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How Do the Presidential Candidates' Tax Plans Affect Taxpayers' Marginal Tax Rates?

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Summary

The Presidential candidates have proposed comprehensive tax plans that reshape tax policy in important ways. The two candidates have put forward two very different visions, with Senator Obama's tax plan emphasizing redistribution and Senator McCain's tax plan focusing more on economic growth. A perhaps neglected aspect of their tax plans is how they alter effective marginal tax rates, the amount of tax that people pay out of their *last* dollar of income.

The concept of a marginal tax rate is important because it determines how much a taxpayer gets to keep when making various decisions, such as how much to work or save. High marginal tax rates can be economically harmful because some decisions may be based more on tax considerations than on economic merit.

The analysis below summarizes some of the effects the candidates' tax plans would have on effective marginal tax rates. Calculations that capture the effects of changes related to both the income and payroll tax are presented for a hypothetical two-earner couple with two children. Although these calculations are for the couple depicted below, they provide a sense of how the plans would affect taxpayers' marginal tax rates in general.

The major findings include:

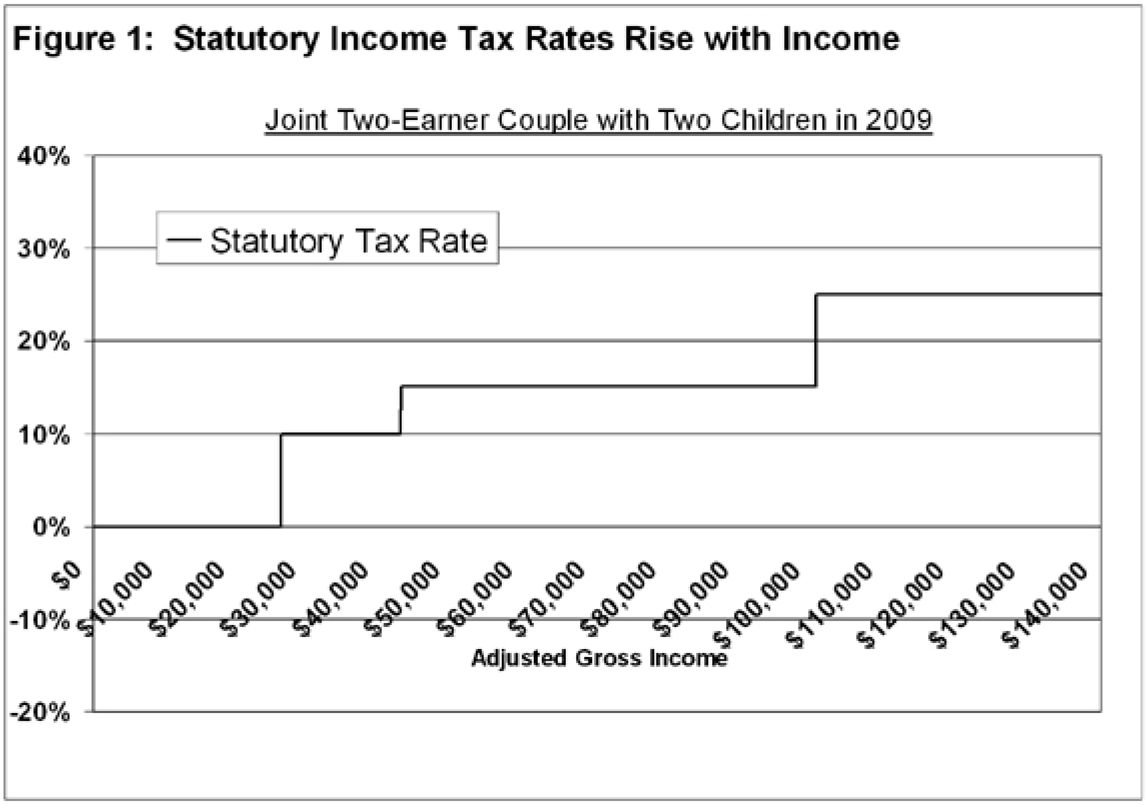
- To the surprise of some, even though Senator Obama's tax plan lowers taxes for the bottom four quintiles, marginal tax rates would fall only for the very lowest-income couples. Taking both income and payroll taxes into account, those at the very bottom of the income distribution would see their effective marginal tax rates fall from 27.4 percent to minus 58.6 percent due to proposed changes to the earned income tax credit and Senator Obama's new "Making Work Pay" credit.
- Most low- and moderate-income couples would see their effective marginal tax rates rise, in some cases, significantly. Indeed, some low- and moderate-income taxpayers will see their marginal rates rise to more than 50 percent.
- High-income taxpayers can also expect their effective marginal tax rates to rise—to 47.2 percent-under Senator Obama's tax plan. This increase is caused by rolling back the 2001 and 2003 reductions in the top two tax rates, curtailing deductions and exemptions at high income levels, and potentially raising Social Security taxes.
- Senator McCain's tax plan also changes marginal tax rates. His proposal to replace the exclusion for employer-based health insurance with a new health tax credit boosts taxpayers' taxable incomes by their health insurance premiums which generally pushes taxpayers into higher tax brackets, but not to as great an extent as Senator Obama's tax plan.

