

[JOINT COMMITTEE PRINT]

**BACKGROUND AND ISSUES  
RELATING TO  
INDIVIDUAL INCOME TAX REDUCTIONS**

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PREPARED FOR THE USE OF THE  
COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES  
BY THE STAFF OF THE  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This pamphlet describes present law and issues relevant to the House Ways and Means Committee's markup of the individual tax reduction proposal presented by the Administration.

Part I describes the principal features in present law which determine individual income tax liability. Part II summarizes the Administration proposal. Part III discusses some of the issues which may arise in considering an individual income tax reduction proposal, including the distribution of the tax cut by income class, marginal tax rates, budgetary concerns, and income tax thresholds. Part IV briefly discusses some of the components of possible alternatives to the Administration proposal.



## I. PRESENT LAW

### Personal exemption

Present law provides a personal exemption of \$1,000 for each taxpayer, his or her spouse, and each dependent whose gross income is less than \$1,000. (This income limit is waived if the dependent is the taxpayer's child and is either under age 19 or a student.) Additional exemptions are provided for age (65 or older) and for blindness.

### Zero bracket amount

Under present law, there is no tax on taxable income within the initial tax bracket, referred to as the "zero bracket amount." This amount also serves as a floor under allowable itemized deductions, so that itemizers can deduct only expenses in excess of that amount.<sup>1</sup>

The zero bracket amount currently is \$3,400 for married taxpayers filing jointly, \$2,300 for single persons and heads of households, and \$1,700 for married taxpayers filing separately.

### Rate brackets and tax rates

Under present law, there are four separate progressive tax rate schedules applicable to individuals; the particular schedule applicable to a taxpayer depends upon the taxpayer's filing status. There are different rate schedules for married couples filing jointly and surviving spouses, married couples filing separately, unmarried heads of households, and other unmarried persons.<sup>2</sup> These rate schedules are shown in Table 1.

<sup>1</sup>Prior to 1977, the law provided a standard deduction, which taxpayers could use if they did not elect to itemize their deductions. The Tax Reduction and Simplification Act of 1977 replaced the standard deduction with the present system, in which the standard deduction is, in effect, built into the rate schedule for all taxpayers and then is "taken back" from itemizers through the floor under itemized deductions.

<sup>2</sup>Heads of households are unmarried individuals who pay more than half the household expenses for themselves and a child or dependent relative who lives with them or for their dependent parents.

Table 1.—Tax Rate Schedules Under Present Law

Single taxpayers			
<i>If taxable income is:</i>		<i>the tax is:</i>	
Not over \$2,300.....		—0—	
<b>Over—</b>	<b>But not over—</b>		<b>of the amount over—</b>
\$2,300.....	\$3,400.....	14%	\$2,300
\$3,400.....	\$4,400.....	\$154+16%	\$3,400
\$4,400.....	\$6,500.....	\$314+18%	\$4,400
\$6,500.....	\$8,500.....	\$692+19%	\$6,500
\$8,500.....	\$10,800.....	\$1,072+21%	\$8,500
\$10,800.....	\$12,900.....	\$1,555+24%	\$10,800
\$12,900.....	\$15,000.....	\$2,059+26%	\$12,900
\$15,000.....	\$18,200.....	\$2,605+30%	\$15,000
\$18,200.....	\$23,500.....	\$3,565+34%	\$18,200
\$23,500.....	\$28,800.....	\$5,367+39%	\$23,500
\$28,800.....	\$34,100.....	\$7,434+44%	\$28,800
\$34,100.....	\$41,500.....	\$9,766+49%	\$34,100
\$41,500.....	\$55,300.....	\$13,392+55%	\$41,500
\$55,300.....	\$81,800.....	\$20,982+63%	\$55,300
\$81,800.....	\$108,300.....	\$37,677+68%	\$81,800
\$108,300.....		\$55,697+70%	\$108,300
Married taxpayers filing joint returns and surviving spouses			
<i>If taxable income is:</i>		<i>the tax is:</i>	
Not over \$3,400.....		—0—	
<b>Over—</b>	<b>But not over—</b>		<b>of the amount over—</b>
\$3,400.....	\$5,500.....	14%	\$3,400
\$5,500.....	\$7,600.....	\$294+16%	\$5,500
\$7,600.....	\$11,900.....	\$630+18%	\$7,600
\$11,900.....	\$16,000.....	\$1,404+21%	\$11,900
\$16,000.....	\$20,200.....	\$2,265+24%	\$16,000
\$20,200.....	\$24,600.....	\$3,273+28%	\$20,200
\$24,600.....	\$29,900.....	\$4,505+32%	\$24,600
\$29,900.....	\$35,200.....	\$6,201+37%	\$29,900
\$35,200.....	\$45,800.....	\$8,162+43%	\$35,200
\$45,800.....	\$60,000.....	\$12,720+49%	\$45,800
\$60,000.....	\$85,600.....	\$19,678+54%	\$60,000
\$85,600.....	\$109,400.....	\$33,502+59%	\$85,600
\$109,400.....	\$162,400.....	\$47,544+64%	\$109,400
\$162,400.....	\$215,400.....	\$81,464+68%	\$162,400
\$215,400.....		\$117,504+70%	\$215,400

Table 1.—Continued

Married taxpayers filing separate returns			
<i>If taxable income is:</i>		<i>the tax is:</i>	
Not over \$1,700.....		—0—	
<b>Over—</b>	<b>But not over—</b>		<b>of the amount over—</b>
\$1,700.....	\$2,750.....	14%	\$1,700
\$2,750.....	\$3,800.....	\$147.00 + 16%	\$2,750
\$3,800.....	\$5,950.....	\$315.00 + 18%	\$3,800
\$5,950.....	\$8,000.....	\$702.00 + 21%	\$5,950
\$8,000.....	\$10,100.....	\$1,132.50 + 24%	\$8,000
\$10,100.....	\$12,300.....	\$1,636.50 + 28%	\$10,100
\$12,300.....	\$14,950.....	\$2,252.50 + 32%	\$12,300
\$14,950.....	\$17,600.....	\$3,100.50 + 37%	\$14,950
\$17,600.....	\$22,900.....	\$4,081.00 + 43%	\$17,600
\$22,900.....	\$30,000.....	\$6,360.00 + 49%	\$22,900
\$30,000.....	\$42,800.....	\$9,839.00 + 54%	\$30,000
\$42,800.....	\$54,700.....	\$16,751.00 + 59%	\$42,800
\$54,700.....	\$81,200.....	\$23,772.00 + 64%	\$54,700
\$81,200.....	\$107,700.....	\$40,732.00 + 68%	\$81,200
\$107,700.....		\$58,752.00 + 70%	\$107,700
Heads of households			
<i>If taxable income is:</i>		<i>the tax is:</i>	
Not over \$2,300.....		—0—	
<b>Over—</b>	<b>But not over—</b>		<b>of the amount over—</b>
\$2,300.....	\$4,400.....	14%	\$2,300
\$4,400.....	\$6,500.....	\$294 + 16%	\$4,400
\$6,500.....	\$8,700.....	\$630 + 18%	\$6,500
\$8,700.....	\$11,800.....	\$1,026 + 22%	\$8,700
\$11,800.....	\$15,000.....	\$1,708 + 24%	\$11,800
\$15,000.....	\$18,200.....	\$2,476 + 26%	\$15,000
\$18,200.....	\$23,500.....	\$3,308 + 31%	\$18,200
\$23,500.....	\$28,800.....	\$4,951 + 36%	\$23,500
\$28,800.....	\$34,100.....	\$6,859 + 42%	\$28,800
\$34,100.....	\$44,700.....	\$9,085 + 46%	\$34,100
\$44,700.....	\$60,600.....	\$13,961 + 54%	\$44,700
\$60,600.....	\$81,800.....	\$22,547 + 59%	\$60,600
\$81,800.....	\$108,300.....	\$35,055 + 63%	\$81,800
\$108,300.....	\$161,300.....	\$51,750 + 68%	\$108,300
\$161,300.....		\$87,790 + 70%	\$161,300

Above the zero bracket amounts, the tax rates range from 14 percent to 70 percent. The rate schedule for single persons contains 16 tax brackets, and all of the other rate schedules contain 15 brackets. An individual's tentative income tax liability (before credits) is calculated by applying the appropriate rate schedule to his or her taxable income. For example, the tax liability (before credits) of a married couple with \$6,500 of taxable income is \$454. This amount is \$294 on the income below \$5,500 and 16 percent of the income over \$5,500 (i.e.,  $\$1,000 \times 16\% = \$160$ ). The \$294 tax on the first \$5,500, which is shown in the tax rate table, is actually computed from the lower brackets, i.e., there is no tax on the first \$3,400 and a 14-percent tax on the next \$2,100. The highest rate to apply to a taxpayer's income (in the example, 16 percent) is called the marginal income tax rate since it applies to the last dollar earned by the taxpayer.

