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INTRODUCTION AND SUMMARY

Objectives

The object of this study is to examine the impact of the personal income tax on employee compensation, the latter's importance as a source of tax revenue, and the reasons for the striking changes which have taken place over the last two decades in the share of income tax revenue attributable to employee compensation.

In principle, the personal income tax is intended to differentiate between taxpayers by size of total income, not by source. It is a widely accepted principle that the tax should treat people in equal positions equally and those in unequal positions unequally.[1] For the most part, equality under the income tax has been interpreted to mean equality of income. Hence it may be argued that only the size, not the source, of an individual's income should be of interest to the Treasury, and the relevance of examining the role of employee compensation in the personal income tax might accordingly be questioned. But the problem of defining and measuring income is not a simple one. In order to differentiate taxpayers mainly by the size of their income (in addition to family size and other relevant personal characteristics), it is necessary that receipts from various sources be summed and treated as interchangeable. In striving for an equitable, as well as workable, measure of personal income, Congress has had to make numerous provisions in the tax law regarding the treatment of receipts from different sources. Twice, for extended periods, Congress deemed it wise to allow an "earned-income" credit on income from work. Realized capital gains and losses have long been the subject of exceptional treatment. In recent times tax credits have been allowed to those with retirement income. These are but three examples out of many. While the ultimate

[1] See, for instance, R. A. Musgrave, *The Theory of Public Finance,* New York, 1959, p. 160.

aim has been taxation according to size of total income, problems of equity and economic efficiency have to a great extent presented themselves, and been attacked, along functional income lines. With this in mind, we present below a statistical account of the income tax burden on employee compensation.

The study is organized around four major topics. First, as a prelude to discussing its share in personal income tax revenue, we examine the *relative coverage* of wage and salary income on tax returns and its effects on the share of total income reported. Second, *the size distribution and composition* of income reported on returns with wages and salaries are investigated. This was done to identify relevant income characteristics of the taxpayers who are the recipients of wages and salaries. Third, the effects of and reasons for the major statutory *provisions* which have at one time or another been aimed at the tax treatment of employee compensation are discussed. Finally, we present estimates of the tax liability attributable to wages and salaries for a period of thirty-five years and analyze their share in total tax liability in the light of the information in earlier chapters.

Terminology

Throughout most of the study we have avoided use of the term "employees" in favor of the more cumbersome, but in this instance more accurate, "returns with wages or salaries." The major source for the statistics analyzed in this book is the Treasury's annual tabulation of data from tax returns as published in *Statistics of Income,* which includes all wages and salaries whether reported by full-time employees without other significant sources of income or by persons who spend only a small amount of time as employees and derive the major portion of their income from other sources. A few who report wages and salaries are therefore not accurately described as employees. Nevertheless, whenever used herein, the term employee should be interpreted to mean, strictly speaking, a tax return with wages or salaries.

Two concepts of income from employment are used throughout the book. The narrower of the two, wages and salaries, designates the amount which must be reported as income on the tax return. The broader, employee compensation, includes, in addition to what must be reported on tax returns, such forms of compensation as employer

TABLE 1

Wages and Salaries Reported and Estimated Total, Income Tax Concept, 1939, 1949, and 1964
(dollars in billions)

Year	Wages and Salaries		Percentage Reported
	Reported (1)	Estimated Total (2)	Col. 1 ÷ Col. 2 × 100 (3)
1939	16.5	45.7	36.1
1949	124.9	133.4	93.6
1964	320.4	328.9	97.4

Source: Table 4.

contributions to social and private insurance, employer contributions to private pension plans, and various items of payment in kind.[2]

Importance of Employee Compensation in Taxable and Total Income

The coverage of employee compensation as defined in the tax law—essentially wages and salaries—is found to have risen strikingly since immediately before World War II. When reported wages and salaries are compared with estimated total amounts, the latter adjusted so as to correspond in concept with the reported figures, coverage is found to have risen from 36 per cent for 1939 to 94 per cent for 1949, and to 97 per cent for 1964, or almost complete coverage (Table 1). The difference between the estimated total of wages and salaries to be reported and the amount actually reported, $8.5 billion for 1964, is not entirely the result of underreporting but also includes the wages and salaries of persons with income too low to require reporting. For 1939 the latter was probably the major reason for the reporting gap, but for 1949 and 1964 the smaller part of the gap—less than one-fourth—can be explained by incomes[3] below the legal filing requirement.

[2] The difference between wages and salaries reported and employee compensation is discussed in detail in the first section of Chapter 2.
[3] For detail see Chapter 2, footnote 9.

