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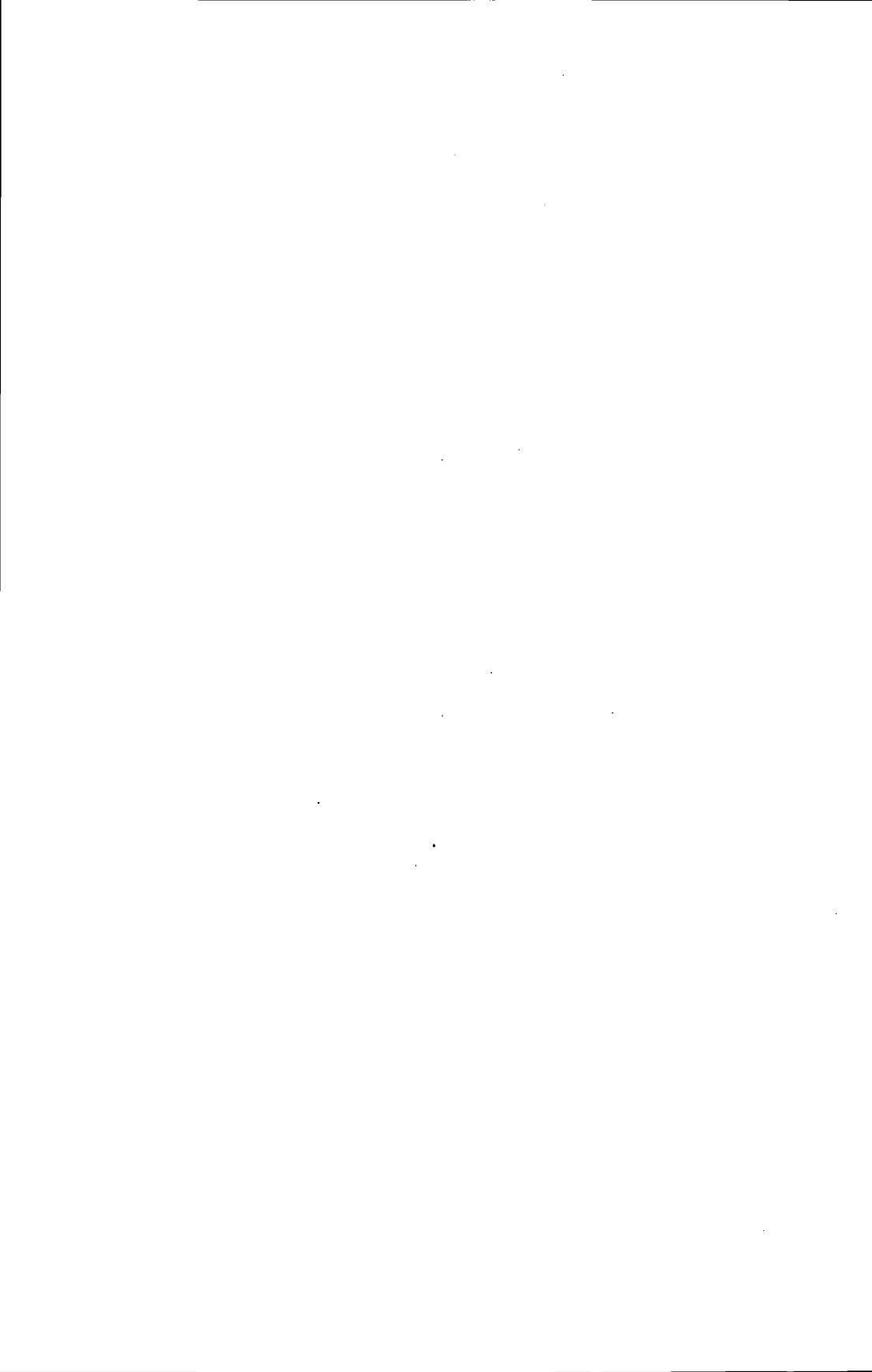
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**The Personal Exemptions
in the Income Tax**



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Summary and Conclusions

A. THE PERSONAL EXEMPTIONS IN THE TAX STRUCTURE

1. The personal exemptions in the federal income tax merit critical examination from time to time both because the tax itself is the country's biggest source of governmental revenue and because the personal exemptions constitute a major component of its structure.

