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ABSTRACT

Based on the assumption that fair tax systems should consider differences in ability to pay resulting from income sharing within families, this publication analyzes the effects of three strategies for federal tax reform on families raising children: the Armey/Shelby flat tax, the Nunn/Domenici USA Tax System, and the Gephardt 10-Percent Tax. Part 1, "Introduction," summarizes the proposals, defines major terms, and compares tax incidence under the proposals and the impact of reduced tax burdens on investment income. Part 2, "Analysis of Specific Tax Reform Provisions Affecting Children and their Families," examines direct and indirect effects on families. Direct effects considered include size of the dependency exemption, tax credit for dependent children, earned income credit, head-of-household rate schedule, "kiddie tax," personal exemption, standard deduction, marital income splitting, alimony payment, child support payment, and child care tax credit. The indirect effects analyzed include elimination of charitable giving, deduction for home mortgage interest, and deduction for state and local taxes. Part 2 also suggests modifications to provide greater benefits to families with dependent children. Part 3, "Simulated Impact of Armey/Shelby Flat Tax on Families with Children," reports results of simulations of the effects on family tax burdens of shifting to a flat tax by comparing equal-revenue versions of the Armey-Shelby flat tax plan and current law. Part 4, "Conclusion," summarizes the report. An Executive Summary is included with the publication. Includes 15 tables and 7 figures. Appendices list supplementary tables and describe the tax model used for the simulation. Contains 49 references. (KDFB)

EXECUTIVE SUMMARY

FEDERAL TAX REFORM
A *Family Perspective*

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THE FINANCE PROJECT

EXECUTIVE SUMMARY

FEDERAL TAX REFORM A Family Perspective

July 1996

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Executive Summary

FEDERAL TAX REFORM A Family Perspective

FAMILIES with children would be affected in important ways by various proposals for major federal tax reform that have been placed on the national agenda. Yet both analysts and proponents of reform have given relatively little attention to the family taxation aspects of their proposals.

The Finance Project, therefore, commissioned a study of the family taxation issues raised by federal tax reform proposals. It was conducted by Michael J. McIntyre, professor of law at Wayne State University Law School, and C. Eugene Steuerle, Senior Fellow at the Urban Institute. The study is one of a series produced by The Finance Project related to public financing and the provision of services for children.

According to the authors, traditional federal tax policies recognize that in order to be fair to individuals, taxation must take into account differing abilities to pay based on how incomes are shared within families, including the support that parents provide for their children. Also, many tax measures are designed to provide additional benefits for low-income families. The economic circumstances of the family are affected not only by size and income, but also by factors such as number of adults present, child-care expenses, and alimony and child-support payments.

Summary of Reform Proposals

Several serious proposals for federal tax reform on the national agenda would modify many of the child- and family-sensitive provisions currently in the tax code. Perhaps reflecting the fact that tax policy toward families has often been shaped by non-family goals, some aspects of these proposals also appear to change family tax policy by default rather than by design.

Table 1.1
Summary of Major Features of Flat Tax, USA Tax, and 10-Percent Tax

Short Name	Congressional Sponsors	Type of Tax	Replaces or reforms the following federal taxes	Proposed Tax Rate	Impact on Federal Revenue
Flat Tax	Rep. Dick Armey Sen. Richard Shelby Sen. Larry Craig*	Flat-rate individual wage tax and business value-added tax with wage deduction**	Replaces individual and corporate income taxes and estate and gift tax	20%, reduced to 17% after two years	$30 billion loss at 20% rate and $138 billion loss at 17% rate, derived from Treasury Department study
USA Tax	Sen. Sam Nunn Sen. Pete Domenici Sen. Bob Kerrey	Graduated individual consumption tax and flat-rate business VAT	Replaces individual and corporate income taxes and implicit replacement (through credit) of FICA payroll tax	Graduated individual rates of 19%, 27%, and 40%, reduced in stages to 8%, 19%, and 40% after 5 years; business rate of 11%	Revenue neutral under Joint Committee on Taxation estimate
10-Percent Tax	Rep. Richard Gephardt	Graduated individual income tax and classical corporate tax	Reforms current individual and corporate income taxes	10% applicable to 75% of population; graduated rates of 20%, 26%, 32%, and 34%	Revenue neutral under Treasury estimate

* Also sponsored in modified form by presidential hopeful Steve Forbes. Forbes proposed a 17% rate immediately. He recommended a larger standard deduction and indicated some willingness to retain the earned income tax credit. The Forbes variant would increase the federal budget deficit by $180 billion (without EITC) to $210 billion (with EITC).

** Some analysts would describe the business component of the flat tax as a "cash-flow" tax.

This study examines three major reform proposals recently introduced in Congress:

Armey/Shelby flat tax. This proposal combines a wage tax on individuals with a business tax on corporations and other business enterprises that is designed to reach consumption of goods and services. The combined tax base is described by some as similar to a value-added tax. Both individuals and businesses would be taxed at a flat rate of 20 percent for the first two years and 17 percent thereafter. This plan replaces the individual and corporate income taxes and the estate and gift tax. Based on a Treasury Department study, it is estimated that the plan would result approximately in a $30 billion loss in federal revenue at the 20-percent rate and a $138 billion loss at the 17- percent rate. A similar plan was advocated by former presidential candidate Malcolm Forbes, Jr.

Nunn/Domenici USA Tax System. This proposal would convert federal income taxes on individuals into a graduated individual consumption tax; the federal corporate income tax would be replaced with a flat-rate value-added tax. In addition, the USA Tax System implicitly would replace (through a credit) the FICA payroll tax. The USA plan would provide for graduated individual rates of 19 percent, 27 percent, and 40 percent, to be reduced in stages to 8 percent, 19 percent, and 40 percent after five years; the business rate would be 11 percent. The Joint Committee on Taxation estimates that this plan would be revenue neutral.

Gephardt 10-Percent Tax: This plan retains the graduated individual income tax, applying a 10-percent rate to about 75 percent of taxpayers; higher-income taxpayers would be subject to graduated rates of 20 percent, 26 percent, 32 percent, and 34 percent. No specific structural changes are proposed in the corporate tax, but the plan would raise an additional $50 billion from this source. It would reform the existing tax code by reducing deductions and closing some corporate loopholes. The Treasury Department estimates that this plan would be revenue neutral.

What These Plans Try to Do

All three proposals seek to meet the three criteria traditionally applied to a personal tax system: administrative economy, efficiency, and fairness.

Each of the plans is premised on the idea that the current income tax is excessively complex to administer, a situation which results in part from congressional compromises that attempt to satisfy many constituencies and to achieve tax fairness through fine-tuning. In the Gephardt plan, the tax code for many individuals would be simplified, but for the most part the plan does not deal with the complexities now experienced by businesses or by high-income individuals. Proponents of the flat tax and the USA plan anticipate simplification by avoiding the need to measure capital income and by taxing certain payments, such as interest income, only indirectly.

The plans, however, have some features that make simplifying the tax code a more difficult task. For example, they do not mesh with tax systems of other countries or of state governments. The authors caution that merely reducing the number of pages in the tax code does not guarantee simplicity, nor does a postcard-size tax form imply that the code would be any less complex to administer than the current one.

As for efficiency, a revenue-neutral major reform of the federal tax system might be more efficient if it continued to eliminate loopholes and special benefits, reduced tax biases against savings, better integrated personal and corporate taxes, and taxed existing capital investments more heavily than new capital investments. A discriminatory tax on old capital, however, would create inequities for those who invested under the old rules, a situation that many commentators would recommend addressing with transition rules.

The sponsors of the three proposals agree on some fairness issues: that the poor should be exempt from taxation; that low-income taxpayers should be taxed proportionally less than other taxpayers; and that a personal tax system should make some adjustments for the family circumstances of taxpayers. They disagree, however, on how progressive a tax system should be and on whether income or consumption is the proper measure of ability to pay taxes.

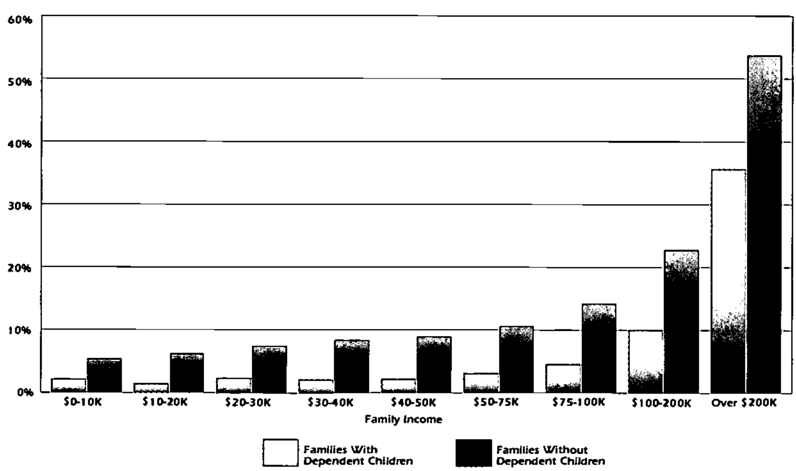
How the Plans Treat Investment Income

Two of the three proposals — the Armey-Shelby flat tax and the USA plan — treat investment income more favorably than income earned from wages. This policy could have important implications for families with children as a group, depending upon when and how the shift in burdens occurs. Across the income spectrum, parents with dependent children — who typically consume a high proportion of their incomes — earn less investment income than other taxpayers during their child-raising years. As a result, a reduction in the relative tax burden on investment income is likely to affect families with children adversely.

How the Proposals Would Modify Current Provisions Affecting Children and Their Families

All three proposals would significantly change current tax law as it applies to children and families. The report examines three cate-

Figure 1.1
Percentage of Capital Income to Total Income, Families With and Without Dependent Children



gories of child- and family-specific tax provisions and how they would be affected under each of the proposals.

Tax Relief for Families with Children in the Home

According to the authors, parents with dependent children have less ability to pay taxes than other individuals with equal incomes. Once a decision is made to provide tax relief to parents with dependent children, several other decisions must be made: how much relief should be given, what mechanism should be used to deliver that relief, and which income groups should receive that relief. In addition, policymakers must decide on the most desirable way to help low-income families, either through the tax code or through various state and federal expenditure programs, or through both. The three proposals discussed in the study differ in their decisions on how to treat families with children.

Table 2.1
Tax Provisions Directly Related to Dependent Children: Current Law, Flat Tax, USA Tax, and 10-Percent Tax

Features of Tax Regimes	Current Law (1996)	Flat Tax	USA Tax	10-Percent Tax
Dependency exemptions, per capita	$2,550**	$5,000*	$2,550	$2,750**
Child (dependency) credit	no	no	no	no
Earned income tax credit	yes maximum benefits: no children: $323 1 child: $2,152 2 children: $3,556	no	no, but refundable credit for 7.65% FICA tax	yes, same as current law
Child-care credit or deduction	yes, credit	no	no	no
Head of household schedule	yes	no	yes	yes
Children taxed at parents' rate (kiddie tax)	yes, investment income	yes, earned income	yes, investment income	yes, investment income

* Exemption applies only to cash wages and pension distributions and not to in-kind employee benefits or to employer share of FICA payroll tax, both of which are fully taxable under business tax.

** Phased out at high income levels.

In the past four decades, changes in federal income tax laws have created a major shift in the tax burden, from taxpayers without children to taxpayers with dependent children. The shift is especially pronounced in the middle-income group. In 1948, a relatively small portion of the overall federal income tax burden was being imposed on middle-income families with children. Over time, the *dependency exemption* — a major mechanism for adjusting tax burdens for the costs of raising children — has lost its relative value, falling from about 42 percent of per capita personal income in 1948 to less than 11 percent in 1996. It would need to be set at about $10,000 to represent the same percentage of per capita income as in 1948.

The Armey-Shelby flat tax proposal goes the furthest of the three proposals in recognizing that an increase in the adjustments of tax burdens for family size may be warranted. It would nearly double the dependency exemption (to $5,000 per child), while the other two plans would provide about the same dependency exemption level as current law. The Armey-Shelby plan, however, only exempts income under the wage component of the flat tax and not employee benefits. Therefore, despite the larger exemption, low-income wage earners with dependents would not be fully protected from taxation.

Figure 2.1
Value of Dependency Exemption Relative to Per Capita Income, 1948 to 1996

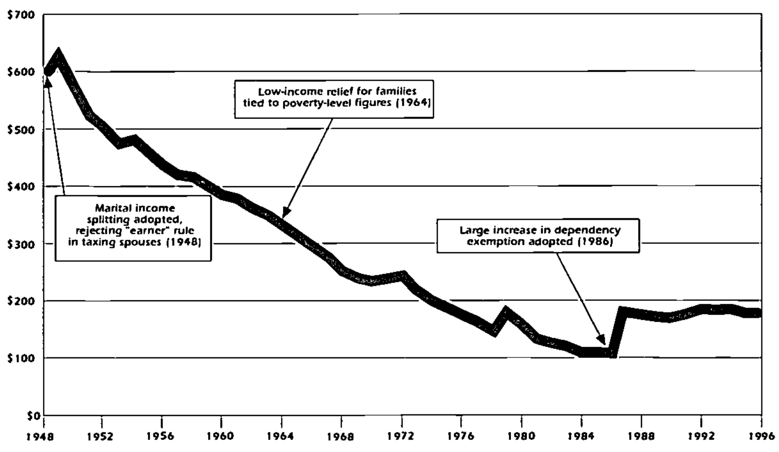


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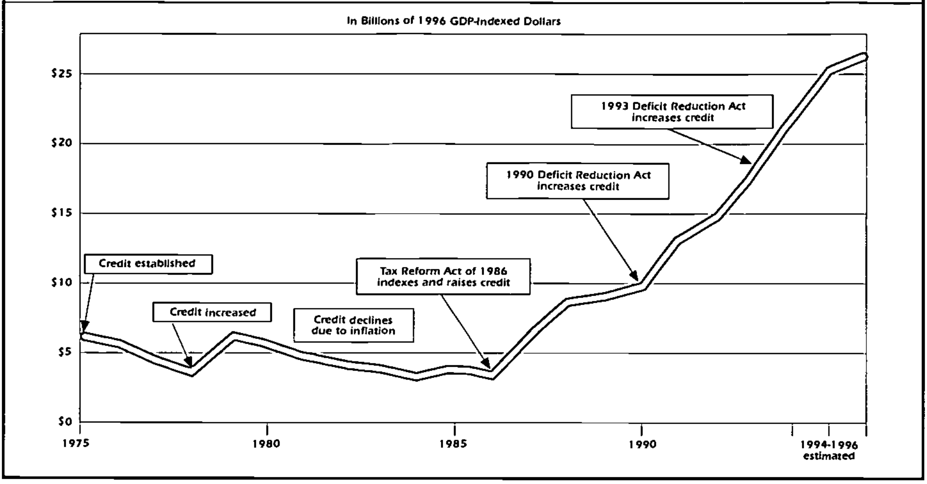
Figure 2.3
Earned-Income Tax Credits, 1975 to 1996



For low-income families, the *earned income tax credit (EITC)* is a major mechanism for delivering tax relief and federal subsidies. It benefited more than 18 million families in 1994. In recent years, it has become an important feature of a combined welfare/tax system, offering incentives to low-income families to continue working rather than to fall back on welfare support.

The Armey/Shelby flat tax would repeal the EITC, which would contribute to a significant increase in the effective tax rate on low-income workers. However, any consumption tax probably requires repeal of the EITC if goals of simplicity are to be obtained, because the EITC requires income information to assess eligibility. The USA plan would repeal the EITC, but would provide a refundable rebate for the FICA tax. Even so, some low-income workers with dependent children would be better off with the EITC than with a rebate. The Gephardt plan would retain the EITC in its present form.

All three proposals would repeal the *child-care credit*. While it is not simple to administer, the child-care credit does mitigate the tax disincentives that some parents face in taking a job. The three plans also would end the exclusion from taxation of employer-provided child care benefits.

Current law allows partial income splitting for marital partners. This effectively treats each spouse as the taxpayer on some portion of the couple's aggregate marital income without reference to which spouse earned the income. The *head-of- household rate schedule*, introduced in 1951, extends to one-parent families some of the tax benefits that marital partners — especially those with substantially unequal incomes — might receive from income splitting. The head-of-household schedule effectively allows the head of a one-parent family to split income with a dependent child. The tax rates for heads of household are the same as the rates for other single individuals, but the tax brackets are wider, thus lowering the tax rates for some heads of household relative to what they would have paid as single taxpayers. The flat tax proposal would eliminate this provision, while the USA Tax System and the Gephardt plan would retain it.

The *"kiddie tax,"* adopted in 1986, deters parents from shifting investment income to their children to avoid tax. It taxes the unearned income of children under age 14 at the marginal rate of their parents. Both the USA and Gephardt plans retain this provision. The flat tax would apply a kiddie tax to the earned income of young children.

Marital Status and the Tax Reform Proposals

Another way of making the federal tax system sensitive to family circumstances is to consider the marital status of taxpayers in setting tax burdens. Again, the three proposals in this study vary considerably on how they would change provisions of current law that depend for their operation on the marital status of taxpayers.

All three tax reform proposals provide *tax-free amounts* for various types of households through some combination of personal exemptions and a standard deduction. The flat tax plan and the USA plan fold the taxpayer exemptions into the standard deduction. The Gephardt plan follows current law by retaining the taxpayer exemptions and making the standard deduction an alternative to itemizing deductions.

Table 2.3
Family-Sensitive Provisions Relating to Marital Status of Parent: Current Law, Flat Tax, USA Tax, and 10-Percent Tax

Features of Tax Regimes	Current Law (1996)	Flat Tax (wage tax component)	USA Tax (personal tax component)	10-Percent Tax
Tax-exempt amounts for adult individuals:				
married (per capita)	$5,900	$10,700*	$6,250	$6,925
single	$6,550	$10,700*	$6,550	$7,750
head of household	$8,450	$14,000*	$7,950	$10,100
Total exempt amount, 2-parent family of four (husband, wife, 2 children)	$16,900	$31,400*	$17,600	$19,350
Total exempt amount, 1-parent family of three (parent, 2 children)	$13,550	$24,000*	$13,050	$15,600
Marriage penalty from rate structure	yes	no	yes	yes
Marriage penalty from exemptions	yes	no	yes	yes
Alimony deduction	yes	no	yes	yes
Child-support deduction	no	no	yes	no

* Exemption does not apply to in-kind fringe benefits or employer share of FICA payroll tax, although both are fully taxable under business tax.

NOTE: The tax-exempt amounts do not include the amounts that would be exempt to low-income families on account of the earned income tax credit.

Since 1969, the tax code has imposed certain "marriage penalties" on some married couples — primarily two-earner spouses with relatively equal incomes. The USA plan and the Gephardt plan would continue the basic structure of only partial *marital income splitting* within a graduated rate structure and no optional single filing by each spouse. This structure necessarily produces marriage penalties. The Armey/Shelby flat tax would eliminate almost all marriage penalties created by the rate structure. All of the plans would continue to provide so-called "marriage bonuses," which primarily benefit married couples with substantially unequal individual incomes.

The elimination of the *alimony deduction* under the flat tax plan would create an initial hardship for the payer; alimony recipients would be granted a new exclusion. This shift in tax burdens from the recipient to the payer might cause state family courts to adjust divorce settlements reached before the imposition of the tax reform, but such adjustments will take time and money. Making the payer taxable on amounts paid in alimony would improve taxpayers' compliance with the tax laws.

The USA plan is the only one of the three that would allow a *deduction for child-support payments*. This proposed change would effectively reverse the current tax benefits for payers and recipients, at least temporarily. The same complexities faced by state courts in adjusting alimony payments for new taxation policies would also occur with child-support payments. The change is likely to create some compliance problems.

Indirect Effects on Families

A change in the deductions for charitable giving, mortgage interest, and state and local taxes may indirectly affect families with children. The three tax reform proposals differ in how they would treat these deductions.

Table 2.4
Treatment of Certain Family-Sensitive Itemized Deductions: Current Law, Flat Tax, USA Tax, and 10-Percent Tax

Features of Tax Regime	Current Law (1996)	Flat Tax (wage tax component)	USA Tax (personal tax component)	10-Percent Tax
Deductions for charitable gifts	yes	no	yes*	no
Home mortgage interest deduction	yes	no	yes*	yes*
Deductions for state and local taxes	yes	no	no	no

* Changes in tax rates would affect the value of these deductions for many taxpayers.

The flat tax and the 10-percent tax (Gephardt) would eliminate the *deduction for charitable giving*; the USA plan would retain it. Part of the tax code since 1917, this deduction was originally intended in part to compensate the giver for relieving the government of what otherwise would be public costs. There is no consensus about the overall impact of eliminating the deduction on charitable giving to non-profit institutions serving children and families, although some types of charities, such as museums, are more likely to be seriously affected than others, such as churches.

The flat tax proposal would eliminate the *home mortgage interest deduction*, whereas the Gephardt plan and the USA plan would retain it. Again, while it is obvious that the current system favors some taxpayers over others (for example, especially high-income individuals with expensive homes and large mortgages), the effect on families with children of changes in this deduction are difficult to predict. For example, renters are likely to be favorably treated by repeal of the deduction and lower tax rates.

All of the reform proposals would eliminate the *deduction for state and local taxes*. The impact of the deduction on children is difficult to quantify. Current tax law shifts some of the burden of state and local taxes to individuals paying federal taxes. This, in turn, makes it easier for states and communities to impose their own taxes and pay for such services as education and children's support. Therefore, removal of this deduction may make it more difficult to sustain such state and local spending. On the other hand, some argue that there may be more direct and efficient ways to subsidize desired state and local services.

The flat tax and USA plans would create major administrative problems for the states, because they now depend heavily upon federal income reporting information for operating their own tax systems.

What Would a Flat Tax Look Like, From a Family View?

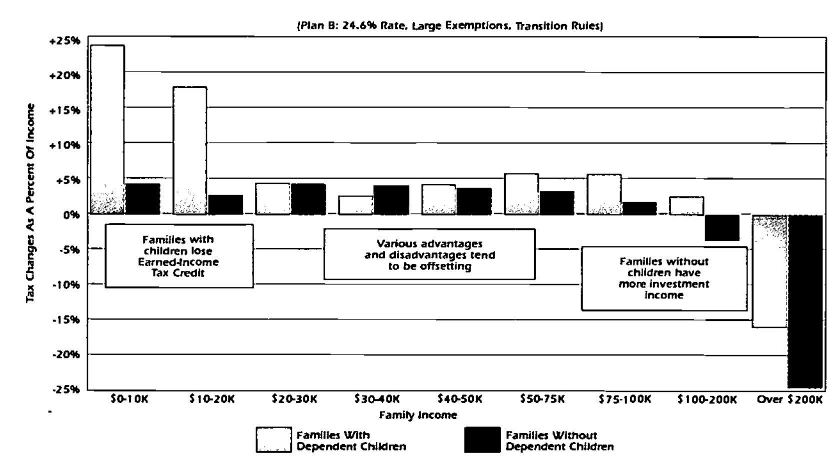
With a microsimulation tax model prepared by the Institute on Taxation and Economic Policy, the authors played out the effects of moving from the current tax system to several versions of the

Armey/Shelby flat tax plan. This model has produced results very similar to other models used to simulate tax reform, but that have not yet been used to examine family-related issues. The simulations show that most families with children would be at a substantial disadvantage under the flat tax plan, compared to those filing units who do not have dependent children.

Setting rates that would result in revenue neutrality under a flat tax is the easiest way to compare *relative* shifts in tax burdens. The authors found that families with dependent children at the bottom end of the income scale would face significant tax increases, and all families with dependent children with income levels below $200,000 would experience some increases. This pattern would be true whether the flat-tax rate was set at 21.4 percent or at 24.6 percent, a range necessary to accommodate the proposed exemption levels and the alternative assumptions regarding transition rules affecting the taxation of capital. All high-income taxpayers would have large reductions in effective tax rates, but high-income families with children would do less well than other high-income taxpayers.

Several factors cause this redistribution of tax burdens to families with children, including the loss of the Earned Income Tax Credit, the change in the rate schedule itself, the taxation of various employee

Figure 3.2
Tax Changes Under the Flat Tax For Families With and Without Children



fringe benefits (primarily health care) under the business component of the flat tax, and the benefits to those who derive greater portions of their income from capital investments. For most families, these features more than offset the benefit of the higher dependency exemption offered under the plan.

Using the proposed 17-percent and 20-percent rates in the flat tax plan and comparing the plan with equal-revenue versions of current law, generally the same effect on families with dependent children would occur. Almost no matter what rate is assumed, and regardless of whether they are revenue-neutral or not, these flat tax plans would tend to raise the *share* of the total tax burden paid by most families with dependent children.

Conclusions

Parents who are raising children are contributing to the general welfare. Their contributions ought to be given at least as much recognition in the design of a new tax system as the contributions of those who invest their income. Furthermore, parents with dependent children have less ability to pay taxes than other individuals. Thus, there is a compelling argument for giving attention to the special circumstances of families in any reform of the federal tax code.

The authors conclude their analysis of the effects of three major tax reform policies on families with dependent children with two general observations.

First, a major flaw in both current law and in all of the reform proposals is the lack of adequate coordination between tax measures designed to help low-income families and spending programs also aimed at helping them.

Second, accounting for family circumstances in setting tax burdens is appropriate at all income levels, not just at the low end. While tax policy is not likely to have a major impact on the well-being of children whose families are at the top of the spectrum, it does have significant social implications for those in the middle-income range.

Changes in tax policy in 1986 began to reverse a nearly 40-year trend toward reducing the value of tax relief for middle-income parents. Furthermore, both major political parties have recently made proposals for child dependency credits that would continue this trend toward helping middle-income parents. The authors of the study, however, see little in the reform proposals they analyzed that would address this issue.

Both the USA plan and the flat tax, because they would reduce the current tax burden on investment income, could also disadvantage families with children because of their typically lower proportion of income from this source. While the impact of changes in tax policy on families with children over their lifetimes is not analyzed, and much may depend upon transition rules, future reform efforts should give attention to the extent that heavier taxes are imposed on parents during their child-raising years.

One way to mitigate or eliminate these perhaps unintended results under the Armey/Shelby or USA Tax plans would be to build into their tax reforms a child dependency credit, higher dependency exemptions, or other family-sensitive devices. Such provisions, however, might require a reduction in taxpayer exemptions, an increase in tax rates, or other structural changes in the proposals.

The Armey-Shelby flat tax also adversely affects low-income families with children because of its proposed repeal of the earned income tax credit. This effect could be eliminated by reinstating an expanded EITC or by making offsetting adjustments in expenditure policy. These modifications may not be easy, however, because the EITC or income-related transfer payments require income data that would no longer be collected.

The benefits of a child dependency credit for reducing the tax burdens of families with children are especially appealing. Both the Clinton Administration and many Republican and Democratic members of Congress have backed a child credit, but their proposals are currently mired in disagreements over reductions in the budget deficit. A child credit could go far toward dealing with many of the family issues raised in this report. However, a child credit should be better coordinated with various rules for phasing out welfare benefits than is done under current law.

The proposals examined in this report should be considered as early drafts in a tax reform process that will continue for some time. It is suggested that future revisions of these and other reform proposals should seriously address the many ways that taxes affect families with children.

