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IS THE MAXIMUM TAX ON EARNED
INCOME EFFECTIVE?

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ABSTRACT

The Tax Reform Act of 1969 included a provision intended to set at 50 percent the tax rate on all personal service income above the 50 percent bracket amount. The current law fails to meet this objective for the vast majority of these taxpayers. This paper explains why the current law is ineffective, simulates our current experience with the law using the National Bureau of Economic Research TAXSIM model, and considers options to the present law.

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1. Introduction

The Tax Reform Act of 1969 included a provision intended to set at 50 percent the tax rate on all personal service income above the 50 percent bracket amount. In general, the reform has failed to meet this objective for two reasons. First, the method of computing the tax rate on earned income is inappropriate. The maximum tax provision involves a method of "stacking" earned and unearned income which underestimates the tax reduction needed to lower the tax rate to 50 percent on all earned income. Second, only a fraction of each additional dollar of earned income is entitled to the lower tax rate accorded earned income. Under existing law, a portion of earned income is taxed at the rates applied to unearned income.

This paper considers each problem in turn. Section 1 examines the implications of the current Maximum Tax provisions with emphasis on the reasons why the maximum rate on personal service income is not 50 percent. Section 2 describes our experience with the present law using NBER's TAXSIM model and the 1977 Individual Tax Model File provided by the Department of the Treasury. Section 3 simulates the effects of alternative Maximum Tax rules.

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1. Implications of the Current Maximum Tax Provision

The current Maximum Tax law, enacted as a part of the Tax Reform Act of 1969, provides a tax reduction for taxpayers with substantial earned income. Equity, efficiency, and revenue cost are all considerations which played a part in the enactment of the statute. Before its enactment it was thought that earned income was inequitably taxed at the higher brackets of the tax schedule. Moreover, work incentives may be reduced by the high tax rates, although a countervailing income effect also exists. Thus, the efficiency of the tax structure could be reduced. High bracket taxpayers have an incentive to shelter their income thus reducing tax revenues. To the extent that sheltering is reduced when marginal tax rates are reduced, the revenue cost the Maximum Tax law is lowered.¹

This paper notes that although the Maximum Tax law did reduce tax liabilities for some high income taxpayers, it has not been effective at reducing the maximum marginal tax rate to 50 percent. Although the income effects have largely been achieved, the price effects have not.

Figure 1 illustrates the effect of the Maximum Tax provision on a hypothetical taxpayer. Without the Maximum Tax, the taxpayer would pay the amount specified by the tax schedule on his or her total taxable income - areas X, Y, and Z. The maximum tax rules reduce the taxpayer's liability by area Y. This represents the difference between what the taxpayer would have paid on his or her earned taxable income (areas X and Y) and what he or she would pay on earned

¹ Sunley (1974) concludes that the reduction in sheltering from the Maximum Tax provision has not been substantial.

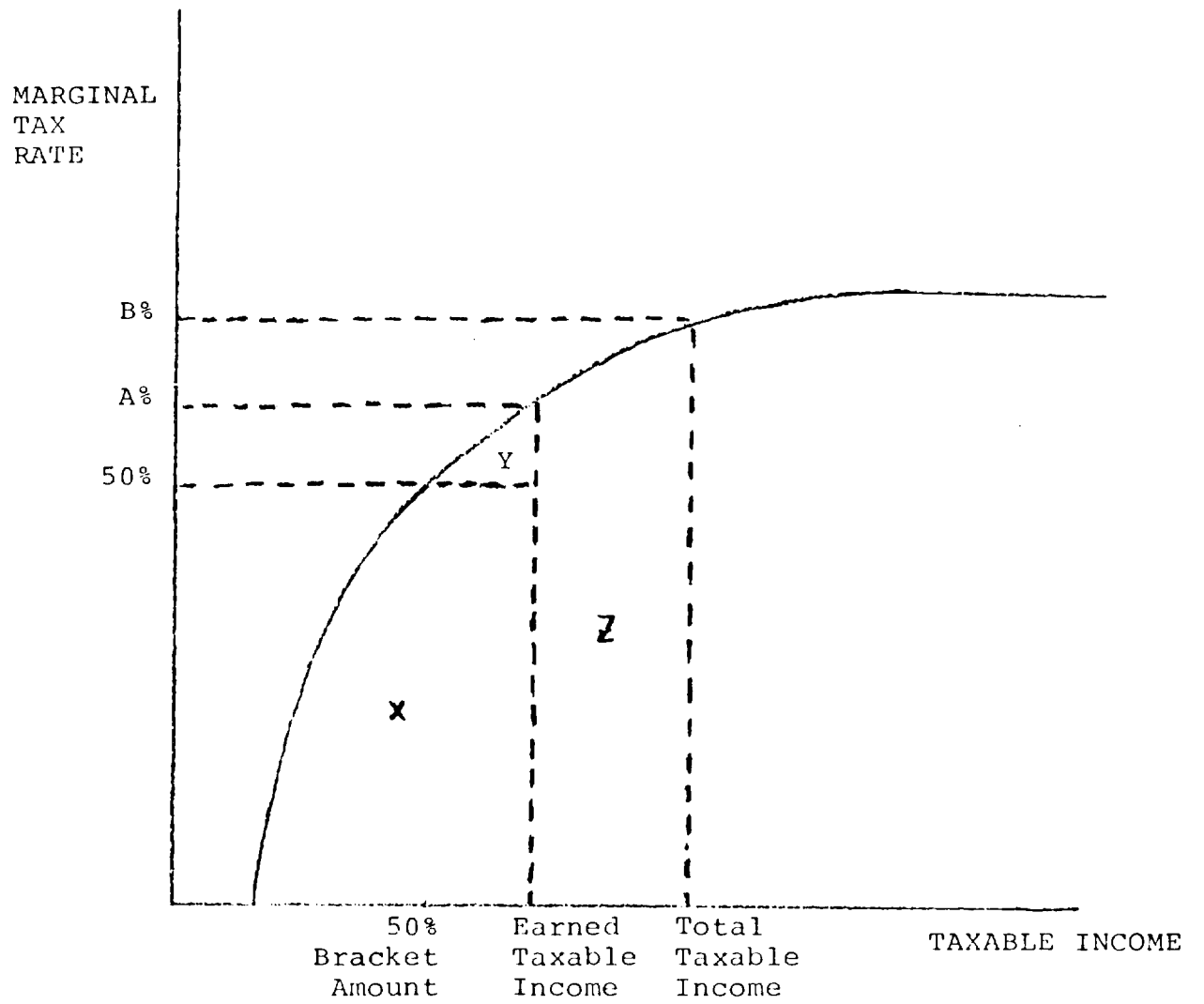
taxable income if the top tax rate were 50 percent (area X).

