

THE STANDARD DEDUCTION  
AND FLOORS IN THE INCOME TAX

Louis Kaplow

Discussion Paper No. 148

11/94

Harvard Law School  
Cambridge, MA 02138

The Program in Law and Economics is supported by  
a grant from the John M. Olin Foundation.

# The Standard Deduction and Floors in the Income Tax

Louis Kaplow\*

## Abstract

The standard deduction and floors -- such as for the medical expense deduction -- are familiar tools for income tax simplification, sacrificing some equity in exchange for reduced compliance and administrative costs. These devices also are believed to have important distributional and revenue effects. Despite apparent differences between the standard deduction and floors -- namely that floors disallow deductions for low expenses whereas the standard deduction allows an excessive deduction -- the two mechanisms are shown to be interchangeable. Moreover, neither the familiar distributional nor revenue effects are inherent in these mechanisms. Thus, the appropriate level of the standard deduction and any floors should be determined entirely by the trade-off between simplification and proper income measurement. The article discusses how such analysis should proceed. One implication is that it may be appropriate these devices to take a different form, treating individuals with deductions below the threshold less favorably than those just at the threshold.

\*Harvard Law School and the National Bureau of Economic Research. I am grateful for comments from David Elsberg and Alvin Warren.

## I. Introduction

The standard deduction is believed to be an important feature of the income tax because it is a central part of the apparatus that defines the level at which taxation begins and because it saves compliance and administrative costs for the majority of taxpayers who do not itemize.<sup>1</sup> In 1991, seventy percent of personal income tax returns claimed standard deductions amounting to \$350 billion.<sup>2</sup> Taxpayers with itemized deductions less than the standard deduction are permitted to deduct an amount equal to the standard deduction; those with deductions above the standard deduction may take the full amount of their deductions.<sup>3</sup> It is conceded that this approach sacrifices accuracy by mismeasuring taxable income with respect to individuals who have low deductions but who are nonetheless permitted to take the standard deduction.<sup>4</sup>

---

<sup>1</sup> See, e.g., Richard A. Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice* 363-64 (3d ed. 1980). For a discussion of the legislative history of the standard deduction (including earlier evolutionary forms) that focuses on congressional motivation, see Allan J. Samansky, *Nonstandard Thoughts about the Standard Deduction*, 1991 Utah L. Rev. 531, 532-40. For empirical evidence on compliance costs, see Mark M. Pitt & Joel Slemrod, *The Compliance Cost of Itemizing Deductions: Evidence from Individual Tax Returns*, 79 Am. Econ. Rev. 1224 (1989). Not all are convinced that the benefits of simplification are significant. See, e.g., Glenn E. Coven, *The Decline and Fall of Taxable Income*, 79 Mich. L. Rev. 1525, 1561-62 (1981). For discussions of tax complexity more generally, see David F. Bradford, *Untangling the Income Tax* 266-81 (1986); Louis Kaplow, *Accuracy, Complexity, and the Income Tax*, Harvard Law School Program in Law and Economics Discussion Paper No. 139 (1994); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 Wis. L. Rev. 1267; Joel Slemrod, *Optimal Tax Simplification: Toward a Framework for Analysis*, Proceedings of the 76th Annual Conference of the National Tax Association 461 (1984).

<sup>2</sup> Department of the Treasury, Internal Revenue Service, *Individual Income Tax Returns 1991*, Table 1.2 (1994).

<sup>3</sup> I.R.C. § 63. For a period of time prior to the 1986 Tax Reform Act, a "zero bracket amount" was used in place of the standard deduction to accomplish the same result. See *infra* note 11.

The income tax has made increasing use of another simplification device, floors, due in part to pressures to raise revenue without raising statutory tax rates. Medical expense deductions are limited to expenditures exceeding 7.5% of adjusted gross income,<sup>5</sup> casualty loss deductions are limited to losses exceeding 10% of income,<sup>6</sup> and miscellaneous itemized deductions (such as unreimbursed employee business expenses and investment expenses) are limited to expenses exceeding 2% of income.<sup>7</sup> Such limits, like the standard deduction, save compliance and administrative costs but sacrifice accurate measurement.<sup>8</sup> Floors differ from the standard deduction in that they reduce all taxpayers' deductions by the threshold amount: taxpayers with deductions less than the threshold receive no deduction and those with deductions above the threshold are allowed to deduct only the excess.<sup>9</sup>

---

<sup>4</sup> See, e.g., Boris I. Bittker & Martin J. McMahon, *Federal Income Taxation of Individuals* 17-20 to -21 (1988); Richard Goode, *The Individual Income Tax* 173-74 (rev. ed. 1976); Alan L. Feld, *Fairness in Rate Cuts in the Individual Income Tax*, 68 Cornell L. Rev. 429, 441 (1983); McCaffery, *supra* note 1, at 1286 n.93; Joel Slemrod & Shlomo Yitzhaki, *Analyzing the Standard Deduction as a Presumptive Tax*, 1 Intl. Tax & Pub. Fin. 25 (1994); Stanley S. Surrey & Gerard M. Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 Wm. & Mary L. Rev. 915, 917-21 (1968) (also noting qualifications to the argument that a sacrifice of equity is involved).

<sup>5</sup> I.R.C. § 213(a).

<sup>6</sup> I.R.C. § 165(h)(2)(A)(ii).

<sup>7</sup> I.R.C. § 67. Details of these and other provisions are ignored, as the analysis does not depend on them.

<sup>8</sup> See, e.g., Surrey & Brannon, *supra* note 4, at 917-21.

<sup>9</sup> Other provisions of the tax code provide floors with respect to the measurement of income rather than for deductions. Consider, for example, thresholds for filing a tax return and for paying social security taxes on income from self-employment. These floors tend to operate differently from those examined here, as discussed in subsection VI.D.

These simplification devices have not received much study, perhaps because they are so familiar and seem so elementary.<sup>10</sup> Nonetheless, many of their most basic features are often misunderstood in ways likely to have a significant effect on the formulation of tax policy. Moreover, the factors bearing on the appropriate level of the standard deduction and any floors have not been carefully identified, and potential alternative forms of threshold rules have not been evaluated. This article offers a framework for considering these issues.

Section II explains why rules having the form of the standard deduction and of a floor should be seen as identical if a proper vantage point is taken. If one makes offsetting adjustments elsewhere in the tax system (exemption levels and tax brackets), the two forms of threshold are precisely equivalent despite the fact that the standard deduction appears to allow all expenses below the threshold (regardless of whether incurred) and a floor appears to allow none.<sup>11</sup> As a result, one can choose between the two types of rules on cosmetic grounds, such as the possibility that one or another may be better understood by taxpayers.<sup>12</sup>

---

<sup>10</sup> For example, a WESTLAW search revealed only one article on the subject: Samansky, *supra* note 1. A recent brief examination by economists is Joel Slemrod and Shlomo Yitzhaki, *supra* note 4. See also Coven, *supra* note 1, at 1556-64; Feld, *supra* note 4, at 438-41; Surrey & Brannon, *supra* note 4, at 917-21. These rules often are mentioned, but rarely to analyze their essential features.

<sup>11</sup> The equivalence will be familiar to some readers, as for a time the federal income tax permitted itemized deductions only to the extent they exceeded the standard deduction, with an adjustment to tax brackets known as the zero bracket amount (equivalent to an adjustment to exemptions). Under that system, the standard deduction did appear as a floor. See, e.g., Coven, *supra* note 1, at 1557; Samansky, *supra* note 1, at 537 & n.38; Slemrod & Yitzhaki, *supra* note 4, at 29. Even for those for whom the argument is not new, displaying the steps helps understand the analysis in the subsequent Sections. Moreover, even with respect to what is arguably known to be equivalent, some commentators have perceived important differences that are not inherent. See, e.g., Goode, *supra* note 4, at 172-73.

Section III demonstrates that no inherent revenue effects result from raising or lowering either the standard deduction or a floor. Nor is there any inherent effect on the overall distribution of income; for example, there is no necessary effect on the minimum level of income that can be earned before owing any income tax. In fact, with appropriate adjustments (in exemption levels or tax brackets), the only effects of adjusting the level of the standard deduction or a floor are on simplification and on the relative taxes paid by individuals with differing amounts of deductions. Because these effects are inherent, they should be the focus of analysis when evaluating these tax rules. Other often emphasized effects on revenue and on the overall distribution of income can safely be ignored because, if undesirable, they can be fully offset in a simple manner and, if desirable, they can be created independently of any adjustment in the threshold levels.

The analysis of Sections II and III suggests that thresholds should be designed to reflect concerns of simplification and accurate measurement. The remainder of the article examines these problems. Section IV questions whether individuals with

---

<sup>12</sup> See, e.g., Staff of the Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 18 (Comm. Print 1987) (offering ease of understanding as reason for substituting standard deduction for zero bracket amount). This equivalence is one of many reasons it is indefensible to justify floors by arguing that only "extraordinary" expenses should be deductible. Because a floor functions the same way as a standard deduction, a floor can be made equivalent to providing additional deductions to those with very low expenses, which contradicts a policy to allow deduction of only extraordinary expenses. It is true that the equity benefit of differentiation increases with the magnitude of the difference, and plausibly at a disproportionate rate. See *infra* note 36 and accompanying text. This suggests that the marginal equity costs of mismeasurement increase with the level of a threshold, which will be relevant in setting the optimal level of a threshold. See *infra* Sections IV & V.

deductions below a threshold -- many of whom are far below the threshold -- should be treated in the same manner as those with deductions equal to the threshold, as is presently done with both the standard deduction and floors. (For example, if the standard deduction is \$5000, individuals with actual deductions of \$1000 take a deduction of \$5000, whereas those with deductions of \$5000 could itemize and take a deduction of \$5000.) Because not all individuals below a threshold are only slightly below it -- indeed, most are significantly below the threshold -- it seems natural to treat those below the threshold less generously than those at the threshold. (For example, all individuals with deductions less than the \$5000 threshold might be allowed to deduct \$2500 rather than \$5000.) The analysis suggests that such treatment promotes accurate income measurement, but may interfere with simplification and create perverse incentives. The best treatment for individuals below the threshold will reflect a compromise among these concerns.