Federal Tax Reform

A Family Perspective

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THE FINANCE PROJECT

FEDERAL TAX REFORM
A *Family Perspective*

July 1996

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Preface

WITH THE 1996 elections only a few months away, federal tax reform has once again taken center stage, as candidates from both political parties vie to position themselves as champions of the American family. In recent months, a host of tax reform proposals have been presented by President Clinton, members of Congress, former presidential candidate Malcom Forbes, Jr., and others. Republican presidential challenger Bob Dole has promised to offer his own formula, and tax reform seems likely to be a hot topic as the Presidential and congressional campaign season unfolds.

Political rhetoric from Democrats and Republicans alike claims the urgency of tax reform to ease the financial burden on working families raising children. Yet to date, public discussion of alternative reform strategies has concentrated primarily on their likely effects on future economic growth and the national deficit. Very little serious attention has been devoted to potential impacts on the economic well-being of families with children. Accordingly, in the current highly charged debate over federal tax reform, The Finance Project offers an important and heretofore missing perspective: a focus on families. This report, *Federal Tax Reform: A Family Perspective*, provides a sound and credible baseline for weighing the merits of alternative tax reform strategies and for shaping future tax policies that will achieve greater simplification and fairness while protecting the economic well-being of families raising children.

Families raising children will be directly and indirectly affected by the provisions of the prominent federal tax reform proposals. Depending on their size, composition, and income level, some families will pay more and some will pay less in federal taxes. As a result, the amount of disposable income they have to meet their children's needs will go up or down. Federal revenues may also be affected, with implications for the benefits that families will reap over time from federal spending on health, social supports, education, and investments in community development. Yet the emerging tax reform proposals are also likely to influence the economic well-being of families raising children in more subtle ways. Undoubtedly, they will have an array of spillover effects on state and local revenues and spending, on state and local economies, on philanthropies, and on the voluntary sector — sources that all play a critical role in financing education and an array of other supports and services to children and families and to maintaining the vitality of the communities in which they live. Understanding the magnitude and implications of these direct and indirect effects is critical to assessing the wisdom of proposed strategies for tax reform and for crafting future proposals that will make federal tax policy simpler, fairer, and more family-friendly.

In this report, The Finance Project examines three major proposals that would fundamentally change the way the federal government taxes individuals and corporations:

- The Flat Tax, proposed by Rep. Dick Armey, Sen. Richard Shelby, and Sen. Larry Craig;
- The USA Tax, proposed by Sen. Sam Nunn, Sen. Pete Domenici, and Sen. Bob Kerrey; and
- The 10-Percent Tax, proposed by Rep. Richard Gephardt.

The report provides a thoughtful, politically neutral assessment of the likely effects of these proposed strategies for federal tax reform on families raising children. It describes how each would change specific provisions of current federal tax policy that have direct effects on families with children — for example, the size of the dependency exemption, the earned income tax credit, the mortgage interest deduction, and the child care tax credit. The report highlights the implications of their treatment of investment income for families with children and those without children. And it reports the results of simulations of the effects on family taxburdens of shifting to a flat tax by comparing equal-revenue versions of the Armey-Shelby flat tax plan and the current law. Finally, the report also suggests how current law and the reform proposals could be modified — without necessarily changing their basic character — to provide greater benefits to families with dependent children.

The Finance Project is a nonpartisan policy research and development group established by a consortium of national foundations to improve the effectiveness, efficiency, and equity of public financing for education and an array of other community supports and services for children and their families. Over a three-year period that began in January 1994, the project is conducting an ambitious agenda of policy research and development activities, as well as policymaker forums and public education. The aim is to increase knowledge and strengthen the capability of governments at all levels to implement strategies for generating and investing public resources that more closely match public priorities and more effectively support improved education and community systems.

Recognizing the importance of the debate over federal tax reform to the public financing of services and supports for children and their families, in early 1996 The Finance Project's Working Group on Strategies for Generating Revenue for Education and Other Children's Services, chaired by Henry Coleman of Rutgers University, commissioned this report by Michael McIntyre of the Wayne State University Law School and Eugene Steuerle of The Urban Institute. This paper reflects the ideas and interpretations of its authors. We hope that their views will stimulate new thinking and encourage congressional policymakers and other federal leaders to examine the ideas and findings presented here and to use them to develop, revise, and evaluate federal tax reform proposals affecting families.

On behalf of the sponsors of The Finance Project, I would like to thank the authors for their collaboration in producing this comprehensive, balanced, and authoritative study under a tight deadline. I would also like to thank the chair and members of the Working Group for their assistance in conceptualizing the project and providing valuable input and guidance throughout the study. Thanks are also due to Robert McIntyre and John O'Hare of the Institute for Taxation and Economic Policy for conducting the simulations reported in the study. I would like to acknowledge the reviewers whose thoughtful and timely comments helped shape the final presentation of findings and conclusions: Thomas Barthold, Alan Feld, William Gale, Jane Gravelle, Robert Greenstein, Janet Holtzblatt, Dana Naimark, William Niskanen, James Nunns, and Richard Pomp. Finally, I want to acknowledge the extraordinary efforts of Carol Cohen of The Finance Project staff, who managed this project from beginning to end.

Cheryl D. Hayes
Executive Director

I. Introduction

SEVERAL recent proposals for fundamental changes in the federal tax system have been engaging the attention of political leaders and tax commentators. These proposals have generated much discussion and controversy, because they would make major changes — in some cases, radical changes — in the way the federal tax burden is distributed. Tax analysts who have reviewed these proposals, however, have given relatively little attention to the family taxation issues that these proposals raise and to the likely impact of these proposals on families with children. Indeed, even the sponsors of these proposals may not yet have focused their attention carefully on such issues during this early stage of the tax reform process. We hope to contribute to the debate over fundamental tax reform by describing how families with children would be treated under the various reform proposals and by suggesting how those proposals might be modified to address these issues.

Scope and Objective

The family is the primary social structure in the United States for nurturing and raising children. Support for families has long been an expressed policy goal of both major U.S. political parties. Whether U.S. tax policy should be designed specifically to benefit families is an issue of legitimate debate. We subscribe to the traditional view that a personal tax system should be designed primarily to distribute tax burdens in a way that is fair to all individuals, irrespective of their family circumstances. We also believe, however, that a tax system cannot be fair to individuals unless it takes into account the differences in ability to pay that result from the way that income is shared within families of different sizes and types. That is, we generally believe that marital sharing and the support that parents provide for their children have important economic consequences that ought to be taken into account in fixing the tax liabilities of individuals.

Current law includes several measures designed to benefit low-income families. Some of these measures are defended on tax policy grounds, whereas others are defended on spending policy grounds. In our view, a major objective of family taxation reform should be to coordinate the tax measures that are designed to benefit low-income families with children with the various direct expenditure programs targeted at such families.

Many provisions of the current federal income tax are specifically designed to take into account the economic circumstances of the family. Examples include:

- the dependency exemption;
- the earned income tax credit;
- the child and dependent care credit;
- the marital joint filing and income splitting rules;
- the deduction for alimony payments and the nondeductibility of child support payments;

- the standard deductions that vary in amount for different types of households; and
- the special rate schedule for heads of households.

Both major political parties have proposals for adding a child dependency credit to this list.

The various proposals for fundamental tax reform now on the national agenda would modify or eliminate many of these family-sensitive provisions and would make other changes in current law that might have important consequences for families with children. In some cases, the sponsors of these proposals apparently have allowed design choices that are unrelated to the family to set family taxation rules by default.

Many of the provisions of current law that adjust tax burdens for family circumstances were controversial when they were adopted, and they remain controversial. In some cases, they are the product of political compromises between incompatible viewpoints. The simple fact is that no clear consensus has emerged — in the tax literature, among political leaders, or among the taxpaying population — on the appropriate weight to give to family circumstances in the design of a personal tax.[1]

In Section II of this report, we compare the provisions of current law that are particularly important to families with children with the proposed treatment of the family under the various reform proposals. Our focus in that section is on particular tax policy choices and on the design of particular types of family-sensitive provisions.

Section III reports the results of a simulation of the distributional impact on families with children of one leading flat-tax proposal. That simulation was performed for us by the Institute on Taxation and Economic Policy (ITEP), using its microsimulation tax model.[2] According to that simulation, most families with children would do significantly less well under the flat-tax proposal than they do under current law. This finding may be surprising to some analysts, because the flat-tax proposal calls for a major increase in the dependency deduction and has been promoted by its sponsors as a "pro-family" reform. Due to time and resource restraints, we did not attempt to simulate the distributional effects of other major reform proposals.

Many of the family-sensitive features of the various reform proposals could be modified to provide greater benefits to families with children without changing the basic character of the reform proposals. We suggest, when appropriate, what those modifications might be. When modification is impossible, we explain why.

All of these reform proposals are works in progress. They have been changed many times and are likely to undergo additional change. We suspect that the proponents of these proposals have not yet focussed intensively on family taxation issues. We assume that at least some of the positions that they are currently taking on those issues are open to review. We hope that this report will be useful for such a review.

Summary of Reform Proposals

Perhaps as many as a dozen major reform plans have been put forward for consideration by members of Congress and other politicians in the past two years. Some of these proposals are well developed for this early stage of the reform process, whereas others are little more than a one- or two-page press release. In this report, we examine in detail the following three proposals, each representing radically different approaches to federal tax reform:

Armey/Shelby flat tax, sponsored by Representative Richard K. Armey (R-Texas), Senator Richard Shelby (R-Ala.), and Senator Larry E. Craig (R-Idaho). This proposal combines a wage tax on individuals with a business tax on corporations and other business enterprises. Only one tax rate would be used, and the same rate would be applicable to individuals and businesses, although individual taxpayers would be granted a standard deduction and dependency deductions under the wage tax. The flat tax would provide for some progressivity, but significantly less than is provided under current law. The tax would not be progressive with respect to income at high income levels, due to the exclusion of investment income from the tax on individuals and the allowance of a deduction for investments under the business tax.

Nunn/Domenici USA Tax System, sponsored by Senators Sam Nunn (D-Ga.), Pete Domenici (R-N.M.) and Bob Kerrey (D-Neb.). This proposal would convert the federal income taxes on individuals and corporations into a personal consumption tax and a business value-added tax (VAT). This proposal purposefully seeks to retain the progressivity of current law — but it may fail to do so for taxpayers at the very high end of the income spectrum.[3]

Gephardt 10-Percent Tax, sponsored by House Minority Leader Richard Gephardt (D.-Mo.). This proposal would reform the existing individual and corporate income taxes by reducing deductions, closing some corporate loopholes, and lowering the rates on individuals. The rates of the individual income tax would remain graduated, and the tax would remain progressive with respect to income throughout the income spectrum.

Although we give some attention to several other reform proposals, we do so largely to illustrate points we make about the three proposals that are the focus of this report. We summarize here the distinctive features of the three proposals without discussion of their family-sensitive features. The family aspects of the proposals are addressed in Section II. Table 1.1, below, provides a quick overview of the major features of the three plans.

A Note on Progressivity

A tax is said to be progressive with respect to income throughout the income spectrum if the ratio of taxes to income (appropriately defined) increases as income increases. If that ratio decreases as income increases, the tax is said to be regressive. A common method of achieving progressivity is to use graduated tax rates. A single-rate income tax system would be progressive with respect to income, however, if it provided for some tax-exempt amount and imposed tax on income (appropriately defined). If the exemption level is low, the tax would be only mildly progressive. A very large exemption level — $50,000, for example — would cause the tax to be steeply progressive. Of course, most analysts who favor a redistributive tax policy are not likely to be satisfied with the amount of progressivity resulting from a small exemption level.

A consumption tax with a tax-exempt amount would be progressive with respect to consumption, but might not be progressive with respect to income because it does not tax saved income until that income is spent on consumption. In general, a single-rate consumption tax that provided an exempt amount would become regressive with respect to the income of an individual taxpayer if the amount of that taxpayer's deduction for saved income exceeded the tax-exempt amount. Because saved income constitutes a large portion of the income of high-income taxpayers, a single-rate consumption tax, such as the Armey/Shelby flat tax, tends on average to be regressive at high-income levels. At very high income levels, even a graduated consumption tax, such as the Nunn/Domenici USA plan, tends on average to become regressive.

Table 1.1
Summary of Major Features of Flat Tax, USA Tax, and 10-Percent Tax

Short Name	Congressional Sponsors	Type of Tax	Replaces or reforms the following federal taxes	Proposed Tax Rate	Impact on Federal Revenue
Flat Tax	Rep. Dick Armey Sen. Richard Shelby Sen. Larry Craig*	Flat-rate individual wage tax and business value-added tax with wage deduction**	Replaces individual and corporate income taxes and estate and gift tax	20%, reduced to 17% after two years	$30 billion loss at 20% rate and $138 billion loss at 17% rate, derived from Treasury Department study
USA Tax	Sen. Sam Nunn Sen. Pete Domenici Sen. Bob Kerrey	Graduated individual consumption tax and flat-rate business VAT	Replaces individual and corporate income taxes and implicit replacement (through credit) of FICA payroll tax	Graduated individual rates of 19%, 27%, and 40%, reduced in stages to 8%, 19%, and 40% after 5 years; business rate of 11%	Revenue neutral under Joint Committee on Taxation estimate
10-Percent Tax	Rep. Richard Gephardt	Graduated individual income tax and classical corporate tax	Reforms current individual and corporate income taxes	10% applicable to 75% of population; graduated rates of 20%, 26%, 32%, and 34%	Revenue neutral under Treasury estimate

* Also sponsored in modified form by presidential hopeful Steve Forbes. Forbes proposed a 17% rate immediately. He recommended a larger standard deduction and indicated some willingness to retain the earned income tax credit. The Forbes variant would increase the federal budget deficit by $180 billion (without EITC) to $210 billion (with EITC).

** Some analysts would describe the business component of the flat tax as a "cash-flow" tax.

Armey/Shelby Flat Tax

A leading proposal among Congressional Republicans is the Armey/Shelby flat-tax proposal. A similar plan was advocated during the Republican presidential primaries by presidential hopeful Malcolm S. (Steve) Forbes, Jr. In addition, its basic approach apparently has been endorsed by the National Commission on Economic Growth and Tax Reform (the Kemp Commission), a private group that was established by the Republican leadership in the House and Senate.[4] The Armey/Shelby flat tax and several alternative versions of the flat tax are based on a proposal designed in the early 1980s by Robert E. Hall and Alvin Rabushka of the Hoover Institution for War and Peace.[5] The idea of a single-rate tax has a heritage that goes back at least to the single-rate concept promoted in the 1950s by economist Milton Friedman. Some trace the concept to the Scottish economist Adam Smith.[6]

Following the Hall/Rabushka plan, the Armey/Shelby flat tax has two components, a wage tax imposed on individuals and a business tax imposed on all businesses, whether or not incorporated. Both components would have the same tax rate and are viewed by supporters as parts of an integrated tax plan. Some commentators have described the flat tax as a consumption tax because the combined tax base of the two components of the tax is similar to the base of a value-added tax.[7] As discussed below, the proper classification of the tax is a matter of legitimate debate.

The flat-rate tax is proposed as a replacement for the three progressive components of the federal tax system: the personal income tax, the corporate income tax, and the estate and gift tax. The regressive federal excise taxes, the FICA and related payroll taxes, and the self-employment tax would be retained.

Wage Component of Flat Tax. Individuals would report on their tax return their cash wages derived from activities conducted in the United States, and their cash distributions from pension plans. They would not report other forms of income, such as interest, dividends, capital gains, and wages earned outside the United States. No deductions would be allowed, aside from dependency exemptions and a standard deduction. Tax credits, such as the earned income tax credit of current law, also would not be allowed. Tax would be imposed at a single rate — that is, without the graduated marginal tax rates of current law.

Business Component. Businesses would be taxable on their gross receipts derived from business activities in the United States, minus various business inputs, and minus the payments of wages and pensions to employees who are subject to tax on those payments under the wage component of the flat tax. Interest receipts would be exempt from tax, and no deduction would be permitted for interest payments. The rate would be the same flat rate applicable to individuals. All capital expenditures for capital equipment and all inventory purchases would be deductible immediately.

Employee benefits, such as health insurance plans, that are provided in kind to employees would be taxed in full under the business tax. This result is obtained by including the gross receipts of a business enterprise in the tax base without allowing the enterprise any deduction for the costs of providing those benefits. Undistributed pension benefits would remain tax-deferred. State and local governments, public charities, and all other non-profit organizations would be required to collect a tax on the amount of the fringe benefits that they provide to their employees. The point of extending the flat tax to the non-profit sector is to prevent tax discrimination in the taxation of the compensation of their employees and employees in the profit sector.[8]

The tough stand on employee benefits apparently does not extend to executive perquisites. For example, business entertainment expenses — such as hunting lodges, tickets to sporting events, and business-related meals and travel — would be fully deductible.[9] Such expenditures are not deductible, or are deductible only in part, under current law.

A business would lose the deduction it currently may claim for FICA taxes and other related payroll taxes.[10] Thus, self-employed individuals would be liable for the full FICA payroll tax without any deduction.[11] Deductions would not be allowed for state and local income and property taxes.

Revenue Effects. The Armey/Shelby plan calls for a flat rate of 20 percent in the first two years and a 17-percent rate thereafter. According to our extrapolation from the Treasury Department's study, the plan would result in an annual revenue loss to the federal government of $38 billion using a 20-percent rate. The Treasury Department estimates that the long-run, fully phased-in revenue loss would increase to $138 billion per year using the 17-percent rate. The Treasury estimates do not take into account how much corporations and other businesses might reduce their tax liability by engaging in planning activities.[12] Nor does the Treasury Department attempt to estimate the possible revenue effects of the proposal from changes (positive or negative) in economic growth.

The flat tax proposed by Steve Forbes on the campaign trail apparently would adopt a 17-percent rate immediately and would provide for a larger standard deduction. Forbes has indicated that he might propose retention of the earned income tax credit, which currently provides substantial tax relief to low-income workers. He has stated that his plan is designed to give taxpayers a tax cut. The immediate impact of such changes from the Armey proposal obviously would be a further decrease in tax revenues. We do not attempt to estimate the possible positive or negative impact of those changes over time.

Nunn/Domenici USA Tax System

The USA Tax sponsored by Senators Sam Nunn (D-Ga.), Pete Domenici (R.-N.M.), and Bob Kerrey (D-Neb.) is a fairly well-developed proposal for converting the federal income taxes on corporations and individuals into two consumption taxes. The "USA" in the title stands for "Unlimited Savings Allowance." That plan combines a graduated personal consumption tax on individuals, called the "individual tax," with a value-added tax (VAT) collected from businesses, called the "business tax."[13] The USA tax would replace the personal income tax and the corporate income tax of current law. It also would replace, in effect, the FICA payroll tax by allowing individuals and businesses to reduce their USA tax by the full amount of their FICA taxes. The Joint Committee on Taxation (JCT) has scored the USA plan as revenue neutral.[14]

Individual Tax. The overall goal of the individual component of the USA plan is to tax individuals on the net amount of their current consumption expenditures by taxing them only on the portion of their income that they do not save. It is a graduated personal consumption tax that uses taxable income of current law, with many modifications, as the starting point in measuring taxable consumption. It then allows individual taxpayers to take a deduction for amounts spent on investment assets, such as stocks and bonds, and for amounts deposited in savings accounts. It also allows a deduction for certain educational expenses. These deductions — the unlimited saving allowance (USA) — are intended to operate much like an individual retirement account (IRA), except of course that the various limitations imposed on amounts deposited in IRA accounts would not apply. Although similar in concept, the operation of the unlimited saving allowance under the USA plan is substantially more complex than the operation of an IRA under current law.[15] Withdrawals from a USA account used to finance consumption would be taxable.

The rate schedule of the USA individual tax has three tax brackets and three tax rates. The rate for the top bracket is set at 40 percent. The bottom two rates are initially set at 19 percent and 27 percent. Those rates decline over a five-year transition period, reaching 8 percent and 19 percent at the end of the transition.[16] Separate rate schedules are provided for single persons, married persons, and heads of households. The top rate of 40 percent is reached at rather low income levels: for single persons at $14,000, for heads of households at $21,100, and for married couples filing jointly at $24,000.

Business Tax. All businesses, without reference to their form of organization, are taxable under the business tax at a flat rate of 11 percent. As applied to domestic transactions, the business component of the USA tax is similar to the business component of the flat tax, except that no deduction is allowable for wage payments to employees.[17]

Gephardt 10-Percent Tax

The 10-Percent Tax is a progressive individual income tax using graduated rates. In contrast to the other two plans, it accepts income, rather than consumption, as the proper measure of ability-to-pay taxes, and it shifts a substantial portion of the overall burden of taxation to high-income taxpayers. To reduce the tax rate, however, it denies taxpayers the right to deduct the cost of various expenditures that some analysts contend should be allowable in measuring net taxable income. The Gephardt 10-percent plan is proposed as an amendment to the current individual and corporate income taxes, which would remain in place in modified form. No changes are proposed in other federal taxes. It is designed to be revenue neutral.

The Gephardt plan offers a rate of only 10 percent (above exemption amounts) to about 75 percent of individual taxpayers. Most of these taxpayers now pay tax at a rate of 15 percent.

The 10-percent proposal would retain the current five-bracket graduated rate structure of current law, with separate schedules for single, married, and head-of-household taxpayers. The proposed rates for all of the tax brackets are lowered and the widths of the brackets are also adjusted. The five proposed bracket rates are 10%, 20%, 26%, 32%, and 34%. These lower rates are achieved by taxing various employee fringe benefits, eliminating all deductions except for home mortgage interest, and closing various corporate loopholes, many of which are not specifically identified.

No specific structural changes in the corporate tax are proposed. The plan does anticipate, however, raising an additional $50 billion from the corporate sector, and significant changes in the rules governing the treatment of corporations undoubtedly would be needed to raise that amount of additional revenue.

Some of the major features of the three tax reform proposals are set forth in Table 1.1, above. Details of the proposals that are particularly relevant to a discussion of family taxation issues are provided in Section II, below.

Major Goals of Proposed Reforms

The traditional goal of a personal tax system is to raise the revenue required to finance some specified level of public expenditures in accordance with the three normative criteria of fairness, efficiency, and administrative economy.[18] All three proposals seek to meet these three criteria.

Administrative Economy. The premise of all three proposals is that the current income tax has been enacted with too little weight given to the criteria of administrative economy. No one disputes that many features of the current income tax are extremely complex and that major simplification is both desirable and possible. All three proposals for fundamental reform would achieve some measure of simplification by eliminating provisions of the tax code that are largely peripheral to the core functions of a personal tax system. Simplicity gain can be expected, *inter alia*, from the reduction in the time required to complete a tax return, the amount of record-keeping required, the reduction in computational errors, the reduction in tax planning costs, and the reduction in audit and other compliance costs of the Internal Revenue Service.

Much of the complexity of current law is the result of spending policy choices and tax policy choices willfully made by Congress. Some of those choices may be foolish or at least ill advised, and others may reflect an overly refined sense of fairness or an overly developed sense of loyalty to political supporters and campaign contributors. Whatever the reasons for those choices, new policy choices must be made if the tax system is to be made less complex.

The Gephardt 10-percent plan seeks to simplify the tax code for a substantial majority of individual taxpayers by trading off complicating deductions for a lower rate. No substantial simplification gains can be expected from this type of proposal in the taxation of business income (of individuals or corporations) or in the taxation of high-income individuals. The taxation of employees on various employee fringe benefits would be likely to increase their compliance costs to some degree.

The flat tax and the USA plan make major structural changes in the existing tax. Proponents of these proposals claim that these changes would greatly simplify the system. They expect simplification benefits from exempting capital gains and certain other items of capital income and allowing the full expensing of various capital costs. The flat-tax proponents also expect simplification gains from taxing certain payments, such as interest income, indirectly by denying a deduction to the payor and not taxing the recipient. In evaluating those claims, the following points are relevant:

- A new tax still on the drawing board always seems less complex than an operating tax system. Taxes tend to become more complex as they move through the legislative process.[19] Supporters of a tax reform generally must accept some compromises from their original position to obtain the votes needed for enactment. History suggests that the goal of simplification is typically the first casualty when tax policy battles are fought in Congress. Even if an uncomplicated tax code could be enacted, it would tend over time to become more complex as Congress responded to new circumstances and new political pressures.

- In the modern world of free trade and tightly linked capital markets, a country must coordinate its major national taxes to some degree with the tax systems of other countries. As currently designed, the flat tax and the USA tax do not yet fit comfortably with the tax systems of America's major trading partners.[20] Measures to improve that fit will likely add to the complexity of the two systems.

- The flat tax and the USA tax also fit poorly with the existing tax systems of state governments, which currently rely on federal income tax data to enforce their tax systems. Corporate taxpayers can expect little simplification and perhaps some additional complexity if, after tax reform, they are still con fronted in the various states in which they operate with several different versions of the former federal tax system. Individuals with business or investment income also might face additional complexity at the state level.[21]

- The number of pages in the tax code is not a good indication of its simplicity or complexity. Many lengthy provisions reduce complexity by providing clear answers to important questions, and some short provisions are enormously complex. A postcard-size tax code can be far more complex at the operational level than the current income tax or the proposed replacements for it.

- Some proposals that would simplify the tax law might have the collateral effect of increasing complexity in some related area of the law. For example, the replacement of a tax-based subsidy for low-income families with a direct spending program would simplify the tax system but would complicate the welfare system. Such collateral effects ought to be taken into account in evaluating the contribution of a reform proposal to simplification.

- In the short run, any major tax reform is likely to add to complexity simply because of the need for taxpayers and the tax administrators to understand the new regime and adapt to it. In addition, most tax reforms contain transition rules that can greatly increase complexity as long as they remain in effect.

We make these points not to downgrade the importance of simplification in tax reform. We regret the fairly low priority that administrative economy has been given in the past by policymakers, and we welcome well-considered measures that would address the many different causes of complexity for different types of taxpayers. We caution, however, that expectations of the possible gains from major reform should be kept in a realistic range.

Efficiency. A revenue-neutral major reform of the federal tax system might improve efficiency for the following four reasons. First, many of the tax preferences embedded in the tax code tend to cause a misallocation of capital and other resources, with resulting costs in efficiency. The landmark 1986 tax act removed many tax preferences, apparently with positive effects on the economy. To the extent that the major reform proposals eliminate loopholes and special benefits, they may be seen as a continuation of the 1986 attempt to create a "level playing field" for alternative uses of capital.

Second, some tax analysts believe that replacing the individual income tax with a consumption tax, such as the flat tax or the USA tax, would remove what they contend is a current economic distortion in the decision between present and future consumption. Removing that perceived distortion might have the effect of increasing the private savings rate which, in turn, might produce an increase in the growth rate of the U.S. economy. Other tax analysts believe that a consumption-based tax,in order to raise the same revenue as an income tax, would need to have a higher tax rate on wage income, and that higher rate would increase the distortion in the decision between working and leisure.

Third, some analysts contend that the existence of an unintegrated tax on corporate income imposes efficiency costs on the economy and that integrating that tax with the personal income tax or eliminating it entirely would improve efficiency.

Fourth, some analysts have argued that efficiency gains would be obtained under the flat tax as a result of its shifting of a portion of the tax burden to businesses that acquired capital goods under current law and that would be denied any depreciation deduction or other allowance for their capital costs under the flat tax. The flat tax then would operate like a lump sum levy on old capital — a classically efficient, albeit classically unfair, tax. This efficiency benefit largely would be eliminated if Congress adopted the recommendation of many commentators, including the Kemp Commission, to provide businesses with generous transition rules.[22] The magnitude and direction of the likely efficiency consequences of major federal tax reform are still subject to much debate.[23]

Fairness. Most tax analysts would agree that a primary criterion for designing a personal tax system is fairness.[24] They often disagree on the requirements for fairness and on the appropriate trade-offs among the sometimes competing goals of efficiency, administrative economy, and fairness.

