

The Thomas A. Roe Institute for Economic Policy Studies

January 30, 1989

**ENDING THE TAX CODE'S ANTI-FAMILY BIAS BY
INCREASING THE PERSONAL EXEMPTION TO \$6,300**

Thomas M. Humbert
John M. Olin Fellow

INTRODUCTION

Every lawmaker claims to be pro-family. Yet the income tax code devised by Congress reflects a different reality. The federal income tax system treats children less favorably than a business lunch. Like spending for the movies, the costs of raising children are for the most part considered a routine, discretionary expense, instead of America's most important investment in its future.

Reflecting this strange premise, the tax allowance for the costs of nurturing children — the personal exemption — has been permitted to erode dramatically in value over the years. The result has been a half century of steeply increasing federal income taxes on Americans who raise children. In 1948, the median-income family of four paid virtually no income taxes, and only \$30 a year in direct Social Security taxes (1 percent of income). This year, the equivalent family will pay \$2,669 in income taxes and over \$2,500 (7.51 percent of income) in Social Security taxes. Just looking at federal income taxes, this median-income family's tax burden has soared over 2,500 percent from 0.3 percent of income to over 8.0 percent of income in about four decades. Singles and married couples without children, by contrast, largely have escaped this income tax increase.

Sapping Families' Financial Health. As taxes on children have climbed, the family's ability to provide for its own needs has been impaired. New government programs are touted as a cure for the family's financial ills. But these congressional "remedies" are for a problem created by Congress. And

new taxes to finance government programs would sap even further the financial ability of the family to stand on it own.

A far more effective strategy to address the problem would be simply to allow a family with children to keep a greater portion of its own income. Restoring the personal exemption to the equivalent of its level after World War II would allow that family to keep thousands of dollars more of its own money, making the family less dependent on government, improving access to health care, child care, and education opportunities, and giving the working poor a fighting chance to climb out of poverty.

Toward A Fair Tax System. As a political strategy, increasing the personal exemption could head off government-provided day care, mandatory health care, education subsidies, and similar initiatives that would prolong the process of first taking away family income and then giving it back in government-determined services. It could also reduce pressure for a boost in the minimum wage — which would cut employment opportunities for the poorest and least skilled Americans.

In the presidential campaign, George Bush recommended a \$1,000 tax credit for each child under age four in families earning less than \$20,000. The Bush proposal would be an important step toward a fair tax system for the American family. Moreover, the Bush plan does not discriminate between traditional families and families where both spouses work. It does not subsidize one life style at the expense of another. Further, the tax credit approach gives the same financial assistance to all families, not bigger tax breaks to wealthier families.

Yet this “toddler tax credit” is not enough. The real challenge for Congress and the incoming Bush Administration is to empower the family by rolling back the postwar tax increases on children. This strategy will require tax policy to recognize that children are America’s most important capital investment and are fundamental to productivity gains and to future economic growth.

Reversing 40 Years of Discrimination. As its ultimate goal, the Bush Administration should press Congress to increase the personal exemption to at least \$6,300 — \$4,300 above where it now stands. At this level, the personal exemption would shield from taxes about the same portion of income as it did in 1948 when the modern income tax first began to take form. This would give the median-income family of four over \$25,000 in tax-free income. Combined with the current \$5,000 standard deduction, this exemption would eliminate from the income tax rolls those four-person families earning less than \$30,200 yearly — about one-half of today’s tax returns.

More important, with this action, Congress and the Bush Administration would strengthen the family and reverse 40 years of mounting tax discrimination against children.

HOW THE TAX CODE BECAME ANTI-FAMILY

On October 13, 1981, senior Treasury official Eugene Steuerle told a tax conference that “perhaps no change in the nation’s tax laws has been more significant, yet less recognized, than the shift since the late 1940s in the relative tax burdens of households of different size.”¹ In the years since Steuerle’s observation, the anti-family, anti-children bias has remained, despite the 1981 and 1986 tax acts.

