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FAIRNESS IN RATE CUTS IN THE INDIVIDUAL INCOME TAX*

Alan L. Feld†

The Economic Recovery Tax Act of 1981 (the 1981 Act) made significant changes in federal income, estate, and gift taxation, touching virtually every taxpayer.¹ The centerpiece of the 1981 Act consisted of rate reductions in the individual income tax.² These reductions, said to average 23%, served a number of different but related objectives. First, those in favor of the tax cuts posited that all taxpayers would benefit from equitable, across-the-board reductions in an excessive and growing tax burden.³ Related to this objective was an anticipated reduction in the size of the federal government, because less tax money would be available to finance federal spending.⁴ Second, supporters of rate reductions focused on the effect of federal taxes on incentives⁵ and argued that a cut in marginal tax rates would lead to an increase in productivity.⁶ Third, marginal rate reductions would offset both the recently en-

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† Professor of Law, Boston University School of Law. I would like to thank Clayton Gillette, Michael Melton, Michael O'Hare, Aviam Soifer, and David Terkla who read earlier drafts of this article and made helpful suggestions. My thanks also to my research assistant, Marc Rosenberg.

¹ The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

² I.R.C. § 1 (Supp. V 1981). In addition to rate reductions, the 1981 Act made significant alterations in the income tax base. *See, e.g., id.* §§ 168 (accelerated cost recovery in lieu of conventional depreciation), 168(f)(8) (safe-harbor leasing), 128 (all savers certificates, a new form of savings with exempt interest), 221 (deduction for married couples to alleviate the so-called marriage penalty). Although changes in the tax base have important effects on the taxation of individuals, this article will focus primarily on the rate reductions. *See infra* note 10.

³ The Senate Finance Committee felt that the rate reductions would "lower personal tax burdens, and restrain the growth of the Federal Government." S. REP. NO. 144, 97th Cong., 1st Sess. 11 (1981) [hereinafter cited as SENATE REPORT].

⁴ "The committee believes that its program of tax reductions will increase the likelihood that Federal spending will be restrained over an extended period of time . . ." *Id.*

⁵ High marginal tax rates probably exert considerable influence on economically productive decisionmaking. Higher taxes arguably will cause people to alter their savings-consumption or work-leisure decisions from what they would be absent tax considerations. *See infra* notes 74-75.

⁶ The Senate Finance Committee stated:

[T]hese marginal rate reductions will accomplish two important goals of the economic recovery program. First, they provide equitable across-the-board relief from the excessive and steadily growing tax burden that is imposed under current law. Second, they reduce the distortions, inefficiencies and disincentives that result from the current high level of marginal tax rates.

SENATE REPORT, *supra* note 3, at 23, reprinted in 1981-2 C.B. 413.

acted increases in the social security tax⁷ and the effects of inflation.⁸

By contrast, considerations traditionally highlighted in connection with income tax changes played only a minor role in structuring the 1981 Act rate reductions. Little was heard of the virtues of progressivity in the income tax, of the role of federal tax policy in achieving redistribution of income, or of fairness to low- and moderate-income families.

Proceeding from a historical perspective, this article sets the important changes wrought by the 1981 Act against the backdrop of another important transitional period, 1940 to 1945. Part I describes the changes in rates and certain other structural elements of the income tax between 1939 and 1979. Part II develops four criteria for analyzing the impact of rate changes: (1) changes in marginal rates; (2) changes in effective rates; (3) changes in after-tax income; and (4) changes in discretionary income. Part III discusses the 1981 Act changes and evaluates those changes under the four criteria. Finally, Part IV applies the four criteria in a comparison of the 1939, 1979, and 1984⁹ tax schedules.

The article concludes that the Act fell far short of the equity rhetoric that surrounded it. The focus on problems of high inflation and low productivity to the exclusion of other concerns led the 1981 Act to reallocate many of the burdens of the tax system down the income scale, rather than equitably reducing the tax burden on all taxpayers. In addition, the Act will turn many individuals whose incomes fall below subsistence levels into new taxpayers. These effects of the 1981 Act alter some of the nearly forty years of experience that date from the World War II income tax changes.

⁷ Prior increases in social security taxes, needed to provide funds to keep the system solvent, had led to a greater overall tax burden for most taxpayers. *See* Social Security Act Amendments of 1977, Pub. L. No. 95-216, § 101(a)(1), 91 Stat. 1509, 1510-11.

⁸ Sensitivity to the effects of inflation pervaded the tax debate. Popular discussion emphasized the phenomenon of "bracket creep," whereby adjustments in income to meet inflation lead to greater than proportional increases in income tax under a progressive tax rate structure. After-tax income in real dollars thus declines for a taxpayer whose economic well-being otherwise remains unchanged.

The Committee on Ways and Means stated:

[A]n automatic income tax increase is occurring as inflation pulls taxpayers into higher brackets while diluting the real value of the personal exemption, the zero bracket amount and other fixed dollar parameters in the existing tax law. The committee believes that an equitable tax reduction is needed, sufficient in every income class, insofar as it is feasible, to offset these tax increases, so that the proportion of household income that is paid in individual income and employee social security taxes is no higher than it was in 1980.

H. REP. NO. 201, 97th Cong., 1st Sess. 16 (1981). *See infra* Section IIIA (discussing various methods of accounting for the effects of inflation on tax rate schedules).

⁹ The 1981 Act changes are to be fully phased in by 1984. I.R.C. § 1 (Supp. V 1981). The article thus addresses the rate reductions in their first year of full implementation. *See infra* Section IV.

I

THE HISTORICAL CHANGES

A. Changes in Individual Tax Rates¹⁰ from 1939 to 1979

The United States' entry into World War II prompted a major restructuring of domestic taxes. The government needed to increase revenues to finance the war effort; simultaneously, it had to keep domestic buying power in check to control inflation. Higher individual income taxes helped achieve both objectives.

In 1939, total federal tax revenues were \$5.2 billion.¹¹ The individual income tax and the corporate income tax accounted for \$1 billion and \$1.2 billion respectively; the balance came largely from excise and employment taxes.¹² In 1945 the federal government collected \$43.8 billion, a more than eightfold increase.¹³ Increases in individual and corporate income tax generated much of the new revenue; in 1945 they accounted for \$19 billion and \$16 billion respectively.¹⁴ Individual income taxes thus grew from 19.2% of revenues in 1939 to 43.4% of revenues in 1945 and from 1.1% of the gross national product to 9.0% in that same period.¹⁵

The most obvious World War II change was a general increase in

¹⁰ The focus here on the individual income tax rates is not intended to obviate the important effects of other elements in the tax structure. The rates in the schedule determine the effect of the individual income tax only in part. Erosions in the tax base and special rates for certain kinds of income help determine the level and incidence of the tax. Exemptions, deferral of income, acceleration of deductions, and the special treatment of capital gains, all can have important effects on an individual's tax liability. Tax provisions that have these effects receive much attention in the literature, however, while fundamental elements of the tax laws tend to be taken as givens, including the shape and magnitude of the nominal rate schedule. *But see* Klein, *A Proposal to Simplify the Income Tax Rate Structure*, 1964 WIS. L. REV. 539.

In order to make a closer comparison of the rate schedules for individuals in 1939 and 1979, and thus evaluate the impact of rate schedules on the tax system, this article lays to one side changes in the base. This approach also ignores rate changes that are expressed as changes in the base. *See, e.g.*, I.R.C. § 51 (1939) (current version at I.R.C. § 6013) (joint return filing provision). Similarly, to avoid the difficult questions concerning the proper taxable entity within the family, this article deals chiefly with individuals rather than with family units. For a fuller discussion of these issues see Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975); McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977).

¹¹ STATISTICAL APPENDIX TO ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1969, at 50, table 10 (1970).

¹² *Id.* at 46, table 10.

¹³ *Id.* at 50, table 10. In contrast, over the same period, the GNP doubled from \$90.5 billion in 1939 to \$211.9 billion in 1945. U.S. BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970 PART 1, ser. F 47-70, at 229 (1975) [hereinafter cited as HISTORICAL STATISTICS 1970 PART 1].

¹⁴ U.S. BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970 PART 2, ser. Y 358-373, at 1107 [hereinafter cited as HISTORICAL STATISTICS 1970 PART 2].

¹⁵ *See supra* note 13.

individual income tax rates. In 1939 the individual income tax consisted of two parts, a normal tax of 4% applicable to all net income¹⁶ and a surtax imposed on net income in excess of \$4,000.¹⁷ The surtax ranged from 4% at the bottom of the scale to 75% on net income exceeding \$5 million.¹⁸ During the war years, the surtax exemption disappeared, so that the surtax applied even on net incomes under \$4,000.¹⁹ In addition, the surtax began at higher rates and the spaces between brackets narrowed. By 1944, the normal tax was 3% and the surtax ranged from 20% on the first dollar of net income to 91% on net incomes exceeding \$200,000.²⁰ The result of these changes was a steeper rate structure imposing higher rates at every income level.

After World War II, the rates did not revert to their earlier levels. The Cold War and the United States military involvement in Korea required a continued high level of federal taxation. Congress did not reduce the marginal tax rates until the mid-1960s, when the top rate fell from 91% to 70% of taxable income, and the bottom rate from 20% to 14%.²¹

In 1979, the base year from which this article compares the 1981

¹⁶ I.R.C. § 11 (1939). Net income consisted of gross income less deductions. *Id.* § 21(a). The term adjusted gross income entered the tax lexicon only in 1944, when the development of the standard deduction required a new term for gross income less business deductions. Individual Income Tax Act of 1944, ch. 210, § 8(a), 58 Stat. 231, 235-36 (codified at I.R.C. § 22(n) (1939)). The 1954 Code introduced the term "taxable income." I.R.C. § 63 (1954).

¹⁷ I.R.C. § 12(b) (1939). The 1939 Code defined surtax net income as "the amount of net income in excess of the credits against net income provided in section 25(b)." *Id.* § 12(a). Section 25(b) provided credits against net income for the personal exemption and for dependents. These credits against net income had the effect of deductions and differed from credits against the tax liability itself.

¹⁸ *Id.* § 12(b).

¹⁹ For taxable years beginning after December 31, 1941, the surtax was imposed on the first dollar of surtax net income. Revenue Act of 1942, ch. 619, § 103, 56 Stat. 798, 802-03 (codified at I.R.C. § 12(b) (1939)).

During the war years, the income tax structure underwent a number of war related and temporary changes. The Defense Tax, which had the effect of increasing the amount of tax owed for most taxpayers by 10%, was enacted in 1940. *See* Revenue Act of 1940, ch. 419, § 201, 54 Stat. 516, 520 (codified at I.R.C. § 15), *amended by* Second Revenue Act of 1940, ch. 757, § 101(d), 54 Stat. 974. The Defense Tax was repealed by the Revenue Act of 1941, ch. 412, § 104(a), 55 Stat. 687, 693.

The Revenue Act of 1942 introduced the 5% Victory Tax. Ch. 619, § 172(a), 56 Stat. 798, 884 (codified at I.R.C. § 450). For taxable years beginning after December 31, 1942, the Victory Tax was applied to victory tax net income in excess of a \$624 exemption. The 1939 Code defined victory tax net income as gross income (not including gain from the sale or exchange of capital assets, certain amounts of interest, and certain amounts received as compensation for injury or sickness) less specified deductions allowable under I.R.C. § 23. *Id.* (codified at I.R.C. §§ 451, 452). The Victory Tax was repealed by the Individual Income Tax Act of 1944, ch. 210, § 6(a), 58 Stat. 231, 234.

²⁰ Individual Income Tax Act of 1944, ch. 10, §§ 3, 4(a), 58 Stat. 231, 231-32. The Code did, however, place a cap on the maximum marginal rate: a ceiling on total tax liability prevented the effective tax rate from exceeding 90% of net income. *Id.* § 4(b), 58 Stat. 231, 232 (codified at I.R.C. § 12(g)).

²¹ Revenue Act of 1964, Pub. L. No. 88-272, § 111(a), 78 Stat. 19, 22-23.