On the following two points, the sponsors of the three proposals seem to agree:

- The poor generally should be exempt from direct personal taxation, and low-income taxpayers should pay less, proportional to their income, than middle- and high-income taxpayers.

- A personal tax system should make some adjustments in tax burdens to take account of the family circumstances of taxpayers.

They disagree, sometimes sharply, on the following issues:

- Sponsors of the 10-percent tax and the USA plan believe that the federal tax system should apply graduated tax rates in order to achieve a redistribution of marketplace rewards for individuals at low-, middle-, and high-income levels. Some sponsors of the flat tax oppose redistributive tax policies on principle, whereas others favor some progression primarily in favor of individuals toward the low end of the income spectrum. Most flat-tax supporters appear to favor some welfare payments, which provide progressivity on the expenditure side of the budget.

- The sponsors of the 10-percent tax believe that income is the proper measure of ability to pay taxes. The sponsors of the flat tax and the USA tax generally would measure the taxable capacity of individuals with respect to their consumption.[25]

The fairness of a tax depends on the overall distribution of burdens it produces, not on any one feature of the tax. Thus, any full analysis of the fairness of a tax must embody realistic assumptions about how its burdens are in fact distributed. Determining the distributional impact of a tax, however, is often difficult, and the difficulty is increased when the tax has not yet gone into effect and many of the details of its design have not been worked out.[26]

Fairness of the federal tax system also depends on the total mix of taxes, not just on the very visible direct taxes on individuals and corporations. Indeed, a full analysis of the fairness of the U.S. tax structure would take into account the FICA payroll tax, the various federal excise taxes, and the taxes imposed by state and local governments. These taxes are generally regressive relative to income. The sponsors of the USA tax enhance the progressivity of their system by allowing the FICA payroll tax to be credited against their individual and business taxes.[27]

Revenue. In theory, the tax rates proposed in the three reform plans addressed in this report could be increased to yield whatever amount of revenue Congress is likely to want to raise. Thus, revenue considerations are not paramount in evaluating the merits of the basic design of the three taxes or in considering whether they give appropriate attention to family taxation issues. The estimated revenue yield of the three taxes is relevant, however, in comparing the distributional effects of the taxes among themselves and to current law. The USA plan and the 10-percent tax are estimated to be revenue neutral. If further analysis suggests that they raise too much or too little revenue, their rates could be adjusted rather easily to produce the desired revenue yield with little impact on their overall distributional patterns.

The Armey/Shelby flat tax is estimated by the Treasury Department to produce a revenue loss of $138 billion at the proposed permanent rate of 17 percent and to be revenue neutral at a rate of 20.8 percent.[28] By extrapolation from the Treasury figures, the revenue loss would be $30 billion at the 20 percent rate proposed for its two-year transitional period. In both cases, those estimates do not account for transition rules, which, if adopted, would result in additional revenue losses. To achieve revenue neutrality, the flat-tax rate would have to be increased or other features of the tax would need to be changed, with the most notable candidates for change being the level of the standard deductions and the dependency exemption. Such changes would have important implications for the family taxation issues addressed in this report.

Tax Incidence Under the Proposals

The incidence of a tax is its effect on the welfare of individual taxpayers. In many circumstances, the person who is nominally subject to a tax does not bear its burden. For example, analysts generally expect that the burden of a retail sales tax will fall on the consumer of the goods and services subject to that tax, even if the legal obligation to pay the tax is imposed on the seller of those goods and services. It is easy to imagine circumstances, however, in which the burden of a sales tax might be borne, at least in part, by the seller or the producer instead of by the buyer.

The fairness and, in some cases, the efficiency of a tax is typically determined by reference to its incidence. In most cases, the incidence of a tax can only be estimated, and often those estimates are necessarily crude.

Analysts generally have assumed that an individual income tax, such as the Gephardt 10-percent tax, would be borne by the taxable unit that pays the tax. The incidence of a corporate income tax is more controversial. A common assumption is that a corporate tax initially would be borne by corporate shareholders, but ultimately it would become a burden on all holders of assets producing investment income. Similar shifting may take place with respect to some capital income taxes imposed on individuals. We do not challenge those assumptions in this report.

The 11-percent business tax that would be imposed under the USA plan is a type of value-added tax (VAT). The usual assumption is that a VAT is passed on to consumers in the form of higher prices for the goods and services subject to the tax. Although the USA business tax differs in some significant ways from a traditional VAT, we see no strong reasons for believing that those differences would have a material impact on its incidence. The USA individual tax is also a type of consumption tax, but it is imposed directly on individuals or other taxable units. The prevailing assumption, which we indulge, is that such a tax would be borne by the taxable units on which it is imposed.

The likely incidence of the flat tax is unclear. If the wage tax and business tax are considered as parts of an integrated whole, the combined tax package might be characterized as a value-added tax with a lower effective rate on the wage component of value added. As noted above, the prevailing assumption is that the burden of a VAT is passed on to consumers in the form of higher prices for the taxed goods and services. That the entire amount of the flat tax would be passed on to consumers, however, seems to us and to other analysts to be highly unlikely. The more likely result is that all or most of the wage component of the tax would be borne by the wage earner. Indeed, the rationale for providing wage earners with a tax-free amount is grounded in a belief that they would bear the effective burden of the wage tax.

It also seems likely that at least some portions of the business tax would not be shifted forward to consumers. We have assumed in this report that the tax imposed on employee fringe benefits would be shifted in the long run to employees in the form of lower wages. This assumption is in accord with the common assumption that the employer component of the FICA tax is borne by employees. In its study of the flat tax, the Treasury Department also made this same assumption.

As noted above, some portion of the flat tax, assuming no transition rules, would be imposed on the returns from old capital. It seems plausible that this portion of the flat tax would be borne by the owners of the old capital. This is the assumption that we have indulged, as have other analysts who have addressed the issue.

In the simulation of the flat tax presented in Section III, below, we have assumed that the remaining portion of the business component of the flat tax would be shifted in part to consumers and in part to holders of capital. The Treasury Department assumed that all of the tax would be borne by holders of capital. Fortunately, none of the conclusions presented in this report depend significantly on our assumption about the incidence of this portion of the flat tax.

The discussion above addresses the problem of determining the likely effects of the various tax reform proposals on various taxable units. Our assumption is that those burdens would be distributed among the members of those taxable units, generally in accord with the prevailing patterns of sharing within the family. That is, we assume that a tax on the income or consumption of one spouse typically would be borne in part by the other spouse and that a tax imposed on parents would be borne in part by their children.

When a tax benefit is granted on account of the presence of children in the home, it typically is granted to parents rather than to the children. We generally assume, nevertheless, that such child-sensitive provisions typically increase the well-being of the children. This assumption seems to be particularly plausible at low-and middle-income levels. At high-income levels, the impact of such measures on the welfare of children may be negligible in many cases.

In discussing the incidence of the various reform proposals and making comparisons with current law, we are focussing on annual measures of tax burdens. We acknowledge that the annual incidence of the reform proposals may differ from their incidence over the life cycle of individual taxpayers. That is, the benefits or detriments that an individual may receive or suffer in a particular taxable year may be offset by losses or gains suffered or enjoyed in later periods.

An annual measure of tax burdens may be criticized for its failure to take into account lifetime burdens. At the same time, however, a focus on lifetime burdens might be criticized for a failure to take account of the here and now. In evaluating the impact of a proposed tax reform on children, a focus on the here and now seems to us to be particularly appropriate. In our view, a tax reform is favorable to children if it provides benefits to children while they are children, even if it might be unfavorable to them in their old age. Similarly, a reform that would treat children harshly is subject to criticism on that ground even if those children can expect to enjoy favorable tax treatment some decades in the future.

Finally, we note that the incidence of a tax may be affected in important ways by the transition rules that accompany it. For example, the movement to a consumption tax without transition rules is likely to impose a one-time levy on old capital that penalizes holders of such capital. Such a rule might disadvantage the elderly, who hold a disproportionate amount of old capital, and indirectly benefit the young. The long-and short-term effects of transition rules, however, are often complex and uncertain. For that reason, those effects are often omitted from most accounts of the incidence of a tax.

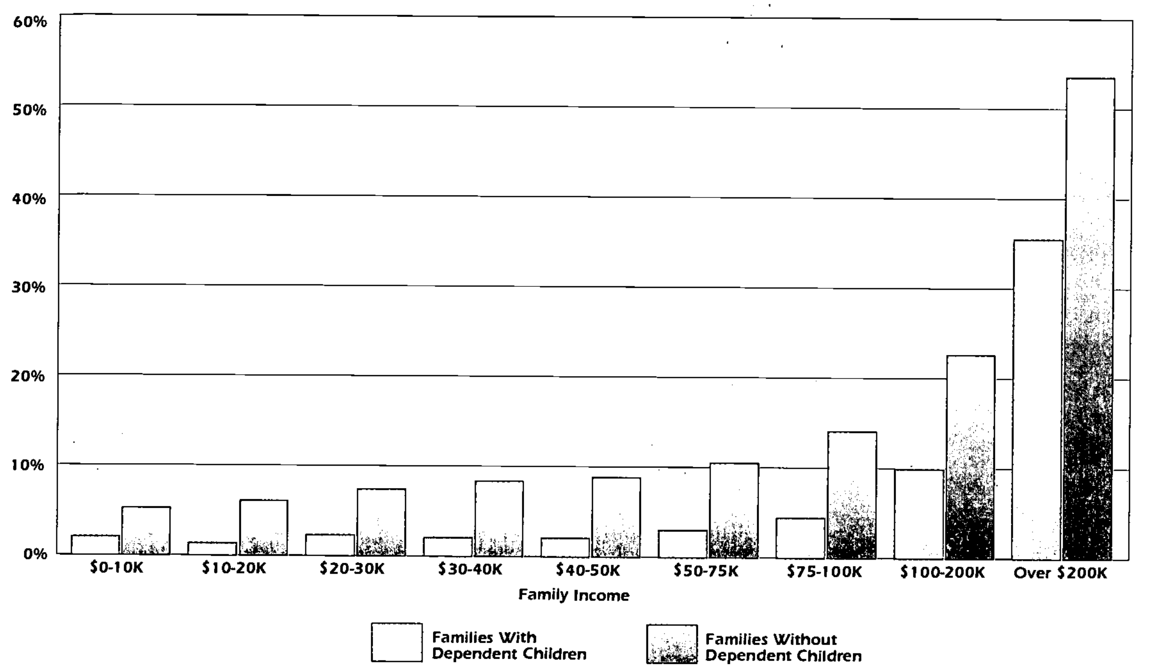
Impact on Families of Reduced Tax Burden on Investment Income

The Armey/Shelby flat tax and the Nunn/Domenici USA plan are intended to be taxes on consumption rather than on income. A consumption tax provides more favorable treatment to investment income than an income tax. In an ideal personal consumption tax, taxpayers would compute their tax liability for the taxable year by first calculating their income for that year and then subtracting therefrom the amount of the change in their net savings for that year. If they used their invested income in some later year to finance consumption, they would be required to pay tax on that amount in that year.

The individual component of the USA plan generally is a personal consumption tax of the type described above. The Armey/Shelby flat tax attempts to approximate the results achieved under a personal consumption tax without the complexity of measuring the amount of current income that each individual has devoted to investment or the amount of previously invested income that each individual has converted to consumption. How well this scheme actually operates to approximate the results of a personal consumption tax is an important issue, but that issue is beyond the scope of this report. It is clear, nevertheless, that the flat tax and the USA plan generally would provide substantially more favorable treatment to individuals receiving investment income than they receive under current law or than they would receive under the Gephardt 10-percent plan.[29]

The generally more favorable treatment of investment income under the Armey/Shelby flat tax and the USA plan may have important implications for families with children, because such families typically earn less investment income than other taxpayers. Figure 1.1, below, shows the ratio of capital income (investment income) to total income at various income levels for U.S. filing units with children and for filing units without children. The information provided in this figure is derived from a representative

Figure 1.1
Percentage of Capital Income to Total Income, Families With and Without Dependent Children



sample of taxpayers incorporated into the ITEP Model for taxable year 1996.[30] It is independent of any features of the current income tax, the proposed flat tax, or the USA plan.

One story told by Figure 1.1 is that capital income, as a percentage of total income, is highly concentrated at the top end of the income spectrum. This is a familiar story in the tax literature and is the reason that flat-rate consumption taxes, which give more favorable treatment to investment income, tend to be regressive with respect to annual income.[31]

The other story told by Figure 1.1 is that families with children are likely to be disadvantaged during their child-rearing years, absent strong compensating measures, by a shift from an income tax to a consumption tax. The reason is that filing units without dependent children, at all income levels, derive a higher percentage of their income from capital than do filing units with dependent children. As a result, filing units without dependent children would get a proportionally larger benefit from a tax change that eliminated some or all investment income from the tax base or allowed taxation of that income to be postponed indefinitely.

Table 1.2 contains the data used to construct Figure 1.1. As shown in that table, families with dependent children with family income between $30,000 and $75,000 have, on average, about one quarter of the investment income of filing units without any dependent children. Thus, filing units without dependent children generally would obtain four times as great a benefit from more favorable treatment of investment income as families with dependent children, assuming no other changes in the tax system. The magnitude of that benefit would depend on many factors, including the tax rate. But the relative

Table 1.2
Investment Income As a Share of Total Income, For Filing Units With and Without Dependent Children, 1996

Family Income*	Investment Income/ Total Income, Families With Children	Investment Income/ Total Income, Families Without Children	Ratio: No Children/ With Children
$0-10,000	2.2%	5.5%	2.5
$10-20,000	1.5%	6.4%	4.3
$20-30,000	2.4%	7.6%	3.2
$30-40,000	2.1%	8.2%	4.0
$40-50,000	2.1%	8.6%	4.0
$50-75,000	2.7%	10.2%	3.8
$75-100,000	4.3%	13.6%	3.2
$100-200,000	9.5%	22.3%	2.3
Over $200,000	35.1%	53.1%	1.5

* The ITEP concept of family income used to place tax returns into income classes is total tax return income, **plus** tax-exempt interest, untaxed government transfer payments, and certain tax-sheltered business and investment income, **minus** state and local tax refunds and net operating loss carryovers.

NOTE: "Income" used in calculations includes only realized income (not unrealized capital gains). Investment income includes interest (taxable and tax-exempt), dividends, realized net capital gains, rent and royalty income (not losses), and other miscellaneous related items. It does not include pension income and imputed income from home ownership — income items that are treated favorably under the current income tax and under the proposed replacements.

Source: ITEP Model

change in tax burdens in favor of filing units without children — because that change is manifest in all income classes — is entirely independent of the tax rate schedule and of all other features of the Armey/Shelby flat tax and the Nunn/Domenici USA plan that are not targeted at families with children.

In theory, a consumption-based tax could compensate for the increase in relative burdens it would impose on families with dependent children by providing special allowances for such families. The Armey/Shelby flat-tax proposal does offer a substantially larger dependency exemption than current law (or than either the Nunn/Domenici USA plan or the Gephardt 10-percent tax). Some portion of that extra dependency exemption is intended, however, to compensate for various other features of the flat tax that would be unfavorable to low-and middle-income families. The question is whether the exemption is adequate for the several tasks being assigned to it. That question is addressed with the simulations of the Armey/Shelby flat tax presented in Section III, B, below.

The exemption needed to compensate for the exclusion of investment income from the tax base would be significant at middle-and upper-income levels. For example, in the $40,000 to $50,000 income bracket, taxpayers without dependent children, on average, have investment income of $3,851, whereas families with children, on average, have investment income of only $961 — a difference of $2,890. The average difference in the $75,000 to $100,000 income bracket is $8,016.[32] A large dependency allowance that varied with income would be needed to make up for such differences.[33]

Justification for Special Allowances for Children

Virtually all income tax systems provide significant tax benefits to parents in order to take into account the impact of family sharing and family support obligations on their ability to pay. Whether those tax benefits are justified under tax policy criteria, however, remains a matter of some dispute. Some analysts assert that raising children is a consumption choice, no different for tax purposes than choosing to take a vacation or choosing to own a dog. The contrary view, which we embrace, is that children are themselves potential taxpayers and that they should properly be seen as the appropriate taxpayer on their own consumption and savings. Under this view, dependency exemptions and various other child-relief mechanisms operate to provide some limited "income splitting" between parents and children. That is, those relief mechanisms operate to provide the parents and children with some of the tax benefits that would result if the income were deductible by the parents and taxable to the children. These mechanisms are similar in justification to the income splitting provided to married couples under the current income tax.

We do not attempt in this report to reprise in detail the theoretical arguments in favor of family allowances.[34] The fact is that current law and all of the reform proposals addressed in the report assume that granting substantial tax benefits for children is an appropriate tax policy. In comparing those proposals, it is appropriate to move beyond the question of whether child allowances are justified and to address the questions of how generous those allowances should be and how they should be designed.

Endnotes

1 We are concerned in this report with family taxation issues in a personal income tax and a personal consumption tax, because several of the proposals on the national agenda would replace the income tax with a consumption tax.

2 The main features of the ITEP model are described in Appendix B.

3 Official data on the distributional impact of the tax for very high income individuals have not yet been made available, although sponsors of the plan have indicated that average tax burdens would go up by 4% for taxpayers with adjusted gross income over $200,000. No breakdown of the over-$200,000 income group is provided. The impact of a tax reform on taxable units with income over $200,000 is extremely important to many proponents of progressive taxes. Although that group represents only 1.2% of taxable units, it possesses 16.2% of total income.

4 The Kemp Commission did not specifically endorse a particular tax reform plan and was intentionally vague on many major issues. Its report has generally been interpreted, however, as an implicit endorsement of the flat tax.

5 Hall is an economist on the Stanford University faculty, specializing in labor economics. Rabushka is a political scientist.

6 In *Wealth of Nations* (1776), Adam Smith asserted that "[t]he subject[s] of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities." Although some analysts see this statement as a justification for single-rate taxation, proponents of progressive taxation typically have interpreted this inherently cryptic remark to mean that high-income individuals should pay at higher rates than low-or middle-income individuals because they have proportionally a greater ability to pay taxes than low-or middle-income individuals.

7 The sponsors of the flat tax have sometimes described the tax as an income tax and have insisted that all components of income, including investment income, would be taxable under the plan. Hall and Rabushka, in their draft statute, describe the tax as an "income tax" and provide rules for computing what they characterize as "taxable income." The rules provided, however, are inconsistent with income tax principles.

8 Analysts generally conclude that the business tax on fringe benefits probably would be passed on to employees in the form of lower wages, although existing wage contracts would likely cause some of the tax to be paid by employers in the short run.

9 Under current law, such expenses, even if considered to be reasonable business expenses under IRC § 162, would not be deductible under IRC § 274. The Armey/Shelby bill would repeal that latter section, as would the draft legislation proposed by Hall and Rabushka. Hall and Rabushka would allow a deduction for "the actual cost, if reasonable, of travel and entertainment expenses for business purposes." Armey/Shelby allows a deduction for amounts paid for property and services "in connection with any business activity." Both of these standards appear to be lower than the standard of IRC § 162, which allows a deduction for " ordinary and necessary business expenses." The various executive perquisites mentioned in the text were all allowable as deductions under the IRC § 162 standard; to avoid that result, Congress enacted IRC § 274 in 1962 and has amended it periodically to reduce so-called expense account living.

10 The expectation is that the economic burden resulting from the loss of the business deduction for FICA taxes would be passed on to employees. As with the tax on fringe benefits, however, existing labor contracts might cause employers to bear some of that tax in the short run.

11 The amount of self-employment tax due is a percentage of a self-employed individual's income, whereas the business tax is not based on income. Thus, self-employed individuals must compute both their income and their flat-tax amount under the Armey/Shelby plan.

12 The Treasury estimate of the revenue implications of the business component of the flat tax is based on actual corporate tax returns. It is highly likely that many corporations, particularly banks, will show net losses under the Armey/Shelby plan because of the exclusion provided for interest receipts. If that plan were adopted, it would be likely that corporations showing losses would merge with corporations showing gains, resulting in a significant drop in tax revenues.

13 In general, a VAT is a form of sales tax that is collected in stages from producers, distributors, and retailers on their sale of goods or services. The tax imposed at each stage is the amount that the taxpayer has added to the value of the goods and services it sold, multiplied by the tax rate.

14 In accordance with standard Congressional and Treasury Department practices, the revenue estimate is made on the assumption that macroeconomic aggregates are held constant.

15 For discussion of the operation of the unlimited saving allowance, see Alvin C. Warren, *The Proposal for an "Unlimited Savings Allowance,"* 68 *Tax Notes* 1103 (Aug. 28, 1995).

16 The high rates in the early years are needed to fund transition tax relief for retired persons and other individuals who are drawing down investment assets that were already taxed under prior law. Several commentators have suggested that the transition relief has design flaws. For discussion, see Louis Kaplow, *Recovery of Pre-Enactment Basis Under a Consumption Tax: The USA Tax System,* 68 *Tax Notes* 1109 (Aug. 28, 1995).

17 The treatment of foreign trade under the two plans, however, is different. The flat tax allows gross receipts from imports to be exempt, and it taxes gross receipts from exports. The USA tax, in contrast, includes the value of imports in the tax base and does not tax gross receipts from exports. The USA tax also uses accrual accounting for taxing inventory, whereas the flat tax uses the cash method of accounting.

18 A "personal" tax in the lexicon of this report is a tax that links taxes due with particular individual taxpayers and that has been designed to take account of their ability to pay. Thus, a traditional income tax or a consumption tax that imposes tax on individuals with respect to their aggregate net consumption for the taxable period and that allows appropriate exclusions to reflect ability-to-pay would be personal taxes. A retail sales tax, a traditional value-added tax, or an excise tax on particular consumption goods would not constitute personal taxes.

19 For discussion of the potential for complexity under the USA plan, see Martin D. Ginsburg, *Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici's Tax World,* 48 *National Tax Journal* 585 (1995). For an analysis of the potential for complexity under the flat tax, see Alan L. Feld, *Living With the Flat Tax,* 48 *National Tax Journal* 603 (1995); see also Michael J. McIntyre, *Book Review: Low Tax, Simple Tax, Flat Tax* by R. Hall and A. Rabushka, in *New Republic*, July 11, 1983, pp. 35-37.

20 For example, the United States has developed a complex network of tax treaties to reduce the risks of international double taxation and fiscal evasion under its income tax and the income tax systems of its treaty partners. The methods of double tax relief and the measures for avoiding fiscal evasion would need to be altered substantially if the United States replaced its individual and corporate income taxes with consumption taxes.

21 As discussed below in Section II, C, 3, b, the federal reforms will put substantial pressure on the states to adopt complementary reforms.

22 See, e.g., Jane G. Gravelle, *Income, Consumption, and Wage Taxation in a Life-Cycle Model: Separating Efficiency From Redistribution,* 81 *American Economic Review* 985 (1991).

23 The Kemp Commission argues that a flat tax would produce important efficiency gains by eliminating what it views as multiple levels of taxation on saved income. See National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century,* 70 *Tax Notes* 413-430 (January 22, 1996) at 423. For a generally negative assessment of the efficiency claims of the Kemp Commission, see William G. Gale, *The Kemp Commission and the Future of Tax Reform,* 70 *Tax Notes* 717 (Feb. 5, 1996) at 720, 723.

24 Some analysts contend that "fairness" is too vague a concept to provide useful guidance in the design of a tax system.

25 The USA plan is much more effective than the flat tax in forging a link between an individual's consumption and his or her tax obligations. For example, because the flat tax is territorial — that is, it would apply only to economic activities conducted in the United States — it would exempt individuals on income derived outside the United States. Consumption financed by those foreign earnings would be exempt from tax or would be taxed at an effective rate below the rate on consumption financed by domestic earnings. The USA plan, in contrast, would tax

individuals with respect to their worldwide consumption. As another example, the USA plan would impose a tax burden directly on individuals who withdrew savings for consumption, whereas the flat tax would rely on its business component to impose such a burden on individuals indirectly.

26 For discussion of the distributional implications of the various recent reform proposals, see Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden*, 69 *Tax Notes* 1517 (Dec. 18, 1995).

27 For analytical purposes, it is often useful to evaluate the progressivity of the FICA tax in conjunction with the Social Security benefits that it finances. It makes little sense, however, to discuss Social Security benefits in the context of a proposal to replace the FICA tax with a tax that would not be linked in any way to those benefits.

28 For the most recent Treasury Department estimates of the revenue effects of the Armey/Shelby proposal, see Office of Tax Analysis, U.S. Treasury Department, *'New' Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds*, 70 *Tax Notes* 451 (Jan. 22, 1996).

29 As discussed above, the incidence of the Armey/Shelby flat tax is unclear. It is possible that a switch from the current income tax to the flat tax would result, in the short run, in higher tax burdens on some forms of investment income in some very limited circumstances.

30 As explained in Appendix B, the sample was prepared by the Internal Revenue Service from its tax files and made available to researchers after eliminating taxpayer names and other confidential material and blurring certain data on high-income taxpayers to prevent identification.

31 The USA tax, in an attempt to be distributionally neutral, would impose a combined marginal tax rate on consumption of 51 percent at middle-and high-income levels and would offset the burden of the FICA payroll tax at all income levels.

32 See Table A-1 of Appendix A for details.

33 Parents with dependent children tend to have less investment income, as a percentage of total income, than other taxpayers in part because they are younger, on average, than the rest of the taxpaying population. Older taxpayers tend to have a higher percentage of their income from investments for at least two reasons. One reason is that their wage earnings tend to decline once they pass the traditional retirement age. A second reason is that they have had more time to accumulate the capital stock that produces investment income. The elderly — that is, persons at least 65 years old — derive, on average, around a third of their income from capital. At middle-income levels, the percentage is closer to one quarter; it drops to about a tenth at low-income levels. Elderly taxpayers with annual incomes in excess of $200,000 typically receive over two-thirds of their income from capital.

Even if the elderly are removed from consideration, the exclusion of investment income from the tax base would disadvantage families with dependent children. The relative bias against such families, however, would be cut approximately in half in the middle income range. That is, for filing units with income between $30,000 and $75,000, the ratio of the percentage of investment income to total income for nonelderly families without dependent children is only two times (not four times) the percentage of investment income to total income for families with dependent children. See Table A-2 of Appendix A for additional details.

34 For a full discussion of the merits of child allowances on tax policy grounds, including a detailed response to the children-as-consumption argument, see Michael J. McIntyre and Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 *Harvard Law Review* 1573-1630 (1977) at 1599.

II. Analysis of Specific Tax Reform Provisions Affecting Children and their Families

A PERSONAL tax system affects dependent children primarily through the taxes it imposes on their parents, guardians, or other caretakers. The Armey/Shelby flat tax, the Nunn/Domenici USA plan, and the Gephardt 10-percent tax all propose to change current tax law in ways that would affect significantly taxpayers with children. We describe and discuss the policy choices that those plans embody and make some constructive suggestions for the improvement of those plans.

We have organized our discussion of the family-sensitive tax provisions affecting taxpayers with children — and, thus, children — into three general categories. The first category, addressed in Part II, A below, is made up of provisions that provide benefits for taxpayers who provide a home or other support for a child. Five such provisions are addressed here: (1) dependency allowances (exemptions or credits), (2) the earned income tax credit, (3) the child-care credit, (4) the head-of-household rate schedule, and (5) the taxation of the income of children at the marginal rate of their parents (the so-called "kiddie tax").

