Pepperdine Law Review

Volume 40
Issue 5 *Symposium: Tax Advice for the Second Obama Administration*

Article 4

4-26-2013

Tax Reform and the American Middle Class

Kirk J. Stark

Eric M. Zolt

Tax Reform and the American Middle Class

Kirk J. Stark & Eric M. Zolt*

I. INTRODUCTION

This essay offers some preliminary thoughts on how concern for the economic conditions of middle-income households should figure, if at all, in coming debates over federal tax reform. Our analysis is motivated by two key developments in American economic life over the past quarter century. The first is what many commentators refer to as "middle class decline"—a term generally meant to capture the bleak economic conditions of the American middle class as compared to previous eras, including stagnated wages, job polarization, and more limited economic opportunities. According to a Pew Research Center study published in August 2012,

* The authors would like to thank Bruce Bartlett, David Miller, and participants at the *Pepperdine Law Review* symposium on *Tax Advice for the Second Obama Administration*. This article is part of *Pepperdine Law Review*'s January 18, 2013 *Tax Advice for the Second Obama Administration* symposium, co-sponsored by Tax Analysts.

"[s]ince 2000 the middle class has shrunk in size, fallen backward in income and wealth, and shed some—but by no means all—of its characteristic faith in the future."[1] Recent data from the U.S. Census Bureau appear to confirm these trends, revealing a decline in real median household income to levels not seen since the mid-1990s.[2] Whereas median household income in 1996 was $50,661 (in 2011 dollars), by 2011 that figure had fallen to $50,054.[3] Changes in household net worth reveal an even bleaker picture: from its peak at $152,950 in 2007, median household wealth plummeted to $93,150 in 2010, up only slightly from the 1983 level of $91,056.[4] These sobering figures underscore the increased vulnerability of America's middle class families, casting doubt on the long-cherished image of the United States as a land of opportunity.

A natural and perhaps predictable policy response to these trends is to offer relief, often through the tax code. For example, following the publication of the September 2012 Census data, the White House immediately responded by urging Congress to extend the Administration's proposed middle-class tax cuts.[5] In early January 2013, Congress agreed (to an extent) and enacted legislation making permanent the Bush-era tax cuts for households earning less than $450,000 per year.[6] This action reinforces, and in many ways accelerates, the second key development motivating our analysis: the substantial reduction in the federal tax burden on middle-income households over the past thirty years.[7] Whereas in 1979 the middle class (defined here as the middle quintile of the income distribution) faced an average tax rate of 18.9% for all federal taxes combined, by 2009 that figure had fallen to 11.1%—a 41% reduction in the average tax rate.[8] To be sure, average tax rates today are lower across the board (21% lower for all

---

1. PEW RES. CENTER, FEWER, POORER, GLOOMIER: THE LOST DECADE OF THE MIDDLE CLASS 1 (Aug. 22, 2012), *available at* http://www.pewsocialtrends.org/files/2012/08/pew-social-trends-lost-decade-of-the-middle-class.pdf.

2. CARMEN DENAVAS-WALT ET AL., U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2011, at 38 (Sept. 2012).

3. *Id*.

4. PEW RES. CENTER, *supra* note 1, at 13.

5. *See* THE NAT'L ECON. COUNCIL & THE COUNCIL OF ECON. ADVISERS, THE MIDDLE-CLASS TAX CUTS' IMPACT ON CONSUMER SPENDING & RETAILERS (Nov. 2012), *available at* http://www.whitehouse.gov/sites/default/files/uploads/consumer_report_embargo.pdf.

6. *See* American Taxpayer Relief Act of 2012, H.R. 8, 112th Cong. §§ 101–04 (enacted). Notably, Congress did not extend the so-called payroll tax holiday by which the employees' share of social security taxes were reduced from 6.2% to 4.2% for taxable years 2011 and 2012.

7. *See generally* Binyamin Appelbaum & Robert Gebeloff, *Tax Burden for Most Americans Lower than in 1980's*, N.Y. TIMES, Nov. 29, 2012, http://www.nytimes.com/2012/11/30/us/most-americans-face-lower-tax-burden-than-in-the-80s.html (explaining benefits enjoyed by the middle class due to a reduced federal tax burden).

8. *See* Chuck Marr, *Federal Income Taxes on Middle-Income Families Remain Near Historic Lows*, CTR. ON BUDGET & POL'Y PRIORITIES (Apr. 2, 2012), http://www.cbpp.org/cms/index.cfm?fa=view&id=3151.

quintiles combined). Even so, the middle quintile's share of the overall federal tax burden has also fallen, down 31% from 13.6% in 1979 to 9.4% in 2009.[9] These data are for all federal taxes combined, but the trends are even more pronounced if one focuses only on individual income taxes. For example, the middle 60% of the income distribution accounted for fully 35% of federal income tax payments in 1979, but only 12.6 % by 2009.[10]

While neither of these developments is new or surprising, their juxtaposition tees up a predicament Congress will likely face in evaluating further tax changes, especially those designed to address the federal government's long-term fiscal imbalance. *On the one hand, the American middle class is facing economic stagnation of historic proportions; but on the other hand, federal tax burdens on the middle class are at historically low levels*. Given this state of affairs, how should tax reform—especially revenue-increasing tax reform—affect the middle class? Should future tax changes reduce middle class tax burdens further still, in the name of providing additional relief for America's struggling middle-income families? Or should Congress abandon its long-established practice of reducing middle-class tax burdens and revert to a tax code with distributional properties more in keeping with that of earlier eras? In short, as the federal income tax enters its second century, what is the proper direction of tax reform as it relates to the American middle class?

Needless to say, these are very large questions, too complex and unwieldy to be satisfactorily addressed within the confines of this short Essay. Thus, our aim here is necessarily modest—to provide a brief status report on how the American middle class fares in the current tax system and sketch out the beginnings of a framework for thinking about how a concern for the well-being of middle class households might figure in future tax reform efforts, if at all. The bulk of our analysis in the pages that follow is descriptive. Parts II and III set forth some basic data showing the current economic and fiscal circumstances of middle class households. These two parts reveal some of the statistical detail underlying the two developments described above—i.e., the increasing hardship experienced by middle class households as well as their diminishing federal tax burdens. If there is a basic bottom line to this portion of our analysis, it is that the middle class is indeed struggling, but neither the root causes of America's "middle class decline" nor the policy solutions to address it are likely to be found within

9. The middle quintile's share of pre-tax income also fell, but by a substantially lesser amount—i.e., from 15.8% to 14.7% (a decline of 7%). *See* discussion *infra* Part III.A.1.

10. *See* Marr, *supra* note 8.

the confines of the Internal Revenue Code.

