DISTRIBUTIONAL ASPECTS OF TAX REFORM
DURING THE PAST FIFTEEN YEARS

Benjamin A. Okner
U.S. Treasury Department

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DISTRIBUTIONAL ASPECTS OF TAX REFORM
DURING THE PAST FIFTEEN YEARS

by

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Since the mid-1960s, each of the U.S. revenue acts has been skewed so as to distribute a large part of the tax reduction to those in the lower- and lower-middle income groups. While these cuts have served in large measure to alleviate the income tax burden on the poor, they have also helped to maintain the progressivity of the individual income tax. This has occurred mainly because Congressional changes generally have offset the effects of rising money incomes that push taxpayers into higher tax brackets and because the tax-free income level has been raised several times. Thus, when measured at 1978 income levels, we find that the overall ratio of personal taxes to income is actually lower in 1978 than it was under 1964 law. This is true for taxpayers at all income levels except those with incomes of $100,000 and over.
Tax liabilities will change over time both because of changes in money income and statutory changes in the law. Thus, if we want to keep the relative distribution of the tax burden constant over time, it would be necessary to index the tax system both for inflation and real growth. The basic exemption, the per exemption tax credit, the standard deduction, and the width of the marginal tax brackets all would have to be increased at the rate of growth in money income. However, there seems to be little enthusiasm in Congress for enacting any such "automatic" system of indexing for personal tax purposes.

Even though the United States has no formal indexing system, in order to analyze properly the effects of various tax structures over time, it is necessary somehow to hold constant the level of money income. One way to do this is to go back and adjust the money incomes, standard and itemized deductions, and exemption level data for changes in the price level that have occurred during the past 15 years. A simpler alternative involves using a single data set that contains individuals' incomes for one particular year and applying to it the tax rates and structural tax provisions that were in effect at different times during the period being studied. The latter procedure is the one used in this analysis.
In the remainder of this paper, the distributional effects of several major U.S. tax cuts enacted during the past 15 years are assessed at 1978 income levels and are compared with personal tax liability under 1978 law. Before this, there is a brief section outlining the definitions and concepts used in the analysis. The last section of the paper contains a description and examination of the Carter Administration's 1978 tax proposals for individuals as well as the individual provisions of the "Revenue Act of 1978," approved by the House of Representatives in August 1978. Appendix A provides a brief outline of major personal income tax changes since 1964 and Appendix B includes additional statistical material.

**Concepts and Methodology**

**Income**

Unless otherwise noted, the income concept used in this paper is "expanded income." This is as close as it is possible to get to a taxpayer's net, or economic, income based solely on the information reported on his income tax return. It is equal to adjusted gross income (AGI) plus tax preference items and less investment interest to the extent that such interest does not exceed investment income.
When calculating expanded income, tax preferences are defined as the dividend exclusion (of up to $100 per taxpayer) and income from sources that are considered to be tax preferences for purposes of the minimum tax. The principal item in this category is the excluded half of net long-term capital gains.

It is particularly difficult to define correctly investment expense and income when calculating expanded income. In terms of existing tax data, it is hard to determine investment expenses other than interest because normally they are lumped into the "miscellaneous deduction" category along with such items as the various other business or employee-expense deductions. Accordingly, for computational purposes, investment expense is defined as all interest expense (other than mortgage interest) deducted on the tax return. Investment income is defined as the total of realized capital gains, interest, and dividend income reported on the return.

To the extent that investment interest expense does not exceed investment income, it is considered to be an ordinary expense incurred in obtaining such income. Thus, on a return with $1,000 of investment income and $800 of investment interest, the investment interest deduction would be reduced by
$800 and expanded income would include only the net amount of $200 investment income. The same procedure is used when investment interest exceeds the amount of investment income reported on the tax return. In that case, investment interest would be deducted from investment income and the latter amount would be set equal to zero (along with an appropriate adjustment of the interest-paid deduction).

All these adjustments to AGI obviously represent an attempt to convert the statutorily defined income concept into one that is more meaningful for economic analyses. While the adjustments described may have a rather large impact on the incomes of those at the upper end of the income scale, they play only a minor role for those in the low- and middle-income ranges.

Distribution of Income

Because there appears to be widespread misinformation about the distribution of income in the United States, it seems appropriate to include some data on where people with different absolute income amounts rank in the overall spectrum. In the recently released Roper Survey, the researchers found that

the public defines "middle-income" families as those having annual incomes of between $20,000 and $40,000. Below $20,000 is "low;" above $40,000 is "high." When asked this question, respondents were queried about a "family of four with two children." While the wording of the Roper question was not detailed, the responses indicate an extremely unrealistic appraisal of the distribution of income in this country.

Recently released data from the U.S. Bureau of the Census indicate that income for families in 1977 was actually distributed quite differently than the Roper respondents believed. The Census data which were collected in March 1978 are shown in Table 1 which also contains information on the distribution of expanded income in 1978.

The two sets of data in Table 1 are not directly comparable because of important differences in the reporting unit (i.e., the Census family versus the tax-filing unit) as well as differences in the way income is defined in the two data sets.

