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COVERAGE OF EMPLOYEE COMPENSATION IN THE PERSONAL INCOME TAX

This chapter is devoted to two closely related questions: (1) To what extent is employee compensation covered on tax returns? (2) What is the relative importance of employee compensation in total income as reported on tax returns and as estimated independently of the tax return figures? Since the concepts of income chosen in answering these and later questions are of first-order importance, a brief explanation and discussion of alternative income concepts will be provided before analysis of the data.

Appropriate Income Concepts

For the purpose of estimating the degree to which employment income is reported on tax returns, the tax law concept of income is obviously the only logical choice. The Internal Revenue Code's somewhat forbidding label for its concept is "adjusted gross income." In general, AGI includes all payments in excess of "ordinary and necessary" expenses, whether in cash or in kind, which a person may have received through trade or as compensation during a given period of time. Different interpretations may, however, be attached to what constitutes "receipt" of income. As the concept has evolved from the statutes and court interpretations,¹ income is only received when it is realized and at the disposal, that is, available at the demand, of the taxpayer. Thus the grant of something of value to a taxpayer is usually not deemed sufficient to

¹ The U.S. income tax laws have never contained a general definition of income but merely an enumeration of items to be included or excluded. See my *Personal Deductions in the Federal Income Tax*, Princeton University Press for National Bureau of Economic Research, 1960, note 1, p. 2; also Richard Goode, *The Individual Income Tax*, Washington, D.C., 1964, p. 14.

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be treated as income so long as a taxpayer has not taken, or has not yet been able to take, all steps necessary to determine the final realization value of his asset. A capital gain is not recognized as income so long as there is no realization through sale, even though the taxpayer may be free to do so at any moment. An employer's contributions to an employee's pension fund are not considered income to the employee until he can freely dispose of it.

Thus, as a broad generalization, under the law both the availability and the value of an asset must be reasonably established for it to constitute taxable income. It should be noted that it is not the physical receipt of money, or money's worth, that constitutes realization, but merely the taxpayer's ability to command its use with certainty and without undue delay. Interest credited to a person's savings account, even though the owner has not yet claimed it and taken physical possession of it, is considered taxable income in the year earned. In this instance neither the amount nor the taxpayer's ability to dispose of the income is significantly in doubt.² This method of reckoning income is known as "constructive realization." Mostly as a consequence of the constructive-realization doctrine, employee compensation has been interpreted under the Revenue Code as consisting in the main of money wages and salaries, fees, commissions, tips, and bonuses. These must be reported whether in the form of money, merchandise, or property. But most of the supplements (or "fringe benefits") paid for by employers as part of employee compensation which have become significant since World War II are not included in reported wages and salaries. These supplements consist chiefly of employer contributions to both public and private retirement systems, employer contributions for insurance against unemployment, death and medical care expenses, stock-option benefits, meals and lodging furnished at the convenience of the employer, training and education supplied by employers, and part of the sick pay received under an employer's wage continuation plan.³

² The dividing line becomes very thin if interest credited to an individual's savings account is compared with the interest accruals on U.S. government savings bonds that are sold at a discount from their face value at maturity but may be redeemed at stated amounts before the maturity date. The taxpayer may elect to include interest on these government savings bonds in AGI annually as it accrues or when the bonds are sold (or redeemed). The apparent inconsistency in treatment must be attributed to the desire of Congress to increase the attractiveness of savings bonds to holders rather than to any fundamental difference between these interest accruals.

³ These items, and provisions of the tax law applying to them, are discussed in detail in Chapter 4.

In contrast to the statutory AGI concept, which underlies the reported amounts of employee compensation, under the accretion (or Haig-Simons) concept of income, realization is not a criterion of what constitutes income. Rather, anything that enhances an individual's spending power is viewed as income.⁴ The source of the accretion and whether or not it has been realized are of no concern under this broad definition. All that matters is that differences between individuals in their power to satisfy their wants are accurately reflected. Henry Simons' formulation is the most widely used. It equates personal income for any period to the algebraic sum of the value of an individual's consumption and the change in his net worth, or the value of what an individual could have consumed over a period of time without altering the value of his property rights.⁵ Thereby, all accretions, no matter what their source, enter into personal income: gifts, inheritances, and any kind of windfall along with factor earnings such as wages, interest, and rent.

Employee compensation, under this concept, is the money value of any consumption or accretion in net worth obtained by a person in return for the services rendered to an employer between two points of time. Administrative considerations may, of course, make strict adherence to a total accretion concept impractical, and it may serve as a normative guide rather than as a statutory definition. But, provided it is valid, a norm is indispensable in deciding how to deal with practical problems as they arise from day to day. For example, without a normative concept of income, it is difficult to deal consistently with such problems as the treatment of expenses associated with the employment of married women outside the home, employer payments to employees while the latter are absent from work because of illness, or employer contributions to employee pension funds.⁶

The broader term "labor income" has been avoided in this study in favor of that of "employee compensation" because the latter comes closer to denoting payments of all kinds by employers to employees.