A Taxpayer's Marginal Tax Rate

Each person's marginal tax rate is the amount that they pay in tax on their last dollar of income. The impact of the tax paid on that last dollar is important economically because it determines how much a taxpayer gets to keep when making important decisions such as how much to work or save. Consider, for example, a taxpayer deciding whether to work more, perhaps deciding whether to work more hours (i.e., overtime), accept a freelance assignment, work harder in anticipation of a larger raise, or accept a higher-paying job. The after-tax reward from these decisions is determined by a taxpayer's marginal tax rate. High tax rates reduce the after-tax reward and it becomes less worthwhile for the taxpayer to earn more money.

Of course, work effort is just one decision affected by marginal tax rates. Marginal tax rates affect many other decisions made by households and businesses, including the choice between receiving compensation as taxable wages or fringe benefits, such as employer-based health insurance, how much to give to charity, how much to borrow when purchasing a home, how much to save, how much to invest, the composition of investment portfolios, and whether to start a business. Moreover, there is abundant academic research indicating that taxes play a role in all of these decisions, although the size of the effect is sometimes uncertain. High tax rates can be economically harmful because some decisions may be based more on tax considerations than economic merit.

Many people may be surprised to learn that statutory tax rates—the ones listed in the tax tables that accompany their tax forms—can be so different from the marginal tax rates. The statutory tax rates are set to rise fairly gently as our incomes rise. See Figure 1 for a chart of the statutory rates on a two-earner couple earning up to $140,000 and filing a joint tax return next year.[1]



Source: Computations by the Tax Foundation

But the schedule for a taxpayer's effective marginal tax rate—what he pays on his last dollar of income—tells a very different story. As shown in Figure 1A for the same couple, marginal tax rates careen up and down, veering well below zero and well above the statutory rates. They can be very high for taxpayers with modest income.[2]

What causes marginal tax rates to deviate so sharply from statutory tax rates? The tax code is cluttered with complex deductions, exemptions and credits that affect marginal tax rates. These provisions are often "targeted" to low- or moderate-income taxpayers. In some cases, such as under the earned income tax credit (EITC), the tax benefit initially goes up as a person's earnings rise. This income range is the so-called phase-in range where the marginal tax rate is below the statutory tax rate. Conversely, may find that they earn too much to qualify for the full benefit. As they earn more they begin to lose benefit. Eventually, the benefit may be completely eliminated. This income range is called the phase-out range, where the tax benefit is "recaptured" and the marginal tax rate rises above the statutory rate.

These phase-ins and phase-outs cause marginal tax rates to deviate sharply from the statutory tax rate. As a result, charts of the marginal tax rate schedule have sometimes been likened to a major city's skyline where the skyscrapers represent the targeted tax benefits phasing in and out, causing taxpayers' marginal tax rates to fluctuate, sometimes wildly.