Section V asks how to set the threshold level. First, the Section examines how this question is affected by whether individuals below the threshold receive the same treatment as those at the threshold or instead receive less generous treatment. Second, the Section addresses how thresholds should vary with income. (Currently, floors vary with adjusted gross income<sup>13</sup> but the standard deduction does not.<sup>14</sup>)

---

<sup>13</sup> I.R.C. §§ 67, 165(h)(2)(A)(ii), 213(a).

<sup>14</sup> I.R.C. § 63. Originally, the standard deduction did vary with income. See Revenue Act of 1941, ch. 412, § 102(a), 55 Stat. 687, 689-91 (codified at I.R.C. § 400) (permitting 10% reduction of tax to individuals with gross income under \$3000); Individual Income Tax Act of 1944, ch. 210, § 9(a), 58

Section VI pursues a range of further issues, including how the analysis is applicable to different types of family units, which items should be subject to thresholds, and the choice of separate thresholds (as with the floor for medical expenses) versus group thresholds (as with the standard deduction in lieu of many itemized deductions). Section VII briefly concludes.

## II. The Equivalence of a Standard Deduction and a Floor

Suppose that the income taxes one must pay are given by the tax rate schedule  $T(\text{AGI} - D - E)$ , where AGI is adjusted gross income,  $D$  refers to deductions, and  $E$  is the exemption amount. The analysis will consider the case of a single individual with a single exemption; the extension to other household configurations is presented in subsection VI.A. In addition, it will be useful for much of the analysis to focus on individuals with the same adjusted gross income; how thresholds should vary with income is addressed in subsection V.B.<sup>15</sup>

Consider first a rule permitting a standard deduction in the amount  $SD$ . Under this rule, individuals will deduct  $D$  or  $SD$ , whichever is larger. There are two cases.

1. When  $D > SD$ , the tax owed is  $T(\text{AGI} - D - E)$ .
2. When  $D \leq SD$ , the tax owed is  $T(\text{AGI} - SD - E)$ .

---

Stat. 231, 236-37 (codified at I.R.C. § 23aa) (allowing 10% deduction from adjusted gross income, not to exceed \$500). For a more complete history of the standard deduction, see Samansky, *supra* note 1, at 532-40.

<sup>15</sup> See also *infra* note 25 (exemption levels may depend on income).



Consider, instead, implementing a floor,  $F$ , in the same amount:  $F = SD$ . In addition, simultaneously increase the exemption by  $SD$  to  $E'$ :  $E' = E + SD$ .<sup>16</sup> (Equivalent to the latter,  $E$  could remain fixed and  $T$  could be shifted downward by the amount  $SD$ , as with the former "zero bracket amount."<sup>17</sup>) There are two cases.

1. When  $D > F$ , the tax owed is  $T(AGI - (D - F) - E')$ . One can substitute  $E + SD$  for  $E'$  and  $SD$  for  $F$ . Then it is apparent that this condition is identical to providing that, when  $D > SD$ , the tax owed is  $T(AGI - D - E)$ . This is precisely the condition with the original, standard deduction rule.
2. When  $D \leq F$ , the tax owed is  $T(AGI - E')$ . Again make the substitution of  $E + SD$  for  $E'$ . Then this condition is identical to saying that when  $D \leq SD$ , the tax owed is  $T(AGI - SD - E)$ . This too is the condition with the original, standard deduction rule.

Illustration: Suppose that the standard deduction was \$5000 and the exemption was \$2000. Individuals would not pay tax on the first \$7000 of adjusted gross income; in addition, their taxable income would be reduced by the amount by which their deductions exceeded \$5000.

---

<sup>16</sup> To move in the reverse direction -- by substituting a floor for a standard deduction -- one must reduce the exemption, creating the possibility that the exemption would become negative. (A negative exemption is feasible and conceptually coherent, although cosmetically unappealing. Cf. *infra* subsection IV.A.2.) For the scenarios considered in this article, it is not clear that a negative exemption would ever arise under the current federal income tax. More generally, there are two points to note. First, one can accomplish the same result by instead adjusting the welfare scheme and the level of tax brackets. Second, one could adjust the forms of deductions themselves. That is, because in principle the two forms are identical in their effects on every taxpayer, one can simply adopt a version that guarantees that the resulting exemption is nonnegative.

<sup>17</sup> See *supra* note 11.

Substitute a floor of \$5000 and an exemption of \$7000. Again, the first \$7000 of income would be exempt (now entirely due to the exemption itself) and taxable income would be reduced by the amount deductions exceeded \$5000.

Thus, for any given amount of deductions, the two regimes produce the same tax obligation for any given tax schedule T. This result implies not merely revenue neutrality, but the stronger conclusion that every taxpayer pays the same tax, so there are no equity or incentive effects to consider.

Because the two forms are equivalent, the discussion hereafter often will use the language of a threshold. Also, illustrations may use one form or the other; it should be understood that this is only to simplify the exposition, as nothing in the argument could possibly depend on the choice. (Thus, an example may use the threshold for a standard deduction and refer to nonitemizers; for a floor, the threshold could be taken to be the same, and nonitemizers would refer to those with deductions below the floor.)

### **III. Why Thresholds Inherently Affect Relative Tax Burdens But Not Revenue or the Overall Distribution of Income**

Conventional wisdom holds that increasing the standard deduction loses revenue,<sup>18</sup> whereas increasing the level of floors for deductions raises revenue.<sup>19</sup> But the preceding Section

---

<sup>18</sup> See, e.g., John F. Due, *Personal Deductions*, in *Comprehensive Income Taxation* 37, 62-64 (Joseph A. Pechman, ed. 1977); Emil M. Sunley, *Summary of the Conference Discussion*, in *Comprehensive Income Taxation* 261, 264-65.

<sup>19</sup> See, e.g., Nonna A. Noto & Dennis Zimmerman, *Limiting State-Local Tax Deductibility: Effects Among the States*, 37 *Nat. Tax J.* 539 (1984).

proves that a standard deduction and a floor produce identical effects, if one makes offsetting adjustments in the exemption (or in the tax schedule). Thus, conventional wisdom reflects the implicit assumption that one will not make the corresponding adjustment in the level of exempt income.<sup>20</sup>

This Section criticizes the practice of associating threshold levels with revenue effects. It is more useful to think of any revenue effect as arising from a choice of the appropriate exemption level rather than from adjusting the level of the threshold. Similar analysis suggests that one should also think of exemptions rather than the height of the standard deduction as determining the overall distribution of income, in particular the level of income at which the income tax begins.<sup>21</sup>

Threshold levels do matter for policy analysis, but only insofar as these levels affect relative tax burdens (among individuals with the same adjusted gross income) and simplification of tax compliance and administration. These effects should dictate policy on thresholds because such effects are inherent: they will arise regardless of whether or how one adjusts the level of exempt income. By contrast, effects on

---

<sup>20</sup> See Surrey & Brannon, *supra* note 4, at 917-18.

<sup>21</sup> It is common for exemptions and the standard deduction to be viewed as functioning similarly in their role of defining the tax-exempt level of income and determining progressivity. See, e.g., William J. Turner, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 Vill. L. Rev. 1703, 1711, 1713 (1986); John H. Lavelle & James P. Daniels, *Rate Cuts, Return of Standard Deduction Only Two of the Many Changes Affecting Individuals*, 15 *Taxation for Lawyers* 132, 132 (1986). Both exemptions and the standard deduction indeed have the described effect: an individual with adjusted gross income less than the total of the standard deduction and exemption level will owe no tax. But, as this Section emphasizes, the only inherent effect of the standard deduction concerns the relative treatment of taxpayers with the same level of adjusted gross income. See Slemrod & Yitzhaki, *supra* note 4, at 33 n.1.

revenue and the overall income distribution are, in principle, wholly independent of how thresholds are set: any such effects of changing a threshold can be nullified if that is desired or can be achieved by adjusting exempt income without changing the threshold.

To make the argument precise, consider raising the standard deduction from SD to SD'.<sup>22</sup> With no other change, revenue will fall.

1. Taxpayers with deductions such that  $D < SD$  all receive a greater standard deduction and thus pay less tax.
2. Those with deductions such that  $SD \leq D < SD'$  now take the standard deduction of SD' rather than an itemized deduction of D, and will pay less tax.<sup>23</sup>
3. Those with deductions such that  $D \geq SD'$  are unaffected.

Illustration: Suppose that the standard deduction was \$5000 and the exemption was \$2000. Raising the standard deduction to \$6000 reduces the taxable income of those with deductions below \$6000: those with deductions less than \$5000 now take a standard deduction of \$6000 rather than of \$5000. Those with deductions above \$5000 and below \$6000 now take the (higher) standard deduction of \$6000. Those with

---

<sup>22</sup> The claim to be demonstrated is, in a sense, obvious. Surely, one can offset revenue effects of just about any change in tax rules by adjusting the level of the exemption. Moreover, because exemptions apply to all taxpayers of a given adjusted gross income, they can be used to determine the level of adjusted gross income at which income tax must first be paid. The only remaining questions concern the extent to which adjusted gross income rather than adjusted gross income minus deductions should measure taxable income and whether accurate measurement is worth the compliance and administrative costs. But this view is not broadly known or understood, as suggested by the discussion in note 28, so a rigorous demonstration seems appropriate.