The effect on marginal tax rates is also illustrated by Figure 1. Before the Maximum Tax was enacted, a taxpayer with earned income above the 50 percent bracket amount paid a marginal tax rate of A percent. Under the maximum tax provision, a taxpayer with no unearned income receives a tax rate reduction of (A-50) percent.

However, a taxpayer with no unearned income in this income class is truly rare. Figure 1 shows a taxpayer whose total income exceeds his earned income. For such taxpayers, the marginal rate on earned income is generally in excess of 50 percent. Consider how much this taxpayer's liability increases if he earns an additional dollar of income. In the absence of the Maximum Tax provision his tax liability on that dollar would have been B cents. As already noted, this provision reduces his tax rate on earned income (A-50) percent. Hence, the taxpayer's additional tax liability or marginal tax rate on earned income is (B-A+50) percent. Only in the special case where B percent equals A percent will the marginal tax rate on earned income be 50 percent.

Two comparatively small classes of taxpayers meet this criterion. First, taxpayers with small amounts of unearned income may have the tax rate on their total income, B percent, equal to the tax rate on their earned income, A percent. In other words, such taxpayers have sufficiently little unearned income to cause a change in tax brackets. Second, taxpayers with very large earned incomes who are in the highest tax rate bracket (regardless of other income) can have any amount of unearned income and not have a change in bracket. In the context of the diagram, both A percent and B percent would be equal to

FIGURE 1



the maximum statutory rate and the marginal tax rate on earned income, $(B-A+50)$ percent, would be reduced to 50 percent.

The Personal Income Tax file compiled by the Department of the Treasury indicates that only one taxpayer in seven with a marginal tax rate of 50 percent or greater fits into one of these two classes. The remaining taxpayers, numbering roughly 1,850,000 in 1980, had marginal tax rates on earned income in excess of fifty percent. This paper measures the extent of failure of the maximum tax provisions and considers the effectiveness of alternative types of regulations at reducing the marginal tax rate on earned income to 50 percent.

