COLLOQUIUM ON TAX POLICY

AND PUBLIC FINANCE

SPRING 2006

PROFESSOR JEFFREY LIEBMAN

Harvard University

SHOULD INDEPENDENT TAXATION BE A BARRIER TO RETURN-FREE FILING FOR THE U.S.?

April 20, 2006
NYU School of Law
120 Furman Hall
Time: 4 to 6 p.m.
Number 14

Preliminary: Comments Welcome

Should Independent Taxation Be a Barrier to Return-Free Filing for the U.S.?

Jeffrey Liebman and Daniel Ramsey*
April 13, 2006

1. Introduction

More than 30 countries, including the UK, Germany, and Japan, operate personal income tax systems in which a significant share of taxpayers do not need to file tax returns (GAO 1996). Instead, these countries use withholding systems in which the correct amount of tax is withheld during the year.

The tax systems in most of the return-free countries are much simpler than the U.S. tax system is, and studies have shown that in the absence of similar simplifications the benefits of a return-free system for the U.S. would be limited (Gale and Holtzblatt, 1997; U.S. Treasury, 2003). There are four main simplifications that would be needed for the U.S. to reap the full benefits of return-free filing:

- the complicated existing set of child-related tax provisions would need to be replaced by a simple child benefit;
- interest and dividend income would need to be taxed at a flat rate and withheld at source;
- deductions would need to be limited; and
- married spouses would need to be taxed independently.

* This paper was prepared for the Center for American Progress "Options for Tax Reform" conference on March 24, 2006. We thank Alan Auerbach for his comments at that conference. Liebman is Professor of Public Policy at Harvard's Kennedy School of Government and a Research Associate at the National Bureau of Economic Research. Ramsey is a research assistant at the National Bureau of Economic Research.

The first three of these simplifications are straightforward. Indeed, a strong case can be made for each of them even in the context of the current tax-filing system.

Child Benefits. Recent research has shown that existing tax provisions associated with children (including dependent exemptions, the EITC, the child credit, and child care deductions and credits) are complex, produce high marginal tax rates and large marriage penalties for some taxpayers, and provide benefits that are greater for low-and high-income families than for middle-income families (Cherry, 1998; Ellwood and Liebman, 2001). There is, therefore, a strong case for replacing the existing provisions with a simple per-child payment even if we maintain our current tax filing system.[1]

Capital Income. Many of the most complicated features of the existing tax code are associated with the reporting of capital income. Currently capital income is taxed at different rates according to type of income and length of holding period. Simplifying the taxation of capital income by taxing it all at a single rate via withholding at source could ease integration of the personal and corporate income taxes, ending the double taxation of earnings from corporate equity. Again, this is a step that would be appealing even in the absence of a discussion of return-free filing.

Deductions. Tax deductions distort consumption decisions, shrink the tax base (leading to higher tax rates and greater deadweight loss), and often have perverse distributional consequences. Experts ranging from Gephardt (1995) to the President's

---

[1] Because of economies in scale in child rearing, it might make sense for the payment to decline with the number of children. For example, the payment could be $2200 per child for the first two children and then $800 per child for additional children beyond two. The Ellwood and Liebman (2001) and Cherry and Sawicky (2000) proposals along these lines were for unified tax credits that phased-in with earnings. In the current context, however, we favor a flat benefit for all children that would replace not only all of the existing tax provisions but also a considerable share of TANF and Food Stamp payments to low-income families with children. Many other countries have simple child benefits of this sort payable to all families with children regardless of income or earnings. See http://www.childpolicyintl.org/ and O'Donoghue and Sutherland (1998) for country-by-country listings.

Advisory Panel on Federal Tax Reform (2005) have advocated limiting or eliminating many deductions. This is a third simplification that has appeal even absent a move to a return-free system. Countries with return-free systems often maintain a few deductions, but claiming them requires a procedure outside of the basic tax-filing mechanism.[2]

The fourth simplification, independent taxation, is more problematic. In a tax system with multiple brackets, independent taxation greatly facilitates the exact withholding required for a return-free system because is means that information about one spouse's income does not need to be communicated to the other spouse's employer. Independent taxation would also reduce marginal tax rates on secondary earners and eliminate inequities associated with treating cohabitation differently from marriage. So far, so good. But there is a potentially serious drawback to independent taxation. Since household members share economic resources, a strong argument can be made on ability-to-pay grounds that total household resources should be taken into account in determining tax liability (Shaviro, 2006).

