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Volume Author/Editor: C. Harry Kahn

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CHAPTER 5

Nonbusiness Tax Payments

DEDUCTION from gross income, on individual returns, of various non-business taxes paid during the tax year has been permitted from the beginning of the federal income tax. In recent times taxes have included state income taxes, real and personal property taxes, automobile license fees, poll taxes, and state and local retail sales taxes (including special taxes on gasoline, and tobacco) that are imposed directly on the consumer. Sales taxes, collected by the retailer and paid by him to the government, may be deducted by the consumer, provided the tax is not hidden in the sales price.¹ This requirement that a tax, to be deductible, must be imposed on the person who deducts it, has been interpreted to exclude from the deductible list sales taxes that are imposed on the manufacturer or wholesaler. Until 1951 that interpretation excluded the gasoline taxes of a number of states and still excludes the cigarette taxes of several. A further requirement, that a deductible tax must be for a public nonbusiness purpose, excludes special assessments for local improvements tending to enhance the value of the property assessed, and charges that vary with a specific service rendered, such as water taxes. No taxes levied by the federal government—income taxes, estate and gift taxes, excises,² and social security taxes—are allowed as deductions.

Trend in Taxes-Paid Deductions

The amounts deducted on tax returns for property, income, and sales tax payments have been large as far back as our statistical record goes. The totals for the period 1927-1956 are shown in Table 26. Between 1927 and 1939 they varied from \$600 million to \$1 billion, and from 3.1 to 5.5 per cent of reported income (Table 27). From 1940 on the amount deducted as taxes paid exceeded \$1 billion in every year.

¹ A tax is considered separately stated whenever it is clear that it was added to the sales price and charged as a separate item to the consumer, although there need be no sales statement to that effect. Before 1942, only those state and local sales taxes that were explicitly imposed on the consumer, thus legally making him the taxpayer, could be deducted in arriving at net income.

² Until 1943 federal excises, as for instance admissions taxes, for whose payment the individual purchasing the item was legally liable, were allowed as deductions. Changes in the law have thus moved in opposite directions, toward liberalization of deductibility for state and local excises and abolition of it for all federal excises.

NONBUSINESS TAX PAYMENTS

TABLE 26

Nonbusiness Tax Payments Deducted and Estimated Total Deductible
Nonbusiness Tax Payments, 1927-1956

(dollars in millions)

YEAR	Nonbusiness Taxes Actually Deducted		Estimated Total Taxes Eligible for Personal Deductions (3)	Amount Deducted on Tax Returns as Per Cent of Total	
	Taxable Returns (1)	All Returns (2)		(1) ÷ (3) (4)	(2) ÷ (3) (5)
1927	537	801	1,638	32.8	48.9
1928	576	889	1,723	33.4	51.6
1929	560	974	1,836	30.5	53.1
1930	499 ^a	903 ^a	1,894	26.3	47.7
1931	340 ^a	834 ^a	1,865	18.2	44.7
1932	353 ^a	766 ^a	1,792	19.7	42.7
1933	308	678	1,681	18.3	40.3
1934	337	605	1,942	17.4	31.2
1935	386	645	2,136	18.1	30.2
1936	532	737	2,321	22.9	31.8
1937	649	875	2,464	26.3	35.5
1938	602	861	2,555	23.6	33.7
1939	663	917	2,564	25.9	35.8
1940	901	1,289	2,793	32.3	46.2
1941	1,380	1,672	3,077	44.8	54.3
1942	1,893	2,148	3,359	56.4	63.9
1943	2,101	2,147	3,490	60.2	61.5
1944	1,152	1,194	2,858	40.3	41.8
1945	1,225	1,269	3,121	39.3	40.7
1946	1,269	1,348	3,819	33.2	35.3
1947	1,547	1,654	4,531	34.1	36.5
1948	1,500	1,649	5,227	28.7	31.5
1949	1,812	1,984	5,957	30.4	33.3
1950	2,068	2,230	6,597	31.3	33.8
1951	n.a.	n.a.	7,569	n.a.	n.a.
1952	3,034	3,186	8,476	35.8	37.6
1953 ^b	3,453	3,647	9,159	37.7	39.8
1954 ^b	3,826	4,085	9,833	38.9	41.5
1955	n.a.	n.a.	10,775	n.a.	n.a.
1956 ^b	5,543	5,828	11,810	46.9	49.3

Includes fiduciaries.

^a Estimates based in part on taxable returns with income of \$5,000 and over.

^b The tax deduction figures for these years exclude the deductions reported on fiduciary returns.

Source: Columns 1 and 2: *Statistics of Income*; column 3: see Appendix H.