Table 1

Shares of Census Total Money Income and Expanded Income Received by each Fifth of the Population, 1977 and 1978

<table>
<thead>
<tr>
<th>Units, ranked from lowest to highest income</th>
<th>Census families, classified by 1977 total money income</th>
<th>Tax units, classified by 1978 expanded income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent of income received</td>
<td>Income range</td>
<td>Percent of income received</td>
</tr>
<tr>
<td>Under $ 7,903</td>
<td>5.2%</td>
<td>Under $ 3,810</td>
</tr>
<tr>
<td>Under $ 7,903 - 13,273</td>
<td>11.6</td>
<td>3,810 - 8,231</td>
</tr>
<tr>
<td>Under $ 13,273 - 18,800</td>
<td>17.5</td>
<td>8,231 - 13,873</td>
</tr>
<tr>
<td>Under $ 18,800 - 26,000</td>
<td>24.2</td>
<td>13,873 - 22,247</td>
</tr>
<tr>
<td>26,000 and over</td>
<td>41.5</td>
<td>22,247 and over</td>
</tr>
<tr>
<td>40,493 and over</td>
<td>15.7</td>
<td>41,028 and over</td>
</tr>
<tr>
<td>Memo: Median income</td>
<td>$16,009</td>
<td>$10,735</td>
</tr>
</tbody>
</table>


Note: The median adjusted gross income on individual income tax returns filed for 1976 was $9,700. See U.S. Internal Revenue Service (Preliminary Report), Statistics of Income — 1976 Individual Income Tax Returns, (Washington, 1978), Table 1, p. 9.
Despite these caveats, it is clear that if the public believes that those with family incomes below $20,000 should be classified in the low-income category while the Census data show that families with such incomes actually include more than 60 percent of all U.S. families, there must be a serious misunderstanding of the facts by the Roper respondents (i.e., the general public). In like fashion, the Roper respondents indicated that a family would need income of $40,000 or above to be classified as a high-income unit; in fact, the Census data indicate that families with incomes that high are financially better off than 95 percent of all U.S. families.

The quintile breakpoints for the 1978 expanded income distribution are also shown in Table 1. The absolute income breakpoints are lower than those shown for the Census data primarily because the Census money income concept includes transfer payments that are not taxable and hence are excluded from expanded income. Despite this, it is interesting to note how closely the income levels become for those in the fourth and highest quintiles. Finally, for each distribution, the top
5 percent of families is comprised of those with incomes of roughly $40,000 and above. While the Roper respondents defined families with incomes of $40,000 and over as being in the high-income category, it seems doubtful that they really were talking about the richest 5 percent of U.S. families.

While a more detailed analysis of recent tax changes might use a different income classification, for most tabulations in this paper approximately half of all families are included in the lowest income class -- "Under $10,000."

For reference purposes, the following information on the distribution of returns by income class is presented: Under $10,000, 47.7% of all returns; $10,000-$20,000, 29.0%; $20,000 to $50,000, 21.2%; and $50,000 and over, 2.0% of total returns.

This makes it convenient to compare what happened to tax burdens of those in the bottom half of the income distribution with the effect of tax changes on the more affluent.
Progressivity

While there are many ways to measure and compare the progressivity of alternative tax structures, the method used here is quite simple. If the effective tax rates -- taxes divided by expanded income -- for low-income units fall and the rates for high-income ones drop less or rise when comparing a new with an old tax distribution, the new tax structure is considered to be more progressive than the old one. If the reverse occurs, the new tax law is considered to be less progressive.

Another statistic used extensively is that relating to percentage changes in tax liability experienced by units at different income levels when comparing two tax structures. Under this measure, a change is considered progressive if the percentage cut in tax burdens is greatest at low income levels and the percentage change then declines for those at higher income levels.

Of course, there are many other ways to measure progressivity, but more complex measures are not used in this analysis primarily because the results often are difficult to interpret (for example, when two Lorenz curves cross) and they normally provide the same information as one can get from examining patterns of effective tax rates.
One final thing that should be noted in this section is that the data used lead us to understate somewhat the "true" effect of tax changes for taxpayers in the lowest income group for the early years. This is because all the tabulations were done using information in the Treasury's Individual Income Tax File for 1975, with incomes and population projected to calendar 1978 levels. If a family had been required to file a return under the 1964 or 1969 tax laws, but did not have to do so under 1975 law, it will not be represented in the basic 1975 Tax File. Since it is "missing from" the 1975 File, there is no way to simulate the effects of earlier tax changes for such a family—although in fact its income tax liability dropped from some positive value to zero. For the same reason, the calculated quintile points and 1978 median income for tax returns shown in Table 1 also are a bit too high. 

Examination of detailed tabulations indicates that this is a problem only for those in the "Under $10,000" income class. For all other income levels, the number of returns included in the tabulations for each year is quite constant over time.
Comparison of Tax Changes During the Last Fifteen Years

There have been several tax laws enacted during the past 15 years: the ones included here are the Revenue Act of 1964, the Tax Reform Act of 1969, and the Tax Reduction Act of 1975. The figures shown below are for each of these tax laws as they existed after all the permanent features of the legislation were implemented. Similarly, those for the Tax Reduction Act of 1975 are for that law when it was fully effective. The current-law data reflect the tax law that is in effect for calendar year 1978.

At present, the conventional wisdom is that the tax proposals sent to Congress by the Administration last January closely followed in the populist-liberal tradition of the 1950s and early 70s, while the bill passed by the House of Representatives in early August (H.R. 13511) skewed the distribution of individual income tax cuts much more heavily in favor of middle- and upper-income taxpayers than normally had been the case in the past. / Somewhere in the

/ It should be noted that this analysis deals only with the Federal individual income tax. Many findings would be different if changes in Social Security payroll taxes were also considered.
discussion there is usually included the explanation that the poor and lower-income families had been given more than enough of the "tax largess" in prior years and the country would be faced with an unparalleled tax revolt if the past pattern was repeated.

