Volume Title: Personal Deductions in the Federal Income Tax

Volume Author/Editor: C. Harry Kahn

Volume Publisher: Princeton University Press

Volume ISBN: 0-870-14122-8

Volume URL: http://www.nber.org/books/kahn60-1

Publication Date: 1960

Chapter Title: Personal Interest Payments

Chapter Author: C. Harry Kahn

Chapter URL: http://www.nber.org/chapters/c2423

Chapter pages in book: (p. 109 - 125)

CHAPTER 6

Personal Interest Payments

DEDUCTION of interest paid, as of nonbusiness tax payments, has been allowed by the federal income tax laws from the very beginning. To this day, all interest paid on personal as well as business indebtedness has been deductible, with the single exception of interest incurred for carrying tax-exempt securities. Currently, the only distinction drawn is by the method of deduction. Interest expenses incurred for business or professional reasons are deducted in computing adjusted gross income; nonbusiness interest, if the taxpayer chooses to itemize, is deducted from adjusted gross income in computing taxable income. This distinction has been important since 1944, when the amount allowed for philanthropic contributions and medical expenses as well as the amount of the standard deduction became dependent upon the size of adjusted gross income. This chapter deals with nonbusiness interest only.

Nonbusiness interest is defined by the law as interest on loans contracted neither for the production of taxable income nor in connection with taxpayers' trade or business, but for personal or family purchases and expenses. Probably a major share of deductible personal interest is paid for mortgages on owner-occupied residences. Since 1939 tenant stockholders in cooperative apartment buildings have also been able to deduct their proportionate share of interest paid on the cooperative's indebtedness. Interest on personal loans includes that paid in discount form; that incurred in installment buying if separately stated; and if not separately stated, an amount equal to six per cent of the average unpaid balance under an installment contract may be deducted.

Trend in Deductions Claimed

Total personal interest in the category deductible[1] from adjusted gross income to compute taxable income was nearly constant in abso-

[1] For 1936-1939 Copeland's estimate of cash interest expenditures by households—families and single persons, estates, personal holding companies and trusts—was used here as a measure of total deductible personal interest (see Morris A. Copeland, *A Study of Moneyflows in the United States*, National Bureau of Economic Research, 1952, pp. 66-67). For 1939-1953 we used the Federal Reserve Board's figures for monetary interest payments of consumers, which cover "natural persons and personal trusts" (see Board of Governors of the Federal Reserve System, *Flow of Funds in the United States, 1939-1953*, Washington, D.C., 1955, p. 239).

lute amount during the period 1936-1945. It varied only between $1.3 and $1.6 billion during these ten years owing to consistently low interest rates and the wartime restrictions on residential construction and the output of consumer durables. As a per cent of income, total personal interest declined steadily from 2.4 in 1936 to less than 1 per cent in 1945. But beginning with 1946 the trend was reversed. The absolute and relative amounts rose in every year—from the low of $1.3 billion in 1945 to $8.5 billion in 1956, or from 1 per cent to nearly 3 per cent of income.

The amount of this interest appearing as itemized deductions on tax returns rose from 42 per cent of the total in 1936 to 82 per cent in 1943, when it exceeded $1 billion. Since then the standard deduction has held the amount of itemized interest deductions to roughly one-half of estimated total personal interest (Table 34). Like the ratios of deductible nonbusiness taxes to income, the ratio of personal interest deductions to income on tax returns has shown the same pattern of change as the ratio of total personal interest to total income (Chart 12). Again, mainly because of the operation of the standard deduction, the tax-return ratios since 1941 have been consistently higher than the ratios for the underlying totals. But the relative difference in the ratios is considerably greater for interest than for taxes. For 1944 interest deducted on taxable returns was 2.1 per cent of income reported, whereas the corresponding countrywide percentage was only 0.9 per cent; for 1956 the percentages were 3.8 and 2.9, respectively (Table 35).

Interest Deductions and Homeownership

One probable reason for the high ratio of interest to income on tax returns is that the returns with itemized personal interest expenditures are largely those of homeowners with mortgages, who tend to have sizable outlays for interest.[2] The available evidence suggests that many

[2] See, for instance, 1956 Survey of Consumer Finances, "Consumer Indebtedness," *Federal Reserve Bulletin*, July 1956, p. 691: "About two-thirds of all mortgage debts outstanding exceed $3,000. Spending units rarely have personal debts in excess of $3,000 . . . and more than half of all units with such debt owe less than $500." And it is reported that about two-thirds of spending units with mortgage debt also have some kind of personal debt (p. 702), the latter being defined as all short-term and intermediate-term consumer debt other than charge accounts and mortgages. The interest cost per dollar of debt is of course greater on personal loans than on home mortgages, but the difference is not large enough to offset the great disparity in the amounts of principal involved.