Some of the largest gyrations in marginal tax rates occur at the lower end of the income spectrum due to the earned income tax credit (EITC). The credit initially increases in size as a taxpayer's earnings rise. Because these very low-income taxpayers have no taxable income or other income tax, the credit takes the form of a payment from the government—a negative income tax—and their effective marginal tax rates are negative (i.e., taxpayers with incomes below about $19,200 in Figure 1A). The rate drops as low as minus 40 percent. That is, for every additional dollar earned by these very low-income taxpayers, they receive 40 cents from the federal government.

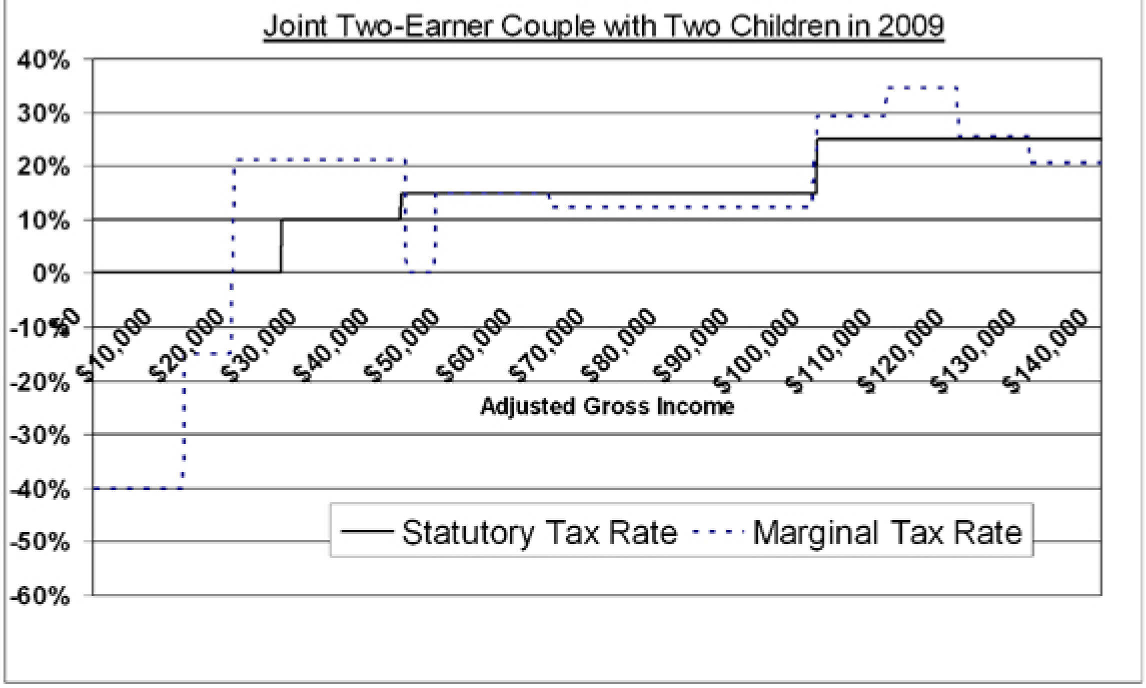
When the EITC is phased out, this phenomenon reverses. The taxpayer's liability increases as the credit is "recaptured," and the effective marginal tax rate rises above the statutory tax rate for taxpayers with incomes between roughly $19,200 and $43,000, reaching as high as 21.6 percent.

For people in the upper-income range, between roughly $100,000 and $130,000, different tax benefits are phased out-the child tax credit and the Hope and Lifetime Learning education credits-giving rise to marginal income tax rates as high as 34.5 percent.

Other provisions in current law with similar effects include the savers credit and the child and dependent care credit. Still other provisions phase out the personal exemption (the personal exemption phase-out or PEP) and itemized deductions (the so-called "Pease" provision named after Congressman Pease), which increase effective marginal tax rates for higher-income taxpayers.

