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# PHASE-OUTS INCREASE TAX RATES AND TAX COMPLEXITY[1]

The tax code is littered with rules that phase out various deductions, exemptions, and credits as taxpayers' incomes rise. These rules create hidden increases in marginal tax rates for unsuspecting citizens and greatly complicate tax calculations. Some of the items that taxpayers lose with higher incomes are deductible individual retirement accounts, Roth IRAs, the earned income tax credit (EITC), the exclusion of social security benefits from taxable income, the child credit, education credits and deductions, a portion of itemized deductions, even the personal exemption.

***The tax code is littered with rules that phase out various deductions, exemptions, and credits as taxpayers' incomes rise. These rules create hidden increases in marginal tax rates for unsuspecting citizens and greatly complicate tax calculations.***

Phase-outs create troubling problems in the areas of economic efficiency, simplicity, and fairness. The economy's efficiency suffers because phase-outs raise marginal tax rates throughout the phase-out zone and thereby reduce incentives to work, save, and invest. For people close to hitting a phase-out threshold or already in a phase-out zone, phase-out-generated marginal tax rate spikes are a clear and perverse signal from the government not to work harder and not to save and invest more. Tax simplification is another victim. Phase-outs make the tax code more complicated, which raises tax enforcement and compliance costs by making the tax code harder to understand and by making tax liabilities harder to compute. The booklet that accompanies an individual's yearly tax forms contains 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 violate any reasonable standard of fairness.

[1] This paper expands and updates (to tax year 2001) an earlier IRET study on phase-out provisions in the tax code: Michael Schuyler, "Phase-Outs Are Bad Tax Policy," *IRET Economic Policy Bulletin*, No. 71, January 1998.

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Giving urgency to the need for reform is the growing number of taxpayers being snared by these disguised tax rate increases. Newly released Internal Revenue Service (IRS) data for tax year 1998 reveal that, due to the tax code's arbitrary phase-out of a portion of total itemized deductions with rising income, "4.9 million higher-income taxpayers were unable to deduct $26.9 billion of itemized deductions, an increase of 15.8 percent from the 1997 [dollar] amount" and an increase of 9.5 percent in the number of tax filers caught by that phase-out.[2] The IRS's Taxpayer Advocate Service in its Annual Report To Congress recommends repeal of both this limitation and the personal exemption phase-out, which is also hitting more taxpayers each year. "The confusing and complex calculations for determining allowable deductions add significant tax and economic burden to a growing number of middle-income taxpayers."[3] The number of taxpayers trapped by the individual alternative minimum tax (AMT) is also mushrooming, in part due to the phase-out of the AMT's exempt amount as income rises. The IRS found that from tax years 1997 to 1998, the number of tax filers caught by the AMT shot up 38.1 percent.[4] Millions of additional taxpayers will be swept into the complex, distortionary AMT if regular income tax rates are eased without providing relief from the phase-out of the AMT's exempt amount and other aspects of the AMT.

***For people close to hitting a phase-out threshold or already in a phase-out zone, phase-out-generated marginal tax rate spikes are a clear and perverse signal from the government not to work harder and not to save and invest more.***

During the Presidential campaign, George W. Bush specifically pledged to soften the impact of two phase-outs. He recognized that the phase-out of the Earned Income Tax Credit (EITC) creates a strong work disincentive for many lower-income families as they begin moving towards the middle class because it sharply increases their effective marginal tax rates. By creating a 10% tax bracket on the first few thousand dollars of income and doubling the child credit, President Bush's tax plan would zero out the regular income tax liabilities of most lower-income people experiencing the EITC phase-out, thereby cutting their now very high effective marginal tax rates by about a third. In addition, he recommended approximately doubling the income threshold at which another large phase-out, that of the child credit, begins. The higher threshold would greatly reduce the number of families exposed to the work and saving disincentives and the tax complexity that the child credit's phase-out creates. President Bush's and his staff's

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[2] David Campbell, Michael Parisi, and Brian Balkovic, "Individual Income Tax Returns, 1998," Internal Revenue Service, *Statistics Of Income Bulletin*, Fall 2000, p. 11.

