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Volume Title: The Personal Exemptions in the Income Tax

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Volume Publisher: UMI

Volume ISBN: 0-870-14482-0

Volume URL: <http://www.nber.org/books/selt68-1>

Publication Date: 1968

Chapter Title: Some Questions Raised by the Personal Exemptions

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Chapter URL: <http://www.nber.org/chapters/c1147>

Chapter pages in book: (p. 15 - 37)

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Some Questions Raised by the Personal Exemptions

1. THE EXEMPTIONS AND THE TAX BASE

The purpose of this study is to examine the personal exemptions in the federal income tax in the light of their objectives, their history, their actual functioning, and of various alternative means of achieving their purposes.

The federal individual income tax is by far the biggest single source of tax revenue in the United States. In 1965 it raised \$49.5 billion, or well over one-half of the net budget receipts of the national government (total budget receipts less refunds and transfers to the highway and social security trust funds). All other tax sources of federal, state, and local governments ranked well behind: the federal corporation income tax yielded \$25 billion, state and local property taxes, \$23 billion, and the aggregate of all other state and local government taxes, \$29 billion.

To raise sums of the magnitudes required in recent years, the income tax must have wide coverage and must be levied at substantial rates. The fact is that the tax now reaches the greater part of personal incomes in at least some degree. More than 90 per cent of the population and of the total amount of adjusted gross income estimated to have been received by all individuals in the United States were accounted for on tax returns filed in recent years. (Adjusted gross income is, roughly, net income before personal exemptions and nonbusiness or personal deductions.) *Taxable* returns have covered close to three-fourths of the population as taxpayers or dependents, and have accounted for about 85 per cent of the total amount of adjusted gross income.

But the coverage of the income tax is much narrower when judged

by the proportion of total adjusted gross income that the tax law now terms "taxable income"—that is, income actually subject to any of the bracket rates of tax. In 1964, taxable income in this sense was about 53 per cent of the total. The shrinkage of total adjusted gross income on its way to taxable income took place as follows: of the \$434.6 billion total, \$58.6 billion did not appear on taxable returns, having been received by persons who were not required to file returns because their gross incomes were too small, by those filing returns whose incomes were only equal to or less than the sum of their personal exemptions and their allowable nonbusiness deductions, and, assuming no estimating error, by those who failed to report or understated their incomes. Of the amount reported on taxable returns, \$88.3 billion disappeared through the personal exemptions and \$58.4 billion through the personal deductions. In all, nearly one-half of the total adjusted gross income of all individuals and 39 per cent of the reported adjusted gross income of taxable individuals was excluded from taxable income (Table 1). The personal exemptions alone, consisting of \$600 for each person, including dependents, plus \$600 more for each taxpayer or his spouse who was aged 65 or more or was blind, removed from the category of taxable income about 23 per cent of the total adjusted gross income of taxable individuals in 1964.

As is indicated in part by these figures, the personal exemptions are a major component of the income tax structure: their levels largely de-

TABLE 1
Adjusted Gross Income, Personal Exemptions, Nonbusiness Deductions,
and Taxable Income, 1964
(billion dollars)

1. Total adjusted gross income	434.6
2. Minus amounts not on taxable returns	58.6
Amount unreported on any returns	37.9
Effective personal exemptions on nontaxable returns	15.2
Effective nonbusiness deductions on nontaxable returns	5.5
3. Equals: adjusted gross income on taxable returns	376.0
4. Minus exemptions and deductions on taxable returns:	146.7
Personal exemptions	88.3
Nonbusiness deductions	58.4
5. Equals: taxable income on taxable returns	229.3

SOURCE: See Table 13 for source and notes.

termine the proportion of the population and of total personal income covered by the tax; they exert great influence upon the amount of revenue it produces; and they are the most important means by which the law takes account of differences in the family responsibilities of different taxpayers. Because of their central importance, the structure and level of the personal exemptions naturally invite critical examination from time to time.

2. RELATION BETWEEN PERSONAL INCOME AND THE TAX LAW'S ADJUSTED GROSS INCOME

Adjusted gross income is a statutory concept designed to approximate net income after allowing for expenses incurred in a trade or business. Presumably for administrative reasons, however, expenses incurred by an individual in obtaining wages and salaries, interest, dividends, and other so-called nonbusiness incomes, are not generally allowed as deductions in arriving at adjusted gross income. Instead, such outlays, which include union dues, fees for investment counsellors, rent of a safe deposit box, etc., are deductible *from* adjusted gross income before arriving at "taxable income."

In recent years the estimated annual totals of individuals' adjusted gross income as defined by the tax law have commonly been about one-eighth smaller than total personal income as estimated by the Department of Commerce.¹ Various receipts in money and kind that Commerce includes in personal income are excluded from the tax law's concept of income. The most important of these are transfer payments of various kinds, such as old-age and disability benefits under the Social Security System, unemployment benefits, relief payments, etc.; "other labor income," which includes nontaxable fringe benefits; "imputed interest" in the form of services provided by financial institutions; and "imputed net rent" of owner-occupied dwellings. On the other hand, some types of receipts that the tax law regards as income are not included in personal income as defined by the Department of Commerce.

¹ The figures for recent years may be found in C. Harry Kahn, *Employee Compensation Under the Income Tax*, New York, NBER, 1968, Appendix Table A-1.