Act changes, the individual income tax rates continued to range from 14% to 70%. The federal individual income tax produced \$251.5 billion in revenue, accounting for 10.4% of GNP and 54.6% of federal government revenue.²² These percentages of revenue and GNP resemble the 1945 levels.²³ The corporate income tax, in contrast, had managed to shed more of the World War II tax effects. By 1979, corporate income tax revenues represented only 3.0% of the GNP and 15.5% of government revenue,²⁴ down sharply from 1945 levels.²⁵

Over the forty years from 1939 to 1979, individual income taxes became an essential component of federal revenues. As federal government activities expanded, revenues from individual income taxes moved from 1.1% to over 10% of the GNP. Over the same period, marginal rates rose sharply to 1945 levels, and receded very little from that peak.

B. The Personal Exemption and the Zero Bracket Amount: The "Gatekeepers" of the Code

World War II also brought basic individual income tax changes other than marginal rate increases. Congress extended the income tax to a large number of previously untaxed households. The magnitude of this extension is striking. In 1939, approximately 6% of the total population filed individual tax returns, slightly more than half of which reported any tax owing.²⁶ By 1945, the proportion of returns filed had increased to over 35%, of which over five-sixths were taxable returns.²⁷ When the number of households covered by returns is considered, the coverage of the tax system was extended from about 5% to 74% of the

²² The 1979 GNP was \$2,413.9 billion. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1981, at 420, table 699 [hereinafter cited as STATISTICAL ABSTRACT 1981]. Federal government tax revenues were \$460.4 billion. *Id.* at 256, table 434.

²³ *Cf. supra* text accompanying note 15 (individual income tax in 1945 accounted for 9.0% of GNP and 43.4% of revenues). The 1979 ratio of individual income tax to GNP was 116% of the corresponding 1945 ratio; the 1979 ratio of individual income tax to total revenues was 126% of the 1945 ratio.

²⁴ In 1979, the corporate income tax generated \$71.4 billion. STATISTICAL ABSTRACT 1981, *supra* note 22, at 256, table 434.

²⁵ *Cf. supra* notes 13-14 and accompanying text (corporate tax in 1945 accounted for 7.6% of GNP and 36.5% of revenues). The 1979 ratio of corporate income tax to GNP was 39.5% of the corresponding 1945 ratio; the 1979 ratio of corporate income tax to total revenues was 42.5% of the 1945 ratio. Reduction in the relative level of the corporate tax owes more to deductions and credits such as the investment tax credit than to general rate reduction. These favorable provisions may discriminate against some sectors of the economy and benefit larger corporations. *See* A. FELD, TAX POLICY AND CORPORATE CONCENTRATION 23-54 (1982).

²⁶ In 1939, the total population of the United States was 131 million, yet only 7.7 million individual income tax returns were filed; 4.0 million returns reported some tax liability and 3.7 million were nontaxable. HISTORICAL STATISTICS 1970 PART 1, *supra* note 13, ser. A 6-8, at 8; HISTORICAL STATISTICS 1970 PART 2, ser. Y 393-411, at 1110.

²⁷ The 1945 population was 140 million; 50 million individual income tax returns were filed, of which 42.7 million reported liability. *Id.*

population.²⁸

The Code contains two principal gatekeepers, the personal exemption and the zero bracket amount (ZBA), which determine the base income level from which the government begins to tax. Changes in either of these structural components will expand or contract the number of individuals drawn in as taxpayers. The personal exemption and ZBA, however, are not limited in impact to low income taxpayers. Changes in these components affect the tax rate and after-tax income of every taxpayer.²⁹

1. *Historical Changes in the Personal Exemption*

The 1939 to 1945 increase in the coverage of the individual income tax flowed principally from reduction of the personal exemption. The deductible amount for a single individual in 1939 was \$1,000. For a married couple, the 1939 personal exemption was \$2,500.³⁰ Each dependent gave rise to an additional \$400 deduction.³¹ Because the median household income in 1939 was \$1,231 a year, only a small percentage of the population had incomes large enough to be subject to tax.³²

The high level of the personal exemption meant that the income tax reached only discretionary household income: for each household the tax base excluded a significant amount of income available to cover subsistence at a modestly acceptable level of comfort.³³ The tax fell on relatively few families and when it did apply, it extended only to family income in excess of that part which covered food, clothing, and shelter needs.³⁴

By 1945, however, both the level and the value of the personal ex-

²⁸ See L. SELTZER, *THE PERSONAL EXEMPTIONS IN THE INCOME TAX* 62 (1968).

²⁹ See *infra* Section IIB.

³⁰ I.R.C. § 25(b)(1) (1939).

³¹ *Id.* § 25(b)(2).

³² The 1939 figure represents median money wage or salary income of primary families and unrelated individuals. HISTORICAL STATISTICS 1970 PART 1, *supra* note 13, ser. G 353-371, at 303. The analogous 1979 statistic—family and nonfamily households' total wage or salary income—is \$16,637. U.S. BUREAU OF THE CENSUS, CURRENT POPULATION REPORTS, SER. P-60 NO. 129, MONEY INCOME OF FAMILIES AND PERSONS IN THE U.S.: 1979, at 152, table 38 (1981). Note that money income in both 1939 and 1979 would exceed these figures by the amount of investment income and other receipts. The percentage of families with incomes under \$2,500 (the married couple exemption) was 87.9% in 1939. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1943, at 390, table 428 (1944). When the additional \$400 deduction for each child is considered, many more households are removed from the tax base.

³³ As used in the text, discretionary income means a household's income less a fixed amount to cover subsistence; subsistence is treated as a uniform amount for all households without variation for most individual circumstances.

³⁴ Before World War II, the relatively small number of households covered by the personal income tax led to a fairly high level of public esteem for the tax laws. Thus in 1941 public opinion rallied behind efforts to finance the war and many people were dismayed by

emption had declined sharply. War related changes reduced the exempted amount to \$500 per person.³⁵ Inflation further cut the buying power of the shrunken allotment.

After World War II a relatively low exemption level became a permanent feature of the federal income tax. A 1947 Treasury study analyzed several different standards for the personal exemption as a "major issue" in individual income tax policy.³⁶ The study compared the level of the personal exemption with three possible "subsistence" levels: a maintenance budget, reflecting the minimum standard of living necessary to maintain health and efficiency of a manual worker; a somewhat higher city workers' budget, based on actual urban costs; and a "health and decency" budget, reflecting the cost of healthful and reasonably comfortable living.³⁷ The study found that the 1947 personal exemption level of \$500 fell below all three standards for single individuals or married couples; families with dependents could meet the maintenance budget, but not the others. In 1948, Congress increased the personal exemption to \$600, where it remained for many years.³⁸ Following this small step, and for the past thirty-five years, the proper amount of the personal exemption has stirred relatively little controversy.

Beginning in the late 1960s, tax policymakers linked exemption levels with the poverty level, an income line used for some welfare classification purposes.³⁹ The personal exemption plus the predecessors of the zero bracket amount, discussed below, were intended to exempt income below the poverty level from the income tax.⁴⁰ This rationale emphasized the "gatekeeper" function of the personal exemption, preventing

congressional delay in satisfying the government's revenue needs. R. PAUL, *TAXATION IN THE UNITED STATES* 303 (1954).

³⁵ Revenue Act of 1942, ch. 619, § 131(a), 56 Stat. 798, 827-28 (codified at I.R.C. § 25(b)(1)).

³⁶ DIVISION OF TAX RESEARCH, U.S. DEP'T OF THE TREASURY, *INDIVIDUAL INCOME TAX EXEMPTIONS, INTRODUCTION* (1947).

³⁷ *Id.* at 3-13.

³⁸ Revenue Act of 1948, ch. 168, § 201, 62 Stat. 110, 112 (codified at I.R.C. § 25(b)(1)). The Tax Reform Act of 1969, Pub. L. No. 91-172, § 801(a), 83 Stat. 487, 675, increased the amount of the exemption to \$625 for taxable years beginning after December 31, 1969, and before January 1, 1971. The Act also implemented a series of increases in the personal exemption, which reached its highest point of \$750 for taxable years beginning after December 31, 1972. *Id.* § 801(b)-(d), 83 Stat. 487, 675-76. The Revenue Act of 1978 raised the exemption to its current level of \$1,000. *See infra* note 42 and accompanying text.

³⁹ The official poverty level, itself a child of the 1960s, was determined by the money income required to purchase three times the cost of the "economy food plan," based on a Department of Agriculture finding that families of three or more spend a third of their income on food. (A slightly higher factor is applied for smaller households.) The number is adjusted annually for inflation. *See* U.S. BUREAU OF THE CENSUS, *CURRENT POPULATION REPORTS, SER. P-60, NO. 124, CHARACTERISTICS OF THE POPULATION BELOW THE POVERTY LEVEL: 1978*, app. A, at 205.

⁴⁰ H. REP. NO. 658, 94th Cong., 1st Sess. 14 (1975); S. REP. NO. 437, 92d Cong., 1st Sess. 53-55 (1971); H. REP. NO. 413, 91st Cong., 1st Sess. pt. 1, 204-08 (1969).

taxation of those households so poor as to require public assistance.⁴¹

The Revenue Act of 1978 increased the personal exemption to the present level, \$1,000.⁴² Although this amount doubled the 1945 figure, the consumer price index had increased fourfold between 1945 and 1979.⁴³ In effect, the \$1,000 exemption in 1979 was worth approximately \$248 in 1945 dollars, almost one-half the 1945 exemption of \$500.

Proposals to increase the personal exemption to offset the effects of inflation have received little attention.⁴⁴ A tax change that would reduce the liability of every taxpayer might be expected to have broad appeal. Instead, the wide distribution of benefit would result in relatively modest gains for any single taxpayer while the revenue loss to the Treasury would be significant. An increase of \$100 in the personal exemption in 1983 would benefit a hypothetical family of four in the 30% bracket (taxable income \$29,000-\$35,000) by \$120 in 1983, whereas the revenue loss would probably amount to \$4.5 to 5 billion.⁴⁵

2. *The Personal Exemption as "Tax Subsidy"*

Apart from its "gatekeeper" function, the personal exemption affects taxpayers in every income class.⁴⁶ Unfortunately, a misperception confusing the personal exemption with tax expenditures has contributed to the neglect of the personal exemption.⁴⁷ A federal income tax benefit cast as a deduction or exclusion provides a greater after-tax benefit to

⁴¹ The text omits any discussion of the general tax credit, a short-lived mechanism expressing some characteristics of the personal exemption in credit form. See I.R.C. § 42 (1976) (expired Dec. 31, 1978).

⁴² Pub. L. No. 95-600, § 102(a), 92 Stat. 2763, 2771 (codified at I.R.C. § 151).

⁴³ Using the base 1967 = 100, the Consumer Price Index for 1945 was 53.9 and for 1979 was 217.4. See HISTORICAL STATISTICS 1970 PART 1, *supra* note 13, ser. E 135-166, at 210; STATISTICAL ABSTRACT 1981, *supra* note 22, at 467. Here, as elsewhere in the article, comparisons of dollar amounts between years are adjusted for inflation based on changes in the consumer price index. These adjustments are imperfect because they fail to reflect long-term changes in the mix of goods and services people enjoy at different income levels, they ignore changes in public sector provision of goods and services, and they allocate no part of productivity increases to changes in the adjusted amounts. The adjusted amounts therefore serve only to make rough comparisons, particularly when made over many years.

⁴⁴ For one proposal, see *Tax Aspects of the President's Economic Program, Hearings Before the House Comm. on Ways and Means*, 97th Cong., 1st Sess. 913 (statement of Alan Feld), reprinted as *The Case for an Increase in the Personal Exemption*, 12 TAX NOTES 1459 (1981). See also Schenk, *Simplifying Dependency Exemptions: A Proposal for Reform*, 35 TAX LAW. 855 (1982) (expressing concern over practical application of personal exemption rules).

⁴⁵ See H.R. REP. NO. 1800, 95th Cong., 2d Sess. 304 (1978).

⁴⁶ See *infra* Section IIB. (discussing impact of changes in personal exemption on taxpayers in every income category).

⁴⁷ As to the concept of tax expenditures, see generally S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973); Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C.L. REV. 225 (1979); Feld, Book Review, 88 HARV. L. REV. 1047 (1975).

higher income taxpayers than to others.⁴⁸ Such a deduction or exclusion operates as an "upside-down" subsidy. Not every tax provision favorable to a class of taxpayers, however, constitutes a disguised subsidy. The income tax levies its progressive rates on a net income base that reflects the taxpayer's ability to pay. The personal exemption appropriately takes the form of a deduction to modify an individual's tax base and to exclude from taxation the income required for household necessities. Any disparate benefit resulting from different marginal rates reflects a proper application of the income tax, not a separate government expenditure through the tax system.

