How The Tax Bill Increases Taxes

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You've heard by now from economists and journalists that the summer's big tax bill makes our already screwy tax code even more complex. If only that were the worst thing about it! The bill's most insidious feature, which has gone largely unnoticed, is that it substantially raises marginal tax rates for certain middle- and high-income people with children. That's right: A bill that 'cuts' taxes can actually increase marginal tax rates--by anywhere from five to 30 percentage points in typical cases.

Two provisions of the bill do the damage: the per-child tax credit and the HOPE tax credit for higher education. The reason is that past some income threshold, both tax credits are reduced as the taxpayer earns more income. Over this income range, therefore, marginal tax rates are necessarily higher.

Here's how it works. Imagine you're a married taxpayer with an adjusted gross income (AGI) of $110,000 a year. At this income level or below, you get the whole $500-per-child tax credit. But if you earn an additional $1,000, you lose $50 of that tax credit. That loss in your ability to take the tax credit translates into a five-percentage-point tax on the extra $1,000--in addition to your normal tax rate. Taxpayers with an AGI of about $110,000 are typically in the 28% federal tax bracket. So instead of paying the statutory marginal tax rate of 28%, you would actually be in a 33% tax bracket.

It gets worse. Imagine that you have a child in college who qualifies for the new HOPE education tax credit of $1,500 per year. If you're married and have an AGI between $80,000 and $100,000, you lose $75 of the tax credit for every additional $1,000 you make, translating into an implicit marginal tax rate of 7.5 percentage points. So your marginal tax rate, rather than being 28%, is actually 35.5%. If you have two children attending college, you lose $150 of the tax credit for every additional $1,000 of income. This adds 15 percentage points to your marginal tax rate, making it 43%.

It's even worse for single parents. Say you're a single parent with an adjusted

gross income between $40,000 and $50,000 and one child in college. For every additional $1,000 you make in that range, you lose $150 of the tax credit, driving your marginal tax rate up by 15 points. If you had two children in college, an extra $1,000 in income would cost you an additional $300 of the tax credit, making your marginal tax rate a whopping 30 points higher. Some single parents in the $40,000 to $50,000 income range, therefore, will find themselves paying a marginal tax rate of 45%, rather than the more typical 15%. In short, the new tax bill triples marginal tax rates for some unlucky parents.

This type of tax-bracket weirdness is inevitable whenever Congress and the White House try to target tax relief for a group with incomes below some threshold, since the relief must be phased out for people with higher incomes. This suggests a larger question: why exclude people above a certain income level from the benefits of the tax cuts? The answer is that a zealous group of social engineers in Congress and the White House get apoplectic at the thought of granting tax relief to 'the rich'--which in this case seems to mean any single person with income above $40,000 and/or any married couple with income over $80,000. And so, once again, our bureaucrats in Washington have bolstered the role of envy in the U.S. tax code.