CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on Finance
United States Senate

November 26, 1991

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Tuesday, November 26, 1991.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, I appreciate the opportunity to appear today before the committee to discuss how families with children are doing in relation to other families and to comment on Title I of the "Tax Fairness and Savings Incentive Act of 1991" (S. 1921). My testimony today will focus on how the income and tax situations of families with children compare with those of other families, and how these situations have changed over the past decade and one-half.[1]

A number of conclusions arise from this analysis. Three of the most striking are:

- Average family income, adjusted for family size, is lower for families with children than for other types of families. Furthermore, between 1977 and 1989, average pretax income for families with children grew very little, less than 10 percent after controlling for inflation.

- Rates of income growth varied markedly for families with children at different points in the income distribution. Between

1. Families are divided into three groups for purposes of this analysis: families with a related child under age 18; childless families with both the head and spouse, if any, under age 65; and childless families with the head or spouse age 65 or older. Individuals not living with relatives are treated as one-person families, so families include the entire noninstitutionalized population. To compensate for differences in family size and changes in consumer prices, CBO used adjusted family income, which is a measure of incomes relative to the appropriate poverty thresholds of the Bureau of the Census. Income consists of all cash income, including realized capital gains, plus employers' share of payroll taxes and corporate income taxes imputed to individuals. Federal taxes include individual and corporate income taxes, payroll taxes, and excise taxes.

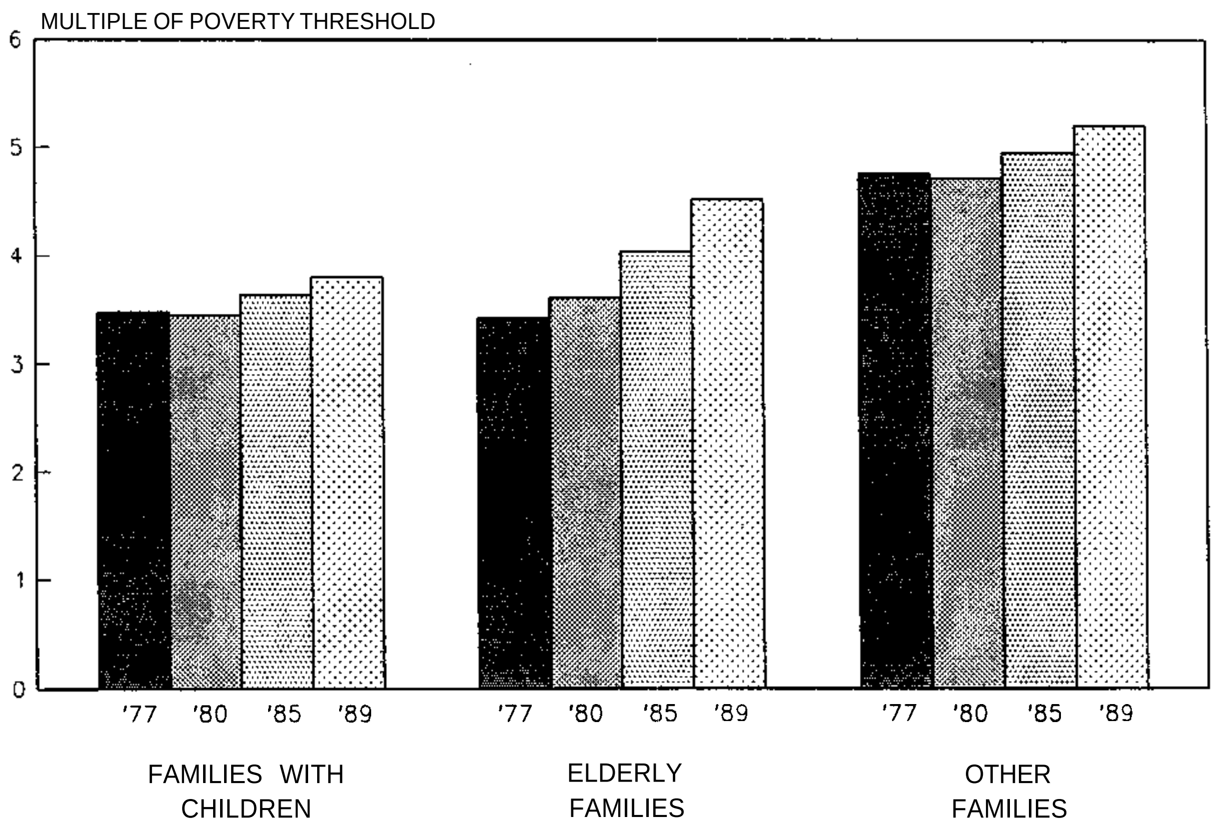
1977 and 1989, the average pretax income for families with children in the bottom three income quintiles was virtually unchanged, while the average pretax income for families in the highest income quintile increased by more than 25 percent.