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TABLE 27

Deducted Nonbusiness Tax Payments as Per Cent of Income on Tax Returns,
and Estimated Total Nonbusiness Tax Payments as Per Cent of
Total Adjusted Gross Income, 1927-1956

YEAR	<i>Taxes Deducted as Per Cent of AGI^a</i>		<i>Total Deductible Taxes as Per Cent of Total AGI^a</i>
	<i>Taxable Returns</i> (1)	<i>All Returns</i> (2)	(3)
1927	2.7	3.2	2.3
1928	2.5	3.1	2.3
1929	2.5	3.4	2.4
1930	3.2	4.3	3.0
1931	3.3	5.2	3.8
1932	3.9	5.5	4.8
1933	3.7	5.2	4.6
1934	3.6	4.2	4.4
1935	3.5	3.9	4.4
1936	3.4	3.5	4.0
1937	3.8	3.7	4.0
1938	4.3	4.1	4.6
1939	3.8	3.6	4.0
1940	3.5	3.2	4.0
RETURNS WITH ITEMIZED DEDUCTIONS			
1941	3.6	3.7	3.6
1942	3.5	3.6	3.1
1943	2.8	2.9	2.7
1944	3.5	3.6	2.1
1945	3.5	3.6	2.2
1946	3.3	3.3	2.4
1947	3.4	3.6	2.6
1948	3.4	3.6	2.8
1949	4.0	4.2	3.2
1950	3.8	4.0	3.3
1951	—	—	3.3
1952	4.2	4.3	3.5
1953	4.3	4.4	3.6
1954	4.3	4.4	3.9
1955	—	—	4.0
1956	4.6	4.7	4.0

^a Income (reported on tax returns, and total) is adjusted gross income (AGI).

Source: Deductible nonbusiness tax payments from Table 26; income figures from Table 17 and Appendix Table D-2.

By 1956 it approached \$6 billion. Since 1943 the amounts reported on taxable returns have been, for obvious reasons, only slightly less than those for all returns, but before that time the difference was very considerable—in 1933 only one-half the total appeared on taxable returns. According to the reported figures, the ratio of tax deductions

to income was in all years except 1937-1940 higher on nontaxable than on taxable returns³ (Table 27).

Our attempt to estimate the aggregate amount of taxes eligible for deduction involved a good deal of conjecture, since it required the division of tax collection figures as reported by federal, state, and local governments into personal and business components, in accordance with current tax laws. Since in most of them (real estate, retail sales, and gasoline) governmental reports do not distinguish between the two categories, our allocations are only approximate. The estimated total amount eligible for deduction shows an almost continuous rise over the 30-year period 1927-1956, from \$1.6 to \$11.8 billion. Between 30 and 50 per cent of this total was reported as deductions on tax returns in the pre-World War II period. Just before the enlargement of the standard deduction, in 1942-1943, the amounts had risen to almost two-thirds of the estimated total. Since then it has been in the range of 30 to 40 per cent until 1954. Figures for the most recent year, 1956, indicate a sharp upturn to one-half of the eligible amount (Table 26).

Unlike the similar comparisons for philanthropic contributions, the relationship between deducted taxes and income as revealed on tax returns and that between the corresponding aggregates are in close agreement (Table 27 and Chart 10). Taxes claimed as deductions on taxable returns rose from about 2.7 per cent of income reported to 4.6 per cent over the period 1927-1956. Our estimate of aggregate deductible taxes as a per cent of total income rose from 2.3 to 4 per cent over the same period. Both series show that most of the rise took place during the transition from the 1920's to the 1930's,⁴ and that since the early

³ There are probably two reasons for this. In the 1920's and 1930's nontaxable returns were filed largely by business proprietors and recipients of certain types of property income (rents, royalties, and capital gains). Gross incomes on these returns exceeded the filing requirement of \$5,000, even though net incomes were often low and frequently negative. For instance, of the \$370 million of nonbusiness taxes deducted on nontaxable returns in 1933, \$171 million was claimed on returns with no net income after business and personal deductions. Most of these returns were in the business and property income category (*Statistics of Income for 1933*, p. 21), and it is possible that a significant part of the taxes designated as nonbusiness should have been entered as business taxes.

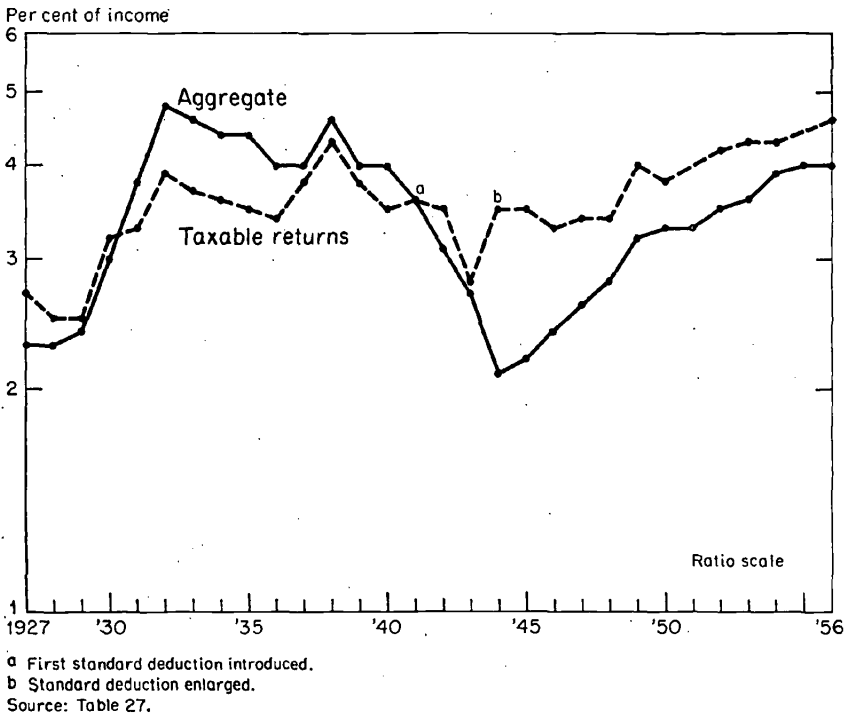
The second reason, probably more applicable to the years after 1940, is that many of the nontaxable returns were filed by heads of large families, whose incomes exceeded the filing requirement, but were reduced to the tax-exempt level by high exemptions and property taxes on owned homes.

