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: Front matter, Personal Deductions in the Federal Income Tax

Chapter Author: C. Harry Kahn

Chapter URL: http://www.nber.org/chapters/c2417

Chapter pages in book: (p. -32 - 0)

PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX

C. HARRY KAHN
RUTGERS UNIVERSITY

A STUDY BY THE
NATIONAL BUREAU OF ECONOMIC RESEARCH, NEW YORK

PUBLISHED BY
PRINCETON UNIVERSITY PRESS, PRINCETON
1960

L.C. Card 59-14898

Printed in the United States of America
by Princeton University Press, Princeton, New Jersey

2,002,177

Kahn, Charles Harry, 1921-

Personal deductions in Federal income tax. Princeton ,N. J., Princeton University Press, 1960.

xxix, 237 p. illus., tables. 24 cm. (National Bureau of Economic Research. Fiscal studies, 6)

Bibliographical footnotes.

1. Income tax—U. S.—Deductions. I. Title. (Series)

HJ4653.D4K2 336.24 59-14898

MATERIAL SUBMITTED BY PUBLISHER.

PERSONAL DEDUCTIONS
IN THE FEDERAL INCOME TAX

NATIONAL BUREAU OF ECONOMIC RESEARCH

FISCAL STUDIES

1. *Fiscal Planning for Total War*
   William Leonard Crum, John F. Fennelly, and Lawrence Howard Seltzer
2. *Taxable and Business Income*
   Dan Throop Smith and J. Keith Butters
3. *The Nature and Tax Treatment of Capital Gains and Losses*
   Lawrence H. Seltzer
4. *Federal Grants and the Business Cycle*
   James A. Maxwell
5. *The Income-Tax Burden on Stockholders*
   Daniel M. Holland
6. *Personal Deductions in the Federal Income Tax*
   C. Harry Kahn

RELATION OF THE DIRECTORS TO THE WORK AND PUBLICATIONS OF THE NATIONAL BUREAU OF ECONOMIC RESEARCH

1. The object of the National Bureau of Economic Research is to ascertain and to present to the public important economic facts and their interpretation in a scientific and impartial manner. The Board of Directors is charged with the responsibility of ensuring that the work of the National Bureau is carried on in strict conformity with this object.

2. To this end the Board of Directors shall appoint one or more Directors of Research.

3. The Director or Directors of Research shall submit to the members of the Board, or to its Executive Committee, for their formal adoption, all specific proposals concerning researches to be instituted.

4. No report shall be published until the Director or Directors of Research shall have submitted to the Board a summary drawing attention to the character of the data and their utilization in the report, the nature and treatment of the problems involved, the main conclusions, and such other information as in their opinion would serve to determine the suitability of the report for publication in accordance with the principles of the National Bureau.

5. A copy of any manuscript proposed for publication shall also be submitted to each member of the Board. For each manuscript to be so submitted a special committee shall be appointed by the President, or at his designation by the Executive Director, consisting of three Directors selected as nearly as may be one from each general division of the Board. The names of the special manuscript committee shall be stated to each Director when the summary and report described in paragraph (4) are sent to him. It shall be the duty of each member of the committee to read the manuscript. If each member of the special committee signifies his approval within thirty days, the manuscript may be published. If each member of the special committee has not signified his approval within thirty days of the transmittal of the report and manuscript, the Director of Research shall then notify each member of the Board, requesting approval or disapproval of publication, and thirty additional days shall be granted for this purpose. The manuscript shall then not be published unless at least a majority of the entire Board and a two-thirds majority of those members of the Board who shall have voted on the proposal within the time fixed for the receipt of votes on the publication proposed shall have approved.

6. No manuscript may be published, though approved by each member of the special committee, until forty-five days have elapsed from the transmittal of the summary and report. The interval is allowed for the receipt of any memorandum of dissent or reservation, together with a brief statement of his reasons, that any member may wish to express; and such memorandum of dissent or reservation shall be published with the manuscript if he so desires. Publication does not, however, imply that each member of the Board has read the manuscript, or that either members of the Board in general, or of the special committee, have passed upon its validity in every detail.

7. A copy of this resolution shall, unless otherwise determined by the Board, be printed in each copy of every National Bureau book.