The 1981 Economic Recovery Tax Act (ERTA) at least has kept matters from getting worse by indexing the tax system for inflation and by providing modest additional tax relief. Had ERTA not been enacted, inflation-induced “bracket creep” and the erosion of the personal exemption would have raised the average income tax on the median-income² family of four from about 10 percent in 1980 to almost 13 percent by 1986 (see Chart 1). But thanks to ERTA, the median-income family’s tax burden actually fell one percentage point to about 9 percent of income. Families of all sizes experienced similar tax reductions (see Table 1).

The 1986 Tax Reform Act was the most pro-family and pro-children legislation in 50 years. At last, the income tax threshold was raised above the poverty line, with 5 million poor families taken off the tax rolls altogether. Moreover, a disproportionate share of tax relief was given to larger families, as a result of doubling the personal exemption, which will take full effect this year.

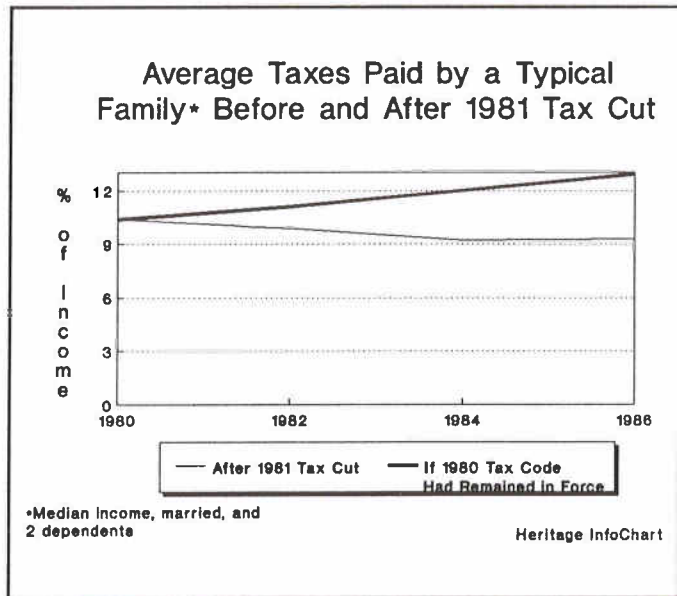


Chart 1

1 Eugene Steuerle, "The Tax Treatment of Households of Different Size," in Rudolph G. Penner, ed., *Taxing the Family* (Washington, D.C.: American Enterprise Institute, 1983), p. 73.

2 Median income is the level of income such that 50 percent of all families are above it, and 50 percent, below. Median family income is a useful measure for tax purposes because it provides a snapshot of the financial condition of the household in the middle of the income distribution. Average family income is total income divided by number of households, and thus average family income could be anywhere in the income distribution of families and is therefore less representative of the typical household.

Table 1
Federal Income Tax for Median Income Family
by Family Size and Type, 1948-1989*

Year	Median family income (\$)	Single			Joint				Head of Household				
		Tax (\$)	tax as percentage of income	No children	2 children	4 children	2 children	4 children	Tax (\$)	tax as percentage of income	4 children		
1948	3,187	300	9.7	208	6.5	9	0.3	0	0	109	3.4	0	0
1954	4,167	534	12.8	402	9.6	162	3.9	0	0	282	6.8	42	1.0
1960	5,620	780	13.9	625	11.1	385	6.9	145	2.6	511	9.1	265	4.7
1966	7,532	962	12.8	741	9.8	524	7.0	328	4.4	668	8.9	451	6.0
1972	11,116	1,544	13.9	1,201	10.8	916	8.2	631	5.7	1,108	10.0	814	7.3
1978	17,640	2,602	14.8	2,101	11.9	1,768	10.0	1,408	8.0	2,093	11.9	1,722	9.8
1980	21,023	3,348	15.9	2,643	12.6	2,176	10.4	1,756	8.4	2,600	12.4	2,110	10.0
1982	23,433	3,543	15.1	2,767	11.8	2,327	9.9	1,904	8.1	2,757	11.8	2,297	9.8
1984	26,433	3,641	13.8	2,844	10.8	2,421	9.2	2,061	7.8	2,888	10.9	2,429	9.2
1986	29,458	4,107	13.9	3,217	10.9	2,744	9.3	2,348	8.0	3,283	11.1	2,767	9.4
1987	30,853	3,869	12.5	2,876	9.3	2,306	7.5	1,736	5.6	2,611	8.5	2,041	6.6
1989**	33,499	4,244	12.7	3,269	9.8	2,669	8.0	2,069	6.2	2,969	8.9	2,369	7.1