- Effective individual income tax rates--the percentage of pretax income paid in individual income taxes--are projected to be lower in 1992 than they were in 1977 for families with children in all income quintiles except the highest. Increases in payroll taxes, however, are projected to offset the decline in individual income taxes for families with children in all but the lowest income quintile, causing total federal effective tax rates to be slightly higher in 1992 than they were in 1977 for middle- and upper-income families with children.

PRETAX INCOMES

In 1989, about one-third of all families had children. These families contained more than 55 percent of all people. In 1989, families with children had lower average pretax income, adjusted for family size, than other types of families (see Figure 1). While the average income for families with children was less

FIGURE 1. AVERAGE PRETAX FAMILY INCOMES AS MULTIPLE OF POVERTY THRESHOLD, 1977-1989



SOURCE: Congressional Budget Office tax simulation model.

than four times the poverty level, the average income for nonelderly childless families was more than five times the poverty level, and the average income for elderly families was more than four and one-half times the poverty level.

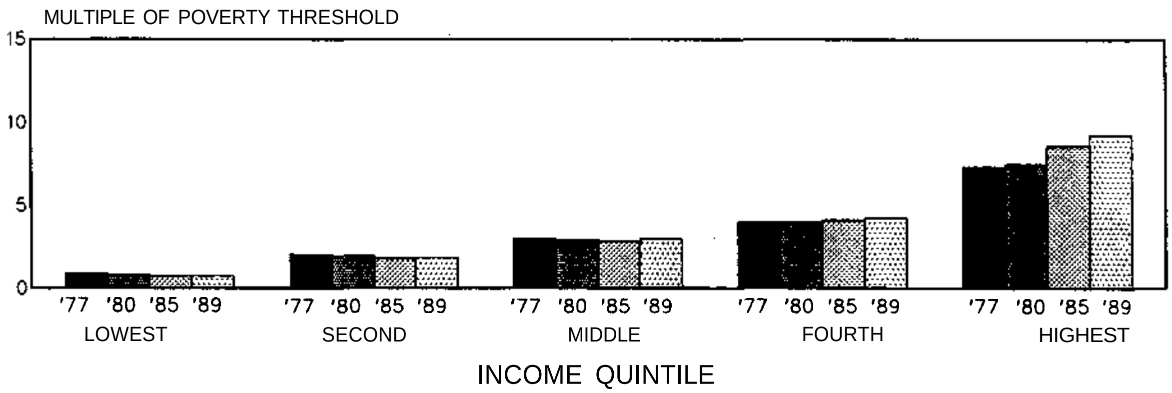
Between 1977 and 1989, the average pretax family income for families with children grew by less than 10 percent, as did the average pretax income of nonelderly childless families. In contrast, average pretax family income for elderly families grew by more than 30 percent during the same period.

Average incomes grew at different rates during the 12-year period. After declining between 1977 and 1980, average pretax income for families with children and for nonelderly childless families grew by slightly more than 1 percent a year during the 1980s. Average pretax income of elderly families grew steadily over the period, although all the growth in income between 1977 and 1980 was among high-income families. While the average pretax income of elderly families, adjusted for family size, was below that of families with children in 1977, by 1989 it was about 20 percent higher.

