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PROVISIONS AFFECTING TAX LIABILITY OF EMPLOYEES

Special provisions of the tax law have had a varying influence on the functional components of income. Some provisions have affected all components, others only a single one. Those provisions which have, in the main or exclusively, affected the taxation of employment income are considered below. Among these, the more prominent are withholding of tax at source, excludable sick pay, allowance for child care of working mothers, deferred compensation, payment in kind at the convenience of the employer, and the erstwhile earned-income credit. Not all had a significant effect on tax liability; some were deemed important for the policy issues they raised rather than for their current effect on tax liabilities.

Witholding at Source

Withholding, already touched upon in Chapter 2, was not intended to affect the amount of tax liability but merely the timing and administration of tax payments. Although in recent proposals in favor of withholding of tax on dividends and interest improved coverage [1] was the dominant consideration, it was neither the primary motive for nor a significant effect of the introduction of withholding on wages and salaries.[2] Before the introduction of withholding, i.e., before 1943, indi-

[1] See the President's Tax Message of April 20, 1961, as reprinted in House Document No. 140, pp. 8–9.

[2] In the Annual Report of the Secretary of the Treasury for 1943 (p. 85), three reasons for the enactment of withholding are advanced: first, to prevent hardship to those "not accustomed to yearly budgeting"—an allusion to the problem of meeting the tax liability on a year's income in one lump-sum payment; second, the increase in flexibility of the income tax as a countercyclical tool if changes in rates could be made effective shortly after enactment; and third, the greater assurance of collection that was expected to result from withholding (which presumably refers both to prevention of default and to complete reporting

viduals were not required to pay tax in advance of filing the final return for the taxable year (for most persons, between January 1 and March 15 at that time). As long as the income tax concerned only a relatively small, high-income segment of the population, and rates were mild when judged by later standards, payment of tax in one lump sum caused no widespread problem. But after the outbreak of the Second World War, rates were increased, exemptions were lowered, and incomes rose rapidly. The income tax had changed within a short time span from a tax on a few to a mass tax. As a result, the need to set aside sufficient funds to meet a year's tax liability created problems for many of the new taxpayers, who were not accustomed to accounting and saving in advance of requirements. An obvious solution was to move collections closer to the time of accrual. Up to 1966, this was accomplished by requiring employers to withhold a fixed percentage of all wages in excess of the employee's exemptions. In addition, quarterly payments on the basis of estimated tax were required of all taxpayers for whom withholding falls short of final annual tax liability by more than a stated amount.[3]

As a consequence of the current payment system adopted in 1943, taxpayers as a group have been *ahead* of schedule in paying taxes in seven out of eleven years since 1954, instead of lagging anywhere from one to more than fourteen months behind accruals. Aggregate "overpayments" by some taxpayers and "underpayments" by others are shown annually for 1943–64 in Table 17. Overpayment results when the combined amount of tax withheld and quarterly payments on estimated tax (if any) exceed final tax liability for the year. Underpayment is the amount of tax still owed at the time of filing.

(coverage) of income). In the Treasury's explanatory statement on the 1964 Act, only the first reason for withholding is cited: "The purpose of withholding Federal income taxes on wages and salaries is to distribute the payment of such taxes throughout the year rather than in one lump sum." Treasury Department, *Summaries of Provisions in the Revenue Act of 1964,* Washington, 1964, TP-8, p. 1.

[3] Withholding rates were set so as to approximate tax liability at the first-bracket rate on the amount above exemptions on the assumption of a standard deduction of 10 per cent. From 1954 until 1963 the withholding rate on wages and salaries was 18 per cent on all amounts in excess of a weekly exemption of $13 per person. Under the 1964 Act the withholding rate was reduced to 14 percent, but in May 1966 five steps were added to the existing 14 per cent rate and the exemption was raised. (For rates, see Appendix E.) Taxpayers whose current payments on account of withholding fall short of their estimated tax liability by $40 or more must file a "Declaration of Estimated Income Tax" and make quarterly payments in advance of filing the annual income tax return.

TABLE 17

Amount of Overpayment and Underpayment in Relation to Total Income Tax Liability, 1943–64
(dollars in billions)

Year	Overpayment (refunds plus credits) (1)	Underpayment (tax due) (2)	Total Income Tax Liability (after credits) (3)	Col. 1 ÷ Col. 3 (4)	Col. 2 ÷ Col. 3 (5)
1943	0.66	2.74	14.58	.05	.19
1944	1.36	2.41	16.35	.08	.15
1945	1.83	2.41	17.22	.11	.14
1946	1.94	2.74	16.28	.12	.17
1947	1.97	3.01	18.24	.11	.16
1948	2.68	2.21	15.62	.17	.14
1949	1.96	2.12	14.68	.13	.14
1950	2.07	3.11	18.58	.11	.17
1951	2.54	3.72	24.44	.10	.15
1952	2.93	3.60	28.04	.10	.13
1952[a]	2.93	3.60	27.80	.11	.13
1953	3.28	3.38	29.43	.11	.11
1954	3.72	3.02	26.67	.14	.11
1955	3.61	3.78	29.61	.12	.13
1956	3.98	4.10	32.73	.12	.13
1957	4.52	3.94	34.39	.13	.11
1958	4.80	4.09	34.34	.14	.12
1959	5.11	5.08	38.64	.13	.13
1960	5.69	4.75	39.46	.14	.12
1961	5.98	5.67	42.23	.14	.13
1962	6.58	5.62	44.90	.15	.12
1963	6.94	6.27	48.20	.14	.13
1964	5.89	7.07	47.15	.12	.15

Source: Treasury Department, *Statistics of Income.*
[a] Fiduciaries included from 1952 on.

Until 1953, total underpayments tended to exceed overpayments. From 1954 on, the opposite has been evident. Overpayments in 1962 were $6.6 billion, underpayments $5.6 billion. In 1964, overpayments were less than underpayments, but this is because the 1964 Act provided for tax reduction in two steps, spread over two successive years, whereas the withholding rate was lowered immediately by the full

amount, thereby causing more taxpayers to experience underwithholding than normally would have at the new rate schedule. Beginning in May 1966, a graduated withholding system was adopted whose rates extended from 14 to 30 per cent in six steps. By itself this would have resulted in more overwithholding than previously. To avoid it, the basic withholding exemption was increased from $676 to $700 at an annual rate, and the first $200 of wages above the exemption became subject to a zero withholding rate. Withholding for most married couples and single persons with AGI over $7,600 who elect the standard deduction will be less than final tax liability for the year. For those working less than a full year, overwithholding may continue to result whenever there is little or no income from other sources.*

The difference between overpayments and underpayments, in the aggregate, has in most years not exceeded $1 billion. Current payments of taxpayers whose actual income exceeded their estimate based on previous years' income have tended to fall short of final liabilities unless their income was substantially wages and salaries and did not exceed the first bracket of taxable income. For a taxpayer with the two last-named characteristics, an increase in income would not result in underwithholding. Similarly, a decrease in income might not result in overwithholding as long as a taxpayer stayed within the first bracket in all pay periods. However, if he missed one or more pay periods, overwithholding would quite probably be the result. In principle, current underpayment by some who underestimated might be expected to be balanced by current overpayment by others who experienced unforeseen decreases in income. For the system as a whole, underpayments and overpayments might thus be expected to cancel out in years when economic activity exhibits no exceptional advances or declines.[4]

Furthermore, the occurrence of underpayment and overpayment might be expected to have no predictable relation to income source. One would, of course, expect to find a bias toward overpayments at the lower end of the annual income distribution, and one in favor of underpayment at the upper end. This follows from the premise that those who have favor-

[4] The observation that overpayments and underpayments approximately balance in many years may have been the basis for the Treasury's statement that "generally, the total amount withheld over a year approximately equals a person's tax liability." Treasury Department, *Summaries of Provisions in the Revenue Act of 1964*.

* Preliminary 1966 data show overpayments of $8.65 billion, underpayments of $7.61 billion. The number of returns were 49.4 million and 17.8 million respectively.

able surprises tend to underpay whereas those whose income falls short of the estimate tend to overpay. But the distribution of overpayment and underpayment would otherwise show no bias as to income source or type of tax payment.

However, bias in the distribution of overpayments by income source is likely to occur when the current payment system consists of withholding on one source and quarterly payments on estimated tax on other sources. This is especially so when, as was true until 1966, the withholding rate is not graduated and determined on the assumption that the standard deduction applies. For all taxpayers with deductions in excess of the allowable minimum and taxable income confined to the first bracket, overwithholding was predetermined. Predetermined overwithholding was also, in effect, restricted to taxpayers with wages and salaries, especially seasonal workers, as in the building trades, logging, and the clothing industry. Tables 18 and 19 show that the distribution of over- and underpayment has not occurred randomly in the past.

