The Heritage Foundation Backgrounder

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REDUCING THE TAX BURDEN ON THE EMBATTLED AMERICAN FAMILY

INTRODUCTION

Lawmakers from both parties in Washington have suddenly awakened to something well understood by Americans who struggle every month to stretch their paycheck to meet family needs: the American family is overtaxed. To cut this tax burden, bipartisan legislation has been introduced in Congress to raise the personal exemption for children in the federal tax code, which is the exemption to offset the cost of raising a child. Other proposed legislation would use a tax credit to reduce the tax bite on families with children. And most recently, the National Commission on Children, chaired by Senator Jay Rockefeller, the West Virginia Democrat, has recommended a $1,000 refundable annual tax credit for each child in a family.

These moves to relieve families with children of some of their tax burden is a welcome, if belated, recognition that action must be taken to reverse a trend in the tax system that has hurt American families. Thanks to huge increases in taxes during the past four decades, the average American family has seen a steadily larger slice of its income disappear, making it harder for many families to support their children. By the mid-1990s, federal tax revenue as a percentage of gross national product (GNP) will equal 20 percent, a rate reached only twice before in the post-World War II period: once in 1969 and once in 1981. The heaviest burden of the rise in taxation falls on families with children.

One-Third to Government. When state and local taxes are included, government now takes over one-third of the income of a two-parent family. Measured by average post-tax per capita income, families with children are now the lowest income group in the U.S.; their average post-tax income is below that of elderly households, single persons, and couples without children.

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.

The federal tax code has become increasingly biased against families with children. The main reason for this is the steady decline in the value of the personal exemption applying to children, which is the tax allowance for the cost of raising children. During the past four decades the federal income tax burden on a family of four has increased by a staggering 150 percent. Single Americans and married couples with no children have escaped the bulk of this tax increase.

In 1948 a median income family of four paid virtually no income tax and only $60 in Social Security taxes (then set at 2 percent of its income).[1] Today the equivalent family pays nearly 24 percent of its income to the federal government in taxes. The income loss in 1989 for the average family due to increases in federal taxes in the post-World War II period is approximately $8,200 – or roughly the annual average mortgage paid on a family home.

Vicious Circle. This reduced tax benefit for children has reduced sharply the American family's ability to provide for its own needs. Worse still, families are caught in a vicious circle. The federal government responds to the financial worries of families by creating new programs to provide services to these families. Then to finance these new programs, Congress raises taxes, further diminishing the ability of families to provide for themselves and triggering calls for more government programs.

To break out of this vicious circle, the American family needs tax relief. Such tax relief can be accomplished in various ways, each with different implications for families and for federal finances.

Arguably the simplest method is to raise the personal exemption for children. This would involve no complicated change in the tax code and would mean, in effect, a larger tax deduction to offset the cost of raising each child. Bipartisan legislation designed to restore the eroded personal exemption for dependent children has been introduced in the House (H.R. 1277) by Frank Wolf, the Virginia Republican. His bill would raise the exemption for children from today's $2,150 to $3,500. A companion bill (S.710) has been introduced in the Senate by Dan Coats, the Indiana Republican.

An alternative method would be to grant a tax credit for children.[2] This differs from an increase in the exemption in two important ways. First, it grants each taxpaying family the same dollar amount of tax relief per child. By contrast, of

1 A median household income level is the level at which half of the households have an income above that level and half below.

2 An exemption means that the income covered by the exemption is not subject to taxation. A tax credit directly reduces tax liability by the value of the credit. For a family whose income is taxed at a 15 percent tax rate, a $1,000 exemption and a $150 credit have the same value.

course, an increase in the exemption would give more relief to families on higher tax brackets.[3] Second, a credit can be used by families to offset their Social Security taxes as well as income tax. This would mean greater tax relief for low-income working families with children, most of whom pay heavy Social Security taxes that are deducted from their paychecks before any deductions or exemptions are applied. A tax credit also can be made "fully refundable," meaning that if the available credit exceeds a family's total tax liability the family receives the difference as a check from the Treasury.

Refundable Credit. Frank Wolf also has introduced a tax credit bill (H.R. 2633). It would allow a refundable credit for children under age five in working families. For families with earnings below $10,000, this credit would equal 5 percent of earnings for each child. For families with earnings between $10,000 and $50,000, the credit would equal $500 per child. This credit would be phased out gradually for families with incomes over $50,000.

The National Commission on Children recommended a refundable tax credit of $1,000 for every child. The Commission's credit would be available to every family, including those on welfare. This in effect would increase substantially benefits for families on welfare, as well as give some tax relief for working Americans. A version of this was introduced in the House as H.R. 2242 by Thomas Downey, the New York Democrat. His bill would provide an $800 per child refundable credit available to all families, including those on welfare.