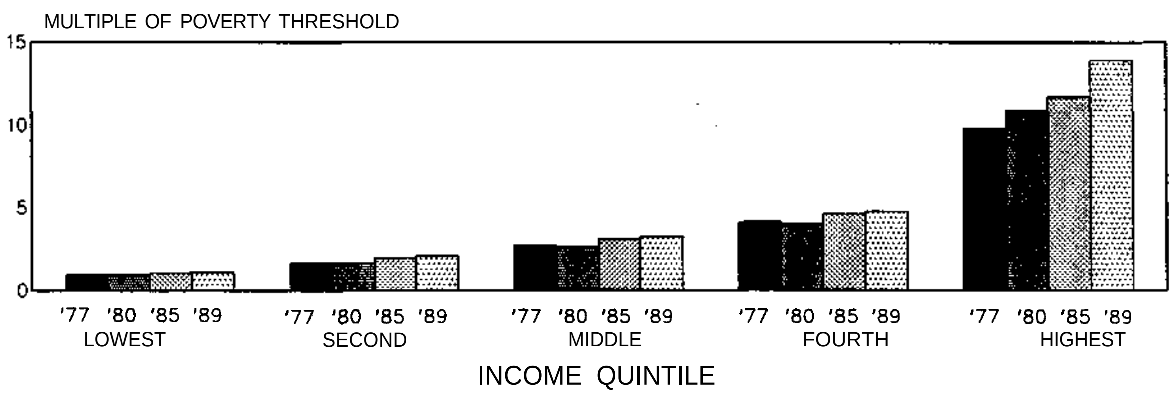
The change in average pretax income of families with children varied widely at different points in the income distribution (see Figure 2). Average pretax income was virtually unchanged between 1977 and 1989 for families in the bottom three income quintiles, rose slightly for families in the next-to-

FIGURE 2. AVERAGE PRETAX INCOMES BY INCOME QUINTILE, 1977-1989

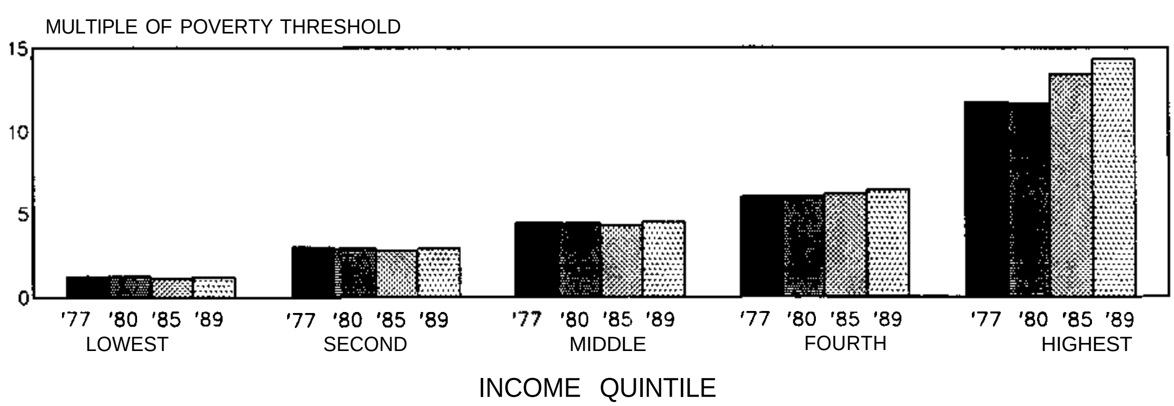
FAMILIES WITH CHILDREN



ELDERLY FAMILIES



OTHER FAMILIES



SOURCE: Congressional Budget Office tax simulation model.
NOTE: Income quintiles are for specific type of family.

highest income quintile, and grew by more than 25 percent for families in the highest income quintile.

The change in average pretax income for nonelderly childless families at different points in the income distribution was similar to that for families with children. The only significant growth in average income was for families in the highest income quintile. In contrast, average pretax family income grew for elderly families at all points in the distribution, but here too the highest income families experienced the greatest income growth.

Changes in earnings dominated overall changes in income for nonelderly families. More than 90 percent of nonelderly families received at least some income from earnings, and earnings accounted for 85 percent of their total family income. Earnings in constant dollars dropped during the late 1970s, particularly for low-income families, as rapid inflation eroded wage rates. Between 1980 and 1985, overall average earnings rose slightly, though the gains were concentrated in the upper part of the income distribution as the 1980 and the 1981-82 recessions and a bout of double-digit inflation depressed average real earnings for nonelderly families in the bottom three quintiles. Earnings gains in the latter 1980s were spread over all parts of the income distribution and were sufficient to yield a small rise in overall average earnings during the entire 1977-1989 period. For families in the bottom three quintiles, however, the small gains between 1985 and 1989 were not enough to offset earlier declines, and average earnings in constant dollars for those families was lower in 1989 than in 1977.

