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CHAPTER 9

Summary of Findings

The Purpose of Personal Deductions

AT THE outset we find that the personal deductions, unlike the personal exemptions, were not established as a separate distinct category until World War II. This is largely because the personal deductions came into the tax law at widely separate points in time and under markedly different conditions. The interest paid, taxes paid, and casualty loss allowances are as old as the Civil War income tax, and may have been written into early tax laws with the businessman's circumstances in mind at a time when the income tax was not contemplated as a mass tax.[1] The allowance for philanthropic contributions, to protect philanthropy from the possible effects of high taxes, was enacted in 1917; the medical expense deduction was added to the list in 1942 in order to differentiate between taxpayers on the basis of their medical expenses of "extraordinary" size; and the child-care allowance, designed primarily for working mothers who are without husbands or who are supplementing family incomes below $5,100, was enacted in 1954 but has in its present form no quantitative significance. The long time intervals between enactment of the various personal deductions probably account for some of the features noted by critics as inconsistencies in the law. It is frequently pointed out, for instance, that the allowances both for medical expenses and casualty losses (fire, collision, storm, theft) attempt to deal with the subject of personal loss—one indirectly with loss of health (that is, only to the extent that there are actual expenditures), the other directly with loss of material belongings. Yet the casualty loss allowance has no lower or upper limits on the amount deductible (it even permits the carry forward and carry back of losses if they exceed current-year income), whereas the medical allowance has both quantitative restrictions.

At numerous points in our study, particularly in connection with the philanthropic contributions and medical expense allowances, a policy problem has persistently emerged—one that has become increasingly acute in recent times. How well is the income tax suited to serve as a vehicle for governmental action in the social welfare area? That is, how effectively can a tax rebate be substituted for an expenditure program? In a loose sense, a tax reduction conditional on a given

[1] For instance, note 18 of Chapter 6.

expenditure has some of the aspects of an expenditure program. In this context it becomes of immediate importance to identify the motivations and purposes underlying a deduction. A deduction may be intended to grant relief from a quasi-involuntary expenditure, and thereby differentiate between taxpayers whose incomes, though apparently equal, are of different sizes in some relevant sense; or a deduction may be geared as a stimulus to expenditures on which society is currently placing a high order of priority. The first is intended to further refine taxable income; the second has features of a government expenditure program.

Both these considerations are potentially present in the medical expenditures allowance. As constituted since 1942, the relief and interpersonal equity aspects, rather than the incentive aspects, have been the dominant consideration in the medical allowance. And, as we saw in Chapter 7, taxpayers who have been able to claim the deduction had medical expenses far above average for the population, both absolutely and relatively to income. Recent proposals, such as for no limit on deductibility of voluntary health insurance premiums[2] and addition to the list of personal deductions of an allowance for educational expenses beyond high-school level,[3] would tend to move the deductions further in the direction of indirect expenditure programs. Indeed Congress always has the option of making public expenditures in the form of tax concessions rather than budget appropriations.[4]

Quantitative Findings: Deductions within the Tax Structure

Personal deductions reported on taxable returns have risen from an estimated 8 per cent of income reported in the years 1918-1921 to an average of over 13 per cent in 1953-1956 (Table 7). But the individual deductions have not uniformly behaved in this way. Particularly striking is the decline in the relative importance of interest paid, and the relative rise in taxes paid.

In 1929 over 40 per cent of the total consisted of personal interest

[2] See Chapter 7, p. 134.

[3] See, for instance, the President's Committee on Education Beyond the High School, *Second Report to the President*, Washington, D.C., July 1957, pp. 56, 90.