⁴ Our estimates of aggregate deductible taxes for years before 1927 (see Appendix H) indicate that they were in the neighborhood of 2 per cent of total adjusted gross income throughout the '20's. For the tax return series we have no figures earlier than 1927.

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'30's there has been no increase in the level of deductible taxes relative to income. (The sharp decline in the first half of the '40's was caused by the wartime curtailment of state and local activities, which led to some tax reduction at those levels.) For recent years the ratios on taxable returns shown in the table and chart are consistently somewhat

CHART 10



Deductible Nonbusiness Taxes as Per Cent of Income, 1927-1956

higher than for the underlying totals, because all the tax returns used have itemized deductions.

However, the disparity is not nearly so great as it is in the corresponding two series for philanthropic giving (Tables 13 and 18). The obvious difference between voluntary giving and compulsory tax-paying leads one to expect more dispersion in the amount per tax return in given income groups for contributions than for taxes paid. Since certain taxes are practically inescapable, and their incidence by income groups probably regressive, the difference in tax payments between those who itemize and those who choose the standard deduction is

likely to be less than in some other expenditures. A further probable reason for the smaller differences in ratios between itemized returns and those of the whole population is that many homeowners do not itemize their taxes. In 1956, roughly one-half of the homeowners in the United States itemized their deductions on tax returns.⁵ For that year the ratio of deductible taxes to income was 4.7 per cent for itemized returns and 4.0 per cent for the whole population. A large proportion of homeowners apparently make use of the standard deduction, and others are exempted from filing because of low incomes.⁶ In addition to the ratio between deductions for taxes paid and reported income, the distribution of the deduction among taxpayers with incomes of varying size is of interest. It will now be examined.

Reported Tax Deductions by Size of Income on Tax Returns

Certain qualifications of the data must be noted at the outset. After 1943, we have only the data from returns with itemized deductions, and the information presented must therefore be viewed cautiously. Furthermore, the percentages in Tables 28 and 29 give us a clue to the incidence of the deduction allowed for taxes, not of taxes as such.⁷ The figures shown are not an indication of the incidence of any group of taxes, for three important reasons: (1) They are subject to the taxpayer's understanding of the law in addition to his memory and accuracy in reporting the taxes he paid during the preceding year. Omissions and overstatements are therefore likely to occur. As we find in Table 30, many taxpayers did not claim any deductions for taxes, even

⁵ In 1950 there were 23.6 million owner-occupied dwellings in the United States (Bureau of the Census, *Census of Housing, 1950*, Vol. 1, Part 1), but only 9.3 million tax returns showed a deduction for taxes and still fewer, 6 million, a deduction for interest. In 1956 the figures were about 29.5 million owner-occupied homes, 17.8 million returns with tax deductions, and 13.7 million with interest deductions (see Table 36). The number of homeowners itemizing is undoubtedly smaller than the number of taxpayers claiming deductible taxes, though possibly larger than the number deducting interest.

⁶ According to the Survey of Consumer Finances, 18 per cent of the 1953 nonfarm homeowners had money incomes below \$2,000 in 1952 ("Housing Arrangements of Consumers, 1955 Survey of Consumer Finances," *Federal Reserve Bulletin*, August, 1955, p. 9).

⁷ The figures were misunderstood at least once. See Tax Foundation, Inc., *Federal Excise Taxes*, 1956, p. 22, where it is concluded that "according to federal income tax data for returns with itemized deductions the burden of deductible state and local taxes, a substantial part of which consists of sales taxes, is approximately proportional up to income levels over \$100,000."

TABLE 28

Deductions for Taxes Paid as Per Cent of Income, and Percentage Distribution of Total,
by Size of Income on Taxable Returns, Selected Years, 1928-1956

