News Release
THE FEDERAL RESERVE BANK of KANSAS CITY
925 Grand Boulevard • Kansas City, MO 64198 • Phone: 816.881.2683

FOR IMMEDIATE RELEASE
December 7, 2006

CONTACT: Tim Todd
816/881-2308
e-mail: timothy.todd@kc.frb.org

MIDDLE-INCOME TAX RATES: TRENDS AND PROSPECTS

Since the early 1980s, U.S. tax policy has seen a lot of changes, culminating with three major tax bills in 2001-2003. Many of these modifications, which lowered marginal tax rates and increased deductions, exemptions and credits, benefited middle-income households. As a result, the effective federal income tax rate for middle-income households has reached 25-year lows, dropping from 7.5 percent in 1979 to 2.7 percent in 2003.

In contrast to income taxes, effective federal payroll tax rates have been relatively stable for middle-income households. Consequently, a larger fraction of their tax liability is devoted to paying payroll taxes, which finance Social Security benefits and a portion of Medicare. Payroll taxes climbed from 46 percent of middle-income federal taxes in 1979 to 64 percent in 2002.

Troy A. Davig, senior economist at the Federal Reserve Bank of Kansas City, and C. Alan Garner, assistant vice president and economist, explore these trends and their implications for the future in “Middle-Income Tax Rates: Trends and Prospects.” The article is featured in the fourth quarter edition of the Bank’s *Economic Review*.

Davig and Garner point out that while federal tax rates paid by middle-income households have generally declined in recent years, under existing tax law, these rates will increase in the future because the provisions of the major post-2000 tax bills expire in 2011. In fact, the authors say, if there are no changes to current law, the decline in federal income tax rates is likely to be completely reversed during the next 10 years, and households with children would face the largest tax increases among middle-income households. Because of the large federal deficit and impending budgetary pressures from population aging and rising medical costs, keeping middle-income tax rates at current low levels will be a formidable challenge in the years ahead.

The article is available on the Bank’s Web site at www.KansasCityFed.org

###