TABLE 34

Personal Interest Payments Deducted on Tax Returns and Estimated Total Deductible Personal Interest Payments, 1927-1956

YEAR	*Personal Interest Deducted* *Taxable Returns* (*millions*) (1)	*All Returns* (2)	*Total Deductible Interest Payments*[a] (*billions*) (3)	*Amount Deducted as per cent of Total* 1 ÷ 3 (4)	2 ÷ 3 (5)
1927	827[b]	1,131[b]			
1928	927	1,368[b]			
1929	922	1,439[b]			
1930	640	1,250[b]			
1931	371	940[b]			
1932	352	796[b]			
1933	296	643			
1934	313	606			
1935	327	572			
1936	397	593	1.4	28.4	42.4
1937	405	606	1.4	28.9	43.3
1938	340	557	1.3	26.2	42.8
1939	383	583	1.3	29.5	44.8
1939	383	583	1.4	27.4	41.6
1940	467	751	1.5	31.1	50.1
1941	754	956	1.6	47.1	59.8
1942	1,010	1,168	1.5	67.3	77.9
1943	1,038	1,066	1.3	79.8	82.0
1944	696	719	1.3	53.5	55.3
1945	683	704	1.3	52.5	54.2
1946	694	749	1.6	43.4	46.8
1947	855	928	2.0	42.7	46.4
1948	903	1,014	2.5	36.1	40.6
1949	1,106	1,238	3.0	36.9	41.3
1950	1,372	1,511	3.6	38.1	42.0
1951	—	—	4.2	—	—
1952	2,095	2,240	4.8	43.6	46.7
1953[c]	2,585	2,739	5.7	45.4	48.1
1954[c]	2,985	3,205	6.3	47.4	50.9
1955	—	—	7.3	—	—
1956[c]	4,544	4,810	8.5	53.5	56.6

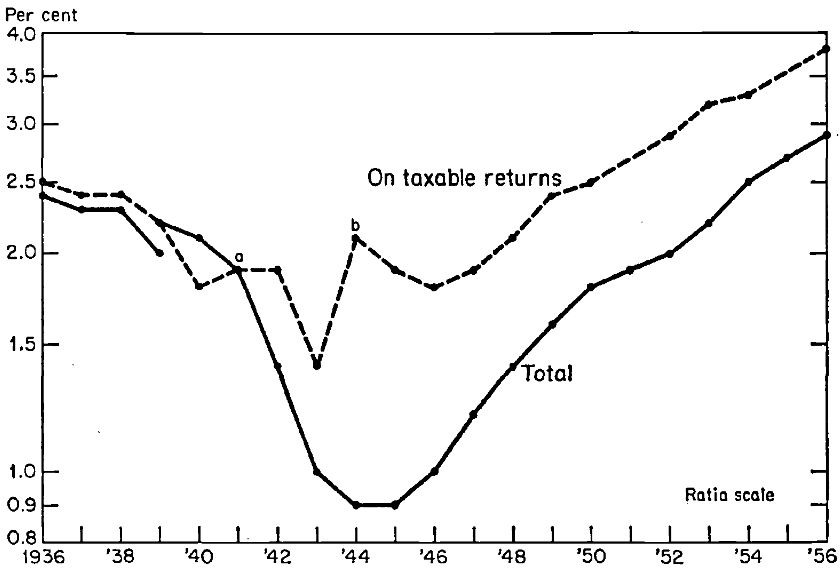
[a] *1936-1939*: Morris A. Copeland, *A Study of Moneyflows in the United States* (NBER, 1952), pp. 66-67; *1939-1952*: Board of Governors of the Federal Reserve System, *Flow of Funds in the United States, 1939-1953*, Washington, D.C., 1955, p. 239.

[b] Estimates.

[c] The interest deduction figures for these years exclude those reported on fiduciary returns.

of them itemize their deductible interest (and property taxes).[3] As Table 36 shows, there were an estimated 13.6 million nonfarm homeowners with mortgage debt in 1956; there were also 13.7 million tax returns with itemized deductions for interest expense. This means that all nonfarm homeowners with mortgage debt could have item-

CHART 12



a First standard deduction introduced.
b Standard deduction enlarged.
Source: Table 35.

Deductible Personal Interest as Per Cent of Adjusted Gross Income, 1936-1956

ized their deductions in that year. If owner-occupied mortgaged farm homes were included in the comparison, the percentages on line 5 would be lower. However, it is probable that the majority of such farmers filing tax returns treat mortgage interest as business expense rather than prorating it between residential and business purpose. Most of such interest, even if properly prorated, is business interest.

