Newest Study Shows '97 Tax Cuts Came Too Late to Stem Rising Burden on Family

Congress's 1997 tax cut apparently came too late to shield many American families from yet another annual rise in their total tax burden. According to a new study by the Tax Foundation, federal, state, and local taxes will claim 38.2 percent of the income of a median two-income family (earning $54,910), up from 37.3 percent in 1996. The median one-income family's tax burden is projected to be 35.6 percent of its income this year, up from 35.5% in 1996.

The latest Tax Foundation analysis shows that the current level of taxes for the median two-income family is nearing the historic highwater mark established before the massive 1981 tax cuts. Taxes took a 38.9 percent bite out of the median two-income family's total budget in 1981.

The new study — Special Report No. 74, titled "Tax Burden on American Families Rises Again" — confirms that with increased prosperity comes increased taxes. In terms of inflation-adjusted dollars, the $22,521 total tax burden that a median dual-earner family will bear this year will be the highest ever. As the comparison in Chart 2 demonstrates, two tax trends are primarily responsible for the jump in tax burden over recent decades — the upward trend in state and local taxation and the increase in the federal payroll tax used to fund social insurance programs:

- State and local taxes combined have, as a share of the family budget, grown over five

**Median Family continued on page 2**

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**Chart 1: Taxes as a Percentage of Income for Median One- and Two-Income Families**

<table>
<thead>
<tr>
<th>Year</th>
<th>One Income</th>
<th>Two Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>28.1%</td>
<td>28.1%</td>
</tr>
<tr>
<td>1965</td>
<td>27.0%</td>
<td>27.0%</td>
</tr>
<tr>
<td>1975</td>
<td>25.5%</td>
<td>25.5%</td>
</tr>
<tr>
<td>1985</td>
<td>24.2%</td>
<td>24.2%</td>
</tr>
<tr>
<td>1995</td>
<td>23.4%</td>
<td>23.4%</td>
</tr>
<tr>
<td>1997</td>
<td>23.5%</td>
<td>23.5%</td>
</tr>
</tbody>
</table>

Source: Tax Foundation.

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Front & Center

**Tax Reform and Tax Relief Will Continue to be the Top Priority in 1998**

Rep. Bill Archer (R-Texas)
percentage points from 1955 to 1997 (from 7.4 percent to 12.9 percent).

- Payroll taxes (employee contributions) have also climbed sharply, from about 1.6 percent of the median two-earner income in the mid-1950s to about 7.3 percent this year.

To a large extent, as seen in the pie charts below, this growth in tax burdens has crowded out other important parts of the family budget, such as saving. In fact, taxes now claim a greater share of the median two-income family's budget (38.2 percent) than food (8.9 percent), clothing (3.7 percent), housing (15.3 percent), and transportation (6.6 percent) — combined.

To determine the total tax burden on the median one- and two-income families, as shown in the table to the right, the Tax Foundation calculated federal income taxes and payroll taxes directly off the family income. The burden of all other federal, state, and local taxes were computed indirectly using formulas derived from national averages.

The Tax Foundation imputes to individuals the burden of all taxes paid by business.

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Chart 2: A Snapshot of Taxes and the Median One- and Two-Income Family

<table>
<thead>
<tr>
<th></th>
<th>1955</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Single</td>
<td>Dual</td>
</tr>
<tr>
<td>Median Family Income</td>
<td>$4,069</td>
<td>$5,250</td>
</tr>
<tr>
<td>Federal income tax</td>
<td>$296</td>
<td>$475</td>
</tr>
<tr>
<td>Federal Payroll Tax:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee Portion</td>
<td>$79</td>
<td>$84</td>
</tr>
<tr>
<td>Employer Portion</td>
<td>$79</td>
<td>$84</td>
</tr>
<tr>
<td>Other Federal Taxes</td>
<td>$354</td>
<td>$457</td>
</tr>
<tr>
<td>State and Local Taxes</td>
<td>$302</td>
<td>$457</td>
</tr>
<tr>
<td>Total Taxes</td>
<td>$1,109</td>
<td>$1,489</td>
</tr>
<tr>
<td>After Tax Income</td>
<td>$3,039</td>
<td>$3,845</td>
</tr>
<tr>
<td>Taxes as a Percentage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>of Total Income</td>
<td>26.7%</td>
<td>27.9%</td>
</tr>
<tr>
<td>Inflation Adjusted</td>
<td>$6,024</td>
<td>$8,089</td>
</tr>
</tbody>
</table>

Note: The burden of federal and state corporate income taxes are included. After-tax income includes employer's share of payroll taxes because the burden of the payroll tax is assumed to reduce income before the "gross" seen on paychecks. Total taxes as a percentage of income is calculated by adding the employer's share of the payroll tax to the median-family income.

