The Heritage Foundation Backgrounder

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REDUCING THE CRUSHING TAX BURDEN ON AMERICA'S FAMILIES

INTRODUCTION

The federal government has put America's families under financial siege. Middle-income as well as blue-collar families are finding it hard to buy a first home or pay for their children's college tuition. To a large degree, this is because of an explosive rise in the burden of federal taxation.

- In 1950, the average American family with children paid only 2 percent of its income to the federal government in taxes. Today that same family pays 24.5 percent.[1]
- The average family now loses $10,060 per year of its income due to the increase in federal taxes as a share of family income. This tax loss exceeds the annual cost of the average home mortgage.
- When state and local taxes are included the government now takes 37.6 percent of the income of the average family with children.[2]
- Most employed wives are not aware that they are really working to support Uncle Sam, not to raise their family's standard of living. Among married-couple families where both the husband and wife are employed, two-thirds of the wife's earnings go to pay for increased federal taxes; only one-third goes to supporting the family.

1 These figures include federal income and Social Security taxes.

2 This figure includes federal income tax, Social Security taxes, federal indirect taxes, and state and local taxes. The author wishes to thank Chris Edwards of the Tax Foundation for providing this information.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

☞ If federal taxes as a share of family income were restored to the 1950 levels, the average employed mother in a two-parent family could leave the labor force entirely and the family would see only a modest drop in post-tax income, compared with the family's post-tax income under today's tax rates.

During the past four decades, the federal income tax burden on a family of four has increased by over 300 percent as a share of family income. Single Americans and married couples with no children have escaped most of this tax increase.

☞ Measured by average after-tax per capita income, families with children now are the lowest income group in America. Their average after-tax income is below that of elderly households, single persons, and couples without children.

The family is the core of American society. It is the principal mechanism through which values, knowledge, discipline, and motivation are passed from one generation to the next. The family almost alone molds the character of future generations, and thus it serves as the foundation of civilized life. If the family is weakened, government programs cannot repair the damage. But rather than bolstering the American family, the government actually undermines it. The ever-increasing government tax burden on families with children must be reversed if American society is to regain its health and vitality.

Clinton's Promises

During the presidential campaign, candidate Clinton charged that "The Republicans who run the federal government have abandoned working families. Millions of Americans are running harder and harder just to stay in place... middle class families pay more and earn less."[3] As a solution, Clinton promised to reduce the taxes paid by families with children, stating:

> Virtually every industrialized nation recognizes the importance of strong families in its tax code; we should too. We will lower the tax burden on middle class Americans....[4]

This theme was repeated in the book *Putting People First*, by Bill Clinton and Al Gore, where the authors again promised to "grant additional tax relief to families with children."[5]

The Kasich Budget Plan

Since coming to office, however, President Clinton has instead proposed enormous increases in federal spending and has increased taxes on middle class families.[6] Fortunately, Representative John Kasich (R-OH) has developed an alternative budget, which fulfills Clinton's promise to cut taxes for families with children. The Kasich budget plan will provide a $500 tax credit for each child in a family. All families with children who

3 "Putting People First: A National Economic Strategy for America," Clinton campaign document, p. 8.

4 *Ibid.*, p. 9.

5 Bill Clinton and Al Gore, *Putting People First* (New York: Times Books, 1992), p. 100.

6 Robert Rector, "President Clinton's Commitment to Welfare Reform: The Disturbing Record So Far," Heritage Foundation *Backgrounder* No. 967, December 17, 1993.

pay taxes and have incomes below $200,000 will be covered by the plan.[7] Under the plan, a family with two children will see its taxes cut by $1,000 and its post-tax income raised by $1,000. In effect, the Kasich plan puts $500 in the pocket of parents for each child in their family.

HOW WASHINGTON HAS HIKED TAXES ON CHILDREN

Federal taxation of families with children has increased dramatically over the past four decades. In 1948, the typical family of four paid just two percent of its income to the federal government in direct taxes.[8] In 1992, the equivalent family paid nearly 24.5 percent of its income to the federal government.[9] As Chart 1 shows, when state and local and indirect federal taxes are included, the tax burden on that family equals 37.6 percent its income.[10]

The rise in federal income taxes on families with children in the last four decades has been much faster than for other groups of Americans.[11] The root cause of this growing anti-family bias in the federal income tax code is the eroding value of the personal exemption. The personal exemption for children was intended to offset part of the annual costs of raising a child by allowing families to deduct an amount of money from their taxable income. In 1948, the personal exemption was $600. This was equal to roughly 17 percent of the median income of a family of four, then $3,468.[12] For the average family, the $600 personal exemption shielded 68 percent of family income from federal income tax. Families could reduce their tax bill further by itemizing deductions or taking the standard deduction, and this protected most of the remaining 32 percent of income from income tax. The result: in the late 1940s and early 1950s the average family with children paid little or no income tax.

In the past four decades, however, increases in the personal exemption have lagged far behind the rise in incomes and inflation. Chart 2 shows the declining value of personal exemptions relative to the income of the average family of four. As the value of the personal exemption has declined, the income tax paid by families with children has increased.[13]

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7 The Kasich tax credit can be used to reduce a parent's income or Social Security taxes. Parents who pay little or no income tax will have their Social Security tax reduced; however, these parents will continue to receive full credit toward retirement under the Social Security system. Working families who pay no taxes would not receive funds under the Kasich plan but these families already receive up to $3,500 through the earned income tax credit.