Table 18 shows that in 1959 over 90 per cent of overpayments occurred on returns with tax withheld, the rest on returns with only quarterly declarations. However, 52 per cent of underpayments was

TABLE 18

Amount of Overpayment and Underpayment of Tax by Type of Current Payment, 1953 and 1959
(dollars in millions)

	1959		1953	
	Amount	Percentage of Total	Amount	Percentage of Total
Amount of overpayment	5,111	100.0	3,282	100.0
Returns with withholding only	4,160	81.4	2,562	78.1
Returns with withholding and quarterly payments	453	8.9	305	9.3
Returns with quarterly payments only	497	9.7	415	12.6
Amount of underpayment	5,077	100.0	3,382	100.0
Returns with withholding only	1,255	24.7	971	28.7
Returns with withholding and quarterly payments	1,166	23.0	649	19.2
Returns with quarterly payments only	1,582	31.2	1,013	30.0
Returns with no current payments	1,075	21.2	749	22.1

Source: Treasury Department, *Statistics of Income.*

TABLE 19

Number of Returns with Overpayment and Underpayment, 1943–64
(number in millions)

Year	With Overpayment (1)	With Underpayment (2)	Total Filed (3)	Col. 1 ÷ Col. 3 (4)	Col. 2 ÷ Col. 3 (5)
1943	16.0	15.9	43.7	.37	.36
1944	22.9	22.6	47.1	.49	.48
1945	33.5	14.5	49.9	.67	.29
1946	34.4	13.6	52.8	.65	.26
1947	33.0	15.3	55.1	.60	.28
1948	38.4	8.1	52.1	.74	.16
1949	30.2	13.8	51.8	.58	.27
1950	32.0	14.3	53.1	.60	.27
1951	31.0	18.6	55.4	.56	.34
1952	32.1	19.3	56.5	.57	.34
1953	32.7	19.0	57.8	.57	.33
1954	35.2	16.6	56.7	.62	.29
1955	35.4	18.7	58.2	.61	.32
1956	36.1	19.4	59.2	.61	.33
1957	37.6	18.6	59.8	.63	.31
1958	37.4	18.1	59.1	.63	.31
1959	38.4	19.1	60.3	.64	.32
1960	39.4	18.2	61.0	.65	.30
1961	40.0	18.6	61.5	.65	.30
1962	40.9	18.7	62.7	.65	.30
1963	41.4	19.3	63.9	.65	.30
1964	39.3	22.5	65.4	.60	.34

Source: Treasury Department, *Statistics of Income.*

accounted for by returns with no withholding and only 48 per cent by returns with it. Since only wages and salaries are subject to withholding, and all other income payments require quarterly declarations of estimated tax, it can be concluded that overpayment was largely accounted for by returns with wages and salaries, whereas the larger part of underpayments occurred on returns with little or no wages and salaries.[5] Further evidence that the distribution of over- and under-

[5] The percentages cited to suggest this conclusion are on the conservative side. Returns with both withholding and quarterly payments were counted as employee income returns. If they were omitted from the comparison, wage and salary

payments is not the result of random errors is seen in Table 19. Since 1954 the frequency of returns with overpayment has been regularly twice as great as that for underpayment. In the absence of any particular bias, the number of overpayments should exceed the number of underpayments when actual incomes fall short of taxpayers' estimated incomes, and vice versa when actual incomes exceed estimated incomes. That the number with overpayment has in every year been large compared to that with underpayment, and that the average overpayment is small compared to the average underpayment,[6] is consistent with the hypothesis that overpayments have been concentrated on returns with wages or salary and taxable income in the first bracket and underpayments on returns with relatively little employment income, or returns in general that fall into high brackets.

Overpayment of tax, although eventually corrected by appropriate refund, results in some advantage to the Treasury. Underpayment, although there is an eventual payment of tax due, is an advantage to the taxpayer. Where there is a temporary overpayment, the Treasury in effect obtains an interest-free short-term loan from the individuals concerned. Conversely, where there is temporary underpayment, the taxpayers concerned have the use of short-term funds interest-free. Since interest-free loans *to* taxpayers will eventually result in higher taxes, and interest-free loans *from* taxpayers in lower taxes, it follows that if one group consistently borrows while another consistently lends, the taxes on the first group are somewhat overstated and on the second group somewhat understated. The size of the resulting transfer depends on the level of the appropriate interest rates.

If one applies the Treasury's penalty rate of 6 per cent,[7] the 1961

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returns would account for 81 per cent of overpayment and only 25 per cent of underpayment in 1959. The proportions for other returns remain unchanged. Similar results are obtained for other years, as can be observed from the 1953 data included in Table 18.

[6] This is evident if it is recalled that the dollar aggregates of over- and underpayment are nearly equal (Table 17), whereas the respective frequencies are not.

[7] The Treasury charges 6 per cent interest on tax payments made after the legal payment date. It is also required to pay interest at 6 per cent on overpayment of tax on which refund is not made "within 45 days after the last date prescribed for filing the return." See Internal Revenue Code, 1954, Chap. 67, Secs. 6601–6602, 6611–6612.

The choice of the Treasury's "penalty" rate in this context is arbitrary. To the Treasury the funds borrowed at short term are not worth 6 per cent since it has been able to borrow at lower rates. To the taxpayer the cost may be

TABLE 20

Estimated Net Interest on Temporary Over- and Underpayments of Tax, 1961
(million dollars)

	Returns with Wages and Salaries	Other Returns
Temporary overpayments of tax	5,437	546
interest imputed on overpayment (6%)	−254	−22
Temporary underpayments of tax	2,702	2,965
interest imputed on underpayments (6%)	144	169
Net interest cost (−) or gain (+)	−110	147

Source: See Appendix E.

net interest cost to taxpayers with wages and salaries on account of overpayment was $110 million (Table 20). On the other hand, a net interest saving of $147 million for 1961 must be imputed to taxpayers with only other income. Against the background of total tax liability for 1961 ($42.2 billion) and the total amounts of under- and overpayments, these figures seem very small. This is partly because the interest estimates cited are the net amounts for each group of taxpayers and partly because of the relatively short time periods involved.[8]

An interest burden was presumed on those who overpay and an imputed interest offset to tax liability for those who underpay. This is of course not consistent wtih the theory that many taxpayers typically consider their overpayments a means by which to force themselves to save. Some are said to understate exemptions deliberately so as to bring about overwithholding. In that case taxpayers, far from demanding interest, are willing to pay (in interest forgone) for the service of having their savings "forced" in equal monthly installments. A close analogy is

more than 6 per cent if he finds it necessary to borrow for his personal needs until refund is made. For instance, new-auto sales finance rates charged by four large companies were on average 12.4 per cent per annum in 1961. See R. P. Shay, *New Automobile Finance Rates,* New York, NBER, Table 8. Paul Smith finds gross finance charges for 1959 on various types of consumer credit ranging from 9 per cent to 24 per cent. See *Cost of Providing Consumer Credit,* New York, NBER, Table 1.

[8] Interest was computed on the assumption that overpayments occurred in twelve equal monthly installments so that, depending on when refund was made, the average overpayment period varied between six and ten months. Similar assumptions were made regarding underpayments. For detail, see Appendix E.

participation in the familiar annual Christmas Club.[9] This explanation of tax-payment patterns implies that employees have a lower time preference for money than other taxpayers. Accordingly, nonemployees (strictly speaking, those with relatively little wages and salaries) find uses for their funds which outweigh any value they may see in the savings feature of overwithholding.

The change from a flat to a graduated withholding rate in 1966 will undoubtedly affect the distribution and relative amounts of temporary over- and underpayments. For some taxpayers, the former is even likely to increase; for many more, underpayments are expected to decrease. But it is very difficult to predict how great the effect on the respective balances will be.

Earnings of Married Women

In principle, the wages and salaries of working wives are not different from any other employment income, and therefore do not require distinctive tax treatment. The main difference between wives working outside the home and all other persons is that the former could otherwise generate considerable income in the home. They have therefore high opportunity costs to consider when seeking employment outside the home. Such opportunity costs exist for all persons, male[10] or female, but they are especially significant for mothers with children of preschool age. Like food, clothing, and shelter, child care and related household chores are a basic necessity for a family with small children, and at least an important consumption item for other families with children. Provision of these services in our society is closely associated with the female spouse—hence the assertion that her opportunity costs vis-à-vis the market are high—but they could of course be, and sometimes are, performed by the male spouse, suggesting that the opportunity cost equal

[9] In some isolated cases, Christmas Clubs are administered by employers on behalf of employees. Funds paid in are at the employer's disposal until Christmas without interest charge to him, thus completing the analogy to overwithholding of tax.

[10] Many services that are ordinarily purchased by families, such as dry cleaning, home repairs and improvements, haircuts, and so forth, can also be produced in the home by the consumer himself. Persons who choose to allocate their time in this manner forgo some of the advantages of specialization in favor of consuming their own services. But regardless of whether a person consumes his own services or purchases them with income earned outside the home, the first alternative is one of his opportunity costs.

to the money's worth of housework is not a uniquely female problem.

Ideally an income tax would include such home-generated income in the tax base. If it does not, persons who take full advantage of specialization, and therefore purchase housekeeping and child-care services from others, suffer a tax disadvantage. As long as the income a housewife generates in the home is no less [11] than she would earn through employment outside it, she is clearly better off by not entering the labor market. Her home-produced services are now tax-free, whereas her income from outside employment would be taxed and therefore would not suffice to purchase services equivalent to those she produced in the home. Assuming for the sake of simplicity that domestic services purchased are independent of husband's income, for a family spending $3,500 yearly for housekeeping and child care, the amounts a wife needs to earn at 1967 tax rates to replace herself in the home vary as follows with husband's income: [12]

Husband's Income	*Wife's Breakeven Income*
$7,000	$4,220
12,000	4,377
20,000	4,663

As the above figures illustrate, a wife's breakeven income rises as family income rises. This is because under ordinary circumstances it is to a couple's advantage to file a joint return, which since 1948 has permitted husbands and wives to split their combined income. The rate of tax applicable to a wife's labor market earnings is therefore equal to, or somewhat higher than, the marginal rate of tax applicable to the family's income without her earnings. The higher the husband's income, the higher the marginal rate on any labor market earnings of the wife and hence the greater the amount she needs to earn to break even.

A solution equitable to all taxpayers would require inclusion of the money's worth of home-produced income in the tax base. This would increase the equity of the tax as well as its neutrality with respect to allocation of effort between home and market production. The practical difficulties in the way of this solution are obvious, have been stated be-

[11] Measured by what the family would have to pay to obtain similar services, such as baby sitting, housecleaning, and cooking, from a hired person.

[12] The computations are based on the assumption that the couple had two dependent children and filed a joint return on which deductions equal to 10 per cent were claimed.

fore, and therefore need not be repeated here.[13] A type of solution which moves in the opposite direction, but which has wide appeal, is to allow wives who work outside the home a deduction roughly equal to the minimum cost of obtaining housekeeping services. Such a deduction may be granted to all wives employed outside the home, as in the case of the British income tax cited by Vickrey,[14] or it may be restricted to actual cash outlays for certain domestic help, as in the U.S. income tax since 1954.[15] The first proposal appears intended to compensate employed wives for the lack of tax-free imputed income which they could have generated in the home. The second emphasizes the hardship experienced when housekeeping and child care services are purchased out of low incomes.