INCOME GROUPS (\$'000's)	1928-29		1932-34		1941-43		1945-47		1952		1954 ^b		1956 ^b	
	All Returns	Itemized	All	Itemized	All	Itemized	All	Itemized	All	Itemized	All	Itemized	All	Itemized
	returns	returns	returns	returns	returns	returns	returns	returns	returns	returns	returns	returns	returns	returns
Under 2	1.5	2.2	2.4	2.6	3.6	1.8	3.7	0.5	4.6	0.5	4.6	0.6	5.1	0.7
2-3	1.7	3.1	3.1	3.1	3.3	2.0	3.6	0.7	4.4	0.8	4.3	0.9	4.9	1.1
3-5	2.8	3.4	3.4	3.3	3.8	2.8	3.5	0.9	4.1	1.2	4.4	1.5	4.7	1.7
5-10	2.8	3.9	3.8	3.8	3.1	3.1	3.5	1.5	4.2	1.5	4.4	1.9	4.7	2.3
10-25 ^c	2.8	4.3	4.2	4.2	3.2	3.2	3.2	2.1	4.3	2.1	4.4	2.3	4.7	2.8
25-50 ^c	2.5	4.6	4.5	4.5	3.2	3.2	2.9	2.6	4.1	3.2	4.0	3.2	4.3	3.6
50-100	2.4	5.5	4.9	4.5	3.4	3.4	2.9	2.8	3.9	3.6	3.7	3.5	4.1	3.8
100-500	2.1	6.2	5.6	4.4	3.4	3.4	3.0	3.0	4.0	3.9	3.7	3.6	4.3	4.3
500 and over	1.7	4.7	4.3	3.7	2.9	2.9	2.3	2.3	3.1	3.1	3.0	3.0	3.4	3.4
Average	2.4	3.8	3.8	3.4	2.4	2.4	3.4	1.1	4.2	1.5	4.3	1.8	4.6	2.2
TAXES PAID AS PER CENT OF ADJUSTED GROSS INCOME														
Under 2	2.4	7.7	8.0	14.4	20.4	20.4	7.3	1.9	1.9	1.2	1.2	1.0	1.0	1.0
2-3	3.4	7.1	5.9	17.3	26.2	26.2	14.4	5.2	5.2	3.9	3.9	3.0	3.0	3.0
3-5	12.7	20.1	19.6	21.3	24.0	24.0	25.4	23.9	23.9	23.7	23.7	17.8	17.8	17.8
5-10	22.6	23.6	20.9	17.2	10.7	10.7	16.8	34.7	34.7	40.2	40.2	45.1	45.1	45.1
10-25 ^c	22.7	18.9	19.7	14.6	9.0	9.0	17.0	12.0	12.0	12.5	12.5	18.2	18.2	18.2
25-50 ^c	11.3	9.5	10.5	7.0	4.5	4.5	9.1	12.5	12.5	11.0	11.0	7.6	7.6	7.6
50-100	8.5	6.3	7.2	4.1	2.8	2.8	5.3	5.4	5.4	4.2	4.2	4.1	4.1	4.1
100-500	10.4	5.2	6.6	3.2	2.1	2.1	3.8	3.8	2.7	2.7	2.7	2.7	2.7	2.7
500 and over	5.9	1.7	1.6	0.9	0.4	0.4	0.7	0.7	0.7	0.5	0.5	0.6	0.6	0.6
Total ^a	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

PER CENT OF TOTAL AMOUNT DEDUCTED

^a Net income groups until 1943; adjusted gross income groups thereafter.
^b Excludes fiduciary returns.
^c For 1952 and 1954, group limit is \$20,000 instead of \$25,000.
^d Totals do not always equal 100 per cent, due to rounding.

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TABLE 29

Deductions for Taxes Paid as Per Cent of Income on Taxable Returns with That Deduction, by Income Groups, Selected Years, 1934-1956

INCOME GROUP ^a (\$000's)	1934	1937	1939	1941	1945	1947	1949	1952	1954	1956
	Under 2	n.a.	4.3	n.a.	n.a.	5.1	4.8	4.7	5.5	5.4
2-3	n.a.	4.2	n.a.	n.a.	3.9	4.0	4.2	4.8	4.7	5.2
3-5	n.a.	4.1	n.a.	n.a.	3.9	3.9	4.1	4.3	4.5	4.9
5-10	4.5	4.5	4.5	4.1	3.6	3.9	4.2	4.3	4.4	4.8
10-25 ^b	4.4	4.8	4.8	4.1	3.4	3.6	4.5	4.5	4.5	4.8
25-50 ^b	4.3	4.9	5.0	4.0	3.2	3.2	4.1	4.2	4.1	4.3
50-100	4.4	5.2	5.0	4.1	3.2	3.2	3.9	4.0	3.8	4.1
100-500	4.8	5.7	5.0	4.0	3.4	3.2	4.0	4.2	3.8	4.4
500 and over	3.8	4.5	5.0	3.7	2.9	2.3	3.4	3.3	3.1	3.5
Average deduction per return (dollars)	n.a.	268	n.a.	n.a.	182	195	244	278	289	336

^a Net income classes for years before 1944; adjusted gross income classes thereafter.

^b For 1952 and 1954 the percentages are for returns in the \$10-20,000 and the \$20-50,000 income groups.

before the introduction of the standard deduction, although it is unlikely that as many as 15 per cent of those who filed returns in the \$5,000 to \$10,000 income group incurred no deductible taxes. (2) We have no knowledge of the actual composition of the taxes deducted, even though we know the list of legally deductible taxes. (3) The

TABLE 30

Per Cent of Taxable Returns with Deductions for Taxes Paid, by Size of Income Reported, Selected Years, 1937-1956

INCOME GROUP ^a (\$000's)	<i>All Returns</i>			<i>Returns with Itemized Deductions</i>					
	1937 ^b	1939	1941	1945	1947	1949	1952	1954	1956
Under 2	57.0	—	—	74.2	75.6	81.5	84.3	86.0	86.1
2-3	74.0	—	—	87.0	87.0	90.9	92.8	93.0	93.5
3-5	81.9	—	—	91.3	91.8	96.0	97.1	97.0	97.3
5-10	84.3	87.3	87.0	92.2	92.7	96.2	98.3	98.3	98.2
10-25 ^c	89.5	91.8	90.6	93.7	94.3	96.9	97.7	98.2	98.4
25-50 ^c	92.7	94.8	93.3	95.2	95.5	97.4	98.1	98.1	98.4
50-100	94.9	96.4	95.3	95.5	96.0	97.6	98.3	98.4	98.8
100-500	97.0	98.4	97.1	97.2	97.8	98.3	98.5	98.3	99.0
500 and over	95.7	100.0	97.5	96.6	99.3	98.0	98.8	97.2	97.8
Average	71.9	—	—	85.5	87.9	93.6	96.1	96.7	97.1

^a Net income groups for years before 1944; adjusted gross income groups thereafter.

