



tax notesSM

Volume 47, Number 12 • Monday, June 18, 1990

SPECIAL REPORTS	A Different Perspective on the Bubble	1483
	Why Partnerships Should Recognize Certain Gains ..	1487
	Deducting Interest Paid to Foreign-Related Parties ..	1494
	NYSBA Offers Ideas on Sec. 163(j) Regs.	1495
BENEFITS	House Panel Unhappy With ERISA Enforcement	1407
	Stark To Propose Tax Bill for Health Care	1409
	Employee Reimbursement Regs. Said To Favor Feds ..	1411
THE BUDGET	Senate Budget Resolution No Help to Summit	1412
FROM CONGRESS	Senate Ethics Committee Hears Durenberger Case ...	1413
	Climate Said To Be Warm for Passage of Carbon Tax ..	1415
INTERNATIONAL	Senate Panel Examines Seven Tax Treaties	1418
	Stalled U.S.-F.R.G. Treaty Gains in Bundestag	1420
	Where Subchapter C Meets Foreign Provisions	1422
TAX POLICY	Graetz Sees Little Change in 'Tax Process'	1424
	Sequel to Disney: du Pont Co. Close to Sec. 249 Line ..	1426
IRS NEWS	Lookback Accounting for Long-Term Contracts	1433
VIEWPOINT	Financing Options for Long-Term Health Care	1515
	What Degree of Progressivity Do We Want?	1517
	The Tax Bubble Is More Than an Illusion	1521
LETTERS	IRS Not To Blame for Alex Council's Suicide	1519
	'Missing the Point' on the Crane Rule	1519
	Let Sleeping Carryover Basis Lie	1520

DEPARTMENTS

Calendar	1534	International Tax News	1473
Congressional Record	1531	Labor Department News	1518
Congressional Roundups	1528	Letters to the Editor	1519
Court Opinions	1463	Press Watch	1529
Economic Perspective	1515	Recent Tax Articles	1428
Fiscal Facts and Figures	1525	Special Reports	1483, 1487, 1494, 1495
Focus on the IRS	1441	State Tax and Budget Actions	1479
Focus on Treasury	1429	State Tax News	1518
GAO Reports	1443	Summary of Contents	1402
Internal Revenue Bulletin	1445	Tax Accounting News	1477
Internal Revenue Manual	1442	Tax Politics	1517
IRS Letter Rulings	1449	This Week's Tax News	1405
IRS Regulations	1433	Viewpoint	1521
IRS Tech Advice Memos	1447	Washington Roundup	1524



YES, THE BUBBLE REALLY EXISTS

by Steve Charnovitz

Steve Charnovitz is a Legislative Assistant on the Democratic Steering and Policy Committee, U.S. House of Representatives. The views expressed here are those of the author only.

Viewpoint is open to any person who wishes to express an opinion on tax or fiscal policy. It is our hope that the opinions expressed in this column will contribute to the development of a sound and administrable system of taxation. Please address submission to the editor.

In the years before he became President, Ronald Reagan was fond of criticizing the progressive income tax as the "invention of Karl Marx." Following this belief, President Reagan sought to reduce progressivity in the tax code and succeeded in lowering the rates on the highest income earners from 70 percent to 28 percent.

The significance of these changes becomes clearer when it is recalled that from the very beginning, the U.S. income tax has adhered to the principle of progressivity. The first income tax of 1862 imposed a tax of three percent on incomes below \$10,000 and a tax of five percent on incomes above \$10,000. The 1913 tax, which began the current system, instituted graduated rates from one to seven percent. The top bracket began at \$500,000.

While the compression of graduated rates during the 1980s represented a major change in tax principles, the most radical change may have been the introduction of regressive marginal rates on high incomes in the Tax Reform Act of 1986. This new feature, commonly called the "bubble," imposes a lower marginal rate (28 percent) on the highest-income taxpayers than it does on the upper-income taxpayers who are in a 33 percent bracket.