How much the phase-in and phase-out of tax benefits affect a taxpayer's effective marginal tax rate depends on the generosity of the provision and the rate at which it is phased in and out. Also, some taxpayers are subject to the alternative minimum tax, which has its own tax base and tax rates of either 26 percent or 28 percent. Finally, there are also important interactions between the income and payroll tax as some income tax provisions have been designed to offset, in some manner, the payroll taxes that are paid (e.g., the earned income tax credit and aspects of the refundable portion of the child tax credit).

Figure 1A: Effective Marginal Tax Rates Can Differ Substantially from Statutory Tax Rates



Source: Computations by the Tax Foundation

When designing tax provisions that are targeted by income or earnings, tax writers typically pay careful attention to the ways in which they interact with other provisions and their implications for both the income and payroll tax. Generally, there is some attempt to strike a balance between a provision's policy objective and the broader concern that marginal effective tax rates not be allowed to rise too high.

How Do the Presidential Candidates' Tax Plans Affect Marginal Tax Rates?

Both Senator Obama's and Senator McCain's tax plans affect marginal tax rates, but for different reasons. Senator Obama's tax plan includes a number of proposals for new or expanded tax benefits that are generally targeted to low- and moderate-income taxpayers. Many of these additions to the "skyline" change taxpayers' effective marginal tax rates in important ways, lowering or raising them, sometimes significantly.

Figure 2 takes another look at a married couple with two children and two jobs, earning between $10,000 and $140,000. While Figures 1 and 1A above refer only to income taxes, Figure 2 includes payroll taxes as well, providing a more complete picture of the tax plans' overall effects.[3] Two marginal tax rates for tax year 2009 are compared, one if current laws stay in place and one if Sen. Obama's tax plan becomes law.

