Joint Economic Committee
*Republicans* **Representative Kevin Brady** *Vice Chairman*

**REPUBLICAN STAFF ANALYSIS**

# Historical Tax Rates: Rhetoric vs. Reality

November 14, 2012

## Introduction

A recent report by the Congressional Research Service (CRS) claims that changing the top statutory individual income tax rate has little or no effect on economic growth.[1] To support this claim, the CRS report compares the top rates from 1945 through 2010 with various economic indicators, such as private saving, investment, productivity, and per capita GDP; and it finds no statistically significant relationship. This result should not be surprising. The top rate is only one feature of our tax system. By itself, the top rate tells us nothing about the overall tax burden.

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When it comes to economic growth, what matters most are the *effective marginal* tax rates on labor and capital. *Effective* rates reflect the interaction between statutory rates, credits, and deductions for individuals and businesses, as well as the distribution of income. *Marginal* rates measure the additional taxes paid on additional income earned. Thus, the effective marginal tax rate determines the after-tax return to labor and capital, which affects the incentive to work, save, and invest. The top rate affects the economy only to the extent that it affects the effective marginal tax rate.[2]

## Historical Rates and Economic Growth

Between the mid-1940s and the early-2000s, the top statutory individual income tax rate declined from 94 percent to 35 percent.[3] Despite this dramatic decline, the average annual rate of growth in real per capita Gross Domestic Product (GDP) has exhibited no discernible trend. See the chart at the top of page 2.

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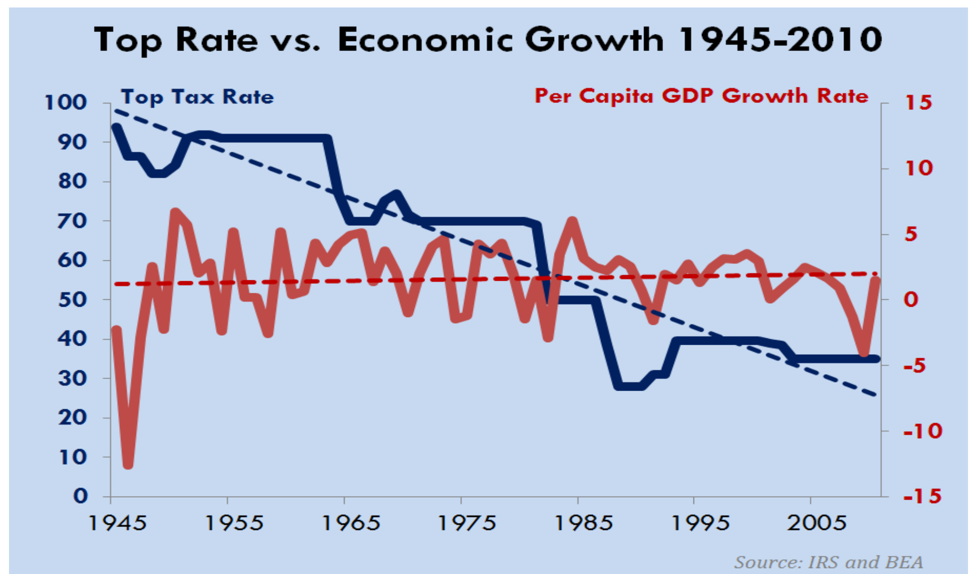
A recent CRS report says historical evidence supports the claim that "the top tax rates appear to have little or no relation to the size of the economic pie." Many pundits and policy advocates have actively publicized the CRS report and proclaimed that it proves raising taxes on the richest Americans won't adversely affect the economy. In fact, the CRS report merely proves historical changes in the top rate provide a misleading indicator of how the overall tax burden has changed over time.

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**Top Rates and Effective Rates**

The dramatic decline in the top statutory individual income tax rate provides a striking visual image. The fact that this decline appears to have no effect on the economy seemingly lends supports to the conclusion that we can tax the rich with economic impunity. But there is another conclusion that can also be drawn. Exorbitant tax rates don't have much effect on the economy if they don't affect much income.