^b Fiduciary returns included in 1937 only.

^c Income groups are \$10-20,000 and \$20-50,000 in 1952 and 1954.

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legally deductible items are not suitable for use in a study of tax incidence. The income tax law has too many omissions for such a purpose; for example, it permits deduction of sales taxes imposed at the retail level but not those collected from the manufacturer or wholesaler.

The figures in Tables 28 and 29 show that, as a percentage of income reported on all taxable returns, the deduction tends to rise slightly up to the \$100,000 level. The figures for years before 1944 show this clearly. For later years it is not certain, but the higher percentage on low-income than on high-income returns after 1943 can be mostly, if not altogether, explained by the standard deduction. From the figures shown in Table 28 we can say with some confidence that, had there been no standard allowance, the deduction for state and local taxes in the 1950's would have amounted to between 3 and 4 per cent of all income reported on tax returns; and this percentage would have varied only little by size of income reported.

Among returns with deductions for taxes paid (omitting itemized returns with no tax deductions) there is little variation in the percentage deducted, by size of income reported (Table 29). Even for the years after 1943, the significant variations are confined to the two extremes of the income scale. Between the income groups \$2,000 to \$3,000 and \$100,000 to \$500,000 they remain within one percentage point. Between those income levels, in 1945, the percentage deducted declined from 3.9 to 3.4 per cent; in 1949, from 4.2 to 4 per cent; in 1953, from 4.7 to 4.2 per cent; and in 1956, from 5.2 to 4.4 per cent. For selected years in the 1930's our figures show increases in percentage to the same upper level. The reversal occurred apparently for reasons besides the standard deduction, as shown by the figures for 1941.

The distribution of the tax deduction is not surprising in view of two characteristics of the taxes eligible for deductions. First, the deduction is heavily weighted with property taxes of homeowners and state personal income taxes—both usually well recorded in the minds and files of taxpayers. Second, state and local excises and sales taxes are not all deductible, and are paid in such small amounts and so frequently that some taxpayers tend to forget part or all of them. This seems to be true especially of low-income taxpayers (see Table 30). Other taxpayers resort to such rule-of-thumb estimates as a percentage of income corresponding to the local rate of sales tax. Thus the relation to income of tax deductions can hardly be taken as in-

dicative of the actual incidence by income groups of state and local taxes.

Tax Deductibility as a Coordination Device

The rationale behind the deductibility of taxes paid in computing taxable net income has undergone some change over the years. In our earliest income tax acts, the idea that net income after taxes is the true measure of taxpaying ability seems to have been implicit. Accordingly all taxes, including the federal income tax, paid in the tax year, were deductible. Developments following the United States' entry into World War I suggested that continuation of this practice would force tax rates to very high levels, and eventually only state and local taxes remained eligible.⁸ Today tax deductibility appears to be regarded as primarily a coordination device.⁹ It is held that without it the states would find it difficult to continue to use the income tax since, first, the combined rates might easily become confiscatory and, second, interstate competition might force a retreat from income taxation by states whose tax rates are now relatively high. The same justification is, of course, not advanced for the other state and local taxes, but their deductibility has probably been continued to avoid discrimination against states without income taxes.¹⁰

From a look at Table 31 it becomes evident that the states could at present raise their income tax rates appreciably without thereby seriously increasing the combined state and federal tax liability of high-income taxpayers. We have chosen the 1956 New York State income tax, with its top rate then at 7 per cent, as typical for illustration. In 1953, 28 out of the 33 states with income taxes had top rates not exceeding 7 per cent and none had a rate higher than 11 per cent.¹¹ From the table it is evident that the increase in the marginal rate of tax, on account of the state tax, is progressive only at the lower part of the income scale. As net income rises, any progression in state marginal

⁸ See p. 7 for more detail.

⁹ See Herbert E. Klarman, "Income Tax Deductibility," *National Tax Journal*, September 1948, pp. 241ff, and also the comment by Byron L. Johnson and Klarman's, rejoinder, in *National Tax Journal*, March 1949, pp. 88-90; L. L. Ecker-Racz, "Intergovernmental Tax Coordination: Record and Prospect," *National Tax Journal*, September 1952, p. 254; Joseph A. Pechman, "The Individual Income Tax Base," *Proceedings of the National Tax Association*, Detroit, 1955, p. 306; William Vickrey, *Agenda*, pp. 93-100.

¹⁰ Vickrey (*op.cit.*, p. 95), however, appears to argue in favor of such outright discrimination to encourage the use of income taxes by the states.