[3] IRS Taxpayer Advocate Service, *National Taxpayer Advocate's Annual Report To Congress, FY 2000*, Internal Revenue Service, p. 85.

[4] IRS, "Individual Income Tax Returns, 1998," *op. cit.*, p. 8.

understanding and concern that phase-outs increase disincentives and complexity bodes well for future tax reform efforts.

**A Flock of Phase-Outs**

Some of the deductions, exemptions, and credits that the individual income tax eliminates or restricts when a taxpayer's income grows are: the tax exemption for social security benefits, the EITC, the deduction for IRA contributions, the personal exemption, the medical deduction, the miscellaneous business deduction, the casualty loss deduction, total itemized deductions (on top of the just-mentioned limitations on specific 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, the section 179 expensing election (also phased out for corporate taxpayers), and the alternative minimum tax exempt amount.[5] In addition, some tax provisions impose tougher than normal requirements on taxpayers above various income thresholds. One example is that people can normally avoid a tax underpayment penalty if their withholding plus estimated tax payments equal at least 100% of their prior year's tax, but people whose prior year's adjusted gross income exceeded $150,000 can only use this safe harbor if withholding plus estimated tax payments equal at least 110% of their prior year's tax liability.[6]

***IRS data for tax year 1998 reveal that, due to the ... phase-out of a portion of total itemized deductions with rising income, "4.9 million higher-income taxpayers were unable to deduct $26.9 billion of itemized deductions, an increase of 15.8 percent from the 1997 [dollar] amount"... The number of taxpayers trapped by the individual alternative minimum tax (AMT) is also mushrooming, in part due to the phase-out of the AMT's exempt amount as income rises.***

The individual alternative minimum tax (AMT) also has a phase-out. (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.) 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 failure of the government to index the AMT exempt amount and

[5] The limitations on the deductions for medical costs, miscellaneous business expenses, and casualty losses 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.

[6] The requirement for higher-income individuals rises to 112% of prior year's tax in 2002. Another safe harbor is paying during the year at least 90% of what the end-of-year tax liability proves to be. But individuals with difficult-to-predict incomes, which includes many higher-income individuals, have particular difficulty estimating their eventual tax liabilities and cannot rely on that safe harbor.

its phase-out threshold for inflation is pushing a rapidly increasing number of individual taxpayers into the AMT.)

The Taxpayer Relief Act of 1997 (TRA-97) added a grab bag of complicated new phase-outs to this already long list. The tax 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.[7]

***The marginal tax rate is the rate of tax a person must pay on an additional dollar of income. It is the tax rate that is relevant when people decide whether they should work, save, or invest a bit more or a bit less, or otherwise alter their production and consumption behavior.***

Other federal taxes also have phase-out provisions. The corporate income tax imposes two surtaxes to phase out the tax savings from lower rates in the graduated corporate rate schedule. The basic corporate tax rates are 15%, 25%, 34%, and 35%. A 5% surtax at the top end of the 34% bracket creates a 39% rate on income between $100,000 and $335,000 to "recapture" the "benefits" of the 15% and 25% rates. A 3% surtax on a portion of the 35% bracket creates a 38% rate from $10,000,000 to $18,333,333 to "recapture" the "benefit" of the 34% rate. Corporations with incomes above $18,333,333 pay an effective flat tax rate of 35% on total taxable income. The estate and gift tax likewise has a phase-out. Its phase-out takes the form of a 5% surtax on taxable estates between $10,000,000 and $17,184,000, which phases out the benefits of the tax's graduated rate schedule. Although the death tax's top statutory rate is 55%, the surtax lifts the marginal tax rate in the phase-out zone to 60%. (In effect, the phase-out creates a rate bracket of 60% on taxable estates between $10,000,000 and $17,184,000.)

The Appendix briefly describes the many phase-out provisions in the 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.

Which, if any, phase-outs a specific taxpayer encounters depends on the taxpayer's income and other tax-related factors. Many taxpayers will experience no phase-outs; others will experience one or more phase-outs over different parts of their income; others will be hit by multiple phase-outs on the same dollars of earnings, with one rate spike piled on top of another.

[7] TRA-97 did not remove any already 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 the phase-out.

