

# A taxing way to live



PHOTO BY ROBERT ERVIN

## After 25-year lows, sharp tax increases likely for middle-income households

**L**ike the average American, Greg Paprocki—a husband, father and entrepreneur—gets a few tax breaks.

Paprocki, 34, of Omaha, Neb., considers himself middle-class, although as an illustrator he does earn more than the average household. His marriage to Beth in 2004 allows the couple to file taxes jointly, and the birth of Lydia in late 2006 offers them an additional deduction.

Effective federal tax rates for middle-income households actually are at 25-year lows as a result of changes in the tax laws beginning in the early 1980s and culminating in 2001-2003. Still, Paprocki feels like he “absolutely” pays too much in taxes.

Middle-income Americans may think this way partly because growing household incomes have kept the dollar amount of taxes paid from declining as dramatically as the percentage tax rate, say Troy Davig, senior economist, and C. Alan Garner, assistant vice president and economist, both at the Federal Reserve Bank of Kansas City. Additionally, middle-income households have not experienced comparable declines in state and local tax rates.

It’s no wonder, then, that Paprocki says, “It’s hard to get ahead.”

For him and many other middle-income taxpayers, this situation is unlikely to improve.

Although legislation could change, under current law the effective federal tax rates on middle-income households are projected to rise sharply, say Davig and Garner, who recently researched the trends and prospects of middle-income tax rates. Much of the economic analysis and political debate about these federal tax changes focus on the impact on upper- and lower-income groups, while the

impact on middle-income taxpayers is sometimes forgotten.

“Among middle-income households,” Davig says, “those with children have experienced the greatest decline in effective federal tax rates. However, going forward, these households will face the largest tax increases among middle-income households and all in this bracket will likely see a rise.”

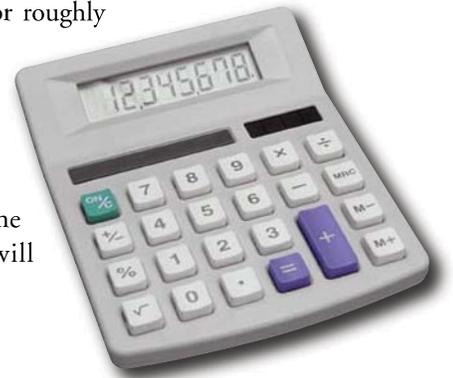
Under current law, the income tax rate for middle-income households with children is projected to double from 2004 to 2013. Elderly and non-elderly households without children face a more gradual increase until 2011, when they experience a jump in tax rates stemming from the expiration of tax provisions.

With the federal government running a substantial deficit, increases in the middle-income taxes are likely as fiscal policy makers attempt to move the budget closer to balance. Unfunded liabilities of Social Security and Medicare, in addition to state and local funding requirements such as education, Medicaid and public employee retirement, imply that middle-income households could face tax increases going forward, Garner says.

These projected changes will impact a wide spectrum of middle-income households.

For families like Fred and Judy Clark, who are nearing retirement, and Stan and Pat Hoig, who have been retired for roughly 20 years and living on a fixed income, an increase in taxes means an impact on their spending.

For families like the Paprockis, not only will



# Taxes 101

Changes in tax liabilities are a result of household circumstances (such as a shift in income or birth of a child), or legislated changes in the federal tax code. As a result, federal taxes for different income groups change constantly.

These tax law changes can be “targeted” when policymakers want to alter tax treatment for a specific group, such as the child tax credit, which only benefits households with children. Tax law changes are “general” when they are broad-based, such as an increase in the amount of personal exemptions.

Since 2000, Congress has lowered individual income tax rates, increased child and dependent care credits, and reduced taxes on dividends and capital gains. Modest revisions in any given year might not be noticed, but in time these revisions could build into a large change in the middle-income tax rate.

Tax trends for middle-income taxpayers can be difficult to determine, say Troy Davig and Alan Garner, economists with the Federal Reserve Bank of Kansas City.

These households are defined as “middle-quintile taxpayers.” The Congressional Budget Office divides the U.S. population into quintiles, or fifths of the income distribution, using a comprehensive income measure.

Income quintiles are not fixed groups; households can move from one group to another. Two households in the same income quintile may differ considerably in their tax liabilities. For example, two married-couple households with the same income might

have different tax liabilities because they have a different number of children.

A household’s taxable income is calculated based on gross income (wages, interest, pensions), less: adjustments (retirement plan contributions, moving expenses, interest on education loans), deductions (standard or itemized) and personal exemptions.

