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Volume Author/Editor: C. Harry Kahn

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Chapter Author: C. Harry Kahn

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CHAPTER 8

The Standard Deduction

WHEN the federal income tax became a mass tax in the early 1940's, the ever-present demand for simplification of the tax return, for the benefit of both the majority of taxpayers and the auditing authorities, became more insistent. The first serious attempt at simplification was made in 1941. Through it, the majority[1] of taxpayers with gross incomes of $3,000 or less could choose to compute their taxes with itemized deductions or to determine the amounts from a simple table, in which the tax due at each income level had been computed, allowing for varying personal exemptions and for a minimum personal deduction in the form of a 10 per cent tax reduction. The latter was equal to a deduction of about 4 per cent of gross income for the group as a whole, but less for those whose gross incomes were only a little more than the exemptions, and they were usually better off itemizing their deductions. The initial result was that 45 per cent of the returns with income below $3,000, and 40 per cent of the total filed were in the standardized form. The percentages rose somewhat in the following two years after the standard allowance had been revised to 6 per cent of gross income. For 1943, 56 per cent of the returns with less than $3,000 income were the short form with standard deduction.

Failure of this method to achieve the desired shift of most taxpayers with small incomes to the simplified return, and the difficulty encountered in use of gross income as the basis for the simplified schedule, led to the adoption of a new system in 1944. The adjusted gross income concept became the means of placing all taxpayers on an equal basis for the purpose of applying a standard personal deduction.[2] The new minimum was set at 10 per cent of adjusted gross income with an upper limit of $500 per return, with the result that in 1944 over 80 per cent of tax returns filed were on the short form with the standard deduction. A further liberalization in 1948, when the "split-income" provision for married couples was enacted, extended the minimum 10 per

[1] From 1941 to 1943 the optional standard deduction was available only to taxpayers with gross incomes up to $3,000 and derived from wages and salaries, dividends, interest, and annuities.

[2] See p. 8 for a somewhat more detailed explanation.

cent optional deduction to almost all returns in the $5,000 to $10,000 income group and raised the upper limit from $500 to $1,000.[3]

Trend in Choice of the Standard Deduction

While the introduction of the 10 per cent minimum allowance in 1944 caused most taxpayers to shift from itemized deductions to the new standard deduction, and the number has remained high since then, its proportion of the total has nevertheless steadily declined. By 1956, it had slipped to 69 per cent of all returns and 63 per cent of taxable returns (Table 57). The decline was much more pronounced in the

TABLE 57

Number of Tax Returns with Standard Deduction as Per Cent of All Returns, 1941-1956

(numbers in millions)

	Number of Returns with Standard Deduction		*Total Number of Returns Filed*		*Per Cent with Standard Deduction*	
YEAR	*Total* (1)	*Taxable* (2)	*Total* (3)	*Taxable* (4)	*Total* (1)÷(3) (5)	*Taxable* (2)÷(4) (6)
1941	10.3	6.2	25.9	17.5	39.6	35.4
1942	16.1	11.3	36.6	27.6	44.0	40.9
1943	20.3	18.2	43.7	40.2	46.5	45.3
1944	38.7	34.6	47.1	42.4	82.1	81.7
1945	41.5	34.8	49.9	42.7	83.0	81.5
1946	44.1	30.3	52.8	37.9	83.4	79.9
1947	44.7	32.6	55.1	41.6	81.1	78.4
1948	43.2	29.1	52.1	36.4	83.0	79.9
1949	42.1	27.7	51.8	35.6	81.3	77.8
1950	42.7	29.5	53.1	38.2	80.5	77.2
1951	43.9	31.6	55.4	41.6	79.1	76.0
1952	43.7	31.6	56.5	42.8	77.3	73.7
1953	43.4	31.4	57.8	44.2	75.1	71.2
1954	41.0	28.9	56.7	42.6	72.3	67.8
1955	41.4	29.3	58.3	44.7	71.0	65.5
1956	40.7	29.3	59.2	46.3	68.8	63.3

Source: *Statistics of Income.*

amounts of deductions taken. Of the 1944 total of $12.5 billion personal deductions on taxable returns, $7.9 billion or 63 per cent con-

[3] The extension applied to all joint returns, and returns of single persons and heads of families. Only married couples filing separate returns were held to the old $500 upper limit per return; but few did from 1948 on, since few of those choosing the standard deduction also found it advantageous to file separately.

sisted of standard deductions. In 1956, the total had risen to $33.5 billion, but only $12.5 billion or 37 per cent was in the form of the standard deduction (Table 58). The change in relative positions of standard and itemized deductions is further brought out in Chart 15, which shows each as a per cent of total adjusted gross income for the period 1941-1956.

