The Heritage Foundation Backgrounder

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HOW TO STRENGTHEN AMERICA'S CRUMBLING FAMILIES

INTRODUCTION

America's families are under siege. Middle-income as well as blue-collar families are finding it hard to buy a first home or pay for their children's college tuition, partly because a steady rise in the burden of taxation means they have less money in their pockets. Working families also suffer because slow productivity growth in the United States economy in recent decades means real wages have stagnated. Poor families have been especially hard hit. Those who fall below the poverty line enter a dispiriting welfare system of perverse incentives that undermine work, personal responsibility, and family stability. What is worse, the incentives of the welfare system mean fathers become a financial liability if they stay with their family. This encourages fathers to abandon their responsibilities.

Growing Tax Burden. The growing tax burden has undermined the finances of millions of families. When state and local taxes are included, government now takes over one-third of the income of the average two-parent family. During the past four decades, the federal income tax burden on a family of four has increased by over 300 percent as a share of family income. Single Americans and married couples with no children have escaped most of this tax increase. Measured by average after-tax per capita income, families with children now are the lowest income group in America. Their average after-tax income is below that of elderly households, single persons, and couples without children.

Families with children face a disproportionate tax burden because the federal tax code has become increasingly biased against these families. The main reason for this has been the steady decline in the value of the personal exemption applying to children, which is the tax allowance for the cost of raising children.

Fortunately, lawmakers in Washington seem at last to have come to understand that the American family is overtaxed. To cut this tax burden, lawmakers from both parties have submitted legislation in Congress. On the Republican side, bills cutting taxes on families have been introduced in the House by Representatives Frank Wolf of Virginia (H.R. 1277) and Vin Weber of Minnesota (H.R. 3744), and in the Senate by Indiana Senators Dan Coats (S. 710) and Bob Kasten (S. 1920). On the Democrat side, bills have been introduced in the Senate by Senators Albert Gore of Tennessee (S. 995), Lloyd Bentsen of Texas (S. 1921), and Bill Bradley of New Jersey (S. 1846), and in the House by Representative Tom Downey of New York (H.R. 2242). In addition, President George Bush as well as Governor Bill Clinton have proposed family tax relief in their campaigns for the White House.

Wage Stagnation. These measures represent a welcome, if belated, recognition that action is needed to reverse a tax trend that is wounding American families. But because mushrooming taxation is only one factor in the financial problems facing the average American family, easing the tax burden is not the complete solution. The other cause for concern is the slowdown in the growth of real wages and salaries for working parents. Since 1970, wages and salaries, adjusted for inflation, have grown much less rapidly than in the 1950s and 1960s.[1] For the first 25 years following World War II, the average family could expect a continuing improvement in income, based on the steady real growth of one breadwinner's earnings. But since about 1970, a growing number of families have found it necessary for both parents to enter the work force for there to be even modest growth in real family income, both before and after taxes. And even though the Reagan tax cuts enacted in the 1980s did help, this tax relief was not sufficient to offset the policy mistakes of the 1970s. Caught between this slowdown in wage growth and the rise in taxation, most parents today thus find they must work more and more to achieve even a modest annual improvement in family income.

Family Disintegration. The third major problem facing families and children is the decline of marriage. Studies indicate that many of the social problems of young Americans—which often continue into later life—are linked to their upbringing in single-parent households. The erosion of the institution of marriage has affected all segments of American society, but its consequences have been most devastating in low-income communities. In the black community the decline of marriage is now a crisis. In 1965, when the War on Poverty began, roughly one out of four black children were born out of wedlock. The rate today is 65 percent, and if current trends continue the rate will rise to 75 percent by the year 2000.

Much of the increase in single parenthood among the poor is caused by an expanding welfare state which has transformed low-income fathers from necessary breadwinners to financial burdens for their families. The current welfare system actively rewards households in which a father avoids his obligations, and it penalizes marriage. A new system is needed which promotes the formation of self-sufficient, two-parent families.

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1 All income figures in this paper are adjusted for inflation using the U.S. Bureau of Labor Statistics Consumer Price Index, model CPI-U-X1. This deflator more accurately depicts changes in consumer prices in the 1970s and early 1980s, and is more accurate for historical comparisons. If the alternative CPI-U were used, the data would show the same rates of income growth as those presented in this chapter for the 1950s, 1960s, and 1980s, but slightly lower income growth in the 1970s. All figures in the text depicting taxes as a percentage of income and income lost to increased taxes are unaffected by the inflation measure chosen. For a discussion of the CPI-U-X1 and CPI-U, see U.S. Bureau of the Census, *Money Income of Households, Families, and Persons in the United States: 1990*, Current Population Reports, Series P-60, No.174 (Washington, D.C.: U.S. Government Printing Office, 1991), pp. 8-9.

A comprehensive policy to strengthen American families must include four key elements:

Element #1: Family Tax Cuts. There must be tax cuts to relieve the burden on overtaxed families with children. Federal taxes on working families with children should be cut at least $1,000 for each dependent child.

Element #2: Increased Productivity. Policies are needed to stimulate productivity growth in the economy and thereby raise the real wages and salaries of American parents as well as other workers. These policies require tax cuts on savings and investment. Among the necessary steps: a reduction in the capital gains tax, expanded individual retirement accounts (IRAs), and tax fairness for investment by allowing business to deduct the full value of new investments in plants and equipment as a business expense.

Element #3: Spending Cuts. Increasing taxes on other Americans to finance tax relief for families with children might help those families in the short run, but it would do so only by reducing long-term economic growth and thus adding to the wage stagnation problem. Tax cuts which would cause further increases in the federal deficit also would be folly. Thus family tax relief should be paid for by capping the growth of non-defense federal spending. Holding the spending growth at roughly five percent per annum would allow a reasonable level of tax relief. In this way, each dollar of family tax relief would be matched by one dollar in reduced domestic spending.

Element #4: Welfare Reform. The current welfare system discourages work, marriage, and family responsibility, and encourages welfare dependency. To rebuild America's shattered poor families, the welfare system must be overhauled to promote responsible behavior, marriage, and self-sufficiency.

In welfare, you get what you pay for. Since the 1960s the government has been paying for single parenthood and non-working households and it has been getting dramatic increases in both. The welfare incentive system must be revised to promote rather than penalize marriage and self-sufficiency. This can be accomplished by increasing support to low-income two-parent and single-parent families who are prepared to work. Conversely, the high welfare benefits that go to non-working single mothers on welfare must be reduced, and some welfare mothers should be required to work in exchange for the benefits they receive.