In Part IV we turn to the question of whether the dominant legislative strategy of the past three decades—i.e., that of "middle class tax relief"—has outlived its usefulness. We consider an alternative legislative bargain—one admittedly at odds with current political dynamics—of deemphasizing (or perhaps even surrendering) the goal of middle class tax relief in favor of a tax code designed to underwrite a more durable, or potentially even more robust, social safety net. To be clear, we make no claims regarding the appropriate level of federal tax burdens for the middle class; nor do we favor any particular distribution of the tax burden across income classes. Rather, our chief point is that the U.S. middle class may be better served by a fortification of key expenditure programs designed to alleviate economic insecurity, even if it means a less progressive tax system. We contend that this approach, which characterizes the tax/transfer systems of most major developed countries and serves as the basic framework of the U.S. Social Security system, may ultimately better serve the long-term well-being of the American middle class than the country's current reliance on a top-heavy tax system to fund a modest welfare state.

II. THE STATE OF THE AMERICAN MIDDLE CLASS

Any discussion of the middle class necessarily begins with a focus on definitions. While the term "middle class" carries significant rhetorical power—at least in the political arena—for better or for worse there is no single definition or common understanding that applies across all settings.[11] The term means different things to different people, a fact that often confounds policy debates. This definitional elasticity is, of course, part of the term's longstanding appeal, enabling political entrepreneurs to make relatively "flexible" commitments to their constituencies. Studies show that most people believe themselves to be part of the "middle class."[12] This suggests that political pledges to support policies benefitting the middle class will likely have broad appeal, even though actual policy outcomes may have a narrower or more skewed class of beneficiaries.[13]

One arguably objective definition of middle class sets the outer bounds at specified percentiles of the income distribution.[14] For example, one might

---

11. *See* Catherine Rampell, *Defining Middle Class*, N.Y. TIMES (Sept. 14, 2012, 4:26 PM), http://economix.blogs.nytimes.com/2012/09/14/defining-middle-class (addressing the debate surrounding the definition of middle class and its impact on political discourse).

12. M.D.R. Evans and Jonathan Kelley, *Subjective Social Location: Data from 21 Nations*, 16 INT'L J. PUB. OPINION RES. 4 (2004) ("[I]n all societies there is a pronounced tendency to see oneself as being in the middle of the social hierarchy").

13. Rampell, *supra* note 11.

14. *See* Anthony B. Atkinson & Andrea Brandolini, *On the Identification of the "Middle Class"*

equate middle class with the middle quintile of the income distribution such that the outer bounds are the fortieth and sixtieth percentiles.[15] This is sometimes referred to as a "fixed size" approach in that the relative group size of different segments of the population will not change over time.[16] Even this seemingly precise approach, however, is subject to dispute and qualification. For example, one might take issue with the use of income, rather than, say, consumption or wealth (or some combination of the these measures), as the basis for ranking households. Or one might quarrel about where to set the outer bounds. Perhaps focusing on the middle 60% (i.e., households between the twentieth and eightieth percentiles) would be more appropriate, or possibly two breakpoints that are not equidistant from the median. Regardless of the boundaries chosen, a fixed size approach enables a longitudinal comparison of the income or tax shares of different groups of the income distribution (e.g., quintiles) without concern that relative group size may have shifted over time. We will return to this point below in our discussion of the Pew Research Center's recent study of the middle class.

An alternative approach is to define middle-class households as those with income levels representing some specified percentage of median household income. This "income boundaries" approach might, for example, consider middle class households to be those within the range of 75% to 125% of median income or some alternative boundaries.[17] The income boundaries approach has the advantage of capturing an intuitively attractive range of income levels that many would regard as falling within the "middle tier."[18] It also permits an analysis of the changing size of the middle class over time. Unlike the fixed size approach, with an income boundaries approach it is possible to determine whether the middle class shrinks or grows in response to changes in the distribution of income.[19] This mode of analysis may be particularly useful in evaluating the effects of "job polarization"—the skewing of employment growth into both high-skill/high-

(Soc'y for the Study of Econ. Inequality, Working Paper No. 2011-217, 2011), *available at* http://www.economicswebinstitute.org/essays/middleclass.pdf.

15. *Id*.

16. *Id*.

17. These specific percentages, around which the economics profession is said to be converging in its definition of the middle class, appear to have their origin in a 1987 paper on income inequality by economist Lester Thurow. *See* Lester Thurow, *A Surge in Inequality*, SCI. AM., May 1987, at 30. *See also* Martin Ravallion, *The Developing World's Bulging (but Vulnerable) Middle Class* 3–6 (World Bank Dev. Res. Grp., Policy Research Working Paper No. 4816, 2009), *available at* http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-4816.

18. *See* Thurow, *supra* note 17; Ravallion, *supra* note 17, 445–54.

19. *See* Thurow, *supra* note 17; Ravallion, *supra* note 17, 445–54.

wage jobs and low-skill/low-wage jobs, accompanied by a "hollowing out" of middle class employment opportunities.[20]

Our purpose here is not to endorse or reject any particular methodology in regards to the definition of middle class. Nevertheless, a note of caution is in order, as the discussion that follows often relies on alternative definitions of middle class depending upon the data source being considered. Where data sources conflict in their use of the term "middle class," we will attempt to make clear the researchers' definitions and how they might differ from alternative understandings.

In a study published in late 2012 on the eve of the presidential election, the Pew Research Center undertook a comprehensive analysis of the state of the middle class, evaluating both subjective indicia of well-being based on a July 2012 survey of 2508 adults and government data from the Census Bureau's annual Current Population Survey.[21] The study, which received wide news coverage upon its release, offers a relatively recent statistical snapshot of middle class economic conditions (as well as perceptions of those conditions).

The Pew survey results reveal an unmistakable pessimism among the 1287 respondents who self-identified as middle class. Of these individuals, 85% indicated that "it is more difficult today than 10 years ago for the middle class to maintain their standard of living."[22] Much of this pessimism is no doubt attributable to the lingering effects of the Great Recession. Despite the fact that the recession officially ended three years ago, the survey results indicate that 42% of respondents believe their current financial situation is worse now than it was immediately preceding the recession.[23] Thus, it would appear that for many in the middle class the "soft" recovery over the past three years amounts to virtually no recovery at all. Indeed, more than half of middle-class respondents (51%) believe that it will take at least another five years to recover from the effects of the economic downturn.[24]

When asked about the longer term future, nearly half (47%) of respondents identifying as middle class indicated that their children would likely have a standard of living about the same or worse than their own, with more than a quarter (26%) specifying that their children's standard of living would be either "somewhat worse" or "much worse."[25] A strong majority of

---

20. *See* DAVID AUTOR, CENTER FOR AM. PROGRESS, THE POLARIZATION OF JOB OPPORTUNITIES IN THE U.S. LABOR MARKET: IMPLICATIONS FOR EMPLOYMENT AND EARNINGS (April 2010), *available at* http://economics.mit.edu/files/5554.

