National Center for Policy Analysis

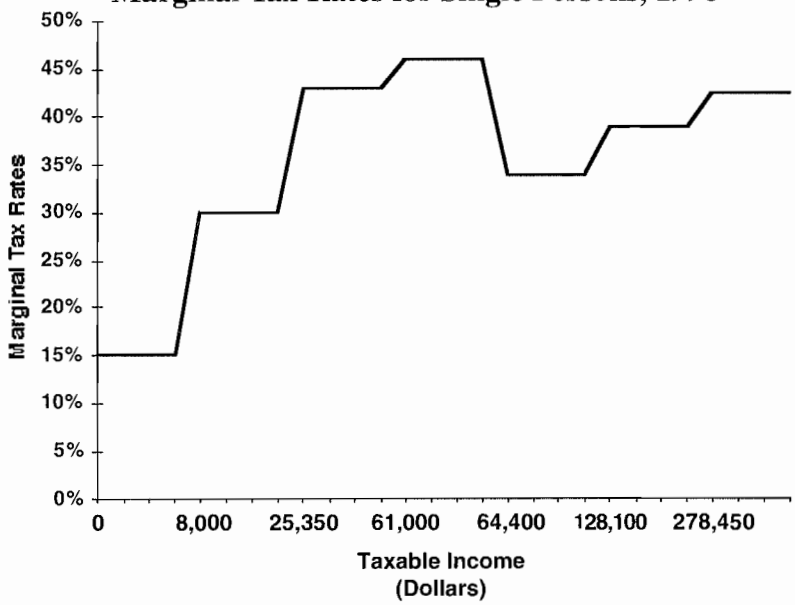
BRIEF ANALYSIS
No. 261
For immediate release:
Wednesday, April 22, 1998

The Middle-Class Tax Squeeze

Since the sweeping tax cuts of 1981, little has been done to directly benefit middle-income American families — those with taxable earnings between $30,000 and about $65,000 a year. During that period, federal taxes have been raised eight times, with only one small tax cut in 1997. The latest figures from the Tax Foundation show that the taxes have been ratcheted upward so that in 1997 the total burden of federal, state and local taxes on a median-income two-earner family was 38.2 percent of income. This average family paid $22,521 in taxes from its 1997 income of $54,910. As a share of Americans' incomes, the federal tax bite alone is now at its highest level since the height of World War II. Last year Rep. Dick Armey (R-Texas) called this plight of American workers "the middle-class squeeze."

FIGURE I

Combined Federal Income and Payroll Marginal Tax Rates for Single Persons, 1998



Note: This does not account for the Earned Income Tax Credit, which eliminates income taxes for some lower-income people.

Source: Cato Institute.

Families with young children will see some relief as a result of last year's tax cut: a family of four will receive a tax credit against 1998 taxes for each child under age 12. But millions of middle-class households without children at home and without capital gains income will get essentially nothing from the 1997 tax bill.

The Role of the Payroll Tax. Much of the escalating tax burden is attributable to hikes in the payroll tax — a tax that is levied on the first dollar of earnings. Thus even a minimum-wage earner is taxed at a 15.3 percent rate on each minimum-wage dollar earned. For most Americans, payroll tax increases have canceled out, nearly dollar for dollar, the benefits of any income tax cuts. (In addition, the federal gasoline tax has tripled since 1980, state and local property taxes continue to climb and so do a multitude of fees and assessments.) The payroll tax — 12.4 percent for Social Security and 2.9 percent for Medicare for the 15.3 percent total — is nominally split between employer and employee, but economists agree that the entire burden actually falls on the employee.

Tax Cuts and Tax Rates. The 12.4 percent Social Security payroll tax is levied on only the first $68,400 of earnings. As a result, the marginal tax rate — the tax on each additional dollar earned — is higher for middle-income Americans than for those earning far more. Figures I and II show the combined marginal federal income and payroll tax rates for singles and for married couples in a one-earner family at various income levels. Note that rates are highest on those in the middle.

- One-earner families with taxable incomes between roughly $40,000 and $65,000 a year face a combined marginal tax rate of 43.3 percent — a federal income tax rate of 28 percent plus the 15.3 percent payroll tax.