Table 36 also shows that, of the nearly 26 million nonfarm homeowners, only a possible maximum of 18 million, or somewhat less than seven-tenths, itemized their taxes in 1956. Since it can be assumed that all who itemize mortgage interest also itemize tax deductions, it is likely that the number of nonmortgage homeowners who itemize de-

[3] See the end of the next section.

ductions is relatively small. If, for example, nearly all the returns with interest deductions in 1956 were those of homeowners, then only about 4 million out of the 12 million debt-free nonfarm homeowners, or about one-third, could have itemized. It is of course unlikely that all the 13.7 million returns with deductible interest are those of home-

TABLE 35

Deducted Personal Interest Payments as Per Cent of Income on Tax Returns, and Estimated Total Personal Interest as Per Cent of Total Adjusted Gross Income, 1936-1956

YEAR	*Interest Deducted as Per Cent of AGI* *Taxable Returns* (1)	*All Returns* (2)	*Total Deductible Interest as Per Cent of Total AGI* (3)
1936	2.5	3.8	2.4
1937	2.4	3.6	2.3
1938	2.4	3.9	2.3
1939	2.2	3.3	2.0
1939	2.2	3.3	2.2
1940	1.8	2.9	2.1
	RETURNS WITH ITEMIZED DEDUCTIONS		
1941	1.9	2.1	1.9
1942	1.9	2.0	1.4
1943	1.4	1.4	1.0
1944	2.1	2.2	.9
1945	1.9	2.0	.9
1946	1.8	1.9	1.0
1947	1.9	2.0	1.2
1948	2.1	2.2	1.4
1949	2.4	2.6	1.6
1950	2.5	2.7	1.8
1951	—	—	1.9
1952	2.9	3.0	2.0
1953	3.2	3.3	2.2
1954	3.3	3.5	2.5
1955	—	—	2.7
1956	3.8	3.9	2.9

Source: Deductible interest payments from Table 34; income figures from Table 17 and Appendix Table D-2.

owners, but it is even less likely that all the 17.8 million returns with tax deductions are those of homeowners. Thus probably fewer than one-third of the debt-free homeowners itemized deductions.

Many regard deductions allowed for taxes and personal interest to be in line with, if not specifically designed for, encouragement of homeownership. The figures presented above suggest that in recent years probably more than one-half of homeowners with mortgages have benefited to some extent from interest deductions, but that a

TABLE 36

Number of Tax Returns with Deductions for Interest and Taxes Compared with Total Number of Owner-Occupied Residences and Number of Mortgaged Owner-Occupied Residences, 1950, 1952, 1953, and 1956

	1950	*1952*	*1953*	*1956*
		(in millions)		
1. Owner-occupied dwelling units	23.6	25.8	26.6	29.5
2. Nonfarm	19.8	22.0	22.8	25.6
3. Farm	3.8	3.8	3.8	3.8
4. Mortgaged owner-occupied dwellings	9.9	—	—	—
5. Nonfarm	8.7	10.3	10.7	13.6
6. Farm	1.2	—	—	—
7. Tax returns with itemized deduction for interest	6.0	8.1	9.5	13.7
As per cent of line 5	69.0%	78.6	88.8	100.8
8. Tax returns with itemized deductions for taxes	9.3	11.8	13.4	17.8
As per cent of line 2	47.0%	53.6	58.8	69.3

1950: lines 1 to 3: Census of Housing: 1950, Vol. I, Part 1, Table L;
line 4: lines 5 + 6;
line 5: line 2 multiplied by 0.44, the ratio of dwelling units (in one- to four-dwelling unit structures without business) for which mortgages were reported to total nonfarm owner-occupied units for which mortgage status was reported. *Census of Housing,* Vol. I, Part 1, Table T;
line 6: number of owner-occupied farms (fully owned and partly owned), which were mortgaged in 1950. 1950 Census of Agriculture, *1950 Farm Mortgage Debt,* 1952, p. 11.
1952 and 1953: line 1: Number of households in the United States multiplied by estimated per cent of owner-occupied dwelling units. The latter were obtained for 1952 and 1953 by straight interpolation between the percentages for 1950 and 1956. *Statistical Abstract of the United States, 1956,* Tables 47 and 972;
line 2: line 1 — line 3;
line 3: Farm dwellings were 16 per cent of the total in 1950, and 14 per cent in mid-1954 (for latter figure, see Bureau of the Census, *Housing and Construction Reports,* Series H-101, No. 1). The 1952 and 1953 percentages were obtained by interpolation, and were multiplied by line 1 to obtain line 3;
line 5: line 2 multiplied by 0.47 to obtain figures for 1952 and 1953, and by 0.53 to obtain them for 1956. See Survey of Consumer Finances, "Housing and Durable Goods," *Federal Reserve Bulletin,* June 1957, Supplement, Table 2. To obtain a ratio for 1956 the average for early 1956 and early 1957, (that is, of 0.50 and 0.44) was used. For 1957, see above source. For 1956, "Durable Goods and Housing," *Federal Reserve Bulletin,* August 1956, Supplement, Table 20.

much smaller fraction of homeowners without mortgages have benefited from a specific deduction for taxes paid. Inasmuch as those with mortgages are presumably newer homeowners, the deduction has been consonant with the subsidy objective. Two-thirds, at the most, of nonfarm homeowners with mortgages were subsidized via the income tax in 1950, three-fourths in 1952, and four-fifths in 1953. By 1956, as we have seen, the number of returns with deductions for interest had risen to include (conceivably) nearly all homeowners with mortgage debt. The number of returns with itemized interest deductions has risen from 6 million in 1950 to 14 million in 1956, while the estimated number of mortgaged nonfarm houses rose over the same period from 9 to 14 million. For 1954 and 1956, the tax equivalents of the interest deduction, and therefore the extent of any implied subsidy, are shown below.

