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REAGAN'S TAX REVOLUTION: A BIG BOOST FOR FAMILIES AND THE POOR

INTRODUCTION

Ronald Reagan's tax reform plan offers major gains for the working poor. It does so as part of a comprehensive effort to lighten the tax burden on families, correcting in part the anti-family bias of the current tax code.¹ The Reagan plan seeks specifically to raise the zero-bracket amount and personal exemptions and to expand the earned income tax credit, thereby improving the lot of the poor and of families. If enacted, the Reagan proposal would ensure that families with income at or below the poverty level no longer paid any federal income tax.

The federal tax burden on the poor has been increasing for many years. The tax code distressingly has had the same systemic bias against the poor as it has had against taxpayers in general. Inflation-induced bracket creep, for example, has meant that taxes rise automatically with inflated incomes. Since tax brackets are narrower at lower income levels, and the personal exemption and standard deduction (known as the zero-bracket amount) constitute a larger proportion of income, bracket creep has disproportionately hurt

1. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (Washington, D.C.: Government Printing Office, May 1985), see especially pp. 5-22.

This is the third in a series on the President's tax reform plan. It was preceded by "Reagan's Tax Revolution: Ending the Free Ride for State and Local Taxes," Issue Bulletin No. 114, June 14, 1985 and "Reagan's Tax Revolution: Fair Play for Energy," Issue Bulletin No. 115, July 10, 1985. Future studies will examine the plan's impact on international finance and trade, financial institutions, and savings, investment, and risk-taking.

lower-income taxpayers. This was corrected only partially by the 1981 Tax Act. To make matters worse, while the poverty threshold is indexed to inflation, the tax threshold is not. The result: increasing numbers of Americans have been stung by federal tax liabilities, resulting in an unintended shift of the tax burden toward families, especially larger ones.

In the 1960s and 1970s, Congress made a number of attempts to eliminate the tax burden on poor families by increasing the personal exemption and standard deduction, or by enacting tax credits such as the earned income tax credit (EITC). Despite these efforts, the real value of the current \$1,000 personal exemption is now about half what it was in 1955 and has fallen from 14 percent of median family income in that year to just 4 percent.² Even the EITC lost its impact because it was not indexed for inflation.

By removing poor families from the tax rolls, the Reagan tax revolution guarantees that they will never reenter those rolls so long as they are poor. Indexation, already in place for this year, will prevent bracket creep. And the President's tax reform proposes to give a big financial boost to families and the poor.

MAJOR PROVISIONS DIRECTLY AFFECTING THE POOR AND FAMILIES

Increasing the Zero-Bracket Amount and Personal Exemptions

The Reagan tax proposal recommends key tax code changes that would aid poor Americans significantly. The zero-bracket amount (ZBA) is currently \$2,390 for unmarried individuals and heads of households, \$3,540 for married couples filing jointly, and \$1,770 for married couples filing separately. For nonitemizing taxpayers, no tax is imposed on income up to that amount. For itemizing taxpayers, the ZBA is subtracted from deductions to determine taxable income. Generally, unless deductions total more than the ZBA, a taxpayer does not itemize.

Each taxpayer now is also entitled to deduct a personal exemption of \$1,040 as well as \$1,040 for each dependent. For the blind, and elderly, an additional \$1,040 personal exemption is provided. Starting in 1985, current law provides for the ZBA and personal exemption to be adjusted for inflation, determined by the previous year's consumer price index.

2. Rebecca M. Blank and Alan S. Blinder, "Macroeconomics, Income Distribution, and Poverty," (Cambridge, Massachusetts: National Bureau of Economic Research, Working Paper No. 1567, February 1985), p. 35.

The Reagan Plan: The ZBA would increase to \$2,900 for single returns, \$4,000 for joint returns, \$2,000 for married persons filing separately, and \$3,600 for single heads of households, starting in 1986. The personal and dependent exemption would be increased to \$2,000. The exemptions for the blind, and elderly would be repealed, but the tax credit for the elderly, blind and disabled would be expanded, which would have the net effect of increasing the tax-free income levels for the blind and elderly.

As the following tables illustrate, the Reagan proposal will provide significant relief to the poor and to all families:

TABLE 1
Comparison of Personal Exemption and ZBA for 1986 under
Current Law and the Reagan Proposal

	Current Law <u>1/</u>	Reagan Proposal
Personal exemption:		
For taxpayers, spouses, and dependents (each)	\$1,080	\$2,000
For the blind and the elderly (each)	1,080	<u>2/</u>
Zero-bracket amount:		
Single persons	2,480	2,900
Heads of households	2,480	3,600
Married couples	3,670	4,000

Source: Office of the Secretary of the Treasury May 28, 1985

1/ Includes indexation for expected inflation.