Source: Tax Foundation.

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Chart 3: Representative Budget of Two-Income Family, 1957 and 1997

Source: Tax Foundation.

At the National Conference in 1997, participants examined the pros and cons of adopting a more "dynamic" process of federal revenue estimating — that is, one which takes the behavioral effects of taxation into account.

Following are select excerpts from conference participants:

**Keynote Address**

_James C. Miller III, Ph.D., former Director, Office of Management and Budget_

...Suppose you want to do a forecast. How do we handle changes in policy?....

The easiest thing, of course, is to be an anti-supply-sider and say that taxes don’t constitute incentives, that changes in tax rates or coverage do not affect behavior, and thus you simply multiply through....

The alternative is dynamic scoring, overall tax revenue from this source? But secondary effects are important also....The ramifications of single policy changes are endless.

I know that it’s not possible to make all these calculations, to think of every effect....But as Frank Knight used to say,”How can just one price change?” One price change changes everything else. The larger the change in price, the larger the base to which the price applies, the bigger the change throughout the economy.

**Kenneth J. Kies, Chief of Staff, Joint Tax Committee:**

...In January 1996, we announced a one-year program in which we were going to go out to expert economic modelers covering a wide spectrum and ask them to tell us how they would go about predicting the macroeconomic effects of two major tax restructuring proposals: a flat income tax and a broad-based consumption tax....

...The whole process then led to a symposium that we held January 17, 1997, and the publication that we released today is the culmination of that process. The next panel will spend much of its time describing, not only how the tax modeling project was put together, but what was learned from it....

Part of our job is still to help people understand what we do. And, in that context, we have learned that the more we share and open up what we do, the greater confidence people have in our revenue estimates. In the case of the Speaker and the Majority Leader, they were skeptical of how reliable our capital gain estimates were until we went over and essentially took them through the entire estimate. I will say that the Speaker, in particular, has been quite supportive of our work as a consequence of learning more about the extent to which we already do take into account behavioral response....

**Panel One:** "What We’ve Learned and Where We're Going" 

_Peter Taylor, Ph.D., Senior Economist, Joint Tax Committee_

...Let's talk a bit about the goals of the tax modeling project. A number of modeling approaches exist out there. We wanted to compare them to determine where there was a consensus...[and] to determine the accuracy and speed with which macroeconomic effects of tax proposals could be produced, in order to explore how these macro effects could be included in the revenue estimating process....

Revenue estimates must be precise and accurate in order to be of value to the budget process....So, are models that estimate macro effects up to the task?....

Lessons from modeling macro effects of tax proposals: First, the types of model structure affect the results significantly....Second, behavioral response assumptions affect the results....So determining what's the right model or what's the right result depends a certain amount on determining which parameters are the best and what's the...

**Conference continued on page 6**
I want to tear the income tax out by its roots so that it can never grow back again. I want to get the IRS out of the individual lives of all Americans and eliminate all the loopholes in the tax code, creating a new, fairer system. The only way to achieve this is by replacing the income tax with a tax on the consumption of goods and services.

There is a reason why I am so firm in my commitment to abolish the income tax: As Chairman of the Ways and Means Committee, I do my own taxes. I am convinced that if most Members of Congress did their own taxes, we would have had tax reform long ago.

But where does the President stand on tax reform? After all, any overhaul of our nation's tax system must have the President on board. I intend to discuss tax reform with the President and pursue opportunities on this issue. He has shown a willingness to be flexible on important issues before; perhaps he will again.

