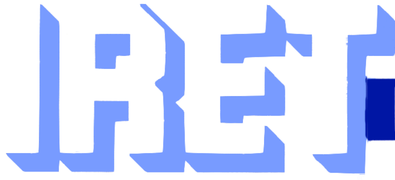
POLICY BULLETIN

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PHASE-OUTS ARE BAD TAX POLICY

The tax code is littered with rules that phase out various deductions, exemptions, and credits as taxpayers' incomes rise. Some of the items that taxpayers lose with higher incomes are the deductibility of individual retirement account (IRA) contributions, the earned income tax credit (EITC), the exclusion of social security benefits from taxable income, a portion of itemized deductions, even the personal exemption. The Taxpayer Relief Act of 1997 (TRA-97) adds significant new phase-outs. Its two largest provisions, the child credit and tax subsidies for college students, are both conditioned by phase-outs.

The tax code is littered with rules that phase out various deductions, exemptions, and credits as taxpayers' incomes rise...The Taxpayer Relief Act of 1997 (TRA-97) adds significant new phase-outs.

Phase-outs create troubling problems in the areas of economic efficiency, simplicity, and fairness. Phase-outs raise marginal tax rates throughout the phase-out zone and, thereby, reduce incentives to work, save, and invest. Phase-outs make the tax code more complicated, which raises tax enforcement and compliance costs, both by making the tax code harder to understand and by making tax liabilities harder to compute. The instruction book that accompanies an individual's yearly tax forms includes an obstacle course of special instructions and worksheets testing whether various phase-outs affect the taxpayer and, if so, how much each relevant phase-out restricts the deductions, exemptions, or credits the taxpayer may claim. Further, although phase-outs are often called fair because they tend to increase tax progressivity, the arbitrariness and surreptitiousness of most phase-outs violates any reasonable standard of fairness.

A Flock of Phase-outs

Prior to this year's legislation, the individual income tax eliminated or restricted the following deductions, exemptions, and credits when taxpayers' incomes grew: the tax exemption for social security benefits, the EITC, the deduction for IRA contributions, the personal exemption, the

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medical deduction, the miscellaneous business deduction, the total of itemized deductions, the deduction for losses on rental real estate, the dependent care credit, the adoption credit, the exclusion for interest income from U.S. Savings Bonds used for higher education expenses, and the alternative minimum tax exempt amount.[1] In addition, some tax provisions impose tougher than normal requirements on taxpayers above various income thresholds. An example is the increased amount of estimated tax a person must pay to avoid underpayment penalties if the person's adjusted gross income exceeds $100,000.[2]

To this already long list, TRA-97 has added a welter of complicated new phase-outs. The benefits created in TRA-97 that taxpayers lose as their incomes rise are: the $500 child credit, the HOPE Scholarship tax credit, the lifetime learning tax credit, the education IRA, the Roth IRA, the deduction for certain interest on student loans, and the $5,000 tax credit for first-time home buyers in the District of Columbia. TRA-97 did not remove any of the existing phase-outs. But in a few cases (e.g., deductible IRA contributions), it raised the income threshold at which a phase-out begins or otherwise eased a phase-out.

Other federal taxes also have phase-out provisions. The corporate income tax, for instance, imposes two surtaxes to phase out the tax savings from the graduated corporate rate schedule. The first surtax is 5% of every dollar of taxable corporate income above $100,000 and below $335,000 and raises the 34% statutory tax rate in that corporate income range to an effective marginal tax rate of 39%; the second surtax is 3% of each dollar of taxable income between $10,000,000 and $18,333,333 and boosts the 35% statutory tax rate to an effective marginal tax rate of 38%. Corporations with incomes above $18,333,333 pay an effective flat tax rate of 35% on total taxable income. The estate and gift tax phases out the benefits of the unified credit and the graduated estate and gift tax schedule with a 5% surtax. Although the top statutory estate and gift tax rate is 55%, the surtax lifts the marginal tax rate in the phase-out zone to 60%. The individual alternative minimum tax (AMT) also has a phase-out. A certain amount of income may normally be disregarded when computing the AMT, but, as income increases, that exempt amount must be added back to the tax base. (The individual AMT is, in effect, a parallel individual income tax: people must pay either the standard income tax or the individual AMT -- whichever is larger.)

Appendix I identifies the phase-out provisions in the standard individual income tax. For each of these phase-outs, it reports the income threshold at which the phase-out begins, the income range over which the phase-out continues, and the maximum number of percentage points by which the phase-out may boost the marginal tax rate of people within its phase-out zone. Appendix II covers

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[1] The limitations on the deductions for medical costs and miscellaneous business expenses are properly classified as phase-outs because, as a taxpayer's income rises, the taxpayer is required to disregard for tax purposes increasing amounts of expenses in those areas.

[2] Compared to prior law, TRA-97 eases the differential in most later years, and it suspends the differential for one year (tax year 1998). The differential in the stringency of the safe harbor amount of estimated payments between taxpayers with AGIs above and below $100,000 is particularly inappropriate because higher-income taxpayers often have difficult-to-predict incomes that make it very hard for them to estimate their end-of-year tax liabilities accurately.

the major phase-outs mentioned above in the corporate income tax, the estate and gift tax, and the individual AMT.

Chart 1 shows the income ranges over which most of the individual income tax phase-outs occur. The tax code generally designates phase-outs in terms of adjusted gross income (AGI).[3] For example, the new HOPE Scholarship tax credit is phased out over the $10,000 AGI range from $40,000 to $50,000 for single filers and over the $20,000 AGI range from $80,000 to $100,000 for joint filers. The complexities of the Chart drive home the large number and haphazard variety of income-based phase-outs.

The complexities of the Chart [illustrating phase-outs in the individual income tax] drive home the large number and haphazard variety of income-based phase-outs.

The relative heights of the lines are roughly based on the potential of the various phase-outs to raise marginal tax rates. For example, the partial phase-out of the dependent care credit for 1 child increases the marginal tax rate by 1.33 percentage points, on average, for taxpayers with AGIs between $10,000 and $28,000 who would otherwise qualify for the maximum credit.[4] The partial phase-out of the dependent care credit for 2 or more children increases the marginal tax rate by 2.67 percentage points, on average, for taxpayers with AGIs between $10,000 and $28,000 who would otherwise qualify for the maximum credit. The phase-out of the tax credit for first-time District of Columbia homebuyers would affect few taxpayers, but for those taxpayers who would qualify except for being in the phase-out range, the effective increase in their marginal tax rates would be a whopping 25 percentage points.

