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SIMPLIFICATION AND EQUITY AS GOALS OF TAX POLICY

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It must appear to an observer of the tax scene that simplification is the most widely quoted but the least widely observed of the goals of tax policy. Nearly everyone likes to talk simplification. Only a few people, such as Dr. Thomas Atkeson, have said anything concrete on how to accomplish it.

Since "simplification" is only one of several competing goals of tax policy, an assessment of its place should start with an attempt to state those goals in comparative terms. The main rival to simplification is, of course, equity. To bring out this conflict precisely and yet with simplicity, we may define equity as the characteristics of a tax which make the relative burden on each taxpayer fair in the light of all the particular circumstances of each taxpayer. Simplicity is the characteristic of a tax which makes the tax determinable for each taxpayer from a few readily ascertainable facts.

To round out the tax policy goals, it remains to say something about efficiency. Here, two somewhat different definitions are in circulation. A definition which has appealed to a considerable segment of the economics profession is that a tax is efficient if its relationship to the particular circumstances of a taxpayer is such as to minimize his tendency to change those circumstances so as to reduce the tax. This is the oft cited neutrality principle.[1] Men of affairs, on the other hand, have taken a more relaxed view of efficiency, namely, that a tax is efficiently

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1. *Cf.*, *e.g.*, R. MUSGRAVE, THEORY OF PUBLIC FINANCE, 140 (1959).

structured so long as it does not cause taxpayers to change their circumstances in socially undesirable ways. Thus, most people would not consider it to be a disadvantage of our tax system, i.e., that it is inefficient, if the tax were affected by the circumstance of contributions made to charity, which factor in turn might cause people to make more contributions.[2]

So far we have stated only definitions. But there is some value in noticing that the goals of tax policy can be expressed as implying some features about the relationship of taxes and particular circumstances and that the implied features are generally contradictory. Equity calls for looking at all the circumstances that might bear on the fairness of the amount of tax, while the essence of simplicity is to ignore some facts. The efficiency principle operates to invalidate some seemingly happy compromises between equity and simplicity. Thus, in the early days of the property tax, the valuations called for by equity were thought to be far from simple in actual operation. The convenient compromise was to establish the tax by the number of windows, a simple fact more or less related to house value. The effort had to be abandoned, however, because taxpayers could too readily change the fact of the number of windows.

It is presumably an accepted principle of fairness for most people that the individual income tax should relate to income after medical costs.[3] Let us explore this further. Medical costs are not one fact, but a highly complex set of facts. The set includes the facts of what was spent for various items; and in some cases it also includes all the additional facts that throw light on whether a particular item, such as a swimming pool, was bought for medical reasons or for other reasons.

The briefest thought about the medical expense deduction will bring home the conflict between equity and simplicity. To make each individual's tax fair in the light, *inter alia,* of his medical history, would re-

2. Some readers will think of efficiency as a matter of ease of administration and compliance. It will be observed that we have defined simplicity to cover this.

3. For present purposes we do not try to define the word "fair." We use it to cover the principles by which the legislators, or the public, relate relative tax burden to circumstances in general, for example, the principle that tax burdens should, in fairness relate, *inter alia,* to income after medical costs. We avoid the question of examining the correctness of this principle by defining equity as being concerned only with how a specific set of legal rules carry out this principle in the light of all the particular circumstances of each taxpayer. While irrelevant to the present discussion, we might add that we happen to agree with the principle of fairness stated above, viz., that medical costs are relevant in some degree to determining fair tax burdens.

quire each taxpayer to record and submit a host of facts about expenditures and about the reasons for expenditures. Obviously, the goal of equity requires true facts, so part of the system would have to include a reasonable amount of fact verification, i.e., audit.