8 The value of the personal exemption also declined between the imposition of the federal income tax in 1913 and World War II. But 1948 is chosen as a benchmark because it is neither a depression year nor a war year, and because it marks the beginning of a long period of high inflation and rising taxes.

9 These figures represent the tax rates for a family of four at the median family income level for two-parent families.

10 Estimate based on data supplied by U.S. Bureau of the Census.

11 See Robert Rector, "How to Strengthen America's Crumbling Families," Heritage Foundation *Backgrounder* No. 894, April 28, 1992.

12 Mary F. Henson, *Trends in Income, by Selected Characteristics: 1947 to 1988*, U.S. Bureau of the Census, Current Population Reports, Series P-60, No. 167 (Washington, D.C.: U.S. Government Printing Office, 1990), p. 19.

13 For the personal exemption today to have the same value relative to family income that it did in 1948, it would have to be about $7,000 in 1992 and an estimated $8,000 in 1996.

The second tax blow to family finances has been the increase in Security Social taxes, technically known as "payroll taxes." In 1948, workers paid a two percent Social Security tax on annual wages of up to $3,000: one percent was paid directly by the employee and one percent paid indirectly by the employer through the so-called employer share.[14]

By 1992, combined Social Security taxes had risen to 15 percent of wages on incomes up to $55,500. While all workers have suffered from skyrocketing Social Security taxes, the bite has been most severe on working families with children. The reason for this is that Social Security taxes, unlike regular income taxes, are not adjusted for the number of dependents in a family. So a working parent trying to support a family of four feels the sting of this tax far more sharply than a single person at the same wage level. The effect of Social Security taxation is particularly severe on lower-income parents; a family with an income of $25,000 per year, for instance, pays $3,750 in Social Security taxes. Moreover, Social Security taxes on today's young parents greatly exceed the real value of any retirement benefits they will receive from the system.[15]

The Government Assault on Family Income. Chart 3 shows the growth in direct federal taxes as a share of median family income.[16] In 1948, effective tax rates equalled 2 percent of income for the average family of four. By 1970, they had risen to 16 percent, by 1992 to 24.5 percent.

Chart 4 shows the pre-tax and post-tax income for average family of four between 1948 and 1992.[17] All figures are adjusted for inflation. As the chart makes clear, the growth of pre-tax family income since the late 1960s has slowed. At the same time the "tax bite" or share of family income taken by the IRS has increased enormously.

Taxing Families Out of House and Home. The income loss due to increased taxation has seriously strained American family finances and profoundly affected American family life. Chart 5 shows the effects of increases in federal income and Social Security taxes since World War II on the finances of the average family. Total pre-tax income for the median family of four in 1992 was $47,787.[18] After taxes this family's income fell to $36,915. If federal taxes as a percentage of family income were restored to 1948 levels, the family's post-tax income would have been $46,975. For the median-income American family, the loss of income in 1989 because of the increase in federal taxes as a share of family income, due to the falling value of the personal exemption and the rise in Social Security taxes since the late 1940s, was $10,060.

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14 Liberal and conservative economists agree that both shares of the Social Security tax are in fact direct taxes on workers' wages. See Joseph A. Pechman and Benjamin A. Okner, *Who Bears the Tax Burden?* (Washington, D.C.: The Brookings Institution, 1974), pp. 25-43.

15 Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: The Cato Institute, 1980).

16 Social Security and income taxes as a share of the median income for a family of four in each year. Henson, *op. cit.*, p. 21 and other data provided by the Bureau of the Census. Tax calculations from Heritage model, assuming that families claim itemized deductions equal to 23 percent of gross income through 1986 and 18 percent thereafter.

17 Pre-tax income includes the so-called employer's share of Social Security tax which is deducted from parent's wages. The tax burden calculated includes income tax and both shares of Social Security tax.

18 Data from the U.S. Bureau of the Census. Total pre-tax family income includes the employer share of Social Security tax deducted from the parents' wages.

This income loss severely affects the ability of families to support themselves. The median price of a single family home purchased in 1992, for instance, was $103,700. The average annual mortgage payment on such a home (including principal and interest) was $7,380.[19] Thus, the annual family income loss due to increased federal tax rates for the average family in the last four decades actually exceeds the annual cost of an average family home mortgage.

Family Time Famine. The loss of income due to rising taxes also helps explain why so many mothers have felt compelled to join the work force to make ends meet. For the average family in which both the husband and wife are employed, the wife's earnings equal about 34 percent of total family income.[20] The average employed mother, juggling her job and family demands, knows only too well that despite her efforts the paychecks she brings home do not seem to be raising her family's living standard very much. The reason: only about one-third of her earnings actually are taken home for the family's budget. The remaining two-thirds of today's mother's earnings pay the higher federal taxes on family income levied since World War II. In fact, if federal tax rates as a percentage of family income were restored to 1948 levels, and if the average employed mother in a two-parent family were to leave the labor force entirely, the family would see only a moderate dip in real post-tax income.