Adding more complexity, many phase-outs use modified definitions of AGI, and the modifications often differ from one phase-out to another. For instance, the phase-out of the social-

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[3] In contrast, the schedule of progressive tax brackets is based on taxable income. AGI differs from taxable income because AGI is measured before subtracting personal exemptions and most deductions. For example, if a couple with an AGI of $50,000 in 1997 has two dependent children, claims the standard deduction, and files jointly, the couple's taxable income would be $32,500 -- $17,500 less than the couple's AGI. Because a given AGI corresponds to a taxable income that is thousands of dollars lower (with the exact difference depending on filing status, number of exemptions, and deductions claimed), phase-out ranges would begin at much lower stated dollar amounts if they were expressed in terms of taxable income instead of AGI.

[4] The partial phase-out of the dependent care credit actually occurs in a series of steps, each covering $2,000 of AGI. Rather than trying to report that complicated pattern, in which AGI changes within a step do not affect the amount phased out but small AGI changes from one step to the next have a very big impact, it is assumed throughout this study that phase-outs proceed smoothly over the phase-out range. Also, if the taxpayer could not claim the maximum credit for reasons unrelated to the phase-out (e.g., dependent care expenses below that permitted by the credit, lack of taxable income), either the phase-out would not cause as much of a jump in the marginal tax rate or the phase-out range would be shorter.

security-benefit exemption adds to modified AGI half of social security benefits and all tax exempt interest, and the phase-out of deductible IRA contributions modifies AGI by including IRA contributions and certain foreign earned income and foreign housing allowances normally excluded from AGI.[5] Because of these differences in the definition of modified AGI, taxpayers need to follow very carefully the specific instructions for the particular phase-out in question.

Money for the Treasury and Progressivity

Phase-outs have two properties that lawmakers have found very appealing: they increase the government's tax revenues and they heighten tax progressivity. Acting Assistant Treasury Secretary Donald Lubick referred to both these features when he defended in Congressional testimony the Clinton Administration's wish that the child credit be "targeted", that is, phased out with rising income. "A targeted child credit is an efficient way to address the increase in relative tax burdens faced by larger families...The relief is directed to low- and middle-income taxpayers because of the limited resources available for tax reduction and higher-income taxpayers' relatively greater ability to pay current levels of income taxes."[6] Earlier in his testimony, Mr. Lubick had associated phase-outs with fiscal responsibility. "Given the need for fiscal discipline, one of our principles throughout President Clinton's tenure has been that tax relief should be concentrated on middle-income taxpayers."

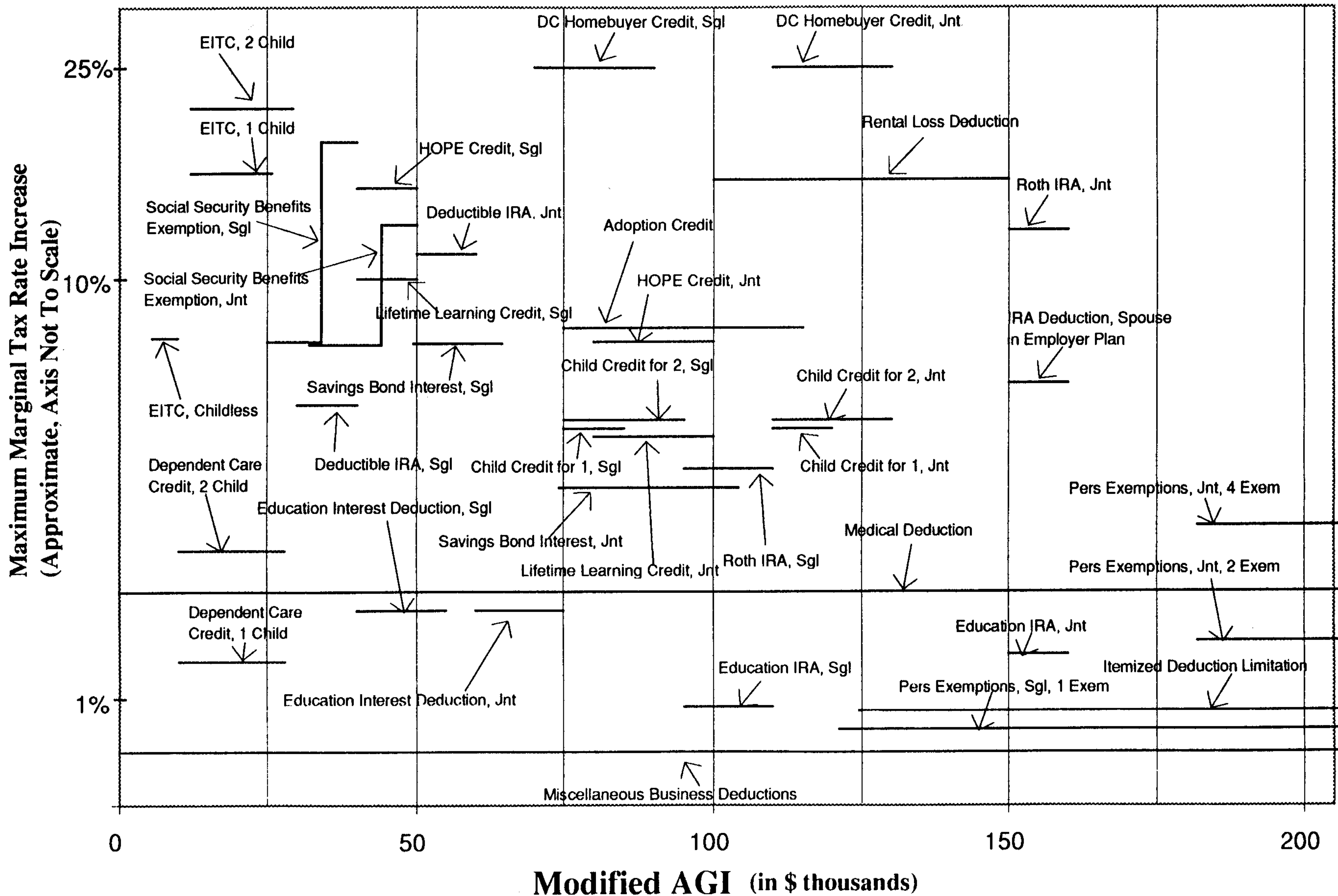
Although phase-outs limit the revenue cost to the government of the deductions, exemptions, and credits being phased out, whether that is desirable or undesirable depends on circumstances. Taking more tax dollars from wage earners, savers, and entrepreneurs is not necessarily a good thing. If the tax revenues are used to finance wasteful or otherwise inappropriate government spending programs, it would be better to cut the spending and not collect the revenues. If the spending represents the best use of the resources it consumes, on the other hand, it is reasonable to seek revenues. Still, that does not justify a particular phase-out rule unless the phase-out has fewer undesirable side effects regarding economic efficiency, simplicity, and equity than any alternative means of increasing tax collections.