This paper uses data from NBER's Taxsim model along with additional data from the Current Population Survey to investigate the equity implications of a switch from joint to independent taxation of the sort that might occur in conjunction with adoption of return-free filing. There are two main finding. First, although there are winners and losers from the reform (as there will be in any revenue-neutral tax reform), it is straight forward to set the parameters of the return-free system so as to roughly match the current distribution of the tax burden by income decile. Second, because the existing treatment

[2] The UK, for example, maintains a deduction for charitable contributions. Taxpayers make a payment to a charity that is 80 percent of their intended gift and the charity files with the government to receive the remaining 20 percent. Until it was recently eliminated, the UK's home mortgage deduction could be claimed by filing a form with the government. But only the limited number of taxpayers eligible for this deduction filed the form.

of married couples under the tax code is far from the ideal that would be prescribed based on strict application of utilitarian ability-to-pay principles, the equity losses from not taking total household resources into account are offset by other equity gains. In particular, the current system treats one-earner couples more favorably and two-earner couples less favorably than ability-to-pay considerations would suggest, and the reform removes this inequity.

2. Debates over Independent Taxation

In 1970, Greece was the only European Union country employing independent taxation. Since then, Austria, Belgium, Denmark, Finland, Italy, the Netherlands, Spain, Sweden, and the UK have all switched to independent taxation of earned income. Australia and Japan also use independent taxation (O'Donoghue and Sutherland, 1998; Congressional Budget Office, 1997).

In Europe, the switch was the product of an unusual alliance between the women's liberation movement and pro-family groups (Soler Roch, 1999). In many European countries, joint taxation stemmed from a patriarchal tax system in which only men were considered to be taxpayers and married men were required to pay tax on the combined incomes of both themselves and their spouses. Reformers called for abolishing this system and providing equivalent treatment of men and women. A 1984 European Commission memorandum concluded that "a system of totally independent taxation is to be recommended form the point of view of achieving equal treatment [of women]." But, there was a second reason for reform. Under the joint taxation systems in place in Europe around 1970, couples faced large marriage penalties once women started to enter the paid labor force. Indeed, in several countries the same tax schedule applied to both single individuals and married filers. Pro-family groups therefore favored reform as a way to eliminate marriage penalties.

In the U.S., Rosen (1977), Brazer (1980), and Munnell (1980) were the first experts to call for a switch to independent taxation (Stout, 1981). Rosen (1977) argued that independent taxation would make the tax system marriage neutral -- eliminating marriage penalties and bonuses--, and it would reduce marginal tax rates on secondary earners -- earners who, optimal tax theory suggests, should have low marginal tax rates because they have high labor supply elasticities. Munnell (1980) emphasized that independent taxation was an appealing response to the increase in two-earner couples, in cohabitation rates, and in divorce. She noted that assessing the same tax on a one-earner and two-earner couple with the same income raises equity concerns because the one-earner couple will typically have greater untaxed leisure and unpaid work at home and because the two-earner couple will generally have greater work-related expenses. Moreover, Munnell added, having a tax system which differentiates between couples with and without marriage licenses becomes less attractive as long-term cohabitation becomes more common and as income during married years becomes less correlated with lifetime income.

From a utilitarian horizontal equity perspective, joint taxation and independent taxation create different inequities. Under joint taxation, a one-earner couple in which the husband earns $100,000 from full time work and who has a spouse who could earn $40,000 if she chose to work full time in paid work is taxed the same as a two-earner couple in which both spouses work full time and earn $50,000 each. The one-earner couple clearly has greater potential earnings (or alternatively is consuming greater untaxed leisure and self-produced services) and should be taxed more heavily. Under independent taxation, the one-earner couple would be taxed more heavily than the two-earner couple. However, consider a second scenario. Under independent taxation, two spouses who are full time workers and earn $70,000 and $30,000 will be taxed more heavily than two spouses who are full time workers and each earn $50,000. In this case, the two couples have the same ability to consume and the same leisure and they should therefore face the same tax, as would be the case under joint taxation.