21. PEW RES. CENTER, *supra* note 1.

22. *Id.* at 1, 20–21.

23. *Id.*

24. *Id.*

25. *Id.* at 121.

all respondents (72%), including 71% of those self-identifying as middle class, believe that it is harder to get ahead today than it was ten years ago.[26] The Pew study notes that those approaching retirement age are especially pessimistic about the future, with approximately half of respondents ages fifty to sixty-four indicating that they are less economically secure than ten years ago.[27] These findings are consistent with an earlier Pew study characterizing baby boomers as "the gloomiest generation" because of their downbeat perspective on future economic opportunities.[28]

To put the survey results in context, the Pew "Lost Decade" report also includes a summary description of government data from the Census Bureau's annual Current Population Survey.[29] Data summarized include the Annual Social and Economic Supplements (ASEC) for each year's report from March 1971 to March 2011.[30] If the survey on middle-class attitudes accounts for the inclusion of the term "Gloomier" in the Pew study's subtitle, the Census data provide the basis for the terms "Fewer" and "Poorer."

The key to understanding these findings is in Pew's definition of the "middle tier" of the income distribution as consisting of those households with income ranging from 67% to 200% of median household income.[31] This is an example of the income boundaries type approach to defining the middle class, as noted above. When defined this way, the middle class has unquestionably shrunk over the past 40 years. Whereas middle income households accounted for 60.8% of the total population in 1971, by 2011 that figure had fallen to 50.7%.[32] Both the lower income (below 67% of median household income) and upper income (above 200%) categories increased in size over the same period.[33] The size of the lower income group increased from 25.2% to 29.3% of the population over this period, while the upper income group rose from 14% to 20%.[34]

Viewed from a number of different perspectives, middle class income

26. *Id*. at 123 (65% of upper; 71% of middle; 77% of lower).
27. *Id*. at 26.
28. *Baby Boomers: The Gloomiest Generation*, PEW RES. CTR. (June 25, 2008), *available at* http://www.pewsocialtrends.org/2008/06/25/baby-boomers-the-gloomiest-generation/.
29. PEW RES. CENTER, *supra* note 1, at 10, 60–62, 66–67, 71, 89, 101–06.
30. *Id*.
31. *Id*. at 15.
32. *Id*. at 65.
33. *Id*.
34. *Id*. at 65–66.

has also declined in recent years.[35] For most of the period from 1970 to the end of the century, median household income steadily increased.[36] Thus, for example, median household income for 1971 was $45,147 (in 2011 dollars) and had reached $54,842 by 2000 (again, in 2011 dollars).[37] By 2010, however, this figure had fallen to $51,006.[38] When adjusted for household size, median household income shows a larger increase from 1970 to 2010 (due to declining family size); still, however, median household income for 2010 is lower (at $59,127) than it was in 1997 (at $59,194).[39]

These income changes, along with the reduced number of households meeting the Pew definition of "middle tier," have resulted in middle class households claiming a significantly smaller share of the nation's total income.[40] More specifically, over the forty-year period from 1970–2010, the middle tier's share of income declined from 62% to 45%, while the upper income group increased its share from 29% to 46%.[41] During this same period, the lower income group's share of income fell only slightly—from 10% to 9%.[42] Again, we emphasize that part of the decline in the middle class's share of income is attributable to the changing *size* of the three income groups.[43] Recall that the percentage of households within the 67%-200% income range dropped nearly ten percentage points over the 1971–2011 period. Naturally, a group representing a smaller percentage of the total population is likely to account for a correspondingly smaller percentage of the nation's income. Even so, the Pew study emphasizes that the share of middle-income households' income "fell more sharply (by 27%) than its share in the adult population," whereas the "share of upper-income households in aggregate income rose faster (by 60%) than "its share in the adult population (up 44%)."[44]

Changes in the distribution of wealth provide further evidence for the Pew study's characterization of a middle class in decline. Whereas the median income of middle-tier households declined modestly over the period from 2000 to 2010, the net worth of these households—defined as assets minus debt—fell by 28%, dropping from $129,582 in 2000 to $93,150 in 2010.[45] In these data we see clear evidence of the crisis in housing markets

35. *Id*. at 60–61.
36. *Id*. at 60.
37. *Id*. at 61.
38. *Id*.
39. *Id*.
40. *See id*. at 89.
41. *Id*. at 89–90.
42. *Id*.
43. *Id*. at 89.
44. *Id*. at 90.
45. *Id*. at 2.

that has plagued the U.S. economy from 2007 onward.[46] Because middle-class wealth is concentrated in owner-occupied housing, this segment of the income distribution was hit especially hard by the housing crises.[47] While wealthier families also suffered losses in home values as a result of the housing crisis, their more diversified asset portfolios shielded them from the magnitude of losses experienced by middle-income families.[48] Thus, over the same period of 2000–2010, the median wealth of upper-tier households increased (barely) by 1%, as compared to the 28% decline for middle-class households.[49]

It bears noting that the data just described reflect two very different types of changes in economic conditions, one cyclical and one secular. The cyclical change is, of course, the Great Recession of 2007–2009. This significant economic contraction—the most severe downturn in the world economy since the Great Depression of the 1930s—no doubt accounts for the particularly sharp declines in household income and wealth over the past several years.[50] Yet there is another, deeper change underlying these data: a long-term secular change that both predates and survives the Great Recession.[51] Most analysts ascribe the shrinking of the middle class to the phenomenon of job polarization.[52] Job polarization is a long-term global trend that has been driving patterns of economic growth in almost all industrialized countries over the past three decades.[53] At the heart of these fundamental changes is the global integration of labor markets, as well as technological advances resulting in increased automation of routine work.[54] These long-term global patterns help explain the widely observed phenomenon of rising income inequality in the United States, and give

46. *See id*. at 13.
47. *See id*. at 14.
48. *See id*.
49. *See id*. at 2–3.
50. *See id*. at 5.
51. Josh Mitchell & Austin Nichols, *Job Polarization and the Great Recession*, UNEMPLOYMENT & RECOVERY PROJECT (Urban Inst., Wash. D.C.), Oct. 2012, at 1, *available at* http://www.urban.org/UploadedPDF/412680-Job-Polarization-and-the-Great-Recession.pdf).
52. DAVID AUTOR, CENTER FOR AM. PROGRESS, THE POLARIZATION OF JOB OPPORTUNITIES IN THE U.S. LABOR MARKET: IMPLICATIONS FOR EMPLOYMENT AND EARNINGS (2010) *available at* http://economics.mit.edu/files/5554; *see also* David Autor & David Dorn, *The Growth of Low Skill Service Jobs and the Polarization of the U.S. Labor Market*, 103 AM. ECON. REV. (forthcoming 2013), *available at* http://economics.mit.edu/files/1474.
53. *See* Autor & Dorn, *supra* note 52, at 1; Mitchell & Nichols, *supra* note 51, at 18.
54. *See* Mitchell & Nichols, *supra* note 51, at 4.

empirical support to the mounting sense of a middle class in decline.[55] Thus, while the Great Recession accounts for the most dramatic declines in income and wealth detailed in the Pew Center's *Lost Decade* study, the secular trend of job polarization suggests that middle class decline may be an even deeper and more intractable problem, raising long-term challenges for policymakers that will outlast the effects of the Great Recession.