#### Maximum tax

Although the tax rates range up to 70 percent on taxable income in excess of \$215,400 for joint returns and \$108,300 for single returns, a maximum tax rate of 50 percent generally applies to personal service income (for example, salaries and wages). The maximum tax applies to single individuals with taxable earned income above \$41,500 and married couples with taxable earned income above \$60,000, since these are the levels at which present tax rates rise above 50 percent.<sup>3</sup>

#### Earned income credit

Under present law, taxpayers living with children are entitled to a refundable credit equal to 10 percent of the first \$5,000 of earnings (for a maximum credit of \$500). The credit phases out at a rate of 12.5 percent (i.e., a reduction in the credit of 12½ cents for each additional dollar of income) as income rises from \$6,000 to \$10,000. Thus, no credit is available for families with incomes of \$10,000 or more.

The earned income credit may be received in the form of advance payments added to employees' paychecks.

#### Capital gains

Under present law, taxpayers may deduct from gross income 60 percent of the amount of any net capital gains for the taxable year. The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's net capital gain is 28 percent (70 percent top tax rate on the 40-percent includible capital gain).

<sup>3</sup> The actual marginal tax rate on earned income may be greater than 50 percent even for those individuals whose tax liability is calculated using the maximum tax. This occurs for two reasons. First, the tax liability on unearned income is calculated by "stacking" it after earned income, so that each additional dollar of earned income may push a taxpayer's unearned income into higher brackets. Second, because itemized deductions are, in effect, allocated on a pro rata basis between earned income and other income, each dollar of earned income causes an additional amount of itemized deductions to be allocated to earned income. As a result, a larger portion of the deductions reduces income which would be taxed at a 50-percent rate rather than at the higher rates applicable to other income.

**Add-on minimum tax**

Present law imposes an add-on minimum tax on items of tax preference other than the capital gains deduction and adjusted itemized deductions. The tax applies at a rate of 15 percent on the sum of an individual's tax preferences in excess of one-half of regular income taxes paid or, if greater, \$10,000.

**Alternative minimum tax**

Present law imposes an alternative minimum tax on individuals to the extent that the tax on alternative minimum taxable income exceeds their regular income tax, including the "add-on" minimum tax.

In general, alternative minimum taxable income is based on the sum of the taxpayer's gross income reduced by allowed deductions, and increased by tax preference items (i.e., adjusted itemized deductions and the capital gains deduction). The minimum tax rate ranges from 10 percent on amounts over \$20,000 to 25 percent on amounts over \$100,000.

## II. ADMINISTRATION PROPOSAL

### Reduction in tax rates

By 1984, all tax rates in the current tax rate schedules would be reduced by approximately 30 percent. Thus, the range of tax rates would be 10 to 50 percent instead of the 14 to 70 percent range under present law. Interim reductions for 1981, 1982, and 1983 would be approximately 5, 15, and 25 percent, respectively. The 5-percent tax cuts for 1981 would be reflected in a 10-percent reduction in income tax withholding and estimated tax payments starting July 1, 1981. Subsequent adjustments to withholding schedules would occur on January 1 of 1982, 1983, and 1984. Rate schedules for joint returns under the Administration proposal are shown in Table 2. Comparable rate reductions would be made to the other rate schedules.

### Elimination of maximum tax

Effective in 1984, the current provision for a maximum tax rate of 50 percent on earned income would be eliminated, since the maximum tax rate applying to all types of income would be 50 percent, as specified above.

### Reduction in alternative minimum tax and capital gains tax rate)

Under the proposal, the maximum rate of the alternative minimum tax would be lowered in 1982, 1983, and 1984 to 24, 21, and 20 percent, respectively. These rates would be approximately equal to the maximum rate on capital gains under the regular rate schedule which would be in effect in that year. The deduction for net capital gains would remain at 60 percent. Because the maximum regular tax rate would be reduced from 70 percent to 50 percent over 4 years, the maximum tax rate on capital gains would be reduced from 28 percent to 20 percent.

### Revenue effect

The Administration proposal is estimated to reduce calendar year tax liability by \$14.6 billion in 1981, \$48.7 billion in 1982, \$92.9 billion in 1983, \$129.8 billion in 1984, \$152.8 billion in 1985, and \$178.9 billion in 1986. Fiscal year receipts would be reduced by \$6.4 billion in 1981, \$43.9 billion in 1982, \$80.8 billion in 1983, \$119.8 billion in 1984, \$146.6 billion in 1985, and \$171.9 billion in 1986. These figures include increased outlays associated with the refundable portion of the earned income credit.

Table 2.—Administration's Proposed Tax Rate Schedules for 1981, 1982, 1983, and 1984: Joint Returns

Taxable income bracket	Present law		Administration proposal <sup>1</sup>							
			1981		1982		1983		1984 and subsequent years	
	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket
\$0-\$3,400-----	\$0	0%	\$0	0%	\$0	0%	\$0	0%	\$0	0%
\$3,400-\$5,500-----	0	14	0	13	0	12	0	11	0	10
\$5,500-\$7,600-----	294	16	273	15	252	14	231	12	210	11
\$7,600-\$11,900-----	630	18	588	17	546	15	483	14	441	13
\$11,900-\$16,000-----	1,404	21	1,319	20	1,191	18	1,085	16	1,000	15
\$16,000-\$20,200-----	2,265	24	2,139	23	1,929	21	1,741	19	1,615	18
\$20,200-\$24,600-----	3,273	28	3,105	27	2,811	24	2,539	22	2,371	21
\$24,600-\$29,900-----	4,505	32	4,293	30	3,867	27	3,507	24	3,295	23
\$29,900-\$35,200-----	6,201	37	5,883	35	5,298	31	4,779	28	4,514	27
\$35,200-\$45,800-----	8,162	43	7,738	41	6,941	37	6,263	33	5,945	32
\$45,800-\$60,000-----	12,720	49	12,084	47	10,863	42	9,761	38	9,337	36
\$60,000-\$85,600-----	19,678	54	18,758	51	16,827	47	15,157	42	14,449	40
\$85,600-\$109,400-----	33,502	59	31,814	56	28,859	50	25,909	45	24,689	43
\$109,400-\$162,400-----	47,544	64	45,142	61	40,759	55	36,619	49	34,923	47
\$162,400-\$215,400-----	81,464	68	77,472	65	69,909	58	62,589	52	59,833	49
\$215,400 and over-----	117,504	70	111,922	66	100,649	60	90,149	53	85,803	50

<sup>1</sup> Compared with present law, tax rates are reduced approximately 5 percent in 1981, 15 percent in 1982, 25 percent in 1983, and 30 percent in 1984.

### III. ISSUES FOR COMMITTEE CONSIDERATION

#### A. Distribution of Tax Cut by Income Class

##### 1. Overview

A central issue in the choice of an individual income tax reduction proposal is the distribution of the reduction by income class. The distribution of income tax burdens under current law is determined primarily by the provisions described above in Part I. Two general concerns arise in considering this distribution: economic impact and equity. With respect to economic impact, the principal issues discussed below in the section on marginal tax rates are whether the distribution of the tax burden by income class has any effect on the overall spending or savings propensities of consumers and on their work effort.

Considerations of equity are, of course, largely subjective, but two types of information may be helpful in reaching a conclusion about the desirable distribution of the tax burden—data on the impact of tax changes scheduled for 1981 and data on the overall distribution of the tax burden. There are several viewpoints from which discussions of equity may proceed. First, some may argue that any tax reduction should offset tax increases scheduled to take effect in 1981, so that the distribution of tax burdens remains approximately the same as it would have been without these increases. This approach will appeal to those who believe that the 1980 distribution is appropriate or, at least, the best starting point from which to analyze legislative proposals. Another point of view would focus on the 1981 status quo as the reference point for discussion of equity considerations. A third point of view could be that neither the 1980 nor 1981 distributions provides a useful reference point and that the tax burden should be reexamined *de novo* (i.e., without using present law to define a desirable distribution). These individuals may believe, for example, that the tax system currently is too progressive or too regressive. This view would call for a general examination of the distribution of the tax burden under current law. The following sections provide information relevant to each of these points of view. First, there is a discussion of the tax changes scheduled for 1981. Next, data on the overall distribution of the tax burden is presented. Finally, the tax reductions proposed by the Administration are compared to the changes scheduled for 1981 and the overall distribution of the tax burden under present law.