To compensate only wives employed outside the home for the tax-free income obtained by housewives is an incomplete measure from an equity point of view. The basic equity criterion underlying the income tax is the equal treatment of equals, not merely the equal treatment of families with married females. Yet the latter is implied by the provision of an allowance for working wives: it fails to take into account that an allowance equal to the value of housewives' services granted to families with married women discriminates against all single taxpayers who have no imputed income from wives' housework. This difficulty has also been noted by Vickrey,[16] who proposed to take account of the advantage enjoyed by families in which one spouse stays at home by granting them a smaller exemption, which in effect would constitute an implicit valuation of the wife's industry in the home. To take account of part-time employment outside the home, the exemption is increased by a fraction of the smaller of the amounts earned by each spouse until it reaches a level such as might "for tax purposes be assumed to indicate full-time employment." [17]

[13] See especially the excellent discussion by Donald B. Marsh, "The Taxation of Imputed Income," *Political Science Quarterly*, December 1943, pp. 514–521; also William Vickrey, *Agenda for Progressive Taxation*, New York, 1947, pp. 44–52, and Henry C. Simons, *Personal Income Taxation*, Chicago, 1938, pp. 110–112.

[14] *Agenda for Progressive Taxation*, p. 46.

[15] See discussion by Joseph Pechman in *Individual Income Tax Provisions of the 1954 Code*, National Tax Journal, March 1955, pp. 120–122.

[16] *Agenda for Progressive Taxation*, pp. 47–48.

[17] In terms of present exemptions, both single persons and married couples might each be granted a basic exemption of $600. But the exemption for

This provision would be appropriate to meet both equity and efficiency criteria. The latter, it will be recalled, concerns the possible distortion in allocation of a wife's time between home and labor market when the income she generates is not taxable in both cases. Little is known about the actual effect the income tax has had on the participation of women in the labor market.[18] Probably more than any other statistical efforts, those of Mincer and Cain, though not directed at the effects of the income tax as such, throw light on this question. Mincer shows, by use of cross-section data from the 1950 Census, that the labor force response of married women is negatively correlated with husband's income, but positively with the wage rate for female workers —indeed, that the latter is considerably stronger than the former.[19]

There is thus some statistical confirmation, at least with respect to wives' behavior, of what theory has long suggested on a priori grounds: that the income effect of a decrease in wage rate (increase in tax) would tend to increase the supply of labor, but that the price effect

married couples, where both work outside the home, might be increased by 25 per cent of the smaller of the two earnings figures up to a maximum of $1,200. In this case, a $2,400 income would be presumed to signify full-time employment outside the home. There was a generalized working-spouse credit of this type in the United States in 1944 and 1945, but its tax value had an upper limit of $15.

[18] A paper by Clarence H. Long, "Impact of the Federal Income Tax on Labor Force Participation," in *Federal Tax Policy for Economic Growth and Stability,* Joint Committee on the Economic Report, Washington, 1955, pp. 153–166, is largely devoted to searching for possible tax influences on the labor force participation of wives. But Long's data are confined to the relation between labor force participation of wives and annual income of husbands. They throw no light on the effect of the tax on labor force participation. As Long himself points out, "the computations . . . tell us nothing about how the earnings, and the tax on earnings, of other family members besides the husband would influence the decision of the wife to work" (p. 157).

[19] Mincer's computations show that for a 1 per cent variation in median income of male family heads (wife present) in Standard Metropolitan Statistical Areas in 1949, the labor force participation of wives in 1950 varied .83 per cent in the opposite direction, but that for a 1 per cent variation in median income of females, it changed 1.50 per cent in the same direction. See Jacob Mincer, "Labor Force Participation of Married Women: A Study of Labor Supply," in *Aspects of Labor Economics,* Princeton for NBER, 1962, Table 1, p. 72. Cain, in a later and more extended study, notes that Mincer's major finding "that, for wives, the positive wage effect exceeds the absolute value of the negative income effect . . . was weakened by my research but not overturned." Whereas Cain's results for 1950 tended to confirm those of Mincer, for 1940 and 1960 the confirmation had to be qualified in some respects. See Glen G. Cain, *Married Women in the Labor Force,* Chicago, 1966, Chapters 3 and 4, and especially pp. 84 and 117.

would operate in the direction of diminishing it.[20] It is reasonable to assume that Mincer's and Cain's findings with respect to the labor force response of wives to changes in wage rates can be expanded to include a change in tax treatment of wives. An adjustment in tax so as to treat wives' labor market income more symmetrically with income from work in the home and leisure would presumably have an effect similar to an increase in the wage rate.[21]

As has been indicated, under the income tax since 1948, wives' earnings are treated as an addition to total family income. Hence, the higher the latter (without the wife's money income), the higher the marginal rate of tax applicable to her earnings and the greater the disparity in treatment between labor market income, on the one hand, and home labor and leisure on the other. Before 1948, i.e., before the introduction of income splitting between husbands and wives, it was in their interest to file separate returns if they had separate incomes, and therefore tax rates on wives' incomes were independent of their husbands' incomes. If wives' labor force participation was sensitive to these differences in tax rates on their earnings, the differences would presumably be confirmed by an increase in covariation of husbands' and wives' earnings. The higher a husband's income, under present income tax practice, the higher must be the wife's market earnings to equal the cost of replacing her work in the home plus the tax on her earnings.[22] Mincer's data (though presented for a different purpose) show indeed a rise in intercorrelation between male and female earnings between 1940 and 1950.[23]

Current federal practice is to allow the deduction of a limited amount of cash outlays made for the care of dependents. The dependent must be a child under 13 years of age, or a person incapable of caring for

[20] See, for instance, Lionel Robbins, "On The Elasticity of Demand for Income in Terms of Effort," *Economica,* June 1930, pp. 123–129.

[21] Cain reaches the same tentative conclusion regarding the effect of the personal income tax on market work of wives. *Married Women,* p. 122.

[22] For years prior to 1948 a wife's breakeven income may be defined as $W_b = D \cdot \frac{1}{1 - .9r}$ where W_b = wife's breakeven income, D = value of wife's services in the home, and $.9r$ = tax rate on wife's income after allowance for deductions equal to 10 per cent of earnings. The expression for years beginning with 1948 is $W_b = D \cdot \frac{1}{1 - .9rf}$, where rf = marginal rate of tax on family income including wife's earnings.

[23] "Labor Force Participation," p. 73, n. 10. The rise in correlation was from $r = .4$ in 1940 to $r = .8$ in 1950.

himself. The deduction has an upper limit of $600 per taxpayer for one child or dependent and $900 for two or more children or dependents. The taxpayer must have been "gainfully" employed when the expenses claimed were incurred. Men may claim the deduction if widowed, divorced, or if married to a woman who has been institutionalized for at least ninety days. All employed women with eligible dependents may claim the deduction, but a working wife may do so only provided she files a joint return with her husband, and is required to reduce the maximum allowable by each dollar by which their joint income exceeds $6,000.[24]

It is evident that the allowance is largely confined to (1) working wives with children under 13 whose family income is below $6,900 for the year, and who incur cash child-care expenses large enough to exceed, together with any other itemized deductions the family may have, the amount allowed as a standard deduction; (2) widowed, divorced, or legally separated persons with dependents to be cared for while they work. Whenever child care is obtained through "unpaid" family workers (older children, grandparents, etc.), no deduction is allowed. For these reasons not many child-care deductions may be expected. While there were 5.5 million working wives with children under 12 in 1958,[25] the number of returns with child-care deduction was only 272,000 for 1960, or less than 6 per cent of the 1958 figure (Table 21).[26]

The deduction has declined in total amount and frequency between 1956 and 1960, which is exceptional when compared to the sharply rising trend in all other itemized deductions.[27] Perhaps the most striking feature is that of the small amounts involved—$0.1 billion compared

[24] Thus, if a couple has one dependent, no deduction can be taken if their joint income equals or exceeds $6,600; if there is more than one dependent it vanishes at $6,900.

[25] Henry C. Lajewski, "Working Mothers and Their Arrangements for Care of Their Children," *Social Security Bulletin*, August 1959, p. 9.

[26] The figures in the table are the result of the pre-1964 Act allowance, which was somewhat more restricted than that available from 1964 on. The major differences are: (1) the age limit for dependents other than those incapable of caring for themselves was 12 rather than 13 years; (2) the deduction was limited to $600 regardless of how many dependents were cared for; (3) the maximum joint income at which an employed married woman may claim the full allowable child-care deduction was raised from $4,500 to $6,000.

[27] C. Harry Kahn, *Personal Deductions in the Federal Income Tax*, Princeton for NBER, 1960, Chapter 3.

TABLE 21

Number of Returns with, and Amount of, Child Care Deduction, Selected Years, 1954–60
(dollars in millions)

Year	Amount Claimed (1)	Number of Returns (thousands) (2)	Average Amount (col. 1 ÷ col. 2) (3)	AGI: On Returns with Child Care Deduction (4)	AGI: On All Returns (5)	Deduction as Percentage of AGI of Claimants (col. 1 ÷ col. 4) (6)
1954	88.0	273	322	1,164	229,221	7.6
1956	110.6	329	336	1,502	267,724	7.4
1960	103.1	272	379	1,332	315,466	7.7

Source: Treasury Department, *Statistics of Income.* (Column 4 estimated by multiplying income class averages of income for all returns by frequency of child care deductions.)

to total itemized deductions of $32.8 billion. Average child-care deductions have been less than $400, considerably below the modest limit of $600. The explanation lies in the income limitation imposed on the use of the deduction by married women. As is seen in Table 22, only the $4,500–$6,000 income group had an average deduction ($347) less than that for all returns ($379). The deduction vanished for married women over the $4,500–$5,100 income range.

It can be concluded that the deduction in its present form is largely directed toward the alleviation of hardship arising from the combination of child-care expenses and low income experienced by some persons. It relates primarily to the fact that the consumption of home-produced goods and services tends to be a large part of total consumption for a family with small children and low income. From an equity and efficiency point of view, as has been seen, the problem exists for all families no matter what the size of their income. In principle, the fact that child care and housekeeping may absorb much of the income of a working woman does not call for a tax deduction. Substantially the same problem would exist if income were imputed to those who consume their own services in the home. In that case, the hardship suf-

TABLE 22

Average Amount and Relation to Income of Child Care Deduction, by AGI Groups, 1960

AGI (thousand dollars)	Amount Claimed (thousands) (1)	Number of Returns (2)	Average (col. 1 ÷ col. 2) (3)	Deduction as Percentage of AGI [a] (4)
2 or less, 2–3	15,158	39,822	381	16.2
3–4.5	41,107	107,896	381	9.9
4.5–6	22,729	65,578	347	6.8
6–10	20,105	49,821	404	5.6
10–25	3,727	8,366	445	3.5
25 and over	291	526	553	1.3
Totals	103,117	272,009	379	7.7

[a] For the income groups with less than $3,500, more detail was available for 1954 and 1956:

AGI Group	*1954*	*1956*
2 or less	26.2	19.3
2–3	13.8	14.5

fered by a low-income working mother would be no different from that of any person whose earnings in the market are insufficient to cover what by current standards are considered necessities.