2. More than 90 per cent of the aggregate of personal incomes as defined by the tax law—termed adjusted gross income—has been accounted for on the annual income tax returns filed in recent years. Nevertheless, only a little more than one-half of the aggregate becomes “taxable income,” i.e., subject to any of the bracket rates of tax. Most of the rest is excluded by the personal exemptions and the personal or nonbusiness deductions. The personal exemptions on taxable returns alone removed \$91.9 billion, or 22.5 per cent of adjusted gross income, from the taxable category in 1965.

3. One aspect of the part played by the personal exemptions in the tax rate structure is provided by the following calculation: if all persons who were excluded from income tax by the exemptions and nonbusiness deductions in 1965 had been excluded in some other manner, as by a direct exclusion of all with incomes below some figure, and the exemptions (but not the deductions) had been eliminated for taxable persons, the same amount of tax revenue raised by the income tax in 1965 could have been obtained with a reduction of 27 per cent in the average tax rate on all taxable income. At the same time, there would have been a redistribution of tax liabilities to the disadvantage of those with larger families, the aged, and the blind, and in favor of those who had previously had fewer exemptions.

4. Until World War II, the personal exemptions in this country functioned primarily to exclude most persons and the greater part of personal income from the income tax. Less than 5 per cent of the popu-

lation, including taxpayers and their dependents, and less than one-third of the total amount of adjusted gross income were covered by taxable returns in most years prior to 1941. Until 1934, the value of the personal exemptions for taxable persons was restricted to a reduction in liability for normal tax: the exemptions were not allowed in computing surtax. The income tax was transformed during and after World War II into a mass tax of unrivaled revenue yield by radically reduced levels of personal exemptions, an accompanying great rise in personal incomes (in part from inflation), and drastically increased tax rates, particularly in the lower brackets. The aggregate dollar amounts of the exemptions on taxable returns rose substantially, despite the cuts in the statutory allowance for each exemption, because of the great increase in the number of taxable persons and a disproportionate increase in exemptions for dependents, the allowance for whom was raised to equality with that for the taxpayer beginning in 1944. Between 1939 and 1965, total adjusted gross income on taxable returns rose twenty-threefold, the dollar amount of exemptions on them, fourteenfold, and the dollar amount of exemptions for dependents, sixty-sevenfold. In recent years more than 90 per cent of the population has been represented on income tax returns, taxable and nontaxable. Individual income tax revenues, which had never reached \$1.5 billion in any year prior to 1940, totaled \$49.5 billion in 1965. And whereas taxpayers with incomes under \$10,000 had accounted for little more than 1 per cent of individual income tax revenues in 1929, they accounted for 40.1 per cent in 1965. Given roughly the recent levels and distribution of the nation's personal income, the scale of the personal exemptions and the rates of tax in the first few brackets largely govern the revenue yield of the individual income tax. In 1965, 67 per cent of the total revenues came from taxable income taxed at bracket rates of 20 per cent or less. Despite the wide graduation of bracket rates, income tax revenues constituted only 19.4 per cent of total taxable income and only 11.9 percent of total adjusted gross income on taxable returns.

5. From 1913 to 1948, Congress changed the exemption levels frequently, in both directions, to produce sizable increases or decreases in tax revenues. Since 1948, however, the personal exemptions proper have been left unaltered, despite major tax increases brought on by the Korean War in 1950-51, major tax reductions in 1954 and 1964, and

a rise of 35 per cent in consumer prices in 1948–66. Proposals have been made from time to time to employ increases and decreases in the personal exemptions as countercyclical measures designed to produce large changes in tax revenues. Such alterations, however, now appear to command less support than changes in the first few bracket rates and other tax rates because of concern that they would be less readily reversible and more disruptive of taxpayer understanding.

6. Two factors have weighed strongly against more or less permanent increases in the levels of the existing exemptions despite the drastic erosion in their purchasing power: (1) Any increase would be relatively costly in revenue because it would reduce the taxable income of every taxpayer. At the average effective tax rate on all taxable income in 1964—20.6 per cent—an increase of only \$100 for each exemption would have reduced tax revenues by about \$3 billion. (2) Only a small part of the benefit would go to persons in the lower taxable income groups for whom an increase in the exemption levels is presumably most needed. Taxpayers with adjusted gross incomes under \$5,000, for example, accounted for only 22.9 per cent of the total number of exemptions on taxable returns in 1965, while those with adjusted gross income of \$9,000 and over accounted for 35 per cent. The absolute tax-reducing value of any uniform increase in the amount of each exemption, moreover, would be greater for larger incomes that are subject to higher marginal bracket rates, than for smaller. A taxpayer whose last \$1,000 of taxable income had been subject to a 50 per cent bracket tax rate would have his tax cut by \$50 for each of his exemptions if the statutory allowance were increased by \$100, while one whose marginal rate had been 16 per cent would have his tax reduced by only \$16 for each of his exemptions.