There is reason to expect this trend to continue, in view of the previously mentioned factors influencing taxpayers to revert to the itemized form. These influences are widening of the scope of existing deductions, particularly the 1954 increase in the medical deduction; the more generous allowance of installment interest; the addition of the child care allowance; the growth of homeownership; and the rise in incomes. The rise in incomes is important because taxpayers are apparently less impressed with the convenience of the standard deduction as their incomes rise. We find in Table 58 that the decline in proportion of deductions in standard form during 1944-1956 is not attributable in any significant sense to the gradual movement of some taxpayers into the income range where the standard deduction's upper limit becomes effective. Most of the decline occurred within the group eligible for the flat 10 per cent of income deduction, that is, on returns with incomes up to $10,000. Within that income range the decline was from 65 to 43 per cent of deductions taken between 1948 and 1956. Assuming that the proportion in the below-$10,000 income group had remained at 65 per cent during 1948-1956, the over-all ratio of standard deductions to total deductions would have declined only from 58 to 54 per cent instead of the actual decline from 58 to 37 per cent shown in Table 58.[4]

The reason for the decline is fairly clear from a glance at Table 59. Close to 90 per cent of taxpayers in the lowest income group have been choosing the standard deduction since 1944. This ratio declines as we move to higher income groups; in the $5,000 to $10,000 group, two-thirds chose the standard deduction in 1949 and a little over one-half in 1956. As a result the amounts of itemized deductions have been rising, and the amounts of standard deduction falling, relative to total

[4] To isolate the effect of the movement of tax returns from the less-than-$10,000 group to the above-$10,000 group on the ratio of standard to total deductions, the $25,969 million deductions taken by the former group for 1956 (column 5, Table 58) was multiplied by 0.65; the result, when added to the amount in column 3, calls for: $18,118 \div 33,508 = 0.54$.

TABLE 58

Amount of Standard Deductions Compared with Total Personal Deductions on Taxable Returns, 1941-1956

(amounts in millions of dollars)

	Standard Deductions			*All Personal Deductions*			*Standard Deductions as Per Cent of Total Deductions*[a]		
YEAR	*Total* (1)	*Below Upper Limit*[b] (2)	*Subject to Upper Limit*[b] (3)	*Total* (4)	*Correspond-ing to* (2) (5)	*Correspond-ing to* (3) (6)	(1) ÷ (4) (7)	(2) ÷ (5) (8)	(3) ÷ (6) (9)
1941	401	401	—	4,033[c]	2,062	1,971	9.9	19.4	—
1942	1,112	1,112	—	7,000[c]	4,335	2,665	15.9	25.7	—
1943	1,814	1,814	—	8,610[c]	5,167	3,443	21.1	35.1	—
1944	7,883	7,226	657	12,477	10,005	2,472	63.2	72.2	26.6
1945	7,873	7,183	689	13,130	10,270	2,860	60.0	69.9	24.1
1946	7,455	6,594	862	13,168	9,672	3,496	56.6	68.2	24.7
1947	8,541	7,557	984	15,602	11,436	4,167	54.7	66.1	23.6
1948	9,545	8,938	608	16,472	13,742	2,730	57.9	65.0	22.3
1949	9,082	8,548	534	16,803	13,998	2,806	54.0	61.1	19.9
1950	10,135	9,472	662	19,043	15,713	3,330	53.2	60.3	19.9
1951	11,566	10,796	771	22,399	18,435	3,964	51.6	58.6	19.5
1952	12,069	11,231	838	24,622	20,225	4,397	49.0	55.5	19.1
1953	12,533	11,617	916	26,961	22,155	4,806	46.5	52.4	19.1
1954	11,600	10,687	914	27,476	22,188	5,288	42.2	48.2	17.3
1955	12,027	10,963	1,064	30,524	24,177	6,347	39.4	45.3	16.8
1956	12,471	11,232	1,238	33,508	25,969	7,539	37.2	43.3	16.4