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

HOW WASHINGTON HAS HIKED TAXES ON CHILDREN

Federal taxation of families with children has increased dramatically over the past four decades. In 1948, a family of four at the median family income level paid just two percent of its income to the federal government in taxes.[2] In 1989 the equivalent family paid nearly 24 percent of its income to the federal government.[3] When state and local taxes are included, the tax burden on that family exceeds one-third of its income.[4]

As Table 1 shows, the rise in federal income taxes on families with children in the last four decades has been much faster than for other groups of Americans. From 1954 to 1989, the average federal income tax rates for single persons and married couples with no children did not increase.[5] But for a married couple with two children, the average income tax rate more than doubled. And for a family with 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 value of the personal exemption. The personal exemption for children was intended to offset part of the annual costs of raising a child by allowing families to deduct an amount of money from their taxable income. In 1948, the personal exemption was $600. This was equal to roughly 20 percent of the median income of two-parent families, then $3,272.[6] For a family of four, the $600 personal exemption shielded nearly 80 percent of family income from federal income tax. Families could reduce their tax bill further by itemizing deductions or taking the standard deduction, and this protected most of the remaining 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.

In the past four decades, however, increases in the personal exemption have lagged far behind the rise in incomes and inflation. Although the Tax Reform Act of 1986 raised the value of the personal exemption from $1,000 to $2,000, this only partially offset the erosion in the value of the exemption since the 1940s. Chart 1 shows the declining value of personal exemptions relative to the median income of two-parent fami-

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

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

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

5 The average or effective 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.

6 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.

Table 1

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

		Single		Joint					
				No Children		2 Children		4 Children	
Year	Median Family Income	Tax	% of Income	Tax	% of Income	Tax	% of Income	Tax	% of Income
1948	$3,187	$300	9.4%	$208	6.5%	$9	0.3%	$0	0.0%
1954	4,167	534	12.8	402	9.6	162	3.9	0	0.0
1960	5,620	780	13.9	625	11.1	385	6.9	145	2.6
1966	7,532	962	12.8	741	9.8	524	7.0	328	4.4
1972	11,116	1,544	13.9	1,201	10.8	916	8.2	631	5.7
1978	17,640	2,602	14.7	2,101	11.9	1,768	10.0	1,408	8.0
1980	21,023	3,348	15.9	2,643	12.6	2,176	10.4	1,756	8.4
1982	23,433	3,543	15.1	2,767	11.8	2,327	9.9	1,904	8.1
1984	26,433	3,641	13.8	2,844	10.8	2,421	9.2	2,061	7.8
1986	29,458	4,107	13.9	3,217	10.9	2,744	9.3	2,348	8.0
1987	30,853	3,869	12.5	2,876	9.3	2,306	7.5	1,736	5.6
1989	34,213	4,404	12.8	3,352	9.8	2,751	8.0	2,151	6.3

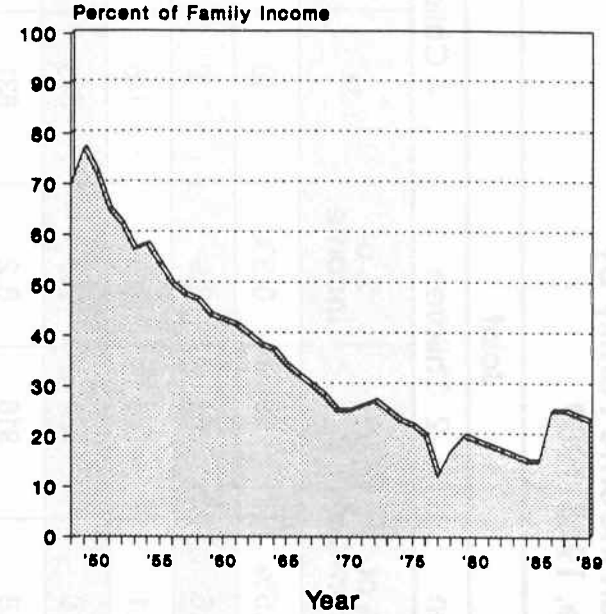
Note: Median Income is the level at which half of all families have income below that level, and half above. Examples assume itemizable expenses equal to 23 percent of Adjusted Gross Income in all years. No deductions are made for two-income families.

Sources: Figures for 1948-1978 from Eugene Steurle, "The Tax Treatment of Families of Different Sizes," *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. Income data based on *Money Income of Households, Families and Persons in the U.S.*, U.S. Bureau of the Census, various years.

lies. As the value of the personal exemption has declined, the income tax paid by families with children has increased.

For the personal exemption today to have the same value relative to family income that it did in 1948, it would have to be about $8,000 in 1992 and an estimated $9,000 in 1996. At least a partial restoration of the value of the personal exemption is a necessary step in improving the financial well-being of American families.

Chart 1
Share of Income Protected from Federal Income Tax by Personal Exemptions



Source: Heritage Tax Model, Income data from U.S. Bureau of Census. Heritage DataChart

The second tax blow to family finances has been the increase in Security Social taxes, technically known as "payroll taxes." In 1948, workers paid a two percent Social Security tax on annual wages of up to $3,000: one percent was paid directly by the employee and one percent paid indirectly by the employer through the so-called employer share.[7]

By 1989, combined Social Security taxes had risen to 15 percent of wages on incomes up to $48,000. While all workers have suffered from skyrocketing Social Security taxes, the bite has been most severe on working families with children. The reason for this is that Social Security taxes, unlike regular income taxes, are not adjusted for the number of dependents in a family, so a working parent trying to support a family of four feels the sting of this tax far more sharply than a single person at the same wage level. The effect of Social Security taxation is particularly severe on lower-income parents; a family with an income of $25,000 per year, for instance, pays $3,750 in Social Security taxes. Moreover, Social Security taxes on today's young parents greatly exceed the real value of any retirement benefits they will receive from the system.[8]

Undermining Family Income. Chart 2 shows the growth in federal taxes as a share of median family income.[9] At two percent of income in 1948, effective tax rates have risen each decade. By 1979, the median family of four paid 24 percent of its income to

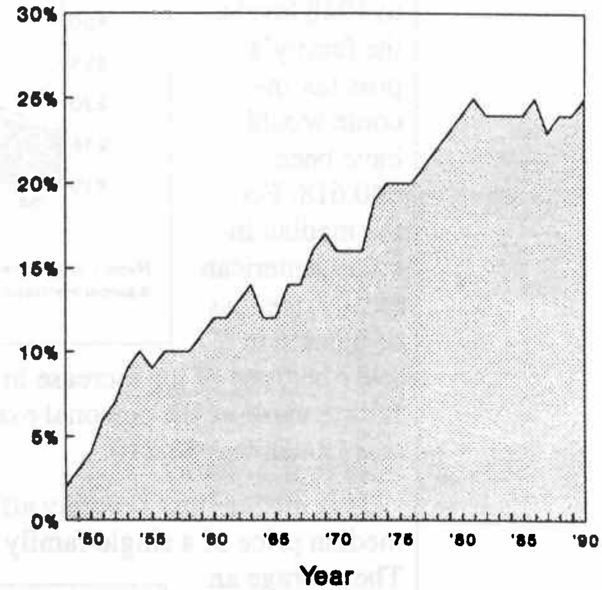
7 Liberal and conservative economists agree that both shares of the Social Security tax are in fact direct taxes on workers' wages. See Joseph A. Pechman and Benjamin A. Okner, *Who Bears the Tax Burden?* (Washington, D.C.: The Brookings Institution, 1974), pp. 25-43.