Additional evidence to support the revolt scenario was provided by the 2-to-1 victory of Proposition 13 (that substantially cut property taxes in California) and the introduction (or threat of introduction) of similar measures in several other States. The interesting question at this point seems to be, which (if any) of these allegations are true?

Perhaps the best way to assess what took place during the past 15 years is to examine the net change in the distribution of tax burdens between the beginning and end of the period. Information on tax liabilities and changes between 1964 and 1978 is shown in Table 2. At the time of its enactment, the Revenue Act of 1964 was estimated to involve a revenue loss of some $10 to $12 billion, when compared with the law then in effect. The figures in Table 2 indicate that at 1978 income levels the revenue loss associated with that legislation would now be about $37 billion.
Table 2
Comparison of Individual Income Tax Burdens, 1964-75,
by Expanded Income Class

(1978 Levels of Income)

<table>
<thead>
<tr>
<th>Expanded income class a/</th>
<th>Percentage of returns</th>
<th>Expanded income</th>
<th>Revenue Act of 1964</th>
<th>Change in liability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Present law</td>
<td>Effective liability:tax rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(percent) ($millions)</td>
<td>(percent) ($millions)</td>
</tr>
<tr>
<td>($000)</td>
<td>(percent)</td>
<td>($millions)</td>
<td>($millions)</td>
<td>(percent) ($millions)</td>
</tr>
<tr>
<td>0-5</td>
<td>25.2%</td>
<td>56,245</td>
<td>-128</td>
<td>-0.2%</td>
</tr>
<tr>
<td>5-10</td>
<td>21.6%</td>
<td>141,494</td>
<td>8,248</td>
<td>5.8%</td>
</tr>
<tr>
<td>10-15</td>
<td>15.9%</td>
<td>175,368</td>
<td>17,067</td>
<td>9.7%</td>
</tr>
<tr>
<td>15-20</td>
<td>13.1%</td>
<td>202,036</td>
<td>24,054</td>
<td>11.9%</td>
</tr>
<tr>
<td>20-30</td>
<td>14.7%</td>
<td>314,194</td>
<td>44,773</td>
<td>14.2%</td>
</tr>
<tr>
<td>30-50</td>
<td>6.6%</td>
<td>213,769</td>
<td>39,258</td>
<td>18.4%</td>
</tr>
<tr>
<td>50-100</td>
<td>1.6%</td>
<td>93,804</td>
<td>24,009</td>
<td>25.6%</td>
</tr>
<tr>
<td>100 and over</td>
<td>0.4%</td>
<td>76,222</td>
<td>26,873</td>
<td>35.3%</td>
</tr>
<tr>
<td>Total b/</td>
<td>100.0%</td>
<td>1,264,312</td>
<td>184,145</td>
<td>14.6%</td>
</tr>
</tbody>
</table>

Source: Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

a/ Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

b/ Includes negative incomes not shown separately; therefore, components will not add to totals.

August 24, 1978
Of particular interest for this analysis is the distribution of the total cut among families at different income levels. The 22.3 million taxpayers with incomes under $5,000 account for about one-fourth of all returns. /\n
If the earlier-year returns that are now "missing" from the data file were included, there is little doubt that the "Under $5,000" income class would include at least 30 percent of all returns.

Between 1964 and 1978, the average effective tax rate for these returns dropped by more than 8 percentage points and their aggregate tax liability dropped by more than 100 percent. /\ In similar fashion, the effective rate for the

/\ It is possible for low-income returns to have negative tax liability because of the refundable earned-income credit enacted in 1975.

19.2 million returns in the $5,000 to $10,000 income class dropped by over 6 percentage points during the 15-year interval and the aggregate tax liability of these returns dropped by more than 50 percent.

While these are impressive drops, again the data are understating the situation because the very lowest income returns are absent. Over the course of time, a large
proportion of the lowest-income units simply have been unable to partake in any additional tax cuts because their tax liability was already down to zero and we have only limited refunds (e.g., the earned-income credit) for such tax units.

During the same time period, effective tax rates for those with incomes of $50,000 and over -- who compromise the top 2 percent of the population -- fell by only 0.2 percentage points. And the effective tax rate for those in the $100,000 and over income class rose slightly -- from 34.6 percent to 35.3 percent.

An equally illuminating picture of what occurred to the tax liabilities of the low-income population can be seen by examining the effective tax rates shown in Table 3. Tax relief for those in the lowest income group (under $10,000) obviously was substantial since the percentage of their expanded income that went for tax payments dropped from almost 11 percent under 1964 law to about 4 percent under current law. As can be seen in the remainder of the table, the percentage point reductions in effective tax rates for taxpayers in the other income classes were considerably lower during the 1964-78 period.
Table 3

Expanded Income and Individual Tax Liability Under Present Law and Under
Selected Revenue Bills, 1964-75, by Expanded Income Class

(1978 Levels of Income)

