Who Faces the Highest Marginal Tax Rates?

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Cutting marginal tax rates for all taxpayers is a centerpiece of the Republican tax plan. In particular, reducing the top personal income tax rate from 39.6 to 33 percent is touted as essential, both to decrease taxes for those who face the highest burdens and to stimulate economic growth.

But there are several problems with this position:

- **Reducing the top rate will make no difference to the taxes paid by more than 99 percent of all taxpayers.** Fewer than one percent of taxpayers have incomes high enough so that they currently face the 39.6 percent tax rate, while two-thirds of taxpayers face a top marginal income tax rate of 15 percent. Taxpayers in income brackets below the top would receive no benefits at all from a cut in the top rate.

- **Reducing the tax rate paid in the lowest tax bracket, in contrast, would reduce taxes for almost everyone who pays income taxes, regardless of income level.** All income taxpayers pay the lowest rate on at least part of their incomes, so all would benefit from a reduction in the lowest rate. At the same time, taxpayers at the lowest income levels would also get to keep a larger share of each additional dollar they earned.

- **High marginal tax rates are at least as much of a problem for many families at the lower end of the income distribution as for those at the top.** In fact, because some taxes and tax credits phase out before the top income range, low and moderate-income families may get to keep a smaller share of each additional dollar they earn than do families in the highest income tax bracket.

- **The effects of rate reductions on work incentives could be at least as important for lower-income families as for high-income ones.** Reducing marginal rates at the bottom could encourage low-income households to work more hours—a move that would give them little additional income under current tax rates. Research suggests that reducing rates at the top end, if it has any effect at all, is most likely to encourage the spouses of high-earning workers to get jobs rather than stay at home.

- **To the extent that rate cuts produce economic stimulus, cuts affecting lower-income taxpayers are likely to be the most effective.** Lower-income households are more likely than those at the top of the distribution to spend any additional dollars that they take home, which would increase the immediate economic impact of the tax cuts.

I. Marginal versus average tax rates: Which tax rates are high, and for whom?

A longstanding principle of our tax systems is that taxes should be based on ability to pay. The system is progressive, with higher-income taxpayers paying a higher share of their income in taxes. For example, a family with a total income of $160,000 might owe as much as $40,000, or 25 percent of their total income, in federal taxes. A similar-sized family with an income of $30,000, in contrast, would owe much less—perhaps $4,500, counting payroll taxes. The *average* tax rate for this family—their total tax payments divided by their total income—would therefore be much less: about 15 percent, compared with the 25 percent paid by the higher-income family. Of course, the actual take-home, after-tax income of the lower-income family would still be much lower—about $ 25,500, compared with $120,000 for the higher-income family.

If each of these families gets a similar-sized increase in pay, the progressiveness of the tax system means that the higher-income family will pay a larger proportion of that increase to the government in taxes, and their share of the total taxes paid will go up. But when we have a situation like the one that we've seen in the last decade—when before-tax income increased much more for people at the top of the income scale than it did for others—the share of after-tax income going to higher-income families can increase as well.

The reason why taxes go up as a share of total income as income rises is that incomes at different levels are subject to different statutory tax rates under the personal income tax system. For example, a family of four that takes the standard deduction and claims four exemptions would pay no income taxes on their first $25,000 or so in earnings. They would pay 15 cents in income taxes out of every additional dollar they earn over this exemption level, up through about $70,000 in annual earnings. At annual earnings of $70,000, only the $45,000 in income that they earn over the exemption level would actually be counted as *taxable income.* If such a family has additional earnings above $70,000, say, $80,000, these additional earnings would place them in the 28-percent tax bracket. However, this higher tax rate of 28 percent would apply only to the $10,000 of taxable income they received that was over the $70,000 threshold. Such a family's *marginal* tax rate would be 28 percent, because they would now be paying 28 cents in income taxes out of each additional dollar that they earn, but their *average* tax rate would be well below 28 percent, because they would still be paying 15 cents in income taxes out of each dollar on most of their income, and no income tax at all on some of their income. Overall, this family would pay about $9,550 in income taxes (15 percent of the amount between $25,000 and $70,000, plus 28 percent of the amount over $70,000), giving them an overall average income tax rate of just under 12 percent.