An intense debate will and should take place over which form of tax relief for families would be the best approach. But another element in the debate will be how to "pay" for relieving families of part of their tax burden. Predictably, liberals such as Downey maintain that to avoid increasing the federal deficit any tax relief for families must be financed by tax increases on "the rich."

But tax relief for families with children need not mean imposing higher taxes on other households. Nor need it mean imposing new taxes on business and investment; this would hurt all families by weakening the economy and destroying jobs.

Restraining Spending Growth. Instead, tax relief for families can be funded by restraining the growth of federal, non-defense spending. With such a constraint on federal spending, reducing taxes on families would be deficit neutral. This means that each year the savings from slowing (not even cutting) the growth of new non-defense spending would offset the revenue losses from phasing in tax relief to families with children.

3 It should be noted, of course, that the current tax code begins to phase out personal exemptions for married couples with combined annual taxable income above $150,000 in 1991. (This amount will be indexed for inflation in subsequent years.) Thus an increase in the exemption for children would have a diminishing impact for families with incomes above this level.

Restraining the growth of non-defense spending to 4 percent per annum through the so-called "Four Percent Solution"[4] would permit, without any increase in the deficit, not only full enactment of, say, the Wolf-Coats bill but additional tax reductions that would spur the kind of general economic growth from which families with children would benefit. Such tax cuts could include expanded individual retirement accounts and a phase-in of tax deductions for business investments in the year that the investment is made. These tax reductions would increase savings and investment, thereby stimulating economic growth and raising parents' wages. By directly relieving the tax burden on families and spurring economic growth through pro-saving and pro-investment tax relief, the "Four Percent Solution" would reduce significantly financial pressures on America's families.

HOW WASHINGTON HAS HIKED TAXES ON CHILDREN

American families face many problems, only few of which government can solve. When problems are caused by government policies, however, they can be solved by new policies. The most serious problem caused by government is the enormous financial burden imposed by a tax code now biased strongly against children.

Federal taxation of families with children has increased dramatically over the past four decades. In 1948, a family of four with the median family income level paid 2 percent of its income to the federal government in taxes.[5] In 1989 the equivalent family paid nearly 24 percent of its income to the federal government.[6] When state and local taxes are included, the tax burden would exceed one-third of family income.[7]

Table 1 shows that a disproportionate share of the increase in federal income taxes over nearly 40 years falls on families with children. From 1954 to 1989, the average federal income tax rates for single persons and married couples with no children either remained the same or actually fell.[8] But for a married couple with two children the average income tax rate more than doubled, and for a family with

4 For a description of the Four Percent Solution and the tax relief options available under the plan, see Scott Hodge, "The Four Percent Solution to Runaway Federal Spending," Heritage Foundation *Backgrounder* No. 823, April 15, 1991.

5 The value of the personal exemption also eroded between the imposition of the federal income tax in 1913 and Word War II. But 1948 is chosen as a benchmark because it is not a depression year and not a war year, and because it marks the beginning of a long period of high inflation and rising taxes.

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

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

8 The average income tax rate is a measure of total taxes compared with income. By contrast, the marginal tax rate, or "tax bracket," is a measure only of the tax paid on the last dollar earned. Thus many families have experienced a cut in their marginal tax rates, yet their average tax rates have climbed.

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

		Single		Joint						Head of Household			
				No Children		2 Children		4 Children		2 Children		4 Children	
Year	Median Family Income	Tax ($)	% of Income	Tax ($)	% of Income	Tax ($)	% of Income	Tax ($)	% of Income	Tax ($)	% of Income	Tax ($)	% of Income
1948	3,187	300	9.7	208	6.5	9	0.3	0	0	109	3.4	0	0
1954	1,000	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	34,213	4,404	12.8	3,352	9.8	2,751	8.0	2,151	6.3	3,052	8.9	2,451	7.2

*Figures for 1948-1978 from Eugene Steurle, "The Tax Treatment of Families of Different Size," *Taxing the Family* (Washington, D.C.: American Enterprise Institute, 1983), p. 76. Figures for 1978-1989 from Thomas M. Humbert "Ending the Tax Code's Anti-Family Bias by Increasing the Personal Exemption to $6,300", Heritage Foundation *Backgrounder* No. 687, January 30, 1989, and separate calculations.
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.*

four children the average income tax rate rose from zero in 1954 to 2.6 percent in 1960 and to 6.3 percent in 1989.