A sharp rise in the relative share of reported wages and salaries in reported adjusted gross income (AGI) occurred over the same period as did the rise in coverage (Table 2). Wages and salaries rose steadily from two-thirds of AGI in 1939 to over four-fifths in 1964. Part of the explanation for this increase in relative share in reported AGI is the rise which occurred in the underlying aggregate: estimated total wages and salaries rose from 70 per cent of total AGI in 1939 to 76 per cent in 1964. But it will be noted that the share in reported AGI was less than the share in the aggregate before World War II and greater than that in the aggregate thereafter. Clearly, the rise in coverage accounted for the major part of the rise in relative share in reported income. This, however, was not inevitable. Had the coverage of other income risen to the same degree as that of wages and salaries, the latter's share in reported income would not have increased on that account.

In the last column of Table 2 the share of employee compensation in personal income is shown for three years. Here too a substantial rise from 1939 to 1964 is evident. But in all of the years shown, the share of employee compensation in personal income was less than that of wages and salaries in AGI.

A comparison of columns 3 and 6 of Table 2 suggests, as already noted, that the coverage of wages and salaries was less than that of other income before World War II and greater than that of other income in postwar years. There are two plausible explanations for this change. The drastic lowering of personal exemptions must have had a greater impact on the coverage of wages and salaries than on that of other income, since the former is more concentrated in low-income groups than the latter.[4]

Thus, even if wages and salaries had previously been more accurately reported than other income, this could have been offset by the effect of high exemptions on coverage. The lowering of exemptions would then have to bring about a changed relationship of coverage ratios such as that actually found. But the same results could have been caused by the introduction of withholding of tax at the source in 1943, which applied then as now only to wages and salaries (although current payments of tax on other income were required through quarterly estimated declarations of income and tax). Which the major reason is

[4] A glance at Table 6, below, makes this evident.

TABLE 2

The Share of Employment Income in Total Income, Three Measures, 1939, 1949, and 1964
(dollars in billions)

	Reported			Estimated Totals					
Year	Wages and Salaries (1)	AGI (2)	Col. 1 ÷ Col. 2 (per cent) (3)	Wages and Salaries (4)	AGI (5)	Col. 4 ÷ Col. 5 (per cent) (6)	Employee Compensation (7)	Personal Income (8)	Col. 7 ÷ Col. 8 (per cent) (9)
1939	16.5	25.2	65.5	45.7	65.5	69.8	48.0	74.5	64.4
1949	124.9	160.6	77.8	133.4	186.2	71.6	141.2	210.5	67.1
1964	320.4	396.7	80.8	328.9	434.6	75.7	363.7	506.7	71.8

Source: Cols. 1–6 from Table 5; cols. 7–9 from Table 29.

(for the increased coverage of wages and salaries) thus hinges on whether the increase occurred before or after 1943. Our figures (presented in Tables 7 and 8, below) show (1) that a large part of the rise in coverage of wages and salaries, that is, from 36 per cent in 1939 to 86 per cent in 1942, occurred before the introduction of withholding, and (2) that the coverage ratio for wages and salaries rose above that for all other income as early as 1941.

Income Composition on Returns with Wages and Salaries

Only a small portion of AGI reported on returns with wages and salaries originates from other sources. In 1964, 8.9 per cent, and in 1941, 8.7 per cent (with very little change in intervening years), came from another source. On more than 60 per cent of returns with wages or salaries and AGI of $5,000 or less, no other income is reported. Even when all returns with wages or salaries are considered, more than half show no other income.[5] For those returns of employees who had other income, the latter was 13 per cent of AGI.

The import of these figures is that, although in a strict sense the findings in this study apply to "income from employment" rather than to "income of employees," for practical purposes there is little difference between the two. On the great majority of returns wage income or salary is the most, or only, important source of income. For 1964, reported wages and salaries expressed as a percentage of AGI varied as follows by deciles of wage and salary returns: [6]

Lowest tenth by size of AGI	124.3
2nd	94.9
3rd	94.7
4th	95.1
5th	95.6
6th	95.9
7th	95.8
8th	95.7
9th	94.2
Highest	79.7
Total	91.1

[5] See Chapter 3, Table 12.
[6] From Table 15.

Special Problems in the Taxation of Employee Compensation

A number of problems are specific to employee compensation. Some have been dealt with in the tax law, others have been the subject of continuing study. Discussed below are these major issues: withholding at the source, the earnings of working wives, the treatment of earned versus unearned income, excludable sick pay, deferred compensation, and various fringe benefits and expenses incurred at the convenience of the employer.