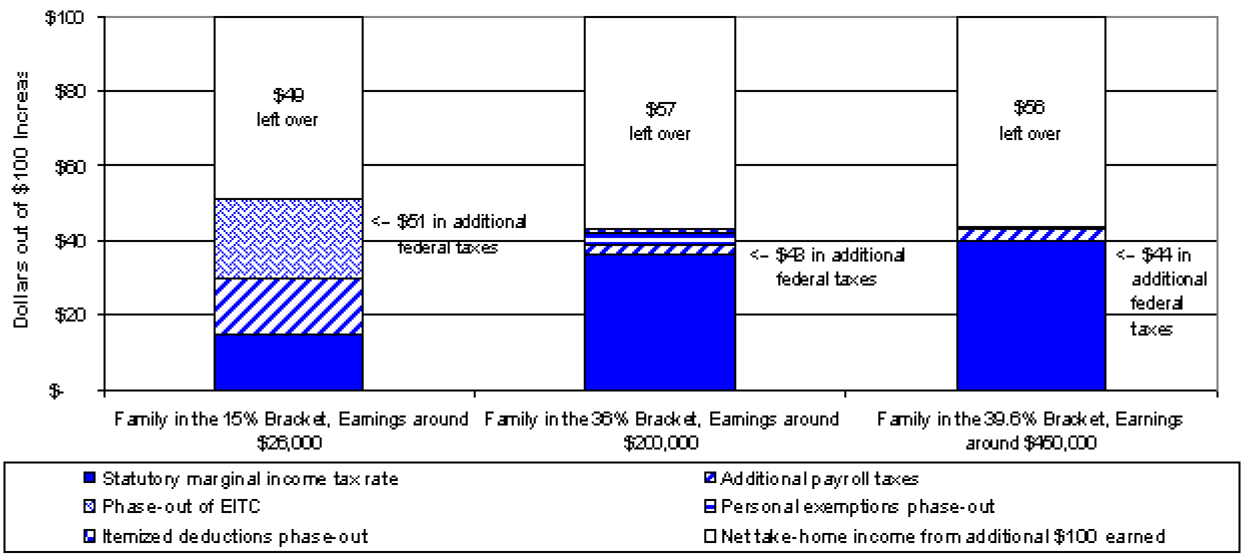
Marginal tax rates therefore measure the *change* in tax liability associated with a specific *change* in income, and comparing marginal rates can reveal how the tax system affects incentives to work more or to save more. Marginal tax rates are affected by the statutory rate structure built into the tax system—the specific tax rates associated with particular income brackets—but they are also affected by other factors that influence taxable income and take-home pay. Lower-income taxpayers pay a marginal income tax rate of 15 percent on their earnings, for example, but that doesn't mean that they actually get to keep 85 cents out of each additional dollar they earn. In addition to the 15 cents in income tax, they bear the burden of additional payroll taxes, and they may lose additional sources of support as their eligibility for tax credits such as the Earned Income Tax Credit (EITC) phases out.

As a result, the *effective* marginal tax rate—the marginal tax rate taking all tax-related changes in income into account—that families face may be substantially higher than the statutory marginal income tax rate for families in their tax bracket. While the statutory tax rate at the bottom of the taxable income scale is only 15 percent, many lower-income working families will actually lose a much larger proportion of each additional dollar they earn to taxes. For example, for each additional dollar earned at incomes under the payroll tax ceiling a family's payroll taxes go up by another 15.3 cents—7.65 percent taken directly from their paychecks, and another 7.65 percent paid for them by their employers. Most economists believe that the employer's share of the tax eventually comes out of wages also, because employers in competitive industries will be forced to offer lower wages than they otherwise would have if they are to pay the tax and still price their products competitively. In addition, families with two or more children who fall into the lower part of the15-percent tax bracket will have incomes in the "phase-out" range of the EITC, and would lose 21 cents in tax credits with an additional dollar of earnings. Thus, even considering just *federal* taxes, the *effective* marginal tax rate facing some families in the lowest statutory tax bracket can be not just 15 percent, but instead, over 50 percent.

Effective marginal tax rates are even higher for still lower-income households just above the poverty level, who are (ironically) "exempt" from the income tax because their incomes are so low. Accounting for the changes that would occur in such a family's food stamps and other forms of assistance (such as child care and health care subsidies) as a result of an increase in earnings, the overall effective marginal tax rate can reach 100 percent or more, as benefits disappear just as fast as income increases! In other words, some households face the prospect of "no net gain" from an increase in their before-tax labor income. A major goal of welfare reform was to "make work pay" for such families, and increased earnings disregards in many states' welfare programs have helped to lower these high marginal rates. But unfortunately, earnings disregards generally phase out over time, leaving long-term low-income workers with children in just as awkward a position as they were in before.