During the past year, the bubble has been the focus of increasing attention and debate. The polls suggest that the public is strongly opposed to the drop-off in the 33 percent rate, and would support legislation to fix the bubble as part of a comprehensive fiscal reform.

Because the bubble was the by-product of a complicated compromise, no one defends the provision on equity or efficiency grounds. Until recently, the argument against fixing the bubble relied either on the agreement that the Tax Reform Act would not be tinkered with or on the promise that "no new taxes" would be imposed. Now

that taxes may be considered in the ongoing deficit reduction talks, a new argument against correcting the bubble is sprouting. This revisionist view holds that the bubble is not really regressive.

In terms of marginal tax rates, everyone agrees that there is a bubble. Consider these examples based on 1989 rates: A family of two earning \$31,000 pays a marginal tax of 28 cents for each additional dollar of income. A better-off family earning \$75,000 pays a marginal tax of 33 cents for each additional dollar. But at the top, a family earning \$178,000 pays a lower marginal tax of only 28 cents per dollar.

The new argument against the bubble is that progressivity should be judged not by marginal rates but by average (or effective) rates. Although marginal rates may rise and fall in the bubble, average rates—it is claimed—continue to rise right through the bubble. Viewed in this way, the current tax system remains "progressive" up to the end of the bubble (after which the tax rate flattens out at 28 percent).

The new argument against the bubble is that progressivity should be judged not by marginal rates but by average (or effective) rates.

A sample of recent op-eds, articles, and editorials in the press shows the influence of this revisionist perspective. From a *Wall Street Journal* op-ed: "There is no lower-bracket loophole for the 'rich.' The 'rich' pay a higher effective rate than do the middle-class taxpayers subject to the bubble. In fact, the bubble actually augments the progressivity of the tax code."

From a *Washington Times* op-ed: "...there is no tax advantage to being in the higher income groups." "... Thus, the whole 'unfairness' argument now being used by the Democrats is specious, and they know it."

From an article in *The Washington Post*: "As a result, upper-middle income earners are taxed at a higher marginal rate than the richest taxpayers (although richer taxpayers still pay a higher average rate)."

From an article in *the National Journal*: "The wrong conclusion that many have leapt to is that those only-relatively-well-to-do people in the bubble pay higher effective tax rates than do those with the greatest wealth. In fact, effective tax rates rise gradually from 0 to 28

VIEWPOINT

percent, with those of greater income steadily paying more."

From an editorial in *the New York Times*: "People make too much of the bubble. Even with it, the rich still pay higher taxes."

From an editorial in *The Wall Street Journal*: "Mr. Rostenkowski is exploiting a widespread confusion over the difference between average tax rates and marginal rates. As the table shows, no one pays an average individual tax rate above 28 percent."¹

The idea that the bubble is just a "delusion" can be traced, at least in part, to an analysis done by Byrle M. Abbin several months ago in *Tax Notes* (October 2, 1989). Mr. Abbin characterizes as "erroneous" the impression that the "33 percent taxpayers pay a higher percentage of their income to the government than do those with more income." To prove this point, he presents three examples based on 1989 rates: For a family (of two) earning \$50,000 before personal exemptions, the tax would be \$8,864, for an average of 17.7 percent. For a family earning \$150,000 before exemptions, the tax would be \$40,414, or 26.9 percent. For a family earning \$250,000 before exemptions, the tax would be \$70,000, or 28.0 percent.

The idea that the bubble is just a 'delusion' can be traced, at least in part, to an analysis done by Byrle M. Abbin several months ago in Tax Notes.

Clearly, Mr. Abbin's data are correct. But they are the right answer to the wrong question. In calculating average rates, Mr. Abbin looks at taxes owed (Form 1040, Line 38) as a percentage of Adjusted Gross Income minus Deductions (Form 1040, Line 35). This choice of a denominator is critical because it directly affects whether average tax rates appear to be progressive.

