The Income Tax and the Costs of Earning a Living

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I. INTRODUCTION

Financial advisers tell clients planning their retirements that they can maintain their standard of living in retirement with only a fraction of their preretirement gross income—usually somewhere between 60% and 90%.

They also warn married couples that the net financial gain from being a two-earner rather than a one-earner couple can be surprisingly small.

In both cases, the explanation is that with work come expenses, including commuting, clothes for work, food at work, the Social Security wage tax, and the need to save a portion of income for retirement.

An income tax system founded on ability-to-pay principles should include some sort of earned income allowance to measure the net incomes of workers more accurately. The allowance would reflect the facts that (1) any given salary earned by a worker represents a lesser ability to pay tax than the same dollar amount received by a retiree,

and (2) any given combined earnings of a two-earner couple represents less ability to pay than the same amount earned by a one-earner couple. In fact, however, the U.S. income tax falls far short of appropriately reflecting the costs of earning a living. Although there is a

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1 E.g., Am. Sav. Educ. Council, The Power to Choose, at http://www.ascc.org/apecpwr3.htm (last visited Sept. 22, 2002) (suggesting that 60% to 80% of preretirement earnings is a reasonable estimate); Dept of Labor, Top 10 Ways to Prepare for Retirement, at http://www.dol.gov/pwba/pubs/top10text.htm (Aug. 1997) (reporting that 70% of preretirement income will suffice for most people, but that low-wage earners may need 90% or more).

2 See Sandra L. Hanson & Theodora Ooms, The Economic Costs and Rewards of Two-Earner, Two-Parent Families, 53 J. of Marriage and the Family 622, 631 (1991) (finding that a wife's work-related expenses offset, on average, 68% of her earned income for wives of high-income husbands, 56% for wives of middle-income husbands, and 46% for wives of low-income husbands; see generally Linda Kelley, Two Incomes and Still Broke? (1996) (estimating the costs and benefits of being a two-earner couple, and suggesting that the costs often outweigh the benefits).

3 Or by a member of the idle rich, although the idle rich are few compared to retirees.
very limited credit for work-related child care expenses,\textsuperscript{4} and more
generous deferral provisions for retirement savings,\textsuperscript{5} other basic em-
ployment-related expenses are nondeductible,\textsuperscript{6} as is the Social Secu-
ity wage tax. There is even an important adjustment \textit{in the wrong direction}: taxpayers 65 years of age or older (typically but not neces-
sarily retired) receive an additional standard deduction of $900.\textsuperscript{7}

The purpose of this Article is to examine the case for a universal earned income allowance (EIA). Section II responds to an influential
critique by Boris Bittker of the concept of a universal EIA, and ex-
plains in broad outline how an EIA would work. Section III considers
in some detail the issues involved in designing a universal EIA, includ-
ing the expenses the EIA should take into account and the formula
that would achieve the fairest approximation of those expenses. This
discussion relies heavily on empirical data concerning the typical size
of work-related expenses at different income levels. Section IV
briefly considers economic efficiency implications of the EIA propo-
sal. Section V describes and evaluates precedents of various sorts, in-
cluding: an EIA briefly in effect in the federal income tax in the
1920's and 1930's; the two-earner deduction that existed from 1981 to
1986; the current, decidedly nonuniversal, earned income tax credit
(EITC); the EIA for purposes of determining eligibility for federal
college loans; and allowances for work-related expenses in the income
tax systems of Japan, France, and (formerly) Canada. Section VI is a
conclusion.

II. Critique and Response

Although the issue of an EIA for secondary earners in marriages
has received considerable academic\textsuperscript{8} and even legislative\textsuperscript{9} attention, as

\textsuperscript{4} IRC § 21 (providing for a credit, at the rate of 20\% for most taxpayers, for up to
$3,000 (one child) or $6,000 (two or more children) of work-related child care expenses); see also § 129 (excluding from income up to $5,000 received from an employer pursuant to a dependent care assistance program).

\textsuperscript{5} IRC § 219 (individual retirement accounts), §§ 401-420 (employer-sponsored pensions and individual retirement accounts).

\textsuperscript{6} See Section III.A for a taxonomy of work-related expenses and for descriptions of the
income tax rules governing the various types of expenses. A few categories of work-re-
lated expenses are deductible as so-called miscellaneous itemized deductions, subject to
the 2\% of AGI floor, IRC § 67, but even this limited deductibility is not generally available
for the three types of expenses described in Section III.A.

\textsuperscript{7} IRC § 63(f)(1)(A); Rev. Proc. 2001-59, § 3.07, 2001-2 C.B. 623, 626 (inflation adjustments
for 2002). For an argument for repeal of the additional standard deduction, see
Jonathan Barry Forman, Reconsidering the Income Tax Treatment of the Elderly: It's
Time for the Elderly to Pay Their Fare Share, 56 U. Pitt. L. Rev. 589, 601, 616-17 (1995).

has the EITC for low-wage workers, the possibility of a universal EIA has received almost no attention. The only significant discussion of an EIA in the last three decades, by Boris Bittker in 1975, was so negative that it may have discouraged further consideration. Proposals for a two-earner deduction for married couples were then in the air, and Bittker criticized those proposals on the ground that “the concept of an earned income [allowance] solely for two-job married couples is curiously narrow,” because everyone who is employed commutes, wears clothes at work, eats at work, and has less time to keep house and cook. Although this observation would seem to support a universal EIA, Bittker argued it did not, because a universal allowance would be “self-defeating.” The universal allowance would be enjoyed by “virtually all taxpayers,” and assuming the lost revenue was recouped by a general increase in rates, “the government would be robbing Peter to pay Peter.”

Even if everyone in the taxpaying universe worked full-time, this would not be correct for most EIA designs. Consider, for example, an allowance that assumes that work-related expenses are not a function of the amount of earned income, and so simply allows a flat deduction of $X for each full-time worker (the equivalent of exempting the first $X of earned income from tax). Imagine a simple economy, with just two types of workers (and an equal number of each type): the Lows, who earn $30,000 annually, and the Highs who earn $80,000. If there were no EIA and a flat tax of 20%, then for each Low-High worker pair, the system raises $22,000 tax ($110,000 x .20); the tax comes $6,000 from Low and $16,000 from High. Now assume Congress introduces an EIA in the form of a $5,000 deduction, and raises the flat rate just enough (to 22%) to make the change revenue neutral (assuming no behavioral effects from the tax law changes). Now Low would pay tax of $5,500 ($25,000 x .22), and High would pay tax of $16,500 ($75,000 x .22). Despite the universality of the EIA, it would affect the distribution of the tax burden, in a progressive direction.

9 IRC § 221 (1954).
12 Id. at 1435.
13 Id.
14 Id.
15 Id.
16 The assumption is not correct, but it is not far off the mark. The best evidence is that among full-time workers, work-related expenses rise only slightly with the wage rate. See text accompanying notes 88-102.
The explanation is that the benefit of the $5,000 EIA would go equally to Low and High, but the increased tax rate to pay for the new allowance would fall disproportionately on High, who would have three times more income subject to the rate increase than would Low. More simply put, the EIA would offset a larger percentage of Low's income than of High's. The point is not that the change in tax burdens is necessarily a good thing—although it may be, if a 75/25 ratio more accurately reflects relative net incomes than does an 80/30 ratio—but merely that introducing a revenue-neutral allowance is not a pointless exercise even if the entire taxpaying population is employed full-time; it is not "robbing Peter to pay Peter."17

Perhaps Bittker assumed that the EIA would be designed as a flat percentage of earned income, rather than as a fixed dollar amount for all full-time workers. In that special case, his criticism would be valid. There is no difference, for example, between the original system of no EIA and a flat 20% tax, and an EIA equal to 20% of earned income coupled with a 25% tax on the remaining income. Under the latter system, Low still would pay $6,000 ($24,000 x .25), and High would still pay $16,000 ($64,000 x .25).18 The evidence on the relationship

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17 Analyzing the effects of introducing an EIA together with a rate increase sufficient to achieve revenue neutrality becomes more complicated in a system with progressive marginal rates. Suppose that the taxpaying population is divided equally between Lows earning $20,000 annually and Highs earning $40,000, and that the marginal tax rate is 10% on the first $20,000 of income, and 30% above that level. A Low would pay tax of $2,000, and a High would pay $8,000, for a total of $10,000 of revenue. Now suppose Congress introduces a $5,000 EIA, together with an increase in tax rates sufficient to offset the revenue loss from the EIA. For example, the introduction of the $5,000 EIA would be revenue neutral if each tax rate were increased by 25%. Thus, the new rates would be 12.5% on the first $20,000 and 37.5% thereafter (any number of other changes to the tax rate schedule also could achieve revenue neutrality, with different effects on the relative tax burdens of Low and High). Under the new system, Low would pay tax of $1,875 ($15,000 x .125), and High would pay tax of $8,125 (($20,000 x .125) + ($15,000 x .375)). The effect of the change is still progressive, but not as much so as in the example in the text. The explanation for the smaller effect is that it is the net of two effects working in opposite directions. As with the example in the text, the EIA would offset a larger percentage of Low's income than High's, with progressive effects. On the other hand, High's offset income would have been taxed at a higher rate than Low's offset income; this effect is regressive. In the example, the net effect happens to be progressive, but that would not always be the case. Assume the same pre-EIA tax system, but assume that Lows earn $20,000 and Highs earn $30,000. Before the EIA, a Low would pay $2,000, and a High would pay $5,000. The introduction of the EIA would be revenue neutral if the rates were increased by 40%, to 14% and 42%. Under the new system, Low would pay $2,100 ($15,000 x .14) and High would pay $4,900 (($20,000 x .14) + ($5,000 x .42)). This time the regressive effect is larger than the progressive effect, and the net result is regressive. As emphasized in the text, however, the crucial point is not whether a revenue-neutral EIA is a progressive or regressive change in tax burdens, but simply that it is not a nothing.

18 The equivalency would hold even if the system had progressive marginal rates. Suppose the same facts as in the text, except the pre-EIA system has a 10% bracket up to $30,000, and a 30% bracket thereafter. Low would pay $3,000 tax on $30,000 income, and High would pay $18,000 tax on $80,000. The tax liabilities would not change with the
between income levels and work-related expenses, however, does not suggest an EIA of this sort. There are innumerable possible EIA designs between the polar cases of a fixed dollar amount for all full-time workers and a flat percentage of all earned income, and none of those intermediate designs would be pointless exercises. The particular intermediate design proposed in this Article,\(^9\) which is based on the best available evidence about actual work-related expenses at various income levels, is closer to the fixed dollar amount pole than to the flat percentage pole. Like the fixed dollar amount deduction, it would be far from a pointless exercise even if the population consisted of nothing but full-time workers with different wage rates.

But the population, of course, does not remotely resemble a society of worker bees, and actual patterns of labor force participation make the Bittker criticism even less valid. It is simply not true, at the beginning of the 21st century, that "virtually all taxpayers"\(^20\) work. Excluding full-time homemakers from the ranks of "virtually all taxpayers" was not reasonable in the 1970's, and it remains unreasonable today. In 1970 the labor force participation rate for married women was 40.5%; by 1998 it had risen to 61.2%.\(^21\) Neither then nor now would a universal EIA—with two allowances to a two-earner couple and only one to a one-earner couple—be a pointless exercise in robbing Peter to pay Paul. At both times, a universal EIA would have the effect of distinguishing roughly two-fifths of married couples from the other three-fifths. The identities of the larger and smaller groups have switched over the decades, but at neither time could it be said that virtually all married couples would obtain the same number of EIAs. The other large group of unemployed individuals (besides full-time homemakers) is, of course, retirees. In 1999 there were 34.4 million people (12.7% of the population) aged 65 or older in the United States;\(^22\) of those, less than 20% of the men and less than 10% of the women participated in the labor force.\(^23\) It is not true that virtually everyone works when there are about 30 million retired senior citizens. Even when Bittker wrote, a quarter century ago, there were far too many retirees to support his statement that virtually everyone was

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\(^9\) See text accompanying notes 88-119.
\(^20\) Bittker, note 11, at 1435.
\(^22\) Id. at 13.
\(^23\) Id. at 403 (16.9% labor force participation for men and 8.9% for women).
employed, and the statement is even less supportable today. The labor force participation rate of the elderly has declined over that time, and the percentage of the population 65 or older has increased significantly (and will increase even more dramatically as baby boomers begin to retire).