<sup>23</sup> The discussion in the text ignores that changing the standard deduction will affect incentives with respect to the activities giving rise to the deductions, which in turn would affect revenue. The main argument is unaffected by this consideration, and the discussion in subsection IV.B.2 will take such effects into account.

deductions above \$6000 continue to itemize and are unaffected. Total taxable income and thus total revenue fall.

Next, suppose that one simultaneously reduced the exemption level by  $SD' - SD$ , which means that the new exemption  $E'$  is such that  $E' = E - SD' + SD$ .<sup>24</sup>

1. Taxpayers with  $D < SD$  pay the same tax as in the initial regime: the benefit from the increased standard deduction is offset exactly by that from the reduction in the exemption.
2. Those with  $SD \leq D < SD'$  pay more tax: they get a higher deduction (the difference between  $SD'$  and  $D$ ), but by less than the fall in the exemption level.
3. Those with  $D \geq SD'$  pay more tax: they get the same deduction, as they continue to itemize, but have a lower exemption.

This combined change, from  $(SD, E)$  to  $(SD', E')$ , raises revenue.

Reduce the exemption by the amount of the increase in the standard deduction: to \$1000. Taxpayers with deductions below \$5000 benefit by \$1000 (in taxable income) from the increase in the standard deduction and lose by \$1000 from the decrease in the exemption. Those in the \$5000 to \$6000 range gain from the higher standard deduction -- in an amount less than or equal to \$1000 -- and lose \$1000 from the decrease in the exemption, for a net loss. Those with deductions above \$6000 are unaffected by the change in the standard deduction but have \$1000 less of income protected by the exemption. Total taxable income and thus total revenue rise.

Finally, consider the exemption level  $E^*$  that, combined with the increase in the standard deduction from  $SD$  to  $SD'$ , is revenue

---

<sup>24</sup> See *infra* note 28 (discussing a reform proposal of this type).

neutral.<sup>25</sup> Observe that  $E' < E^* < E$ ; that is, the exemption falls, but not by the full amount by which the standard deduction increases. (An exemption of  $E$  results in less revenue and  $E'$  in more; hence, there exists some intermediate exemption  $E^*$  at which revenue is unaffected.)

Suppose that a standard deduction of \$6000 and an exemption of \$1500 produces the same revenue as a standard deduction of \$5000 and an exemption of \$2000.

What, then, is the difference between the initial regime with a standard deduction and exemption of  $(SD, E)$  and the final regime with  $(SD', E^*)$ ? First, taxpayers with  $SD \leq D < SD'$  no longer itemize.

Taxpayers with deductions ranging from \$5000 to \$6000 no longer itemize.

As a result, their taxable income no longer reflects precisely their expenditures. This may affect equity and the marginal incentives to undertake the expenditures. If the deductions are appropriate in the first place, the combination of equity and incentive considerations from failing to take the deductible expenditures into account is deemed to be unfavorable. On the other hand, administrative and compliance costs are saved.<sup>26</sup>

---

<sup>25</sup> One could think of a single exemption level  $E^*$  that would be revenue neutral, or one could attempt to be more distribution neutral by allowing the adjustment in the exemption level to depend on income. Thus, for example, if raising the standard deduction costs less revenue for those with very high adjusted gross income (because few itemize), only a small adjustment in the exemption would suffice. (Currently, exemptions do depend implicitly on income because of the phase-out provision in I.R.C. § 151(d)(3). In addition, as indicated in note 14, the level of the standard deduction formerly depended on income.)

<sup>26</sup> Compliance cost savings would arise due to reduced recordkeeping, effort in learning the law, and time spent completing tax forms. Administrative cost savings include a reduction in effort to process returns, the need to audit returns, and the time required to conduct audits and engage in subsequent litigation. Evidence of actual average compliance and administrative costs (such as that compiled for the IRS in Arthur D. Little, Development of Methodology for Estimating the Taxpayer Paperwork Burden, Final Report to the

Second, taxpayers for whom  $D < SD' - (E - E^*)$  pay less taxes whereas taxpayers with  $D > SD' - (E - E^*)$  pay more. Some taxpayers with low deductions (individuals for whom  $D < SD$ ) get a higher standard deduction; others with low deductions ( $SD \leq D < SD' - (E - E^*)$ ) switch to the standard deduction and have an increase in their deduction that exceeds the fall in the exemption level. Those with high deductions consist of individuals ( $SD' - (E - E') < D < SD'$ ) who no longer itemize and thereby get the new higher standard deduction but the exemption falls by a greater amount, and individuals ( $D \geq SD'$ ) who continue to itemize and thus get the same deduction but a lower exemption. In summary, for any given level of adjusted gross income, those with low deductions receive more favorable treatment and those with high deductions receive less favorable treatment.

Taxpayers with deductions less than \$5500 benefit (the rise in the standard deduction reduces their taxable income by more than \$500 while the fall in the exemption increases their taxable income by \$500) and those with deductions above \$5500 are worse off (the rise in the standard deduction reduces their taxable income by less than \$500, if at all, while the fall in the exemption increases taxable income by \$500). Taxpayers with low deductions are treated more favorably and those with high deductions less favorably. The difference in their treatment has narrowed and is less than the difference in taxable income that would result if all individuals deductions were measured. For example, individuals with deductions of \$5200 and \$5800 are now treated identically (both take the standard deduction), and individuals with deductions of \$4000 and \$7000 are now differentiated by \$1000 (the former takes the standard deduction of \$6000 and the latter itemizes) rather than by \$2000 (when the former took a standard deduction of \$5000).

---

Department of the Treasury (Internal Revenue Service: Washington, D.C.). (1988) probably overstates potential savings. The reason is that such costs probably increase in the amount of the deductions. Thus, among itemizers, those who just find it profitable -- the ones who would no longer itemize if the standard deduction were raised slightly -- will tend to be those with the lowest costs.

This second set of effects would tend to be undesirable to the extent that the deductions were equitable in the first instance. If from an ideal distributive standpoint one would differentiate tax burdens on individuals with the same adjusted gross income by the amount of the deductions, the ideal is met when all take full deductions. Relative to such tax burdens, a higher threshold treats those with low deductions more favorably and those with high deductions less favorably than the posited ideal, reducing the degree of desirable differentiation.<sup>27</sup>

This example demonstrates that one can raise or lower the standard deduction or floors in a manner that is revenue neutral and does not affect the overall distribution of income.<sup>28</sup> Thus,

---

<sup>27</sup> Many question the desirability of various of the itemized deductions, including those deductions subject to floors. See, e.g., Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 Calif. L. Rev. 1485 (1991); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 Stan. L. Rev. 831 (1979). If one doubts the merit of itemized deductions, one may disfavor such differentiation and thus look upon the standard deduction or floors more favorably. See, e.g., Musgrave & Musgrave, *supra* note 1, at 364. But debate about the desirability of deductions is separate in principle from the question of how deductions should be structured under the assumption that they will be made available. See, e.g., Coven, *supra* note 1, at 1563-64 (arguing that if adjusted gross income is a preferable tax base for some, it must be preferable for all). It has also been suggested that the standard deduction or floors may reflect nonqualifying expenses by those with low deductions that are analogous to qualifying expenses, which would imply that less inequity is involved in providing thresholds. See Surrey & Brannon, *supra* note 4, at 918-919 (suggesting, for example, that nonitemizers include renters who do not benefit from the property tax deduction available to homeowners). Such arguments, however, seem more relevant to determining what deductions should be permitted (perhaps the property tax deduction should be eliminated, or extended to renters) than to designing the form of deductions. For example, the standard deduction provides its benefit to renters whose other itemized deductions are low but not to those with high deductions. And, as between two individuals with equal nondeductible expenses to maintain their health -- cost of exercise, good nutrition -- those who become sick or injured have higher costs but do not get a higher deduction if they do not itemize or if their expenses are below the medical expenses floor.

<sup>28</sup> Moreover, by adjusting exemption levels, it is not even necessary to change stated tax rates, which might be subject to strict political limitations. This possibility motivates proposals that might be interpreted as embodying the view the standard deduction is centrally involved with revenue and distribution. See Daniel Feenberg & Jonathan Skinner, *Raising Revenue Without Raising Tax Rates*, 58 Tax Notes 969 (1993); Thomas Marks,



the threshold levels should be set based on the equitable assessment of changes in relative tax burdens among individuals of a given level of adjusted gross income, effects on incentives to undertake deductible expenditures, and changes in administrative and compliance costs.<sup>29</sup> These effects are

Joyce Haefner, and Nick Gugie, *Raising Revenue (To Reduce Revenue) Without Raising Tax Rates*, *New York Style*, 58 *Tax Notes* 1547 (1993). In particular, Feenberg and Skinner suggest eliminating one exemption for each tax unit and raising the standard deduction by the amount of an exemption. As the example in the text indicates, this would raise revenue from taxpayers with higher deductions (deductions exceeding the original, lower standard deduction), who they note tend to be those with higher income. Thus, they claim to have a progressive method of raising revenue without raising tax rates. The analysis here suggests that their proposal can best be understood when decomposed into two components (either of which could be enacted independently): (1) raise the standard deduction and reduce the exemption by a lesser amount, which preserves revenue neutrality; (2) reduce the exemption further to the point of elimination. The first component is a pure reduction in the threshold; it is revenue and distribution neutral (see *supra* note 25) and should be assessed on the merits, taking into account equity of income measurement, compliance costs, and so on. (Feenberg and Skinner seem to favor this effect on the ground that most of the underlying deductions are undesirable; indeed, because they measure progressivity with regard to adjusted gross income rather than adjusted gross income minus itemized deductions, they implicitly assume that the deductions are improper in measuring ability to pay.) The second component is a pure reduction in exemption levels, which obviously raises revenue without "raising tax rates." Of course, for those with incomes that previously placed them in the zero bracket and now fall in a positive bracket, there is a rate increase. Moreover, for those who used to itemize but do no longer, they are subject to a higher effective marginal rate, because (as the authors show) deductions rise with income. (To illustrate, if the nominal tax rate is 20% and deductible expenses typically are 5% of income, the effective rate of an itemizer is 19%, because each added dollar of income raises deductions by five cents and thereby reduces tax by one cent. When the individual no longer itemizes due to the higher standard deduction, the effective rate will equal the nominal rate of 20%.) All this shows that one cannot raise revenue progressively without raising effective tax rates on someone, which should hardly be a surprise. Feenberg and Skinner's analysis, therefore, may be conceptually confusing and (perhaps for that reason) of relevance only in an environment where there is a taboo against raising stated tax rates that does not carry over to hidden rate increases.