Had Mr. Abbin chosen a different denominator—say, Taxable Income (Form 1040, Line 37)—the results would have looked very different. For a family of two earning \$50,000 before personal exemptions (and \$46,000 after exemptions), the tax would still be \$8,864, for a new average rate of 19.3 percent of taxable income. For a family earning \$150,000 before exemptions (and \$146,000 after), the tax would be \$40,414, for a new average of 27.7 percent. For a family earning \$250,000 before exemptions (and \$246,000 after), the tax would be \$70,000, for a new average of 28.5 percent.

A full projection of average tax rates calculated in this way disproves the suggestion that the bubble is some kind of mirage. In fact, it shows that not only is there a bubble in marginal rates, but there is also a corresponding bubble in average tax rates. For example, a family of two with taxable income of \$100,000 would pay 25.2 percent

of it in taxes. With a taxable income of \$250,000, that family would pay 28.4 percent. With a taxable income of \$500,000, that family would pay only 28.2 percent. (See Table 1)

When they are graphed, the average tax rate bubble differs from the marginal tax rate bubble in three important respects. First, the apex of the average rate bubble varies with the number of exemptions. With two exemptions, the bubble peaks at 28.6 percent (at an income of \$177,720). With four exemptions, it peaks at 29.1 percent (at an income of \$200,120). With six exemptions, it peaks at 29.5 percent (at an income of \$222,520). The apex of the average rate bubble will always occur at the end of the marginal rate bubble — that is, where the 33 percent marginal rate drops back to 28 percent. (In technical terms, the average rate crosses the 28 percent point at the income level where the benefits of the 15 percent marginal rate are fully phased out. This is the income shown in the Tax Rate Schedule above which a computation using the worksheet is required.)

A second difference is in the shape of the bubble. The marginal rate "bubble" is actually a rectangle. The rate is either 28 or 33 percent, but nowhere in between. By contrast, the average rate bubble is a continuous curve that becomes hyperbolic in shape after it peaks.

Table 1

Average Tax Rates			
(Family of Two, 1989 Rates)			
Table Income	Tax	Average Tax	
\$25,000	\$3,754	15.0%	
\$50,000	\$9,977	20.0%	
\$74,850	\$16,935	22.6%	Beginning of bubble
\$100,000	\$25,234	25.2%	
\$155,320	\$43,490	28.0%	Exactly 28%
\$177,720	\$50,882	28.6%	Peak average rate
\$250,000	\$71,120	28.4%	End of bubble
\$500,000	\$141,120	28.2%	

A third difference is that while the marginal rate plunges abruptly, the average rate declines slowly. This means that no matter how high one's income goes, the average rate never falls as low as 28 percent. (In technical terms, the hyperbola approaches the 28 percent rate asymptotically from above.) For instance, at an income of \$10,000,000, a family of two would have a tax rate of 28.01 percent.

Let me summarize. The Abbin view alleges that even though marginal rates rise to 33 percent and then fall to 28 percent, average rates continue to increase throughout the bubble. The alternative view suggested here is that just as marginal rates rise and fall, so too do average rates. Which view is right? The answer depends on what denominator is used in the equation to calculate average tax rates. Mr. Abbin uses Adjusted Gross Income minus Deductions. The analysis here uses Taxable Income.

So which denominator is correct? Making this judgment requires a brief detour to the theory behind the bubble. Under the Tax Reform Act of 1986, the 33 percent marginal rate is imposed in two steps. First, starting at a

¹Byrle M. Abbin, "Don't Pop the Bubble," *The Wall Street Journal*, May 15, 1990. Warren Brooks, "Bursting the Bubble," *The Washington Times*, May 31, 1990. "On Deficit Negotiators' Table, Menu List Billion-Dollar Entrees," *The Washington Post*, May 13, 1990. "Tax Bubble Confuses Many Members," *National Journal*, April 7, 1990. "New Taxes Without Fear," *The New York Times*, May 27, 1990. "Rosty's Bubble," *The Wall Street Journal*, March 14, 1990.

certain income level—the beginning of the bubble—the taxpayer gradually begins to “lose” the benefit of the 15 percent marginal rate on the first dollars earned. When this phaseout is complete, the full tax is exactly 28 percent of taxable income.