B. RATIONALE OF THE PERSONAL EXEMPTIONS

1. Two views of the primary purpose of personal exemptions have long been held. One regards them as aimed at excluding from tax those persons whose incomes are only equal to or less than the minimum amounts needed for a tolerable standard of living, family responsibilities considered. The other regards them as designed to exclude from tax that portion of *all* incomes required for this need. In the first view, the ex-

emptions are limited to the poor; in the second, they are extended to all. The United States has followed the second view.

2. Although the precise purposes of the personal exemptions in the United States have never been explicitly stated by Congress, they appear in practice to serve the following functions: (1) they exclude from income tax altogether individuals and families with the smallest incomes; (2) in form, at least, they provide a deduction from otherwise taxable income for the essential living expenses of all taxpayers, thereby reducing the effective tax rates below the nominal ones at all levels of income; (3) they provide significant additional allowances for taxpayers with dependents and for those who are aged or blind; (4) when combined with a substantial first bracket tax rate, such as has been in force since World War II, they create a lively progression of effective tax rates in the lower part of the income scale and add at a diminishing rate to the progression provided by rising bracket rates for larger incomes.

3. The exclusion of the poor from a global or comprehensive income tax is nowadays generally accepted as necessary to avoid impairing their health, their economic efficiency, and the welfare of their children. The same considerations support an exclusion level that varies with the number and perhaps even the ages of a person's dependents; and these considerations argue also against any but modest tax rates on incomes not far above the exclusion limits. The disproportionate weight of sales and excise taxes on families with low income, and, nowadays, of payroll income taxes such as those levied for Social Security, argues in the same direction.

4. For taxable persons, however, an equal exemption for each taxpayer on his own account is essentially illusory. What everyone appears to gain from an equal allowance must be made up by higher tax rates on the taxable portion of incomes. It is true, of course, as previously noted, that the present \$600 per capita exemption produces a greater absolute tax saving for incomes subject to higher bracket rates than for those subject to lower, but, in fixing bracket rates, Congress is well aware of this and pays close attention to the combined effects of proposed personal exemptions and proposed bracket rates on tax liabilities for incomes of varying size both before and after the exemptions.

5. The most cogent reason for not confining the personal exemptions

to the poor is to take account of varying family responsibilities at other income levels. Some scholars would confine the allowances for dependents of taxable persons to the lower taxable income groups on the ground that the allowances are not needed by those with medium and upper incomes; expenditures on dependents for the latter groups are said to be a form of discretionary consumption. On the other hand, dependent allowances for those in a wide medium-income range can be defended as a means of promoting horizontal equity—a more equitable tax treatment of persons with *equal* incomes but *unequal* family responsibilities, such as a childless couple and one with four children, both with \$10,000 income.

6. The presumptive basis for the extra exemption allowed to the aged and the blind is that they need a larger after-tax income than other persons to maintain either the minimum acceptable standard of living or the standard enjoyed by other persons with equal before-tax incomes. The available evidence from budget studies and from the practices of relief agencies does not support such a presumption in the case of the aged, and provides only limited support in that of the blind. There are other categories of taxpayers who are handicapped by physical, mental, or emotional disabilities of kinds that entail extra expenses, not allowed as medical deductions, to maintain the same standard of living as nonhandicapped persons with equal incomes. Perhaps the best explanation of the special tax concession for the aged and blind alone is twofold: (1) the difficulty of identifying and of obtaining simple yet adequate proof of many other handicaps; and (2) the long tradition, extending over many centuries, of special sympathy for the aged and blind.

7. A double exemption is allowed, in effect, for each child with income over \$600 who is under 19 or who, regardless of age, is attending school, if he receives more than one-half of his support from his parents. The child obtains an exemption on his own account, and the parents also obtain an exemption for him as a dependent. This treatment doubtless errs on the side of generosity, and appears to be inequitable as between parents in otherwise equal circumstances who provide complete support for such children and those whose children contribute to their own support. But the two principal alternative treatments that have been used in this or other countries have aroused strong objections: (1) Add the dependent's income to that of the tax-

payer if the latter chooses to claim an exemption on his account. This subjects the dependent's income to the taxpayer's highest bracket rate, and it implies that the taxpayer has full control of the dependent's income, which is commonly far from true. (2) Remove from the category of dependents anyone with an income of \$600 or more even though he receives more than one-half of his support from the taxpayer. This alternative has the effect of imposing an absurdly high tax rate on the parent for the last few dollars of a child's income as it reaches or somewhat exceeds \$600, and also implies that the taxpayer has full control of the dependent's income.