Charts 6 and 7 show why this is so. Average total pre-tax income in 1992 in families where both spouses were employed was $55,908. Of this, the husband's average earnings were $36,455 and the wife's average earnings were $19,453.[21] After federal taxes, post-tax income for this family fell to $42,412. If federal tax rates as a percentage of family income were restored to 1948 levels, the family's post-tax income would be $35,725 if only the husband worked, and just $6,687 less than the family's current post-tax income today with both spouses working. Thus nearly two-thirds of the employed wife's average earnings go to pay for increased taxation; only one-third to support the family.

This does not mean that all employed mothers would want to leave the labor force if taxes were lowered to earlier levels. But it does show strongly that rising federal taxation is a key factor in the financial and personal strains that force many mothers reluctantly into the work force. It also helps to explain why parents today typically spend 40 percent less time interacting with their children than did parents in earlier generations. While parents in 1965 spent 30 hours per week in direct contact with their children, by 1985 such time spent with children had dropped to just 17 hours.[22]

Surveys indicate that the pressure on parents to work harder and longer to keep the family financially afloat is eroding the quality of family life. A 1988 *USA Today* survey found that 73 percent of two-parent families would choose to have one parent remain at home full time to care for their children if "money were not an issue."[23] A 1989 survey

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19 Data provided by the National Association of Realtors.

20 U.S. Bureau of the Census, *Earnings of Married-Couple Families*, Current Population Reports, Series P-60, No. 165 (Washington, D.C.: U.S. Government Printing Office, 1989), pp. 8, 9.

21 Pre-tax income figures include the employers' share of Social Security tax. Data from the U.S. Bureau of the Census.

22 William R. Mattox Jr., "The Parent Trap," *Policy Review*, Winter 1991, p. 6.

23 *Ibid.*

by *The New York Times* found that 72 percent of employed fathers and 83 percent of employed mothers feel torn between the demands of their jobs and their desire as parents to spend more time with their families. A 1989 Cornell University study discovered that two-thirds of mothers employed full time would prefer to work fewer hours in order to devote more time to family life. And over half of the fathers and mothers surveyed in a similar *Los Angeles Times* poll conducted in 1990 stated that they feel guilty about spending too little time with their children.[24]

CONCLUSION: PROVIDING FAMILY TAX RELIEF

America's often disparaged traditional two-parent family is the principal social institution by which the work ethic, self discipline, intellectual motivation, and moral character are passed on to the next generation. The American family is the foundation of American society. When the family is weakened, the nation is weakened.

But the American family is in deep trouble. A crushing tax burden is making it increasingly difficult for middle-class families to support themselves. What families need from government is not new spending and new social programs. Those have done little or nothing to help families, and paying for them merely has added to the tax burden on these same families. The best way for the federal government to strengthen families and assist parents in their vital role of raising the next generation of Americans is to reduce their tax burden.

Fortunately, Representative Kasich has developed an alternative budget that fulfills Clinton's promise to cut taxes for families with children. The Kasich budget plan will provide a $500 tax credit for each child in a family.[25]

All families with children who pay taxes and have incomes below $200,000 will be covered by the plan. Under the plan, a family with two children will see its taxes cut by $1,000 and its post-tax income raised by $1,000. In effect, the Kasich plan puts $500 in the pocket of parents for each child in their family. Families with children need and deserve the Kasich family budget.