From a lifetime perspective, it might seem that the absence of an EIA does not unfairly burden workers relative to retirees, because everyone will be both a worker and a retiree. Suppose everyone started working at age 21, retired at 65, and died promptly at 80. In such a world, the existence or nonexistence of an EIA would be a matter of indifference, in terms of tax fairness between workers and retirees. If the absence of an EIA resulted in the overtaxation of individuals during their working years, undertaxation during their retirement years would fully compensate them. In the real world, however, people divide their adult lives very differently between working years and retirement years. The compensatory undertaxation in retirement will be of no benefit to a taxpayer who dies before retirement. From a lifetime perspective, a tax system without an EIA overtaxes those who spend a lower-than-average percentage of their adult years in retirement (because they retire late, die early, or both), and undertaxes those who spend a higher-than-average percentage of their adult lives in retirement.

\[24\] In 1970, 9.83% of the population was 65 or older. U.S. Census Bureau, Statistical Abstract of the United States 29 (100th ed. 1979).
\[25\] In 1970, 3.9% of the civilian labor force was 65 or older. U.S. Census Bureau, note 21, at 405. That had decreased to 2.9% by 1999. Id.
\[26\] In 1980 11.3% of the population was 65 or older. Id. at 13. That had increased to 12.7% by 1999, Id., and is projected to increase to 18.5% by 2010. Id. at 15.
\[27\] Moreover, the differing tax treatment of workers and retirees would not prevent a person from achieving any desired allocation of lifetime consumption between his working years and his retirement years. If income received in retirement is tax-favored, that simply decreases the amount a taxpayer needs to save in his working years in order to achieve his desired level of after-tax retirement income.

\[28\] Current retirees might object, however, that it is unfair to introduce an EIA now, too late to do them any good. There are two possible versions of this transition objection. First, current retirees may have relied on continued favorable tax treatment of retirees when they decided how much to save for retirement. Their reliance, however, would have been on the absolute level of taxation of their retirement income, not on the taxation of their retirement income relative to the taxation of current workers. Depending on the overall fiscal picture, it might be possible to introduce an EIA for current workers without increasing the tax burden on current retirees—and thus without disturbing their reliance interests.

The second version of the transition objection, however, focuses on intergenerational fairness. Current retirees might complain that even if their reliance interests are protected, it is still unfair to make them the unlucky EIA transition generation. When they were working, they were overtaxed relative to their parents’ generation, and now that they are retired, they are not correspondingly undertaxed relative to their children’s generation. This is a plausible complaint, but there are two plausible responses. First, an EIA might eliminate significant inequities in the current income tax—in particular, overtaxation of
In sum, the claim that an EIA would be available to virtually all taxpayers was wrong in 1975 and it is wrong today. It has become even more wrong with respect to retirees, and somewhat less wrong with respect to married women, but there were and are millions on each side of each divide (workers versus retirees, and employed wives versus homemakers). Whether or not a universal EIA would be a good idea, it certainly would not be a pointless exercise.

III. Designing An Earned Income Allowance

A. Three Possible Types of Earned Income Allowances

Work-related expenses arguably worthy of an income tax allowance fall into three general categories: (1) out-of-pocket expenses that would not be incurred but for the job, and that are necessary to perform the job (commuting, work clothes, and the extra cost of meals at work); (2) costs of replacing imputed income one would have if one did not work full-time (major examples include paid child care, house cleaning, yard care, convenience foods, and laundry services); and (3) the employee’s portion of the Social Security wage tax. As the policy analysis is different for each type of expense, I discuss the advisability of an allowance for each type of expense separately.

1. Type 1 Expenses: Commuting, Work Clothes, and Meals at Work

An allowance for these expenses is central to the goal of tax equity between taxpayers who work for a living and those who do not. If tax liabilities are to reflect the relative abilities to pay of workers versus retirees, and of two-earner couples versus one-earner couples, the system must attempt to adjust for these work-related expenses. A failure to do so taxes workers on more than their true net incomes. In short, of the three categories this is the easiest case for an allowance. If there is to be an EIA of any sort, it should reflect typical amounts of these expenses.

two-earner couples vis-a-vis one-earner couples, and overtaxation of those who spend few years in retirement vis-a-vis those whose golden years stretch on for decades. Some transitional unfairness might be a price worth paying to achieve these equity gains. Second, their generational good fortune with respect to Social Security would dwarf any generational inequity current retirees might suffer from the introduction of an EIA: The vast majority of current retirees will receive much more from Social Security than a fair return on their Social Security contributions. C. Eugene Steuerle & Jon M. Bakija, Retooling Social Security for the 21st Century 103, 107 (1994) (indicating substantial net transfers to most current retirees through the Social Security system).
It is well established, of course, that actual commuting expenses are not deductible as business expenses under § 162. The standard rationale is that an employed taxpayer could reduce his commuting expenses to zero by living across the street from work (or, better yet, sleeping on the floor of his office). Thus, any commuting expenses are the result of the taxpayer’s personal choice to live elsewhere, and are nondeductible under § 262(a) as “personal, living, or family expenses.” In light of land-use patterns in most U.S. metropolitan areas, featuring substantial distances between the location of the housing supply and the location of the job supply, the tax system’s assumption that all commuting expenses are a matter of personal choice is simply wrong. It would make more sense to assume that all working taxpayers have no choice but to live a substantial distance from work and to incur substantial commuting expenses. Of course, some taxpayers incur unnecessarily high commuting expenses for personal reasons, which suggests that a deduction for actual commuting expenses would be theoretically inappropriate—as well being the source of major compliance and enforcement difficulties. A better approach would be a formula-based allowance, which would permit a working tax-

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29 Sanders v. Commissioner, 439 F.2d 296 (9th Cir. 1971) (citing Commissioner v. Flowers, 326 U.S. 465, 466 (1946); Smith v. Warren, 388 F.2d 671 (9th Cir. 1968)); Treas. Reg. § 1.262-1(b)(5). Certain employer-provided commuting-related fringe benefits, however, are exempt from gross income. IRC § 132(a)(5), (f) (providing an exclusion for “qualified transportation fringes”). Subject to rather low dollar ceilings, both transit passes and parking at work can qualify for exclusion. Id.


31 In some cases, however, there is a plausible policy argument for allowing even a taxpayer who opts for an unnecessarily expensive commute to deduct his actual expenses. Suppose three taxpayers—A, B, and C—all have the opportunity to take the same high-paying job. Unfortunately, the only housing available near the job is very expensive. A takes the job, and buys an expensive home close to work. B also takes the job, but he buys a moderately-priced home far from work and incurs high commuting expenses. C takes a lower-paying job, located a short and inexpensive commute from moderately-priced housing. Among the three choices, the current income tax disfavors B. A benefits from the favorable tax treatment of expensive owner-occupied housing (the exclusion of imputed rental income and the deductibility under § 163(h)(3) of home mortgage interest). C, of course, does not have to pay tax on the forgone income from the higher-paying job; he is not taxed on his earnings potential to the extent it remains unrealized. Poor B, however, is not able to claim a deduction for his high commuting expenses. In theory, a commuting expense deduction for B might promote both fairness (by giving B a tax benefit analogous to those enjoyed by the other two taxpayers) and efficiency (by removing the tax incentive to choose more expensive housing or a lower-paying job, rather than a more expensive commute). In practice, however, there is no way to distinguish B from taxpayers who elect to live far away from their work for other reasons less deserving of tax recognition. And even if all taxpayers with unusually expensive commutes were in B’s situation, the recordkeeping and enforcement costs of a deduction based on actual expenses would be substantial.
payer to deduct typical commuting expenses without having to substantiate actual expenses (and thus without regard to whether the taxpayer’s actual expenses were higher or lower than the deduction produced by the formula). This approach might be described as assuming there is no personal element in choosing to have, say, a 10-mile commute, but that any longer commute is due to personal considerations. This can achieve only very rough justice. It is overly generous for the taxpayer who walks to work, and inadequate for the taxpayer with an unavoidably lengthy commute. Still, it is fairer than the current system’s assumption that any commute of any length is the result of a personal decision not to live across the street from work.

Similar analyses apply to the extra costs of work clothes and the extra costs of meals at work. A deduction based on actual expenses is not a good idea, because of concerns about unnecessarily high expenses incurred as personal consumption choices, and concerns about claimed deductions for nonexistent expenses. Yet the current system’s assumption—that working taxpayers have no unavoidable work-related clothing or food expenses—is clearly wrong. Again, the best approach would be a formula deduction based on data about typical costs of work clothes and food at work.

2. Type 2 Expenses: Costs of Replacing Imputed Income

This category usefully can be subdivided into child care on the one hand, and everything else on the other. Alone among the expenses in this category, Congress has selected child care for tax recognition, through both the child care credit and the exclusion for benefits received under dependent care assistance programs. These allowances raise important and difficult tax policy issues, relating both to whether there should be any tax allowance for child care expenses, and to design details if there is to be an allowance. Major design issues include: (1) whether the allowance should be based on a formula or on actual dollars expended for child care; (2) the ceiling (if any) on expenditure...
tures eligible for the tax allowance; and (3) whether the allowance should be a credit, exclusion, or deduction (or whether, as under current law, there should be more than one type of allowance). Although all these issues could be addressed in this Article, they are hereby declared (somewhat arbitrarily) outside its scope. The explanation is that the tax treatment of child care expenses is best analyzed in the context of the overall income tax treatment of families with children, and this Article cannot supply that context.\textsuperscript{37}

Child care costs aside, it is a close question whether there should be an allowance for other costs of replacing imputed income. If there is to be an allowance for such expenses, the structure of the allowance would be fundamentally different from that of an allowance for Type 1 expenses. Every worker would be entitled to a Type 1 allowance. On the assumption, however, that one unemployed adult is enough to meet a family’s reasonable needs for in kind services, the Type 2 allowance should not be available to one-earner couples, but only to unmarried workers and to two-earner couples. Moreover, while a two-earner couple would receive two Type 1 allowances, the couple would obtain only one Type 2 allowance.\textsuperscript{38} Table 1 summarizes the differences between the eligibility rules for Type 1 and Type 2 allowances.

\begin{center}
\begin{tabular}{lccc}
\textit{Table 1} & & & \\
\text{Appropriate Number of EIAs, by Type of EIA} & & & \\
& & & \\
\text{and by Taxpayer Category} & & & \\
& & & \\
\textit{Unmarried Earner} & \textit{One-Earner Couple} & \textit{Two-Earner Couple} & \\
\text{Type 1 EIA} & one allowance & one allowance & two allowances \\
\text{Type 2 EIA} & one allowance & zero allowances & one allowance \\
\end{tabular}
\end{center}

Certainly an equity case can be made for a Type 2 EIA, but it is less compelling than the case for a Type 1 allowance. A Type 1 allowance is needed to arrive at a fair measure of net income for workers. A Type 2 allowance, by contrast, would cover what are concededly personal consumption expenses, which are ordinarily \textit{not} deductible under an income tax\textsuperscript{39} (or, for that matter, under a consumption tax). Nevertheless one might defend a Type 2 allowance as a means of

\textsuperscript{37} I have addressed the tax treatment of child care expenses in that context elsewhere. Lawrence Zelenak, Children and the Income Tax, 49 Tax L. Rev. 349, 409-16 (1994).

\textsuperscript{38} In fact, the EIA in the college financial aid statute is structured in precisely this manner. See text accompanying notes 157-63.

\textsuperscript{39} IRC § 262(a) (except as otherwise expressly provided, no deduction for “personal, living, or family expenses.”).
achieving greater fairness between taxpayers with and without certain types of imputed income, but that argument is subject to a slippery slope objection. It is hard to imagine any sort of personal consumption expenditure that some people do not avoid by doing it themselves; some people even build their own homes. Thus, an argument that fairness demands a deduction whenever someone else enjoys an equivalent consumption benefit from tax-free imputed income is an argument for wiping out most of the base of the income tax. On the other hand, perhaps the difference between households with and without full-time imputed income producers is special. Arguably, it results in especially large and especially easy-to-identify differences in amounts of imputed income between households, so that it is feasible to grant a tax allowance in recognition of this difference without falling the rest of the way down the slippery slope.