##### 2. Tax changes scheduled for 1981

Under present law and in the absence of legislation, three factors would significantly change the distribution of individuals' tax liability in 1981—(1) the interaction between inflation and fixed dollar amounts in the tax system, such as rate brackets, (2) the interest-

dividend exclusion adopted in the Crude Oil Windfall Profit Tax Act of 1980, and (3) the increase in the rate and base of social security taxes.

*Effect of inflation*

The effect of inflation on tax liability, commonly known as "bracket creep," is by far the most significant of these factors. Its effect can be illustrated by several examples. In 1980, a couple with no children and an income of \$5,000 would have had no tax liability, because its income was less than the sum of its personal exemptions (\$2,000) and the zero bracket amount applicable to married couples (\$3,400). Suppose that the family's income rose at the rate of inflation, which is assumed to be 10 percent, so that its income in 1981 was \$5,500. Because the values of exemptions and the zero bracket amount stay constant, tax liability in 1981 is \$14. Thus, even though the family's income has risen no faster than inflation, so that its real before-tax income is constant, its tax liability has increased from zero to \$14, reducing its real after-tax income. Because the fixed dollar parameters of the tax system are not changed, the distribution of tax burden, in terms of real income, does change as a result of inflation.

The effect of inflation on tax liability varies according to a taxpayer's income. Generally, the tax reduction necessary to compensate for the effects of inflation would be smaller in absolute dollars for lower income than higher income households, but would result in a larger tax cut, in percentage terms, for lower income households. This can be illustrated by comparing the effect of inflation on a family with \$50,000 of adjusted gross income with the example in the previous paragraph. Under current law, assuming that deductions are not itemized and that no credits are allowed, the tax liability of a married couple with \$50,000 of income is \$13,798. If the family's income rises by 10 percent, to \$55,000, then its tax liability would be \$16,248, and its average tax rate would increase from 27.6 percent to 29.5 percent. However, if personal exemptions, the zero bracket amount, and the rate brackets had been adjusted by the 10-percent rate of inflation, its tax liability would be \$15,178, which would imply the same average tax rate and the same real after-tax income as in the prior year. The tax reduction necessary to compensate for the effects of inflation would thus be \$1,070. Although this is a much larger amount than the \$14 figure derived for the low income family above, this reduction as a percentage of tax liability (6.6 percent) is much smaller than the corresponding percentage for the low income family (100 percent).

The same pattern appears in computing estimates, at 1981 income levels, of the actual total tax reductions necessary to compensate for the effect of inflation in increasing average tax rates even as real income stays constant. The figures in Table 3 show the tax reduction which would result from adjusting rate brackets, the personal exemption, the zero bracket amount, and the earned income credit by 9.14 percent, which was the increase in the GNP deflator between the third quarter of 1979 and the third quarter of 1980. Compensating for the effects of inflation would involve a tax cut which is large in absolute amount but smaller as a percent of tax liability for high income than low income taxpayers.

Table 3.—Tax Increases From Inflation:<sup>1</sup> Aggregate Total and Percent of Income Tax Liability Under Present Law by Income Class (1981 Income Level)

Expanded income (thousands)	Aggregate total (millions)	Percent of income tax liability
Below \$5.....	\$168	( <sup>2</sup> )
\$5-\$10.....	1,232	19.3
\$10-\$15.....	1,365	8.4
\$15-\$20.....	1,570	6.8
\$20-\$30.....	3,703	6.3
\$30-\$50.....	5,268	6.1
\$50-\$100.....	2,781	5.4
\$100-\$200.....	771	3.2
\$200 and over.....	253	1.2
Total.....	17,110	6.0

<sup>1</sup> Revenue gain from *not* adjusting personal exemption, earned income credit, zero bracket amount, and rate brackets by 9.14 percent.

<sup>2</sup> Individual income tax liability is negative for this group because earned income credits exceed tax.

#### *Dividend-interest exclusion*

The second major tax change scheduled for 1981 is the \$200 per taxpayer exclusion of interest and dividends from gross income, which was adopted in the Crude Oil Windfall Profit Tax Act of 1980. This new provision replaces, for 1981 and 1982, the former \$100 per taxpayer exclusion which was applicable only to dividends.

#### *Social security tax increases*

The third set of changes having a major influence on individuals' 1981 tax burden is the increase in the rate of social security taxes and the *ad hoc* increase in the base of the taxes. The rate of the tax on employees increased from 6.13 percent in 1980 to 6.65 percent in 1981, and the rate on the self-employed increased from 8.1 percent to 9.3 at the same time.<sup>1</sup> Although the base of these taxes normally rises by the percentage increase in average wages in order to maintain the real value of the tax, the law specifies an *ad hoc* increase to \$29,700 for 1981, a figure higher than the \$28,200 which would have applied under the normal indexing formula. Only the excess of \$29,700 over \$28,200 is counted as an increase in this analysis.

Table 4 presents figures by income class on the three changes scheduled for 1981. If the committee wishes to adopt a tax cut which offsets these changes, then tax reductions for each income class greater than or equal to the amounts shown would be necessary.

<sup>1</sup> The tax rate on employers also increased from 6.13 to 6.65 percent. Because the incidence of this increase is uncertain, it is not considered in this analysis.

**Table 4.—Scheduled Tax Increases for 1981: Aggregate Change in Revenue and as Percent of Tax Liability and After-Tax Income, by Income Class (1981 Income Level)**

Expanded income <sup>1</sup> (thousands)	Aggregate change in revenue (millions)					Total increase as percent of tax liability	Total increase as percent of after-tax income
	Inflation increase <sup>2</sup>	Interest and dividend exclusion <sup>3</sup>	Net income tax increase	Employee and self- employed social security increase <sup>4</sup>	Total increase		
Below \$5.....	\$168	\$-25	\$143	\$228	\$371	( <sup>6</sup> )	1.0
\$5-\$10.....	1,232	-141	1,091	530	1,621	25.4	1.5
\$10-\$15.....	1,365	-208	1,157	742	1,899	11.6	1.4
\$15-\$20.....	1,570	-222	1,348	880	2,228	9.7	1.4
\$20-\$30.....	3,703	-564	3,139	2,011	5,150	8.8	1.5
\$30-\$50.....	5,268	-862	4,406	2,692	7,098	8.3	1.8
\$50-\$100.....	2,781	-391	2,390	926	3,316	6.4	1.9
\$100-\$200.....	771	-83	688	175	863	3.6	1.5
\$200 and over.....	253	-21	232	44	276	1.3	.6
Total.....	17,110	-2,517	14,593	8,227	22,820	8.0	1.6

<sup>1</sup> Expanded income is equal to adjusted gross income plus excluded capital gains and various tax preference items less the smaller of investment interest paid or investment income.

<sup>2</sup> Revenue gain from *not* adjusting personal exemption, earned income credit, zero bracket amount, and rate brackets by 9.14 percent.

<sup>3</sup> Revenue loss from expanding the \$100 dividend exclusion to the \$200 interest and dividend exclusion.

<sup>4</sup> Revenue gain resulting from ad hoc increase in the wage base (to \$29,700) above what would occur under indexing (\$28,200), and from increase in rate to 6.65 from 6.13 percent for employees and to 9.3 from 8.1 percent for the self-employed.

<sup>5</sup> Individual income tax liability is negative for this group because earned income credits exceed tax.

Table 4 also shows the sum of these changes as a percentage of both percent income tax liability and after-tax income. This sum is a larger percentage of income tax liability for lower-income than higher-income families. As a percent of after-tax income, the total scheduled increase rises between the lowest income class and the second (\$5,000 to \$10,000) class, is relatively constant through the \$20,000 to \$30,000 class, rises again for the \$30,000 to \$100,000 class and falls for the highest two income groups.

As noted above, the significance of this information on scheduled tax changes may depend on the committee's judgment concerning the equity of the distribution of tax liability before these increases went into effect. If the committee believes that the distribution in 1980 was appropriate, then it may wish to provide for a tax cut to offset the net increases shown in the table. However, to the extent that this distribution is felt to be inappropriate, the goal of simply offsetting these scheduled increases is less compelling.