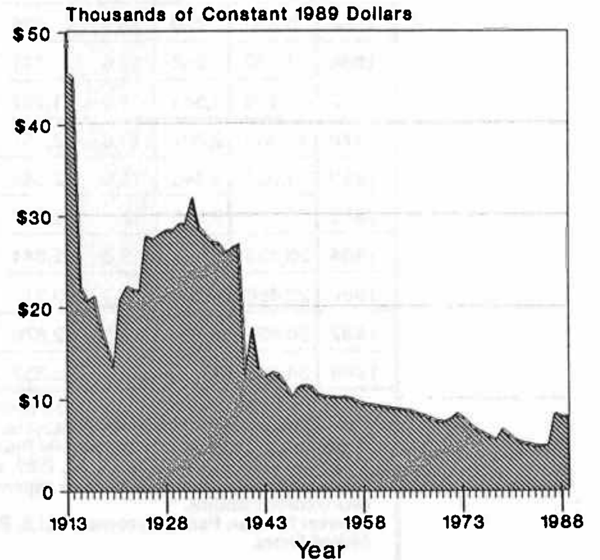
The root cause of this growing anti-family bias in the federal income tax code has been the eroding of the value of the personal exemption. U.S. income tax policy has rested on three principles since the inception of the federal income tax in 1913:

1) **The burden of tax should rise as incomes rise.** This does not imply a progressive tax, but simply that the dollar amount of taxes paid should rise as incomes rise (many states, for instance, apply a flat tax in accordance with this principle).

2) **There should be some exemptions from taxation for activities that would lead to generation of more taxable income.** Thus the personal and the corporate tax codes include many deductions for investment spending, travel costs of the self-employed, and other costs related to income generation.

3) **Tax relief should be allowed for activities deemed to be crucial to the basic fabric of American society.** Example include the costs of raising a family, charitable contributions, and some of the costs of buying a home. Tax relief for raising children, of course, is also justified by economists as an "investment" cost to nurture the next generation of productive american workers.

The personal exemption for children thus was intended to relieve part of the annual costs of raising a child from taxable income. In 1948, the personal exemption was $600, equal to roughly 20 percent of the median income of two-parent families, which was then $3,272.[9] For a family of four, the $600 personal exemption shielded nearly 80 percent of family income from federal income tax. In addition, families could reduce their tax bill further by itemizing deductions or taking the standard deduction, and this protected most of the remaining 20 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.



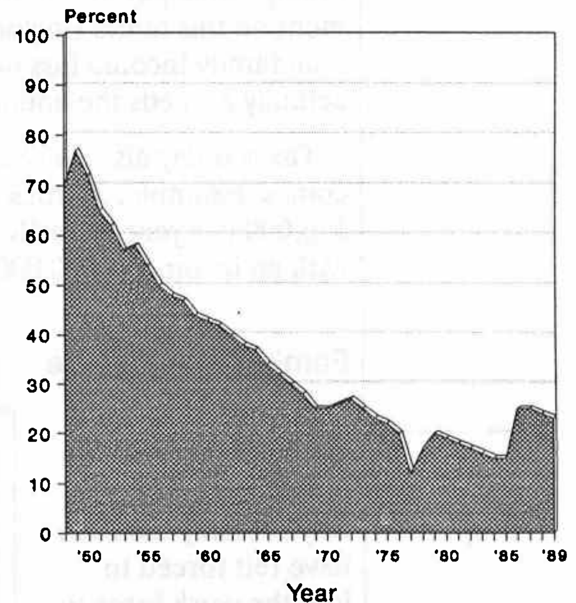
* Value of personal exemptions in the federal income tax code for a married couple with two children; all figures in constant 1989 dollars.
Source: Joseph A. Pechman, *Federal Tax Policy* (5th Ed.) (Washington, D.C.: Brookings Institution, 1987), Table A-1, pp. 313-314.

In the past four decades, however, the value of the personal exemption has lagged far behind the rise in inflation. Thus although the 1986 tax reform raised the value of the personal exemption to $2,000, this only partially offset the erosion in the value of the exemption since the 1940s. Chart 2 shows the declining value of personal exemptions relative to the median income of two-parent families. As the value of the personal exemption has declined, the income tax paid by families with children has increased dramatically. Indeed, for the personal exemption today to have the same value relative to family income that it did in 1948, it would have to be around $8,000 in 1992 and around $10,000 in 1996. At least partially restoring the value of the personal exemption is a necessary step in improving the financial well-being of American families.

9 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.

The second major blow to family finance has come from the increase in Social Security taxes. In 1948, workers paid a two percent Social Security tax on annual wages of up to $3,000: one percent paid directly by the employee and one percent paid indirectly by the employer through the so-called employer share.[10]

Combined Social Security taxes rose by 1989 to 15 percent of wages. While all workers have suffered from skyrocketing Social Security taxes, their bite has been most severe on working families with children. Since Social Security taxes are not adjusted for the number of dependents in a family, a working parent trying to support a family of four feels the burden of this tax far more acutely 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 pays $3,750 in Social Security taxes. Social Security taxes for young parents today greatly exceed the real value of any retirement benefits they will receive from the system.[11]



Share of median family income not subject to federal income tax due to personal exemptions: husband, wife and two children.
Sources: Mary F. Henson, U.S. Department of Commerce, *Trends in Income, by Selected Characteristics: 1947 to 1988* (Washington, D.C.: Bureau of the Census, April 1990, P-60, No. 167, Table 15, p. 21. Pechman, *Federal Tax Policy* (5th Ed.), *op. cit.,* pp. 313-314.