Standard estimation models, furthermore, usually exaggerate the revenue savings. The problem is that the increased marginal tax rates produced by phase-outs worsen anti-growth tax biases, and those biases slow the economy. When the economy slows, tax collections suffer. Standard revenue

[5] Because the definition of modified AGI differs among the phase-out provisions, the horizontal positions of the lines in the Chart are not always strictly comparable.

[6] Statement of Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of Treasury, Testimony before the House Ways and Means Committee, March 5, 1997.

AGI RANGES OF PHASEOUTS



estimation models, though, are static in the sense that they ignore those anti- growth effects. Hence, a phase-out that weakens the economy tends to save less revenue for the Treasury than advertised.

Similarly, unless one believes that the tax system is never progressive enough and should always be more progressive (logically culminating in complete, government-enforced equality of incomes despite differences in people's industriousness, skills, and saving behavior), greater progressivity through the tax system is not necessarily a good thing. Too often, proposals are made for increasing the tax system's progressivity without inquiring whether it is sufficiently progressive already or, perhaps, overly progressive, given the problems created when the government takes income from those who earned it and gives it to other people. Moreover, if greater progressivity is sought, a particular phase-out is the proper way to do it only if that phase-out causes fewer problems than any other means of redistributing the income.

How Phase-outs Increase Marginal Tax Rates

Over the income range in which a deduction, exemption, or credit is being phased out, additional income adds to a person's tax bill in two ways. First, the extra income is subject to regular income tax. Second, the extra income reduces the amount of the deduction, exemption, or credit that is being phased out. A lower deduction or exemption raises taxable income further, and further increases the tax. A lower credit reduces the amount subtracted from tax, and again the person's tax bill is higher than otherwise. In either case, the higher tax is, in effect, a penalty on the extra income that triggered the phase-out.

Phase-outs raise marginal tax rates throughout the phase-out zone and, thereby, reduce incentives to work, save, and invest.

For instance, suppose that a person is in the 28% tax bracket. Also suppose that the person had been claiming a credit that is being phased out at a rate of 15 cents for each $1 of added income. First, then, an extra $1 of income increases the person's pre-credit tax liability by 28 cents. At this point, the person's marginal tax rate is 28%. Second, though, the extra $1 of income increases the person's tax liability by another 15 cents because it reduces by that amount the credit the person can subtract from his or her tax bill. Thus, the additional tax triggered by an extra $1 of income is 43 cents (28 cents plus 15 cents). In this case, the person's effective marginal tax rate is 43%, of which the phase-out is responsible for 15 percentage points. The hike in the marginal tax rate due to the phase-out extends over the income range in which the deduction, exemption, or credit is being phased out. At incomes above and below the phase-out range, the phase-out does not affect the marginal tax rate.

As a concrete example, consider the phase-out of the HOPE Scholarship tax credit. Suppose that a single parent has one dependent child entering college, and suppose that tuition costs are sufficient for the parent to claim the maximum $1,500 HOPE Scholarship tax credit in 1998 (ignoring for a

moment the income limitation attached to the new credit). The HOPE Scholarship tax credit is phased out ratably over the $10,000 modified AGI range from $40,000 to $50,000. This taxpayer loses 15 cents of credit per dollar of income in the phase-out range.[7] Accordingly, if the parent's modified AGI is between $40,000 to $50,000, each extra $1 of income will increase the parent's tax bill in two ways. First, the regular tax on the extra $1 of income will raise the parent's tax liability by either 15 or 28 cents, depending on the parent's tax bracket.[8] Second, the extra $1 will reduce the HOPE Scholarship tax credit by 15 cents, which raises the parent's tax bill by 15 cents. Thus, in the phase-out zone for this credit, the single parent's effective marginal tax rate on each additional $1 of income will be either 30% (if the parent is in the 15% tax bracket) or 43% (if the parent is in the 28% tax bracket). Note further that modified AGI includes income from saving as well as wages. Thus, parents who save for their children's education are penalized with a reduction in the tax credit designed to encourage education.[9]

As another example, this one involving a deduction, consider the 2% AGI threshold for the miscellaneous business expense deduction. The tax code allows individuals to claim miscellaneous business expenses only to the extent that they exceed 2% of AGI. Suppose that a taxpayer itemizes, has miscellaneous business expenses of $1,500, and an AGI of $60,000. Because 2% of that AGI is $1,200, the person can only claim miscellaneous business expenses of $300 ($1,500 of valid deductions - $1,200 income-based disallowance). For this taxpayer, an extra $1 of AGI would lower his or her miscellaneous business expense deduction by 2 cents and raise his or her taxable income by an additional 2 cents, for a total of $1.02. If the taxpayer is in the 28% rate bracket, this increases his or her tax liability by 28.56 cents (28% of $1.02). The taxpayer's effective marginal tax rate on the added $1 of income is 28.56%, of which the phase-out contributes 0.56 percentage points.[10]

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[7] If the pre-phase-out credit were smaller, the loss per dollar of income in the phase-out range would also be smaller. For example, if tuition costs were sufficiently low that the taxpayer's maximum credit was only $1,000, the taxpayer would only lose 10 cents of credit per dollar of income in the phase-out range.

[8] Tax brackets depend on taxable income, not AGI. At the start of the phase-out, the taxpayer in the example will probably have a taxable income within the 15% rate bracket. At about the mid-point of the phase-out range, the taxpayer's taxable income will most likely cross over into the 28% rate bracket.