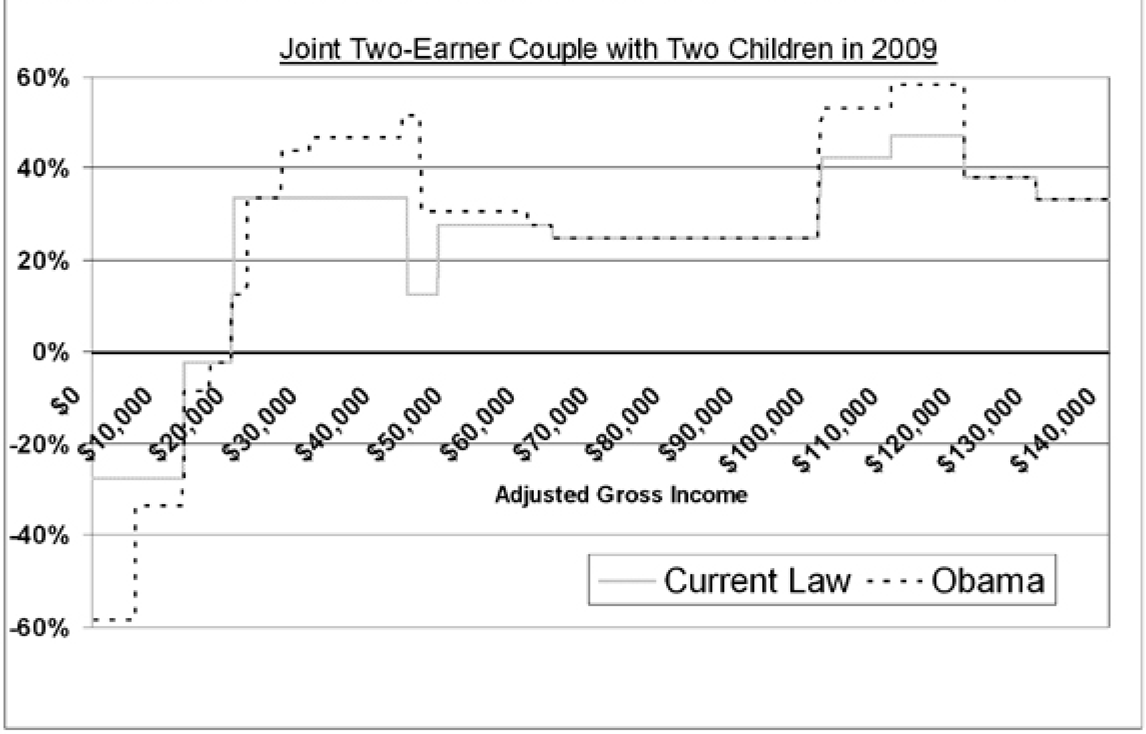


Figure 2: Effective Marginal Tax Rates under Current Law and Senator Obama's Tax Plan (Includes Income and Payroll Taxes)

Source: Computations by the Tax Foundation

Under Sen. Obama's plan, the already negative marginal tax rates for low-income taxpayers drop further, due to his proposals to expand the EITC and for a new "Making Work Pay" credit. The new credit would equal 6.2 percent of the first $8,100 of a worker's wages, and it would phase out for moderate-income taxpayers. Both of these provisions would sharply reduce marginal tax rates for taxpayers with the lowest earnings, reducing their combined income and payroll tax rates to minus 58.6 percent.[4]

However, these and other provisions are phased out in short order under both current law and Senator Obama's tax plan, which causes effective marginal tax rates to rise for moderate-income taxpayers. Senator Obama also expands the child and dependent care credit and begins to phase down this expansion at $30,000 of income. The combination of the phase-out of the EITC, the "Making Work Pay" credit, and the child and dependent care credit pushes the effective marginal tax rate to as high as 51.7 percent.[5] That is, the taxpayer who benefits from all these provisions at a lower income discovers that he gets to keep less than one half of every additional dollar of earnings in the roughly $30,000-to-$43,000 range.

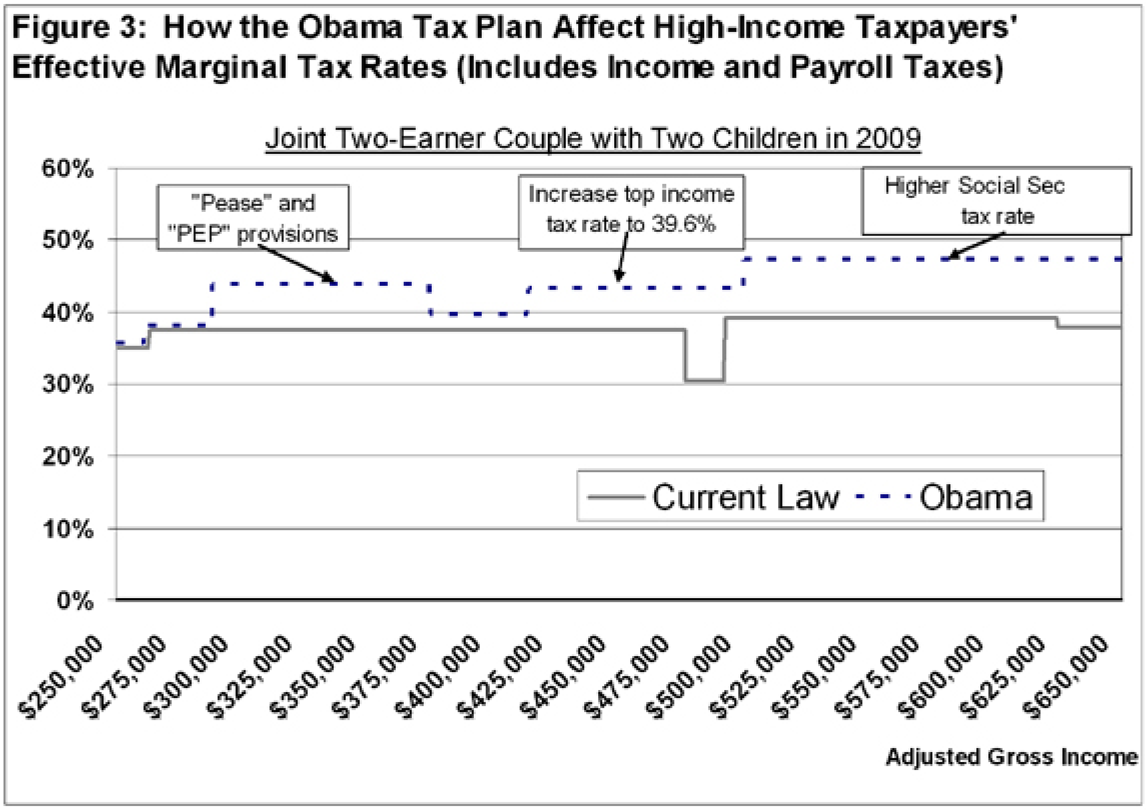
As has been extensively reported, three components of the Obama plan would raise the marginal tax rates of higher-income taxpayers.