Various tax provisions that depend for their operation on the marital or household status of their primary caretakers also may affect the economic well-being of children. Part II, B discusses (1) the tax-exempt levels of income (or consumption) for different types of households, (2) the treatment of marital partners through the tax rate structure, and (3) the treatment of former spouses with respect to alimony payments and child-support payments.[1]

Finally, Part II, C briefly examines four issues that relate indirectly to the well-being of children. Those are (1) the proposed repeal of the deduction for charitable gifts; (2) the proposed repeal of the home mortgage interest deduction; (3) the proposed repeal of the deduction for state and local taxes, and (4) the impact of the proposed reforms on the ability of state and local governments to administer their current tax systems.

A. Provisions Relating to the Presence of a Child in the Home

Table 2.1 provides an overview of the provisions of current law and the three reform proposals that directly relate to the presence of a dependent child in the taxpayer's home.[2] The details of those provisions are addressed in Sections II, A, 1 through II, A, 3, below.

Table 2.1
Tax Provisions Directly Related to Dependent Children: Current Law, Flat Tax, USA Tax, and 10-Percent Tax

Features of Tax Regimes	Current Law (1996)	Flat Tax	USA Tax	10-Percent Tax
Dependency exemptions, per capita	$2,550**	$5,000*	$2,550	$2,750**
Child (dependency) credit	no	no	no	no
Earned income tax credit	yes maximum benefits: no children: $323 1 child: $2,152 2 children: $3,556	no	no, but refundable credit for 7.65% FICA tax	yes, same as current law
Child-care credit or deduction	yes, credit	no	no	no
Head of household schedule	yes	no	yes	yes
Children taxed at parents' rate (kiddie tax)	yes, investment income	yes, earned income	yes, investment income	yes, investment income

* Exemption applies only to cash wages and pension distributions and not to in-kind employee benefits or to employer share of FICA payroll tax, both of which are fully taxable under business tax.

** Phased out at high income levels.

1. Tax Relief for Dependent Children

The case for adjusting tax burdens for family size rests on the proposition that parents with dependent children have less ability to pay than other equal-income taxpayers because of the expenditures that parents typically make to support their children. Compare, for example, a family of four (husband, wife, two dependent children) with $50,000 of income with a family of two (husband, wife, no children) with $50,000 of income. If ability to pay is defined in terms of an individual's actual consumption and the family members are sharing resources in the expected fashion, it seems obvious that each individual family member in the family of four has less ability to pay than the individuals in the family of two. If income (consumption plus savings) is the appropriate measure of taxable capacity, it seems equally obvious that the individual members of the larger family have less taxable capacity, per capita, than the members of the smaller family.[3]

Once a decision is made to provide tax relief[4] to parents with dependent children, three further tax policy issues must be confronted: (1) how much relief should be given, (2) what mechanism should be used to deliver that relief, and (3) which income groups should receive that relief. In addition, policymakers must concern themselves with the relationship between relief provided through the tax code and relief for poor families provided through various state and federal welfare programs. These issues are addressed in Sections II, A, 1, a through II, A, 2, b.

One possible reform of the various allowances for dependents (not discussed here in detail) would roll all of those allowances together into a single delivery mechanism. For example, a child credit, partially dependent upon work, might be designed as a unified mechanism that would substitute for a dependency exemption, child credit, and the EITC. The authors of this study, as well as Congressman Thomas E. Petri (R.-Wis.), have proposed or suggested such a combination in the past.[5] Under current law, these provisions have significantly different eligibility rules, reflecting somewhat different policy judgments about who should receive their benefits.[6] A single delivery mechanism would require more uniform eligibility rules, including a common definition of a "dependent child." Changes in those definitional rules would advantage some parents and disadvantage others.

a. Dependency Exemption

The dependency exemption is a major mechanism for adjusting tax burdens for the costs of supporting children, and is the only mechanism that provides tax benefits to all middle-income families with dependent children. The dependency exemption for 1996 is $2,550 per dependent child. Since 1987, it has been phased out for high-income taxpayers.[7] For tax year 1994, taxpayers claimed a total of approximately 70 million dependency exemptions.

The Armey/Shelby flat-tax proposal would increase the dependency exemption to $5,000 — nearly double the current level. Advocates of the flat tax frequently claim that the flat tax would not affect low-income families adversely, because of the generous exemption levels. The business component of the Armey/Shelby flat tax, however, would indirectly affect workers, including low-income workers, through the disallowance of a deduction for certain fringe benefits (primarily health care) and for FICA taxes. As discussed above, the intended and likely effect of the disallowance of the deduction is to impose tax on FICA benefits and the affected employee benefits, and that tax is likely to be passed on to employees in the form of lower wages (or other compensation). Thus, low-income families, as well as other taxpayers, are not fully protected from taxation by the generous exemption levels.[8]

Assume, for example, that a business provides its workers with health insurance benefits valued at $3,000 per year. That amount would be fully taxable under the business component of the flat tax without reference to the income status of the workers, and presumably the tax would be passed on to workers in the form of lower wages. Mr. A works for that business, receiving a wage of $15,000. He has two dependent children and a wife, Mrs. A, who earns $10,000. Their combined income is $25,000, which is below the tax-exempt amount for their family of $31,400 (see Table 2.3). Yet they are taxable, indirectly, on the $3,000 of health insurance benefits provided by Mr. A's employer.[9]

The Nunn/Domenici USA plan would provide the same dependency exemption as current law, but would eliminate the phase-out of the exemption at high-income levels. The Gephardt 10-percent tax would boost the exemption by $200, to $2,750, and would retain the phase-out rule.

As noted earlier, the Armey/Shelby plan, in contrast to the other two plans, is estimated to lose substantial revenues. Thus, if its long-term proposed tax rate of 17 percent is maintained and large deficits or large budget cuts are to be avoided, some changes in the proposal will be necessary. One of the few possible changes that would raise substantial amounts of revenue would be a lowering of the exemption level for dependents.[10] The proposal as it now stands, nevertheless, goes the farthest of the three reform plans in advocating an increase in the adjustments of tax burdens for family size.[11]

Historical Trends

Few changes in federal income tax laws over the past four decades have had as far-reaching effects on the distribution of federal tax burdens as the shift in the relative tax burdens from taxpayers without dependent children to taxpayers with dependent children. The increase in relative tax burdens has been particularly marked for middle-income taxpayers with children.[12]

The modern era of family taxation in the United States may be traced to 1948, when important changes (discussed in Section II, B, 2, below) were made in the taxation of married couples. At that time, middle-income families with dependent children were asked to shoulder a relatively small portion of the overall federal income tax burden. Their relative burdens have gone up steadily since then.

The change in relative burdens on families with dependent children did not occur because policymakers, after careful study, concluded that parents with dependent children were being taxed too lightly. Instead, it happened primarily because the chief mechanism for granting tax relief to families with dependent children — the dependency exemption — was not adjusted sufficiently to keep up with economic growth or with inflation.

Many amendments have been made in the tax code since 1948 to keep low-income families off the tax rolls. The preferred technique for raising tax-free levels in the 1960s and early 1970s was an increase in the standard deduction. That approach provided a cheaper means of raising tax-exempt levels than raising the dependency and taxpayer exemptions, because such an increase was of no benefit to middle-and high-income taxpayers who itemized their deductions. Since 1975, the earned income tax credit has been used to target relief at low-income families with children.

Figure 2.1
Value of Dependency Exemption Relative to Per Capita Income, 1948 to 1996

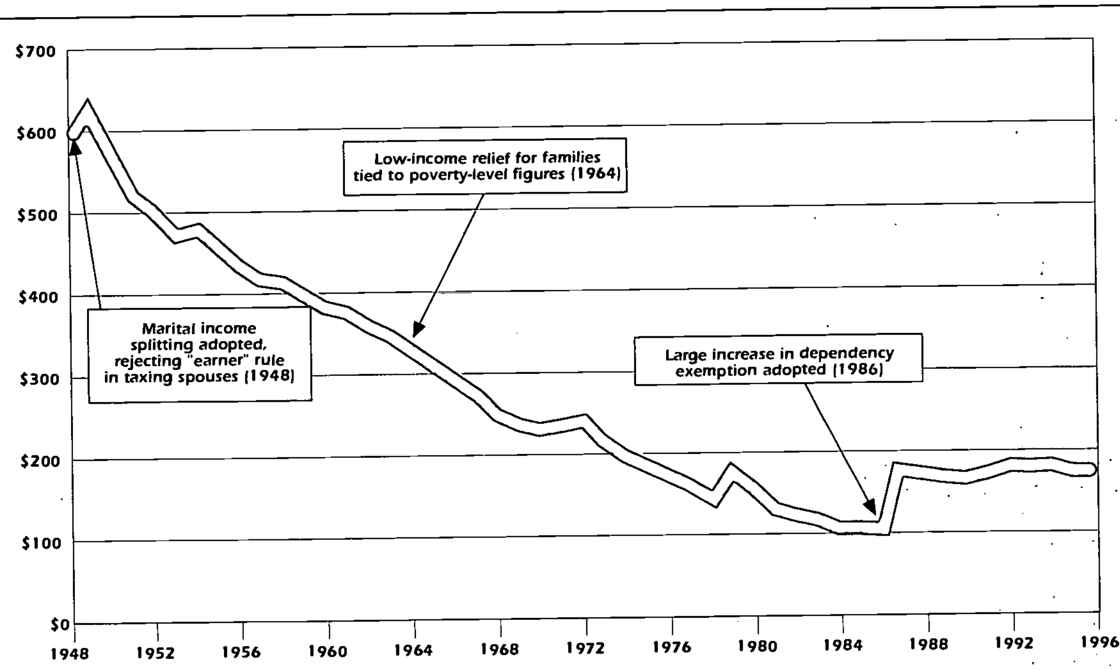
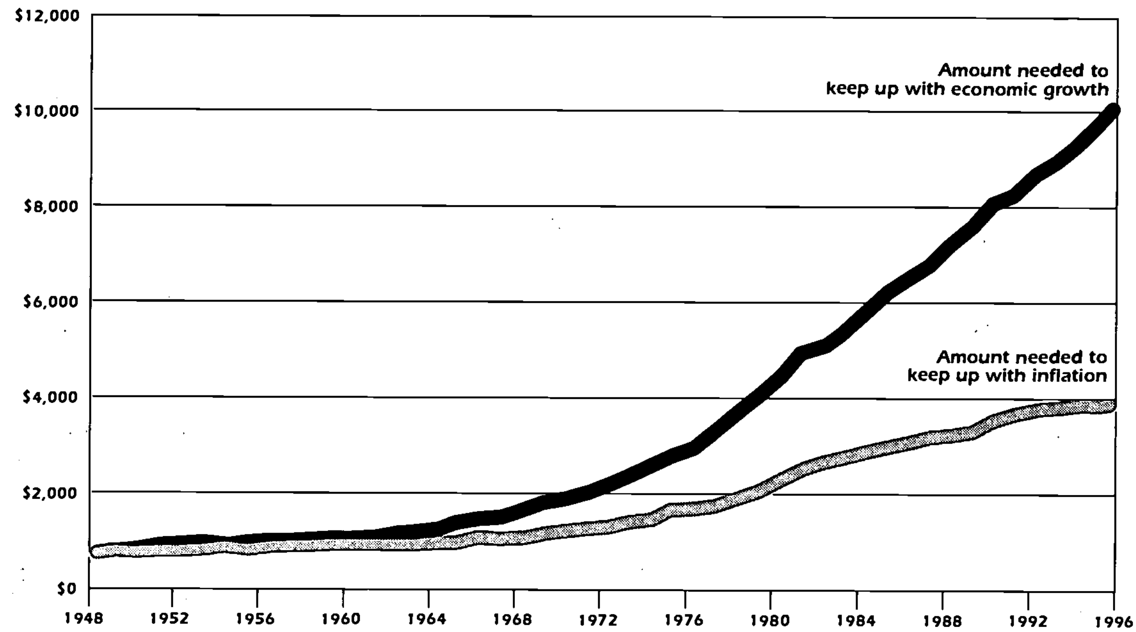


Figure 2.2
Amounts Required to Preserve Value of Dependency Exemption at its 1948 Level, 1948 to 1996



Our comparisons of current relief for dependent children to the level of relief provided in 1948 are not meant to suggest that generous relief for dependents is required now because it was given back in 1948. The year 1948, nevertheless, is an interesting point of departure, because that was the year that the federal government adopted marital income splitting as a national policy. The basic premise underlining that policy is that the income earned by one family member and spent for the benefit of another should be taxable to the person who enjoys the benefits of the income and not necessarily to the earner. This premise also underlies the case for generous dependency exemptions and for many other types of relief provided to families with children.

Over the 48-year period from 1948 to 1996, the dependency exemption has grown from $600 to $2,550 — slightly more than a four-fold increase. During that same period, per capita personal income has grown from $1,425 to $23,882, which is more than a sixteen-fold increase. As a consequence of economic growth, the dependency exemption fell from about 42 percent of per capita personal income in 1948 to less than 11 percent by 1996. Figure 2.1, on page 32, shows this historical trend. That figure also marks the changes in the dependency exemption from 1964, when Congress began to set relief for families with children by reference to poverty-level statistics, and from 1986, when Congress moved in the direction of more generous relief for such families.

The dependency exemption for 1996 would need to be set at approximately $10,000 for it to represent the same percentage of per capita income as it represented in 1948. Simply to adjust the dependency exemption for post-1948 inflation would require that it be increased to nearly $4,000. The dependency exemption is now indexed for inflation, but indexing did not begin until after 1988. The increases in the dependency exemption that would have been required to keep pace with economic growth and inflation from 1948 to 1996 are shown in Figure 2.2, above.

None of the major reform proposals on the table today would go so far as to restore the original value of the dependency exemption relative to per capita income or to make equivalent changes in other delivery mechanisms. The Armey/Shelby flat tax proposal, by calling for an increase in the dependency exemption to $5,000, does make a significant statement about the views of its supporters on the importance of children in formulating tax policy. Some other features of that plan, however, are generally disadvantageous to most families with children, as shown in Section III, below.

As discussed in Section I, above, the tax policy case for large allowances for children rests on the proposition that children are properly viewed as taxpayers in their own right and that income earned by their parents and spent to finance their consumption should be taxed to them rather than to the parents.[13] The size of the allowances for children under this theory would depend on estimates of the typical sharing patterns within the family. In our view, sharing within the family is adequate to justify rather large dependency allowances.

The current level of dependency allowances appears to be grounded on the theory that the income spent to satisfy the basic subsistence needs of children should be exempt from tax. It is unclear whether this theory is based on tax policy considerations or welfare considerations. If the former, then the dependency allowances should not be phased out at high-or middle-income levels. If the latter, they should be phased out at fairly low income levels.

b. Tax Credit for Dependent Children (Child Credit)

A child dependency credit, generally referred to as a child credit, is a possible alternative mechanism for delivering tax relief to parents with dependent children. The credit might be a fixed amount per dependent child, or the amount of the credit might vary with family size. It could be fixed in amount at all income levels, or it could be phased out at middle-or high-income levels.

Both the leadership of Congress and the Clinton Administration have recently offered proposals for granting a child credit. An omnibus tax bill containing a credit of $500 per child was passed by Congress in late 1995, but the bill was vetoed by President Clinton.[14] The Clinton Administration also proposed a child credit in 1995, and its budget proposal to Congress for 1997 contains a slightly revised version of that proposal.[15] A child credit is not included in any of the reform proposals addressed in this report, although the credit might be used as an alternative mechanism to achieve some of the apparent goals of those proposals.

A child credit is worth more to a taxpayer, dollar for dollar, than a dependency exemption, because the dependency exemption is subtracted from the amount subject to tax (whether income or consumption), whereas the credit is subtracted from the amount of the tax otherwise payable. Leaving aside special features of current law, a dependency exemption of $10,000 would offset exactly $1,500 in taxes for parents in the 15-percent tax bracket — the lowest bracket provided under current law. It would offset $2,800 in taxes, however, for parents in the 28-percent bracket. In contrast, a credit of $1,500 would provide the same dollar benefits to taxpayers in the 15-and 28-percent brackets, and, of course, to taxpayers in the higher brackets.[16] In comparing child credits to dependency exemptions, therefore, the credit may be viewed as an exemption that is automatically reduced as taxpayers move into higher tax brackets.[17]

The child credit proposals of the Clinton Administration and the Congress have become enmeshed in the debate over the proper means of reducing or eliminating the federal budget deficit. Much of that debate has centered on whether or not tax relief for the middle classes is appropriate in the middle of a deficit reduction effort. In the context of a revenue-neutral major tax reform, deficit issues can be sidestepped. Of course, any liberalization of dependency allowances in a revenue-neutral context would require an increase in the relative tax burdens imposed on taxpayers without dependents. If the ground rules of the reform proposal require revenue neutrality, however, the debate can focus on the trade-offs between the fairness claims of parents with children and the fairness claims of other taxpayers without concern that a victory for one side or the other would have adverse effects on the deficit.

We do not believe that a child credit should simply be added to the current list of relief mechanisms for families. We see significant simplification gains in providing tax relief to families with dependent children through one mechanism that integrates the benefits of current law and any new benefits that policymakers are prepared to give to families with dependent children. Under current law, relief is now targeted at families with children through the dependency exemption and, for low-income families, through the earned income tax credit (EITC). Adding a third relief mechanism with a different set of eligibility rules appears to us to be needlessly complex. We recognize that rolling two and perhaps all three mechanisms into a single mechanism will require some changes in policy — for example, a uniform definition of "dependent" would probably be required. Such changes may create some additional winners and losers in order to achieve gains in administrative economy.

We do not have strong views as to whether, in tax theory, the combined mechanism should be a credit or a deduction. Assuming the continuation of the EITC and the cash payments in welfare programs, however, the use of a unified credit would seem to be the preferred approach. In addition, we believe that a credit mechanism that combined the benefits of the EITC and the dependency exemption could be coordinated better with various rules for phasing out welfare benefits than is possible under current law. That coordination issue is addressed in Section II, A, 2, b, below.

2. Tax Relief for Low-Income Families with Children

In Section II, A, 2, a, below, we discuss the effectiveness of the earned income tax credit (EITC) of current law in providing both tax and welfare benefits to low-income families with children, and suggest how its repeal would disadvantage those families. Section II, A, 2, b discusses the need to coordinate the various tax and welfare measures targeted at low-income families with children.

a. Earned Income Tax Credit

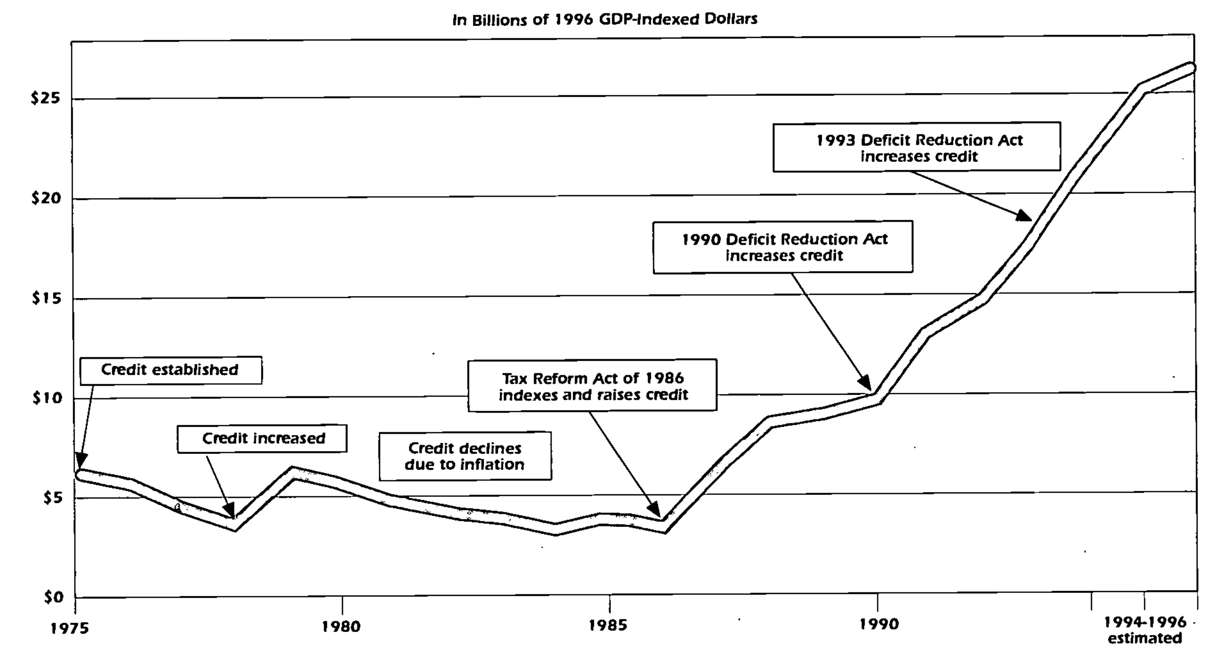
Current law provides low-income workers with a refundable tax credit — that is, besides reducing the tax liability for low-income families, the government sends a check to the taxpayer for any amount by which the allowable credit exceeds the taxpayer's liability for taxes payable on his or her income tax return. This earned income tax credit (EITC) provides significant benefits to low-income families with dependent children and more limited relief to other low-income individuals. Taxpayers with income over specified income thresholds are not eligible for the EITC.

The EITC began as a limited program in 1975 during the Ford administration and has been expanded several times since then, with large increases enacted in 1986, 1990, and 1993. The 1993 additions only became fully effective in 1996.

According to preliminary IRS data, the EITC was claimed by approximately 18 million families in 1994, with average benefits exceeding $1,100 per family. Around 80 percent of the approximately $20 billion in credits claimed for 1994 represented amounts refunded to taxpayers.

For 1996, individuals with two or more qualifying children and wage income between $8,890 and $11,610 may claim the maximum EITC credit of $3,556 (40% of $8,890). Individuals with one child

Figure 2.3
Earned-Income Tax Credits, 1975 to 1996



receive a maximum credit of $2,152 (34% of $6,330) in the income range from $6,330 to $11,610. Individuals with no children receive a maximum credit of $323 (7.65% of $4,220) at a wage level between $4,220 and $5,280. Relatively few taxpayers eligible for the EITC fall within these narrow income ranges. Thus, most taxpayers receive only a fraction, and sometimes a small fraction, of the maximum credit. The EITC is fully phased out for two-, one-, and no-child families at, respectively, $28,495, $25,078, and $9,500. All of the income-level amounts are indexed for inflation.

Historically, the EITC has been promoted as a useful mechanism for lowering income taxes and offsetting FICA (Social Security) taxes for low-income individuals with dependent children, as well as offsetting the work disincentives associated with welfare. Both of these goals continue to be invoked to justify the EITC. Today, the EITC probably should be considered primarily as an extension of a combined welfare/tax system. That is, it has important tax and welfare features that to some extent are inseparable.

A major goal of many federal welfare programs — e.g., Aid to Families with Dependent Children (AFDC), food stamps, and housing vouchers — is to lift families with dependent children out of poverty. Such programs typically provide the highest benefits to parents who do not work in the labor market, thereby creating serious work disincentives. An important goal of the EITC has been to counter those disincentives by providing help to low-income parents who work in paid employment outside the home.

Reform Proposals and the EITC

The current version of the Armey/Shelby flat tax would repeal the EITC. The Nunn/Domenici USA plan also would repeal the EITC, but it would compensate for that loss in significant part by providing for a refundable rebate for the FICA payroll tax. The Gephardt 10-percent tax would retain the EITC in its present form.

Flat Tax and the EITC. Various simulations of the distributional impact of the Armey/Shelby flat tax, including the one presented in Section III, below, indicate that it would significantly raise the effective tax rate on low-income workers. A major reason for that distributional result is the repeal of the EITC.[18] The increases in the dependency exemption and standard deductions provided in the Armey/Shelby plan would replace only a small portion of the benefits that low-income workers would lose from repeal of the EITC.

Some proponents of the flat tax believe that it is unfair to take into account the proposed repeal of the EITC in evaluating the impact of the proposal on the distribution of tax burdens. In their view, the EITC is a spending program, and its repeal should be evaluated as spending reform, not as tax reform. The classification of the EITC as a spending program is plausible, but so is its more traditional classification as a tax provision.[19] We see little to be gained here in debating the proper classification, because the impact on low-income workers of a repeal of the EITC obviously would be the same whatever the outcome of such a debate.

Proponents of the flat tax — and any other consumption-based tax — may have little practical choice but to advocate repeal of the EITC, unless they are prepared to sacrifice a major part of the simplification gains that they hope to achieve by not having to measure capital income. The EITC is necessarily income-based, unless high-income individuals with low wages are to be made eligible for the EITC. To administer the EITC, therefore, the tax authorities must obtain substantial information about the capital income of prospective recipients of the EITC. By making the issue of relief for low-income workers a problem for the welfare system and not the tax system, the sponsors of the flat tax would avoid this potential complexity of the flat tax. That complexity, however, would simply be offloaded to the welfare system, as we discuss in Section II, A, 2, b, below.

USA Plan and the EITC. The Nunn/Domenici USA tax, in its current form, also would eliminate the EITC. It would mitigate the impact of that repeal, however, by allowing individuals a tax credit for the 7.65-percent FICA payroll tax withheld from their wages and by allowing businesses a credit for their portion of the FICA tax.[20] If economic analysts are correct in concluding that the employer portion of the FICA tax generally is borne by the wage earner, then the Nunn/Domenici plan provides, in effect, a 15.3-percent FICA credit that would likely accrue to the benefit of the worker.[21]

Notwithstanding this large credit, many low-income taxpayers with children would do better having the EITC than the FICA credit. For example, a low-income taxpayer with two or more children and wages of $10,000 would be much better off with the EITC than with the FICA credit. As noted above, the EITC for that taxpayer was worth $3,556 in 1996, whereas the credit for the FICA tax is worth $765 directly, or $1,530 if the FICA credit granted to businesses is passed on to employees. As family income increases, the relative advantage of the EITC over the FICA credit decreases. For a family with two or more children, the EITC would provide greater benefits than the FICA credit until family income reaches $16,500. Thereafter, the FICA credit would provide the greater benefit. For a family with one child, the cross-over point is $12,833.

The FICA credit would be more favorable to most low-income workers without dependent children, who are allowed a maximum EITC of $323. All middle-and high-income workers would benefit more from the FICA credit, because they are not entitled to an EITC.[22] The EITC provides such varied amounts to low-income workers that almost any change of its structure would be likely to create some losers as well as some winners. Nevertheless, most low-income families close to or below the poverty line would suffer quite significant losses in income from the replacement of the EITC by a FICA credit.[23]

The EITC has been a major topic of discussion during the contest between Congress and the Clinton Administration over the 1996 budget. Revision of the EITC is likely to be a topic on the public agenda for some time, whatever the political fate of the major reform plans addressed in this report. The EITC has received political support from many sources, including, at various times, from the leadership of the two major political parties. It has been favored because of the work incentives that it provides, as well as the relief that it delivers to low-income families. Some supporters have seen it as a politically viable alternative to an increase in the minimum wage. The EITC has also received criticisms from a range of sources, partly because of problems with its implementation and partly, as discussed below, because it is not well integrated with income-tested welfare programs. Congress and the IRS have attempted to deal with the problem of ineligible participants receiving the credit by reforming eligibility criteria and by checking more closely with taxpayers over the existence of dependents.