TABLE 2
Principal Adjustments to Personal Income as Defined and Estimated by the
Department of Commerce to Obtain Total Adjusted Gross Income, 1964
(billion dollars)

1. Personal income	496.0
2. Minus components excluded from adjusted gross income:	89.7
a. Transfer payments	36.8
b. "Other" labor income (nontaxable)	15.6
c. Imputed interest	14.1
d. Imputed net rent and income in kind	13.2
e. Total of various others	10.0
3. Plus AGI components excluded from personal income:	28.3
a. Personal contributions for social security and government insurance	12.5
b. Net gains from sales of property	7.9
c. Annuities and pensions	3.4
d. Other income, net	4.5
4. Equals: Total AGI	434.6

SOURCE: C. Harry Kahn, *Employee Compensation Under the Income Tax*, New York, NBER, 1968, Appendix Table A-1.

The most important of these are the amounts of wages and salaries and of income from self-employment that are paid by workers as social security taxes, and net gains from sales of property. The principal adjustments in reconciling the estimated totals of personal and adjusted gross income for 1964 are shown in Table 2.

While adjusted gross income only approximates net income in an economic sense, it is a closer approximation than "taxable income" because the latter excludes the deductions allowed for personal exemptions, certain state and local taxes, medical expenses, charitable gifts, and various other uses of income.

3. THE PRESENT STATUTORY PROVISIONS GOVERNING THE PERSONAL EXEMPTIONS

The present personal exemptions in the federal income tax consist of a deduction, in computing taxable income, of \$600 for each exemption

to which a person filing an income tax return is entitled. Anyone whose *gross* income during a calendar or his fiscal year equals or exceeds \$600 if he is under 65 years of age, or \$1,200 if he is 65 or more, is required to file a return. He is entitled to one exemption on his own account and to one for each dependent. In a joint return, both spouses are regarded as taxpayers, each entitled to an exemption. A married person filing a separate return may also claim the personal exemption of his spouse if the latter is not the dependent of another person and has no gross income. An additional exemption is allowed for a taxpayer who is aged 65 or more and still another is allowed for one who is blind; and if a joint return is filed, these additional exemptions are allowed also for spouses who are aged or blind. For example, an aged couple without dependents, both of whom are blind, is entitled to personal exemptions totaling \$3,600.

An exemption is allowed for each child (including stepchild or adopted child) who was under 19 years of age at the close of the calendar year in which the taxpayer's taxable year began, or who, regardless of age and of income, was a student full time at a regular educational institution or in accredited on-farm training for at least five calendar months during the year, if the taxpayer furnished more than one-half of his support exclusive of scholarship grants. If the child was 19 or over and not a student the exemption is allowed only if the child had less than \$600 gross income and the taxpayer provided more than one-half of his support.

The taxpayer is also allowed an exemption for each of the following kinds of dependents, provided he contributed more than one-half to their support and they had less than \$600 gross income: parent, ancestor of parent, descendent of a child, brother, sister, stepbrother, step-sister, stepmother, stepfather, mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law; uncle, aunt, nephew, or niece; and any person (other than the taxpayer's spouse) who lived in the taxpayer's home and was a member of his household during the entire taxable year, provided the relationship between such person and the taxpayer was not in violation of local law (e.g., the exemption cannot be claimed for a mistress). In calculating the gross income of a claimed dependent, no account is taken of tax-exempt interest, disability compensation, social security benefits, or other receipts excluded by law from gross income, but the amount of such receipts that is used

for the support of the dependent, except a student's scholarships, must be taken into account to determine whether the taxpayer has furnished more than one-half of the dependent's support.

If an individual during a taxable year was supported by several persons none of whom contributed more than one-half, any one of the group who had contributed more than 10 per cent of the support may claim the exemption if all the others who contributed more than 10 per cent declare in writing that they will not claim the exemption for that year. The older rule limiting the exemption to the person who had contributed more than one-half of the dependent's support was frequently capricious in application because it provided no benefit to any of two or more persons who shared equally the expense of supporting a parent or other relative.

In addition to the foregoing restrictions, a dependent must be a citizen or resident of the United States or a resident of Canada, Mexico, the Canal Zone, Republic of Panama, or, under certain circumstances, the Republic of the Philippines, at some time during the calendar year in which the taxpayer's taxable year begins, or an alien child legally adopted by and living with a United States citizen abroad.

Although taxpayers are allowed an exemption for each of their dependents, and about 93 per cent of the returns of married persons are joint rather than separate returns, the individual rather than the family is the legal taxpayer-entity under the federal income tax. It is the individual, not the family, who is required to file a return and to pay a tax if his income exceeds the amounts stated in the statute. He or his guardian is required to do this even if he is a dependent and/or a minor. And whether his income is less than or exceeds his exemptions and deductions, it is not included in the tax return of his parents or other person of whom he is a dependent. A married couple may choose to file either a joint or separate returns. When they file a joint return, they are taxed (with minor exceptions) as if one-half of their combined income was reported by each spouse as a single person.