A similar point may be made about the social security tax portion of these scheduled increases. Some may see these increases as making the distribution of the tax more equitable, and, also, they may be perceived to be offset by future social security benefits. Under this view, these increases would not affect the desired distribution of income tax relief. In contrast, others may believe that these increases have a material effect on individuals' ability to pay taxes and, thus, that they should be taken into account in designing an income tax reduction proposal.

### **3. Overall distribution of tax burden**

The overall distribution of the tax burden under present law can be assessed in several ways. One of the most useful is to compare the distributions by income class of the number of tax returns, the total amount of income, and the amount of income tax liability. The data allowing this comparison are shown in table 5. These data are subject to the important limitation that the income concept used does not include any items not in adjusted gross income except the tax preferences which are included in the statutory definition of "expanded income." Thus, transfer payments, many fringe benefits, and tax-exempt interest are not included. In addition, this income definition uses accounting rules prescribed for the income tax, even though these rules may not take account of the impact of inflation on measuring real interest and capital gains and may differ from those used to report income for other purposes.

Under a tax system in which everyone paid the same absolute amount of tax, the distribution of tax liability would be the same as the distribution of taxpayers. Since tax liability under current law is related to income, the burden of tax liability falls much more heavily on higher income groups than would be the case under such a system; this is evident from comparing the first and third columns of table 5.

**Table 5.—Percentage Distribution of Number of Tax Returns, Income, and Tax Liability, and Average Tax Rate, by Income Class (1981 Income Levels)**

[In percent]

Expanded income (thousands)	Percentage distribution <sup>1</sup>				Average tax rate	
	Tax returns	Expanded income	Income tax liability <sup>2</sup>	Income and social security tax liability	Income tax liability only <sup>3</sup>	Income and social security tax liability
Below \$5.....	19.4 (19.4)	2.1 (2.1)	0.2 (0.2)	0.7 (0.7)	-0.4	6.8
\$5-\$10.....	17.2 (36.6)	6.6 (8.7)	2.5 (2.7)	3.4 (4.1)	5.3	10.7
\$10-\$15.....	14.3 (50.9)	9.1 (17.8)	5.7 (8.4)	6.8 (10.9)	9.8	15.3
\$15-\$20.....	11.6 (62.5)	10.4 (28.2)	8.0 (16.4)	9.0 (19.9)	12.1	17.9
\$20-\$30.....	18.1 (80.6)	22.9 (51.1)	20.3 (36.7)	22.0 (41.9)	14.0	19.7
\$30-\$50.....	14.6 (95.2)	28.0 (79.1)	29.8 (66.5)	29.8 (71.7)	16.7	21.9
\$50-\$100.....	3.9 (99.1)	12.7 (91.8)	17.9 (84.4)	15.7 (87.4)	22.3	25.5
\$100-\$200.....	.7 (99.8)	4.6 (96.4)	8.4 (92.8)	6.8 (94.2)	28.6	30.1
\$200 and over.....	.2 (100.0)	3.7 (100.0)	7.3 (100.0)	5.7 (100.0)	31.0	31.5
Total.....	100.0	100.0	100.0	100.0	15.7	20.5

<sup>1</sup> Cumulative totals in parenthesis. Totals may not add to 100 percent because of rounding.

<sup>2</sup> Includes only tax returns with positive tax liability.

<sup>3</sup> Includes all tax returns.

Under a proportional income tax system, in which each taxpayer's tax liability was the same fraction of his or her income, the distribution of tax liability would be the same as the distribution of income. A comparison of the second and third columns of table 5 shows that the present tax system is progressive, that is, the distribution of tax liability is weighted more heavily toward higher income taxpayers than the distribution which would prevail under a proportional tax. This difference is especially noticeable for the lowest and highest income groups; the tax burdens of the middle income groups (\$20,000 to \$50,000) are not very different from what they would be under a proportional income tax. Another way to use these figures is to divide total tax liability by total expanded income to obtain an average tax rate for each income class. Under a proportional income tax, the average tax rate would be equal for each income class. Under present law, the average rate rises from 1.3 percent for the lowest group to 9.8 percent for the \$10,000 to \$15,000 group, rises gradually over the next three groups, and then rises to 22.3 percent for the \$50,000 to \$100,000 group and to 31.0 percent for the highest income group.<sup>2</sup>

Some might argue that the preceding discussion is incomplete because it ignores social security taxes. Others, however, would argue that the financing and benefits of the social security system should be analyzed apart from the questions of equity within the income tax system. To provide information for those who subscribe to the first point of view, table 5 also shows combined income and payroll taxes as a percentage of expanded income and an average tax rate computed for both payroll and income taxes. Because the social security tax (1) does not apply to capital income, which tends to be more highly concentrated among higher income groups than wages and salaries, (2) uses a proportional rate rather than progressive rates with exemptions and deductions, and (3) applies only on wages up to a ceiling amount (\$29,700 in 1981), it is less progressive than the income tax. Thus, the combined burden of income and payroll taxes falls somewhat more heavily on lower income groups, in relative terms, than the burden of the income tax by itself.

#### **4. Effect of Administration proposal**

The relationship of the tax reductions proposed by the Administration to the concepts and data discussed in the previous sections is presented in Table 6. For the purpose of this table, which shows a full year of inflation and social security tax changes, the first full year of the Administration proposal is represented by a 10 percent across-the-board rate cut. (The proposed 5-percent rate cut for 1981, starting July 1, is a 10-percent cut at annual rates.)

<sup>2</sup>The average tax rates are somewhat overstated because they do not take account of the income of those who do not file tax returns.

Table 6.—Aggregate Change in Revenue by Income Class: Scheduled Tax Increases and Administration Proposal by Income Class

[1981 income level, millions of dollars]

Expanded income (thousands)	First full year		After 3 full years	
	Scheduled income and social se- curity tax increases	Adminis- tration proposal (10 percent rate cut)	Scheduled income and social se- curity tax increases <sup>1</sup>	Adminis- tration proposal (30 percent rate cut)
Below \$5.....	371	-69	664	-143
\$5-\$10.....	1,621	-931	4,330	-2,320
\$10-\$15.....	1,899	-1,926	5,338	-4,826
\$15-\$20.....	2,228	-2,635	5,732	-6,645
\$20-\$30.....	5,150	-6,379	13,164	-16,479
\$30-\$50.....	7,098	-9,394	18,101	-23,681
\$50-\$100.....	3,316	-5,457	9,448	-14,106
\$100-\$200.....	863	-2,035	2,640	-5,946
\$200 and over.....	276	-1,474	873	-4,710
Total.....	22,820	-30,301	60,289	-78,858

<sup>1</sup> Revenue from (a) *not* adjusting personal exemption, earned income credit, zero bracket amount, and rate brackets by 3 full years of inflation (assumed to total 31.29 percent) and (b) repealing 1981 ad hoc increase in the wage base (to \$29,700) above what would occur under indexing (\$28,200), and from 1981 and 1982 increases in rate from 6.13 to 6.70 percent for employees and from 8.1 to 9.35 percent for the self-employed.

The first two columns of Table 6 compare the aggregate revenue change, by income class, from the increases in income and social security taxes scheduled for 1981 with the reductions which would be caused by the Administration's proposal. These figures show that the total size of the proposed tax cut is about one-third larger than the total amount of scheduled increases; however, the proposal does not offset the inflation and social security increases for the lowest two income brackets. For the income groups above \$10,000, the Administration proposal more than offsets the scheduled increases. Generally, the excess of the proposed reduction over the amount of scheduled increases is larger for the higher income groups. The same general pattern appears when social security is left out of the comparison. To illustrate this point using the figures in Table 6 for the sum of income and social security tax increases, for the \$10,000 to \$15,000 income group, the proposed reduction is 1.4 percent larger than the amount of scheduled increases, while for the \$200,000 and over group the proposed reduction is 434 percent larger than the amount of scheduled increases. The same general conclusions apply to the Administration proposal when fully phased in, as shown by comparing the last two columns of Table 6. The general pattern results primarily from the fact that the Administration has proposed an across-the-board reduction and that tax increases from inflation are a higher percentage of

tax liability for low-income families than high income families. Those who argue that the proposed tax reductions should simply offset scheduled increases would probably wish to shift some of the proposed reductions from the higher income groups to the lower income groups. However, others may argue that the distribution of tax burden already is too heavily weighted toward high-income groups, or that other considerations, such as reducing marginal tax rates, dictate that the tax cut should not simply offset scheduled increases.