It can thus be seen that the complication between equity and simplicity may be summed up by saying that equity has a cost. Equity depends upon establishing facts in each case, i.e., information. Intelligent planning of a tax system should not entail buying information which is not worth its cost. Under an approach which emphasized equity at the expense of simplicity, the result of establishing particular medical facts would be to determine that an equitable tax on one individual with $5,000 of wages is $498 and on another with the same amount of wages but having $20 in medical expenses is $495. The costs which buy this refinement in equity would be:

(1) The taxpayer would have to have a reasonably sophisticated knowledge of what medical expenses are deductible (or pay an expert for this knowledge).
(2) The taxpayer would have to record the expense items and be able to prove them.
(3) There would have to be, at least on a sample basis, some audit of these items.

The tax law recognizes in a number of specific ways that some refinements of equity would involve excessive costs in terms of simplicity. Medical expenses, for example, are only deductible to the extent they exceed a floor of three per cent of adjusted gross income so that expenses below the floor do not affect tax. The standard deduction provision (including the minimum standard deduction) also serves to eliminate the fine graduations of equity that could be achieved by knowing the exact amount of deductions for each taxpayer.[4]

It is significant that although these two deduction provisions seem to work in opposite directions, their real effect is substantially the same. The medical floor operates to deny deductions, and the standard deduction operates to allow deductions. But the final tax effects of these differences in direction are largely washed out in the bracket rates which have been set to achieve the needed revenue while taking into account

4. Dr. Atkeson was, during his tenure at the Internal Revenue Service, intimately concerned with the development of the standard deduction and the medical expense deduction.

the effects of these structural provisions. The important aspect of the provisions is that they produce the result that medical expenses, less than the three percent of adjusted gross income floor, and itemized deductions, up to the amount of the standard deduction available to an individual, do not change the income tax that an individual owes.

The basis for provisions such as these can be articulated in more sophisticated fashion than by saying that they are "for administrative reasons." They are designed to prevent being involved in excessive costs to obtain minor improvements in equity. This analysis can lead to more specific comments on the appropriate role of simplification devices.

One comment is suggested by the passage of time. When the standard deduction was adopted in 1943, it was limited to $500 per return, but a married couple filing separately could take $1,000. Since then income per tax return has virtually tripled. Also in 1943, the typical level of itemized deductions among itemizers was about fourteen percent. In 1965 the level was about nineteen percent.

If one agrees that the standard deduction provision was about right when it was first adopted, it follows that the relative differences in personal expenses which were excluded from affecting the determination of tax liability in 1943, today could be excluded similarly only by a provision that uses a higher percentage and higher ceiling levels in the application of the standard deduction.

Another line of argument that leads to a standard deduction is the following: Many of the burdens reflected in itemized deductions are in fact borne by people who are not able to obtain those deductions. An obvious example is the property tax. Every taxpayer lives some place and almost all pay for their housing either by rent or by having some of their assets tied up in home ownership. In virtually all of these cases the person living in the home bears the burden of property taxes. Based on average relationships, it appears that people through the lower and middle income brackets up to approximately $20,000 probably bear a property tax burden of around four percent of their adjusted gross income (whether or not they have a property tax receipt to show for it), and probably very few get by with less than a two or three percent burden. But if a taxpayer is a tenant, he cannot obtain a deduction as such for this proprty tax burden since he is not the person legally liable for the tax. Instead, he gets this property tax burden reflected through the standard deduction.

A similar argument can be advanced about state taxes in general. The literature on state and local public finance attests to a continuous need for more revenue and a search for untapped sources. In the aggregate, state and local income, personal property, and general sales taxes are about five percent for all itemizers. Probably few taxpayers escape with a share of these burdens (or an equivalently higher real property tax burden) amounting to less than two to three percent of their income.

One could speculate that most of the taxpayers who were fortunate enough to have little or no medical expenses probably reached that happy state by incurring extra costs to preserve health which were non-deductible.

These last considerations suggest that there are probably very few taxpayers in the lower or middle brackets who would not be entitled to deductions of at least six percent of adjusted gross income if they were permitted to reflect all these burdens. A decision to allow a ten percent standard deduction is equivalent, for a $5,000 AGI taxpayer, to ignoring the more precise equity that would result if the tax computation were adjusted to the particular circumstance that his deductions should have been between six and ten percent. For a taxpayer at this income level the resulting distortion may mean an understatement of tax of at most $35. This seems to be a very small difference where the theoretical fairness achieved by these fine distinctions rests ultimatly on highly qualitative judgments.