III. Taxation of the American Middle Class over Time

If data on the economic condition of the middle class suggest ongoing hardship and stagnation, government tax data reveal a declining fiscal burden on middle-income households over the past three decades. The sections below detail the evolution of the federal tax burden over the period from 1979 to 2009, relying principally on data published by the Congressional Budget Office (CBO).

A. CBO Data on Income Shares, Average Tax Rates and Tax Shares

CBO data offer numerous insights into the shifting tax burden over time for the American middle class. Because the data are available for years 1979-2009, it is possible to evaluate changes in the distribution of the federal tax burden over a full three decades. In addition, CBO income data are presented for each of the five quintiles of the income distribution, an example of the fixed size approach to defining the middle class discussed above. As noted above, this approach enables a comparison of income or tax shares over time without the concern that changing shares are attributable to changes in relative group size.

The tax data are broken down into four separate categories of taxes: individual income taxes, social insurance taxes, corporate income taxes, and excise taxes. Total federal tax burden consists overwhelmingly of the first two of those categories—individual income taxes and social insurance taxes, with corporate income and excise taxes representing a relatively small share of total federal tax receipts. Accordingly, our focus will be on three separate figures: (1) total federal taxes, (2) individual income taxes, and (3) social insurance taxes. For each of these categories, we will focus on average tax rates both by quintile and tax shares. First, however, we consider briefly how CBO income data vary from the Pew findings discussed above.

55. *Id.* at 2.

1. Pre-Tax Income and Income Shares

Recall that the Pew study's discussion of the distribution of U.S. household income indicated a dramatic decline in the share of income claimed by middle class households.[56] Whereas the middle class accounted for fully 62% of income in 1970, by 2010 its share had plummeted to 45%.[57] Over the same period, the share of income accruing to the upper class rose from 29% to 46%.[58] These stark changes in the distribution of income no doubt reflect the rise of income inequality over the past four decades, including most notably the significant income gains enjoyed by the top 1% of the income distribution over this period.[59] However, the magnitude of the changes in the distribution of income reported in the Pew study are also a function of the study's reliance on an income boundaries approach to defining the middle class. That is, the decline in the middle class's share of national income as reported by the Pew study is partly attributable to the fewer number of households satisfying the "67%–200% of median income" definition of middle class.

Because the CBO data are reported in fixed quintiles rather than by reference to income boundaries,[60] it is possible to see the changes in the income distribution from an alternative perspective. The broad trends described in the Pew study are also evident in the CBO data; because of a difference in methodology, however, the figures are not quite as dramatic. Over the period from 1979 to 2009, the average pre-tax income of the middle quintile increased from $53,100 to $64,300 (in 2009 dollars), representing a 21% increase.[61] By contrast, the top quintile average pretax income jumped from $136,200 to $223,500, a 65% increase.[62] Significantly, the top 1% of the income distribution enjoyed a whopping 133% increase in

56. *See supra* notes 36–39 and accompanying text.

57. PEW RES. CENTER, *supra* note 1, at 89–90.

58. *Id.*

59. *See, e.g.*, Ezra Klein, *In 2010, 93 Percent of Income Gains Went to Top 1 Percent*, WASH. POST (Mar. 5, 2012, 10:59 PM), http://www.washingtonpost.com/blogs/wonkblog/post/in-2010-93-percent-of-income-gains-went-to-the-top-1-percent/2011/08/25/gIQA0qxhsR_blog.html.

60. *See* CONG. BUDGET OFFICE, DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2008 AND 2009, at ii (July 2012), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43373-06-11-HouseholdIncomeandFedTaxes.pdf

61. CONG. BUDGET OFFICE, DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2008 AND 2009: SUPPLEMENTAL TABLES, at tbl. 3 (July 2012), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43373-Supplemental_Tables_Final.xls

62. *Id.*

average pretax income, increasing from $523,300 in 1979 to $1,219,700 in 2009 (down from $1,917,200 in 2007).[63]

Like the Pew data, these figures provide strong evidence of an increasingly skewed distribution of income, with an ever-larger share of national income accruing to the wealthiest families. However, the CBO data show a less dramatic shift in pretax income shares than the Pew data. According to the CBO, the middle 60% claimed 48.9% of before tax income in 1979, but only 44.1% in 2009—a 10% decrease[64] (compared to a 25% decrease from 1980 to 2010 in the Pew study).[65] By contrast, the top quintile increased its share of before tax income from 44.9% in 1979 to 50.8% in 2009—a 13.1% increase[66] (compared to a 53.3% increase from 1980 to 2010 in the Pew study).[67] Table 1 shows the progression of these trends in five-year increments from 1979 to 2009 for the bottom quintile, the middle 60%, and the top quintile.

Table 1: Before Tax Income Shares, 1979-2009

	Bottom Quintile	**Middle 60%**	**Top Quintile**
1979	6.2%	48.9%	44.9%
1984	5.5%	47.2%	47.3%
1989	4.9%	45.8%	49.3%
1994	5.1%	46.1%	48.8%
1999	4.8%	42.2%	53.0%
2004	4.7%	43.1%	52.2%
2009	5.1%	44.1%	50.8%

A comparison of the Pew and CBO data make clear the significance of alternative approaches to describing income categories. While there is no

63. *Id.*
64. *Id.*
65. *See* PEW RES. CENTER, *supra* note 1, at 89–90.
66. CONG. BUDGET OFFICE, *supra* note 61, at tbl. 3.
67. *See* PEW RES. CENTER, *supra* note 1, at 89–90.

question that higher income households have claimed an increased share of national income over the past three decades (a fact highlighted by both methodologies), the magnitude of that shift depends on the specification of income groupings. During a period of job polarization in which middle income employment opportunities are in decline (in favor of both lower and higher skill jobs), an income boundaries approach will, by mathematical necessity, show a greater skewing of income than a fixed size definition of income classes.

