When Marginal and Statutory Tax Rates Differ

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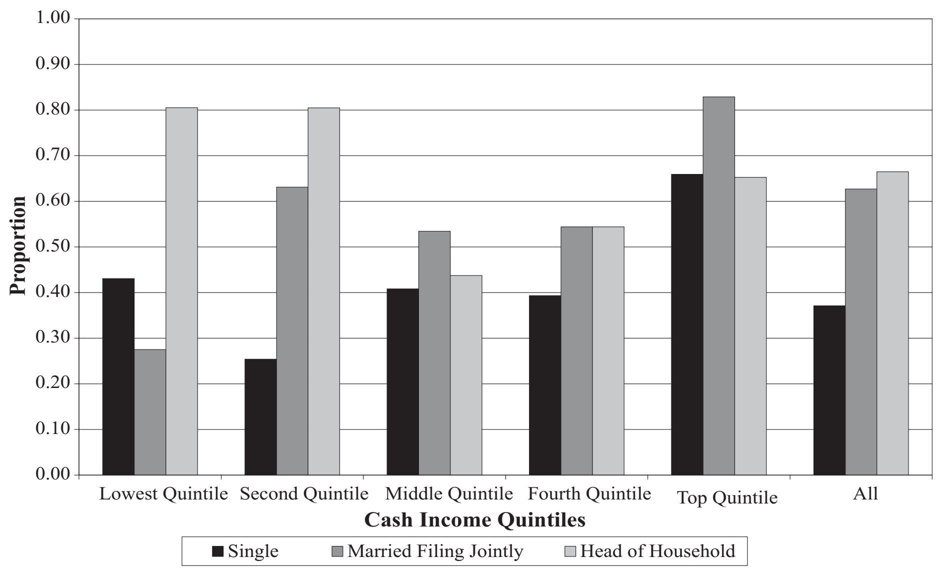
From an economic perspective, marginal tax rates — the tax paid on an additional dollar of income — play a critical role in determining the consequences of a change in tax policy: Marginal rates influence a taxpayer's incentive to seek (and report to the IRS) extra income. Low marginal tax rates on labor may provide wage earners additional incentive to work more; low marginal rates on capital gains or dividends may increase the incentive to save and invest.

In an uncomplicated tax system, determining a taxpayer's marginal tax rate is straightforward: The marginal rate is equal to the statutory rate, the actual rate applied to taxable income. The current federal income tax has six statutory rates — 10, 15, 25, 28, 33, and 35 percent — that apply to most income. Preferential rates apply to long-term capital gains and qualified dividends as well as to other forms of income.

For millions of taxpayers, however, marginal tax rates differ markedly from statutory rates. Because of the tax code's wide array of phase-ins and phaseouts of various deductions, exemptions, and credits, the majority of taxpayers face a different marginal rate than their statutory rate. For example, a married couple with one child and $120,000 in taxable income faces a statutory tax rate of 25 percent. However, because the child tax credit ($1,000 per child in 2008) phases out at a rate of $50 for each $1,000 in income above $110,000 for married taxpayers, the couple essentially loses 5 percent of the tax credit for every additional dollar earned. As a result, the couple's marginal tax rate is 30 percent rather than the statutory rate of 25 percent.

Proportion of Tax Units with Differing Statutory and Effective Marginal Rates, by Income Level (2007)



Source: Urban-Brookings Tax Microsimulation Model

For a description of the model and the procedure used for calculating marginal tax rates, see Katherine Lim and Jeffrey Rohaly, "The Impact of the Presidential Candidates' Tax Proposals on Effective Marginal Tax Rates," Tax Policy Center (Sept. 30, 2008), http://www.taxpolicycenter.org/publications/template.cfm?PubID=411759.

Rules concerning phase-ins and phaseouts are generally complex, particularly when taxpayers face multiple phase-ins or phaseouts. This complexity can lead to taxpayer confusion over after-tax returns to increased work and investment. Unequal marginal and statutory rates make it difficult for taxpayers to understand the economic incentives created by the tax code.

Marginal and statutory rates differ for about two-thirds of married filers and heads of households and for about one-third of single filers (see graph). Taxpayers at the top and the bottom of the income distribution are generally more likely to incur phase-ins and phaseouts and therefore to face marginal tax rates that differ from their statutory rates. The two rates are more likely to be equal for middle-income taxpayers.