(Resolution adopted October 25, 1926 and revised February 6, 1933 and February 24, 1941)

COMMITTEE ON FISCAL RESEARCH

In the planning and conduct of its fiscal studies the National Bureau benefits from the advice and guidance of its Committee on Fiscal Research. The members of the Committee are:

LAWRENCE H. SELTZER, *Chairman*

Wayne University; Research Staff, National Bureau of Economic Research

WILLIAM A. BERRIDGE, *Economist, Metropolitan Life Insurance Company*

ROY BLOUGH, *Columbia University*

WILLIAM J. CARSON, *University of Pennsylvania; Executive Director, National Bureau of Economic Research*

GERHARD COLM, *Chief Economist, National Planning Association*

W. L. CRUM

LEWIS W. DOUGLAS, *Chairman of the Board, Mutual Life Insurance Company*

L. L. ECKER-RACZ, *Fiscal Economist, U.S. Treasury Department*

SOLOMON FABRICANT, *New York University; Director of Research, National Bureau of Economic Research*

ALVIN H. HANSEN, *Graduate School of Public Administration, Harvard University*

CLARENCE HEER, *University of North Carolina*

WALTER W. HELLER, *University of Minnesota*

E. GORDON KEITH, *University of Pennsylvania*

M. SLADE KENDRICK, *Cornell University*

WALTER LICHTENSTEIN, *Vice-President (retired), First National Bank of Chicago*

WESLEY LINDOW, *Vice-President, Irving Trust Company*

GEOFFREY H. MOORE, *Associate Director of Research, National Bureau of Economic Research*

RICHARD A. MUSGRAVE, *The Johns Hopkins University*

GEORGE B. ROBERTS, *Chairman, National Bureau of Economic Research*

CARL S. SHOUP, *Columbia University*

DAN T. SMITH, *Graduate School of Business Administration, Harvard University*

JOHN H. WILLIAMS, *Nathaniel Ropes Professor Emeritus, Harvard University*

FOREWORD

QUESTIONS of taxation, government expenditures, and public debt policies, always of lively public interest, have assumed a new importance in recent years because of the great increase in the magnitudes involved. Between 1929 and 1957, government purchases of goods and services increased from 8 to 15 per cent of the gross national product, and the sum of government transfer and net interest payments rose from 2.2 to 7.9 per cent of total personal income. While the gross national product in current dollars was rising to 4⅓ times its 1940 level between that year and 1957, the aggregate annual tax revenues of the federal, state, and local governments of the United States—exclusive of social security taxes—rose to 6¾ times their 1940 level. The total of federal, state, and local government debt outstanding, exclusive of the amounts held by government agencies, accounted for 37 per cent of the aggregate volume of net public and private debt in 1957, as against 18 per cent in 1929 and 37.5 per cent in 1940.

In consequence of their new magnitudes, taxation, government expenditures, and public debt operations have become an important part of the economic climate in which individuals and business enterprises must make their decisions. This development has been so recent, and has been characterized by such frequent changes in important elements, that the accumulation of well-organized bodies of factual materials and analysis of them have lagged behind. To promote the growth of knowledge and understanding in the widening area of government fiscal operations, the National Bureau of Economic Research, with the aid of its Committee on Fiscal Research, has sponsored a number of studies in recent years. Among these are: *Fiscal-Planning for Total War*, by Crum, Fennelly, and Seltzer (1942); *Taxable and Business Income*, by Smith and Butters (1949); *The Nature and Tax Treatment of Capital Gains and Losses*, by Seltzer (1951); *Recent Developments in Dominion-Provincial Fiscal Relations in Canada*, by Maxwell (1948); *The Ownership of Tax-Exempt Securities, 1913-1953*, by Lent (1955); *Interest as a Source of Personal Income and Tax Revenue*, by Seltzer (1955); *The Income-Tax Burden on Stockholders*, by Holland (1958); and *City Expenditures in the United States*, by Brazer (1959).

Among the elements of the country's revenue structure none is more important than the federal individual income tax. It is by far the biggest single source of tax revenue in the United States. In 1957 it raised $36 billion or about 50 per cent of the net budget receipts of the national government.[1] All other tax sources of federal, state, and local governments ranked well behind: the federal corporation income tax yielded $21.5 billion, and the aggregate of state and local government taxes of all kinds about $28 billion.

The present-day importance of the personal income tax dates only from World War II. Before 1940, even under the high tax rates of World War I, the annual yield of the tax had never reached $1.5 billion. It averaged well under $1 billion in the prosperous decade of the 1920's, and fell to less than one-half that amount in several years of the 1930's. In most years before 1940, an income tax was paid by fewer than four persons in a hundred of all aged 15 or more, and by fewer than 6 per cent of all gainfully employed persons. An abrupt change accompanied American preparation for and participation in World War II. Sharp reductions in personal exemptions and steep increases in tax rates were applied to the rapidly expanding personal incomes resulting from rising output, employment, and prices. Annual collections from the tax rose from less than $1 billion in 1940 to $6.6 billion in 1943, to $18.3 in 1944, to $21 billion in 1948, to $32.5 in 1953, and, as noted, to $36 billion in 1957; and the number of taxable returns had risen to 47 million by 1957.