1.1 The Stacking Rule

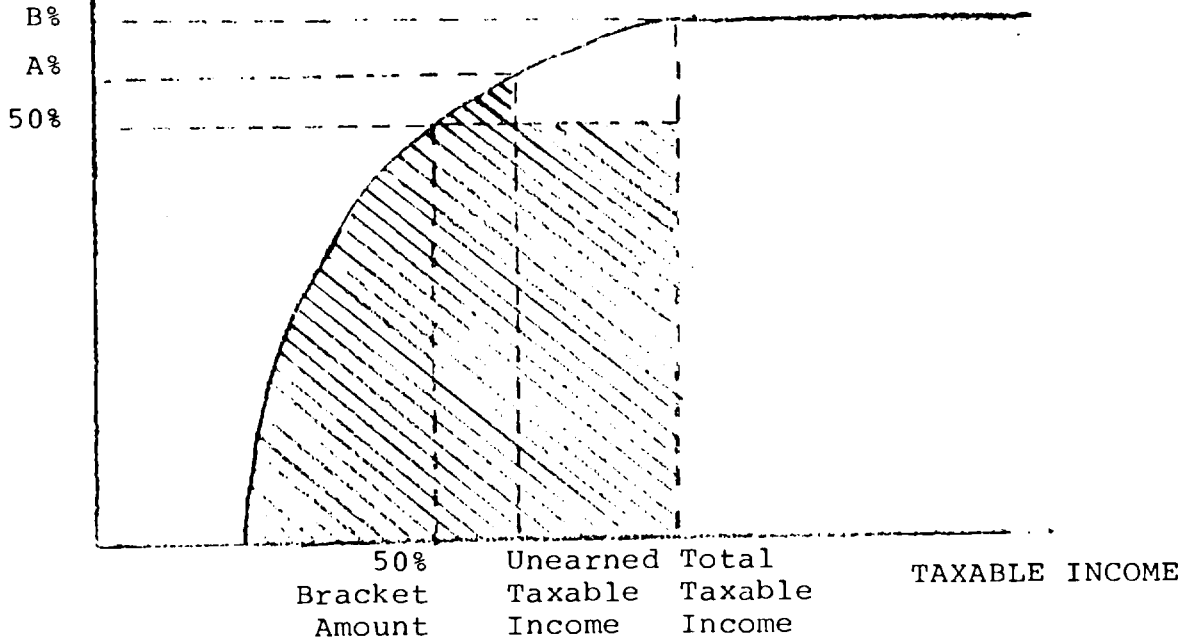
The reason for the failure of the existing maximum tax provisions to produce a 50 percent maximum rate is that such a ceiling is incompatible with taxation of unearned income at rates based on total income received. As Figure 1 illustrates, the tax rate on additional unearned income equals the tax rate on total income (B percent). However, as this discussion has indicated, the tax rate on total income determines the tax rate on earned income, $(B-A+50)$ percent. The tax rate on earned income is therefore not independent of the amount of total income received. In order to achieve this independence, and assure a maximum tax rate of 50 percent on earned income, the tax rate on unearned income must also be independent of the amount of total income received.

The problem of independence of rate is a result of the "stacking" of unearned income on top of earned income. Note in Figure 1 that earned income is measured from the origin to the amount labelled "Earned Taxable Income" and unearned income is represented as an amount over and above, or "stacked on top of" earned income.

Consider an alternative stacking order represented in Figures 2 and 3. In these cases, unearned income is stacked first, with earned income on top. These diagrams illustrate a set of tax provisions which would assure a maximum rate on earned income of 50 percent. In Diagram II, unearned income exceeds the 50 percent bracket amount. The tax liability, represented by the shaded area, would be computed by applying the statutory rate schedule to unearned income and adding 50 percent of earned income. Diagram III illustrates the tax liability of a taxpayer with unearned income less than the 50 percent bracket amount. In this case, the statutory rates apply with the exception of an upper limit of 50 percent. Under this arrangement the tax rate on both earned and unearned income is independent of the total amount of income received. Note that although this alternative stacking arrangement sets a ceiling of 50 percent on the tax rate applicable to earned income, it also substantially reduces the tax rate on unearned income.