2. Tax Shares—Total, Individual Income, and Social Insurance

We turn now from changes in the distribution of income to changes in distribution of federal tax burdens. It bears noting that changes in the distribution of taxes may be attributable to either changes in the distribution of income or changes in the law. It is important to keep in mind that *both* of these factors were at work over the period from 1979 to 2009.[68]

We focus first on the distribution of total federal taxes, including all four categories of federal tax receipts mentioned above. There are a few points worth emphasizing here, especially as compared to the income data just reviewed. As shown in Table 2, the middle 60% of the income distribution accounted for 42.6% of all federal taxes paid in 1979.[69] By 2009, this figure had fallen to 32.1%, a decrease of nearly 25%.[70]

Table 2: Tax Shares for All Federal Taxes, 1979-2009

	Bottom Quintile	**Middle 60%**	**Top Quintile**
1979	2.1%	42.6%	55.3%
1984	2.5%	42.6%	54.9%
1989	1.7%	40.0%	58.3%
1994	1.6%	38.0%	60.4%
1999	1.4%	33.5%	65.1%
2004	1.2%	32.6%	66.2%
2009	0.3%	32.1%	67.9%

68. *See supra* Part III.A.
69. CONG. BUDGET OFFICE, *supra* note 61, at tbl. 3.
70. *Id*.

These reductions in the middle class tax burden are significantly larger than the reduction in income share experienced by the middle class. Recall that the middle 60%'s share of income fell by 10% from 1979 to 2009 (i.e., from 48.9% to 44.1%, as shown in Table 1 above), but its share of total federal taxes fell by more than twice that amount.[71] In other words, while changes in the distribution of income account for *some* of the changes in the distribution of the overall tax burden on the middle class, the magnitude of the reduction in the middle 60%'s tax share suggests that policy changes also played a significant role in driving down middle class tax burdens.

Not surprisingly, the trends just described are even more pronounced in the context of the individual income tax. As shown in Table 3, the middle 60% accounted for 35% of individual income tax receipts in 1979.[72] Three decades later, however, this figure had fallen to 12.5%.[73] Roughly stated, one might say that the middle class share of the federal income tax burden in 2009 is about one-third of the level it was at thirty years earlier. Again, we emphasize that the middle class share of total pretax income declined over this same period, but the percentage decline in the middle class share of income over this period (10%) appears quite modest as compared to the decline in its share of federal income tax liabilities (a 64% decline for the middle 60% and a 75% decrease for the middle quintile).[74]

Table 3: Tax Shares for Income Taxes, 1979-2009

	Bottom Quintile	Middle 60%	Top Quintile
1979	0.0%	35.0%	65.0%
1984	0.4%	33.6%	66.0%
1989	-0.6%	29.3%	71.3%
1994	-1.6%	26.8%	74.8%
1999	-1.9%	21.3%	80.6%
2004	-3.0%	17.7%	85.3%
2009	-6.6%	12.5%	94.1%

The major (and significant) exception to these trends is the distribution of social insurance tax liabilities. Unlike the federal income tax, payroll

71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.*

taxes for Social Security and Medicare are explicitly regressive—with an initial statutory rate of 15.3% (i.e., 12.4% Social Security tax plus 2.9% Medicare tax) that applies to a threshold of $113,700 (for 2013) and a 2.9% tax on wages above that threshold.[75] In addition, until this year, these taxes applied *only* to wages, excluding all other types of income, most notably investment income. Accordingly, one would expect a far more regressive distribution of social insurance tax burdens than for the individual income tax. The figures presented in Table 4 confirm these intuitions.

Table 4: Tax Shares for Social Insurance Taxes, 1979-2009

	Bottom Quintile	**Middle 60%**	**Top Quintile**
1979	4.5%	59.4%	36.1%
1984	4.3%	55.9%	39.8%
1989	4.0%	55.5%	40.5%
1994	4.2%	52.4%	43.4%
1999	4.9%	52.2%	42.9%
2004	5.0%	50.7%	44.3%
2009	5.3%	49.4%	45.3%

In 1979, the middle 60% accounted for 59.4% of all federal payroll taxes.[76] Here too the middle 60%'s share of the tax burden declined over the 1979–2009 period, but not nearly as much as the percentage decline in the individual income tax.[77] By 2009, the middle 60% accounted for 49.4% of social insurance taxes paid, a 16.8% decline from 1979.[78] Over this same period, the top quintile increased its share of social insurance taxes from 36.1% to 45.3%—a percentage increase of 25.5%.[79]

75. It bears noting that when taxes and benefits are considered together, the overall Social Security system is progressive, favoring lower- and middle-income earners. This is attributable to the formula for calculating Social Security benefits. *See* Jeffrey Liebman, *Redistribution in the Current U.S. Social Security System*, (Nat'l Bureau of Econ. Res., Working Paper No. 8625, 2001).

76. CONG. BUDGET OFFICE, *supra* note 61, at tbl. 2.

77. *Id.*

78. *Id.*

79. *Id.*

3. Average Tax Rates—Total, Individual Income, and Social Insurance

Finally, consider the changes in average tax rates over the period from 1979 to 2009. Once again, our focus is on total federal taxes (i.e., income, payroll, corporate and excise combined) as well as on the individual income tax and social insurance taxes.

Importantly, average tax rates have fallen for *all* quintiles combined during this period.[80] CBO calculates an average federal tax rate of 22% for all quintiles combined in 1979 but only 17.4% in 2009.[81] Disaggregating this trend among the five quintiles, it becomes apparent that the bottom half of the income distribution experienced the most significant decline in average tax rates.[82]

Table 5: Average Federal Tax Rates for All Taxes, 1979-2009			
	Bottom Quintile	**Middle 60%**	**Top Quintile**
1979	7.5%	18.3%	27.1%
1984	9.4%	17.5%	23.8%
1989	7.6%	17.3%	25.1%
1994	6.8%	16.7%	27.1%
1999	6.5%	16.6%	27.7%
2004	5.1%	13.6%	24.9%
2009	1.0%	11.0%	23.2%

As shown in Table 5, the average tax rate for the middle 60% fell from 18.3% in 1979 to 11.0% in 2009, representing a nearly 40% decline.[83] For the top quintile, average federal tax rates fell from 27.1% to 23.2%—a 14.4% decline.[84] The bottom quintile, which faced a 7.5% average tax rate in 1979, was subject to a 1% average federal tax rate in 2009—an 86.6% decline.[85]

80. *See id.* at tbl. 1.
81. *Id.*
82. *See id.*
83. *Id.*
84. *Id.*
85. *Id.*

Once again, as was true of tax shares, the changes are more pronounced when focusing only on the individual income tax, as shown in Table 6.