3. Data and Analytical Approach

We build a microsimulation model of the U.S. tax system to explore the distributional implications of moving to independent taxation. We start with raw data from the NBER Taxsim Model, which is largely the same as the SOI public use file. We augment these data by imputing the share of earnings accruing to each spouse and the hours worked of each spouse using information from the March 2002 Current Population Survey. Imputing the share of earnings accruing to each spouse allows us to overcome the fact that tax-return based data for married couples provide only the aggregate earnings of the two spouses. Imputing hours worked allows us to calculate a potential income measure for each household – which adjusted for family size – becomes our main measure of ability to pay.[3] Specifically, we measure potential income as the sum of

[3] We follow a hot-deck imputation procedure within married-couple earnings deciles. In other words, for each married joint tax return we randomly draw an observation from the same earnings decile in the CPS and assign the secondary earnings share and hours worked data from that observation to the tax return. Hours worked are calculated by multiplying usual weekly hours by weeks worked. In a future revision we may do a more sophisticated imputation, forming cells based on number of dependents and amount of asset

household asset income and the earnings that would accrue if each spouse had worked 2000 hours during the year.[4]

To compare joint and independent taxation we model taxes paid by married joint filers under the current joint tax system with the taxes these couples would pay under a reformed system with independent taxation. Our model of the current tax system includes itemized deductions, personal and dependent exemptions, differential tax rates for dividends and capital gains, and the EITC and Child Credit. We do not model the alternative minimum tax. For simplicity, we also drop observations with negative AGI from our sample.

In simulating a system of independent taxation, one needs to make decisions about what the rules will be for allocating capital income between the two spouses. Possibilities include letting the household allocate capital income so as to minimize its taxes, requiring the higher earner to claim all capital income, splitting the capital income equally, or allocating the capital income according to each spouse's earnings share. One also needs to make decisions about how to allocate personal and dependent exemptions, deductions, and tax credits. In constructing our independent taxation example we make these decisions so as to make the system as conducive as possible to return-free filing. We decided to tax all capital income (interest, dividends, and capital gains) at a constant rate of 15 percent. This would facilitate withholding at source and make the allocation across spouses irrelevant. We gave each spouse one personal exemption and half of the

---

income in addition to earnings. Also, we would like to investigate whether by using the SIPP – with its topical module on taxes – rather than the CPS would allow us to impute from a set of married couples that more accurately matches the population of married couples filing joint returns.

[4] See Fullerton and Rogers (1993) for a justification of the potential income concept. For non-working spouses (for whom we do not observe wage levels), we currently impute their potential earnings at the sample mean for working secondary earners. In a subsequent draft, we plan to implement a more sophisticated method that differentiates based on demographic factors such as education levels.

standard deduction. We modeled the curtailing of deductions as a tax credit equal to 15 percent of the household's itemized deductions in excess of the standard deduction. Finally, we replaced dependent exemptions, the EITC, and the child credit with a child benefit that would be paid to each family independent of income.[5] So as to avoid creating losers from this reform among the EITC population, we specified the child benefit as \$2700 for the first child, \$1700 for the second child, and \$800 (the value of the \$3200 dependent exemption in the 25 percent bracket) for each additional child. While the existence of all of these different provisions makes it challenging to isolate the different factors that determine the empirical results, there is simply no way to study a change to independent taxation without making choices about how things like capital income, itemized deductions, and child benefits are allocated.

The final modeling decision we made concerned the tax schedule under independent taxation. For analytic clarity we originally modeled each bracket as half as wide as under the current married joint tax schedule. This is a schedule that is less favorable than the existing schedule for single filers. However, our simulations showed that our reform was bringing in significantly more revenue than the current system. While there are various ways we could have altered our alternative tax system to make the reform approximately revenue neutral, we chose to do so by adopting the current schedule for single filers as the schedule that each spouse faced under independent taxation.

4. Results

[5] This benefit would also replace a portion of TANF and Food Stamps, but we do not model those programs in our analysis.

We present three sets of results from our simulation exercise. The first shows how the distribution of the tax burden by income level changes from the reform. The second shows the distribution of tax increases and tax cuts under the reform. The third shows how the two systems compare on horizontal equity. Our analysis is performed at the married couple level. So under independent taxation we calculate the separate tax due from each spouse and then aggregate back to the couple level for comparison with the existing joint tax system.