In a similar vein, Noto and Zimmerman, *supra* note 19, argue that the best way to raise revenue through curtailing the deduction for state and local taxes is to impose a modest floor (low enough that most taxpayers who itemize would be above the threshold). They favor this over other alternatives because it would not have a differential effect among states. But their proposal is a charade. Instead of imposing a floor of X, one could ignore state and local taxes, raise the standard deduction by X and reduce exemptions by X. For taxpayers above the threshold, which they intend to be almost everyone, as well as for nonitemizers, this alternative proposal is identical in its effects. Thus, their proposal really has nothing to do with limiting the deductibility of state and local taxes. (The only effect would be on the few taxpayers below their threshold, but the effect on them they would prefer to avoid in any event.)

<sup>29</sup> If one ignores this principle, then attempts to offer relief to lower-income taxpayers likely will be poorly targeted; for example, a higher standard deduction only reduces relative tax burdens for those without itemized expenses. Samansky illustrates the point well in observing that the

explored next.

#### IV. Optimal Treatment of Taxpayers Below the Threshold

Both the standard deduction and existing floors on deductions treat taxpayers with deductions anywhere below the threshold in the same manner as taxpayers with deductions equal to the threshold. Taxpayers with no or low deductions receive the standard deduction, which is what an itemizer with deductions just equal to the threshold receives.<sup>30</sup> With floors, taxpayers with no or low deductions receive no deduction, which is what one with deductions equal to the threshold receives.<sup>31</sup>

This Section considers whether such treatment is appropriate. Subsection A examines optimal treatment under the assumption that the treatment affects neither compliance efforts nor the propensity to make expenditures that qualify as deductions. Subsection B accounts for such behavioral effects.

---

more generous standard deduction for the elderly and blind, I.R.C. § 63(f), does not equally benefit such individuals with low incomes because not all will use the standard deduction. See Samansky, *supra* note 1, at 554.

<sup>30</sup> For example, if the standard deduction is \$5000, a nonitemizer with \$2000 of deductions receives a deduction of \$5000, which just equals the deductions of an itemizer who has \$5000 of deductions.

<sup>31</sup> By contrast, with income thresholds (as with that for paying social security taxes when self-employed), it is more common for individuals below the threshold to be treated as though their income were zero, which differs from the treatment at the threshold. See *infra* subsection VI.D.

## A. Optimal Treatment When Behavior Is Taken As Given

### 1. Standard Deduction

Consider again the case of a standard deduction of SD. Observe that those with  $D < SD$  need not receive a deduction equal to SD. In fact, those taxpayers could be assigned a deduction of 0 or any other amount. Moreover, because the group of taxpayers with  $D < SD$  has actual deductions ranging from 0 to SD,<sup>32</sup> the appropriate treatment most naturally involves a deduction of some positive amount less than SD. For example, if the standard deduction is \$5000, one might give individuals who do not itemize a \$2500 deduction.

The optimal level of the deduction permitted to nonitemizers depends on the purpose of the itemized deductions. It is commonly suggested that the level of the standard deduction is part of the apparatus that determines the exempt level of income. But, paralleling the argument in Section III, this is not a necessary purpose, as one can adjust exemptions to accomplish the same result. Recall that the only feature inherent in the deduction permitted to nonitemizers is that the deduction determines nonitemizers' taxable income relative to that of otherwise identically situated itemizers (those with the same adjusted gross income).

---

<sup>32</sup> As will be discussed in the text below, some individuals who take the standard deduction will have deductions somewhat above SD; these will be individuals who either made mistakes or guessed that it was not worthwhile to undertake the effort necessary to itemize. This qualification would have some effect on the optimal deduction, but the qualitative result would be similar.

If the purpose of particular deductions were exclusively to encourage particular behavior (such as charitable contributions) and were believed to be contrary to equity (i.e., the proper measure of income for purposes of determining an equitable tax burden would involve no deduction), then the optimal standard deduction would be zero. After all, individuals who take the standard deduction have no marginal incentive because they do not take the particular deductions.<sup>33</sup> Thus, the only effect of increasing the permitted deduction would be to reduce equity.

However, the purpose of deductions may instead be to measure income more accurately for reasons of equity.<sup>34</sup> This purpose has been offered to justify all the itemized deductions.<sup>35</sup> When subtracting deductions from adjusted gross income improves the measurement of ability to pay, an intermediate deduction would most plausibly be appropriate. The reason is that errors in

---

<sup>33</sup> This oversimplifies, as will be discussed in subsection B.

<sup>34</sup> The nature and weight of this benefit has received remarkably little attention. For a preliminary investigation, see Kaplow, *supra* note 1, at 4-7. The argument is similar to that offered in Louis Kaplow, *Optimal Insurance Contracts when Establishing the Amount of Losses is Costly*, 19 Geneva Papers on Risk & Ins. Theory (forthcoming 1994), which suggests that individuals contesting insurance awards (private or public) should be given higher amounts only if they demonstrate losses that exceed by some significant amount what they would have received if they did not dispute their claim; relatedly, the optimal award for those who will not appeal their initial awards is an amount amid the range rather than at the top.

<sup>35</sup> For investment and employee business expenses, the argument is straightforward. The argument that the deduction of interest is appropriate under an income tax is familiar. See, e.g., White, *Proper Income Tax Treatment of Deductions for Personal Expense*, House Comm. on Ways & Means, 86th Cong., 1st Sess., Tax Revision Compendium 365 (Comm. Print 1959). For the medical expense and casualty loss deductions, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 331-43 (1972), and others argue that such costs reduce ability to pay; some commentators, see *supra* note 27, disagree. Analysis of charitable contributions and state, local, and foreign taxes also is controversial. See, e.g., Andrews, *supra*, at 344-75 (charitable deduction); Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 Am. J. Tax Pol. 9 (1987).

measuring income are usually viewed as involving a cost that rises disproportionately with the amount of the error.<sup>36</sup> (An error of \$1000 is viewed as more than twice as bad as an error of \$500.)

To be concrete, suppose that the cost of an error is deemed to be proportional to the square of the magnitude of the error. Then equity would dictate that the optimal level of the deduction equal the mean of the distribution of deductions for nonitemizers.<sup>37</sup> For example, if nonitemizers' deductions were uniformly distributed over the range from 0 to SD, the optimal deduction for nonitemizers would be SD/2: \$2500 in the illustration with a threshold of \$5000. If, instead, many had deductions clustering at the low end of the range (as seems plausible<sup>38</sup>), the optimal deduction would be less than SD/2. So, if most nonitemizers have very small itemized deductions, equity might best be achieved by a nonitemizers' deduction of, say, \$1000 rather than the \$5000 that a conventional standard deduction formulation would permit.

---

<sup>36</sup> From a utilitarian or many other welfarist (consequentialist) frameworks, mismeasurements of income would affect welfare increasingly at the margin due to individuals' risk aversion. See Kaplow, *supra* note 1, at 4-7. (If the social judgment reflected infinite risk aversion in a Rawlsian fashion, a deduction approaching the threshold amount would be appropriate, because errors of underestimating taxable income are of trivial importance compared to errors of overestimating income. This argument, however, may hold only for the lowest income group, which is exempt from tax in any event.)

<sup>37</sup> It is a familiar statistical property that the mean minimizes the sum of the square of deviations.

<sup>38</sup> One suspects that the distribution of itemized deductions is highly skewed, with the peak at or near zero and the density gradually trailing off as the amount increases. The upper tail is truncated when one considers only those with  $D < SD$ , but the distribution in the range from zero to SD would remain skewed toward zero. For some particular deductions, like interest or casualty losses, a significant portion of nonitemizers have deductions precisely equal to zero. If one were considering the casualty loss floor rather than the standard deduction, therefore, the skew would be more pronounced.

In such a new regime, one would adjust terminology to reflect the newly created functional distinction. Currently, the phrase "standard deduction" signifies both the threshold above which individuals choose to itemize and the level of the deduction taken by nonitemizers. If nonitemizers were allowed a deduction less than the threshold amount, however, one would need to state separately the levels of the "itemization threshold" and the "nonitemizers' deduction."

Illustration: Suppose that the itemization threshold was \$5000 and the nonitemizers' deduction was \$1000, because most taxpayers with deductions below \$5000 had very low deductions. An individual with deductions of \$2000 would be required to take the nonitemizers' deduction of \$1000. For if such individuals were permitted to itemize, the regime would de facto involve a \$1000 conventional standard deduction, and for individuals having deductions in the range from \$1000 to \$5000, savings in administrative and compliance costs would be forgone.

