The Journal of FINANCE

VOL. XXVII | MAY 1972 | NO. 2

DISTRIBUTION OF FEDERAL AND STATE INCOME TAXES BY INCOME CLASSES*

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FOR AS LONG AS I can remember, policy makers in the executive and legislative branches of government have been bombarded with complaints by taxpayer representatives that the burden of taxation is crushing on (a) all taxpayers, (b) taxpayers who receive most of their income from earnings, or (c) taxpayers who rely mainly on property income. Depending on who the spokesman represents, the tax system is destroying work incentives, undermining investment incentives, or crippling everybody's incentives. These charges are made when taxes are rising, when they are falling, or when they have remained the same for years. Not all of these charges can be correct, yet they continue to be repeated in congressional hearings, public forums, and private conversations.

Of course, part of the apparent paradox is that the same set of tax rates is regarded by some people as high, and by others as quite reasonable or even low. But the main explanation is that most people have no basis for judging what the tax rates really are. The nominal rates of income tax bear very little relationship to the actual tax rates paid by most taxpayers because the tax base is riddled by numerous special provisions that some people believe to be perfectly reasonable and others condemn as loopholes or, more recently, label as "tax expenditures."[1] The fact is that, while marginal federal income tax rates do rise as high as 70 per cent and maximum state rates now reach as high as 18 per cent, nobody pays these rates on his entire income. This gives every taxpayer the opportunity to grumble about high tax rates without really paying taxes at these rates.

In years past, I have tried my best to inform the public about the tax facts of life. The two editions of my book, *Federal Tax Policy,* contain an attractive

* Presidential Address, American Finance Association Annual Meetings, New Orleans, Louisiana, December 28, 1971.

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1. For a discussion of the concept of tax expenditures, see Stanley S. Surrey, "Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance," *Harvard Law Review,* Vol. 84, No. 2 (December 1970), pp. 352-408.

chart showing that actual effective rates of federal individual income tax on the total income reported on tax returns never exceeded 29 per cent under the 1964 tax law in any income class and do not exceed 34 per cent under present law. Since the income reported does not include such receipts as tax-exempt interest and allows for such generous deductions as percentage depletion and accelerated depreciation, the actual effective rate on economic income must be much lower than 34 per cent.

But, alas, few people—except for some of the cognoscenti of the tax profession and my own students who had to listen to an hour's discourse on the significance of that chart—paid any attention to these facts that I still regard as startling. There was a slight burst of interest in these figures when Secretary of the Treasury Joseph W. Barr revealed his amazing discovery that 154 individuals with adjusted gross incomes of $200,000 or more paid not a dime to the federal treasury on their 1966 incomes. Had he remained in office long enough, he would have learned that the number of these lucky citizens rose to new records of 222 in 1968 and 301 in 1969. But Congress was sufficiently impressed by the 1966 number. It responded by enacting the Tax Reform Act of 1969 which closed some loopholes and even added a new 10 per cent tax on a few—but by no means all—tax preferences. But the zeal for tax reform has unfortunately abated, as evidenced by the recently enacted Revenue Act of 1971 which reduced federal taxes by a total of $15.7 billion for the period 1971-73, validated part of the Asset Depreciation Range (ADR) system and reintroduced the 7 per cent investment credit, and also managed to slip through the Domestic International Sales Corporation (DISC) arrangement which will permit exporters to make annual deferrals of several hundred millions of dollars of taxes for indefinite periods.

I remain convinced that the lack of progress on tax reform is mainly a matter of public education. If only the public could be fed an unusual statistic every year to keep up its tax reform temperature, Congress might be persuaded to continue the job it started in such a promising way in 1969. In the interest of contributing to the flow of information, I am taking this opportunity to add to the stock of knowledge about the real income tax burdens in this country. This knowledge is based on a new file of income data which has been prepared by my colleague Ben Okner and some bright young programmers and research assistants for the purpose of estimating the distribution of federal, state, and local tax burdens by income classes. We have not completed the entire study, but the results on income taxation are already available and they are interesting enough to be discussed separately. I offer them here in the hope that they will capture the interest of someone who has the willingness and capacity to dramatize the need for tax reform as effectively as Secretary Barr did in 1969.