Vertical Equity

Given that there are several free parameters to be set in designing the system of independent taxation (including the width of the tax brackets, the tax rate on capital income, the rate at which deductions will be permitted, and the generosity of child benefits), one would expect that it would be straightforward to find a set of parameters that can approximately match the distribution of the current tax burden by income percentile. Only if the separate allocation of wage earnings had widely disparate impacts at different parts of the income distribution would this not be the case.

Figure 1 illustrates that our rather arbitrary set of parameter choices comes quite close to matching the current distribution of the married couple tax burden.[6] In both systems, the top quintile pays 76 percent of taxes. Increases in taxes for couples with disparate earnings levels and reductions in rate at which one can claim itemized deductions are offset by the lower rate of taxation on interest income and expanded child benefits. Taxpayers in the third and fourth quintiles pay slightly more of the burden and

[6] Note that the married couple tax burden is skewed more to higher percentiles than is the overall tax burden.

taxpayers in the first and second quintiles pay somewhat less of the burden. The large reduction at the very bottom is somewhat misleading. Because the child benefit in the reformed system is independent of income, people in the phase-in region of the EITC receive a large tax cut under the reform. Conceptually, this is meant to be offset by reductions in TANF and Food Stamps, but these are not part of our model.

The middle column of Table 1 shows the change in average tax rate from the reform for the median taxpayer in each AGI decile. Except at the very bottom, where tax-related child benefits are increasing dramatically, the typical taxpayer in each income decile has little change in average tax rates.

The lesson of these initial results is that independent taxation does not create any insuperable problems with regard to vertical equity. Even with an arbitrary set of parameters for the new system, we have come quite close to matching the distributional burden of the current tax system by AGI decile. By tinkering with the parameters further it should be possible to mimic the current distribution of the tax burden even more closely.

Winners and Losers

The remainder of Table 1 shows more details about the distribution of changes in average tax rates within different AGI deciles. Except at the bottom where the child benefits distort the results, the biggest (90^{th} percentile) average tax rate increases are between 5 and 7 percentage points (depending on the income decile) and the biggest (10^{th} percentile) declines in average tax rates range from 1 to 4 percent. Losers are households with disparate earnings levels and those in higher tax brackets with large itemized deductions. Winners are households with equal earning levels, ones with children, and high income households with interest income.[7]

Horizontal Equity

The traditional argument against independent taxation is that it assesses a different level of tax on households with the same income, with households in which spouses have disparate earnings levels paying more in tax than households in which the earnings levels of the two spouses are similar. This point is illustrated in Figure 2 which shows the distribution of average tax rates by taxable income level for married taxpayers under both the current U.S. tax system (top panel) and the illustrative system of independent taxation (bottom panel).

This figure is motivated by the somewhat old fashioned view that taxable income is the appropriate measure of ability-to-pay, a view that is increasingly being abandoned for approaches with more solid grounding in economic theories of social welfare. Under the old fashioned view, the appropriate measure of ability-to-pay is total income adjusted for family size via personal and dependent exemptions and other circumstances via itemized deductions.

The top panel shows that joint taxation performs very well on horizontal equity when taxable income is taken as the appropriate measure of ability-to-pay.[8] Most taxpayers at a given income level are clustered at or just below the average tax level implied by the tax the married tax schedule assesses on that level of taxable income. If it

[7] The gains for those with interest income are somewhat misleading in that if one adopted a reform of this sort one would likely want to eliminate the deductibility of interest at the corporate level.
[8] An attractive alternative to showing the scatter of points would be to adopt the Auerbach and Hassett (1999) measure of horizontal equity, something we are in the process of implementing.

were not for tax credits (in our model just the child tax credit and the EITC) and the favored treatment given to dividends and capital gains, the distribution of points in this top panel would collapse to a single line determined by the tax schedule. In contrast, the bottom panel which shows the distribution of average tax rates by taxable income under independent taxation, shows a much wider dispersion of average tax rates at any income level. This occurs because under independent taxation tax levels are different depending on the fraction of total household earnings accruing to each spouse. Thus, Figure 2 illustrates the classic argument against independent taxation.