¹¹ See U.S. Treasury Department Tax Analysis Staff, *Overlapping Taxes in the United States*, January 1, 1954, Table 12.

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rates is easily swamped by the effect of the high federal marginal rates. Thus for a married taxpayer with \$25,000 net income, although the nominal top marginal rate of New York tax was 7 per cent, deductibility reduced it to an actual 4.3 per cent. But at the \$50,000 net income level, the same nominal rate becomes 2.9 per cent, and at \$500,000,

TABLE 31
Effect of Deductibility on Combined Marginal Rates of Federal and New York State Individual Income Tax at Selected Income Levels, 1956 Rates
(married couple, no dependents)

NET INCOME (\$000's) (1)	Marginal Rate		Federal and State Rates Combined (4)	Increase in Marginal Rate due to State Tax ^a (4) - (2) (5)
	Federal (2)	N.Y. State (3)		
3	20	2	21.6	1.6
5	20	3	22.4	2.4
10	26	6	30.4	4.4
25	38	7	42.3	4.3
50	59	7	61.9	2.9
100	72	7	74.0	2.0
500	91	7	91.6	0.6
1,000	91	7	91.6	0.6

^a This equals $S(1 - F)$, when S = state marginal rate, and F = federal marginal rate.

a mere 0.6 per cent.¹² For more than half of the income-tax states which in turn grant deductibility for the federal income tax paid, this effect is considerably reinforced. But to deal with reciprocal deductibility at this point would complicate unnecessarily the discussion of the effect of deductibility under the federal tax law.

The preceding exposition needs qualification to take account of the many taxpayers who choose the standard deduction offered by the

¹² The increases in the effective rate of tax due to the New York income tax were as follows:

Net Income (\$000's)	Without Deductibility	With Deductibility
5	1.30	1.04
10	2.90	2.15
25	5.30	3.28
50	6.15	2.53
100	6.58	1.84
500	6.92	0.64
1,000	6.96	0.63

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federal income tax law, and who therefore can make no specific deduction for taxes paid to their states and localities. The type of computation shown in Table 31 is not strictly applicable to that group of taxpayers. But the fact that a taxpayer makes use of the standard deduction may be considered presumptive evidence that he has obtained all, if not more than, the benefit the law was intended to bestow. Nevertheless, for those who have not "used up" all of their standard deduction, a rise in state or local tax rates would not be mitigated by deductibility. In any immediate sense, the amount of an increase in state and local taxes paid for by the federal government is (1) less in the aggregate and (2) even more unequally distributed among income groups than is apparent from a consideration of the federal marginal tax rates separately (column 2, Table 31).

The first point is amply illustrated by the figures in Table 32. The

TABLE 32
State and Local Taxes Deducted on Taxable Returns, Cost of the Deduction to Federal Government, and Net Cost to Taxpayers, 1952-1956
(amounts in millions of dollars)

	<i>Estimated Total Amount Eligible for Deduction</i>	<i>Amount Itemized (taxable returns)</i>	<i>Cost to Federal Government</i>	<i>Net Cost to Taxpayers Itemizing</i>	<i>Cost to Government as Per Cent of:</i>	
	(1)	(2)	(3)	(4)	<i>Taxes Itemized</i>	<i>Taxes Eligible for Deduction</i>
					(5)	(6)
1952	8,476	3,004	1,021	1,983	34.0	12.0
1953	9,159	3,453	1,122	2,333	32.5	12.2
1954	9,833	3,826	1,106	2,720	28.9	11.2
1955	10,775	n.a.	—	—	—	—
1956	11,810	5,543	1,598	3,945	28.8	13.5

Source, by column

- | | |
|--|--------------------------|
| (1) Table 26. | (4) Column 2 — column 3. |
| (2) <i>Statistics of Income</i> (individual returns only). | (5) Column 3 ÷ column 2. |
| (3) See Appendix G. | (6) Column 3 ÷ column 1. |

cost to the federal treasury of itemized deductions for state and local nonbusiness taxes in terms of current federal rates was \$1 billion in 1952 and \$1.6 billion in 1956. This constituted 34 per cent of the non-business taxes itemized on taxable returns in 1952, and 29 per cent of the amount itemized for 1956. But of the estimated total of nonbusiness-connected taxes paid by individuals, the amount absorbed by the federal income tax was 12 per cent in 1952, and 14 per cent in 1956. The second point, relating to the fraction of an increase in state or

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local taxes that is passed on to the federal government at various income levels, is illustrated in Table 33 and Chart 11. That fraction is initially set by the marginal federal rates of income tax to which the

TABLE 33

Estimated Fraction of an Increase in State and Local Nonbusiness Taxes Passed on to Federal Government in the Form of Deduction, 1956