*Figures for 1948-1978 from Eugene Steuerle, "The Tax Treatment of Families of Different Size," *Taxing the Family*, 1983, p. 76.

**estimates based on projected median family income using CPI figures from the U.S. government.

Note: Example assumes itemizable expense equal to 23 percent of AGI in all years. No deductions are made for two-income families.

Source: Median family income -- U.S. Bureau of the Census, *Money Income of Households, Families and Persons in the United States*.

Neither the 1981 nor the 1986 tax reforms, however, completely removed the decades of accumulated tax bias against families. The median-income family of four will have its income taxes cut to 8.0 percent of income in 1989, down from the 1986 level of 9.3 percent. But this tax burden is still far above the level for the median-income family with children throughout most of the 1940s, 1950s, and 1960s (see Table 1).

TAX INCREASES ON THE FAMILY

Despite the 1981 and 1986 tax reforms, the American family is still over-taxed. Table 1 shows the tax burden on singles, heads of household, and married couples with no children, two children, and four children. Measured as a percentage of income, the income tax burden has risen most dramatically for families with children, with the biggest tax increases hitting the largest families. Single Americans and married couples without children pay about the same portion of their income in taxes as they did in the 1950s.

The reason for such a tax increase on families has been the erosion of the real value of the personal exemption as a result of inflation (see Chart 2). The personal exemption is \$2,000 per person under current law. By comparison, adjusted for inflation, the personal exemption in 1948 was worth \$3,000, \$7,000 in 1940, and around \$10,000 in the 1920s and 1930s. Though increased numerous times, the personal exemption has fallen far behind the amount needed to keep up with inflation.

Nor has the value of the exemption kept up with increases in income (see Chart 3). The exemptions for a median-