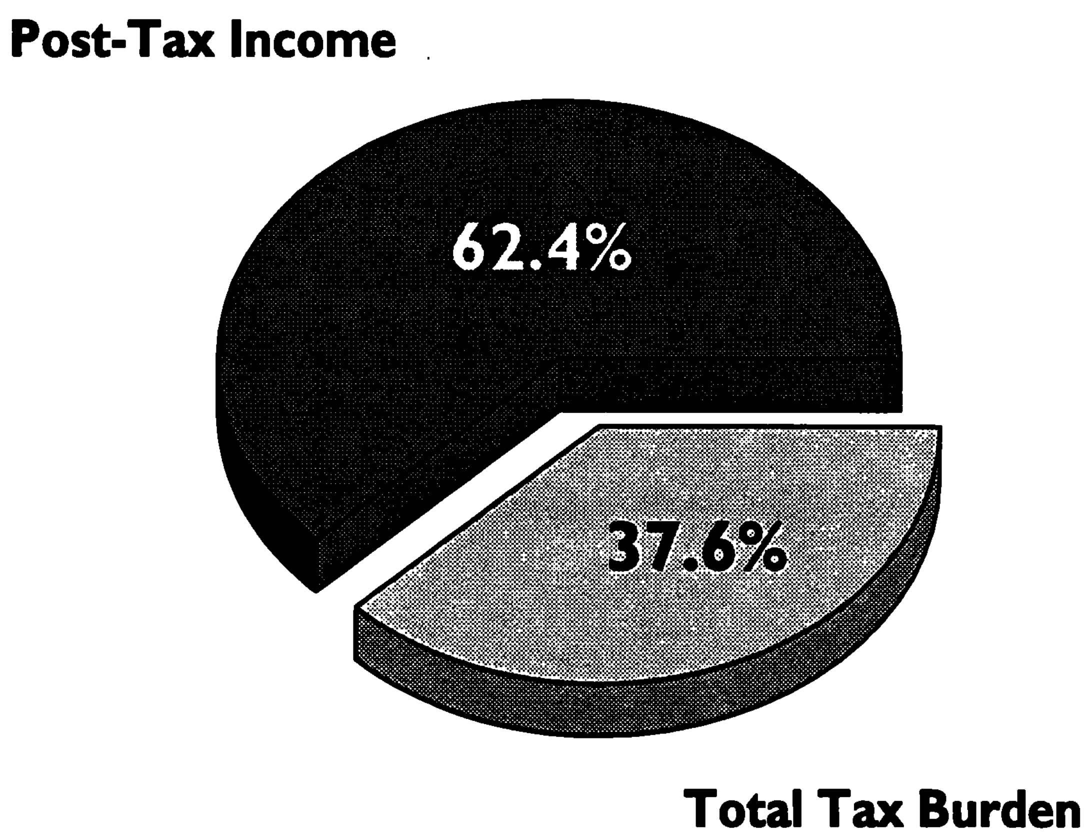
Robert Rector
Senior Policy Analyst

24 *Ibid.*

25 To understand family tax relief it is important to note the difference between a tax credit and a tax exemption. With an income tax exemption, income equal to the amount of the exemption is exempted from income tax. Thus for a family in the 15 percent income tax bracket, a $500 increase in the personal exemption decreases taxes owed by $75. By contrast, under a tax credit the amount of the credit is deducted from the taxes paid. It directly reduces tax liability. Thus for the same family in the 15 percent income tax bracket, a $500 tax credit decreases net taxes by $500. And because a tax credit can be applied to both income and Social Security taxes, it is the better way to reduce the tax burden on modest-income families.

Chart 1

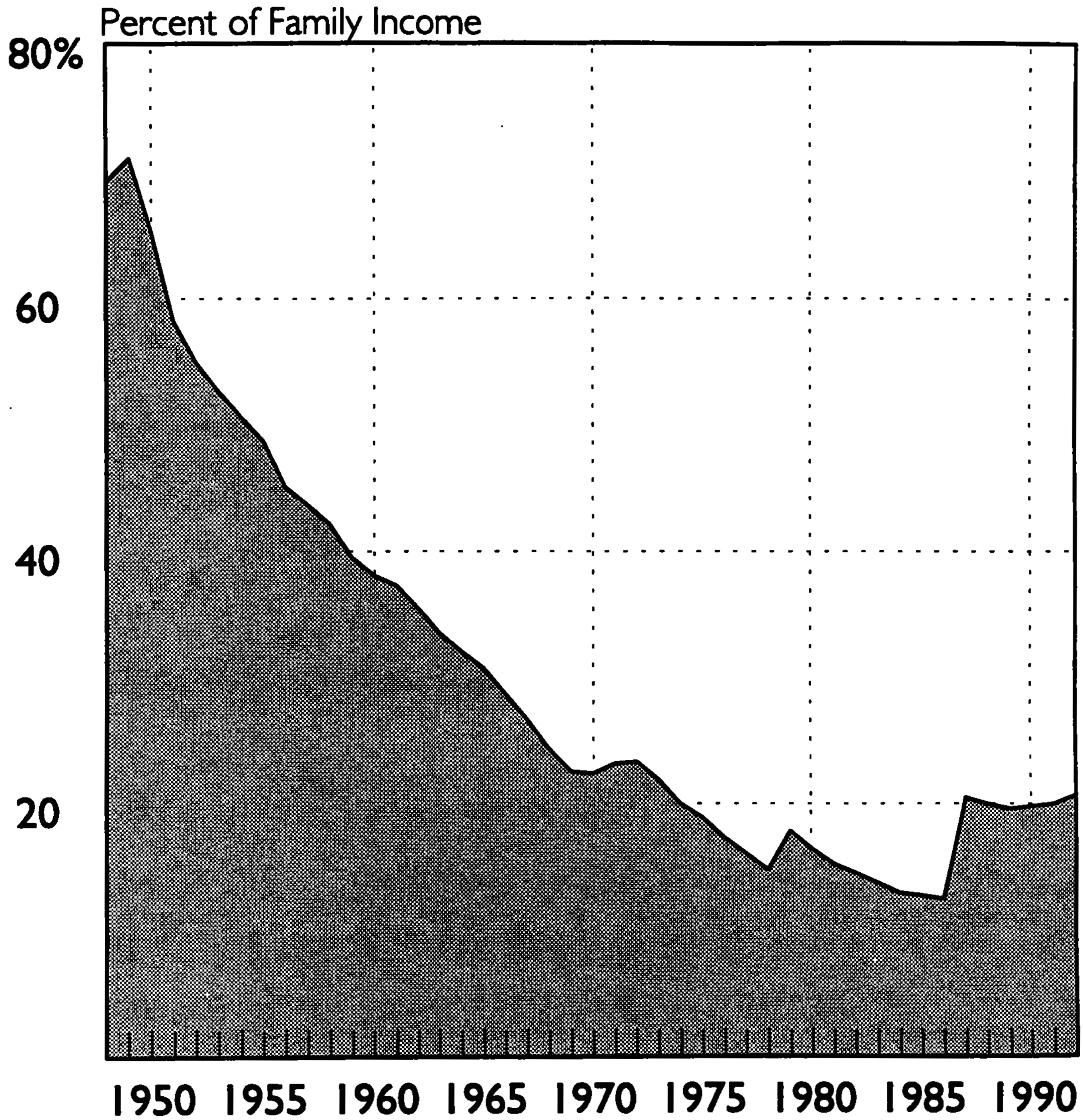
Total Federal, State and Local Tax Burden on a Median Income Family of Four in 1992



Source: Data provided by the Tax Foundation.