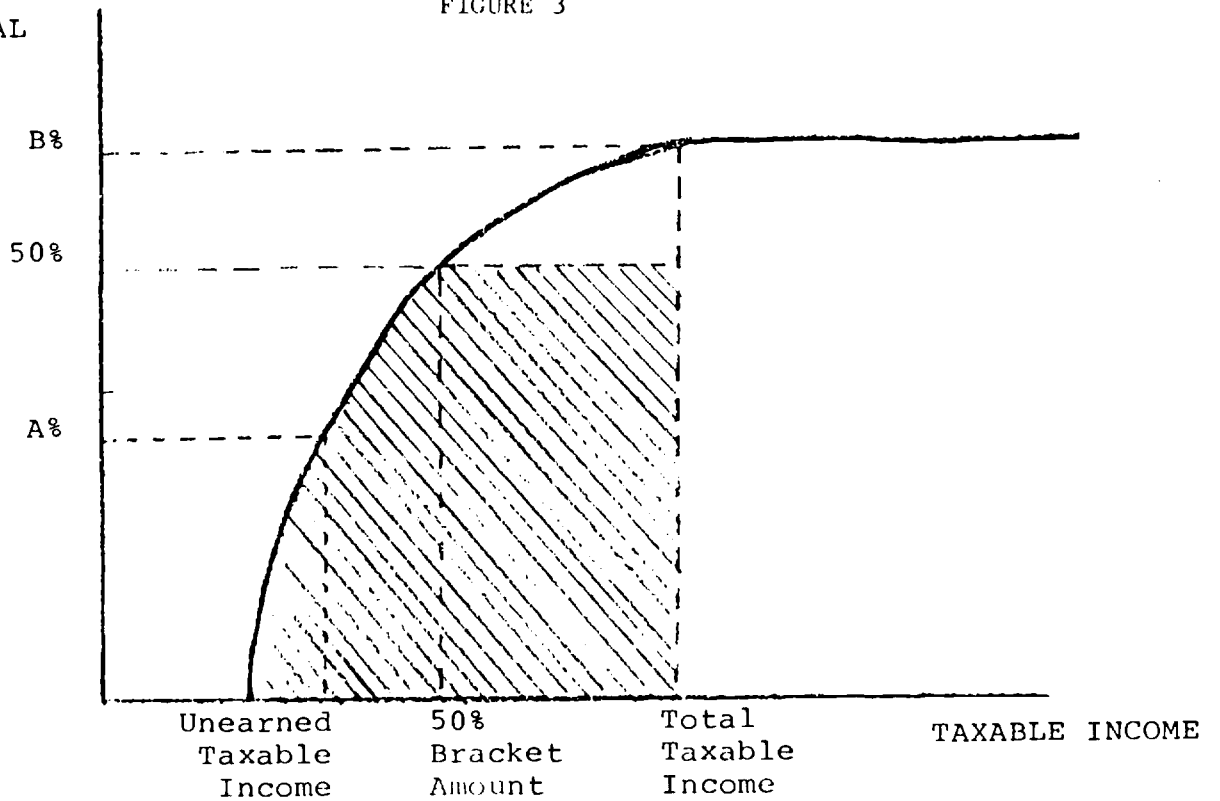
MARGINAL
TAX
RATE

FIGURE 2



MARGINAL
TAX
RATE

FIGURE 3



1.2 Allocation of Deductions and Exemptions

The second reason the maximum tax provision currently fails to set a 50 percent limit on the tax rate on earned income is that under existing law only a portion of an additional dollar of earned income is treated as "earned" and receives the favorable treatment accorded earned income. The rest will be taxed at rates applicable to unearned income. If we define, "F" as the percent of each additional dollar of earned income treated as earned income for tax purposes, the marginal tax rate on earned income becomes:

$$F (B-A+50) \text{ percent} + (1-F) B \text{ percent.}$$

It should be clear that the tax rate is generally in excess of 50 percent as $B > A > 50$.

As any taxpayer who has filled out his own Form 1040 knows, one is not taxed on one's total income, but on total income less itemized deductions or the standard deduction and the personal exemption. Similarly, the maximum tax is computed not on total earned income or Personal Service Income but on Earned Taxable Income. The tax law specify the computation of Earned Taxable Income (ETI) as:

$$(1) \quad \text{ETI} = \frac{\text{PSINC}^*}{\text{AGI}} \times \text{TAXINC} - \text{PREF}$$

The terms in the above equation are defined as follows:

ETI Earned Taxable Income is earned income on which taxes are paid.

PSINC Personal Service Income is earned income which includes wages, salaries, and other employee compensation related to the supply of laborless deductions attributed to such income.

*The ratio PSINC/AGI has a maximum value of unity. substantial adjustments to income might have Personal Service Income in excess of Adjusted Gross Income.

- AGI Adjusted Gross Income is total income, earned and unearned, adjusted for the costs of incurring that income.
- TAXINC Taxable Income is AGI less deductions and exemptions.
- PREF Preference Income is tax deductions which Congress has deemed worthy of special treatment.

An anomaly exists because an additional dollar of earned income is not necessarily an additional dollar of earned taxable income. It can be shown¹ using Equation 1 that an additional dollar of Personal Service Income will raise Earned Taxable Income by the fraction:²

$$(2) \quad \frac{TAXINC}{AGI} + \frac{PSINC}{AGI} - \frac{TAXINC}{AGI} \times \frac{PSINC}{AGI}$$

Equation 2 represents "F," the fraction of each additional dollar of earned income treated as earned income for tax purposes. This fraction will be less than one if both Personal Service Income and Taxable Income are less than Adjusted Gross Income. The sum of two fractions less than one minus their product is less than one.

Taxable Income is necessarily less than Adjusted Gross Income as the taxpayer is entitled to deductions and exemptions. Personal Service Income is less than Adjusted Gross Income if the taxpayer receives a positive amount of

¹ Using the chain rule:
$$\frac{dETI}{dPSINC} = \frac{AGI(PSINC + TAXINC) - PSINC \times TAXINC}{AGI^2}$$

² Taxpayers with $AGI > PSINC$ form a special case. For these taxpayers an additional dollar of $PSINC$ raises ETI by one dollar.

unearned income, usually the case in this income class. As a result, only a fraction of each additional dollar of earned income is treated as earned.