Table 6: Average Federal Tax Rates for Income Taxes, 1979-2009

	Bottom Quintile	**Middle 60%**	**Top Quintile**
1979	0.0%	7.2%	15.9%
1984	0.7%	6.4%	14.0%
1989	-1.3%	5.7%	14.7%
1994	-3.2%	4.9%	15.1%
1999	-4.5%	4.9%	17.2%
2004	-5.4%	2.7%	14.0%
2009	-9.3%	1.1%	13.4%

The middle 60%'s average income tax rate dropped from 7.2% in 1979 to 1.1% in 2009—an 84.7% decrease.[86] By contrast, the top quintile's average income tax rate fell from 15.9% to 13.4%—a 15.7% decrease.[87] Meanwhile, the bottom quintile, which faced a 0.0% average income tax rate in 1979, was subject to a negative 9.3% average income tax rate by 2009.[88] Here we see the clear effect of the earned income tax credit, a refundable tax credit designed to supplement the labor income of low-income households.

86. *Id.*
87. *Id.*
88. *Id.*

Finally, consider average tax rates under the Social Security and Medicare programs. In contrast to the data for other taxes presented above, here tax rates have actually increased across most of the income categories, as shown in Table 7.[89]

Table 7: Average Federal Tax Rates for Payroll Taxes, 1979-2009			
	Bottom Quintile	**Middle 60%**	**Top Quintile**
1979	4.9%	8.2%	5.5%
1984	6.0%	8.8%	6.4%
1989	6.7%	9.4%	6.6%
1994	7.0%	9.2%	7.5%
1999	8.3%	9.5%	6.4%
2004	8.2%	8.8%	6.6%
2009	8.3%	8.5%	7.2%

The middle 60% faced an average tax rate of 8.2% in 1979, slightly lower than the 8.5% average tax rate it faced in 2009.[90] The top quintile increased its average tax rate for social insurance taxes from 5.5% to 7.2%, while the bottom quintile's average tax rate jumped from 4.9% in 1979 to 8.3% in 2009.[91] In other words, while both the bottom and the top of the income distribution experienced significant increases in average tax rates over this thirty-year period, the middle 60% experienced a relatively modest increase in social insurance average tax rates over the 1979-2009 period.

B. Legislative Changes Reducing Middle Class Tax Burdens

The CBO data just described reveals an unmistakable reduction in middle class tax burdens over the past three decades, whether one focuses on average tax rates or tax shares. Yet as we have attempted to emphasize, these figures can only tell part of the story. Dramatic changes in the distribution of pre-tax income over the past three decades—favoring the wealthiest households—account for much, though not all, of the tax shift evident in the figures above. In this section, we offer a slightly different perspective on the same issue, and provide a brief narrative account of the

89. *See id.*
90. *Id.*
91. *Id.*

key legislative changes to the U.S. tax system that help account for the observed decline in middle class taxes.

We emphasize four distinct categories of statutory changes over this period, all of which have had the effect of reducing the tax burden of low- and middle-income households over the past several decades; (1) increases in the personal exemption and standard deduction: (2) the growing significance of the earned income tax credit; (3) the emergence of tax relief focused specifically on families with children; and (4) the introduction of new, lower statutory tax rates as part of the Bush-era tax cuts. As explained below, the tax reductions effectuated through these changes were not the result of some well-conceived public policy, but rather evolved from a combination of ad hoc factors suiting the political dynamics of the moment.

1. Personal Exemption and Standard Deduction.

Much of the reduction in middle class tax burdens over the past thirty years is attributable to increases in personal exemptions[92] and the standard deduction.[93] The modern income tax, enacted in 1913, featured a very large basic exemption ($3000 for singles; $4000 for married couples) that effectively rendered the tax inapplicable to the vast majority of Americans.[94] However, the exemption was substantially reduced during both world wars, increasing the number of taxpayers subject to the income tax and increasing the tax burden on households already subject to the tax.[95] Congress first indexed the personal exemption for inflation in 1985, ending the process of increasing the nominal amount periodically through affirmative Congressional action.[96] In the mid-1980s, the exemption was increased substantially—from $1080 in 1986 to $1900 in 1987.[97] For 2013, the figure

92. *See* ROBERT A. WILSON, INTERNAL REVENUE SERV., PERSONAL EXEMPTIONS AND INDIVIDUAL INCOME TAX RATES, 1913–2002 (2012), *available at* http://www.irs.gov/pub/irs-soi/02inpetr.pdf

93. *See* John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX. L. 203, 209–18 (2011) (recounting the history of the standard deduction).

94. *See* WILSON, *supra* note 92, at 216.

95. *Id*.

96. *Id*. at 217.

97. *Id*. at 220.

is $3900.[98] Thus, a family of four will pay no tax on its first $15,600 of income simply by virtue of the personal exemption.[99]

The standard deduction plays a similar role in providing an effective zero-bracket amount.[100] Although the original standard deduction was enacted in 1944, it was not until twenty years later, in 1964, that Congress established the "minimum standard deduction" with the express purpose "to remove from the tax rolls those persons with minimum incomes and also to provide those with incomes just slightly above these levels a somewhat larger tax reduction than is made available generally through the rate cuts."[101] The chief policy motivation here was that "poor people shouldn't have to pay taxes"—as a practical matter, however, this change benefitted everybody[102] and set in motion the process of systematically reducing the income tax burden on the bottom half of the income distribution. Like the personal exemption, the standard deduction was increased several times between 1977 and 1986, and then increased as part of the Tax Reform Act of 1986.[103] Whereas in 1986 the standard deduction was $2480 for single taxpayers ($3670 for married filing jointly), by 1988 the deduction was increased to $3000 ($5000 for married couples filing jointly).[104] These amounts are indexed for inflation with the result that 2013 figures are now $6100 for single individuals and $12,200 for married filing jointly. Together with the personal exemptions, the standard deduction ensures that a family of four will face an effective zero-bracket amount of $27,800—but this is before any credits are taken into account.

2. Expansion of the Earned Income Tax Credit

The expansion and increased generosity of the earned income tax credit (EITC) has also served to increase the number of taxpayers not subject to income tax. Congress first introduced the earned income tax credit in 1975, following several years of discussion (begun in the mid-1960s) of the possible introduction of a negative income tax.[105] Generally speaking, the

98. I.R.S. News Release IR 2013-4 (Jan. 11, 2013), *available at* http://www.irs.gov/uac/Newsroom/Annual-Inflation-Adjustments -for-2013.

99. *See id*.