From 1945 through 1963, the top statutory tax rate generally exceeded 90 percent for individuals with taxable income greater than $200,000.[4] According to Internal Revenue Service (IRS) data, taxpayers with Adjusted Gross Income (AGI) of $200,000 or more accounted for only 1 percent of the total AGI reported in each of those years.[5] So, when the top rate was 90 percent, it applied to only 1 percent of AGI.

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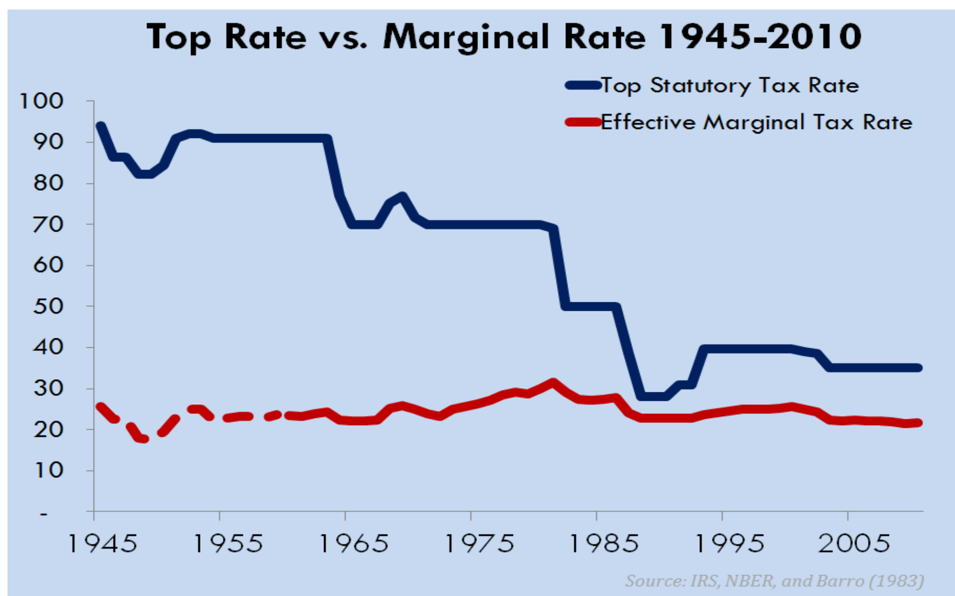
A more economically relevant measure of the individual income tax burden is the effective marginal rate. This rate measures the additional taxes paid on additional income earned, weighted by the distribution of total AGI. By this measure, the income tax burden has generally remained within a relatively narrow range.[6] See the chart on the top of page 3.

While the effective marginal income tax rate is more relevant than the top statutory income tax rate, neither rate fully reflects the overall burden of taxation on the economy. A comprehensive measure would include every kind of tax (income, sales, property, estate, etc.) collected at every level of government (federal, state, and local). Without a more complete measure, it is impossible to accurately determine how much or how little taxes affect the economy.




***Unlike the top statutory tax rate, the effective marginal tax rate has generally remained within a relatively narrow range.***

## A History Lesson for Today

When the top rate exceeded 90 percent, the economic effects were small because the share of income affected was small.[7] But that is no longer the case. Successive rounds of tax reform have lowered the top rate and expanded the share of income subject to it.

According to IRS data, the share of AGI reported by individual taxpayers who are subject to the top statutory income tax rate reached a peak of 18 percent in 2007 prior to the last recession.[8]

| AGI Reported by Taxpayers Subject to the Top Statutory Tax Rate | | | | | | |
|---|---|---|---|---|---|---|
| | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** |
| Trillions of Dollars | $1.2 | $1.4 | $1.5 | $1.3 | $1.0 | $1.2 |
| Percent of Total AGI | 17% | 17% | 18% | 16% | 13% | 14% |
| *Source: IRS* | | | | | | |

***Given the much greater share of income now subject to the top rate, any future rate increase will have a much greater effect on the economy.***

The historical reduction in the top individual income tax rate, relative to the top corporate income tax rate, has also resulted in a shift in business legal form. Most net business income is now earned by businesses that are subject to the individual income tax, rather than the corporate income tax.[9] See the chart on the top of page 4.