The reasoning behind this computation is to allocate a taxpayer's deductions among earned and unearned sources of income. The fraction of each dollar treated as earned income depends upon the share of earned income in total income. This seems a reasonable approach, as tax deductible expenditures are made out of both earned and unearned income. But this technique tends to raise the effective tax rate on earned income about 50 percent.

A further implication of this method of computation is that investment income can benefit from the maximum tax provision although it was intended to apply only to earned income. Part of each additional dollar of unearned income is taxed at the lower rate applicable to earned income. If we define "G" as the fraction of each dollar of unearned income treated as earned income for tax purposes, the tax rate on unearned income is reduced by the maximum tax provision from B percent to:

$$G(B - A + 50) \text{ percent} + (1 - G)B \text{ percent.}$$

G can be computed from the tax provisions as:

$$G = \frac{PSINC \times (AGI - TAXINC)}{AGI^2}$$

The tax relief accorded unearned income by the maximum tax provision rises with the share of earned income in total income and the share of deductions in total income. However sensible the rationale for allocating deductions may be, its effect is to lower the tax rate on unearned income and to violate the 50 percent ceiling on the tax rate on earned income.

2. Experience With the Existing Maximum Tax Rule

The preceding section described mathematically why the maximum tax provision is ineffective at achieving its objective. In this section, I use NBER's TAXSIM model, based on the Individual Tax Model File for 1977 provided by the U.S. Department of the Treasury. The data has been updated to 1980 for use in this paper.¹ The calculations suggest that, for the overwhelming majority of high income taxpayers, the maximum tax provision does not reduce the marginal tax rate on earned income to 50 percent.

Table 1 shows that of the 2,150,000 taxpayers whose marginal tax rates would have been 50 percent or higher, only 7.5 percent have their marginal tax rate reduced to 50 percent or less as a result of the maximum tax provision. The current law does not even come close to meeting its maximum rate objective. 36 percent of these taxpayers have marginal tax rates on earned income above 52 percent. Of the 64 percent with rates under 52 percent, 38 percent had tax rates under 52 percent without the maximum tax. In other words, of the 1,355,000 taxpayers who would have had marginal tax rates over 52 percent, only 41 percent have these rates reduced to under 52 percent by the maximum tax provision.

Table 2 shows that a majority of the 2,150,000 taxpayers with tax rates over 50 percent receive no tax reduction at all as a result of the maximum tax

¹ The Individual Tax Model File is a stratified sample of actual tax returns filed for 1977. It contains roughly 100,000 taxpayers, including all taxpayers with incomes in excess of \$200,000. The TAXSIM program calculates a 1980 tax file by inflating the 1977 data to account for changes in population and income. TAXSIM revenue estimates were within 3 percent of current Treasury revenue estimates for 1980.

provision. To be eligible for the Maximum Tax provision, taxpayers must have earned taxable income at least equal to the 50 percent bracket amount. Taxpayers also lose eligibility if they income average or are married and file separate returns.

Table 3 illustrates how high income taxpayers might be ineligible for the maximum tax provision, either because a large portion of their income is measured or because larger deductions reduce their Earned Taxable Income below the threshold.

Table 4 shows that even among taxpayers benefitting from the maximum tax provision, more than three-fourths do not have their marginal tax rates reduced to 50 percent. In fact, 21 percent of taxpayers eligible for the maximum tax have marginal tax rates on earned income above 54 percent. The maximum tax provision is, therefore, far from achieving a maximum rate of 50 percent on earned income. Only one taxpayer in three with a marginal tax rate of 50 percent or more is eligible for the maximum tax provision, and only one taxpayer in twelve has his marginal tax rate reduced to 50 percent as a result of the maximum tax provision.

In addition to being ineffective at achieving a maximum marginal tax rate of 50 percent, the existing maximum tax provision creates the anomaly of lowering marginal tax rates as income rises. This anomaly applies to both earned and unearned income. Table 5 shows the effect on marginal tax rates of higher earned income, holding unearned income constant. The marginal tax rate on earned income declines monotonically from 70 percent to 50.2 percent as earned income increases. Even more surprising, the tax rate on unearned income also

declines monotonically from 70 percent to 66.2 percent as earned income increases. The maximum tax provision which was intended to reduce marginal tax rates on earned income has the effect of reducing tax rates on unearned income as well.