To raise sums of the magnitudes of those of recent years, the income tax must have wide coverage and must be levied at substantial rates. In truth, the tax now reaches the great bulk of personal incomes in at least some degree. In 1957, taxable returns accounted for about 86 per cent of the total amount of adjusted gross income estimated to have been received by all individuals in the United States. (Adjusted gross income is, roughly, net income before personal exemptions and personal deductions.) About 21 per cent of the total revenue yield was supplied by taxpayers with adjusted gross incomes under $5,000, and 60 per cent by those with adjusted gross incomes under $10,000. These revenues and the remaining 40 per cent were raised by income-bracket rates of tax on taxable income—after personal exemptions and personal deductions—ranging from a minimum of 20 per cent on the first dollar of taxable income to a maximum of 91 per cent.

The present monograph by C. Harry Kahn embodies the results of

[1] Total budget receipts less refunds and transfers to the highway and social security trust funds.

one segment of a broader study of the personal income tax being made by several scholars under the sponsorship of the National Bureau.

The point of departure of Kahn's monograph is the scope of taxable income. Although the coverage of the income tax is wide, in the sense that four-fifths of the country-wide total of adjusted gross income of individuals is reported on taxable returns, it is much narrower when judged by the proportion of total income included in what the statute now terms "taxable income"—that is, income actually subject to any of the bracket rates of tax. Taxable income in this sense, Kahn points out, embraced only $128 billion of the $273 billion of total adjusted gross income in 1955, about 47 per cent. The shrinkage of total adjusted gross income on its way to taxable income took place as follows: $43 billion did not appear on taxable returns, having been received by those whose incomes were less than the sum of their personal exemptions and their allowable personal deductions, and, assuming no estimating error, by those who failed to report or understated income; $71 billion of the amount appearing on taxable returns disappeared through personal exemptions; and $31 billion disappeared through personal deductions. In consequence, slightly more than 53 per cent of the total adjusted gross income of all individuals, and 44 per cent of the adjusted gross income of taxable individuals, was excluded from taxable income, that is, was not formally subject to any of the income-bracket rates of tax.

Since the tax rates now begin at 20 per cent of the very first bracket of taxable income, and are strongly graduated upward, elimination of any segments or types of income from the taxable category may confer substantial benefits upon some taxpayers at the expense of others. The basis for all such eliminations is properly subject to close scrutiny. Moreover, when taxable income is reduced roughly equally for all by such eliminations, Kahn asks whether the resulting higher nominal tax rates for the smaller amount of taxable income, to raise a given amount of revenue, do not have adverse effects upon incentives to work and invest, compared with a lower nominal rate structure for a larger base. For example, the disallowance of personal expense deductions would permit all bracket rates to be reduced by approximately one-fifth (the 50 per cent bracket rate could be cut to 40 per cent, and so on); or, alternatively, each bracket rate could be cut by 5 percentage points, Kahn estimates.

As Kahn recognizes, reductions in nominal tax rates brought about in this way would not have changed the aggregate tax liability of individuals nor, on the average, the effective marginal rates of tax at different income levels. Their principal effect would have been to shift a larger portion of the aggregate tax burden to those whose personal expense deductions exceeded their standard deductions. Apart from the possible advantage of reducing nominal rates without changing the actual aggregate tax burden or, on the average, the effective marginal tax rates, the desirability of reducing or eliminating the personal deductions turns on the rationale of the deductions themselves.

The personal deductions, the personal exemptions, the system of graduated tax rates, and various other provisions of the income tax law originate in the desire of Congress to take account of variations in the personal situations of the taxpayers. The formal rate structure, outside the starting rate, plays only a negligible role in determining the effective tax rates of the vast majority of taxpayers. More than three-fourths of all taxpayers are subject only to the starting rate. For them, a brisk graduation of effective rates is provided by the combination of the single starting rate, personal deductions, and personal exemptions. For significant numbers of taxpayers, the effective tax rates are also influenced importantly by other provisions of the law: exclusion from taxable income of certain kinds of retirement income, death benefits, and limited amounts of dividend income; credits against the tax otherwise payable for limited amounts of retirement income and dividends; and the special treatment of capital gains and losses. In short, the actual tax structure comprises a considerable variety of provisions besides the schedule of formal tax rates, and the nonbusiness expense deductions constitute but one type of such provisions.