TAXING FAMILIES OUT OF HOUSE AND HOME

The income loss due to increased taxation seriously strains family finances and profoundly affects family life in America. Chart 3 shows the effects of the increases in federal income and Social Security taxes on the finances of the average family. Total pre-tax income for the median two-parent family in 1989 was

10 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.

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

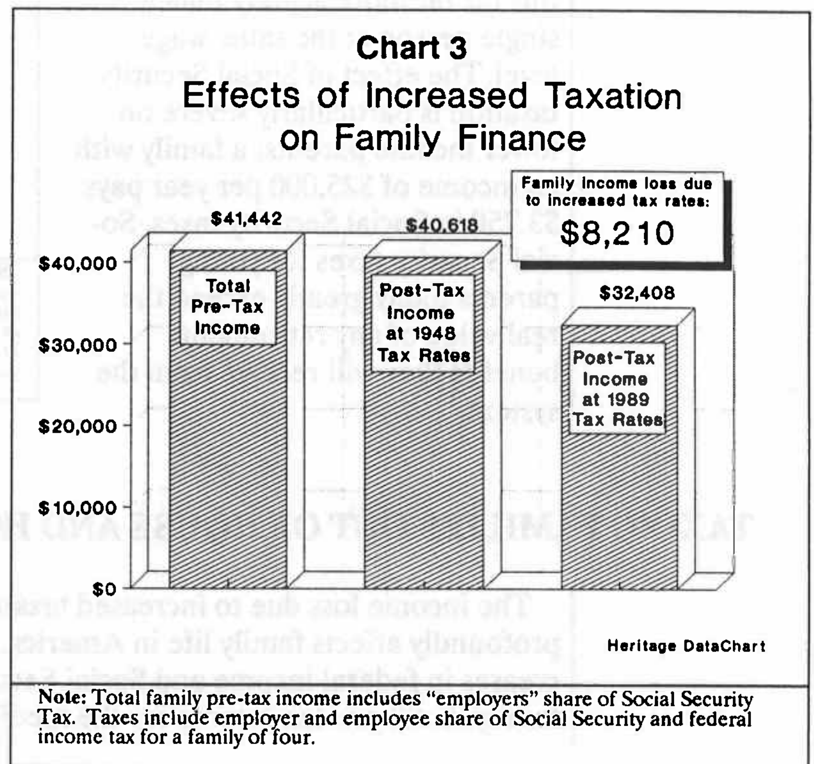
$41,442.[12] After taxes this family's income falls to $32,408. If federal taxes as a percentage of family income were restored to 1948 levels, the family's post-tax income would rise to $40,618. For the median income American family, the loss of income in 1989 because of the increase in federal taxes on families, due to the falling value of the personal exemption and the rise in payroll taxes since the early post-World War II period, was $8,210.

This income loss severely affects family finance. The median price of a single family home purchased in 1989 was $93,100; the average annual mortgage payment on this home (including principal and interest) was $7,920.[13] Thus, the annual family income loss due to increased federal tax rates for the average family actually exceeds the annual cost of an average family home mortgage.

Taxes today also place a severe burden on working families with very modest incomes. Example: A truck driver working to support a wife and two children on $16,000 per year typically will pay $2,075 of this in federal taxes. A typical family with an income of $20,000 will pay $3,781 in taxes.

Family Time Famine

The loss of income due to rising taxes also helps explain why so many mothers have felt forced to join the work force to make ends meet — and yet seem to add little to the family budget by taking a job. For the average family in which both the husband and wife are employed, the wife's earnings equal about 32 percent of total family income.[14]



Note: Total family pre-tax income includes "employers" share of Social Security Tax. Taxes include employer and employee share of Social Security and federal income tax for a family of four.

