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WHOSE MONEY IS IT?

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PROF. SCHWARTZ: I hope that it is a provocative question. I want to talk about this question because answering it is fundamental to making equitable, efficient tax policy. More specifically, my question is: how do we apportion household earnings among the various household members into taxable incomes and associated tax units? Put simply, that is, "Whose money is it?"

This is not a new question. In fact, it is an old question that was debated and discussed in great depth for years, revolving around the issue of income splitting between married couples in the days of separate filing.[20] In those days, married couples with a single earner sought to allocate, through a private contract, a portion of the single earner's income — typically the husband — to the non-earner spouse — typically the wife — in order to take advantage of the lower rates faced by the non-earner.[21] In 1930, the Supreme Court held in *Lucas v. Earl* that taxpayers could not split their income in this way for tax purposes.[22] However, in a decision later that year, *Poe v. Seaborn*, they allowed families residing in states with community property laws to report split income.[23] Then, in 1948, Congress reformed the Federal Income Tax, extending this option to all taxpayers in all states.[24]

Now, an important part of the discussion in those days revolved around the question of who "owned" the income. In *Taxing*

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[20] *See* Amy C. Christian, *The Joint Return Rate Structure: Identifying and Addressing the Gendered Nature of the Tax Law*, 13 J.L. & POL. 241, 255-56, 282-87 (1997) (explaining the mechanics of income-shifting).

[21] *See id.* at 254-57; *see also* Lucas v. Earl, 281 U.S. 111, 113-14 (1930) (involving a husband and wife who entered into such a contract).

[22] 281 U.S. at 114-15 (holding that because the husband earned the income, he could not impute by contract any portion thereof to his wife for tax purposes).

[23] 282 U.S. 101 (1930) (distinguishing this case from *Lucas v. Earl*, 281 U.S. 111).

[24] Revenue Act of 1948, Pub. L. No. 80-471, tit. III, pt. I, 62 Stat. 110, 114-16.

Women, Ed McCaffrey quotes California's then Representative, Bertrand Gearhart, as saying:

> We tax the individual's income. If, in your state, you want to insist that that income belongs to the husband and that the wife has no interest in it at all, logically he should pay the tax on it. In our state, the State of California, the husband never was regarded and is not treated as the owner of all of that income. From the instant that it is earned, according to the law of the state, it became and was the property of the community partnership. The wife owns half, the husband owns half.[25]

At the same time, others argued that since a married couple acts as a single economic unit, it should be taxed as a single economic unit.[26] Although I doubt that the protagonists in these debates had anticipated it, economists have spent some significant effort in the last 50 years investigating the validity of two of the underlying claims made.[27] The first is that married couples act as a single economic unit — that is, as if it is all "our" money. The second is that married couples act as if income earned by a family is half his and half hers. These are not, in fact, the same things.

Economic theory has offered essentially two views of the married couple as economic agents. The traditional common preference models' view is that families pool all their resources and make consumption decisions as if they were maximizing a single objective function. This is consistent with the it's-all-ours story. The implication of the pooling of resources in a family is that family expenditure decisions should not depend on who earns the money and married couples should be taxed as a single unit.

The alternative models regard joint family decisions as

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[25] *See* EDWARD J. MCCAFFREY, TAXING WOMEN 53 (1997).

[26] *See* Marjorie E. Kornhauser, *Theory Versus Reality: The Partnership Model of Marriage in Family and Income Tax Law*, 69 TEMP. L. REV. 1413, 1436-37 (1996) (explaining the rationale behind taxing married couples as a single economic unit).

[27] *See id.* at 1431-50 (stating that spouses should be taxed separately); *see also* Christian, *supra* note 20, at 265-79 (comparing the effects of income splitting and income aggregation).

growing out of bargaining between husbands and wives. These are husbands and wives who sometimes have divergent interests that are framed by social institutions and norms governing marriage and divorce and, most importantly, are influenced by their individual economic circumstances. This means that these models predict that family expenditure decisions may depend on who earns it and who controls the money. This carries the implication that husbands and wives should be treated as distinct economic units for tax purposes.

It turns out that it is quite difficult to empirically distinguish between these models. I could talk a long time about that but I won't. Instead, what I will talk about is that there seems to be mounting evidence that family consumption decisions do depend upon the distribution of earnings between the husband and the wife. In some pretty conclusive evidence, Lundberg, Pollack and Wales show that when the United Kingdom began remitting their substantial child benefit allowance directly to mothers rather than as supplements to fathers' paychecks, spending on children's clothing rose by an average of £50 and spending on mothers' clothing rose by an average of £40 for an average two-child family receiving a child allowance of about £500.[28] The point is, simply, that switching to direct payments to the mother from payments to the father caused significant changes in what the money was spent on.