## 2. Floors

Rather than a threshold, consider the case in which the standard deduction takes the form of a floor. The analysis of subsection 1 must apply, for Section II establishes that floors -- with an adjustment in the exemption level -- are identical to a threshold in the form of a standard deduction. The appearance of the argument, however, differs, so it is worth sketching briefly.

With a floor, as with the medical expense deduction, taxpayers with expenses just above the threshold receive a very small deduction and those with deductions at the threshold receive a deduction of zero. The logic of subsection 1 suggests

that taxpayers with expenses below the threshold should receive a "negative deduction" -- that is, an inclusion -- somewhere between zero and the negative of the threshold amount. This result might seem quite strange to taxpayers or members of Congress. One could, however, readily avoid the potential perception problems raised by such an inclusion of phantom income.<sup>39</sup> Simply give taxpayers with expenses above the floor a deduction for the full amount of their expenses and give taxpayers with expenses below the floor a much lower deduction; all taxpayers thereby would have their exemptions (or zero bracket amounts or standard deduction rules) adjusted so as to wipe out the revenue effect while producing the same result. Such adjustments are always possible, as explained in Section II.

Illustration: Suppose that (given one's income) the threshold were \$2000. With a floor, taxpayers claiming expenses of \$2001 would receive a \$1 deduction, so by subsection 1's logic those with deductions under \$2000 would receive a deduction of, say, -\$1000 (that is, an inclusion of \$1000). To eliminate this appearance, one could simply convert the floor into a standard deduction type of threshold: taxpayers with deductions of at least \$2000 would receive a full deduction, those with lower deductions would receive a "standard medical deduction" of \$1000, and the deduction permitted to all who itemize could be reduced by \$2000. (That is, all taxpayers who itemize would show total deductions that were \$2000 higher on account of this adjustment, so one could reduce by \$2000 their total deductions. Alternatively, one could reduce exemptions.<sup>40</sup>)

---

<sup>39</sup> The fact that nonitemizers get phantom deductions, often very substantial ones, has not been a source of great concern. But reactions to real benefits based on phantom deductions can be expected to differ from reactions to real costs based upon phantom imputations.

<sup>40</sup> Reducing the level of exempt income by \$2000 would affect nonitemizers, but the deduction permitted nonitemizers could simultaneously be increased by \$2000. Then nonitemizers would have \$2000 more of a deduction just as all itemizers do; reducing everyone's exemption by \$2000 would then be a wash.

## B. Optimal Treatment When Behavior Is Taken Into Account

Setting the deduction permitted nonitemizers (or to taxpayers who do not detail their deductions when there is a floor) below the threshold increases the incentive for taxpayers to be above the threshold. Taxpayers might move themselves above the threshold in two ways.<sup>41</sup>

### 1. Compliance Effort

Consider a taxpayer who suspects that her total itemized deductions are close to the threshold. Perhaps they are a bit higher or lower, but it would take quite a bit of effort to discern their precise amount. Under the current regime, such a taxpayer would simply take the standard deduction. There is some risk that she is paying a few extra dollars of tax, but she avoids a greater compliance cost.<sup>42</sup>

By contrast, in a regime in which nonitemizers received a deduction much lower than that allowed to itemizers just above the threshold, the taxpayer's calculus would differ. Now, if she does not evaluate her deductions, she receives a deduction below the threshold. But if she computes her deductions and it turns out that her deductions are just above the threshold, she

---

<sup>41</sup> A third technique is evasion: taxpayers who learned that their deductions were just below the threshold would have a substantial incentive to cheat by overstating deductions. Incentives to cheat exist currently, but the jump in permitted deduction at the threshold would substantially enhance the marginal incentive. (Of course, penalties that are based on the extent to which tax is evaded would also increase by a corresponding amount.)

<sup>42</sup> For evidence on the extent to which individuals could itemize but do not, see Pitt and Slemrod, *supra* note 1. They also offer a model for analyzing the itemization decision, as does Joel Slemrod, *The Return to Tax Simplification: An Econometric Analysis*, 17 Pub. Fin. Q. 3 (1989).



receives a much larger deduction. Thus, she is more likely to review her records, learn details of the law, and make calculations.

Illustration: Suppose that there is a standard deduction of \$5000. A taxpayer believes it equally probable that her deductions are either \$4900 or \$5100. If she undertakes the effort to discern her actual deductions, she has a 50% likelihood of reducing her taxable income by \$100. If her tax rate were 30%, the expected value of the benefit would be \$15. (The additional tax savings if deductions are \$5100 rather than \$5000 will be  $30\% \times \$100 = \$30$ , and this has a likelihood of 50%.) Thus, if the recordkeeping, other effort, and the possible added expense of an accountant involve costs of more than \$15, say \$50, she will not undertake the effort.<sup>43</sup> (And, as a result, IRS administrative costs are saved because fewer returns will involve itemized deductions.)

If the deduction permitted nonitemizers were reduced to \$2500, the taxpayer's calculus would change. Now, if she finds that her deductions are actually \$5100, she can claim the total amount, rather than taking the nonitemizers' deduction of \$2500. The expected value of doing the relevant work is now \$390, which justifies the compliance effort valued at \$50. (The additional tax savings if deductions are \$5100 rather than \$2500 will be  $30\% \times \$2600 = \$780$ , and this has a likelihood of 50%.)

The trade-off is now clear: as one reduces the deduction permitted nonitemizers, equity is better served (as indicated in subsection A) but compliance and administrative costs increase. The resulting optimal deduction would be higher than that when only equity was taken into account. Nonetheless, it is plausible that the resulting optimal deduction would be lower than the threshold amount, as is currently provided.<sup>44</sup>

---

<sup>43</sup> The potential deductibility of expenses to determine tax under I.R.C. § 212(3), as limited by I.R.C. § 67, is ignored to simplify the exposition.

<sup>44</sup> Begin with the nonitemizers' deduction equal to the threshold and contemplate reducing it a bit. The compliance cost effect described in the text would probably be modest. On the other hand, the equity effect is likely to be large, because allowing a deduction equal to the threshold overstates deductions for everyone not at the threshold, and such a deduction overstates

## 2. Deductible Expenditures

Prospective nonitemizers who are allowed a deduction below the threshold might respond in another manner: by increasing qualifying expenditures to exceed the threshold.<sup>45</sup> Under the alternative regime just discussed, the incentive to surpass this threshold would be very powerful for individuals who otherwise would be just below the threshold.

Illustration: Suppose that an individual with qualifying expenditures of \$4900 would receive a nonitemizers' deduction of \$2500, whereas one with expenditures of \$5000 would receive an itemized deduction of \$5000. If the marginal tax rate were 30%, the additional permitted deduction would be worth  $30\% \times (\$5000 - \$2500) = \$750$ . Surely, an individual could find a charity she did not dislike so much that it would not be worth making a \$100 contribution that would save \$750 in tax!

Evaluating this second incentive is difficult. To the extent incentives are viewed as undesirable (as would be the case if an individual tries to find a more expensive medical treatment or incur wasteful employee business expenses solely to be able to itemize), this second incentive would favor a deduction to nonitemizers higher than that recommended when considering only what level was most equitable for the group as a whole. However, if the incentives merely cause taxpayers to rearrange their affairs (as when incurring an expense at a somewhat different time so that it is in a tax year where it will make a greater

---

deductions by a substantial amount for the majority who probably have low total deductions.

<sup>45</sup> This phenomenon would also increase compliance effort because, during the tax year, taxpayers may be more inclined to undertake efforts to predict their level of itemized deductions. (Although the magnitude of the incentive differs, such an incentive exists currently because expenditures are only deductible at the margin if their total exceeds the threshold.)

difference<sup>46</sup>), the incentive cost may involve primarily the additional efforts in arranging one's life to minimize one's tax burden. Finally, the incentives may be viewed positively, as when one makes additional charitable contributions in December to qualify as an itemizer. But it is not clear how positively such an incentive should be viewed, for the fact that one is permitted a deduction (with a value equal to one's marginal tax rate, if an itemizer) rather than, say, a double deduction, suggests a policy that favors only a limited incentive.

### 3. Summary

Both incentive effects most plausibly favor permitting taxpayers below the threshold (including a significant portion who are far below the threshold) a deduction that equals or is not very far below the deduction permitted to those at or just above the threshold. Determining the extent to which the optimal deduction for nonitemizers is below the threshold, therefore, depends on the relative magnitude of these incentive costs and the benefits of more accurate measurement of income for those with low deductions.

---

<sup>46</sup> See *infra* subsection VI.B.

## V. Setting the Threshold Optimally

### A. How Treatment Below the Threshold Affects the Trade-off Between Accurate Income Measurement and Simplification

Raising thresholds involves a familiar trade-off: a higher threshold sacrifices equity or other purposes motivating the tax provisions subject to the threshold, but a higher threshold reduces compliance and administrative costs.<sup>47</sup> (Following the analysis in Section III, effects on revenue and the amount of income exempt from tax will be ignored, because these matters can both be offset by adjusting the exemption.) The nature of this trade-off depends on whether those below the threshold receive treatment equal to those just at the threshold -- as with the current standard deduction and floors -- or less generous treatment, as Section IV indicates may be appropriate.

#### 1. Treatment of Nonitemizers Equals Threshold

Begin with the current form of standard deduction. If it were raised from \$5000 to \$5100, there would be effects on two groups. First, taxpayers with deductions ranging from \$5000 to \$5100 would no longer itemize.<sup>48</sup> This is the source of the savings in compliance and administrative costs. There would be a mismeasurement problem for this group of taxpayers, but it would

---

<sup>47</sup> See *supra* note 4. As discussed in Section IV.B, the level of the threshold also affects which individuals face marginal incentives for expenditures on deductible items.