<table>
<thead>
<tr>
<th>Expanded income class</th>
<th>Expanded income ($000)</th>
<th>Present law liability ($millions)</th>
<th>Present law liability (percent)</th>
<th>Revenue Act of 1964 liability ($millions)</th>
<th>Revenue Act of 1964 liability (percent)</th>
<th>Tax Reform liability ($millions)</th>
<th>Tax Reform liability (percent)</th>
<th>Tax Reduction liability ($millions)</th>
<th>Tax Reduction liability (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 10</td>
<td>$ 197,739</td>
<td>$ 8,118</td>
<td>4.1%</td>
<td>$ 21,432</td>
<td>10.8%</td>
<td>$ 16,067</td>
<td>8.1%</td>
<td>$ 11,990</td>
<td>6.1%</td>
</tr>
<tr>
<td>10 - 20</td>
<td>377,404</td>
<td>41,121</td>
<td>10.9%</td>
<td>54,697</td>
<td>14.5%</td>
<td>48,583</td>
<td>12.9%</td>
<td>45,531</td>
<td>12.1%</td>
</tr>
<tr>
<td>20 - 50</td>
<td>527,963</td>
<td>84,031</td>
<td>15.9%</td>
<td>93,885</td>
<td>17.8%</td>
<td>88,665</td>
<td>16.8%</td>
<td>86,126</td>
<td>16.3%</td>
</tr>
<tr>
<td>50 and over</td>
<td>170,026</td>
<td>50,882</td>
<td>29.9%</td>
<td>51,134</td>
<td>30.1%</td>
<td>49,904</td>
<td>29.4%</td>
<td>49,666</td>
<td>29.2%</td>
</tr>
<tr>
<td>Total b/</td>
<td>1,264,312</td>
<td>$184,145</td>
<td>14.6%</td>
<td>$221,148</td>
<td>17.5%</td>
<td>$203,222</td>
<td>16.1%</td>
<td>$193,296</td>
<td>15.3%</td>
</tr>
</tbody>
</table>

Source: Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

a/ Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

b/ Includes negative incomes not shown separately; therefore, components will not add to totals.
The data in Table 2 (plus the more detailed information given for the laws in intervening years in Table 3) strongly support the proposition that tax cuts during the past 15 years were extremely progressive.

Moreover, it is inevitable that future tax cuts will have to be concentrated among wealthier groups in the economy. The reason for this is that the various structural changes enacted between 1964 and 1978 removed 13 million (about 74 percent) of the returns with incomes below $5,000 that were taxable under 1964 law from the tax rolls. An additional 3 million (a little over 16 percent) of all formerly taxable returns with incomes of $5,000 to $10,000 were also removed.

Since it is not possible to provide very much additional relief to families in the very lowest income brackets, a tax relief bill that contained substantial cuts concentrated among the 51 percent of all families with incomes between $5,000 and $20,000 would now be needed to continue the progressive pattern of tax relief that has taken place during the past 15 years. Conversely, substantial new cuts aimed at the 18.8 million families with incomes of $30,000 to $50,000 -- essentially the richest 25 percent of all families in the United States -- would reverse substantially the trend of the recent past.
Current Law Compared with the 1978 Carter Proposal
and The Congressional Alternatives for Future Years

In the preceding section, it is easy to see the tendency towards relatively stable tax burdens for those at the upper end of the income scale, along with sharp drops for those at the bottom since 1964. This tendency towards greater progressivity in the income tax occurred fairly quietly, with little explicit debate about the "proper distribution" of the tax burden or the distribution of after-tax income. It was fairly generally agreed that whenever taxes were cut, a relatively large proportion of the benefits should go to those at the low end of the income scale.

President Carter's proposed changes to the personal income tax structure, introduced as H.R. 12078 in the House of Representatives last spring, would have continued the general pattern of the last 15 years. Effective tax rates for those with incomes under $20,000 would have dropped a little, while the rates for the more affluent would have risen a bit. In the aggregate, the effective tax rate for all individuals would have dropped by 1.1 percentage points (see Table 4).
Table 4

Expanded Income and Individual Tax Liability under Present Law and Selected Proposals
(1978 Levels of Income)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>($000)</td>
<td>(.........$millions....) (percent)</td>
<td>($millions) (percent)</td>
</tr>
<tr>
<td>Under $10</td>
<td>197,740</td>
<td>6,080</td>
</tr>
<tr>
<td>$10 - 20</td>
<td>377,404</td>
<td>36,249</td>
</tr>
<tr>
<td>20 - 50</td>
<td>527,963</td>
<td>77,303</td>
</tr>
<tr>
<td>50 and over</td>
<td>170,026</td>
<td>51,256</td>
</tr>
<tr>
<td>Total b/</td>
<td>1,264,312</td>
<td>170,853</td>
</tr>
</tbody>
</table>

Source: Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

a/ Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

b/ Includes negative incomes not shown separately; therefore, components will not add to totals.

August 21, 1978
The most significant aspects of the Carter proposals for increasing tax progressivity were the $240 tax credit that would have replaced the current $750 personal exemption plus the lower tax rate schedules. By themselves those provisions would have resulted in a revenue loss of $20.4 billion dollars at 1978 income levels; and of this total, about 40 percent of the tax relief would have gone to taxpayers with incomes of $20,000 or less. Other proposals affecting individuals would have raised revenue by $7.6 billion, and the net cut for individual taxpayers was estimated to be $12.7 billion.

It was not until after the proposals were made public and sent to the Congress "that the growing burden of taxes on middle- and upper-income taxpayers" became an important political issue.