[4] The expenditure aspect of deductions and exemptions has been discussed by Clarence D. Long and Selma Mushkin in "Welfare Programs and Economic Growth and Stability," *Federal Expenditure Policy for Economic Growth and Stability*, Subcommittee on Fiscal Policy of the Joint Economic Committee, 85th Cong., 1st Sess., 1957, pp. 1028-31.

payments, one-fourth of nonbusiness taxes, and one-fifth of philanthropic gifts. For 1956, personal deductions amounted to $34 billion on taxable returns, of which 37 per cent was taken in the form of the standard deduction (first introduced in 1941). Of the $21 billion of itemized deductions, state and local nonbusiness taxes paid were over one-fourth, contributions and interest paid each over one-fifth, and medical expenses one-seventh.

Quantitatively, personal deductions have never been as significant as personal exemptions. For 1956, exemptions on taxable returns amounted to some $75 billion as against $34 billion for deductions. But the trend in the relative importance of deductions has been upward, while for exemptions it has been downward since prewar days (Table 3). Estimated effective exemptions (for all income recipients) declined from about seven-tenths of total adjusted gross income in prewar days to one-third in 1955. Effective personal deductions, on the other hand, rose from 7 per cent of total adjusted gross income in 1939 to 12 per cent in 1955. Thus personal allowances are less than formerly related to population and family size and more to selected types of expenditures and size of income (to income especially since the inauguration of the standard deduction).

The ratio of personal deductions to income varies only slightly between different income groups from the bottom to top of the income scale. In recent years a significant rise occurred only above the $100,000 income level (Table 12). This is a change from prewar years when total deductions exhibited a tendency to rise in relation to income reported over most of the income scale. The change may be ascribed primarily to the addition of the standard deduction and the medical expense allowance, which raised the ratio of deductions to income for low- and middle-income taxpayers. In contrast, the personal exemptions decline relative to income from the bottom of the income scale upward (Table 4). A striking contrast emerges in the differential effect of deductions and exemptions on the progression of effective tax rates. When we omit personal deductions (and retain exemptions) in order to isolate their effect on tax rates, the ratio of tax to income rises from 11 per cent in the lowest income group to 77 per cent at the top for the year 1953. When we omit personal exemptions (now retaining deductions), the ratio rises only from 20 to 61 per cent. Thus the personal deductions, as a group, have tended to dampen the progression of effective rates, and the exemptions have added considerably to effective rate progression (Table 5 and Chart 2).

How are personal deductions important to the total tax liability or tax rates? Again with 1953 incomes and 1953 tax rates, liabilities were reduced by the presence of personal deductions from an estimated $36 billion to $29 billion, or by $7 billion. In that year their revenue cost was somewhat less than one-fourth of the actual yield of the personal income tax. Alternatively, the over-all importance of the personal deductions might be expressed in terms of rates. If we hold tax liabilities approximately constant, the increase in tax base in a system without personal deductions permits a reduction of all nominal rates by close to 5 percentage points. The over-all average rate of tax (total tax liability divided by tax base) would then have been 20.7 instead of 25.4 per cent (Table 6).

Through their effect on the tax base, the personal deductions may also affect the built-in flexibility of the tax. We observed (Table 10) that the deductions have been slightly less sensitive than the current tax base to cyclical fluctuations in income. Hence, for a given level of tax liabilities, the deductions tend to reinforce built-in flexibility somewhat (Table 11). This means that at given levels of tax yield, changes in tax liabilities in response to changes in income tend to be a bit larger with than without the deductions. This is not necessarily so if fixed tax rates, with and without deductions, are assumed. Then the higher level of tax yield resulting without deductions might produce a change in tax liabilities with change in income greater than that in the presence of deductions.