2/ Replaced with expanded credit.

TABLE 2
 Comparison of the Poverty Threshold and the Tax-Free
 Income Level for 1986 under Current Law and the President's
 Proposal

Status	Poverty Threshold	Tax-Free Current Law <u>1/</u>	Income Levels Reagan Proposal
Single Persons without dependents	\$ 5,800	\$3,560	\$4,900
Heads of households with one dependent <u>2/</u>	7,700	7,945	10,158
Married couples <u>3/</u>	7,500	5,830	8,000
Married couples with two dependents <u>2/</u> <u>3/</u>	11,400	9,575	12,798

Source: Office of the Secretary of the Treasury May 28, 1985

1/ Includes expected indexation for inflation.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

TABLE 3
1986 Tax-Free Levels of Income for the Elderly and Blind
and Those with Employer-Provided Disability Income

	Single		Joint (Couple)	
	Current Law	Reagan Proposal	Current Law	Reagan Proposal
Ordinary Taxpayer	\$3,560	\$4,900	\$5,830	\$8,000
Age 65 or More <u>1/</u>				
No Social Security	9,383	11,600	14,450	17,667
Average Social Security <u>2/</u>	10,640	11,900	18,990	19,500
Blind <u>1/</u>				
No Social Security	4,640	11,600	7,990	17,667
Average Social Security <u>2/</u>	10,640	11,900	18,990	19,500
Under Age 65, with Employer- Provided Disability Income (\$6,000 single/\$9,000 joint)	9,383	10,400	14,450	15,333

Source: Office of the Secretary of the Treasury May 28, 1985

The Earned Income Tax Credit

The federal tax with the most pernicious effect on the poor is the Social Security payroll tax. This rose from 12 percent of total federal tax receipts in 1950 to 38 percent in 1983. In the same period, maximum taxable earnings have grown much faster than average earnings, and the payroll tax rate has quadrupled. The result has been disastrous for the poor, forcing the least able to pay more taxes. The payroll tax burden for a family of four at the poverty line has risen from 4.5 percent in 1970 to 12.3 percent in 1980 to 13.4 percent in 1983.

The earned income tax credit (EITC) was enacted in 1975 to improve work incentives and provide relief from the payroll tax to

3. Ibid., p. 36.

working low-income taxpayers with children. It differs from other tax credits in that it is refundable; in other words, if the credit exceeds tax liability, the difference is paid to the taxpayer by the government. Despite upward adjustments in the EITC, inflation has eroded the credit significantly. The maximum credit was \$400 in 1975, climbed to \$500 in 1979, and was raised to \$700 last year--an increase of just 38 percent in a period when the consumer price index soared more than 85 percent. Inflation also has reduced the number of families eligible for the credit and the credited amount for those who remain eligible.

The Reagan Plan: The maximum credit would increase to 14 percent of the first \$5,000 of earned income, or \$700. By lowering the percentage by which the credit is reduced with rising income, the income level at which the credit would be eliminated would rise to \$13,500 from the present \$11,000. Beginning in 1986, moreover, the maximum credit and the income limits would be adjusted for inflation to prevent the credit from declining in value.

OTHER PROVISIONS AFFECTING THE POOR

Several other provisions in the Reagan tax proposal affect families and the poor. Among them:

Repealing the Two-Earner Deduction

The so-called "marriage penalty," or the increase in the aggregate tax liability of two married workers, results from the progressive tax rate structure. To a certain degree, it is ameliorated by the existence of a separate rate schedule for joint returns. Further relief was provided in the 1981 Tax Act, which allowed a deduction for a portion of a second wage earner's income. This, however, is a poorly designed means of correcting the distortions from aggregating income in marriage. For many, the deduction does not eliminate the "marriage penalty," while for others, it actually provides a "marriage bonus."

As American Enterprise Institute Adjunct Scholar Douglas Besharov and Resident Scholar John Weicher point out, the President's proposal is not "punitive" toward working wives nor is it an attempt to encourage the "traditional family values" associated with nonworking wives. Rather, it is remedial, retreating a little from overcorrection of the problem of working wives' marginal rates. Even if the President's proposal is enacted, tax rates on working wives still will be far lower than they were as recently as 1975. "By fairly taxing a mother's earnings," Besharov and Weicher write, "the

President's proposal more nearly neutralizes the tax code's impact on her decision about entering the work force."⁴ Ideally, the tax code should neither encourage wives to work nor discourage them from doing so. Since the Administration proposals include flatter tax rate schedules and lower marginal tax rates, the significance of tax consequences for individual work decisions will be greatly reduced.