Charts 1a and 1b display the income ranges over which most of the individual income tax's phase-out provisions occur and the increases in marginal tax rates they have the potential to produce. Chart 1a presents this information for married couples filing jointly, and Chart 1b does so for singles. One's first reaction on seeing the charts may be that they look extremely cluttered and complicated. They are. Showing the many income tax phase-outs together conveys a sense of their large number, haphazard variety, and great complexity. Indeed, the charts understate the phase-outs' complexity because they do not show the many tedious and confusing steps required to actually calculate them.

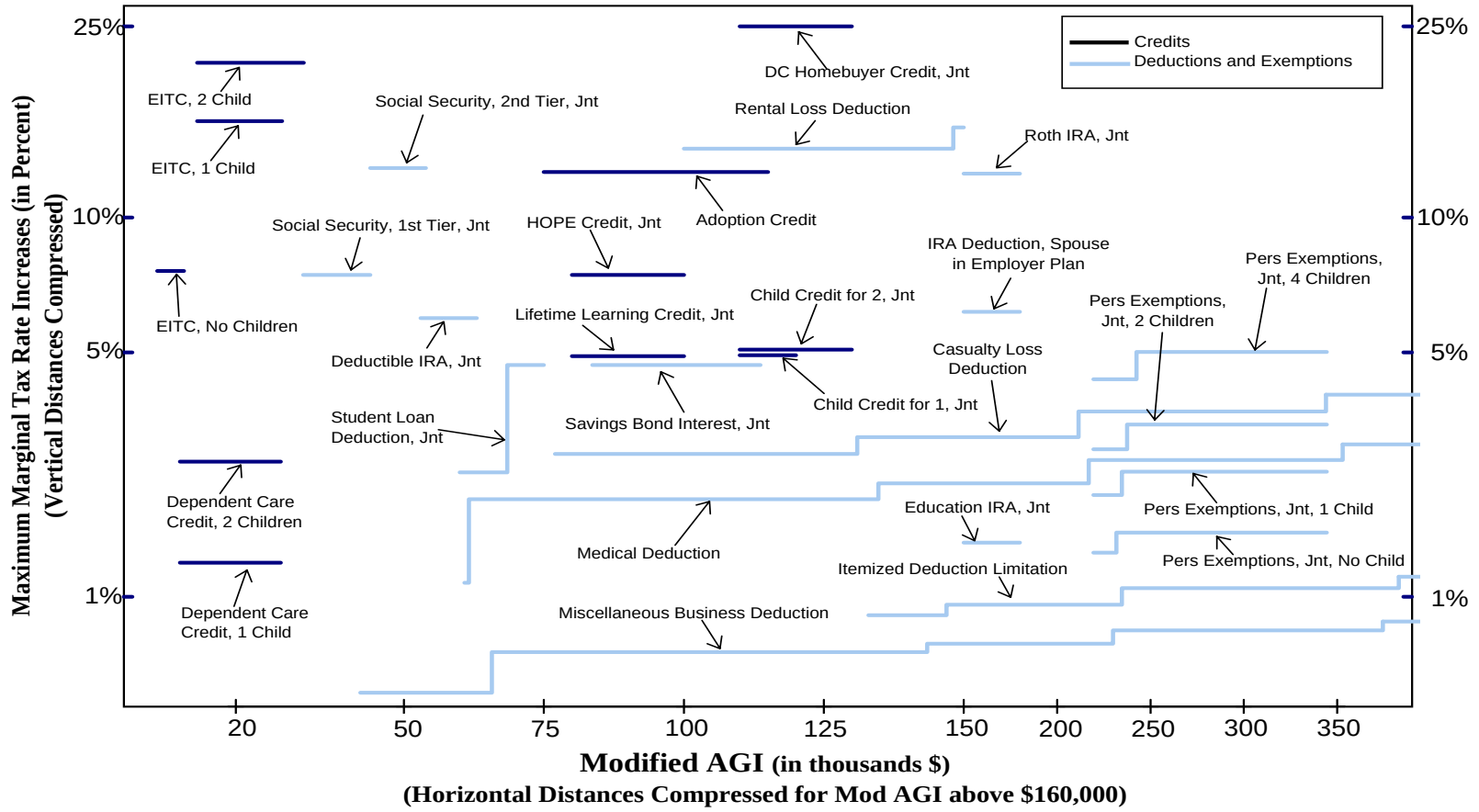
***Normally, a person's marginal tax rate equals the rate of the tax bracket in which the person's last dollar of income lies...Over the income range in which the government is phasing out a deduction, exemption, or credit, however, extra income adds to a person's tax bill at more than the statutory rate.***