It should be noted that this analysis of the distributional impact of the Administration's proposal does not take into account the effect of the proposed Accelerated Cost Recovery System (ACRS). Approximately 20 percent of the tax reduction from that proposal will accrue to unincorporated businesses in 1981, but the data necessary to calculate the distribution by income class are not available.

Another way to gauge the impact of the Administration's proposal is to calculate the reductions by income class as a percentage of either tax liability or after-tax income. These figures are shown in Table 7. As a percentage of tax liability, the proposed reductions are approximately uniform across income classes, while the scheduled increases are a greater percentage of tax liability for low-income than high-income taxpayers. The last two columns show that the scheduled increases (or a tax cut to offset them) would have a roughly uniform effect as a percentage of after-tax income for all but the lowest and highest income groups. The Administration proposal, on the other hand, would increase after-tax income by 1 to 1.5 percent more for the higher-income groups than for the middle-income groups.

**Table 7.—Tax Changes as Percentage of Tax Liability and Percentage of After-Tax Income, for Scheduled Tax Increases in 1981 and Administration Proposal (First Full Year) by Income Class**

[1981 income level, in percent]

Expanded income (thousands)	Percentage of income tax liability		Percentage of after- tax income	
	Scheduled income and social se- curity tax increases	Adminis- tration proposal (10 percent rate cut) <sup>2</sup>	Scheduled income and social se- curity tax increases	Adminis- tration proposal (10 percent rate cut) <sup>2</sup>
Below \$5.....	( <sup>1</sup> )	( <sup>1</sup> )	1.0	0.2
\$5-\$10.....	25.4	14.6	1.5	0.9
\$10-\$15.....	11.6	11.8	1.4	1.4
\$15-\$20.....	9.7	11.5	1.4	1.7
\$20-\$30.....	8.8	10.9	1.5	1.9
\$30-\$50.....	8.3	11.0	1.8	2.4
\$50-\$100.....	6.4	10.6	1.9	3.2
\$100-\$200.....	3.6	8.4	1.5	3.4
\$200 and over.....	1.3	7.0	.6	3.2
All income classes.....	8.0	10.6	1.6	2.1

<sup>1</sup> Individual income tax liability is negative for this group because earned income credits exceed tax liability.

<sup>2</sup> First full year effect.

A final way to gauge the impact of the Administration proposal on the distribution of tax burdens is to examine the average tax rate under present law and under the Administration proposal. As in Table 5, the average tax rate can be computed either for the income tax or both income and social security taxes (combined). Table 8 presents the resulting computations. Average tax rates would be lowered by roughly uniform amounts in most income classes by a tax cut which exactly offsets net scheduled increases, while the Administration proposal would lower average rates somewhat more for the higher income groups than for lower income groups.

Table 8.—Average Tax Rate Under Present Law, Present Law with Repeal of 1981 Scheduled Tax Increases, and Administration Proposal (First Full Year)

[1981 income levels, in percent]

Expanded income (thousands)	Average tax rate—income tax liability only			Average tax rate—income and social security tax liability		
	Present law	After repeal of scheduled income tax increases	After Administration proposal (10 percent rate cut)	Present law	After repeal of scheduled income tax increases	After Administration proposal (10 percent rate cut)
Below \$5.....	-0.4	-0.8	-0.6	6.8	5.9	6.6
\$5-\$10.....	5.3	4.4	4.5	10.7	9.4	10.0
\$10-\$15.....	9.8	9.1	8.7	15.3	14.2	14.2
\$15-\$20.....	12.1	11.4	10.7	17.9	16.7	16.5
\$20-\$30.....	14.0	13.2	12.4	19.7	18.5	18.2
\$30-\$50.....	16.7	15.9	14.9	21.9	20.5	20.1
\$50-\$100.....	22.3	21.2	19.9	25.5	24.1	23.2
\$100-\$200.....	28.6	27.7	26.1	30.1	29.1	27.7
\$200 and over.....	31.0	30.7	28.8	31.5	31.1	29.3
Total.....	15.7	14.9	14.0	20.5	19.3	18.9

## B. Marginal Tax Rates

### 1. Overview

An individual's marginal tax rate is the rate applicable to the last or to the next dollar of income received. If an individual is subject to a 25-percent marginal rate, then the return to additional work effort and saving is reduced by 25 percent. For example, if this individual is considering working on an overtime assignment which pays \$40, then the after-tax reward to this work effort is \$30. A higher marginal tax rate would reduce the return to this work effort even further, affecting the incentive to undertake the assignment. A similar point may be made with respect to investment decisions. If the individual with a 25-percent marginal rate invests in a security with a 10-percent return, the after-tax return would be 7.5 percent. Thus, the marginal tax rate affects the incentive to save rather than use the same resources for current consumption. The same reasoning may be used to show that marginal tax rates also influence the incentives to engage in activities which are heavily taxed versus those which are lightly taxed. With high marginal rates, for example, there is more incentive to invest in lightly taxed investments or to take jobs in which a high proportion of compensation is in the form of non-taxable fringe benefits than would be the case with low marginal rates.

A great deal of concern has been raised about the effect on the efficiency of the economy of the marginal tax rates characteristic of the current individual income tax and of the resulting impact on the incentives which affect economic behavior. It is not technically difficult to lower marginal tax rates, but the degree to which the committee may wish to lower them may involve comparing the economic efficiency benefits of such a reduction with the costs or benefits related to the achievement of other goals of the tax system, such as distribution by income class (discussed above), and budgetary goals (discussed below). The remainder of this section provides information relevant to assessing these trade-offs. First, data are presented on recent trends in average and marginal tax rates. This is followed by a discussion of the impact of marginal tax rates on work effort and saving. Finally, the effect of the Administration proposal on marginal tax rates is assessed.

### 2. Recent trends in marginal and average tax rates

Any taxpayer's marginal tax rate is determined both by the tax rate schedules and by the definitions necessary to arrive at the amount of taxable income which is subject to the rate schedules. Thus, virtually every provision affecting an individual's tax liability may affect his or her marginal rate. If personal exemptions were increased, an individual's taxable income would be reduced, and this would drop many taxpayers into lower tax brackets. A similar point may be made about the zero bracket amount. If an exclusion or deduction were eliminated, some individuals would be pushed into higher tax brackets; the additional revenue which this would raise, however, could be used to pay

for a general rate reduction which could result in a net reduction in marginal tax rates. A modest widening of rate brackets would lower marginal rates for some, but not all, taxpayers. Direct reductions in the tax rates appearing in the rate schedules would lower marginal tax rates for some, or all, taxpayers, depending on the extent of the reduction.

In order to compare the impact of proposals which, for example, decrease some taxpayers' marginal rates by a large amount and leave others unchanged, with proposals which provide a smaller reduction in rates for a larger number of taxpayers, it is useful to develop an index of the average marginal tax rate which takes into account the position of all taxpayers.

Table 9 presents data on recent trends in an index of average marginal tax rates. These figures are computed by weighting each taxpayer's marginal tax rate, assumed to depend only on the taxpayer's rate bracket, by his or her adjusted gross income. Thus, this index gives an approximate indication of how much income tax revenues would increase if all taxpayers' adjusted gross income increased by a small, uniform percentage. Weighting by income is an approximate way of ensuring that each taxpayer's marginal rate has a weight which approximates the extent to which the incentive resulting from a reduction in his or her marginal tax rate might be expected to affect the overall economy. It should be noted that these figures do not take into account State and local income taxes, social security taxes, and the marginal tax rates implicit in Federal transfer payment programs. (The last of these is discussed briefly in Part III. D., below.)

The marginal rate figures in table 9 show that during the period covered by the table, the average marginal rate reached a low of 21.8 percent in 1965, the year that the largest post-World War II tax cut was fully phased in. The marginal rate then rose to 27.5 percent in 1969, when the 10-percent income tax surcharge was in effect, and then fell to a relatively low figure (24.0) in 1971, after the surcharge was removed. Since 1971, however, the marginal rate has increased each year, and, using this index, it is estimated that the figure for 1981 would be 32.2 percent under present law.