Another line of analysis suggested by this way of articulating the relationship of equity and simplicity, is directly related to the minimum standard deduction. Actually the minimum standard deduction is a method of providing the equivalent of a larger personal exemption for taxpayers whose income leaves them very close to the poverty line. This objective could have been achieved by providing a diminishing addition to the personal exemption. The significance of putting the added allowance in the form of a minimum standard deduction is that it provides the additional relief to those low income taxpayers whose itemized deductions are moderate or low, but denies that additional relief where the taxpayer is already taking high itemized deductions.

On the basis of the previous analysis, this result is quite defensible. It has been brought out in discussions of the poverty program and the negative income tax proposals, that many, perhaps most, families with incomes near the poverty levels have very little tax sophistication. The costs for them in time and knowledge of having to meet the intricacies of deductibility and of preserving the necessary records would be very large. The prospect of providing that the income tax can be determined in most cases without ascertaining the particular circumstances respecting the availability of these various deductions is a proper adjustment between equity and simplicity. The expansion of the minimum standard deduction technique has been suggested as a desirable way of extending further relief to the lower brackets when that step becomes fiscally possible.

Another consideration suggested by the equity-simplicity relationship involves whether it would be desirable to expand the technique of the medical expense deduction to other deduction areas, i.e., to limit deductibility to some percentage of AGI. This has, for example, been proposed in connection with the charitable contribution deduction.[5] In an important sense, the contribution deduction is involved in what we have called the common, or non-economist, version of efficiency. Many policy makers consider as the important part of the contribution deduction the fact that it might cause the individual to change the circumstances that determine his tax liability, that is, that it might cause him to contribute more to charity. In view of this incentive character of the contribution deduction, it has been suggested that a better approach would be to disallow deduction for some minimum contributions, where conspicuously the tax motive has not had much result, but then allow this deduction above that level even for a taxpayer who uses the standard deduction. It has been suggested that such a level might be put at three or four percent of AGI. The extension of deductibility above such a level to the millions of taxpayers who use the standard deduction would itself raise a serious conflict of objectives between efficiency and simplicity, which would be the reason to make the level fairly high.

A final implication from our statement of the equity-simplicity relationship is the thought that on simplification grounds the tax law should avoid making the amount of tax dependent on facts which are themselves hard to establish. An excellent example is provided in the medical expense deduction. In 1963 the Treasury recommended that deductible medical expenses be defined to exclude deduction of items which are normally purchased for non-medical reasons even though it may be a fact that in a particular case this item, say, a swimming pool, was bought *only* because the doctor said, "You ought to buy a swimming pool." In any real life situation swimming pools are bought for various reasons, including reasons like, "For years my family has been after me

5. JOSEPH A. PECHMAN, FEDERAL TAX POLICY 78-79 (1966).

to get a swimming pool, and last year my doctor told me a swimming pool would do me a lot of good." A tax law that avoids factual determinations of this sort will be a better tax law, and the simplicity gain will far outweigh the occasional equity loss.

In conclusion, we can see that these problems are not at their root peculiar to taxes but are fundamental to the law itself. The law is a marvelous instrument for providing equity and definiteness to human relationships. Its application, however, involves costs, and this must be kept in mind constantly. The ingenuity of lawyers abbetted by economists can certainly provide beautifully subtle shades of equity considerations to deal with each variety of particular circumstance. The very complexity of the system we have observed, however, poses serious problems to many persons affected who are not aware of the fine points. The case for things like model statutes and standardized contracts is closely akin to the case for standard deductions and deduction floors. They are both a recognition of the cost of applying a complex legal system. In the tax field Dr. Atkeson has seen this problem clearly and contributed substantially to its solution.