Quantitative Findings: Size and Significance of Major Deductions

Examination of the major individual deductions—philanthropic contributions, taxes paid, interest paid, and medical care expenses—reveals some striking differences in coverage of the underlying expenditure items for which these deductions were designed. This is illustrated in Table 62 for the years 1950, 1952, and 1954. Judging by the ratio of reported to estimated total expenditures, coverage appears to be greatest for contributions: eight-tenths according to one estimate, over nine-tenths according to another. Personal interest payments deducted came to one-half of the estimated total of such payments; nonbusiness tax payments to somewhat over four-tenths; and medical expenses to not

TABLE 62

Selected Deductions Compared with Estimated Total Expenditures, by Category, 1950, 1952, and 1954

(dollar amounts in billions)

	1950	*1952*	*1954*
Philanthropic Contributions:			
Estimated total			
Andrews	3.7	4.5	4.8
Based on miscellaneous sources	2.7	3.4	4.1
Amount deducted	2.3	3.1	3.9
Deductions as per cent of total			
Andrews	61.3	68.6	81.3
Based on miscellaneous sources	82.8	93.0	94.0
Nonbusiness Tax Payments:			
Estimated total	6.6	8.5	9.8
Amount deducted	2.2	3.2	4.1
Deductions as per cent of total	33.8	37.6	41.5
Personal Interest:			
Estimated total	3.6	4.8	6.3
Amount deducted	1.5	2.2	3.2
Deductions as per cent of total	42.0	46.7	50.9
Medical Expenses:			
Estimated total	8.3	9.4	10.6
Amount deducted[a]	1.6	2.1	3.0
Estimated medical expenses of claimants[b]	2.5	3.4	4.5
Deductions as per cent of total	18.9	22.8	28.1
Claimant's expenses as per cent of total	30.6	36.0	42.2

[a] After exclusions.

[b] Estimated medical expenses of those claiming the deduction.

Source: Tables 16, 26, 34, 41, and 42, and *Statistics of Income.*

quite three-tenths. The ratio of medical deductions to estimated total medical expenses in the deductible category is particularly low, owing to the requirement that medical expenses below a stipulated percentage of the taxpayer's income be excluded from the deduction. When we include the amount falling below that floor for those who took the deduction, their medical expenses amount to approximately 40 per cent of the total of potentially deductible expense.

The tax equivalents of the amounts deducted in itemized form for the four major expenditure categories added to $3.5 billion in 1954 and $4.8 billion in 1956. The tax equivalents of each category are shown below.

	1954	1956
	(dollars in billions)	
Philanthropic contributions	1.1	1.5
Taxes paid	1.1	1.6
Interest paid	0.8	1.2
Medical expenses	0.6	0.7

These tax equivalents do not include the revenue foregone on account of the standard deduction. For instance, if we assign an appropriate fraction of the standard deduction to philanthropic contributions, the 1956 tax cost for the latter would be raised to $2 billion. (And if we wanted a still more inclusive figure to take account of all tax concessions in the area of philanthropy—as for corporation gifts, property transfers, and property income of philanthropic organizations—we would arrive at roughly $2.6 billion for 1956.)

Care must be taken not to designate the tax equivalents as simple tax losses. If intended to spur private expenditures, for instance, in the philanthropic domain, the figures represent more accurately the tax cost to the government of encouraging expenditures which might otherwise have to be undertaken by government. Two questions therefore need to be answered before the nature of this tax rebate can be appraised correctly: first, to what extent are philanthropic donations made for purposes in which the government's interest is considerable? Second, to what extent does the tax rebate affect the volume of giving? Only after these two questions are answered would we know enough to say whether, and to what extent, lower tax rates would be possible without the contributions deduction. If tax rates could not be reduced commensurately with the resulting broadening of the tax base, the deduction allowance may be said to constitute an indirect government expenditure which is not reflected in the government's budget.

The first question—the degree to which the typical philanthropic dollar and the typical tax dollar are complementary—may be referred to the estimated distribution of contributions by broad areas of activity. In 1954 an estimated two-thirds of the gifts of living donors went to religious organizations; over one-fifth for health, education, and welfare; and the remainder to private foreign aid, foundations, and a vast miscellany usually designated as philanthropy.