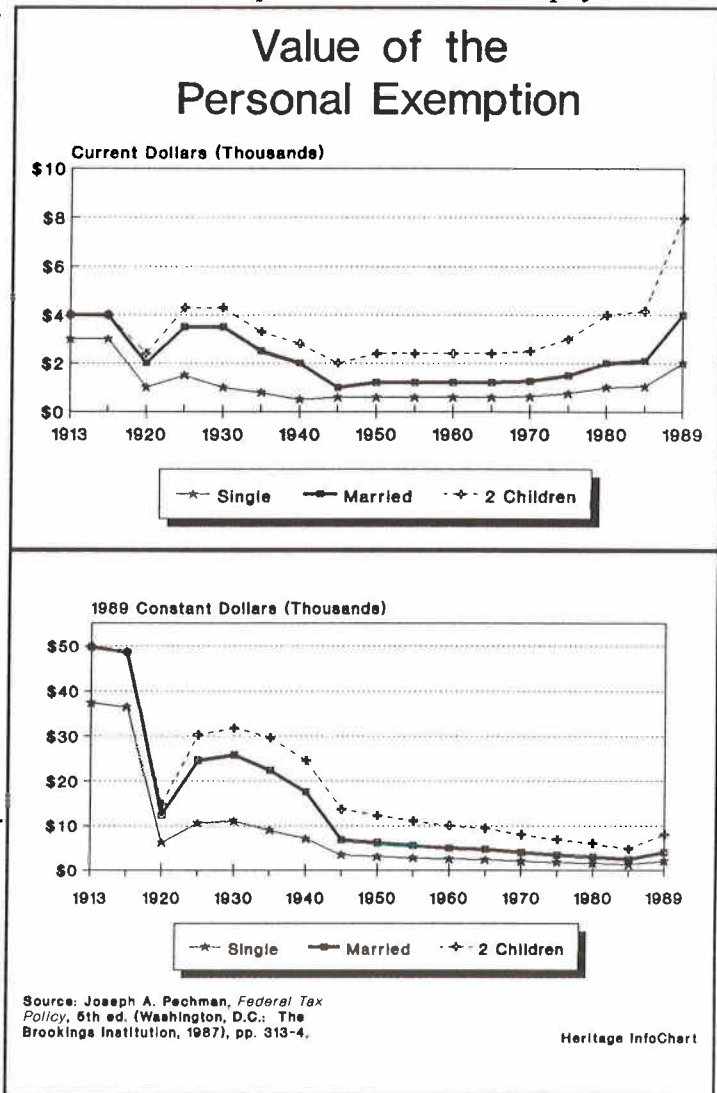


Chart 2

income family of four shielded 75 percent of income from tax in 1948. The exemptions for the same median-income family today would shield less than 25 percent of household income. The personal exemption would have to equal about \$6,300 per person, or over \$25,000 in tax-free income for a family of four, to shield the same proportion of income as in 1948. Simply put, today's family faces heavy tax discrimination compared with equivalent families in earlier generations, and its tax status also has eroded when it is compared to that of single Americans or couples without children.

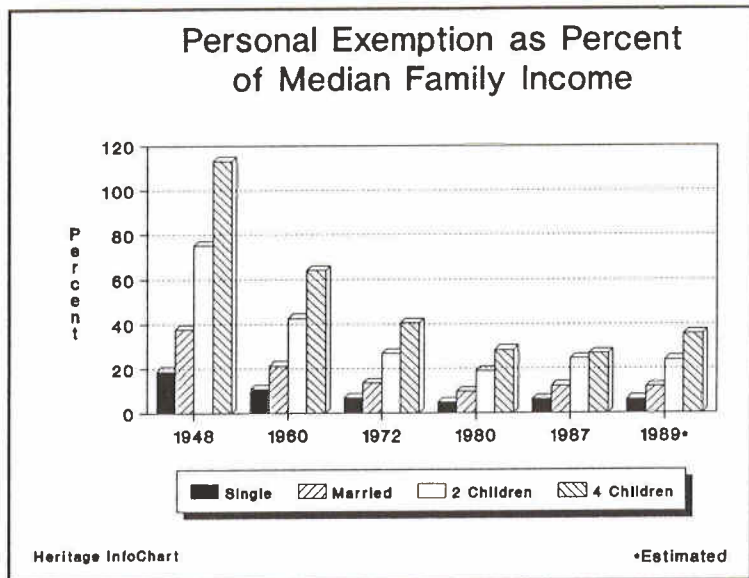


Chart 3

Advent of the Income Tax. The best standard for judging the current tax code is the immediate postwar period. During that time, the modern income tax emerged as the basic government revenue source. Prior to World War II, the U.S. government was far different in size and scope. In 1929, for example, total government receipts were less than 4 percent of gross national product (GNP). But in the years preceding and immediately after World War II, the U.S. became a modern industrial society and assumed world leadership. To finance these growing domestic and foreign responsibilities, the income tax was extended to a majority of workers; and in 1943 income tax withholding became the backbone of the current system.

Starting in the postwar years, receipts have tended to average 15 percent to 20 percent of GNP, with the individual income tax accounting for the overwhelming proportion of general revenue funds. Thus, making comparisons between the late 1940s and late 1980s gives an accurate and valid picture of how the tax burden has changed, given the similar scale of government activity as a feature of national economic activity.³

THE CASE FOR INCREASING THE PERSONAL EXEMPTION

There is little justification in tax theory for allowing the personal exemption to decrease in real value when measured against income growth or

³ *Economic Report of the President*, Council of Economic Advisors, February 1988.

inflation. Nor is there any rationale for shifting the burden of taxation more onto families with children, especially for imposing the largest tax increase on those families least able to pay. Admittedly, Congress never legislated the change specifically, least of all did lawmakers explicitly try to justify raising taxes on children. Indirectly and unintentionally, however, by not legislating remedies to soften the effects of inflation, Congress has eroded the value of the personal exemption.