	Total deductible interest paid	Amount itemized, taxable returns	Tax cost to federal government	Cost to government as per cent of	
	(dollar amounts in millions)			amount itemized	total deductible
1954	6,346	2,985	762	25.5	12.0
1956	8,499	4,544	1,176	25.9	13.8

Comparison of the number of returns showing interest deductions with the total number of itemized returns suggests that homeowners with mortgage debt may be a sizable proportion of the total, but not so overwhelming a proportion as commonly supposed. Of 18.5 million returns with itemized deductions in 1956, 13.7 million had deductions for interest. This is three-fourths of itemized returns.[4] However, since not all returns with interest deductions are necessarily those of homeowners, the true number of returns with mortgage interest deductions is a lower percentage of the total of itemized returns.[5] There is a greater possibility that a preponderance of itemized returns with personal deductions are filed by homeowners (with or without mortgage debt), for we have also observed that 17.8 out of 18.5 million returns reported deductible taxes. Undoubtedly many of these—although how many is unknown—were returns of debt-free homeowners. But as nearly all taxpayers incur some deductible taxes, a significant number of returns may have been itemized because of other sizable personal deductions, such as philanthropic contributions or medical expenses. All we can say is that, since homeowners probably constitute a large proportion of the group that itemizes, they are also likely to be the

[4] In the $5,000 to $10,000 income group, however, the number of returns with deductible interest rose as high as 86 per cent (Table 38).

[5] Here, too, the trend has been upward. In 1950 the number of returns with interest deductions was 58 per cent of the total number itemizing; in 1953, 66 per cent deducted interest, and in 1956, 74 per cent.

major beneficiaries of personal deductions which make provision for sudden personal hardship, such as medical expenses and uninsured losses. Those who do not itemize already when personal hardship occurs must first exhaust the unused part of their standard deduction before they can benefit from the medical expense and casualty loss allowances.

Deductions by Size of Income on Tax Returns

Deductions for interest paid decline as a percentage of income above the $5,000 to $10,000 level (Table 37). This contrasts with deductions

TABLE 37

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

INCOME GROUP[a] ($000's)	*All Returns*				*Returns with Itemized Deductions Only*					
	1934	*1937*	*1939*	*1941*	*1945*	*1947*	*1949*	*1952*	*1954*	*1956*
Under 2	—	5.0	—	—	6.9	6.3	6.1	7.4	6.2	6.6
2-3	—	5.7	—	—	4.7	4.8	5.0	5.8	5.2	5.3
3-5	—	5.9	—	—	4.4	4.4	4.9	5.0	5.3	5.6
5-10	8.1	5.7	5.4	4.3	4.0	3.7	4.4	4.5	4.9	5.4
10-25[b]	7.0	4.8	4.5	3.5	2.9	2.8	3.3	3.7	3.9	4.1
25-50[b]	6.0	3.9	3.6	2.7	2.3	2.4	2.5	2.7	2.8	3.1
50-100	5.0	3.3	3.0	2.4	2.3	2.2	2.3	2.3	2.5	2.9
100-500	4.0	2.8	2.6	1.9	2.4	2.5	2.0	2.5	3.0	3.9
500 and over	3.7	3.3	1.5	1.0	1.4	1.1	1.0	1.1	1.8	2.3
Average amount of interest deducted (dollars)	—	353	—	—	194	199	242	274	300	352

[a] Net income groups until 1943; adjusted gross income groups thereafter.
[b] For 1952 and 1954 the percentages are for returns in the $10-20,000 and the $20-50,000 income groups.

taken for philanthropic contributions (larger percentages deducted at the top of the income scale than at the bottom) and for taxes paid (deductions almost proportional to income). In 1934 the decline in interest deductions was from 8 to 4 per cent; in 1941, from 4 to 1 per cent over the same income range; and in 1956, from 5 to 2 per cent. For returns with incomes below $5,000, the figures for 1937 show a slight rise in the ratio of deductible interest to income; the figures for the most recent years show declines, but this may have been caused by the standard deduction.