The Data

The basic file combines information on 30,000 families and single persons in the 1967 Survey of Economic Opportunity (SEO) conducted by the U.S. Census Bureau for the Office of Economic Opportunity, and on a sample of about 90,000 federal individual income tax returns filed for the year 1966. This MERGE File contains data for low income SEO families who are not in the tax population, as well as the more complete—and more accurate—income tax information for higher income individuals. The basic economic unit in the MERGE File is the family or single unattached individual, but the file contains income data for each person in the family as well as for the family as a whole.

A detailed description of how this remarkable file was developed is available elsewhere.[2] Briefly, the process consisted of estimating for each family unit in the SEO file the kind of tax return or returns that would have been filed by each family and then, for tax filers, by matching each SEO tax unit with a return selected from the tax file. For the nonfilers, the only available information on income was from the SEO record; for the filer, the income data in the tax file were substituted for the corresponding information in the SEO file. This permits us to take advantage of the superior income reporting on tax returns and to use the capital gains data which are available on tax returns but are excluded from the SEO income concept. As in the case of most field surveys, there was virtually no upper "tail" of the income distribution (i.e., incomes above $30,000) in the SEO file. At these levels, the tax file was substituted in toto for the SEO file without going through the intermediate procedure of matching the two files. This failure to match resulted in the loss of a considerable amount of demographic, education and employment information for high-income families, but this gap does not affect the type of tax analysis to be attempted in this paper. Finally, the income information in the MERGE File has been corrected for nonreporting and underreporting, so that—with the appropriate weights applied to the sample units—the file accounts for the total incomes estimated to have been received in the United States in 1966.

The substitution of tax return incomes for the income reported in the SEO survey and the corrections for underreporting and nonreporting had a dramatic effect both on the income aggregates and on their distribution. In the original SEO survey, the poorest fifth of the families had incomes under $2,762 and received 4.1 per cent of total money income; the highest fifth of the families had incomes of $10,982 or more and accounted for 42.7 per cent of the total. After the adjustments to the file, the poorest fifth of the families had incomes under $3,261 and received 3.4 per cent of the total, while the highest fifth moved up to $12,500 and received 45.1 per cent of total money income (Table 1).

Although the upward shift can be seen all along the income distribution, the effect is most pronounced among those at the very top. Before adjustment, the top 5 per cent included families with incomes of $16,933 and over and they received 16.0 per cent of total money income. After adjustment, the top 5 per cent included families with incomes of $20,227 and over that received 19.1 per cent of the total money income. The share of the total received by the top 1 per cent of all families increased from 4.8 per cent to 6.8 per cent after adjustment. This large change in the relative distribution of income mainly reflects

2. In Benjamin A. Okner, "Constructing a New Data Base From Existing Microdata Sets: The 1966 MERGE File," *Annals of Economic and Social Measurement*, Vol. 1, (June 1972). The development of the file was financed by a grant from the Office of Economic Opportunity.

TABLE 1
COMPARISON OF SHARES OF MONEY INCOME RECEIVED BY EACH FIFTH OF FAMILIES BEFORE AND AFTER ADJUSTMENT FOR NONREPORTING AND UNDERREPORTING OF INCOME, 1966[a]

Families ranked from lowest to highest income	Before adjustment: Income range	Before adjustment: Per cent of income received	After adjustment: Income range	After adjustment: Per cent of income received
Lowest fifth	Under $2,762	4.1	Under $3,261	3.4
Second fifth	$2,762- 5,381	10.8	$3,261- 6,057	10.7
Middle fifth	5,381- 7,852	17.5	6,057- 8,747	17.0
Fourth fifth	7,852-10,982	24.9	8,747-12,500	23.8
Highest fifth	10,982 and over	42.7	12,500 and over	45.1
Top 5 per cent	16,933 and over	16.0	20,227 and over	19.1
Top 1 per cent	33,333 and over	4.8	44,792 and over	6.8

[a] The income concept used is "money income" as defined by the U.S. Bureau of the Census. It includes money factor income and transfer payments, and excludes capital gains.

the addition of high-income family units that were omitted from the original SEO population.