In addition to the concern about the introduction of a new tax allowance for personal consumption expenses, the other objection to a formula-based Type 2 EIA is that the connection between employment status and incurring the expense is much weaker for Type 2 expenses than for Type 1. For the typical worker, it is simply not possible to have a job without incurring costs for commuting, work clothes, and food at work. By contrast, one could be employed yet incur few or no Type 2 expenses, by deciding either to work a “second shift” at home producing imputed income (translated from tax jargon, this means preparing meals, washing clothes, mowing the lawn, and cleaning the house), or simply by settling for delivered pizza, dirty clothes, tall grass, and a messy house. Not only is the absence of an unemployed adult a weak indicator of the existence of Type 2 expenses; the presence of an unemployed adult is a weak indicator of the nonexistence of such expenses. Even with one or two unemployed adults in the household, taxpayers may pay for housecleaning, yard work, and prepared food, because they are unable or unwilling to do the work themselves. Consider the case of a one-earner couple that incurs such expenses because the nonearner is sick or disabled, yet would not be able to claim the Type 2 allowance.\footnote{Under current law, the costs of replacing the imputed income of a sick homemaker are not deductible as a medical expense. Ochs v. Commissioner, 195 F.2d 692 (2d Cir. 1952).}

Much of the impetus for an EIA is, of course, the desire to achieve greater tax fairness between working and retired taxpayers. Yet a Type 2 allowance may not be desirable from that perspective. It may be more reasonable to expect even a two-earner husband and wife in their thirties or forties to do their own housekeeping, than to expect the same of a retired couple in their late seventies or older. A Type 2
allowance for the two-earner couple, but not for the retired couple, is not clearly a move in the direction of greater fairness. Thus the "fit" between the absence of an unemployed adult and the existence of Type 2 expenses is poor in both directions. Many two-earner couples and unmarried workers will have low Type 2 expenses,\footnote{41} and some one-earner couples and retirees will have high Type 2 expenses.

One response to the objection of poor fit might be to base the Type 2 allowance on actual expenses rather than a formula. But this would seem to impose an unreasonably heavy recordkeeping burden on taxpayers, and an overwhelming enforcement burden on the Service. Another response to the poor fit objection would be to make the Type 2 formula-based allowance available to everyone except a working-age, one-earner couple with a healthy nonearner spouse. This could be structured equivalently, and more simply, as a special tax surcharge on such couples. Even if its proponents did not package the proposal that way, its opponents would so describe it, and political defeat almost certainly would follow.

A Type 2 EIA is not necessarily a bad idea. Compared with a Type 1 EIA, however, it is much less clearly a good idea. For that reason, I limit the discussion of the details of designing an EIA to the design of a Type 1 EIA.\footnote{42}

3. Type 3 Expenses: The Employee’s Social Security Wage Tax

One important reason for the advice that one can maintain one's preretirement standard of living on considerably less than 100% of preretirement income is that after retirement there is no longer any need to save for retirement.\footnote{43} For the most part, the income tax system already takes this into account. Most earnings saved for retirement are taxed \textit{not} in the year they are earned, but rather in the year of consumption during retirement. This is true of qualified employer-based retirement savings,\footnote{44} of traditional IRAs,\footnote{45} and of the employer's share of the Social Security wage tax.\footnote{46} The one glaring exception is the employee's own share of the Social Security tax, which

\footnote{41} Type 2 expenses will be especially low for an unmarried worker who cohabits with a homemaking significant other.

\footnote{42} See Section III.B.


\footnote{44} IRC §§ 401-420.

\footnote{45} IRC §§ 219, 408.

\footnote{46} No statutory provision explicitly excludes this tax from an employee's gross income, but the Service has never asserted that it should be included in gross income. The income taxation of Social Security benefits is discussed in Subsection III.A.4.
is subject to income taxation in the year earned.\(^{47}\) Retirement planning guides routinely note that it is not necessary, in order to maintain one's standard of living in retirement, to replace that portion of earned income that is used to pay the employee's Social Security tax.\(^{48}\) It would seem, then, that the employee's Social Security tax should be removed from the base of the income tax, both to promote equity between workers and retirees,\(^{49}\) and to harmonize the income taxation of the Social Security tax with the income taxation of other forms of retirement savings.

The peculiar income tax treatment of Social Security taxes dates back to the very beginning of the Social Security system. The Social Security Act of 1935 divided the wage tax into equal employer and employee shares,\(^{50}\) and specified that the employee's share "shall not be allowed as a deduction to the taxpayer in computing his net income. \ldots\)\(^{51}\) By contrast, there was no provision including the employer's share in the employee's income tax base; Congress implicitly assumed it to be outside the scope of the definition of gross income.

A review of the background of the 1935 Act suggests that the differing income tax treatments of the two parts of the Social Security tax was essentially accidental. The President's Committee on Economic Security had recommended a social security tax with equal employer and employee shares, on the ground that a widespread sharing of the burden of providing old-age income security was appropriate: "[A]n orderly system under which employers, employees, and the Government will all contribute appears to be the dignified and intelligent solution of the problem."\(^{52}\)

Apart from the differing income tax treatment of the two halves of the Social Security tax, the bifurcation has no economic significance; a tax on wages has the same effect whether nominally imposed entirely

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\(^{47}\) IRC § 275(a)(1)(A) (providing that no deduction shall be allowed for the tax imposed under the Federal Insurance Contributions Act on employees by IRC § 3101).

\(^{48}\) See, e.g., McGill et al., note 43, at 389-91.

\(^{49}\) More precisely, this would promote equity between those who spend higher-than-average portions of their lives working ("workers"), and those who spend higher-than-average portions of their lives in retirement ("retirees"). See text accompanying note 28.

\(^{50}\) Social Security Act of 1935, ch. 531, § 801 (employee share) and § 804 (employer share), 49 Stat. 620, 636, 637.

\(^{51}\) Id. § 803, 49 Stat. 620, 637.

\(^{52}\) Report to the President of the Committee on Economic Security 33-34 (1935) [hereinafter Economic Security Report]. The Report elaborated: "Contributions by the employees represent a self-respecting method through which workers make their own provision for old age. \ldots\) To the employers, contributions toward old-age annuities are very similar to the revenues which they regularly set aside for depreciation on capital equipment." Id. at 33. The Ways and Means and Finance Committee reports note the decision to bifurcate the wage tax into equal employee and employer shares, but offer no rationale for that approach. H.R. Rep. No. 74-615, at 29-30 (1935); S. Rep. No. 74-628, at 41-42 (1935).
on the employer's payroll, on the employees' wages, or one-half on each.\textsuperscript{53} As it happens, there is a consensus among economists that workers bear virtually the entire burden of the Social Security tax.\textsuperscript{54} The more fundamental point, however, is that the ultimate incidence of a wage tax does not depend on whether the tax is \textit{called} a tax on workers, a tax on employers, or some combination of the two. It may be that the Congress of 1935 failed to understand this, and wrongly believed that a nominal sharing of the burden created a real sharing,\textsuperscript{55} or it may have understood but thought the symbolism of sharing was nevertheless important.\textsuperscript{56}

In any event, it appears that the decision to bifurcate the base was made prior to and independently of consideration of the income tax treatment of Social Security taxes, and that the income tax treatment followed almost instinctively from the bifurcation decision. There is no discussion in either the report of the Committee on Economic Security\textsuperscript{57} or in the congressional committee reports\textsuperscript{58} of the exclusion of the employer's share of the tax from the employee's income tax base. It did not seem to have occurred to anyone that there was even a decision to be made, since the employee was never nominally in receipt of amounts paid as employer tax. As for the employee's share, the official explanation for nondeductibility was that it was a kind of federal income tax, and federal income taxes are not deductible.\textsuperscript{59} This explanation is inadequate. The decision whether to make \textit{real} income tax liability deductible in computing the income tax base is simply a decision whether to have a tax with a tax-inclusive or a tax-exclusive base,\textsuperscript{60} whereas the decision whether to make the Social Se-

\textsuperscript{53} Joel Slemrod & Jon Bakija, Taxing Ourselves 64-66 (2d ed. 2000).
\textsuperscript{54} E.g., id. at 67-68.
\textsuperscript{55} See Richard A. Musgrave & Peggy B. Musgrave, Public Finance in Theory and Practice 264 (5th ed. 1989), speculating that the bifurcation of the tax base may have been the result of "mere stupidity."
\textsuperscript{56} Edward McCaffery has noted that nominally imposing a portion of the tax on employers could be a means of making the tax less painful to workers, by taking advantage of the phenomenon of loss aversion—that is, that never having been paid a dollar is less painful than having been paid the dollar and then watching it be taxed away. Edward J. McCaffery, Cognitive Theory and Tax, 41 UCLA L. Rev. 1861, 1876-83 (1994). McCaffery does not claim, however, that the 1935 decision to bifurcate the tax necessarily was based on an intuitive congressional understanding of loss aversion.
\textsuperscript{57} Economic Security Report, note 52.
\textsuperscript{59} "Since the tax on employees is a Federal income tax, [§ 803 of the Act] makes it clear that such a tax is not deductible." H.R. Rep. No. 74-615, note 52, at 30.
\textsuperscript{60} In a tax with a tax-exclusive base, the tax base to which the rates apply excludes the tax liability. Well-known examples include sales taxes and the federal gift tax. In a tax with a tax-inclusive base, the tax liability is included in the base to which the rates apply. Well-known examples include the federal income tax and the federal estate tax. In a flat rate tax system, the choice between the two types of bases is purely stylistic; any tax-exclu-
curity wage tax deductible for income tax purposes is a choice between income tax and consumption tax treatment of a portion of retirement savings. In a pure income tax, all income would be taxed when earned, regardless of whether it is saved or consumed. Thus, including the employee’s Social Security tax in the income tax base is consistent with a pure income tax model. In a cash flow consumption tax, income is taxed only when it is consumed.\textsuperscript{61} Assuming the employee’s Social Security tax is viewed as a form of mandatory retirement savings, consumption tax treatment would be to exclude the wage tax from the income tax base (but to tax Social Security benefits when they are received and consumed in retirement). The fact that a decision already had been made to have a tax-inclusive base provided no guidance (contrary to the expressed congressional belief) in deciding between income tax and consumption tax treatment. The only stated justification for the nondeductibility of the employee’s Social Security tax—that a wage tax is a kind of income tax, and income taxes are not deductible—is no justification at all.\textsuperscript{62}

None of this proves, of course, that the 1935 decision to make the employee’s tax nondeductible was wrong, but it does suggest that the issue deserves not so much reconsideration as a belated consideration for the first time. The starting point for that consideration should be to ask whether there is any good reason to impose immediate income taxation on this one aspect of basic retirement savings,\textsuperscript{63} given the pol-

\textsuperscript{61} Some of the vast literature on the relative merits of income taxes and consumption taxes is surveyed in Lawrence Zelenak, The Selling of the Flat Tax: The Dubious Link Between Rate and Base, 2 Chap. L. Rev. 197 (1999).

\textsuperscript{62} Even if one rejects the view of the Social Security tax as mandatory retirement savings, and instead views it as “pure” tax, the characterization of the tax as a kind of income tax should be irrelevant to its federal income tax deductibility. The tax-inclusive nature of the federal income tax merely means that federal income tax liability should not be deductible for federal income tax purposes (see the explanation at note 60). The decision to have a tax-inclusive federal income tax does not determine whether other income taxes should be deductible for federal income tax purposes. In fact, state and local income taxes are deductible, IRC § 164(a)(3), and their deductibility is not inconsistent with the tax-inclusive nature of the federal income tax.