[9] Some parents may be able to avoid this penalty on saving for a child's education by putting some of the saving in the child's name. That way, returns on that portion of the saving would not restrict the parents' eligibility to claim the credit. (This assumes it is the parents who claim the credit and that they pay enough of the education costs to do so.) Giving the saving to the child would mean that yearly tax returns might have to be filed for the child on interest income. Also, until the child reaches age 14, interest income might be taxed at the parent's marginal rate because of the "kiddie tax" introduced as part of the 1986 tax act.

[10] The size of the marginal tax rate increase depends on the individual's tax bracket. For a person in the 15% tax bracket who claims the miscellaneous business expense deduction, the boost in the marginal tax rate due to the phase-out of this deduction would be 0.3 percentage points; for the person in the example in the 28% tax bracket, it was 0.56 percentage points; for a person in the 31% tax bracket, it would be 0.62 percentage points; for a person in the 36% tax bracket, it would be 0.72 percentage points; and for a person in the 39.6% tax bracket, it would be 0.792 percentage points.

Phase-outs Worsen Tax Distortions

As explained above, when taxpayers lose deductions, exemptions, or credits because their incomes are increasing, the losses produce a spike in the taxpayers' marginal tax rates throughout the range of income over which the phase-out occurs. The tax rate spike hurts the economy because it aggravates tax biases against work, saving, and a variety of specific products and activities that the tax code treats more harshly than others. By compounding tax biases, phase-outs urge people to work less, save less, and be less productive.

Consider, for instance, a single individual of age 62 or over who takes the standard deduction, has yearly social security benefits of $12,000, and receives private pension, interest, and dividend income of $30,000. This taxpayer would normally be in the 28% tax bracket. Due to the income-based phase-out of the exemption for social security benefits, each additional dollar of income requires the individual to add 85 cents of social security benefits to taxable income, for a combined increase in taxable income of $1.85. At the margin, therefore, each extra dollar of income from private saving raises the person's tax bill by 51.8 cents: 28 cents due to regular tax and 23.8 cents due to the phase-out of the exclusion for social security benefits. Note that the tax is effectively imposed on the income from saving that triggered the tax hike, not on the social security benefit itself. This very high tax bite is a powerful inducement for the person to save less and consume more. As a result, some people receiving social security and some younger people planning ahead for their retirement years will decide to save less than they otherwise would because of the tax penalty. The tax-induced drop in saving leaves those people less financially secure and, because saving and investment are major contributors to productivity, leaves society as a whole less productive.

Wage and salary income of people who continue working after they begin receiving social security benefits can also trigger taxation of benefits (as well as being subject to payroll taxes). For those who fall in the phase-out zone for the exclusion of benefits from income, the penalty against work effort is at least as bad as against saving. If working beneficiaries also run afoul of the social security earnings test, the tax penalty will be even harsher, exceeding 100% of added wage income in some cases.[11]

Complexity

Phase-outs worsen the complexity of the tax system. When a deduction, credit, or exemption is phased out, taxpayers have two additional administrative burdens. They must start by very

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[11] Social security beneficiaries may earn limited amounts of wages without losing social security benefits. However, for each dollar of wages above the exempt amount, beneficiaries age 62-64 lose $1 of benefits for every $2 in wages (a 50% tax rate); beneficiaries age 65-69 lose $1 of benefits for every $3 in wages (a 33.33% tax rate). The loss of benefits reduces the amount of benefits subject to tax, resulting in a bit less of a tax spike than would be indicated by simply adding up all the income, payroll, and penalty tax rates, but effective marginal tax rates of 85% plus for people age 65-69 or 100% plus for people age 62-64 are routinely possible.

carefully reading the tax instructions to learn if the phase-out might apply to them. Then, if the phase-out could affect them, they must work through the actual phase-out computations.

The phase-out computations are generally not difficult, but they are tedious and come, of course, on top of all other tax calculations. In the Form 1040 Instructions for 1996, for instance, the worksheet for calculating the phase-out of the social security benefit exemption required 18 lines, the worksheet for the personal exemption's phase-out had 9 lines, and the worksheet for the phase-out of the IRA deduction took 10 lines (19 lines if there was a contribution to a nonworking spouse's IRA). Many other phase-outs did not have separate worksheets, leaving taxpayers to slog through the steps on their own.

Phase-outs make the tax code more complicated, which raises tax enforcement and compliance costs, both by making the tax code harder to understand and by making tax liabilities harder to compute.

IRAs illustrate the complexity attributable to phase-outs. From 1981 to 1986, IRAs did not have a phase-out, and each worker could make yearly deductible contributions of up to $2,000, subject to a few qualifications. Contributing was a simple matter, and IRAs became hugely popular. The 1986 tax act suddenly changed that. The IRA deduction was reduced or eliminated if a taxpayer's modified AGI exceeded $25,000 ($40,000 for a couple filing jointly) and if the worker or the worker's spouse was an active participant in an employer-sponsored pension plan.[12] With this restriction, many workers found themselves barred from making deductible IRA contributions, and many others had to perform detailed computations to ascertain if they could still contribute and, if so, how much.[13] No longer was making a deductible IRA contribution a simple matter. Not surprisingly, IRA contributions plummeted. Although this was mostly because so many workers were now ineligible, the fact that people who remained fully eligible also reduced their contributions suggests that some workers found the new rules sufficiently confusing and intimidating that they avoided IRAs for that reason alone.

The phase-outs are probably somewhat more confusing than otherwise because there are so many different phase-out thresholds, as can be seen in Chart 1. One suggestion that has been floated for easing the compliance burden is to establish just a few phase-out thresholds, perhaps a low-income one, a middle-income one, and a high-income one. Unfortunately, while this suggestion is not without merit, coordinating phase-out thresholds would reduce complexity only slightly; the bulk

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[12] This year's tax bill raises the threshold, introduces a new type of nondeductible IRA (with its own phase-out), and makes other changes.