Based on the data presented earlier, it seems that there was (and probably still is) a serious misunderstanding in the Congress and by the general public about the distribution of the Administration's proposed personal income tax cuts. Families with incomes below $20,000 comprise more than 75 percent of the 88.5 million total returns and would have received only 52 percent of the individual tax relief under H.R. 12078 (see Table 5). All of the remaining cuts would
### Table 5

**Distribution of Individual Tax Changes by Income Class under Various Revenue Bills**

**Selected Years, 1976-78**

<table>
<thead>
<tr>
<th>Expanded income class ( b )/</th>
<th>1978 Administration proposal</th>
<th>Revenue Act of 1978</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>H.R. 12078</td>
<td>H.R. 13511</td>
</tr>
<tr>
<td>($000)</td>
<td>($.............$millions..............)</td>
<td></td>
</tr>
<tr>
<td>Under $10</td>
<td>-1,998</td>
<td>-508</td>
</tr>
<tr>
<td>$10 - 20</td>
<td>-4,668</td>
<td>-2,124</td>
</tr>
<tr>
<td>20 - 50</td>
<td>-6,458</td>
<td>-5,021</td>
</tr>
<tr>
<td>50 and over</td>
<td>408</td>
<td>-2,469</td>
</tr>
<tr>
<td>Total c/</td>
<td>-12,731</td>
<td>-10,271</td>
</tr>
</tbody>
</table>

**Percentage distribution of tax cuts**

| Under $10                     | 15.7                         | 4.9                 |
| $10 - 20                      | 36.7                         | 20.7                |
| 20 - 50                       | 50.7                         | 48.9                |
| 50 and over                   | -3.2                         | 24.0                |
| Total c/                      | 100.0                        | 100.0               |

**August 25, 1978**

**Source:** Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

**a/** All comparisons are with current law effective for 1978.

**b/** Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

**c/** Includes negative incomes not shown separately; therefore, components will not add to totals.
have gone to those with incomes between $20,000 and $50,000 -- families that comprise virtually all of the remaining families in the top quintile of the population. Only the richest 2 percent of all families would have experienced a small tax hike under the Administration proposals. Surely, a tax program where 87 percent of the net tax cuts would have gone to some 50 percent of the families with incomes greater than the median would be of great benefit to those who in reality are in the middle- and upper-middle income categories.

Nevertheless, instead of the $12.7 billion individual tax cut that the President settled on, the House Ways and Means Committee reported out a bill with a $10.3 billion individual tax revenue loss. Even though the House bill (H.R. 13511) provides $2.5 billion less tax relief for individuals, the way in which the relief is distributed among income classes is quite different both from the patterns in the past and also from the distribution of cuts in the Administration's tax proposal (See Tables 6 and 7).

Under H.R. 13511, families with incomes below the median income would receive only 5 percent of the tax benefits as compared with 16 percent under the Administration proposal. At the high end of the income scale, the richest 2 percent of
### Table 6

**Individual Tax Liability under Current Law and Reductions under Selected Proposals**

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<td>H.R. 13511</td>
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<td>Tax liability : Change from present law: Percentage change</td>
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<tr>
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<td>-5.6</td>
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Source: Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

a/ Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

b/ Includes negative incomes not shown separately; therefore, components will not add to totals.
all families would receive nearly a quarter of the total individual tax relief provided by the House bill; under the Administration proposals their tax burden would increase slightly.

When the two proposals are viewed in terms of the percentage tax cut to be experienced by families at various income levels (see Table 7), it is even more evident that the Carter proposal was much more progressive than is H.R. 13511. Taxpayers in the $5,000 to $10,000 income class would have received a tax cut in excess of 20 percent; those in the $10,000 to $30,000 income ranges would have received aggregate tax reductions of 10 percent to 20 percent; and much smaller percentage reductions — including a small tax increase for those with incomes of $100,000 and over — would have gone to the very richest taxpayers under H.R. 12078. Under the House-passed measure, on the other hand, the aggregate tax reduction amounts to 5.6 percent, and cuts in the 4 percent to 6 percent range are realized by taxpayers at all income levels.

The House-passed bill not only favors high-income families generally but is especially beneficial to people with wealth since it also lowered the maximum tax rate on income
from capital gains. And finally, the House scuttled virtually all of President Carter's tax reform proposals.

Obviously Mr. Carter and the Administration believed that most Americans want "fairness" in the form of increased progressivity and fewer "loopholes" in their tax system. This was reflected in the President's tax proposals. What is perplexing is that the very same goals are found in the results of the recent Roper Survey. Roper indicates that the American public considers tax reform the third most pressing national problem, ranking only behind controlling inflation and lowering the crime rate. And significantly, "tax reform" to the Roper respondents is equated much more frequently with tax fairness than with tax reductions.

The popularity of the capital gains tax cut partly may be explained by other findings in the Roper Survey. Roper found that, by a modest margin, Americans consider the existing treatment of capital gains to be a "reasonable deduction" rather than a "tax loophole." Indeed, the Report indicated that "there is strong sentiment for a lower capital gains tax." Even among people who own no stock, only 23 percent want to tax capital gains at the same rate as other income.
This seems an anomaly, in light of the fact that most capital gains go to the rich. But presumably everyone, at one time or another, hopes that he will make a profit on the mutual funds stock or other property he owns. And when he does, he wants the capital gains tax break waiting for him.

At this time, obviously there are many paradoxes between many of the survey findings and Congressional action. Of course, H.R. 13511 must still be passed by the Senate and go through a conference procedure to reconcile differences between the House and Senate versions of the bill before it becomes law. Thus, the final bill passed by the Congress may look quite different from what we now see. It simply is much too early to know whether the economic and political pundits who think that the shape of the current and future tax bills is likely to be quite different from the norm during the past decade or so, or whether we are indeed witnessing a one-time aberration.
Conclusion

When assessed in political terms, it is clear that the pattern of ever-increasing individual income tax progressivity that was prevalent during the last fifteen years is now being seriously questioned. Whatever the exact shape of the tax bill that finally emerges from the 95th Congress this fall, the distributional effects are sure to be far less progressive than the pattern found in the past.