Chart 2

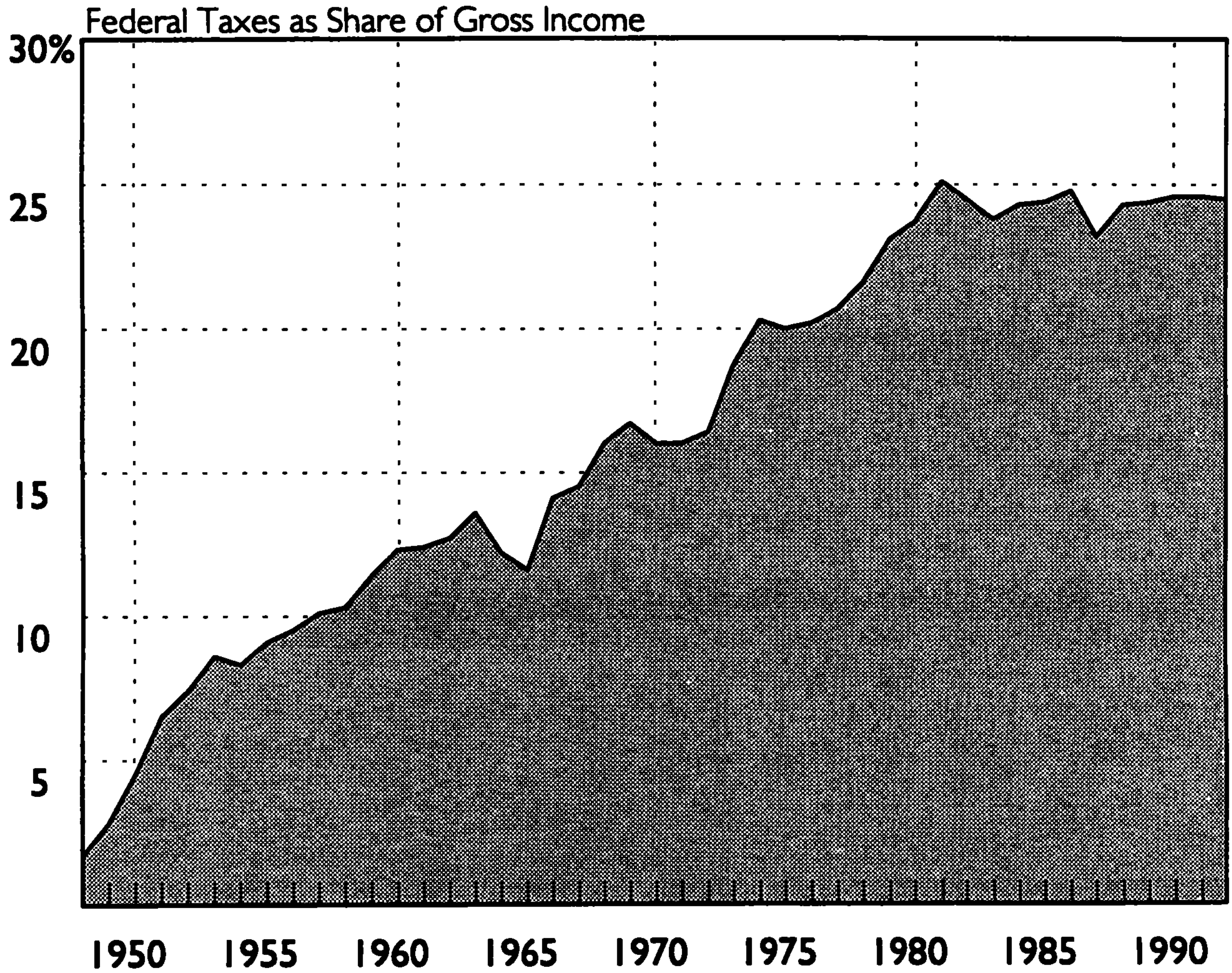
Share of Family Income Shielded from Federal Income Tax by Personal Exemptions



Source: Heritage Tax Model, income data from U.S. Bureau of the Census.