[13] Workers barred in some years from making deductible IRA contributions may make nondeductible contributions, but that entails still more paperwork, including an additional tax form to be filed and a greatly complicated tax situation in the future as they make withdrawals from the IRA. Withdrawals must be attributed proportionally to deductible contributions and non-deductible contributions; the former are taxable upon withdrawal, the latter are not.

of the problem would remain. A taxpayer would still have to investigate the rules governing each phase-out that might apply to him or her -- the income level at which the phase-out begins is one of the rules but there are many others -- and then perform all the calculations for that specific phase-out. Even worse, the bunching of phase-outs would increase the odds that taxpayers would be subject to more than one phase-out at the same time. Multiple phase-outs occurring over the same income range could create an extremely sharp spike in a taxpayer's marginal tax rate and a quantum leap up in complexity of calculations.

Fairness

Tax-policy debates about fairness often center on the relationship between people's tax liabilities and their incomes. What fairness really means in this context, however, has proven extraordinarily subjective and controversial. Some contend that people's tax bills should increase more rapidly than their incomes. This relationship, which is known as tax progressivity, demands, for instance, that if a person's income doubles, the amount of taxes the person pays to the government *more* than doubles. If one believes in progressivity, an essential follow-up question -- but one that advocates of progressivity rarely address -- is how much progressivity is enough. Should taxes rise slightly more rapidly than income? Should taxes rise much more rapidly?

A competing standard of fairness is that people's tax bills should rise at the same rate as their incomes. With what is known as a proportional tax, if a person's income doubles, the person's tax bill also doubles. A good case can be made for a proportional system. For the most part, a person's income represents payments for labor and capital services offered to the market, and the person's income is proportional to the person's efforts and contributions to economic output. It is only fair that a person making twice the effort and generating twice the output should receive, after tax, twice the compensation, which implies a proportional tax system.

The income tax system is already progressive because of its exempt amounts and ascending schedule of marginal tax rates in the various income brackets. If one believes that the current rate structure does not provide enough progressivity, the most direct and visible way to increase progressivity would be to steepen the rate schedule or to increase the standard deduction and/or personal exemption. Either method would be a clearer, simpler way to increase progressivity than phase-outs.

On the other hand, suppose one believes in progressivity but thinks that the income tax is already progressive enough. In that event, the use of phase-outs to inject additional progressivity would be unfair. And if one believes that people's tax liabilities should be proportional, rising in step with their incomes, phase-outs would certainly have to be judged unfair.

Although discussions of fairness in the context of tax policy often mention only the relationship between tax liabilities and income, another very important criterion of equity, surely, is according people equal treatment under the law. Specifically, if a particular deduction, exemption, or credit based on the nature of an expense is available to taxpayers in general, it is unfair to take it away from

a particular group of taxpayers because of a characteristic unrelated to the rationale for the deduction, exemption, or credit. The child care credit and miscellaneous business expense deduction provide good examples. These costs of earning income are as real for high income earners as for low income earners. The true measure of income -- revenue less the cost of earning the revenue -- suggests that everyone should be allowed a full deduction for such expenses.

[T]he arbitrariness and hidden nature of phase-outs are contrary to tax fairness.

Some policymakers defend the phase-out of the child credit and other phase-outs by insisting that tax policy ought to favor the poor and middle class. For example, early in 1997, President Clinton said, "Over the last four years, we have provided tax relief to millions of working Americans and to small businesses. But I want to go further by helping middle-income Americans raise their children, send them to college, and save for the future."[14] At one level this message is plausible: middle-income Americans may be overtaxed relative to the services they receive from the government.[15] But hidden in the President's message is the very disturbing idea that tax rules should be based on what groups a policymaker wants to help or hurt, not on what rules would produce a less distortionary and less complicated tax system. For example, the phase-out of the child and education credits are a form of tax discrimination against the upper middle class and wealthy.

At the other end of the income scale are credits aimed at discriminating in favor of the poor. One of the largest credits subject to a phase-out is the EITC, a program of government aid to the working poor. The EITC is, in essence, a welfare program, but it differs from most welfare programs because it has the commendable feature of pegging aid to work, at least up to a certain level of income. Because one expects low-income assistance to be reserved for the poor or near poor, means testing of the EITC does not violate most people's personal standard of fairness. The EITC phase-out is still troubling on other fronts, though. It increases the EITC's complexity, and, even more damaging, it creates a powerful disincentive against additional work effort within the phase-out range.

Consider a single filer with 2 eligible children, wages in 1998 of $20,000, and no other income. This worker would qualify for the EITC but be in the middle of its phase-out zone. The phase-out rate for an individual with two or more children is 21.06%. Thus, an additional dollar of wages

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[14] Budget Message Of The President in Office Of Management And Budget, *The Budget Of The U.S. Government, Fiscal Year 1998* (Washington, DC: Government Printing Office, 1997), p. 6. Although the President claimed that his tax proposals were targeted towards the middle class (he even labelled the main provisions a "Middle Class Bill of Rights"), the actual proposals defined the middle class as ending at such low income levels that millions of households who regard themselves as solidly middle class would be excluded. The Administration, for example, recommended that the child credit begin phasing out at a modified AGI of $60,000. By any objective measure, that is hardly upper income. A two-earner couple would bump into that phase-out if each has gross wages of just $30,000.

[15] If some government services are not worth the money, the appropriate response is both to cut taxes and to rein in government spending.

would increase the worker's income tax by 15 cents (the person is probably in the 15% tax bracket) and reduce the credit the person can subtract from tax by approximately 21 cents. As a result, the worker would owe 36 cents more income tax on the extra dollar of income. In other words, the EITC phase-out pushes this low-income worker's marginal income tax rate from 15% to 36%. This is a powerful work disincentive. If the same worker has only one child, the EITC and its phase-out rate are both smaller. The phase-out rate is approximately 16%. In combination with the regular income tax, it produces an effective marginal income tax rate of about 31%. (To find the total marginal tax rate, one must add the payroll tax. The employee share of the payroll tax increases the worker's marginal tax rate by another 7.65%. In addition, it is generally accepted that the employer share of the payroll tax is passed on to workers, as well.) It is true that the EITC provides a powerful work incentive while it is being phased in (earnings from $0 to $12,260 in 1998), but more workers are in the phase-out range than the phase-in range.[16] On balance, then, the EITC, which is often thought of as a spur to work effort by the working poor, may actually discourage more work than it stimulates.

Instead of adding more phase-outs to the tax system, the President and the Congress should be rescinding those already on the books. Ideally, all phase-outs should be swept aside in a fundamental overhaul of the tax system.