\textsuperscript{63} The 7.65% employee wage tax actually has two components: a 6.2% tax to finance Social Security benefits, and a 1.45% tax to finance Medicare. IRC § 3101(a) (6.2% tax), § 3101(b)(6) (1.45% tax). Although the characterization of the tax as a form of retirement savings applies more obviously to the 6.2% tax, the Medicare tax could be viewed as retirement savings for the particular purpose of financing one’s health care in retirement. Under this view, tax deferral is appropriate for both components of the tax. Actually, given the decision not to impose income tax on the current health insurance costs of most workers,
icy decision that all other forms of basic retirement savings—the other half of Social Security, employer-sponsored pensions, and IRAs—are granted income tax deferral. The so-called “income tax” is really a hybrid income-consumption tax, and the tax treatment of these other forms of retirement savings indicates a settled policy that amounts that must be saved for retirement (either as a matter of legal mandate or in the dictates of prudence) give no rise to current ability to pay tax and should be taxed on a consumption tax model. By contrast, retirement savings in excess of the demands of prudence do give rise to current ability to pay and should be taxed on an income tax model. Given this basic framework, which is both firmly estab-

IRC § 106 (excluding employer-provided health insurance from gross income), there is a strong argument that the proper income tax treatment of the Medicare tax is not merely deferral of taxation until retirement, but permanent exclusion (that is, deduction of the tax when paid, and no later inclusion of benefits received).

There is a difficulty, however, with thinking of the Medicare tax as a special form of retirement savings. With the Social Security tax, almost every dollar of wages subject to the tax goes into the benefits calculation. 42 U.S.C. § 415 (2002) (calculation of “primary insurance amount”). Given this close relationship between taxes paid and benefits received, it is easy to view the Social Security tax as a form of retirement savings. With the Medicare tax, by contrast, one either has had sufficient wages subject to tax to entitle one to Medicare benefits, or one has not. 42 U.S.C. § 426(a) (2002) (a person who is at least 65 years old is entitled to Medicare Part A benefits if he is eligible to receive Social Security benefits; the amount of Social Security benefits does not matter). There is no marginal benefit to the payment of Medicare taxes in excess of the amount necessary to qualify for coverage upon retirement. When a taxpayer receives no further benefit for additional Medicare taxes paid, it is difficult to think of the additional taxes as a form of retirement savings. To the extent a taxpayer receives no benefit from Medicare taxes, however, the Medicare taxes should be deducted from his income tax base on the simple ground of absence of economic benefit; in terms of ability to pay, money one must pay as a pure tax (that is, a tax with no corresponding benefit) is the equivalent of money one never earned at all.

64 As Deborah Geier recently has pointed out, the failure to tax the employee’s share of the Social Security tax on a cash flow model is more inconsistent with the rest of the income tax today than it was in the 1930’s. Deborah A. Geier, Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income, 22 Va. Tax Rev. 1, 43-55 (2002). Although the cash flow model applied to employer-funded pensions by the 1930’s, id. at 48-49, the cash flow model did not apply to employee-funded retirement savings at that time. Neither IRAs nor deductible employee contributions to employer-sponsored plans existed in the 1930’s. The IRA provision was not enacted until 1974, and § 401(k) (providing cash flow treatment for employee contributions to qualified plans) was not enacted until 1978. Id. at 52-53.


66 See text accompanying note 61, briefly describing the basic difference between the income tax model and the consumption tax model.

67 This seems to be the policy underlying § 401(a)(17), which provides that “[a] trust shall not constitute a qualified trust . . . unless . . . the annual compensation of each employee taken into account under the plan for any year does not exceed $200,000.” The dollar limit is subject to adjustment for post-2001 inflation. IRC § 401(a)(17)(B).
lished in practice and attractive in theory, the current nondeductibility of the employee's Social Security wage tax is simply wrong.\textsuperscript{68}

In short, there is a compelling case to be made for an income tax deduction for the employee's Social Security tax.\textsuperscript{69} It is, however, a somewhat more complicated case than that for a formula deduction for work-related (Type 1) expenses, for two reasons. First, it is tied up with the debate between proponents of an income tax base and proponents of a consumption tax base.\textsuperscript{70} From the perspective of a hardcore income tax proponent, it makes perfect sense not to allow a deduction for any retirement savings, including the employee's Social Security tax (assuming that tax is understood as a form of mandatory retirement savings, rather than as simply an exaction). By contrast, a deduction for work-related expenses is necessary to measure correctly both net income and personal consumption. It is appropriate under either tax base, and so is not caught up in the great income-versus-consumption debate. Second, the income tax treatment of Social Security is a part of the debate about fundamental reform of the Social Security system,\textsuperscript{71} and any decision about it will have to be made in that much larger context. An allowance for work-related expenses, by contrast, need not wait for a new consensus on the future of Social Security. Because the context for a work-related expense allowance is so much simpler than that for a Social Security tax deduction, it would be reasonable to move ahead first on a Type 1 EIA for work-related expenses.

4. The Income Tax Treatment of Social Security Benefits

Although the focus of this Article is on downward adjustments to the income tax base of workers, another source of tax unfairness be-

\textsuperscript{68} Under certain conditions, however, excluding Social Security benefits from income can exactly compensate for the failure to allow a deduction for the Social Security tax. This possibility is considered in Section III.A.4.

\textsuperscript{69} This is not a new idea. See, e.g., David F. Bradford & Treasury Dep't, Blueprints for Basic Tax Reform 34 (2d ed., rev. 1984) [hereinafter Blueprints] (describing a model income tax base that would allow a deduction for the employee's Social Security tax).

\textsuperscript{70} In the legal literature, major contributions to the debate include William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974); Barbara H. Fried, Fairness and the Consumption Tax, 44 Stan. L. Rev. 961 (1992); Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 Yale L.J. 283 (1994); Alvin C. Warren, Jr., Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975).

between workers and retirees is the 100% exclusion of Social Security benefits from the income tax base of lower-income retirees.\textsuperscript{72} The rules governing the income taxation of Social Security benefits are quite complex, but very generally benefits are not taxable for lower-income retirees, are 50% taxable for middle income retirees, and are 85% taxable for higher-income retirees.\textsuperscript{73}

Before 1984, all Social Security benefits were exempt from taxation. That exclusion was based not on any express statutory command, but on a trio of revenue rulings from 1938 and 1941, holding that various types of Social Security benefits were not within the scope of gross income.\textsuperscript{74} All three rulings are remarkable for their utter lack of analysis. Each ruling describes the benefits in question and then states, without any explanation, that the benefits are not subject to income tax.

The Social Security Amendments of 1983 introduced the taxability of one-half of Social Security benefits paid to middle- and higher-income beneficiaries.\textsuperscript{75} The Senate Finance Committee report defended the continued 100% exclusion for lower income beneficiaries as "assuring" that lower-income individuals, many of whom rely upon their benefits to afford basic necessities, will not be taxed on their benefits."\textsuperscript{76} The problem with this defense, of course, is that the standard deduction and personal exemptions already ensure that there will be no income tax on income needed to pay for basic necessities.\textsuperscript{77} In effect, then, lower-income retirees are given a double tax-free allowance for the cost of subsistence.\textsuperscript{78} Workers, by contrast, receive only a single allowance for their subsistence expenses, through the standard deduction and personal exemptions.\textsuperscript{79}

\textsuperscript{72} More precisely, from a lifetime perspective the unfairness is between those who spend a smaller-than-average percentage of their adult years in retirement, and those who spend a larger-than-average percentage of their adult years in retirement. See text accompanying notes 27-28.

\textsuperscript{73} IRC § 86.


\textsuperscript{75} Pub. L. No. 98-21, § 121, 97 Stat. 65, 80-84.


\textsuperscript{77} See S. Rep. No. 99-313, at 31-33, reprinted in 1986-3 C.B. (vol. 3) at 31-33 (indicating that the standard deduction plus personal exemptions are intended to approximate a taxpayer's poverty level).

\textsuperscript{78} Taking into account the increased standard deduction for the elderly, discussed in text accompanying note 7, it is actually more than a double allowance.

\textsuperscript{79} Arguably, the EITC mitigates or eliminates this unfairness for low-income workers with children. For low-income workers without children, however, the EITC is small or nonexistent. It is fully phased out at modified AGI (or, if greater, earned income) of only $11,060, or $12,060 for a joint return, IRC § 32(b); Rev. Proc. 2001-59, § 3.05, 2001-2 C.B. 623, 625-26, and is unavailable to workers younger than 25 or older than 64, IRC § 32(c)(1)(A)(ii)(I).
The 1983 Senate Finance Committee report justified taxing only one-half the Social Security benefits of higher-income workers “in recognition of the fact that social security benefits are partially financed by after-tax employee contributions.”

80 This explanation could use greater elaboration, but the 50% exclusion does make considerable sense. Start with the premise that retirement savings should be taxed under a consumption tax model, rather than an income tax model. For the 50% of an employee’s Social Security “savings” on which he has not already paid tax (that is, the employer’s share of the wage tax), consumption tax treatment means taxing all retirement distributions attributable to those savings. This would be consistent with the consumption tax treatment of employer-sponsored pensions and of traditional IRAs. For the other 50% of the employee’s Social Security “savings,” which he paid tax on when the savings occurred (that is, the employee’s share of the wage tax), results similar or identical to those obtained under a cash flow consumption tax can be achieved by exempting from tax all retirement distributions attributable to those savings. In particular, if a taxpayer’s marginal income tax rate is the same in the year of wage tax “savings” and in the year a retirement distribution is received, allowing no deduction for the savings and not taxing the distribution produces the same results as allowing a deduction for the savings and taxing the distribution. 81 Outside of the Social Security context, Congress has recognized this equivalency by permitting taxpayers to save for retirement using either traditional IRAs (taxed under the cash flow model), or Roth IRAs (taxed under the yield exemption model). In effect, then, the 50% exclusion of Social Security benefits results in the taxation of all Social Security retirement “savings” under a consumption tax model; the 50% of distributions attributable to previously untaxed “savings” are taxed (cash flow model), and the 50% of distributions attributable to previously taxed “savings” are excluded (yield exemption model). It is as if a taxpayer did


81 For example, suppose a taxpayer wants to save $2,000 of this year’s wages for retirement. His marginal tax rate this year is 20%, and his marginal tax rate in retirement also will be 20%. Any investment he makes this year will triple in value by the time he retires. If he is allowed an IRA deduction for his savings, he will not have to pay any tax this year on the $2,000 of wages. The IRA will grow to $6,000 by the time of distribution, and a 20% tax on the $6,000 distribution will leave him with $4,800 to consume in retirement. Suppose instead he cannot deduct his retirement savings this year, but any retirement distributions will be completely free of tax. This is the treatment afforded to Roth IRAs by § 408A. He will have to pay $400 tax this year on the $2,000 wages, leaving him with $1,600 to save for retirement. That $1,600 will triple to $4,800 by the time of his retirement, and the $4,800 distribution will be tax-free. Again, he is left with $4,800 to consume in retirement. The equivalency is no mystery. After all, (2,000 x 3) x (1 - .2) = (2,000 x (1 - .2) x 3. The former is the formula for the traditional IRA; the latter is the formula for a Roth IRA.
one-half of his Social Security savings in a traditional IRA, and one-half in a Roth IRA.\(^{82}\)

Thus, there is a principled basis for the 50% exclusion for distributions, taking as a given the 50% taxability of contributions. Outside of the Social Security context, however, Congress has pursued consumption tax treatment of retirement savings much more by cash flow treatment than by yield exemption treatment,\(^{83}\) and reasonably so. Matching the imposition of tax with the flow of cash has obvious liquidity and transparency advantages for most taxpayers. Moreover, there is a bottom-line difference between cash flow treatment and yield exemption treatment whenever a taxpayer faces a marginal tax rate during his earning years different from the rate he faces in retirement. In the usual situation of a lower rate during retirement, cash flow treatment produces a lower overall tax burden than yield exemption treatment. As Deborah Geier recently has suggested, the lower burden under the cash flow approach seems preferable, "as a rough form of lifetime [income] averaging."\(^{84}\) In sum, although the 50-50 hybrid treatment of distributions follows logically enough from the 50-50 hybrid treatment of contributions, it would make more sense to put the income taxation of Social Security entirely on a cash flow model, with a full deduction for an employee's contributions and full taxability of distributions.\(^{85}\)

The 85% inclusion for higher-income beneficiaries was introduced in 1993.\(^{86}\) The remaining 15% exclusion is intended to approximate the percentage of benefits on which the recipient has already paid in-

\(^{82}\) See Geier, note 64, at 45 n.133 (suggesting the same analogy). Although the two portions of Social Security savings are nominally equal in amount, the yield exemption portion is more valuable to the taxpayer than the cash flow portion, because the taxpayer has already satisfied his income tax obligation with respect to the yield exemption portion. Suppose, for example, a taxpayer in the 20% bracket received a $10,000 Social Security distribution, with $5,000 attributable to the previously-taxed employee contribution, and $5,000 attributable to the not-yet-taxed employer contribution. If the 50% exclusion is viewed as applying entirely to the $5,000 attributable to the employee contribution, then the distribution on account of the employee contribution is worth $5,000 to the taxpayer, but the distribution on account of the employer contribution is worth only $4,000 (after tax).