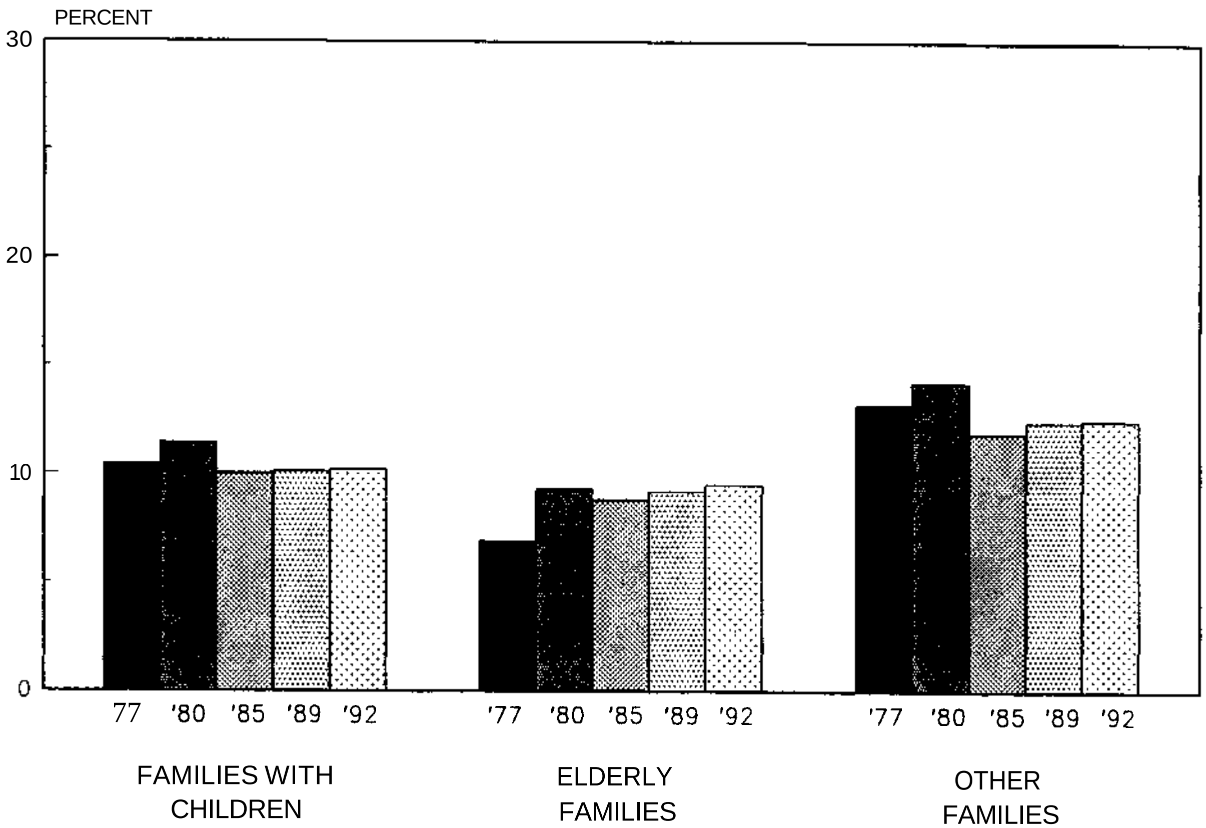
TAXES OF FAMILIES WITH CHILDREN

Overall, families with children are projected to pay about 10 percent of their incomes in federal individual income taxes in 1992, not much different than their effective tax rate in 1977 (see Figure 3).[2] This percentage is less than the 12 to 13 percent effective rate projected for childless nonelderly families. The difference results in large part because the tax code includes preferences for families with children such as the Earned Income Tax Credit (EITC), the Dependent Care Credit, and dependent exemptions.

Changes in effective individual income tax rates vary for families at different points in the income distribution (see Figure 4). Families with children in the lowest income quintile receive a subsidy, on average, rather than pay a tax, through the refundable earned income tax credit. This subsidy has become larger as a result of the expansions made in the EITC in both the