Chart 3

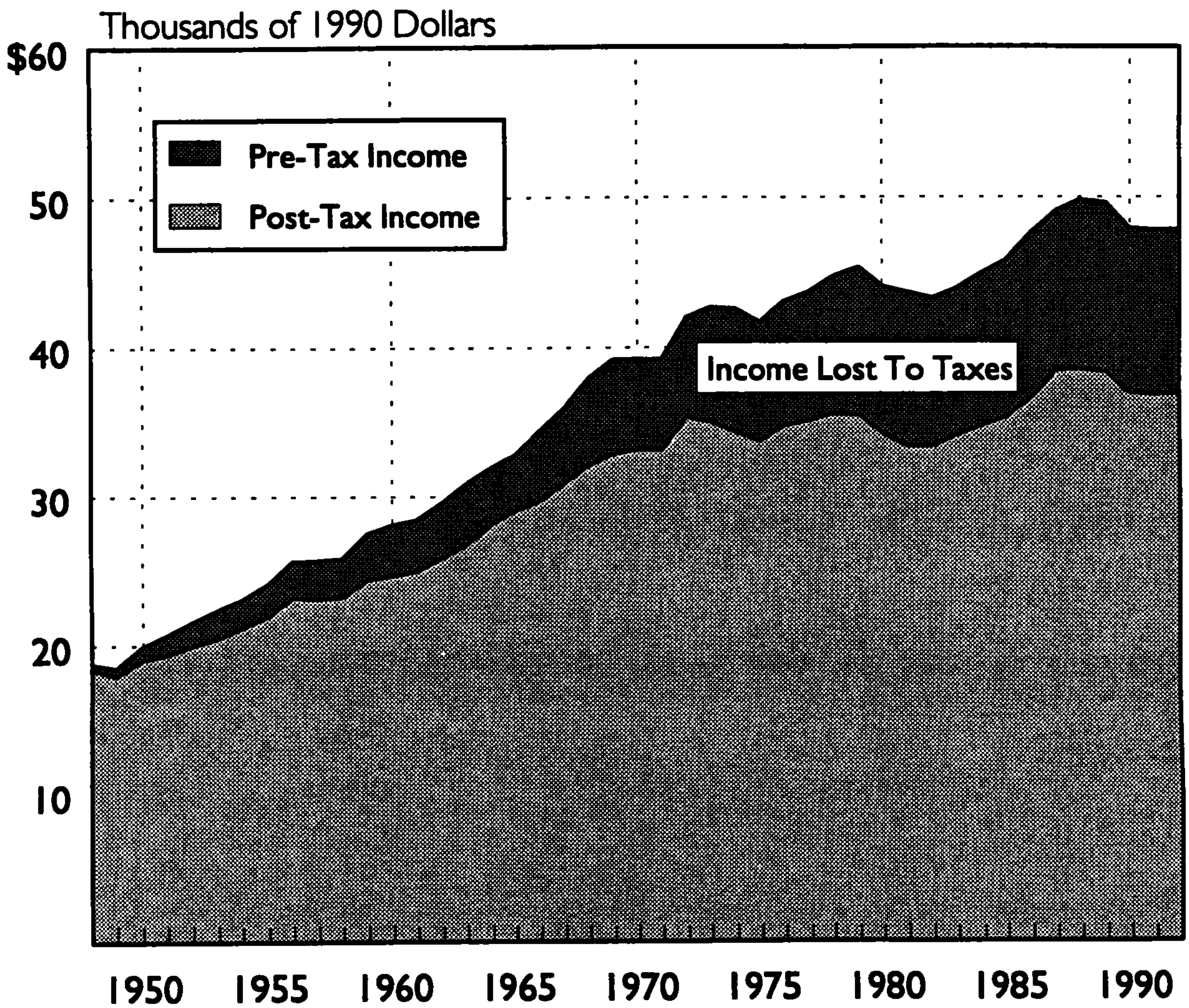
Federal Taxes as a Share of Median Family Income: 1948-1992



Note: Figures are for a median income family of four.
Source: Heritage Tax Model, income data from U.S. Bureau of the Census.