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

the federal government. Because of Ronald Reagan's policies, the rise in federal tax rates on the average family was halted. If Reagan had persevered in his original tax reduction plans, taxes as a share of average family income actually would have declined. But the Reagan income tax cuts enacted in 1981 were offset partly by tax increases in 1982. And following the recommendations proposed by the 1982 National Commission on Social Security Reform, Reagan unwisely agreed to accelerate the introduction of future Social Security tax hikes scheduled under legislation enacted by President Carter in 1977.

Chart 2

Federal Taxes as a Share of Median Family Income: 1948-1990



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

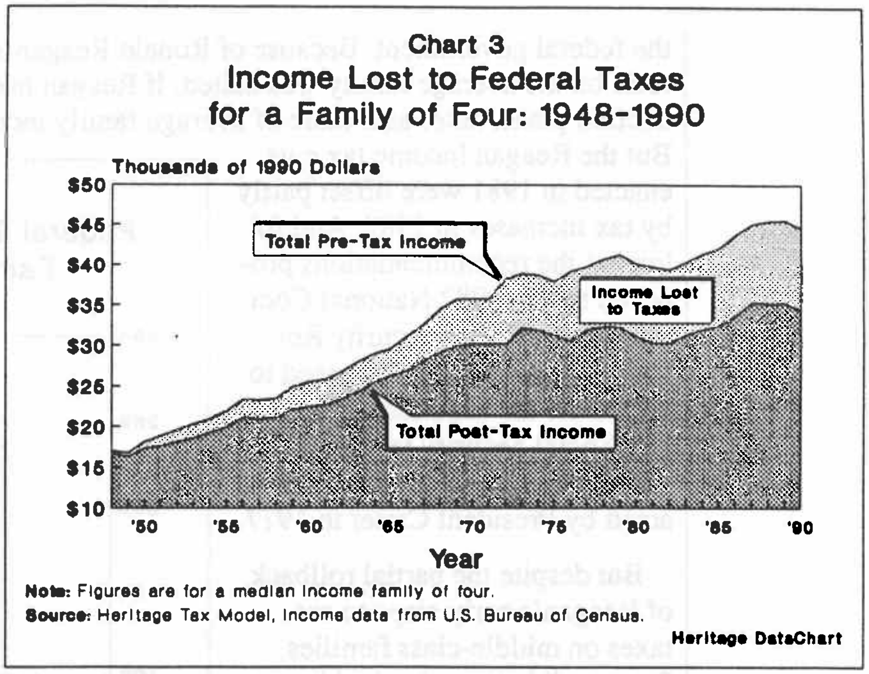
Heritage DataChart

But despite the partial rollback of Reagan's early steps to cut taxes on middle-class families, Reagan did stem what had been a relentless growth in taxes as a share of family income. The 1980s were the first decade since World War II when effective tax rates on the average family with children did not rise. Average taxes in 1989 were 24 percent of family income, roughly what they were in 1979.

The effect of federal taxes on family income is shown in Chart 3 (next page). Two facts stand out. One is that in each decade up to 1980 the rate of increase in pre-tax family income declined. The other is that the "tax bite," or the share of family income collected by the IRS, increased. Thus taxes rose as income growth slowed. This trend peaked during the 1970s. In that decade median pre-tax family income, adjusted for inflation, increased by about \$6,000. But of that \$6,000, exploding federal taxes swallowed up \$4,000. Thus of every dollar in income gained by the average family in the 1970s the federal government took 66 cents.

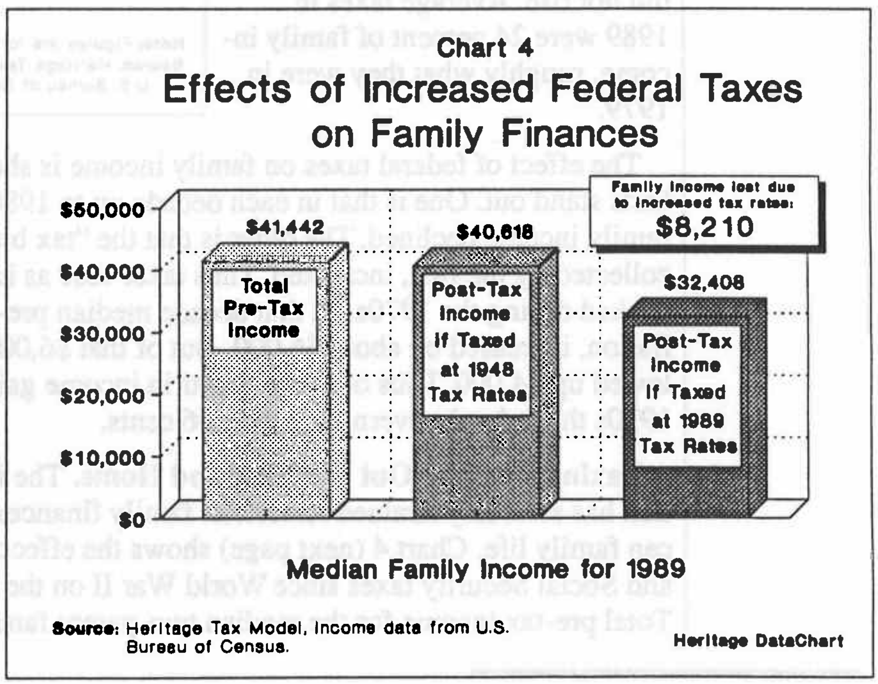
Taxing Families Out of House and Home. The income loss due to increased taxation has seriously strained American family finances and profoundly affected American family life. Chart 4 (next page) shows the effects of increases in federal income and Social Security taxes since World War II on the finances of the average family. Total pre-tax income for the median two-parent family in 1989 was \$41,442.[10] After

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



taxes this family's income fell to $32,408. If federal taxes as a percentage of family income were restored to 1948 levels, the family's post-tax income would have been $40,618. For the median income American family, the loss of income in 1989 because of the increase in federal taxes as a share of family income, due to the falling value of the personal exemption and the rise in Social Security taxes since the late 1940s, was $8,210.