This classic argument hinges, however, on the view that two households with the same taxable income deserve to be taxed equally. If taxable income is not the right measure of ability-to-pay then this result is not relevant. Figure 3 illustrates what happens when we adopt a more modern approach to measuring ability-to-pay, ranking households on their potential income – the income they would receive if both spouses worked full time (2000 hours per year).[9] Here the spread in average tax rates at a given income level is quite similar under the two tax systems. Each system has its strengths and weaknesses. Independent taxation does a better job at taxing equally households with the same potential income that make different hours choices. Joint taxation does a better job of taxing equally households with the same hours level but different spouse wage levels. Given that the ideal – joint taxation based on potential income -- is not achievable, there seems little basis, on horizontal equity grounds, to prefer either one of the two available imperfect approaches.

---

[9] We have also examined an equivalence-scale-adjusted measure of potential income. In particular we have adjusted by the formula recommended by National Research Council (1995) which calculates per capita consumption by dividing total consumption by (adults + .7* kids)$^{.7}$. Because we are limiting our analysis to married couples, this adjusts only for number of dependents and does not have much impact on our results.

5. Conclusion

Because it produces marriage neutrality as well as low marginal tax rates for secondary earners, independent taxation has long been seen as an attractive alternative by some analysts. But detractors have complained that such a system is inequitable because households with the same incomes but different allocations of earnings between the two spouses would pay different amounts of tax. We have shown that when viewed from the appropriate potential earnings perspective, an illustrative independent taxation system and the current personal income tax system do not differ much in aggregate horizontal equity. Independent taxation is more equitable in the treatment of households with different amounts of labor effort while joint taxation is more equitable in the treatment of households with the same labor effort but different spouse wage levels. Given that the two approaches are similar on horizontal equity grounds, the other advantages of independent taxation make such a system quite appealing, something that a large share of OECD countries have already figured out. Indeed, like the other three tax simplifications that would be needed for the U.S. to reap the full benefits of return-free filing, there is a strong case for independent taxation whether or not the U.S. adopts return-free filing.

References

Auerbach, Alan J. and Kevin A. Hassett (1999). A New Measure of Horizontal Equity. NBER Working Paper 7035.

Brazer, Harvey E. (1980). "Income Tax Treatment of the Family in Henry Aaron and Michael Boskin, editors, *The Economics of Taxation.* (Washington, DC: Brookings Institution).

Cherry, Robert (1998). Universalizing the EITC: a Progressive Pro-family Agenda," Brooklyn, NY: Brooklyn College.

Cherry, Robert and Max Sawicky (2000). "Giving Tax Credit Where Credit is Due. A 'Universal Unified Child Credit' That Expands the EITC and Cuts Taxes for Working Families." Washington, DC: Economic Policy Institute.

Congressional Budget Office (1997). *For Better or For Worse: Marriage and the Federal Income Tax.*

Ellwood, David T. and Jeffrey B. Liebman (2001). "The Middle Class Parent Penalty: Child Benefits in the U.S. Tax Code" *Tax Policy and the Economy,* 15: 1-40.

Fullerton, Don and Diane L. Rogers (1993) *Who Bears the Lifetime Tax Burden.* Washington, DC: Brookings Institution.

Gale, William G. and Janet Holtzblatt (1997). "On the Possibility of A No-Return Tax System," *National Tax Journal*, 50: 475-485.

General Accounting Office (1996). Tax Administration: Alternative Filing Systems. GAO/GGD-97-6. Washington, DC: Government Printing Office..

Gephardt, Richard (1995). "10% Plan."

Kaplow, Louis (2000). Horizontal Equity: New Measures. Unclear Principles. NBER Working Paper 7649.

National Research Council (1995). *Measuring Poverty: A New Approach.* Washington, DC: National Academy of Sciences.

Munnell, Alicia (1980). "The Couple Versus the Individual under the Federal Personal Income Tax, " *New England Economic Review*, May/June: 56-75.

O'Donoghue, Cathal and Holly Sutherland (1998). *Accounting for the Family: The Treatment of Marriage and Children in European Tax Systems.* Innocenti Occasional Papers, Economic and Social Policy Series no 65. Florence: UNICEF International Child Development Centre.