The second question—the effect of deductibility on the volume of giving—has two aspects: the effect of tax rates on the reported amounts of gifts and on the actual amount of gifts. The available evidence for both is highly tentative. The figures we were able to marshal suggest the possibility that deducted contributions are considerably overreported; and they provide no evidence that philanthropic giving in the aggregate depends appreciably on tax incentives.

Without answering the questions raised, the considerations and data mentioned give substance to two broad questions of tax policy: first, whether the government should have contributed $1.6 billion in the form of tax reduction to the living donors of the $4.2 to 4.8 billion gifts made in 1954; second, whether such a tax rebate might in future be most appropriately accomplished by a deduction from income, as at present, or through a tax credit.

A large part of the $2.8 billion tax equivalent of deductions for nonbusiness taxes and interest paid in 1956 is probably for property taxes and mortgage interest of homeowners with mortgage debt. For that year, deducted nonbusiness taxes were 4.7 per cent of income reported on returns with itemized deductions; and estimated total deductible taxes were 4.0 per cent of total adjusted gross income. The discrepancy in the percentages is surprisingly small, for we naturally expect the amounts of taxes paid by those who itemize to show higher than average ratios to income. The small discrepancy may be explained by the somewhat regressive incidence of state and local tax systems, and by the compulsory nature of taxes, with the result that tax payments of those who itemize and those who choose the standard deduction are closer in amounts than some other expenditures are. By no means all homeowners itemize their deductions: in 1956 there were nearly 26 million nonfarm homeowners but only close to 18 million returns with an itemized tax deduction. Therefore, well over 8 out of 26 million nonfarm homeowners did not itemize, though they paid property taxes.

For homeowners with mortgage interest (as well as property taxes) the picture may be different. We estimate that there were close to 14 million nonfarm homeowners with mortgage debt in 1956. The number of tax returns reporting an itemized interest deduction was also just short of 14 million for that year (Table 36). It is thus likely that a much larger proportion of homeowners with mortgage debt than of homeowners in general itemize their deductions. Even for interest, however, the difference between the ratio of deducted interest to income reported on tax returns and the ratio of estimated total personal interest paid to total adjusted gross income has been narrowing recently. In 1944, deducted interest was 2.2 per cent of income on tax returns, and total deductible interest was 0.9 per cent of total income. In 1956, the respective percentages were 3.9 and 2.9 (Table 35), reflecting the sharp rise in installment interest payments for recent years.

The medical expense allowance, as we have seen, is quantitatively less significant than the three other major deductions. Owing to the 5 per cent floor and the standard deduction (which prevented many taxpayers from itemizing medical expenses, even if these exceeded 5 per cent of their income), the deductions claimed on tax returns were somewhat less than 20 per cent of total private medical outlays as estimated by the Department of Commerce in the period 1942-1950. By 1956 the deductions had risen to 29 per cent of total outlays, mainly because of the abolition of the percentage exclusion after age 65 and the lowering of the exclusion for all from 5 to 3 per cent. Total medical expenses incurred by those able to claim a deduction were about 30 per cent of estimated total medical expenses in 1942, and over 45 per cent in 1956 (Tables 41 and 42). The claimants of these relatively large amounts filed only 18 per cent of all returns (Table 43). In relation to income, we find that during the fifteen years under study medical deductions have been between 6 and 9 per cent of income reported by persons claiming the deductions, and total medical expenses of that group have been between 9 and 14 per cent of its income each year since 1942. Total personal medical expenditures for the United States have been about 4 per cent of total adjusted gross income over the same period (Table 45).

We conclude from the statistics presented that, in line with the law's intent, the medical deduction has benefited taxpayers whose average medical expenses are far above the average of the rest of the population in relation to income. In addition to being large relative to income, medical expenses of those taxpayers were also well above average in absolute size. The latter result is not a necessary consequence of the percentage floor under the deduction but may be caused largely by the standard deduction. If one wishes to view the medical deduction as an indirect government subsidy, its tax equivalent in 1956 was $700 million, about one-seventh of the nearly $5 billion medical expenses of taxable individuals who claimed the deduction. Of the $700 million, an estimated $133 million or one-fifth, was for taxpayers over 65 years old. One-fourth of their medical expenses, compared to 13 per cent for those under 65, was absorbed by the tax equivalent of the medical deduction.