ADJUSTED GROSS INCOME GROUP (\$000's)	Average Marginal Rate of Federal Tax (1)	Taxable Returns with Deduction for Taxes as per cent of All Returns (2)	Per Cent of Nonbusiness Taxes Shifted to Federal Government (1) × (2) (3)
0.6-1	.20	1.6	0.3
1-1.5	.20	4.7	0.9
1.5-2	.20	9.4	1.9
2-2.5	.20	13.5	2.7
2.5-3	.20	17.7	3.5
3-3.5	.20	22.2	4.4
3.5-4	.20	28.4	5.7
4-4.5	.20	33.1	6.6
4.5-5	.20	37.8	7.6
5-6	.20	46.2	9.2
6-7	.21	48.8	10.1
7-8	.21	49.0	10.5
8-9	.21	48.1	10.3
9-10	.23	47.3	10.9
10-15	.26	51.3	13.6
15-20	.32	65.5	20.7
20-25	.40	74.2	30.0
25-50	.54	83.2	45.0
50-100	.66	92.4	61.4
100-150	.77	96.5	74.3
150-200	.84	97.2	81.7
200-500	.88	97.4	86.1
500-1,000	.87	96.3	84.0
1,000 and over	.87	94.5	82.2

Source: Column 1: *Statistics of Income, 1956*. Change in average tax liability between two income groups divided by change in average taxable income. For income groups above the \$15,000 level, the amount of income subject to alternative long-term capital gains rate was subtracted before computing average taxable income. Similarly the amount of long-term capital gains tax was subtracted before computing average tax liability.

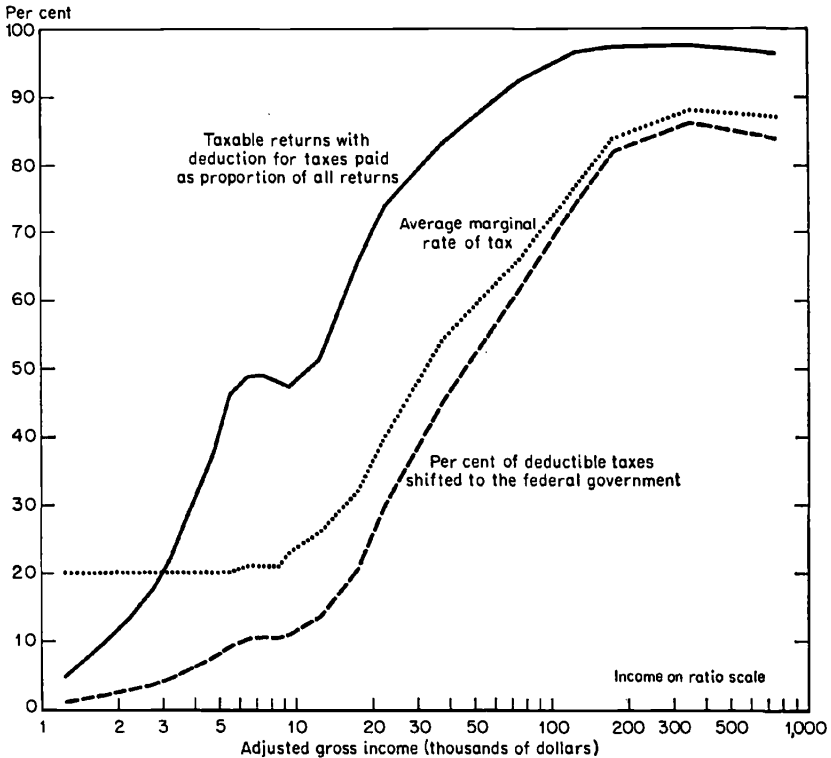
Column 2: *Statistics of Income, 1956*.

various income groups are subject (column 1 of the table). But because the proportion of taxpayers who itemize is small at the bottom of the income scale and large at the top, the fraction of an increase in deductible taxes passed on to the federal government is further reduced—

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greatly for low income groups and slightly for high income groups. That is, the average marginal rate for each income group must be weighted by the per cent of all returns in the group that are taxable and itemize their deductible taxes (column 2 of the table). The result is column 3 of Table 33: the fraction of an increase in deductible taxes

CHART 11



Source: Table 33.

Fraction of an Increase in State and Local Nonbusiness Taxes Passed on to Federal Government, 1956

that is likely to be passed on to the federal government rises from 1 per cent at the bottom to over 80 per cent near the top.¹⁸

¹⁸ The above discussion, based on Table 33 and Chart 11, follows closely and owes much to James N. Morgan, "The Federal Personal Income Tax and the Incidence of Deductible Costs," *American Economic Review*, September 1958. However, Morgan overlooks that it is not the proportion of taxpayers who *itemize* deductions that influences the shiftability to the federal government of an increase in any particular deductible expense, but the proportion of taxpayers who itemize that *particular* expense. With respect to deductible state and local taxes, this point is unimportant.

The fraction of returns with deductions for taxes paid is only an accurate indicator of the proportion of an increase in state and local taxes that will be deducted when we deal with small changes in a particular tax. Such small changes in one tax would not significantly affect the proportion of taxpayers itemizing. Moreover, this proportion is merely an average for all deductible taxes. If the increase in question is one in property taxes, a larger proportion than that suggested in Table 33 would be shifted to the federal government, because generally a greater proportion of property taxpayers than of state and local taxpayers itemize their deductible taxes.