4. THE ITEMIZED AND STANDARD DEDUCTIONS

Closely related to the personal exemptions for the majority of taxpayers is the standard deduction—particularly the minimum standard de-

duction enacted in 1964. From the beginning of the income tax, Congress has provided for the deduction from otherwise taxable income of certain personal or nonbusiness expenses that were thought to reduce taxpaying ability. In recent years the itemized deductions that have bulked largest have been those for taxes paid to state and local governments, interest paid, philanthropic contributions, and extraordinary medical expenses. In 1964 these four deductions accounted for \$42 billion or about nine-tenths of the total itemized deductions on all returns, and consisted of \$14.1 billion for state and local taxes paid, \$12.5 billion for interest paid, \$8.3 billion for contributions, and \$7.1 billion for medical expense. In order to minimize the burdens of record keeping and of tax administration for millions of small taxpayers, an optional standard deduction was introduced in 1941 and subsequently liberalized. Between 1948 and 1963, it permitted any taxpayer to substitute a deduction of 10 per cent of his adjusted gross income, but no more than \$1,000 per return (\$500 each on the separate returns of married couples), for an itemized list of his actual allowable deductions. Since the standard deduction exceeded the deductible expenses of most taxpayers, it constituted the equivalent of an effective, though variable, addition to their personal exemptions, and was used at first on more than four-fifths of all tax returns. This proportion steadily declined in subsequent years as the importance of state and local government taxes, interest payments, contributions, and medical expenses rose, but it still approximated 55 per cent in 1963.

The deliberate use of the standard deduction as an extension of the personal exemptions became far more marked with the provision of a generous *minimum* standard deduction in the Revenue Act of 1964. Such a provision was originally proposed by the present author and was subsequently adopted for the express purposes of raising the limits below which incomes are excluded from tax and of increasing the effective personal allowances in the lower ranges of taxable incomes without increasing them for larger incomes.² Under the Revenue Act of

² See my statement before the Committee on Ways and Means, House of Representatives, 68th Congress, 1st Session, Nov. 20, 1959, reproduced in *Income Tax Revision*, Panel Discussions, 1959, p. 214. See also John F. Kennedy, *President's 1963 Tax Message*, Jan. 24, 1963; Douglas Dillon, statement before the Committee on Ways and Means, *Hearings*, Feb. 6, 1963, p. 38; *Report of Committee on Finance*, U.S. Senate, 88th Congress, 2d Session, on H.R. 8363, 1964, pp. 29-31.

1964, the use of the standard deduction in lieu of itemized deductions remained optional with the taxpayer, and the upper limit remained at \$1,000. But a *minimum* standard deduction, varying with the number of a taxpayer's exemptions, was established to take the place of the previous standard deduction of 10 per cent of adjusted gross income wherever the minimum results in a larger deduction within the \$1,000 limit. The minimum standard deduction was fixed at \$300 for single persons, \$400 for married couples filing joint returns (\$200 each for those filing separate returns), and \$100 more for each dependent or other additional personal exemption.

One effect was to raise the minimum level at and below which persons are excluded from tax to \$900 for single persons, \$1,600 for taxpayers with two exemptions, and \$700 more for each additional exemption, up to \$5,800 for persons with eight or more exemptions. On the basis of figures submitted by Treasury officials and others, the Senate Finance Committee estimated that the minimum standard deduction would remove 1.5 million persons from the income tax rolls and would concentrate in the adjusted gross income classes of \$5,000 or less nearly all of the \$320 million of annual tax relief immediately resulting from the provision. The 1964 income tax returns indicated that these expectations were roughly realized. Although the total number of tax returns was 1.4 million larger than in 1963, the number of *nontaxable* returns increased by 1.4 million; and 92 per cent of the returns employing the new minimum standard deduction had adjusted gross incomes of less than \$5,000.

5. THE PERSONAL EXEMPTIONS AND MINIMUM LIVING STANDARDS

The precise purposes or functions of the personal exemptions have never been explicitly stated by Congress, and, in fact, a number of objectives appear to have been sought at different times both in this and other countries (see Chapter 4). Nevertheless their primary objective is generally accepted as that of protecting from income tax the minimum amounts of income deemed necessary for subsistence or for a tolerable standard of living. This objective has been interpreted in two different ways: (1) the exclusion from the tax of only the very poor,

and (2) the exemption of some minimum amount of income for all. In the United States, the latter interpretation has prevailed, at least in form; in some other countries, the former. Under both interpretations it is nowadays generally accepted that a larger exemption is appropriate for a married couple and for a person with dependents than for a single person. Such differentiation for variation in family responsibilities was once absent in some countries, including the United States. The so-called "additional exemptions" now granted to the aged and the blind in this country are presumably based upon the ground that such persons also require a larger income than others to maintain an equal living standard or a tolerable minimum one.

It need scarcely be said that the objective of protecting some minimum amount of income from tax is by no means synonymous with one of assuring everyone a minimum of income. The personal exemptions in the usual income tax are only capable of aiding those with otherwise taxable income. Their power to safeguard a minimum standard of living is therefore one-sided: they can do nothing for persons without income, and increases in their levels can do nothing for those with incomes too small to be taxable under the previous exemption level. In some so-called negative income tax proposals, designed to guarantee everyone a minimum income, the total personal exemptions of each family unit, or some fraction of that total, would also constitute the minimum amount of income to be guaranteed by the Treasury (see footnote 8 below for citations of various published expositions and discussions of such proposals).