The tax code generally specifies phase-outs in terms of adjusted gross income (AGI). For example, the HOPE Scholarship tax credit is phased out over the $10,000 AGI range from $40,000 to $50,000 for single filers (and heads of households) and over the $20,000 AGI range from $80,000 to $100,000 for joint filers.[8] On the charts, the heights of the lines indicate the potential of the various phase-outs to raise marginal tax rates. For instance, Charts 1a and 1b show that the phase-out of the child tax credit increases the marginal tax rate of families whose AGIs are within its phase-out zone by 5 percentage points.[9] This increase is *in addition to* the normal income tax rate. A taxpayer who would otherwise have a marginal tax rate of, say, 28% would suddenly find his or her marginal tax rate bumped up to 33% (28% + 5%) by the phase-out of the child credit. The phase-out of the tax credit for first-time District of Columbia homebuyers would affect few taxpayers, but for those taxpayers who could claim the credit, the effective increase in their marginal tax rates in the phase-out range would be a whopping

[8] 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 single parent with an AGI of $40,000 in 2001 has two dependent children and claims the standard deduction, the person's taxable income would be $23,300 — only a little more than half of his or her 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 thresholds and ranges occur at much lower taxable incomes than may be apparent when they are expressed in terms of AGIs.

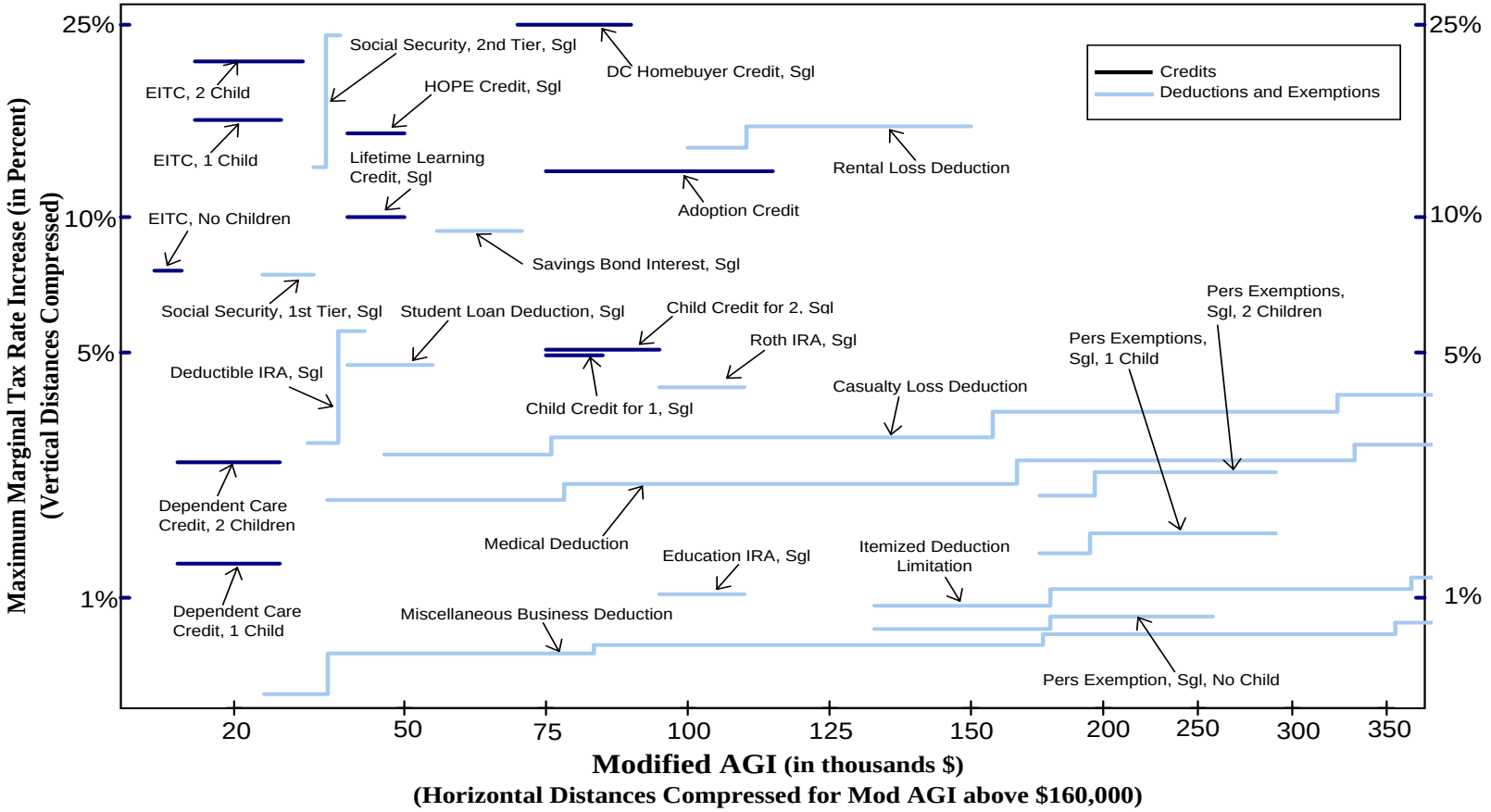
[9] The phase-out of the child credit actually occurs in a series of steps, each covering $1,000 of AGI. Hence, an AGI change within a step does not affect the amount phased out but a small AGI change from one step to the next has a very big impact. Rather than trying to report this and other complicated patterns, it is assumed throughout the study that phase-outs proceed smoothly over their phase-out ranges. Also, in cases where the taxpayer could not claim the maximum credit, deduction, exemption, or exclusion for reasons unrelated to the phase-out (e.g., expenses below the ceiling permitted, 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.