⁴ The standard spending-power definitions of personal income are found in Robert M. Haig, "The Concept of Income—Economic and Legal Aspects," in Haig (ed.), *The Federal Income Tax*, New York, 1921, and in Henry C. Simons, *Personal Income Taxation*, Chicago, 1938. Most of the recent treatises on public finance use the accretion concept as their point of departure in discussing income taxation. Examples are William Vickrey, *Agenda for Progressive Taxation*, New York, 1947, pp. 6-7; Richard A. Musgrave, *The Theory of Public Finance*, New York, 1959, p. 165; and Richard Goode, *The Individual Income Tax*, p. 13.

⁵ Simons, *Personal Income Taxation*, pp. 49-50.

⁶ For a recently stated contrary view, see Boris I. Bittker, "A 'Comprehensive Tax Base' as a Goal of Income Tax Reform," *Harvard Law Review*, March 1967.

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Labor income is not necessarily restricted to compensation for work as an employee, but may be the return for efforts as a self-employed person in farming, professional practice, or business, as a housewife, and as a promoter-entrepreneur who seeks his rewards in the form of capital gains. Only the labor income arising from an employer-employee situation is dealt with here.

Although the Haig-Simons concept has been widely accepted as a guide to policy among students of the income tax, no reasonably accurate statistics of personal income based on that concept are available. The personal income estimates produced by the Commerce Department as part of its national income accounts are, aside from AGI, the closest approximation in existence for the United States. A major difference between the commerce concept and the Haig-Simons concept is the omission from the former of changes in individuals' net worth position. That is, capital gains or losses and gratuitous property transfers are not included in the Commerce estimates. For employee compensation, this difference between the Commerce and Haig-Simons concepts of personal income is not very important, since the omission of capital gains arising from stock options, while significant at very high levels of compensation, has only a minor effect on the total. Of possibly greater import is the absence from the Commerce accounts of deductions for depreciation of human capital formed by education and training of those whose wages and salaries are being measured. However, considerable human capital is formed through on-the-job training for which no "write-off" is required in the Commerce accounts because its value is not imputed to employees as it accrues.⁷

In what follows, AGI and Personal Income, with such modifications as noted, form the basis of discussion.

Taxable and Aggregate Employee Compensation

It is evident from what has been said so far that coverage of employee compensation on tax returns can be examined in two ways: the extent to which employee compensation, when measured as defined for tax purposes, is reported on tax returns, and the extent to which employee compensation is covered when the latter is defined more broadly to

⁷ This will be discussed in more detail in the third section of Chapter 4.

include items that are essentially compensation for current labor services although not treated as such in the income tax.

Table 4 shows, for the period 1929-64, (1) the total amounts of wages and salaries reported on tax returns as published annually by the Treasury Department, (2) annual Commerce Department estimates of wages and salaries, adjusted for comparability with the tax return series, and (3) a Commerce Department series of compensation of employees which includes, in addition to the amounts required to be reported on tax returns, estimates of "supplements" to wages and salaries which may be viewed as compensation but are not reported as such.⁸ In constructing the series of estimated total wages and salaries comparable to amounts reported on tax returns, the following items were assumed to be for the convenience of the employer and were therefore excluded: food furnished to government, commercial, and domestic employees, clothing issued to military personnel, and employees' lodging. In the total compensation series, these items were treated as income and included. In recent years they amounted to approximately \$2 billion. No addition was made for reimbursed moving expenses of employees who changed employers, but the amount is likely to be small (Chapter 4, note 70).

Before World War II, when personal exemptions were high in relation to most personal incomes, only about a fourth or a third of wages and salaries as defined for tax purposes was reported on tax returns. Moreover, a large part of the reported amount was on nontaxable returns (\$6.3 billion out of \$16.5 billion for 1939), and of the amount reported on taxable returns roughly one-tenth was exempt from tax because of the credit for "earned" income which was available on earnings from personal effort until 1943. Thus, only a small proportion of employees' earnings was subject to income tax until 1939, but the statistics from then on tell a different story. Between 1939 and 1943

⁸ Starting with the Commerce Department wage and salary estimates, the amounts paid in kind, estimated nontaxable military pay, and the sick-pay exclusion were subtracted, and an estimate of taxable miscellaneous other labor income was added, to obtain total wages and salaries conforming to the income tax definition shown in column 2 of Table 4. Total employee compensation in column 3 includes, in addition to the items mentioned in the preceding sentence, employer contributions to social insurance and to private pension and welfare plans, and, beginning with 1949, estimated discounts on company goods and services (Table A-2, below).