Support for a consumption tax is growing throughout the nation. Grassroots organizations are forming in all fifty states in support of the abolition of the income tax and I expect to see a growing national consensus in support of such a move.

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We need a tax code that achieves six basic principles: promotes fairness, simplifies compliance, attacks the underground economy, encourages savings and investment, improves the balance of trade, and stimulates economic growth. In my opinion, a consumption tax is the only tax code that embodies all six.

1. **Promotes Fairness**

   Fairness is essential to any tax code. Under a consumption tax, those who spend more would be taxed more. A Geo Metro would have a smaller tax on it than a Rolls Royce. We can get rid of all tax loopholes and create a fair tax code that includes protections for low income Americans.

2. **Simplifies the Tax Code**

   A consumption tax would get the IRS out of the individual lives of all Americans. Americans spend an estimated $200 billion each year just to comply with the income tax.

3. **Attacks the Underground Economy**

   The consumption tax broadens the tax base by taxing the underground economy. Tax evasion costs U.S. taxpayers an estimated $200 billion a year in lost revenues. Under a consumption tax, every Ferrari a drug dealer buys would be taxed. Everyone would have to pay their fair share of federal taxes on all their purchases.

4. **Encourages Savings and Investment**

   As with the flat tax, no savings, investments, or capital gains would ever be taxed. But we tried flattening the tax code in 1986, only to see it grow back as complicated as ever in 1993. The current system punishes anyone who saves and invests by taxing them twice. By ending the double taxation on savings and encouraging investment, a consumption tax would energize the U.S. economy, lift stagnant wages and create jobs.
5. Improves our Balance of Trade

Just imagine how many companies around the world would want to build their world headquarters here if the U.S. had no corporate income tax. American exports would not be subject to the consumption tax. If all taxes were removed from production costs, you could expect export prices to drop. This undoubtedly would lead to a surge in exports and help our balance of trade. All imports would be subject to the consumption tax just like any other product sold in the U.S. This border-adjustability, completely legal under the World Trade Organization, would give us a fair advantage in the global marketplace.

6. Stimulates Economic Growth

The replacement of the income tax with a tax on the consumption of goods and services would provide our economy with a badly needed boost.

Dale Jorgenson, a professor of economics at Harvard University, testified before the House Ways and Means Committee that a consumption tax could increase the projected overall size of the U.S. economy under the current income tax immediately by 13% and then remain at 9% above current economic forecasts. The tremendous surge provided by a consumption tax would mean more work for American businesses and more jobs for American workers.

It would be inaccurate to assume that a consumption tax would increase the price of all products. It is easy to forget that for every television, car or note pad we buy, the cost of federal taxes is built into the final price of that product. A consumption tax would merely offset the hidden price of the corporate income tax in today's products. In addition, the income tax would no longer be withheld from a worker's paycheck.

I would like to overhaul our nation's tax system as soon as conceivable possible. However, real tax reform is a massive undertaking that will only be successful with strong, national, grassroots support. I expect tax reform to be one of the defining issues in next year's Congressional elections. With its economic advantages and ultimate simplicity, the consumption tax is the only choice for those who want real tax reform. Everyday we are moving closer to reaching this necessary level of support. With its economic advantages and ultimate simplicity, the consumption tax is the only choice for those who want real tax reform.

However, while we are stuck with the current system, I am committed to delivering tax relief to the American people. In 1997, the Congress passed over $100 billion in tax relief to the American people. The Taxpayer Relief Act of 1997 was the first net tax reduction since 1981. I plan to make a strong effort for another tax reduction bill next year. We anticipate the possibility that we'll be ahead of schedule in balancing the budget, which would give us the opportunity for some additional tax cuts.

It could be argued that for 40 years, the Democrats played politics on the spending side - the more they spent, the more votes they could get. Now the pendulum is swinging. We're talking about downsizing Washington and giving money back to the taxpayers.

I will do all within my power as Chairman of the Ways and Means Committee to offer additional tax relief to the American people if we are able to do so within the context of a balanced budget. Ultimately, it is my hope that America's journey to the 21st century will also include replacing the income tax with a tax on consumption.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. The views expressed in these columns are not necessarily those of the Tax Foundation.
Conference Debates Dynamic Revenue Estimating

Conference
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right parameter, and there’s a lot of work that still needs to be done in this area.