# Chart 1a AGI Ranges Of Phase-Outs And Potential Marginal Tax Rate Increases, Couple




- The phase-out of a credit increases taxes on a one-for-one basis. It produces a marginal tax rate spike with a height equal to the phase-out rate.
- The phase-out of a deduction or exemption increases taxable income, and the higher income leads to a larger tax bill. It produces a marginal tax rate spike with a height equal to the phase-out rate times the tax bracket rate. These marginal tax rate spikes are ***in addition to*** normal marginal tax rates.
- The steps in some of the lines on the chart show jumps from one tax bracket to the next higher one. The exact AGIs at which the steps occur will vary from taxpayer to taxpayer depending on amounts and types of income, expenses, and other tax-related factors.
- Calculations are for tax year 2001.

# Chart 1b AGI Ranges Of Phase-Outs And Potential Marginal Tax Rate Increases, Single




- See notes for Chart 1a.
- In cases involving children, it is assumed the taxpayer files as a head of household. (The income ranges over which provisions are phased out are generally the same for single filers and heads of households, but one exception is personal exemptions, which are phased out over a higher AGI range for heads of households than for single filers.)

25 percentage points. For a single filer who would otherwise be in the 31% tax bracket, the phase-out of the District of Columbia homebuyers credit would push his or her marginal tax rate to 56% (31% + 25%) in the phase-out range.

Adding still more complexity, many phase-outs use modified definitions of AGI, and the modifications often differ from one phase-out to the next. For instance, the phase-out of the tax exemption for most Social Security benefits includes in its definition of modified AGI half of Social Security benefits and all tax-exempt interest, while 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.[10] 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.[11]

***At the start of the 28% rate bracket ... [a Social Security beneficiary's] actual marginal tax rate soars to 51.8% because of the combination of the 28% regular tax rate and the 2nd tier of the Social-Security-benefit-exemption phase-out.***

**How Phase-Outs Increase Marginal Tax Rates**

The marginal tax rate is the rate of tax a person must pay on an additional dollar of income. It is the tax rate that is relevant when people decide whether they should work, save, or invest a bit more or a bit less, or otherwise alter their production and consumption behavior. Normally, a person's marginal tax rate equals the rate of the tax bracket in which the person's last dollar of income lies. For instance, if a person is in the 28% tax bracket and earns $100 more, the person's tax bill will normally rise by $28: the person's marginal tax rate is 28%. Over the income range in which the government is phasing out a deduction, exemption, or credit, however, extra income adds to a person's tax bill at more than the statutory rate. In effect, the phase-out increases the person's marginal tax rate.