Major elements of the problem of assuring minimum living standards to those whose incomes would otherwise be inadequate have been attacked in the United States through the Social Security System. Members of certain leading categories of the needy—the indigent aged, the disabled, the blind, and families with dependent children lacking parental support—are eligible to receive regular assistance payments geared to individual needs through joint federal-state assistance programs established under the Social Security Act. The partial maintenance of income during periods of temporary unemployment is provided for more than three-fourths of all employees by state-administered unemployment compensation plans financed by federal and state taxes on employers. Assurance of regular monthly incomes after retirement or in the event of prior total disability is now provided for more than 90 per

cent of all employed persons and their spouses through the Federal Old Age, Survivors, and Disability Insurance System, which is financed by a tax on employment compensation levied equally upon employers and employees and by a comparable tax upon the self-employed. The monthly payments going to retired persons and their spouses under this system, as well as under other governmental and private pension plans, contribute materially to maintaining tolerable living standards for a large group that formerly provided a major fraction of the poverty-stricken. Nevertheless, it may be noted that, even in 1962, about one-third of all families with annual money incomes of less than \$3,000 had a head aged 65 years or more.³

To reduce the role of the financial burdens of illness as a source or aggravation of poverty, important extensions of the Social Security System were made by amendments enacted in 1965. To all persons aged 65 or more, regardless of income, wealth, or employment status (with only minor exceptions),⁴ the federal government now offers two kinds of financial aid against medical costs: (1) hospital insurance provided merely upon application and without charge, under which the government pays stipulated generous sums towards expenses incurred for hospital and posthospital care, and (2) medical insurance, offered on a voluntary basis at one-half the estimated cost, under which the government pays a large part of various other medical expenses, principally those incurred for physicians' services. These insurance programs are popularly known as Medicare. In addition, joint federal-state programs to cover the hospital and other medical expenses of the "medically indigent" of all ages (Medicaid) are authorized, under which substantial federal grants-in-aid, ranging upwards from 50 per cent of the total costs, are made to states operating approved programs. These programs may include not only persons and families eligible under other programs of government assistance to the needy, but all persons who, as defined by the various states, are "medically indigent" in the sense that their incomes are not large enough to cover their hospital and other medical expenses without hardship. To finance the free hospital insurance for the aged, Congress enacted a scheduled succession of increases in the social security tax rates on employment compensation, but it made no

³ Council of Economic Advisers, *Annual Report*, 1964, p. 61.

⁴ Some present and former federal employees, some aliens, and persons convicted of treasonable activity.

special provision for the other federal costs of the 1965 amendments.

In many Western countries, including Canada, Great Britain, and Sweden, analogous systems of social security include or are supplemented by so-called family allowances, under which the national government makes regular cash payments to all families with children, regardless of means. In Canada the payment is \$6 a month for each child under 10 years of age and \$8 for each one between 12 and 16.⁵ In addition, a youth allowance of \$10 a month is paid for each dependent child aged 16 or 17 who is receiving full-time educational training or who is precluded therefrom by physical or mental infirmity. In Great Britain, the payment is nothing for a first child, 8 shillings (\$0.96) a week for a second, and 10 shillings (\$1.20) a week for a third and each subsequent child below the age limits.⁶ The payments are made monthly in the form of a book of vouchers cashable weekly at any post office, and, except in unusual circumstances, are payable only to the mother. The age limits are 15 years for children who leave school at that age, 16 for certain incapacitated children, and 19 for children who remain at school or are apprentices. In Sweden the payment is S. Kr. 900 a year (about \$174) for each child under 16, payable to the mother.⁷ Canada and Sweden exclude the family allowances from income tax but Britain does not. On the other hand, Sweden has no personal exemption for children in its income tax, and Canada allows an exemption of only \$300 for children eligible for family allowances but \$550 for others, though the full exemption is allowed for those eligible for youth allowances.

In the United States, besides transfer payments to various categories of the needy and social insurance programs, other well-known government efforts to ameliorate poverty and to remove its causes include the use of public funds and public credit to promote low-cost housing, to eliminate slums, to regenerate depressed areas, and to widen educational opportunities. In addition, a lively discussion has recently developed about the possibility of establishing a nation-wide guaranteed minimum income for all, with the federal Treasury making up the de-

⁵ *Health and Welfare Services in Canada*, Department of National Health and Welfare, Ottawa, 1966, pp. 59-65.

⁶ *Social Security in Britain*, British Information Services, Harrow, 1964, pp. 10-11. Dollar equivalents are for the pound at \$2.40.

⁷ *Social Benefits in Sweden*, The Swedish Institute, Stockholm, 1966, p. 2.

iciency in anyone's income—a so-called negative income tax—to supplement or replace many existing programs for the poor.⁸

6. FUNCTIONS OF THE PRESENT PERSONAL EXEMPTIONS

By looking closely at the ways in which the current personal exemptions in the United States actually operate, we may distinguish more specifically the following principal services that they perform:

1. They exclude from the income tax altogether individuals and families with the smallest incomes. In 1965, 23 per cent of the population was not represented on taxable returns either as taxpayers or dependents. This proportion doubtless included some persons who were properly taxable but who failed to file returns as well as those whose incomes were smaller than the sum of their exemptions and deductions.