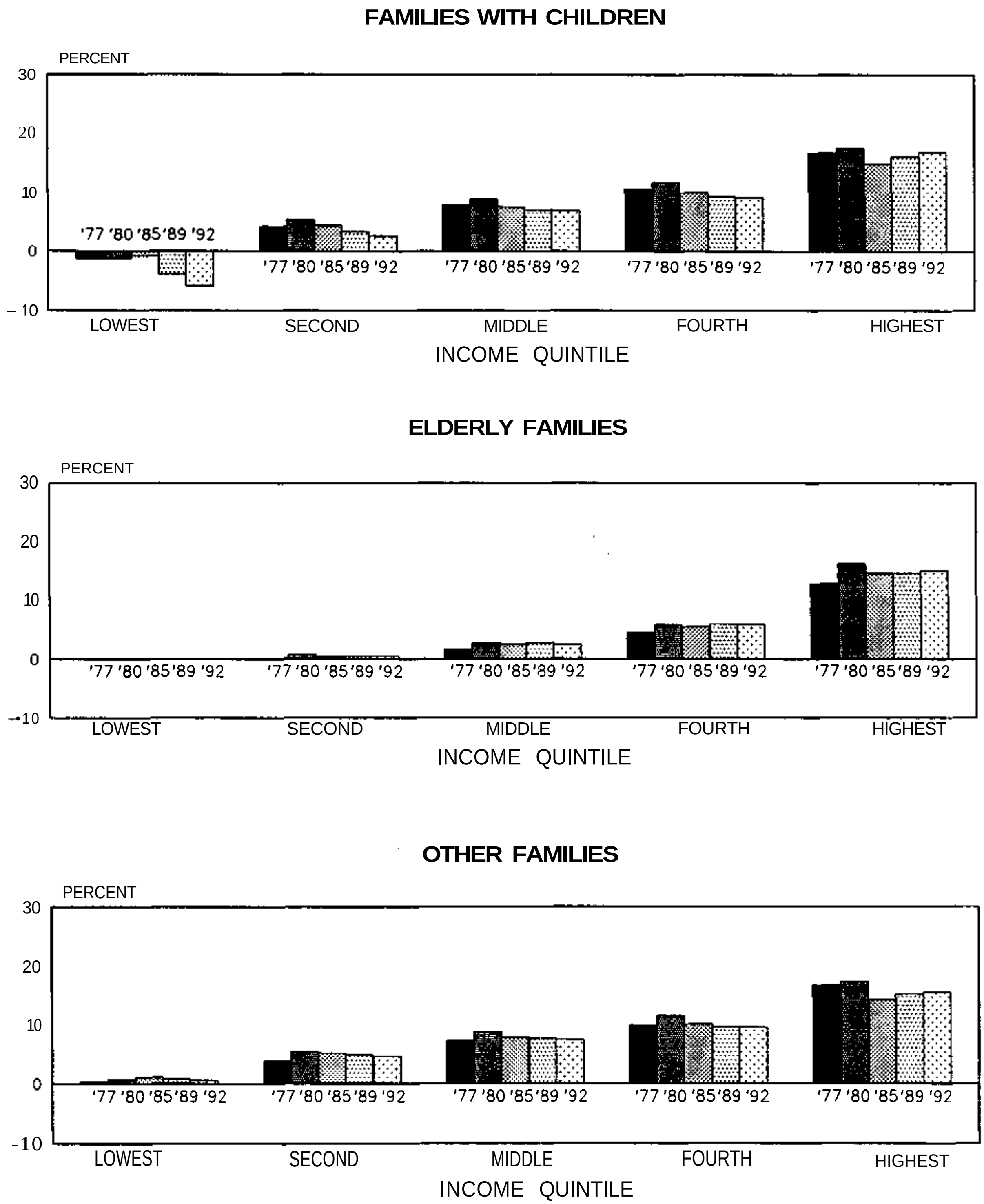
2. The complete change in effective federal tax rates is best measured using projections through 1992, by which time most provisions of the Omnibus Budget Reconciliation Act of 1990 will be fully phased in.

FIGURE 3. AVERAGE EFFECTIVE FEDERAL INDIVIDUAL INCOME TAX RATES, 1977-1992



SOURCE: Congressional Budget Office tax simulation model.

