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GRADING FAMILY TAX RELIEF PROPOSALS

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INTRODUCTION

Families with children have suffered a dramatic increase in their tax burden in the last forty years, especially when compared with other groups in society. This tax hike has been caused in large part by inflation, which has significantly eroded the value of the personal exemption, thereby subjecting more of a family's income to the income tax. Combined with large increases in payroll taxes, the median-income family of four is now sending 24 percent of its income to Uncle Sam, compared with 3 percent as recently as 1948.[1] Four major proposals have been introduced to address this problem by lowering the tax burden on American families. They are:

✓ **The Republican $500 Credit.** This proposal calls for a $500 tax credit for every dependent child under age 18. The House version of the credit, popularized by incoming House Speaker Newt Gingrich (R-GA) and the Contract With America,[2] applies only to families with an annual income of $200,000 or less. In a Senate version of the proposal, sponsored in the 103rd Congress by Senator Pete Domenici (R-NM), there is no income limit. Thus, in the Senate version, the credit is made available to all families.

✓ **The Clinton plan.** The Administration has proposed a $500 tax credit for every dependent child under age 13 in families with annual income of less than $75,000.[3]

✓ **The Gephardt plan.** Incoming House Minority Leader Richard Gephardt (D-MO) has offered a plan to reduce taxes for all families with incomes below $75,000.

✓ **The Gramm plan.** Senator Phil Gramm (R-TX) has proposed to double, from $2,500 to $5,000, the personal exemption for each dependent child. Gramm's plan would retain current law regarding the phase-out of the personal exemption at higher incomes.

1 Robert Rector, "Reducing the Crushing Tax Burden on the Embattled American Family," Heritage Foundation *Backgrounder* No. 981, March 7, 1994.

2 The Republican Contract also calls for reductions in the capital gains tax, reduced tax penalties against business investment, and expanded Individual Retirement Accounts.

3 The Administration proposal includes a $10,000 deduction for college tuition and a modest expansion of Individual Retirement Accounts.

When lawmakers consider the merits of rival "middle-class tax cut" proposals, it is important that they understand the proper purposes of this tax relief. It is not to promote economic growth. To be sure, the reduction in spending that is to "pay" for tax relief will provide a boost to the economy by returning resources from the less efficient government sector to the more efficient private sector. But the family tax cut proposals are not designed as such to be an economic stimulus. Other tax reforms have been put forward for that purpose, ranging from the sweeping rate reduction and simplification proposal advanced by Representative Richard Armey (R-TX) to other proposals which would cut marginal tax rates and lower taxes on saving and investment.

The primary purpose of the tax proposals now being discussed is instead to address the imbalance in the tax code that has become more and more onerous in recent years—the increased tax burden on families with children. This is the group most damaged by the reduction in the value of the personal exemption, and middle-class families are the ones who have suffered the largest percentage increase in their tax burden. Lawmakers thus need to be clear in their minds that the primary goal must be to reduce that disproportionate burden on families with children—not by increasing the taxes of other Americans but by cutting federal spending.[4]

Further, lawmakers clearly should seek to rectify this imbalance in tax burdens in ways which do not conflict, or conflict least, with other objectives of tax reform. These other objectives include general economic growth and preserving incentives to encourage Americans to improve their standard of living through work and risk-taking.

IS TAX RELIEF SPREAD FAIRLY TO TAXPAYERS?

How do the proposals rate against the criteria discussed above? Most families would receive some tax relief under each plan being discussed. Most of the plans, however, would penalize higher-income families by phasing out or eliminating the tax credits above certain income levels.

Republican Credit

Senate version **Grade:** A

House version **Grade:** B

All taxpaying families would benefit under the Senate proposal. Unfortunately, the House version takes away the full value of the $500-per-child tax credit once family income reaches $200,000 per year. This decision to bar some families from receiving the tax relief was not made to minimize revenue losses. Because of the pattern of working careers, very few children live in upper-income families. In fact, only about 83,000 out of 52 million children below age 18 in 1992 lived in families with annual incomes above $200,000.[5]

Despite the few children in high-income households, some Republicans in the 103rd Congress feared that opponents would classify their proposal as a tax cut to the "rich." This led House Republicans to place the income limit now in the Contract. The election results indicate that this concession to the politics of envy was unnecessary. But because of that unwise concession, a real problem arises with the House plan: the elimination of the credit for upper-income families in the House plan has the same effect as an increase in marginal tax rates.

4 See Scott A. Hodge, "Washington Should Turn Bipartisan Talk of Family Tax Cuts Into Action," Heritage Foundation *Backgrounder* No. 1004, September 27, 1994.

5 U.S. Bureau of the Census, 1992 Current Population Survey.

Clinton plan **Grade: C**

The President also proposes a $500-per-child tax credit, but his plan is significantly more restrictive than the Contract's. The White House plan begins to phase out the value of the credit when family income reaches $60,000 and families with income of over $75,000 receive no benefit at all. The Administration apparently thinks such people are rich, but a family consisting of a $40,000 blue collar worker and a $35,000 teacher hardly qualifies as wealthy.

Gephardt plan **Grade: C**

Beyond limiting tax relief to those with incomes under $75,000 and purportedly also granting tax relief to those without children, the Gephardt plan contains few details. Indications are that it will be very similar to the White House proposal. Since Gephardt plans to offer tax benefits to those without children, the amount of tax relief available to help families presumably will be lower. The Gephardt proposal, therefore, does not make a priority of reducing taxes on families with children.