Since these interest payments are made in connection with various types of personal consumption, such as housing, installment purchases of durable goods, and personal expense loans, it is not surprising to find that after a certain level of income they are a declining percentage of income as income rises. The decline in proportion to income reported, however, is not duplicated in the fraction of taxpayers claiming interest deductions, which has grown larger with income up to the $5,000 to $10,000 level. Above that level the relative frequency of interest deductions declined somewhat but did not fall to the low frequency for taxpayers with incomes under $3,000 (Table 38). Between 1944

TABLE 38

Number of Taxable Returns with Deductions for Personal Interest as Per Cent of All Taxable Returns Itemizing Deductions and as Per Cent of Total, by Size of Income Reported, 1934-1956

INCOME GROUP[a]	*Per Cent of All Returns*			*Per Cent of Returns with Itemized Deductions*					
($000's)	*1934*[b]	*1937*[b]	*1941*	*1945*	*1947*	*1949*	*1952*	*1954*	*1956*
Less than 2	—	19.1	—	25.1	23.6	24.8	30.4	33.7	34.3
2-3	—	27.3	—	46.1	44.2	45.7	47.1	49.2	51.3
3-5	—	44.8	—	58.1	58.5	65.4	68.8	72.3	73.1
5-10	53.0	51.7	51.9	60.0	59.1	70.4	80.0	83.9	85.8
10-25[c]	57.0	55.7	53.4	49.8	50.8	59.8	69.8	74.3	79.3
25-50[c]	60.4	60.1	55.3	47.4	48.9	53.5	58.8	63.9	64.4
50-100	64.2	65.4	59.0	50.6	52.4	54.7	56.8	60.0	62.2
100-500	68.2	74.8	64.8	55.7	58.8	60.2	60.9	61.7	65.6
500 and over	71.4	79.6	76.2	68.5	63.5	69.6	67.4	64.8	71.8
Average	—	34.0	—	45.0	47.7	57.7	67.0	72.5	76.0
PER CENT OF TOTAL CLAIMING INTEREST									
Less than 2		22.4		16.0	9.2	4.6	3.3	2.3	1.9
2-3		10.8		27.4	24.2	15.3	8.5	6.6	5.3
3-5		33.9		36.6	42.4	47.6	39.1	36.9	28.8
5-10		21.2		12.6	16.0	24.6	40.7	45.4	52.7
10-25[c]		8.7		5.4	6.1	5.6	5.5	6.0	9.3
25-50[c]		2.0		1.4	1.5	1.6	2.3	2.3	1.5
50-100		0.7		0.5	0.4	0.5	0.5	0.4	0.4
100-500		0.3		0.1	0.1	0.2	0.1	0.1	0.1
500 and over		d		d	d	d	d	d	d
Total[e]		100.0		100.0	100.0	100.0	100.0	100.0	100.0

[a] Net income groups until 1943; adjusted gross income groups thereafter.
[b] Fiduciary returns included in 1934 and 1937 only.
[c] For 1952 and 1954, group limit is $20,000 instead of $25,000.
[d] Less than 0.05 per cent.
[e] Total may not equal 100 because of rounding.

and 1956, there was a substantial rise in the proportion of returns with deductions for nonbusiness interest in the $5,000 to $10,000 group—from 61 to 86 per cent. For the most part this appears to be a reflection of the growth of mortgage and consumer debt in the middle income range during the postwar period.[6]

The bulge since 1944 in the relative frequency of returns with interest deductions among those itemizing in the $3,000 to $25,000 income range tells us something about the identity of "itemizers." In 1956 four out of five taxpayers in this group had interest deductions. We may take this as indirect evidence that a high proportion of those who benefit from itemizing in this middle income range are homeowners with mortgage debt.[7] The fact that over 90 per cent of those with interest deductions in 1956 reported incomes in the $3,000 to $25,000 range (Table 38) further strengthens the supposition that a large proportion of the tax returns with interest deduction are those of homeowners.

Interest Paid Out and the Income Concept

The question whether all interest, not only that incurred in the production of taxable income, should be allowed as a deduction relates to the very essence of the income concept underlying the tax. It is generally agreed that the question would not arise if the statutory concept of taxable income included consumption income derived from the ownership of property. Possession of durable consumer goods allows a short-circuit of the market economy upon which a modern income tax, based on money income, depends. Widespread avoidance of the market economy would indeed seriously undermine the possibilities for a workable income tax. Those who own durables—a residence, a washing machine, or an automobile—and consume the services of their property in preference to obtaining the same services through the market, thereby secure a tax advantage. They lower their money income if they choose to own durable consumer goods rather than a

[6] See 1956 Survey of Consumer Finances, *op.cit.*, Supplementary Table 2, where the frequency of spending units with some debt is shown to rise continuously from 37 per cent of all units in the under $1,000 money income group to 76 per cent in the $7,500 to $9,999 group. For those with $10,000 and over, it drops back to 65 per cent.

[7] The 1956 Survey of Consumer Finances notes that "Total debts of less than $500 were reported with greatest frequency in income brackets under $3,000. On the other hand, debts of $5,000 or more were most frequent among incomes of $7,500 and over." *Ibid.*, p. 691. Debts of that size may be presumed to be primarily mortgage debts. At the income level cited, the standard deduction is fairly high relative to the deductible expenditures that a taxpayer might have, except if he is a homeowner with debt. It seems reasonable to conclude from the high frequency of interest on returns with itemized deductions in the $3,000 to $25,000 income range that a majority of this group are homeowners.

financial asset of equivalent value; but they presumably also lower their money expenditures for housing, laundry services, or transportation by not obtaining equivalent services through the market. Other things remaining the same, the investor in consumer durables has lowered his money income, though not his total income, by an amount equal to the current rate of return on an investment in some financial asset. This amount escapes the income tax.[8] The two methods of consumption correspond to those of the outright owner of durable goods and the so-called renter, or pay-as-you-go consumer.