WITHHOLDING AT THE SOURCE

Withholding has already been mentioned in the discussion of the rise in coverage of wages and salaries. But the major reasons for the introduction of withholding on wages and salaries were (1) to give changes in tax rates and income immediate effect by moving collections closer to the time of accrual of tax, and (2) to avoid hardship for those who find it difficult to budget for large, lump-sum payments by substituting current payment in installments. From 1943 to 1966, withholding was at a flat rate on all payments to employees in excess of exemptions.

One result in recent years, especially since 1954, has been that total overwithholdings on one group of taxpayers, and therefore refunds, have exceeded the amounts owed by another group at the end of the year. For 1963, overpayments were $6.9 billion, underpayments $6.3 billion. The former were concentrated on returns subject to withholding, the latter on returns not subject to withholding (Table 18, below). Whereas the totals of overpayments and of tax owed are similar in magnitude, the number of returns involved are not. Again for 1963, 41 million returns showed overpayment, 19 million required additional payments (Table 19, below). The great difference in frequencies is because overpayments are common on returns with wages and salaries predominating, and underpayments (tax owed) on returns with mainly other income. It is difficult to predict whether the introduction of graduated withholding in 1966 will alter the pattern described. Though the total amounts of overpayment and underpayment of tax have been large, these amounts are outstanding only for short periods, and the interest costs are accordingly small relative to total tax liabilities.

WORKING WIVES

No specific allowance of quantitative importance exists now against compensation earned outside the home by married women. Yet the issue is frequently raised. Wives typically generate nonmoney income in the home which they must wholly or in part forgo when they accept employment outside the home. Because income generated in the home is not imputed for tax purposes, a bias against working for monetary compensation exists. Whether this bias should be corrected by compensating housewives through some kind of deduction is critically examined in Chapter 4.

Because the value of housewives' services tends to be greatest when there are preschool-age children, the case for an allowance for mothers who work to compensate for the loss of tax-free income is the one most frequently advanced. The United States income tax has included since 1954 a limited allowance for explicit child-care expenses of working mothers (and widowed or divorced men caring for a dependent). The deduction cannot exceed $900, and is not available to married couples in any amount if their joint income exceeds $6,900. The deduction is thus not primarily directed at the equity and economic neutrality aspects of the issue, but rather emphasizes the hardship element in the case of low-income families with relatively large cash outlays for the care of dependents when the mother is gainfully employed outside the home. For this reason the child-care deduction has been quantitatively small—$103 million for 1960, the latest year for which data are published. For the relatively small number who deducted such expenses, the deduction was an average 8 per cent of AGI (Table 21, below).

EARNED VERSUS UNEARNED INCOME

It has long been recognized that income from work, as opposed to income from property, involves costs which are difficult to measure, even approximately, and which presumably for that reason have not been allowed as deductions *per se*. The costs referred to are threefold: (1) The cost of investment in human capital, such as education and training. No formal deduction against income from personal effort for the cost of education, similar to depreciation allowances for physical capital, exists at present. (2) Work outside the home usually involves

increases in living costs which would not otherwise be incurred. (3) Of two persons with equal amounts of money income, the one who derives his income from work is worse off by the amount of leisure he sacrifices than the one who derives his income from property. The first of the three items is probably the simplest to deal with. Amortization of education expenses over time would pose no insuperable difficulties, and revenue costs in the foreseeable future are estimated at less than $1 billion annually (Chapter 4).

At present no explicit allowance for the three items exists, although the United States income tax included earned-income credits for 1924–31 and again for 1934–43. These were, for the most part, presumptive in character. A minimum amount of income was presumed earned by all taxpayers regardless of source, and a ceiling was placed on the amount considered earned. Because of the minimum guaranteed to all taxpayers as "earned," no meaningful distinction between earned and unearned income was possible over a significant income range. Accordingly, in the last two years before its final demise, less than 10 per cent of the credit was claimed against income which was above the presumptive level (Table 23, below). Explicitly recognizing this shortcoming, the Secretary of the Treasury recommended in 1943 that the credit be eliminated.

EXCLUDABLE SICK PAY

Since 1954, employees have been permitted to exclude from taxable income, under certain conditions, up to $100 of wage continuation weekly if received from their employer during absence from work because of illness or injury. Under the 1964 Act, if an employee receives over 75 per cent of his weekly wages during absence because of illness, there is a thirty-day waiting period before the exclusion becomes available. If he receives less than 75 per cent, he may exclude up to $75 weekly for the first thirty days of illness and $100 thereafter. When wage continuation is the result of formal arrangement with an insurance company, no exclusion is reported on the tax return. It must be reported in order to be allowed only when wage continuation is a matter of informal employer policy.