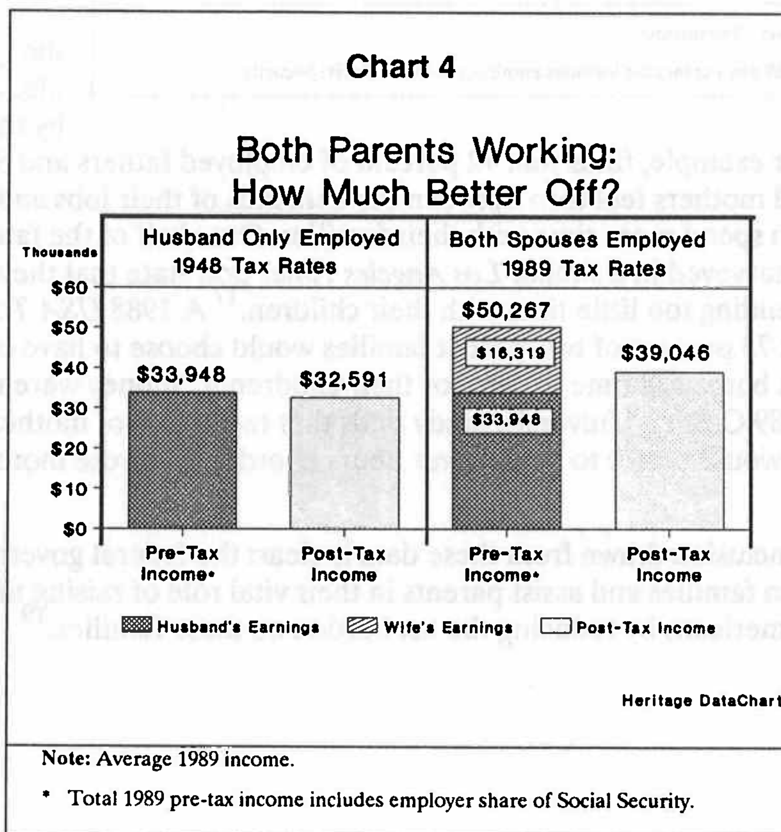
12 Data provided by the U.S. Bureau of the Census. Total pre-tax family income includes the employer share of Social Security tax deducted from the parents' wages.

13 National Association of Realtors, *Home Sales*, January 1991, p. 12.

14 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.

Yet the average employed mother juggling her job and family demands would be dismayed to learn that only about one-third of her earnings are available to raise the family's standard of living – far less than the proportion of a similarly-placed mother's earnings in the late 1940s. The remaining two-thirds pay for the increase in federal taxes on family income during the post-World War II period. 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 experience only a moderate dip in post-tax income today.

Charts 4 and 5 show why this is so. Average total pre-tax income in families where both spouses were employed was $50,267 in 1989. Of this, the husband's average earnings were $33,948 and the wife's average earnings were $16,319.[15] After federal taxes, post-tax income for this family fell to $39,046. If federal tax rates as a percentage of family income were restored to 1948 levels, the family's post-tax income would be $32,591 if only the husband worked, or only $6,455 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.



Note: Average 1989 income.

* Total 1989 pre-tax income includes employer share of Social Security.

This does not suggest that all employed mothers would want to or should leave the labor force if taxes were lowered to early post-war levels. It does suggest strongly that mushrooming federal taxation has played a key role in the financial and personal strains that afflict many families and force many mothers reluctantly into the work force. It also, in turn, helps to explain why parents today typically spend 40 percent less

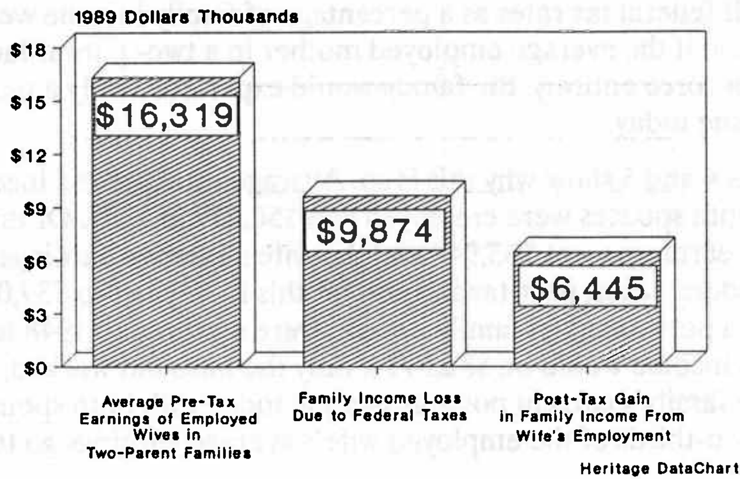
15 Pre-tax income figures include the employers' share of Social Security tax. Data provided by the U.S. Bureau of the Census.

time with their children than did parents in 1965. While parents in 1965 spent 30 hours per week in direct contact with their children, such time spent with children had dropped to only 17 hours by 1985.[16]

Surveys indicate that the pressure on parents to work harder and longer to keep the family financially afloat is beginning to erode the quality of family life. A 1989 survey by the *New York Times*, for example, finds 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. Over half of the fathers and mothers surveyed in a similar *Los Angeles Times* poll state that they feel guilty about spending too little time with their children.[17] A 1988 *USA Today* survey finds 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."[18] And a 1989 Cornell University study finds that two-thirds of mothers employed full-time would prefer to work fewer hours in order to devote more time to family life.

Chart 5

Working Wives: Uncle Sam - Not Family - Gains Most



Note: Average 1989 income.