An additional problem remains to be addressed: the ability of taxpayers to overdeclare income to receive higher credit amounts. This problem, which one of us has deemed a "superterranean economy," does not require cheating. Two neighbors could baby-sit for each other and generate significant EITCs as a consequence.[24]

b. Coordination of Tax Provisions with Implicit Taxes Embedded in Welfare Programs

In some important respects, an individual with a dependent child who is receiving welfare payments may be viewed as being subject to a "negative" income tax. The welfare check is roughly equivalent to a refundable tax credit for a dependent child. If that individual should begin to work, the welfare rules provide that the welfare payment is phased out. For example, for each additional $10 over some amount that the individual earns, the welfare check might be reduced by $3, for an effective "tax" rate of 30 percent. At the same time, the income that the individual is earning is taxable under the federal and state income taxes and under the FICA payroll tax. In this simple case, the effective marginal "tax" rate that the individual would face may easily exceed 50 percent. In real life, various additional factors may combine to raise the effective rates even higher.[25]

An important objective of public policy — whether characterized as tax policy or welfare policy — should be to substantially reduce the high marginal "tax" rates that welfare recipients typically face when they attempt to enter the workforce. A reduction in those rates presumably would encourage welfare recipients to enter the workforce and avoid a long-term dependence on welfare. The current tax system, operating in tandem with various welfare programs, is said to create "poverty traps" because it discourages welfare recipients from taking the steps into the workforce — steps that offer them the only realistic hope of avoiding long-term poverty for themselves and their children. We suggest that the avoidance of such poverty traps should be an important objective of any major tax reform.

A child credit provides a means of linking together the welfare system and the tax system. Just as a welfare payment operates as a refundable tax credit that is *phased out* as income increases, so also a child credit could be designed to operate as a welfare payment that would be *phased in* as income increases. The phase-in rules of one set of credits can be designed to offset, wholly or in part, the phase-out rules of the other credit, thereby reducing implicit marginal tax rates considerably. Once the credit is fully phased in, it would remain constant throughout the low-and middle-income ranges, thereby avoiding the implicit taxes that result under current law from the phase-out of the EITC or welfare credits.

Another potential advantage of a unified approach to tax and welfare issues is the opportunity thereby provided for reducing marriage penalties resulting from the implicit taxes imposed by the welfare system. Those marriage penalties can be extraordinarily high under current welfare policies.

Consider, for example, a female welfare recipient with a dependent child who is considering marriage to a male wage earner whose wages are somewhat above the threshold for receiving welfare. Prior to marriage, they would each be considered for welfare by reference to their own earnings — one would receive welfare benefits and the other would not. After marriage, their eligibility for welfare would be a function of their combined incomes. The likely result would be that neither of them would be eligible for welfare if they married — with a drop in their combined income of 30 percent or more in many cases. A potential loss of income of that magnitude would be a strong financial impediment to their marriage.

In the example above, a generous child credit could reduce the marriage penalty resulting from the introduction of income into the household by marriage. The introduction of wage income into the household would trigger a drop in welfare payments to the wife and mother. The marriage, however, would automatically activate a child credit that would offset, in whole or in part, the taxes otherwise due on the wage income of the husband. With full coordination — which, we fully concede, would be a difficult political achievement — the high marriage penalties of the welfare "tax" system could be eliminated entirely. They can be substantially reduced even with limited coordination.

None of the major tax reform proposals on the national agenda attempt to address the poverty traps created by the interplay of tax and welfare policies.[26] What analysts should realize is that individuals in the welfare system are implicitly subject to "tax" on their incomes even if the explicit tax system is consumption-based and provides them with generous exemptions from the explicit tax. In addition, the proponents of a consumption tax should realize that their goal of eliminating the need for individuals to report their nonwage income may not be achievable as long as their reform is not coordinated with the income-based welfare system that would remain in place.

3. Other Provisions Affecting Families with Dependent Children

The sections below discuss the child-care credit, the special rate schedule for heads of household, and the so-called kiddie tax, which requires young children to pay tax at the marginal tax rate of their parents. Although these provisions are very important to the families to whom they apply, they affect only a modest percentage of families with dependent children.

a. Child-Care Credit

Parents with one or more children under age 13 may claim a tax credit under current law for a portion of the expenses for child care and household services that they incur in pursuing gainful employment outside the home. The allowable credit is a percentage (30 percent at low-income levels, phased down to 20 percent) of qualifying expenses. Qualifying expenses are capped at $2,400 (one qualifying dependent) or at $4,800 (two or more qualifying dependents). In the case of a two-job married couple, the expenses eligible for the credit generally cannot exceed the income of the lower-earner spouse. Taxpayers claiming the credit must provide the Internal Revenue Service with the name, address, and taxpayer identification number of their provider.

A deduction for child-care expenses was introduced in 1954, during the Eisenhower administration, primarily as a mechanism for encouraging mothers on welfare to work outside the home. The deduction was capped at $600 and was phased out at rather low income levels. The allowance has been expanded several times and was converted into a credit in 1976. As shown in Table 2.2, the child-care credit was claimed in 1995 by just over 6 million taxpayers for total credits of under $3 billion. For a taxpayer with adjusted gross income of $10,000 or less and two qualifying dependents, the maximum credit is $1,440. The maximum credit is $960 for parents with income of $30,000 or more.[27]

All three reform proposals would repeal the child-care credit. The case for repeal is not overwhelming on administrative economy, efficiency, or fairness grounds.

The child-care credit is moderately difficult to administer, due to the intricacy of some of its qualifying rules. Thus, repeal would provide some simplification gains and would retain the possibility of the post-card tax return that some proponents of the flat tax have advocated.

The case for repeal on efficiency grounds is at best mixed. An initial and continuing purpose of a child-care allowance has been to mitigate the tax and welfare disincentives that some parents face in taking a job in the labor market. The efficiency problem arises because self-performed child-care services are not taxed, whereas cash income spent for child care would be taxable in the absence of a child-care allowance. Maintaining the credit would cause some modest increase in the tax rate, which could have some efficiency costs. Those costs would need to be balanced against the possible efficiency gains from granting the credit.

The child-care credit is available to all taxpayers with qualifying dependents, not just those eligible for welfare. The efficiency case for granting a child-care allowance for middle-and high-income taxpayers is difficult to assess, due to the significant likelihood that child care provides parents and other guardians with some consumption benefits. Indeed, some commentators assert, albeit without supporting evidence, that the child-care credit creates a positive incentive for women to work outside the home. Some political opposition to the credit is grounded on this possible effect.

Table 2.2
Child-Care Credits Claimed, 1995

Income Class* ($000)	Returns (000)	Amount ($000,000)
Below $10	—	—
$10 to $20	452	166
$20 to $30	864	402
$30 to $40	1,012	446
$40 to $50	826	335
$50 to $75	1,545	672
$75 to $100	900	415
$100 to $200	494	247
$200 and over	84	43
Total	6,177	2,724

* The income concept used to place tax returns into classes is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad.

SOURCE: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000*, JCS-21-95 (1995)

The case for a child-care credit on fairness grounds also is mixed. One argument for a child-care allowance is that it constitutes a legitimate cost of earning income and ought to be deductible in a tax system seeking to measure net income (or net consumption). Those arguing that child-care expenses constitute a business cost can show that the costs of child care are closely analogous to certain expenses, such as the costs of travel away from home, that are deductible as a cost of earning income.[28] On the other hand, those costs are also analogous to certain other expenses, such as the cost of most types of personal clothing, that are not deductible, notwithstanding a close relationship to business. Because child-care costs arise from the quintessentially personal decision to have and raise children, a case for the deduction on business-expense grounds can never be conclusively made.[29]

A second fairness argument for a child-care allowance is a variant of the argument we endorsed above for granting generous dependency allowances. According to that argument, amounts spent for the benefit of a child ought to be taxable to the child in a tax system that taxes consumption to the consumer and, in the case of an income tax, income to the beneficiary. Amounts spent for child care clearly fall within the category of amounts spent for the benefit of a child. In a tax system that is already granting generous allowances for dependent children, a child-care allowance would be justified only if child-care expenses generally represent an above-average level of spending on children.[30] The premise that parents paying substantial child-care expenses spend more money on their children than other parents is a plausible premise, but we are not aware of any organized data on this point.[31]

Repeal of the credit for household and dependent care services would raise approximately $2.7 billion in revenue, according to the tax expenditure budget prepared by the Joint Committee on Taxation. That amount is not unimportant, but it is too small to affect the overall tax rate significantly.

Related Provisions

Under current law, taxpayers may receive child-care benefits from their employer, subject to some limitations, without paying tax on those benefits. That exclusion from income is similar in effect to the child-care credit. The technical rules governing the exclusion, however, are not coordinated with the related provisions of the child-care credit. For example, the exclusion is limited to child-care services valued at $5,000, whereas the comparable limit under the credit is $2,400 for one child and $4,800 for two or more children. The cost in forgone federal income tax revenue of the exclusion for employer-provided child-care services is estimated by the Joint Committee on Taxation at around $700 million for 1996.

All three tax reform proposals apparently would eliminate this exclusion for employer-provided child care. The Gephardt 10-percent tax would do so by repealing the exclusion of current law, with the result that employees receiving that benefit would be taxable under the individual income tax.[32] The Armey/Shelby flat tax would tax the amount of the benefit under the business component of the flat tax. The Nunn/Domenici USA plan would treat "dependent care assistance" provided by an employer as a taxable fringe benefit under its tax on individuals, and no deduction would be allowable in computing the business component of that tax.

Alternatives to Child-Care Credit

Some analysts have criticized the child-care credit on the ground that it provides benefits only to single parents who work and two-earner married couples and not to families in which one of the parents remains at home as a full-time caretaker. They have suggested that the tax code should provide an enhanced dependency deduction or a general child dependency credit in place of the child-care credit. Extending the benefits of the child-care credit to all parents with dependent children, however, would cost many times more than the existing child-care credit in terms of forgone federal tax revenue. In addition, such an allowance would fail to address the differential treatment between, on the one hand, one-earner couples and, on the other hand, two-earner couples and one-earner heads of households, that many analysts believe is the basic purpose of the credit.[33]

b. Head-of-Household Rate Schedule

The head-of-household rate schedule is available under current law to unmarried individuals with a qualifying dependent, most typically a minor child. The Nunn/Domenici USA plan and the Gephardt 10-percent tax would retain that rate schedule. The Armey/Shelby flat tax, which has only one rate schedule, would eliminate it.

The tax rates contained in the head-of-household schedule under current law are the same as the rates on the schedule for other single individuals, but its tax brackets are wider. This change in bracket widths has no impact on heads of households who would be subject to the 15-percent bracket under the single schedule (income of $24,000 or below for 1996). Those with income above that level, however, obtain a tax benefit from using the head-of-household schedule. For example, under 1996 tax rates, a single parent with taxable income of $30,000 and filing as a head of household would save $780 in taxes from using that schedule instead of the singles schedule. For a head of household with taxable income of $50,000, the tax savings would be $1,060. The maximum tax savings of $2,467 is available to heads of household with taxable income of $263,750 and above.

The head-of-household schedule was introduced into the tax code in 1951. Its purpose was to extend to one-parent families some portion of the tax benefits that two-parent families received under the marital income splitting regime adopted nationally in 1948. Under that regime, marital partners were allowed to report one-half of the total income of their marital partnership on the same rate schedule used by single individuals. In contrast to the head of household schedule, the benefits of marital income splitting were available to all marital couples, whether or not they had dependent children. The important changes that have been made in the 1948 regime for married couples are discussed in Section II, B, 2, below.

The purpose of the head-of-household schedule is to take account of the differences in ability to pay of heads of households relative to equal-income single individuals due to the difference in their support obligations. In effect, the head of a one-parent family is allowed to split income with a dependent child, with the child's portion of the parent's income being taxed at a low or zero rate. The head-of-household schedule operates like a dependency exemption that increases in value with increases in the total income level of the one-parent family.

The special rate schedule for one-parent families creates the potential for a marriage penalty because a husband and wife with children could reduce their taxes under current law by getting a divorce, using the deduction for alimony to equalize their individual incomes, and then having one former spouse file as a head of household and the other spouse file as a single person. The former spouses cannot both file as a head of household under current law and still live together, because a head of household is defined as a person providing *more than half* of the cost of maintaining the household. It does not appear that significant numbers of married couples have availed themselves of this tax-avoidance opportunity.

c. Kiddie Tax

Under current law, as amended in 1986, children under the age of 14 are taxable on their unearned income at the marginal tax rate of their parents. This rule is popularly, if inexactly, referred to as the "kiddie tax." Its point is to prevent parents from avoiding the bite of the graduated rate structure by shifting investment income to their children.[34] Its adoption has reduced the tax planning benefits obtaining from establishing certain family trusts, thereby reducing the complexity for the taxpayer and the tax authorities that is associated with such tax planning.[35] Earned income — e.g., income that children earn from baby-sitting or delivering newspapers — is not subject to the kiddie tax rule.

Both the Nunn/Domenici USA plan and the Gephardt 10-percent tax retain the rule of current law. The rule has limited application under the USA plan, however, because the tax on all investment income is deferred indefinitely under that plan.

The Armey/Shelby flat tax would apply a kiddie tax to the *earned* income of young children. This result is achieved by requiring parents to report the earnings of their children under age 14 on their own tax return. The kiddie tax does not apply to investment income because such income is exempt under the wage component of the flat tax. The rationale for applying a kiddie tax to earned income, although unstated, is probably related to the desire to avoid having the child claim a standard deduction and the parents claim a dependency exemption.[36]

B. Provisions Depending on Marital Status

Table 2.3, below, provides a summary of the features of current law and of the three reform plans that depend for their operation on the marital status of the taxpayer. These provisions have a major impact on the tax burdens imposed on parents with dependent children, and thus are important in determining the relative impact of the alternative tax systems on children.

Section II, B, 1 discusses the rules under current law and the reform proposals that establish the threshold amount below which no tax is imposed. The impact of the earned income tax credit (discussed in Section II, A, 2, a) on the tax-free level is not discussed here, although it may affect the threshold amount. Section II, B, 2 discusses the marital tax regimes of current law and the reform proposals. The treatment under current law and the reform proposals of alimony payments and child support payments made to a former spouse are addressed in Sections II, B, 3 and II, B, 4, respectively.

1. Tax-Free Amounts for Households — Personal Exemptions and Standard Deduction

The tax-free level under current law is determined by two mechanisms: the taxpayer exemption and the standard deduction. For 1996, the taxpayer exemption is set at $2,550. This is the same amount as the dependency exemption. These personal exemptions were set at $2,000 after the phase-in of the 1986 tax act (1989) and have been adjusted upwards for inflation since then.

Each type of filing unit has its own standard deduction level. For married couples, it is $6,700, for a per capita standard deduction of $3,350. Married individuals filing separately are entitled to the same per capita standard deduction. Heads of household may take a standard deduction of $5,900, and single individuals (other than heads of household and certain widows and widowers entitled to file as married) may claim a standard deduction of $4,000. These amounts are all indexed for inflation. The standard deduction is taken as an alternative to itemized deductions. The personal exemptions are phased out at high-income levels.

Table 2.3
Family-Sensitive Provisions Relating to Marital Status of Parent: Current Law, Flat Tax, USA Tax, and 10-Percent Tax

Features of Tax Regimes	Current Law (1996)	Flat Tax (wage tax component)	USA Tax (personal tax component)	10-Percent Tax
Tax-exempt amounts for adult individuals:				
married (per capita)	$5,900	$10,700*	$6,250	$6,925
single	$6,550	$10,700*	$6,550	$7,750
head of household	$8,450	$14,000*	$7,950	$10,100
Total exempt amount, 2-parent family of four (husband, wife, 2 children)	$16,900	$31,400*	$17,600	$19,350
Total exempt amount, 1-parent family of three (parent, 2 children)	$13,550	$24,000*	$13,050	$15,600
Marriage penalty from rate structure	yes	no	yes	yes
Marriage penalty from exemptions	yes	no	yes	yes
Alimony deduction	yes	no	yes	yes
Child-support deduction	no	no	yes	no

* Exemption does not apply to in-kind fringe benefits or employer share of FICA payroll tax, although both are fully taxable under business tax.

NOTE: The tax-exempt amounts do not include the amounts that would be exempt to low-income families on account of the earned income tax credit.

The standard deduction and the personal exemption combine to provide the following *per capita* tax-free amounts for adult individuals in each of the three types of households given tax status under the tax code:

- married individuals (per capita), $5,900 ($3,350 + $2,550)
- single individuals, $6,550 ($4,000 + $2,550)
- head of household, $8,450 ($5,900 + $2,550)

The three tax reform proposals also provide tax-free amounts for various types of households. The Armey/Shelby flat tax and the USA plan fold the taxpayer exemptions into the standard deduction. The Gephardt 10-percent tax, following current law, retains the taxpayer exemptions and makes the standard deduction an alternative to its itemized deductions. The per capita tax-free amounts under the three plans are as follows:

Tax-Free Amounts (Per Capita) for Taxpayers and Spouses

Type of Household	Armey/Shelby Flat Tax	Nunn/Domenici USA Plan	Gephardt 10-Percent Tax
Married (per capita)	$10,700	$6,250	$6,925
Single	$10,700	$6,550	$7,750
Head of household	$14,000	$7,950	$10,100

As noted in the discussion above of the dependency exemption, employees are not shielded by the exempt amounts from taxation on certain employee benefits under the business tax component of the flat tax. That is, those benefits are taxed to their employer, and that tax is likely to be passed on to them in the form of lower wages. Thus, a low-income wage earner who receives significant fringe benefits might be exempt from tax under the wage component of the Armey/Shelby flat tax and still would bear a tax burden under the business component of that tax, notwithstanding the exemption levels shown above. Workers who consume their income also would be taxable, without exemptions, under the business component of the USA plan.

2. Marital Income Splitting

The modern history of the current federal system of marital taxation begins in 1948, when Congress adopted marital income splitting as a conscious federal policy. Before the 1948 reform, federal family taxation policy was in disarray. Supreme Court decisions handed down in the 1930s established the following three inharmonious rules.

First, the wage income of a married individual residing in a common law state (i.e., a state, such as New York or Michigan, that has adopted family property laws derived from the English Common Law) was taxable to that individual, notwithstanding the existence of a legally binding contract assigning the income to the individual's spouse.

Second, one-half of the wage income of a married individual residing in a community property state (i.e., a state, such as Washington or Louisiana, that has adopted family property laws derived from the community property law of Spain or France) was taxable to that individual's spouse.

Third, marital partners residing in common law states were free to shift property income between themselves as long as they were prepared to transfer nominal ownership rights to the income-producing property. In some cases, the shifting was arranged through short-term trusts, intra-marital loans, and similar measures. Of course, spouses residing in community property states were allowed full splitting of their property income, whether or not they arranged an actual transfer of nominal ownership rights.

The three rules summarized above created significant disparities in the federal tax burdens imposed on equal-income married couples, with those disparities being a function of their state of residence and the source of their individual incomes. The 1948 tax act ended the tax disparities between common law and community property states by extending marital income splitting to married persons residing in common law states.

In a tax system that provides for full marital income splitting, each spouse is taxable as an individual on one-half of the total income of their marital partnership. Such a system is not designed primarily to benefit dependent children. It is available, after all, to childless couples and to couples with adult children no longer dependent on their parents. Its purpose is to tax each spouse on that share of the total income of their marital partnership that is used to enhance their material well-being. It can be viewed as implementing the traditional income tax policy goal of relating the burdens of taxation to the consumption and net savings of individual taxpayers.[37]

In 1969, Congress adopted a special tax rate for single individuals that guaranteed that they would pay no more than 120 percent of the tax imposed on marital partners having the same aggregate income. This 120-percent rule reflected a political compromise between those who contended that equal-income marital couples should bear equal taxes and those who contended that individuals with equal income should pay equal taxes notwithstanding differences in their marital status.[38] The revenue cost of introducing the "singles" rate schedule was modest — on the order of $200 million per year in forgone revenue. Despite the low cost, the implications of this change for federal tax policy were very large, for reasons explained below.

Under the system adopted in 1969, marital partners became taxable on their aggregate incomes as a unit, under a rate schedule with brackets exactly twice as wide as the brackets under the rate schedule of prior law. The tax brackets on the marital unit schedule, however, were less than twice as wide as the brackets on the newly created schedule for single persons. The effect was that two marital partners having approximately equal separate incomes would pay less in tax if they were allowed to file separate tax returns and to compute their separate tax liabilities on the new singles schedule. The only way to do so, however, was to terminate their marriage. The tax savings that marital partners could obtain from getting a divorce and filing separately came to be called a "tax on marriage" or a "marriage penalty."

Congress has adopted legislation from time to time to reduce the marriage penalties created by the 1969 act. Other legislation, unfortunately, has increased those penalties. Marriage penalties were reduced sharply under the 1986 tax act, due to the flattening of the rate structure and the introduction of fuller income splitting at middle-income levels. Marriage penalties were increased by the 1993 tax act for high-income married couples. No changes have been made in the basic system of multiple graduated rate schedules introduced in 1969, which necessarily produces marriage penalties. The USA plan and the 10-percent tax would continue that basic structure.

In contrast, a perfectly flat tax would eliminate all marriage penalties created by the graduated rate structure. The Armey/Shelby flat tax would eliminate graduated rates and would tax all taxpayers at a flat rate without reference to their marital status. This approach, combined with the equal per capita standard deductions provided to single and married persons, would eliminate almost all marriage penalties created by the rate structure.[39]

The current tax system and all of the proposed replacements addressed in this report provide under some circumstances what are sometimes characterized as "marriage bonuses." A "marriage bonus" may be defined as the amount of the reduction in aggregate tax burdens that two individuals obtain from getting married. In a progressive tax system employing a marital income splitting rule, two unmarried individuals with substantially unequal individual incomes typically would obtain a so-called "marriage bonus" from getting married.[40] "Marriage bonuses" are a normal result of any progressive tax system that permits some degree of marital income splitting.

The primary beneficiaries of the multiple rate structure of current law are marital partnerships in which only one partner engages in full-time paid employment outside the home. In some cases, the other partner is engaged in unpaid employment in the home as the primary caretaker for a child. These marital partnerships would be less advantaged relative to single taxpayers and two-earner married couples under the Armey/Shelby flat tax. That change is not due, however, to any marriage-specific feature of the flat tax proposal. It is due instead to the elimination of the relative advantage given to them through marital income splitting in a graduated rate structure — an advantage that obviously disappears with a flat rate.[41]

3. Alimony Payments

Under current law, alimony is deductible to the payor and taxable to the recipient. The effect of this arrangement is to extend some degree of income splitting to formerly married individuals. Thus, the treatment of current law is consistent with the income splitting approach to family taxation. The Armey/Shelby flat tax would repeal the deduction for alimony and also would give an exemption from tax to alimony recipients. The USA plan and the 10-percent tax would retain the treatment of alimony under current law. Taxing alimony to the wage earner would eliminate one or two lines from the tax return. In addition, the Armey/Shelby approach would improve compliance; studies indicate that taxpayers significantly overreport alimony payments and significantly underreport alimony receipts.

In the typical case, alimony flows from the higher-earner taxpayer to the lower-earner taxpayer. In a tax system having graduated rates, therefore, taxing the recipient of alimony rather than the payor results in a net reduction in the aggregate tax burdens of the two former spouses. If the tax savings to the payor and the tax detriment to the recipient are properly taken into account in setting the level of the alimony payments, the alimony recipient should obtain a net benefit from having been made taxable on the alimony payments. That is, the recipient would receive an additional alimony payment sufficient to pay the tax and to give that individual some fair share of the resulting tax savings. Divorce settlements that provide for the payment of alimony are typically structured so that they deflect some or all of the tax savings from the alimony deduction to the alimony recipient.

Under the conditions summarized above, former spouses would save taxes from the taxation of alimony payments to the recipient only if the person receiving the payment is in a lower tax bracket than the person making the payment. If they are in the same tax bracket, there is no tax savings. Although the flat tax would have only one statutory tax rate, it does have an implicit zero rate because of its standard deduction. If one former spouse's income, prior to receipt of an alimony payment, would be below the amount of the standard deduction, then the former spouses would benefit under the flat tax if alimony payments were taxable to the recipient. In other cases, there would be no overall benefit to the spouses under the flat tax.

For the reasons discussed above, the deduction for alimony generally results in a reduction in taxes paid by divorced couples; that revenue loss must be recouped by imposing higher taxes on other taxpayers. The overall impact on families with children from the deduction is therefore unclear. What we would need to know is whether the benefits that divorced couples with children receive from the deduction exceeds the detriment that other families with children suffer from paying higher taxes. We are aware of no organized data on this point. We speculate that divorce is more common for childless couples than for couples with children, but we also suspect that a childless former spouse is less likely to receive substantial alimony payments than a former spouse with children.

In the short run, the elimination of the alimony deduction under the Armey/Shelby flat tax would complicate life for former spouses who reached divorce settlements before enactment of the flat tax. The reversal of the treatment of alimony from the treatment of current law would give a temporary windfall to the alimony recipient and would create at least a temporary hardship for the alimony payor. In some cases, however, state family courts would be likely to reestablish the terms of the original divorce settlement by reducing the payor's alimony payment obligations to take account of the change in circumstances. The social costs of these renegotiations of old agreements could be high, not only in court costs and legal fees, but also in the resulting strain on those former couples who have lost the ability to get along together easily. Those costs should be taken into account in a full evaluation of the administrative advantages and disadvantages of this feature of the Armey/Shelby flat tax.

4. Child Support Payments

All of the reform proposals except the USA plan would retain the provision of current law that makes child support payments taxable to the payor and exempt to the recipient. The USA plan would allow a deduction to the payor and would make the payments taxable to the recipient. Both the USA plan and the flat tax plan would treat alimony payments and child-support payments in the same way — both deductible to the payor in the case of the USA plan and both taxable to the payor in the case of the flat-tax plan. As a result, divorced and separated parents would not need to make sharp distinctions between alimony and child support under these plans, which would thereby simplify their tax planning.

The proper tax policy treatment of child-support payments is unclear. Those who hold that the earner is the proper taxpayer on earned income presumably would oppose the deduction of support payments. The earner rule, however, is inconsistent with marital income splitting — an approach endorsed under current law and under the three reform proposals. If an income splitting approach is carried over to children, then child-support payments would be deductible to the payor and taxable to the *child*, not to the custodial parent. It certainly would be an odd result, however, to allow income splitting between separated parents and their children and to not allow it within fully intact families.

As discussed above, the dependency exemption can be understood as a mechanism for allowing limited income splitting with children. If the dependency exemption is generous, then the issue of who to tax on support payments has reduced importance, because the parent taxable on the support payments presumably would be the one who would be allowed to claim the dependency exemption.

In a tax system with graduated tax rates, a rule that taxed child-support payments to the recipient parent and made them deductible by the payor parent typically would result in lower aggregate taxes on those parents, assuming that the payments flow from the higher-bracket taxpayer to the lower-bracket taxpayer. The point is the same as the one made above with respect to alimony payments. Both parents would be better off under a deduction rule as long as some mechanism was in place that would require them to share fairly the net tax savings. Even in a single-rate system, such as the Armey/Shelby flat tax, divorced or separated parents would obtain a net benefit from the deduction rule whenever the recipient parent's income otherwise would have been below the tax-exempt level.