Inflation and other factors have, of course, affected various groups. Some might argue, therefore, that there is no particular reason to turn back the clock to aid families rather than other groups. But there are at least six reasons why good tax policy requires restoring the relative value of the personal exemption to what it was in the 1940s.

Reason #1: There is growing concern about the cost of raising children.

It is a longstanding principle of taxation that some relief should be given to parents for their financial sacrifice in raising children. In the immediate postwar period, in fact, the median-income family with children was not subject to income taxes at all. But especially during the 1960s and 1970s, income taxes on the family soared, even as the costs of raising children also jumped, and education, housing, and health expenditures outpaced inflation. Even moderate-income families today face a severe financial burden in raising children. Increasing the personal exemption would help roll back tax increases and offset some of the higher costs of raising children.

Reason #2: Demographic changes are straining the economy and social insurance programs.

Raising the personal exemption could provide an incentive for Americans to have more children. American Enterprise Institute Senior Fellow Ben Wattenberg argues that the U.S. will need a higher fertility rate to sustain its growing economy and social benefits. He points out that, in recent years, the fertility rate in the U.S. has fallen significantly below its long-term replacement rate. This poses a number of problems. For one thing, it means that the economy will face a decline in young workers. For another, it means that such social programs as Social Security will come under increasing financial strain as a rising population of elderly Americans have to be supported by contributions from a declining population of workers.

Reason #3: Raising the exemption would aid the working poor and encourage more Americans to go off welfare.

It makes no sense to tax low-income workers so much that government support programs — paid for out of those taxes — are necessary to give them a subsistence income. To be sure, the 1986 Tax Reform Act raises the income tax threshold (which includes exemptions plus the standard deduction) slightly above the poverty line for virtually every type of family,

except singles.⁴ Yet families significantly above the poverty line have not been given sufficient tax relief to roll back the tax burden accumulated since the 1940s.

Incentives for the Poor. The working poor are especially vulnerable; they are hit with a high initial tax bracket of 15 percent, together with the equivalent of an additional tax if they lose benefits by leaving the welfare rolls. This combination can easily raise their effective marginal tax rate to higher levels than now are imposed on the rich.

If the personal exemption were increased to \$6,300, the income tax threshold for a family of four would increase to 250 percent of the poverty level, up from 105 percent under current law (see Chart 4). Thus such a family would not begin to pay income tax until it was well clear of the poverty level. The benefit of this is that incentives are enhanced for the poor and working groups to save, work, and invest. Families of other sizes would enjoy similar proportionate increases in tax-free income under such a change.

Moreover, an increase in the personal exemption would be very effective in directing government financial assistance toward those moderate- and low-income workers who suffered the heaviest tax increases over the last 40 years and faced the greatest barriers to work effort. In fact, a \$6,300 personal exemption initially would wipe out at least the federal income tax burden for low-income and working families.