<sup>48</sup> As noted previously, this is not precise, as the group who would no longer itemize may include some individuals with deductions somewhat above \$5100, and some of those with deductions between \$5000 and \$5100 would not have itemized previously.

be quite small.<sup>49</sup> Second, for those with lower deductions, the mismeasurement -- implicit overestimate -- of their deductions would rise by \$100.

## 2. Treatment of Nonitemizers Less Generous Than the Threshold

Now suppose that one raises the threshold in a regime in which those below the threshold receive less generous treatment. An increase in the threshold can be analyzed in two steps.

First, increase the threshold keeping the level of the deduction for nonitemizers fixed. As with the familiar standard deduction, there will be a reduction in compliance and administrative costs on account of those who no longer itemize. Unlike the current form of standard deduction, however, taxable income will be significantly mismeasured for this group: before the increase in the threshold, they itemized and thus received accurate treatment; after the increase, they do not itemize and receive a lower nonitemizers' deduction. (For example, a taxpayer with deductions of \$5050 may now receive a nonitemizers' deduction of, say, \$2500.) The effect on those who already itemized also differs. By assumption, their deduction is held constant at this point in the analysis, so there is no further mismeasurement on account of this group. Thus, the mismeasurement effects of this adjustment are qualitatively different from those with the current form of standard deduction: instead of some increase in mismeasurement for all those below

---

<sup>49</sup> For an infinitesimal change in the threshold, the marginal mismeasurement cost would be zero if one follows the assumptions used previously. See *supra* note 36 and accompanying text.

the threshold there is a large increase in mismeasurement concentrated on the few who no longer itemize.

Second, to complete the analysis, one must allow the level of the nonitemizers' deduction to be adjusted. Presumably, it would be appropriate to raise it somewhat, reflecting that some relatively high-deduction taxpayers have been added to the pool of nonitemizers. This adjustment improves matters; indeed, it is made only to the extent that it does.<sup>50</sup> (It results in an increase in mismeasurement for those with deductions less than the nonitemizers' deduction and a decrease for those with deductions that are more; the latter effect would be more significant.)

### 3. Under Which Regime Would the Optimal Threshold Be Higher?

Observe that, for any given threshold, the mismeasurement costs are less for the regime with a lower nonitemizers' deduction than for the current regime; for any given threshold, the modified regime sets the nonitemizers' deduction to minimize mismeasurement costs whereas the current regime does not.

(Indeed, the current approach sets the nonitemizers' deduction at the point in the range that may maximize equity costs.<sup>51</sup>)

---

<sup>50</sup> To illustrate, suppose that the only issue is accuracy of measurement for equity's sake and the optimal nonitemizers' deduction is, say, equal to the mean of deductions for those in the nonitemizers' group. When one raises the threshold, the pool of nonitemizers grows by adding individuals with relatively high deductions -- higher than those of all individuals originally in the pool. This necessarily increases the mean level of deductions for the nonitemizing group. Because a nonitemizing deduction equal to the mean is assumed to minimize equity costs, it must be that increasing the deduction from its original level (which, as just explained, is now below the new mean) to the new mean must reduce the level of equity costs.

<sup>51</sup> From almost any vantage point, equity costs would probably be maximized at one of the extremes in the range. Because it is probably true that actual

Therefore, confining attention solely to accuracy of measurement, it seems plausible<sup>52</sup> that the optimal level of thresholds would be higher if the modified treatment were used rather than the current treatment. But the incentive effects identified in subsection IV.B increase as the gap between the threshold and the nonitemizers' deduction increases, so it is not clear under which approach the optimal threshold would be higher.

#### B. How Thresholds Should Vary with Income

A threshold's level should vary with income to the extent the relevant costs and benefits of adjusting the threshold vary with income. Except for equity effects, it does not seem plausible that the costs and benefits of the threshold level would vary significantly with income. Notably, compliance and administrative costs associated with an individual taking \$5000 of itemized deductions are likely to be similar regardless of adjusted gross income. (To be sure, individuals with higher incomes are likely to have greater deductions, but for a given deduction amount the costs of recordkeeping, preparation, and audit should be about the same.<sup>53</sup>) In addition, the incentive

---

deductions for nonitemizers concentrate toward the low end, setting the deduction equal to the upper end of the range is likely to maximize mismeasurement.

<sup>52</sup> The claim is qualified because the argument in the text indicates that the total equity costs are lower for the modified approach than the current approach. But in setting the threshold, it is the *marginal* cost that is relevant. Obviously, the marginal and total equity costs under both approaches are zero when the threshold is at zero. Therefore, it is necessarily true that the marginal costs under the modified approach are lower initially and through some range if its total equity costs are lower. But one cannot rule out the possibility that when the threshold becomes sufficiently high, the marginal costs of the modified regime might be higher. (This does not seem likely. When the threshold is high, a large portion of taxpayers are nonitemizers and few are near the boundary between itemizing and not itemizing. The current approach involves marginal equity costs with respect to all nonitemizers whereas the modified approach involves significant costs but only with respect to those who are induced to become nonitemizers.)

effects described in subsection IV.B (which are most pronounced when individuals below the threshold receive treatment less generous than those at the threshold) do not obviously depend on adjusted gross income; they may, however, be more serious for higher-income individuals if such individuals face a higher marginal rate, because the incentive depends on the magnitude of the expected tax savings.

Consider why equity costs are likely to depend directly on the level of income. First, mismeasurement of a given amount probably is less costly to social welfare the higher is the taxpayer's income.<sup>54</sup> Thus, precision is more important for lower-income taxpayers, favoring a lower threshold for them.

---

<sup>53</sup> There are, no doubt, many qualifications, and further empirical evidence might indicate that this conjecture is mistaken. For example, higher-income individuals may have more education and thus find it easier to understand the rules and thus comply with them. On the other hand, such individuals have higher costs of their time, suggesting that their compliance costs would be higher.

Perhaps more significant is the fact that, with our current form of thresholds, compliance and administrative cost savings are marginal whereas the mismeasurement cost concerns all who are not itemizing. This latter group is greater for lower-income groups, suggesting that a lower threshold might be appropriate. On the other hand, if the nonitemizers' deduction is below the threshold, then both the cost savings and mismeasurement costs involve the marginal group -- that which falls below the threshold as a consequence of the threshold being increased -- so it is less clear that the optimal height of the threshold would depend on income on this account.

<sup>54</sup> This does not follow simply from the assumption of diminishing marginal utility of income. Rather, from a utilitarian perspective, it has to do with changes in the rate at which marginal utility falls. It is usually assumed that individuals' utility functions exhibit decreasing absolute risk aversion. This is equivalent to stating that for a risk of a given absolute dollar amount (say, a 10% chance of losing \$1000), a poor person would be willing to pay more to insure against such a risk than a rich person. Taking an ex ante perspective on distributive justice, the equity cost of tax system mismeasurement is given by individuals' risk premiums. (This argument is developed in Kaplow, *supra* note 1, at 4-7.) Bringing in the assumption of declining absolute risk aversion, it follows that the equity cost of errors of a given dollar amount is greater the lower is the taxpayer's true income. (Adopting a perspective more egalitarian than utilitarianism would suggest that the equity cost of random errors is even greater for the poor; in particular, errors that result in overstating the true income of the poor would be most worrisome.)



This argument for a lower threshold for low-income taxpayers should not be disturbing because of its apparent regressive distributive effect. Recall that the height of thresholds, including the standard deduction, should not in principle depend on distributive concerns because one can independently adjust exemptions and the tax rates to make the system more or less progressive.<sup>55</sup> (Thus, if the standard deduction for the rich were increased by \$1000, one might similarly reduce the level of their exemption.<sup>56</sup>) Rather, as argued in Section III, the relevant issue when setting thresholds is the relative treatment of individuals -- in this case, the poor -- with the same adjusted gross income but different levels of deductions.<sup>57</sup> Nonetheless, it seems that much discussion of both the level of the standard deduction and whether it should vary with income is concerned in substantial part with its effect on vertical equity

---

<sup>55</sup> See, e.g., Coven, *supra* note 1, at 1560; Samansky, *supra* note 1, at 551. Stanley Surrey and Gerard Brannon note this point and argue in particular that "the minimum standard deduction is a method of providing the equivalent of a larger personal exemption for taxpayers whose income leaves them very close to the poverty line." Surrey & Brannon, *supra* note 4, at 919. They observe that the difference is that using a standard deduction provides more relief to low-income taxpayers with low itemized deductions than to those with high deductions, and they suggest that this seems defensible in light of their argument that individuals with low itemized expenses have similar nonqualifying expenses. See *id.* at 918-20, discussed *supra* note 27.

<sup>56</sup> Following the logic of Section III, the reduction in exemption level that would be revenue neutral -- in this case, for those with sufficiently high adjusted gross income -- would be less than the \$1000 increase in the threshold. (If the exemption were reduced by \$1000, those who did not previously itemize would be unaffected, but those with higher deductions would have their taxable income increase by \$1000 on account of the lower exemption but would not receive all, or perhaps any, of the benefit of the higher standard deduction.)

<sup>57</sup> Similarly, it would be irrelevant that a given compliance cost borne by the poor may be more deleterious because of the distributional effect, because this too can be taken into account in setting rates and exemption levels. (Also, as suggested in note 53, a given amount of time taken by the poor has a lower opportunity cost than when taken by the rich. One might say that requiring all individuals to spend the same amount of time on tax compliance efforts constitutes a proportional tax -- on ability -- although individuals with a sufficiently high value of time will pay others to do their work for them and thus not bear the full burden of such an implicit tax.)