Nevertheless, there is a useful sense in which the amounts of taxpayers' incomes may be considered the fundamental or presumptive basis for levying different effective tax rates; and all departures from this standard may be said, in this sense, to invite special scrutiny. It is from this point of view, implicitly, that Kahn reviews critically the conceptual basis and legislative history of each of the major personal expense deductions. He measures their quantitative importance for different income groups and in the aggregate. He devotes separate chapters, with much new material and analysis, to deductions for philanthropic contributions, nonbusiness tax payments, personal interest payments, medical expenses, and the standard deduction. His discussion and some of his findings raise the question whether a less liberal provision for personal deductions should not be considered.

However, the positive value of personal deductions and the possible advantage of expanding some of them, even if others are reduced, should not be overlooked. The "miscellaneous deductions," which Kahn does not discuss in detail, and which accounted for $2.9 billion or 14 per cent of the itemized deductions in 1956, include many negative-income or true expense items similar to the business expenses that are deductible *before* arriving at adjusted gross income. These so-called nonbusiness deductions—not allowed in arriving at adjusted gross income, and disallowed entirely if not deductible from adjusted gross income—include fees paid to accountants, investment advisers, attorneys, and custodians; professional and union dues; outlays for uniforms and tools; and other expenses incurred in the production of income. Some similar kinds of expenses are not now deductible from either gross or adjusted gross income, such as commutation fares and other transportation costs of employees in going to and from work, a considerable item for many. For the physically handicapped, they also include special expenses, as for taxicabs, incurred in order to earn a livelihood. The law now treats these as consumption outlays. While the per capita personal exemptions are regarded by some as a general allowance for all such expenses, they obviously offer no more allowance to those who actually incur them than to those who do not.

The personal deductions also allow Congress greater flexibility in determining the schedule of effective tax rates. In 1944, for example, and again in 1948, by enlarging the optional standard deduction, Congress reduced the effective tax rates on most moderate incomes without cutting the formal rates, or raising the level, or formally altering the uniformity of the per capita personal exemptions. In 1941-1943, a standard deduction, in the form of a 10 per cent reduction in tax, was available only to taxpayers with gross income from specified sources up to $3,000. In 1944 the optional standard deduction was made 10 per cent of adjusted gross income, with an upper limit of $500. In 1948 the upper limit was extended to $1,000 for married couples filing joint returns and for single persons (for married persons filing separate returns, the ceiling was kept at $500). Whereas in 1943 only 45 per cent of taxpayers chose the standard deduction, the proportion rose to 82 per cent in 1945, and approximated 80 per cent in 1948. It is not inconceivable that Congress might at some time prefer, for example, a modest tax cut in the form of an additional $100 to the standard deduction, or a transportation deduction of $100 for all employed persons rather than reducing the formal tax rates or raising the per capita exemptions.

Nevertheless, despite important grounds, equitable and other, for some of the nonbusiness deductions, all such allowances properly invite the closest scrutiny. The sums that they remove from the category of taxable income—$31 billion in the aggregate in 1955—are taken from each taxpayer's highest rate bracket. To the extent that some taxpayers are permitted the benefit of excessive allowances, the burden upon others must be increased. In this volume, Harry Kahn performs the valuable service of subjecting the whole category of the personal expense deductions, and each of its major components, to close quantitative and conceptual analysis.

LAWRENCE H. SELTZER

PREFACE

THIS monograph is intended to shed light on one aspect of our experience with personal income taxation. Personal deductions—such as those for philanthropic contributions, medical and dental expenses, personal interest payments, and nonbusiness taxes—have long been an important, though rather undefined, element of the individual income tax in the United States. They have a significant influence on the amount and the distribution of income that is ultimately subject to tax. They thus affect the distribution of tax liability among taxpayers and, by reducing the proportion of total personal income included in the tax base, they tend to raise the general level of nominal tax rates or lower the amount of income tax collected. While this is not a study of tax base definition, per se, it does constitute an attempt to throw light on one aspect of the derivation of the tax base as it has developed over past decades, and particularly as we know it today. We are indeed concerned with one facet of the relation between the income tax and its base.

The fact that without personal deductions the distribution of tax liability would be different—and either the nominal rates lower or the income tax yield higher—leads us to inquire into the nature of these deductions and the reasons for them, their place in the income tax, their size, and their relation to income and to the expense totals from which they are derived. This phase of the income tax has received little more than piecemeal attention until now. The personal allowances have never been studied as a whole, although important contributions have been made on each of the major deductions separately, both in the form of comment on their rationale and justification in principle, and in statistical information here and there.