In the long run, the USA plan of taxing child-support payments to the recipient should favor both the recipient parent and the payor parent in most cases. In the short run, however, recipient parents with child-support agreements already in place would suffer some significant hardship unless they were able to get their child-support agreements amended to reflect the new rule. Many courts could be expected to respond favorably to a petition from a recipient parent for a readjustment in the court-approved child support order. Getting new support orders, however, would produce the same types of added complexity for divorced or separated parents and for the family courts as would arise from the proposal in the Armey/Shelby flat tax to change the current tax treatment of alimony payments.[42]

C. Indirect Effects on Families

The proposed treatment of the deductions for charitable giving, for home mortgage interest, and for state and local taxes under the reform proposals are summarized in Table 2.4, below. Section II, C, 1 discusses the likely impact of the elimination of the deduction for charitable giving on the overall level of such giving. Children have a major stake in the level of charitable giving to the extent that various charitable organizations — churches, universities, hospitals, research foundations, and poverty-relief groups, to name just a few — provide a range of important services and benefits to children.

Section II, C, 2 discusses the potential impact of an elimination of the deduction for home mortgage interest. Elimination of that deduction, according to some commentators, may affect the ability of middle-income families to obtain affordable housing — generally the largest expense in the budget of middle-income families. There are also potential benefits of repeal, however, especially to renters.

Section II, C, 3 discusses the possible impact of the reform proposals on the finance systems of state and local governments, which support many programs, such as public education, that are of fundamental importance to children. Two issues are addressed in that section — the proposed repeal of the deduction for state and local taxes, and the possible impact of major reform on the ability of the states to administer taxes on corporate and individual income.

Proposals for elimination or reform of the three deductions addressed in this section have been discussed frequently in the context of the current income tax. For example, the proposals for major reform made by the Treasury Department in 1984 included recommendations for eliminating the deduction for state and local taxes, for placing modest limits on the deduction for charitable giving, and for eliminating the home mortgage deduction for second homes.[43] We do not undertake in this report a full examination of the merits of those deductions or of the alternative spending programs that might be designed to achieve some of their goals in more efficient ways. Our limited objective is to highlight those aspects of the debate over those deductions that are particularly relevant in judging the overall impact of the various reform proposals on children and families. Whatever the merits of these deductions, their retention may affect decisions relating to tax rates, personal exemption levels, child credits, and other provisions that benefit children.

Table 2.4
Treatment of Certain Family-Sensitive Itemized Deductions: Current Law, Flat Tax, USA Tax, and 10-Percent Tax

Features of Tax Regime	Current Law (1996)	Flat Tax (wage tax component)	USA Tax (personal tax component)	10-Percent Tax
Deductions for charitable gifts	yes	no	yes*	no
Home mortgage interest deduction	yes	no	yes*	yes*
Deductions for state and local taxes	yes	no	no	no

* Changes in tax rates would affect the value of these deductions for many taxpayers.

1. Charitable Giving

Current law provides a deduction for gifts of money and property to organizations that qualify as charities under various statutory tests. In the case of cash gifts and gifts of intangible property such as shares of stock, the taxpayer may deduct the full value of the gift. A taxpayer making a gift of appreciated tangible property can deduct only the amount of his or her basis (typically cost minus previous tax benefits) in that property, and certain limitations would prevent a deduction in some cases. Various other limitations apply to prevent self-dealing and other perceived abuses and to limit the deduction to a percentage of the giver's income. The amount of charitable giving in the United States is estimated at over $100 billion a year, although a substantial fraction of that total is not claimed as a deduction on federal tax returns.

The charitable deduction has been a part of the tax code since 1917. The theory of the deduction, according to its legislative history, is that it compensates the giver for relieving the government of a financial burden that otherwise would have to be met by an appropriation of public funds.[44] As shown in Table 2.5, the cost in 1995 to the government in forgone revenue from the deduction is estimated at approximately $17 billion, with the tax benefits concentrated in the high-income group.

The USA tax is the only one of the three reform proposals that would retain the deduction for charitable giving, and then only in the individual component of that tax. Gifts by businesses, incorporated or otherwise, would not be deductible. Because the top rate of the USA tax is about the same as the top rate under current law, the tax savings to high-income taxpayers resulting from the deduction to individuals for cash gifts would remain about the same. Middle-income taxpayers would have an increased incentive to give under the USA tax, however, because the 40 percent rate is reached at fairly low income levels under the USA tax.

Despite continuation of the charitable deduction under the individual component of the USA plan, the incentive for individuals to give would be reduced somewhat, because taxpayers would lose the benefit they enjoy under current law of deducting the value of intangible and certain other property rather than their tax basis in that property. For example, under current law, if an individual buys stock for $100 and it appreciates in value to $200, she would be allowed a charitable deduction of $200. A deduction of $100 would be sufficient to treat persons donating property equally with persons making cash gifts; the deduction in excess of basis provides an added incentive to charitable giving.[45]

Although there is a fairly extensive economic literature on the impact of the charitable deduction on the levels of gift giving, there is no consensus on what that impact is.[46] Almost certainly the impact is sig-

Table 2.5
Charitable Contributions Deduction, 1995

Income Class ($000)	Total Tax Benefits ($000,000)
$0-50	$1,405
$50-100	$5,388
Over $100	$10,070
Total	**$16,862**

SOURCE: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000*, JCS-21-95 (1995)

nificant for gifts to certain types of charities. It also seems clear that substantial giving would continue even if the deduction for charitable giving were removed. For example, the conventional view is that gifts to churches would not be affected strongly by repeal of the deduction, but that gifts to the arts would be strongly affected.

The Armey/Shelby flat tax would affect charitable giving not only by removing the deduction, but also by eliminating the estate and gift tax.[47] Under current law, a wealthy person who transfers assets by gift or devise to friends or family must pay a substantial estate or gift tax on that transfer. That tax generally is avoided, however, if the transfer is made to a qualifying charity. For that reason, the estate and gift tax is thought to give wealthy individuals a significant impetus to make charitable gifts or to establish charitable foundations.

Some analysts have suggested that the deduction for charitable giving is not an efficient instrument for achieving its laudatory goals. They would replace the deduction either with a tax credit for charitable gifts or with some type of direct spending program. Any such replacement obviously would reduce the amount of revenue available for other purposes, such as reduction in the tax rate.

2. Home Mortgage Interest Deduction

Under current law, individual taxpayers who borrow money to buy or improve a personal residence or a vacation home may deduct the interest paid on their loan, to the extent that the amount of the loan does not exceed $1 million. If they borrow money after acquiring their home and put the home up as security (a "home equity loan"), they also may deduct the interest, subject to a cap of $100,000 on the amount of the loan. This deduction is available only to those who itemize their deductions and not to those claiming a standard deduction. In 1995, the mortgage interest deduction was claimed by 28 million taxpayers, for an estimated loss in foregone tax revenue of $58 billion. Table 2.6, below, shows the distribution by income class of the tax savings that taxpayers receive under current law from claiming the mortgage interest deduction.[48]

Table 2.6
Distribution of Tax Savings From Claiming Mortgage Interest Deduction, 1995

Income Class ($000)	Amount of Tax Benefits ($000,000)	Average Benefit Per Claimant ($)	Percentage of Total Tax Benefits	Percentage of Total Tax Returns
Nonitemizers	—	—	0%	74.4%
Itemizers Not Claiming	—	—	0%	4.3%
Itemizers Claiming				
$0-30	$905	$499	1.6%	1.4%
$30-75	$16,194	$1,108	27.8%	11.2%
$75-100	$12,253	$2,192	21.0%	4.3%
$100-200	$16,359	$3,603	28.0%	3.5%
Over $200	$12,624	$9,763	21.6%	1.0%
Totals	**$58,335**	**$465***	**100%**	**100%**

* Includes all filing units.

SOURCE: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000*, JCS-21-95 (1995)

The Armey/Shelby flat-tax proposal would eliminate the home mortgage interest deduction completely, without any transition rules. The USA plan would retain the deduction for home purchases (subject to the $1 million cap), but would eliminate the deduction for home equity loans. Under the Nunn/Domenici USA plan, however, the deduction would be available to all taxpayers, whether or not they itemize their deductions under current law. The Gephardt 10-percent tax would retain the home mortgage interest deduction of current law without change. Taxpayers who itemize their deductions would get a smaller tax benefit from the deduction, however, because of the general reduction in the tax rates.

As shown in Table 2.6, on the previous page, the home mortgage interest deduction currently provides no tax savings to taxpayers who do not itemize their deductions (about 74 percent of all tax returns). It also provides no tax savings to itemizing taxpayers who do not have a home mortgage (4.3 percent of total taxpayers). As a class, taxpayers with income below $30,000 receive a tax reduction of less than $500 per itemizer, whereas the average tax savings for itemizing taxpayers with income over $200,000 approaches $10,000. The average tax savings for itemizing taxpayers in the middle-income range ($30,000 to $75,000) is a little over $1,000.

The overall impact on families with dependent children of a repeal of the deduction for home mortgage interest is difficult to predict. That impact will depend in part on whether the basic features of the current income tax are continued, as they would be under the Gephardt 10-percent tax, or whether the current income tax is replaced with some form of consumption tax, such as the Armey/Shelby flat tax or the Nunn/Domenici USA plan. The continuation of the deduction under the Nunn/Domenici USA plan is likely to have effects quite different from current law.

It is beyond the scope of this report to provide a full discussion of the possible effects of the proposed repeal of the home mortgage deduction under the Armey/Shelby flat tax and the Gephardt 10-percent tax or of the proposed retention of the deduction under the Nunn/Domenici USA plan.[49] We do offer the following general observations.

- Renters are likely to benefit from any steps that reduce the relative advantage to homeowners, either under an income tax or under a consumption tax. Thus, poor and middle-class families with dependent children who rent their home would tend to benefit from repeal of the deduction, perhaps through lower housing costs, perhaps from lower tax rates.

- The primary tax benefit that individuals receive from home ownership under current law is the exclusion from gross income of the imputed income from investment in a personal residence. In a consumption tax, all gains from investment are treated favorably, thereby reducing the relative benefit obtained from home ownership.

- Under the current income tax, the deduction for home mortgage interest reduces inequality of treatment between taxpayers who own their own home outright and those who have a home mortgage, whereas it creates an inequality between renters and homeowners having a mortgage. In the USA plan, retaining the deduction would create an inequality between the two categories of homeowners that otherwise would not exist.

- The effect on families with children of the relative change in the benefits to renters and homeowners and homeowners with and without mortgages would depend on the number of families with children in each of those categories.

The tax reform literature is replete with proposals for repealing the deduction for home mortgage interest. Many analysts conclude that it is an inefficient subsidy for home ownership that primarily benefits high-income individuals with expensive homes — a group not in great need of a tax subsidy. Even if analysts reached a consensus in favor of repeal, however, they might not agree on the transition rules, if any, that should be provided to taxpayers who purchased a home in reliance on the deduction and who might have difficulty meeting their mortgage payments if the deduction were eliminated completely. Nor are they likely to agree on whether the federal government should seek to promote home ownership through some alternative means.

3. State and Local Taxation

All three reform plans would finance lower tax rates by eliminating the deduction for state and local taxes. That feature of the reform plans is addressed in Section II, C, 3, a. The Armey/Shelby flat tax and the Nunn/Domenici USA plan would eliminate the federal income taxes on individuals and corporations, to be replaced by taxes that differ significantly from the taxes now imposed by the states. Section II, C, 3, b discusses the implications that such a shift in federal taxes would have on the ability of the states to administer their current income taxes.

a. Deduction for State and Local Taxes

Current law allows taxpayers who itemize their deductions to deduct the amount of any income or property taxes that they have paid to a state or local government. For 1995, approximately 30 million taxpayers (21 percent of filers and 83 percent of itemizers) claimed a deduction for state and local taxes, with a cost in forgone federal tax revenue of approximately $26 billion.[50] All three of the reform proposals would eliminate the deduction for state and local taxes.

Some analysts have argued for repeal of the deduction for state and local income and property taxes on two grounds. First, they contend that the federal government should not create a bias in favor of the use by the states of income and property taxes — which the deduction for those taxes clearly does. Second, they claim that the deduction provides an unfair transfer of wealth from low-tax states, which often are relatively poor, to high-tax states, which often are relatively rich.

Supporters of the deduction for state and local taxes contend that the bias in favor of more progressive state income taxes is an appropriate federal policy. Indeed, they argue that the competitive pressures created by the federally mandated free trade among the states has the effect of undermining state power to impose progressive taxes and that the deduction is a rather modest step toward countering that effect. They also argue that the deduction for subnational income and property taxes is necessary to properly measure the net income of taxpayers, because the amounts paid as state and local income and property taxes generally do not result in additional consumption and savings for the particular taxpayers. They concede, however, that residents of high-tax states receive, on average, more services from their state and local governments than residents of low-tax states.

The impact on children of a repeal of the deduction for state and local income and property taxes is difficult to quantify, and we have not attempted to do so in this report.[51] There are several ways, nevertheless, that repeal might have some adverse or positive consequences for children, and especially for low-and middle-income children.

One obvious effect of the deduction for state and local income and property taxes is to reduce the burden of those taxes on the persons paying them and to shift a portion of it to individuals paying the federal income tax. This reduction in state burdens, in turn, may make it easier for states to impose such taxes. Children are likely to benefit from the shift of a portion of the burden of state taxes to the federal government to the extent that they generally benefit from a higher level of state and local services.[52] They are also potential beneficiaries from the lowering of the state taxes paid by their parents. At the federal level, however, the deduction for state and local taxes tends to favor taxpayers at higher-income levels. In addition, the revenue lost at the federal level must be made up for somehow, with negative consequences for whoever would pay that substitute tax or would receive lower benefits from a cut in federal expenditures.

Property taxes are a major source of funding for public education in most states, and children are the obvious beneficiaries of such funding. Children attending public schools in those states stand to benefit, therefore, from federal measures that make it easier for the states to impose property taxes.[53] The recent trend in several states, however, has been to rely less on the property tax to finance the schools, largely because of the inequality in spending levels among property-rich and property-poor school districts that tend to result from heavy reliance on property taxes. In any event, a property tax deduction is almost certainly a poorly targeted incentive for promoting the educational goals of the federal government.

The deduction for state and local income taxes provides an incentive to states to use those taxes rather than more regressive taxes, such as the sales tax, to finance their expenditures. It is not at all clear, however, that the states have acted in response to that incentive. Low- and middle-income families, along with other low-and middle-income taxpayers, tend to pay less in state and local taxes when their state relies for revenue on graduated or flat-rate income taxes rather than on regressive sales taxes. Of course, high-income taxpayers, including high-income families, tend to benefit when a state relies on regressive taxes.

b. Effects on State Tax Administration of Replacement of Federal Individual and Corporate Income Taxes

Some commentators contend that the Armey/Shelby flat tax and the Nunn/Domenici USA tax pose major administrative problems for the states.[54] The Gephardt 10-percent tax, because it retains the basic design features of current law, is not likely to affect the administration of state taxes very much. The adoption of the flat tax or the USA tax, however, would create major administrative problems for the states if they attempted to continue their current systems, and it would create strong incentives for them to adapt their systems to fit the new federal model. Serious technical and transitional problems would arise, moreover, even if the states were prepared to abandon their present commitment to income taxes.

Most of the states collect a substantial fraction of their tax revenues from their individual and corporate income taxes, with the individual income tax being the more important. For 1991, the states on average obtained 25 percent of their revenues from those two sources. The median percentage is 26 percent, and the range is wide. Delaware, Maryland, and Massachusetts obtained over 40 percent of their total tax revenue from those sources, whereas Texas, Nevada, Washington, and Wyoming did not collect any income tax revenues. New York was ranked ninth at 32 percent and California was eleventh at 31 percent. The percentage of revenue from income taxes was over 20 percent for 36 of the 50 states. More than 75 percent of the income tax revenue typically comes from the individual income tax.[55]

In administering their income taxes, the states rely heavily on federal tax audits for enforcement and on information provided to the federal government by taxpayers on various information reporting forms. Both the flat tax and the USA tax, however, would abolish the federal corporate tax, thereby eliminating a significant portion of the current federal information reporting requirements. Although the states still would be able to obtain some limited information from the federal government that would be useful to them in enforcing their corporate income taxes, they would get far less useful information than they now receive.

The flat tax and the USA tax also would abolish a major part of the tax on individuals. Under the flat tax, the federal government would not collect information on the interest, dividends, rents, royalties, and capital gains of individual taxpayers. Individual taxpayers would report only their cash wages and pension distributions to the federal government. To continue to impose income taxes in their present forms, therefore, the states would need to obtain information about the investment income of their taxpayers largely without federal assistance. Under the USA tax, the federal government would continue to collect some information on investments in order to police the unlimited savings allowance. Even under that plan, however, the states would get less information than they currently receive. For example, they would not routinely receive information reports on the amount of investment income earned in a USA account or on the business income derived by individuals.

The states might be able to substitute the business tax component of the Nunn/Domenici USA plan or the Armey/Shelby flat tax for their current corporate income taxes. At this early stage of the reform process, it is uncertain whether the many technical issues that those taxes present can be worked out satisfactorily. In principle, however, the states could piggyback onto those taxes in much the same way that they currently piggyback on the federal corporate tax.

Endnotes

1 We address child-support issues in this part because of their close relationship with alimony payments.

2 The dependency exemption, of course, may be available to the non-custodial parent under some circumstances.

3 We have just presented in outline form the argument that a consumption tax should impose burdens with reference to the ability to pay of the consumer and that an income tax should impose burdens with reference to the ability to pay of the consumer or saver. See Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax," 90 *Harvard Law Review* 1573-1630 (1977).

4 We use the term "tax relief" generically to refer to a tax benefit conferred through the tax system, without reference to whether that relief is justified on tax policy grounds or on spending grounds (or is not justified at all).

5 For a proposal for a unified credit, see C. Eugene Steuerle and Jason Juffras, "A $1,000 Tax Credit for Every Child: A Base of Reform for the Nation's Tax, Welfare, and Health Systems," Urban Institute (1991); "Child Credits: Statement of C. Eugene Steuerle before Senate Finance Committee," August 7, 1995. For a proposal for a unified deduction mechanism that was ultimately adopted by New York State, see Michael J. McIntyre, "Tax Consequences of Family Sharing Practices Under New York Law: A Critique and a Proposal for Reform," 49 *Albany Law Review* 275-351 (1985) at 342.

6 For example, current law allows a non-custodial parent to claim a dependency exemption but not an earned income tax credit.

7 One effect of the phase-out is to raise the top marginal tax rate for some high-income taxpayers with children above the top statutory rate (39.6%) in the rate schedules. In 1996, the phase-out begins for married couples at adjusted gross income of $176,950, for heads of household at $147,450, and for single individuals at $117,950. These phase-out thresholds are adjusted annually for inflation. As a result of the phase-out, tax burdens are not adjusted for differences in family size at high-income levels.

8 Employee benefits would be included in the tax base of the business component of the USA plan. Our assumption, however, is that the burden of that tax would be passed forward to consumers rather than backward to employees. Of course, employees would be taxable, at the rate of 11%, on their purchases of goods and services, and they would not be protected from tax by the personal exemptions.

9 The fact that the tax-exempt amounts apply only to wage and pension income is significantly less important for families with children at middle-and upper-income levels, because most of those taxpayers will have sufficient wage income to utilize the full amount of the exemption.

10 At the initial 20-percent rate, the approximate cost in forgone revenue under the flat tax of increasing the dependency exemption from $2,550 to $5,000 could be computed by multiplying $2,450 by 20% by the number of exemptions. Under current law, taxpayers claim approx-

imately 70 million exemptions. Assuming no change in that number under the flat tax, the revenue cost of the increase in the exemption level would be approximately $34 billion. In fact, some taxpayers currently claiming dependency exemptions would be below the tax-free thresholds under the flat tax and would not benefit from the increase in the exemptions.

11 The Institute on Taxation and Economic Policy (ITEP) simulation of the flat tax presented in Section III suggests that the benefits to families with dependent children from the large dependency exemption are more than offset, on average, by various features of the flat tax that are unfavorable to such families.

12 In addition to the shift in income tax burdens, the FICA (Social Security) payroll taxes also have risen substantially over this same period. The main impact of the FICA tax has been on middle-class workers, many of whom are supporting and caring for dependents. The FICA tax makes no adjustments for family size.

13 The view that income spent for a child should be taxable to the child is not necessarily inconsistent with the view that having children constitutes a consumption choice. Assume, for example, that one individual chooses to have a child and another individual chooses to acquire a racehorse. Both individuals have made what can be characterized as a consumption choice. Assume that the child and the horse both earn income. The owner of the horse is taxable on the horse's earnings, whereas the earnings of the child are taxable to the child. Once children are recognized as taxpayers in their own right, then the question arises as to whether they or their parents should be taxable on income spent for their benefit.

14 H.R. 2491, The Balanced Budget Act of 1995, would have granted taxpayers a nonrefundable tax credit of $500 for each qualifying child under the age of 18. The credit is phased out, beginning at $110,000 for married taxpayers filing joint returns, and at $75,000 for taxpayers filing single or head-of-household returns. Neither the credit amount nor the threshold for the phase-out rules would be indexed for inflation.

15 The proposal would provide taxpayers with a nonrefundable tax credit of $300 for each qualifying child under the age of 13 for taxable years 1996, 1997, and 1998, with the amount of the credit increased to $500 for subsequent years. The credit would lapse if certain deficit reduction targets were not met. It would be phased out ratably for taxpayers with adjusted gross income (AGI) over $60,000, and would be fully phased out at AGI of $75,000. Beginning after calendar year 1999, the maximum credit and the beginning point of the phase-out range would be indexed annually for inflation.

16 It is sometimes argued that a credit is more progressive than an exemption, because an exemption is worth more at higher tax rates. This point is obviously correct if the only feature of the tax system being changed is the credit or exemption. In the context of a reform that might include rate changes, however, the use of a credit combined with an increase in tax rates could be exactly as progressive as the use of an exemption, assuming that progressivity is measured by reference to the burdens imposed on various income classes. Unless all taxpayers were receiving the credit or exemption or were of the same family size, however, the impact on particular taxpayers within each income class would not necessarily be precisely the same under the two mechanisms.

17 As suggested above, a dependency exemption of around $10,000 would be needed to replicate the benefits that the exemption provided to parents of dependent children in 1948. A child credit of $1,500 would not be enough to fully replace those benefits, in part because the bottom rate in 1948 was higher than 15 percent, and in part because the 1948 tax rate schedule had steeply graduated rates, with a top rate over 90 percent. A credit of less than $400 would be needed to provide the benefits that low-income parents and most middle-income parents obtain from the dependency exemption under current law.

18 The other reason is that the flat tax would impose tax on employer-provided health insurance and certain other fringe benefits (not pensions) and on the employer portion of the FICA payroll tax.

19 For discussion of such definitional problems, see Michael J. McIntyre, "A Solution to the Problem of Defining a Tax Expenditure," 14/1 *U.C. Davis Law Review* 79-103 (1980).

20 For presentation of a proposal for dividing the EITC into a welfare component to be administered through a refundable credit and a direct exemption for the working poor from the FICA tax, see George K. Yin and Jonathan Barry Forman, "Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor," 59 *Tax Notes* 951-960 (May 17, 1993).

21 Current law allows employers to deduct their portion of the FICA tax. That deduction is equivalent to a credit, the amount of which can be determined by multiplying the deduction by the employer's tax rate. For an employer in the 35% bracket (the bracket applicable to most corporate employers), the deduction is equivalent to a credit of about 2.7%. Thus, the USA plan implicitly adds a FICA credit of approximately 12.6% to the implicit FICA credit under current law of approximately 2.7%. Our assumption here is that businesses would pass on the after-tax cost of the FICA tax to their employees. This assumption is not entirely consistent with our general assumption that the business portion of the USA plan would be passed on to consumers. It seems justifiable, however, because the FICA tax would not be a uniform burden on value added; rather, it would be a burden proportional to wages paid.

22 We note that the sponsors of the USA plan set its rates for middle-income taxpayers to achieve distributional neutrality; they would most likely reexamine their rate structure if they revised their treatment of the FICA credit or the EITC.

23 In evaluating the FICA credit, it is assumed that its benefits would be passed on to workers. Workers whose wage level is set by the minimum wage, however, run the risk that they would not receive the benefit of the credit.

24 C. Eugene Steuerle, "The IRS Cannot Control the New Superterranean Economy," 59 *Tax Notes* 1839-1840 (June 28, 1993). The IRS apparently has not yet detected significant evidence of a superterranean economy. The risk appears to be serious enough, however, that the Clinton administration developed a proposal in 1995 to reduce the incentive for inflating self-employment income.

25 One recent study of AFDC recipients indicates that members of those households frequently face combined "tax" rates under the welfare and tax systems in excess of 70 percent. See Linda Giannarelli and Eugene Steuerle, "The True Tax Rates Faced by Welfare Recipients," 1995 *NTA Proceedings* (88th Annual Conference), forthcoming. These implicit tax rates are derived not only from the individual income tax, but also from Social Security taxes, state and local income taxes, the phase-out of the EITC, and the phase-out of various welfare benefits such as AFDC, Food Stamps, Medicaid, and housing subsidies. But see Janet Holtzblatt, Janet McCubbin, and Robert Gillette, "Promoting Work through the EITC," 48 *National Tax Journal* 591-607 (1994) (suggesting that the EITC changes in 1993 generally reduced marginal tax rates facing many families with children).

26 To a modest degree, the EITC of current law operates to reduce poverty traps.

27 A recent article argues that the child-care allowance is progressive with respect to income, measured over a short- and a medium-time period. See Rosanne Altshuler and Amy Ellen Schwartz, "On the Progressivity of the Child-Care Tax Credit: Snapshot Versus Time-Exposure Incidence," 49 *National Tax Journal* 55-71 (1996).

28 See C. Eugene Steuerle, "Tax Credits for Low-Income Workers with Children," 4 *The Journal of Economic Perspectives* 201-212 (1990). See also Michael J. McIntyre, "Evaluating the New Tax Credit for Child Care and Maid Service," 5 *Tax Notes* 7-9 (May 23, 1977).

29 Both the proponents and critics of the child-care credit agree that some of the technical features of the child-care credit, including the use of a credit rather than a deduction, are inconsistent with a business-expense rationale for the allowance. Of course, these features of the credit do not undermine the case for some allowance for child-care expenses.

30 See Michael J. McIntyre, "Fairness to Family Members Under Current Tax Reform Proposals," 4 *American Journal of Tax Policy* 155-192 (1985) at 174, note 40.

31 An additional argument sometimes made for a child-care allowance is that such an allowance is allegedly an effective measure for indirectly taxing the parents in a one-earner, two-parent family on the imputed income they derive from the child-care services performed by the stay at-home spouse. For a lengthy discussion of the implicit premises of this argument and a rejection of them, see Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax," 90 *Harvard Law Review* 1573-1630 (1977) at 1609-1620.

32 This result is achieved by repealing IRC § 129, which allows employees to exclude from gross income the "dependent care assistance" provided by their employer.

33 For example, assume that a head of household has $10,000 in wages and $2,000 in child-care costs. That individual's net additional income from work clearly is not $10,000. Nor is there a spouse at home generating nonmarket income.

34 To simplify compliance with this rule, parents may elect to include the investment income of their children on their own tax return.

35 However, an adjunct to the kiddie tax — the denial of a taxpayer exemption to a child who is declared as a dependent on someone else's tax return — has increased filing complexity significantly. Some analysts defend the so-called double exemption, whereas others oppose it.

36 The supporters of the flat tax may also have wanted to eliminate the need for dependent children to file their own tax return.