Between these two cases falls that of the debtor-owner who pays interest on the sum borrowed to obtain services from the ownership of one or more durable goods. His interest is deductible under the

[8] This applies in full only to the modern United States income tax. Since the inception of the income tax in Great Britain, the net rental value of an owner-occupied house has been imputed and included in the owner's income. It seems to have caused no great difficulties of administration. A neat summary of the British position is given by Alfred Marshall: "The Income Tax Commissioners count a dwelling house inhabited by its owner as a source of taxable income, though it yields its income of comfort directly. They do this, not on any abstract principle; but partly because of the practical importance of houseroom, partly because the ownership of a house is commonly treated in a business fashion, and partly because the real income occurring from it can easily be separated off and estimated" (*Principles of Economics*, 8th ed., London, 1938, p. 77).

The only serious attempts made in the United States to cope with the problem of rent occurred in connection with the Civil War income tax and during the early years of the Wisconsin tax. In the Civil War law a solution was attempted by permitting tenants to deduct their rent payments from income to put them on an even footing with owner-occupants, who were not required to include any imputed rentals. In 1863 the Commissioner of Internal Revenue began to argue for a more clear-cut solution. "It will, I think, contribute to fairness if the provision allowing a deduction for rent paid for dwelling-houses be stricken from the law, and that owners of such houses, residing in them, be charged with their rental value as income" (*Report of the Secretary of the Treasury on the State of the Finances for the year ending June 30, 1863*, Washington, 1863, p. 70). The Commissioner's drive was soon seconded in a report of the Special Revenue Commission of 1865, which recommended "that in assessing the income tax no allowance whatever be made for house rent, or at least that the amount allowed to be deducted for rental should not in any case be allowed to exceed three hundred dollars." The commissioners apparently had both tenants and owner-occupants in mind, but they stressed primarily the very sizable revenue losses that resulted from the "excessive and unreasonable" deductions claimed for rental payments (House Executive Documents, Vol. 7, No. 34, 39th Cong., 1st Sess., pp. 27-28; the commission consisted of David A. Wells, Stephen Colwell, and S. S. Hayes). Subsequently only the allowance for rental payments was repealed by Congress.

The Wisconsin income tax, from its inception in 1911, followed the British practice and that suggested by the Commissioner in 1863, until 1917. The provision was repealed in that year because of the difficulties encountered in obtaining an "estimated rental" figure with the then existing property tax information, and because of a widespread practice of overstating expenses, which could be offset against gross imputed rent.

income tax, which places him roughly in the same favorable tax position as the clear-owner. If his interest were not deductible he would be moved closer to the position of the renter; the thinner his equity in a residence or appliance, the smaller the disparity between borrower-owner and renter, but the greater that between borrower and clear-owner.

In the absence of imputation of a return on the equity in durable goods, the interest deduction is thus ambiguous, as recognized by at least two previous writers.[9] Because of the ambiguity, neither has come to a firm conclusion about policy in the absence of a system of income imputation. Their views, which tend toward opposite conclusions, merit analysis in our discussion of the problem.

Vickrey concludes that there is no clear-cut equity case for or against an interest deduction, but that there are other reasons making the elimination of the deduction desirable. First, with an increase of the tax base rates could be decreased correspondingly. "This may be a distinct advantage insofar as it decreases the intensity of such other inequities as cannot be eliminated and reduces the effect of the tax on incentives to production."[10] Second, abolition of the interest deduction might accelerate the further step toward complete inclusion of imputed rent and interest in the tax base.[11]

White's reasoning favors retention of the interest deductions, although he holds that the only wholly satisfactory solution would be imputation of return on durable goods to the owner-user. Indeed, for owner-occupied houses, he refrains from any recommendation for treatment of interest under the present system, concluding simply that "without the inclusion of an imputed net rental there is no clear-cut equity criterion for the treatment of mortgage interest."[12] However, when the proceeds of a loan are for the purpose of acquiring consumer goods other than houses, he considers that greater equity results

[9] See William Vickrey, *op.cit.*, pp. 22-26; and Melvin I. White, "Deductions for Nonbusiness Expenses," pp. 357-360.

[10] *Op.cit.*, pp. 23-24. In the above quotation, he was discussing mortgage interest only, but later on he clearly implied that his recommendations cover all nonbusiness interest.

[11] Earlier, Robert M. Haig, in dealing more briefly with the tax treatment of homeowners, stated a similar view: "The present position is anomalous, particularly when one remembers that such owners, while they may not deduct insurance and upkeep, may, nevertheless, deduct the taxes on the property and the interest on any money they may have borrowed to carry the property. The way to remove the anomaly is to approach the definition of income more closely in practice." See "The Concept of Income—Economic and Legal Aspects," p. 24.