Pamela Moomau, Ph.D., Economist, Joint Tax Committee

...What did we find? We were concerned that in the short run, when you have a major change in taxes, you're going to have a lot of winners and losers. And the losers might...generate a lot of unemployment.... And during that little time, you might have a shrinking of the tax base. So we wanted to include models that attempted to address that issue....

...It may be that these models are trying to talk about something that we haven't experienced before. So they don't know how to model it, and maybe the economy won't behave the way they think because it's a different experience. But on the other hand, it's the best judgment that they have based on what's happened so far. And if we're telling policymakers that there's going to be an increase in employment, and an increase in revenues, and it turns out to go in the opposite direction, it's not clear that we've improved the process any. So that's one of the reasons that we think there needs to be a lot more work in this field to examine whether that's an area of concern, and if so, whether we can get a little more unanimity on how to treat it, incorporating it in revenue analysis....

Panel Two: "Some Friendly Advice — A View from the Outside"

Jane Gravelle, Ph.D., Senior Specialist in Economic Policy, Congressional Research Service

...I don't think there's enough consensus on the behavioral responses to begin using dynamic scoring. I think some of the comments made by the Joint Tax Committee panel are very apropos. I was just at the meeting of the National Tax Association listening to the revenue estimators there. One of them was a revenue estimator from California who's going through this big dynamic scoring thing. And I asked him, in the question-answer period, how this process had worked out. And he said, "You know, each bill that came through, we'd do a little dynamic estimate and everything. But when we had the big tax cut, we did that in three days. We didn't have time to run it through the dynamic revenue estimating process."

So, essentially, when it comes down to the crunch, you've got to not only have something that everybody agrees on, and that works, but something that will work quickly.

I think not doing dynamic scoring at this time is not a problem, though, because I really think the bulk of the evidence that we have says these effects are very small. If you get a one percent increase in your taxable base that you don't take into account, you probably have not done very much damage to your revenue estimating. And particularly, if you happen to have ended up having a little more revenue than you needed, I'm not sure in these days of looming concerns about Social Security and Medicare, that's the worst thing in the world.

Gary Robbins, President, Fiscal Associates

...By ignoring the effects of tax and spending policies on economic activity, the current system is biased in favor of higher taxes and spending. The current scoring method gives full credit to a tax increase even though that increase may discourage work, savings and investment. Current scoring methods often under-count the cost of new spending initiatives which subsidize a particular activity. In other words, a static estimate of a tax increase will overestimate the actual tax revenue received, and lead to a larger-than-expected budget deficit. A static estimate of a tax decrease will underestimate the actual tax revenue and lead to a smaller than expected budget deficit. A static estimate of spending increases will underestimate the actual cost and lead to a larger than expected budget deficit. And a static estimate of a spending cut will underestimate the actual savings and lead to a smaller than expected budget deficit. Combined, these forecast errors all point towards more government.

...[T]he current ad hoc rules are equivalent to having a model which predicts that taxes have no impact on the aggregate supply of labor, capital, savings or outputs. Those who urge that dynamic scoring should not be undertaken believe this to be the case. Of
Does the Euro Have a Future?

I recently returned from Europe where I participated in a series of meetings on international economic developments. While these sorts of meetings are very useful, two impressions really stood out.

The first is the enormous difference in the way public policy is developed on the continent of Europe as opposed to in the United Kingdom and the United States. This can be summarized as the difference between consensus and conflict. Especially in the multilateral organizations like the Organization for Economic Cooperation and Development and the European Union, the decision process is one of consultation, cooperation, compromise, and, eventually, consensus. To an American, the process can appear as a curious cacophony.

The American and British systems are based on an entirely different set of "c's", namely conflict and competition. American politicians compete for votes and political leverage with every tool at their disposal, even, occasionally, ideas. This competition puts the respective parties in direct conflict most of the time. To a continental, this process presents a different sort of chaos.