How does this above-normal marginal tax rate come to be? In addition to the normal tax on the income itself, a person in a phase-out range finds that the extra income reduces the size of the deduction, exemption, or credit that is being phased out. The drop in the deduction, exemption, or credit produces the second increase in the person's tax bill and marginal tax rate.

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[10] And if a taxpayer both receives Social Security benefits and claims an IRA deduction, the taxpayer must consult a specialized IRS publication (IRS Pub. 590) to learn about and follow detailed rules regarding the order in which to stack the two phase-outs.

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

When a taxpayer is losing a credit, the increase in the person's marginal tax rate is precisely equal to the credit's phase-out rate. How so? Tax credits are subtracted directly from tax liabilities. Consequently, a decrease in a credit produces an identical increase in tax liability. For example, suppose a taxpayer is in the 28% tax bracket and has been claiming a credit that is being phased out at a 7.5% rate (such as the Hope Scholarship tax credit in the case of a joint filer). An extra $1 of income will (1) increase the person's pre-credit income tax liability by 28¢ and (2) increase the person's tax liability by another 7.5¢ because it reduces the credit by that amount. As a result, the extra $1 of income will raise the person's tax liability by 35.5¢. The person's effective marginal tax rate jumps to is 35.5%.[12] At incomes above and below the phase-out range, the phase-out does not affect the marginal tax rate.

***The twin phase-outs [of itemized deductions and the personal exemption] lift the [single] person's marginal tax rate to 32.65% (while the person is in the 31% statutory rate bracket) and then to 37.92% (once the person reaches the 36% statutory rate bracket).***