Another important characteristic of the MERGE File is the flexibility it provides in defining income. For purposes of analyzing the burden of taxation on income, it is clearly not sufficient to compare the taxes paid with the income subject to tax. We are more interested in a comparison of the taxes paid with total incomes, whether taxable or not. To provide this type of information, we adopted as the basic concept of income for the MERGE File a comprehensive definition that is intended to correspond as closely as practical to an economic concept of income, that is, consumption plus tax payments plus (or minus) the net increase (or decrease) in the value of assets during the year. This concept, which is called *adjusted family income* (AFI), is the sum of national income (as defined in the national income accounts)[3] plus transfer payments plus accrued gains on farm assets and nonfarm real estate. In keeping with the national income concept, AFI includes corporation incomes before tax. This procedure has the advantage not only of consistency but also of providing a complete account of the accrued income claims of the household sector. Retained earnings of corporations, which are thus automatically included in adjusted family income, may be regarded as an approximation of accrued capital gains on corporate stock during the year.[4] AFI includes only

3. The only departure from the official definition of income is the omission of interest imputed to individuals for the services rendered to them by the banking system.

4. We used this approximation because the annual fluctuations in the value of corporate stock are huge and even three-to-five year averages may not give an adequate representation of accrued capital gains. Martin J. Bailey and Martin David have shown that over very long periods, capital gains on corporate securities are roughly equal to retained earnings. See Martin J. Bailey, "Capital Gains and Income Taxation," in Arnold C. Harberger and Martin J. Bailey (eds.), *The Taxation of Income from Capital* (Brookings Institution, 1969), pp. 15-26; and Martin David, *Alternative Approaches to Capital Gains Taxation* (Brookings Institution, 1968), pp. 242-46.

income which accrues directly to families and individuals, and thus excludes the income of fiduciaries and of the institutional population that is not represented in the SEO file.

To illustrate the magnitudes involved, Table 2 compares the major income

TABLE 2
COMPARISON OF VARIOUS INCOME CONCEPTS, 1966[a]
(billions of dollars)

	Item	Amount
Money factor income[b]		484
Add:	Wage supplements[c]	40
	Imputed rent	12
	Retained corporate profits	22
	Corporation income tax	26
	Accrued capital gains on farm assets and nonfarm real estate	35
	Interest on life insurance policies	6
Equals:	Total income before transfers	625
Add:	Transfer payments[d]	34
Equals:	Adjusted family income	659
Memorandum:	Adjusted gross income[e]	474

[a] Data based on the MERGE File.
[b] Money factor income is the sum of wages and salaries, interest, dividends, rents and royalties, and farm and nonfarm proprietorship income.
[c] Wage supplements include employer contributions to private pension and welfare funds, social security, workmen's compensation, unemployment insurance, and civilian government retirement systems.
[d] Transfer payments include social security benefits, public assistance, veterans disability compensation, workmen's compensation, and unemployment compensation payments received by individuals.
[e] As defined in the Internal Revenue Code.

concepts in the file. *Money factor income,* which includes the money incomes received by individuals from production, amounted to $484 billion in 1966. We then add wage supplements, imputed rent, accrued capital gains on farm assets and nonfarm real estate, retained corporate earnings and the corporation income tax allocated to individual stockholders, and interest on life insurance policies to obtain *total income before transfers* of $625 billion. Finally, we add transfer payments to obtain *adjusted family income,* which totalled $659 billion in 1966. *Adjusted gross income,* which is the basic definition of income in the federal income tax code, amounted to $474 billion in 1966, or $10 billion less than *money factor income,* the narrowest of the income concepts shown in Table 2.