FIGURE 4. EFFECTIVE FEDERAL INDIVIDUAL INCOME TAX RATES BY INCOME QUINTILE, 1977-1992



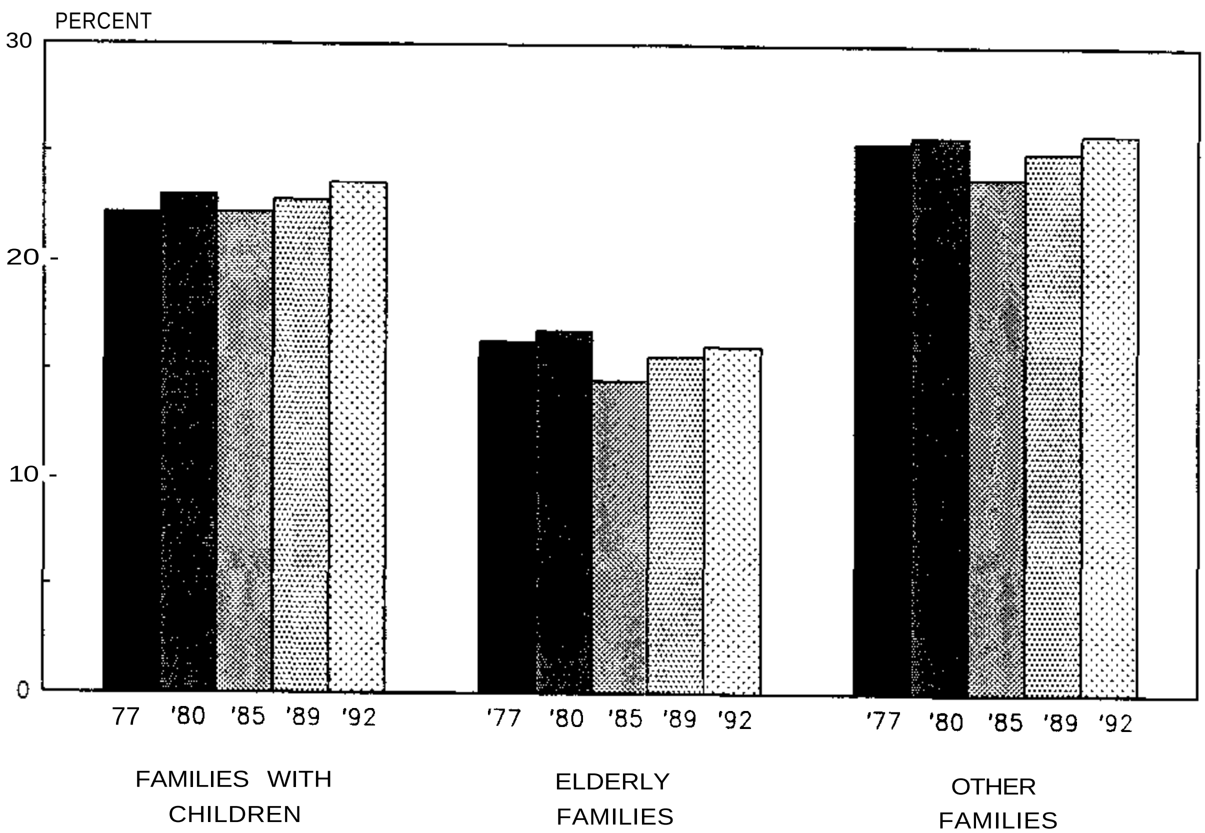
SOURCE: Congressional Budget Office tax simulation model.
NOTE: Income quintiles are for all families.

Tax Reform Act of 1986 and Omnibus Budget Reconciliation Act of 1990. Families with children will receive average credit refunds in 1992 equal to about 6 percent of their pretax incomes. Because low-income families without children do not qualify for the EITC, they will face slightly positive income tax rates.

Families with children in the middle three quintiles will face effective income tax rates in 1992 that are projected to be lower than the rates they faced in 1977. The biggest drop is projected for families with children in the second quintile, some of whom will benefit from the expanded EITC. At the top end of the income distribution, families with children are projected to pay virtually the same percentage of pretax income in individual income taxes in 1992 as families paid in 1977. Effective individual income tax rates have risen steadily since 1985 as the elimination of various tax preferences has offset the large rate decreases of the early 1980s.