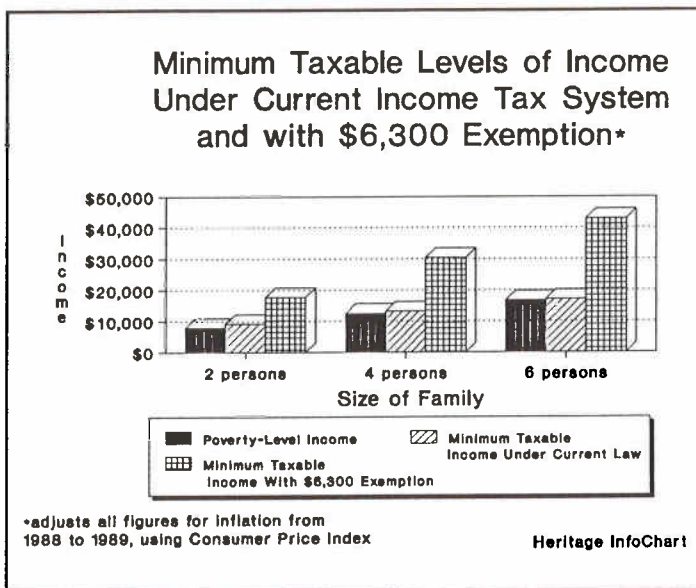


Chart 4

Reason #4: The change would be of immediate help to the embattled middle class.

Middle-income Americans have been hard pressed by escalating taxes on the family. These families today are forced to make heavy financial sacrifices to raise their children. This has encouraged many middle-income families to press for new government programs to assist them with such expenditures as child care and college tuition — even though these programs limit their

4 Joseph A. Pechman, *Federal Tax Policy* (Washington, D.C.: Brookings Institution, 1987), pp. 83 and 84.

discretion as parents and cost tax dollars, imposing a heavier tax burden and a further erosion of their financial situation.

Increasing the personal exemption would allow middle-income families to escape this “Catch 22” situation. They would be able to keep more of their income and thus to pay for the costs of raising their children. This would reduce the pressures to seek new programs that could be financed only through tax hikes. The overwhelming portion of the tax benefits from higher exemptions would go to those earning less than \$70,000 per year.

When the family is strong, the need for government programs is reduced. Increasing the personal exemption is a strategy to empower the family, strengthen its resources, and liberate it from reliance on government.

Reason #5: Raising children should be treated as an “investment” for tax purposes, not as an item of “consumption.”

Economists long have disagreed about the nature of expenditures on children. Some believe that they should be treated as any other item of “consumption.” Parents, they say, receive pleasure from raising children, so they alone should bear the cost. In this view, there is little reason for giving a special tax preference for children, any more than providing a tax break for purchasing a television set.

This view is disputed by a growing body of economic literature. It considers outlays on such items as health services, housing, and education as an investment in “human capital,” which leads to higher productivity and future output, much like maintaining or constructing an industrial machine.⁵ Moreover, the prospective returns on investments in education, according to one 1988 British government analysis, could be about 25 percent, much larger than most investments in the British or American economies.⁶

Investing in People. The distinction between capital and consumption — always somewhat arbitrary — is particularly difficult in the case of spending on human beings. Yet reasonable distinctions are possible. The U.S. tax code allows businesses to deduct their expenditures for the health or training of their workers, but gives very limited tax benefits to parents investing in their children’s future productivity.

A higher personal exemption is one practical way of providing some allowance for the outlays in raising children, such as education and health care, which are more in the nature of human capital expenditures.

⁵ See Gary S. Becker, *Human Capital* (Cambridge, Massachusetts: National Bureau of Economic Research, 1964).

⁶ Cleve Wolman, “A Better Way to Finance Students,” *Financial Times*, December 1, 1988, p. 17; see also, Becker, *op. cit.*

Reason #6: The family is the basic unit of taxation, and exemptions should reflect this.

Most tax theorists regard the family household as the basic unit of taxation. Thus one goal of tax policy has been to impose equal taxes on families who have command over equal resources. The two-earner deduction, different rate schedules for marital status, and income splitting have been used in the past as rough devices to help adjust taxable income for family circumstances. The personal exemption is another adjustment for the taxpaying ability of the family.

For example, a single person earning \$25,000 enjoys a much higher standard of living than a family with children earning the same amount. The personal exemption is supposed to help account for the greater sacrifices and necessary costs of raising a family, thereby more accurately measuring a family's actual living standard.

The current \$2,000 personal exemption does not come close to measuring the true sacrifice required by a family to raise a child. A larger exemption would lead to a tax liability more in line with each household's real circumstances.