Inasmuch as there is no particular reason why we cannot have both tax reform (i.e., increased horizontal equity) along with any degree of progressivity in the tax system that is desired, what is now emerging seems to be a backward step in the formulation of tax policy. Once a taxable income base is defined, the rates, credits, or personal exemptions all can be easily manipulated so as to achieve any given distributional effect that is desired.

Hence, it seems that neither the Administration nor the Congress has dealt realistically with the substantive questions in this area. Structural provisions in the law can and should be dealt with separately on their merits (or
demerits!). Once taxable income is defined -- and only after that is completed -- should the Congress tackle the question of distributing tax burdens among persons at various income levels. The final outcome might be a substantially less progressive system than now exists; it might simply be a proportional tax on a newly defined tax base; or conceivably, it might even be a regressive rate schedule with those in the low tax brackets paying higher marginal rates than those at the top.

Whatever the final outcome, the rational way to enact tax legislation would seem to require dealing with it in the order that is outlined above.
Summary of Major Individual Tax Provisions
of Selected Revenue Bills, 1964-78
The Revenue Act of 1964

A. Deductions

1) 5% floor on itemized deductions was eliminated.
   Eliminated deductions for state and local taxes other than income, sales, property, and gasoline taxes. Limited deductions for casualty losses to amounts in excess of $100.

2) Maximum charitable deduction was increased from 20% to 30% of taxpayer's income for all types of contributions except those to organizations not supported by the public -- to which the 20% limit still applies.

3) 5-year carryover was permitted for unused charitable contributions, still subject to the 30% limitation each year.

4) Deductions for child care were liberalized and a new deduction for moving expenses was added.

5) The Act permitted a minimum standard deduction of $300 for each taxpayer plus $100 for every exemption allowed the taxpayer (up to a maximum of $1,000).

B. Capital Gains

1) The percentage inclusion was reduced for capital gains on sales of securities held more than 2 years from 50% to 40%.

2) The alternative tax on capital gains was cut from 25% to 21%.

3) Special capital gains tax reductions were deleted.

C. Aged

1) Retirement income credit was reduced from 20% to 15%.

2) 3 more special provisions were added:
a) Profits from the sale of the principal residence by persons 65 years and over were given a one-time capital gains exemption of up to $20,000;

b) For a husband and wife both over 65, the limit on income subject to retirement credit on joint returns was raised 50% from $1,524 to $2,286;

c) Cost of medicines and drugs purchased by persons over 65 was made fully deductible.

D. Income Averaging

1) Averaging of income over a 5-year period was allowed if income in the current year exceeded the average of the four prior years by 33-1/3 percent and this excess was greater than $3,000.

2) Averaging was available to taxpayers who had been self-supporting for 5 years.

F. Stock Options

Limited stock option privilege was provided to cases where it was used for incentive purposes and the chance of manipulation was eliminated:

1) Stock must be held for 3 years or more;

2) Option must not be for a period of more than 5 years;

3) The option price must be at least equal to the market price of the stock when the option was issued;

4) Stockholders' approval for the options must be obtained;

5) The extent to which new options could be exercised when old options were outstanding was restricted.
F. Sick Pay

Redesigned to be of assistance primarily to persons with long illnesses:

1) The exclusion was restricted during the first 30 days of absence to $75 per week or 75% of employee's regular pay (whichever was less);

2) No exclusion was permitted during the first 30 days if the employee's sick pay exceeded 75% of regular pay;

3) The full $100 exclusion per week would continue to apply only after an absence of 30 days.

G. Other Changes

1) Premiums paid by employers on coverage above $50,000 under group-term insurance plans would be included in the taxable income of employees.

2) Capital losses could be carried forward against capital gains and at least $1,000 of ordinary income per year for an indefinite period rather than the 5-year limit under prior law.

3) Personal holding company provisions were tightened.

4) The 1962 rule which disallowed as a deduction a portion of travel expenses for certain business trips which are combined with a vacation was repealed.

5) An interest deduction was denied for amounts borrowed under a systematic plan to pay premiums on life insurance.

H. Final rate structure began at 14% and ended at 70% in a substantial downward revision of the marginal tax rate schedule. Instead of two $1,000 brackets, the rate schedule began with four $500 brackets. The top bracket began at $100,000 taxable income rather than $200,000 as before.
Tax Reform Act of 1969

A. Increases in Personal Exemption and Standard Deduction

1) The personal exemption was increased from $600 to $625 for calendar year 1970; to $650 on July 1, 1970; to $650 for 1971; to $700 for 1972; and to $750 for 1973 and thereafter.

2) The standard deduction was increased to 13% with a $1,500 ceiling in 1971; to 19% with $2,000 ceiling in 1972; and to 15% with a $2,000 ceiling in 1973 and thereafter. (Ceilings for married taxpayers filing separate returns were 1/2 the above amounts.)

B. Low-income Allowance Revised Over 3-year Period

The prior minimum standard deduction of $200 plus $100 per exemption with a $1,000 limit was changed to a flat $1,000 minimum standard deduction. The new minimum standard deduction was $1,100 in 1970, $1,050 in 1971, and $1,000 in 1972 and thereafter.

C. Tax Treatment of Single Persons

The Act provided a new, lower rate schedule for single persons effective in 1971. This assured that tax liabilities for single persons did not exceed 17% to 20% of liabilities for married couples for taxable incomes between $14,000 and $100,000 with the maximum differential of 20% reached at a taxable income level of 24,000. (Under prior law, the differential could be as much as 42%.)