President's Advisory Panel of Federal Tax Reform (2005). *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, DC, Government Printing Office).

Rosen, Harvey S. (1977). "Is It Time to Abandon Joint Filing?" *National Tax Journal*, 30: 423-428.

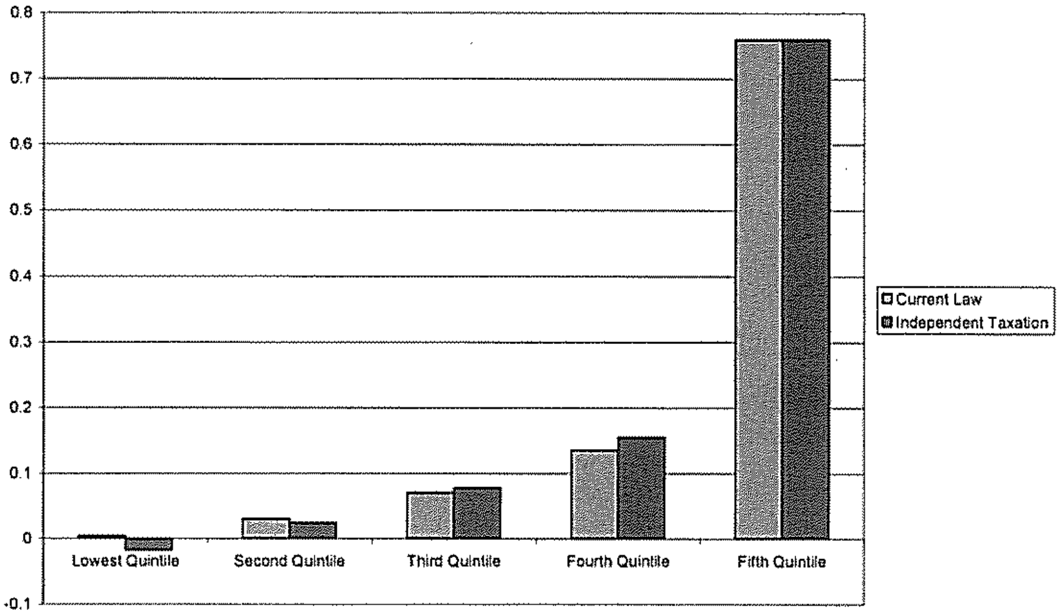
Shaviro, Daniel (2006). Households and the Fiscal System. NYU Law School.

Soler Roch, Maria Teresa, editor (1999). *Family Taxation in Europe*. (The Hague: Kluwer Law International).

Stout, Lynn A. (1981). "The Case for Mandatory Separate Filing by Married Persons," *Yale Law Journal*, 91: 363-382.

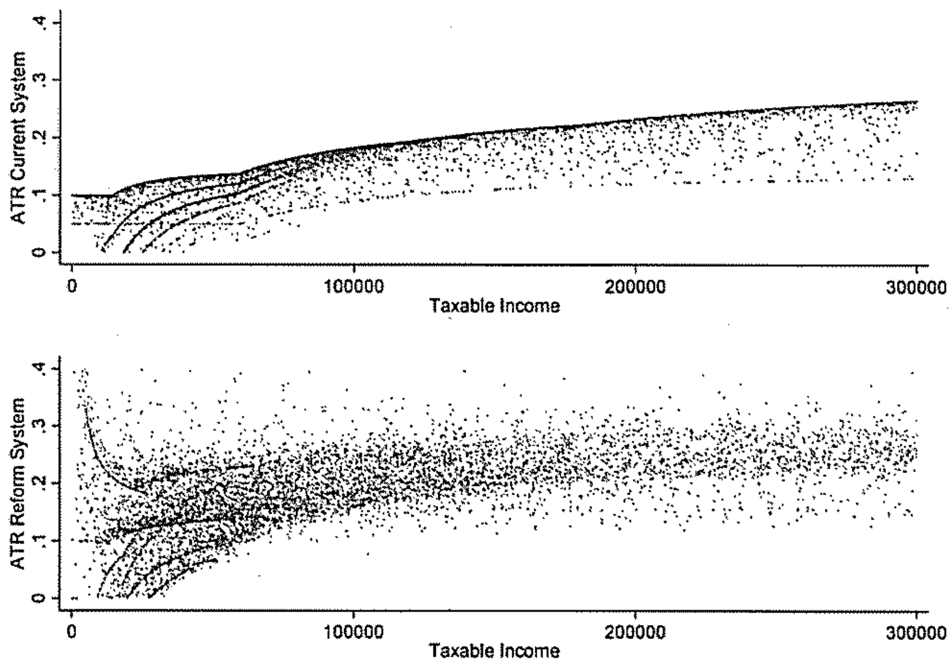
U.S. Treasury (2003). *Report to The Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite*. Washington, DC: Department of the Treasury.