100. *See* Brooks, *supra* note 93, at 216.

101. *Id*. at 212; *see also* SEAN LOWRY, CONG. RESEARCH SERV., TAX DEDUCTIONS FOR INDIVIDUALS: A SUMMARY (2012), *available at* https://www.fas.org/sgp/crs/misc/R42872.pdf.

102. *See* Brooks, *supra* note 93, at 212 ("The result was that all taxpayers could get at least $900 . . . of income tax-free . . . .").

103. *Id*. at 217.

104. *Standard Deduction Amount, 1970–2012*, TAX POL'Y CTR. (Jan. 10, 2012), http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=171.

105. Dennis Ventry, *The Collision of Tax and Welfare: The Political History of the Earned Income Tax Credit, 1969–99*, 53 NAT'L TAX J. 983, 986–95 (2000).

EITC is a refundable credit—often characterized as a wage subsidy[106]—that is available to taxpayers with certain levels of earned income as defined in § 32 of the Internal Revenue Code.[107] The credit is phased-in over very low income levels, then hits a plateau, followed by a phase-out that works to ensure that higher-income households receive no tax credit.[108] The amount of the credit available to any given taxpayer is a function of these various statutory parameters—i.e., the phase-in and phase-out percentages, the maximum allowable credit, and the breakpoints for the beginning and end of the plateau.[109]

The EITC started out small in 1975 but eventually expanded to provide benefits to households that arguably include "middle class" earners.[110] In addition, at times, Congress has augmented the EITC, such as with the introduction in 2009 of the "Making Work Pay" tax credit[111] as part of the American Recovery and Reinvestment Act of 2009.[112] The 2009 legislation also included for the first time a higher amount of refundable credit for families with three or more children (previously the credit did not differentiate between taxpayers with two or more children).[113]

For 2013, the amount of the refundable credit available to a household ranges from a maximum of $487 for those with no qualifying children to $6044 for those with three or more qualifying children.[114] Income thresholds for eligibility for the EITC also vary depending on the number of qualifying children.[115] For a married couple with two qualifying children, the EITC is

---

106. *Id.* at 992.
107. I.R.C. § 32 (2006).
108. Ventry, *supra* note 105, at 986–95.
109. *Id.*
110. *See id.* at 999; *Earned Income Tax Credit Parameters, 1975–2013*, TAX POL'Y CTR. (Jan. 28, 2013), http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=36&Topic2id=40&Topic3id=42.
111. *The Making Work Pay Tax Credit*, IRS, http://www.irs.gov/uac/The-Making-Work-Pay-Tax-Credit (last updated Mar. 25, 2013).
112. American Recovery and Reinvestment Act of 2009, § 1001, Pub. L. No. 111-5 (codified at I.R.C. § 36A).
113. ELIZABETH KNEEBONE, METRO. POLICY PROGRAM, ECONOMIC RECOVERY AND THE EITC: EXPANDING THE EARNED INCOME TAX CREDIT TO BENEFIT FAMILIES AND PLACES (Jan. 2009), *available at* http://www.brookings.edu/~/media/research/files/papers/2009/1/29%20eitc%20kneebone/20090126_eitc_kneebone.pdf.
114. *Preview of 2013 EITC Income Limits, Maximum Credit Amounts and Tax Law Updates*, IRS (Jan. 22, 2013), http://www.irs.gov/Individuals/Preview-of-2012-EITC-Income-Limits,-Maximum-Credit—Amounts-and-Tax-Law-Updates.
115. *Id.*

completely phased out at $48,378.[116] At income levels below this amount, the EITC serves first to offset any positive tax liability, then makes any excess available as a refund.[117]

3. Introduction of the Child Tax Credit

A third category of tax benefits reducing the income tax liability of low- and middle-income households includes those targeted to families with children. This family-focused tax relief has accelerated in the past several years. This includes the introduction of the Child Tax Credit in 1997 as part of the Taxpayer Relief Act of 1997.[118] The credit was initially pegged at $400 per child (for taxable year 1998) but then was increased to $1000 per child via Bush era tax legislation.[119] The Child Tax Credit was made permanent as part of the 2013 fiscal cliff legislation.[120] In addition to the Child Tax Credit, there is also the Dependent Care tax credit (i.e., I.R.C. § 21).[121] Increases in the amount of this credit (ensuring that expenses up to $6000 would be creditable) were permanently extended in connection with the 2013 fiscal cliff legislation.[122]

4. Reductions in Statutory Tax Rates

Finally, legislative changes enacted as part of the Bush tax cut legislation in 2001 and 2003 further reduced the income tax liability of low- and middle-income households. The Economic Growth and Tax Reconciliation Act of 2001[123] and the Jobs and Growth Tax Relief Reconciliation Act of 2003[124] chiefly benefit high-income households, though the Bush tax cut legislation also included provisions introducing a new 10% rate bracket and an expansion of the 15% bracket.[125] In addition, the 2001 legislation included modifications to the rate structure (as well as changes to the standard deduction and the EITC) to substantially reduce the

116. *Id*.
117. *See* Ventry, *supra* note 105, at 1008.
118. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of I.R.C.).
119. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of I.R.C.).
120. American Taxpayer Relief Act of 2012, § 103(b), (c), Pub. L. No. 112-240, 126 Stat. 2313 (codified as amended at I.R.C. §§ 24(d)(4), 32(b)(3)).
121. I.R.C. § 21 (West, Westlaw through P.L. 112-209).
122. *Id*. § 101(a).
123. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of I.R.C.).
124. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered section of I.R.C.).
125. Economic Growth and Tax Relief Reconciliation Act of 2001, § 101(a).

marriage penalty for middle-income households. These rate reductions, combined with personal exemptions, the standard deduction, refundable EITC, child tax credits and other family-focused tax relief, work to ensure that millions of taxpayers pay no federal income tax.[126]

* * *

To summarize, Congress has enacted numerous tax provisions over the past three decades to reduce, and in many cases completely eliminate, the federal income tax liability of low- and middle-income households.[127] To be sure, these households still face significant tax burdens, most notably through the payroll taxes enacted to fund Social Security and Medicare,[128] as well as often substantial state and local taxes, like regressive retail sales taxes. Nevertheless, the provisions described above have served the extremely valuable function of mitigating the financial hardship faced by many low-income households.[129] Like the many politicians and countless Americans who welcomed these changes in federal tax law, we find it difficult not to embrace the concept of tax relief for the struggling families in America's lower and middle income classes.