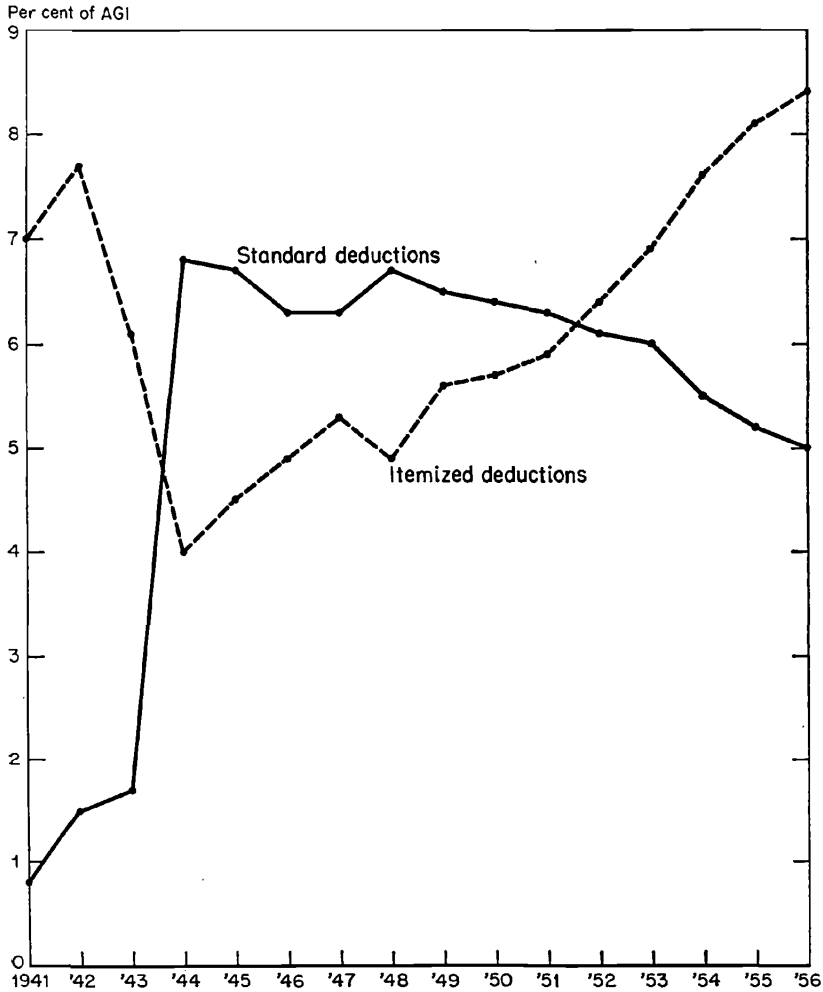
[a] On individual returns only; does not include fiduciary returns.

[b] For the years 1941-1943, only taxpayers with less than $3,000 gross income, mainly derived from wages and salaries, could elect the standard deduction. From 1944 to 1947 taxpayers with more than $5,000 adjusted gross income were limited to a $500 standard deduction. From 1948 on this limit was raised to $1,000 for married persons filing joint returns and for single taxpayers.

[c] Total deductions for 1941-1943 in this table are not comparable to those shown in Tables 7, 8, and Appendix Table D-1 because no attempt was made to eliminate business-type deductions from the miscellaneous category, by income groups. Figures broken down by income groups had to be used to obtain the amount of deduction below and above the income level at which the limit on the standard deduction becomes effective.

adjusted gross income within each income group (Table 60). For 1956, the amount of itemized deductions rose from 3 to 9 per cent, and the amount of the standard deduction declined from 9 to 5 per cent of in-

CHART 15



Source: Appendix D.

Standard and Itemized Deductions as Per Cent of Total Adjusted Gross Income, Taxable Returns, 1941-1956

come in the range to $10,000—the income range for which the minimum allowance was 10 per cent for all taxpayers. What explains such a sharp divergence? It is explained, to some extent, because the ratio of deducti-

TABLE 59

Number of Taxable Returns with Standard Deduction as Per Cent of All Taxable Returns, by Size of Income Reported, Selected Years, 1941-1956