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TABLE 4

*Total Wages and Salaries Reported on Tax Returns Compared with
Total Estimated Employee Compensation, 1929-64*
(dollars in billions)

Year	Wages and Salaries		Total Employee Compensation, Including Supplements (3)	Amount Reported as Percentage of	
	Reported on Tax Returns (1)	Estimated Total (Income Tax Concept) (2)		Total in Col. 2 (4)	Total in Col. 3 (5)
1929	11.4	46.5	51.0	24.5	22.4
1930	10.2	42.0	46.7	24.3	21.8
1931	8.6	35.0	39.6	24.6	21.7
1932	8.4	26.7	31.0	31.5	27.1
1933	7.6	25.2	29.5	30.2	25.8
1934	8.7	29.6	34.2	29.4	25.4
1935	10.0	32.2	37.3	31.1	26.8
1936	11.7	37.9	42.8	30.9	27.3
1937	14.2	41.8	47.8	34.0	29.7
1938	13.3	38.5	44.9	34.5	29.6
1939	16.5	45.7	48.0	36.1	34.4
1940	27.7	49.5	52.0	56.0	53.3
1941	47.1	60.0	64.6	78.5	72.9
1942	65.6	75.9	85.1	86.4	77.0
1943	82.8	92.4	109.6	89.6	75.7
1944	91.1	98.1	121.4	92.9	75.0
1945	91.7	98.0	123.2	93.6	74.4
1946	99.2	105.1	117.9	94.4	84.1
1947	114.8	119.6	129.0	96.0	89.0
1948	125.9	132.0	141.2	95.4	89.2
1949	124.9	133.4	141.2	93.6	88.5
1950	139.1	145.2	154.8	95.8	89.9
1951	160.5	166.7	180.9	96.3	88.7
1952	174.3	180.8	195.5	96.4	89.2
1953	187.7	194.7	209.2	96.4	89.7
1954	186.0	192.9	208.2	96.4	89.3
1955	200.7	208.0	224.7	96.5	89.3
1956	215.6	224.7	243.1	96.0	88.7
1957	228.1	235.7	256.0	96.8	89.1
1958	227.6	236.7	257.8	96.2	88.3
1959	247.4	255.4	279.2	96.9	88.6

(continued)

TABLE 4 (concluded)

Year	Wages and Salaries		Total Employee Compensation, Including Supplements (3)	Amount Reported as Percentage of	
	Reported on Tax Returns (1)	Estimated Total (Income Tax Concept) (2)		Total in Col. 2 (4)	Total in Col. 3 (5)
1960	257.9	266.8	292.8	96.7	88.1
1961	266.9	273.7	301.4	97.5	88.6
1962	283.4	291.4	322.2	97.3	88.0
1963	299.4	306.3	339.4	97.7	88.2
1964	320.4 ^a	328.9	363.7	97.4	88.1

Source: Col. 1, Treasury Department, *Statistics of Income*; col. 2, estimated as shown in Table A-2, line 8; col. 3, estimated as shown in Table A-3, line 9.

^a Adjusted for comparability with earlier years by subtracting from the tabulated figure "excludable" sick pay, moving expense deductions, and employee business expense deductions.

the amount of wages and salaries reported rose from 36 to 90 per cent of the total when measured as defined by tax law. This extremely rapid rise in coverage was a result of the sharp reduction in personal exemptions which took place in several steps beginning with 1940, and the rise in incomes that occurred at about the same time. By 1947 the coverage of wages and salaries had reached a peak of 96 per cent, only a fraction of a point short of the level maintained throughout the decade of the 1950's and less than two points below that for 1964.⁹

The coverage of employee income as defined for tax purposes is thus remarkably high, especially if one considers that the unreported amount includes the wages earned by persons whose income was too small to require filing a return. For 1952, when the filing requirement was still \$600 for all persons, a rough estimate of wages and salaries unreported because earned by persons with income below that level was \$1.6 billion. For 1961, the amount below the filing level and hence

⁹ Similarly small gaps between estimated total and reported amounts are shown in Department of Commerce, Office of Business Economics, *Income Distribution in the United States*, Washington, 1953, Exhibit 4, and in Selma F. Goldsmith's pioneer study, "Appraisal of Basic Data Available for Constructing Income Size Distributions," *Studies in Income and Wealth* 13, New York, 1951.