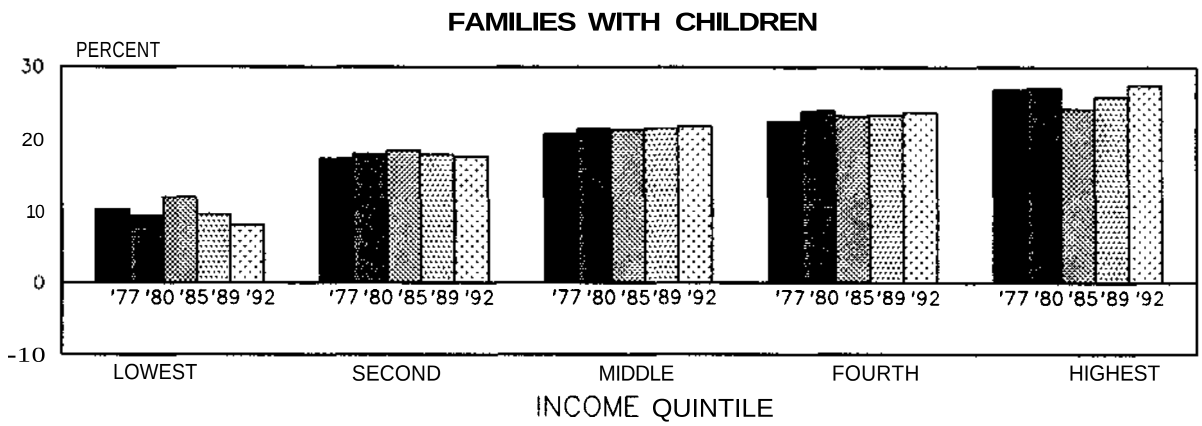
Since 1977, total federal effective tax rates have increased slightly for families with children and for nonelderly childless families (see Figure 5). Only low-income families with children will face lower total effective tax rates in 1992 than similar families faced in 1977 (see Figure 6). For those families, tax reductions since 1985 have more than offset the increases they experienced during the early 1980s. Although the increase in total effective tax rates for