TAX BURDENS IN 1966

The first important fact to be noted about the income taxes in this country is that they do not impose a heavy burden on individual incomes in the aggregate. According to the MERGE File, federal and state-local individual income taxes amounted to $59 billion in 1966; corporation income taxes added $26 billion, making a total of $85 billion for all income taxes combined.[5] This

5. It should be noted that the individual income taxes are reported in the MERGE File before

amounts to about 13 per cent, or just a little over one-eighth of the $659 billion of adjusted family income shown in Table 2.

The real question is whether these aggregate figures cover up large variations by income classes or among types of incomes. What were the relative 1966 tax burdens of the rich as compared with middle- and low-income recipients? Since the federal corporation income tax rate was 48 per cent, did property incomes as a whole bear a much larger share of the total tax burden than earnings? How progressive were the income tax rates, when account is taken of the incomes that were not subject to tax? To answer these questions, we must turn to the MERGE File.

It will be instructive and interesting, I believe, to examine the data for the individual and corporation income taxes separately and then to see the effect of the two taxes in combination.

Individual Income Tax

The MERGE File contains the federal individual income tax reported by each taxpaying unit in 1966, so that it is possible to show the burden of this tax by income classes merely by comparing the amount of tax reported with the total amount of income. It is also a relatively simple matter to allocate the tax paid by each taxpayer between the amounts of property income and earnings he reported on his tax return.[6] But since the MERGE File contains nonreported as well as reported income, we are not limited to making comparisons of taxes paid to reported incomes. It is also possible to show how the same taxes compare with the total income in each class, whether reported or not.

The results of this calculation are summarized in Table 3, which shows the effective rates of federal and state-local income taxes on adjusted family income for each income class. To highlight the relative tax burdens on earnings and on property income, the table also shows separately the effective rates of tax for families who report earnings as their major source of income and those who report property income as their major source.[7] Since we are dealing only with the individual income tax, the amount of the corporation income tax allocated to each taxpayer is excluded from adjusted family income in making the effective rate calculations in this table. However, to make it possible to follow the same group of taxpayers through the subsequent tables, the classification by income groups in Table 3 is on the basis of adjusted family income *including* the corporation income tax.

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adjustment for audit and are, therefore, slightly understated. The corporation tax figure was taken from the national income accounts which include audit adjustments; but it excludes about $8 billion of tax attributable to fiduciaries and nonprofit organizations.

6. Reported property income is the sum of dividends, interest, rents and royalties, income from estates and trusts, and the full amount of net statutory capital gains. Earnings include wages and salaries, farm and nonfarm business and professional income, partnership income, and small business corporation income. Since there is no way of determining which type of income was the marginal income, the allocation was made in proportion to the amounts of property income and earnings reported by each taxpayer.

7. For the nonfiling population, "reported" incomes were those obtained from the SEO file. The state income taxes are the amounts shown on returns with itemized deductions only. For both filers and nonfilers, the incomes used as a basis of classification by major source were the receipts that are included in adjusted family income.

TABLE 3

EFFECTIVE RATES OF FEDERAL AND STATE-LOCAL INDIVIDUAL INCOME TAXES FOR FAMILIES WITH MAJOR SOURCES OF INCOME FROM PROPERTY AND FROM EARNINGS, BY ADJUSTED FAMILY INCOME CLASSES, 1966
(in percentages)

	Federal individual income tax only			Federal and state-local individual income taxes[b]		
Adjusted family income class[a] (thousands)	Major source property income	Major source earnings	All families[c]	Major source property income	Major source earnings	All families[c]
$0-5[d]	0.7	3.8	2.7	0.8	3.9	2.8
5-10	2.4	6.3	6.0	2.6	6.5	6.3
10-15	5.3	7.8	7.8	5.6	8.3	8.3
15-20	6.4	9.0	8.9	6.9	9.6	9.5
20-25	5.6	9.7	9.5	5.9	10.6	10.3
25-50	8.0	11.7	11.2	8.5	12.7	12.2
50-100	13.2	18.3	17.3	14.1	20.0	18.9
100-500	16.7	23.5	19.9	18.3	25.6	21.8
500-1,000	19.3	31.4	21.0	21.2	34.3	22.9
1,000 and over	18.1	46.6	19.2	19.8	51.3	21.0
Total	8.2	8.8	8.8	8.9	9.4	9.4

Source: Data based on the MERGE File for 1966. Classification by major source of income is based on adjusted gross income as defined in the Internal Revenue Code.