In contrast, although highest-income households are subject to phase-outs of their own, their effective federal marginal tax rates fall well short of the effective rates facing those lower-income families subject to EITC phase-out (see figure below). The highest effective marginal rates among high-income households are those of taxpayers in the 36-percent bracket who are also subject to phase-outs of personal exemptions and itemized deductions—but these features boost effective rates by only a few percentage points at most. (Taxpayers in the very top 39.6-percent bracket are well above the phase-out range for personal exemptions, implying that that particular phase-out adds nothing to their effective marginal rate.)

Additional Federal Taxes Paid On a $100 Increase in Earnings for Three Families at Different Income Levels*



* Married, filing jointly, two children.

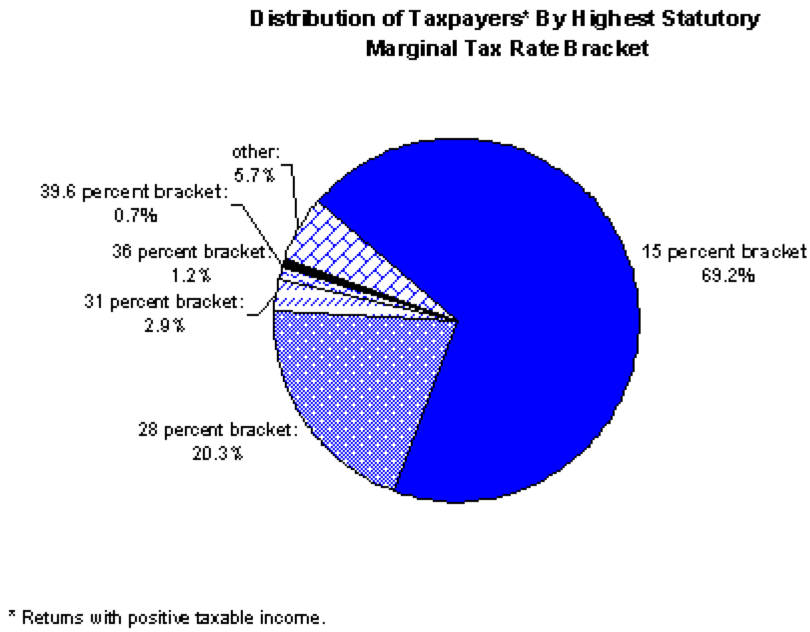
Adding the effects of federal-level payroll taxes to the marginal tax rate calculation raises higher-income effective marginal rates much less than it raises lower-income effective rates. That is because the Social Security (OASDI) portion of those taxes is collected only on earnings up to about $80,000 per earner (resulting in a zero marginal tax rate above that level), while the Medicare HI portion of those taxes—with no taxable maximum—is only 2.9% of the 15.3% total payroll rate. Thus, payroll taxes bring the high-end effective marginal tax rate up to no more than 44 percent for families in the 36-percent income tax bracket (which starts at over $166,500 in taxable income), unless the family has large amounts of unearned income or includes at least three earners all filing on the same tax return. Incomes high enough to be in the 36- or 39.6-percent brackets would be well past the phase-out levels of other tax preferences such as child credits, dependent care credits, and Individual Retirement Accounts, so these features would not add anything to such families' effective marginal tax rates. (Note that to face a statutory marginal rate of 36 percent in 2001, a married-couple family must have *taxable* income—income after exemptions and deductions—of over $166,500; to be in the 39.6-percent bracket, taxable income must exceed $297,350.)