Earned Versus Unearned Income

Problems somewhat analogous to those concerning working wives (discussed in the preceding section) arise concerning income from work in general. In recognition of the differences between income from personal effort and income from property, an explicit "earned-income" credit was part of the tax law from 1924–31 and again from 1934–43.

The case for income tax differentiation between earned income and income from property is in three parts,[28] only the first two of which

[28] All three reasons mentioned below are discussed at length by Vickrey, and much of the discussion is based on his *Agenda for Progressive Taxation* (see pp. 48–51 and 126).

have been widely cited in its support. First, no allowance against income from personal effort for the investment made in skill or intellectual preparation to obtain such income exists similar to the depreciation allowance granted those employing physical capital. Hence it is argued that the income tax discriminates in favor of capital in the form of plant and machinery, and against that in the form of education and training. Second, income from work usually requires increases in living costs not associated with income from property. An employed person needs to live near his place of work, which often means increased costs of housing. He also may have extra expenses for clothing, travel, and meals, none of which are deductible. A person who lives on property income exclusively has thus, in a very real sense, lower living expenses. Such expenses as are associated with the management of his property are allowed as business expense deductions. Third, the individual who derives his income from property is better off by the amount of extra leisure he enjoys than the one who derives his income from employment. A person who seeks no income in the labor market thereby consumes his own services, whether through home production or pure leisure. Yet two such persons may pay identical amounts of tax if their respective money incomes are equal.

The lack of recognition [29] in the tax law of the three items discussed must be ascribed in large part to the difficult identification problems connected with them. Yet, of the three, investment in education and training is probably the least difficult to measure—up to a point—and also the most important on the score of neutrality in taxation. An allowance could be made for it through amortization of explicit education expenses, such as tuition fees, books, and travel. These can be written off against the income earned by the taxpayer over an appropriate num-

[29] Actually, since 1958 education and training expenses have been deductible if "primarily for the purpose of: (1) Maintaining or improving skills required by the taxpayer in his employment or other trade or business, or (2) Meeting the express requirements of a taxpayer's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his salary, status, or employment." See Treasury Department, Instructions for Form 1040, *Statistics of Income*, 1960, p. 141. As Richard Goode has pointed out, "If a similar attitude were taken toward physical capital, deductions from taxable income presumably would be allowed for maintenance expenditures and capital replacement costs, but would be denied for depreciation on capital outlays intended to establish new firms, to enlarge existing enterprises, or to introduce new products." See Goode, "Educational Expenditures and the Income Tax," in S. J. Mushkin (ed.), *Economics of Higher Education*, Washington, 1962, p. 284.

ber of years, and this method seems more precise than any generalized credit or deduction aimed at allowing for investment in education and training. Goode has estimated that students' own current outlays for tuition, books and supplies, and travel, but exclusive of the value of scholarship aid received from private or governmental bodies, might approach $3.1 billion by 1969–70.[30] Depending on the time period over which education expenditures were amortized, the level of annual deductions would be lower than this figure for several years. In addition, Goode estimates that at least one-tenth of the amount amortizable would not be deducted because of wastage through death, and because of women students who become housewives and who therefore have no taxable income against which the investment may be written off. Assuming a 25 per cent marginal tax rate for college-educated taxpayers, an allowance for explicit education expenses would result in a revenue cost of $700 million once annual write-offs reached the level corresponding to 1969–70 private education outlays. As has been stressed by others, the greater part of investment in education receives an automatic, though unintended, immediate write-off in the form of forgone earnings. Becker has estimated this indirect cost at roughly 75 per cent of the total private cost of college education in the United States.[31] The same is true of substantially the entire cost of on-the-job training. Since its value is not included in taxable income, it also is in effect accorded an immediate write-off. Compared to other forms of capital formation, investment in education and training may thus not be at as great a disadvantage as appears at first when only explicit costs are considered. It may of course be argued that forgone earnings are well-nigh ubiquitous since leisure activities and work in the home also involve forgone earnings. Those investing in education are therefore not given an isolated advantage in the treatment of these earnings. Nevertheless, it can be argued that the greater the forgone-earnings component in the total cost of an investment, other things equal, the more favorable its tax treatment.

The "leisure" differential, and the difference in cost of living associated with income from work, are more difficult to allow for. No explicit payment corresponding to the value of leisure enjoyed by those with property income exists. And differences in the cost of living di-

[30] *Ibid.*, pp. 284–295.

[31] Gary S. Becker, *Human Capital*, New York, NBER, 1964, p. 149.

rectly associated with a job occur in so many subtle ways as to present insuperable identification problems: housing, food, clothing, all may be affected.

Yet the case is no more than an extension of the working-wife problem discussed in the preceding section. The solution found most consistent there, it will be recalled, was to allow married couples an exemption greater than that for single persons only if both had income from employment, the second exemption to be allowed only to the extent that the smaller of the two incomes approached the level presumed to indicate full-time employment. In order to make the treatment of income from work in the labor market completely general vis-à-vis all other income, one might extend the additional exemption to *all* persons with such earnings up to a specified level. For married couples, the provision that the allowance applies to "the smaller of the two incomes" up to a specified level would be dropped. In effect, housewives and persons with income from property only would not receive the earned-income credit. Thus, assuming a basic exemption of $600 and an earned-income credit limited to $600 per person, a married couple, none of whose income was from personal services outside the home, would obtain only one $600 exemption; a couple with one spouse earning income outside the home would obtain an exemption of $600 plus an earned income credit limited to $600; and a couple in which both spouses earned income outside the home would be entitled to $600 plus two earned-income credits (in other words, a maximum exemption of $1,800).[32] Even this method makes only very crude allowance for differences in leisure time available to different taxpayers. Two wage earners with equal earnings but unequal rates of pay per hour will enjoy different amounts of free time. Yet both will receive the same earned-income credit. No simple credit device of the type described can distinguish between employees who receive unequal amounts of paid free time, such as vacations, coffee breaks, and lunchtime, not to speak of the length of the workweek itself.

How close did the earned-income credits of 1924–31 and 1934–43 come to fulfilling the above three objectives? The credit for 1924 was 25 per cent of the tax on earned income. The latter was defined as any earnings from employment or self-employment up to a maximum of $10,000, but for *every* taxpayer a minimum of $5,000 was treated as

[32] Exemptions for dependent children would of course be a separate matter, and not of relevance here.

"earned," regardless of source. For 1925–27 the maximum was raised from $10,000 to $20,000, and for 1928–31 from $20,000 to $30,000. That anyone could take the credit up to the first $5,000 of net income gave it a peculiar twist, for this amounted, in essence, to a 25 per cent tax cut on that amount of income. The "earned-income" credit was, in effect, only a credit on earned income in excess of $5,000—very much the opposite of what was suggested above as perhaps being appropriate. The law seemed to say that an adjustment for income in the form of leisure and home production, as well as amortization of investment in oneself, is a pressing matter at income levels above $5,000, but not below.

The earned-income credit was not re-enacted during 1932 and 1933 "under demands for more revenue." [33] Subsequent demands for reinstatement were nearly unanimous in stressing, as the reason for the credit, amortization of investment in professional education and training to the exclusion of the leisure and living-expense aspects.[34] If amortization of investment in human beings is accepted as the rationale for the credit, the fact that it differentiated between "earned" and "unearned" only above a relatively high level of income would not necessarily conflict with its aim. It might be presumed that the investment aspect is unimportant for earned incomes of $5,000 or less, but becomes increasingly significant above this level.[35] The earned-income credit was indeed reinstated for 1934 in a form substantially similar to the earlier one. The major change was that all incomes below $3,000 were treated as earned. If net income exceeded $3,000, earned income was presumed to be at least $3,000 but not more than $14,000. The credit itself equaled 10 per cent of the net income defined as earned, but had to be used as a deduction from net income instead of a direct offset against tax liability as before.

While its actual quantitative significance is now mainly of historical interest, the fraction of the total credit which actually applied to earned income above the minimum available to all taxpayers is noteworthy. Table 23 separates for each year the amount of credit available to all, regardless of source, from the amount of "true" credit (that is, the

[33] See *The Revenue Bill of 1934, House of Representatives,* Report No. 704, p. 6.

[34] House of Representatives, *Revenue Revision, 1932,* Hearings Before Committee on Ways and Means, pp. 184 and 364.

[35] This may still leave inadequately explained the presumption that all income below $5,000 was earned.

TABLE 23

Tax Value of Earned-Income Credit Allocated Between "True" Earned Income and Presumed Earned Income, 1924–43
(dollars in thousands)

		Credit Attributable to "True" Earned Income Only			
Year [a]	Total Credit (1)	Total (2)	Wages and Salaries (3)	Credit on Income Regardless of Source [b] (4)	Col. 2 ÷ Col. 1 (5)
1924	30,637	6,507	5,720	24,130	21.2
1925	24,570	15,552	13,417	9,017	63.3
1926	24,647	15,368	13,429	9,279	62.4
1927	24,915	15,908	13,965	9,005	63.8
1928	34,790	24,621	21,422	10,167	70.8
1929	22,062	18,671	16,331	3,392	84.6
1930	24,886	17,113	15,541	7,771	68.8
1931	17,491	11,987	11,037	5,504	68.5
1934	22,887	6,053	5,594	16,834	26.4
1935	27,424	7,524	6,954	19,900	27.4
1936	36,631	9,699	8,856	26,932	26.5
1937	42,201	11,140	10,217	31,061	26.4
1938	37,504	9,897	9,100	27,607	26.4
1939	47,352	11,638	10,646	35,714	24.6
1940	83,555	13,171	12,012	70,384	15.8
1941	158,004	16,965	15,176	141,039	10.7
1942	351,020	34,520	30,594	316,500	9.8
1943	509,671	50,148	44,092	459,523	9.8

Source: Treasury Department, *Statistics of Income*. For 1924–31, the total in col. 1 is as tabulated there. Cols. 2, 3, and 4 could be computed without difficulty from the Treasury statistics since these are available by income groups below and above the $5,000 net income level.