[a] Adjusted family income excludes corporation income tax for the purpose of calculating effective rates, but includes it for the purposes of classification by income classes.

[b] State income taxes are amounts shown on returns with itemized deductions.

[c] Includes unattached individuals.

[d] Excludes families with negative incomes.

Table 3 permits a number of interesting observations. In the first place, the federal income tax never exceeded 29 per cent of the incomes reported on tax returns in 1966 in any income class. Table 3 shows that when the tax actually paid is compared with the *total* income for all families, the burden of the federal individual income tax never exceeds 21 per cent of income in any class. For most income classes, the tax is almost a pittance. It is less than 10 per cent of income below $25,000 and reaches 20 per cent only after income exceeds $100,000.

Second, the federal income tax as a whole is progressive throughout most of the income scale, although the progression is not very steep. The top effective rate of 21 per cent is reached in the $500,000-1,000,000 class; beyond this point, because nontaxable incomes are so important, the tax became slightly regressive. For families with adjusted family income of $1,000,000 or more in 1966, the tax was only 19 per cent of income.

Third, the federal individual income tax bears much more heavily on those who rely primarily on earnings than on those who rely primarily on property income. In each adjusted family income class, the tax rate on total income for earners is very much larger than the rate on the income of property income recipients. For example, in the $25,000-50,000 class, earners pay 46 per cent more tax on their income than do property income recipients—11.7 per cent as against 8.0 per cent. As most observers suspected, the consequence is that the variation in tax burdens *within* income classes is very large. Obviously, an attorney with very little property income who earns $30,000 a year pays a higher tax than an individual whose income consists primarily of interest or dividends and some capital gains or tax exempt interest. In other words, aside from the modest degree of progression by income classes, the major weakness of the federal individual income tax is its uneven impact on taxpayers with the same total income and different income sources.

Fourth, state-local individual income taxes add only slightly to the effective rates of tax throughout the income scale.[8] Otherwise, the conclusions based on the federal individual income tax alone are unchanged. The top effective federal and state-local income tax rate was about 23 per cent in the $500,000-1,000,000 class.

The Corporation Income Tax

Federal and state corporation income taxes amounted to only about 4 per cent of adjusted family income in 1966. Consequently, the additional burden of this tax cannot be large in most income classes. Nevertheless, corporate ownership is distributed very unevenly and it is possible that the corporation income tax imposes a relatively heavy burden in some of the higher income classes.

To allocate the corporation income tax by income class, the classical—and still troublesome—question of the incidence of this tax must be resolved. Although a few economists believe that a major share of the corporation income tax is passed along to the consumer in the form of higher prices, most believe that it is a tax on capital. Among the latter, some believe that the tax is borne entirely by owners of corporate capital; others that it is borne by owners of capital generally, on the ground that capital will tend to move into those areas that yield the greatest after-tax returns and that this movement will eventually equalize after-tax returns on capital throughout the economy.

Because this question is still in dispute, I have calculated the incidence of the corporation income tax on both assumptions. (Obviously, either of these assumptions produces a much more progressive distribution of the corporation income tax burden than would the assumption that it is paid by consumers.) The two calculations are given in Table 4.[9] The degree of progression by income classes is substantial—much more substantial, in fact, than the degree of progression in the individual income tax—and this conclusion holds on either of the two basic assumptions. As between the two, the distribution of the corporation tax burden by income classes is much more progressive if the tax is a tax on corporate capital than if it is a tax on capital generally. The maximum burden of the corporation income tax is 40 per cent and 19 per cent

8. Since we were able to identify only the state-local income taxes on returns with itemized deductions, the effective rates in Table 3 are understated slightly.

9. State corporation income taxes, which amounted to 6.4 per cent of the combined total of federal and state taxes in 1966, are not shown separately in this table. The amounts can be derived by multiplying the figures in Table 4 by .064.