Additional Federal Taxes Paid with a $100 Increase in Earnings for Three Families at Different Income Levels (married taxpayers filing jointly, two children)

Federal Tax Feature:	Family in the 15% Bracket, Earnings around $26,000:	Family in the 36% Bracket, Earnings around $200,000:	Family in the 39.6% Bracket, Earnings around $450,000:
Statutory marginal income tax rate	$15	$36	$40
+ Additional payroll taxes	$15	$3	$3
+ Phase-out of EITC	$21	$0	$0
+ Phase-out of child tax credit, IRAs	$0 (income too low)	$0 (income too high)	$0
+ Phase-out of personal exemptions	$0 (income too low)	$3	$0 (income too high)
+ Phase-out of itemized deductions	$0 (income too low)	$1	$1
Total additional federal taxes due to $100 increase in earnings:	$51	$43	$44

II. Who would benefit from a cut in the top marginal tax rate?

One of the reasons why a cut in the top marginal rate would be unlikely to affect the economy in any significant way is simply because it would affect very few taxpayers. The IRS's Statistics of Income (tax return data) indicate that in tax year 1997, of the 99,217,292 total returns filed, only 691,359 of them (or just seven-tenths of one percent) had taxable income high enough to be subject at all to the top (39.6 percent) marginal rate. Even including the second-highest bracket of 36 percent, fewer than 2 percent of taxpayers faced either of the top two statutory marginal tax rates. In contrast, nearly 69 million taxpayers—more than two-thirds of all taxpayers—had taxable income low enough so that their last dollars earned were taxed at the bottom statutory rate of 15 percent. Among single-parent heads of households, the contrast is even starker: fewer than one-half of one percent of those taxpayers were in the top two brackets, while 89 percent were in the 15-percent bracket. Thus, the vast majority of taxpayers would not benefit from a reduction of the top marginal tax rates.



III. Why are marginal tax rates so high at the bottom?

The Earned Income Tax Credit is at least part of the reason why some low-income families face high marginal tax rates. The credit helps many low-income families, but it can raise marginal tax rates for some workers. The credit unambiguously increases incentives for individuals to go to work: in order to receive any of the credit, one must have earnings. In fact, over a "phase-in" range at very low incomes (up to around $10,000 for families with two or more children), it encourages people to increase their earnings, by contributing an extra 40 cents for each additional dollar earned. But past the income range in which families qualify for the maximum credit, the EITC is phased *out* as earnings increase. This adds over 21 percent to the effective marginal tax rate for families with two or more children, hence *reducing* the incentive for a low-income worker to increase hours or move to a higher-paying job. Because for some families the phase-out range of the EITC extends into the level of income that is subject to income taxes, families caught in that overlap are subject to some of the highest effective marginal tax rates in the federal tax system. Research has confirmed that the EITC has two different effects: it has a significantly positive effect on labor force participation, but has a smaller negative effect on hours of work for people who are already in the labor market and whose earnings fall into the phase-out range.

Some work disincentives are inevitable in any program targeted to low-income families, because the benefits received must decline as earnings rise if the program is not to be prohibitively expensive. In addition to the federal EITC, many states have come up with their own versions of the EITC that "piggyback" on the federal program. While these state versions add to the size of the overall credit and give people even larger incentive to choose working over not working, the more generous combined EITC implies that even more must be phased out as income rises. Hence, somewhat ironically, state EITCs raise effective marginal tax rates in the phase-out range still further (even as they further boost after-tax incomes). In some cases the state EITC boosts the marginal tax rate by more than 15 additional percentage points.

Despite the inevitable increase in effective marginal rates arising from the EITC phase-out, there *are* ways to expand the generosity of the credit without exacerbating the problems caused by high rates. For example, extending the phase-out range of income while keeping other features the same would reduce the effective marginal tax rate for those currently in the phase-out range, while extending the benefits of the EITC to some families who currently do not qualify. (For newly-eligible families, however, effective marginal tax rates would come up as their tax burdens fell.) Increasing the level of income at which the EITC starts phasing out, even keeping the current phase-out rate, is another option. This would push off the boost in marginal rates to higher income levels and could help "smooth" overall marginal rates, because the EITC's current phase out range is just above poverty level, where many other assistance programs phase out as well.

IV. How can we reduce tax rates for all taxpayers, both at the top and at the bottom?

Proponents of the President's plan often seem to suggest that reducing all marginal tax rates is necessary in order to provide tax relief to all taxpayers. But this again confuses marginal and average tax rates. All families who pay personal income taxes pay the 15-percent marginal rate on at least the first portion of their taxable income. For married-couple families filing joint returns, for example, the first $45,200 of taxable income (that is, income in excess of the roughly $25,000 of deductions and exemptions) is subject to the 15-percent tax rate in 2001. Even if a family's income is high enough to place the last dollars it earns in a higher statutory bracket, a reduction in the bottom statutory rate would still reduce its tax burden. For example, reducing the bottom marginal tax rate from 15 percent to 10 percent on the first $12,000 of taxable income for married couples is worth $600 (5 percent of $12,000) for *all* married couples with taxable incomes greater than $12,000, regardless of their statutory marginal rate bracket. The reduction in the top marginal rates in the President's plan is simply *not* necessary for the purposes of extending tax relief to all taxpayers.