Beginning with 1944, most taxpayers have chosen the standard deduction. In that year eight out of ten made use of it. Since then, there has been a decline to six out of ten in 1956 (Table 57). In dollar amounts, out of $12.5 billion total personal deductions on taxable returns in 1944, $8 billion or 63 per cent was accounted for by the standard deduction. In 1956, the total had risen to $33.5 billion, but only $12.5 billion or 37 per cent was in the form of the standard deduction (Table 58). In part, the decline has been caused by the rise in incomes during that thirteen-year period, since taxpayers in the low-income groups choose the minimum allowance with greater frequency than those in the middle- and high-income ranges (Table 59). The growth in deductible expenditures has also contributed to the decline, as, for example, expenditures resulting from the growth in homeownership. Certainly the liberalization of provisions for deductibility has had an effect in some cases, reinforced by the 1954 code, which lowered the floor for the medical allowance and added a new deduction, the child-care allowance for working mothers.

Quantitative Findings: Size of Deductions by Income Groups

Although the ratio of total deductions (itemized and standard) to income has in recent years shown only small variations by size of income, ratios for the major allowances have exhibited substantially different patterns (Table 63). The philanthropic contributions deduction has tended to rise as a per cent of income, but perhaps not as steeply as is frequently suggested by those who consider philanthropy an activity of the very rich. There has been only a faint rise, if any, up to the $100,000 level of reported income for the years examined from 1922 to 1956 (Tables 19 and 20). Before 1943 the average ratio of contributions to income stayed as a rule under 3 per cent for incomes below the $100,000 level. After 1943 reported contributions have, on average, exceeded 3 per cent of income well before the $100,000 level was reached, but they still remained below 4 per cent in the $50,000 to $100,000 income group. For incomes above $100,000 the ratio turned up appreciably in all years. On returns with $500,000 and more it has been over 6 per cent in all years since 1943, and close to 12 per cent in 1956. Only in that income group has the average rate of giving moved halfway toward the limit on the amount deductible.

In view of two recent extensions of the limit above its original 15 per cent of income, its importance is of special interest. For 1949, 1954, and 1956, we estimate that in the under-$20,000 income range no more than 3 per cent of returns reported contributions in excess of the scriptural tenth (Table 22). There follows a mild rise up to $50,000, and only above that level does the ratio begin to rise significantly. Less than 0.5 per cent of all returns showed contributions in excess of 20 per cent of income in 1954 and 1956. The amount reported in excess of 20 per cent of income for 1954 was $68 million, or less than 2 per cent of total contributions for that year. The figures suggest that there were few persons with incomes below $50,000 whose contributions

TABLE 63

Major Itemized Deductions and Standard Deduction Reported on Taxable Returns: Per Cent of Income Reported and Percentage Frequency of Deductions on All Taxable Returns, by Income Groups, 1956