In attempting a comprehensive picture of the personal expense allowances, we have concentrated on two approaches: (1) to assay the quantitative importance of personal deductions, both in the aggregate and for each major deduction; and (2) to explore, where possible, the reasons for enactment and the basis for continuation of the laws providing for personal expense deductions. Total personal deductions have been compared with, or studied in conjunction with, the magnitudes of such relevant figures as income, personal exemptions, the tax base, and tax liabilities. Several of the specific deductions were related to income, to the underlying expenditure aggregate, and where relevant to the specific purpose they are presumed to accomplish. In addition to annual totals for all income groups, we also present the amount of deductions claimed broken down by size of income as reported on tax returns. The tax return distribution of income and personal deductions was selected because, aside from the great difficulties involved in any attempt to transform that distribution into one of family units, it is also more relevant to problems in the income tax area. But still only a rough idea of the incidence of personal deductions by size of income can be obtained. The search for reasons leading to the introduction and continuance of personal expense deductions is important, because there is little or no recorded explanation for several of the deductions now allowed. For each of the major deductions we have briefly inquired into its relation to the concepts underlying an income tax, its relation to the other deductions, and the form it was given.

The two objectives were, of course, not treated apart from each other, and they are discussed separately only in the first three chapters. Chapter 1 deals solely with the nature and origin of the personal deductions, and sets the stage for Chapter 2, where the reader is given a picture of the quantitative development of personal deductions in the aggregate, and of the significance of the aggregates vis-à-vis other income tax magnitudes. Chapter 3 presents a brief survey of changes in the composition of the aggregate by types of deductions, and a breakdown by size of income reported. Each of the major types of deductions—philanthropic contributions, taxes paid, interest paid, medical expenses, and casualty losses of personal property—and the standard deduction, are dealt with separately in Chapters 4 to 8.

By far the major source of the data presented below, unless otherwise noted, is *Statistics of Income,* Part I, containing the annual tabulations by the Internal Revenue Service. As used in this study the figures are characterized by three limitations: 1) Although based on very large samples in most instances, they are nevertheless liable to some sampling error; this should be borne in mind when comparisons are made between *Statistics of Income* totals and other estimates, such as those of the Department of Commerce. 2) All figures, within the above qualification, constitute summations of those reported on tax returns, that is, they are pre-audit figures and therefore subject to such revisions as the reporting units or the revenue authorities later decide to make. 3) Because the *Statistics of Income* figures are transcribed from samples of tax returns, some discontinuities in historical series have resulted from changes in the tax law. Whenever feasible, we attempted to correct such discontinuities through estimates of our own.

I am indebted to many for advice, useful criticism, and aid in preparing the data. My gratitude is especially great to Lawrence H. Seltzer who first proposed this study to me, and from whose incisive comments and suggestions both this document and its author have benefited.

A number of persons reviewed the manuscript. Gerhard Bry and Thor Hultgren, members of the staff reading committee, made trenchant comments, most of which were in one form or another gratefully incorporated. Many helpful suggestions were received from V. W. Bladen, Martin Bronfenbrenner, Melvin G. de Chazeau, James S. Earley, Laszlo L. Ecker-Racz, Solomon Fabricant, Harold M. Groves, Daniel M. Holland, M. Slade Kendrick, Harry W. Laidler, Joseph A. Pechman, and Melvin I. White.

At all times I benefited from the prompt and courteous cooperation of government agencies, especially the Statistics Division of the Internal Revenue Service, whose annual compilations of data, as already pointed out above, constitute the major statistical source used in the study; the Treasury Department's Tax Advisory Staff of the Secretary (later Tax Division of the Analysis Staff); and the Commerce Department's National Income Division.

I received valuable material aid on particular aspects of the study from F. Emerson Andrews, then with the Russell Sage Foundation; Herbert E. Klarman, of the Hospital Council of Greater New York; Robert Lampman, of the University of Wisconsin; Morris Mendelson, of the National Bureau; Joseph A. Pechman, of the Committee for Economic Development; and Carl S. Shoup, of Columbia University. To Margaret T. Edgar, who expertly edited this final version and made valuable suggestions, I owe a particular debt of gratitude. A substantial part of the computations were performed by Sarah F. Cutter, Arnold Oliphant, Kathryn S. Marin, and Lola Stark. The charts are the skillful work of H. Irving Forman. Hannah W. Kahn read the manuscript and made many comments in the dual capacity of a student of public finance and a patient wife.

While I have hoped to thank all those who have aided me, it goes almost without saying that they do not necessarily approve of the contents of the book or share any responsibility for errors that remain.

CONTENTS

APPENDIXES

TABLES

APPENDIX TABLES

CHARTS