Another fairness-based criticism of phase-outs is that although they can produce big tax increases, the rules and arithmetic are so complicated that taxpayers are often unsure of or confused about how much extra they are paying. People may legitimately object to such hidden taxes in much the same manner that they dislike having hidden charges tacked onto other bills they receive. If a private merchant adds hidden charges to bills, customers at least have the option of going to other merchants who practice more open billing. Indeed, the hidden charges may even be illegal! With tax bills from the government, unfortunately, people do not have that choice. A rising schedule of rate brackets is a much more visible method of taxing away an increasing share of people's incomes as their incomes grow than are phase-outs.

Conclusion

Phase-outs raise marginal tax rates and wreak havoc on economic incentives over the affected ranges of income. Although phase-outs can be extremely attractive politically because they are partially hidden and can be (mis-)touted as "fair", they are very bad tax policy -- distortionary, complicated, and unfair. Instead of adding more phase-outs to the tax system, the President and the Congress should be rescinding those already on the books. Ideally, all phase-outs should be swept aside in a fundamental overhaul of the tax system.

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[16] Based on author's calculations using IRS data for tax year 1994 published in Therese M. Cruciano, "Individual Income Tax Returns, Preliminary Data, 1994," SOI Bulletin, Spring 1996, p. 25.

Phase-outs violate several key principles to which a tax system should adhere. They needlessly damage economic incentives: taxpayers who are in the process of losing deductions, exemptions, or credits because of rising income experience higher marginal tax rates than otherwise, thereby sharpening harmful tax biases against work and saving. Phase-outs are complicated, which confuses taxpayers and adds to their paperwork costs. Further, although phase-outs are often defended vigorously because they steepen tax progressivity, the increased progressivity is actually unfair if the income tax is already sufficiently progressive or too progressive. Regardless of debates about progressivity, the arbitrariness and hidden nature of phase-outs are contrary to tax fairness. Further, phase-outs violate the concept of affording all citizens equal treatment before the law.

In light of these problems, policymakers should reexamine the phase-outs now in the tax code. Most should be eliminated. New phase-outs should not be introduced. The inefficiencies and confusion introduced into the tax system by phase-outs are further evidence that fundamental overhaul and simplification of the tax system is sorely needed. When politicians are seeking to save money for the U.S. Treasury, phase-outs should be one of the last places they look, not one of the first.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.

APPENDIX I

INCOME-BASED PHASEOUTS IN THE INDIVIDUAL INCOME TAX[1]

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To[2, 3]
$500 Child Credit (Reaches $500 per eligible child in 1999 and later years.) (Introduced in TRA-97)	*Single Filer*: Modified AGI of 75,000 *Joint Filer*: Modified AGI of 110,000.	*Single Filer*: Phased out by $50 for each $1,000 of modified AGI above the threshold. Thus, phaseout range is 10,000 for each qualifying child. *Joint Filer*: Phased out by $50 for each $1,000 of modified AGI above the threshold. Thus, phaseout range is 10,000 for each qualifying child.	*Single Filer*: 5 percentage points (e.g., 28% becomes 33%) *Joint Filer*: 5 percentage points (e.g., 28% becomes 33%, 31% becomes 36%)
HOPE Scholarship Credit (Up to 1,500 yearly tax credit per student for each of first 2 years of college.) (Introduced in TRA-97)	*Single Filer*: Modified AGI of 40,000. *Joint Filer*: Modified AGI of 80,000.	*Single Filer*: Phased out over 10,000 range from 40,000 to 50,000. *Joint Filer*: Phased out over 20,000 range from 80,000 to 100,000.	*Single Filer*: 15 percentage points per student (e.g., 15% becomes 30%, 28% becomes 43%) *Joint Filer*: 7.5 percentage points per student (e.g., 28% becomes 35.5%) (Because credit is per student, marginal tax rate increases will double if taxpayer has 2 eligible students in first 2 years of college.)
Lifetime Learning Credit (Up to 1,000 yearly tax credit per taxpayer.) (Introduced in TRA-97)	*Single Filer*: Modified AGI of 40,000. *Joint Filer*: Modified AGI of 80,000.	*Single Filer*: Phased out over 10,000 range from 40,000 to 50,000. *Joint Filer*: Phaseout begins at modified AGI of 80,000. Phased out over 20,000 range from 80,000 to 100,000	*Single Filer*: 10 percentage points per taxpayer (e.g., 15% becomes 25%, 28% becomes 38%) *Joint Filer*: 5 percentage points per taxpayer (e.g., 28% becomes 33%)

[1] This is a relatively complete list, but there is no guarantee that every rule which could be construed as a phaseout has been included.

[2] This is the marginal rate increase that would be experienced by a taxpayer who would claim the maximum deduction, exemption, or credit except for the phaseout. If the taxpayer would not qualify for the maximum amount for other reasons, the marginal tax rate increase due to the phaseout would generally be less or the phaseout range shorter.

[3] For simplicity, these numbers assume that phaseouts occur smoothly over the phaseout range. In fact, many phaseouts proceed in steps, which produces a more complicated pattern of marginal tax rate changes.