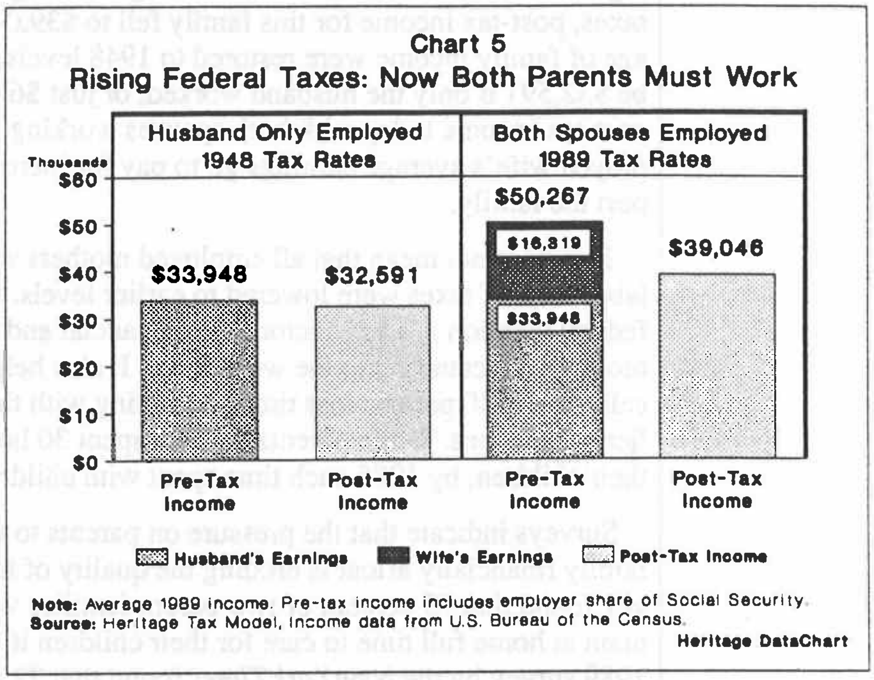
This income loss severely affects the ability of families to support themselves. The median price of a single family home purchased in 1989, for instance, was $93,100. The average annual mortgage payment on such a home (including principal and interest) was $7,920.[11] Thus, the annual family income loss due to increased federal tax rates for the average family in the last four decades actually exceeds the annual cost of an average family home mortgage.

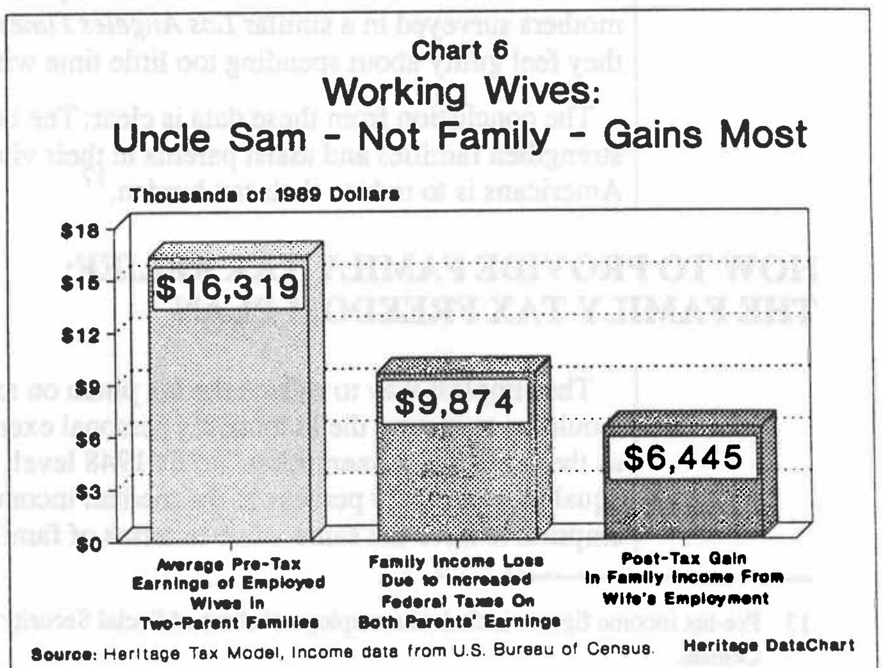


10 Data from the U.S. Bureau of the Census. Total pre-tax family income includes the employer share of Social Security tax deducted from the parents' wages.

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

Family Time Famine. The loss of income due to rising taxes also helps explain why so many mothers have felt compelled to join the work force to make ends meet. For the average family in which both the husband and wife are employed, the wife's earnings equal about 32 percent of total family income.[12] The average employed mother, juggling her job and family demands, knows only too well that despite her efforts the paychecks she brings home do not seem to be raising her family's living standard very much. The reason: only about one-third of her earnings actually are taken home for the family's budget. The remaining two-thirds of today's mother's earnings pay the higher federal taxes on family income levied since World War II. In fact, if federal tax rates as a percentage of family income were restored to 1948 levels, and if the average employed mother in a two-parent family were to leave the labor force entirely, the family would see only a moderate dip in real post-tax income.





Charts 5 and 6 show why this is so. Average total pre-tax income in 1989 in families

12 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.

where both spouses were employed was $50,267. Of this, the husband's average earnings were $33,948 and the wife's average earnings were $16,319.[13] 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 just $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.

This does not mean that all employed mothers would want to or should leave the labor force if taxes were lowered to earlier levels. But it does show strongly that rising federal taxation is a key factor in the financial and personal strains that force many mothers reluctantly into the work force. It also helps to explain why parents today typically spend 40 percent less time interacting with their children than did parents in earlier generations. While parents in 1965 spent 30 hours per week in direct contact with their children, by 1985 such time spent with children had dropped to just 17 hours.[14]

Surveys indicate that the pressure on parents to work harder and longer to keep the family financially afloat is eroding the quality of family life. A 1988 *USA Today* survey found that 73 percent of two-parent families would choose to have one parent remain at home full time to care for their children if "money were not an issue."[15] A 1989 survey by the *New York Times* found that 72 percent of employed fathers and 83 percent of employed mothers feel torn between the demands of their jobs and their desire as parents to spend more time with their families. A 1989 Cornell University study discovered that two-thirds of mothers employed full time would prefer to work fewer hours in order to devote more time to family life. And over half of the fathers and mothers surveyed in a similar *Los Angeles Times* poll conducted in 1990 stated that they feel guilty about spending too little time with their children.[16]

The conclusion from these data is clear: The best way for the federal government to strengthen families and assist parents in their vital role of raising the next generation of Americans is to reduce their tax burden.[17]

HOW TO PROVIDE FAMILY TAX RELIEF: THE FAMILY TAX FREEDOM PLAN

The simplest way to reduce the tax pinch on middle class families with children would be to restore the income tax personal exemption for children, generally known as the "dependent exemption," to its 1948 level. 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, it would have to be set at

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

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

15 *Ibid.*

16 *Ibid.*

17 *Ibid.*

approximately $8,000 in 1992 and raised to about $9,000 by the mid-1990s. Doing this would put roughly $1,000 in the pocket of the average family in new tax relief for each child.

