Chapter Summaries

Chapter 14: Applying Ability-to-Pay Principles – Federal Personal Income Tax

Chapter 14 considers some issues associated with the federal personal income tax (PIT) that are of particular concern to U.S. taxpayers. The issues are analyzed from the perspective of the ability-to-pay tradition in which Haig–Simons income (Y_{HS}) is viewed as the ideal tax base. The chapter begins with a description of the tax structure and tax base.

1. The PIT is a graduated tax. Taxable income is divided into a number of ranges called brackets, and the tax rate (the so-called marginal tax rate) applied to each bracket increases as bracketed income increases. The tax rates vary from 10% to 35% (2008).
2. Taxable income is much less than Y_{HS}, both the personal income and capital gains components.
3. The main differences between taxable income and Haig–Simons income are exemptions, exclusions, and deductions.
   a. Exemptions – the first dollars of income are exempt from taxation.
   b. Exclusions – sources of income that could be taxed but are excluded from taxable income. The main exclusions are: employee fringe benefits; public assistance transfers and part of the Social Security pensions; income earned on certain assets held for retirement; imputed income on owner-occupied homes and the value of their own crops that farm families consume; and interest on state and local bonds (so-called municipal bonds).
   c. Deductions – expenditures that are deducted from the tax base. The main deductions are: extraordinary medical expenses; state income or sales taxes (not both); local property taxes; mortgage interest payments on a principal residence; and charitable contributions (including those to educational and religious organizations).
4. Capital gains are taxed only when they are realized (the asset is sold). Also, capital gains on assets held for more than one year are taxed at a 15% rate regardless of the taxpayer's income (2008).

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The chapter next discusses the horizontal equity of the PIT given the various exemptions, exclusions, and deductions.

5. Exemptions are viewed differently from exclusions and deductions because they are a way of making the PIT (or any income tax) progressive at the low end of the income scale.
6. There are two notions of horizontal equity: 1. Two people with the same Y_{HS} should pay the same tax; and 2. Feldstein's version: Two people with equal utility before tax should have equal utility after tax.
7. If taxable income were the same as Y_{HS}, then the two versions of horizontal equity would be equivalent, since Y_{HS} is seen as the best surrogate measure of utility.
8. The exclusions and deductions are called *loopholes* because they violate the first version of horizontal equity. Two taxpayers with equal Y_{HS} can pay very different amounts of tax depending on the exclusions and deductions they claim.
9. The exclusions and deductions do not violate Feldstein's version of horizontal equity, however, because the tax breaks inherent in them are capitalized by the competitive market system. This is demonstrated with a home-owner and apartment example. The principles in terms of Feldstein's version of horizontal equity are:
   a. Once a competitive market system reaches its equilibrium in response to a tax, exclusions and deductions cannot be a source of horizontal inequity (any inequities would be the result of monopoly elements in the market economy);
   b. Changes in exclusions and deductions do generate horizontal inequities, but only until the market reaches its new equilibrium.
10. The argument for removing exclusions and deductions rests on other grounds:
    a. Exclusions and deductions introduce inefficiencies of two kinds. One is that they require higher tax rates to raise the same amount of tax revenue, and the efficiency loss of a tax rises with the square of the tax rates. The other is the inefficiencies in the favored markets, which are driven away from their normal supply and demand equilibriums.
    b. Exclusions and deductions are worth more to higher income taxpayers under a graduated tax, which may be a source of vertical inequity. To avoid this problem, governments can use tax credits rather than exclusions and deductions. A tax credit is a percentage of the taxpayer's tax liability. As such, a tax credit gives the same percentage tax break to all taxpayers.
    c. Exclusions and deductions can be an excessively costly way to support favored activities, as illustrated with the exclusion of interest received on municipal bonds. The federal government sacrifices more in tax revenue with this exclusion than the state and local governments receive in subsidy.

