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TAX TREATMENT OF FAMILIES

Louis Kaplow

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Harvard Law School
Cambridge, MA 02138

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Abstract

The appropriate income tax treatment of families involves allocating burdens between single individuals and married couples and adjusting burdens to account for the number of dependents. This note briefly analyzes these issues. [It will be an entry in the forthcoming Encyclopedia of Taxation and Tax Policy.]

Tax Treatment of Families

Tax systems must allocate burdens among single individuals, married couples, and families with varying numbers of dependents. The federal income tax originally treated each taxpayer separately, as do many developed countries today, but it now permits married couples to be treated as a unit. This means, for example, that couples in which each spouse earns $25,000 pay the same tax as couples in which one spouse earns $50,000 and the other earns $0. With individual treatment, the latter couple would have a relatively higher tax burden because of the tax system's progressivity: an individual with $50,000 of income pays more than twice the tax of a single individual with $25,000.

Aggregation of spouses' income is supported by those who believe that spouses typically share resources. In addition, enforcing separate taxation would be difficult. Couples could manipulate which spouse receives unearned income and incurs deductible expenses. Indeed, under the prior individual taxation regime, spouses in community property states were each taxed on half of earned income, and many states adopted community property laws, apparently so that their residents could receive this benefit.

But aggregation is blamed for discouraging the work effort of second earners (typically wives) whose labor supply is particularly responsive to wages and thus to taxes. Under individual taxation, a second earner would be taxed at a lower rate on initial earnings. The primary reason that the income tax discourages second earners, however, is its failure to tax the imputed income of spouses who work in the home: if one earns $10,000 in the market, this will not be enough after taxes to pay $10,000 to hire someone to perform domestic work that one no longer has time to do. The child care credit is a partial remedy for some families, and a modest two-earner deduction previously existed. Larger earned income allowances and taxing the second (lower-earnings) worker's income at lower rates have been proposed.

Also, the extent of actual sharing within the family is questioned. If spouses largely retain control over their own earnings, it is argued that they should be taxed separately on these earnings. Unequal sharing, however, does not obviously favor the resulting heavier taxation of couples with unequal incomes. Part of any increased tax burden may be borne by the relatively poor spouse, whose poverty is greater the less equal is the sharing.

Another feature of the current system is that it uses a separate rate schedule for married couples that taxes them at higher rates than single individuals. That is, a married couple with $50,000 of income pays more than twice the tax of a single individual with $25,000 of income. Thus, prospective spouses with equal earnings face a marriage penalty. Despite this penalty, however, prospective spouses face a net subsidy if their earnings are sufficiently unequal. A single individual with income of $50,000 and another with income of $0 would pay less income tax if they married: the tax savings from income splitting (being taxed as if each spouse earned $25,000) exceeds the tax cost due to higher rates for married couples.

The primary rationale for applying a higher rate schedule to married couples is that economies of scale in living arrangements increase their ability to pay. Although scale economies increase well-being, they also imply that married couples benefit more per dollar of disposable income. This factor favors lighter taxation if higher taxes on those with higher incomes are justified on the ground that marginal dollars are less valuable to the wealthy. Thus, it is ambiguous whether economies of scale favor higher or lower tax burdens on married couples. Also, many doubt that single individuals are unable to realize scale economies, by finding roommates if they wish. (Relatedly, the similarity between the economic situation of cohabiting adults and married couples is offered as an argument for taxing the latter as single individuals.)

In addition to the different rates applied to married couples and single individuals, the income tax reflects family size by allowing an exemption, currently about $2000, for each member. The exemption per person does not fall as family size increases, which would be analogous to the typical treatment in welfare programs. And the size of exemptions does not increase with income; rather, exemptions are phased out at high income levels.

If the family really is the unit of taxation, it may seem more natural to treat dependents similarly to spouses. For example, if a spouse reduces effective income by almost a half, perhaps adding children should produce a similar result. France takes such an approach, while giving less weight to children than adults. The United States income tax makes a partial allowance of this sort by subjecting single individuals to a lower rate schedule if they have dependents.

Such an extension of the taxable unit from married couples to the entire family would significantly increase the tax benefits from having dependents for middle- and upper-income couples. The distributive rationale for this result is that, when children are present, adults need substantially more income before reaching any given living standard -- say, before being able to afford a summer home. By contrast, the constant exemption reflects a view of children as fixed costs, affecting parents' ability to pay no differently than leasing a sports car, which would have the same annual cost regardless of the purchaser's income.