INCOME GROUP[a] ($000's)	*1941*	*1944*	*1947*	*1949*	*1952*	*1954*	*1956*
Under 2	49.8	87.5	86.8	89.0	89.8	89.0	88.3
2-3	33.6	82.0	81.3	83.4	82.3	79.5	77.8
3-5	—	77.5	75.1	74.0	72.6	67.2	65.7
5-10	—	61.5	59.0	67.1	63.2	56.5	51.0
10-25[b]	—	34.2	34.5	53.5	53.9	49.4	43.0
25-50[b]	—	13.7	13.1	21.9	25.5	21.7	15.4
50-100	—	7.1	5.5	2.7	8.1	7.0	6.4
100-500	—	3.1	2.1	3.2	3.3	2.5	1.9
500 and over	—	1.8	1.2	0.4	0.5	0.3	1.1
Total	35.4	81.7	78.4	77.8	73.7	67.8	63.3

[a] For 1941, returns with standard deduction are classified by gross income; itemized returns classified by net income. For later years, classification by adjusted gross income.

[b] For 1952 and 1954, class limit is $20,000 instead of $25,000.

ble expenditures to income tends to rise somewhat over the income scale.[5] Hence as incomes rise, more taxpayers find that they lower their tax liability by itemizing deductions. But the modest rise in deductible expenses as per cent of income can hardly explain fully the pattern observed in Table 60.

The missing part of the explanation appears in the percentages shown in Table 61. Here we expressed the itemized deductions as per cent of the income of those itemizing (rather than of the income of all taxpayers as in Table 60). Now deductions fall as a per cent of income, even over that range for which the standard deduction is a flat 10 per cent for all taxpayers. In other words, among taxpayers who itemized deductions, those with the lowest incomes show the highest ratio of itemized deductions to income. This suggests strongly that, to undertake the labor of filing itemized returns, relatively larger amounts of deductible expenses were required for those in the lowest income groups than for those with somewhat higher incomes. It suggests that, on average, the further down taxpayers are in the income distri-

[5] See Table 12 and the discussion of it in Chapter 3. But it should be borne in mind that the rise in the ratio of itemized deductions to income, as the income scale rises, was moderated by the introduction of the medical allowance in 1942. Thus for 1943 the increase in the deductions-income ratio was no longer as steep as in the earlier years (Table 12).

TABLE 60

Standard and Itemized Deductions as Per Cent of Total Adjusted Gross Income in Each Income Group, Taxable Returns, Selected Years, 1941-1956

INCOME GROUP[a] ($000's)	*1941* Itemized	*1941* Standard	*1944* Itemized	*1944* Standard	*1947* Itemized	*1947* Standard	*1949* Itemized	*1949* Standard	*1954* Itemized	*1954* Standard	*1956* Itemized	*1956* Standard
Under 2	5.5	1.6	2.5	8.7	2.8	8.6	2.6	8.8	2.9	8.7	3.2	8.7
2-3	6.3	1.3	3.1	8.2	3.3	8.1	3.4	8.3	4.5	7.9	5.0	7.7
3-5	8.6	—	3.6	7.7	5.0	7.5	5.1	7.4	6.7	6.6	7.1	6.5
5-10	10.0	—	5.8	4.8	7.1	4.5	6.3	6.7	7.9	5.7	8.9	5.1
10-25[b]	9.5	—	7.3	1.1	8.1	1.2	7.6	3.6	8.7	3.8	9.4	3.1
25-50[b]	9.2	—	7.7	0.2	8.7	0.2	9.3	0.6	10.5	0.8	10.8	0.5
50-100	9.7	—	8.7	0.1	9.9	c	10.3	0.1	11.9	0.1	12.2	0.1
100-500	10.8	—	10.9	c	12.0	c	12.8	c	15.9	c	17.1	c
500 and over	13.0	—	12.4	c	12.6	c	13.4	c	18.8	c	19.3	c
Average	7.4	0.8	4.0	6.8	5.2	6.3	5.6	6.5	7.6	5.5	8.4	5.0

[a] Net income groups for 1941; AGI groups for other years.
[b] For 1954, class limit is $20,000 instead of $25,000.
[c] Less than 0.1 per cent.

bution, the less inviting they find the possibility of reducing taxable income by, for example, 1 per cent, through itemizing their personal deductions rather than taking the standard allowance.[6] In more gen-

TABLE 61

Itemized Deductions as Per Cent of Income on Taxable Returns with Itemized Deductions, by Income Groups, Selected Years, 1941-1956