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not reported may have been in the neighborhood of \$1.3 billion, or about one-fifth of the \$6.7-billion gap for that year.¹⁰

When viewed against the broader background of estimated total employee compensation (which includes employer contributions for social insurance, private health insurance, retirement plans, payments in kind for the convenience of the employer, and nontaxable military pay) the amounts reported have been equal to about 88 per cent of the total for the most recent decade. However, no allowance is made in this figure for the fact that some part of employer contributions to private retirement plans will be reported as retirement income at a future date. Only the roughest estimate of how much this may be is possible since the actual figure will depend on the current age distribution of future beneficiaries, the level of future incomes, and the level of personal exemptions at future dates. If one included an estimate of future pension reporting by projecting forward the current estimated reporting ratio for pensions and annuities, the percentage of total compensation reported would be raised from 88.1 to 89.6 for 1964.¹¹

Estimates of the value of compensation received in the form of stock options, expense-account allowances in excess of "ordinary and necessary" expenses, employer-furnished training and education, and reimbursed moving expenses are not included in total employee compensa-

¹⁰ A tax return must be filed by every person under 65 years old who has had gross income of \$600 or more during a year, and by every person 65 years old or over whose annual gross income was \$1,200 or more. The \$600 filing requirement has been in force since 1948; the separate \$1,200 limit for persons 65 and over was instituted in 1954. (For the 1952 estimate, see Daniel M. Holland and C. Harry Kahn, "Comparison of Personal and Taxable Income," in *Federal Tax Policy for Economic Growth and Stability*, Joint Committee on the Economic Report, Washington, 1955, p. 335.) The 1961 estimate was obtained by multiplying (a) wages and salaries reported for 1961 on returns with AGI below the filing level as given in *Statistics of Income*, by (b) the ratio of all Census frequencies with wages and salaries to Census frequencies in wage and salary groups subject to withholding for the Census group with money income below \$1,200. It is assumed that wages and salaries are reported on returns with income below the required filing level mainly because of overwithholding of tax. Frequencies of persons who had tax withheld from their wages and salaries were estimated from Bureau of the Census, *Current Population Reports, Consumer Income*, Series P-60, No. 39, 1963, Table 29.

¹¹ The projected estimate of employer contributions that will be reported as retirement income was obtained by multiplying employer contributions for 1964 (\$9,527 million, Table A-3) by 0.64, the ratio cited in Chapter 4, footnote 44. The product, \$5,517 million, was added to the \$320,413 million of reported wages and salaries for 1964. The sum of \$325,930 million divided by total compensation for 1964 resulted in the adjusted percentage of 89.6.

tions in Table 4. As pointed out earlier, estimates of total employee compensation are essentially those of the Commerce Department,¹² which excludes these items for conceptual reasons (e.g., stock options) or for lack of data (e.g., expense allowances in excess of "ordinary and necessary" expenses). For recent years, most of the difference between total employee compensation, as shown in Table 4, and the total to be reported on tax returns is accounted for by employers' contributions to social and private insurance and pension plans. The reconciliation between the estimates is given below (dollars in billions):

	1961	1963	1964
Wages and salaries, income tax concept	273.7	306.3	328.9
Plus:			
Employer contributions to			
Social security	5.7	7.5	7.9
Other retirement and welfare plans	15.6	18.5	19.7
Discounts on company goods and services and miscellaneous payments	1.1	1.3	1.5
Payments in kind	2.0	2.1	2.2
Excluded military cash pay	2.5	2.8	3.0
Sick pay exclusion	0.8	0.9	0.5
Equals:			
Total employee compensation	301.4	339.4	363.7

Note: For detail and sources, see Tables A-2 and A-3.

Some rough estimates for two of the omissions for a single recent year can be obtained. The value to employees of realized capital gains from stock options, which may be much less than the amount of accrued gain, has been estimated at \$0.4 billion (1960), and reimbursed moving expenses at \$0.2 billion (1962).¹³ No estimates are available for the possible size of expense allowances in excess of what is considered "ordinary and necessary." The value of on-the-job training and schooling, although it has been estimated with great care elsewhere,¹⁴ need not be considered a serious omission if the need for some form of amortization of investment in human capital is recognized. The omis-

¹² Our estimates exceed the Commerce estimate of total employee compensation by the amount of estimated discounts on company goods and services and miscellaneous other fringe benefits to employees from 1949 on (Table A-3).

¹³ The source for each estimate is given in Chapter 4, in the sections dealing with deferred compensation and fringe benefits, respectively.

¹⁴ See Jacob Mincer, "On-the-Job Training: Costs, Returns, and Some Implications," in *Investment in Human Beings*, New York, NBER, 1962, pp. 50-79.

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sion of its value from this estimate of total employee compensation may be viewed as an immediate "write-off."