[12] *Op.cit.*, p. 359.

when the interest incurred is deductible. Unlike the case for residential housing where all three categories—renters, mortgagors, and clear-owners—are significant, for other durables, particularly automobiles, "the renter population is comparatively small," and imputation impractical in most cases. Hence, by allowing the debtor-owner of an automobile a deduction for his interest paid, a significant measure of equity is achieved between the two principal types of owner-users of consumer durables. The renters, that is, the users of taxis and public transportation services and of laundry services outside the home, continue, of course, to be at a disadvantage. He argues further that interest incurred for current household expenses should be deductible. For such outlays everyone falls into the role of the renter, who pays as he consumes (uses). Of two who consume at a given level, the one with "sufficient receipts or a cash balance" from which to finance spending without borrowing has a higher income than one who does not. "Therefore," White concludes, "treatment consistent with the income concept permits the deductibility of personal interest where the funds are used for ordinary current expenses."[13]

The income concept referred to is that proposed for the income tax by Henry C. Simons, who defines income simply in terms of the dual objectives of consumption and accumulation over a specified time interval, measured in market prices.[14] White at the outset adopts that definition of income for his analysis of personal deductions. Finding it impracticable to compute directly the sum of each taxpayer's consumption and the changes in cash balances and other asset holdings, he proceeds "to translate the definition, to reformulate it in familiar accounting 'income' categories," in the manner we outlined above. For housing, automobiles, and appliances, he compares three individuals with equal incomes and assets: the "renter," the borrower-owner, and the clear-owner. Each has clearly the same income under both methods of accounting, but the mortgagor and clear-owner have

[13] *Ibid.*, p. 360.

[14] See note 7, Chapter 1. While Simons does not address himself to the problem of the proper treatment of interest expenses under the income tax, his forerunner Georg Schanz, who apparently influenced Simons considerably, argued—though without much explanation—for the deduction of all interest: "We include, then, in income all net proceeds and receipts in kind (*Nutzungen*), money's worth of services of third persons, all gifts, inheritances, legacies, lottery winnings, insurance settlements (*Versicherungskapitalien*), annuities, speculative gains of any kind; we exclude all interest on debts and capital losses." See "Der Einkommensbegriff und die Einkommensteuergesetze," *Finanz Archiv, XIII* (1896), p. 24; also pp. 3 and 7. (Translation ours.)

imputed incomes arising from their investments in consumer durables, which gives them an advantage under the income tax.

For cases in which debt is incurred to finance current household expense, White seems to depart from this method of comparison, and compares two individuals whose consumption is the same, but whose incomes, however defined, differ. If the source of disparity in consumption is higher "receipts or a cash balance" for person A than for B, wherein does B's disadvantage under the tax law lie? If higher receipts allow A to consume at a given level without borrowing, then the disparity is obviously taken care of under current tax law and requires no compensating interest deduction for B. But if the reason is the possession of a cash balance, then White's case appears to have more merit. It would then rest on the argument that a taxpayer who possesses a cash balance has an imputable income in the sense that he would not need to borrow at interest when in need of additional funds. But this has really no connection with the manner in which the cash balance is eventually employed.[15] The designation of this case as that of "recurrent household expenses," in which every one assumes the role of the tenant, appears somewhat beside the point. For it is the investment in a cash balance rather than in household expenses that gives rise to imputable income at present not included in the tax base. It is the fact that a taxpayer invests in a residence, from which there is no explicit monetary return, that raises an equity problem—not the fact that he borrowed for residential use.

The distinction we stress is important because White's emphasis on household expenses leads to his conclusion that in this case "everyone falls in the role of the tenant—that is, is on a pay-out-as-you-consume basis," and that the interest deduction is therefore an unambiguous correction of an inequity, whereas in the case of durables the renters were given no relief and the deduction accordingly was ambiguous. But if we apply the same frame of analysis to the cash balance case as White (and Vickrey) employed for housing and other durables, we find the same ambiguity as before. Let A, B, and C each come into the possession of $1,000. A and B invest in interest-bearing securities; C prefers to hold it as cash. Now assume B and C decide to increase their consumption temporarily by $1,000; B, rather than selling his securities, borrows $1,000 at interest, and C uses his cash

[15] Indeed the cash balance is employed at all times, for presumably the very act of holding it idle, with the attendant sacrifice of explicit interest return, is compensated by liquidity and a feeling of security.

balance, that is, borrows so to speak from himself. Now, by allowing B to deduct his interest payments, which he incurs on his debt, he is put on the same tax basis as C. But A, who continues to keep his $1,000 invested in securities, is now at a disadvantage. Without the interest deduction A and B are in the same position; C is favored. With the interest deduction B and C are on the same basis; A is discriminated against.