For 1934–43, only the net income equivalents of the credit were published, and the tax equivalents were computed from the published data. The amount in col. 4 was obtained by multiplying the normal tax rate by the sum of (a) the earned income credit on all returns with less than $3,000 net income and (b) the frequency times $300 for all returns with net income over $3,000. The totals in column 1 were found by multiplying the normal tax rate by the earned-income credit. The amounts in columns 2 and 3 were obtained residually.

[a] No earned-income credit was allowed for 1932 and 1933.

[b] 1924–1931: all net income less than $5,000; 1934–1943: all net income less than $3,000.

amount conditional on the existence of earned income). In the first period, 1924–31, much of the total was true credit, except for 1924, when the ceiling on income defined as earned was $10,000 and exemptions were lower than for the other seven years. In the second period, 1934–43, the true credit was consistently and strikingly less than the nominal credit. As exemptions were lowered, an increasing share of the credit applied to income below $3,000 on which the credit was available regardless of source. In the last three years of its existence, nine-tenths of the credit was of the nominal type. It was precisely in these terms that the credit's demise was viewed by the Secretary of the Treasury:

> As a step toward simplification of the individual income tax it was proposed by the Treasury that the earned income credit be eliminated. The Treasury did not oppose the objective of differentiation in favor of genuine earned income. However, it took the position that for a large proportion of taxpayers the credit was not a real earned income credit since the first $3,000 of net income was considered earned net income regardless of the source, and that the view of the credit was out of all proportion to the complexities which the credit produced in the computation of the tax.[36]

The latter part of the Secretary's statement is borne out by the statistics in Table 24. After 1940 the earned income credit reduced total tax liability (before credit) by less than 4 per cent, and at no time did the reduction exceed 7 per cent. These figures include the amount available on all income regardless of source. If attention is restricted to the reduction in tax liability on wages and salaries on account of the credit in excess of the amount available regardless of income source (col. 2, Table 21), its value is found to be less than 1 per cent of tax liability on all wages and salaries after 1940. Only in the period 1928–31 did that part of the credit reduce tax liability on wages and salaries by more than 10 per cent. By 1943 it had declined to one-half of 1 per cent of tax liability on wages and salaries.

Excludable Sick Pay

Since 1954, employees who are absent from work because of illness or injury, and who continue to receive wages or salaries under an employer-financed wage continuation plan, may under certain conditions

[36] *Annual Report of the Secretary of the Treasury*, 1943, p. 87.

TABLE 24

Reduction in Tax Liability as a Result of Earned Income Credit, 1924–43

	Percentage Reduction in	
Year	Total Liability on Account of Total Credit (1)	Liability on Wages and Salaries on Account of "True" Earned Income Credit (2)
1924	4.2	3.3
1925	3.2	9.6
1926	3.3	9.2
1927	2.9	9.0
1928	2.9	11.9
1929	2.2	11.7
1930	5.0	12.2
1931	6.6	13.3
1934	4.3	3.6
1935	4.0	3.7
1936	2.9	3.2
1937	3.6	3.4
1938	4.7	3.7
1939	4.8	3.6
1940	5.3	2.3
1941	3.9	0.8
1942	3.8	0.6
1943	3.4	0.5

Source: Col. 1: col. 1, Table 23, divided by the sum of col. 1, Table 28, and col. 1, Table 23, in per cent; col. 2: col. 3, Table 23, divided by the sum of col. 2, Table 28, and col. 3, Table 23, in per cent.

Note: Years 1924–28 not shown separately in Table 28; *Statistics of Income* used as source.

exclude such pay from taxable income at a maximum rate of $100 a week. Any arrangement under which an employer undertakes to continue a sick employee's wages, including those in which there is simply a policy of continuing to pay employees during illness, qualifies for the "sick-pay" exclusion.[37] Under the 1954 Act, payments for the first seven calendar days of an absence on account of ordinary sickness were not excludable. However, if there was at least one day of hospitalization, or if the absence was due to injury, the exclusion applied from the first day of absence.

Difficulties caused by, and objections to, the sick-pay exclusion led President Kennedy and the Secretary of the Treasury to argue for its repeal.[38] A major objection, widely shared, was that the exclusion placed a premium on absenteeism. An employee covered by a wage-continuation plan may in many cases be better off financially when slightly ill and at home than when at work, "and the employee who stays on the job, even though ill or injured, is in effect penalized for working." [39] It was also argued that the exclusion tends to be unrelated to medical hardship as such. An employee staying at home because of a minor injury which requires little or no medical expense can exclude up to $100 per week from his wages, whereas someone requiring expensive medical care, but continuing at work, has no similar exclusion. In addition, there were problems of distinguishing between injury and mere sickness. This made considerable difference, since there was no exclusion for the first week of illness unless it could be classed as injury or unless there was at least one day of hospitalization (the latter also being a possible cause for abuse).

The sick-pay exclusion was modified under the 1964 Act, but not repealed. Employees receiving less than 75 per cent of their regular weekly wages while absent may exclude up to $75 a week from the first day of absence if hospitalized for at least one day, or after seven days if not hospitalized.[40] If the employee is still absent from work after

[37] Internal Revenue Code of 1954, Section 105(e).

[38] See Committee on Ways and Means, *President's 1963 Tax Message Along with Principal Statement, Technical Explanation and Supporting Exhibits and Documents Submitted by Secretary of the Treasury, Douglas Dillon,* Washington, 1963, pp. 16 and 45.

[39] *Ibid.,* p. 16.

[40] The seven-day waiting period applies under the 1964 Act regardless of whether the absence is caused by illness or injury, as long as there is no hospitalization.

TABLE 25

Frequency and Amount of Sick-Pay Exclusion Compared with Frequency and Amount of Wages and Salaries Reported, 1954–64
(dollars in billions)

Year	Sick-Pay Exclusion: Number of Returns (millions) (1)	Sick-Pay Exclusion: Amount (2)	Wages and Salaries Reported: Number of Returns (millions) (3)	Wages and Salaries Reported: Total Amount [a] (4)	Wages and Salaries Reported: Amount on Returns with Exclusion [a] (5)	Percentages: Col. 1 ÷ Col. 3	Percentages: Col. 2 ÷ Col. 4	Percentages: Col. 2 ÷ Col. 5
1954	0.9	0.35	49.9	186.0	–	1.8	0.2	–
1955	1.2	0.44	51.3	200.7	–	2.3	0.2	–
1956	1.4	0.54	51.9	215.6	–	2.7	0.2	–
1957	1.4	0.57	52.6	228.1	–	2.7	0.2	–
1958	1.5	0.62	51.6	227.6	9.7	2.9	0.3	6.4
1959	1.6	0.68	52.9	247.4	10.7	3.0	0.3	6.4
1960	1.6	0.68	53.6	257.9	11.3	3.0	0.3	6.0
1961	1.6	0.76	54.0	266.9	11.8	3.0	0.3	6.4
1962	1.7	0.78	55.1	283.4	13.0	3.1	0.3	6.0
1963	1.9	0.88	56.3	299.4	14.6	3.4	0.3	6.0
1964	0.8	0.52	57.5	320.4	n.a.	1.4	0.2	n.a.

Source: Treasury Department, *Statistics of Income.*
[a] Net of exclusion.

thirty days, the weekly excludable amount rises to $100 and is available to any employee without regard to the level of his regular wages. The limitations imposed under the 1964 Act caused a 60 per cent decline in the number of returns filed with excludable sick pay and a 40 per cent decline in the amount excluded (Table 25).

What has given rise to the present treatment of employer payments to employees for time away from work because of illness? In the case of employees who finance their own sick-pay plans, such payments may be considered as properly excludable, although, strictly speaking, the premiums rather than the benefits should be treated as costs.[41] However, to the extent that plans are employer financed, the same cause for

[41] See Melvin I. White, "Consistent Treatment of Items Excluded and Omitted from the Individual Income Tax Base," *Tax Revision Compendium,* Committee on Ways and Means, Washington, Vol. 1, pp. 317–321.

exclusion does not exist, since employer contributions, though they constitute imputable income to the employee, are already excluded from his taxable income. To exempt both premiums and benefits might prove to be one exclusion too many.

It cannot be said that Congress was entirely unaware of these problems when the provisions of the 1954 Revenue Code were drawn up. In fact, the current practice existed long before 1954 with respect to wage continuation plans financed through *formal* insurance contracts by the employer. Only employers' informal, self-insured plans functioned in a twilight zone of uncertainty with respect to the tax treatment of benefit payments from them.[42] Thus, though equal in substance, benefit payments originating from formal insurance contracts were considered excludable from taxable income, whereas those made under less formal arrangements were in most cases taxed to the employee as wage or salary payments. In putting the current $100 sick-pay exclusion into the Code, Congress very much had its eye on the latter inequity, but did not attempt to solve the larger issue of whether any exclusion at all is called for when the premium payments are not made out of the beneficiary's taxable income.

The forgoing must be kept in mind when interpreting the published statistics on the amount and income-size incidence of the sick-pay exclusion. Where the arrangement for sick pay is a formal one, so that the payments may be made through an insurance company, the amount paid need not be reported as long as it does not exceed a weekly rate of $100. No exclusion appears on the tax return in these instances. Where wage continuation is not institutional, but simply a part of the employer's policy or a combination of both, part or all of the sick pay is included in the employee's withholding statement and thus needs to be deducted on the tax return to make the exclusion effective. It is therefore only this latter amount that has appeared in the statistics under the heading of sick-pay exclusion.