For 1943-45 the gap between total employee compensation and the total as defined in the tax law is wider than for more recent years. The explanation for this is not a decline in wage and salary supplements but the large size of excludable military cash pay and allowances as well as military income in kind during the Second World War. Nontaxable wage and salary supplements, in the form of employers' contributions to insurance and pension plans, have steadily increased in relative size, as will be shown below (Tables 27 and A-2).

The high coverage of wages and salaries accounts as well for the high coverage ratio of income in general under the personal income tax. For recent years, over 90 per cent of total income, as defined for tax purposes, has been reported on tax returns (Table 5, compare columns 2 and 5). Table 5 makes evident how important has been the role of wages and salaries in producing so high an over-all coverage. Over 75 per cent of estimated total AGI has been received as wages and salaries. But of the total reported on tax returns, wages and salaries are an even higher proportion: 81 per cent for recent years. This merely reflects the fact that the coverage ratio for wages and salaries is higher than that for all other income. We observe from a comparison of columns 3 and 6 in Table 5 that wages and salaries constituted a smaller proportion of income on tax returns than of estimated total income until 1940, and a larger proportion of income on tax returns than of total income for every year since then.

While total reported wages and salaries in recent years account for more than four-fifths of reported AGI, this relation does not, of course, hold at all income levels. For 1964, they account for an even higher share of AGI in the broad income range \$3,000 to \$20,000 (Table 6), but for a much smaller share above that income level. For the group of returns on which AGI of \$20,000-\$50,000 was reported, wages and salaries were on average less than one-half of AGI, and on returns with AGI over \$50,000 they were on the average less than one-third.

Because wages and salaries are more concentrated at low income levels than are other major functional components of income (such as dividends, rents and royalties, capital gains), the impact of high personal and dependents' exemptions was greater on the tax-return coverage of the former than on that of the latter. As exemptions were low-

TABLE 5

Wages and Salaries in Relation to Total AGI, 1918-64
(dollars in billions)

Year	Total Reported			Estimated Total (Income Tax Concept)		
	Wages and Salaries (1)	Adjusted Gross Income (2)	Per Cent of AGI Col. 1 ÷ Col. 2 (3)	Wages and Salaries (4)	Adjusted Gross Income (5)	Per Cent of AGI Col. 4 ÷ Col. 5 (6)
1918	8.3	17.1	48.5			
1919	10.8	21.4	50.5			
1920	15.3	25.6	59.8			
1921	13.8	21.7	63.6			
1922	13.7	23.6	58.1			
1923	14.2	27.5	51.6			
1924	13.6	28.5	47.7			
1925	9.7	24.3	39.9			
1926	10.0	24.6	40.6			
1927	10.2	25.4	40.2			
1928	10.9	28.0	38.9			
1929	11.4	27.2	41.9	46.5	76.5	60.8
1930	10.2	19.6	52.0	42.0	63.1	66.6
1931	8.6	14.1	61.0	35.0	49.9	70.1
1932	8.4	12.3	68.3	26.7	38.0	70.3
1933	7.6	11.7	65.0	25.2	37.3	67.6
1934	8.7	14.1	61.7	29.6	45.0	65.8
1935	10.0	16.3	61.3	32.2	49.2	65.4
1936	11.7	21.0	55.7	37.9	58.4	64.9
1937	14.2	23.2	61.2	41.8	62.3	67.1
1938	13.3	20.7	64.3	38.5	56.3	68.4
1939	16.5	25.2	65.5	45.7	65.5	69.8
1940	27.7	39.6	69.9	49.5	70.7	70.0
1941	47.1	62.7	75.1	60.0	86.0	69.8
1942	65.6	85.1	77.1	75.9	107.9	70.3
1943	82.8	105.9	78.2	92.4	130.2	71.0
1944	91.1	116.9	77.9	98.1	138.4	70.9
1945	91.7	120.6	76.0	98.0	141.3	69.4
1946	99.2	134.8	73.6	105.1	157.9	66.6
1947	114.8	150.3	76.4	119.6	173.2	69.1

(continued)

TABLE 5 (concluded)

