Washington is moving on to tax reform. Earlier this week, the Senate Republicans made it clear that they want to focus on tax overhaul and critical fiscal legislation. Republicans and Democrats have already outlined their plans. Income taxes have always been a very important and often contentious subject. Before we review the key issues, let's step back and review tax policy generally.

I remember my first tax class in Champaign, Illinois over 50 years ago. We learned that income tax policy was more than simply raising money. Taxes have always been an instrument of economic and social policy for the government, as well.

Income taxes became a permanent part of life in America with the passage of the 16th Amendment in 1913. The first tax amount was 1% on net personal incomes above $3,000 with a surtax of 6% on incomes above $500,000 (that's about $9 million of income in today's dollars). By 1918, at the end of WWI, the top rate was 77% (for incomes over $1 million). During the Great Depression, the top marginal tax rate was 63% and rose to 94% during WWII. The top rate was lowered to 50% in 1982 and eventually 28% in 1988. It slowly increased to 40% in 2000, was reduced again from 2003 to 2012 and now is back at 40%. Corporate tax rates are 35% nominally, though the effective rate for corporations is between 20% and 25%.

Changes in the tax structure can influence economic activity. For example, take the deduction for home mortgage interest. If that deduction were eliminated, the housing market would most likely feel a big hit and economic growth, at least temporarily, would likely decline. In addition, an argument is often made that tax cuts raise growth. Evidence shows it's not that simple. Tax cuts can improve incentives to work, save and invest for workers, however, they may subsidize old capital that may undermine incentives for new activity and growth. And, if tax cuts are not accompanied by spending cuts or increased economic growth, then the result is larger federal budget deficits.

Our income tax system is a “progressive” system. That means that the tax rate goes up as the taxable amount increases. It is based on a household’s ability to pay. It is, in part, a redistribution of wealth as it increases the tax burden on higher income families and reduces it on lower income families. In theory, a progressive tax promotes the greater social good and more overall happiness. Critics would say that those who earn more are penalized by a progressive tax.

So, with that background, let’s look at some of the key issues.

The Republicans and the White House outlined their principles last Thursday:

- Make taxes simpler, fairer, and lower for American families
- Reduce tax rates for all American businesses
- Encourage companies to bring back profits held abroad
- Allow “unprecedented” capital expensing
- Tax cuts would be short-term and expire in 10 years (and could be passed through “reconciliation” procedures by a simple majority)
- The earlier proposed border adjustment tax on imports has been removed

Also this week, Senate Democrats indicated an interest in working with Republicans if three key conditions are met:

- No cuts for the top 1% of households
- No deficit-financed tax cuts
- No use of fast-track procedures known as reconciliation

The last big tax reform was 1986. It was a bipartisan bill with sweeping changes. Its goals were to simplify the tax code, broaden the tax base and eliminate many tax shelters. It was designed to be tax-revenue neutral. The tax cuts for individuals were offset by eliminating $60 billion annually in tax loopholes and shifting $24 billion of the tax burden from individuals to corporations. It needed bipartisan support because these were permanent changes requiring a 60% majority vote.

With all that in mind, sit back, relax and follow what comes out of Washington in the next few months. It will be interesting to watch how everything plays out for tax reform, the next very important piece of proposed legislation.