In the next step, the taxpayer gradually begins to “lose” the benefit (i.e., the zero percent tax rate) of his personal and dependent exemptions. There are two ways to look at this. One way (Mr. Abbin’s) is that taxes go up because more income becomes taxable. The other way is that taxes go up because the rate climbs from 28 to 33 percent in order to recapture the benefit of the exemptions.

The case for the Abbin approach is that Taxable Income (Line 37) is not inclusive enough. Taxable income should be viewed as a variable rather than a fixed amount which can include all or part of the exemptions. While nominally exempt, these exemptions can become “taxable” for high-income taxpayers. Thus, in Mr. Abbin’s view, the unnamed Line 35 becomes the appropriate denominator for calculating average taxes.

The case for the approach offered here is that it is better to do the analysis with the statutory definition of “taxable income” (26 USCA section 63(a), 63(d)(2)) because that is, after all, the figure that is used to calculate tax liability. It may seem as though Personal Exemptions become taxable, but actually high-income taxpayers continue to derive full benefit from these exemptions (as Line 36 shows). They just pay a greater tax rate on the rest.

Many of those who have been influenced by the hybrid formula introduced by Mr. Abbin may be unaware that it is not the traditional formula used in economics. Consider these definitions from popular public finance textbooks: “The relationship between the bracket (marginal) and average rates shown in the table is a purely mechanical one. Both relate to taxable income as base.”² The average tax rate is “computed by dividing total tax liability by total net income subject to tax.”³ An effective tax rate is defined as the “actual taxes paid, divided by the taxable base.”⁴ “The average tax rate is computed by dividing the tax bill or tax liability by the tax base, either adjusted gross income or taxable income.”⁵

²Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, Second Edition, Page 235.

³Wayland D. Gardner, *Government Finance: National, State, and Local*, Page 198.

⁴David Hyman, *Public Finance*, Page 667.

⁵James Buchanan and Marilyn Flowers, *The Public Finances: An Introductory Textbook*, Page 223.

(Using AGI or the broader “economic income” as the denominator for calculating effective rates is the best way to measure the progressivity of a tax system. Of course, both of these methods require empirical data on the amount of average deductions. Mr. Abbin does not use such an approach. His approach is purely mechanical using AGI minus deductions.)

So which denominator is correct? While I would not argue that Mr. Abbin’s method is wrong, I would argue that the traditional method using a fixed definition of taxable income is more sound. Individuals pay taxes based on their taxable income. If they are in the bubble, they face a tax rate of 33 percent—the normal 28 percent plus the added five percent recapture (26 USCA section 1(g)(1)). Furthermore, it should be noted that the unnamed Line 35 which Mr. Abbin depends upon is an intermediate calculation which itself is useless for determining tax liability.

The popular case against the bubble remains perfectly valid. It causes a serious inequity which cannot be solved by definitional gymnastics.

Because the methods relied upon in the revisionist interpretation are neither the best way nor the traditional way to analyze the bubble, the popular case against the bubble remains perfectly valid. The bubble is real. It causes a serious inequity which cannot be solved by definitional gymnastics.

The best solution to the bubble would be to apply progressive tax rates to the highest-income earners—those “above” the bubble. At present, their marginal rate drops to 28 percent and remains flat. Their average rate is slightly regressive, falling from about 29 to 28 percent. (Using the Abbin method, their average rate is a flat 28 percent.)

The beginning of wisdom on income tax progressivity comes not from Karl Marx, but from the fountainhead of modern economics, Adam Smith. In his *Wealth of Nations*, Smith wrote: “It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion.” The issue of how to reinstitute tax fairness above the bubble is complicated enough. Let’s not make it harder by denying that the bubble exists.