Year	Total Reported			Estimated Total (Income Tax Concept)		
	Wages and Salaries (1)	Adjusted Gross Income (2)	Per Cent of AGI Col. 1 ÷ Col. 2 (3)	Wages and Salaries (4)	Adjusted Gross Income (5)	Per Cent of AGI Col. 4 ÷ Col. 5 (6)
1948	125.9	164.1	76.7	132.0	187.0	70.6
1949	124.9	160.6	77.8	133.4	186.2	71.6
1950	139.1	179.9	77.3	145.2	203.3	71.4
1951	160.5	203.0	79.1	166.7	228.3	73.0
1952	174.3	216.0	80.7	180.8	242.3	74.6
1952 ^a	174.3	215.3	81.0	180.8	242.3	74.6
1953	187.7	228.7	82.1	194.7	256.9	75.8
1954	186.0	229.2	81.2	192.9	255.6	75.5
1955	200.7	248.5	80.8	208.0	275.7	75.4
1956	215.6	267.7	80.5	224.7	296.6	75.8
1957	228.1	280.3	81.4	235.7	309.4	76.2
1958	227.6	281.2	80.9	236.7	314.0	75.4
1959	247.4	305.1	81.1	255.4	336.7	75.9
1960	257.9	315.5	81.7	266.8	349.4	76.4
1961	266.9	329.9	80.9	273.7	361.7	75.7
1962	283.4	348.7	81.3	291.4	383.1	76.1
1963	299.4	368.8	81.2	306.3	403.4	75.9
1964	320.4	396.7	80.8	328.9	434.6	75.7

Source: Cols. 1 and 2, Treasury Department, *Statistics of Income*; col. 4, derived as shown in Appendix Table A-2, line 8; col. 5, derived as shown in Appendix Table A-1, line 27.

^a Fiduciaries excluded from 1952 on.

ered and incomes rose, the differential effect on the filing of returns by persons with employment income was reduced to one of minor importance. The changes that occurred in the early 1940's are brought out in Table 7. Whereas in 1939 the average of wages and salaries per employee was not even half as great as the exemption for a married couple, in 1945 it was more than twice as great.¹⁵

¹⁵ Average wages and salaries shown in Table 7 are obtained by dividing estimated dollar amounts by the annual average number of full-time and part-

The Effect of Withholding on Coverage

The sharp reduction in exemptions and the rise in level of incomes in the early 1940's were apparently the cause of the surge in the relative share of wages and salaries in income reported on tax returns to a level higher than the relative share in total income. Prior to the 1940's, as noted above, wages and salaries held a lower relative share in income on tax returns than in total income. But the early date of the rise in coverage of wages and salaries on tax returns above that of the rest of income comes as a surprise. Withholding of tax from wages and salaries at the source was introduced in 1943, and it has been assumed that this is the main cause of the higher coverage of employee than of nonemployee income.¹⁶ Yet, as can be observed in Table 4, 86 per cent of estimated total wages and salaries was reported on tax returns as early as 1942, in contrast to 36 per cent three years earlier. Most of the rise in coverage of wages and salaries appears to have occurred before withholding was enacted. From 1939 to 1942, coverage rose by fifty points. In the years after withholding it rose by eleven points.

It is uncertain whether the more recent eleven-point increase in

time employees. The annual average number of full-time and part-time employees is the average of twelve monthly figures (*Survey of Current Business*, June 1945, p. 17). It is therefore smaller than the total number of persons employed in a given year, and the averages in column 4 of the table are therefore somewhat overstated. Because of unemployment, this overstatement may have been differentially greater in 1939 than in 1945. Overstatement of the average results because the Commerce Department concept of average number of full and part-year employees does not necessarily result in two frequencies whenever two persons each work part of a year for wages. Yet there are two (potential) taxpayers and tax returns.

Actually, it is not merely income from wages and salaries but the total income of persons receiving wages and salaries that determines whether or not they are required to file a tax return. We have no statistics of total income of wage and salary earners for the years in question, but, as will be seen in Table 9, below, wages and salaries have, on average, constituted over 90 per cent of total income of these persons.

¹⁶ "There is little question that income tax withholding on wages and salaries is responsible for the relatively small amount of underreporting of this type of income." Russel C. Harrington, Commissioner of Internal Revenue, 1956-58, "Improving Income Tax Reporting," *Tax Revision Compendium*, Vol. 2, Committee on Ways and Means, 1959, p. 1464. "General tax compliance with respect to income from salaries and wages has been largely and satisfactorily achieved by a system of tax withholding." Statement on the President's Message on Taxation by Douglas Dillon, then Secretary of the Treasury, before the Committee on Ways and Means, May 3, 1961, p. 34.