In the Tenth Federal Reserve District, where the Federal Reserve Bank of Kansas City is located, the median income for middle-income households ranges from \$40,000 to \$70,000. The District includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

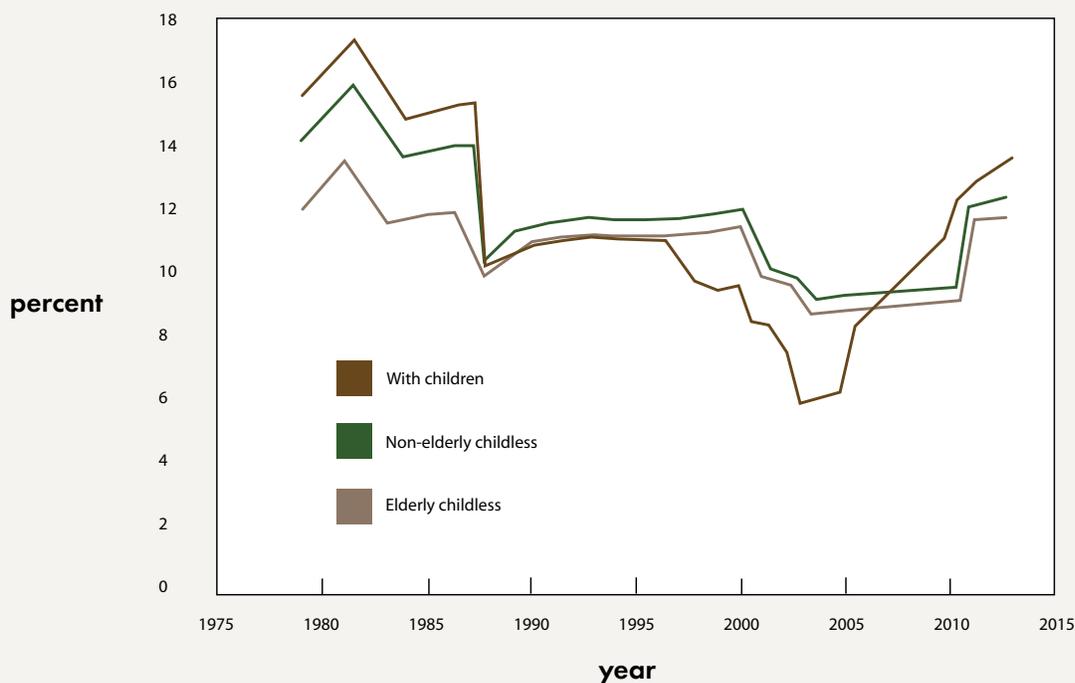
Additionally, taxes are indirectly transferred to households, such as business taxes and social insurance taxes.

Business taxes are ultimately shifted to households through complex adjustments in wages, prices and quantities traded, although the amount shifted can only be estimated. For employer-paid social insurance taxes, an analysis suggests payroll taxes paid by employers are largely reallocated to workers, mostly through lower wages.

Keith Price, a certified public accountant of 35 years in Cheyenne, Wyo., knows that the last thing middle-income households want is a tax increase, but they should be prepared for it. This means cutting back on the day-to-day frivolous expenses rather than savings funds.

“Most people in that (middle-income) group are tight on money,” Price says, “so an increase is not nice.”

## Effective Federal Income Tax Rates for Different Middle-Income Groups



their short-term spending be impacted, but also their long-term saving for their golden years and their daughter's college education. Paying higher taxes while maintaining an adequate nest egg may affect the family's lifestyle, although Paprocki can't imagine where they could cut back.

"We live pretty modestly," Paprocki says, "watching how every dime is spent."

## Going down

The total federal income tax liability has declined dramatically for middle-income households, dropping from 7.5 percent in 1979 to 2.7 percent in 2003.

"Tax policy in the United States has experienced several major changes during the past 25 years," Davig says. "Many of which were explicitly designed to benefit middle-income households."

This downward trend is a result of the ratification of various tax bills. First, in 1981, changes in the law reduced income tax liabilities. Then in 1986, changes led to a stabilization of rates. A third period of sharp declines began in 1997 and gained more momentum after the passage of three tax bills in 2001-2003.

Meanwhile, social insurance tax rates—referred to as "payroll taxes" because they are deducted directly from an employee's paycheck—have been relatively stable. By 2006, each employee paid 7.65 percent of his/her wages in payroll taxes, with an equal amount matched by employers, to finance Social Security benefits and portions of Medicare.

To assess the differences across middle-income households, the Congressional Budget Office reports rates for three groups:

- households with children,
- non-elderly childless households,
- elderly childless households.