37 Some analysts argue that this should be the goal of an income tax employing the Haig/Simons income concept, which defines income for tax purposes as the sum of the market value of taxpayer's consumption for the year plus the net change in the taxpayer's savings for that year. Simons did not address the income-attribution issues presented by his income definition. See Henry Simons, *Personal Income Taxation* (1938). For an attempt to link the choice of income attribution rules with the choice of the tax base, see Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax," 90 *Harvard Law Review* 1573-1630 (1977); see also Michael

J. McIntyre, "Implications of Family Sharing for the Design of an Ideal Personal Tax System," Chapter 6 of *The Personal Income Tax: Phoenix from the Ashes* (Richard Bird and Sijbren Cnossen, eds.) (1990).

38 Some commentators sought to defend that compromise on the grounds that it served as an effective mechanism for taxing the alleged "economies of scale" of communal living. No attempt was made to quantify those alleged benefits or to explain why they should be treated differently for tax purposes from other forms of untaxed consumer surplus. For a detailed criticism of the economies-of-scale argument, see Michael J. McIntyre, "What Should Be Redistributed in a Redistributive Income Tax?: Retrospective Comments on the Carter Commission Report," in W. Neil Brooks, ed., *The Quest for Tax Reform* 189-209 (1988) at 197.

39 Married taxpayers with dependent children, however, would continue to bear a modest marriage penalty because the exemption offered to a single head of household under the flat tax plan is $330 larger ($14,000– $10,700) than the per capita exemption offered to married individuals. For example, assuming a flat-tax rate of 20 percent, marital partners with two children would save a total of $132 ($330 x 0.2 x 2) in taxes under the flat tax if they divorced and claimed the standard deduction for a head of household.

40 For example, assume that A, who earns income of $5,000, marries B, who earns income of $45,000. Assume also that the tax system provides a per capita tax-exempt amount of $10,000, allows joint filings for married couples, and imposes tax on amounts above the tax-exempt amount at 20%. Before marriage, A is exempt from tax and B is liable for tax of $7,000 (20% of ($45,000 – $10,000)). After marriage, the tax is $6,000 (20% of ($45,000 + $5,000 – $10,000 – $10,000)). Assuming that A and B are fully sharing income, A's level of income spent on himself goes from $45,000 to $25,000.

41 For one-earner married couples with children, some of the reduction in the benefits that they previously received from income splitting would be obtained instead through the larger dependency exemption provided in the Armey/Shelby flat-tax proposal.

42 The USA plan, as initially proposed, would have retained the treatment of child-support payments provided under current law.

43 See Treasury Department, 1 *Tax Reform for Fairness, Simplicity, and Economic Growth* (1994) at 77-84 (popularly referred to as "Treasury I").

44 The legitimacy of the charitable deduction has been a matter of extensive debate among tax analysts. See, e.g., William D. Andrews, "Personal Deductions in an Ideal Income Tax," 86 *Harvard Law Review* 309-385 (1972); Mark Kelman, "Personal Deductions Revisited: Why They Fit Poorly in an 'Ideal' Income Tax and Why They Fit Worse in a Far from Ideal World," 31 *Stanford Law Review* 831-883 (1979). See also C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," 12 *The American Journal of Tax Policy* 399-447 (1995).

45 One commentator has suggested that the tax incentive for charitable giving would be reduced under the USA tax because saved income would become more valuable to an individual under that tax plan than it is under current law, whereas the tax benefit from the deduction would remain the same. See Alan L. Feld, "Nunn-Domenici and Nonprofits," 68 *Tax Notes* 1119-1120 (Aug. 28, 1995).

46 For discussion of that literature and an attempt to assess the impact of recent tax reforms on charitable giving, see Charles T. Clotfelter, Chapter 7, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," and especially the comments on that chapter by Don Fullerton, in *Do Taxes Matter: The Impact of the Tax Reform Act of 1986* 203–242, Joel Slemrod, ed. (1990). See also William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," 103/4 *Journal of Political Economy* 709-738 (1995); Charles T. Clotfelter and Richard Schmalbeck, "Effects of Reform on Charitable Giving and Nonprofit Institutions," paper presented at Brookings Institution conference, "The Economic Effects of Fundamental Tax Reform," Feb. 15-16, 1996 (forthcoming).

47 In addition, the Armey/Shelby flat tax would require the non-profit sector, including all charitable organizations and state and local governments, to administer a special tax on employee fringe benefits provided by employers. The primary benefit taxed under that scheme would be employer-provided health insurance. This feature of the flat tax might reduce the net amounts available to charities if charities end up bearing the burden of some portion of that tax. (Our general assumption is that the fringe benefit tax will be passed on to employees, but in the short run, full shifting to employees is not very likely.) Extending the employee benefit tax to the non-profit sector, however, would be necessary under the flat tax to avoid discrimination against employees in the for-profit sector. We do not attempt in this report to evaluate the overall merits of a tax on employee benefits.

48 Table 2.6 shows tax savings; it does not necessarily show the benefits obtained from the deduction. The primary benefit that taxpayers obtain from the treatment of home ownership under current law is the exclusion of the rental value of their home from their gross income. In a tax system that taxed such imputed income, the deduction would be proper, and the persons treated improperly would be homeowners who were paying interest on their mortgage but were taking the standard deduction.

49 For an analysis of the impact of various tax reform proposals on housing, see Jane Gravelle, "The Flat Tax and Other Proposals: Effects on Housing," Congressional Research Service Report 96-379, April 29, 1996. See also Patric Hendershott, Richard Green, and Dennis Capozza,

"Effects of Reform on Home Ownership and Housing Prices," paper presented at Brookings Institution conference, "The Economic Effects of Fundamental Tax Reform," Feb. 15-16, 1996 (forthcoming).

50 Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000*, JCS-21-95 (1995), Tables 2 and 3.

51 For discussion of the estimation problems and an attempted partial solution, see Paul N. Courant and Edward M. Gramlich, Chapter 8, "The Impact of the Tax Reform Act of 1986 on State and Local Behavior," and especially the comments on that chapter by Steven D. Gold, in *Do Taxes Matter: The Impact of the Tax Reform Act of 1986* 243-285, Joel Slemrod, ed. (1990).

52 For state-by-state data on recent and historical levels of state and local spending on education and other children's services, see Steven D. Gold et al., "State Investments in Education and Other Children's Services: Fiscal Profiles of the 50 States," prepared for The Finance Project, September 1995.

53 We do not mean to imply that only children benefit from their education. In our view, the social gains from public education are rather widely distributed.

54 See Dan R. Buck, "Federal Tax Restructuring: Perils and Possibilities for the States," 9 *State Tax Notes* 415-418 (Aug. 7, 1995). A revised and updated version of that article is forthcoming in the newsletter of the Multistate Tax Commission. For additional discussion, see Douglas Holtz-Eakin, "Consumption-Based Tax Reform and the State-Local Sector: A Study for the American Tax Policy Institute" (forthcoming).

55 The data on state taxes are derived from the Institute on Taxation and Economic Policy (ITEP) State Tax Model.

III. Simulated Impact of Armey/Shelby Flat Tax on Families with Children

ONE WAY to estimate the distributional impact of a proposed tax reform on certain categories of taxpayers is to simulate its effects on a representative sample of the taxpaying population. In this section, we present the results of some simulations of the Armey/Shelby flat tax. The objective of these simulations is to provide information on the overall impact of that version of the flat tax on families with dependent children. These simulations are particularly interesting in the case of the flat tax, because the distributional impact of that tax is expected to differ substantially from the distribution of tax burdens under current law. In selecting that tax for simulation, we do not imply anything about its relative merits or importance. We have omitted a simulation of the other reform proposals addressed in this report because of restraints of time and resources.

The simulations presented in this section were produced for us by the Institute on Taxation and Economic Policy (ITEP), using its microsimulation tax model. We refer to that model as the ITEP Model. The basic features of that model are described in Appendix B. That model allows us to estimate the average tax burdens that various categories of taxpayers would pay at various income levels under current law and under the flat tax, as proposed and as modified by us to meet revenue targets and certain design objectives. Simulations were done for categories of taxpayers specified by marital status and by the number of dependent children in the family. Our findings do not appear to be sensitive to the specific features of the ITEP Model.

One virtue of a good simulation is that it imposes certain consistency requirements on a tax proposal. For example, if a proposal promises low rates and large exemptions and also promises to raise a specified amount of tax revenue, a simulation should determine whether those promises can be kept or are mutually incompatible under some set of plausible assumptions. Another virtue of a good simulation is that it can estimate the likely overall impact on a target group of a variety of tax changes, some of which are favorable to that group and some of which are not. For example, the ITEP Model allows us to determine whether the benefits to families of the large dependency exemption proposed for the flat tax are sufficient to overcome certain features of the flat tax proposal that are unfavorable to families with dependent children.

A third virtue of a simulation is that it can estimate the distributional impact of certain changes in a proposed reform. The ITEP Model was used to estimate the distributional impact of raising the rate of the Armey/Shelby flat tax and reducing its exemption levels so as to raise more revenue. The distributional impact of providing certain transitional rules to the flat tax was also simulated.

The results of our simulations are in line with other studies of the Armey/Shelby flat tax and do not appear to be sensitive to the choice of tax model. Here, however, we provide considerably greater detail on the impact of the Armey/Shelby flat tax on particular types of filing units at various income levels.[1] The simulations are for calendar year 1996. The ITEP Model and other models of its type do not provide information on the lifetime effects of tax changes on taxpayers.

The Armey/Shelby flat tax proposal includes some features that would be beneficial to many families with children and some that would increase their tax burdens over current law. Features of the flat tax that would tend to benefit families with children would include:

- Larger dependency exemption (up from $2,550 to $5,000).
- Larger tax-free levels (up from $5,900 for each married person to $10,700).[2]
- In addition, families currently in marginal tax brackets above 15 percent could see a reduction in their marginal tax rate.[3]

On the other side of the accounting ledger are various proposed changes that would be detrimental to many families with children. Those changes would include:

- Repeal of the Earned Income Tax Credit (EITC);[4]
- Taxation under the business component of the flat tax of certain employee fringe benefits, such as employer-provided health insurance, with the burden of that tax passed on to workers in the form of lower wages;[5]
- Full taxation without deduction of the employer portion of the FICA tax;[6]
- Repeal of the child-care credit;
- Higher marginal tax rate (up from 15 percent) for most families with children; and
- Lower tax burden on investment income (see Figure 1.1 in Section I, above).

Prior simulations of the Armey/Shelby flat tax, by the Treasury Department and by the Tax Foundation, have indicated that it would increase the share of the tax burdens for all income classes below $200,000 and would reduce the share of taxes substantially for taxpayers with income over $200,000.[7] The overall results under the ITEP Model are very similar to Treasury's findings and are qualitatively similar to the findings of the Tax Foundation.[8]

One question addressed in this report is whether that same distributional pattern would emerge for low-, middle-, and high-income families with children. The simple answer to the question is "yes," with a more detailed answer provided below.

The other question addressed here is how various types of households with children would fare under the flat tax relative to taxpayers without children. As the tables below demonstrate, the answer to that question depends in part on the version of the flat tax that is under scrutiny. The general result, however, is that families with children do not do well under any of the versions of the flat tax examined here except at the very highest income level, and even at that level they generally do not do as well as taxpayers without children. Large families generally do better than small families under the various versions of the flat tax, probably because they benefit disproportionally from the increase in the dependency exemption, but they do not do as well as taxpayers without children.

Revenue Neutrality

The proposed tax rate under the Armey/Shelby flat tax is 20 percent, with a drop to 17 percent in two years if that drop would not increase the deficit. Under current federal government revenue levels, neither tax rate would provide a revenue-neutral change in the tax system according to simulations by the Treasury Department and by the ITEP Model. That is, the federal government would be expected under these simulations to take in less revenue under the flat tax (at either 17 percent or 20 percent) than it would take in under the current income tax. At a 20-percent flat rate, the estimated revenue loss is $30 billion under the Treasury Department's study and $49 billion under the ITEP Model.[9] At a 17 percent rate, the flat-tax revenue shortfall is $138 billion under the Treasury Department's estimate and $156 billion under the ITEP Model. The shortfall is very much larger if transition rules are provided under the business component of the flat tax. Transition rules of that type have been a normal feature of prior tax reforms.

To determine the impact of tax reform on families with children, any comparison between a reform proposal and current law must be done on a revenue-neutral basis to yield meaningful results. To make the point, assume that some would-be tax reformer proposed a flat tax with a tax rate of 5 percent and asserted that all families with children would do well under that reform. That claim is likely to be true as long as the impact on families with children of the resulting federal deficit or the resulting spending cuts (or some combination of both) is ignored. Note, however, that the shift in relative burdens between households with children and those without children is likely to be about the same whether or not the comparison is made in a revenue-neutral context.

The following three comparisons might be made to determine the distributional implications of a proposed tax reform that is estimated to lose revenue:

- Compare the distributional effects of current tax law to the distributional effects of the proposed tax reform and a package of spending cuts;
- Compare the distributional effects of current law, modified to reduce its revenue yield, to the distributional effects of the reform proposal; and
- Compare the distributional effects of current tax law to the distributional effects of the proposed reform, modified to increase its revenue yield.

The first of these three approaches is unattractive, because it is unclear what spending cuts might be made to finance the projected revenue loss under the flat tax. In addition, the distributional impact of many spending cuts is difficult to model. Who are the specific beneficiaries, for example, of amounts spent on national defense or on controlling air pollution?

We have adopted both the second and the third methods. Employing the second method, we have compared the flat tax as proposed (at a 17-percent rate and a 20-percent rate) with a version of current law that would raise, according to the ITEP Model, the same amount of revenue as the proposed versions of the flat tax. To avoid getting enmeshed in disputes about the proper distribution of the simulated cuts in taxes under current law, we distributed those cuts pro rata to taxpayers in accordance with their simulated liabilities under current law. Thus, if the proposed reform would cut revenues by 10 percent, we compare that proposal with current law after awarding all taxpayers in the ITEP Model a 10-percent across-the-board cut.

To employ the third method, we compared the distributional effects of current law with the distributional effects of a flat-tax proposal that was modified to make it revenue neutral. The flat tax, by design, is not very flexible. As a practical matter, the only two features of that tax that could be modified easily to raise significant amounts of revenue are the tax rate and the exemption levels. We present below the results of several different simulations in which one or both of these two variables were modified. In some simulations, the large standard deductions and dependency exemption proposed in the Armey/Shelby plan were retained, and the tax rate was increased sufficiently to make the tax plan revenue neutral. In other simulations, the exemptions were scaled back sharply so as to minimize the rate increase needed to make the tax plan revenue neutral. This general approach was followed by the Treasury Department when it simulated the distributional impact of the Armey/Shelby flat tax.

In the discussion below, we use the term "large exemptions" to refer to the exemptions as proposed in the Armey/Shelby plan. The term "modest exemptions" refers to the exemptions that have been scaled back to reduce the revenue loss otherwise resulting under the proposal.[10]

Some proponents of the flat tax have asserted that adoption of the tax would result in substantial revenue gains that would obviate the need for increasing the proposed flat-tax rate or scaling back its exemption levels. We do not address that issue in this report. Many supporters of the Armey/Shelby flat tax, including Congressman Richard Armey, have indicated that they intend their proposal to be "deficit neutral" — that is, they intend that their plan, in conjunction with certain spending cuts, would not increase the deficit, even if its adoption has no positive impact on economic growth.[11] Indeed, they already have modified their proposal in this direction.

Incidence Assumptions Incorporated into the ITEP Model

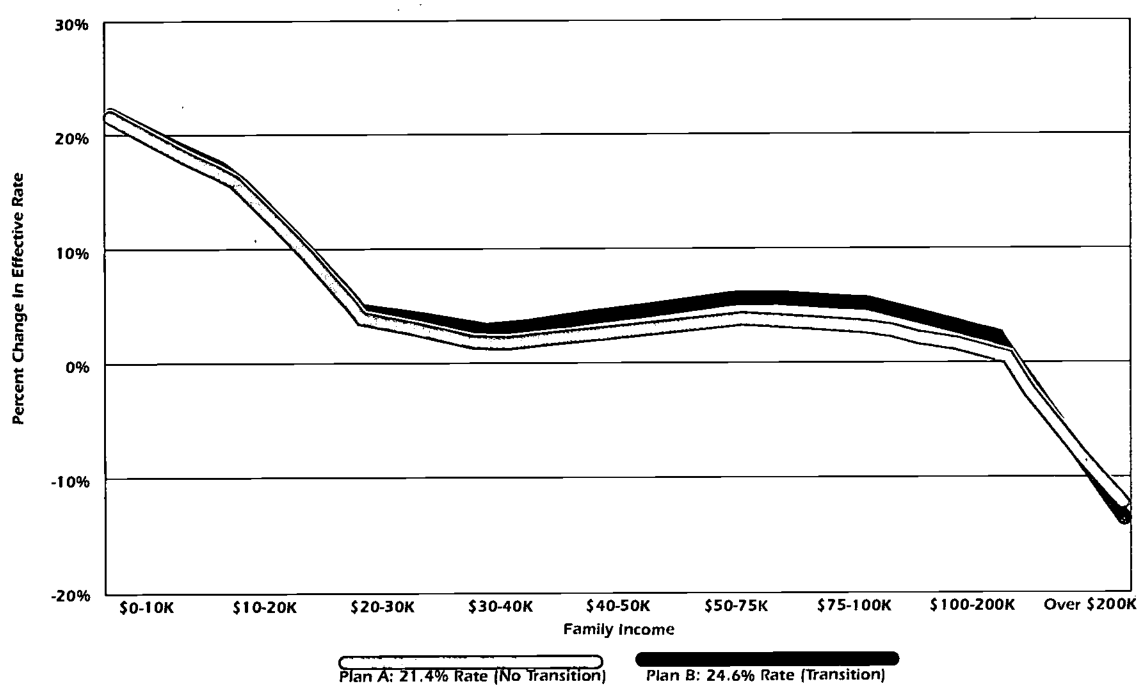
To simulate the distributional effects of a tax proposal, it is necessary to build into the tax model some assumptions about who would bear the burden of that tax. Who bears the burden of a tax — the incidence of a tax — is a classically difficult question for tax analysts to answer. The question is particularly difficult for the flat tax, which is a new tax that combines features of various familiar taxes in ways that might affect its incidence. That is, the tax has features of a wage tax, a value-added tax, and a tax on capital. There is not any clear consensus among tax analysts about the incidence of a flat tax.

The ITEP Model incorporates the following assumptions about the incidence of the Armey/Shelby flat tax:

- The wage tax is paid by the wage earner;
- That portion of the business tax that is imposed on employee benefits and on FICA taxes is passed on to employees in the form of lower wages; and
- The remaining portion of the business tax is passed on in part to consumers and in part to holders of capital.[12]

The first of these assumptions is unlikely to be controversial. The Treasury Department indulged that assumption and also the second assumption in its study of the flat tax. The second assumption is consistent with the general view in the economics literature that the employer portion of the FICA tax is passed on to workers in the form of lower wages. The third assumption differs from the assumption made by the Treasury Department in its study of the flat tax. Treasury assumed that all of the remaining portion of the flat tax would be borne by capital. Some might dispute whether that assumption is realistic. Some of the tax is likely to be borne by capital, but some of it might be passed on to consumers in the form of higher prices for the goods and services produced by the enterprises subject to the flat tax.[13] Because of a concern that this assumption might be critical to our inquiry, we obtained results of simulations that incorporated

Figure 3.1
Changes From Current Law (1996) in Effective Tax Rates for Families with Dependent Children Under Revenue-Neutral Flat-Rate Tax With Proposed Large Exemptions



our assumption and results that incorporated the Treasury Department's assumption. The results differed in their details but were essentially the same.

Changes in Effective Tax Rates

Figure 3.1, above, shows the changes in effective tax rates that families with children would face if Congress adopted one of two alternative versions of the Armey/Shelby flat-tax proposal as a replacement for the current individual and corporate income taxes and the current estate and gift tax.[14] The first version, labelled "Plan A," is revenue neutral under the ITEP Model at a tax rate of 21.4 percent; it would have large exemptions and no transition rules. The second version, labelled "Plan B," is revenue neutral at a tax rate of 24.6 percent; it also would have large exemptions and would provide full transition rules to eliminate a double tax on "old capital" — i.e., on assets acquired before the introduction of the tax. Under the ITEP Model, 3.2 percentage points must be added to the flat-tax rate in order to finance transition relief.

As Figure 3.1 illustrates, families with children would face significant tax increases at the bottom end of the income spectrum and some increases at all income levels below $200,000 under both of the versions of the flat tax shown therein. The substantial increases in effective tax rates at low-income levels are due primarily to the proposed repeal of the earned income tax credit and to the taxation of various employee benefits (primarily health care benefits) and the employer portion of FICA taxes under the business component of the flat tax. A notable feature of Figure 3.1 is that it shows almost no difference in the effective tax rates on low-income families when the rate of the flat tax is increased from 21.4 percent to 24.6 percent.

For high-income taxpayers, the rate relief and the exclusion of investment income from the tax base of the individual component of the flat tax would combine to produce very large reductions in effective tax rates, whether the flat-tax rate is set at 21.4 percent or at 24.6 percent. Transition relief reduces taxes at the high end even more.

Within the middle-income range, families with children would pay higher taxes, on average, at each income level, notwithstanding the large proposed increase in the standard deductions and dependency exemption. The various detriments that the flat tax proposal would provide to families with children more than cancel out the benefits. Transition relief apparently provides little benefit to middle-income families; the higher rates necessary to provide that relief end up raising taxes, on average, at each middle-income level.

Changes in Burdens for Middle-Income Families

Table 3.1, below, presents the results for middle-income families under two alternative versions of the Armey/Shelby flat tax. The first version is Plan B, presented above. It has a revenue-neutral rate of 24.6 percent, provides full transition rules, and provides the large exemptions as proposed. The second version, "Plan C," has a low rate of only 17.3 percent, very close to the long-term rate of 17 percent proposed in the Armey/Shelby plan. To make Plan C revenue neutral, the exemption levels were reduced, from large to modest, and transition rules were eliminated.

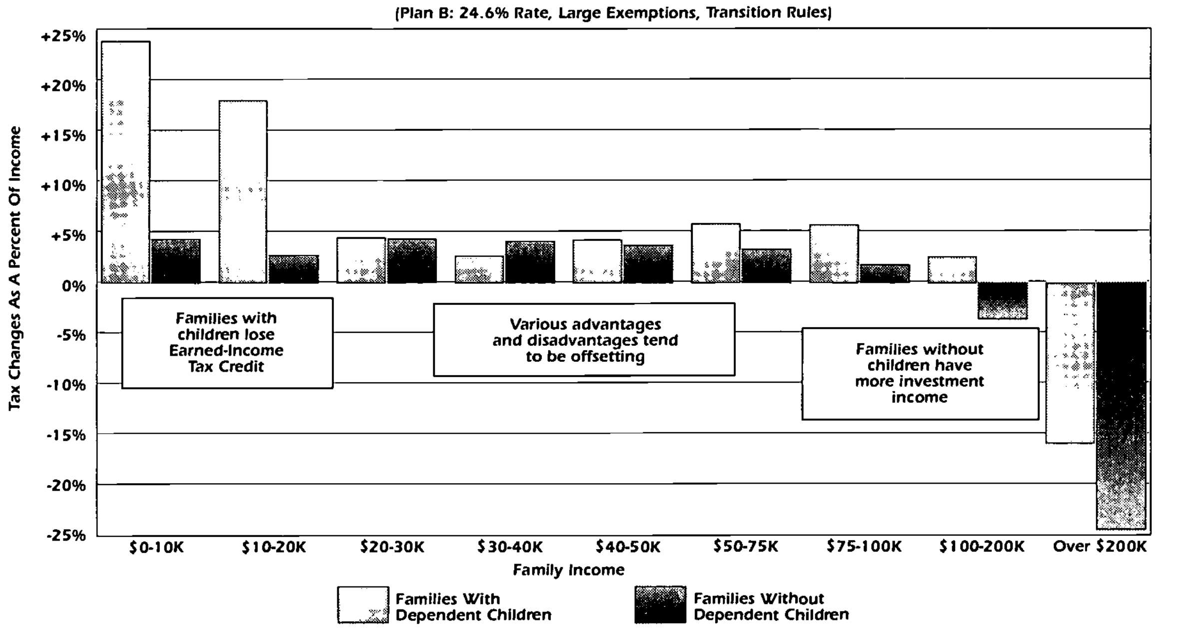
Table 3.1
Tax Change Under Different Flat-Rate Plans For Middle-Income Families With Children, Revenue Neutral With and Without Transition Provisions, Large and Modest Exemptions

Families with Children, Income Range $30,000 to $75,000	Flat Rate of 24.6% (Plan B) Large Exemptions, Transition		Flat Rate of 17.3% (Plan C) Modest Exemptions, No Transition	
	% Tax Change	Average Tax Change	% Tax Change	Average Tax Change
Husband, wife, 1-2 children	+53%	+$2,680	+62%	+$3,120
Husband, wife, 3 or more children	+43%	+$1,720	+83%	+$3,310
Single parent, 1-2 children	+51%	+$2,340	+49%	+$2,250
Single parent, 3 or more children	+29%	+$980	+75%	+$2,500

NOTE: The plan with large exemptions has the exemptions as proposed in the Armey/Shelby flat tax. In the modest exemption plan, the dependency exemption was reduced to $2,400 (from $5,000), the per capita standard deduction for singles and married couples was reduced to $5,100 (from $10,700), and the standard deduction for heads of household was reduced to $6,700 (from $14,000). These reductions follow the methodology of the Treasury Department in constructing a low-rate, revenue-neutral plan.

SOURCE: ITEP Model

Figure 3.2
Tax Changes Under the Flat Tax For Families With and Without Children

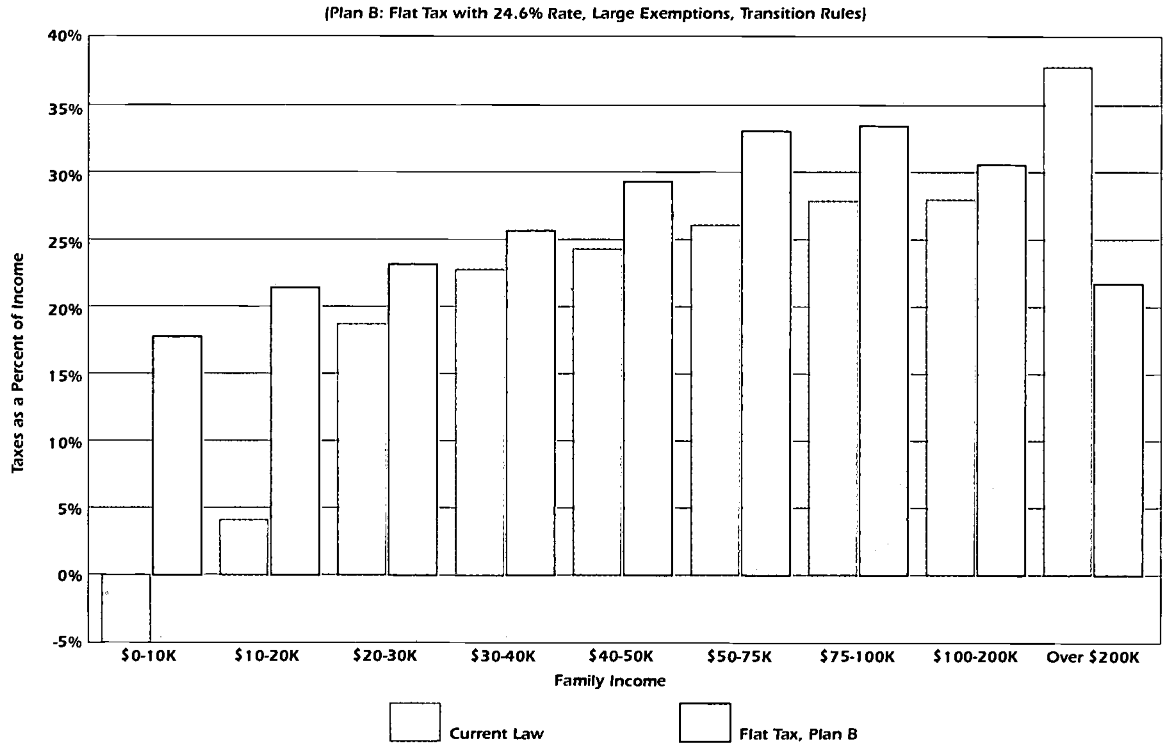


Middle-income families with children would experience significant tax increases under both Plan B and Plan C. As expected, families with children would generally do better under Plan B than Plan C, on account of the higher exemptions provided in that plan. Large families would do better under Plan B than small families, and one-parent families would do somewhat better than two-parent families. A fuller description of the distributional results under Plan B and Plan C is provided in Table A-4 of Appendix A.