But entirely aside from the fact that it does not seem possible to achieve completely equitable treatment, through an interest deduction, between all who consume the same services with different financial arrangements, it also seems questionable whether equity within certain consumption categories is the goal to be achieved.[16] Even if we grant that for automobiles, washing machines, dishwashers, and so forth, the corresponding renter populations are comparatively small, it is not clear that a gain in equity between different types of users of long-lived appliances is one of the tests of a good income tax. It is evident that such an equity goal would widen the disparity in treatment between those whose consumption patterns do not lean toward the direct employment of capital and those who delight in the accumulation of consumer durables.[17] Nor would it be enough to show that nearly everyone owns an automobile, with or without debt; even here the interest deduction will increase the advantage of those who, with given incomes and assets, own two or three automobiles over those who own only one because they happen to prefer fine foods and the theatre to a second or third car. What seems desirable is a tax law that is neutral with respect to all consumption, rather than neutral within particular categories of consumption. The issue is thus between owners and renters in a larger sense, renters being those with relatively small investments in property that yields consumption services, and owners those with relatively large investments in such property.

As noted above, probably the major beneficiaries of the interest

[16] White is not the only one who seems to imply that equity can be achieved by treating the consumers of given services equally. Vickrey also, in passing, gives evidence of subscribing to it: "All forms of durable consumer goods give rise to an imputed income . . . although the discrimination is not so patent if the item in question is not commonly rented, and the services derived by the owner are of a type not comparable to any service commonly furnished separately." *Op.cit.*, p. 25.

[17] Essentially this point is embodied in Simons' treatment of the problem of income in kind: "The direct employment of capital is far from equally feasible for different kinds of consumption or for different people with similar consumption tastes" (*op.cit.*, p. 114). See also Donald B. Marsh, "The Taxation of Imputed Income," *Political Science Quarterly*, December 1943, p. 532.

deduction in recent years have been homeowners with mortgage interest. For this group the allowance is in effect an incentive-subsidy, which encourages home ownership over tenancy. However, we found no evidence that the law's partiality was deliberate. Congress simply did not choose to attempt a distinction between interest as a business expense and interest as a personal consumption expenditure.[18] It may be argued that the distinction is not always possible, or even valid. If the proceeds of a residential mortgage loan are used in business, the security for the loan cannot designate the interest paid as nonbusiness. A nominal business loan may be put to personal uses. A person with a business or investments in securities, when borrowing on a residence, could nominally invest his own money in a home and borrow, to repay himself, on his inventory or securities as collateral. These are difficulties which would complicate the administration of the law if personal interest expenses were disallowed as deductions. To some extent a difficulty exists even now, since personal interest cannot be deducted from gross income in arriving at adjusted gross income, but only from the latter to calculate taxable income.

One suggestion has been that deductibility of interest helps those likely to find home ownership financially most difficult—the mortgagors. Whereas home mortgagors are helped (the debt-free owners having an offsetting tax advantage through nonimputation), it does not follow that the interest deduction constitutes an effective form of assistance. For a given amount of interest the amount of the subsidy rises with rising taxpayer income, owing to the progressive rate schedule of the income tax. In addition, the data presented in Tables 37 and 38 show that the frequency and size of interest deductions have had some tendency to rise with income. For these and other reasons, some students view the deduction as a somewhat awkward instrument for encouragement of home ownership.[19]

In conclusion, the standard deduction has in some measure succeeded in counteracting the disparity in tax treatment between homeowners

[18] When the matter was debated in the Senate in 1913, Senator Cummins gave the following reply to a colleague's complaint that the law as it stood discriminated against the renter: "I think the conclusion of the Senator from Utah is correct. It is simply another illustration of the fact that the bill was composed to meet the conditions of organized business, such as merchants and manufacturers, and is not well fitted to meet the situation as it actually exists" (*Congressional Record*, 63rd Cong., 1st Sess., p. 3848).

[19] See, for instance, White, *op.cit.*, pp. 359-360.

and renters.[20] But it is only a rough and incomplete type of adjustment, and above all its effects move toward granting relief through extension of an allowance which itself appears to some as questionable. Once a deduction is found of questionable value, from the standpoint of preserving the tax base, its removal rather than its extension might be preferable.

[20] Somewhat paradoxically an argument to the contrary may, and indeed has been made, that increases in interest rates can be passed on in part to the federal government by those who itemize their deductions, but not by those who use the standard deduction. Since there is a positive relationship between the number of itemized returns and size of income, not only the rising marginal rates of income tax but also the rising proportion of itemized returns tend to result in favored treatment of high-income taxpayers (see note 13, chapter 5). However, it should be stressed that, in the case of interest, the effect of the standard deduction can be gauged only if one uses the ratio of those who itemize an interest deduction to all persons with deductible interest rather than the ratio of those who itemize to all taxpayers as proposed by J. N. Morgan. For lack of comparable data we have therefore refrained from presenting a chart for personal interest payments comparable to Chart 10 for taxes paid.