Several trends have emerged, Garner says. First, the tax rate for elderly childless households has remained fairly stable, although there



---

**MIDDLE-INCOME FAMILIES WITH CHILDREN**—like Greg, Beth and baby Lydia Paprocki—have seen the greatest federal tax rate benefits. But looking ahead, they will face the largest tax rate increases among middle-income households, under current law.

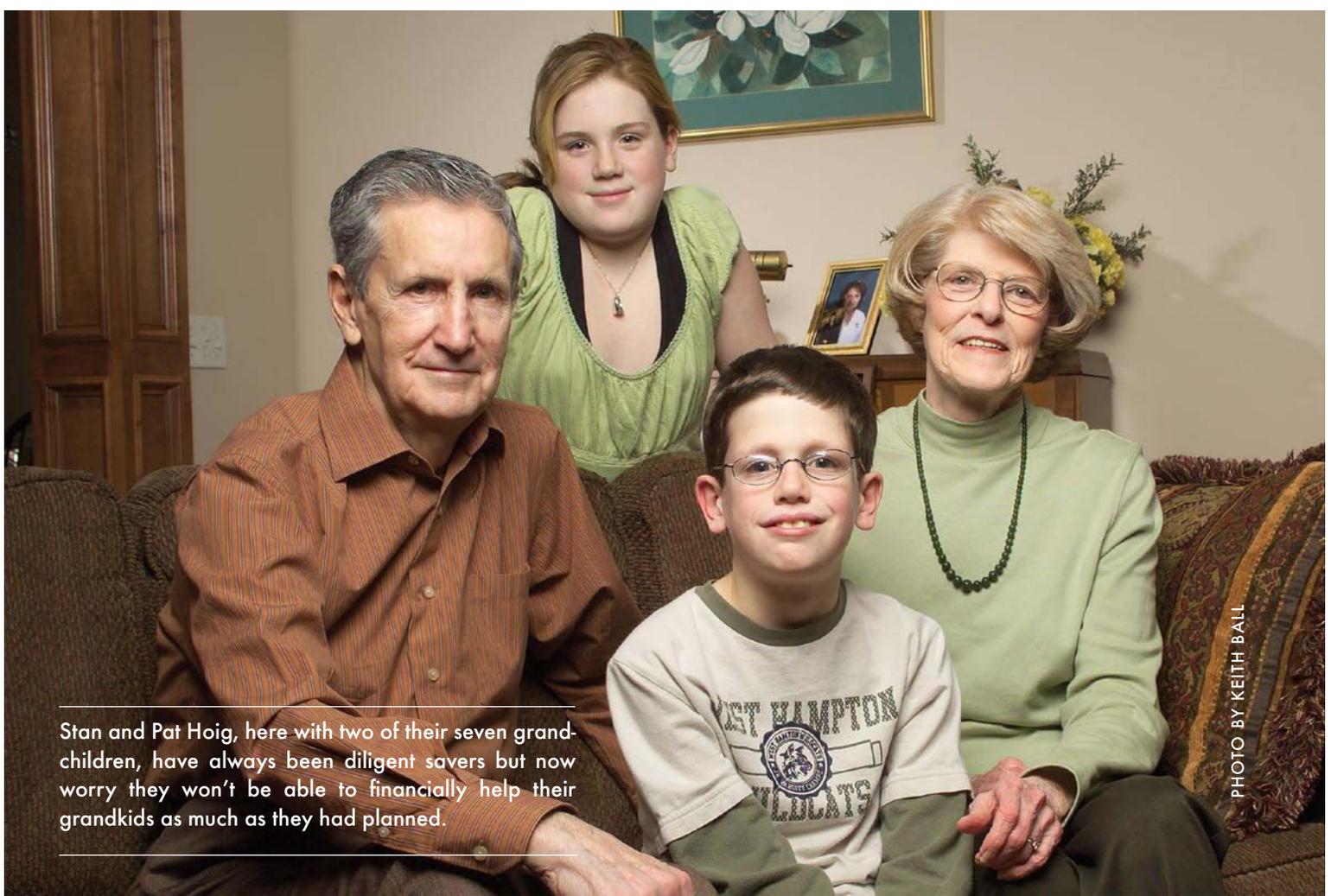
---

was a slight upward trend in the 1990s that was reversed by the post-2000 changes in tax law.

Second, the tax rate for both non-elderly households without children and households with children has declined, following the general trend for all middle-income households. And, non-elderly households with children have experienced sharper declines than households without children.

"The difference in the downward trends between non-elderly childless households and households with children is a consequence of changes in tax law, instead of income differences," Garner says.