\(^{83}\) Although Roth IRAs represent a recent introduction of yield exemption treatment outside the Social Security context, to date the significance of Roth IRAs is minor compared with employer-sponsored pensions and traditional IRAs. See Investment Company Institute, IRA Ownership in 2002, at 1 (Sept. 2002) (estimating that 34.8 million U.S. households own traditional IRAs, and 12.9 million households own Roth IRAs).

\(^{84}\) Geier, note 64, at 46.

\(^{85}\) This is the system proposed in Blueprints, note 69, at 54. Of course, transitional rules would be necessary for the taxation of benefits. Retirees who were subject to the 50-50 hybrid treatment of their Social Security contributions should not pay tax on 100% of their Social Security benefits.

income tax, by reason of the nondeductibility of the employee’s Social Security wage tax. In effect, the 15% exclusion represents basis to which beneficiaries are entitled by reason of income tax previously paid on their Social Security “contributions.” This makes perfect sense under an income tax analysis, but it is not clear why some Social Security retirement savings should be taxed under an income tax model when Congress otherwise is committed to consumption tax treatment (generally cash flow, but with some yield exemption as well) for retirement savings.

To sum up: Starting from the premise that retirement savings are to be taxed under a consumption tax model, and given the hybrid income tax treatment of Social Security contributions, the 100% exclusion for lower-income beneficiaries is too generous, the 50% exclusion for moderate-income beneficiaries is just right, and the 85% inclusion for higher-income beneficiaries is too harsh. It would probably be better, however, to move to pure cash flow taxation, with all Social Security contributions exempt from the income tax and all distributions fully taxable. These issues, however, are best considered in connection with broader questions of Social Security reform, rather than in the context of the income tax treatment of work-related expenses.

B. Determining a Reasonable Formula for a Type 1 EIA for Work-Related Expenses

1. A Formula Allowance Based on Analysis of Consumer Expenditure Survey Data

Suppose Congress decides that a deduction for work-related expenses is a good idea, but that considerations of administrative feasibility dictate (as they almost certainly do) a formula deduction, rather than a deduction based on each worker’s actual expenses. What would be a reasonable formula for the deduction? Considering the widespread interest in retirement planning, there is a surprising dearth of good information on the typical relationship between levels of earned income and amounts of Type 1 work-related expenses (commuting, work clothes, and food at work). By far the most useful study for this purpose is that reported by McGill, Brown, Haley, and Schieber in Fundamentals of Private Pensions (“Fundamentals”).

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87 Robert J. Myers, Is the 85-percent Factor for Taxing Social Security Benefits Perpetually Correct?, 58 Tax Notes 1545, 1545 (Mar. 15, 1993). Myers explains that the exclusion percentage should increase over time, as Social Security benefits become less generous relative to wage taxes previously paid by beneficiaries. He estimates that after 2027 the correct exclusion would be about 28%. Id. at 1545-46.

Despite the usefulness of the study, it has one major drawback for present purposes: It does not analyze separately the work-related expenses of one-earner and two-earner households. I discuss the significance of that drawback later. Fundamentals explains that the ideal approach to studying work-related expenses would be to monitor a representative group of workers and keep track of their actual expenses, but that to date no one has been willing to incur the trouble and expense inherent in that approach. In lieu of the ideal, the Fundamentals study uses data from the Consumer Expenditure Survey ("CES") to compare expenditure patterns of similar pre- and post-retirement households, and assumes the differences in expenditures in certain categories are attributable to the difference in work status. The study compares households (married or single) with a householder between the ages of 50 and 64 and with one or two full-time workers, with similar-income households with a householder between the ages of 60 and 74 and no full-time workers. The expenditure categories analyzed are food, clothing, and transportation. Food at work is not a separate CES category, but the study treated the excess of food expenditures of working households over food expenditures of retired households as an indication of the cost of extra food expenditures attributable to working. The study found this difference was $831 at the lowest income level ($8,500), and declined to only $388 at the highest income level ($85,000). The authors suggest, however, that $388 understates the actual work-related food expenses for upper-income households, because "additional leisure time in retirement gives [higher income households] a greater opportunity . . . to eat out

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89 See text accompanying notes 116-19.
90 McGill et al., note 43, at 392.
91 Bureau of Labor Statistics, U.S. Dep't of Labor, Bull. 2425, Consumer Expenditure Survey, 1990-91, at 1 (1993). The Consumer Expenditure Survey is an ongoing survey of the spending patterns and living costs of U.S. consumers conducted by the Bureau of Labor Statistics. It uses a combination of quarterly interviews and two-week spending diaries to track both the large expenditures (such as cars and appliances) and smaller purchases (such as food, housekeeping supplies, and personal care products) of each participant over a year-long period. The Fundamentals study uses survey data from the years 1980 to 1992, with the results converted to 1993 dollars. McGill et al., note 43, at 393.
92 Id. at 392-93.
93 Id. at 393.
94 Id.
95 Id. at 394-95.
96 Id. at 395 tbl. 18-7.
more often than when they were working," so that the increase in leisure food expenditures offsets part of the decrease in work-related food costs.97 They conclude that work-related food expenses do not vary greatly with income, and that $731 is a reasonable estimate of those expenses at all income levels.98 Comparing clothing expenditures of working and retired households, and attributing the difference to work, the study finds that the difference increases gradually with income (from $242 at $8,500 income to $587 at $85,000).99 The analysis of transportation expenses yields a similar pattern of costs gradually increasing with income, from $1,140 at $8,500 income to $1,870 at $85,000.100

Combining the food, clothing, and transportation analyses, and expressing the combined expenses as a percentage of income, the study indicates that work-related expenses are typically approximately 25% of the first $8,500 of earned income, and 1.5% of additional income up to $85,000 (the highest income level considered in the study).101 Adjusting for inflation from 1993 to 2002, and aiming for round numbers, this suggests that a reasonable tax deduction for Type 1 work-related expenses would equal 25% of the first $10,000 of earned income, and 1.5% of additional earned income, at least up to $100,000.102

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97 Id. at 395.
98 Id.
99 Id. at 396 tbl. 18-8.
100 Id. at 398 tbl. 18-9. As a check on the plausibility of these numbers, the study notes that assuming an average cost of commuting of $0.28 per mile, an average commute (one way) of 10.7 miles, and 240 round-trip commutes per year, the average commuter should have annual costs of $1,438. Id. at 397.
101 Author's calculations based on data in id. at 395-98. The 25% figure (rounded up from 24.8%) for the first $8,500 consists of 8.6% for food (using $731 across income levels), 2.8% for clothing, and 13.4% for transportation. The 1.5% figure for additional income consists of no additional expenses for food, .5% for clothing, and 1% for transportation. The study does not investigate whether work-related expenses continue to increase as income rises above $85,000 (about $100,000 in 2002 dollars). A deduction of 1.5% of income above the $100,000 level might be appropriate, but a new study is necessary to verify that. In any event, it would not be unreasonable to disregard the additional work-related expenses associated with very high incomes even if the data support the existence of such expenses. See text accompanying notes 103-06.
102 Under current law, an employee can exclude up to $2,220 per year of employer-provided parking at work, and up to $1,200 per year of employer-provided transit passes or transportation in a "commuter highway vehicle." IRC § 132(f); Rev. Proc. 2001-59, note 7, § 3.09, at 626 (inflation adjustments for 2002). A formula deduction for work-related expenses is premised on the notion that it is better to do rough justice with an easy-to-administer formula than to attempt exact justice by measuring the actual expenses of each taxpayer. In keeping with that policy, it would be appropriate to repeal the "qualified transportation fringe" exclusion on enactment of a formula deduction. Workers should not be unhappy about this tradeoff, since the formula suggested in the text produces a deduction larger than the maximum exclusion under § 132(f) for any full-time worker (even at the minimum wage).
It is unknown—and, as a practical matter, unknowable—to what extent the data underlying the *Fundamentals* study reflect unnecessarily high expenses, as to which personal motivations dominate business motivations. If this is thought to be a serious problem, the deduction described in the preceding paragraph could be reduced by some more-or-less arbitrary amount to adjust for the personal element presumed to be lurking in the data. For example, if 12% of the expenses identified in the study are thought to be unnecessary across the entire income distribution, the deduction could be reduced to 22% of the first $10,000 of earned income and 1.3% of additional income. Alternatively, one might conclude that there is no significant personal element in the data supporting the 25% deduction for the first $10,000 of earned income, but that the 1.5% allowance for additional income should be eliminated or significantly reduced. I address that possibility immediately below.

2. *The Extra Work-Related Expenses of Higher-Wage Workers*

Although the *Fundamentals* study provides strong evidence of the existence of modestly greater work-related expenses for higher-wage workers, a policy question remains as to whether these expenses merit a tax allowance. In other words, should the deduction be limited to 25% of the first $10,000 for all workers, or should higher-wage workers be allowed to deduct 1.5% of additional income? An argument could be made that any increase in commuting expenses associated with higher wage rates is not strictly necessary, but rather reflects an income effect—that is, a personal decision by those with more money to live farther from work, to drive more expensive cars, and to commute alone instead of carpooling.\(^{103}\) Even accepting the factual premise of the argument, one still might support allowing the 1.5% deduction based on the precedent established by the treatment of business travel expenses under § 162(a)(2). Lower-income business travelers manage to conduct business flying coach and staying at the Holiday Inn. Higher-income business travelers could do the same, but when they fly first class and stay at the Ritz-Carlton, they may deduct the entire cost; the excess over coach and Holiday Inn is not disallowed.\(^{104}\)

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\(^{103}\) A similar argument might be made with respect to work clothes, but less persuasively. Being a high-powered lawyer does not preclude commuting by public transportation, but it probably does preclude (in many cities) wearing jeans at work. In any event, the commuting component of the 1.5% figure is about twice as large as the clothing component. See note 99.

\(^{104}\) A parenthetical in § 162(a)(2) does disallow the deduction of “amounts which are lavish or extravagant under the circumstances,” but it does not apply to first class air travel or luxury hotels. Rev. Rul. 63-144, Q&A 42, 1963-2 C.B. 129, 136-37.
More importantly, the issue should be viewed as one of horizontal equity between workers and retirees at the same levels of affluence.\textsuperscript{105} From that perspective, the additional 1.5\% deduction may be appropriate. Even if the commutes of affluent workers tend to be more expensive than strictly necessary, it is still the case that affluent retirees avoid those expenses. For example, a $100,000-income worker may be able to live in the suburb of his dreams only by incurring greater-than-actually-necessary commuting expenses, but a retiree incurs no equivalent costs to live in the same suburb. As a matter of horizontal equity between a $100,000-income worker and a $100,000-income retiree, allowing the worker to deduct 1.5\% of her last $90,000 of income is defensible. As for vertical equity between $10,000-income workers and $100,000-income workers, adjustments to the tax rate schedules can achieve whatever degree of progressivity is desired, taking into account the 1.5\% deduction.

Despite the strength of the argument for allowing the 1.5\% deduction, two caveats are in order. First, given the modest size of the marginal deduction rate indicated by the \textit{Fundamentals} study, there is not a great deal at stake here. A deduction of 1.5\% of $90,000 is worth only $364.50 in the 27\% bracket. Second, even if the system allows the 1.5\% deduction up to a point, it would not be unreasonable to cut it off eventually. It may be that the facts do not support continuing the deduction above $100,000,\textsuperscript{106} and even if the facts are supportive, the personal element may loom so large that a tax allowance is not desirable.