THE NATURAL RESOURCES TAX REVIEW

The Natural Resources Tax Review, edited by Frank M. Burke, Jr., a noted oil and gas tax practitioner, provides timely and insightful commentary on oil and gas, hard mineral, and timber taxation. It also provides the full-text documents needed by professionals working in natural resources taxation. Published six times a year to keep you current.

For free sample copies please call (800) 336-0439. In the Washington, D.C. area call 532-1850.



tax notesSM

Volume 48, Number 1 • Monday, July 2, 1990

SPECIAL REPORTS	What To Do About Social Security Surpluses	83
	Restructuring the Over-Leveraged Company	91
THE BUDGET	Bush Flips Lips on Need for New Revenues	7
FROM CONGRESS	Treasury Suggests Revisions to Estate Freeze Bill	14
	Rostenkowski Proposes Creating 25 Enterprise Zones ...	17
	Dole Serves Warning on Alcohol Fuels Credit	25
	Small Businesses Ask Relief on Social Security Tax	19
TAX-EXEMPTS	GAO Takes Aim at Hospitals Over Charitable Care	18
BENEFITS	Snag in Child Care Conference Attributed to Summit ...	20
	By Any Other Name, Simplification Still Difficult	21
CORPORATE	Has Goldberg Found a Way To Privatize Reg. Writing? ..	24
INTERNATIONAL	Budget Woes Force Puerto Rico To Rethink Tax Reform ..	75
STATE TAXES	N.J. Lawmakers Vote Tax Hike on Top-Bracket Filers ...	80
SUPREME COURT	Unconstitutional W.Va. Tax Ordered Refunded	57
VIEWPOINT	Using the Tax Code To Encourage Charitable Giving ...	113
	Jenkins Case Illustrates 'Legislative Underreaching' ..	115
	The Bubble's Common Denominator	117
LETTERS	Regulation Writers Have a 'Secret Mantra'	120

DEPARTMENTS

Calendar	126	IRS Regulations	35
Congressional Hearings	125	IRS Tech Advice Memos	45
Congressional Record	123	International Tax News	73
Congressional Reports	82, 125	Letters to the Editor	120
Congressional Roundup	114, 116	Press Watch	121
Court Opinions	57	Recent Tax Articles	29
Economic Perspective	113	Special Reports	83, 91
Focus on the IRS	39	State Tax and Budget Actions	79
Focus on Treasury	31	Summary of Contents	2
GAO Reports	112	Tax Accounting News	77
Index	128	Tax Politics	115
Internal Revenue Bulletin	43	This Week's Tax News	5
Internal Revenue Manual	40	Viewpoint	117
IRS Letter Rulings	45	Washington Roundup	82

unfair—it adds progressivity to a two-rate, and what eventually becomes a flat-rate tax structure at the top of the heap. If Congress wants the tax system to be more progressive, to have more than two brackets, and/or to raise more revenue from income taxes, that is an entirely separate issue. Mr. Charnovitz, at least, is willing to express his true purpose in writing: "... apply progressive tax rates... above the bubble." But as Senator Bradley

stated: "Unfortunately, many people believe—incorrectly—that taxpayers subject to the 33 percent rate are being treated unfairly compared to higher income taxpayers whose top marginal rate is 28 percent." In joining Sen. Bradley and other observers, all I ask is that others in Congress be as forthright and not hide behind the populist slogan—"the bubble-is-unfair"—if their real agenda simply is to increase taxes!

Charnovitz' Response

The detailed analysis in Mr. Abbin's reply underlines the thesis of my article. To reach the conclusion that the bubble is "not unfair," one must ignore the normal procedures for calculating average tax rates and instead devise a new method.

As I stated in my article, there is something to be said for the method Mr. Abbin uses. The point I wanted to make, however, is that most of the audience for the "ever-expanding Verity Squad" is probably unaware that the Squad's argument depends upon a new definition of "taxable income"—an uncommon denominator, if I may say so.