INCOME GROUP[a] ($000's)	*1941*	*1944*	*1947*	*1949*	*1952*	*1954*	*1956*
Under 2	10.0	18.3	20.1	21.4	24.2	23.7	24.2
2-3	7.5	17.0	19.3	20.1	21.7	21.8	22.2
3-5	8.4	15.9	18.9	19.3	19.8	20.0	20.2
5-10	9.5	14.4	16.7	19.1	18.2	18.3	18.1
10-25[b]	8.9	10.7	11.8	15.2	16.7	16.7	15.9
25-50[b]	8.6	8.9	10.0	11.7	12.7	13.1	12.7
50-100	9.8	9.4	10.4	11.2	12.2	12.8	13.0
100-500	9.9	11.2	12.2	13.1	15.2	16.2	17.4
500 and over	11.3	12.6	12.7	13.4	17.5	18.8	19.5
Average	9.1	14.0	15.7	17.1	17.5	17.8	17.6

[a] Net income groups for 1941; AGI groups for other years.
[b] For 1952 and 1954, group limit is $20,000 instead of $25,000.

[6] An alternative, but somewhat far-fetched, explanation would be that although the ratio of personal deductions to income is a rising function of income over the range up to $10,000, the dispersion of the individual ratios about the mean is greater in the lowest income groups than further up. This would explain why the relatively few whose deductions exceed the 10 per cent minimum allowance in the lowest income group have higher deductions-to-income ratios than those with higher incomes who also itemize.

eral terms, it suggests that the lower their incomes, the more willing taxpayers are to forego in the interest of simplicity, some of the refinements of income and the subsidies implied by personal deductions.

Considerations in Determination of Size of Standard Deduction

The quantitative presentation so far shows that, if the primary aim was simplification, the extent to which taxpayers have used the standard deduction since 1944 indicates the success of the device. The Treasury saves a great amount of auditing and litigation as long as a large number of persons can be induced to use the minimum allowance.[7] Whether the taxpayers' "cost of compliance" has been comparably reduced depends on the extent to which they compute their tax liabilities both ways to find which is smaller. This in turn depends largely on the size of the minimum allowance.

Congress may attempt to set an allowance which permits the Treasury to collect approximately the same amount of gross revenue whichever tax form is selected. Taxpayers would still have to determine their monetary advantage by a trial of both methods. On the other hand, the government may aim at the same amount of net revenue obtainable if all taxpayers itemize, by passing on wholly or in part the savings in administrative expense to taxpayers who choose the simplified return. In that case only a minimum of taxpayers might find it necessary to compute their tax both ways.

It appears that, in effect, Congress has moved from the first approach to the second. In the 1942-1943 period, when the minimum allowance was 6 per cent, and close to the average ratio of itemized deductions to income of those eligible,[8] many taxpayers undoubtedly computed their taxes both ways. The 1944 move, to a more generous allowance (10 per cent of income) than the actual average, probably eliminated much of the taxpayer's paperwork, although the tendency to omit such comparisons appears greater the further down one goes in the income scale

[7] "The standard deduction has made a major contribution to the successful administration of the modern mass personal income tax by greatly reducing the importance of personal deduction errors." See Marius Farioletti, "Some Results from the First Year's Audit Control Program of the Bureau of Internal Revenue," *National Tax Journal,* March 1952, pp. 75-76. The Audit Control Program of 1948 uncovered major errors in personal deductions on one out of three returns with itemized deductions, but on only one out of 250 returns with standard deductions.

[8] In 1940, the last year prior to the first standard allowance, deductions in the group with incomes up to $3,000 were 7.5 per cent of income on average.

(Table 61). It may be that at the bottom of the income distribution, say up to $3,000, taxpayers are considerably more interested in convenience and simplicity than in small tax savings. That the rather sparse 1941 allowance of roughly 4 per cent enticed over 43 per cent of eligible taxpayers to adopt it, suggests that the government could get a considerable amount of tax simplification, even if those who obtained it had to pay for it. Such reasoning suggests a third possible guide to a standard deduction policy. The government, rather than passing the savings in administration cost on to the taxpayers who participate in the simplification program, might require these taxpayers to pay for the privilege of a simplified tax return in the form of a minimum allowance well below the previous average as it did, in effect if not intentionally, in 1941.

