July 1993

tax and financial ISSUES

Working For Peanuts With Bill and Hillary, or Honey, I shrunk their paychecks

As the U.S. Senate and House of Representatives finish haggling over the final form of income and energy tax increases, another battle is shaping up which will affect the working families of America. The issue is whether the government will raise income and employment taxes to such a level that some working parents will find it economically unattractive to continue employment.

Responding to greater opportunities in the work place, lower marginal tax rates, and tax incentives that offset the cost of child care, the percentage of women employed has risen dramatically over the past twenty years. Because of the uncertainty of employment in the middle management of large American corporations, having two incomes has become increasingly necessary as a means of hedging against interruptions in employment due to corporate restructurings.

Working women also want to stay employed because a prolonged absence from the work force may result in a permanent reduction in future wages. This risk has increased dramatically since corporate downsizings started in the 1980's. It is now much more difficult to re-enter the job market after a prolonged absence for raising a family.

Chronology of Events

1975 Dependent care credit enacted (Section 21). Maximum qualifying costs are $2,400/individual, up to a maximum of $4,800.

1981 $5,000 dependent care exclusion enacted (Section 129).

1982 The Social Security wage base is indexed to inflation, allowing for annual tax increases on wages without legislative action.

1983 Deduction for two wage earning families is enacted (Section 221). The deduction equals 10% of the lower earning spouse's wages, up to a maximum of $30,000.

1986 Tax Reform Act of 1986 lowers maximum tax rate to 28%. The two-earner deduction is eliminated.

1989 Total use of dependent care credit and dependent care exclusion is limited to $5,000 in qualifying expenses. (The previous limit was $9,800.) This change also adversely affected single wage earners with dependents.

1991 Bush budget agreement with Congress raises maximum marginal income tax rates to 36% (considering itemized deduction and personal exemption phaseouts).

1993 The Clinton administration finds that it is unable to find any married individuals to work in the Justice Department because everyone has paid nannies "under the table." Zoe Baird and Kimba Wood are sent into exile. Having unreported domestic help is referred to as either "Nannygate" or "Having a Zoe Baird problem." Compliance with payroll tax reporting for domestics approaches 0% except among individuals interested in becoming high level Federal appointees.

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1993	High marginal tax rates return. Enactment of maximum marginal tax rates of 43% is expected (considering phaseouts).
1993	The Clinton health insurance tax force floats trial balloon of a 10% wage tax, termed a "wage based health insurance premium." Also expected are proposals to limit the income tax exclusion for employer provided medical benefits.
1975-93	Inflation erodes the value of dependent care tax benefits which are NOT indexed to inflation. The real deduction value of the $5,000 dependent care exclusion enacted in 1981 is now $2,900.

The Economics of Two Income Families

The ability of a family to have both parents working and raise children depends on the ability of the lower paid spouse to generate adequate income after taxes, child care costs, and employment costs such as commuting.

Things that promote the second spouse working include:

a) The availability of low cost child care, especially from family members or an employer.

b) The existence of low income tax rates on the income of the second spouse.

c) The ability to generate high income. Professional couples are more likely to be two income couples because it is easier for them to offset the cost of child care.

d) The ability to get tax breaks for the cost of child care that was incurred in connection with earning the second income.

In 1983-5 up to $12,800 could be earned by a second spouse before earnings were subjected to income taxes. This marked the high point in the government encouraging employment through tax policy.

Conversely, the following are obstacles to employment of the second spouse:

- Payroll taxes: these reduce the return on work effort and increase the cost of child care that must be paid for with after tax dollars.
- Costly government filing requirements
- Child care costs not being tax deductible
- High marginal income tax rates
- Inability to earn an income that is high enough to offset the cost of child care

What is your situation??????????????

The following four tables show the effect on the second spouse's ability to work based on tax policy and the cost of child care.

Every family has a different need to work. Those with high fixed commitments to retire debt and put aside money for children's educations may work even at economic returns that are lower than 50%. However, there is a limit to which the government can push this trend. It appears as if they will simply be reducing the overall work product in the economy, or else drive it underground.

In the 1980's the trend was to encourage people to work by making it financially attractive to do so.

The 1990's appear to be the decade of the shakedown. These tables show that the climate has turned hostile towards working spouses. Unless compensation is received in nontaxable form, it is difficult to construct a scenario where it is economically attractive for the second spouse to work if significant child care costs are incurred.

Scenario #1: 1988's situation showing how much a second spouse could earn after taxes and expenses if an employer maximized the use of nontaxable fringe benefits instead of paying taxable wages.								
MAXIMUM NONTAXABLE BENEFITS	**HYPOTHETICAL EARNINGS OF SECOND SPOUSE**							
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Value of Pre Tax Health Insurance	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)
Less: Dependent Care Exclusion	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Taxable Wages	**1,000**	**11,000**	**21,000**	**31,000**	**41,000**	**51,000**	**61,000**	**71,000**
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Employment Taxes	(77)	(842)	(1,607)	(2,372)	(3,137)	(3,443)	(3,443)	(3,443)
Less: Income Taxes	(301)	(3,311)	(6,321)	(9,331)	(12,341)	(15,351)	(18,361)	(21,371)
Less: Child Care Expense	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Income After Taxes and Child Care Expenses	**(378)**	**5,848**	**12,073**	**18,298**	**24,523**	**31,207**	**38,197**	**45,187**
Taxes & Expenses - % to Gross Wages	103.8%	70.8%	59.8%	54.3%	51.0%	48.0%	45.4%	43.5%