28 EMPLOYEE COMPENSATION UNDER THE INCOME TAX

TABLE 6

*Reported Wages and Salaries as Percentage of AGI Reported on All Returns,
by Income Groups, Selected Years, 1939, 1949, 1959 and 1964*
(dollars in millions)

AGI (thousand dollars)	Wages and Salaries		Col. 1 ÷ Col. 2 (per cent)	Wages and Salaries		Col. 1 ÷ Col. 2 (per cent)
	(1)	AGI (2)	(3)	(1)	AGI (2)	(3)
	1939			1949		
Less than 2	\$ 4,088	\$ 4,891	83.58	\$ 17,098	\$ 20,648	82.81
2-3	4,433	5,606	79.08	26,319	30,278	86.92
3-5	4,256	5,939	71.66	47,407	53,840	88.05
5-10	1,922	3,598	53.42	24,173	30,971	78.05
10-25	1,124	2,666	42.16	6,302	13,344	47.23
25-50	394	1,186	33.22	2,136	5,764	37.06
50-100	180	679	26.51	964	3,074	31.36
100-500	89	510	17.45	460	2,145	21.45
500 and over	5	176	2.84	24	510	4.71
Total	16,491	25,251	65.31	124,883	160,574	77.77
	1959			1964		
Less than 2	\$ 11,581	\$ 13,081	88.53	\$ 11,320	\$ 12,789	88.51
2-3	14,570	17,834	81.70	12,109	15,530	77.97
3-5	49,516	56,254	88.02	40,941	48,324	84.72
5-10	121,678	134,403	90.53	148,272	164,488	90.14
10-25 ^b	40,845	56,483	72.31	86,128	103,124	83.52
25-50	5,716	14,164	40.36	16,766	34,505	48.59
50-100	2,499	7,559	33.06	3,609	10,463	34.49
100-500	921	4,230	21.77	1,199	5,707	21.01
500 and over	45	1,088	4.14	69	1,730	3.99
Total	247,371	305,096	81.08	320,413	396,660	80.78

Source: Treasury Department, *Statistics of Income*.

^a Net income class for 1939.

^b Class limits for 1964: 10-20 and 20-50.

coverage can be attributed to withholding to any significant extent. Attributing it to this cause would have merit if it were possible to show that after the introduction of withholding the coverage of wages and salaries increased more than that of other income. A comparison of employment and nonemployment income reporting for selected years

TABLE 7

*Personal Exemptions and Wages and Salaries Per Employee
and as Percentage of AGI, 1939-45 and 1964*

Year	Exemptions (dollars)			Wages and Salaries Per Employee ^b (dollars) (4)	Percentage Share of Wages and Salaries in AGI	
	Single Person (1)	Married Couple (2)	Each Dependent (3)		On Tax Returns (5)	Estimated Total (6)
1939	1,000	2,500	400	1,154	65.5	69.8
1940	800	2,000	400	1,196	69.9	70.0
1941	750	1,500	400	1,335	75.1	69.8
1942	500	1,200	350	1,594	77.1	70.3
1943 ^a	500	1,200	350	1,835	78.2	71.0
1944 ^a	500	1,000	500	1,975	77.9	70.9
1945 ^a	500	1,000	500	2,039	76.0	69.4
1964	600	1,200	600	5,052	80.8	75.7

^a In 1943, the exemptions shown were not applicable to the special Victory Tax of that year. A \$624 exemption for the taxpayer only was allowed, except that on joint returns the Victory Tax exemption of \$624 was increased by the other spouse's income up to \$624. In 1944-45, the dependents' exemptions shown were not applicable for computation of normal tax income, but only for surtax income. For normal tax only a \$500 exemption was allowed per taxpayer, except that for a joint return it was enlarged by the amount of the spouse's income up to \$500. For more detail, see Lawrence H. Seltzer, "Personal Exemptions in the Federal Income Tax," NBER, in preparation, Ch. IV.

^b Obtained by dividing estimated total wages and salaries (income tax concept), excluding Hawaii and Alaska but including nontaxable military pay (see Table A-2, lines 8 - 7 + 3), by the average number of full- and part-time employees (Commerce Department, *The National Income and Product Accounts of the United States, 1929-1965*, Table 6.3). The numerator used differs from the figures in Table 4, col. 2, because it was not possible to estimate average number of employees for Hawaii and Alaska or to separate nontaxable from taxable military employees.

is presented in Table 8. Nonemployment income reported on tax returns was 61 per cent of estimated total nonemployment income in 1942, and rose in small steps to 72 per cent in 1964—also an eleven-point rise in coverage. In view of this lack of difference in the rise of the coverage ratios of wage and nonwage income during the years between the introduction of withholding and the 1960's, it would appear that withholding

TABLE 8

*Coverage Ratio for Employment Income Compared to That for
Nonemployment Income, 1939-45, 1951, and 1960-64*