INCOME GROUP[a] ($000's)	*Philanthropic Contributions* (1)	*Taxes Paid* (2)	*Interest Paid* (3)	*Medical Expenses* (4)	*Total Itemized* (5)	*Standard Deduction* (6)
MAJOR DEDUCTIONS AS PER CENT OF INCOME ON RETURNS WITH ITEMIZED OR STANDARD DEDUCTIONS						
Under 2	6.1	5.1	2.3	7.0	24.2	10.0
2-3	5.2	4.9	2.7	6.1	22.2	10.0
3-5	4.2	4.7	4.1	4.2	20.2	10.0
5-10	3.5	4.7	4.7	2.5	18.1	10.0
10-25	3.5	4.7	3.3	1.7	15.9	7.7
25-50	3.3	4.3	2.0	0.9	12.7	3.1
50-100	4.1	4.1	1.8	0.6	13.0	1.6
100-500	6.9	4.3	2.6	0.3	17.4	0.7
500 and over	11.9	3.4	1.6	0.1	19.5	0.1
Total	3.9	4.6	3.8	2.5	17.6	9.6
NUMBER OF RETURNS WITH MAJOR DEDUCTIONS AS PER CENT OF ALL TAXABLE RETURNS						
Under 2	10.5	10.0	4.0	6.9	11.7	88.3
2-3	20.7	20.7	11.4	14.6	22.2	77.8
3-5	33.0	33.4	25.1	21.5	34.3	65.7
5-10	47.6	48.1	42.1	27.0	49.0	51.0
10-25	55.9	56.1	45.2	23.6	57.0	43.0
25-50	83.1	83.3	54.4	22.6	84.6	15.4
50-100	92.4	92.5	58.2	24.6	93.6	6.4
100-500	97.0	97.2	64.4	31.2	98.1	1.9
500 and over	97.3	96.6	71.0	36.8	98.8	1.2
Total	35.3	35.6	27.9	20.7	36.7	63.3

[a] Income is adjusted gross income.

might have been affected by the increase in the ceiling from 15 to 20 per cent in 1952, and to 30 per cent in 1954. In that income range originated well over nine-tenths of total contributions.

In contrast to the philanthropic contributions allowance, the relative size of medical deductions varies inversely with income. This is the pattern presumably desired for it. In 1942, the results of the consumer expenditure surveys of 1935-1936, and probably also of 1941, were already well known. They showed that medical expenditures rose as income rose, but not in proportion to it, and that medical expenses of all consumer units were about 4 per cent of money income (Table 39). The floor under the deduction was set at 5 per cent of income. It was clear from the start that medical hardship, as defined in the tax law, was most likely to occur among persons at the bottom of the income pyramid and to diminish with size of income, and that only a modest fraction of total medical expenditures would be deductible.

For 1956, medical deductions were 10 per cent of income on returns reporting medical deductions and less than $3,000 income, and 1 per cent on returns reporting $100,000 and over. For the same two groups, the proportion of total medical expense deductible was about four-fifths at the lower end and one-half near the upper (Tables 46 and 47). The frequency of medical deductions claimed among high-income taxpayers was very low until 1951. In that year, removal of the floor at 65 years was reflected in a sharp rise in the frequency of medical deductions on high-income tax returns—for instance, from 5 per cent in 1950 to 25 per cent in 1956 for the $50,000 to $100,000 income group (Table 51).

Of the 10.6 million returns with itemized medical deductions in 1956, 2.4 million showed medical expenses well in excess of 10 per cent of reported income (Table 52). They constituted 4 per cent of all tax returns filed. That figure is presumably a fair indication of the number of returns with relatively large medical expenses, since most taxpayers with medical outlays of 10 per cent of income would hardly choose the standard deduction.

That statement appears only approximately correct in relation to deductible expenses generally. Other evidence suggests that the preference for itemized deductions rises with income level, but not solely because of the slight increase in the ratio of deductible expenditures to income as its level rises. The ratio of itemized deductions to income on itemized returns falls markedly over the range up to $10,000. For 1956, the relatively few with incomes less than $2,000 who itemized claimed deductions equal to 24 per cent of reported incomes; those in the $5,000 to $10,000 group had deductions equal to 18 per cent (Table 63). This observation suggests that, on average, the further down taxpayers are in the income distribution, the less sensitive they tend to be to the possibility of reducing their taxable income by a given small percentage through itemizing their deductions rather than taking the standard deduction. In other words, taxpayers at the bottom of the income scale appear less inclined than those further up to compute their tax liability both ways in order to determine which would minimize their tax liability. The lower their income, the more willing taxpayers seem to be to forego, for the convenience of simplicity, some of the refinements of income and the subsidies implied by the personal deductions.