Raising the exemption, however, would not in fact be the best way to provide relief. Most families with incomes below $27,000 per year do not pay enough income tax to get the full value of raising the personal exemption for dependent children to $9,000. Yet they are still heavily taxed. This is because income liable to Social Security taxes is not reduced by exemptions and other deductions. Families with modest incomes thus need relief from Social Security taxes as well as from income taxes. A practical way to give reasonable tax relief to these families would be to enact a non-refundable "child credit." Parents would use such a credit to reduce both their income tax and the employer and employee Social Security tax liability.

The following example illustrates the difference between an income tax exemption and a tax credit. With an income tax exemption, income equal to the amount of the exemption is exempted from income tax. Thus for a family in the 15 percent income tax bracket, a $1,000 exemption decreases taxes owed by $150. By contrast, under a tax credit the amount of the credit is deducted from the taxes paid. It directly reduces tax liability. Thus for the same family in the 15 percent income tax bracket, a $1,000 tax credit decreases net taxes by $1,000. And because a tax credit can be applied to both income and Social Security taxes, it is the better way to reduce the tax burden on modest income families.

As Chart 4 above showed, increases in federal tax rates as a percentage of family income since the early 1950s have raised the tax burden on the average family by over $8,000 per annum. While it would be impossible to eliminate this excessive taxation in one step, it is possible to begin to roll back the family's tax burden. The most effective way to begin to roll back the tax burden would be to provide a $1,000 tax credit for each child under age eighteen in working families. The tax credit could be used to reduce a family's income tax liability, employee Social Security tax liability, and employer Social Security tax liability.[18] The credit would be available to working, taxpaying families only. And the credit would not be refundable, meaning the value of the credit could not exceed a family's financial liability from income and social security taxes. For the average family in the 15 percent federal income tax bracket, a $1,000 per child credit would give roughly the same level of tax relief as raising the dependent exemption in the income tax code back to 1950 levels.

The credit would substantially reduce the tax burden of lower income working families. Federal taxes would be eliminated on working families with incomes below roughly 120 percent of the federal poverty threshold. Example: Under the proposal, a family of four earning around $16,000 in 1992 would pay no federal taxes.[19] Families

18 The maximum value of the proposed credits 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. For families receiving the earned income tax credit (EITC), the value of the new credits proposed in this study would not exceed the family's net tax liability after receipt of the earned income tax credit. Thus if the current EITC already reduced a family's tax liability to zero, that family would not be eligible to receive the proposed new credits because it has no tax liability.

with earned incomes above $16,000 generally would have their taxes cut by the full $1,000 per child but would continue to pay some reduced federal taxes.

Young Child Credit. The families facing the most severe financial pressures of all are those with young children. The reason is that families with one or more pre-school children either must bear the cost of day care for their children or must forego the salary of one parent while she or he remains at home to care for the children. Thus a tax policy designed to help families with children should give greater tax relief to families facing the higher costs of raising young children. Such a family policy, moreover, should not discriminate against families making the economic sacrifice of keeping one parent at home to care for young children. An extra $500 credit for each child under age six in the family would help to offset the extra costs faced by these families. This credit would be available to all taxpaying families with young children and would replace the current dependent care tax credit, which is available only to parents using paid non-parental day care.[20]

The family tax freedom plan thus would provide two levels of tax credit:[21]

Level I: a $1,000 tax credit for each child aged six to eighteen.

Level II: a $1,500 tax credit for each child under age six.

Both credits could be used to reduce income tax liability and Social Security taxes owed through the employee and employer share. And the credits would not be refundable—meaning they could not exceed the value of a family's combined income tax and Social Security tax liability.

This system of tax credits would constitute an important but only modest step toward alleviating the crushing tax burden that has been imposed on families with children since 1948. With the proposed new credits, a two-parent family at the median family income with one pre-school and one school age child would pay $2,500 less in taxes. Total federal taxes on this family would fall to around 19 percent of income, or roughly the same level as existed in 1973. Thus, while the credits would be a small first step in the right direction, they still would not go very far toward eliminating the excessive taxation since World War II.

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19 As with the current earned income tax credit, low-income families would continue to earn credit toward future Social Security retirement benefits based on the amount of labor performed—even if no actual Social Security taxes were paid.

20 The proposed credits also would replace the current tax exclusion for employer provided dependent care for children.

21 For a full discussion of the family tax freedom plan, see Robert Rector, "Reducing the Financial Burden on the Embattled American Family," in Scott A. Hodge, ed., *A Prosperity Plan for America—Fiscal 1993* (Washington, D.C.: The Heritage Foundation, 1992).

GRAPPLING WITH WAGE STAGNATION

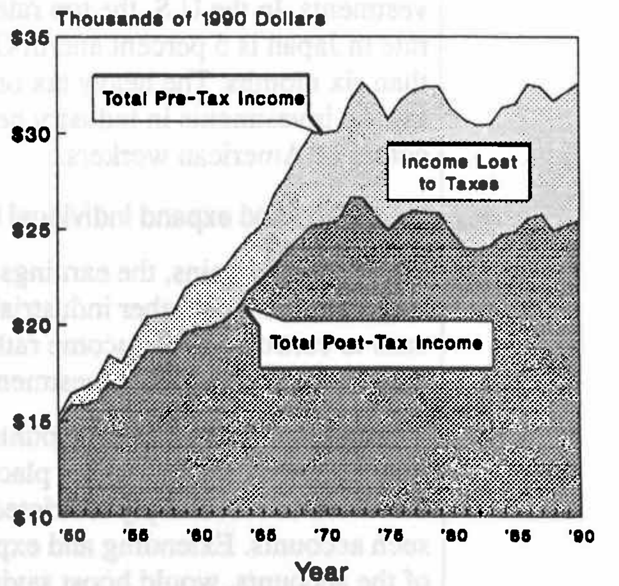
The most pressing financial problem facing families with children today is overtaxation, and this can be addressed by tax relief measures such as those outlined above. But families with children face another financial problem which requires a more indirect and long-term solution. That problem is the slowdown in wage and salary growth due to low productivity improvements in the U.S. economy. The heavy tax burden on savings and investment is a principal cause of this slow growth.