COVERING THE REVENUE LOSS FROM INCREASED EXEMPTIONS

Raising the exemption to \$6,300 for all Americans would reduce the U.S. Treasury's income tax revenues by about \$100 billion to \$130 billion.⁷ This revenue loss could be lowered, however, by limiting the increased exemption to children claimed as dependents. A \$6,300 children's exemption, for example, would cut income tax revenues by about \$30 billion to \$50 billion.⁸ If limited further to children under five years of age, the tax revenue loss would be less than \$12 billion.⁹ George Bush's proposal to give families earning less than \$20,000 a \$1,000 tax credit for each child under four would cost \$2.5 billion.¹⁰

Some imaginative proposals, however, would link increases in the personal exemption with other social policy objectives, potentially leading to less revenue loss for the U.S. Treasury. Under one plan, the personal exemption

⁷ Estimates based on Internal Revenue Service, "Individual Income Tax Returns," *Statistics of Income*, 1984, p. 61. Since these estimates are based on numerous simplifying assumptions, they should be viewed as broadly indicative of possible revenue losses, rather than as precise figures. They are also "static," and therefore unrealistically assume no changes in economic behavior resulting from the change.

⁸ IRS, *op. cit.*

⁹ *Statistical Abstract of the United States*, 1987, U.S. Department of Commerce, Bureau of the Census. No phase-out of the exemption is assumed.

¹⁰ Figures released by Bush campaign staff.

could be increased in return for further tax reform. The deduction for state and local income and property taxes is used primarily by upper-income families and tends to subsidize high-tax states. Eliminating this deduction would raise \$15 billion.¹¹

Another option would be a floor for itemized deductions of 20 percent of adjusted gross income. Under this plan, only the amount of allowable expenses exceeding 20 percent of income would be deductible from taxes. This would raise \$31 billion.¹² While eliminating many tax-induced distortions in the economy, however, a deduction floor would make no distinction between economically efficient and inefficient deductions.

Relief for the Middle Class. Changes in the homeowner's mortgage interest deduction could be viewed as another option to offset an increased personal exemption, as some studies show that the mortgage interest deduction inefficiently shifts resources to the housing stock and away from more valuable capital investment and saving.¹³ Few deductions enjoy more popular and political support, and home purchases currently are regarded as the family's most important capital investment, deserving of special tax treatment. Yet many American families fiercely support the mortgage deduction mainly as a tax break for the middle class, rather than an objective in itself. They argue that they need the tax relief to help finance other family expenditures. Increasing the personal exemption would give them this relief and could soften their support of the mortgage deduction. And in general, increasing the personal exemption would provide more total tax relief to middle-income families with children than they can obtain from the current deduction for mortgage interest.

THE DYNAMIC EFFECT OF RAISING THE EXEMPTION

In reality, concerns about revenue losses are vastly overstated. Little faith should be put in "static" revenue estimates because they do not incorporate any change in economic incentives for work, saving, or investment. In essence, these models assume that the economy would be no more productive or robust following the tax cut than before. Such static assumptions were shown to be erroneous in 1981, when they predicted that tax cuts would trigger an economic slowdown and a sharp reduction in tax revenue. They are just as unrealistic when used to assess the impact of an increase in the exemption.

Drawing Americans Off Welfare. Exempting upwards of one-half of all taxpayers from the income tax rolls obviously would have enormous

11 Pechman, *op. cit.*, pp. 358-363.

12 *Ibid.*, p. 100.

13 Patricia H. Hendershott and Sheng-cheng Hu, "The Allocation of Capital Between Residential and Nonresidential Uses: Taxes, Inflation, and Market Constraints," Working Paper No. 718 (Cambridge, Massachusetts: National Bureau of Economic Research, 1981).

consequences for economic incentives and social welfare outlays. Reducing the marginal income tax rate for millions of low paid taxpayers to zero would give poor and working Americans an enormous income boost as well as an incentive to work, engage in entrepreneurial activity, and pursue work training or further education. And by making work more rewarding, a higher exemption also would draw people off the welfare rolls and make them less dependent on government support programs, thereby reducing government social welfare spending (see Chart 5).