More generally and looking at a broader range of evidence, spending on a wide range of goods and services changes as the share of income earned by the wife increases. As an example, when this occurs, spending on restaurant meals and childcare increases; spending on alcohol and tobacco decreases.[29] The implication for tax policy is that while the evidence may not be fully conclusive, there is significant evidence that husbands and wives do not ignore the source of the income in making economic decisions. That means that it may be inappropriate to view them as a single economic unit.

There is another issue that we need to address. Our treatment

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[28] *See* Shelly J. Lundberg et al., *Do Husbands and Wives Pool Their Resources? Evidence from U.K. Child Benefit*, 32 J. HUM. RES. 463 (1997).

[29] *Cf.* Peter D. Brandon, *Income-Pooling Arrangements, Economic Constraints, and Married Mothers' Child Care Choices*, J. FAM. ISSUES, May 1, 1999 at 350 (reporting that a wife's abilities to participate in childcare payments is key to choice of childcare).

of the household is inconsistent in light of the many different types of household structures we have today in the United States. The differential treatment of couples depending on their marital status raises serious issues about equity between married and unmarried couples. This only scratches the surface of the problem. In fact, our tax treatment of families leads to some bizarre inconsistencies.

Consider the following story: a man and a woman are involved in a long-term relationship, building together a complicated 1990's family. The family involves her children from a previous marriage, children she has adopted on her own, and children they have adopted together. Finally, the man and woman split up. The oldest of these children, now 19, chooses to live with the father. At this point, the nineteen-year-old is in college and the father substantially supports her. Thus, he claims her as a dependent on his tax return. She files her own tax return reporting her own modest income, paying taxes at a lower marginal tax rate, which induces little disincentive to work. It sounds like a happy story. Now, what if I tell you that their names are Woody Allen and Soon Yi Previn. Now it's complicated. We have three ways of viewing these two for tax purposes. First, they can file as I have just described. Second, they can be required to file separately as unrelated individuals. Since they are not married, they do not have to file jointly and there is no need to file — no marriage penalty. Finally, they may get married, in which case we tax them as a married couple filing jointly and they face a potentially significant marriage penalty. Now, I do not mean to make too much of this example and, certainly, not to make fun of Mr. Allen and Ms. Previn. Still, I hope it illustrates the difficulties we face in forging equitable taxation when we employ a tax system that levies taxes differentially based upon the intimate personal relationships between people.

Finally, I should note that this discussion has completely ignored the claim that children have to the earnings of their parents. The substantial experience we have in this country with divorce and child support payments indicates that children, in some sense, own some of the earnings of their parents. Divorced fathers are routinely required to pay some of their earnings to support their children.[30] As

[30] *Cf.* 59 AM. JUR. 2d, Parent and Child §59 (1987) (requiring adjudication and contribution of child support; further mandating that no father can release himself

such, equitable taxation turns on the question "how much money did an individual have claim to" or "whose money is it?" We may find ourselves moving towards a system of separate filing, perhaps, even something like the French system. In France, income earned by all household members is pooled for tax purposes. It is then divided among all family members. In the French system, children are counted as half an adult. Recent work by Lazear and Michael, based on United States data, has suggested that we use a weight of .4 for a child. But these are details.[31]

Most tax policy research related to the family moves fairly quickly from the observation that the family income can be earned by various family members, to a discussion of problems posed by pursuing the inconsistent goals of marriage neutrality, progressive taxation, and horizontal equity across families with equal income. Thus we discuss the marriage tax, labor supply, household structure and formation and so on. At the same time, our principles of income taxation suggest that we tax folks based on their ability to pay. In the case of the income tax, forming an estimate of ability-to-pay must begin with a definition of individual income and that turns on a definition of what is the economic unit that is appropriate for taxation. I would like to suggest that measuring and allocating income across household members — whether the household is defined by marriage, cohabitation, or blood relations — is an important and complicated task that must be accomplished first in order to create an equitable and efficient system of income taxation.

PROF. THOMAS: Thank you, Amy.

Just one comment on the Allen/Previn household, I wonder if they would be a bonus couple rather than a penalty couple? I think, she would be lucky if they were a penalty couple.[32]

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from an obligation to support merely by giving child away).

[31] *See* EDWARD P. LAZEAR & ROBERT T. MICHAEL, ALLOCATION OF INCOME WITHIN THE HOUSEHOLD 147-48 (1988) (observing that an adult spends $100 on himself for every $40 he spends on a child, indicating an income allocation ratio of $100 to $40, or 1 to .4, suggesting that .4 represent a child for income tax purposes).

[32] If both spouses earn at least one-third of their combined income, they are likely to incur a marriage penalty. Thus if one spouse had an adjusted gross income of $1million in a given year, the other spouse would have to have at least $500,000 in adjusted gross income for the couple to experience the marriage penalty effect. If one spouse contributes less than one-third of aggregate income, filing a joint return generally