2. In form, at least, they provide a deduction from otherwise taxable income for a portion of the essential living expenses of all who remain taxpayers. Such an allowance of some tax-free income for all has the political appeal of appearing to soften the impact of the tax for

⁸ See Milton Friedman, *Capitalism and Freedom*, Chicago, 1962, pp. 191–195; Lowell E. Gallaway, "Negative Income Taxes and the Elimination of Poverty," *National Tax Journal*, September 1966, pp. 298–307; Christopher Green, *Negative Taxes and the Poverty Problem*, Brookings, 1967; Christopher Green and Robert J. Lampman, "Schemes for Transferring Income to the Poor," in "A Symposium: Negative Income Tax Proposals," *Industrial Relations*, February, 1967, pp. 121–137; George Hildebrand, "Second Thoughts on the Negative Income Tax," *Ibid.*, pp. 138–154; Earl Rolph, "The Case for a Negative Income Tax Device," *Ibid.*, pp. 155–165; Earl Rolph, "The Negative Income Tax," *Proceedings of the National Tax Association*, 1966, pp. 147–153; Thomas K. Hitch, "Why the Negative Income Tax Won't Work," *Challenge*, July–August 1966, pp. 13–15; Robert J. Lampman, "Approaches to the Reduction of Poverty," *American Economic Review, Papers and Proceedings*, May 1965, pp. 521–529; Edward E. Schwartz, "A Way to End the Means Test," *Social Work*, July, 1964, pp. 3–12; D. B. Smith, "A Simplified Approach to Social Welfare," *Canadian Tax Journal*, May–June 1965, pp. 260–265; Robert Theobald, ed., *The Guaranteed Income: Next Step in Economic Evolution?*, Garden City, N.Y., 1963; James Tobin, "Improving the Status of the Negro," *Daedalus*, Fall 1965, pp. 878–898; James Tobin, Joseph A. Pechman, and Peter M. Mieszkowski, "Is a Negative Income Tax Practical?," *The Yale Law Journal*, November 1967 (reprinted by the Brookings Institution, December 1967).

everybody. But it also has the disadvantage of necessitating higher tax rates on the taxable portions of income to raise a given amount of revenue.

3. They provide significant additional allowances for taxpayers with dependents and for those who are aged 65 or more or are blind. They thereby create differences in tax liabilities among taxpayers with equal money incomes but different numbers of dependents and between those who are and those who are not aged 65 or more or blind. Thus, on an adjusted gross income of \$5,000 in 1967, a single person not aged or blind paid a tax of \$671, a two-exemption individual or family, \$501, a four-exemption family, \$290, a six-exemption family, \$84, and a seven-exemption family paid no tax, assuming that each took the minimum standard deduction. A part of these differences is attributable to the minimum standard deduction, which, as previously noted, varies with the number of exemptions.

4. When combined with a substantial first bracket tax rate, such as has been in force in the United States since World War II, they create a lively progression of effective tax rates in the very first brackets of taxable income, and they add to the progression provided by the rising bracket rates for larger incomes. They do this by placing a zero rate, in effect, on the amount of otherwise taxable income equal to the personal exemptions, leaving only the balance subject to the first and succeeding bracket rates; and this taxable amount constitutes a rising proportion of total income as incomes increase. Although the Revenue Act of 1964 split the former first bracket of taxable income into four graduated ones of \$500 each for single persons and \$1,000 each for joint returns, it retained substantial, though lowered, tax rates for them—14, 15, 16, and 17 per cent, respectively, for years after 1964. In consequence, the personal exemptions, supplemented by the standard deduction, continue to provide a major part of the progression of the effective tax rates at low and medium income levels.

7. WHO GET THE EXEMPTIONS?

A summary quantitative answer to this question is provided by Tables 3, 4, and 5.

Table 3 sets forth a classification by marital status of the number of tax returns and of the kinds of personal exemptions claimed thereon

TABLE 3
Distribution of Personal Exemptions by Marital Status, 1965

Marital Status	Number of Returns	Number of Exemptions for			Total Number of Exemptions
		Taxpayer and Spouse	Dependents	Age and/or Blindness	
		<i>All Returns</i>			
Joint returns	39,303,938	78,601,002	65,874,707	5,328,649	149,804,357
Separate returns	2,851,212	3,582,980	3,253,434	195,864	7,032,279
Heads of households	1,887,912	1,887,912	2,596,666	92,807	4,577,384
Surviving spouses	201,837	201,837	336,598	13,939	552,374
Single persons	23,351,400	23,351,401	3,021,355	2,402,133	28,774,890
Total	67,596,300	107,625,130	75,082,758	8,033,396	190,741,281
		<i>Taxable Returns</i>			
Joint returns	33,921,099	67,838,037	55,530,447	2,752,165	126,120,643
Separate returns	1,927,904	2,224,609	1,531,651	60,697	3,816,957
Heads of households	1,656,907	1,656,907	2,178,658	59,338	3,894,904
Surviving spouses	132,830	132,830	206,705	5,006	344,541
Single persons	16,062,052	16,062,052	1,723,360	1,241,162	19,026,570
Total	53,700,794	87,914,437	61,170,816	4,118,362	153,203,616
		<i>Nontaxable Returns</i>			
Joint returns	5,382,840	10,762,967	10,344,261	2,576,487	23,683,714
Separate returns	923,305	1,358,368	1,721,787	135,165	3,215,320
Heads of households	231,004	231,004	418,007	33,470	682,481
Surviving spouses	69,006	69,006	129,892	8,935	207,832
Single persons	7,289,348	7,289,348	1,297,994	1,160,976	9,748,320
Total	13,895,506	19,710,694	13,911,940	3,915,033	37,537,666

SOURCE: *Statistics of Income*, 1965, Table 19.