As Chart 3 showed, median family income in constant dollars grew less rapidly in the 1970s and 1980s than in prior decades. Moreover, most of the increase in family income in the 1970s and 1980s was due to wives entering the labor force. While in earlier periods a husband's salary alone normally could provide a steady increase in real family income, after 1970 it became necessary in many families for both spouses to enter the labor force just to achieve even a modest increase in the family's standard of living.

Chart 7 shows the constant-dollar growth of income in married couple families in which only the husband is employed (These data are a reasonable proxy for the salary growth of husbands in general since World War II). Between 1950 and 1970, the real income of husbands nearly doubled. Between 1970 and 1990, however, real pre-tax incomes grew by only 8 percent.[22] What is worse, growing federal taxation swallowed up what little income gain there was; post-tax in-

Chart 7

Income Lost to Federal Taxes for Single-Earner Families: 1949-1990



Note: Figures are for a median income married couple family with wife not in the labor force.
Source: Heritage Tax Model; income data from U.S. Department of Census.

Heritage DataChart

22 These data slightly underestimate the growth in real incomes since 1970 because they do not include increases in non-wage benefits such as medical coverage. Nevertheless even if increase in benefits are taken into account the fact remains that there was a significant slowdown in the increase of husbands' total income (including salaries and benefits) after 1970. Data from Henson, *op. cit.* See also U.S. Bureau of the Census, *Money Income of Households, Families, and Persons in the United States: 1987*, Current Population Reports, Series P-60, No. 162 (Washington, D.C.: U.S. Government Printing Office, 1989), p. 107. This gives historical data on the incomes of males employed full time year round. More recent data are available in later issues. All data series show nearly identical trends in male earnings over time.

come for these single-earner families has not increased at all over the past twenty years.

The stagnation in post-tax income of working husbands played a large role in inducing large numbers of wives to enter the labor force in the 1970s and 1980s. While this extra labor did raise family incomes somewhat, at least half of the family income added in this manner was swallowed by escalating federal taxes. Today's families thus are being crushed by the dual problem of high taxation and slow wage growth.

Lawmakers interested in relieving the financial pressures on the modern family thus cannot merely reduce taxes on families. They also must enact policies that will restore wage growth to the levels that prevailed in the 1950s and 1960s. This means tax reforms that will spur the savings and investment needed to make the U.S. economy more productive, so that American workers can enjoy higher incomes. Among the necessary reforms:[23]

1) Cut the capital gains tax rate to 15 percent and index this tax rate to the rate of inflation.

In contrast with America's leading industrial competitors, investors in U.S. companies face high taxes on the nominal value of gains they make in the value of their investments. In the U.S. the top rate of capital gains is 28 percent. By contrast, the top rate in Japan is 5 percent and in Germany there is no such tax on assets held for longer than six months. The heavy tax on U.S. capital gains discourages Americans from making the investments in industry necessary to improve productivity, and thus the incomes of American workers.

2) Extend and expand Individual Retirement Accounts (IRAs).

Like capital gains, the earnings Americans receive on their savings is more heavily taxed than in most other industrialized countries. This high taxation encourages Americans to consume their income rather than to save. This in turn reduces the available pool of money for new investment.

Individual Retirement Accounts (IRAs) reduce the tax bias against savings by deferring income taxes on income placed into the special accounts. Unfortunately, the 1986 Tax Reform Act sharply restricted the amount of income that families could place in such accounts. Extending and expanding these accounts, and revising the tax treatment of the accounts, would boost savings and so increase the pool of funds available for productive new investments.[24]

3) Reduce taxes on business investment by indexing depreciation schedules for inflation.

In most industrialized countries, firms effectively are allowed to deduct the full cost of new plant and equipment from their taxable profits, much like any other business expenses. In the U.S., however, arcane depreciation schedules force firms to wait many years for tax relief on major investments of new plant and equipment. Indexing depre-

23 For a complete discussion of measures needed to boost savings and investment in the U.S. economy, see Daniel J. Mitchell, "A Tax Reduction Strategy to Spur Economic Growth," in Hodge, *op. cit.*

24 For an elaboration of the IRA proposal, see *ibid.*

ciation schedules for inflation, which would give firms more "up front" tax relief for investments, would be an important first step toward achieving a fairer tax treatment of investments, and thereby boosting new investment.

Because these tax changes would improve productivity and thereby raise the wages of parents and other workers, they are profoundly pro-family. If, by making such reforms, the U.S. can restore productivity increases and wage growth to the rates enjoyed in the 1950s and 1960s, the average parent could expect real hourly wages to grow by nearly 50 percent in the next decade. This is crucial to relieving the financial pressures on today's beleaguered families.[25]

HOW TO PAY FOR FAMILY TAX RELIEF

Several proposals on Capitol Hill to relieve taxes on families with children, such as those sponsored by Senator Gore, Representative Downey, and Senator Bentsen, would cut taxes modestly for middle-class families but would couple these tax cuts with increases on higher-income families. The trouble is that these tax increases would slow investment, which in turn would slow the growth of economic productivity and hence slow real wage growth for the average American. The result: What families would gain by tax relief they would lose in the slower growth of real wages. Thus tax proposals like the Gore-Downey plan and the Bentsen plan actually would hurt American families.

The proper way to provide for family tax reduction is not to increase taxes on other Americans. Raising taxes on one group to cut the tax burden on another would do nothing to improve productivity in the economy and likely would reduce it. The way to pay for tax cuts for families is to restrain the growth of federal non-defense spending, which has grown faster than the rest of the economy for the last three decades. If a cap of five percent per annum were placed on the growth of total federal domestic spending, the resultant "waste dividend" would be sufficient to finance most of the family and growth tax package outlined above.[26] Under such a plan the family tax credits outlined above could be phased in over a four-year period. In each year during the phase-in the tax revenue loss from the proposed credits would be matched, dollar for dollar, by spending reductions under the five percent spending growth cap. The value of the family tax credits would be increased each year and would reach their full value of $1,000 for a school-age child and $1,500 for a pre-school child in 1996. In that year the revenue loss from the proposed new tax credits for children would be around $55 billion per annum. A five percent spending cap first instituted in fiscal 1993 would result in a corresponding domestic spending reduction in 1996 of some $46 billion. Up to an additional $10 billion per annum could be obtained through extra cuts in the de-

25 Many experts believe that reducing the tax rates on savings and investment would so stimulate economic growth that they would cause an increase in overall federal tax revenues. Thus, according to these analysts, tax cuts on investments and savings would help reduce the federal deficit. However, for purposes of this study, it is assumed that tax cuts on savings and investment would increase economic growth but would neither increase nor decrease federal tax revenue, thus they would have no impact on the federal deficit. See *ibid.*, p. 32.