More generous treatment of married couples and dependents is sometimes viewed as undesirable because it would favor the rich: a given exemption is worth more to those in higher tax brackets, and an increasing exemption would benefit them even more. But determining proper taxation of married couples and families with dependents is in important respects distinct from deciding upon the degree of progressivity. After all, coherent redistribution is impossible unless one first decides to and from whom one is redistributing income and which units are properly characterized as rich and poor.

Most analysis of the proper treatment of families emphasizes the redistributive role of the income tax. If, instead, tax burdens should depend in part on benefits received from the government, rather different principles would apply. For example, the receipt of many tax-funded benefits, like public education, increase with family size, suggesting that heavier burdens be placed on larger families or at least reducing the force of arguments favoring more generous treatment.

Tax treatment of the family depends on more than the federal income tax, or the states' income taxes that are much smaller in magnitude and usually treat families similarly. Social security taxes as well as social security benefit formulas and welfare programs significantly affect the disposable income of families of different types. For all taxpayers but the rich, social security taxes are a sizable fraction of their tax burden, and these taxes do not adjust for family size in the same way as income taxes; nor do benefit rules respond in the same manner. To illustrate, a second earner entering the labor force bears the full effective burden of social security taxes but initially receives no increase in future retirement benefits. Similarly, the effect of the income tax on the poor cannot be determined without accounting for social security taxes and benefits and other transfer programs, including the earned income tax credit (EITC), which is formally part of the income tax. The marriage penalty from the EITC, for example, can be thousands of after-tax dollars for some lower-income couples. Also, it is more familiar to identify welfare payments than income tax exemptions as having a positive effect on fertility, although the latter play a role and would be more significant under some proposed alternatives.

Taxation of the family also concerns gifts and bequests. Indeed, a large portion of all giving other than to public charities is to family members, so tax issues concerning gifts have an important effect on the treatment of families.

The income tax excludes gifts and bequests from donees' income and does not permit any deduction to donors. (By contrast, spouses implicitly are each taxed on half of combined income; this is equivalent to assuming that resources are shared, giving a gift deduction to the higher-income spouse, and taxing the gift to the lower-income spouse.)

A comprehensive view of income might include gifts in donees' income, as they clearly increase ability to pay. Donors would still be denied a deduction on the theory that they have benefited by giving the gift at least as much as by direct consumption. (Also, as a quid pro quo may be present, some so-called gifts are really payments for services.)

A view that the tax system should maximize social welfare might be more favorable to gifts. Gifts do increase ability to pay, which is relevant for redistributive purposes. But gifts also have the desirable feature that the same economic resources provide a double benefit, to both donor and donee. Thus, economic welfare may be enhanced by subsidizing gifts.

The current system does not fully embrace either view. Existing income tax treatment of gifts is commonly rationalized on the ground that taxing or subsidizing them would be difficult, particularly for myriad small gifts within the family. However, there is a gift and estate tax, separate from the income tax, levied on large gifts by the wealthy.

Gifts of property are also important in an income tax system because they result in future income from the property being taxed to the donee, often a child in a low tax bracket, rather than to the donor, who may be in the highest bracket. Rules concerning trusts and other assignments of income reduce this practice, but outright transfers of property, as well as some less complete transfers, have long been permitted to shift the tax burden on future income to the donee. (Also, unrealized appreciation on property transferred as a gift is taxed to the donee; if given as a bequest, unrealized appreciation is never taxed.) Under the 1986 tax reform, however, unearned income of children under fourteen is taxed to their parents, which eliminates much of the tax benefit from such transfers. This provision can be seen as embodying a view that -- at least with respect to transfers of property -- the entire (immediate) family is the unit of taxation, rather than just the married couple.

Many rules affect the tax treatment of families, and no consensus exists about their proper form. Further illumination of these issues will be possible from analysis that unavoidably will become ever more complicated. Simple, intuitive appeals will be increasingly qualified or displaced by arguments that (1) give greater attention to the economics of the family, as by analyzing decisions to marry, have children, and allocate resources among members (Becker 1991); (2) appeal directly to principles of distributive justice and economic welfare, as in the vast literature on optimal income taxation, rather than relying primarily on abstract ability to pay norms (Kaplow 1992); (3) integrate the effects of all major tax and transfer programs (Boskin and Puffert 1987); (4) adopt a lifetime perspective, often used in studies of tax incidence, because individuals spend parts of their lives in different family units; and (5) examine more closely other countries' tax systems, which vary greatly from that in the United States in their treatment of the family (Pechman and Engelhardt 1990).

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