TABLE 1

DISTRIBUTION OF MARGINAL TAX RATES
WITH AND WITHOUT
THE MAXIMUM TAX PROVISION

Rate (%) Without Max Tax	Number of Taxpayers	Distribution of Marginal Tax Rates (%) Under Maximum Tax Law		Distribution of Marginal Tax Rates (%) Under Maximum Tax Law								
		under 50	exactly 50	50-51	51-52	52-54	54-56	56-60	60-65	65-70	over 70	
50-51	787,837			100%								
51-52	29,704				100%							
52-54	302,961		28%	21%		51%						
54-56	362,255		2%	1%	41%		56%					
56-60	184,034	1%	11%	10%	5%	1%	12%	60%				
60-65	269,537	2%	8%	10%	24%		6%	10%	40%			
65-70	120,791	2%	4%	5%	26%	1%	10%	12%	5%	35%		
over 70	94,438	2%	5%	11%	21%	9%	6%	10%	4%	4%	28%	
TOTAL	2,151,561	0.5%	7%	42.5%	14%	8%	12%	7%	6%	2%	1%	

Rates over 70 percent might be generated by the floors placed on drugs and medical expenses. Additional income raises the floor thereby lowering the amount deductible. Rates under 50 percent on earned income might be generated by ceilings such as those on deductible contributions.

TABLE 2

DISTRIBUTION OF TAXPAYERS BENEFITTING FROM MAX TAX

<u>Adjusted Gross Income</u>	<u>Number of Taxpayers</u>	<u>Number Using Max Tax</u>	<u>% Using Max Tax</u>
under 50,000	155,400	0	0
50,000 - 100,000	1,440,200	329,700	22.9%
100,000 - 200,000	450,900	290,900	64.5%
200,000 - 500,000	93,500	66,800	71.4%
500,000 - 1,000,000	8,900	5,100	57.3%
over 1,000,000	2,600	1,130	43.5%
	2,151,500	693,600	32.2%

TABLE 3
EXAMPLES OF TAXPAYERS INELIGIBLE
FOR THE MAXIMUM TAX PROVISION

<u>Tax Rate</u> on <u>Earned</u> <u>Income</u>	<u>Earned</u> <u>Income</u>	<u>Unearned</u> <u>Income</u>	<u>Total</u> <u>Income</u>	<u>Deductions</u>	<u>Taxable</u> <u>Income</u>	<u>Earned</u> <u>Taxable</u> <u>Income</u>
54%	40,000	100,000	140	28,000	110,000	32,000
64%	80,000	80,000	160	50,000	110,000	55,000
64%	100,000	500,000	600	250,000	350,000	58,333
70%	100,000	20,000	120	50,000	70,000	58,333

TABLE 4

DISTRIBUTION OF MARGINAL TAX RATES
OF TAXPAYERS USING MAXIMUM TAX

Rate (%) Without Max Tax	Number of Taxpayers	Distribution of Marginal Tax Rates Under Maximum Tax Law		Distribution of Marginal Tax Rates Under Maximum Tax Law									
		under 50	exactly 50	50-51	51-52	52-54	54-56	56-60	60-65	65-70	over 70		
50-51	0												
51-52	108	100%											
52-54	146,375		57%	43%									
54-56	157,684		5%	1%	94%								
56-60	75,201	3%	28%	25%	11%	2%	31%						
60-65	169,654	3%	12%	16%	38%	1%	9%	16%	5%				
65-70	77,327	3%	6%	8%	40%	1%	15%	19%	8%				
over 70	67,784	3%	8%	15%	30%	13%	8%	13%	5%	5%			
TOTAL	694,134	2%	21%	18%	39%	2%	8%	7%	3%	>1%			

TABLE 5

HIGHER EARNED INCOME WITH UNEARNED INCOME UNCHANGED
LOWERS MARGINAL TAX RATES

<u>Earned Income</u>	<u>Unearned Income</u>	<u>(000) Deductions*</u>	<u>(000) TAXINC</u>	<u>TAX RATE No Max Tax</u>	<u>TAX RATE EARNED INCOME</u>	<u>TAX RATE UNEARNED INCOME</u>
60,000	1,000,000	212	848	70.0%	70.0%	70.0%
75,000	1,000,000	215	860	70.0%	66.7%	70.0%
110,000	1,000,000	222	888	70.0%	62.6%	69.9%
140,000	1,000,000	228	912	70.0%	58.5%	69.7%
210,000	1,000,000	242	968	70.0%	55.0%	69.4%
270,000	1,000,000	254	1,016	70.0%	53.1%	69.1%
500,000	1,000,000	300	1,700	70.0%	52.7%	68.7%
1,000,000	1,000,000	400	1,600	70.0%	52.0%	68.0%
2,000,000	1,000,000	600	2,400	70.0%	51.3%	67.3%
5,000,000	1,000,000	1,200	4,800	70.0%	50.7%	66.7%
10,000,000	1,000,000	2,200	8,800	70.0%	50.4%	66.4%
20,000,000	1,000,000	4,200	16,800	70.0%	50.2%	66.2%

*It is assumed in all examples that the hypothetical taxpayer deducts 20% of his AGI.