For this reason, the importance of the exclusion is somewhat greater than the published figures—$522 million for 1964—would suggest. The latter is only 0.2 per cent of reported wages and salaries (Table 25,

below). As a consequence, the exclusion has only a minor impact on the effective tax rate on wages and salaries. However, the question whether the exclusion is called for in principle transcends its current quantitative importance. It may be argued that where premium payments to a wage-continuation plan are not included in wages, an exclusion of benefit payments is not necessary on equity grounds. It has been pointed out that, as a form of assistance to those who are ill, a deduction related to medical expenses may be more appropriate and efficient.

DEFERRED COMPENSATION

The most prominent form of deferred compensation is employer financing, wholly or in part, of employee retirement plans. Employer contributions to such plans are not treated as current income to employees. Instead, benefit payments must be reported as retirement income when received by the employee. A threefold tax advantage results: (1) The postponement of inclusion in taxable income results in a lower effective rate on that portion of compensation, for employees at time of retirement are typically in lower marginal tax brackets than before. Indeed, for 1964 only about 64 per cent of the benefit payments that might be included in taxable income was reported on tax returns; most of the rest was presumably received by persons below the required filing level. (2) The postponement of tax as such has the effect of an interest-free loan. (3) The annual interest earned on amounts accumulated in a pension fund is not subject to tax as current income, and therefore funds compound at a higher rate than would otherwise be the case.

Employer contributions to retirement plans other than social security amounted to $9.4 billion in 1964. An indication of difference in tax because of the first tax advantage alone may be obtained from the difference between the effective rate on wages and salaries and that on pensions and annuities reported on tax returns. The rate on wages and salaries was 10.9 per cent, that on pensions and annuities for the same year only 6.5 per cent.

In addition to employer contributions to private plans on behalf of employees, there are those made to social security, which amounted to $7.9 billion in 1964. Unlike contributions to private plans, these do not give rise to taxable income even at the time benefit payments are received. Current taxation of all employer contributions to social secu-

rity and private retirement plans, as well as employee contributions which are now taxable, would be a possible alternative to the present tax treatment. But a point against this has been the existence of many private pension plans which do not vest the right to the employer's contributions should the employee leave this employer before retirement or some stipulated period of time. A simple general solution would be to include all benefits, whatever their source, in taxable income, and to exclude all contributions from employees and employers. This, however, would increase the advantage now enjoyed by those able to defer income "realization" until retirement.

Another form of deferred compensation accorded favorable tax treatment is option rights, which are usually granted to executive-level employees to purchase stock in their corporation at a given price within a stipulated period of time. Gains arising from such options are treated as long-term capital gains, and are therefore taxed at lower than ordinary rates, provided various conditions are met. Capital gains treatment is defended as a means of encouraging proprietary interest in their business among executive employees. While little quantitative information is available concerning stock option gains, a few salient features appear well established: (1) The total gains from stock options are very small in relation to total wages and salaries. (2) They are sizable only in relation to the regular salaries of top corporate executives, but not so large as to account significantly for the difference between salaries and total income of employees reporting AGI in excess of $50,000. (3) The revenue cost of the present stock option treatment appears to be small. It is much smaller than any apparent tax saving to the employee, because the cost of granting stock options is not a deductible expense for corporations, whereas salary payments are. Neither the effect on income distribution nor on incentives is known at present.

CONSUMPTION PAID FOR BY EMPLOYERS

An area of considerable quantitative importance, and difficulty, is that of employees' expenses paid for by employers. Expenses may be paid by employers in kind, by furnishing meals, lodging, or any other items of value to their employees, or they may be paid for through reimbursement of cash outlays under "expense account" arrangements. Expenses thus paid by employers may range from "ordinary and neces-

sary" business expenses to "fringe benefits," that is, compensation. If the latter, they must be reported and included in AGI as compensation; otherwise, they may be excluded from AGI. The problem is complicated by the allowance of some consumption expenditures as business expense if they are made at the employer's convenience. Most meals and lodging supplied by employers are probably interpreted in that manner by employees and therefore excluded from reported wages and salaries, although the Commerce Department includes their value ($2.1 billion in 1964) in its estimates of wage and salary disbursements. The total amount paid to employees under expense-account arrangements is not known at present.