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11. Taxing capital gains on a realized rather than an accrued basis has the effect of giving interest-free loans to taxpayers, and the value of the loan increases with the marginal tax rates (i.e., with taxpayers' income).
    Income from capital is not indexed for inflation under the PIT. The next section of the chapter discusses how this lowers the real returns to capital relative to wage income.
12. Income from capital suffers twice from not being indexed for inflation. First, the nominal or observed return to capital increases by the instantaneous rate of inflation (or annual inflation rate if the return is measured annually). Second, the value of assets rises by the accumulated rate of inflation from one time period to any future time period. Wage income increases only by the accumulated rate of inflation. Therefore, the nominal return to capital is taxed more heavily by not indexing for inflation than wage income, and the real rate of return to capital suffers in comparison with wage income.
13. The way to protect income from capital from inflation relative to wage income depends on the form that the returns to the capital take:
    a. Capital gains: when the asset is sold, increase the basis (purchase price) of the asset by the accumulated inflation since the time of purchase.
    b. Interest rates: deduct the instantaneous (or annual) rate of inflation from the nominal or observed interest rate in computing the taxable interest income.

The next issue considered is the problem of variable incomes, either over time or within a family, with graduated tax rates.

14. Suppose two people have the same total income over a five year period, but one person's income varies considerably year by year whereas the other person has a constant income each year. The person with variable income will pay higher income taxes over the five-year period because a higher proportion of her income is taxed at higher marginal tax rates. The way around this is to allow *income averaging* of variable incomes over time, but the federal PIT does not currently permit income averaging.
15. Married couples are allowed to file jointly – combine their incomes – and the joint income brackets are wider than the single income brackets. The purpose of joint filing was to give a tax break to married couples with highly unequal incomes – for example if one person works but the other does not – because of the increased needs of married couples and their families. If both people work and earn similar incomes, however, then joint filing can generate a higher tax liability – a so-called marriage penalty – than if each person filed singly, since more of the combined income is taxed at higher marginal rates. There is no way to avoid penalizing some married couples under joint filing with graduated tax rates.

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The final section of the chapter discusses some issues involved in switching from the current personal income tax to a personal expenditures (consumption) tax, in which taxpayers would be allowed to deduct their savings each year in computing their tax base. Many economists favor a switch to a personal expenditures tax.

16. The switch to a personal expenditures tax involves an uncomfortable trade-off between efficiency and equity. There are large dynamic efficiency gains because of increased saving and investment, which lead to a larger future capital stock and much higher output. The equity problem with switching is that the current elderly generation is hurt badly. The elderly paid tax on their saving while working, and tax on the capital income generated by the saving. A switch to personal expenditures tax would tax them a third time as they draw down their savings to finance consumption during their retirement. Attempts to remove the burden on the elderly turn out to remove most of the dynamic efficiency gains from the switch to an expenditures tax.
17. The text discussed a number of administrative tax issues as well:
    a. A personal expenditures tax is not necessarily less complex than the current PIT because people would still have to keep track of and register their various forms of saving in order to deduct their savings in computing taxable income.
    b. A personal expenditures tax can be quite progressive by levying graduated tax rates on consumption.
    c. *Real assets* can be taxed using a prepayment option, under which the asset is not deductible when purchased but then the consumption stream from the asset over time is excluded from the tax base. Similarly, the proceeds from loans to finance assets are not counted as part of the tax base, but then the debt service on the loan (repayment of principal plus interest) is included in the tax base.
    d. The taxation of *bequests/inheritances* under a personal expenditures tax depends on point of view. Counting bequests as the final act of consumption by the deceased and therefore taxable, views the individual as the appropriate unit for taxation. Counting the inheritance as part of the income of the heirs and therefore not taxable unless consumed by them views the family as the appropriate unit of taxation.
18. The current federal PIT is a *hybrid tax* that has features of both an income and an expenditures tax. Assets purchased for retirement are treated exactly as they would be under a personal expenditures tax: The purchase of these assets and the income they earn are untaxed, and then they are taxed when sold during retirement. Houses are also treated as they would be by using the prepayment option under a personal expenditures tax, except that interest on the mortgage would no longer be deductible. Therefore, a switch to a personal expenditures tax may not have much effect for the many taxpayers whose primary forms of saving consist of retirement assets and their houses. This would be especially true if the interest deduction on mortgages were retained.

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