Figure 3.2, above, shows the percentage changes in tax burdens for families with children and for other filing units that would result from substituting Plan B for current law. As that figure illustrates, families with children at the low end of the income spectrum do badly relative to other taxpayers under Plan B, because of the loss of the earned income credit. They do no better than families without children in the middle-income range, despite the large proposed increase under Plan B in the dependency exemption. At the high end, all taxpayers do well, but families less so, due to the fact that families with children tend to have less investment income than other taxpayers.

The comparisons made above have focused on the replacement of the current corporate and individual income taxes and the estate and gift taxes with some version of the Armey/Shelby flat tax. The taxes being replaced are the more progressive of the federal taxes. Figure 3.3, below, shows the overall distribution of tax burdens resulting from *all* federal taxes under current law and under Plan B. That figure shows that the federal tax system, including all federal taxes, is steeply progressive at very low income levels and then only mildly progressive throughout the rest of the income spectrum. With Plan B, the federal tax system would be mildly progressive through the low-and middle-income ranges and then would become regressive at income levels above $100,000.

Figure 3.3
Effective Federal Tax Rates on Families With Dependent Children Under Current Law and the Flat Tax — All Federal Taxes*



* Includes all federal income, Social Security, excise, and estate taxes.

Comparisons of Original Plans to Scaled-down Version of Current Law

The tables and figures above compared current law with various revenue-neutral versions of the Armey/Shelby plan. Table 3.2 compares the Armey/Shelby flat-tax proposal, with its proposed rates of 17 percent and 20 percent, with revenue-equivalent versions of current law. That is, the estimated distribution of burdens under the flat tax proposals is compared with the distribution of burdens that would result under current law after taxes were reduced across-the-board to match the revenue shortfall of the flat-tax plans.

Table 3.2 shows that families with one or two children would pay significantly higher taxes, on average, at all income levels below $100,000 under both the 17-percent and 20-percent plans. Families with more than two children would do badly under the flat-tax plans at low-income levels and some middle-income levels, but would come close to breaking even, or experience a nominal tax cut, at other middle-income levels. All families with children and family income in excess of $200,000 would have huge tax cuts, on average, under both of these flat-tax proposals.

Comparison to Flat, Low-Rate Tax with Transition Provisions

One of the stated goals of some flat-tax proponents is to have a flat-tax rate under 20 percent and to provide generous transitional relief to businesses that invested in depreciable assets under current law.[15]

Table 3.2
Tax Increase (+) or Decrease (-) for Families with Children Under Armey/Shelby Flat Tax, As Proposed, with Tax Rates of 20 Percent (Losing $49 Billion) and 17 Percent (Losing $156 Billion), Compared with Equal-Revenue Version of Current Law

Family Income	Two Parents, 1-2 Children		Two Parents, 3+ Children		Single Parent, 1-2 Children		Single Parent, 3+ Children	
	20% Rate	17% Rate	20% Rate	17% Rate	20% Rate	17% Rate	20% Rate	17% Rate
$0-$10K	+$1,680	+$1,640	+$1,570	+$1,530	+$1,110	+$1,080	+$810	+$790
$10-$20K	+$2,430	+$2,340	+$3,060	+$2,960	+$2,190	+$2,140	+$2,630	+$2,560
$20-$30K	+$850	+$810	+$1,660	+$1,530	+$800	+$770	+$1,180	+$1,160
$30-$40K	+$500	+$420	+$300	+$250	+$1,120	+$960	-$10	-$20
$40-$50K	+$1,340	+$1,130	+$530	+$430	+$1,760	+$1,490	+$750	+$640
$50-$75K	+$2,490	+$2,080	+$1,750	+$1,470	+$2,090	+$1,740	+$1,440	+$1,230
$75-$100K	+$2,760	+$2,290	+$2,440	+$2,050	+$1,880	+$1,520	+$870	+$680
$100-$200K	+$1,340	+$1,030	+$530	+$340	+$1,390	+$1,050	-$4,460	-$3,900
Over $200K	-$56,020	-$48,310	-$63,160	-$54,450	-$34,130	-$29,630	-$24,140	-$20,820

NOTE: An equal-revenue version of current law was determined under the ITEP Model by granting taxpayers an across-the-board tax rate reduction sufficient to reduce tax revenues to the level that would be collected under the flat-tax proposals.

SOURCE: ITEP Model

To achieve those dual goals, the large dependency exemptions and standard deductions of the Armey/Shelby flat tax would need to be reduced if the flat tax proposal is to be revenue neutral. The version of the Armey/Shelby flat tax designed to achieve these goals is labelled "Plan D." Table 3.3 shows the changes in the distribution of tax burdens on families with children that would result from replacing current law with Plan D. Under Plan D, low-and middle-income families with children, on average, would pay significantly higher taxes. High-income families, however, would enjoy dramatic tax reductions.

A word of caution is in order. The results shown above represent a snapshot in time and do not reflect the distribution of tax burdens over a life cycle. The increase in relative tax burdens on families with children that apparently would occur in switching from an income tax to an Armey/Shelby flat tax might be offset, at least in part, by reductions in the taxes imposed on those families when the children are gone from the home. The reason is that family savings tend to peak when parents are between their child-raising years and their years of retirement. However, and this is a crucial point, the relative tax burden even on the same family would be higher during years of child-raising and lower during periods when children were gone from the home. Moreover, many of the effects shown above are due to changes from current law that are unrelated to the taxation of investment income, such as the reduced deductibility of Social Security taxes.

Many of the adverse effects on families with children resulting from the flat tax proposal examined above might be offset by enriching the family-sensitive provisions of that proposal or by adding some new

Table 3.3
Average Change in Tax Burdens On Families with Children of Revenue-Neutral Flat Tax (Rate of 19.3 Percent) with Modest Exemptions (Plan D), By Family Type and Income Level, With Transition Rules*

Family Income (000)	Two Parents, 1-2 Children	Two Parents, 3+ Children	Single Parent, 1-2 Children	Single Parent, 3+ Children
$0-10	+$1,620	+$1,540	+$1,100	+$790
$10-20	+$2,690	+$2,990	+$2,850	+$2,770
$20-30	+$2,420	+$2,550	+$2,500	+$2,810
$30-40	+$2,870	+$2,820	+$2,790	+$2,710
$40-50	+$3,700	+$3,820	+$3,120	+$3,340
$50-75	+$4,510	+$4,790	+$2,880	+$3,850
$75-100	+$4,050	+$4,640	+$940	+$2,880
$100-200	+$520	+$240	-$1,920	-$4,270
Over $200	-$87,660	-$96,690	-$69,260	-$94,260

* Following the Treasury Department's methodology, the proposed dependency exemption of $5,000 was reduced to $2,400, and the proposed per capita standard deduction of $10,700 ($14,000 for heads of household) was reduced to $5,100 ($6,700 for heads of household). The rate was set at 19.3%. These changes were required to fund transition rules under the business component of the flat tax.

ones. For example, a generous child dependency credit (of the type discussed in Section II, A, 1, b, above) might provide offsetting benefits to low-and middle-income families.[16] Alternatively, direct expenditure programs might be designed to provide offsetting benefits to families with children.

As noted above, the results of any simulation depend to some degree on assumptions incorporated into the simulation model. To the extent possible, however, we have attempted to insulate our results from those assumptions by performing a number of sensitivity analyses along the way. Our hope is that as tax reform efforts evolve in the future, the family issues addressed here will be reexamined under a variety of different assumptions and models.

Endnotes

1 A "filing unit" in this context is one of the following:

- a single person without a qualifying dependent;
- a head of household (i.e., a single person with a qualifying dependent);
- a married person filing separately; or
- a married couple filing jointly.

In general, families with children are filing units claiming a dependency exemption for one or more dependent children.

2 Of course, this feature of the flat tax applies to taxpayers whether or not they have children.

3 About 10 million families with children (24 percent) currently face a *marginal* tax rate above 15 percent — i.e., at a rate of 28% or above. These taxpayers would face lower marginal rates under a 20-percent flat tax. Only about 3.4 million families (8 percent) face an *average* tax rate on taxable income (gross income minus allowable deductions and exemptions) greater than 20 percent — the average and marginal rate on taxable income under a 20-percent flat tax.

4 For discussion of the EITC, see section II, A, 2, a, above.

5 The impact on families of taxing health care insurance can be substantial. For example, the average amount of health benefits that would be taxable to parents with dependent children in the $40,000 to $50,000 income range under the Armey/Shelby flat tax would be approximately $4,400, according to the ITEP Model. The comparable figure for all taxpayers in that income group would be approximately $3,500.

6 The denial of the FICA deduction amounts to a surtax of 1.3 percent to 1.9 percent on wages per individual up to $62,700, and a surtax of 0.25 percent to 0.36 percent on wages above that level. The range of surtax rates reflects the range of potential flat tax rates.

7 See Office of Tax Analysis, U.S. Treasury Department, " 'New' Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds," 70 *Tax Notes* 451-461 (Jan. 22, 1996) at Table 2; Tax Foundation, "Side-by-Side Comparison of Flat Tax Plans Shows Lower Tax Burdens, Revenue Across the Board," 40 *Tax Features* 6 (Table, "Comparison of Average Federal Income Tax Burden Under Alternative Flat Tax Systems, 1997 Estimates") (February 1996). The Treasury study assumes a tax rate of 20.8% and the Tax Foundation study assumes a tax rate of 20%.

8 The three models are not strictly comparable, due to classifier differences. That is, they do not use the same concepts of expanded income in grouping taxpayers by income.

9 The Treasury estimated the revenue effects of the flat tax at a rate of 20.8%. We made minor arithmetical adjustments to determine the revenue loss at 20%.

10 The amounts of the scaled-back exemptions are taken from the Treasury Department's simulation of the flat tax.

11 See Dick Armey, "The Flat Tax In Our Future," Address on Reintroducing the Freedom and Fairness Restoration Act, National Press Club, Washington, D.C., July 19, 1995 (predicting a revenue shortfall of $40 billion from a 20-percent flat tax in the first year and promising offsetting spending cuts).

12 The simulations reported here incorporate the assumption that 75 percent of the residual corporate tax (after deducting the taxes on employee benefits) would be borne by capital (old and new) and the balance borne by consumers if no transition rules are provided. With full transition rules, the assumption is that one-half of the tax would be passed on to consumers and the balance to holders of capital. Simulations were also run, without producing significantly different results, that incorporated an assumption that a higher portion of the tax was being shifted to owners of capital. Many economists would argue that with complete transition rules for old capital, a consumption tax gets converted into the equivalent of a wage tax. The distributional implications of that argument for the flat tax, however, are unclear.

13 The combined business and individual tax has many features of an origin-based value-added tax (VAT) — i.e., a VAT that is imposed by the country in which the goods and services are produced. The familiar European VATs are destination-based, with the tax imposed where the goods and services are sold. Tax analysts generally assume that a destination-based VAT is passed on to consumers in higher prices. With an origin-based VAT, however, the goods and services that are taxed must compete in the marketplace with untaxed goods and services produced elsewhere. In such circumstances, there is some question as to whether all of the tax could be passed on to consumers. Some commentators suggest that changes in the exchange value of the dollar relative to other currencies due to an origin-based VAT would have the effect of raising the price of imports and lowering the price of exports. In such an event, some or all of the burden of an origin-based VAT would be borne by imports. See, e.g., Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," 48 *National Tax Journal* 619-647 (1995). This argument, however, does not necessarily hold for the flat tax. Under the Treasury Department assumption that the individual component of the flat tax would be borne by U.S. workers, the tax would not be pushed forward to foreign consumers and would not affect the exchange value of the dollar. In addition, a non-uniform portion of the labor component of value added is not taxable under the flat tax, due to the standard deductions and dependency exemptions. The situation is complicated further by the fact that the flat tax is expected to have some effect on interest rates, which in turn would affect the exchange value of the dollar. Given all these complications, the likely impact of future exchange rate adjustments on the incidence of the flat tax is at best uncertain.

14 For details, see Table A-3 of Appendix A.

15 Jack Kemp, in his role as chair of the National Commission on Economic Growth and Tax Reform, has advocated these two tax policy goals.

16 Restoring the EITC would reduce significantly the adverse effects of the proposal on low-income families. The EITC, however, is income-based; it cannot be limited to low-income taxpayers unless all taxpayers are required to report the amount of their investment income to the tax authorities. For discussion of this point, see Section II, A, 2, a, above.

IV. Conclusion

OUR OBJECTIVE in this report is to show the implications for families with children of three proposals for major tax reform — the Armey/Shelby flat tax, the Nunn/Domenici USA plan, and the Gephardt 10-percent tax. To maintain our focus on that objective, we have attempted to avoid becoming enmeshed in the ongoing debates about the degree to which the tax system should pursue a redistributive goal through graduated tax rates and the appropriateness of using consumption (consumed income), rather than income (consumed or saved), as the measure of taxable capacity. Our assumption is that most proponents of major tax reform share the common goal of adjusting tax burdens for family circumstances, although they may disagree on the weight to give to that goal and on the implications of that goal for the design of specific tax provisions.

Many proponents of a tax on consumption contend that individuals ought to be taxable on what they draw out of society (their consumption) rather than on what they put into society (their income).[1] That position is sometimes traced to Thomas Hobbes, the 17th-century philosopher, who asserted in *Leviathan* (1651):

> [T]he Equity of Imposition, consisteth rather in the Equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there, that he which laboureth much, and sparing the fruits of his labor, consumeth little, should be more charged, than he that living idlely, getteth little, and spendeth all he gets; seeing the one hath no more protection from the Common-wealth, than the other?

The opposing view is that taxes should be imposed with respect to ability to pay and that income is a better measure of ability to pay than consumption. Proponents of the ability-to-pay approach contend that society has a rightful claim to some fair share of the income that individuals derive from marketplace transactions, whether those individuals choose to spend that income or save it. That moral claim to a share of income is based on the premise that society, acting through government, has created the marketplace and supporting infrastructure that allows individuals to earn substantial incomes. As Hobbes has famously asserted, human life in a society without government is "solitary, poore, nasty, brutish, and short."

Although we do not choose between the two faces of Hobbes in this report, we do suggest strongly that both viewpoints are consistent with a tax system that adjusts tax burdens for family circumstances. Surely the proponents of consumption taxation recognize that parents who are raising and nurturing children are contributing to the general welfare and are not, in Hobbes's phrase "living idlely." We believe that the important contributions of nurturing parents to the future of society ought to be given at least as much recognition in the design of a tax system as the contributions of those who invest their income in the hope of private gain.

At the same time, proponents of the ability-to-pay approach should recognize that parents who are supporting children have less ability to pay than otherwise similarly situated individuals who do not currently have those responsibilities. It may be, as the Carter Commission of Canada asserted, that a "dollar is a dollar is a dollar" — that all economic gains, whether in the form of wages, business profits, interest, rents, or other returns on investment, contribute equally to ability to pay. It is also true, however, that a dollar which a parent spends to support a child is a dollar which is not available to finance that parent's own consumption or savings. The question is not whether amounts spent by parents to support children constitute income — they certainly do — but whether those amounts ought to be taxed to the parents without reference to the fact that the benefits of the income are enjoyed by the children.

Section II of this report addresses in some detail a wide range of issues that would affect children, either directly or indirectly. We emphasize here two major points.

First, a major flaw in current law and in all of the reform proposals, as currently drafted, is the lack of adequate coordination between tax measures designed to give relief to low-income families and spending programs designed to provide such relief. Many other analysts have concerned themselves with this lack of coordination, and some provisions of current law have been modified to improve that coordination. It seems plain to us, however, that policymakers have not given the high priority to this issue that we believe it deserves.

Second, we believe that differentiation in tax burdens on account of family circumstances is appropriate throughout the income spectrum, not just at the low end. What the tax system does at the very top of the income spectrum is not likely to have a major impact on the well-being of children. In the middle-income range, however, the treatment of families with children is likely to have significant social implications.

The historical trend since 1948 has been towards reducing the relative value of tax relief granted to middle-income parents. The 1986 tax act moved against that trend by substantially increasing the amount of the dependency allowance. And both major political parties recently have made proposals for child dependency credits that would continue in that new direction. We see little in the reform proposals studied in this report, however, that would reduce the relative tax burden of middle-income families with children. The Armey/Shelby flat tax proposal, by offering a much larger dependency exemption, has made a useful political statement on behalf of that group. But the ITEP simulations of that proposal presented in Section III show that other features of the flat tax proposal more than offset the benefits to families with children of the larger exemption.

The USA plan is generally described by tax analysts as combining two consumption taxes: a personal consumption tax imposed directly on individuals and a value-added tax (VAT) collected from business enterprises. It is generally assumed that the tax burdens under this proposal would fall on consumers.

The Armey/Shelby flat tax also has been described by some analysts as a consumption tax, because the sum of the tax bases of its two components is similar to the tax base of a VAT. The fact that the sum of the tax bases is consumption, however, does not necessarily mean that the tax will be passed on to consumers. Our assumption in this report is that workers would bear the burden of the individual component of the tax and also that portion of the business tax imposed with respect to employee fringe benefits. The Treasury Department made this same assumption in its analysis of the flat tax. We have assumed that the remaining portion of the business tax would fall in part on holders of capital and in part on consumers. This latter assumption is open to challenge. Fortunately, our results do not depend significantly on its validity.

Both the USA plan and the flat tax generally would reduce the current tax burden imposed on investment income and, assuming revenue neutrality, would increase the tax burden on other types of income. Families with children would be disadvantaged by this shift in tax burdens because they typically derive a lower proportion of their income from investments than do other taxpayers. Whether families with children would bear a greater burden over their lifetimes because of the reduction in the current tax burden on investment income is an issue we have not explored in this report. Imposing heavier taxes on parents during their child-raising years may be undesirable, however, even if that change in the timing of taxation has no adverse impact on their lifetime tax burdens.[2] A child dependency credit, higher dependency exemptions, or other family-sensitive devices might be used to mitigate or eliminate this undesirable result under the two reform plans. To provide such benefits to families with children, those plans might need to reduce taxpayer exemptions, increase tax rates, or make structural changes in their proposals.

The Armey/Shelby flat tax adversely affects low-income families with children because of its proposed repeal of the earned income tax credit (EITC), combined with its taxation of certain employee fringe benefits. This result is largely independent of the choice of tax rates. The adverse effects on low-income families with children could be eliminated by reinstating an expanded EITC or by making offsetting adjustments in expenditure policy. The EITC and income-related transfer payments, however, cannot easily be retained under many versions of a consumption tax, including the flat tax, because data on all sources of income would no longer be collected. More favorable treatment of low-income families with children would require an infusion of additional money into the tax system, through higher tax rates or through some other mechanism.

This report provides the first comprehensive look at family taxation issues under three recent tax reform proposals. We have not attempted to judge the overall merits of these proposed reforms or to decide which of them, in its present form, is most favorable to families with children. Our goal has been to describe and analyze those features of the reforms likely to affect families with children, to suggest how those features might be improved, and to point out the additional analytical work that remains to be performed. As we have indicated elsewhere in this report, we view these three proposals as early drafts in a reform process that is likely to continue for some time to come. We hope that future revisions of these and other reform proposals will seriously address the many family taxation issues discussed in this report.

Endnotes

1 See, e.g., Robert E. Hall and Alvin Rabushka, *The Flat Tax* (1995), reproduced in *Tax Notes* (Special Supplement, Aug. 4, 1995), at 18.

2 In debating tax fairness, many proponents of consumption taxes favor a focus on lifetime tax burdens, whereas many income tax proponents favor a focus on tax burdens imposed over a relatively short period. For an argument in favor of the latter position, see Michael J. McIntyre, "Implications of Family Sharing for the Design of an Ideal Personal Tax System," in Richard Bird and Sijbren Cnossen, eds., *The Personal Income Tax: Phoenix from the Ashes*, Chapter 6 (1990).

Appendix A: Supplementary Tables

Table A-1
Amounts of Capital Income and Other Income, Filing Units With and Without Dependent Children, 1996

Family Income*	Families With Children: Total Income	Families With Children: Capital Income	All Units Without Children: Total Income	All Units Without Children: Capital Income	Capital Income Ratio: No Children/ Children
$0-$10K	$5,481	$118	$5,705	$312	2.6
$10-$20K	$14,875	$225	$14,781	$953	4.2
$20-$30K	$24,905	$589	$24,704	$1,873	3.2
$30-$40K	$34,980	$722	$34,710	$2,863	4.0
$40-$50K	$44,909	$961	$44,596	$3,851	4.0
$50-$75K	$61,064	$1,640	$60,625	$6,157	3.8
$75-$100K	$85,618	$3,654	$85,577	$11,670	3.2
$100-$200K	$130,306	$12,442	$129,850	$28,903	2.3
Over $200K	$481,302	$168,841	$559,594	$297,098	1.8
Addendum: $30-75K	$49,665	$1,210	$46,127	$4,244	3.5

* The ITEP concept of family income used to place tax returns into income classes is total tax return income, **plus** tax-exempt interest, untaxed government transfer payments and certain tax-sheltered business and investment income, **minus** state and local tax refunds and net operating loss carryovers.

NOTE: Figures include only realized income (not unrealized capital gains). Capital income includes interest (taxable and tax-exempt), dividends, realized net capital gains, rent and royalty income (not losses), and other miscellaneous related items.

SOURCE: ITEP Model

Table A-2
Investment Income As a Share of Total Income, For Filing Units With and Without Dependent Children, Including and Excluding Elderly, 1996

Family Income ($000)	Elderly Filing Units	All Filing Units Without Children		Filing Units With Children	Ratio: No Children/ With Children	
		Excluding Elderly	Including Elderly		Excluding Elderly	Including Elderly
$0-10	9.4%	3.0%	5.5%	2.2%	1.4	2.6
$10-20	13.2%	2.3%	6.4%	1.5%	1.5	4.2
$20-30	18.9%	3.4%	7.6%	2.4%	1.5	3.2
$30-40	22.5%	4.1%	8.2%	2.1%	2.0	4.0
$40-50	23.4%	4.3%	8.6%	2.1%	2.0	4.0
$50-75	26.7%	5.1%	10.2%	2.7%	1.9	3.8
$75-100	34.5%	7.0%	13.6%	4.3%	1.6	3.2
$100-200	45.0%	13.8%	22.3%	9.5%	1.4	2.3
Over $200	67.9%	45.5%	53.1%	35.1%	1.3	1.8

SOURCE: ITEP Model

Table A-3
Effective Tax Rates on Families with Dependent Children, Current Law and Revenue-Neutral Armey/Shelby Flat Tax, at 21.4% and 24.6% Rates, With and Without Transition Rules

Family Income ($000)	Effective Tax Rates			Change in Effective Tax Rates from Current Law	
	Current Law	Rate of 21.4% No Transition Rules	Rate of 24.6% With Transition Rules	Rate of 21.4%	Rate of 24.6%
$0-10	-17.7%	4.4%	4.6%	22.0%	22.3%
$10-20	-11.3%	5.1%	5.6%	16.4%	16.9%
$20-30	2.7%	6.8%	7.4%	4.1%	4.7%
$30-40	7.2%	9.0%	10.0%	1.8%	2.8%
$40-50	8.8%	11.7%	13.1%	2.9%	4.3%
$50-75	10.7%	14.7%	16.5%	4.0%	5.8%
$75-100	13.7%	17.0%	18.9%	3.3%	5.2%
$100-200	17.5%	18.5%	19.7%	1.0%	2.2%
Over $200	33.1%	20.6%	17.8%	-12.5%	-15.3%

SOURCE: ITEP Model

Erratum to *Federal Tax Reform: A Family Perspective* July 10, 1996

The supplementary table on page 80 includes incorrect figures. The correct table is as follows:

Table A-4
Relative Impact of Alternative Revenue-Neutral Flat Tax Proposals On Filing Units With and Without Dependent Children

	Flat-Tax Plan with Rate of 24.6% (Plan B) Large Exemptions and Transition			Flat-Tax Plan with Rate of 17.3% (Plan C) Modest Exemptions and No Transition		
	Average Tax Change		Relative Tax Disadvantage (+) Or Advantage (–) For Filing Units With Children	Average Tax Change		Relative Tax Disadvantage (+) For Filing Units With Children
Family Income ($-000)	Filing Units With Children	Filing Units Without Children		Filing Units With Children	Filing Units Without Children	
$0-10	$ +1,230	$ +240	$ +990	$ +1,170	$ +300	$ +870
$10-20	+2,520	+430	+2,090	+2,760	+730	+2,030
$20-30	+1,170	+1,040	+130	+2,230	+1,180	+1,050
$30-40	+980	+1,460	–480	+2,360	+1,350	+1,010
$40-50	+1,920	+1,660	+260	+2,910	+1,250	+1,660
$50-75	+3,540	+2,040	+1,500	+3,460	+1,000	+2,460
$75-100	+4,410	+760	+3,650	+2,770	–1,010	+3,780
$100-200	+2,820	–4,600	+7,420	–610	–6,680	+6,070
Over $200	–73,790	–133,450	+59,660	–76,480	–120,290	+43,810

Source: ITEP Model. See note to Table 3.1.

Appendix B: The Institute on Taxation and Economic Policy (ITEP) Tax Model

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state, and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the existence of children in the family, and age. To forecast future revenue and incidence, the model relies on government or other widely respected economic projections.

Below is a list of each area of the model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types, and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and itemized deduction phase-outs, and
- credits, including earned income tax credits and child care credits.

The Consumption Tax Model analyzes the revenue and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes, and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuitbreakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue and incidence of current corporate income tax law, possible rate changes, and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a microsimulation model. It currently uses the following micro-data sets and aggregate data:

Micro-Data Sets:

IRS 1988 Individual Public Use Tax File, Level III Sample
IRS 1990 Individual Public Use Tax File
Current Population Survey: 1988, 1989, 1990, 1991, 1992, 1993
Consumer Expenditure Survey: 1988, 1989, 1990, 1991, 1992
Federal Reserve Survey of Consumer Finance

Aggregated Data Sources:

Miscellaneous IRS data
Congressional Budget Office and Joint Committee on Taxation forecasts
Other economic data (Commerce Department, WEFA, etc.)
State tax department data
Data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.)
State-specific consumption and consumption tax data (Census data on Government Finances, etc.)
State-specific property tax data(Government Finances, etc.)
American Housing Survey 1990
1990 Census of Population Housing

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