Moreover, the conclusion that the exemption functions as an "upside-down" subsidy is generally based on an evaluation of the deduction or exemption in isolation from other characteristics reported in the taxpayer's return. As discussed in greater detail later, one measure of the fairness of a tax change is the relative change in an individual's tax burden. Thus, in evaluating the fairness of a decrease in tax through a change in the personal exemption, the dollar amount of tax benefit may be larger for a taxpayer with greater income, but the relative change may be far smaller.⁴⁹ If the ratio of the change in tax to total tax liability declines with income, then tax reduction through a personal exemption change should be characterized as "right side up."⁵⁰

A particular application of the tax expenditure argument posits

⁴⁸ This result flows from the simple arithmetic of applying the graduated rate schedule to a deduction. For example, a \$100 deduction for a taxpayer with an 11% marginal rate produces tax savings of \$11; the same deduction for a taxpayer in a 50% bracket produces \$50 in tax savings.

The Code contains scores of special tax provisions that confer subsidies through the remission of taxes. The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 308, 88 Stat. 297, 313, requires separate budget reports of tax expenditures. Occasionally a tax expenditure arises when Congress extends an appropriate structural element of the tax law to subsidize a designated group. Thus, unlike the basic personal exemption allowance, the extra exemptions allowed for children who are students age 19 or over, the blind, and the elderly probably constitute tax expenditures rather than basic structural elements of the tax Code. The estimated revenue loss for 1983 for these three classes is \$1.6 billion, \$30 million, and \$2.4 billion respectively. See OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS G, TAX EXPENDITURES, THE BUDGET OF THE UNITED STATES GOVERNMENT, 1983, at 28-30, table G-1. Nevertheless, the income distribution of the benefits for the blind and the elderly does not seem to skew significantly in favor of wealthy taxpayers. In 1979, when 12.5% of all returns filed reported adjusted gross income of \$30,000 or more, 9% of the extra personal exemptions for blindness and 10% of the extra personal exemptions for the elderly went to taxpayers in this income class. U.S. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME: INDIVIDUAL INCOME TAX RETURNS 1979, at 10, table 1.1; *id.* at 45, table 2.8 (1982) [hereinafter cited as STATISTICS OF INCOME 1979].

⁴⁹ See *infra* table following note 76 (Homestate Option 2.3 reflects this result).

⁵⁰ *Id.* Further, any variation in the net benefit per taxpayer by income class must be considered along with the number of taxpayers in each class. In our current system, the vast majority of taxpayers fall within low or middle level marginal-rate categories. For example, in 1979, 83% of the personal exemptions claimed were in tax returns with less than \$30,000 adjusted gross income. The returns in this category accounted for 87.5% of the individual filings for that year. STATISTICS OF INCOME 1979, *supra* note 48, at 45, table 2.8.

that tax relief targeted at the poorest members of society will not reach them through changes in the personal exemption. The very poor generally file no tax returns and incur no tax liability. Any increase in the personal exemption would have no effect on these people because their tax liability cannot fall below zero. This argument is not persuasive against a properly shaped personal exemption; it merely demonstrates the limitations inherent in any adjustment in taxable income, such as a deduction or exclusion, as a way to relieve poverty. Direct-aid programs may be better instruments for relief of the poor than changes in the income tax. Of the weapons in the tax arsenal, only a credit against tax, refundable when greater than the tax liability, can serve this function. No exclusion or deduction would have the effect of reaching this excluded class. For everyone else, however, especially low and moderate income taxpayers, the failure of adjustments in tax liability to reach nontaxpayers is irrelevant in choosing between increases in the personal exemption and other provisions for adjusting taxable income or rates.⁵¹

Congress has failed to increase the personal exemption to correspond with inflationary cuts in the value of the dollar. Neglect of the personal exemption stems in part from misperceptions of the exemption as a subsidy that grants its greatest benefit to wealthy taxpayers. At a proper level, the personal exemption could serve as an exclusion of the income necessary for subsistence living, leaving only discretionary income available for taxation. In its current form, the personal exemption fails to accomplish this goal.

3. *The Standard Deduction—Zero Bracket Amount*

The zero bracket amount supplements the function of the personal exemption. The ZBA sets an additional threshold level for filing an individual tax return, and thereby excludes as taxpayers a further set of low-income earners. In addition, the ZBA tries to provide an easily administered substitute for itemized deductions.

The large increase in tax return filers anticipated as a result of the

⁵¹ A more traditional concern with the personal exemption is whether it should be the same for all individuals or vary with family circumstances. See Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1099-1100 (1948). The argument for a variable personal exemption contends that the cost of providing support for a single person exceeds the incremental cost of providing for a dependent; a single taxpayer thus should receive a larger deduction. Such was the case in 1939, when single taxpayers received a \$1,000 personal exemption, and taxpayers with dependent children received only \$400 per child. (On the other hand, the \$2,500 exemption for a married couple may appear somewhat anomalous.) See *supra* notes 30-31. However, given the current inadequacy of the personal exemption, see *supra* notes 42-43 and accompanying text, it makes little sense to differentiate among classes of taxpayers. Moreover, the ZBA to some degree does make distinctions based on family status. The ZBA for a married couple, \$3,400, lies about midway between the ZBA for a single person, \$2,300, and the ZBA for two single persons, \$4,600. Also, dependents with unearned income may not claim the ZBA. I.R.C. § 63(e) (Supp. V 1981).

World War II reduction of the personal exemption pressed the Treasury to simplify tax return filing.⁵² Most of the new taxpayers had never filled out an income tax return. The standard deduction allowed simplified reporting by authorizing a deduction of 10%, up to \$500, in lieu of itemized nonbusiness deductions.⁵³ Using the standard deduction, a taxpayer computed his tax from a table of income and dependency levels, so that a taxpayer whose only income consisted of compensation could file a return with minimal computation. For most taxpayers the standard deduction obviated the need to keep track of personal expendi-

⁵² In the House Report on the Individual Income Tax Act of 1944, which set the pattern for the standard deduction, the Committee stated:

The bill is confined to the simplification of the individual income tax. In the preparation of this legislation your committee had in mind the following objectives:

1. To relieve the great majority of taxpayers from the necessity of computing their income tax.
2. To reduce the number of tax computations.
3. To simplify the return form.

H. REP. NO. 1365, 78th Cong., 2d Sess. 1 (1944).

Another World War II innovation had great significance for the income tax but does not bear directly on the subject of this article. The influx of new taxpayers in 1942 foreshadowed a potentially enormous administrative problem. The income tax had operated largely on voluntary reporting based on self-assessment, with lump sum or quarterly payments. Audits of returns provided some after-the-fact review. The large group of taxpayers entering the system would have to file tax forms for the first time. Some invariably would neglect to do so. The audit staff would be swamped, making enforcement of the tax much more problematic. New taxpayers might dissipate their income before they paid the tax levied on it. To meet these concerns the Treasury initially proposed a system for withholding taxes on wages, dividends, and bond interest at the source. After the House passed a bill embodying these proposals, the Treasury dropped the withholding of interest for administrative reasons. As finally enacted, withholding applied only to salaries and wages. H. REP. NO. 2333, 77th Cong., 2d Sess. 14 (1942) (statement by Mr. Doughton).

The fact that machinery already existed for the collection at the source of social security taxes on compensation income may have influenced Congress to apply withholding for income taxes only to compensation, thereby avoiding the administrative problems arguably presented by an entirely new withholding system for dividends and interest. *See* S. REP. NO. 1631, 77th Cong., 2d Sess., 165, 167 (1942), *reprinted in* 1942-2 C.B. 504, 626, 627. The withholding provisions as originally enacted in 1942 applied first to the victory tax, then to the normal tax and surtax. Revenue Act of 1942, ch. 619, § 172(a), 56 Stat. 798, 888-91 (codified at I.R.C. § 466).

Withholding of taxes on salaries and wages has become an integral part of the income tax system. Income tax compliance is highest for income in the form of salaries and wages, falling off dramatically for other forms of income. In effect, then, when the enforcement machinery of the income tax is taken into account, the tax bears more heavily on salary and wages than on other forms of income. The Tax Equity and Fiscal Responsibility Act of 1982 added provisions for withholding on interest and dividend income, Pub. L. No. 97-248, § 301, 96 Stat. 324, 576-84, but Congress repealed them in 1983 before they went into effect. *See* The Interest and Dividend Compliance Act of 1983, Pub. L. No. 98-67 (Aug. 5, 1983).

⁵³ Congress introduced the standard deduction in the Revenue Act of 1941, ch. 412, § 102(a), 55 Stat. 687, 689-91 (codified at I.R.C. § 400). Originally called "Optional Tax on Individuals with Certain Gross Income of \$3,000 or Less," the section permitted taxpayers to file a simplified return with a 10% reduction of tax. *Id.* The Individual Income Tax Act of 1944, ch. 210, § 9(a), 58 Stat. 231, 236-37 (codified at I.R.C. § 23aa), allowed taxpayers a deduction of 10% from adjusted gross income up to \$500.

tures for charity, interest, and the like.⁵⁴ For the government, it minimized the audit resources needed to police the deductions of millions of taxpayers reporting modest amounts. The result was surprisingly workable considering the magnitude of the increase in the number of taxpayers.

For almost two decades after World War II, the standard deduction remained at 10% of adjusted gross income, although the ceiling was raised to \$1,000 in 1948.⁵⁵ The Revenue Act of 1964 introduced the minimum standard deduction, to enhance the amount deductible by low-income filers.⁵⁶ The minimum standard deduction took into account the number of dependents, as well as the income of the taxpayer. This alternative standard deduction evolved through several formulations. In 1977 the standard deduction became a fixed dollar amount dependent on the filing status of the taxpayer, was renamed the zero bracket amount, and was built directly into the tax tables.⁵⁷

The Code currently sets the threshold for filing a tax return for most single individuals at \$3,300, the sum of the personal exemption (\$1,000) and the ZBA (\$2,300).⁵⁸ For an individual above the threshold, the ZBA provides the benefit of a variable deduction that declines with itemized deductions the taxpayer otherwise would claim.⁵⁹ The ZBA adds a full \$2,300 deduction for a single individual with no itemized deductions. The added amount declines dollar-for-dollar as the taxpayer's itemized deductions increase and, at \$2,300 of itemized deductions, the ZBA becomes valueless to the taxpayer.

This sliding value implies two different effects. First, the amount of a taxpayer's itemized deductions tends to increase with income,⁶⁰ and the ZBA benefits therefore tend to disappear as income rises. The ZBA provides little or no benefit to high income itemizers, and primarily benefits low to moderate income taxpayers. The ZBA benefits are thus inversely proportional with the income of the taxpayer. Second, certain itemized deductions, such as interest and property taxes, provide a tax preference for personal consumption. To the extent that the ZBA

⁵⁴ Taxpayers near the margin, on the other hand, computed their taxes both ways to determine the more favorable method. Some taxpayers sought to alternate standard-deduction with itemized-deduction filing years and to group deductions in the latter.

⁵⁵ See Revenue Act of 1948, ch. 168, § 302(a), 62 Stat. 110, 114-15.

⁵⁶ See Revenue Act of 1964, Pub. L. No. 88-272, § 112(a), 78 Stat. 19, 23 (codified at I.R.C. § 141 (1976) (repealed 1977)).

⁵⁷ See Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 102(a), 91 Stat. 126, 135-37 (codified at I.R.C. § 63 (Supp. V 1981)).

⁵⁸ See I.R.C. § 6012(a) (Supp. V 1981). In certain cases where an individual may not claim the full benefit of the ZBA (e.g., a nonresident alien) the filing threshold reverts to \$1,000. *Id.* § 6012(a)(1)(C)(i)-(iv).

⁵⁹ See *id.* § 63.

⁶⁰ Some itemized deductions derive from home ownership, which also correlates with income. Cf. R. GOODE, *THE INDIVIDUAL INCOME TAX* 117 (rev. ed. 1976).

blunts these incentives, it moves the tax system toward encouragement of savings rather than consumption. The very nature of the ZBA, however, imposes an important limitation on its usefulness in the tax structure. To take advantage of the ZBA the individual taxpayer in effect waives itemized deductions up to \$2,300. Medical expenses, state income taxes, and casualty losses may constitute involuntary applications of income that reduce ability to pay, but the ZBA taxpayer nonetheless will be unable to claim these deductions.⁶¹ As the amount of these involuntary yet nondeductible payments increases, the ZBA distorts the process of identifying discretionary income as the base for taxation.⁶²

In short, the ZBA unsuccessfully tries to do double duty. It does serve many taxpayers as an easily administered substitute for itemized deductions. It cannot, however, simultaneously supplement the personal exemption in defining the appropriate tax-exempt subsistence level for income tax purposes.⁶³

⁶¹ See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); see also Feld, *Abortion to Aging: Problems of Definition in the Medical Expense Tax Deduction*, 58 B.U.L. REV. 615 (1978).