The Reagan Plan: The Reagan tax plan proposes repealing the two-income deduction enacted in 1981.

Child-Care Credit

A nonrefundable credit currently is allowed to taxpayers who incur employment-related child and dependent care expenses. The amount of expenses eligible for the credit is subject to a dollar limit and earned income limit. The maximum allowable expenses for one qualifying dependent individual are \$2,400; for two or more they are \$4,800. The expenses eligible for the credit cannot exceed the earned income of a single householder or of the lower earning spouse in a two-parent household. The credit ranges from 20 percent to a maximum of 30 percent. Because the credit is intended in part to help lower-income workers, the maximum credit is allowed only for those with adjusted gross incomes of \$10,000 or less. The credit is decreased by one percentage point for every additional \$2,000 of earnings, down to the minimum of 20 percent of eligible expenses claimed by taxpayers with taxable incomes over \$28,000.

The Reagan Plan: The credit is to be changed to a deduction, which would be closer to the treatment given other business-related expenses. An equivalent deduction, of course, is relatively less favorable to low-income families than the current credit, since they face lower tax rates. But there is only minimal negative impact of this change on low-income families. Very few have benefited from the child-care credit. In 1983, only 1 percent of married-couple families and 6 percent of single-householder families who claimed the EITC also claimed the child-care credit.⁵ What is much more important is that all low-income families, including the small number now using the child-care credit, will enjoy tax reductions from the Reagan proposal's increase in the zero-bracket amount, personal exemptions, and EITC. These offset and exceed any losses from the change in treatment of child-care expenses.

4. Douglas J. Besharov and John C. Weicher, "Return the Family to 1954," The Wall Street Journal, July 8, 1985.

5. Joint Committee on Taxation, Federal Tax Treatment of Individuals below the Poverty Level (Washington, D.C.: Government Printing Office, 1985), p. 7.

Tax on Medical Benefits

Employer-paid health insurance premiums are now fully exempt from tax, as are a number of other fringe benefits.

The Reagan Plan; The first \$10 a month in employer-paid health premiums for single Americans and the first \$25 for families would be taxed as income. The majority of low-income families would not be affected, either because they will fall below the new tax threshold or do not receive employer-paid health benefits. Yet over one-third of low-income taxpayers could pay some tax on health benefits--up to \$45 per family annually.

Since even the wealthiest taxpayers would incur an additional maximum burden of only \$105 from this measure (based on a 35 percent top marginal rate), it would raise only about \$4 billion in new revenue by 1990. This proposal also would place a higher relative burden on low-income taxpayers than on higher income Americans. In addition, taxing the first \$20 of a health benefit would do nothing to discourage the tax-free over-insurance that has been contributing significantly to medical cost inflation.

The proposal to tax health plans in this way is a perplexing departure (in effect, a complete about-face) from the Administration's longstanding policy of seeking to cap the tax-free treatment of health plans. Up to now, the Administration has sought to tax health plans above a ceiling and not, as this proposal does, below a floor. The earlier and sounder Administration approach would tax the "golden" health plans, which are often a device for providing income in the form of tax-free fringe benefits.

Spousal IRAs

The current law allows a deduction for annual contributions to individual retirement accounts, widely known as IRAs, up to \$2,000 of annual earnings. Thus if husband and wife both work and each earns at least \$2,000 annually, each can make a separate deductible IRA contribution of \$2,000; this gives this dual wage-earning couple the opportunity of contributing \$4,000 annually to IRAs. A married couple with a nonwage-earning spouse, however, now can contribute only a maximum of \$2,250 to two accounts, allocated any way except that not more than \$2,000 can be contributed to any one account. This strongly implies that the traditional homemaker is not entitled to the same benefits in planning for old age as the wage-earner.

The Reagan Plan: Husband and wife each could contribute \$2,000 to an IRA, regardless of which spouse earned it, so long as their joint income at least equals that amount.

This is sound policy. IRA tax benefits are intended to encourage individuals to save for retirement. Not only do IRAs expand the pool

of savings available for investment, but also play an important part in many individuals' overall retirement security strategy. The disproportionate poverty rate among elderly single women is in part a result of their lower historical participation in the paid labor force and, therefore, inadequate retirement benefits. The Administration's proposal recognizes this and addresses the needs of nonearning spouses.

GENERAL ISSUES RAISED BY THE REAGAN PROPOSALS

The Single Poor

The increases in the zero-bracket amount (ZBA) and personal exemptions in effect exempt all poor families from federal income tax. This is not the case for all single persons. Although the gap between the tax-free income level and poverty threshold for single persons would be narrowed by the Reagan proposals, the tax-free income level would still be \$900 less than the poverty threshold in 1986 for those under 65 (see Table 2). The Administration resists closing the gap because this would be a windfall to nonpoor single persons and create a hefty "marriage penalty" when two working single persons married. The Administration also notes correctly that many single persons live with relatives or roommates. As such, many of these are not necessarily poor, and those with official poverty status may not necessarily be needy.