Table 9 also contains figures on how the average income tax rate has changed over the same period. (The average rate is simply total income tax liability divided by total adjusted gross income.) During the 1960's, the pattern of the average rate generally followed the pattern of the marginal rate; both figures reached a low in 1965 and a high in 1969. During the 1970's, however, there were two years, 1972 and 1975, in which average rates fell at the same time that marginal rates increased. Presumably, this occurred because tax reductions which were put into effect in those years did not lower marginal tax rates directly.

**Table 9.—Marginal and Average Tax Rates, Individual Income Tax, 1962-81**

[In percent]

	Marginal rate <sup>1</sup>	Average rate <sup>2</sup>
Calendar year:		
1962.....	24.9	12.9
1963.....	26.1	13.1
1964.....	22.7	11.9
1965.....	21.8	11.5
1966.....	22.2	12.0
1967.....	22.9	12.5
1968 <sup>3</sup> .....	27.0	13.8
1969 <sup>3</sup> .....	27.5	14.3
1970 <sup>3</sup> .....	24.5	13.3
1971.....	24.0	12.7
1972.....	24.4	12.5
1973.....	25.7	13.1
1974.....	26.2	13.7
1975.....	26.8	13.1
1976.....	27.8	13.5
1977.....	28.7	13.8
1979 <sup>4</sup> .....	30.6	14.6
1981 <sup>4</sup> .....	32.2	15.9

<sup>1</sup> The marginal tax rate is the tax rate applicable to the last dollar of income. The table shows the weighted average marginal tax rate for all tax returns, weighted by adjusted gross income.

<sup>2</sup> The average tax rate equals individual income tax liability for a calendar year divided by adjusted gross income.

<sup>3</sup> Includes the surcharge.

<sup>4</sup> Estimated.

The average marginal rate in table 9 is a weighted average of marginal rates from all tax returns. A somewhat more refined measure may be obtained by using the sample of income tax returns which the Joint Committee and Treasury staffs use to make revenue estimates. All income items on the tax return and certain income-linked deductions can be increased by a small uniform percentage, and the resulting increase in tax liability may be calculated. The average marginal tax rate is simply the increase in total tax liability divided by the increase in total income. This makes it possible to use a more expansive definition of income than adjusted gross income and, thus, to take into account the

effect of such provisions as the \$200 interest-dividend exclusion and the 60-percent capital gains deduction. For example, for a taxpayer whose dividend and interest income is less than \$200, the marginal tax rate on this type of income is zero. This effect and the effect of its predecessor, the \$100 dividend exclusion, are not reflected in the figures in table 9. Other provisions which affect actual marginal rates but are not included in table 9 are (1) deductions which increase automatically with income, such as deductions for State and local income and general sales taxes, and thus serve to decrease marginal tax rates, (2) the maximum tax on earned income, and (3) the two minimum taxes. When this analysis is performed to calculate the average marginal tax rate under present law, the result is a figure of 30.4 percent, lower than the 32.2 percent shown in table 9. This type of analysis also may be performed for various possible changes to current law, including the Administration proposal, as is discussed in Part III.B.5, below.

### **3. Effect of marginal tax rates on work effort**

In analyzing the effect of the changes in marginal tax rates on work effort, it is useful to emphasize that a reduction in marginal tax rates has two effects—it increases the taxpayer's after-tax income and it changes his or her incentives. Any tax reduction has an effect on the taxpayer's after-tax income. Thus, the effect on after-tax income of a marginal rate reduction also could be achieved by an alternative form of tax reduction, such as a lump sum rebate. Since such income effects are inherent in any tax system or changes in such a system, it is not particularly fruitful to analyze these effects when the committee is considering alternative methods for achieving tax reduction. Rather, the incentive, or "substitution" effects, of any particular tax reduction should be, if possible, separated from the income effects.

An analysis of the effect on work incentives of a tax reduction involves the answer to the following question: holding after-tax income constant, how would work effort (hours worked) respond to a change in marginal income tax rates? As a theoretical matter, such a reduction would increase work effort, since the monetary reward to giving up an hour of leisure would increase. The size of this effect is an empirical question, however. The estimation of this magnitude is a very difficult statistical exercise, since a methodology must be developed for comparing the work effort of different individuals with different incomes, wage rates, educational backgrounds, etc., and for determining how much of the variation in work effort is attributable only to variation in the after-tax wage rate.

Most of the studies which have been performed on this subject have found that the substitution effect of after-tax wage changes in hours worked is quite small for husbands but rather large for wives, especially wives with children. This pattern is confirmed in one of the most recent and sophisticated studies,<sup>1</sup> except that a significant substitution effect is found for husbands, as well as wives. Thus, these studies indicate that if marginal tax rates were lowered, holding other factors (including after-tax income) constant, many individuals would be willing to work a larger number of hours. This could be manifested as greater

<sup>1</sup> Jerry A. Hausman, "Labor Supply," in Henry J. Aaron and A. Joseph Pechman, eds., *How Taxes Affect Economic Behavior*, Brookings Institution, 1981.

willingness to work full-time instead of part-time, greater acceptance of overtime assignments, less absenteeism, and a larger number of individuals in the labor force.

It should also be noted that there are several other possible impacts of marginal tax rates on work-related activities. First, it has been argued that reduction in marginal tax rates could improve compliance with the income tax, although there is little evidence which bears directly on this question. Second, it has been argued that high marginal tax rates have induced employees to demand a larger portion of their compensation in the form of tax-free fringe benefits, such as health insurance, than would be the case with lower marginal rates, and this substitution of fringe benefits for cash may affect the efficiency with which the economy satisfies employees' needs. To the extent that such effects exist, they would be lessened if marginal tax rates were lowered.

#### *4. Effect of marginal tax rates on saving*

If an individual saves a dollar rather than spending it on current consumption, he or she generally will be able to have in excess of one dollar available for consumption in a future period. The amount of this excess depends on the return available for funds saved and on the marginal tax rate applicable to this return. The quantity of consumer goods which can be purchased in the future with a given amount of money will, of course, depend on the rate of inflation. Thus, the after-tax return (adjusted for inflation) determines the price of future consumption in terms of current consumption, i.e., how much current consumption must be sacrificed to obtain a dollar of future consumption. The higher this price, i.e., the lower the after-tax return, the more expensive it becomes to consume in the future, so that less consumption is likely to take place in the future. As an important determinant of the after-tax return, the marginal tax rate is likely to affect this choice.

As in the above analysis of work effort, it is important to distinguish between the income and substitution effects of marginal tax rate changes on the choice between current and future consumption. Any tax reduction, including a reduction in marginal rates will increase after-tax income and thus generally will lead to an increase in both current and future consumption. However, as discussed above, marginal tax rate reductions also would have incentive, or substitution, effects, because they change the rate at which the taxpayer can trade off between current and future consumption. This discussion emphasizes the substitution effects, which are unique to marginal tax rate reductions.

Three distinct sources of concern with high marginal tax rates have been cited by economists who have analyzed the effects of the income tax on current and future consumption. The first concern is the effect of the marginal tax rates on individuals' incentives to consume in current rather than future periods, the second is the effect of marginal tax rates on aggregate saving, investment, and productivity, and the third involves the effect of the tax system on the composition of saving as a result of its effect on incentives to invest in lightly taxed versus heavily taxed activities and its incentive to borrow—the deduction for non-business interest.

The fact that the marginal tax rates implicit in the current income tax discourage future consumption creates a distortion (relative to a tax system with a marginal rate of zero, such as a *per capita* tax). The importance of this distortion depends on the responsiveness of future consumption to a change in the after-tax rate of return on saving, holding income constant. Empirical studies of this sensitivity are much less numerous than those of labor supply response. The methodological difficulties of studying the responsiveness of consumption to the rate of return are greater because the expected real return (net of expected inflation) must be measured and because the statistical analysis must be performed using time series of observations on total U.S. income and consumption. This methodology requires the assumption that the quantitative relationships among the variables have been unchanged for a long period of time. In spite of these methodological problems, empirical studies do indicate that individuals' plans for future consumption are sensitive to the after-tax rate of return. The marginal tax rate on capital income also may affect the choice between labor and leisure, as well as the choice between present and future consumption. For example, a greater after-tax rate of return may make it more attractive for individuals to work for the purpose of increasing their consumption in retirement years. However, this sort of effect has not been firmly substantiated in empirical research.