⁶² For example, a single taxpayer with \$5,000 in interest income normally would pay taxes on \$1,700, with the ZBA and personal exemption offsetting the remainder. Suppose the individual has no tax-exempt income and does not own a home. Such a taxpayer would be likely to have considerably less than \$2,300 in itemized deductions. One would expect that most of his income goes to pay for food and shelter. If the taxpayer were to incur a medical expense of \$2,000, it would reduce his ability to purchase food and shelter. However, because the ZBA already covers that deduction, the taxpayer's loss of discretionary income will not be reflected in a reduction of the amount subject to tax.

⁶³ Three tax matters unrelated to the World War II period complete the background for the 1981 Act changes: FICA taxes, the earned income credit, and the credit for the elderly.

It is conventional to consider FICA taxes, I.R.C. § 3101 (Supp. V 1981), separately from income taxes because of the historic link between the former and social security benefits. Over the past two decades, however, that link has weakened as the magnitude of the FICA tax burden has increased. For most wage earners, the federal income tax and the FICA tax apply to virtually the same base; for many the latter imposes the greater burden. An individual with \$5,500 income in 1981 incurred income tax of \$314 and social security tax of \$365.75. The individual's employer paid a matching amount in social security taxes. FICA tax revenues for 1979 amounted to \$112.8 billion, STATISTICAL ABSTRACT 1981, *supra* note 22, at 256, table 434.

The earned income credit (EIC), I.R.C. § 43 (1976 & Supp. V 1981), and the credit for the elderly, *id.* § 37, arguably supplement the operation of the personal exemption and the ZBA with regard to low income entrants into the tax system. Wage earners and others who earn services income, if eligible, may claim the EIC. Eligibility is determined by the taxpayer's family status: the taxpayer must have at least one child and either be married, a head of household, or a widow or widower. *Id.* § 43(c) (Supp. V 1981). The credit, which was introduced by the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204(a), 89 Stat. 26, 30-31, reduces tax liability by 10% of earned income up to a maximum credit of \$500. The credit then phases out for adjusted gross income over \$6,000 on a ratio of 1 to 8 (credit : adjusted gross income), I.R.C. § 43(b) (Supp. V 1981), so that the credit disappears at \$10,000. Because the credit is refundable, it operates as a negative income tax for a taxpayer who meets the earned income and family qualifications. The benefit, however, is largely offset by the individual's social security taxes.

Historically, retired persons did not include social security benefits in income. I.R.C. § 86, added by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 121(a), 97 Stat.

II

MODELS TO HELP ANALYZE RATE CHANGES

In comparing different rate schedules, it is important to distinguish between a general increase or decrease in the tax burden and changes in its distribution. A general tax increase or reduction presumably can hold constant the relative distribution of the tax burden. On the other hand, taxpayers at different income levels may not share equally the burden or benefits of a rate change. A comparison of the relative distributions necessarily precedes a judgment concerning the fairness of the changes.

Unfortunately, no single standard for evaluating changes in the distribution of the tax burden enjoys wide acceptance.⁶⁴ Relative changes in marginal tax rates and effective tax rates provide useful information concerning the change in the tax burden on each new dollar of income, and the tax burden on total income, respectively. Often, a more meaningful criterion is after-tax income and the change in the taxpayer's net ability to purchase goods and services. An important refinement of this criterion excludes the portion of income that a taxpayer must commit to maintain a subsistence level of existence; this measure looks to discretionary income as the appropriate measure of change.⁶⁵ Of all the measures, the last probably best captures the common understanding of the income tax and would seem best suited for evaluating income tax changes.⁶⁶

A simplified model will help to analyze fairness in income tax rate changes. Because the personal exemption bears directly on the relative burdens imposed by rate changes, it will be incorporated into the model.⁶⁷

65, 80-84, taxes up to one-half of social security benefits in some cases, based on other income. Section 37 of the Code, the credit for the elderly, partly equalizes the tax burden on those who have provided for their own retirement income by allowing a 15% credit based on an "initial amount," \$2,500 in the case of a single individual. I.R.C. § 37(b) (1976). This initial amount is reduced dollar for dollar by social security benefits received and further reduced on a 1 to 2 ratio by adjusted gross income over \$7,500. *Id.* § 37(c).

As these brief descriptions suggest, the earned income credit and the credit for the elderly address particular problems for certain low income persons. They do not bridge the gap between the more general provisions for the personal exemption and the ZBA and subsistence levels.

⁶⁴ See generally R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* (2d ed. 1966); Jakobsson, *On the Measurement of the Degree of Progression*, 5 J. PUB. ECON. 161 (1976); Musgrave & Thin, *Income Tax Progression 1929-48*, 56 J. POL. ECON. 498 (1948).

⁶⁵ See *supra* note 33 and accompanying text.

⁶⁶ See *infra* Section IIB3.

⁶⁷ See *supra* notes 26-51 and accompanying text. For simplicity in the remainder of the article, the model ignores itemized deductions and therefore treats the personal exemption and ZBA as a unitary concept.

A. Marginal and Effective Rate Comparisons

Suppose the country of Homestate in Year I imposed a tax of 10% on the first \$25,000 of net income and 25% on the balance. *A*, *B*, and *C*, who earned net income of \$5,000, \$20,000, and \$50,000 respectively, incurred tax of \$500, \$2,000, and \$8,750. The total tax revenue, \$11,250, represented 15% of total Homestate net income. Assume further that Homestate's population generally approved the relative distribution of these tax payments. The figures are summarized below:

HOMESTATE TAX—YEAR I

	Net Income	Tax	Effective Rate of Tax	Marginal Tax Rate
<i>A</i>	\$ 5,000	\$ 500	10.0%	10%
<i>B</i>	20,000	2,000	10.0	10
<i>C</i>	50,000	8,750	17.5	25
Total	\$75,000	\$11,250	15	

In year II, Homestate goes to war and wishes to treble its revenues. The country has available several ways to increase its revenues, with varying impact on taxpayers *A*, *B*, and *C*.⁶⁸

1. *Increasing Marginal Rates—Option 2.1*

Homestate could achieve the desired revenue increase simply by trebling its marginal rates, to 30% and 75%. Under this option, both the marginal rates (the rates of tax on the next dollar of income) and the effective rates (the tax paid divided by net income) would bear the same bracket-to-bracket ratio between *A*, *B*, and *C* as they did in year I.⁶⁹

HOMESTATE TAX—YEAR II—OPTION 2.1

	Net Income	Tax	Effective Rate of Tax	Marginal Tax Rate
<i>A</i>	\$ 5,000	\$ 1,500	30 %	30%
<i>B</i>	20,000	6,000	30	30
<i>C</i>	50,000	26,250	52.5	75
Total	\$75,000	\$33,750	45	

C, however, might object to this solution. Although *C* still pays taxes at the same ratio with respect to *A* and *B* as he did in Year I (250%

⁶⁸ For analytic purposes, the text ignores the spending side of the governmental activity, treating the goods and services the government purchased with the added revenue as not enhancing the ability of individuals in Homestate to purchase additional goods and services.

⁶⁹ Each taxpayer would also continue to pay the same proportion of Homestate's total tax revenue: *A* would pay 4.4%, *B* 17.8%, and *C* 77.8%.

greater marginal rate, and 175% of their effective rate) he now forfeits a far more substantial amount of his net income to Homestate.

2. *Altering Step Points and Increasing Rates—Option 2.2*

As an alternative which would mollify *C*, Homestate could reduce the point at which the higher marginal rate begins (referred to as the step point). Homestate then could generate the desired revenue increase without trebling the marginal rate in the highest bracket. For example, suppose Homestate imposes a tax of 30% on the first \$10,000 (a decrease of \$15,000 in the step point) and 52.5% on the balance (an increase of 2.1 times the 25% rate). This schedule also trebles Homestate's revenues in comparison to year I.⁷⁰

HOMESTATE TAX—YEAR II—OPTION 2.2

	Net Income	Tax	Effective Rate of Tax	Marginal Tax Rate
<i>A</i>	\$ 5,000	\$ 1,500	30 %	30 %
<i>B</i>	20,000	8,250	41.25	52.5
<i>C</i>	50,000	24,000	48	52.5
Total	\$75,000	\$33,750	45	

A's situation remains the same under either option. *C*'s position improves under Option 2.2, at *B*'s expense.

3. *Analyzing the Two Alternatives*

Homestate's choice between these alternatives depends upon the criterion and the point of view it applies. From the point of view of taxpayer self-interest, *B* would favor the former option (Option 2.1), whereas *C* would favor the latter (Option 2.2). As long as the step point remains above \$5,000, the change does not directly engage *A*'s self-interest.⁷¹

Homestate also may have a view as to the relative fairness of each option. The country's assessment might proceed from first principles as to the proper role of a tax system, the nature of its base, and the appropriateness of a graduated rate structure as compared to a proportional one.⁷² More likely, Homestate will not treat the Year II tax as a clean slate, but will seek to relate the options to the relatively satisfactory Year

⁷⁰ Under both Options 2.1 and 2.2, Homestate's revenues would rise from \$11,250 to \$33,750.

⁷¹ *A* might have a preference for Option 2.1 if he expects his income to rise above \$10,000, but not as high as *C*'s income.

⁷² See generally W. BLUM & H. KALVEN, *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953); N. KALDOR, *AN EXPENDITURE TAX* (1955); H. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* (1938); W. VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* (1947).

I experience. Option 2.1 appears to make that connection more directly than Option 2.2. The logical connection to the Year I experience runs as follows: if Homestate considered the Year I rates fair, some multiple of those rates should probably be fair as well. This logic reaches a limit, however, if the rates become very high, because most people would reject rates over, at, or near 100% on fairness grounds.⁷³ At lower rate levels, however, an equal percentage change in the tax rates, which maintains the same relationship of tax burdens as in Year I, might be considered fair.

On the other hand, marginal rates better indicate the effect of income taxes on society's productivity. High marginal tax rates probably exert considerable influence on economically productive decisionmaking.⁷⁴ *C*'s 75% marginal rate under Option 2.1 may be so high as to cause concern about tax influences in decisionmaking. Option 2.2 reduces *C*'s marginal rate to 52.5%, but at the cost of increasing *B*'s marginal rate to that same level. Without empirical data,⁷⁵ it is hard to know which alternative provides less total tax oriented change in decisionmaking.

Each of Homestate's alternatives for raising tax rates and revenues derives some support from fairness principles. Productivity concerns play a further role in defining the most desirable alternative. The relative burden that a rate change imposes on different taxpayers, however, is only one consideration. Homestate also must consider the income each taxpayer is left with after the tax. Option 2.1 reduces *A*'s after-tax income from \$4,500 to \$3,500 and *B*'s after-tax income from \$18,000 to \$14,000, a decline in each case of 22%. *C*'s after-tax income suffers a heavier decline of 42%, from \$41,250 to \$23,750. Option 2.2 results in the same 22% reduction for *A* and almost equalizes the decline in after-tax income for *B* and *C*. *B*'s after-tax income drops from \$18,000 in Year I to \$11,750 in Year II, a decline of 34.7%, whereas *C*'s goes from

⁷³ Some, however, may advocate rates at these levels on grounds of income redistribution.

⁷⁴ The marginal-rate criterion focuses on the individual's next dollar of income and how much benefit he will derive from that dollar after taxes. Two large classes of decisions often described as affected by high marginal tax rates are savings-consumption decisions and work-leisure decisions. An individual may save less and consume more currently or may shift time from work to leisure if taxes reduce the net return on saving or working to a low enough level. One underlying premise is that society as a whole would be better off if people would make the same decisions they would make in a tax-free world, a premise often inconsistent with efforts to use the tax system to shape decisionmaking through incentives.