1. Roll back the reduction in the top two tax rates enacted in 2001 and 2003. These changes would increase the top two tax rates from 33 percent to 36 percent and 35 percent to 39.6 percent.

2. Restore the phase out of the personal exemption for higher-income taxpayers (the so-called PEP provision) and the limitation of certain itemized deductions for higher-income taxpayers (the so-called Pease provision).

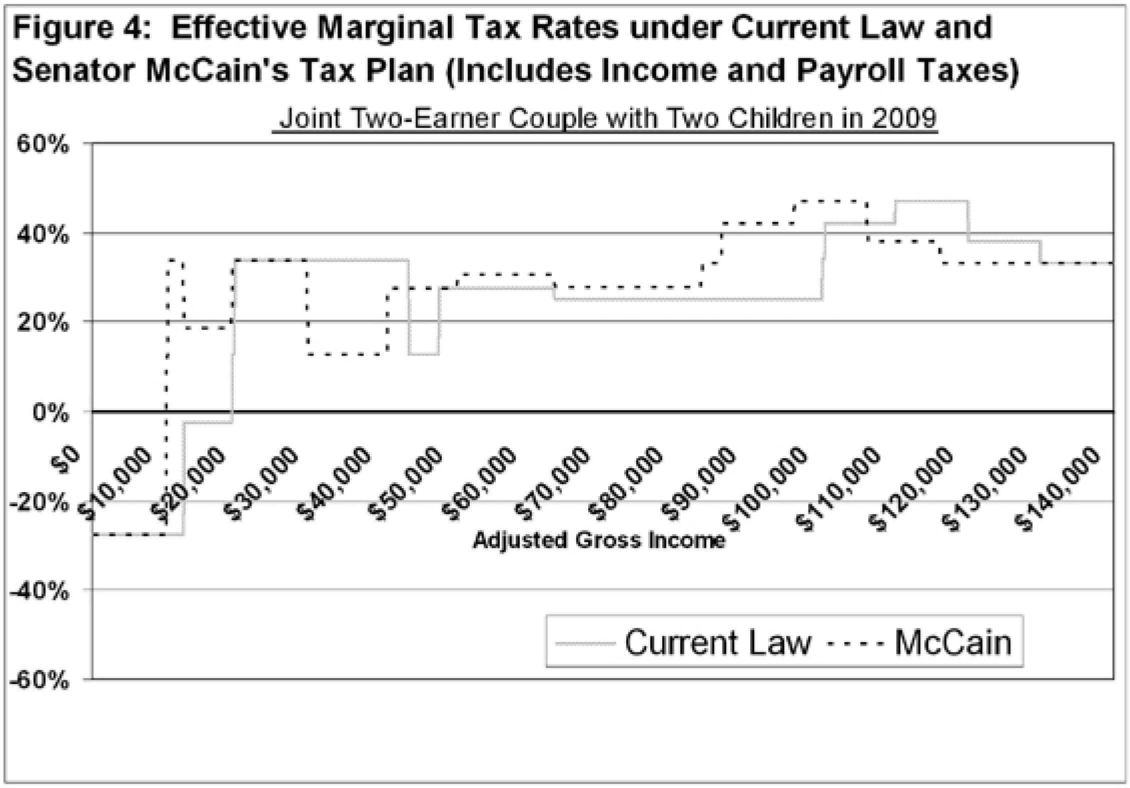
3. Increase Social Security taxes paid by higher-income taxpayers. It is unclear exactly what is being proposed by Senator Obama on Social Security taxes, and his proposal may not even take effect until 2018, outside of the ten-year budget window. Nevertheless, it is assumed here that he would increase Social Security taxes by 4 percent to illustrate the likely effects of his plan on marginal tax rates.[6]

