. Interestingly, the depreciation provision also means that the Federal tax on business has resumed its evolution toward a consumption tax, once again paralleling the trend in individual taxation.

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