A related assumption often implied by the assertion that society as a whole is better off with such decisionmaking is that all individuals will also be better off. It is possible, of course, that the added productivity will benefit some, but not others. In addition, the productivity based view does not account for the possibility of explicit wealth redistribution goals within society. Finally, focusing on the tax code as an incentive or disincentive device ignores the effect that other institutions play in decisionmaking based on productivity.

⁷⁵ Congress often makes tax decisions without the benefit of empirical data.

\$41,250 in Year I to \$26,000 in Year II, a decline of 37.0%. By the standard of proportionality in reduced after-tax income as compared to Year I, both options may be unfair to higher income taxpayers; Option 2.2, however, distributes the decline in after-tax income more evenly.

B. Refining the Model: After-Tax and Discretionary Income Evaluations

The range of Homestate's Year II options broadens significantly if the simplified model takes into account the effects of a personal exemption. Assume that the Year I model had incorporated a \$5,000 personal exemption into the income calculations for *A*, *B*, and *C*. *A*, *B*, and *C* thus had respective net incomes prior to the exemption of \$10,000, \$25,000, and \$55,000. Assume further that the Homestate tax system also includes *X* and *Y*, whose net incomes in Year I were \$3,000 and \$5,000. In Year I both *X* and *Y* were free of any tax liability because the \$5,000 personal exemption excluded 100% of their incomes from the tax.

1. Reducing the Amount of the Personal Exemption—Option 2.3

With the inclusion of a personal exemption in the model, Homestate can now increase revenues in Year II by reducing the personal exemption. If, for example, it cuts the personal exemption from \$5,000 to \$2,000, *X* and *Y* will become taxpayers. Two new taxpayers will now share in the tax burden, and more of the total income of *A*, *B*, and *C* falls within the taxable range. As a result, Homestate does not need to raise marginal rates as much as under either Option 2.1 or Option 2.2. Rates of 25% on the first \$10,000 and 46% on the balance will suffice to achieve required revenues.

HOMESTATE TAX—YEAR II—OPTION 2.3⁷⁶

	Net Income	Taxable Income	Tax	Effective Rate of Tax		Marginal Tax Rate
				Taxable Income	Net Income	
<i>X</i>	\$ 3,000	\$ 1,000	\$ 250	25.0%	8.3%	25%
<i>Y</i>	5,000	3,000	750	25.0	15.0	25
<i>A</i>	10,000	8,000	2,000	25.0	20.0	25
<i>B</i>	25,000	23,000	8,480	36.9	33.9	46
<i>C</i>	55,000	53,000	22,280	42.0	40.5	46
Total	\$98,000	\$88,000	\$33,760	38.4	34.4	

⁷⁶ Because of recognition of the personal exemption, the term "net income" no longer captures the base to which the tax applies. For this reason, a distinction is made in the table between taxable income (the tax base after the personal exemption) and net income (earnings

The criteria introduced earlier can help to compare Option 2.3 with the other Year II options. Viewed from the perspective of self-interest, Option 2.3 benefits *C* and raises everyone else's taxes.

Under the marginal-rate criterion, the reduction in the personal exemption embodied in Option 2.3 allows lower marginal rates for *A*, *B*, and *C* than under the first two options. In addition, *Y*, whose next dollar would have been subject to tax at 30% under the first two options, also enjoys a decline in marginal tax rate. If high marginal rates for these taxpayers affect decisionmaking and productivity, Option 2.3's lower marginal rates may produce less change in taxpayer behavior (as compared with decisionmaking in a tax-free environment) than the other two options.

Only *X* suffers an increase in marginal rate, from 0 to 25%. Of all the taxpayers, *X* probably has the smallest amount of discretionary income and therefore less control than any other taxpayer over decisions that may be influenced by tax rates. *X*'s reaction to tax changes is therefore less important to Homestate's productivity than any other taxpayer's reaction.⁷⁷

A comparison of the change in effective tax rates between Year I and Option 2.3 reveals that two taxpayers, *X* and *Y*, move from paying no tax to incurring tax liability. In addition, although the aggregate effective tax rate goes up 2.9 times, from 11.5% of net income to 34.4%, two taxpayers, *A* and *B*, suffer tax-burden increases by more than the average, of 4 and 4.25 times, respectively. The gain to both from lower marginal rates is therefore more than offset by subjecting a larger portion of their income to tax. In contrast, *C*'s income tax burden goes up only 2.5 times.⁷⁸ By this criterion, *C* benefits disproportionately from Option 2.3.

2. Comparison of After-Tax Income

Marginal and effective rates reflect the tax burden on each addi-

minus the expenses needed to generate earnings). Applied to taxable income, the effective-rate criterion leaves an incomplete picture. The following table reflects the effective-rate comparison for the three Year II Options based on net income.

	Year I	Option 2.1	Option 2.2	Option 2.3
<i>X</i>	0.0%	0.0%	0.0%	8.3%
<i>Y</i>	0.0	0.0	0.0	15.0
<i>A</i>	5.0	15.0	15.0	20.0
<i>B</i>	8.0	24.0	33.0	34.0
<i>C</i>	15.9	47.7	43.6	40.5
Total	11.5	34.4	34.4	34.4

⁷⁷ Pushing the logic to its natural conclusion suggests that an income tax structure that seeks to maximize productivity will embody a declining marginal rate. Taxpayers with higher income and greater choice thus would not suffer tax-induced change in decisionmaking. This result runs counter to the imposition of higher taxes on those taxpayers who enjoy high incomes.

⁷⁸ See table, *supra* note 76.

tional dollar of income and the total tax burden on the taxpayer's net income, respectively. An evaluation of after-tax income focuses on the amount of money that remains for each taxpayer to spend. A comparison of the change in after-tax income between Year I and each of the three Year II options suggests a remarkably different allocation of burdens. Under all three options, after-tax income declines by larger percentages as income increases. This criterion therefore suggests that all three options impose too much of the tax burden on the higher income taxpayers. Option 2.3, however, which lowers the level of the personal exemption to draw X and Y into the tax system, evidences the least disparate treatment of the five taxpayers.

DECLINE IN AFTER-TAX NET INCOME FROM YEAR I TO YEAR II

	Option 2.1	Option 2.2	Option 2.3
X	0.0%	0.0%	8.3%
Y	0.0	0.0	15.0
A	10.5	10.5	15.8
B	17.4	27.2	28.2
C	37.8	33.0	29.3

As expected, X and Y suffer a greater decline in after-tax income under Option 2.3 than under the other two options, and C is better off. Perhaps more surprisingly, A is significantly worse off under Option 2.3. B is better off under Option 2.1, but is treated much the same by Options 2.2 and 2.3. Unlike Options 2.1 and 2.2, Option 2.3 does impose roughly equivalent levels of sacrifice on B and C , but still imposes a substantially greater relative burden on them in moving from Year I to Year II than on the other taxpayers. Y and A are similarly grouped at a percentage of reduction in after-tax income that puts them close to each other and at about half the percentage of B and C .

3. Comparison of Discretionary Income

If net income is taken as the proper measure of tax paying capacity, the comparison of after-tax income provides a satisfactory measure of the changes in personal welfare that Homestate's new tax rates cause. Net income, however, does not adequately measure an individual's ability to pay taxes. Taxpayers need to provide a minimum standard of goods and services for themselves in order to survive in society.⁷⁹ Some might urge that discretionary income (net income minus the amount needed to live at a subsistence level) is the only income realistically available for paying taxes. More generally, however, the concepts of subsistence level and discretionary income are normative concepts, the

⁷⁹ See *supra* note 33 and accompanying text.

content of which depends upon social norms and values as well as on physical minima for food, clothing, shelter, and the like.

By including a personal exemption amount in its tax schedule, Homestate implicitly may have opted for discretionary income as the proper base for its income tax. Assuming that the personal exemption amount of \$5,000 in Year I was an accurate measure of the subsistence income level for an individual taxpayer,⁸⁰ *X* and *Y* had no discretionary income in Year I and properly escaped taxation.

A comparison of after-tax discretionary income under each of the three Year II options yields results very different from those under the other three criteria. The relative burdens under Option 2.3 are especially revealing.⁸¹

DECLINE IN DISCRETIONARY INCOME FROM YEAR I TO YEAR II

	Option 2.1	Option 2.2	Option 2.3
<i>X</i>	0.0%	0.0%	Negative
<i>Y</i>	0.0	0.0	Negative
<i>A</i>	22.2	22.2	33.3%
<i>B</i>	22.2	34.7	36.0
<i>C</i>	42.4	37.0	32.8

Under Option 2.3, *B* suffers a slightly heavier loss of discretionary income than *A* or *C*, but the variation is relatively small. Option 2.3 treats *A*, *B*, and *C* with relative equality, but at the cost of taxing *X*'s and *Y*'s nondiscretionary income and driving down their after-tax incomes below subsistence levels. A determination of the relative fairness of Option 2.3 depends upon the importance of this cost. If it is important to avoid imposing a tax on *X* and *Y*, then Option 2.2 may be preferable.⁸²

The three options for Year II reveal the tradeoffs that Homestate must consider in obtaining its desired revenue increase. Option 2.1

⁸⁰ *X*, whose income in Year I fell below the presumed subsistence level, either lived below the subsistence level, or had to support himself by withdrawing savings, borrowing money, or depending on private or public funds.

⁸¹ The discretionary-income criterion substantially reduces what appeared to be disparate treatment of the five taxpayers. Viewed from this criterion, taxpayers on different levels of a progressive rate schedule are being treated more fairly than the other three criteria would imply. The following table charts the change in after-tax discretionary income from Year I imposed by Option 2.3.

	Year 1	Year 2	Change (\$)	Change (%)
<i>X</i>	\$- 2,000	\$- 2,250	250	Negative
<i>Y</i>	0	- 750	750	Negative
<i>A</i>	4,500	3,000	1,500	33.3
<i>B</i>	18,000	11,520	6,480	36.0
<i>C</i>	41,250	27,720	13,530	32.8

⁸² Indeed, Option 2.2, by altering the step points further, can be fine tuned to bring the relative sacrifices of *B* and *C* closer to *A*'s sacrifice.

(across the board marginal-rate increases) maintains the same proportional differences among taxpayers, but threatens productivity and decisionmaking by requiring a very high marginal tax rate on upper income taxpayers. Option 2.2 (altering the step points) mitigates the high marginal-rate impact of the first option, but forces middle income taxpayers (such as *B*) to bear a greater share of the overall tax burden. Option 2.3 (lowering the personal exemption amount) further reduces the marginal-rate impact, but at the expense of placing a higher tax burden on low-income taxpayers (*X*, *Y*, and *A*) than the previous alternatives.

III THE 1981 ACT

The individual tax cuts in the 1981 Act presented a unique opportunity. The decision to reduce individual income taxes by a large sum—over \$100 billion in 1984 when the provisions are fully phased in—was unprecedented in modern times. The forms that decision could take vary greatly. To some extent, of course, arguments about the form of a tax cut reflect self-interest covered with a rhetorical patina.⁸³ Yet whatever self-interest in fact entered the legislative calculus, it was not chiefly a majoritarian bias: an equal per-capita share of \$100 billion would be \$435 annually for every man, woman, and child,⁸⁴ which is significantly more than most individuals will realize from the 1981 Act.

The 1981 Act allocated the great bulk of the tax cut to rate reduction. Most of the balance of the individual income tax reduction went to mitigate the "marriage tax penalty" by creation of a new deduction for two-earner couples.⁸⁵ Two themes dominated legislative consideration of the individual tax-rate cuts: the need to counter the effects of inflation and the need to increase productivity.⁸⁶ A complete evaluation of the competing economic considerations surrounding the productivity theme is beyond the scope of this article.⁸⁷ The balance of this article examines the fairness of the rate cuts in light of the criteria previously developed, along with the effects of inflation.

⁸³ See generally L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* (1961).

⁸⁴ Based on an estimated U.S. population of 230 million.

⁸⁵ I.R.C. § 221 (Supp. V 1981).

⁸⁶ See *supra* notes 6, 8 and accompanying text.

⁸⁷ Productivity induced rate cuts focus on two separate decisions: the amount of the rate reduction and the proper distribution. Both decisions rest in part on economic assumptions concerning the appropriate level of investment and the proper tradeoff between savings and consumption. See *supra* note 74. Both decisions also implicate economic and political assumptions regarding the proper division of economic decisionmaking between the government and private individuals. Finally, social-equality concerns often require a marginal tradeoff with productivity considerations. See generally A. OKUN, *EQUALITY AND EFFICIENCY: THE BIG TRADEOFF* (1975).