(and revenue).<sup>58</sup> Finally, observe that if one follows the modified approach under which the nonitemizers' deduction is less than the threshold amount, a higher threshold does not imply substantially lower tax payments (and a higher floor does not imply significantly higher tax burdens) even before adjustments are made.<sup>59</sup>

There is a second reason equity costs may depend on income: if marginal tax rates increase with income, a dollar of mismeasurement in taxable income translates into a relatively greater mismeasurement in assessed tax for higher-income individuals. (The extreme case is that there is no equity cost of mismeasurement for taxpayers who are in the zero bracket regardless.<sup>60</sup>) Thus, if marginal rates jump at a particular income level, one might wish thresholds to fall, in order to reduce inaccuracy.

As marginal rates have become flatter, it seems increasingly likely that the first effect -- indicating that accuracy is more important for low-income individuals -- is dominant. Assume for the sake of argument that accuracy is indeed more important for lower-income taxpayers. (The logic is the same, with the

---

<sup>58</sup> See, e.g., Sunley, *supra* note 18, at 264-65.

<sup>59</sup> To illustrate, suppose that the itemization threshold for the rich were raised from \$5000 to \$10,000, while the nonitemizers' deduction were raised from \$2500 to \$5000. Rich taxpayers with  $D < \$5000$  would have taxable income fall by \$2500. (They do not itemize in either regime, and their nonitemizers' deduction rises by \$2500.) But those with  $\$5000 < D < \$10,000$  would have all get lower deductions. (Previously they itemized and received deductions greater than \$5000; now they do not itemize and receive a deduction of \$5000.) Those with  $D > \$10,000$  would be unaffected.

<sup>60</sup> However, the working poor face positive -- and often steep -- marginal rates because of social security taxes and the phase-out of the earned-income credit. See, e.g., Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. Rev. 983, 1018.

direction of the equity effect reversed, if one makes the opposite assumption.) Then, for a conventional standard deduction or floor, the analysis implies that the threshold should increase with income, as is currently true for floors and was once true for the standard deduction,<sup>61</sup> because higher thresholds involve greater mismeasurement. If mismeasurement is more of a problem for lower-income individuals, it is more important to avoid it for them, suggesting the desirability of a lower threshold.

The rate at which thresholds should increase with income is a very complex question. Most directly, how the threshold should vary with income depends on precisely how equity costs vary with income.<sup>62</sup> It also depends on how much inequity results from the treatment given to nonitemizers. This, in turn, depends on the approach to treatment of nonitemizers, as explored in subsection A. Finally, there is the more familiar factor of how the distribution of deductions changes with adjusted gross income; however, as noted at the outset of this subsection, it is less clear that the relevant components are significantly affected by income, rather than by the amount of deductions that would be claimed.

---

<sup>61</sup> See *supra* note 14.

<sup>62</sup> See *supra* note 54.

## VI. Further Issues

### A. Different Family Units

To simplify the exposition, the analysis has focused on the case in which the taxpayer is a single individual. The basic insights, however, are equally applicable to any family configuration.

Suppose, for example, that the family unit was a married couple (filing jointly). Then the family would receive two exemptions rather than one. As a result, any argument of the form "if one raised the standard deduction by \$1000, consider reducing the exemption by \$1000" must be interpreted as referring to the couple's total amount of exemptions.<sup>63</sup> (Thus, one could reduce one of the exemptions by \$1000 or both by \$500.) This would mean that the value of exemptions might depend on family size, hardly a startling change.<sup>64</sup> The same logic would apply when dependents are included: this would increase the number of exemptions, making it appropriate for the adjustments to be made, say, in only the first exemption.

Standard deductions already depend on the family unit.<sup>65</sup> As with exemptions, different adjustments for different family units

---

<sup>63</sup> Formally, one could simply interpret the variable E in Sections II and III as referring to the taxpaying unit's total value of exemptions; the function T(.) would be that for married couples; and SD would refer to their standard deduction.

<sup>64</sup> After all, most arguments for allowing additional tax exemptions to larger families do not warrant exemptions of equal amounts, and most welfare and social security benefits depend on family composition in a nonlinear manner. Nor would there be any great increase in complexity if the value of, say, the first exemption depended on filing status.

<sup>65</sup> I.R.C. § 163(c)(2).

may be necessary. For example, one might contemplate raising the standard deduction for married couples filing jointly by \$1000 while raising that for singles by \$700. Thus, one would need to decrease exemptions (say, the first exemption) for married couples by more than one decreased the exemption for a single individual.

These adjustments are all mechanical and straightforward. If one made them in the manner described, all the arguments of the preceding Sections would go through.<sup>66</sup> Some of this article's points have particular relevance with regard to the tax treatment of different family units. For example, the analysis suggests that the level of the standard deduction should be determined on grounds of simplification and accuracy in measurement of deductions, not for the purpose of determining the distribution of income. Yet the differences in the standard deduction for different family types are often rationalized on these latter grounds.<sup>67</sup>

---

<sup>66</sup> Currently, the total amount of exemptions is a function of family size alone, the standard deduction depends on the type of unit, and floors depend only on adjusted gross income. As discussed in this subsection and elsewhere in the article, none of these relationships is necessary. Indeed, at one time the standard deduction depended on income. See *supra* note 14.

<sup>67</sup> For example, the relative increase in the standard deduction for an unmarried head of a household in the 1986 Tax Reform Act is grounded in the view that such households have costs closer to that of a married couple than a single individual. See Staff of the Joint Comm. on Taxation, *supra* note 12, at 18-19. This view could better be implemented by adjusting exemptions, unless the difference on costs involves primarily itemized deductions for individuals who would not itemize rather than, say, costs of food and clothing, as seems more plausible.

## B. Which Items Should Be Subject to Thresholds?

None of the analysis in this article depends on which items are subject to a threshold. In principle, some simplification can be achieved by establishing a threshold for any deduction. Moreover, if the threshold is small, the equity cost will be negligible.<sup>68</sup> But having many different thresholds might sacrifice rather than enhance simplicity. For example, taxpayers would need to remember the different thresholds during the year in order to know which records to keep. Perhaps to avoid such complication, there is a single 2% floor on miscellaneous itemized deductions,<sup>69</sup> rather than separate floors for each, and a single standard deduction, as discussed in the next subsection.

The benefit of a floor depends on the context. For example, the floor for casualty deductions probably provides little simplification: few taxpayers suffer large numbers of small casualties. Beyond some de minimus exception (perhaps already captured in the \$100 threshold<sup>70</sup>), it is not clear that much further benefit is achieved. The 10% of adjusted gross income threshold<sup>71</sup> seems far higher than necessary for simplification. Perhaps the current rule reflects either ambivalence about the desirability of the deduction or the need to raise revenue, rather than any coherent view about the purpose of the casualty deduction or belief that great simplification is achieved.<sup>72</sup> By

---

<sup>68</sup> See *supra* note 36.

<sup>69</sup> I.R.C. § 67.

<sup>70</sup> I.R.C. § 165(h)(1).

<sup>71</sup> I.R.C. § 165(h)(2)(A)(ii).

contrast, a floor for medical expenses probably involves nontrivial simplification, as many taxpayers have numerous small expenses, such as co-payments for professional services and purchases of prescription drugs.<sup>73</sup>

Another factor bearing on the desirability of a particular floor is the ease with which taxpayers can control the timing of expenditures across tax years. For example, with charitable contributions, a taxpayer might readily shift most giving into particular years to evade much of the effect of a threshold. Shifting would be more difficult for casualty losses, mortgage interest, and state and local taxes. To the extent shifting occurs, the floor will be circumvented and additional (transactional) complexity will arise. Thus, if such manipulation is particularly easy and many taxpayers have sufficient expenditures to exceed the floor in some years, a threshold would be counterproductive.

---

<sup>72</sup> See *supra* note 12 (criticizing the rationale of permitting deduction of only "extraordinary" losses).

<sup>73</sup> The increase in the floor to 7.5% of adjusted gross income (from the former 3%) is probably motivated by other considerations. Also, with many current health plans, one might imagine that the provider (such as an HMO) could provide a single, end-of-year, computer-generated statement listing all co-payments (including for drug purchases).

A similar argument can be made for a floor for charitable contributions, which often involve many small gifts. Many who propose such a floor cite revenue-raising as an argument (which the analysis in Section III suggests is misguided). Relatedly, it is argued that the incentive effect only matters for marginal contributions, so one need not provide the subsidy for the first few percent of adjusted gross income. See, e.g., Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* 45 (1985) ("Proposals for deduction floors have been supported as ways to maintain incentives to give while reducing the revenue cost of the deduction."). This claim, however, ignores the fact that most individuals give only a modest percentage of adjusted gross income. See *id.* at 16-22. But it may be that most tax-motivated givers are large givers, which might justify a floor if the rationale for the deduction is primarily to offer a subsidy rather than to measure ability to pay accurately. (Of course, if the motive is to offer a subsidy, then a direct subsidy, or at least a credit, might seem more appropriate than a deduction.) See generally Louis Kaplow, *A Note on Subsidizing Gifts*, J. Pub. Econ. (forthcoming 1995).