\section{The Inability to Distinguish Full-Time Low-Wage Workers From Part-Time Higher-Wage Workers}

The lowest income level considered in the tables in \textit{Fundamentals} ($8,500) represented full-time work (2000 hours per year) at the 1993 minimum wage of $4.25 per hour.\textsuperscript{107} At the current minimum wage of $5.15,\textsuperscript{108} the equivalent figure would be $10,300. The study results suggest that there is a base cost of being a full-time worker of about $2,500 (in current dollars). Although the study does not address this question, it seems likely that for those who work less than full time,

\begin{footnotesize}
\begin{itemize}
\item More precisely, from a lifetime perspective the concern is horizontal equity between those who spend a smaller-than-average percentage of their adult years in retirement, and those who spend a larger-than-average percentage of their adult years in retirement. See text accompanying notes 27-28. Alternatively, one could view the issue as one of making appropriate adjustments to the taxable incomes of the same taxpayer in different years, to measure correctly the taxpayer's ability to pay tax at different life cycle stages.
\item See note 101 (discussing the limits of the \textit{Fundamentals} study).
\item Id.
\end{itemize}
\end{footnotesize}
the base cost is roughly proportional to the number of days worked during the year. In other words, the base work-related expenses of working one day are about $10 ($2,500/250 days). On the assumption that it is not administratively feasible for the amount of the work-related expense deduction to be based on the number of days worked, there is a difficulty in designing the EIA formula for workers with low annual earnings. The problem is that the tax administrator cannot distinguish between a person with $10,000 income from working 250 days at the minimum wage (who ideally would be allowed a deduction of $2,500), and a person with $10,000 income from working 125 days at twice the minimum wage (who ideally would be allowed a deduction of only a little more than $1,250).109 Unfortunately, there is no choice but to give these two workers the same deduction. The only choice is whether to design the EIA to be fair to the full-time minimum wage worker and overly generous to the part-timer, or whether to design the EIA to be fair to the part-timer and insufficiently generous to the full-time worker. A deduction of 25% of the first $10,000 of earned income (regardless of the numbers of hours or days worked during the year) would implement the first approach. The minimum wage worker would get the $2,500 deduction she deserves, but the part-timer also would get a $2,500 deduction—almost twice what she deserves. A deduction of 13.25% of the first $20,000 would implement the second approach. The part-timer would get the $1,325 deduction she deserves, but the full-time worker would get a deduction only a little more than one-half what she deserves.

The first step in choosing between these two approaches might be an empirical study of which type of $10,000 earner is more common. Even if the study indicated that half-time workers at twice the minimum wage were much more common, however, there still would be a need to decide which type of error was worse. It would not be ridiculous to decide that too small an allowance to the full-time minimum wage worker is a more serious error than too large an allowance to the

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109 The ideal would be the $10 per day base allowance, plus a small additional amount to reflect the extra expenses (1.5% of income) associated with higher wage rates.

110 The inability of the tax administrator to observe wage rates is also at the core of the problem addressed by optimal tax analysis—how to design a welfare-maximizing, tax-and-transfer system, taking into account the fact that a tax based on wages (rather than on wage rates) inevitably imposes some deadweight loss. On optimal tax analysis generally, see Lawrence Zelenak & Kemper Moreland, Can the Graduated Income Tax Survive Optimal Tax Analysis?, 53 Tax L. Rev. 51 (1999).

111 The figure is 13.25%, rather than 12.5%, to reflect the small additional expenses associated with income above the minimum wage. According to the study, a typical full-time worker earning $20,000 would have work-related expenses of $2,650 (25% of the first $10,000, and 1.5% of the next $10,000). A deduction of 13.25% of the first $20,000 and 1.5% of additional income would produce results identical with a deduction of 25% of the first $10,000 and 1.5% of additional income, for those with incomes of $20,000 or more.
part-time worker, so that the allowance should be 25% of the first $10,000 despite the prevalence of excessive allowances for higher-wage, part-time workers.

There are, of course, innumerable possible intermediate resolutions of this issue. Suppose, for example, that research shows that there are very few full-time workers with an hourly wage below $8 (despite the $5.15 minimum wage), and that we are willing to accept some unfairness to those few workers. Then a reasonable deduction schedule could be designed based on the assumption that $16,000 ($8 per hour for 2000 hours per year) is the de facto lowest annual income for full-time workers. The resulting deduction schedule would be 16.2% of the first $16,000 of earned income and 1.5% of additional income.\textsuperscript{112}

This dilemma—of either allowing too large a deduction to part-time workers or too small an allowance to low-wage, full-time workers—may help explain the structure of former § 221 (in effect from 1981 to 1986), which allowed a deduction equal to 10% of the first $30,000 of income of the lower income spouse in a two-earner marriage.\textsuperscript{113} This appears to be very different from a deduction of 25% of the first $10,000 of earned income, and 1.5% above that level, but in fact the resulting deduction amounts are quite similar for workers whose income approaches or exceeds $30,000. At $25,000 income, for example, the 25%/1.5% system produces a deduction of $2,725, and the 10% system produces a deduction of $2,500. At $50,000 income, the 25%/1.5% deduction is $3,100, and the 10% deduction is $3,000. Thus, one might start from the results of the Fundamentals study, with respect to the relationship of work-related expenses to the income of full-time workers, and end up with the § 221 deduction formula,\textsuperscript{114} if allowing too large a deduction to part-time workers were considered a worse error than allowing too small a deduction to low-wage full-time workers.\textsuperscript{115}

\textsuperscript{112} According to the Fundamentals study (converted to current dollars), the deduction at $16,000, for a full-time worker, should be $2,590 (25% of $10,000, plus 1.5% of $6,000). A deduction of 16.2% of $16,000 closely approximates that result.

\textsuperscript{113} IRC § 221 (before repeal in 1986). The two-earner deduction is discussed in more detail at text accompanying notes 143-46.

\textsuperscript{114} No claim is made that this speculation represents the actual thought process of the drafters of the two-earner deduction. In fact, the legislative history of the deduction makes a point of not relying on work-related expenses as a justification for the deduction. See text accompanying notes 143-46.

4. Two-Earner Couples: A Need for More Data

Intuitively, it would seem that the formula deduction schedule should apply separately to the earned income of each spouse. Each spouse must commute separately, and buy his or her own work clothes and food at work. If the deduction formula is 25% of the first $10,000 of earned income and 1.5% of additional earnings, then a husband and wife each earning $30,000 should be entitled to two deductions of $2,800 each—\textit{not} to a single deduction of $3,250.\textsuperscript{117} Although this seems clearly correct in general terms, the problem is that there is no study that provides the necessary kind of information on the work-related expenses of two-earner couples. The \textit{Fundamentals} study includes a mix of one- and two-earner households,\textsuperscript{118} with the proportions of each not reported. In addition to providing no information specific to two-earner households, this means the study results also cannot be taken as indicating the work-related expenses of one earner at any given income level. Assuming that two-earner households normally have substantially higher work-related expenses than equal-income, one-earner households, the inclusion of some unspecified percentage of two-earner households in the mix should result in overstatements of typical work-related expenses for one-earner households at the various income levels. It would be extremely helpful in designing a formula deduction for Type 1 expenses to have the results of another study, modeled on \textit{Fundamentals}, but considering separately one- and two-earner households.\textsuperscript{119}

\textsuperscript{116} ($10,000 \times .25) + ($20,000 \times .015).

\textsuperscript{117} ($10,000 \times .25) + ($50,000 \times .015).

\textsuperscript{118} McGill et al., note 43, at 393.

\textsuperscript{119} There is an existing study, by Sandra L. Hanson and Theodora Ooms, that does focus on the extra work-related expenses of two-earner couples (using data from the CES). Hanson & Ooms, note 2, at 622. Unfortunately, the study does not ask the right questions for purposes of designing a formula deduction. The study makes two kinds of comparisons between various expense categories for one- versus two-earner couples. One comparison controls for family income, while the second controls for the husband's income. Neither can be used to estimate work-related expenses as a percentage of the wife's earnings.

Palmer provides separate retirement income replacement ratios for one-earner and two earner couples, but the difference in the two analyses relates solely to Social Security taxes and benefits. Palmer, note 88, at 64 tbl. II, 73 tbl. A-IV. The work-related expenditure data is \textit{not} calculated separately for one- and two-earner couples.

At a less rigorous level of analysis, Kelley offers unsupported estimates that extra expenses for "personal upkeep" and "transportation and lunches" for an employed wife are proportional to income—for example, a wife with an hourly wage of $25 has five times the amount of these expenses as a wife with an hourly wage of $5. Kelley, note 2, at 10-11. This seems highly unlikely, both intuitively and in light of the \textit{Fundamentals} study.
Although the case for an EIA is based on equity, not efficiency, an EIA could ameliorate the tax disincentive to paid labor. In light of the available evidence on how work-related expenses vary with income, a well-designed EIA would provide for a deduction of a high percentage of the first $10,000 of earned income, but only a low percentage of income above that level.\footnote{This assumes the EIA is designed to be fair to full-time minimum wage workers, even at the cost of being overly generous to part-time, higher-wage workers. See text accompanying notes 107-15.} The efficiency cost of a tax (the excess burden, or deadweight loss) depends on the substitution effect, which in turn depends on \textit{marginal} tax rates (and on labor supply elasticity).\footnote{For a general discussion of the substitution effect of the taxation of labor income, see generally Slemrod \& Bakija, note 53, at 105-10.} It might seem, then, that an EIA of this design would do very little to reduce effective marginal tax rates on the earned income of middle- and high-wage workers. The bulk of their tax reduction from the EIA would seem to be inframarginal—that is, the large deduction based on the first $10,000 of earned income—and an inframarginal tax reduction would not serve to reduce deadweight loss.

Although it may be true that other tax cuts could achieve larger reductions in deadweight loss for the same revenue cost, the EIA may perform better in this respect than an initial glance would suggest. Labor economists draw a distinction between the “intensive margin” and the “extensive margin” of labor supply decisions.\footnote{James J. Heckman, What Has Been Learned About Labor Supply in the Past Twenty Years?, 83 Am. Econ. Rev. 116 (1993).} Decisions whether to work a few hours more, or a few hours less, are made at the intensive margin.\footnote{Id. at 116.} The decision whether to be in the labor force at all is made at the extensive margin.\footnote{Id.} The EIA would indeed have little effect on the labor supply decisions of middle- and high-wage workers at the intensive margin, because their marginal EIA would be very small (perhaps a deduction equal to 1.5% of each additional dollar of earned income). This is not a very powerful objection to the EIA, however, because labor supply elasticities at the intensive margin are close to zero for workers who are committed to the labor force.\footnote{Id. at 118; Slemrod \& Bakija, note 53, at 107. This is largely true even for married women. Once they have made the basic decision to engage in paid labor, their hours worked are quite inelastic with respect to the net wage rate. Thomas Mroz, The Sensitivity of an Empirical Model of Married Women's Hours of Work to Economic and Statistical Assumptions, 55 Econometrica 765, 797 (1987).} It follows that even high marginal rates on the earnings of
these workers cause little deadweight loss, and that there would be little efficiency gain from reducing those rates.

Middle- and high-wage workers also make decisions at the extensive margin (whether to be employed at all), and for those workers the entire EIA, including the large EIA on the first $10,000 of earnings, will be marginal, and so will reduce the deadweight loss from taxation. This effect will be significant, however, only if labor supply elasticity is significantly greater than zero at the extensive margin. The two groups whose labor force participation decisions are notably responsive to after-tax wage rates (and therefore to tax rates) are married women (deciding between paid labor and full-time homemaking) and older workers (deciding between full-time work and retirement).\(^{126}\) Despite its apparent inframarginality, the EIA does operate at the extensive margin, and thus will serve to reduce deadweight loss in two situations where labor supply elasticity is unusually high.