Gramm plan **Grade: B**

The Gramm plan does not explicitly discriminate among taxpayers, but because existing law takes away the personal exemption for high-income taxpayers, not all families would benefit from the doubling of the personal exemption.

WHAT IS THE ECONOMIC IMPACT?

Creation of tax credits and expansion of exemptions in general neither encourages nor discourages economic growth. While other tax proposals are intended to change economic incentives, family tax relief plans generally are meant to achieve another worthy purpose—allowing families to keep more of their money instead of sending it to Washington for the government to spend. Assuming these proposals are financed by reductions in the size of government, the economy will benefit, but the benefit is due to lower levels of federal spending, not the change in tax policy as such. To stimulate growth directly, a tax cut has to reduce marginal tax rates or lower tax penalties against working, saving, and investing. While credits do not encourage productive economic behavior, poorly structured proposals can penalize growth. If a credit or exemption is eliminated or phased out as income reaches a certain level, however, that has the perverse effect of boosting tax penalties on additional working, saving, and investment. In reviewing the rival plans, a proposal with no economic impact receives a C grade. Those with negative consequences receive lower grades.

Republican Credit

Senate version **Grade: C**

House version **Grade: D**

Because the tax credit is available to all families, the Senate version has no harmful economic effects. Under the House plan, however, the moment a family's taxable income reaches $200,000, the family loses the full value of the tax credit. This has the same effect as increasing marginal tax rates for taxpayers in that income range. This spike in marginal tax rates as family income crosses the $200,000 threshold creates a strong disincentive to earn additional income. For example: Under current law, a family with three children whose income climbs from $195,000 to $205,000 will pay $3,890 of taxes on the $10,000 of higher income, a marginal tax rate of 38.9 percent.[6] Under the Contract, however, the family loses $1,500 of tax credits as their income breaches the $200,000 range. As a result, their tax bill rises by $5,390 as their income climbs by $10,000, a marginal tax rate of 53.9 percent.

Clinton plan Grade: D

The Administration proposal suffers from the same defect as the Republican Contract. The only difference is that the credit is phased out between $60,000-$75,000 instead of being eliminated all at once. Because it is phased out (rather than eliminated), the marginal tax rate for families moving through that income range will rise, though not by as much as it will for families under the Contract.

Gephardt plan Grade: D

Although details are murky, the Gephardt plan would either phase out or eliminate the tax credit. As such, it would have similar effects to those found in the Clinton plan.

Gramm plan Grade: C-

The Gramm plan is the only family tax cut proposal that does not include an explicit income cap. But it does contain an implicit cap because it retains current income tax law regarding the availability of the personal exemption. The value of the personal exemption is phased out under current law, resulting in higher marginal rates on income in the phase-out range. The Gramm proposal to double the exemption thus would extend the income range affected by higher marginal tax rates.

It is important for lawmakers to appreciate that while each of the proposals with an income limit may appeal to class warfare rhetoric, seemingly to the advantage of the middle class, these proposals actually create a hidden tax barrier for middle-class Americans trying to improve their standard of living. The increased marginal tax rates that apply in these proposals when the tax relief is phased out constitute a form of "income ceiling" for middle-class families, making it harder for them to aspire to higher-income levels. For instance, under the Clinton plan, families earning $60,000 encounter what amounts to a tax surcharge until they reach an income of $75,000. Limiting tax relief to Americans below a certain income thus will have the perverse effect making it harder for middle-income Americans to achieve additional income gains.

What Happens to the Deficit?

All the proposed tax cuts are said to include offsetting reductions in the growth of government spending. As such, all the proposed tax cuts presumably will be accompanied by broader fiscal legislation, the net effect of which will be to reduce government spending and borrowing. Some of the proposed offsets, however, are far from clear.

Republican Credit (Both versions) Grade: B

Republicans have not yet specifically stated the spending "cuts" they will use to finance their tax cut proposal. Both the House Republican alternative budget and the Senate Republican budget offered earlier this year, however, are expected to be the starting point for next year's

6 The family would be subjected to a 36 percent personal income tax rate and a 2.9 percent Medicare tax.

budget debate. These budgets contained more than enough genuine spending savings to finance the proposed tax cuts.

Clinton plan **Grade: B-**

The Administration has released a partial list of proposed reforms and spending savings to finance its proposed tax cuts. While there is reason to question how real some of these savings are, the Administration seemingly is prepared to link specific spending cuts with tax cuts to avoid a rise in the deficit.

Gephardt plan **Grade: D**

The House Democratic plan exists only as an outline. There are neither specific nor vague spending savings under consideration.

Gramm plan **Grade: A**

The Gramm plan includes a specific plan to finance his tax cuts. These cuts are 16 percent reductions in annual appropriations for selected government departments and agencies.

CONCLUSION

Of all major demographic groups, families with children have seen their taxes climb the most during the post-World War II era. Media speculation that proposals to grant tax relief are no more than a political "bidding war" for the middle class ignores the wide recognition that family tax relief is long overdue. The challenge for Congress is to design tax and budget legislation that achieves the primary purposes of family tax relief in ways which conflict least with the other objectives of tax reform.