TABLE 6
MARGINAL TAX RATES FALL AS BOTH EARNED AND UNEARNED INCOME RISE

<u>Earned Income</u>	<u>Unearned Income</u>	<u>Deductions*</u>	<u>TAXINC</u>	<u>TAX RATE</u>		<u>TAX RATE</u>	
				<u>No Max Tax</u>	<u>EARNED INCOME</u>	<u>UNEARNED INCOME</u>	<u>UNEARNED INCOME</u>
62,500	62,500	25,000	100,000	59.0%	59.0%	59.0%	59.0%
75,000	75,000	30,000	120,000	64.0%	60.4%	63.6%	63.6%
112,500	112,500	45,000	180,000	68.0%	59.9%	67.1%	67.1%
150,000	150,000	60,000	240,000	70.0%	57.4%	68.6%	68.6%
225,000	225,000	90,000	360,000	70.0%	53.8%	68.2%	68.2%
300,000	300,000	120,000	480,000	70.0%	52.0%	68.0%	68.0%

*It is assumed in all examples that the hypothetical taxpayer deducts 20% of his AGI.

This anomaly holds even if the share of earned income in total income does not change. Table 6 shows a set of taxpayers who derive income equally from earned and unearned sources. Note that the tax rate reduction increases monotonically with income. In the case of earned income, the tax rate reduction due to the maximum tax overwhelms the increasing tax rates of the tax table and lowers the tax rate as income increases. Note that all of these hypothetical taxpayers have marginal tax rates greater than 50 percent.

3. Alternative Maximum Tax Rules

As already noted, two problems keep the marginal tax rate on earned income above 50 percent. First, the stacking order makes the marginal tax rate on earned income dependent on total income received. Second, additional earned income is not fully treated as earned for tax purposes. Alternative maximum tax provisions must remedy both problems in order to be successful at reducing marginal rates on earned income to 50 percent.

The first problem is remedied by adopting the stacking order shown in Figures 2 and 3. By stacking earned income on top of unearned income, tax rates on both sources are independent of total income received above the 50 percent tax bracket.

The second problem involves allocation of a taxpayer's deductions among earned and unearned sources of income. The current method allocates deductions according to the share of income from each source in total income. However, as already shown, this will mean that a portion of any increment to earned income will be taxed as if it were unearned. Only two possible alternatives avoid this problem. The first is to allocate all deductions to unearned income, then to earned income. The second is to allocate deductions to earned income, then to unearned income. As earned income is taxed at a more favorable rate than unearned income, the second alternative will reduce marginal tax rates on earned income to 50 percent with less reduction in tax revenue. This method of computing taxes implicitly places a tax on deductions at a rate equal to the difference between the rate on unearned income and 50 percent.

I have used the TAXSIM model to simulate both alternative tax rules paying particular attention to the distribution of marginal tax rates on earned income and the resulting loss of tax revenue. Tables 7 and 8 show the results of these simulations for 1980.

I also use the TAXSIM model to simulate the effects of eliminating all tax brackets above 50 percent. This alternative would reduce the tax rate on both earned and unearned income. Tables 7 and 8 compare this change with the status quo and the alternative proposed above.

Table 7 shows that even establishing a top tax rate of 50 percent will not mean that no one has a marginal tax rate above 50 percent. Many provisions of the tax code restrict deductibility of certain expenses to a certain percent of income. As additional income may constrain the use of deductions, the effective tax rate on earned income may well exceed the top statutory tax rate.

Table 7 is limited to the roughly 2,150,000 taxpayers simulated to potentially have rates above 50 percent. Without the current maximum tax provision, 62 percent of these taxpayers would have marginal tax rates over 52 percent. Under current regulations, 36 percent of these taxpayers have marginal tax rates on earned income above 52 percent. The option described in this paper reduces to 9 percent the proportion of this group with tax rates above 52 percent. These simulations also suggest that under current law fewer than one taxpayer in three among this group elects to take the maximum tax. This figure rises to 54 percent under the option described.

On the other hand, allocating all deductions to unearned income lowers the cost of making these deductions relative to current law. Under this option all

deductions would reduce tax liability at the higher rate applicable to unearned income. Currently a portion of the deductions reduce taxes at the lower rate applied to earned income, the remainder at the higher unearned rate. This option increases the benefits at the upper end of the income scale where unearned income is more concentrated.

TABLE 7

DISTRIBUTION OF MARGINAL TAX RATES ON EARNED INCOME

	<u>NO MAXIMUM TAX</u>	<u>CURRENT LAW</u>	<u>APPLY DEDUCTIONS TO EARNED INCOME</u>	<u>APPLY DEDUCTIONS TO UNEARNED INCOME</u>	<u>50% TOP BRACKET</u>
under 50	0	1%	1%	4%	5%
exactly 50	0	7%	25%	26%	27%
50-51	37%	43%	37%	37%	37%
51-52	1%	14%	28%	29%	31%
52-54	14%	8%	1%	0%	0
54-56	17%	12%	2%	1%	0
56-60	9%	7%	3%	2%	0
60-65	12%	5%	2%	1%	0
65-70	6%	2%	1%	0%	0
over 70	4%	1%	1%	0%	0

NOTE: The above percentages are based on a total of 2,151,561 taxpayers simulated to have a tax rate above 50 percent.