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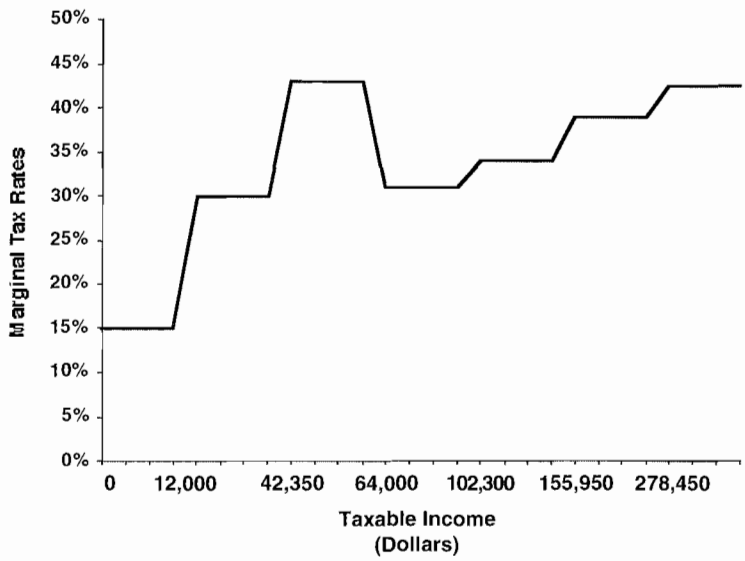
- Single taxpayers with taxable incomes roughly between $61,000 and $64,400 face an combined marginal tax rate of 46.3 percent — a federal income tax rate of 31 percent plus the 15.3 percent payroll tax.
- Two-earner families in which each earns about the same (not shown in the figures) can face a combined marginal tax rate of 46.3 percent on combined incomes of about $100,000 to $131,000 because each pays the Social Security payroll tax on earnings up to $68,400.

Above these incomes, the combined marginal rate falls because the Social Security part of the payroll tax is no longer levied. *Thus middle-income taxpayers can face higher marginal tax rates than the highest-income taxpayers.*

FIGURE II

Combined Federal Income and Payroll Marginal Tax Rates for Married Couples, 1998



Note: This does not account for the Earned Income Tax Credit, which eliminates income taxes for some lower-income people.

Source: Cato Institute.

Changing Tax Brackets. Sen. Paul Coverdell (R-Ga.) and Rep. John Thune (R-S.D.) have proposed to relieve the middle-class squeeze by raising the income ceiling on the 15 percent income tax bracket. Ways and Means Committee chairman Bill Archer (R-Texas) likes this idea, which economist Larry Kudlow and the author of this analysis first proposed in *National Review*.

Under current law the 28 percent tax bracket creeps up on single workers at a taxable income level of $25,350 and on married couples at $42,350. If the 15 percent bracket were stretched to $35,000 of income for singles and $50,000 for married couples, federal revenues would fall on a static basis by $25 billion a year — or roughly the amount of the budget surplus now projected.

The principle here is simple: all middle-class families in America should be in the 15 percent tax bracket — not the 28 percent bracket. That was the intention of the 1986 Tax Reform Act, which simplified the income tax by establishing just tax brackets — a 15 percent bracket for middle-income earners and a 28 percent rate for higher-income earners. The 1990 and 1993 tax increases violated this principle by reintroducing multiple tax rates, the highest climbing to 39.6 percent. Eventually Congress should expand the 15 percent tax bracket to apply to all Americans with earnings below the income level at which people stop paying Social Security payroll taxes — currently $68,400 a year.

Middle-Income Relief. This plan would limit the top marginal tax rate to 30.3 percent except for some two-earner families and single workers. It also would provide middle-income workers with significant tax relief.

- A single filer with taxable income of $32,000 a year would receive an $864 tax cut.
- A married couple with taxable income of $48,000 a year would get a $734 tax cut.

Raising the income threshold at which higher income tax rates kick in would help relieve the tax squeeze on the middle class.

This Brief Analysis was prepared by Stephen Moore, director of fiscal policy studies at the Cato Institute.