While the Administration's arguments have merit, it seems reasonable that, as long as the federal government has an official definition of poverty, it should be a matter of policy not to tax those it calls poor. It is illogical and inefficient to take money with one hand from a group that the government is assisting with transfer payments with the other hand.

Eliminating the tax liability of all Americans classified as poor would not cost the Treasury much. There were 4.5 million poor "unrelated individuals" under 65 in the U.S. in 1983, but only 2.7 million with any earnings. Their mean income from earnings was \$2,082; thus most pay no income tax. Of poor singles who worked full-time year-round, only 69,000 earned \$5,000 and over. This essentially is the only group of the poor who would pay federal income tax under the Reagan proposal.⁶ As it is, they are already heavily burdened by the Social Security tax.

6. Data from Bureau of the Census, Current Population Reports, Series P-60, No. 147, Characteristics of the Population Below the Poverty Level: 1983 (Washington, D.C.: Government Printing Office, 1985), Tables 11, 32, and 34.

The Administration, therefore, should modify its proposal to exempt single persons under the poverty line from federal income tax by granting them a credit to the extent of their tax liability. This would end the taxation of all Americans deemed poor.

Family Policy

Measures to help the "traditional" homemaker and give her equal tax code treatment with working wives also make sound economic sense. These include eliminating the two-earner deduction, changing the treatment of child-care costs, and increasing the spousal IRA limit aim, as explained above, thereby improving the neutrality of the tax code so that it does not affect personal decisions about entering the work force. The two-earner deduction, for example, does not treat families in similar economic circumstances equally and, in general, goes farther than necessary in attempting to rectify the problem of high marginal tax rates on working wives. The proposed changes in the tax treatment of child-care costs would bring child-care into line with the treatment of other income-generating expenses. Though the credit was introduced to help poor working wives, this is not the group reaping most of the benefits. The increase in the spousal IRA limit, meanwhile, simply equalizes the tax treatment of families in similar economic circumstances.

These measures further redress some of the biases against "traditional" families and families in general that have crept into the tax code in past few decades.

The big winners from the Reagan proposals all are families, those in which husband and wife are both wage earners and those headed by a single person as well as those in which the wife is a traditional homemaker. The increases in the zero-bracket amount (ZBA) and the doubling of the personal and dependent exemptions recognize the social value and the costs of raising children. They redress some of the inequities faced by single heads of households and large families. This marks a significant and laudable shift in tax policy. The majority of families would see their taxes fall under the Reagan plan, and the poorest families would benefit the most.⁷

CONCLUSION

The reform proposed by Ronald Reagan marks a significant advance in federal anti-poverty policy. Single-parent households, poor families, and large families would benefit the most. It rejects those tax measures that push people into poverty or place insuperable

7. The President's Tax Proposals, *op. cit.*, pp. 14-15.

obstacles in the way of Americans trying to work their way out of poverty. Such policies merely and tragically abet welfare dependency and burden other taxpayers. The Reagan proposal, moreover, takes long overdue steps to lighten the disproportionately heavy tax burden on families.

The Reagan tax revolution, however, could do even more for families and the poor. A credit to eliminate the income tax liability of single persons below the poverty line, for instance, would make the policy of exempting the poor from federal income tax explicit and consistent. As for employer-provided health insurance, the Administration should return to its original proposal to cap the amount of tax-free health benefits to discourage over-insurance; it should drop its current proposal to tax the first dollars of such coverage.

Reagan's reforms that help the poor cannot be isolated from the entire tax package, as the poor will benefit little in the long run if measures to help them are coupled with raising corporate taxes and the top marginal personal tax rate. As it is, even under the Reagan proposals, the federal tax code penalizes investment. To further burden business and higher-income Americans will have severe negative impact on job creation and economic development. Measures to help the poor specifically will be of little value to them if the economy stagnates.

To promote growth and thus job opportunities for poor Americans, the top personal rate must be no higher than the 35 percent proposed by Reagan; indeed, it should be trimmed to 30 percent. It is also critical for the poor that tax reform lower the costs of capital and labor and does not attempt to help favored sectors of the economy at the expense of others. Otherwise the result surely will be at the expense of the overall economy. Measures to lower and eliminate the tax burden on families and the poor will help them only if these measures are part of a broader strategy for encouraging investment, savings, and job creation.

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