This may in part explain why the relative frequency of returns with sick-pay exclusion rises with size of reported annual income (Table 26). A downward bias in annually reported income is ordinarily associated with illness, since any loss in earnings capacity would tend to be re-

[42] See the discussion by Roy Wentz, "An Appraisal of Individual Income Tax Exclusions," *Tax Revision Compendium,* pp. 329–333. Also House Report No. 1337, *Internal Revenue Code, 1954,* Washington, 1954, p. 15.

TABLE 26

Number of Returns with Sick-Pay Exclusion as Percentage of All Returns with Wages and Salaries, by Income Groups, 1963 and 1964
(numbers in thousands)

AGI (thousand dollars)	Number with Sick-Pay Exclusion		Number with Wages and Salaries		Col. 1 ÷ Col. 3 Per Cent	Col. 2 ÷ Col. 4 Per Cent
	1963 (1)	1964 (2)	1963 (3)	1964 (4)	1963 (5)	1964 (6)
Less than 2	25	7	5,312	4,442	0.5	0.2
2–5	347	130	14,266	13,207	2.4	1.0
5–6	209	77	5,235	5,101	4.0	1.5
6–7	206	78	5,102	5,023	4.0	1.6
7–10	522	208	10,131	11,086	5.2	1.9
10–15	360	144	5,212	6,142	6.9	2.3
15 and over	118	52	1,860	2,216	6.3	2.3
Nontaxable	84	62	9,185	10,307	0.9	0.6
Totals	1,871	758	56,303	57,524	3.3	1.3

Source: Treasury Department, *Statistics of Income.*

flected in income.[43] That the opposite tendency can be observed on tax returns before and after the 1964 Act revisions may be explained in two ways: First, among those persons whose employers continue to pay wages and salaries, income may decline only very little or not at all, so that the usual bias, described above, is largely eliminated. In that case, what remains is the positive association of illness with age and hence with annual income. Second, the type of wage continuation payments tabulated in Table 26 may be more common for salaried employees than for hourly paid workers. The latter may more frequently receive sick pay under an insurance-company-administered plan, or they may simply not be covered by wage continuation plans as frequently as higher-paid employees.

Of the total number of returns with wages and salaries, only 1 per

[43] See, for instance, Health Information Foundation, "The Economic Costs of Absenteeism," *Progress in Health Services,* Vol. XII, No. 2, 1963. Here, more work-loss days are found among persons with low than with high income.

cent listed employer-provided (noninsured) sick pay for 1964 (Table 25). This sharp decline from 1963, when over 3 per cent of returns with wages and salary had an explicit sick-pay exclusion, reflects the restrictions imposed by the 1964 Act. In total amount, direct employer-provided sick pay has been relatively small. In its first year, the reported exclusion was $352 million; for 1963, $877 million; and for 1964, $522 million, or about 0.2 per cent of total reported wages and salaries in 1954 and 1964. For those reporting the exclusion, it amounted to about 6 per cent of wages and salaries in the period 1958–63.

Deferred Compensation

Employees, like property owners, have the option of deferring the "realization" of some income. The quantitatively most important form of deferral is the employer-financed retirement provision, although for some strategic employees at the managerial level the provision of stock options and of employment contracts, providing for continued compensation at a stated rate for a stated number of years after termination of regular employment, may be of even greater importance.

Employer contributions to a pension fund on behalf of employees are not treated as current compensation for tax purposes, but must be reported as retirement income at the time benefit payments are made. Their omission from current taxable income understates the amount of employees' compensation as reported on tax returns. Even though income is eventually "realized," as employees become eligible for retirement benefits, the postponement of realization to a time late in the individual's life, when his earnings are relatively low, means that no income is reported whenever a retired beneficiary's AGI falls below the current filing requirement.[44] A rough estimate for 1964 is that 64 per cent of benefit payments (net of cost) for that year were reported on tax returns.[45]

[44] The filing requirement for persons over 65 years old has been $1,200 in recent years.

[45] This ratio was obtained by dividing the amount of pensions and annuities reported on tax returns for 1964 ($3.12 billion) by total estimated "benefit payments to be reported" for 1964 ($4.86 billion). The latter estimate was obtained by adding up benefit payments made in 1964 under private industry group plans, individual annuity plans set up by life insurance companies, and government retirement plans, and subtracting the amounts representing costs to individual beneficiaries (Table F-2). Note that the pensions and annuities total

Expressed in more general terms, postponing the realization of some part of compensation through pension plans until late in life when earnings tend to be low results in most instances in lower effective tax rates on that compensation than if it had been treated as currently earned. No less significant is the interest advantage which arises from the postponement of tax on the employer's contributions to a pension fund and the annual return earned on the fund's investments.

The difference between the effective rates on wages and salaries and on pensions and annuities reported on tax returns for 1964 offers a clue to the difference in tax on employer contributions arising from the smaller income, and therefore lower tax rates, at the time of retirement. The mean effective rate on reported wages and salaries of $320 billion was 10.9 per cent. In contrast, the mean effective rate on reported pensions and annuities of $3.1 billion for the same year was only 6.5 per cent. More striking still is the difference when the effective rates on estimated total (reported and unreported) wages and salaries are compared with those on pensions and annuities: the respective rates then become 10.6 per cent and 4.2 per cent.[46] If the treatment of savings through retirement systems were on an accrual basis, some $9.4 billion [47] of employer contributions and $5.2 billion [48] of investment income on

obtained from tax returns includes benefits from all kinds of plans, not only those of retired employees. The coverage ratio given is therefore also more inclusive than employer-sponsored group plans.

[46] For the rates on wages and salaries, see Table 28. Those on pensions and annuities are computed, as shown in Appendix F, by dividing the tax liability estimate for pensions and annuities by (a) reported pensions and annuities and (b) total pensions and annuity payments.

[47] The estimate of total employer contributions consists of (dollars in millions):

	1963	*1964*
State and local government retirement systems	2,180	2,340
Federal civilian employees' retirement systems	1,038	1,140
Corporate systems	5,260	5,900
Total	8,478	9,380

For source, see notes to Table A-3, line 3a.

[48] At the end of 1964, total employee pension fund reserves in private industry were $77.2 billion (SEC, "Private Noninsured Pension Funds, 1965," *Statistical Bulletin,* June 1966, Table 2). Investment income for governmental retirement systems is estimated at $1.6 billion for 1964. Investment income of corporate noninsured pension plans was obtained from *ibid.* For insured corporate pension funds the published asset figure (*ibid.*) was multiplied by the rate of earnings on all life insurance assets as compiled by the Institute of Life Insurance (*Life Insurance Fact Book,* 1965, p. 59). For governmental retirement systems, see U.S. Department of Commerce, Bureau of the Census, *Government Finances in U.S., Finances of Employee Retirement Systems of State and Local Govern-*

retirement fund assets would have been taxed to employees at an average marginal rate close to 22 per cent.[49] Employer contributions to retirement systems of all types have grown from 3.2 per cent of estimated total compensation for 1955 to 4.8 per cent for 1964 (columns 1 and 3, Table 27)—a 50 per cent increase in relative importance—although their level as such may be viewed as still modest.

As suggested at the beginning of Chapter 2, the exemption of employer contributions from taxation to the employee until retirement benefits are received may be viewed as consistent with the realization doctrine which prevails over most of the income tax. Accordingly, as a general rule, income is not recognized until it is available to the taxpayer in the form of cash, or its equivalent. As Goode points out, "everyone would agree that if an employer deposited part of an employee's salary to his credit in a savings account, where it remained at interest until the employee retired, this would not be a sufficient reason for omitting that part of the salary from current taxable income." [50] Yet some fully funded pension plans, which provide employees with vested rights to future benefits, may in essence not be very different from Goode's hypothetical case. Presumably, the difference between the two hinges on the extent to which the employee has access to the savings accumulated on his behalf. The difference between the simple case of income saved and deposited in a savings account, and that of employer contributions to a pension plan becomes greater when the latter does not provide for immediate vesting of the right to a pension, or for any vesting at all. In the absence of vesting, an employee may receive no benefits from the employer-financed part of the plan if he leaves his employer before retirement, despite his earlier participation in the plan. Many plans provide for no vesting, or vest the right

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ments, 1964–65, January 1966, p. 1, and *Social Security Bulletin, Annual Statistical Supplement,* 1964, U.S. Department of Health, Education, and Welfare, Social Security Administration, Table 12, p. 11.

[49] At a 22 per cent average rate (Table 33), the gross tax loss for 1964 was $3.2 billion. Against this figure a tax gain of $0.20 billion on benefit payments now taxable (Table F-1) must be offset. Thus, the net gain from taxing retirement plan contributions and investment income currently would have been $3.0 billion for 1964. The Treasury's estimate for 1966 was only $1.38 billion (see testimony on private pension plans by Stanley S. Surrey, Assistant Secretary of the Treasury, before Fiscal Policy Subcommittee of the Joint Economic Committee, Washington, May 16, 1966), a figure close to what we would obtain had the average effective tax rate of 11 per cent been used.

[50] See Richard Goode, *The Individual Income Tax,* Washington, 1964, p. 114.