Questions Raised by Personal Exemptions

T A B L E 4
Distribution of Personal Exemptions by Income Groups, 1965

Adjusted Gross Income Group (thousand dollars)	Number of Returns	Number of Exemptions for				Total Number of Exemptions
		Taxpayer and Spouse	Dependents	Age and/or Blindness		
Grand total	67,596,300	107,625,130	75,082,758	8,033,396	190,741,281	
Taxable returns total	53,700,794	87,914,437	61,170,816	4,118,362	153,203,616	
Under 3	9,365,186	10,449,355	1,049,575	437,188	11,936,118	
3-5	10,248,524	14,925,081	7,133,087	1,097,638	23,155,807	
5-10	23,010,962	41,157,727	34,315,094	1,606,153	77,078,975	
10-20	9,452,778	18,273,434	15,851,162	645,581	34,770,177	
20 or more	1,623,344	3,108,840	2,821,898	331,802	6,262,539	
Nontaxable returns	13,895,506	19,710,694	13,911,940	3,915,033	37,537,666	
Under 2	10,042,368	12,626,136	3,770,668	2,346,300	18,743,104	
2-5	3,361,273	6,135,314	7,855,136	1,473,422	15,463,872	
5 or more	491,865	949,244	2,286,136	95,310	3,330,690	
Returns under 5	33,017,350	44,135,885	19,808,467	5,354,549	69,298,900	
Returns 5-10	23,473,737	42,052,897	36,528,472	1,693,340	80,274,708	
Returns 10 or more	11,105,211	21,436,348	18,745,819	985,507	41,167,673	

SOURCE: *Statistics of Income*, 1965, Table 19.

TABLE 5
 Percentage Distribution of Total Personal Exemptions and Total Adjusted
 Gross Income on Taxable Returns, by Income Groups, 1965

Adjusted Gross Income Group (thousand dollars)	Personal Exemptions	Adjusted Gross Income
Under 3	7.8	4.4
3-5	15.1	10.0
5-10	50.3	40.9
10-20	22.7	29.7
20 or more	4.1	15.0
Total	100.0	100.0

SOURCE: *Statistics of Income*, 1965, Table 4.

for 1965. The upper section of the table provides this classification for all returns, taxable and nontaxable; the middle section, for taxable returns only; and the lower section, for nontaxable returns.

Married persons filing joint returns comprised the largest group by far of the total return-filing population. They accounted for 79 per cent of the total number of exemptions (including their exemptions for dependents, age, and blindness), and for 58 per cent of the total number of tax returns. Single persons not heads of households accounted for 35 per cent of the total number of returns but for only 15 per cent of the total number of exemptions (including those claimed for dependents, age, and blindness), and only 16 per cent of total adjusted gross income. Married persons filing separate returns accounted for a little more than 3½ per cent of the total number of exemptions and for slightly over 4 per cent of the total number of returns. Heads of households accounted for about 2.8 per cent of the returns and 2.4 per cent of all exemptions; and surviving spouses for about three-tenths of 1 per cent of each.⁹

⁹ A "head of a household" is an unmarried individual who maintains as his home a household in which there resides an unmarried son, daughter, or other descendent, or, with a few exceptions, any dependent with a gross income of less than \$600, or one who supports his parents outside of his home. Such a taxpayer is subject to a special scale of tax rates that give him about one-half of the benefits of income-splitting provided for a joint return of husband and wife. The usual requirement that a dependent reside with the head of a household

Table 4 classifies the personal exemptions on income tax returns both functionally and by income groups. The per capita exemptions allowed solely for taxpayers and their spouses in 1965 accounted for 57.4 per cent of the total number on taxable returns, and those for their dependents, for 39.9 per cent. (In 1959, when exemptions for dependent children were tabulated separately from exemptions for other dependents in *Statistics of Income*, children accounted for 90.9 per cent of the total exemptions for dependents.) The remaining 2.7 per cent was for age and blindness. Age accounted for all but a tiny fraction of these. Taxpayers with incomes between \$5,000 and \$10,000 accounted for 56 per cent of all exemptions for dependents on taxable returns; and those with incomes of \$5,000 to \$20,000, for 82 per cent.

Table 5 shows the percentage distribution by income groups of adjusted gross income as well as personal exemptions on taxable returns in 1965. Only about 8 per cent of the total exemptions and 4.4 per cent of the AGI went to taxpayers with AGI of less than \$3,000; about 15 per cent of the exemptions and 10 per cent of the AGI, to those in the \$3,000 to \$5,000 group, while more than three-fourths of the exemptions and 85.6 per cent of the AGI went to those with incomes above \$5,000. The \$5,000 to \$10,000 group was easily the predominant one as respects both exemptions and adjusted gross income, accounting for just over one-half of the former and 41.9 per cent of the latter.