V. THE PRECEDENTS

A. Pre-World War II Earned Income Allowances in the Federal Income Tax

The Revenue Act of 1924 provided for a credit (not a deduction) equal to 25% of the tax that would be imposed on a taxpayer if his earned net income were his entire income, with a $10,000 ceiling on earned net income for purposes of the credit calculation.\(^{127}\) Inflation adjustments across such long periods of time are problematic, but based on official CPI data, this would be the equivalent of a ceiling of nearly $100,000 in current dollars.\(^{128}\) Although the credit bears some resemblance to a deduction equal to 25% of the first $10,000 (or $100,000) of earned income, its effects differ in two respects.

The first difference relates to the interaction between earned income and investment income. To illustrate, suppose the marginal tax rates are 10% on the first $10,000 of income, and 30% above that.

\(^{126}\) McCaffery, Taxing Women, note 8, at 180-84 (surveying the literature on the elasticity of the labor force participation decisions of married women); Leora Friedberg, The Labor Supply Effects of the Social Security Earnings Test 25 (NBER Working Paper No. 7200, 1999) (finding that the high implicit tax rates of the (since-repealed) Social Security earnings test resulted in significant deadweight loss); Edward P. Lazear, Retirement From the Labor Force, in 1 Handbook of Labor Economics 305, 326 (Orley Ashenfelter & Richard Layard eds., 1986) (surveying the literature on the effect of after-tax wages on retirement decisions, and noting that seven of the eleven studies cited found that high wage rates had "some deterrent effect" on retirement).


level, and that a particular taxpayer has $10,000 of earned income and $10,000 of investment income. The 1924 credit treats the earned income as being taxed in the 10% bracket, so that the 25% credit is only $250. By contrast, a $2,500 deduction would operate against income in the 30% bracket, reducing tax liability by $750. The second difference exists even in the absence of investment income, if more than one marginal tax rate applies to the first $10,000 of taxable income.129

Suppose, for example, the breakpoint between the 10% and 30% bracket was at $6,000, and a particular taxpayer had $10,000 of earned income. His precredit tax liability would be $1,800 ((10% x $6,000) + (30% x $4,000)), the credit would be $450 (25% x $1,800), and his final tax liability $1,350. The credit is the equivalent of a deduction of 25% of the income in the 10% bracket and 25% of the income in the 30% bracket. By contrast, a 25% deduction would operate entirely in the 30% bracket, and the resulting tax on $7,500 would be only $1,050.

The official explanation of the purpose of the credit is intriguing. According to the Ways and Means Committee Report, an EIA was appropriate to achieve tax fairness between workers and those who live off investment income (the idle rich), because the prudent worker lacks ability to pay tax on the portion of his earnings he must set aside to finance his retirement, whereas the coupon clipper has no need to set aside a portion of his income.130 As a guide for tax policy today, there are two problems with this analysis. First, for all that appears from the Committee Report, the 25% figure was simply drawn out of a hat; the report does not explain why provision for retirement required saving such a large fraction of earned income. Second, and more fundamentally, developments in the taxation of retirement savings since 1924 have robbed this justification for an EIA of almost all its force. The justification assumes that, but for the EIA, earnings saved for retirement would be subject to tax in the year they were earned. In a tax world characterized by deferral for employer-sponsored pensions and IRAs, that assumption no longer holds. Even if there are a few gaps in the system—even if a few unlucky workers are unable to obtain tax deferral on reasonable levels of retirement savings—the deferral precedent is so firmly established that the proper fix would be a narrowly targeted expansion of the deferral provisions, not a universal EIA.131 In short, the 1924 Act does not provide a useful precedent in support of reintroducing a universal EIA. The 1924

131 The most significant exception to income tax deferral on retirement savings under current law is the nondeductibility of the employee’s share of the Social Security wage tax. The obvious response to this anomaly, however, would be to make the wage tax deducti-
Act was based on the assumption that tax deferral for retirement savings was not widely available, and that assumption is simply not true today.

Revenue needs during the Great Depression led to the elimination of the EIA in 1932, but Congress resurrected it in modified form in 1934. The new allowance was a deduction equal to 10% of earned net income, with a $14,000 ceiling on income eligible for the deduction. The deduction was allowed in computing the "normal tax" of 4% of net income, but not in computing the progressive marginal rate surtax, which applied to net incomes above $4,000.

Translated to the current federal income tax, with its lowest rate bracket of 10%, the differing treatment of the EIA for purposes of the normal tax and the surtax would be the equivalent of allowing a credit equal to 1% of earned income (that is, a 10% credit on 10% of earned income), up to some ceiling amount. That approach has no obvious

ble, not to introduce an EIA. The possibility of making the wage tax deductible is discussed in the text accompanying notes 43-71.

132 Tax deferral for retirement savings had been introduced to the federal income tax in 1921, but its use had not become widespread by 1924. See James A. Wooten, The "Original Intent" of the Federal Tax Treatment of Private Pensions, 85 Tax Notes 1305, 1313-14 (Dec. 6, 1999). In 1924, the vast majority of workers who saved for retirement did so with after-tax dollars.

133 An interesting technical aspect of the 1924 EIA was how it dealt with the problem of distinguishing earned income (eligible for the EIA) from investment income (not eligible for the EIA). This is a serious problem in the case of income from a closely held business, which typically represents a return on both labor and capital, in uncertain proportions. See generally Michael Knoll, Designing a Hybrid Income-Consumption Tax, 41 UCLA L. Rev. 1791 (1994) (explaining how the problem of distinguishing labor income from returns on capital influences the choice between different versions of hybrid income-consumption taxes). The response of the 1924 Act to this problem was to treat the first $5,000 (close to $50,000 in current dollars) of income of all taxpayers as earned income eligible for the credit. Revenue Act of 1924, Pub. L. No. 68-176, § 209(a)(3), 43 Stat. 253, 264; H.R. Rep. No. 68-179, at 6 (1924), reprinted in 1939-1 (pt. 2) C.B. 241, 246. Although the problem is real, this response has nothing to recommend it. The same effect would be achieved by eliminating the 25% credit and simply reducing the tax rates on the first $5,000 of income (regardless of source) by 25%. Recouping the lost revenue by increasing the rates on income above $5,000 would result in an increase in the overall progressivity of the system. That might or might not be a good thing, but it has nothing to do with distinguishing between taxpayers with and without earned income.


136 Id. §§ 25(a)(4), 25(a)(5)(e), 48 Stat. at 692. The statute confusingly referred to the allowance as a "credit against net income," id. §§ 11, 25(a), but in fact the allowance functioned as a deduction. The first $3,000 of net income always was considered earned income, regardless of its actual source. For a discussion of the similar rule in the 1924 Act, see note 133.


138 Id. § 12 (imposing surtax), § 25(a) ("credit" not allowed against surtax), 48 Stat. at 684, 692.
attractions. If, for example, a taxpayer with $100,000 of earned income (and no other sources of income) has the same ability to pay tax as another taxpayer with $90,000 of investment income (and no other income), and both taxpayers are in the 27% bracket, then a 1% credit will not achieve the desired equalization of tax burdens. The worker’s tax liability will be $1,700 higher ($2,700 additional tax on $10,000 additional income, reduced by a $1,000 credit).

The justification for the 1934 EIA offered in the legislative history is disappointingly vague: “[S]mall relief on earned incomes is justified at this time in order that the tax on various classes of incomes may be proportionate to the ability to pay of the taxpayer having such income.”\(^{139}\) In the absence of any more specific explanation, the best guess is that Congress continued to be concerned about the need to set aside some earned income for retirement, as expressed in the legislative history of the 1924 EIA.\(^{140}\) There is no explanation for the decrease in generosity from the 1924 EIA, which (to oversimplify) eliminated the tax on 25% of earned income, to the 1934 EIA, which (again oversimplifying) eliminated the tax on only 10% of earned income. The explanation may be no more profound than a reaction to the revenue constraints imposed by the Depression.

The Revenue Act of 1943 repealed the EIA introduced by the 1934 Act.\(^{141}\) The legislative history offers no rationale for the repeal, beyond the unsatisfying observation that repeal was one of several “steps toward simplification” contained in the 1943 Act.\(^{142}\)

**B. The Two-Earner Deduction, 1981-1986**

The Economic Recovery Tax Act of 1981 included a provision allowing a married couple filing a joint return to take a deduction equal to 10% of the earned income of the lower-earning spouse, up to a maximum deduction of $3,000 (based on $30,000 of earned income).\(^{143}\) The Senate Finance Committee Report is remarkable for how it mentions, without embracing, a justification for the deduction based on work-related expenses. After explaining the deduction as “a suitable response” to “the marriage tax penalty,” the Report mentions the extra work-related expenses of two-earner couples, but with considerable diffidence:

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In addition, some contend that two-earner couples are less able to pay income tax than one-earner couples with the same income because the former have more expenses resulting from earning income as well as less free time. Under this theory, the new deduction will improve equity by reducing the tax burden of two-earner couples compared to one-earner couples.\textsuperscript{144}

Perhaps the Committee held the work-related expense rationale at arm’s length because it was aware of Bittker’s argument that this rationale called for an EIA for all working taxpayers, rather than only for lower-earning spouses. Thus, the Committee declined to rely on the work-related expense rationale to support an allowance that was far narrower than what the rationale would dictate. Instead, it relied on the marriage penalty rationale, which justified a narrow focus on two-earner couples. Another benefit of not relying on work-related expenses to justify the deduction was not having to explain the design of the allowance by reference to any evidence about the magnitude of such expenses, and about how (if at all) they varied with the amount of earned income.

The Tax Reform Act of 1986 repealed the two-earner deduction.\textsuperscript{145} The official explanation was that the new tax rate structure had decreased marriage penalties so much that targeted marriage penalty relief was no longer needed.\textsuperscript{146} No mention was made of the problem of greater work-related expenses of two-earner couples, but that omission is understandable in light of the decision in 1981 not to rely on work-related expenses in support of the deduction.

C. The Earned Income Tax Credit

1. Would an EIA Be Redundant in Light of the EITC?

In its current version, the EITC provides a 40% refundable credit for the first $10,350 of earned income for a taxpayer with two or more children, a 34% refundable credit for the first $7,370 of earned income for a taxpayer with one child, and a 7.65% refundable credit for the first $4,910 of earned income for a taxpayer with no children.\textsuperscript{147} The credit is phased out as income rises above the subsistence level.\textsuperscript{148} If


\textsuperscript{146} S. Rep. No. 99-313, at 37, 41, reprinted in 1986-3 (vol. 3) C.B. 1, 37, 41.

\textsuperscript{147} IRC § 32(b); Rev. Proc. 2001-59, note 7, § 3.05(1), at 626 (inflation adjustments for 2002).

\textsuperscript{148} For credit recipients with two or more children, the phaseout rate is 21.06%. The phaseout begins at $13,520 modified AGI ($14,520 for joint returns), and ends at $33,178.
the amount of the credit exceeds precredit income tax liability, the excess is refundable. In fact, less than 20% of total EITC dollars operate to offset precredit tax liability; well over 80% function as transfers in excess of tax liability.\textsuperscript{149}

The original credit was in a form considerably less generous than the current version. Only taxpayers maintaining households for dependent children were eligible for the credit. The maximum credit was $400 (10% of the first $4,000 of earned income), and the phaseout range was from $4,000 to $8,000 of earned income.\textsuperscript{150} The legislative history indicated two purposes: to offset (roughly) the employer and employee Social Security taxes on the first $4,000 of earned income, and to encourage those on public assistance to obtain employment.\textsuperscript{151}

With the EITC for workers with dependent children now greatly exceeding the combined employer-employee Social Security tax on credit-eligible earnings,\textsuperscript{152} the legislative history of the most recent major revision of the EITC\textsuperscript{153} emphasizes the credit’s role in alleviating poverty for families with children, in addition to the work incentive effect.\textsuperscript{154} In its current incarnation the EITC can be roughly described as a family size adjustment to the minimum wage—effectively increasing the minimum wage somewhat for workers with one child, and increasing it again for workers with two or more children—although its implementation of that objective is far from perfect.\textsuperscript{155}

It is apparent from this summary that the EITC has very little in common with the sort of EIA proposed in this Article, in terms of either purpose or structure. The legislative history of the credit does not mention the goal of adjusting tax liability to reflect work-related expenses, and the maximum credit amounts are obviously far too


\textsuperscript{152} The 7.65\% credit rate for credit recipients without children, however, exactly equals the rate of the employee’s share of the Social Security wage tax.