Floors and the standard deduction have largely been limited to personal deductions rather than business expenses. This may reflect that proprietors and partners need to keep records in any event, to operate their businesses intelligently; a wide variety of expenses, which must be deducted if net rather than gross income is to be taxed, are recorded in a single set of books.<sup>74</sup> Nonetheless, it may be sensible to make an exception for employee business expenses, currently deductible only by itemizers and subject to the floor on miscellaneous itemized deductions,<sup>75</sup> because many employees would not otherwise keep records.<sup>76</sup>

### C. Separate or Group Thresholds

Separate thresholds initially appear preferable because they reflect individuals' circumstances more precisely than do group thresholds. After all, why should one's medical expenses deduction depend on whether one owns a home?<sup>77</sup> When one combines deductions under a single umbrella -- most importantly, with the standard deduction, but also with the floor for miscellaneous itemized deductions -- errors do tend to cancel out. (One taxpayer may have high medical expenses but few charitable contributions; another may have the reverse.) But such cancellation is far from complete.<sup>78</sup> For example, many who do

---

<sup>74</sup> Indeed, it might complicate rather than simplify bookkeeping if each expense had to be categorized for the purposes of determining whether the expenses in each category were above a floor. Also, the potential for evasion of such thresholds might be great.

<sup>75</sup> I.R.C. § 62(a)(1) (implicitly referred to in I.R.C. §§ 63, 67).

<sup>76</sup> In addition, employees would be less likely to understand the rules (due to a lack of economy of scale), and one might expect substantial errors (which would tend to be favorable to the taxpayer).

<sup>77</sup> See, e.g., Samansky, *supra* note 1, at 548.



not itemize no doubt have few deductions of any kind.

The main virtue of grouping items, noted in subsection B, is the further simplification in not having to keep track of a large number of thresholds. In addition, there is less need to determine the category of particular expenses, because some expenses will be treated the same way regardless of which of two categories they are in. These arguments do seem compelling for many items included as miscellaneous itemized deductions, but the arguments are weaker for the major itemized deductions. First, casualty and medical expenses already have their own floors that must be understood and applied by those who itemize. Second, distinguishing categories is hardly difficult: charitable contributions, mortgage interest, medical expenses, and property taxes are easy to distinguish, and it would be difficult to manipulate classifications. Third, some items involve little recordkeeping. This was already noted for casualties; the same is probably true for mortgage interest and state and local tax payments.<sup>79</sup>

---

<sup>78</sup> If one clustered two items for which taxpayers had the same distribution of expenses and there were a perfect negative correlation, errors would cancel completely. If there were a perfect positive correlation, separate equal thresholds would result in the same treatment as a single threshold for the cluster at twice the level. For intermediate cases, there would be partial canceling of mismeasurement. (Some items -- notably property tax payments and the mortgage interest deduction -- are positively correlated. Others -- like medical expenses and charitable contributions -- presumably have very little correlation, holding adjusted gross income constant.)

<sup>79</sup> For a time, individuals were permitted to deduct part of their cost of medical insurance without regard to the floor, Pub. L. No. 89-97, § 106(a) (1965), 79 Stat. 336, 337, and there is currently such a provision for self-employed individuals, I.R.C. § 162(1). Treating medical insurance differently does have some justification: because it involves a single, large payment (or at most a few) and is readily distinguished from other expenditures in the category, one can permit it to be deducted without sacrificing the benefits of simplification with respect to the many small expenditures. (The rationale for permitting deduction of medical insurance also may differ from that for expenses directly paid. See Kaplow, *supra* note 27. Relatedly, permitting a separate deduction for insurance -- which is implicitly allowed to employees

Grouping also entails a potentially significant cost to simplification: if a taxpayer's expenses on any subset of items in the group are high, one loses simplification benefits with respect to the rest of the group. This is, therefore, a reason for having floors on individual items within the group, as with medical expenses, casualty losses, and miscellaneous itemized deductions.

#### D. Income Thresholds

The analysis has considered deduction thresholds, but it also has some relevance to income thresholds. For example, individuals need not file a self-employment tax return if their self-employment income is under \$400.<sup>80</sup> And domestic employers need not pay social security taxes if wages paid are below a threshold.<sup>81</sup> The simplification rationale and equity costs from these provisions are qualitatively similar to those noted for deductions.<sup>82</sup>

---

for employer-provided coverage, I.R.C. § 106 -- distorts insurance purchasing decisions toward policies with more complete coverage and lower deductibles and coinsurance than otherwise would be chosen.)

In the early 1980's, there was also a provision allowing an above-the-line deduction to nonitemizers for portions of charitable contributions. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 121(a), 95 Stat. 172, 196 (repealed 1986). Because most nonitemizers probably had numerous small contributions, the cause of simplification was hardly served by this measure. (Moreover, in all but the last year that the provision was in force, the benefit provided was partial -- only a 25% deduction with a maximum of \$25 in the first two years.) See also *supra* note 73 (discussing rationale for charitable contribution deduction).

<sup>80</sup> I.R.C. § 6017. Yet we require such individuals to report their income in any event, requiring in some cases that a tax form be filed -- although separate thresholds apply here -- and, in that event, to keep the necessary records to determine net income. Once this effort has been made, it is not that difficult also to calculate the self-employment tax.

<sup>81</sup> I.R.C. § 3121(a)(7)(B).

<sup>82</sup> The analysis is more complicated for the employer because the incidence of the tax may be on the employee. See also *infra* note 83.

Many income thresholds for payment of taxes, such as the two just mentioned, treat individuals just below the threshold significantly differently from those at the threshold: those below the threshold are treated as though income earned or wages paid were zero.<sup>83</sup> The reasons for this vary. To spare an employer the effort of filing returns, treatment must be as if no wages were paid. But it is hardly necessary that an individual who does not complete the self-employment tax form pay a tax of zero; one could require such individuals to pay some fixed amount. And, in both cases, one could simulate the deduction thresholds by adjusting treatment for those above the income thresholds, by allowing the threshold amount to escape taxation. The analysis in Part IV suggests that the current approach of treating those just below the income thresholds much more favorably than those at the threshold may be inappropriate -- even more so than the opposite extreme, reflected in the standard deduction and floors, of treating all those below the threshold as if they were at the threshold.<sup>84</sup>

#### E. Other Approximations

Thresholds are not the only formulaic simplifications in the Internal Revenue Code.<sup>85</sup> For example, the Code provides

---

<sup>83</sup> For employment taxes, the employee still owes the tax, but often it will not be paid, so de facto exemption is involved.

<sup>84</sup> The treatment provided by these income thresholds creates perverse incentives -- those just above the floor receive a significant benefit if they change their behavior so that they are just below it -- in addition to causing large measurement error.

<sup>85</sup> The Code also provides for ceilings or phase-outs for many deductions and credits, such as for individual retirement account contributions, I.R.C. § 219, and child care expenses, I.R.C. § 21, but the rationales are usually entirely different from simplification; often, such provisions limit relief to

depreciation schedules rather than determining depreciation case by case.<sup>86</sup> Regulations provide for deduction of automobile travel expenses at a standard mileage rate. Such provisions do involve a trade-off of simplification and accurate measurement, but the nature of the trade-off differs in important ways from the trade-off with thresholds. Notably, there is not a group with high income or expenses for whom accurate measurement is attempted; rather, all are subject to the simplification.

## VII. Conclusion

The ideas in this paper can be summarized as a number of guidelines for tax policy makers concerned with the standard deduction, floors, and other income and deduction thresholds.

1. Rules in the form of a standard deduction, which provides deductions that exceed nonitemizers' actual deductions, can be used interchangeably with rules in the form of floors, which limit deductions to amounts in excess of the threshold. Thus, the choice between these types of thresholds should be made to facilitate taxpayers' comprehension. One should not be misled by the apparently generous treatment of nonitemizers under the standard deduction in contrast to the harsher treatment of deductions when they are limited by a floor.

---

low- or middle-income groups or moderate their levels, which may implicitly involve hidden increases in marginal tax rates.

<sup>86</sup> I.R.C. § 168. The simplified form allowed in § 179 is systematically more generous than accurate depreciation and thus embodies a further subsidy as well. (It would have been almost as simple to allow a single, immediate, but partial deduction equal to the present value of deductions that might otherwise be available under § 168.)

2. The only inherent effects of thresholds, whatever the form, are on simplification and on the relative treatment of those below the threshold and those above the threshold -- holding adjusted gross income constant. There is no inherent effect on revenue or on the overall distribution of income, as these can be varied independently by adjusting exemption levels and rates. Thus, when deciding whether to use thresholds and how high to set them, progressivity and deficit reduction are best ignored. If one insists on raising taxes without raising tax rates, one can tinker with exemption levels; similarly, exemptions allow all the flexibility necessary in determining the level of income at which the income tax will begin requiring payments to be made.
3. It may not be appropriate to treat individuals below the threshold equally to those at the threshold. After all, the average level of deductions for those who, say, take the standard deduction is substantially lower than the level for those who itemize and have deductions totaling little more than the threshold. Although considerations of equity may favor much less generous relative treatment of those below thresholds, such treatment may produce undesirable incentive effects.
4. Focusing on simplification and accurate measurement of income -- rather than on revenue and the overall distribution of income -- affects how thresholds should be set and how, if at all, they should depend on income. This

perspective is also relevant in determining which items should be subject to deduction thresholds and income thresholds. Many current provisions may be sensible, but not all appear to be rational and there may be significant room to expand the use of thresholds in the income tax.<sup>87</sup>

---

<sup>87</sup> Except for filing requirements, thresholds are not often used on the income side. But it may be worthwhile, for example, to allow the exclusion of interest and dividends in small amounts. Perhaps this problem solves itself: individuals may simply refrain from reporting small income items, while the Internal Revenue Service may not bother to audit such returns or pursue such items on audit. The incentives for deductions are different than for income items because taxpayers are willing, in principle, to spend up to \$9.99 in resources and effort to save \$10.00 in tax. Because such incentives are likely to be socially excessive, see Kaplow, *supra* note 1, at 14-20, thresholds may be more important on the deduction side.