TABLE 4
EFFECTIVE RATES OF FEDERAL AND STATE CORPORATION INCOME TAXES ON ALTERNATIVE INCIDENCE ASSUMPTIONS, BY ADJUSTED FAMILY INCOME CLASSES,[a] 1966
(in percentages)

Adjusted family income class[a] (thousands)	Federal and state corporation income taxes: Assuming corporation tax is borne by owners of corporate capital[b]	Federal and state corporation income taxes: Assuming corporation tax is borne by owners of capital generally[c]
$0-5[d]	0.8	3.7
5-10	0.9	2.3
10-15	0.9	2.1
15-20	1.7	2.7
20-25	3.1	3.7
25-50	6.0	5.4
50-100	11.4	8.1
100-500	24.7	14.1
500-1,000	36.0	17.9
1,000 and over	39.7	19.1
Total	4.0	4.0

Source: Data based on the MERGE File for 1966. Classification by major source of income is based on adjusted gross income as defined in the Internal Revenue Code.
[a] Adjusted family income includes corporation income tax for the purpose of calculating effective rates and for the purpose of classification by income classes. The term "family" includes unattached individuals.
[b] Distributed on the basis of dividend income.
[c] Distributed on the basis of total property income in adjusted family income.
[d] Excludes families with negative incomes.

of adjusted family income[10] for the two incidence assumptions, respectively, and these rates apply at the very top of the income scale for incomes of $1,000,000 or more.

Individual and Corporation Income Taxes Combined

The combined burden of the two income taxes by income classes may be derived from the data in Tables 3 and 4. In making the combination, I have assumed that half the corporation tax is borne by owners of corporate capital and half by owners of capital generally.

The combined data are shown in Table 5. The combined rate of tax begins at 5 per cent for families with incomes under $5,000 and reaches a maximum of 42 per cent in the top class. *The two taxes, which at the federal level alone reach maximum marginal rates of 70 per cent for the individual income tax and 48 per cent for the corporation income tax, impose a maximum burden of substantially less than half of total income even for families whose incomes are $1,000,000 or more.* The combined tax does not even reach 20 per cent for families with incomes of $25,000 to $50,000—and this class plus all those

10. In Table 4, the corporation income tax is included in adjusted family income for the purpose of calculating the effective rates as well as for the purpose of classification by income classes.

TABLE 5
EFFECTIVE RATES OF FEDERAL AND STATE-LOCAL INDIVIDUAL AND CORPORATION INCOME TAXES, ASSUMING HALF THE CORPORATION TAX IS BORNE BY OWNERS OF CORPORATE CAPITAL AND HALF BY OWNERS OF CAPITAL GENERALLY, BY ADJUSTED FAMILY INCOME CLASSES,[a] 1966
(in percentages)

Adjusted family income class[a] (thousands)	Effective rates: Individual income taxes	Corporation income taxes[b]	Total
	All Families[d]		
$0-5[c]	2.7	2.3	5.0
5-10	6.2	1.6	7.8
10-15	8.2	1.5	9.7
15-20	9.4	2.2	11.6
20-25	10.0	3.4	13.4
25-50	11.5	5.7	17.2
50-100	16.7	9.8	26.5
100-500	16.4	19.4	35.8
500-1,000	14.7	27.0	41.7
1,000 and over	12.7	29.4	42.1
Total	9.0	4.0	13.0
	Families[d] *with Major Source of Income from Property*		
0-5[c]	0.8	4.2	5.0
5-10	2.4	9.5	11.9
10-15	4.8	14.1	18.9
15-20	5.9	14.6	20.5
20-25	5.2	13.8	19.0
25-50	7.0	16.5	23.5
50-100	11.0	19.1	30.1
100-500	12.3	25.4	37.7
500-1,000	13.1	28.6	41.7
1,000 and over	11.8	29.9	41.7
Total	7.2	16.8	24.0
	Families[d] *with Major Source of Income from Earnings*		
0-5[c]	3.9	1.0	4.9
5-10	6.5	0.9	7.4
10-15	8.3	1.1	9.4
15-20	9.5	1.7	11.2
20-25	10.4	2.6	13.0
25-50	12.2	4.1	16.3
50-100	18.3	7.2	25.5
100-500	22.4	10.8	33.2
500-1,000	28.7	12.7	41.4
1,000 and over	43.2	12.2	55.4
Total	9.3	2.1	11.4

Source: Data based on the MERGE File for 1966. Classification by major source of income is based on adjusted gross income as defined in the Internal Revenue Code.