TABLE 27

Employer Contributions to Private and Public Pension Plans and Health and Life Insurance as Percentage of Total Employee Compensation, Selected Years, 1929–64

Year	Social Security (1)	Other Retirement and Welfare Plans: Total (2)[a]	Retirement Plans (3)	Health and Life Insurance (4)	Total Employer Contributions (5)
		Percentage of Total Compensation			
1929	–	.53	n.a.	n.a.	.53
1934	–	.93	n.a.	n.a.	.93
1939	.61	3.11	n.a.	n.a.	3.72
1944	.53	2.67	n.a.	n.a.	3.20
1949	.58	3.34	n.a.	n.a.	3.91
1952	.91	3.66	n.a.	n.a.	4.57
1955	1.26	3.83	1.96	1.86	5.08
1956	1.25	4.12	2.15	1.97	5.37
1957	1.44	4.40	2.37	2.03	5.84
1958	1.42	4.56	2.45	2.11	5.98
1959	1.64	4.81	2.50	2.32	6.45
1960	1.93	4.99	2.53	2.46	6.92
1961	1.90	5.18	2.52	2.66	7.08
1962	1.94	5.50	2.52	2.97	7.44
1963	2.21	5.46	2.54	2.92	7.67
1964	2.16	5.42	2.62	2.80	7.58

Source: Table A-3.
[a] Detail may not add to total because of rounding.

to benefits only after completion of a stipulated period of service, say, ten years.[51]

The existence of plans without vesting has been advanced as the main reason for the present practice of excluding employer contributions and interest earned on pension-plan reserves from current AGI in favor of including benefits less employee contributions later on. In line with this reasoning, it might be appropriate to include employer

[51] Walter W. Kolodrubetz, "Vesting Provisions in Private Pension Plans," *Monthly Labor Review*, September 1964, pp. 1014–1021.

contributions and interest on pension reserves in AGI of employees who acquire vested rights to benefits, but less so where rights are not vested. In the latter case, it is argued, it is difficult to value such rights because they are contingent on the employee's remaining in the same job. Yet a requirement that employees include in AGI employer contributions and interest accruals if their plans include vesting, and otherwise not, would have the undesirable effect of discouraging vesting, whereas public policy should, on other grounds,[52] encourage it. The current treatment may thus be preferred as the less objectionable.[53] The presumed difficulty of determining the current value of contributions to nonvested plans may be considered the primary reason for the present treatment of pension-plan contributions. But it may be argued that a consistent application of the realization principle would require that employer and employee contributions be treated alike. At present, employee contributions are not deductible as a cost of obtaining future income, whereas the employer's contribution, by not being included in AGI, is in effect treated as such. By deducting all costs and taxing only benefits, the realization doctrine would apply more uniformly than is now the case.

On the other hand, it can also be argued that the existence of plans without vesting need not be considered an insurmountable obstacle to valuing all contributions to, and interest on, pension funds currently. In the case of vesting, an employee's equity in a pension fund clearly increases with each employer contribution on his behalf. But even under nonvested plans an employee receives something of value from his employer. What this value is cannot be determined for tax purposes without adoption of some arbitrary rule. The rate at which the employer "contributes" to the plan, although contingent on the employee's remaining on his job, may be used as indicative of what the latter receives. Should the employee leave his employer before obtaining vesting, his loss of pension rights can be treated as a capital loss and be deducted accordingly.

Another, though different, form of deferred compensation is the employee stock option. A study of the tax treatment of employee com-

[52] In the absence of vesting, employees forfeit their pension rights when they change jobs, and such plans may thus discourage labor mobility. Vesting of rights avoids this barrier to movement.

[53] For an exposition along these lines, see Goode, *Individual Income Tax*, pp. 114–115.

pensation would not be complete without some consideration of stock options, although no exhaustive treatment is intended here. Stock options are of concern to a relatively small, though highly select and important group of employees, and the problem of how to treat the gain resulting from the exercise of options is too closely tied to the capital gains problem to permit a full discussion here.[54]

Since 1950, capital gains treatment has been accorded to what are termed "restricted" stock options. Typically, such options allow certain corporation executives to purchase stock in their corporation within a given period of time at a stipulated price, which, it is hoped, will be substantially less than the market value of the stock at the time the option is exercised. The gain is the difference between the cost to the option recipient of the stock purchased and the price at which he may dispose of it. The aim of according this gain the favorable capital gains tax treatment is to encourage a proprietary interest in their business among executive employees.

Executives holding stock options have thus an obvious strong interest, in addition to any other motivations they may have, in seeing the price of the stock of their corporation rise. Because of the favorable tax treatment, there is also a strong incentive to obtain as much compensation as possible in that form. Under the 1964 Act, the major restrictions imposed in order that gains realized from the exercise of options may qualify for taxation at capital gains rates are: (1) option stock may not be sold within three years of the date the option was exercised; (2) the option price may not be less than 100 per cent of the stock's market price at the time the option is granted, and the option must be exercised within five years of that time; (3) the employee to whom an option is granted must not be a "substantial" shareholder of the corporation. In the case of large corporations, a "substantial" shareholder is any person holding 5 per cent or more of the voting stock. Prior to 1964, each of the forgoing restrictions was considerably milder. The required holding period after exercise of an option was six months, not three years; the option price could be as low as 85 per cent of market

[54] For detailed treatments of these topics, see D. M. Holland and W. G. Lewellen, "Probing the Record of Stock Options," *Harvard Business Review,* March-April 1962, and George E. Lent and John A. Menge, "The Importance of Restricted Stock Options in Executive Compensation," *Management Record,* June 1962; also, Lewellen, "Executive Compensation in Large Industrial Corporations," NBER (in preparation).

value at the time the option was granted without forfeit of capital gains treatment (although the amount from 85 to 95 per cent of market value had to be treated as ordinary compensation if the stock was sold at more than the option price); and in case of a sustained drop in market price of the stock below the price at the time the option was granted, the option price could be reset at a lower level.[55]

While in recent times stock option benefits have been of great importance relative to regular salaries of executive employees, relative to the aggregate of wages and salaries they have been of minor quantitative importance. No precise data on the annual value of realized stock option benefits are available. Lent and Menge, reporting on the option benefits realized in a sample which comprised most of the industrial and trade firms listed on the New York Stock Exchange with plans in effect in 1957–58, calculated $200 million for 1959 and $164 million for 1960.[56] For all U.S. corporations, their rough estimate is $300–$350 million a year for 1959–60.[57] Next to total reported wages and salaries of $258 billion for 1960 (Table 4), the total value of stock options appears small. Moreover, in relative size there may well be a decline in the amount of stock options, in view of the increased restrictions imposed under the 1964 Act.

Because of the existence of stock options as an alternative method of executive compensation, figures in Table 15 are understated for returns with AGI over $50,000. For this group of returns realized option benefits amounted to roughly 30 per cent of ordinary salary.[58] In some cases, option benefits exceed salary.[59] Yet the impressive size of realized stock option benefits of top executives is not the major reason for the sharp decline of wages and salaries relative to AGI of employees at high income levels. The difference in the reported wages and salaries and estimated AGI of high-income employees exceeds any plausible estimate of the amount of realized stock option benefits. For employees

[55] For a more detailed statement of the differences between the 1954 and 1964 Acts, see Treasury Department, *Summaries of Provisions in the Revenue Act of 1964*, Washington, March 1964, TP-26.

[56] Lent and Menge, "Restricted Stock Options," p. 7.

[57] This figure was obtained informally from one of the authors.

[58] *Ibid.*, p. 12.

[59] Holland and Lewellen found that in a sample of 166 executives in 31 of the nation's 50 largest industrial corporations, a considerable number had option benefits larger than their salaries for the period under consideration. See Holland and Lewellen, "Record of Stock Options," p. 139.

reporting AGI of $50,000 and over, the difference was close to $5 billion in 1961, as shown by the following figures (in millions of dollars):

AGI Classes (000)	*Wages and Salaries*	*Estimated AGI*
50–100	2,452	4,673
100–500	965	2,985
500 and over	57	894

SOURCE: Table B-1.

There is as yet (at least to our knowledge) no evidence as to how effective stock options are in producing the desired results, i.e., "to encourage better corporate management." [60] On the basis of the historical record, it is not even clear that the stock option device has had the effect of supplying a given amount of after-tax executive compensation more cheaply for corporate employers than it could have been supplied through conventional salary payments.[61] But even if the cost *ex post* to a company of paying a given amount of additional after-tax compensation were found to be the same by both methods, it could still be argued that stock options, because their benefits are not known *ex ante,* have greater incentive effects than equivalent amounts of salary. On this question, there is at present no evidence.

Fringe Benefits and Expenses Incurred at Convenience of the Employer

A variety of services are supplied by employers to employees free of charge, some mainly as additional forms of compensation, known as "fringe benefits," others mainly because they are consumed in the line of duty and at the convenience of the employer. The latter are not necessarily income to the employee. Goods and services often supplied free include life insurance, medical care and hospital plans, "courtesy" discounts, expense account perquisites, meals and lodging supplied on

[60] Treasury Department, *Provisions in the Revenue Act of 1964.*

[61] See Holland and Lewellen, "Record of Stock Options," pp. 141–149. The authors found that, since the cost to a corporation (stockholders) of granting stock options is not a deductible expense in computing taxable income, whereas conventional salary payments are, a given additional amount of after-tax compensation could be achieved more cheaply (at pre-1964 rates) through salary than stock options when an executive's ordinary income was less than $100,000.

the premises, reimbursement for moving expenses, and technical instruction away from the job.

As a general principle, payments by an employer on behalf of employees, if not in the nature of an employment-connected expense, should be treated as compensation and included in AGI. Unless there is an overriding social preference for the type of payment in question, failure to include it in AGI is likely to result in inequities and economic distortions. The tax law as a rule requires inclusion in AGI of personal expenses of employees when paid for by employers, but there are major exceptions. Premiums paid by employers to group medical, hospital, and life insurance plans as well as unemployment insurance are not included in AGI, nor are the benefits resulting from these plans. "Courtesy" discounts on company-produced goods and the value of meals furnished on the premises are also generally not treated as taxable income. The estimated value of these exceptions was included in the "total compensation" series shown earlier (Table 4). Premiums for health and life insurance in 1964 are estimated at $6.1 billion and company discounts and miscellaneous other fringe benefits, such as meals on the premises, at $1.5 billion.[62] Whereas premiums paid by employers might be included in employees' AGI without particular difficulty, discounts and employer-furnished meals have in practice been omitted, mainly on administrative grounds. The former are usually small and hard to detect. The latter may be difficult to value and are furnished more or less at the convenience of the employer.