A. The Effect of Inflation on the Fairness Models

A return to the Homestate model will be helpful in evaluating the effects of inflation on the four fairness criteria.

1. *Failure to Adjust for Inflation—Option 3.1*

Assume that Homestate has adopted Option 2.3 for Year II, consisting of a personal exemption of \$2,000 and rates of 25% on the first \$10,000 of taxable income and 46% on the balance. Assume further that inflation runs at a rate of 100% in the next year and that each person's nominal income will double in Year III. Taxes aside, everyone remains in the same economic position. With no adjustment of the tax structure, however, so that the tax rules under Option 2.3 continue, the tax results will be as follows:

HOMESTATE TAX—YEAR III—OPTION 3.1

			<u>Effective Rate of Tax</u>		<u>Marginal Tax Rate</u>
	<u>Taxable Income</u>	<u>Tax</u>	<u>Taxable Income</u>	<u>Net Income</u>	
<i>X</i>	\$ 4,000	\$ 1,000	25.0%	16.7%	25%
<i>Y</i>	8,000	2,000	25.0	20.0	25
<i>A</i>	18,000	6,180	34.3	30.9	46
<i>B</i>	48,000	19,980	41.6	40.0	46
<i>C</i>	<u>108,000</u>	<u>47,580</u>	44.1	43.3	46
Total	\$186,000	\$76,740	41.3	39.2	

By failing to account for inflation, a significant shift in tax burden results from income adjustments that otherwise would restore all individuals to their previous economic condition. Although two dollars of Year III income replace one of Year II income, Homestate's tax revenue more than doubles. The Year III revenue is almost 2.3 times that of Year II.⁸⁸ In the process, all taxpayers suffer an increase in the effective rate of tax on net income. The rate of increase, however, varies from 100% for *X* to 6.9% for *C*, with rates of increase of 33.3% for *Y*, 54.5% for *A* and 17.6% for *B*.⁸⁹

2. *Adjusting the Personal Exemption and Step Point—Option 3.2*

Two elements in the Homestate tax system, stated in dollars unadjusted for inflation, account for the tax increase in real terms: the \$2,000 personal exemption and the \$10,000 "step point" in the rate schedule. If Homestate doubled these numbers to accommodate the impact of in-

⁸⁸ Compare the result to Option 2.3, *supra* table accompanying note 76 (revenues of \$33,760 rise to \$76,740).

⁸⁹ See *id.*

flation, the tax system would impose the same comparative burdens in Year III as were seen in Year II under Option 2.3.⁹⁰

HOMESTATE TAX—YEAR III—OPTION 3.2

			<u>Effective Rate of Tax</u>		Marginal Tax Rate
	<u>Taxable Income</u>	<u>Tax</u>	<u>Taxable Income</u>	<u>Net Income</u>	
X	\$ 2,000	\$ 500	25.0%	8.3%	25%
Y	6,000	1,500	25.0	15.0	25
A	16,000	4,000	25.0	20.0	25
B	46,000	16,960	36.9	33.9	46
C	106,000	44,560	42.0	40.5	46
Total	\$176,000	\$67,520	38.4	34.4	

If Homestate's legislature adopts Option 3.2 rather than Option 3.1 for Year III, it could describe the change as producing a tax cut of \$9,220.⁹¹ Under Option 3.2, neither Homestate nor any of its taxpayers has changed its position from what it was under Option 2.3: Homestate's revenues constitute the same percentage of net income as before and each taxpayer faces the same effective ratio and marginal rate.⁹² Homestate's legislators, nevertheless, might describe the shift to Option 3.2 from Option 3.1 as government largesse.

3. *An Across-the-Board Rate Cut—Option 3.3*

The distribution of the tax cut under Option 3.2 differs substantially from the result that would obtain if Homestate instead adjusted Option 3.1 through an across-the-board cut in the tax rates. To illustrate the latter, consider an across-the-board rate cut of 12% that retains a personal exemption of \$2,000, and imposes a marginal rate of 22% on the first \$10,000, and 40.5% on the balance. This new schedule reduces taxes from Option 3.1 by \$9,180, almost the same amount as Option 3.2,⁹³ but affects Homestate's taxpayers differently.

⁹⁰ See *id.*

⁹¹ Under Option 3.1 Homestate's total tax revenue would be \$76,740; under Option 3.2 the figure is \$67,520.

⁹² Compare *supra* table accompanying note 76 with *supra* table following note 90. The following table compares the effective rate of tax on net income under Option 2.3 with that under Options 3.1 and 3.2.

	<u>Option 2.3</u>	<u>Option 3.1</u>	<u>Option 3.2</u>
X	8.3%	16.6%	8.3%
Y	15.3	20.0	15.3
A	20.0	30.9	20.0
B	34.0	40.0	34.0
C	40.5	43.3	40.5

⁹³ See *supra* note 91 and accompanying text.

HOMESTATE TAX—YEAR III—OPTION 3.3

	Taxable Income	Tax	Effective Rate of Tax		Marginal Tax Rate
			Taxable Income	Net Income	
<i>X</i>	\$ 4,000	\$ 880	22.0%	14.7%	22.0%
<i>Y</i>	8,000	1,760	22.0	17.6	22.0
<i>A</i>	18,000	5,440	30.2	27.2	40.5
<i>B</i>	48,000	17,590	36.6	35.2	40.5
<i>C</i>	108,000	41,890	38.8	38.1	40.5
Total	\$186,000	\$67,560	36.3	34.5	

COMPARISON OF OPTIONS 3.2 AND 3.3

	Dollar Change in Tax From 3.2 to 3.3	Percentage Change in Effective Rate on Net Income
<i>X</i>	\$ 380	+6.4
<i>Y</i>	260	+2.6
<i>A</i>	1,440	+7.2
<i>B</i>	630	+1.3
<i>C</i>	-2,670	-2.4
Total	\$ 40	+0.1

Both Options 3.2 and 3.3 reduce each person's tax from the Option 3.1 levels. *C* fares significantly better in absolute dollars under Option 3.3; his after-tax income is \$2,670 greater than under Option 3.2. The other four taxpayers do substantially worse in absolute dollars and in effective rate of tax on net income, with *A* suffering the greatest increase in tax burden. Recall that Option 2.3 represented a departure from the Year I starting point, and had the least desirable effects on the lower-income taxpayers.⁹⁴ Option 3.3 pushes further in this direction.

B. The Rate Changes in the 1981 Act

The 1981 Act sought to neutralize the effects of inflation in two ways. First, it enacted fixed multiyear tax cuts through 1984 based on across-the-board rate reductions. These cuts began almost immediately.⁹⁵ Second, the 1981 Act mandated indexing, commencing in 1985, for rate brackets, the zero bracket amount, and the personal exemption.⁹⁶

The 1981 Act, in essence, adopted an initial response similar to Option 3.3, phasing in an Option 3.2-like structural adjustment for years

⁹⁴ See *supra* text accompanying notes 81-82.

⁹⁵ I.R.C. § 1 (Supp. V 1981).

⁹⁶ *Id.* §§ 1(f), 63(d); *id.* § 151 (1976 & Supp. V 1981).

after 1984. The latter change, because of its delayed impact, remains vulnerable to subsequent congressional shifts in a way that the already implemented cuts do not.

The rate cuts implemented the proposal for across-the-board tax reductions endorsed by the President. Their form assertedly met the effective-rate criterion of fairness, that all rates decline proportionately: the reductions are described as an average 23% across-the-board reduction.⁹⁷ This average, however, conceals some important variations. When fully phased in, the lowest marginal rate dropped 21.4%, while the highest declined by a third more, 28.6%. Apart from these extremes, in eleven of the sixteen prior-law brackets the rates dropped between 22% and 24%. For the five remaining brackets, the rate in one fell by 21%, in two by 25%, and in the next-to-highest bracket, by 26.8%.⁹⁸ Moreover, the reduction in the top rate became effective immediately in 1981, while the other rate reductions were phased in over the 33-month period from 1981 to 1984. As a result of the timing differences, the favoritism toward higher-bracket taxpayers suggested by the differing rate changes is even more pronounced in the transitional years, 1982 and 1983.

The effect of the cut in the top bracket, from 70% to 50%, is further complicated by its relationship to two categories of income—earned income and capital gain income. Prior law had applied a maximum 50% rate to earned income.⁹⁹ A reduction in the top rate to 50% thus benefited certain high-bracket taxpayers little or not at all.¹⁰⁰ On the other hand, the 1981 Act had the effect of cutting the tax rate on net capital gains from the prior maximum of 28% to 20%, without dealing explicitly with the mechanics of capital gain taxation. The percentage decline in the maximum capital gain rate, 28.6%, exceeds the average 23% across-the-board decline. The dollar impact per dollar of capital gains is smaller, however, than that of the rate cut for ordinary income. The actual effect of the 1981 change at the highest income levels thus varies depending on the composition of the income.

Although the inflation-adjustment rationale explains most of the effective rate cuts, it fails to justify any reduction in the highest rate. Bracket creep does not affect taxpayers with significant income above

⁹⁷ S. REP. NO. 144, 97th Cong., 1st Sess. 4 (1981).

⁹⁸ Compare Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(a), 95 Stat. 172, 176.

⁹⁹ I.R.C. § 1348 (1976), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(c)(1), 95 Stat. 172, 178-79.

¹⁰⁰ The joint committee staff illustrations of the effects of the 1981 Act rate cuts show little benefit accruing in the top brackets through the simple expedient of treating all income as earned income throughout the calculations. STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 23-26, tables IV-1 to 4 (Comm. Print 1981).

the step point for the highest bracket. Prior to 1981, those taxpayers confronted flat rather than graduated marginal rates and there is no need to adjust their marginal tax rates for the purpose of offsetting inflation. Nevertheless, the 1981 Act reduces the rate applicable to all income in the top bracket. The second theme of the 1981 Act, productivity incentives, doubtless supplied an impetus for these rate cuts. High marginal rates arguably discourage "additional work effort" and encourage "tax avoidance."¹⁰¹ Implicit in this choice, as noted earlier, is a tradeoff with progressivity objectives.¹⁰²

The failure of the 1981 Act to make initial adjustments to the personal exemption and zero bracket amount furthers the disproportionate impact of the rate cuts. Although inflation erodes the value of these deductions, the 1981 tax cuts incorporate no adjustments to compensate for such erosion. As demonstrated by the contrast between Options 3.3 and 3.2, across-the-board rate cuts favor higher income taxpayers in comparison to fully indexed reductions.¹⁰³

An additional consequence of the failure to adjust the personal exemption and the ZBA derives from their gatekeeper function. If real incomes remain constant and nominal incomes rise while the threshold dollar amounts remain the same, individuals formerly outside the income tax system will find themselves above the minimum return-filing and tax-paying amounts. In other words, bracket creep into the tax system will persist. As a secondary effect, the ZBA will cover the itemized deductions of fewer taxpayers. Deductions too will rise in nominal amount along with inflation, and more taxpayers will find it advantageous to claim itemized deductions. The added costs in complexity—numbers of additional forms to fill out, file and audit—will be significant as the percentage of itemizing taxpayers rises.

Two recent changes in frequently claimed itemized deductions may reflect the reduced ability of the ZBA to serve its second function as an alternative to itemization. The 1981 Act phases in over several years a provision that allows nonitemizers to claim the charitable contribution deduction.¹⁰⁴ Relatively low dollar limits in the first year of the transition period render the deduction, for at least those years, similar to an additional dollar deduction for nonitemizers, not unlike a direct increase in the ZBA.¹⁰⁵ When the full charitable contribution deduction for nonitemizers is phased in, however, the ZBA will simply offset a smaller bundle of itemized deductions. In effect, the charitable contribution

¹⁰¹ *Id.* at 18.

¹⁰² See *supra* notes 74, 87 and accompanying text.

¹⁰³ See *supra* text accompanying notes 93-94.

¹⁰⁴ I.R.C. §§ 170(i), 63(b)(1) (Supp. V 1981).

¹⁰⁵ For 1982 and 1983 the maximum deduction a nonitemizer may claim is \$25. For 1984 the amount increases to \$75. *Id.* § 170(i) (corresponding to Economic Recovery Tax Act of 1981, Pub. L. No., 97-34, § 121(a), 95 Stat. 172, 241).

deduction change recognizes the reduced value of the ZBA by according it a more modest tax tradeoff against other deductions.