8. THE "COST" OF THE EXEMPTIONS

Table 3 enables us to provide some measures of the "revenue cost" of the various types of exemptions on taxable returns in 1965. These measures answer the question, "How much greater would tax revenues have been in 1965 if certain or all of the personal exemptions had been eliminated but all other things had remained unchanged, except that persons who were excluded from tax altogether by the exemp-

is waived in the case of dependent parents so as not to force taxpayers to uproot parents from their own homes for the sole purpose of qualifying for the tax benefits of a head of a household. A surviving spouse may use the tax rates of a joint return for two taxable years following the death of the other spouse provided the survivor maintains a household for one or more dependents.

tions were excluded by some other device?" In interpreting the word "cost" in this connection, it should be recognized that the exemptions are not a true cost to society as a whole in the sense of using up real resources. The potential revenues that they appear to cost the Treasury constitute spending power retained by the private sector of the economy. Further, within wide limits, the government can raise substantially the same amount of income tax revenue with larger exemptions coupled with higher tax rates on taxable income as with smaller exemptions and lower tax rates. With a *given* level and structure of incomes and tax rates, of course, the more generous the exemptions, the more they reduce the revenue-producing capacity of the income tax. Essentially, the kind of revenue cost entailed by the exemptions is the need to levy higher rates on taxable income to raise a given amount of revenue from the income tax.

But the exemptions do affect significantly the distribution of the tax burden among individuals. The greater the number of persons and their incomes that are completely excluded from tax by the exemptions or by other exclusion devices, the higher must be the average effective tax rate upon those who remain taxpayers, other things being equal. The exemptions also shift the distribution of tax liabilities among taxable persons in favor of those with larger exemptions as against those with smaller. And to the extent that higher marginal tax rates on taxable incomes weaken incentives to work, to save, or to take risks, the larger exemptions that necessitate these higher marginal rates may exert a restrictive influence upon real output and income. For these reasons, it is of interest to have measures of the so-called revenue costs of the various exemptions, and of their costs in terms of the higher tax rates on taxable incomes needed to produce equal revenues.

Since each exemption on taxable returns reduced taxable income in 1965 by \$600, it is a simple matter to determine how much reduction was caused by each type (see Table 3). Turning first to the aggregate exemptions on taxable returns, we can say that they caused a zero rate of tax to be applied, in effect, to \$91.9 billion of adjusted gross income on such returns. If the personal exemptions on taxable returns had been completely eliminated, and the \$91.9 billion thereby added to taxable income had been taxed at the over-all effective rate that actually prevailed on taxable income in 1965—19.5 per cent after tax credits—

the additional revenue would have approximated \$17.9 billion. (Because of the progressive rate structure, the increase of taxable income would doubtless have raised the over-all effective tax rate somewhat above the actual 1965 figure.) Alternatively, and more realistically, the addition of \$91.9 billion to taxable income would have made it possible to obtain the 1965 amount of income tax revenue with a 27 per cent reduction in the average tax rate on all taxable income.

The personal exemptions for taxpayers and their spouses alone (exclusive of their exemptions for dependents, age, and blindness) accounted for 57.5 per cent of the total number of exemptions on taxable returns in 1965, and freed from tax about \$52.7 billion of income on such returns. If these exemptions had been eliminated but all others retained, the additional revenue at the average effective tax rate that prevailed on taxable income in 1965 would have amounted to about \$10.3 billion. Alternatively, the actual 1965 amount of revenue could have been obtained by reducing the average tax rate on taxable income by a little under 17 per cent. If the exemption had been eliminated for only one of the spouses filing joint returns, the other being treated as a dependent, the revenue gain would have been \$7.4 billion, or the average effective tax rate could have been cut by about 14 per cent, assuming that the exclusion limits were such as to avoid increasing the number of taxable returns beyond the 1965 number.

The personal exemptions claimed for dependents freed from tax about \$37 billion of income on taxable returns. If these exemptions had been eliminated but all others retained, the additional revenue at the average effective tax rate that prevailed on taxable income in 1965 would have amounted to about \$7.2 billion. Alternatively, the 1965 amount of revenue could have been obtained by reducing the over-all effective tax rate on taxable income by about 14 per cent.

The personal exemptions for the aged and the blind removed about \$2.5 billion from taxable incomes on taxable returns in 1965. Their revenue cost in that year, estimated by applying the over-all effective tax rate of 19.5 per cent of taxable income, was about \$482 million.

The foregoing estimates are intended only to convey a measure of the fiscal importance of the various exemptions, not to suggest that they be removed.

9. QUESTIONS FOR CONSIDERATION

Various questions respecting the appropriateness of the present exemption provisions with respect to the foregoing and other purposes will emerge during the course of this study. While refraining from specific policy recommendations, we shall endeavor in each instance to present and analyze the principal relevant considerations. Some of these questions are outlined below.

Are the Present Exemption Levels Too Low?

For the purpose of excluding from tax persons with incomes below the minimum amounts deemed necessary for subsistence or for tolerable standards of living, the present \$600 per capita exemption, supplemented by the allowable personal deductions, is often criticized as too low. In truth, for single persons and married couples without dependents, this allowance is less than the amounts made available in many states to the indigent aged, blind, and other disabled or disadvantaged persons who are eligible for public assistance under the federal-state programs authorized by the federal Social Security Act.¹⁰ For single persons the exemption is less than 30 per cent of full-time earnings at the minimum wages allowable in employments covered by the federal Minimum Wage Act; and for families of all sizes it is well below the amounts needed to provide for the "modest but adequate" budget developed by the U.S. Bureau of Labor Statistics for a city worker's family, as adapted for families of varying composition.¹¹

Do Exemptions Shrink the Tax Base Too Much?