TABLE 8

DISTRIBUTION OF TAX BENEFITS

Number of Taxpayers Benefitting

<u>AGI (000)</u>	<u>CURRENT LAW COMPARED TO NO MAX TAX</u>	<u>APPLY DEDUCTIONS TO EARNED INCOME</u>	<u>APPLY DEDUC- TIONS TO UNEARNED INCOME</u>	<u>50% MAXIMUM BRACKET COMPARED WITH CURRENT LAW</u>
30-50	0	11,000	16,000	50,000
50-100	330,000	677,000	632,000	630,000
100-200	292,000	390,000	379,000	382,000
200-500	67,000	72,000	84,000	86,000
500-1,000	5,250	5,100	8,600	9,000
over 1,000	1,200	1,000	2,600	2,800
TOTAL	695,450	1,156,100	1,122,200	1,159,800

Savings Per Taxpayer

<u>AGI (000)</u>	<u>CURRENT LAW COMPARED TO NO MAX TAX</u>	<u>ALTERNATIVE RULE COMPARED WITH CURRENT LAW</u>		<u>50% MAXIMUM BRACKET COMPARED WITH CURRENT LAW</u>
30-50	0	1,270	1,040	170
50-100	640	320	510	420
100-200	3,160	1,410	2,010	2,720
200-500	15,600	6,400	8,900	14,200
500-1,000	49,600	10,700	21,300	57,400
over 1,000	150,100	9,600	42,000	233,800

Total Tax Reduction

<u>AGI (000)</u>	<u>CURRENT LAW COMPARED TO NO MAX TAX</u>	<u>ALTERNATIVE RULE COMPARED WITH CURRENT LAW</u>		<u>50% MAXIMUM BRACKET COMPARED WITH CURRENT LAW</u>
30-50	0	14.1	16.6	8.4
50-100	211.2	216.6	322.3	264.6
100-200	922.7	548.5	761.8	1,039.1
200-500	1,046.8	438.6	747.6	1,225.5
500-1,000	260.4	54.1	183.2	516.6
over 1,000	180.6	9.6	109.2	645.8
TOTAL	2,624.0	1,283.0*	2,140.7	3,716.0

*The total cost of this reform is 1,274 million as the 1,283 million tax reduction is partially offset by a 9 million tax increase among some 400 taxpayers.

The estimated cost of the present Maximum Tax Provision is \$2.624 billion. Roughly 17 percent of this total goes to some 6,500 taxpayers with Adjusted Gross Incomes over \$500,000. Roughly 8 percent of this total goes to some 330,000 taxpayers with Adjusted Gross Income under \$100,000.

The alternative of applying all deductions to earned income described in this paper would cost an additional \$1.274 billion. Roughly 400 taxpayers would pay more taxes under this reform (a total to \$9 million) due to the less generous treatment of deductions. Tax reductions of \$1.283 billion would be distributed among 1,156,000 taxpayers. 688,000 taxpayers with Adjusted Gross Income under \$100,000 would enjoy roughly 18 percent of the benefits. Taxpayers with AGIs above \$500,000 would receive only 5 percent of the benefits. In contrast, applying all deductions to unearned income would cost about 2.140 billion, nearly 68 percent more. Taxpayers earning under \$100,000 would enjoy roughly 16 percent of the benefits while 14 percent would go to taxpayers earning over \$500,000.

Limiting the top bracket to 50 percent would cost an estimated \$3.716 billion. Only 7 percent of this would be distributed among 680,000 taxpayers with less than \$100,000 of adjusted Gross Income. Roughly 13,000 taxpayers with AGI above \$500,000 would receive 32 percent of the benefits.

The figures presented in this paper do not take account of possible behavioral responses by taxpayers to lower marginal rates. A reduction of a taxpayer's marginal tax rate from 70 percent to 50 percent would mean a 67 percent increase in his after tax income on the margin. Such a change seems likely to induce greater effort on the part of the taxpayer. The revenue estimates

supplied in this paper should therefore be considered upper bounds on the cost of options designed to reduce the maximum marginal tax rate on earned income to 50 percent.²

2)The author has considered some possible behavioral ramifications in Alternatives to the Current Maximum Tax on Earned Income to be given at the National Bureau of Economic Research Conference on Simulation Methods in Tax Policy Analysis, January 25-27, 1981.

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Sunley, Emil, (1974), "The Maximum Tax on Earned Income" , National Tax Journal, Vol.XXVII, pp.543-552

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