A second change involves the deductions for medical expenses and casualty losses. The Tax Equity and Fiscal Responsibility Act of 1982¹⁰⁶ increases the adjusted gross income floor to 5% for the former¹⁰⁷ and imposes a new 10% adjusted gross income floor for the latter.¹⁰⁸ These changes are expected to make it more difficult for higher income taxpayers to claim these deductions. Again, the change seems to acknowledge the reduced value of the ZBA, this time by cutting down the value of the deductions the ZBA replaces.

Two relatively new provisions recognize implicitly the inadequacy of the present Code thresholds for taxability by creating independent ones. The Revenue Act of 1978 included some unemployment compensation benefits in gross income.¹⁰⁹ No inclusion occurs unless the unemployment compensation plus adjusted income, with certain modifications, exceeds a base amount. The initial base amount of \$20,000 for an individual and \$25,000 for a married couple filing joint returns was reduced in 1982 to \$12,000 and \$18,000 respectively.¹¹⁰ New section 86, taxing portions of social security benefits for the first time, adopts a similar mechanism with base amounts of \$25,000 and \$32,000.¹¹¹ The objective in each case—to avoid taxation of government benefits received by those in need—obviously could not be reached by reliance on the personal exemption and the ZBA.

Finally, by 1981 the combined personal exemption and ZBA failed even to insulate poverty-level families from federal income tax. The poverty level for 1981 was \$9,287 for a family of four.¹¹² Such a family would have enjoyed a combined ZBA and personal exemptions totaling \$7,400, leaving \$1,887 subject to income tax, for a tax liability of \$261.¹¹³

The 1981 "across-the-board" rate cuts disfavored lower income taxpayers and provided a disproportionately large reduction to wealthier taxpayers. The pattern of rate cuts is not rendered any more even-

¹⁰⁶ Pub. L. No. 97-248, 96 Stat. 324.

¹⁰⁷ *Id.* § 202(b)(1), 96 Stat. 324, 421 (codified at I.R.C. § 213(a)).

¹⁰⁸ *Id.* § 203(a), 96 Stat. 324, 422 (codified at I.R.C. § 165(h) (West Supp. 1983)).

¹⁰⁹ I.R.C. § 85 (Supp. V 1981).

¹¹⁰ Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 611(a), 96 Stat. 324, 706.

¹¹¹ The Social Security Amendments of 1983, Pub. L. No. 98-21, 121(c), 97 Stat. 65, 80.

¹¹² U.S. BUREAU OF CENSUS, CURRENT POPULATION REPORT SER. P-60, NO. 138, CHARACTERISTICS OF POPULATION BELOW THE POVERTY LEVEL: 1981, at 181, table A2.

¹¹³ The text ignores the earned income credit, limited under I.R.C. § 43(b) (Supp. V 1981) to \$88, and employee employment taxes of \$617.59. For 1982 the poverty level for a family of four rose to \$9,862. The income tax liability was \$305, the earned income credit \$17, and the employment tax \$661. See A. Feld, *Our Tax on the Poor*, Wash. Post, Aug. 11, 1983, at A23, col. 1.

handed when viewed as an adjustment to compensate for past and anticipated inflation. Inflation-based relief, if it will come at all,¹¹⁴ is not scheduled until 1985. Much of the disproportionality is attributable to the failure to adjust fixed dollar deductions related to the measure of subsistence. The failure to alter the personal exemption and ZBA will sweep new taxpayers into the system. Finally, when set in the context of the historical pattern from 1939 to the present, the 1981 changes reflect some alteration in the assumptions underlying our progressive rate structure. This last point is analyzed below.¹¹⁵

IV

PLACING THE 1981 ACT IN HISTORICAL PERSPECTIVE

The World War II tax changes converted the income tax from a levy that primarily affected a small part of the population to a tax that reaches most American households.¹¹⁶ Not only did the tax rates increase, but the rate structure became much steeper. In addition, the personal exemption declined sharply, with two significant effects. The decline enlarged the taxpaying population severalfold and converted the tax from a tax on discretionary income to a tax on some nondiscretionary income as well.¹¹⁷ As a companion measure, the standard deduction entered the tax structure.¹¹⁸ These changes were still part of the income tax structure in 1979, three and a half decades after World War II.

The 1981 Act changes cut back on several of these trends. The \$100 billion tax cut led to reduced marginal rates for taxpayers in every bracket. The failure to adjust the personal exemption and the ZBA for inflation, however, shifted the burden of taxation down the income scale.

The four criteria for evaluating rate changes are helpful in analyzing the shifts in tax burdens from 1939 to the present. Tables I through IV¹¹⁹ summarize the differences between 1939 and 1979, and extend the comparison to 1984, the year when the 1981 changes will take full effect. These comparisons will establish that the 1981 Act rate cuts disfavored lower income taxpayers, in contravention of the trend of the previous forty years, and in direct contradiction to the rhetoric surrounding the 1981 "across-the-board" rate changes.

¹¹⁴ See *supra* text accompanying notes 95-97.

¹¹⁵ See *infra* Section IVB.

¹¹⁶ See *supra* notes 11-25 and accompanying text.

¹¹⁷ See *supra* notes 30-38 and accompanying text.

¹¹⁸ See *supra* notes 52-59 and accompanying text.

¹¹⁹ Nineteen eighty-four data are based on 1979 income levels adjusted for an assumed inflation of 33 1/3% from 1979 to 1984.

A. Historical Comparison Under the Four Criteria

1. *Marginal-Rate Comparison*

Table I exhibits the following concerning marginal rates. Although the 1979 marginal rates exceed those for 1939 at every income level except the top one,¹²⁰ the ratio of comparison between 1979 and 1939 is fairly constant at around 5.5 to 1. This ratio suggests that the 1979 rate schedule bears a close similarity to that of 1939. The 1979 schedule, however, is much steeper than the 1939 schedule, rising quickly to a 70% peak rate on incomes over \$106,000. The 1939 schedule reached its highest rate (78%) only after net income exceeded \$5,000,000.

All but one of the 1984 marginal rates lie below their 1979 counterparts. The ratio of rate decline, however, is significant. Except for the lowest bracket (\$6,538 in 1979 income), none of the 1984 marginal rates on incomes below \$52,000 (in 1979 dollars) is less than 87% of its 1979 counterpart.¹²¹ After the \$52,000 mark, this percentage declines to a steady 71% on incomes over \$150,000 (1979 dollars). Taxpayers at the upper end of the scale thus enjoyed a disproportionate share of the benefits of the marginal rate decreases.

Because of its steeper rate structure, the 1979 schedule bears a more attenuated relationship than the 1939 schedule to a basic theoretical support for progressivity in tax rates—declining marginal utility of money. The 1984 rate schedule continues this trend by reaching its highest marginal rate even sooner than did the 1979 schedule.

One basic element in the argument for progressivity is a presumption of declining marginal utility of money; that is, the loss of a dollar of income provides less deprivation to an individual if he has many dollars than if he has few.¹²² Therefore, to minimize the aggregate reduction in utility to the members of society, any new tax burden should fall more heavily on individuals with large amounts of income and more lightly on those with lesser amounts. Although individual utility curves may differ, a relative-sacrifice theory in support of progressivity in income taxation rests to some extent on this idea of declining marginal utility of money.

At the lowest income levels, a tax system accommodates the declining marginal utility of money through low or zero rates on the income used to buy specified minimum levels of food, clothing, shelter,

¹²⁰ Comparative references for this section are illustrated in Table I. Because the 1939 schedule did not reach its peak until \$5,000,000 adjusted gross income (corresponding to \$26,150,000 in 1979), it is a somewhat imperfect measure of comparison. The far more gradual rise in rate progressivity in 1939, however, does correspond to a reasonable theory of the declining marginal utility of money. See *infra* note 124 and accompanying text.

¹²¹ The lowest 1984 bracket is 83% of the 1979 level.

¹²² See W. BLUM & H. KALVEN, *supra* note 72, at 40-42. The idea that money can have a declining marginal utility is a controversial one, as the authors note.

TABLE I
Comparison of Marginal Rates

	Adjusted Gross Income (AGI)		Marginal Rate			Comparison Ratio		
	1939	1979 equivalent	1939	1979	1984	1979/1939	1984/1979	1984/1939
level 1	\$ 1,250	\$ 6,538	4%	18%	15%	4.5	0.83	3.8
level 2	2,000	10,460	4	21	20	5.3	0.95	5.0
level 3	3,000	15,690	4	26	26	6.5	1.00	6.5
level 4	5,000	26,150	8	39	34	4.9	0.87	4.3
level 5	6,250	32,688	8	44	42	5.5	0.95	5.3
level 6	10,000	52,300	10	55	48	5.5	0.87	4.8
level 7	15,000	78,450	13	63	50	4.8	0.79	3.8
level 8	30,000	156,900	23	70	50	3.0	0.71	2.2
level 9	200,000	1,046,000	64	70	50	1.1	0.71	0.78
level 10	5,000,000	26,150,000	78	70	50	0.9	0.71	0.64

and other goods and services.¹²³ The 1939 rate structure reflected this goal by providing a \$1,000 personal exemption and by imposing a 4% rate that extended to net incomes up to \$4,000. Over 80% of all individual tax returns filed incurred tax at or below this rate.¹²⁴ In 1979, the ZBA and the personal exemption excluded \$3,300 for a single individual. The lowest scheduled rate was 14% and it taxed the first \$1,100 of taxable income over the ZBA; 76.8% of all returns filed encountered higher marginal rates.¹²⁵ The lowest rate in 1984 will be 11%¹²⁶ and at least as many returns as in 1979 will encounter higher rates.

Again, at the higher income levels the 1939 rate structure arguably was more related to the marginal utility of money than the 1979 or 1984 structures. If money has declining marginal utility, the decline probably is gradual over a large income interval. Under this theory, the 1979 marginal rate schedule, which reached its top rate at \$106,000, or the 1984 schedule which reaches its top rate at \$79,500¹²⁷, hardly reflects a studied matching of tax burdens to the marginal utility of money. Taxes will increase faster, and after-tax income will decline faster under the 1981 Act, than under a tax structure based on a plausible theory of declining marginal utility.

2. *Effective-Rate Comparison*

Table II analyzes the second criterion, effective rates, and demonstrates a somewhat different perspective. The ratios of the 1979 effective rates to their 1939 counterparts remain relatively uniform at about 6 to 1 in the middle income ranges, but decline somewhat for the higher incomes. At the top of the rate schedule, taxpayers actually do better in 1979, by reason of the compression of the rates and the slightly higher 1939 top rate.¹²⁸ This result parallels marginal-rate comparisons for the two years. The comparison ratio for lower income taxpayers' effective rates, however, is relatively higher than was the marginal-rate comparison. This configuration suggests that the 1979 tax burden has shifted down the income scale, an impression that is reinforced by the observation that the data do not include low adjusted gross income taxpayers

¹²³ When the tax base is conceived of as consisting of discretionary income rather than net income, a sufficient amount of net income to cover subsistence is not subject to tax. *See supra* notes 33, 28 and accompanying text.

¹²⁴ U.S. TREASURY DEP'T, BUREAU OF INTERNAL REVENUE, STATISTICS OF INCOME FOR 1939 (PART I) 16 (1942). The percentage figure in the text is extrapolated from the table.

¹²⁵ STATISTICS OF INCOME 1979, *supra* note 48, at 96, table 3.13.

¹²⁶ I.R.C. § 1 (Supp. V 1981).

¹²⁷ These numbers reflect the top bracket amount for unmarried individuals, *id.* § 1(c), reduced by the \$2,300 ZBA built into the rate table.

¹²⁸ Comparative references for the section are illustrated in Table II.