Chart 4

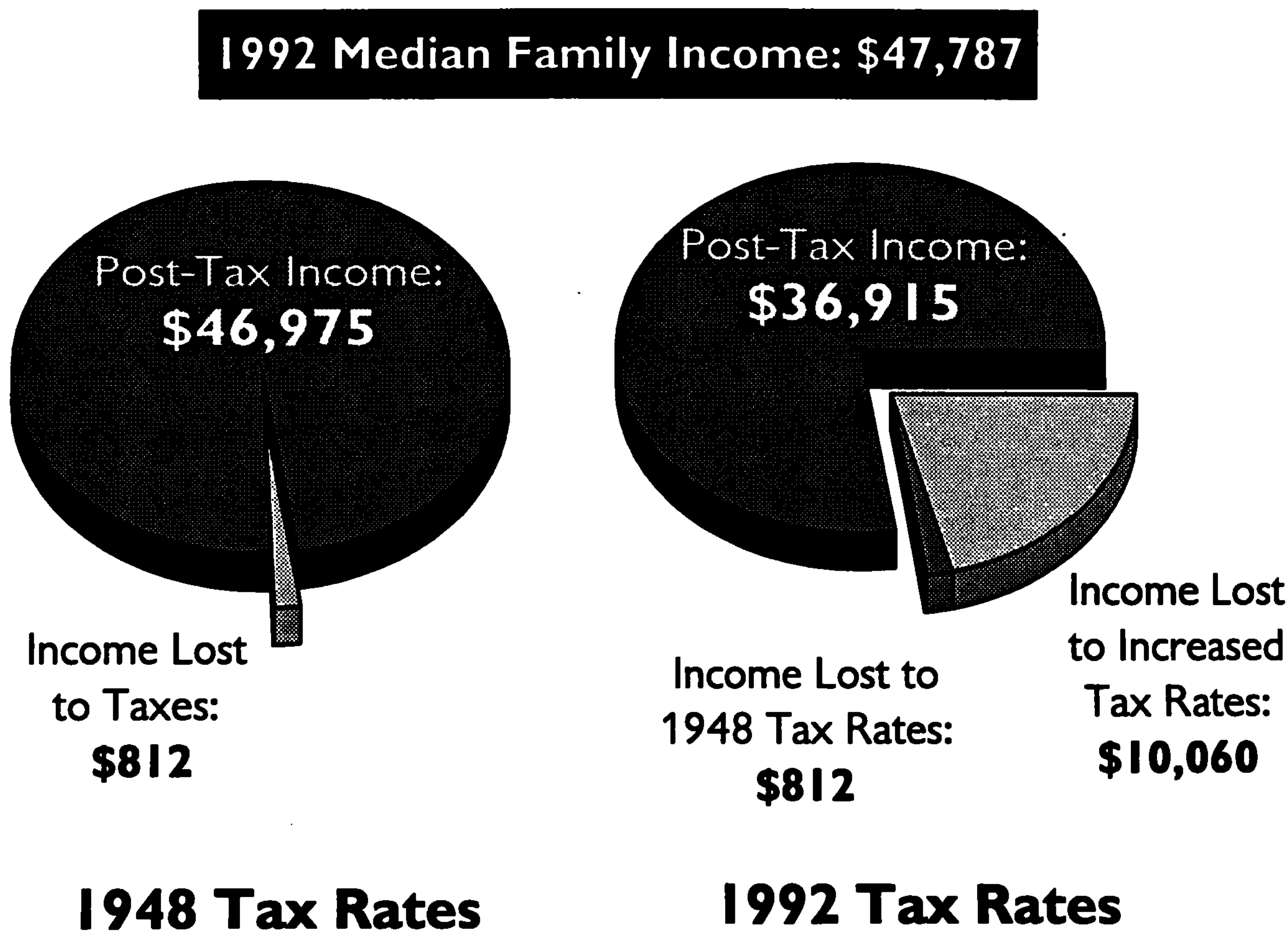
Income and Federal Taxes for a Family of Four: 1948-1992



Note: Figures are for a median income family of four.
Source: Heritage Tax Model, income data from U.S. Bureau of the Census.

Chart 5

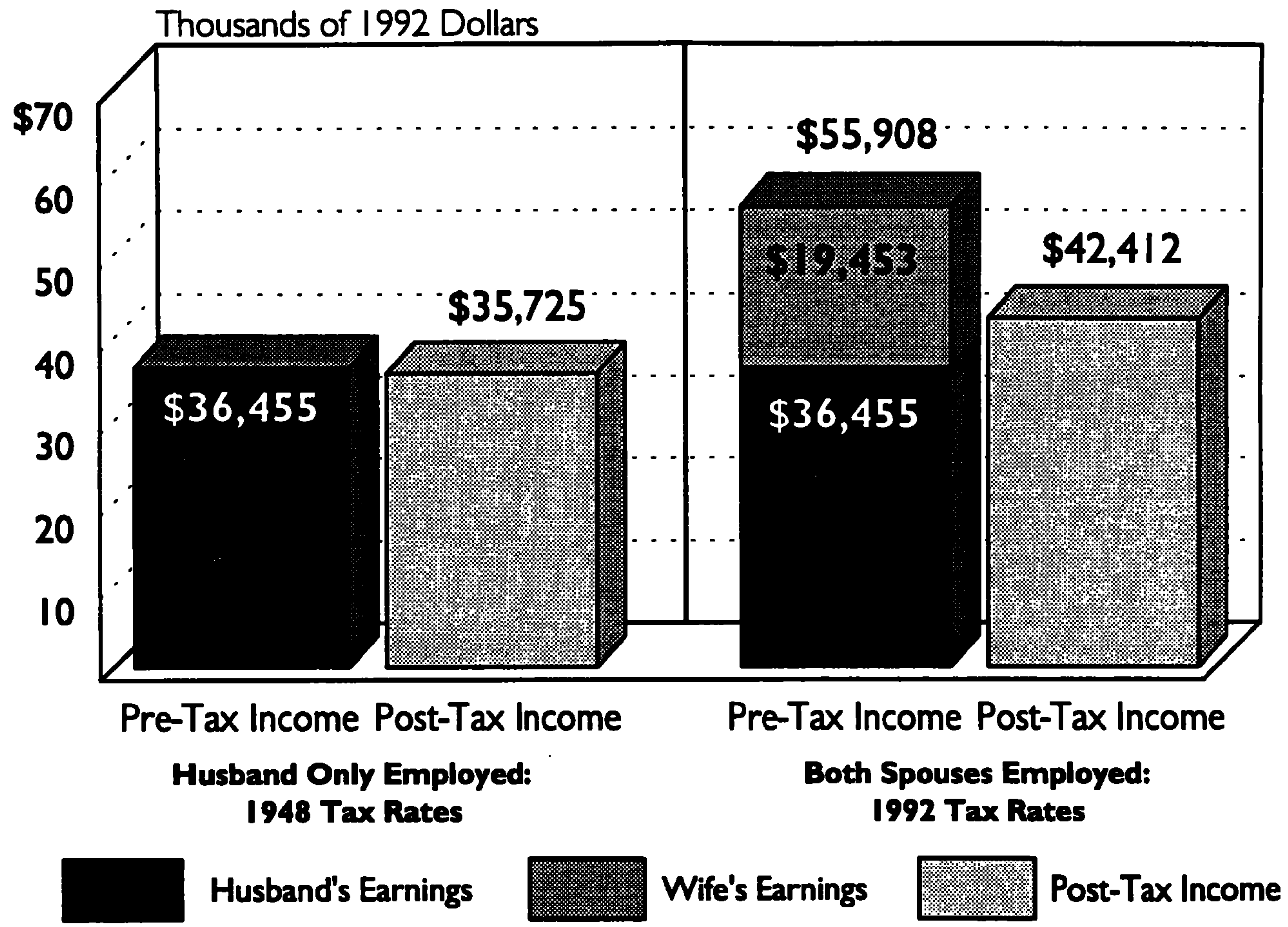
Average Income Families Would be Taxed $10,060 per Year Less if Federal Tax Rates Were Returned to 1948 Levels