The second major concern which has been raised concerning the effect of marginal tax rates on capital income has been their effect on aggregate savings and, thus, investment and productivity. For a variety of reasons, however, the link between aggregate investment and the marginal tax rates in the individual income tax is very uncertain. First, investment may be affected much more directly by other factors, such as the tax treatment of depreciation allowances. Second, the individual income tax could affect only personal saving, which is one of the three components of saving—personal, corporate and government—available to finance investment. Finally, even though it is likely that a higher after-tax return may increase future consumption, it is not clear as a theoretical matter that personal savings would increase simultaneously. This is the case because a higher return on saving actually lowers the amount which an individual needs to save in the current period in order to achieve any future consumption goal. Personal saving would increase in response to an increase in the after-tax rate of return only if desired future consumption increases sufficiently to offset this effect. Whether this is, in fact, the case can be determined only by empirical studies. Although these studies are extremely difficult to perform for the reasons discussed above, there is some indication that future consumption may be stimulated sufficiently by increasing the after-tax return that total personal saving may increase modestly in response to such a change.

A third set of concerns about the impact of marginal tax rates on capital income involves their application in the context of several particular features of the individual income tax. The first concern is that the income tax imposes heavier tax rates on some activities than others (e.g., tax shelters, owner-occupied housing, and precious metals). This provides an incentive to shift from the heavily taxed activities, which may have a higher before-tax rate of return, and

thus may be more productive, to lightly taxed activities. The size of this incentive depends on the marginal tax rate. Thus, it is argued, reducing the marginal tax rate may encourage individuals to shift from less productive to more productive forms of saving. The second concern relates to the present law deduction for non-business interest. Since this provision is, in effect, an encouragement for borrowing, i.e., dissaving, and the average size of this encouragement depends on the average marginal tax rate, it is argued that reducing marginal tax rates will encourage saving by reducing the incentive to borrow. Finally, it is argued that because the income from assets subject to capital gains treatment is taxed only when the assets are sold, high marginal tax rates discourage sales and prevent these assets from being employed in their most efficient uses. Thus, lower marginal income tax rates could increase efficiency by reducing this "lock-in" effect.

#### **5. Effect of Administration proposal**

The preceding discussion indicates that high marginal tax rates may lead to a certain amount of economic inefficiency through their effect on work effort and on future consumption. The Administration proposal puts an emphasis on reduction in marginal tax rates, since by the time it is fully effective, all marginal rates would be reduced by approximately thirty percent. This section briefly discusses the effectiveness with which various methods of structuring a tax reduction affect the average marginal tax rate and compares these to the Administration proposal.

As discussed above in section 1, virtually any provision which affects tax liability may affect an individual's marginal tax rates. However, some tax reductions are much more effective than others, per dollar of revenue loss, in reducing the average marginal rate for the system as a whole. This may be understood by comparing the effects of reducing the 14 and 70 percent tax rates. Reducing the 14-percent rate reduces the marginal tax rate only for the relatively few taxpayers whose taxable income places them in the first bracket. Further, these taxpayers receive a small fraction of total income and, thus, their marginal tax rate has a small weight in the overall average marginal rate. However, reducing the 14-percent rate gives some tax reductions to all taxpayers, the vast majority of whom have an unchanged marginal rate. Thus, reducing the 14-percent rate is an ineffective method, per dollar of revenue loss, of reducing the average marginal rate. With respect to reducing the 70-percent rate, however, the opposite situation occurs. Cutting this rate reduces tax liability only for those taxpayers who also experience a marginal rate reduction. Thus, this is a relatively effective method for reducing the average marginal rate. It should also be noted that, because of the 50-percent maximum tax on personal service income, lowering tax rates above 50 percent primarily affects marginal tax rates applicable to income from capital.

Using the calculations described above in section 2, the Administration proposal when fully phased in, and at 1981 income levels, would lower the average marginal rate to 22.5 percent from the present 30.4 percent, a reduction of approximately 26 percent. The first full year of the proposal, a 10-percent rate cut, would lower the average mar-

ginal tax rate to 27.4 percent, about a 10-percent reduction. Both of these stages of the Administration proposal reduce the average marginal rate 16 percent more per billion dollars of revenue loss than an alternative method of tax reduction—adjusting the personal exemption, the zero bracket amount, and the rate brackets by a uniform percentage.

### C. Budget Issues

The Administration proposal raises several issues concerning budget policy, specifically, what is a desirable size of tax reduction, and whether it is appropriate to approve multi-year, rather than single-year, reductions. Although many of the considerations which relate to these issues are outside the scope of this discussion, several relevant points may be noted.

One way to gauge the size of the Administration proposal is to compare the total revenue loss from the proposal to the total revenue loss from automatic indexing of the individual income tax and from repeal of the 1981 social security increases. The figures in table 10 show that for 1981 and 1982, the revenue loss from the Administration proposal is about the same as the loss from indexing and repeal of social security increases. For 1983 through 1985, however, the Administration proposal would entail a larger tax cut than the alternative proposals, and in 1986, the alternative proposals, which entail annual changes in tax provisions, would become more expensive than the Administration proposal, which provides for no adjustment after 1984. (The revenue estimates for indexing, of course, depend on the assumed inflation rates. Lower inflation would reduce the revenue loss from indexing.)

The choice between multi-year or single-year tax cuts involves similar issues. A multi-year tax cut would have the advantage that individuals could plan long-run decisions with the knowledge of what the tax system would be for the next few years. Thus, economic activity in 1981 could be affected by tax reductions which would entail no revenue loss until 1983 or 1984. However, the uncertainty affecting projections of budget totals implies that a large multi-year tax cut could increase the risk of a large out-year deficit, which could prove to be unacceptable. If this risk is perceived to be large, then many individuals could start to believe that the future phases of a tax reduction would not be allowed to go into effect; this perception could undermine the advantages cited above. Another possible concern is that a multi-year tax cut may make unlikely another major tax bill in the near future, thus making it more difficult to address structural problems in the tax system which may emerge in the next few years. However, the multi-year tax cuts may create greater political pressure to enact the spending cuts needed to achieve the proper budget deficit. Finally, a phased-in reduction of marginal tax rates could encourage taxpayers to make use of opportunities to defer taxable income into future years, such as by accelerating charitable contributions and other deductible expenses, or investing in tax shelters. This argument is not compelling, however, to the extent that for some individuals the marginal rate reductions simply offset the marginal rate increases which would occur as a result of inflation.

**Table 10.—Comparison of Aggregate Revenue Loss of Administration Proposal, Indexing, and Repeal of Social Security Increases <sup>1</sup>**

[In billions of dollars]

	Calendar year liabilities					
	1981	1982	1983	1984	1985	1986
Indexing <sup>2</sup> -----	8.9	31.5	57.0	87.5	123.6	166.1
Repeal 1981 social security increase <sup>3</sup> -----	7.4	16.0	17.7	20.0	21.8	24.4
Total-----	16.3	47.5	74.7	107.5	145.4	190.5
Administration proposal--	14.6	48.7	92.9	129.8	152.8	178.9
	Fiscal year receipts					
	1981	1982	1983	1984	1985	1986
Indexing <sup>2</sup> -----	3.2	25.1	47.2	75.8	109.7	149.7
Repeal 1981 social security increase <sup>3</sup> -----	2.9	15.6	17.2	19.1	21.1	23.5
Total-----	6.1	40.7	64.4	94.9	130.8	173.2
Administration proposal--	6.4	43.9	80.8	119.8	146.6	171.9

<sup>1</sup> July 1, 1981, effective date assumed for all proposals.

<sup>2</sup> Adjustment of the personal exemption, the earned income credit, rate brackets, and the zero bracket amount by the rate of growth of the GNP deflator over the preceding fiscal year. The following inflation rates were assumed for fiscal years 1980 through 1985: 9.14, 10.33, 8.53, 8.07, and 7.51 percent, respectively. The revenue estimate for 1981 assumes an adjustment for half the first year's inflation, i.e., 4.57 percent.

<sup>3</sup> Repeal of 1981 *ad hoc* base increase above what would occur under indexing and 1981 increase in rate. Figures include employer portion of tax.

#### D. Income Tax Thresholds

One feature of the individual income tax which has aroused concern is the tax threshold, the income level at which an individual first becomes liable for income tax. The tax threshold is of interest for reasons of both equity and work incentive effect.

From an equity perspective, some argue that it is unfair for any family with an income below the poverty line to pay income tax, since these families must struggle to provide themselves with necessities for living. Others argue that it is inappropriate to compare income tax thresholds with the poverty lines because the latter are quite arbitrary and because it is desirable that even individuals with modest means should make some contribution toward the cost of federal government services.