Figure 3 shows how these tax increases would alter the effective marginal tax rate for a married couple with $250,000 or more in income. At incomes just over $250,000, the couple is subjected to the alternative minimum tax (AMT), with its broader tax base and separate tax rate schedule. Under the Obama tax plan, this couple moves off of the AMT when their income reaches $288,400. At that point, their effective marginal tax rate would rise to 43.7 percent, in large part due to the phase-out of personal exemptions and the limitation on itemized deductions. Once the taxpayer's personal exemptions are completely phased out, the effective marginal tax rate would drop down to 39.5 percent before increasing to 43.2 percent when they reach the 39.6 percent statutory income tax bracket. Finally, the couple's effective marginal tax rate would rise to 47.2 percent when the new 4-percent Social Security tax rate kicks in.



Source: Computations by the Tax Foundation

Senator McCain's tax plan also affects marginal rates, but for very different reasons. His tax plan includes only two individual tax proposals and only his health tax credit has a material effect on effective marginal tax rates. The McCain health tax credit—$5,000 for family coverage and $2,500 for individual coverage—replaces the current income tax exclusion for employer-based health insurance. The repeal of this exclusion has the effect of increasing taxpayers' taxable incomes, which then pushes some taxpayers into higher income tax brackets. This effect is shown in Figure 4 which compares marginal tax rates under current law to those that would prevail if McCain's tax plan became law. Note the leftward shift of the marginal tax rate schedule. Some taxpayers' effective marginal tax rates go up and others go down.



Source: Computations by the Tax Foundation

Notes

1. Figure 1 also accounts for the "implicit zero tax bracket" faced by low-income taxpayers. This is where taxpayers' income is completely offset by a combination of their personal exemption and standard deduction (or itemized deductions for the few low-income taxpayers who itemize) and they face a zero marginal tax rate. The joint filers depicted in Figure 1 are not subject to the 10-percent bracket until their income in 2009 reaches $26,100.

2. The effective marginal tax rates depicted in Figure 1A are calculated by adding $100 to earnings and calculating the additional tax the couple owes. Several provisions that phase out in steps have been "smoothed" to eliminate any discontinuities in the effective marginal tax rate schedule for purposes of the calculations that underlie Figure 1A.

3. The combined effective marginal income and payroll tax rates were calculated in the same fashion as above: by adding $100 to earnings and calculating the changes in the taxpayer's tax liability. It was assumed that both adults in the household had equal earnings that were subject to Social Security taxes up to the wage cap estimated to be $106,800 in 2009. It was also assumed that the taxpayer bears both the employee and employer share of payroll taxes. The calculations also account for the deductibility of payroll taxes for business tax purposes.

4. The combined income and payroll tax rate for the lowest income taxpayers, as depicted in Figure 2, is minus 27.4 percent under current law.

5. Senator Obama also proposes to reduce the rate at which the EITC is phased out, presumably to mitigate the harmful effects of the higher EITC credit on marginal tax rates. This aspect of his proposal seems to be a recognition of the balance between the policy objective of promoting work amongst the very low-income and avoiding the harmful effects of punitive marginal tax rates for those a bit further up the income scale.

6. Senator Obama's campaign has indicated that Social Security taxes might rise by 2 to 4 percent for taxpayers with earnings above $250,000.

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