Total 1989 pre-tax income includes employer share of Social Security.

The conclusion drawn from these data is clear: the federal government could strengthen families and assist parents in their vital role of raising the next generation of Americans by reducing the tax burden on these families.[19]

16 William R. Mattox Jr., "The Parent Trap," *Policy Review*, Winter 1991, p. 6.
17 *Ibid.*
18 *Ibid.*
19 *Ibid.*

REDUCING TAXES ON FAMILIES

Families of course would benefit from a range of tax cuts, such as a reduction in general income tax rates or, importantly, from cuts in the capital gains tax or business taxes which create new and better jobs for all workers. These tax reductions would help all Americans and should be enacted.

Tax cuts targeted specifically to families also are needed, to undo the damage of the past four decades in which families have shouldered a disproportionately heavy tax burden due to the increasing bias in the tax code. Tax cuts for families would help restore the key principles of the U.S income tax and reduce the need for many expensive welfare and other assistance programs designed to "help" financially-strapped families.

There are three broad ways in which families with children can receive tax relief.

1) **Raise the personal exemption for dependent children.** In this method, the amount of family income covered by personal exemptions, and thus not subject to income tax, is increased. The current exemption is $2,150 per child. For a family in the 15 percent income tax bracket with one child, an increase in the personal exemption for children of $1,000 would reduce the family's annual tax liability by $150.

2) **Create a partially refundable tax credit for children.** While an increase in the dependent exemption decreases only income tax liability, a partially refundable tax credit can reduce the income tax and offset the Social Security tax liability.[20] Total tax liability is reduced by the value of the credits. A $1,000 per child tax credit provided to a family with one child that now owes $4,000 in income tax and Social Security taxes would reduce that family's taxes to $3,000.

3) **Create a "fully refundable" credit.** In a partially refundable credit the value of the credit cannot exceed the Social Security and income taxes that would be owed. With a fully refundable credit, however, if the value of the credit is greater than tax liability, the remainder of the credit is given to the family as cash assistance. Thus for a family with one child that today owes $500 in taxes, a $1,000 per child fully refundable credit would provide $500 in tax relief, reducing the family's tax liability to zero, plus $500 in cash assistance.

Depending on its design, a fully refundable credit may be available only to working families. Example: the existing earned income tax credit (EITC) is a fully refundable credit which provides aid only to families with an employed parent. A fully refundable credit for children also could be made available to non-working

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20 A partially refundable credit would be used to reduce income tax and Social Security taxes paid by the employee and, on behalf of the employee, by the employer.

families on welfare. In this case the tax credit in effect augments conventional welfare benefits.

Legislation and Other Proposals

Three bills and a commission report contain major proposals to reduce taxes on families. Specifically:

H.R. 1277 (S. 710) introduced in the House by Frank Wolf and in the Senate by Dan Coats. Their legislation would raise the personal exemption for dependent children from today's $2,150 to $3,500.

COST: Estimated at $12 billion per year.

H.R. 2633 (S. 1013) also has been introduced in the House by Wolf. The Senate version has been introduced by Charles Grassley, the Iowa Republican. This measure would provide a refundable tax credit for children under age five. The credit would be available only to working families. For families with an earned annual income below $10,000, the credit for each eligible child would be equal to 5 percent of earnings. For families with incomes between $10,000 and $50,000, the credit would be $500 per child. The credit gradually would be phased out for families with incomes above $50,000. This credit would be available only to families that did not claim the current dependent care credit for day care expenses. Thus the Wolf-Grassley bill would establish, for the first time in legislation, the principle of equal treatment by the tax code of families in which one parent stays home to care for the children as for two-earner families using child care.

COST: Estimated at $4 billion per year.

H.R. 2242 has been introduced in the House by Thomas Downey. His bill would replace the current exemption for dependent children with a $800 fully refundable tax credit. The net effect of this would be to give about $450 in extra tax relief per child to families in the 15 percent tax bracket. Although Downey entitles his bill a "Working Family Relief Act," it would give $400 per child in cash welfare benefits to non-working families enrolled in the Aid to Families with Dependent Children (AFDC) program.

COST: Estimated at $25 billion per year. However the bill would pay for this by raising the tax rate on families earning more than $130,000 per year from 31 percent to 35 percent and imposing a 10 percent surtax on families earning more than $250,000.

The Rockefeller Commission, the name usually given to the National Commission on Children chaired by Senator Jay Rockefeller, calls on Congress to create a fully refundable $1,000 credit per child for every family in America. The $1,000 per child credit would replace the current $2,150 personal exemption for a child, yielding a net tax reduction of $677 per child for the average family.[21] The credit would also provide $1,000 per child in additional cash assistance to non-working families on AFDC. And because these families currently receive no benefit from the personal exemption, the net income increase would be a full $1,000 per child – substantially more than the net after-tax income increase for working, tax-paying families.