Year	Nonemployment Income			Employment Income Coverage Ratio (4)
	Reported (1)	Estimated Total (2)	Coverage Ratio Col. 1 ÷ Col. 2 (3)	
1939	8.7	19.8	.44	.36
1940	11.9	21.2	.56	.56
1941	15.6	26.0	.60	.78
1942	19.5	32.0	.61	.86
1943	23.1	37.8	.61	.90
1944	25.8	40.3	.64	.93
1945	28.9	43.3	.67	.94
1951	42.5	61.6	.69	.96
1960	57.6	82.6	.70	.97
1961	63.0	88.0	.72	.98
1962	65.3	91.7	.71	.97
1963	69.4	97.1	.71	.98
1964	76.3	105.7	.72	.97

Source: Col. 1: Table 5, col. 2 minus col. 1; col. 2: Table 5, col. 5 minus col. 4; col. 4: Table 4, col. 4.

may have played some, though not an important, part in causing the difference in coverage between wage and nonwage income.¹⁷

¹⁷ In the present case it is best to consider absolute percentage-point changes. This is to say, we are measuring the contribution of withholding toward complete coverage, which is the theoretical maximum it could have accounted for. An alternative would be to examine the relative increase in coverage, or the relative decrease in the gap, since 1942 for the two types of income. The relative increase in coverage was 13 per cent for wages and salaries, and 18 per cent for other income. But if one were to concentrate only on the relative decrease in the gap, the uncovered portion of wages and salaries is seen to decline from .14 to .03 of the total, or by 79 per cent, whereas that for nonemployment income declined from .39 to .28, or by only 28 per cent. Obviously, the difference results from the change in base with which the same absolute percentage changes were compared. The absolute percentage-point comparison is in order in the present instance because our interest is in how much of the *possible* coverage of income components was actually brought about by withholding. The possible coverage is of course 100 per cent, and we are interested in the contribution withholding has made toward this maximum. Computing the relative decrease in reporting gaps would not answer the question posed.

What explains the sharp rise in employment income coverage, which occurred independently of withholding, to a level far above that of other income sources? One possible explanation is that, as far back as 1929, payments of any kind in excess of the prevailing exemption levels were required to be reported at the source.¹⁸ From 1932 to 1939, employers were required to file an information return giving the names of, and the amounts paid to, all single persons to whom compensation of \$1,000 or more was paid during the year, and all married persons to whom compensation of \$2,500 or more was paid. As personal exemptions were lowered after 1939, so were the requirements for information returns. For 1942, any payment of \$500 or more to a single person, or of \$1,200 or more to a married person, had to be reported at the source. Since it was also the common practice for employers to notify their employees that these information returns had been filed, no taxable employee could safely seek to avoid tax by failing to report, except, possibly, those employees who divided their working time during the year among several employers and received less than \$1,200 (or \$500 if single) from any one, or each, of several employers.

The requirement of information returns by itself is, however, not sufficient to explain the higher coverage of wages and salaries than of other income. Information returns were also required, if an excess of the stated amounts was paid to any one person, for interest, rent, or any other contractual item.¹⁹ But this requirement was surely less coercive in inducing, say, interest recipients, as contrasted with wage and salary recipients, to report fully. Wages and salaries are more likely to be a major source of income,²⁰ and for most persons are received in larger amounts and from fewer payors than any of the other major sources (e.g., dividends, interest, unincorporated business and professional income). Under the conditions of the early 1940's, few would be likely to have interest income as high as \$500 from a single source, whereas wages or salary in excess of that amount from a single employer were common. Rents or royalties in excess of \$500 were probably relatively

¹⁸ I am indebted to Lawrence H. Seltzer for drawing my attention to this point.

¹⁹ Dividend payments were an exception. An information return listing any payment of \$100 or more to a stockholder was required. This may in part explain why the coverage of dividend income has been higher than that of interest income. See C. Harry Kahn, *Business and Professional Income Under the Personal Income Tax*, Princeton for NBER, 1964, Table 7.

²⁰ See the first section of Chapter 3.

more common than interest. But apparently few tenants fulfilled the requirement of filing information returns.

It is possible that even in the absence of any requirement for information returns, the coverage ratio in wages and salaries would have been higher than that for the miscellaneous other sources. For most taxpayers, wage or salary income is the primary income source, and frequently it is received from a single employer. There is less likelihood of erroneous reporting, intentional or unintentional, of a relatively large sum received in instalments at regular intervals from a single employer than of smaller amounts received from miscellaneous sources and possibly at irregular intervals.

We have thus observed two significant developments regarding the coverage of wages and salaries, both of which took place before 1943. First, the drastic lowering of exemptions and the sharp rise in incomes after 1939 triggered an increase in coverage from 36 per cent to 86 per cent in 1942. Second, by 1941 the coverage ratio for wages and salaries had risen above that for other sources, whereas before that year the relationship had been the reverse. It appears thus that reasons other than the introduction of withholding at the source, which did not come into being until 1943, account for both developments.