Prior to 1986, the difference between these groups was modest. However, following these changes, households with children began



Stan and Pat Hoig, here with two of their seven grandchildren, have always been diligent savers but now worry they won't be able to financially help their grandkids as much as they had planned.

PHOTO BY KEITH BALL

facing less stringent tax rates than non-elderly childless households—the tax code changed to benefit those with children.

The 1986 bill increased the personal exemption amount from \$1,080 to \$2,000, impacting all households, but more so those with children. Changes in 1997 established a \$500 child tax credit. The post-2000 tax law changes continued to widen the gap between the two groups due to increases in the child tax credit and dependent care credits.

In contrast to income taxes, federal social insurance tax rates grew, leveling off around 1990 for households with children and non-elderly households without children.

Elderly households without children have seen steady social insurance tax rates. This is a reflection of the small fraction of payroll taxes paid by elderly households who were also eligible for old-age Social Security benefits.

## Rising share of payroll taxes

Over time, a larger fraction of middle-income households' federal tax liability has been devoted to payroll taxes. Because payroll taxes are paid only up to a certain amount of wage income, payroll taxes make up a larger share of the tax liability for low- and middle-income households versus high-income households.

“The falling trend in federal income taxes and the rising, or steady, trend in payroll taxes have a clear implication for middle-income households,” Davig says. “A larger fraction of their tax liability is devoted to payroll taxes.”

Research shows payroll taxes were higher than federal income taxes for 44 percent of all U.S. households in 1979, and that percentage increased to 67 percent in 1999. Current revenues from payroll and income taxes are nearly equal.

Personal federal income taxes as a share of

federal taxes dropped from 40 percent in 1979 to 24 percent in 2002. At the same time, payroll taxes as a share of federal taxes rose substantially—from 46 percent to 64 percent.

“Generally, one way to view the changing composition of tax liability for middle-income households is that the total ‘pie’ (tax liability) has shrunk,” Garner says, “while the size (share) of the ‘slices’ has clearly changed and shifted toward payroll taxes.”

During the next few years, many features of the post-2000 legislation are set to expire, leading to a gradual rise in effective income tax rates going forward. Expiring factors

hobbies will be lucrative, such as winemaking at the small vineyard he’s planning for his land in southeastern Nebraska, although he’s not counting on turning a large profit. Still, he’ll need a small income to supplement his and his wife Judy’s retirement.

“I’ve resigned myself to the fact that we’re going to have to cut back,” Clark says. “Anyone who lives on a fixed income is going to have to cut back.”

Unfortunately this is also true for retirees Pat and Stan Hoig, of Edmond, Okla.

It’s not the day-to-day spending or even their long-term budget that will be most affect-

## **The decline in income taxes for middle-income households during the past 25 years is likely to be completely reversed during the next 10 years.**

contributing to the rise include the decline in the child credit and the expiration of provisions that diminish marriage penalties. In addition, the alternative minimum tax will affect a larger number of middle-income households in the future.

“The decline in income taxes for middle-income households during the past 25 years is likely to be completely reversed during the next 10 years,” Garner says.

The effective federal income tax rate for households with children is forecast to rise from 5.8 percent in 2004 to 13.4 percent in 2013. Households without children will face similar, but less dramatic increases. These families, however, likely will still feel effects.

### **Effect on retirement**

Fred Clark is at least five years from retirement, but already knows when he leaves his job his days won’t be filled with fishing and golf.

“I need to remain productive from a psychological and spiritual standpoint, but more so financially,” says Clark, 61.

So when he retires from his long-time position as a life and disability claims analyst in Omaha, Neb., Clark will still punch the proverbial time clock. He hopes one of his

ed by increased tax rates in the coming years.

“It’s going to impact us to some extent, but we won’t be deprived,” says Pat, 72. “We just won’t be able to do as much for our grandkids.”

Pat, a former elementary school music teacher, and Stan, a former journalism instructor at the University of Central Oklahoma, adamantly saved throughout their lives, always with retirement—and their grandchildren—in mind. They help two of their seven grandchildren pay for college, but worry about the children’s future financial obligations.

“The burden shouldn’t fall on them,” Hoig says.

BY BRYE STEEVES, SENIOR WRITER

### **FURTHER RESOURCES**

#### **MIDDLE-INCOME TAX RATES: TRENDS AND PROSPECTS**

By Troy A. Davig and C. Alan Garner  
[www.KansasCityFed.org/TEN](http://www.KansasCityFed.org/TEN)

**COMMENTS/QUESTIONS** are welcome and should be sent to [teneditors@kc.frb.org](mailto:teneditors@kc.frb.org).