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To
Education Investment Accounts (Education IRA) (Up to 500 per beneficiary. Contributions not deductible but distributions not taxed if certain conditions met.) (Introduced in TRA-97)	*Single Filer*: Modified AGI of 95,000.	*Single Filer*: Phased out over 15,000 range from 95,000 to 110,000.	Earnings on saving become taxable instead of tax free. Equal in present value to losing eligibility to contribute to a conventional, deductible IRA. *Single Filer*: 0.93 percentage point if taxpayer in 28% rate bracket; 1.03 percentage points if taxpayer in 31% rate bracket (e.g., 28% becomes 28.93% and 31% becomes 32.03%).
	Joint Filer: Modified AGI of 150,000.	*Joint Filer*: Phased out over 10,000 range from 150,000 to 160,000.	*Joint Filer*: 1.55 percentage points if taxpayer in 31% rate bracket (e.g., 31% becomes 32.55%).
Interest on Education Loans (Up to 1,000 of interest on education loans deductible in 1998, more in later years.) (Introduced in TRA-97)	*Single Filer*: Modified AGI of 40,000.	*Single Filer*: Phased out over 15,000 range from 40,000 to 55,000.	*Single Filer*: 1 percentage point if taxpayer in 15% rate bracket; 1.87 percentage points if taxpayer in 28% rate bracket (e.g., 15% becomes 16% and 28% becomes 29.87%).
	Joint Filer: Modified AGI of 60,000.	*Joint Filer*: Phased out over 15,000 range from 60,000 to 75,000.	*Joint Filer*: 1 percentage point if taxpayer in 15% rate bracket; 1.87 percentage points if taxpayer in 28% rate bracket (e.g., 15% becomes 16% and 28% becomes 29.87%).
Roth IRA (Up to 2,000 contribution for single filer; up to 4,000 contribution for couple. Contributions not deductible but distributions not taxed if certain conditions met.) (Introduced in TRA-97)	*Single Filer*: AGI of 95,000.	*Single Filer*: Phased out over 15,000 range from 95,000 to 110,000.	Earnings on saving become taxable instead of tax free. Equal in present value to losing eligibility to contribute to a conventional, deductible IRA. *Single Filer*: 3.73 percentage point if taxpayer in 28% rate bracket; 4.13 percentage points if taxpayer in 31% rate bracket (e.g., 28% becomes 31.73% and 31% becomes 35.13%).
	Joint Filer: AGI of 150,000.	*Joint Filer*: Phased out over 10,000 range from 150,000 to 160,000.	*Joint Filer*: 12.4 percentage points if taxpayer in 31% rate bracket (e.g., 31% becomes 43.4%).

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To
Regular Deductible IRA (Up to 2,000 deduction for single filer; up to 4,000 deduction for couple, but subject to phaseout if active participant in employer-provided pension plan.) (TRA-97 increases the phaseout thresholds. Amounts for 1998 listed at right. Further increases in subsequent years.)	*Single Filer*: Modified AGI of 30,000. *Joint Filer*: Modified AGI of 50,000.	*Single Filer*: Phased out over 10,000 range from 30,000 to 40,000. *Joint Filer*: Phased out over 10,000 range from 50,000 to 60,000.	*Single Filer*: 3.0 percentage points if in 15% rate bracket; 5.6 percentage points if in 28% rate bracket (e.g., 15% becomes 18%, 28% becomes 32.6%) *Joint Filer*: 6.0 percentage points if in 15% rate bracket; 11.2 percentage points if in 28% rate bracket (e.g., 15% becomes 18%, 28% becomes 32.6%).
Regular Deductible IRA, if individual is not active participant in employer-sponsored retirement plan but spouse is (TRA-97 greatly eased prior-law restriction.)	AGI of 150,000.	Phased out over 10,000 range from 150,000 to 160,000.	6.2 percentage points, assuming taxpayer in 31% rate bracket
Conversion of Regular IRA to Roth IRA (Introduced in TRA-97)	Prohibited if modified AGI exceeds 100,000.	Restriction takes effect suddenly at 100,000 threshold.	Highly variable, depending on specific facts for taxpayer.
Tax Credit for First Time Homebuyer In District of Columbia (Up to 5,000 Credit) (Introduced in TRA-97)	*Single Filer*: Modified AGI of 70,000. *Joint Filer*: Modified AGI of 110,000.	*Single Filer*: Phased out over 20,000 range from 70,000 to 90,000. *Joint Filer*: Phased out over 20,000 range from 110,000 to 130,000.	*Single Filer*: 25 percentage points (e.g., 28% becomes 53%, 31% becomes 56%). *Joint Filer*: 25 percentage points (e.g., 28% becomes 53%, 31% becomes 56%).

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To
Earned Income Tax Credit (EITC) (For 1998, credit of up to 341 if no children, 2,271 if 1 qualifying child, and 3,756 if 2 or more qualifying children.)	*No Children*: Modified earned income of 5,570.	*No Children*: Phased out over 4,460 range from 5,570 to 10,030.	*No Children*: 7.65 percentage points
	1 Child: Modified earned income of 12,260.	*1 Child*: Phased out over 14,210 range from 12,260 to 26,470.	*1 Child*: 15.98 percentage points
	2 or More Children: Modified earned income of 12,260.	*2 or More Children*: Phased out over 17,830 range from 12,260 to 30,090.	*2 or More Children*: 21.06 percentage points
	ALSO: EITC completely denied if taxpayer's investment income exceeds 2,300 in 1998.	Restriction takes effect suddenly at 2,300 threshold.	At investment-income cutoff point, individual can lose thousands of dollars of tax credits due to one more dollar of investment income.
Loss of Tax Exemption on up to 85% of Social Security Benefits	*Single Filer*: Modified AGI of 25,000.	*Single Filer*: Lose 50 cents of tax exemption for each $1 of modified AGI between 25,000 and 34,000 (limited to up to 50% of social security benefits being included in taxable income); lose 85 cents of tax exemption for each $1 of modified AGI over 34,000 (limited to up to 85% of social security benefits being included in taxable income).	*Single Filer*: Modified AGI between 25,000 and 34,000 (subject to 50% limitation): 7.5 percentage points if in 15% tax bracket; 14 percentage points if in 28% tax bracket. Modified AGI over 34,000 (subject to 85% limitation): 12.75 percentage points if in 15% tax bracket; 23.8 percentage points if in 28% tax bracket.
	Joint Filer: Modified AGI of 32,000.	*Joint Filer*: Lose 50 cents of tax exemption for each $1 of modified AGI between 32,000 and 44,000 (limited to up to 50% of social security benefits being included in taxable income); lose 85 cents of tax exemption for each $1 of modified AGI over 44,0001 (limited to up to 85% of social security benefits being included in taxable income).	*Joint Filer*: Modified AGI between 32,000 and 44,000 (subject to 50% limitation): 7.5 percentage points, assuming taxpayer in 15% tax bracket Modified AGI over 44,000 (subject to 85% limitation): 12.75 percentage points if in 15% tax bracket; 23.8 percentage points if in 28% tax bracket.