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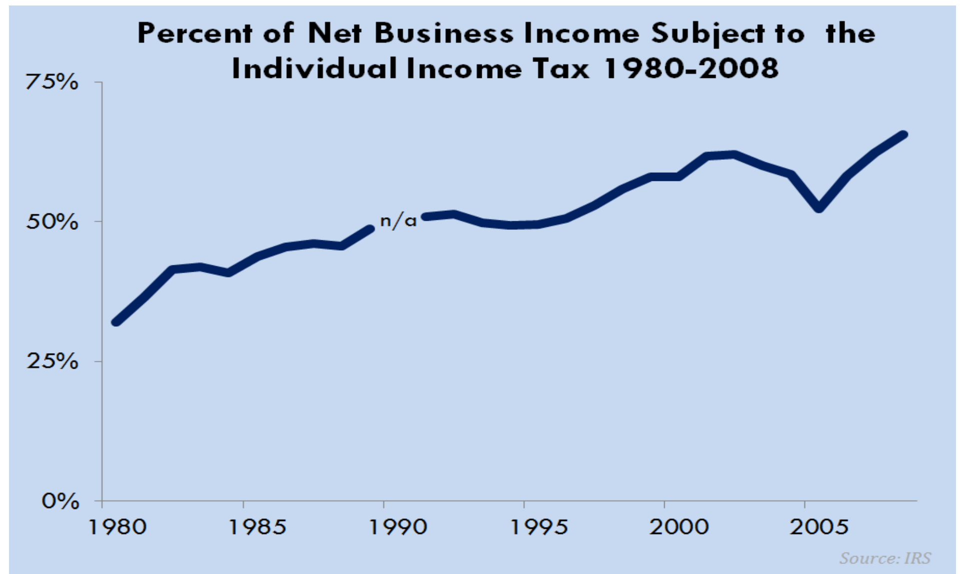


## Conclusion

***Before Congress decides it can raise the top rate without adverse effects, it needs to get the relevant facts about how taxes affect the economy***

Many pundits and policy advocates claim history proves we can tax the rich with economic impunity. They base their claim on an historical comparison between the top statutory individual income tax rate and various economic indicators. Yet this comparison is based on an incomplete and misleading measure of the overall tax burden. Before Congress decides it can raise the top rate without any adverse effects, policy makers need to get the relevant facts about how taxes affect the economy.

**Endnotes:**

[1] Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945, Congressional Research Service, September 14, 2012.

[2] When the effects are small, they may be difficult to measure. But that does not mean they do not exist.

[3] Internal Revenue Service, Statistics of Income, U.S. Individual Income Tax: Personal Exemptions and Lowest and Highest Tax Rates and Tax Base for Regular Tax, 1913-2008, Table 23.

[4] The top statutory income tax rate applied to single individuals with taxable income greater than $200,000 from 1949 through 1964. For married couples filing a joint return, the top rate applied at $400,000 in taxable income. For 1945-1948, the $200,000 threshold applied to both couples and individuals. See Tax Foundation, U.S. Federal Individual Income Tax Rates History, 1913-2011.

[5] JEC Republican Staff calculations based on data from the Internal Revenue Service, SOI Tax Stats Archive.

[6] The average effective marginal tax rate from 1945 through 2010 was 24.2 percent, with a standard deviation of (+/-) 2.6 percentage points. Summary Measures of the US Income Tax System, 1960-2010, National Bureau of Economic Research; Robert J. Barro and Chaipat Sahasakul, Measuring the Average Marginal Tax Rate from the Individual Income Tax, *Journal of Business*, 1983, Vol. 56, No. 4.

[7] The economic effects were also mitigated by offsetting changes in other tax provisions, such as investment tax credits and alternative depreciation schedules.

[8] The current 35 percent top rate applies to income other than long-term capital gains and qualified dividends. Internal Revenue Service, SOI Tax Stats, Individual Income Tax Returns Publication 1304, Table 3.4. For additional information on how taxes affect the amount of income earned and reported by the richest taxpayers, see JEC Republican Staff Commentary, Atlas Shrugs: The Diminishing Returns from Taxing the Rich, May 6, 2011.

[9] Internal Revenue Service, SOI Tax Stats, Integrated Business Data, Table 1.