From the discussion of coordination of federal and state tax rates by deduction of taxes, two conclusions clearly emerge. The deductibility feature of the federal law lessens the actual cost to the taxpayer of a state income tax from what might appear on inspection of the rate schedule per se. Further the actual cost to the taxpayer is not progressive with income in the sense in which nominal state rate schedules are conceived to be progressive. After a certain point in the income scale, the cost of a state income tax as an addition to federal income tax, measured as a per cent of income, declines rather than rises. Thus the states have for some time been able to divert tax revenue from the federal treasury to the state treasuries at little cost to the taxpayer. But the taxpayer must itemize his tax deductions to accomplish it. That it has not occurred to any significant extent may be partially ascribed to lack of understanding of the effect on combined tax rates of deductibility of state income taxes. A large section of the public continues to think of nominal rates separately, rather than of the complexities of combined rates emerging from the action of deductibility devices.

The effect on combined rates of deductibility, as summarized above, has been stated several times in one form or another by students of the income tax.¹⁴ Nevertheless, several of these authorities uphold the deductibility device for state income taxes solely on the ground that it enables states to maintain otherwise unobtainable progressive rate

But with respect to medical expenses and interest paid it makes a great difference which set of percentages is used. Because of the 3 per cent exclusion, the fraction of returns itemizing medical expense is as large at the \$6,000 level as it is at the \$100,000 level (see Table 44). Morgan also ignores the fact that the proportion of taxpayers who itemize is an average with different meaning for different deductible taxes.

¹⁴ See those cited in footnote 9, and a particularly explicit statement in Richard Goode, *The Corporation Income Tax*, 1951, p. 91.

schedules.¹⁵ This inevitably begs the question whether such progressive rate schedules are worth maintaining if indeed they cause the combined federal and state rates to be less progressive than the federal schedule is now, and if their nominal existence serves to mislead many taxpayers on the true impact of state income taxes.

From a national viewpoint one may be inclined to think progressivity of state taxes—if they must be coupled with the current form of tax deductibility—not worth maintaining. But from the states' point of view it may be argued that without deductibility they might be forced to adopt less progressive income tax rate schedules, with the possible result that revenue losses might be replaced by enlarging existing sales taxes, or adopting new ones. It may be countered that a move toward sales taxes is only one of several possible adjustments. The federal government, gaining a somewhat larger tax base if tax deductibility were abandoned, could reduce its rates accordingly, which might help the states toward maintaining some progressivity in their rate structure. But this reduction in federal rates would be of minor significance. In the main, the states might simply raise the same amount of revenue by income taxation as before, but with less progressive rate schedules, leaving progressivity mainly to the federal government. Here it can be objected that the states should have some share in progressivity. Thus deductibility as a coordination device may be one answer to the question of how progressivity is to be shared between the states and the federal government since, as we have seen, over-all progressivity can hardly be increased by the deductibility device.

As the progressivity of state income taxes is reduced or turned into regressivity by the deductibility feature, in the same sense, the deductibility also accentuates regressivity in other state and local taxes. The deductibility of general and selective sales taxes, provided they are imposed by law on the consumer in the sense described above, is based on a partial acceptance of traditional incidence theory.¹⁶ The acceptance is only partial because sales taxes or excises imposed at levels other than the retail stage are not deductible by the consumer-pur-

¹⁵ See Klarman, *op.cit.*, pp. 248-49; Pechman, *op.cit.*, p. 306; Vickrey, *op.cit.*, pp. 95-96. An exception is the article by Morgan, *op.cit.*, p. 657.

¹⁶ Opinion in recent years has been considerably less than unanimous on the incidence of sales taxes. For two significant attempts to revise the theory of sales tax incidence, see H. G. Brown, "The Incidence of a General Output or a General Sales Tax," *Journal of Political Economy*, April 1939, pp. 254-62; and E. R. Rolph, "A Proposed Revision of Excise-Tax Theory," *Journal of Political Economy*, April 1952, pp. 102-17.

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chaser (but they are by the manufacturer or wholesaler), and also because deductibility of the full amount of such taxes assumes that they are fully borne by the consumer.

As frequently pointed out, deductibility of a sales tax depends on form rather than incidence. The law, in permitting the deduction of taxes that the consumer can "segregate," discriminates against those whose consumption patterns encompass a relatively large amount of taxes that cannot be segregated.¹⁷ Most frequently cited cases are the tax treatment in favor of automobile owners over bus and taxi riders, and owner-occupants of houses over tenants. Fare-paying riders and rent-paying tenants pay the motor vehicle and property taxes indirectly, but cannot claim them as tax deductions because they are not paid explicitly. To the extent that motor vehicle and property taxes are justified on the grounds of benefits received, the question arises why they should be treated differently in any way from a locality's special property assessments, which are not deductible for precisely that reason. These special taxes and several others may be viewed as payments to the government for services rendered, and hence are like any other payments made for personal consumption purposes.

Finally, a recurring criticism about the deduction for excises and sales taxes is that it suffers from haphazard administration, owing largely to the many vexing differences in practice depending on what state the taxpayer makes his purchase in.¹⁸ It is difficult for taxpayers to keep accurate records of such tax payments, and not a few are unable to determine what is deductible and what is not. The result, as pointed out above, is that many a taxpayer simply indulges his own fancy, which may partly explain why the distribution of taxes-paid deductions, by size of income, has little resemblance to other distributions of state and local taxes.

¹⁷ Vickrey, *op.cit.*, p. 95.

¹⁸ For example, the tax on cigarettes purchased in a state which imposes it on the wholesaler is not deductible, whereas for those who buy their cigarettes in a state where the tax is legally imposed on the consumer, it is deductible.