Despite their inadequacy by some criteria for certain individuals and families, the present exemption allowances in the aggregate are sometimes criticized for being too large. By removing from the tax base nearly one-fourth of the adjusted gross income of taxable persons, it may be contended that they seriously reduce the revenue-producing power of the income tax or make necessary a discouragingly high scale

¹⁰ See pp. 185 ff. and Table 40 below.

¹¹ See pp. 165 ff. below.

of tax rates on the taxable portions of income, or both. Even though a higher scale of tax rates when applied to only a part of an individual's income may impose only the same total tax burden on him as would be imposed by lower tax rates on the whole of the income, the higher marginal or bracket rates, by subjecting *additions* to income to heavier tax rates than would otherwise prevail, could tend to reduce incentives to work, to save, and to take useful risks, while intensifying the incentive to avoid or evade the tax.

Should the Taxpayer Be Allowed an Exemption on His Own Account?

If the amounts of the present personal exemptions seem too small to achieve the purpose of excluding from tax all who might be held to need such exclusion, and yet are so great in the aggregate as to reduce the tax base seriously, the question naturally arises as to whether some exemptions are too large, or altogether unnecessary, even though others may be too small. For example, is any exemption needed at all for the taxpayer himself, if his income after allowances for his dependents and for age and blindness is greater than the amount established as an appropriate exclusion limit? In other words, should not the personal exemptions be confined to dependents, or if desired, allowed also for the aged and blind, but not allowed for the taxpayer on his own account, after excluding persons with incomes deemed too small to be taxed? Is it not true that what every taxpayer appears to save in taxes by virtue of his own personal exemption must be made up by higher tax rates on the taxable part of his income, if a given amount of tax revenue and a given distribution of income tax burdens are sought?

Should the Exemptions Be Confined to Those with Small or Moderate Incomes

Another way of reducing the shrinkage of the tax base caused by the present personal exemptions would be to confine these allowances to taxable persons with small and moderate incomes, as was long the practice in Great Britain and some other countries. It might be argued in favor of such a practice that no tax allowance is necessary for dependents when income exceeds a moderate level. On the other hand, it may also be contended that the needs of larger families are greater

than those of smaller ones at every income level, and some argue, in fact, that these needs tend to rise with incomes. What are the principal competing considerations in this connection?

Is an Equal Per Capita Exemption Reasonable?

The uniform per capita exemptions, which were adopted in 1944 for purposes of administrative simplification, are relatively more generous to large families than to small ones or single persons. Few other countries follow the practice of providing as large an allowance for dependents as for the taxpayer, and this provision differs materially from our own practice prior to 1944. What do budget studies indicate respecting the comparative minimum living costs of single adults living alone, married couples without dependents, and couples with different numbers of children? What are the administrative considerations involved?

Are the "Additional" Exemptions for the Aged and the Blind Justifiable?

These extra exemptions are allowed without regard to the amount of the taxpayer's income and presumably are based upon the view that such persons must incur significantly higher expenses to achieve the same standard of living as other persons with the same income. The aged account for the great bulk of the extra exemptions, and the number of the aged in our population is growing both absolutely and more than proportionally. What light is thrown by budget studies and other considerations on the justification for the "additional exemption"?

How Appropriate Is the Present "Double Exemption" for Dependent Children with Income?

Under existing law, a taxpayer may claim an exemption for each child under 19 and for those 19 and over who are students, regardless of the amounts of the children's incomes, provided only that the taxpayer furnishes more than one-half of their support. At the same time, each of such dependent children may claim an exemption on his own account if his gross income is large enough (\$600) to require him to file a tax return. The effect in these cases is that the law allows two personal exemptions for the same individual, one as a dependent and one as a taxpayer. How persuasive are the considerations that have led to this treatment?

What Would Be the Effect of Personal Allowances in the Form of Tax Credits Instead of the Present Exemptions?

Since the present personal exemptions take the form of equal dollar allowances at all levels of income, they have greater tax-reducing value for persons in higher tax brackets than for those in lower ones. To avoid this result, some of the states and some other countries have the personal allowances take the form of uniform tax credits; that is, equal deductions from the amount of tax otherwise payable, rather than reductions in the amount of income otherwise taxable. What are the considerations bearing on the relative merits of these alternative treatments?

Should the Levels of the Exemptions Be Altered More Frequently in Response to Changes in the Cost of Living and in the Desired Amounts of Tax Revenue?

Despite the strong conceptual relationship between the level of the personal exemptions and the cost of living, the fact is that the exemption levels in the United States have not been sensitive to changes in living costs. Should they be made more so? Further, in recent years proposals have been made from time to time to employ temporary increases in the amounts of the personal exemption in lieu of, or in addition to, temporary reductions in bracket tax rates as an antirecession measure. What factors have opposed frequent changes in the exemption levels, and what are the considerations bearing upon the possible employment of alterations in these levels as instruments of anti-cyclical policy?