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This Year's Fight Over Taxing the Middle Class—And the Rich

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Our 100-year fight over tax rates has taken some surprising twists and turns since the income tax went universal under FDR.

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Inscribed in stone on the exterior of the Internal Revenue Service headquarters in Washington are the words "Taxes are what we pay for a civilized society", a quotation taken from a 1927 Supreme Court opinion written by Justice Oliver Wendell Holmes, Jr.

The phrase was often repeated by President Franklin D. Roosevelt, for it was during Roosevelt's presidency that the personal income tax for middle class Americans came into existence and tax rates for the wealthiest Americans topped 90 percent. While the 16th Amendment to the Constitution, allowing Congress to levy a national income tax, was ratified in 1913, it initially applied only to those earning $4,000 or more, about $80,000 in today's dollars. They were required to file a 1040 form -- that's what it was called from the beginning -- and to pay one percent of their income in federal taxes. The highest earners, those whose incomes were greater than $500,000 -- equal to about $11 million today -- paid a top rate of 7 percent.

It wasn't until World War II -- and the attendant need to fund U.S. participation in the war -- that the withholding of taxes from the wages of middle class workers was instituted. By the end of the war, even the lowest bracket of wage earners paid about 20 percent of their earnings in income taxes -- making the tax system truly universal. Meanwhile, by 1944, those on the top end of the income scale, with incomes over $200,000 ($2 million in 2011 dollars), were levied a 94 percent tax rate.

And with that run-up and expansion in taxation was launched a political fight that has stayed with us, and which again threatens in 2012 -- when a host of tax cuts are set to sunset at the end of the year -- to bring the federal government to its knees as the White House and House Republicans again clash over to how best to raise revenue, what programs to fund, and how or whether to slash the deficit during a sluggish economic time.

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The first major reductions in post-war tax rates came after the Korean War. They didn't go all that far; the top tax rate was still 70 percent when Ronald Reagan was elected in 1980 (although with deductions, loopholes and tax shelters, many paid a much lower rate).

Reagan's attacks on government and high taxes -- "government is not the solution to our problems; government is the problem" -- and his supply-side Reaganomics launched the fights over tax policy between Republicans and Democrats that reflect the fundamental differences that still exist over the role of government, economic stimulus, how much to tax the wealthy, whether to tax labor and capitol gains income at the same rate, as well as how the economy can be stimulated through government spending and tax policies.

The conflict, in short: Democrats and proponents of English economist John Maynard Keynes believe in an activist role for the public sector in managing the economy and that increasing government spending can help in times of economic downturn. (The Obama stimulus plan follows this theory.) They also believe that government has an important role to play in helping the less fortunate and that the wealthiest need to pay more. (Conservatives like to call this income distribution or socialism.)

Supply-siders in the Reagan tradition believe in the trickle-down theory that economic growth is fostered by lowering income and capital gains tax rates -- that rich people will invest and create jobs. House Budget Chairman Paul Ryan, who has put forward an economic plan that would cut taxes for most Americans especially the wealthy, is the leading GOP proponent of this philosophy. Ryan worked briefly for former Congressman Jack Kemp, an early and enthusiastic supply-side supporter.

President Obama has countered the Ryan-led House tax agenda with the "Buffett Rule," which would raise taxes on the wealthiest Americans. The Senate in a procedural 51-45 vote Monday shot down the measure, named for billionaire investor and Obama supporter Warren Buffett, who famously claimed that his secretary pays a higher tax rate than he does. Republican Susan Collins of Maine was the only Republican to vote for the proposal and Democrat Mark Pryor of Arkansas voted with the Republicans. The legislation would have created a mandatory 30 percent minimum income tax for Americans earning more than $1 million annually. Tax rates on wages currently range from 10 to 35 percent, but under George W. Bush, rates on capital gains were cut dramatically to about 15 percent, so many wealthy Americans -- including presumed Republican nominee Mitt Romney -- pay far lower rates than those who rely on wages alone.

In defending the plan, Obama lit into supply side economics as an "old, broken down" idea that has been proven not to work, saying that "prosperity has never trickled down from a wealthy few" and cutting taxes on the rich has not worked to stimulate the economy.

Romney reported income of about $21 million in 2010 and because it was almost totally from investments, he paid about 14 percent in federal income taxes. Romney is proposing to make permanent most Bush-era tax cuts and eliminate taxes on interest, dividends and capital gains for those earning under $200,000. He would give the top 1 percent of taxpayers an average reduction of $150,000, according to the Tax Policy Center, which also says those in the bottom 20 percent would actually see a tax increase under the Romney plan.

In 2011 the Obamas reported a joint adjusted gross income of $789,674 and paid $162,074 in federal taxes, or just over 20.5 percent.

Polls show about 60 percent of Americans support the Buffett rule and a Pew Research Center pollreleased at the end of 2011 revealed that a majority of Americans believe the wealthy are not paying their fair share of taxes and the tax code should be totally re-written.

That's one thing Democratic and Republican political leaders seem able to agree on: The tax code is a mess.

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The last major overhaul of the tax code took place when a Democratic Congress, working with Reagan, passed the Tax Reform Act of 1986. It simplified the code, decreased individual tax rates, increased corporate taxes and significantly reduced the number of exemptions, deductions, credits and loopholes. The reform also set the tax rate for capital gains at about 23 percent, which was reduced dramatically to around 15 percent as part of the Bush tax cuts.

Ever since the 1986 reform was passed, Congress has been systematically chipping away at the tax code, adding literally thousands of changes and additional tax benefits, exemptions and loopholes, junking up the tax code and making it more complicated and less fair.

"It's out of control, says Eugene Steuerle, an Urban Institute economist. "They keep throwing junk in the tax code which adds to the deficit."

"The Democrats are willing to go after high income people but what scares both political parties is that the middle class pays for most of government and they get most of government benefits. You can't have meaningful savings without going after the middle class," Steuerle insists.

The three largest expenditures in the tax code are all things many middle-class Americans take advantage of -- tax-free employer-provided health insurance, the home mortgage interest deduction and tax-free 401(k) retirement accounts.

The tax exemptions for home mortgage interest cost the government more than the entire budget of the Department of Housing and Urban Development according to Steuerle. It's a lot easier to pass a new tax break than it is to pass a new government program, but both cost the U.S. Treasury money. Using tax code amendments to establish fiscal and social policy is less conspicuous than adding a spending program, observes Chris Edwards, a Cato Institute economist, but it has the same effect.

Tax reform is once again on the agenda because there are a number of deadlines looming at the end of the year with major consequences for tax and spending policy. Not only are the Bush tax cuts set to expire along with the payroll-tax cut, and an Alternative Minimum Tax adjustment but a host of drastic spending cuts are set to go into effect because of congressional failure to reach agreement on deficit reduction last year.

Federal Reserve Board Chairman Ben Bernanke told lawmakers recently that all of this represents "a massive fiscal cliff" facing the nation. Others, in the hyperbole typical to Washington, have taken to calling the expirations "taxmageddon."

As a result, it seems very likely that whatever happens with the election we will get some kind of tax reform in 2013. A number of plans have been introduced but whether Congress will just "fix" the immediate tax issues or deal in a meaningful way with deficit reduction and entitlement reform remains a big -- and open -- question.