Figure 1
Distribution of Tax Burdens: Current Law and Independent Taxation System



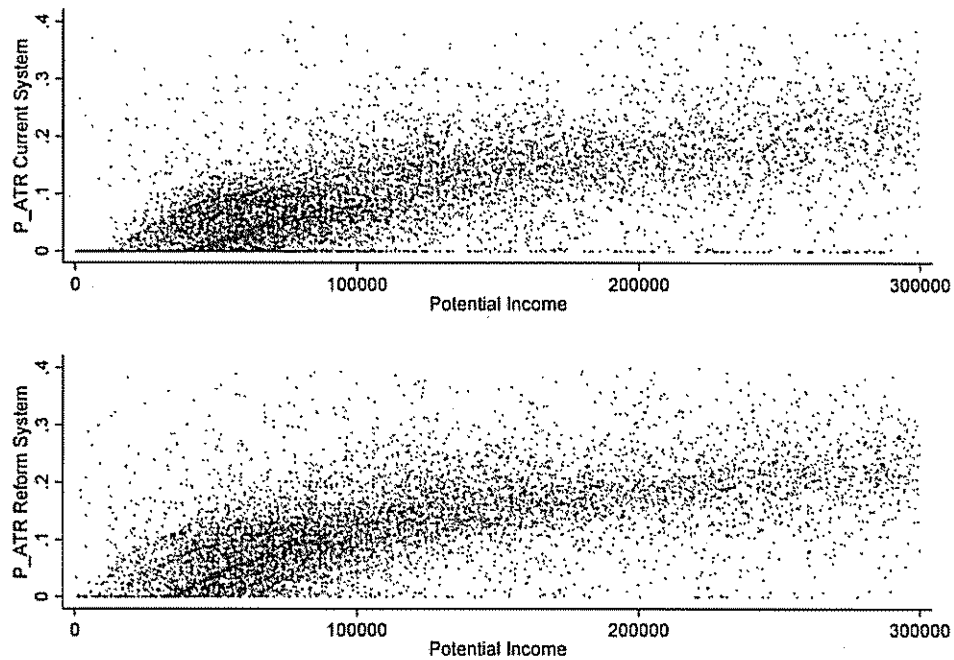
Note: Data are for married filers only.

Figure 2
Distribution of Average Tax Rates by Taxable Income
Under Current System and Independent Taxation



Note: Data are for married filers only.

Figure 3
Distribution of Average Tax Rates by Potential Income
Under Current System and Independent Taxation



Note: Data are for married filers only.

TABLE 1: DISTRIBUTION OF CHANGE IN ATR BY INCOME DECILE (CHANGE IN 100 X TAX / AGI)

	Change Percentiles				
	10th	25th	Median	75th	90th
AGI Decile					
Lowest	-46.3	-25.9	-7.9	3.1	5.3
Second	-13.9	-9.4	-1.8	4.7	5.2
Third	-7.7	-4.4	0.0	2.9	4.7
Fourth	-4.4	-2.7	0.0	2.4	5.1
Fifth	-3.5	-2.2	0.0	3.6	5.8
Sixth	-2.3	-1.2	0.6	4.2	6.4
Seventh	-1.7	-0.5	1.1	4.2	6.6
Eighth	-0.8	0.2	1.4	4.0	6.3
Ninth	-0.7	0.1	1.4	4.2	6.1
Highest	-1.5	-0.3	1.1	3.3	4.9
All Groups	-7.2	-1.9	0.5	3.6	5.6

Note: Data are for married filers only.