TABLE II
Comparison of Effective Rates

	Adjusted Gross Income (AGI)		1939	Tax 1979	1984	Effective Rate			Comparison Ratio		
	1939	1984 equivalent				1939	1979	1984	1979/1939	1984/1979	1984/1939
level 1	\$ 1,250	\$ 6,538	\$ 10	519	718	0.8%	7.9%	8.2%	9.9	1.04	10.25
level 2	2,000	10,460	40	1,274	1,590	2.0	12.2	11.4	6.1	0.93	5.70
level 3	3,000	15,690	80	2,524	3,184	2.7	16.1	15.2	6.0	0.94	5.60
level 4	5,000	26,150	160	6,010	7,428	3.2	23.0	21.3	7.2	0.93	6.70
level 5	6,250	32,688	260	8,705	10,774	4.2	26.6	24.7	6.3	0.93	5.90
level 6	10,000	52,300	600	18,782	22,563	6.0	35.9	32.4	6.0	0.90	5.40
level 7	15,000	78,450	1,160	34,937	39,735	7.7	44.5	38.0	5.8	0.85	4.90
level 8	30,000	156,900	3,970	89,017	92,035	13.2	56.7	44.0	4.3	0.78	3.30
level 9	200,000	1,046,000	96,360	711,387	684,769	48.2	68.0	49.1	1.4	0.72	1.02
level 10	5,000,000	26,150,000	3,790,220	18,284,187	17,420,768	75.8	69.9	50.0	0.9	0.72	0.66

for 1979 whose 1939 counterparts incurred no tax liability.¹²⁹ In addition, the 1979 effective-rate comparison ratio reaches its peak at a point slightly above the 1979 median income, then declines.¹³⁰ The effective-rate comparison thus suggests that the middle and lower range taxpayers suffered proportionately greater burdens from the income tax increases, than did taxpayers not formerly subject to tax.

The 1981 changes shifted the tax burden further down the income scale by granting significant relief primarily to upper income taxpayers. At the lowest income level, the 1981 tax cuts actually lead to a higher effective rate for the same real income as in 1979. By the \$50,000 income mark, effective rates will have declined only 10% from 1979 to 1984. From the \$50,000 mark upward, comparative effective rates decrease rapidly to 72% of the 1979 level. Again, the data do not even account for citizens who were not included as taxpayers in 1979, but who will become taxpayers in future years as inflation pushes their income above the ZBA level.¹³¹

3. *The After-Tax Income Comparison*¹³²

Table III concerns the third measure, change in after-tax income, and presents a significantly different picture of the 1939 to 1979 changes. The lowest income levels exhibit a relatively small decrease in after-tax income from 1939 to 1979. As income rises to \$30,000 (1939 dollars, equivalent to \$156,900 in 1979 dollars), the decline in after-tax income becomes much more acute.¹³³ Based on the after-tax income criterion, it appears that the additional tax burdens in 1979 fell most heavily on taxpayers well above the median level income.

The 1981 changes reverse the forty-year trend to some extent. Although one would anticipate that after-tax income would increase after an across-the-board rate cut, this is not so for the taxpayer at the bottom of the income scale. At the higher levels, however, the more after-tax income an individual enjoyed to begin with, the greater the relative increase added by the 1981 Act. At income levels under \$52,300 (1979 dollars, equivalent to \$69,733 in 1984 dollars), after-tax income rises

¹²⁹ For example, an individual with income of \$800 in 1939 would make \$4,240 in inflation-adjusted 1979 dollars. Such an individual was untaxed in 1939 because of the \$1,000 personal exemption. In 1979, the personal exemption and ZBA would exclude \$3,300 from taxation and the remaining \$940 would be taxed at a 14% marginal rate.

¹³⁰ See *supra* note 32.

¹³¹ See *supra* note 129. Again, inflation will draw a person with adjusted gross income of \$3,000 in 1979 into the tax schedule in 1984 (with 1984 adjusted gross income of \$4,000).

¹³² Comparative references for this section are illustrated in Table III.

¹³³ Note, however, that the gap in after-tax income does not narrow until a taxpayer reaches an exceedingly high level of income. The figures in the low and intermediate range best reflect the comparative positions of the vast majority of taxpayers in both 1939 and 1979.

TABLE III
Comparison of After-Tax Income

	<u>Adjusted Gross Income (AGI)</u>		<u>After-tax Income in 1979 Dollars</u>				<u>Ratio of Change</u>		
	<u>1939</u>	<u>1979</u>	<u>1939</u>	<u>From 1979 Income</u>	<u>From 1979 Income</u>	<u>From 1984 Income</u>	<u>Decline 1939/1979</u>	<u>Increase 1979/1984</u>	<u>Decline 1939/1984</u>
level 1	\$ 1,250	\$ 6,538	\$ 8,717	\$ 6,019	\$ 5,999		7.2	-0.3	7.5
level 2	2,000	10,460	13,947	9,186	9,268		-10.4	0.9	9.5
level 3	3,000	15,690	20,920	13,166	13,302		13.8	1.0	12.9
level 4	5,000	26,150	34,867	20,140	20,579		20.4	2.2	18.7
level 5	6,250	32,688	43,584	23,983	24,607		23.4	2.6	21.5
level 6	10,000	52,300	69,733	33,518	35,377		31.8	5.5	28.0
level 7	15,000	78,450	104,600	43,513	48,649		40.0	11.8	32.8
level 8	30,000	156,900	209,200	67,883	87,874		50.1	29.4	35.5
level 9	200,000	1,046,000	1,394,667	334,613	532,423		38.3	59.1	1.8
level 10	5,000,000	26,150,000	34,866,666	7,856,813	13,084,423		+24.2	71.3	+112.7

less than 5.5% from 1979 to 1984. Only the taxpayers with incomes above this level will realize significant increases in after-tax income.¹³⁴ The 1981 Act thus has mitigated the apparent harsh after-tax effect on the upper income taxpayers of the post-1939 rate changes.

4. *After-Tax Discretionary Income Comparison*

Table IV dealing with the final criterion, after-tax discretionary income, yields an intermediate view of the changes from 1939 to 1979. The calculations equate the \$1,000 personal exemption in 1939 (equivalent to \$5,230 in 1979 dollars and \$6,973 in 1984 dollars) with a subsistence level of income.¹³⁵ After factoring out this subsistence income, the changes from 1939 to 1979 appear less drastic than under the straight after-tax income comparison.

At the lowest income level, after-tax discretionary income decreased by 37.1%. In intermediate income ranges the decrease is less severe; less than 30% for incomes up to \$32,688 in 1979 dollars. In the highest two levels in the table, the rate of decline in after-tax discretionary income from 1939 to 1979 accelerates. Using the discretionary income measure, changes in tax rates from 1939 to 1979 appear to have placed the greatest burden on taxpayers at the low and high ends of the income scale.

A comparison of 1979 discretionary income, adjusted for inflation, and 1984 discretionary income shows some alteration of the 1939 to 1979 trend.¹³⁶ At the lowest income level, discretionary income declines even though marginal rates will be lower. Moving up the schedule to higher incomes, taxpayers will enjoy an increase in discretionary income. By the fifth entry in the table, however, representing \$43,584 in 1984 adjusted gross income, discretionary income will rise 3.3% from 1979. As the data illustrate, discretionary income rises rapidly over 1979 levels only for those taxpayers with incomes over \$55,000 (1984 adjusted gross income). Near the top of the scale, high income taxpayers will enjoy increases in discretionary income of well over 50% from 1979 levels.

B. Analyzing the Changes from a Historical Perspective

The ten adjusted gross income levels tested in these tables when divided into three groups—the three lowest, the three highest and the

¹³⁴ The disparity in after-tax incomes does not necessarily reflect unfairness to upper income taxpayers when an after tax discretionary-income criterion is used. In addition, a greater after-tax burden on upper income taxpayers may reflect the social policies that led to a progressive rate structure in the first instance.

¹³⁵ This level of subsistence, arbitrarily selected to facilitate discussion of discretionary income, is not intended to foreclose inquiry as to the proper level for subsistence.

¹³⁶ Comparative references for this section are illustrated in Table IV.

TABLE IV

	<u>Adjusted Gross Income (AGI)</u>		<u>Discretionary Income Remaining After Tax in 1979 Dollars</u>				<u>Ratio of Change</u>		
	<u>1939</u>	<u>1979</u>	<u>1939</u>	<u>From 1979</u>	<u>From 1984</u>	<u>Decline</u>	<u>Increase</u>	<u>Decline</u>	
			<u>Income</u>	<u>Income</u>	<u>Income</u>	<u>1939/1979</u>	<u>1979/1984</u>	<u>1939/1984</u>	
level 1	\$ 1,250	\$ 6,538	\$ 1,255	\$ 789	\$ 769	37.1	-2.5	38.7	
level 2	2,000	10,460	5,021	3,956	4,038	21.2	2.1	19.6	
level 3	3,000	15,690	10,042	7,936	8,072	21.0	1.7	19.6	
level 4	5,000	26,150	20,083	14,910	15,349	25.8	2.9	23.6	
level 5	6,250	32,688	26,098	18,753	19,377	28.1	3.3	25.8	
level 6	10,000	52,300	43,932	28,288	30,147	35.6	6.6	31.4	
level 7	15,000	78,450	67,153	38,283	43,419	43.0	13.4	35.3	
level 8	30,000	156,900	130,907	62,653	82,644	52.1	31.9	36.9	
level 9	200,000	1,046,000	536,807	329,383	527,193	38.6	60.1	1.7	
level 10	5,000,000	26,150,000	6,321,919	7,860,583	13,454,194	+24.3	71.4	+118.8	

middle four—highlight the points of agreement and disagreement between the four criteria.

For the highest group, all four criteria show a decline in added tax burden from 1939 to 1979 as income increases. Indeed the highest income, representing the top of the 1939 rate scale, is better off by every criterion in 1979 than in 1939.

For the middle group, the marginal and effective rates have increased by relatively equivalent factors from 1939 to 1979. The other two criteria, however, show an increase in relative burden for members of this group that rises with income.

For the three classes at the lowest income level, the marginal-rate and the after-tax income criteria show a rise in relative tax burden with income from 1939 to 1979, implying that lower income taxpayers avoided a proportionate increase in tax burden. This is not the case, however, under the effective-rate and discretionary-income criteria, which show ratios declining with income and therefore higher relative burdens on lower incomes.

Under all four criteria, the 1981 Act rate reductions produce a skewed distribution of the tax cut when adjustments for inflation are considered as the motive for the cuts. The beneficiaries of the form of the tax cut selected are those in the highest income categories. Under the effective-rate and after-tax income measures the lowest income taxpayers receive least favorable treatment. Under the discretionary income measure, the 1981 tax cuts extend the skewed distribution of benefits even further up the income scale. Taxpayers with less than \$50,000 in 1984 adjusted gross income will see little benefit from the rate cuts.

In comparison to the relative changes in tax burden since 1939, the 1981 Act continues some trends and reverses others. The marginal rate schedule grew much steeper from 1939 to 1979, and leveled off at a lower income level. The 1981 marginal rate schedule is even steeper, and levels off even sooner. Under the effective-rate criterion, the 1939 to 1979 changes shifted burdens more heavily onto low and moderate income taxpayers; the 1981 Act continues this trend. Analysis of after-tax income tells a different story of disproportionately heavy burdens on upper income taxpayers below the highest bracket. The 1981 Act can be seen as redressing much of the previous change and restoring a distribution of tax burdens closer to the earlier levels. Even under this view, however, the 1981 Act fails to make a principled adjustment; it over-rewards the wealthy and it fails to remove from the tax system those additional taxpayers brought into it by the reductions in the effective personal exemption. Measured by discretionary income, the 1939 to 1979 period produced a more complex change, overburdening taxpayers at the bottom of the income scale and in its upper middle range and

benefitting the higher bracket taxpayers. The 1981 Act provides significant relief from this historical trend only to taxpayers in the highest income classes.

CONCLUSION

No theory to determine the annual amount that each household should contribute towards the common weal enjoys wide acceptance. Nevertheless, the individual income tax purports to make such determinations. These determinations necessarily involve some arbitrariness but they have been tolerated as reasonable.

When changes occur in tax rules, however, a basis for comparison emerges between what has gone before and the new allocation of the tax burden. This article has articulated four criteria—marginal rate, effective rate, after-tax income, and after-tax discretionary income—for assessing the effects of tax changes and it has applied these criteria to the 1981 Act tax rate reductions. It compared the new tax schedule to a recent base, the income tax in effect for 1979, and to a much earlier base, the income tax as it applied in 1939, before the significant World War II structural changes.

Under all four criteria the 1981 tax reductions favor high income taxpayers and disfavor low income taxpayers. Even on its own terms—reduction in the marginal rates applicable to taxpayers—the Act provided larger cuts in the high income ranges than in the lowest range. Perhaps more significantly, the Act neglected to adjust the personal exemption and the zero bracket amount, both of which have far greater significance for lower income taxpayers. The effects of this failure emerge not only in applying the criterion of discretionary after-tax income, which takes explicit account of these deductions and exemptions, but also when relative changes in effective tax rates and in after-tax income are considered.