8. The present allowance for working wives—a *deduction* of \$600 to \$1,000 for a very restricted category of persons who incur expenses for the support of certain limited classes of dependents for the purpose of enabling the taxpayer to be gainfully employed—falls far short of a general allowance for the direct and indirect costs incurred by married women who are gainfully employed outside the home. A part of a working wife's money income is merely a substitute for income previously enjoyed in the form of her own tax-free services to the household. The net gain to the family is smaller than is indicated by the added money income because the latter is partly offset by the loss of the housewife's services at home and by the additional expenses incurred to replace these services and for transportation and other employment-related costs. Besides the question of equity, there is that of incentives. The extra expenses and heavier income tax sharply reduce the net gain from a wife's employment in many cases. A widely applicable deduction for the actual expenses of working wives would be difficult to frame and administer with precision because some of the principal items of expense, such as domestic service, restaurant-eating, etc., are important forms of personal consumption for housewives and working wives alike. Great Britain meets the problem in a way that applies to all working wives and that avoids the need to distinguish between ordinary and extra expenses: by reducing the taxable income of a married couple, when the wife is gainfully employed, by $\frac{7}{9}$ of her earned income or £140, whichever is less. A similar allowance in the United States could take the form either of a special personal exemption or deduction proportioned to a wife's earned income, but limited to a stated maximum.

9. The personal exemptions in the United States, coupled with the minimum standard deduction, provide all or a large part of the gradu-

ation in effective tax rates for an important range of incomes from the lowest taxable levels to well above, and modify the graduation at all levels for differences among taxpayers in family responsibilities, age, and blindness. For example, if all graduation in bracket rates were abolished and taxable income were made subject only to the 1967 first bracket rate of 14 per cent, the previously existing graduation in effective rates from .13 of 1 per cent to 3½ per cent of adjusted gross incomes of \$3,000 to \$4,000 for a married couple with two dependents would remain unchanged, and more than four-fifths of the entire progression for incomes up to \$10,000 for such a couple would remain. For larger incomes and for single persons, the contribution of the exemptions and the minimum standard deduction to rate progression is much smaller.

C. ALTERNATIVE EXEMPTION TECHNIQUES

1. Four principal types of exemption techniques, sharing more or less common objectives but differing in their distribution of emphasis and effects, have been or are in wide use. They are known as (1) the lump-sum or initial exemption, (2) the continuing exemption, which is the one used in the United States, (3) the vanishing exemption, and (4) the tax credit.

2. The lump-sum exemption completely excludes from income tax those persons with incomes not exceeding a stated amount but does not reduce the taxable income of others. It contrasts sharply with the continuing exemption, which not only excludes from tax those with incomes, after allowable deductions, equal to or less than the amount of the exemption, but also deducts the same amount from the otherwise taxable income of all with larger incomes. In the absence of other provisions to this end, the lump-sum exemption provides no differentiation in tax treatment for variations in the family responsibilities and personal needs of persons above the exclusion limit, and does not add to the progression of effective rates provided by the formal rate structure. It accords with the view that such differentiation is not required or desirable at incomes above the exclusion limits, and that the kind and degree of rate progression desired, if any, is best provided by the formal rate structure. Great Britain formerly employed this type of exemption. Australia and various other countries employ it today for the

taxpayer proper, but combine it with exemptions for dependents at taxable income levels. It permits a given amount of revenue to be raised with lower nominal tax rates than under a continuing exemption, and permits alterations in the exclusion limits without the wide changes in tax revenues and effective tax rates produced by changes in the levels of continuing exemptions.

3. The vanishing exemption is designed to avoid an abrupt separation between nontaxable and taxable levels of income; it provides allowances at taxable levels of income at a declining rate as incomes rise, for a spouse, dependents, and, if desired, for the aged and blind. The amounts of the exemptions gradually approach a vanishing point at a moderate or moderately high income, such as \$10,000 or \$20,000. Numerical examples of possible applications of this technique to the existing income tax are given later in the text. The vanishing exemption is consistent with the view that the exemptions are needed in full only at the lower end of the income scale and are best reduced and finally eliminated as incomes rise. Like the lump-sum exemption, it would permit a given amount of revenue to be raised with lower formal tax rates; and like the continuing exemption, it would contribute to the progressivity of the effective rate structure. A number of countries limit the exemptions for taxable persons and their dependents to taxpayers with incomes below a stipulated limit. The vanishing principle is employed in the United States income tax statute in connection with the minimum standard deduction and the tax credit for retirement income, and it is used in the Social Security Act to govern the benefits payable to eligible retired persons under age 72 who obtain income from gainful employment.