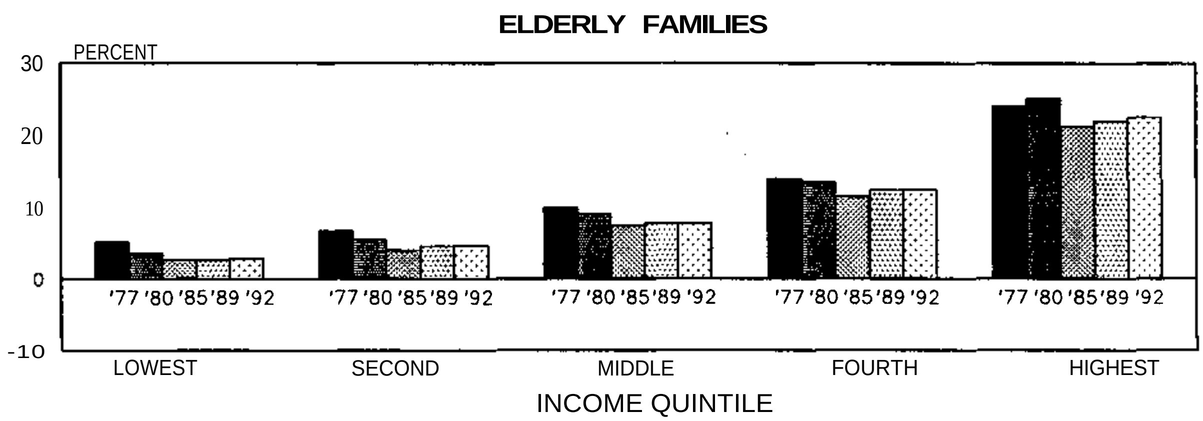
FIGURE 5. AVERAGE TOTAL EFFECTIVE FEDERAL TAX RATES, 1977-1992

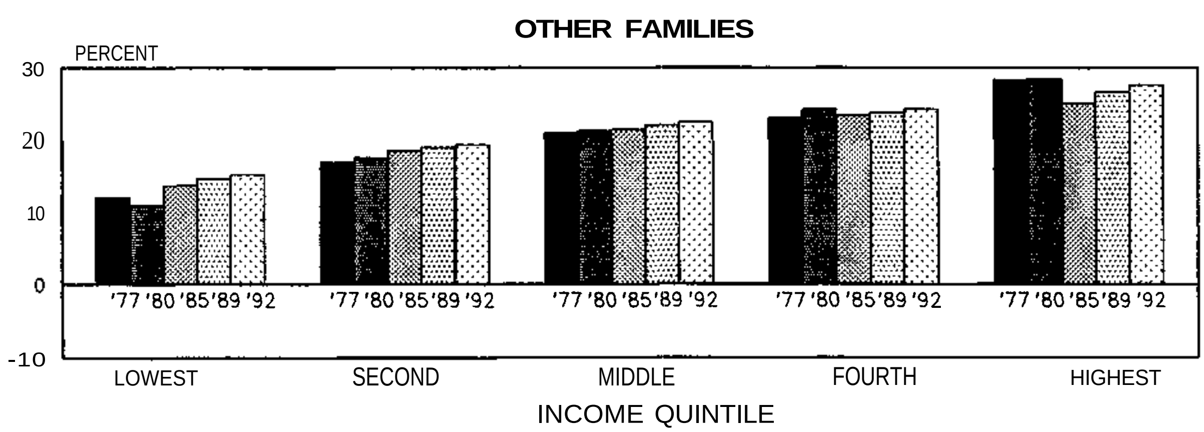


SOURCE: Congressional Budget Office tax simulation model.

FIGURE 6. TOTAL EFFECTIVE FEDERAL TAX RATES BY INCOME QUINTILE, 1977-1992







SOURCE: Congressional Budget Office tax simulation model.
NOTE: Income quintiles are for all families.

middle- and upper-income families with children is small, on average their taxes are projected to be a slightly higher percent of income in 1992 than they were for similar families in 1977.

The increase in total effective tax rates has been primarily the result of rising payroll taxes. The Social Security tax rate has risen from a combined 11.7 percent of taxable earnings on employers and employees in 1977 to the current 15.3 percent, while the limit on taxable earnings has been increased by about half after adjusting for inflation. As a result, the effective social insurance tax rate for families with children--including both Social Security and unemployment insurance taxes--is projected to rise from 7 percent of income in 1977 to about 10 percent of income in 1992. (The effective social insurance tax rate is less than the combined Social Security tax rate because not all income is subject to Social Security taxes.) One justification for the EITC is that it offsets payroll taxes for low-income families. While increases in the EITC have offset the impact of payroll tax increases for low-income families with children, nonelderly families without children have faced similar increases in payroll taxes, but have not benefitted from the EITC. All families who pay payroll taxes, however, benefit from the social insurance programs that the taxes fund.

AFTER-TAX INCOMES

Changes in after-tax income reflect the combined effects of changes in pretax income and changes in effective tax rates. Average pretax income of families with children, adjusted for inflation and changes in family size, has grown little since 1977. Although effective individual income taxes have fallen for all but the highest-income families with children during the same period, increases in effective payroll tax rates have reversed those changes for families with children in the middle of the income distribution. As a result, average adjusted after-tax incomes have grown by slightly less than average pretax incomes for families with children.

CBO estimates that average after-tax income for families with children, when adjusted for inflation and family size, will be 4 percent higher in 1992 than it was in 1977. Although the last actual data for 1989 showed an 8 percent increase in after-tax income, that increase will be cut in half because the recent recession and a small increase in effective tax rates between 1989 and 1992 will cause a small drop in after-tax income between 1989 and 1992. As with pretax income, all of the gains in average after-tax income for families with children so far have been concentrated among higher-income families.

Permanent solutions to the problem of little or no income growth for middle- and low-income families must address the causes of low pretax incomes, which include the limited earnings capacity of many and their willingness and ability to work. Specific policies aimed at strengthening education, job training, employment opportunities, and assistance obtaining and keeping jobs, including child care, may be effective in the long run.

As shorter-term solutions, a number of tax proposals have been offered to help middle-income families with children. Among these is the "Tax Fairness and Savings Incentive Act of 1991" (S. 1921), sponsored by Senator Bentsen and other members of the committee. The bill includes a nonrefundable credit of $300 for each child under the age of 19. The credit would cut taxes for the average family with children by $367 in 1992 and would raise their after-tax income by 1 percent (see Table 1). After-tax income of families with children in the second and third income quintiles would rise by over 1.5 percent. Because the credit is not refundable, families in the lowest income quintile would see little change in their after-tax incomes. As noted earlier, however, those families have benefitted significantly in recent years from increases in the EITC.

TABLE 1. EFFECT OF A NONREFUNDABLE TAX CREDIT OF $300 PER CHILD FOR FAMILIES WITH CHILDREN BY INCOME QUINTILE, 1992

Income Level	Average Change in Taxes (In dollars)	Percentage Change in After-Tax Income
Lowest Quintile	-16	0.2
Second Quintile	-433	1.9
Middle Quintile	-535	1.6
Fourth Quintile	-488	1.0
Highest Quintile	-454	0.4
All families	-367	1.0

SOURCE: Congressional Budget Office tax simulations.