That said, we do ourselves no favors by focusing only on the benefits associated with these provisions and ignoring the costs or potential downside of reducing middle class tax burdens. Many of the legislative changes just described came into existence as part of a larger political bargain reducing taxes across the board—including even larger tax breaks for higher-income households. For example, with regard to the Tax Reform Act of 1986,[130] increases in the personal exemption, standard deduction, and EITC made possible (given the principle of distributional neutrality) the reduction of the top marginal tax rate to 28%.[131] Likewise, tax benefits for lower- and middle-income households in 2001 and 2003 no doubt made the far more substantial reductions for upper-income households easier to swallow politically. The bottom line here is that middle class tax relief often serves as the political grease that facilitates the enactment of tax cuts for higher-income households. But is this political deal—i.e., an acceptance of tax cuts for the wealthy provided that the middle class gets its sugar too—really in

---

126. *See* CONG. BUDGET OFFICE, *supra* note 61, at tbl. 1 (demonstrating that the two lowest income quintiles actually have a negative effective income tax rate).

127. *Cf. id.* (tracing trend of lower effective tax rates for lower and middle income quintiles).

128. *See id.* (detailing Social Insurance tax rates since 1979).

129. *See id.*

130. Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of I.R.C.).

131. *Id.* § 104(b)(8).

the long-term interests of America's middle class? Put differently, as we face tax reform down the road, should we continue to embrace middle class tax relief or should we move beyond it?

IV. BEYOND MIDDLE CLASS TAX RELIEF?

Having now provided a basic empirical snapshot of middle class economic conditions as well as middle class tax burdens, we turn to the more difficult and substantially more contested question of what, if anything, should be done given this state of affairs. How should Congress respond, if at all, to the combined developments of (1) a struggling middle class, that is (2) subject to lower federal tax burdens than at any other time in recent United States history? Our thoughts on this question are necessarily preliminary and tentative; however, we do believe that the discourse over federal tax reform would benefit from a fuller understanding of the possible costs associated with middle class tax relief. As explained below, we see three major arguments (or, perhaps more precisely, categories of arguments) underpinning the case against middle class tax relief.

First, and most obviously, *the long-term structural reduction in middle class tax burdens jeopardizes the country's long-term fiscal stability—and, by extension, the viability of the nation's social safety net*. If there is one rock solid certainty about the United States fiscal situation and possible changes to the tax code in the coming months and years, it is that tax revenues must increase. Our instincts on *how* tax revenues will increase are not significantly at variance with the viewpoint advanced by Greg Mankiw in a recent New York Times op-ed:

> Even if President Obama wins all the tax increases on the rich that he is asking for, the long-term fiscal picture will still look grim. Perhaps we can stabilize the situation for a few years just by taxing the rich, but as greater numbers of baby boomers retire and start collecting Social Security and Medicare, more will need to be done. Which brings us to the middle class.[132]

We agree with this somber assessment, as well as with Mankiw's sense that the middle class will likely have to share in the sacrifice of any meaningful effort to address long-term fiscal imbalance.

Second, *reduced tax burdens for the middle class undermine the political arguments in favor of "shared sacrifice," making it (politically) harder to tackle tax reform that increases tax burdens on higher-income*

132. N. Gregory Mankiw, Op-Ed., *Wishful Thinking and Middle-Class Taxes*, N.Y. TIMES, Dec. 29, 2012, http://www.nytimes.com/2012/12/30/business/on-middle-class-tax-rates-too-much-wishful-thinking.html.

households. This argument is no doubt more controversial than the first, and thus requires further elaboration. The point here is the political inverse of the comment above about middle class tax cuts serving as the political grease facilitating the enactment of tax cuts for the wealthy. In our view, the opposite is also true (or at least will eventually be true)—i.e., increased tax burdens on higher-income households will eventually require, as a political condition precedent, higher taxes on the middle class. As an example, consider the longstanding and politically knotty question of taxing carried interest as ordinary income rather than capital gain. This favorable tax treatment, which has long been the target of tax reform efforts, is still on the books, even in the most recent fiscal cliff legislation. In our view, tax changes like this—i.e., those that require extraordinary political pressure to adopt—are far more likely to be enacted once the middle class plays a greater role in providing tax revenues to help address the country's long-term fiscal imbalance.

Third, the *form of middle class tax relief—especially the common practice of peppering the tax code with "targeted tax relief"—exacerbates price pressures on the middle class consumption bundle, paradoxically rendering the middle class less secure with respect to core spending priorities such as health care, education, and housing*. Much of the middle class tax relief enacted over the past few decades has taken the form of targeted tax relief designed to alleviate some of the financial burden associated with certain types of expenditures. For example, the U.S. income tax features a broad array of tax-based subsidies for housing, health care, and higher education.[133] Not coincidentally, these three categories of expenditures also happen to be the expenses most commonly cited as contributing to the "middle class squeeze."[134] It is an open question (as an empirical matter) whether tax subsidies have alleviated the burden of these expenses on middle class households or exerted upward price pressure on these items, thereby exacerbating the middle class squeeze. Certainly tax subsidies for owner-occupied housing[135] help fuel demand, as do subsidies for employer-provided health insurance[136] and for higher education.[137] We

133. *See Tax Topics—Tax Credits*, IRS (Jan. 17, 2013), http://www.irs.gov/taxtopics/tc600.html

134. *See* Bruce Watson, *The Middle-Class Squeeze: Falling Wealth, Rising Costs*, DAILY FIN. (Oct. 27, 2011), http://www.dailyfinance/com/2011/10/27/the-middle-class-squeeze-fallig-weath-rising-costs.

135. *E.g.*, I.R.C. §§ 121, 163(h)(3) (2006).

136. *E.g.*, *id*. § 106.

137. One example is the American Opportunity Tax Credit. *See, e.g.*, *American Opportunity Tax Credit*, IRS (last updated Nov. 6, 2012), http://www.irs.gov/uac/American-Opportunity-Tax-Credit.

share the impulse behind these efforts to mitigate the costs of core expenditures for middle class households, but we are skeptical about the efficacy of tax subsidies, given their likely impact on the market price of these items.

V. CONCLUSION

The United States has a long tradition of small government and self-reliance. With income stagnation, declining wealth, dramatic increases in the costs of housing, medical care and education, and decreased job security, members of the middle class face significant economic challenges and increased vulnerability. One response is to maintain the current relatively low federal tax burden on the middle class or perhaps reduce it further. This would provide the middle class with the same or more disposable income but do little to fund programs to alleviate economic insecurity.

A different response recognizes that what matters is the combined impact of government's tax and expenditure policies on the welfare of its members. The middle class may be better served by higher taxes if the revenues (from their and the upper quintile's tax increases) are used to fund programs that benefit them. Here, more proportional or regressive taxes for the middle class may be necessary to fund existing and new expenditure programs that provide a crucial safety net or improve chances for economic mobility.