[a] Adjusted family income includes corporation income tax for the purpose of calculating effective rates, and for the purpose of classification by income classes.

[b] Assumes half the corporation tax is distributed on the basis of dividends and half on the basis of total property income in adjusted family income.

[c] Excludes families with negative incomes.

[d] Includes unattached individuals.

NOTE: Figures are rounded and may not add to totals.

below it comprise 99 per cent of all families and 90 per cent of total adjusted family income.

Perhaps of greatest significance, most of the progression in tax burdens is owed to the corporation income tax. In fact, above the $100,000 income level, the corporation income tax is responsible for well over half of the total tax burden. Moreover, the corporation income tax seems to redress the imbalance in the tax burdens between those who rely primarily on earnings for their income and those who rely primarily on property income. Whereas the individual income tax imposes heavier tax burdens on earners, the corporation income tax applies only to income from property. As a result, except in the lowest and highest classes (below $5,000 and above $500,000), the combined burden of the individual and corporation income taxes is higher for property income recipients than it is for earners.[11]

Policy Implications

I wish it were possible to finish the story on the distribution of tax burdens, but that must wait until the computer comes to terms with the MERGE File and disgorges the results. However, serious discussion of tax reform need not await the availability of a distribution of all taxes. Inasmuch as the estate and gift taxes are mere appendages from a revenue standpoint, the income taxes must provide a major share of the progression in the tax system. Moreover, the state and local taxes I have omitted are probably regressive in the lowest income classes.[12] The data on the income taxes in Table 5 should persuade anybody who believes in progressive taxation that U.S. taxes are not very progressive for most of the income scale.

But where and how can we begin? The previous discussion should have made it clear that the culprit is the erosion of the individual income tax and that this erosion is not confined to the higher income classes. Huge amounts of income received by the lower and middle income classes are not taxable, and the personal deductions—which bulk large mainly for these taxpayers—are removing an increasing proportion of the tax base as the years go by. All

11. Determination of the "real" incidence of the corporation income tax requires knowledge of what the returns on corporate and noncorporate capital would have been in the absence of the tax, but only the returns after the imposition of the tax are observable. In constructing Table 5, I assumed that the entire share of the corporation tax borne by corporate capital is a burden, whereas only the reduction below what the return on corporate capital would have been should be so considered. Moreover, although a substantial proportion of the corporation tax was allocated to noncorporate capital, it was not included in the "before-tax" income of recipients of noncorporate capital. For both reasons, Table 5 exaggerates the amount of corporation tax actually paid in the top brackets on the assumption of an even split in the burden and may be close to the distribution of the tax on the assumption that it is borne by owners of capital generally. Further empirical work is needed to determine what the before-tax incomes from corporate and noncorporate capital would have been in the absence of the tax.

12. This is probably the case even though modern incidence theory suggests that the property tax may be a tax on capital rather than a tax on housing expenditures or consumer expenditures generally. (See Peter Mieszkowski, "Tax Incidence Theory: The Effects of Taxes on the Distribution of Income," *Journal of Economic Literature,* Vol. 7, No. 4 (December 1969), pp. 1106-11.) It is doubtful that the degree of progressivity of the property tax on this assumption—which would be the same as the rates shown in the last column of Table 4—would be sufficient to offset the regressivity at the lower end of the income distribution of state-local consumption taxes.

groups strenuously resist even the slightest incursion on the tax favors that the law now bestows upon them. And, with the exception of the 1969 law, each tax bill adds new features that erode the tax base—the most recent one being the "women's lib" amendment in the 1971 Act, which provides deductions for child care for families with incomes up to $27,000. With the narrowing of the base, the tax rates must be kept inordinately high simply to maintain the flow of revenue. These rates encourage still other groups to seek new favors, narrowing the base further, and so the cycle continues.