The question of the reason for the upper limit on the standard deduction—at first $500 and recently $1,000—remains. As we have seen, the average per cent of income deducted has been as large for those with high incomes as for those with low incomes (Table 12). Therefore, a changing functional relation between size of deductions and size of income could hardly have been the reason for the change from a flat percentage to a flat absolute amount at the $10,000 income level. It may be explained in part by a desire to protect deductible expenditures from the inroads of the tax rates that become operative above that level. But that explanation would be consistent only with the incentive aspects of the deductions, that is, with the view that gifts to philanthropy would be seriously reduced by a 10 per cent minimum allowance above $10,000 income, whereas the incentive effect does not operate below that level. It would not apply to the equity aspects of deductions, unless one wishes to argue that equity is more important for taxpayers subject to high tax rates than for the low-rate taxpayers. Or, the reason could rest mainly on grounds of differential audit expense, the argument being that above the $10,000 income level the cost of audit is warranted by the size of the deductions involved per return, whereas below that level it is not. The problem of tax return audit is considered in more detail in the next section dealing with the rationale of the standard deduction, as such.

Rationale of the Standard Deduction

In addition to the view that the standard deduction constitutes an audit-saving device to the Treasury and a convenience to the taxpayer, there is the view that it may bring about a net gain on equity grounds. It is argued that at least some, if not most, of the personal deductions are not justifiable in principle, and that a high standard deduction eliminates a large part of the differential advantage bestowed on those who itemize them.[9] But as a corollary to this, it has been said that to the extent that the deductions are now granted to everybody they are really granted to nobody, and the end result is a mere narrowing of the tax base, rather than the originally intended refinement of it. Indeed, the same result could be approximated without the attendant narrowing of the tax base and hence higher marginal tax rates, by restricting personal deductions to the amount of eligible expenses in excess of 10 per cent of income.[10] Though this would not lower anyone's tax bill,[11] it would permit the lowering of existing bracket rates. As to the alleged unequal treatment of taxpayers because of personal deductions, a preferable solution might be to go to the source of the difficulty rather than to rely on a method, such as the standard deduction, which tends to freeze inconsistencies into the tax system.

The proposition that the standard deduction would help solve the Treasury's audit problem is probably a major reason for its enactment. An audit program covering the deductions of some 40 million additional returns (Table 57) might constitute a difficult and unprofitable job. But such an enlarged audit program was not the only alternative, particularly in view of the actual result of the standard deduction—a minimum allowance of up to $1,000 for all taxpayers. An alternative solution might have been omission of auditing for returns with deductions below 10 per cent of income, or a token audit of such returns.[12] In favor of this alternative solution is the lower cost[13] and greater consistency with the purposes for which the various deductions had been enacted. Presumably there would have been no difference from

[9] See Pechman, "Erosion of the Individual Income Tax," p. 11.

[10] See also White, *op.cit.*, p. 365.

[11] This is true in only an approximate sense. Some taxpayers might pay slightly more tax than previously and others slightly less, because the standard deduction is now computed, on incomes of $10,000 or less, as a per cent of adjusted gross income, rather than as a per cent of the tax base. Therefore, the precise tax equivalent of a taxpayer's standard deduction cannot be allowed for by a mere change in the rate schedule. However, this is at best a minor consideration.

[12] Such a decision would not of course be announced. Taxpayers can be kept on their toes by the mere possibility of audit at any moment.

[13] As we have shown on page 37, the 1944 change-over alone, from the initially small to the enlarged standard deduction, meant a loss in tax base of roughly $2.5 billion, or 40 per cent of the increase in the amount of standard deduction at that time.

present procedures in the audit program for returns claiming deductions in excess of 10 per cent of income, so that auditing costs would not have been greater than with the present standard deduction.

Thus there were three solutions to the Treasury's audit problem as it emerged in the early 1940's: (1) the current minimum allowance of 10 per cent of income up to $1,000 (or any other figure) for taxpayers who do not choose to itemize; (2) allowance of only deductions exceeding, in the aggregate, 10 per cent of income on the grounds, implicit in the current standard deduction, that deductions of most taxpayers need the restraint of audit; and (3) merely token audit for relatively small amounts of personal deductions, as those amounting to less than 10 per cent of income.

Finally, an important consideration is the taxpayer's convenience served by the simplicity of tax returns, which many undoubtedly prefer to whatever additional interpersonal equity and subsidy they might obtain under a system of itemized deductions. In this case analysis can provide little, if any, guide to policy. The two benefits are not only incommensurable, they are mutually exclusive. Only if a reader should decide that most, or all, of the personal deductions are uncalled for in principle would the two desires for a rational tax base and a simple tax return coincide.