D. Maximum Tax

The fifty percent maximum marginal tax rate on earned, personal-service income was introduced. For taxable years after December 31, 1970 and before January 1, 1972, the maximum rate was 60% and for taxable years beginning January 1, 1972 or later, the maximum rate was 50%.

E. Minimum Tax on Preference Income

A 10 percent minimum tax on tax preference items such as excluded capital gains, excess depletion and depreciation, and other tax shelter items was introduced in the 1969 Act.
A. Special Refund of 1974 Individual Income Taxes

A refund equal to 10% of an individual's 1974 tax liability with a maximum of $200 was provided. The rules determining amount of refund favored individuals in the low- and middle-income brackets. The rules also included a phase-out provision that reduced the refund, but not below $100 unless an individual paid less than $100 in taxes.

B. Tax Credit Based on Dependents

For 1975, a tax credit equal to $30 multiplied by the number of taxpayer and dependent exemptions (but not the extra exemptions for age and blindness) was enacted. The credit could not exceed the taxpayer's income tax for 1975.

C. Standard Deduction Increase and Changes

1) The Act redefined the standard deduction so that the amount no longer was based on filing status of individual.

2) It increased the amount of standard deduction that could be deducted by all types of individual taxpayers.

3) For 1975, the low-income allowance was $1,600 for singles, $1,900 for married persons who filed joint returns, and $950 for married couples who filed separately.

D. Earned-income Tax Credit (EIC)

1) The EIC was available only to low-income workers who had dependent children and maintained a household.

2) The maximum credit was equal to 10% of a worker's first $4,000 of earned income or $400 and was reduced by 10% of AGI above $4,000; therefore, it was completely eliminated at $8,000 of AGI.
E. Postpone Tax on Gain From Sale of Residence

Tax on capital gain from sale of a principal residence was postponed if the proceeds were reinvested in the purchase or construction of another principal residence within 18 months, rather than 1 year (as was the case under prior law).
A. Minimum Tax for Individuals

1) The Act raised the minimum tax rate on preference income to 15 percent, and the exemption provided under the minimum tax was reduced to the greater of $10,000 or 1/2 of the regular tax liability.

2) New preferences items were added for:

a) Itemized deductions (other than medical and casualty loss) in excess of 60% of AGI;

b) Intangible drilling costs in excess of the amount deductible if capitalized and amortized over 10 years; and

c) Accelerated depreciation on all personal property subject to a lease (including acceleration that resulted from ADR).

B. Extensions of Individual Income Tax Reductions

1) General Tax Credit (Revenue Adjustment Act of 1975).

The credit was equal to the greater of $35 per capita or 2% of the first $9,000 of taxable income. It was extended for the second 6 months of 1976 and for calendar year 1977.


Minimum standard deduction remained at $1,700 for single returns and $2,100 for joint returns; the
percentage standard deduction remained at 16%; and the maximum standard deduction remained at $2,400 for single returns and $2,800 for joint returns.

3) Earned-income Credit:
   a) The credit was extended through the last 6 months of 1976 and calendar year 1977; and
   b) Eligibility for the credit was extended to people with adult disabled dependents and to people who maintained a household for a child who was either a student or under age 19, but who were not entitled to claim a personal exemption for the child.

C. Tax Simplification for Individuals

1) Revision of Tax Tables for Individuals.

New tables for individuals with taxable incomes of $20,000 or less to be used by both itemizers and those using the standard deduction were established.

2) Deduction for Alimony.

changed alimony from an itemized deduction to a deduction in arriving at AGI after December 31, 1976.

3) Revision of Retirement Income Credit:
   a) The Act simplified the eligibility on the credit and increased the maximum base for the credit for a single person to $2,500 and for a married couple to $3,750;
   b) It eliminated the parallel to Social Security by making the credit available for earned income as well as retirement income and renamed the provision "credit for the elderly;"
   c) It reduced the maximum amount of credit base by 1/2 of AGI in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return. The maximum amount was reduced by exempted Social Security and retirement income;
d) For public retirement system retirees under age 65, the base for the credit was increased to the same amounts as for those age 65 or over.

4) Credit for Child-care Expenses:
   a) The deduction was converted to a tax credit of 20% of eligible expenditures. The maximum limit was $2,000 for one dependent and $4,000 for two or more dependents. Also, the $35,000 income limit under prior law was eliminated;
   b) The distinction between expenses for services inside and outside the home for children was eliminated;
   c) The credit was extended to married couples where one spouse worked part-time or was a student and to a divorced or separated parent who had custody of the child;
   d) Payments to relatives who are not dependents of the taxpayer were made eligible for the credit if the services performed were taxed under Social Security.

5) Sick-pay and Certain Disability Pensions:
   a) The sick-pay exclusion was repealed for temporary absences from work and the exclusion of up to $5,200 a year for retirees under age 65 was continued only for those who are permanently and totally disabled. The $5,200 exclusion was reduced dollar-for-dollar for AGI received (including disability income) in excess of $15,000;
   b) Disability payments were allowed for injuries to civilian government employees that resulted from acts of terrorism as it did for combat-related injuries granted military disability payments. The provision also eliminated the exclusion for non-combat related disability pensions.