Most of the audience for the 'ever-expanding Verity squad' is probably unaware that the Squad's argument depends upon a new definition of 'taxable income'....

Mr. Abbin alleges "technical flaws" in my analysis, but nowhere does he dispute the data I present which show that the bubble exists for average rates as well as marginal rates. Instead, he claims that the traditional method for computing average rates—which I follow—is now "irrelevant."

Mr. Abbin does not dispute that the IRS defines Taxable Income, on Line 37, as Adjusted Gross Income minus deductions and exemptions. Instead, he contends that "section 1(g) [of the IRC] modifies sections 63(a) and (d) in defining taxable income." As an economist, I will have to leave that contention to the lawyers. But it does seem to me that there is an important difference between (1) taking away an entitlement to a personal exemption and (2) applying a five percent surtax (on "taxable" income) equivalent to the tax benefit one derives from a personal exemption. The 1986 TRA does the latter, but not the former.

Mr. Abbin has been caught switching definitions without a permit. He has now owned up to it, but argues that his new definition represents "the most appropriate tax base." For the reasons I discussed in my article, I disagree. But

continued caviling over definitions detracts from what is really the heart of the issue.

If the 33 percent rate did not exist, a simple two-bracket tax system would be progressive in terms of average rates. While there would be only a slight degree of progressivity for taxpayers in the 28 percent bracket, this progressivity would continue to increase very gradually with rising incomes.

It is true, as Abbin states, that the 33 percent marginal rate adds progressivity. But it does so only for those taxpayers "in" the bubble. If one graphs average tax rates for this group, the slope would be steeper as a result of the 33 percent marginal rate than it would have been in the absence of such a rate. The slope is greater because the top average rate goes at least as high as 28 percent (in both methods of calculation).

What is not true, however, is the suggestion that the bubble enhances progressivity for all taxpayers. In fact, for taxpayers "above" the bubble—that is, for very high-income taxpayers facing a 28 percent marginal rate—the step down in marginal rates from 33 to 28 percent eliminates progressivity increasing average tax rates. If one graphs average tax rates for this group, the slope would decline gradually as income increases. Using Abbin's method, the slope would be flat. Thus, all progressivity vanishes above the bubble regardless of the denominator used to calculate average tax rates.

Moreover, the 15-28-33-28 percent marginal rate structure does not provide more progressivity above the bubble than a 15-28 percent marginal rate structure would have offered. With a 15-28 percent structure, the higher the income, the higher the average rate. With a 15-28-33-28 percent structure, the higher the income, the lower the average rate. (Using Abbin's method, the average rate remains flat no matter how high the income.)

Finally, in response to the second paragraph in Mr. Abbin's article wherein he questions my attribution of the word "delusion," let me quote Mr. Abbin's op-ed in the *Wall Street Journal* of May 15, 1990: "Democratic leaders are entering the summit claiming that they are determined to pop the bubble in the name of fairness and simplicity by extending a 33 percent tax rate that allegedly falls on middle-income taxpayers to the 'rich.' But intentional or not, this is a delusion." His word, not mine.

THE EXEMPT ORGANIZATION TAX REVIEW

EVERY CURRENT TAX DEVELOPMENT REPORTED MONTHLY
YOUR COMPLETE SOURCE OF EO TAX INFORMATION FOR ONLY \$295 PER YEAR

SUBSCRIBE TODAY BY CALLING (800) 247-9635

FIND OUT FOR YOURSELF WHY LEADING EO TAX PRACTITIONERS SUBSCRIBE TO THE EOTR.
IF NOT SATISFIED AT ANY TIME WITHIN THE FIRST SIX MONTHS OF YOUR SUBSCRIPTION,
YOU MAY CANCEL AND RECEIVE A FULL REFUND, NO IF'S, ANDS, OR BUTS!