26 For a detailed analysis of how a five percent cap would fund the proposed tax relief, see Hodge, *op. cit.*

fense budget. Under the existing budget agreement, defense spending already is scheduled to be cut some 20 percent in real terms over the next five years. Thus under the spending cap plan, each dollar of family tax relief would be matched by one dollar of reduced non-defense and defense spending. The proposed family tax credits hence would not cause any increase in the federal deficit; the deficit would continue to shrink, and at current projected rates would be cut in half by 1996.

PRO-FAMILY WELFARE REFORM

The current welfare system is anti-family. In fact, the system has made marriage economically irrational for most low-income parents. Welfare has transformed marriage from a legal and social institution designed to protect and nurture children into an institution which imposes financial penalties on nearly all married low-income parents. The current welfare system, in fact, has all but destroyed family structure in the inner city. The problem is that welfare creates strong financial disincentives that effectively block the formation of intact, two-parent families.

Example: Suppose a young man in the inner city has fathered a child out of wedlock with his girlfriend. If this father abandons his responsibilities to the mother and child various levels of government will step in and support the mother and child with welfare. If the mother has a second child out of wedlock, as is common, average combined benefits in a typical state will reach around $13,000 per year.[27] If, on the other hand, the young man does what society believes is morally correct—that is, marries the mother and takes a job to support the family—government policy takes the opposite course. Welfare benefits will almost be completely eliminated. If the young father makes more than $4.50 per hour, the federal government actually begins taking away his income through taxes.

To be sure, the Family Support Act of 1988 permits a family to continue receiving welfare if the father marries the mother and stays with the family—but only as long as he does not work. Once he takes a full-time job to support his family, the welfare benefits quickly are eliminated and the father's earnings become subject to taxation.

27 This figure represents the average value of combined welfare benefits for a single mother with two children enrolled in the Aid to Families with Dependent Children program in the average state. Benefits which the family could receive under the following programs are included in the calculation: Food Stamps, Medicaid, the Women, Infants, and Children food program, Low-Income Energy Assistance, Public Housing, Section 8 Housing, School Lunch Program, School Breakfast Program, Summer Food Program, and the Temporary Emergency Food Assistance Program. The calculation does not assume that the average AFDC family receives benefits from all these programs, but is based on the actual probability of AFDC families also participating in these extra programs. For example, if the cost of public housing subsidies is $5,000 per unit and 25 percent of AFDC families receive public housing subsidies, then the average value of public housing subsidies for AFDC families in general would be $1,250. This procedure provides an accurate calculation of the average value of welfare benefits from different programs received by AFDC families of a given size within each state. Of course, many AFDC families within a given state will have welfare benefits above or below the average in that state, depending on the number of extra welfare programs they participate in.

Current welfare thus may best be conceptualized as a system which offers each single mother an annual "paycheck" worth an average of between $8,500 and $15,000, depending on the state. The mother has a contract with the government; she will continue to receive her "paycheck" as long as she fulfills two conditions:

Condition #1: She must not work; and

Condition #2: She must not marry an employed male.[28]

Low-income parents have responded quite logically to these destructive incentives of the welfare system. Single mothers on welfare in the inner city typically drift through a series of "common law marriages" with different males. While allowing the household to comply with the letter of the welfare law, these relationships lack the social, legal, and financial incentives which help to cement middle-class families and so strong, permanent two-parent families seldom emerge.

The collapse of family structure in turn has crippling effects on the health, emotional stability, educational achievements, and life prospects of low-income children. Children raised in single-parent families, when compared to those in intact families, are one-third more likely to exhibit behavioral problems such as hyperactivity, antisocial behavior, and anxiety, and they are more likely to commit suicide as teenagers.[29] Absence of a father also increases the probability that a child will use drugs and engage in criminal activity.[30] Seventy percent of the juveniles now in state reform institutions grew up in single-parent homes or no-parent homes.[31]

And children in single-parent families are three times as likely to fail and repeat a year in grade school than are children in two-parent families. In all respects, the differences between children raised in single-parent homes and those raised in intact homes are profound, and such differences persist even if single-parent households are compared with two-parent households of exactly the same income level and educational attainment.[32]

But the greatest tragedy is that children from fragmented homes, when grown to adulthood, tend to pass problems on to their own children. Weakened in their own development, children from single-parent homes are markedly less likely to be able to establish a stable married life when they become adults. Studies show, for instance, that young white women raised in single-parent families are 164 percent more likely to bear children out of wedlock themselves, and 111 percent more likely to have children

28 Technically the mother may be married to a husband who works part-time at very low wages and still be eligible for some aid under the AFDC-UP program. However, if the husband works a significant number of hours per month even at a low hourly rate, his earnings will be sufficient to eliminate the family's eligibility to AFDC-UP and most other welfare.

29 Dr. Deborah A. Dawson, "Family Structure and Children's Health and Well-being: Data From the 1998 National Health Interview Survey on Child Health," paper presented at the annual meeting of the Population Association of America, Toronto, May 1990, Table 5.

30 Nicholas Davidson, "The Daddy Dearth," *Policy Review*, Winter 1990, p. 43.

31 Cited by Karl Zinsmeister in *Left and Right: The Emergence of a New Politics in the 1990s?* (Washington, D.C.: The Heritage Foundation and the Progressive Foundation, 1992), p. 27.

32 Dawson, *op. cit.* Davidson, *op. cit.*

as teenagers. If these women do marry, their marriages are 92 percent more likely to end in divorce than are the marriages of women raised in two-parent families.[33] Similar effects are found in black families. Being raised in a single-parent family also triples the probability that a child will become a welfare recipient as an adult.[34] Family instability and its attendant problems thus are passed on to future generations.

While many social and political changes are needed to reverse this instability, one of the most urgent is a major change in the perverse incentives of the welfare system. In particular, incentives from existing programs which promote single parenthood and prolonged dependency must be eliminated or at least reduced. Conversely, new policies must be devised which will promote self-sufficiency and encourage the formation of two-parent families.

What is not needed is policies along the line of those recommended by the National Commission on Children chaired by Senator John D. Rockefeller, the West Virginia Democrat.[35] Although the Rockefeller Commission, which released its report in 1991, trumpeted a strong rhetorical commitment to the principle that two-parent families are best and should be encouraged by government policy, its policy recommendations contradict its own rhetoric. By increasing the economic rewards provided to non-working single mothers relative to working two-parent families, the Commission proposals, like the similar proposals introduced as legislation by New York Democrat Representative Tom Downey (H.R. 3603), would repeat and intensify every mistake of the existing welfare system.