6) Moving Expenses:
   a) The $2,500 maximum deduction under prior law was increased to $3,000 and the 50-mile "distance" test was decreased to 35 miles;
b) The Act exempted in-kind services or reimbursed moving expenses for members of the armed forces on active duty moved by military orders. It exempted military moves from time and mileage requirements and excluded cash reimbursements or allowances to the extent of expenses paid or incurred (as well as all in-kind services provided by the military from taxable income) from taxable income.
Tax Reduction and Simplification Act of 1977

A. New Standard Deduction

The two-part standard deduction (minimum low-income allowance and percentage standard deduction) was eliminated and replaced by a flat standard deduction renamed the "zero bracket amount." The amounts were $3,200 for married persons filing joint returns, $1,600 for married persons filing separately, and $2,200 for single persons and heads of households.

B. New Tax Tables and Rate Schedules

1) Tables were to be issued by the Internal Revenue Service which incorporated standard deduction figures, personal exemptions, and the general tax credit to be used by individual taxpayers regardless of whether they itemized their deductions.

2) Election to Itemize Deductions.

An individual could elect to itemize deductions only if these deductions exceed his zero bracket amount.

3) One-year extension of general tax credit, but limited in two ways:

a) Taxpayer was entitled to include exemptions for age and blindness (not allowed in the 1976 Act); and

b) Married taxpayers who filed a separate return used a $35 per exemption method to compute the general tax credit (the 1976 Act stated that the
greater of one percent of the first $9,000 of taxable income or $35 for each personal and dependency exemption was to be used).

5) A one-year extension of earned-income credit was provided.
Revenue Act of 1978

A. Overview of Individual Income Tax Reductions

1) The zero-bracket amount will be increased.

2) New tax brackets and rate changes will be instituted.

3) The general tax credit will be replaced with a $250 increase in the personal exemption (raising it from $750 to $1,000).

4) The gasoline tax deduction will be disallowed and the medical expense deduction simplified.

B. Bill Provides New Tax Rate Schedules

1) The zero-bracket amount in the joint return schedule will increase from $3,200 to $3,400. For single persons and heads-of-households, the increase is from $2,200 to $2,300. For married persons filing separately, the increase is from $1,600 to $1,700:

   a) The bill will increase the floor under itemized deductions by $200 for joint returns and $100 for single, head-of-household, and separate returns;

   b) The zero bracket amount addition to base period income for income averaging will remain at existing levels.

2) The size of the tax brackets in excess of the "zero bracket" will increase by 6 percent.

3) Three of the lower tax rates will be reduced (the present 19, 22, and 25 percent rates will each be reduced by one percentage point to 18, 21, and 24 percent).
C. **Increase in the Personal Exemption**

The personal exemption will increase from $750 to $1,000 and the general tax credit will be allowed to expire at the end of 1978.

D. **Filing Income Levels Increased**

Because of the increase in "zero bracket" amounts and in the personal exemption, income levels at which a tax return must be filed will rise:

a) New filing levels will be $3,300 for a single person, $5,400 for a married couple both of whom are under age 65; $6,400 if only one spouse is 65 or over, and $7,400 if both spouses are age 65 or over.

E. **Earned-income Credit Simplified and Made Permanent**

1) The allowable earned-income credit for any taxable year will not exceed the excess of $400 or 10 percent of the excess of AGI (or if greater, earned income) over $4,000; and

2) Individuals with earned income less than $4,000 and AGI greater than $4,000 will receive an increase in the amount of credit allowed.

F. **Itemized Deductions**

1) The itemized deduction for state-local nonbusiness gasoline and other motor fuel taxes will be repealed.

2) The bill will repeal the itemized deduction for one half of the cost of medical insurance premiums (up to $150) without regard to the general limitation that medical expenses are deductible only to the extent that they exceed three percent of AGI. The bill provides that only "prescribed drugs" and insulin will be eligible for the medical expense deduction.

3) The deduction for political or newsletter fund contributions will be repealed; however, the income tax credit for such contributions will still remain available.
APPENDIX B

Supplementary Statistical Material
Table B-1

Distribution of Individual Tax Changes by Income Class under Various Revenue Bills, Selected Years, 1964-78*

(1978 Levels of Income)

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Percentage Distribution of Tax Cuts

| $ 0 - 5 | 12.5 | 11.4 | 7.2 | 2.6 | 0.8 |
| 5 - 10  | 23.3 | 30.2 | 35.1| 13.1| 4.2 |
| 10 - 15 | 19.8 | 21.7 | 29.7| 15.9| 8.0 |
| 15 - 20 | 16.9 | 17.4 | 18.5| 20.7| 12.7|
| 20 - 30 | 18.5 | 17.9 | 17.6| 35.2| 27.5|
| 30 - 50 | 8.2  | 6.3  | 5.3 | 15.5| 23.3|
| 50-100  | 2.0  | 0.4  | -1.0| 1.6 | 12.9|
| 100 and over | -1.3 | -5.6 | -12.3| -4.8| 11.2|
| Total   | 100.0| 100.0| 100.0| 100.0| 100.0|

Source: Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

a/ All comparisons are with current law effective for 1978.

b/ Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

c/ Includes negative incomes not shown separately; therefore, components will not add to totals.

August 16, 1978
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<td>1,264,312</td>
<td>184,145 (14.6%)</td>
<td>170,853 (13.5%)</td>
</tr>
</tbody>
</table>

Source: Computed from the Treasury 1975 Individual Income Tax File, with income and population projected to 1978 levels.

a/ Expanded income is equal to adjusted gross income (AGI) plus individual tax preferences less investment interest expense to the extent that it does not exceed investment income.

b/ Includes negative incomes not shown separately; therefore, components will not add to totals.