Each system has its strengths and weaknesses, and I leave it to the political scientists to decide which is better. My point here is, because our systems are so different, it can be difficult for Americans to discriminate between European debates about ideas with momentum, and ideas caught in a debating society. Often, every issue appears to be glacier. But, as one observer put it, these glaciers sometimes move. And over time, they can cover quite a distance.

Take the economic developments within the European Union, for example. To an American, it seems that every issue will be debated to death and little if anything will ever happen on the main issues. And yet, in the last two decades, Europe has made enormous progress moving from a small, loose trading bloc to a largely integrated economic union. The border guards and customs houses between the countries are gone. Their value-added taxes are being harmonized. They're talking about harmonizing their income taxes. And regulations are being brought into alignment one with another.

Even their national currencies are being discarded. Surprised? Well, you're not alone.

Talk of a single European currency has gone on for years. The Europeans have long pointed to the U.S. as demonstrating the clear and significant benefits of a single currency. To Americans, however, it is hard to imagine that any amount of talk would convince the French to put away their Franc, the Germans their Mark, or the Dutch their Guilders. National pride would not allow it. Control over this vital element of economic policy would never be turned over to some independent, multilateral organization.

At least, these were my thoughts and those of the other Americans with whom I was traveling. None of us thought the Europeans would ever walk away from their domestic currencies. In particular, I was convinced the Europeans would never close the doors on their individual central banks and allow one super central bank to set monetary policy for all countries in the Union.

We were wrong, misled by our lack of appreciation of the power and process of consensus. The process of consensus, so different from our own, obscured the steady progress that was made at the multilateral level, at the national levels, and at the popular level. Even when the timetable for the introduction of the new "Euro" was announced, along with the timetable for phasing out the national currencies and closing the national central banks, we were hard-pressed to take it all seriously.

Under the European Economic and Monetary Union (EMU), a monetary union for qualifying countries will go into effect on January 1, 1999. This will entail the irrevocable locking of exchange rates and the introduction of a single currency, the "Euro." At the same time, a European System of Central Banks will become effective, announcing and executing all monetary policy operations in Euros. The Euro will fully replace the national currencies in 2002, at which time the national currencies will no longer be legal tender and will be withdrawn from circulation.

What does this have to do with U.S. tax policy, you ask? Let's start with the phrase "functional currency." Can the Euro be a functional currency? What flexibility does a U.S. taxpayer have in electing the Euro as a functional currency? What does this mean for the recognition of unrealized capital gains and losses? What does it mean for the acceleration of currency gains and losses?

There is a long and growing list of questions that arise for U.S. taxpayers, and these questions could have enormous tax ramifications for some U.S. companies. Interestingly, there seems to have been relatively little consideration given to these questions in Congress, in the Treasury, or in corporate tax departments. Why is that? Perhaps because most Americans still don't believe the Euro will become a reality.

Most Americans may be right, but I wouldn't bet on it in this case. While in Berlin I saw a news program discussing the introduction of the Euro. As part of the story, a Berlin reporter interviewed commuters at rush hour. The reporter walked up to a middle-aged Berliner dressed in workman's clothes and asked if he thought the Euro was coming and if it would be a good thing. His answered, "Of course the Euro is coming. We need it for the future."
Conference

Continued from page 6

...[I]f the choice is no dynamic scoring and using a model that after five years of a fundamental tax reform, the capital stock has doubled and the labor supply has increased by 20 percent, I would say “Well, probably the evidence is closer to its having no effect.” But I think that’s a false choice. Because if the best answer is a relatively small effect or modest effect of a certain type of tax reform, then I think it’s better to make that available to policymakers than rely solely on speculation and faulty analysis. Even if the effects aren’t that big, a relatively small effect in output of, say, 1 percent five years ahead could translate to about $20 billion of revenue. Certainly JCT already scores out five years ahead tax changes on a micro level that have a much smaller magnitude. So even if the magnitude is not big, I think both in an informational sense and in terms of “let’s get the best estimate that we can,” acknowledging that there is some variance, that dynamic estimating would be worthwhile to do as the models develop more fully....

Students and professors from Bloomsburg University and Iona College, attending the conference as part of the Tax Foundation’s College Classroom Project, pose with former U.S. Senator Harry Byrd Jr. (fourth from right, middle row) during a break.