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To
Personal Exemption (2,700 per exemption in 1998)	*Single Filer*: AGI of 124,500 in 1998. (*Head of Headhold*: AGI of 155,650 in 1998.) *Joint Filer*: AGI of 186,800 in 1998.	*Single Filer*: Phased out over 125,000 range from 124,500 to 249,500. (*Head of Headhold*: Phased out over 125,000 range from 155,650 to 280,650) *Joint Filer*: Phased out over 125,000 range from 186,800 to 311,800.	Depends on rate bracket and number of exemptions. In 31% rate bracket, 0.67 percentage point for each exemption (0.67 percentage points for 1 exemption, 2.68 percentage points for 4 exemptions, etc.). In 36% rate bracket, 0.78 percentage points for each exemption (0.78 percentage points for 1 exemption, 3.11 percentage points for 4 exemptions, etc.).
Limitation on Medical Deduction	From first dollar of AGI.	Only medical expenses in excess of 7.5% of AGI are deductible.	1.13 percentage points in 15% rate bracket, 2.10 percentage points in 28% rate bracket, 2.33 percentage points in 31% rate bracket, 2.70 percentage points in 36% rate bracket, 2.97 percentage points in 39.6% rate bracket
Limitation on Miscellaneous Business Expenses	From first dollar of AGI.	Only miscellaneous business expenses in excess of 2% of AGI are deductible.	0.30 percentage points in 15% rate bracket, 0.56 percentage points in 28% rate bracket, 0.62 percentage points in 31% rate bracket, 0.72 percentage points in 36% rate bracket, 0.79 percentage points in 39.6% rate bracket
Limitation on Total Itemized Deductions	AGI of 124,500 in 1998.	Total itemized deductions reduced by 3% of AGI in excess of 124,500. (Disallowance not to exceed 80% of certain itemized deductions.)	0.84 percentage points in 28% rate bracket, 0.93 percentage points in 31% rate bracket, 1.08 percentage points in 36% rate bracket, 1.19 percentage points in 39.6% rate bracket

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To
Exclusion for Interest Income on US Savings Bonds Used for Higher Education Expenses	*Single Filer*: Modified AGI of 52,250 in 1998. *Joint Filer*: Modified AGI of 78,350 in 1998.	*Single Filer*: Phased out over 15,000 range from 52,250 to 67,250. *Joint Filer*: Phased out over 30,000 range from 78,350 to 108,350.	Depends on statutory tax rate bracket and amount of interest. Ex. 7.47 percentage points for *single filer* in 28% rate bracket with 4,000 of US Savings Bond interest. Ex. 3.73 percentage points for *joint filer* in 28% rate bracket with 4,000 of US Savings Bond interest.
Dependent Care Credit (Up to 720 for 1 child, up to 1,440 for 2 or more children)	AGI of 10,000.	*For 1 child*: Maximum credit reduced from 720 to 480 over range from 10,000 to 28,000. *For 2 or more children*: Maximum credit reduced from 1,440 to 960 over range from 10,000 to 28,000.	*1 child*: 1.33 percentage points *2 or more children*: 2.67 percentage points
Adoption Credit (Up to 5,000 credit, 6,000 if "special needs" child)	Modified AGI of 75,000.	Phased out over 40,000 range from 75,000 to 115,000.	12.5 percentage points 15 percentage points if "special needs" child
Deduction for Losses on Rental Real Estate (Up to 25,000 of losses may be deducted)	Modified AGI of 100,000.	Maximum allowable loss deduction reduced from 25,000 to zero over 50,000 range from 100,000 to 150,000.	14 percentage points in 28% rate bracket, 15.5 percentage points in 31% rate bracket, 18 percentage points in 36% rate bracket.
Estimated Tax, Safe Harbor from Underpayment Penalty for Individuals (More restricted safe harbor for upper-income taxpayers than for other taxpayers) (Compared to prior law, TRA-97 eases the restriction and suspends it entirely in 1998.)	AGI of 150,000	Restriction takes effect suddenly at 150,000 threshold.	Depends on specific facts for taxpayer.

APPENDIX II

SOME OF THE MAJOR INCOME-BASED PHASEOUTS IN OTHER FEDERAL TAXES[1]

Item Being Phased Out With Rising Income	Start of Phaseout	Phaseout Range	May Increase Marginal Tax Rate Of Taxpayers In Phaseout Range By Up To[1]
Alternative Minimum Tax (AMT) for Individuals, Exemption Amount	*Single Filer*: Alternative minimum taxable income (AMTI) of 112,500. *Joint Filer*: AMTI of 150,000.	*Single Filer*: Phased out over 135,000 range from 112,500 to 247,500. *Joint Filer*: Phased out over 180,000 range from 150,000 to 330,000. (AMTI is broader than AGI because it disregards various deductions, exemptions, and exclusions.)	Raises AMT tax rate by 6.5 percentage points if in 26% AMT tax bracket (to an effective marginal AMT rate of 32.5%). Raises AMT tax rate by 7.0 percentage points if in 28% AMT tax bracket (to an effective marginal AMT rate of 35.0%).
Corporate Income Tax Corporate income tax has graduated rate schedule, with 4 rate brackets: 15%, 25%, 34%, and 35%.	Two phaseouts: *First* begins at corporate taxable income of 100,000. *Second* begins at income of 10,000,000.	*First phaseout*: 5% surtax on each dollar of taxable corporate income between 100,000 and 335,000 ("recaptures" tax savings from below-34% rates). *Second phaseout*: 3% surtax on each dollar of taxable corporate income between 10,000,000 and 18,333,333 ("recaptures" tax savings from 34% rate).	*First phaseout*: 5 percentage points (raising effective marginal rate from 34% to 39% in this phaseout range). *Second phaseout*: 3 percentage points (raising effective marginal rate from 35% to 38% in this phaseout range).
Estate And Gift Tax's Unified Credit (Compared to prior law, TRA-97 did not change the threshold for the start of the phaseout, but it does slowly raise the amount of the unified credit, starting in 1998. The unified credit had been equal to a 600,000 exemption.)	Taxable estate of 10 million.	Starting at a taxable estate of 10 million, both the unified credit and the graduated rate benefits are recaptured. In the phaseout zone, the marginal tax rate is increased by 5 percentage points -- from 55% to 60%. The phaseout continues until the entire taxable estate is taxed at an average rate of 55%. The phaseout had occurred under old law from taxable amounts of 10 million to 21.04 million. As the unified credit gradually increases in future years, the phaseout range will still start at 10 million but extend higher.	5 percentage points (raising the effective marginal rate of the estate and gift tax to 60% in the phaseout range).

[1] Please refer to footnotes 1, 2, and 3 of Appendix I.