COST: Estimated at $40 billion per annum, including the increased benefits to welfare households. It suggests three options to raise this money: increases in taxes; reductions in programs of a lower priority; or a general constraint of non-defense spending such as that developed in the Four Percent Solution.[22]

THE OPTIONS FOR TAX RELIEF

The most direct way to offer tax relief for middle class families with children would be to return the personal exemption for children, generally is known as the "dependent exemption" to the 1948 levels. In 1948 the dependent exemption was equal to roughly 20 percent of the median income for two-parent families. For the exemption to have the same value in terms of family income in 1992, it would have to be set at approximately $8,000. Raising the exemption from its current level of $2,150 per child to $8,000 would provide roughly $900 in tax relief for each child in the average family.

Raising the exemption thus would be a significant and welcome step toward removing the tax bias against the family. Families with incomes below $26,000 per year, however, do not pay enough income tax to get the full value of raising the personal exemption for dependent children to $8,000. This is because Social Security taxes are not reduced by exemptions and thus impose a very heavy bur-

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21 The personal exemption of $2,150 per child reduces income tax liability by $35 for families in the 15 percent bracket. Thus replacing the exemption with a $1,000 credit produces a net after-tax income increase of $677 for these families.

22 Hodge, *op. cit.*

den on lower-income families. Families below this income level need relief from both income taxes and Social Security taxes. A practical way to provide reasonable tax relief to these low-income families would be to replace the current dependent exemption with a partially refundable "child credit."[23] Parents could use this credit to reduce both their income tax and the employer and employee Social Security tax liability.[24]

As an illustration, consider a family with one child which today owes $2,000 in combined federal taxes. A $1,200 child credit for children below age nineteen would reduce the net tax liability of this family to $800. For families with incomes between $15,000 and $50,000, replacing the dependent exemption with a $1,200 child credit would produce an after-tax income gain of around $900 per child, roughly the same as restoring the dependent exemption to 1948 levels.[25] For families subject to the 28 percent income tax rate, the income gain would be $600 per child.

Parents raising pre-school children face particularly severe financial pressures. Either the family must pay day care costs or forego the earnings of one parent while that parent cares for the infant child. Government policy should not discriminate against families making the economic sacrifice of one parent remaining in the home to care for young children. The current dependent care tax credit is available only to parents who place their children in paid, non-parental day care. This discriminates against parents caring for their own children. To redress this to give families that want one parent to stay home with young children the same tax treatment as those in which both parents work, the federal government should provide a higher credit, such as a credit of $1,800 for any child under 5 years of age.[26] This credit should replace both the dependent exemption and the current dependent care tax credit which is available only to parents using paid non-parental day care.

23 Simply replacing the current personal exemption for children with a partially refundable credit could in certain cases actually result in a net loss of after-tax income for some low-income families. Thus the partially refundable tax credit policies outlined in this paper would require modest additional changes in the income tax code to eliminate this problem.

24 The maximum value of a partially refundable credit thus would not exceed a family's total tax liability, represented by federal income tax and social security taxes paid by the employee and employer minus any earned income tax credit provided to the family.

25 The $1,200 per child credit would replace the current dependent exemption, therefore the net income gain to the family is less than $1,200. In 1991 the exemption is worth $2,150. For a family in the 15 percent income tax bracket, the exemption reduces income tax by $322. Thus the net income gain for that family from the proposed new $1,200 per child credit would equal $1,200 minus $322, or $878.

26 A child under age 5 would receive the $1,800 credit instead of – not in addition to – the $1,200 credit available generally for children.

RESTRAINING THE DOMESTIC SPENDING SPREE

While there is growing agreement that families are overtaxed, there is no consensus about how to provide tax relief without increasing the federal deficit. Some proponents of tax relief for families with children argue that it should be funded by levying higher taxes on other Americans or by hiking business taxes. This would not help families, for it would slow economic growth and cut job opportunities. Revenues to pay for the reductions in taxes on families instead should come from restraining the growth in new government spending.

A large part of the initial tax increases on families after 1948 were to fund the Cold War's defense costs. Defense spending rose from 3.7 percent of gross national product in 1948 to nearly 10 percent in 1960 and fell to 5.4 percent in 1990.

U.S. defense spending continues to plummet. Under the proposed Bush budgets, defense spending falls to 3.8 percent of GNP in 1996, the lowest level since the late 1940s. In constant 1990 dollars, defense spending will fall from $299 billion in fiscal 1990 to $233 in fiscal 1996. Savings in fiscal 1996 alone will equal $66 billion. None of this "peace dividend" is being returned to the taxpayer. Instead, for every $1.00 cut in constant dollar defense below 1990 levels, there is $2.00 in new, non-defense spending.