\textsuperscript{154} “Providing a larger basic EITC to larger families recognizes the role the EITC can play in alleviating poverty. Moreover, this larger credit may provide work incentives and increase equity by reducing the tax burden for those workers with a lower ability to pay taxes.” H.R. Rep. No. 103-111, at 609, reprinted in 1993-3 C.B. (vol. 1) 163.

\textsuperscript{155} See Lawrence Zelenak, Children and the Income Tax, 49 Tax L. Rev. 349, 403-04 (1994) (more fully explaining this view of the EITC).
large to be explained by such a purpose. The maximum credit for workers with two or more children ($4,140 in 2002) translates into a deduction equivalent (for a taxpayer in the 15% bracket) of $27,600—far in excess of any reasonable estimate of work-related expenses for low-wage workers.

Three other features of the credit are also inconsistent with the goal of adjusting tax liabilities for work-related expenses. First, the phaseout makes the credit unavailable to middle- and upper-income workers, yet work-related expenses exist at all income levels. Second, the credit fails to distinguish between one- and two-earner couples, despite the typically greater work-related expenses of two-earner couples. Finally, the refundability of the credit is inconsistent with an EIA for work-related expenses. The obvious limit on an EIA for work-related expenses would be the reduction of taxable income (and thus tax liability) to zero.156 An EIA would never result in net transfers from the government to workers, yet more than 80% of EITC dollars are in excess of income tax liability.

At first glance it may seem that there is common ground between the EITC and an EIA, to the extent that the burden of the Social Security tax is a concern of the EITC, and at least arguably ought to be an EIA concern as well. Even here, however, the differences outweigh the similarities. Congress thought of the original version of the EITC as approximating a refund of the Social Security tax on the first few thousand dollars of earned income, and the current small credit for childless workers follows that tradition. Compared with the way an EIA might adjust taxable income on account of Social Security taxes, this is far too generous in one respect, and far too stingy in another. It is too generous because the adjustment arguably called for under an EIA would be merely to deduct the employee’s share of the Social Security tax from the income tax base. The tax savings would be the amount of the deduction multiplied by the relevant marginal tax rate. The EITC treatment, by contrast, is a complete refund of the Social Security tax on the first few thousand dollars of earnings. On the other hand, an EIA adjustment on account of Social Security taxes would not impose any ceiling on the amount of tax eligible for the deduction; in this respect the EITC treatment is too stingy from an EIA perspective.

In short, regardless of one’s views of the merits of the EITC—either in terms of the attractiveness of its goals or its success in achieving them—the EITC has almost nothing to do with the concerns motivat-

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156 It would make sense, however, to treat a deficit in taxable income caused by the EIA as a net operating loss eligible for carryover. This would be consistent with the current treatment of employee business expenses. IRC § 172(d)(4); Reg. § 1.172-2(a)(3)(i).
ing the proposal for a universal (not phased-out) EIA. There are plausible objections to a universal EIA, but they do not include redundancy in light of the EITC.

D. The College Financial Aid Statute

In order to determine the amount of federal financial assistance to which a college student is entitled, it is necessary to calculate the contribution to college expenses expected of the student’s parents.\textsuperscript{157} The parents’ expected contribution is a function of their “available income.” In determining their available income, the statute includes an “employment expense allowance.”\textsuperscript{158} The allowance applies in two circumstances: if both parents are employed, and if an employed parent is a head of household (or surviving spouse). The amount of the allowance when both parents are employed is the lesser of $3,000 or 35% of the earned income of the lower-income parent; in the case of an employed single parent the allowance is the lesser of $3,000 or 35% of earned income.\textsuperscript{159}

As an EIA currently existing in a federal statute, this is an especially important precedent for an income tax EIA, both with respect to the circumstance under which the allowance is permitted, and with respect to determining the amount of the allowance. On the first point, the curious feature of the financial aid EIA is that it includes no allowance for work-related expenses of the first (or only) earner in a marriage. A one-earner couple is entitled to no allowance, and a two-earner couple to only one. Despite the “employment expense allowance” label, the allowance is not based on the number of individuals with work-related expenses; rather, it is based on the absence of a full-time producer of imputed income in the household. Thus, the allowance is available to two-earner couples and to all working single parents, but not to one-earner couples.

It is not easy to understand the reason for designing the EIA this way. There are arguments for providing an especially generous EIA for taxpayers without a full-time imputed income producer,\textsuperscript{160} but there is no apparent reason for failing to distinguish between the significant work-related expenses of a one-earner couple and the nonexistent work-related expenses of a retired couple. (Retired parents of college age children are not so rare that an allowance for the first working spouse can be dispensed with on the grounds that it would be

\textsuperscript{157} 20 U.S.C. \textsection 1087oo(a)(1) (2002).
\textsuperscript{158} 20 U.S.C. \textsection 1087oo(c)(1)(E) (2002).
\textsuperscript{160} See text accompanying notes 35-40.
In addition to the inequity between workers and retirees, there is also inequity between married working parents and single working parents. A single parent and the working parent of a one-earner couple typically will have similar expenses for commuting, work clothes, and meals at work, yet the financial aid statute treats the married worker as having no work-related expenses. Moreover, a two-earner couple typically will have twice the expenses of this sort as an unmarried worker, yet the statute disregards that difference. Whatever the merits of a special additional allowance for parents with low imputed income, there is little to be said in defense of providing a special allowance for low imputed income, while ignoring the out-of-pocket work-related expenses of the first working spouse.

As for the amount of the EIA when it is available, the financial aid statute at least seems to be in the right ballpark, based on the available information on the magnitude of work-related expenses. Two problems weaken its precedential value, however. First, there is no legislative history indicating the source of the $3,000/35% rule; there is no indication it was based on data about the actual relationship between work-related expenses and the amount of earned income. The second problem is the confusion, discussed above, as to what sorts of work-related expenses are supposed to be covered by the EIA. If, as the eligibility structure suggests, the allowance is aimed at the cost of paying for services a full-time homemaker would provide in kind, there is no reason to take the financial aid statute as authoritative, or even relevant, on the relationship between earned income and the costs of commuting, work clothes, and meals at work.

E. Earned Income Allowances in the Income Tax Systems of Other Countries

Formula-based EIAs are a feature of the income tax systems of several other countries. The next Subsections describe the Japanese and French EIAs, along with a now-repealed Canadian EIA.

1. Japan

The Japanese “employment income deduction” is calculated by applying decreasing marginal deduction rates as earned income in-
increases, according to the following schedule.\textsuperscript{164} (To get a very rough idea of the conversion to dollars, convert at the rate of 100 yen to the dollar; thus the first bracket, for example, would go up to $16,250.)

<table>
<thead>
<tr>
<th>Employment Income (in millions of yen)</th>
<th>EIA Amount (in millions of yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–1.625</td>
<td>lesser of employment income or .650</td>
</tr>
<tr>
<td>1.625–1.800</td>
<td>.650 plus 40% of the excess over 1.625</td>
</tr>
<tr>
<td>1.800–3.600</td>
<td>.720 plus 30% of the excess over 1.800</td>
</tr>
<tr>
<td>3.600–6.600</td>
<td>1.200 plus 20% of the excess over 3.600</td>
</tr>
<tr>
<td>6.600–10.000</td>
<td>1.800 plus 10% of the excess over 6.600</td>
</tr>
<tr>
<td>&gt; 10.000</td>
<td>2.140 plus 5% of the excess over 10.000</td>
</tr>
</tbody>
</table>

In lieu of the formula deduction, a taxpayer may deduct actual work-related expenses (including the costs of commuting, relocating, and work-related education), if they are larger than the formula allowance.\textsuperscript{165}

Notice that the rule for determining the EIA amount in the lowest range (up to 1.625 million yen) can be restated as a 100\% marginal deduction rate for earned income up to 650,000 yen (roughly $6,500), followed by a 0\% marginal deduction rate from that point up to 1.625 million yen (roughly $16,250). For a worker earning 1.625 million yen, the result—which may be reasonable—is a deduction equal to 40\% of earnings. For workers earning significantly below that level, however, the deduction schedule appears overly generous. The 100\% deduction rate for the first 650,000 yen might be appropriate if the majority of those earning at or about that level were extremely low-wage, full-time workers, but the 100\% deduction seems excessive if most cases of extremely low earnings are due to very low hours worked rather than to very low wages.

More significant than the peculiar shape of the marginal deduction schedule at low incomes is the high level of deductions throughout the schedule. As discussed earlier, the most reliable study using data from the United States is consistent with a marginal deduction rate of about 25\% up to about $10,000 of earned income, and about 1.5\% thereafter.\textsuperscript{166} The Japanese schedule calls for deductions several times that


\textsuperscript{165} ITL, note 164, art. 57-2(2).

\textsuperscript{166} See text accompanying notes 88-102.
large. Although it is possible, of course, that work-related expenses are consistently much higher in Japan than in the United States, it is also possible that the Japanese system actually undertaxes workers relative to retirees.

2. France

The EIA in the French income tax is a flat 10% of earned income, up to an inflation-adjusted ceiling. Translated into dollars, the ceiling on earned income eligible for the allowance is in the neighborhood of $110,000. Thus, the maximum deduction is about $11,000. A taxpayer may elect to deduct actual work-related expenses (including commuting costs) instead of the formula deduction, but about 95% of employees use the formula. The system also allows a deduction equal to 10% of pension income. This would largely defeat the purpose of an earned allowance, were it not for the low ceiling (about $3,000) on the maximum pension deduction per household.

Whereas a comparison of the Japanese EIA with data on work-related expenses in the United States suggests the Japanese EIA may be too high for workers at all income levels, the French EIA appears to be insufficiently generous to full-time, low-wage workers (whose actual work-related expenses are probably closer to 25% than 10% of earnings), but far too generous to higher wage workers (whose actual work-related expenses on $100,000 of earned income are likely to be closer to $4,000 than $10,000).

3. Canada

The Canadian EIA was repealed, effective in 1988. The deduction was equal to 20% of employment income, but with a very low ceiling of C$2,500 on income eligible for the deduction, resulting in a C$500 ceiling on the deduction itself. The deduction had been "intended to offset the absence of a general deduction of employment-related expenses." (Commuting expenses were not—and are not—

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168 111,900 euros for 2001. Id.
170 CGI art. 158-5-a; Campbell et al., note 167, at A-75.
171 In the case of pension income of F201,000 or more, the maximum deduction for 1999 was F20,100. Id.
173 An Act to Amend the Income Tax Act, ch. 55, sec. 2(1) s.c. 1371, 1376 (Can.).
deductible, either in lieu of or in addition to the formula deduction.175) Because of the very low ceiling, the deduction was far too small to have reflected the actual amount of work-related expenses for typical taxpayers; it appears to have served a largely symbolic function by officially acknowledging the existence of work-related expenses for employees. The repeal was justified on the ground that the basic personal tax credit introduced at the same time as the repeal of the EIA would more than compensate taxpayers for the loss of the EIA.176 This confuses, however, questions of absolute tax burdens with questions of relative tax burdens. Repeal of the EIA may not have increased the absolute tax burden on workers given the simultaneous introduction of the personal tax credit, but repeal nevertheless increased the tax burden on workers relative to retirees. There was no official explanation of why this shift in relative tax burdens was appropriate.177

VI. Conclusion

A comprehensive reform of the income taxation of workers might allow a deduction for the costs of work-related expenses (commuting, work clothes, and food at work), the costs of replacing imputed income, and the employee’s share of the Social Security wage tax. There are serious objections, however, to a deduction for the costs of replacing imputed income, and any proposals affecting Social Security should be considered in the broader context of Social Security reform. The best place to start, then, is with a deduction for work-related expenses. Although a deduction for actual work-related expenses would be an administrative nightmare, a formula-based deduction could be designed that would be easy to administer, and that would more closely approximate a fair distribution of tax burdens than the current system, which conclusively presumes the correct amount of work-related expenses is zero in all cases.

177 Hogg & Magee, note 174, at 152.