Some employees may receive compensation in the form of payment for personal expenses under expense-account arrangements. The extent to which this may be the case is not known and is difficult to estimate. Reimbursed expenses while traveling away from home need not be included in AGI, and if not reimbursed may be deducted in computing AGI. Such travel is clearly at the employer's convenience and necessitates outlays which might otherwise not have been undertaken, but must also include an element of expense which would have been incurred in any case and which therefore constitutes income. Cases of generous vacation fare and entertainment, paid for by employers ostensibly to permit employees to attend business conventions and confer-

[62] For items included in health and life insurance premiums, see notes to line 3b of Table A-3, items E–I. For company discounts and miscellaneous other items, see lines 5 and 6, Table A-3.

ences, or to entertain customers, have from time to time been a matter of concern to the Treasury.[63] The utility to the employee of compensation in this form can easily be exaggerated, for even though one's ticket to a musical comedy may have been paid for by the employer, it may not be income to one who hates music. But because it is income for some, the law at present may be said to lean in favor of the relatively small number of individuals who can avail themselves of expense accounts. There appears to be no simple solution to this problem.[64]

For the majority of employees, the balance may be in the opposite direction. Except for those to whom food, lodging, or clothing are directly supplied by the employer—and therefore usually deemed to be at the employer's convenience and excluded from AGI [65]—many find their employment-connected expenses not deductible. This is especially true in cases where employees incur additional expense for clothing, food, and travel for which deductions from AGI would be exceedingly difficult to allow, for in all these cases a substantial personal consumption component is present. Only where the personal consumption component is minimal does the tax law now permit employees a "business" deduction: specialized clothing and tools required in an occupation, union and professional association membership fees, subscriptions to professional journals, and employment agency fees, among others. They are part of the "miscellany" included under personal deductions from AGI,[66] and their exact amount is therefore not known. They could not

[63] For instance, see *President's Tax Message Along with Supporting Statement, Detailed Explanation, and Supporting Exhibits and Documents,* U.S. Government Printing Office, Washington, D.C., 1961, pp. 10, 38, and 72.

[64] As Goode has pointed out, rigorous measurement of net income from personal effort is exceedingly difficult, if not impossible, because of the dual role of human beings as both productive agents and consumers. Thus, for employees, consumption can be both the end of production and the intermediate good. See Goode, *Individual Income Tax,* p. 78.

[65] As a general rule, the monetary worth of payments in kind must be reported as income by the employee. For instance, where housing is supplied to employees at the latter's option, with equivalent reductions in wages or salaries, the value of these services must be included in AGI. However, such pure cases are rare. More common instances are those where consumption of services on the premises, such as meals or lodging, has a value to the employer but may vary in value to the employee from zero up to the actual market value of the services. Because of the difficulty of separating employer's from employee's benefits in order to arrive at imputable income, current practice is to presume all services thus furnished as being at the employer's convenience, and no imputation of income is made.

[66] Although not "personal," and therefore not properly part of AGI, they are included in the personal deductions category for administrative reasons.

have exceeded $4.9 billion in 1964, the total of miscellaneous personal deductions for that year. Because of their inclusion under personal deductions, many employees have been prevented from itemizing job-connected expenses as long as they chose the standard deduction.[67] However, unreimbursed travel expenses of employees away from home have been deductible in the computation of AGI, but may in many instances have been included by taxpayers in miscellaneous personal deductions, at least before 1964. Beginning in that year, a specific entry on the form provides for "employee business expense," consisting of transportation and other travel expenses not paid for by employers, to be deducted from gross income. Thus tabulated explicitly for the first time, employee travel and transportation expenses amounted to $2.2 billion in 1964 and were claimed by 2.2 million, or about 4 per cent, of taxpayers with wages or salaries.[68] The deduction of unreimbursed travel expenses separately from other employee business expenses is arbitrary and part of an attempt to hold the line against further erosion of the standard deduction's function to provide a simple tax return.[69]

For the same reason that daily commuting costs to and from one's place of employment are not treated as a deductible expense, the tax law until 1964 did not permit deduction of the expense of moving one's household because of a change in employers. In both instances, personal and "business" expense are closely intertwined. The tax law has proceeded on the assumption that the distance one has to travel to work depends on one's choice of location, which may be a function of personal preferences and not an "ordinary and necessary" part of one's job. While it is thus true that a person may have to travel far to get to his place of work, it can also be argued that he only travels far because he chooses to live far from work. The same reasoning appears to have justified the treatment of moving expenses in the past: a person may have moved because he changed jobs, in which case the expense of moving justified a deductible expense. But a person also might have moved mainly to gain a preferred geographical location and his change of jobs

[67] See C. Harry Kahn, *Personal Deductions in the Federal Income Tax*, Princeton for NBER, 1960, p. 9.

[68] See *Statistics of Income, 1964, Preliminary Individual Income Tax Returns*, p. 3. Before 1964, this expense category was deductible from wages and salaries in computing AGI. Thereafter it was still deducted in computing AGI, but not from wages and salaries. A spurious rise in tabulated wages and salaries is thus likely to have resulted after 1963 because of this change in reporting.

[69] Kahn, *Personal Deductions*, pp. 162–172.

would have been merely incidental to the move. In this case, its cost could not be justified as a deductible expense. Only when a person moved his household because of a transfer to a new location within the same firm was it presumed that the expense was genuinely at the convenience of the employer, provided the latter reimbursed the employee. If an employer reimbursed a newly hired employee for moving expenses, the reimbursement was treated as income.[70]

Under the 1964 Act, the treatment of moving expense has been greatly liberalized. All employees who migrate to a new place of employment, whether for the same or a new employer, may deduct the expense of travel and of moving household goods if not reimbursed.[71] If reimbursed, the employee may exclude the amount of reimbursement from gross income. So as not to bury entirely the old concern over allowing deduction of expenses incurred for personal reasons, the 1964 law requires (1) that the new place of employment be at least twenty miles farther from the employee's former residence than was his old place of employment, and (2) that in case of a nonreimbursed move, the taxpayer be employed in the general location to which he moved for at least thirty-nine weeks during the year following arrival. The liberalization in the treatment of moving expenses is primarily the result of a change in public attitude toward labor mobility rather than a revision of the consensus on equity. It reflects the concern of 1964

[70] Wages and salaries as tabulated by the Commerce Department do not include reimbursed moving expenses as a general rule. Therefore, where such reimbursements had to be reported as compensation on the return, a very slight overstatement of the coverage ratio, as shown in col. 4, Table 4, must have resulted on that account. The overstatement is likely to be slight because reimbursement is relatively rare for new employees. Even if all those who migrated in order to accept a new job had been reimbursed at an average rate of $200 per move, the estimated total of wages and salaries of $291.4 billion for 1962 would have been increased by merely $0.16 billion. This estimate was obtained by (a) multiplying the civilian, noninstitutional labor force of 71,854,000 for 1962 (*Economic Report of The President,* January 1963, p. 194) by the percentage of the male, noninstitutional, civilian labor force which migrated in 1962 to take a *new* job (1.4 per cent; see Samuel Saben, "Geographic Mobility and Employment Status," *Monthly Labor Review,* August 1964), which results in an estimate of 820,000 migrating to take new jobs; and (b) multiplying the estimate in (a) by an assumed average cost of moves to new locations of $200, which gives an estimated moving cost of $165 million for that group. The assumed average moving cost is based on J. B. Lansing, E. Mueller, W. Ladd, and N. Barth, *The Geographic Mobility of Labor: A First Report,* Ann Arbor, Mich., 1963, Table IV-34.

[71] The deduction may be claimed whether a taxpayer itemizes or takes the standard deduction. Discriminatory treatment between reimbursed and nonreimbursed expenses is thus avoided.

for "persons living in depressed areas and those out of work due to technological advance."[72] In its first year, the new deduction totaled only $93 million, claimed on 290,000 returns. Taxpayers in the $2,000–$5,000 AGI group claiming moving expenses deducted an average of $227; those with AGI of $15,000 or more, $618 on average.[73]

The instances discussed illustrate the difficulty of distinguishing at times between payments that constitute additional compensation and payments that are in essence reimbursements for expenses at the convenience of the employer. In some cases a presumption that the latter is the case is reasonable, as in the 1964 Act with respect to the treatment of moving expenses. In others the opposite presumption would be reasonable, as in the case of employer contributions to life and health insurance plans. But in a third area, loosely described as expense account perquisites, not even reasonable presumptions are feasible.

Conclusion

Of the several special provisions affecting the tax liability on employment income, which are considered in detail above, some have applicability to relatively few employees, to whom they may be of great importance, although their significance in the aggregate is minor. Cases in point are long-term gains derived from stock options, often considered an important form of compensation for top executives, but estimated to amount to no more than $0.3 billion in 1960, and the so-called child-care allowance for working mothers, which totaled only $0.1 billion in 1960. These are indeed small figures next to reported wages and salaries of $258 billion. Yet they both raise issues far more important than their immediate effect on total tax liability. In the one case the tax treatment of possibly the most strategic group of employees is at issue. In the other, the limited present allowance for child care opens up the much greater issue of the tax treatment of women in the labor force compared to those working in the home.

Of much greater aggregate quantitative importance is the treatment of deferred compensation and various types of consumption enjoyed "at the convenience of the employer." The former consists largely of employer contributions to social and private pension systems. For 1964,

[72] Treasury Department, *Provisions in the Revenue Act of 1964,* TP-12.
[73] *Statistics of Income,* p. 3.

these amounted to about $17.4 billion, and none of them is treated as currently taxable income; only private pension benefit payments are treated as part of taxable income. But because retirement benefits are typically received when annual money income is low, the tax on this part of compensation is in effect very low. Consumption at the convenience of the employer and various fringe benefits are not counted as income to the employee. Their combined total may have exceeded $3.7 billion in 1964.[74] While there is little disagreement on purely conceptual grounds that these items in varying degree constitute compensation, and therefore taxable income, to the employee, they are nevertheless omitted from AGI because of the practical difficulty of measuring their value. It is almost impossible to divide with any precision the value of services furnished to employees on the job between business expense and income in kind.

Current withholding of tax, which has so far been applied only to wages and salaries, as distinguished from quarterly declarations of estimated tax required for all other income, has on the whole resulted in earlier tax payments by employees than by nonemployees. This is because employees on average are found to require refunds of tax at the time of filing, whereas others, on average, are required to make some additional payment signifying that their current payments have been insufficient. However, the net burden placed on employees by this difference in timing of tax payments was found to be small.

Although there is at present no write-off allowance for investment in education and training, such an allowance in somewhat indirect form was apparently intended during two earlier periods under the title of an earned-income credit. Its demise, contrary to the frequent tendency to liberalize existing allowances, resulted primarily from a widespread recognition that the particular form in which it existed from 1934–43 bore little relation to its purpose. In the light of recurrent interest in the tax treatment of investment in education and training, an extended examination of this earlier experience seemed warranted.

[74] This was the estimated total for income in kind (Table A-2), company discounts, and miscellaneous other payments (Table A-3) in 1964.