4. Instead of providing personal exemptions in the form of deductions from otherwise taxable income, which gives the allowances greater tax-reducing power for those subject to higher bracket rates than for those subject to lower, some countries and some of our states provide personal exemptions in the form of tax credits, which reduce tax liabilities by equal amounts at all income levels; and this is sometimes proposed as a more equitable substitute for the existing exemptions in the federal income tax. Under such a scheme, the current \$600 exemption might be replaced by a tax credit of \$85 for each exemption, this amount being equal to the tax of 14 per cent on the first \$500 of taxable income plus 15 per cent on \$100. In the absence of offsetting reductions in bracket rates, such a substitution would (1) increase the effective

tax rates on all otherwise taxable incomes above \$600, (2) graduate the effective tax rates more steeply, (3) increase the relative tax burdens at each income level above the lowest of taxpayers with larger families and those who are aged or blind as against those with a smaller number of exemptions, and (4) increase total tax revenues. Persons who place major emphasis upon vertical equity—equitable treatment of taxpayers with different incomes—tend to favor such a substitution. Those who emphasize the importance of horizontal equity—equitable treatment of individuals with equal incomes but different personal and family situations—may argue that the demands of vertical equity can be met by adjustments in bracket rates for incomes of different size without denying the claims of horizontal equity.

5. Of the four functions served by the present personal exemptions, the first, that of excluding the poor, tends almost unavoidably to be inadequately performed when the continuing exemptions are equal in amount for all incomes, because of the heavy revenue cost and the diffused effects of raising the exemption levels. The second, that of providing an allowance for the essential living expenses of all taxpayers, is, we have seen, largely illusory. The third, that of providing significant allowances at all or most income levels for taxpayers with dependents and for those who are aged or blind, is performed relatively more generously (and therefore less desirably, in the opinion of some) under the present system of continuing exemptions than it would be if equal tax credits equivalent to the lowest bracket rates were substituted or if any but a slowly vanishing exemption were substituted. The fourth function, that of adding to the progression of effective tax rates at the lower levels of taxable income, is well performed by the present continuing exemptions, and would also be provided by the vanishing exemption and the tax-credit techniques. The lump-sum exemption, however, would not add to the progression provided by the graduated bracket rates.

D. THE APPROPRIATE LEVELS OF PERSONAL EXEMPTIONS

1. The levels of the exemptions must inevitably reflect compromises among competing objectives: the desire to protect an adequate standard of living from tax, adequate revenue, equitable allowances for

variations in needs and responsibilities, workable administration, and others. A social worker or a physician may provide highly individualized diagnoses and treatment for particular persons, but the income tax law necessarily deals uniformly with large *categories* of persons. Even the wide regional and local variations in the cost of living in a country as large and variegated as the United States cannot feasibly be taken into account.

2. In analyzing the principal considerations bearing upon the appropriate levels of the personal exemptions, attention herein is directed mainly to the questions: (1) Do they exclude from tax all those whose incomes are only enough or less than enough, family size considered, for what is generally regarded as a minimum tolerable standard of living?, and (2) Do they make reasonable allowances for dependents and for the aged and blind at other levels of income?

3. A close approach to an objective empirical measure of what American states currently regard as the minimum essentials of a tolerable standard of living is to be found in the budgets for basic needs used by state agencies in providing assistance to needy individuals and families under the Social Security Act. By the test of the family budgets employed in most states under these federal-state programs, the present personal exemptions, as supplemented by the standard deduction, appear to provide adequate exclusion limits for families of more than four, but fall short for smaller families and single persons. To meet this minimum standard, as adjusted by a modest allowance for employment-related expenses and social security taxes, the effective exclusion limits for persons with one, two, three, and four ordinary exemptions, now \$900, \$1,600, \$2,300, and \$3,000, respectively, would have to be raised to about \$1,800, \$2,550, \$2,900, and \$3,250. An increase in the ordinary per capita exemptions to achieve this result would produce far more widespread tax reductions than those intended, and would be extremely costly in revenue. Exclusion limits of these amounts would be moderately lower than the "low-cost" Poverty Income Criterion tentatively worked out by the Social Security Administration for nonfarm families; and it may well be contended that self-supporting persons and families should properly be allowed a somewhat higher minimum standard of living than those on relief. It should be noted, however, that these exclusion limits moderately exceed the Social Security Administration's "economy" Poverty Income Criterion, which is based

upon a food consumption pattern designed for "temporary use when funds are low."