Reductions in the top marginal rates do, however, make up a very large share of the costs of the President's tax cut proposal. The Joint Committee on Taxation estimates that the parts of the President's tax cut plan that reduce tax rates above 15 percent (the 28-, 31-, 36-, and 39.6-percent brackets) would cost $560 billion over 10 years. Reducing the very top marginal rate alone (which would affect fewer than one percent of taxpayers) accounts for 42 percent of this total cost.

What a reduction in the bottom rate alone would *not* do, however, is reduce effective marginal tax rates at the top of the income distribution. Given this, the potential economic benefits of reducing the top marginal rate must be evaluated relative to the potential benefits from alternative ways of reducing taxes. Research suggests that any positive effects from such marginal rate reductions on saving and labor supply would be small. Economists have found that the people most likely to respond to reductions in the top statutory marginal tax rates are women who are secondary earners married to high-wage men—in other words, women whose earnings tend to be discretionary in nature. Their high-paid husbands, in contrast, are generally already working more than full-time, and are quite unlikely to change their labor supply in response to relatively small changes in marginal tax rates. Encouraging increased labor supply from high-income secondary earners would not necessarily be more productive than encouraging low-income workers with incomes near the poverty level to increase their hours or move to a higher-paying job.

Moreover, cutting the top statutory marginal tax rates is costly in terms of revenue loss because the tax rate on every dollar above the top rate threshold would be reduced. If a reduction in the top rates means a larger overall tax cut, the potential economic benefits of that rate cut must be weighed against the costs associated with the decreased public saving that would result from it. In the long run, economic growth depends on saving and investment. A large reduction in the federal surplus will reduce public saving, and it is unlikely to be offset dollar for dollar by an increase in private saving. This will in turn reduce the total pool of resources available for future investment.

The Administration has recently argued that more public saving is not currently needed, and that indeed the economy may be moving into a recession and needs fiscal stimulus. If that is the case, tax cuts focused on those in the top brackets are likely to be relatively ineffective, since research shows that low-income families are much more likely to spend any additional resources they get than are higher-income ones. And for a given aggregate size of the tax cut package, the benefits of a high-end rate reduction that affects hardly anyone ought to be compared with the benefits from an alternative that would provide more significant relief for *all* taxpayers.

The President's tax plan includes other pieces beyond the reduction of statutory marginal tax rates, some of which could potentially benefit lower-income taxpayers. One such feature is the proposed doubling of the child tax credit. This would benefit the family with $26,000 in income featured above, by reducing their taxable income down below the new, higher exemption level that would result from the increased allowance for each child. Thus, their effective marginal tax rate would be reduced from 51 percent to 36 percent, because the component of taxes resulting from the statutory tax rate of 15 percent would be wiped out. The increased exemption level would also benefit some higher-bracket families who are close to the bottom of their tax bracket, and hence would be pushed down to a lower one. But without making the child tax credit refundable, the President's plan still does nothing to reduce the very highest of effective marginal tax rates, those facing families with incomes just above the poverty level. The JEC Democratic staff is now preparing an additional study that will further explore how different tax proposals would affect the marginal tax rates and overall tax burdens of low-income families.

V. Conclusion

In conclusion, high marginal rates are paid not only by the small number of taxpayers at the very top of the income distribution, but also by many taxpayers in lower tax brackets. This problem particularly affects low-income earners with children who have earnings in the phase-out range of the EITC. If the policy goal is to allow families to keep more of each additional dollar that they earn, it is these families who most need our attention. Reducing the top statutory tax rate from 39.6 percent to 33 percent would affect fewer than one percent of taxpayers, but would account for 42 percent of the total costs of reducing marginal tax rates above 15 percent. These dollars could be much better spent to reduce taxes for all taxpayers, and particularly for those lower-income families who actually face the highest marginal tax rates; to reduce debt; or to meet high-priority national investment needs.