Middle-income Americans also would enjoy lower marginal tax rates. With higher exemptions, millions of middle-income taxpayers would drop from the 28 percent tax bracket into the 15 percent bracket — enjoying almost a 50 percent increase in productive incentives.

Thus, by increasing such incentives for economic expansion, a higher exemption would boost the size of the nation's

economy and lead to more tax revenues flowing into the government's coffers. A significant portion of the tax cut thus would ultimately be recouped in increased government revenues through faster economic growth.

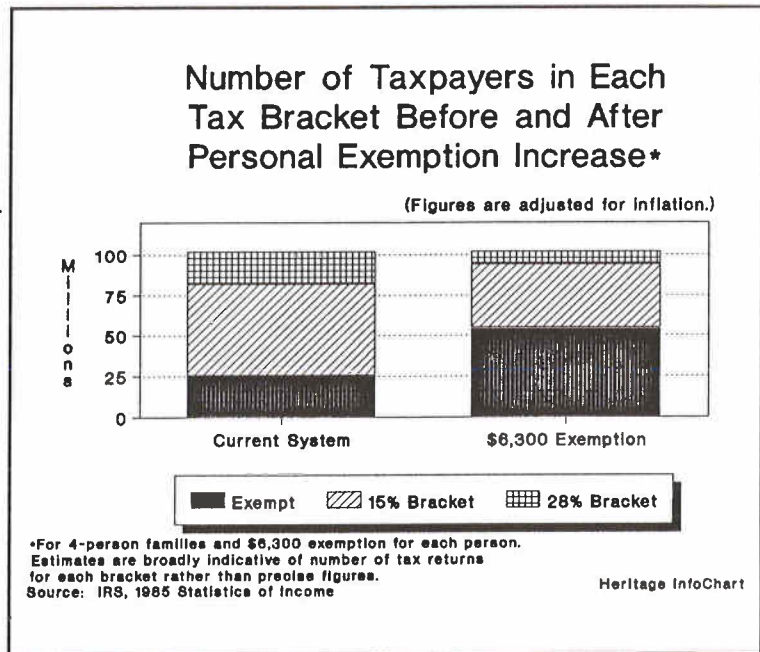


Chart 5

CONCLUSION

As the foundation of a free society, the incubator of traditional values, and the crucible for instilling good character in future generations, the American family must be the first priority of a free and democratic society. Yet the financial pressures on traditional families raising children are acute. The government's discriminatory tax treatment of children has undercut the family's financial security and impeded the ability of parents to provide for the health, education, and welfare of their children. Many point out the bias in the U.S. tax code against saving and investment. They are correct. The greatest bias, however, is that against families with children.

Tax Relief for Rearing Children. Two paths lie ahead. Down one are more government programs to support weakened families. If high taxation of the family is allowed to continue, families increasingly will be unable to provide for themselves. They will look increasingly to the government for help to meet the burden of raising children. The prospect of government taking over the functions and choices of parents should alarm most Americans.

The other path leads toward strong families, a more appropriate role for government, and a growing economy. This path begins by giving American families substantial tax relief for the costs of rearing children. It will require a major, long overdue change in tax policy — it will treat children as an investment in America's future.

Restoring the personal exemption to where it was, in relative terms, in 1948 would allow America's median-income families with two children to keep over \$2,500 more of their own income to raise and nurture their children. A median-income family with four children would enjoy almost a \$4,000 tax cut. With this income boost, families would be less reliant on government programs and have access to vastly improved health and education opportunities.

Strengthening the Family. George Bush's proposal for a "toddler tax credit" shows that he appreciates the vital role in America of families raising children. But to strengthen that crucial institution, his Administration ultimately must ask Congress to roll back a half century of unfair and discriminatory tax increases on America's children.

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