Source: Heritage Tax Model, income data from U.S. Bureau of the Census. Data for a median family of four.

Chart 6

Rising Federal Taxes: Now Both Parents Must Work

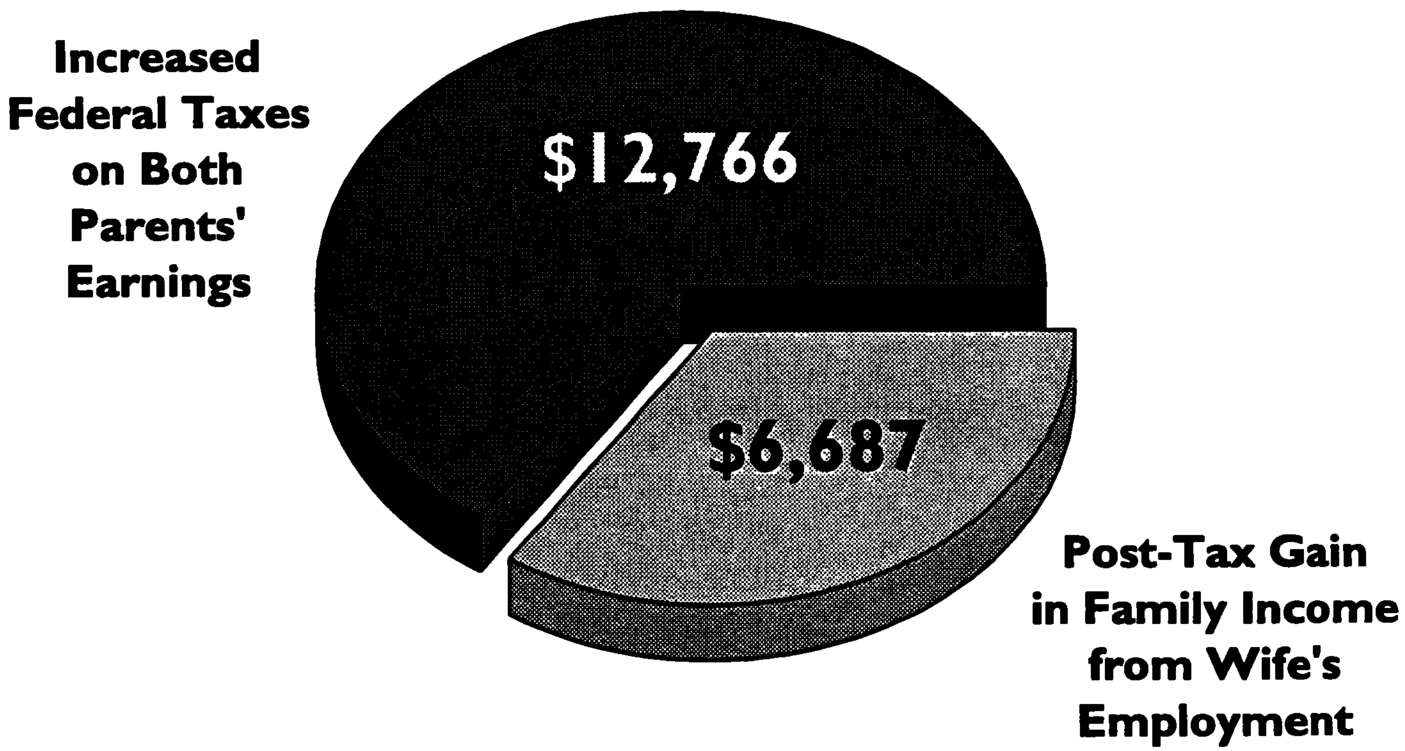


Note: Average 1992 income. Pre-tax income includes employer share of Social Security.
Source: Heritage Tax Model, income data from U.S. Bureau of the Census.

Chart 7

Increased Federal Taxes Consume 65% of the Family Income Provided by Working Wives

Average Pre-Tax Earnings of Employed Wives in Two-Parent Families: $19,453



Source: Heritage Tax Model, income data from U.S. Bureau of the Census.