Scenario #2: 1988's situation showing how much a second spouse could take home if all wages were paid in taxable form.								
ALL WAGES ARE TAXABLE	**HYPOTHETICAL EARNINGS OF SECOND SPOUSE**							
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Value of Pre Tax Health Insurance	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)
Less: Dependent Care Exclusion	0	0	0	0	0	0	0	0
Taxable Wages	**6,000**	**16,000**	**26,000**	**36,000**	**46,000**	**56,000**	**66,000**	**76,000**
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Employment Taxes	(459)	(1,224)	(1,989)	(2,754)	(3,443)	(3,443)	(3,443)	(3,443)
Less: Income Taxes	(1,806)	(4,816)	(7,826)	(10,836)	(13,846)	(16,856)	(19,866)	(22,876)
Less: Child Care Expense	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Income After Taxes and Child Care Expenses	**(2,265)**	**3,960**	**10,185**	**16,410**	**22,712**	**29,702**	**36,692**	**43,682**
Taxes & Expenses - % to Gross Wages	122.7%	80.2%	66.1%	59.0%	54.6%	50.5%	47.6%	45.4%

FICA Limit - 1988	45,000
FICA Limit - 1993	57,600
Income Tax Rate	30.1%
Child Care Expense	10,000
Healthcare Tax	10.0%
Value of Employer Provided Medical Insurance	4,000

Scenario #3: 1993's situation assuming enactment of a 10% health care payroll tax that would replace the medicare tax, and all wages being paid in taxable form.								
ALL WAGES ARE TAXABLE; 10% HEALTHCARE TAX REPLACES MEDICARE TAX	**HYPOTHETICAL EARNINGS OF SECOND SPOUSE**							
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Value of Pre Tax Health Insurance	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)
Less: Dependent Care Exclusion	0	0	0	0	0	0	0	0
Taxable Wages	**6,000**	**16,000**	**26,000**	**36,000**	**46,000**	**56,000**	**66,000**	**76,000**
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Employment Taxes	(972)	(2,592)	(4,212)	(5,832)	(7,452)	(9,072)	(10,171)	(11,171)
Less: Income Taxes	(1,806)	(4,816)	(7,826)	(10,836)	(13,846)	(16,856)	(19,866)	(22,876)
Less: Child Care Expense	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Income After Taxes and Child Care Expenses	**(2,778)**	**2,592**	**7,962**	**13,332**	**18,702**	**24,072**	**29,963**	**35,953**
Taxes & Expenses - % to Gross Wages	127.8%	87.0%	73.5%	66.7%	62.6%	59.9%	57.2%	55.1%

Scenario #4: 1993's situation assuming enactment of the health care payroll tax, a $2,000 maximum exclusion for medical insurance benefits paid by the employer, and assuming maximum use of nontaxable fringe benefit payments instead of taxable wages.								
ALL WAGES ARE TAXABLE; 10% HEALTHCARE TAX REPLACES MEDICARE TAX; $2,000 MAXIMUM EXLUSION FOR MEDICAL INSURANCE	**HYPOTHETICAL EARNINGS OF SECOND SPOUSE**							
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Value of Pre Tax Health Insurance	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Less: Dependent Care Exclusion	0	0	0	0	0	0	0	0
Taxable Wages	**8,000**	**18,000**	**28,000**	**38,000**	**48,000**	**58,000**	**68,000**	**78,000**
Gross Wages	10,000	20,000	30,000	40,000	50,000	60,000	70,000	80,000
Less: Employment Taxes	(1,296)	(2,916)	(4,536)	(6,156)	(7,776)	(9,371)	(10,371)	(11,371)
Less: Income Taxes	(2,408)	(5,418)	(8,428)	(11,438)	(14,448)	(17,458)	(20,468)	(23,478)
Less: Child Care Expense	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Income After Taxes and Child Care Expenses	**(3,704)**	**1,666**	**7,036**	**12,406**	**17,776**	**23,171**	**29,161**	**35,151**
Taxes & Expenses - % to Gross Wages	137.0%	91.7%	76.5%	69.0%	64.4%	61.4%	58.3%	56.1%

Tax and Financial ISSUES

Impact on working single parents with dependents

The proposed disincentives to work also apply to single parents. Single parents, depending on their circumstances, may also be faced with a hidden tax-- the elimination of direct governmental assistance as earnings increase. Clinton's expansion of the earned income credit ensures that an individual with one dependent could be subject to a 53% tax on wage income over $9,100 through $23,470:

Social Security retirement	12.4% *	
Proposed medical tax	10.0 *	
Federal income tax	15.0	
Illinois income tax	3.0	
Phaseout of earned income credit	12.8	
Total tax rate	**53.2%**	* Employer and employee taxes

This tax rate doesn't even include the implied tax from the elimination of direct governmental assistance as family incomes increase. It is clear that low income individuals will opt for the underground economy rather than face this battery of taxes. The political rhetoric says that working is being encouraged. The tax rates say otherwise.

Action

1) All working couples should maximize their use of the $5,000 dependent care exclusion. If your employer doesn't have a flexible benefit plan with this feature, then lobby for it.

2) Use of deferred compensation plans should be maximized. Employer funded plans are preferable to 401(k) plans because the contributions are not subject to employment taxes.

3) Work at keeping child care costs to a minimum.

4) Think twice about accepting employment in locations with high cost of living (ie. high child care and employment costs), and high state and local tax rates. If you own a business, stay out of high cost locations.

5) Seek out employers who cater to working spouses by paying compensation in nontaxable form. If you own a business, maximize fringe benefits to attract qualified employees, especially working women.

6) In future elections vote for candidates who support work effort, not expansion of the programs of big government that require these staggering tax rates on all wage earners.