I suggest that the time has come not only to call a halt to this cycle of erosion, but to reverse it. The information now available makes possible reasonably accurate calculations of the individual income tax base for any number of definitions of taxable income. The object should be to select one base that would permit rates to be lowered drastically across the board, without cutting into the yield of the income tax and without changing to any significant degree the distribution of tax burdens by income classes. Only after agreement has been reached on a revised base would it be appropriate to ask where and how rate graduation should be altered to satisfy the tastes of the national community.

It will come as no surprise to those who have been subjected to my views before that I opt for the broadest possible tax base, for a number of reasons. First, it is extremely difficult in practice to stop short of a complete and comprehensive tax reform. If some incomes remain untaxed or continue to be taxed at preferential rates and if some excessively generous personal deductions are perpetuated, it will be difficult to reconcile taxpayers with other types of income or deductions to the loss of their own preferential treatment. Second, the adoption of a genuinely comprehensive tax base will prevent future inroads into the tax base. It is time to stop using the tax system as a method of back-door spending, and the only way to halt this practice is to remove all the unwarranted tax expenditures now in the law. Third, the more comprehensive the reform, the greater the possibility of reducing tax rates. I doubt that anybody will be very enthusiastic about the prospect that his rates might be reduced by as much as 5 per cent if $5 billion were added to the tax base next year through tax reform. But many people would sit up and take notice if they were told that a rate reduction of 40 per cent across the board would be possible if Congress became serious about a comprehensive income tax base.

Nor is a 40 per cent rate reduction pie-in-the-sky, if the rigorous reforms I have in mind were enacted. My tax revision would drastically alter the relative tax burdens of many large and politically powerful groups; for example, it would increase the tax burdens of homeowners relative to those of renters, recipients of capital gains relative to recipients of other property income, married couples relative to those of single persons, those who itemize deductions relative to those who report the standard deductions, and the rich aged relative to all younger groups. I believe that such shifts in relative tax burdens would greatly improve the equity of the income tax, but others would doubtless have other views.

Another moral of the story I have told is that the corporation income tax cannot be regarded merely as an ugly appendage to the tax system, as most businessmen and some economists view it. Table 5 demonstrates that, without a corporation income tax, very little progression would remain in the tax system. The corporation income tax is needed, therefore, to safeguard much of the progression the system possesses. Moreover, any change that reduces the corporation income tax substantially also reduces progression substantially. One example is the recently enacted 7 per cent investment credit and the ADR method of depreciation, which reduced the federal corporation income tax yield by about 12 per cent (at 1972 income levels). It follows that other proposals to reduce the corporation tax—by a straight rate reduction or by some form of relief for dividends—cannot be supported on distributional grounds unless they are accompanied by structural revisions or rate increases that will raise offsetting revenues from the higher income classes.

Finally, even if my favorite reforms are not adopted, my criticism of the present individual income tax should not be interpreted as a call for another tax to replace it or to provide additional revenue when and if it is needed. As Table 5 reveals, the income tax system is, on balance, progressive. I see no valid reason for turning to a mass consumption tax, be it a retail sales tax or a value added tax, to raise more revenue in the light of the facts shown in this table. At next year's income levels, an increase of 1 percentage point in the federal individual and corporation income tax rates would raise about \$5.6 billion a year. After the recent tax-cutting spree—which most people seem to have enjoyed—I would venture the guess that revenues will fall short of urgently needed expenditures by perhaps \$10 billion or \$15 billion a year. Trial balloons have already been launched to test public acceptance of a value added tax to raise such revenues if they are earmarked for social programs. But such revenues can also be raised from the income taxes by raising the rates 2 or 3 percentage points across the board. For what it is worth, my own view is that no valid justification exists for introducing a consumption tax in lieu of additional reliance on the income taxes, however imperfect they may be.