4. Exclusion limits of these or similar amounts could conceivably be made a part of the existing income tax structure without altering the present continuing exemptions for persons who remain taxable. If lump-sum exemptions were enacted in some such amounts, and "notch" adjustments were provided to prevent incomes moderately above the exclusion limits from being reduced below them by the income tax, our calculations indicate that such exclusion limits could be integrated with the regular tax schedule at relatively small revenue cost. The low revenue cost is explained by the fact that, unlike an increase in the continuing exemptions, the increase in the exclusion limits would not reduce tax liabilities for those with incomes much above the higher exclusion limits.

5. The minimum standard deduction adopted in 1964 is an effective, though imperfect, alternative means of raising the exclusion limits, and one that avoids the need for "notch" provisions. For example, if the present standard deduction were raised from \$1,000 to perhaps \$2,000, and the *minimum* standard deduction from \$300 to perhaps \$1,200 for a single individual, with an addition (as at present) for each additional exemption, substantially increased effective exclusion limits would result. This use of the standard deduction would attenuate materially the importance of the separate allowable deductions, though one or more of the latter, in modified amount, such as one for distinctly abnormal medical expenses, might be retained outside of the standard deduction. Like other means of raising the exclusion limits without increasing the continuing personal exemptions, this method would concentrate tax relief in the lower of taxable income groups and would minimize the reduction in the tax base and in revenue for any given level of exclusion.

6. With respect to whether an exemption of \$600 per dependent discriminates adequately at moderate and higher incomes between the taxpaying ability of persons with few or no dependents and those with a larger number, no objective criterion is readily available. At these levels of income, the exemptions for dependents are not intended to cover the entire cost of the latter's support. While expenditures for the care and education of children and for the support of other dependents are usually in the public interest, and are commonly accompanied by

much personal exertion and sacrifice by the taxpayer, they are also among the most important uses of income: they are forms of consumption. As previously indicated, the present extra exemptions for the aged and the blind are at least adequate in the sense that sufficient empirical evidence is lacking to demonstrate that the needs of these people are significantly greater than those of other persons.

Looking forward to a future in which the economic and fiscal situation may permit more generous exclusion limits, one might consider those suggested by the U.S. Department of Labor's "City Worker's Family Budget for a Moderate Living Standard," as revised from time to time. This budget was originally developed in 1946-47 at the request of Congress for a "modest but adequate" budget for a family of four persons in a large city and its suburbs, with equivalent incomes for family units of different size. Modified to reflect 1966 consumer prices and social security taxes, the 1959 budget would suggest exclusion limits of about \$2,850 for a single individual, \$4,050 for married couples without dependents, and, for persons with dependents, \$1,300 for the first dependent and \$800 for each of the others. If these exclusion limits, together with a specified "notch" adjustment for somewhat larger incomes, had been in force in 1965, we estimate from the figures reported on tax returns for that year, as summarized in *Statistics of Income*,¹ that the revenue cost would have approximated \$4.8 billion.¹

Techniques, however, and their quantitative implementation, are only tools for the attainment of policy objectives. The latter are determined by political choices which, at any time, may properly rest upon a wider range of considerations than those discussed here.

¹ A revision of the City Worker's Family Budget published in October 1967, designed to represent living standards in the 1960's and costs in the fall of 1966, embodied increases in living standards approximating 32 per cent over those reflected in the 1959 budget, in addition to upward cost adjustments for the rise in consumer prices. The total annual cost of this budget averaged \$9,191 in urban areas of the United States, and \$9,376 in metropolitan areas. Acknowledging that the new budget was not currently appropriate for government programs requiring a standard for satisfactory minimum incomes, the BLS announced its intention to develop a lower standard budget "representing a minimum of adequacy . . . without compromising the family's physical health or self-respect as members of the community." (*City Worker's Family Budget, Autumn 1966*, p. vii.) Updated to reflect the rise in consumer prices and personal taxes between 1959 and 1966, the "moderate standard" of 1959 may be regarded as one possible approach to such a minimum standard a decade or more later.