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Hidden Taxes and Subsidies

By Leonard Burman and Mohammed Adeel Saleem

An individual's marginal tax rate — the additional tax that would be owed on an additional dollar of income — is an important indicator of how the tax system affects incentives to work, save, and comply with the tax system. It is natural to think of marginal tax rates as identical to the statutory tax rates — currently 10, 15, 25, 28, 33, and 35 percent — but this is not true for many people. Statutory and effective marginal tax rates differ because some tax benefits phase in or phase out with income, deductions may be limited by income, and certain taxes phase in with income.

These hidden taxes and subsidies are quite common, and have become more so in recent decades. As a result, almost one in three tax-filing units (32 percent) face an effective tax rate at least ¼ point above or below their statutory rate.[1] Although 10 percent face actual tax rates lower than the statutory rates, 22 percent face higher tax rates. Effective tax rates diverge more for married people and single heads of household than for singles, because many surtaxes and subsidies are related to children.

Low-income people are more likely to face subsidies than surtaxes. Their rates are reduced by the phase-in with earnings of the earned income tax credit and the refundable portion of the child tax credit. Nonrefundable credits, too, can move tax filers in the 10 percent tax bracket into a zero effective marginal tax rate — because additional tax liability is totally offset by unused nonrefundable tax credits.

People at all income levels can face tax surcharges because of phaseouts of tax benefits. For example, the earned income tax credit starts to phase out at low income levels. Moderate-income seniors can face a tax penalty because of the taxation of Social Security benefits that phases in with income. Higher-income people are most likely to face tax surcharges due to the phaseout of child-related and education tax credits, the phaseout of itemized deductions, and the phaseout of personal exemptions. Individuals subject to the alternative minimum tax also generally face tax rates that differ from regular income tax rates.

[1]The source for all calculations is the Tax Policy Center Microsimulation Tax Model. The marginal tax rate is calculated by adding the maximum of $100 or 1 percent to wages and salaries and calculating the average tax on the increment. We use this procedure because many phase-ins and phaseouts occur in steps — e.g., the child tax credit phases out at a rate of $50 per $1,000 of adjusted gross income — which can create very large additional taxes for people whose incomes are just below a threshold. The larger increment smoothes out these stepwise phaseouts. Tax rates on capital income will often differ from these rates on earnings; that will be the subject of another analysis.

Percentage of Tax Filing Units With Effective Tax Rate Less Than, Equal to*, or Greater Than Statutory Tax Rate, by Filing Status and Income, 2003

	less	equal	greater
All	**9.5**	**68.0**	**22.5**
Filing Status			
Singles	7.8	81.2	11.1
Married filing jointly	5.7	62.2	32.1
Head of household	26.4	38.2	35.5
Adjusted Gross Income ($1,000s)			
Less than 10	15.3	81.2	3.5
10-20	21.2	57.8	21.1
20-30	3.5	57.5	39.0
30-40	2.7	73.6	23.8
40-50	1.8	75.2	23.1
50-75	0.9	77.5	21.6
75-100	2.0	68.5	29.5
100-200	4.5	37.9	57.6
200-500	19.2	7.5	73.3
500-1,000	28.6	7.5	63.8
More than 1,000	20.4	11.6	68.1

* Calculations treat rates as equal if they differ by less than 0.25 percentage points.

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