Table 11 provides figures on poverty lines for 1980 and forecasts for 1982. Also shown are tax thresholds under present law and the Administration proposal. Comparing present law tax thresholds with 1980 poverty lines shows that poor families with 2, 3, or 4 people did not have tax liability for 1980, but that some poor families with either 1 or 5 or more individuals did pay income taxes for that year. With no change in present law, poverty lines by 1982 would exceed tax thresholds for all types of families except families of three and unmarried heads of households with one child. The same situation would occur under the Administration proposal, which would not change the income tax provisions which have the most effect on tax thresholds—the zero bracket amount, the personal exemption, and the earned income credit.

With respect to work incentives, tax thresholds have been of interest to those who are concerned by the compound impact, on the marginal tax rates faced by low-income working families, of the tax system and various Federal transfer payment programs. The reward for each additional dollar of earnings may be reduced not only because of an increase in income and social security taxes, but also because of a decrease in such benefits as social security, the earned income credit, aid to families with dependent children (AFDC), food stamps, and Medicaid. Recent calculations by Congressional Research Service show that for AFDC families combined benefit-loss and marginal tax rates as high as 78 percent may occur.<sup>1</sup>

<sup>1</sup> See Vee Burke, "Work Disincentives in Income-Tested Programs," in *Work Disincentives and Income Maintenance Programs*, P. Royal Shipp, ed., Congressional Research Service, June 12, 1980, prepared at the request of the Subcommittee on Oversight, Committee on Ways and Means.

**Table 11.—Tax Thresholds Under Present Law and Administration Proposal for 1982, and Poverty Lines, by Family Size**

	Poverty lines <sup>1</sup>			Tax thresholds <sup>2</sup>	
	1980	DRI forecast 1982	Adminis- tration forecast 1982	Present law	Adminis- tration proposal for 1982
Family size:					
1-----	\$4, 180	\$5, 135	\$5, 029	\$3, 300	\$3, 300
2-----	5, 340	6, 560	6, 425	5,400/6,947	5,400/7,147
3-----	6, 540	8, 034	7, 869	8, 098	8, 237
4-----	8, 380	10, 295	10, 083	8, 626	8, 727
5-----	9, 920	12, 187	11, 936	9, 155	9, 216
6-----	11, 180	13, 735	13, 452	9, 683	9, 706

<sup>1</sup> 1980 poverty lines are from Bureau of the Census. 1982 poverty lines are projected by using year-over-year forecasts of the increase in the Consumer Price Index. Sources of forecasts are Data Resources, Inc., and, alternatively, the Administration.

<sup>2</sup> Families of 3 and larger are assumed to consist of dependent children and a married couple filing a joint return; thus, earned income credit eligibility is assumed. For families of 2, the first number shown is for a childless married couple, and the second is for an unmarried head of household with one child and receiving the earned income credit.

Increasing income tax thresholds would improve work incentives by reducing the income range over which individuals may be subject to both the disincentives imposed by the first brackets of the income tax and by the loss of benefits from transfer programs. In addition, such a change could improve the administrative efficiency of the combined tax and transfer systems by reducing the number of families for whom disposable income is increased by transfer programs at the same time it is reduced by the income tax, and, thus, the number of families which must deal with both benefit program administrators and tax administrators.

## E. Technical Issues

### **1. *Alternative minimum tax***

For those taxpayers liable for the alternative minimum tax, the highest marginal tax rate applicable to all types of incomes, including capital gains, is 25 percent. If the committee decides to lower the top rates of the ordinary rate schedules, it may wish to consider reducing the top rate of the alternative minimum tax. This would insure that taxpayers subject to this tax would not have a higher marginal tax rate applicable to capital gains than would other taxpayers. The Administration proposes this type of reduction in the top rate of the alternative minimum tax.

### **2. *Personal holding company tax***

Personal holding companies are closely held corporations, the income of which comes largely from passive investments. In order to insure that these companies do not become a means of avoiding individual income tax, their undistributed income is taxed at 70 percent, the maximum rate in the rate schedules. If the committee decides to lower the maximum tax rate in the rate schedules, it may also wish to consider a corresponding reduction in the personal holding company tax.

### **3. *Effective date***

As a general rule, an interval of at least 45 days between enactment of a tax reduction bill and the effective date of a withholding change is considered desirable. This allows sufficient time for the Internal Revenue Service to prepare and distribute new withholding tables and for employers to make necessary changes in their computer programs or other payroll processing procedures.

If the committee decides on an effective date for withholding changes which falls other than at the beginning of a calendar year, it may wish to provide that withholding is reduced by a greater percentage than is tax liability for the calendar year in which the effective date falls. This is what the Administration proposes. That is, they propose a 5-percent reduction in marginal rates for all of 1981, but a 10-percent reduction in withholding only for the last six months of 1981. This allows many taxpayers to receive immediately the full benefit of the tax reduction rather than receiving a large portion as a tax refund in the following calendar year. However, such an effective date provision may cause underwithholding for some taxpayers who happen to earn the majority of their income in the last half of the year. The potential for some taxpayers to experience large underwithholding increases the smaller is the portion of the calendar year for which the withholding change is effective.

#### **IV. ALTERNATIVES TO ADMINISTRATION PROPOSAL**

##### **A. General Considerations**

If the committee wishes to design its own package of individual income tax reductions, it may wish to weigh the considerations discussed in the previous section. Unfortunately, many of the desired objectives may conflict, and trade-offs may become necessary. For example, a tax cut large enough to reduce marginal rates significantly may arouse budgetary concerns, and an attempt to maximize the reduction in marginal tax rates per dollar of revenue loss may conflict with some notions of what is an equitable distribution of tax reductions. The remainder of this section discusses what could be considered for inclusion of an alternative individual income tax reduction package.

##### **B. Increase in Zero Bracket Amount**

An increase in the zero bracket amount (ZBA) would raise tax thresholds, and, because it would benefit only those taxpayers who do not itemize, the reductions would be concentrated in the lowest income groups. Because an increase in the ZBA also increases the floor under itemized deductions, it reduces the number of taxpayers who can itemize. On the one hand, this would reduce the number of taxpayers who may be influenced by the incentives of itemized deductions, while, on the other hand, it would simplify the tax system by reducing the time these individuals and the Internal Revenue Service must devote to computation, paperwork, and verification. However, an increase in the ZBA would be a relatively inefficient way to cut marginal tax rates.

##### **C. Increase in Personal Exemption**

An increase in the personal exemption would increase tax thresholds and would provide relatively more tax relief to larger families, the elderly, and the blind than alternative methods of tax reduction. Like an increase in the ZBA, an increase in the exemption is not an efficient way to reduce marginal tax rates.

##### **D. Increase in Earned Income Credit**

The committee may wish to consider an increase in the rate of the earned income credit if it wishes to increase tax thresholds or provide relief to poor families with children. Because of their low income and the fact that the credit is refundable, many eligible families would not benefit from other forms of tax reduction. If the committee wishes to increase work incentives for eligible families, it may wish to increase the point at which the phaseout of the credit begins or to lower the phaseout rate. Either of these changes would lower marginal

rates in the income range in which there is overlap between the credit phaseout and the phaseout of welfare benefits also received by many earned income credit recipients.

#### E. Alternative Rate Schedules

A wide variety of rate schedule combinations is possible, and the committee's choice may depend on weighing equity, marginal rate, and budgetary considerations. Various rates can be reduced directly and/or brackets can be widened; the latter, however, generally would not decrease the marginal tax rates of those who remained in the same tax bracket. Two points should be noted, however. First, if the committee wishes to concentrate its marginal rate reduction on investment income, it should consider reducing marginal rates that presently are greater than 50 percent; because of the maximum tax, these apply primarily to investment income. Second, the committee may wish to consider restructuring rate brackets if it is concerned with the average marginal tax rate in general. Suppose, for example, that in the joint return rate schedule, the 14-percent rate were lowered to zero, the 16-percent bracket was increased to 18 percent, and the 24- and 28-percent rates were reduced to 21 percent. The first change would increase tax thresholds and reduce the high marginal rates applicable to those taxpayers who also receive welfare benefits. The second change would raise revenue to pay for the other changes and would increase marginal rates for relatively few taxpayers. The last change would cause large reductions in marginal rates affecting a relatively large number of taxpayers. In addition, such a "flattening" of the rate schedule would reduce the "marriage tax penalty" associated with progressive rate schedules.

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