Soaring Federal Spending. Tax relief for families could be financed simply by controlling domestic spending growth. Under the budget agreement reached by Bush and Congress last fall, domestic spending in nominal terms soared 12 percent in fiscal 1991, will increase 8.2 percent in fiscal 1992, and will increase an average of 7.3 percent annually from 1993 to 1996. This is up from the annual nominal rate of 4.75 percent in the Reagan years. At the rate of domestic spending growth established in the 1990 budget agreement, the federal government will spend a cumulative $667 billion above the Reagan growth rate through 1995. This massive increase amounts to $4.00 in projected new domestic spending for every new dollar in taxes raised by last year's budget agreement.

To put this in perspective, current domestic spending growth is reaching a near historic high in real terms as well as in nominal dollars. In constant dollars, domestic spending will increase by $25 billion dollars per annum between 1990 and 1995. This average annual growth rate will exceed the domestic spending growth rate under Jimmy Carter in constant dollars; it is nearly twice the growth rate under Lyndon Johnson and five times the rate under Reagan.

If the growth of future federal non-defense spending were limited in nominal terms to 6 percent per annum – even though the rise in federal spending should be held below that figure – the savings would fully pay for both the Wolf-sponsored bills now before Congress. Holding the line at 5 percent would permit the government to phase in by the mid-1990s a partially refundable credit of $1,800

for each child under age 5 and $1,200 for other children under 19.[27] Alternatively, a 5 percent spending cap would pay for both the tax relief and spending items in the Downey bill without any tax increase. In this way, tax relief for families would not increase the federal deficit. Each dollar of family tax relief in this case would be matched by a dollar reduction in the projected increase in government programs.

The Four Percent Solution

Further restraining the growth of federal non-defense spending to four percent per annum not only would yield savings sufficient to fund significant tax relief for families but also would permit, without any net increase in the budget deficit, additional tax cuts designed specifically to speed economic growth.

Proposals to lower the tax burden against savings and investment and simulate economic growth which could be funded (along with family tax relief) through a "Four Percent Solution" are:

1) **Expand Individual Retirement Accounts (IRAs)** – the heavy taxation of savings in America reduces the savings rate compared with other countries and inhibits the accumulation of capital necessary to finance future economic growth. Expanding IRAs would reduce the bias against savings and help make America more competitive. The tax savings from IRA proposals vary widely, depending on the extent of the tax relief offered. The most widely discussed proposal, a bill co-sponsored by Senators Lloyd Bentsen, the Texas Democrat, and William Roth, the Delaware Republican, would save taxpayers between $25 billion and $30 billion over five years.

2) **Phase in Full Expensing of Investment Costs** – The current tax code forces business to "write-off" the costs of new equipment, machinery and other investments over many years rather than in the year that they are incurred. This substantially increases the net costs of investment. Businesses ought to be allowed to subtract investment costs in the year they are incurred from the business's total revenue to determine taxable income. This is called "expensing" and is permitted in many other countries. This would lower the costs of the capital and spur new investment. No estimates exist on the tax savings from full expensing, but experts agree that the proposal could be phased in over time in a way to keep five-year costs as high or as low as policy makers choose.

Both expanded IRAs and a phase-in of full expensing of investment costs would boost economic growth significantly and raise the productivity of American workers, increasing the real wages of American parents. Thus the tax relief for

27 These credits would replace the current personal exemption for children.

savings and investment combined with a direct reduction in the tax burden of families would significantly reduce the financial pressures on American families.

CONCLUSION

The family is the foundation of American society. The often-disparaged middle class family is the principal institution by which the work ethic, self discipline, intellectual motivation, and moral character are passed on to the next generation. The family is the original Department of Health and Human Services. Once undermined it cannot be replaced by any array of government programs.

The American family is, however, in deep financial trouble. With federal and state taxes taking nearly one-third of the average family's income, parents are having a difficult time raising and educating their children. While most Americans grumble about rising federal taxes, these taxes have risen faster on families with children than on any other households.

Investing in the Future. Since America's children are America's future, the federal government should invest in the future by strengthening families. It can do this in large measure by curtailing the excessive taxation which has been slowly undermining the family. Families with children of course would be helped to a degree by a general reduction in tax rates on all Americans. But this would not alleviate significantly the disproportionate hike in taxes on such families due to the tax codes increasing bias against families since the late-1940s.

Yet such tax relief for families should not be achieved by allowing the deficit to widen further or by placing ever higher tax burdens on other members of society. Nor should it come by putting the economy in a tailspin through new taxes on business and investment. The proper way to finance tax relief to families with children is to restrain the increase in new government spending. What families need from government is not new spending and new social programs. These programs not only have done little or nothing to preserve families – in many cases the programs actually have triggered the breakup of families. What families really need is for government to allow them to keep a greater share of their own hard-earned money.

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