The treatment of moving expenses because of a change in jobs further illustrates the extent to which problems of interpretation are involved. Before 1964, a distinction between moving at the employer's convenience and moving at the employee's convenience was made on the simple categorical presumption that an employee who is changing his place of employment while continuing to work for the same employer, and who is reimbursed by the latter for his moving expenses, may be considered to have moved at the employer's convenience; all others were presumed to have done so at their own convenience. Under the 1964 Act, all expenses of moving to another locality connected with a change in employment are treated as deductible. It is evident that in cases of this kind, where the distinction between consumption- and employment-connected expense depends on correct interpretation of motivations, the rules adopted will err by either allowing too little or too much. The choice in such instances must then be made on grounds other than equity alone, as indeed was the case when the treatment of moving expenses was liberalized so as to increase the mobility of the labor force.

In a somewhat less ambiguous category, and therefore more clearly fringe benefits, are a number of so-called welfare-plan payments by employers on behalf of employees. These include premiums paid by employers for medical, hospital, life, and unemployment insurance. In these cases neither the premiums nor the benefit payments are part of AGI, and they differ in this important respect from deferred compensation plans under which benefit payments are counted as part of AGI. The value of these welfare-plan contributions by employers is estimated at $10.2 billion for 1964.

Tax Liability on Wages and Salaries

Both the share of wages and salaries in total income tax liability and the average effective rate of tax on wages and salaries have risen sharply since 1939 (Table 3). The share in tax liability rose from 31 per cent of the total for 1939 to 64 per cent for 1949, and to 74 per cent for 1964. Comparison of Tables 2 and 3 shows that the share of wages and salaries in total tax liability was much smaller than the share of employee compensation in total personal income in 1939 and still slightly less in 1949, but exceeded it in 1964.

The total tax burden on a particular source of income depends on (1) the distribution of the source, by income-size classes; (2) the extent to which it is reported by taxpayers, i.e., its coverage; and (3) the extent to which statutory provisions affect its inclusion in the tax base. As has been noted before, wages and salaries are relatively more concentrated in low-income groups than is the rest of income. Since it is essentially a person's total income that determines the tax liability on any part of it, the total income of those receiving wages and salaries determines the effective tax rate on that income share. When reported AGI is broken up into wages and salaries and all other income, the difference in the effective rate of tax on each is for the most part a reflection of the difference in distribution by income size.

TABLE 3

Share in Total Tax Liability and Average Effective Tax Rate Attributable to Wages and Salaries, 1939, 1949, and 1964
(dollars in billions)

	Tax Liability			
Year	Total (1)	Attributable to Wages and Salaries (2)	Col. 2 ÷ Col. 1 (per cent) (3)	Effective Rate on Reported Wages and Salaries (per cent) (4)
1939	.93	.29	31.2	1.7
1949	14.68	9.39	64.0	7.5
1964	47.15	34.81	73.8	10.9

Source: Table 28.

Thus, to reflect differences in income distribution alone, the following effective rates for 1964 are obtained: wages and salaries, 10.9 per cent; all other income, 16.2 per cent (Table 30, below). When tax liabilities are divided by amounts in total rather than only reported AGI, the effective rates (also for 1964) are as follows: wages and salaries, 10.6 per cent; all other income, 11.7 per cent (Table 31, below).

The elimination of most of the difference in effective rates when changing from reported to total AGI reflects the difference in coverage. A third set of effective rates, using personal income instead of AGI as a base, reflects, though not fully, the existence of statutory exclusions and omissions; employee compensation, 9.6 per cent; all other personal income, 8.7 per cent (Table 31, below).

Clearly differences in income distribution, which had constituted the foremost influence on effective rates before World War II, are now outweighed by differences in coverage and statutory provisions, so that the share in tax liability attributable to employee compensation is greater than its share in personal income.

The tax rates thus far cited are effective average rates of tax, and are descriptive of the average tax burden on total wages and salaries. But they do not suggest what the effective tax rate, on average, on a *change* in wages or salaries has been. It is more useful for some purposes to know the effective marginal rather than the effective average rate of tax.

The effective marginal tax rate on all reported wages and salaries for 1964 was close to 22 per cent, or nearly twice as high as the effective average rate. These rates were computed with dollar amounts of reported wages and salaries used as weights. Taxpayers with large amounts of wages or salaries were therefore given more weight than those with small amounts. If each taxpayer is given the same weight when averaging computed marginal rates, the estimate for 1964 is 16.5 per cent. In other words, if each employee's compensation had been increased by one dollar, the average tax rate on it would have been 16.5 cents (Table 33, below).

Of course, average effective marginal rates hide wide variations between income levels. For 1964, marginal rates were computed by AGI group (Table 34, below). Over an income range comprising nearly nine-tenths of wages and salaries, the variation was from a low of 15 per cent to a high of 46 per cent.