WELFARE REFORMS TO PROMOTE STRONG FAMILIES AND SELF-SUFFICIENCY

There is, fortunately, an emerging consensus among Americans that the welfare system has undermined the family and harmed those it was intended to benefit. Lawmakers at the federal and state level should build on this consensus and work together to develop a pro-family welfare strategy which would reform the welfare incentive system by increasing the rewards for work and marriage while decreasing the current rewards to non-work and single parenthood. Among the necessary components of this new strategy:

✘ **Give tax relief to low-income working families.**

Few Americans realize that a father working to support a wife and two children and earning as little as $16,000 per year actually pays around $2,000 to the federal government in taxes. The simplest way to increase the rewards to marriage and work relative to welfare is to reduce the tax burden on low-income working families. The family tax

33 Irwin Garfinkel and Sara S. McLanahan, *Single Mothers and Their Children: A New American Dilemma* (Washington, D.C.: The Urban Institute Press, 1988) p. 31.

34 *Ibid.*

35 National Commission on Children, *Beyond Rhetoric: A New American Agenda for Children and Families* (Washington, D.C.: U.S. Government Printing Office, 1991).

plan outlined earlier in this study would do this by providing families with a non-refundable tax credit of $1,000 for each school age child and $1,500 for each pre-school child. This would eliminate federal taxes on families earning less than 120 percent of the federal poverty income threshold, which was $12,675 for a family of four in 1991. By raising the real earning power of lower-skilled men, this tax reduction would encourage marriage and foster the formation of two-parent families, as well as helping single mothers to work their way off welfare.

✘ **Give vouchers to all low-income families not on welfare for the purchase of medical insurance.**

The current welfare system provides free medical coverage through the Medicaid program to single parents and non-working two-parent families on AFDC, but the government provides little or no assistance to low-income working families to help buy coverage. This discourages work because a welfare mother considering a low-income job in a small firm—which typically will not include a health benefits plan—faces the loss of thousands of dollars worth of medical benefits. It also discourages marriage because a welfare mother marrying a man in a low-wage job in a firm without family medical benefits will again lose medical coverage. The federal government could reduce the anti-work and anti-marriage effects of welfare by enacting the comprehensive medical reform proposed by The Heritage Foundation, known as the Consumer Choice Health Plan.[36] Among other reforms, this plan would provide federal tax credits and vouchers for the purchase of medical insurance to low-income working families not eligible for Medicaid. A proposal with some similarities to the Heritage plan recently has been introduced by President Bush. Under the Bush plan, poor families would receive a voucher worth as much as $3,750 each year for the purchase of medical coverage.

✘ **Reduce the welfare benefits for single mothers enrolled in the AFDC program.**

The higher welfare benefits are, the greater the disincentives to work and marriage. Recipients of Aid to Families with Dependent Children (AFDC) are eligible for benefits from nearly a dozen major welfare program. These include Food Stamps, Medicaid, Public Housing, Low-Income Energy Assistance, and the Women, Infants, and Children food program. In all but five states, the combined value of benefits received by the average AFDC family actually exceeds the federal poverty income threshold. Welfare benefits for families on AFDC should be reduced, particularly in states in which the average value of benefits is well above the poverty level. This would discourage households from staying on welfare because it is comparatively attractive, and yet would not impose actual hardship.

36 For a description of the plan, see Stuart Butler, "A Policy Maker's Guide to the Health Care Crisis, Part II: The Heritage Consumer Choice Health Plan," Heritage Foundation *Talking Points*, March 5, 1991.

✘ Require mothers who do not have children under age five, or who have received AFDC for over five years, to perform full-time community service in exchange for benefits.

The work requirement should not be temporary. Recipients subject to it should be required to perform a community service as long as they receive welfare benefits. Requiring a welfare recipient to work in exchange for benefits greatly reduces the attractiveness of welfare relative to private sector employment. Work requirements thus discourage dependence and encourage efforts toward self-support. A work requirement also eliminates many of welfare's anti-marriage incentives. Example: Under the current welfare system, if a welfare mother marries a fully employed man she will lose some \$10,000 to \$13,000 in welfare benefits. Under a welfare system with a work requirement, the welfare mother still loses benefits upon marrying, but she will be losing benefits for which she must work rather than losing a free income. Hence, the practical loss will be far less significant. Indeed, as long as the welfare mother can obtain a private sector job which pays roughly as much as her previous welfare benefits, then the financial penalty on marriage would be eliminated entirely.

Most mothers with pre-school children would be exempt from this work requirement. Because of the high costs of providing day care, work requirements for mothers with pre-school children almost certainly would increase rather than cut welfare costs. Moreover, great caution should be exercised toward any policy which separates young children from their mothers as this will often have a significant detrimental effect on the child's development. Thus a well-designed work program generally would not include mothers with young children. However, a second rule requiring work by all mothers who have received AFDC payments for over five years, either continuously or in separate periods, is needed to discourage mothers from intentionally having more children to avoid an obligation to work.

If a work requirement of this kind were established, roughly 50 percent of AFDC mothers would be required to work as a condition of receiving benefits. This would be an enormous improvement from the present situation; in the average state only 6 percent of AFDC mothers currently participate in job search, work, or training programs.

✘ Experiment with "wedfare" programs.

Several states, including Wisconsin, are considering so-called Wedfare programs which would give cash bonuses to AFDC mothers who marry, leave AFDC, and remain off the welfare rolls. Example: A welfare mother might be given a payment of \$2,000 if she married and remained off the welfare rolls for at least two years. However, since the real effects of wedfare programs are uncertain, state governments should introduce such programs on an experimental basis and rigorously evaluate them through controlled experiments.[37]

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37 New Jersey has also enacted a variant of wedfare. A wedfare program would probably be most effective if restricted to mothers who are likely to be long-term welfare dependents such as never married mothers who have been on AFDC over two years.

CONCLUSION

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

But the American family is in deep trouble. A crushing tax burden is making it increasingly difficult for middle class families to support themselves. Excessive taxes on savings and investment have eroded the American Dream, reducing the real growth of parent's wages to a fraction of what could be expected in earlier generations. And the ever-growing welfare system has replaced the husband as the principal breadwinner for a growing number of low-income mothers and children.

What families need from government is not new spending and new social programs. Those have done little or nothing to help families, and paying for them has added to the tax burden on us all. What families really need is threefold. First, for government to allow them to keep a greater share of their own hard-earned money. Second, for government to cut taxes on investment and savings in order to stimulate productivity growth and to raise real wages throughout the economy. Third, a reform of the welfare system to promote rather than penalize the formation of self-sufficient, two-parent families. These policies are needed urgently if America is to restore its bedrock social institution.

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