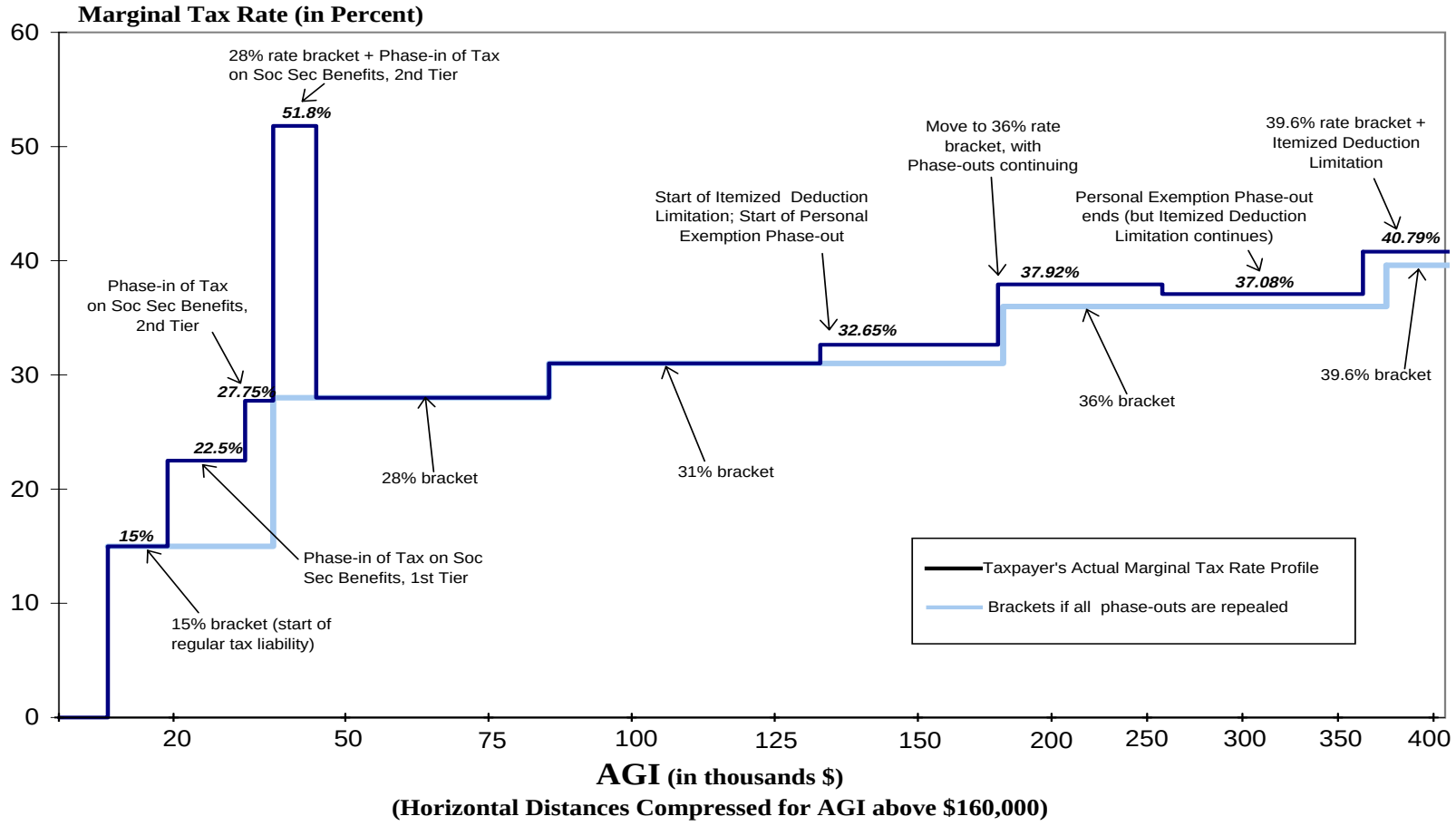
By contrast, the phase-out of deductions, exemptions, and exclusions increases a person's marginal tax rate by increasing taxable income by more than a person's additional earnings. For example, suppose a taxpayer is in the 28% tax bracket and is losing a deduction at a 7.5% rate (such as the itemized deduction for medical expenses). In that event, $1 of additional income will increase the person's *taxable* income by $1.075: $1 due to the income itself and 7.5¢ due to the reduced deduction that can be subtracted in computing taxable income. The result is a 30.1¢ increase in the person's tax liability (28% of $1.075 = 30.1¢). Of that, 28¢ is due to normal tax on the extra $1 of income (28% of $1 = 28¢), and 2.1¢ is due to tax on the 7.5¢ rise in taxable income brought about by the deduction's phase-out (28% of 7.5¢ = 2.1¢). In this case, the person's effective marginal tax rate on the added $1 of income is 30.1%, or 1.075 times the normal tax rate.

**Marginal Tax Rate Profiles**

Charts 2 - 5 provide another way of looking at how phase-outs affect people's marginal tax rates. The charts trace the marginal tax rates of four hypothetical groups of taxpayers, each group with specific tax-related characteristics, at incomes ranging from $0 to slightly above $400,000. As with Charts 1a and 1b, these charts are cluttered and may seem confusing. Again, the reason is that they convey some of the complexity that phase-outs add to the tax system.

[12] A caveat is that if a person's tax liability is zero prior to claiming the amount of credit being phased out and if the credit is non-refundable, a drop in the credit will have no effect on the person's tax liability (which is zero) and no effect on the person's marginal tax rate (which is also zero).

# Chart 2 Marginal Tax Rate Profile of Single Taxpayer with Social Security Benefits




• The marginal tax rate "skyline" for a specific taxpayer depends on amounts and types of income, expenses, and other tax-related factors. In this illustration, the assumptions are as follows: (1) the person is a single filer; (2) the person is age 65 or over; (3) the person receives yearly Social Security benefits of $12,000; (4) the person's itemized deductions are 20% of AGI (and do not include medical, miscellaneous expense, or casualty loss deductions); (5) the person claims the larger of itemized deductions or the standard deduction; and (6) the calculations use year 2001 tax thresholds.

• AGI (line 34 of Tax Form 1040) is on the horizontal axis.

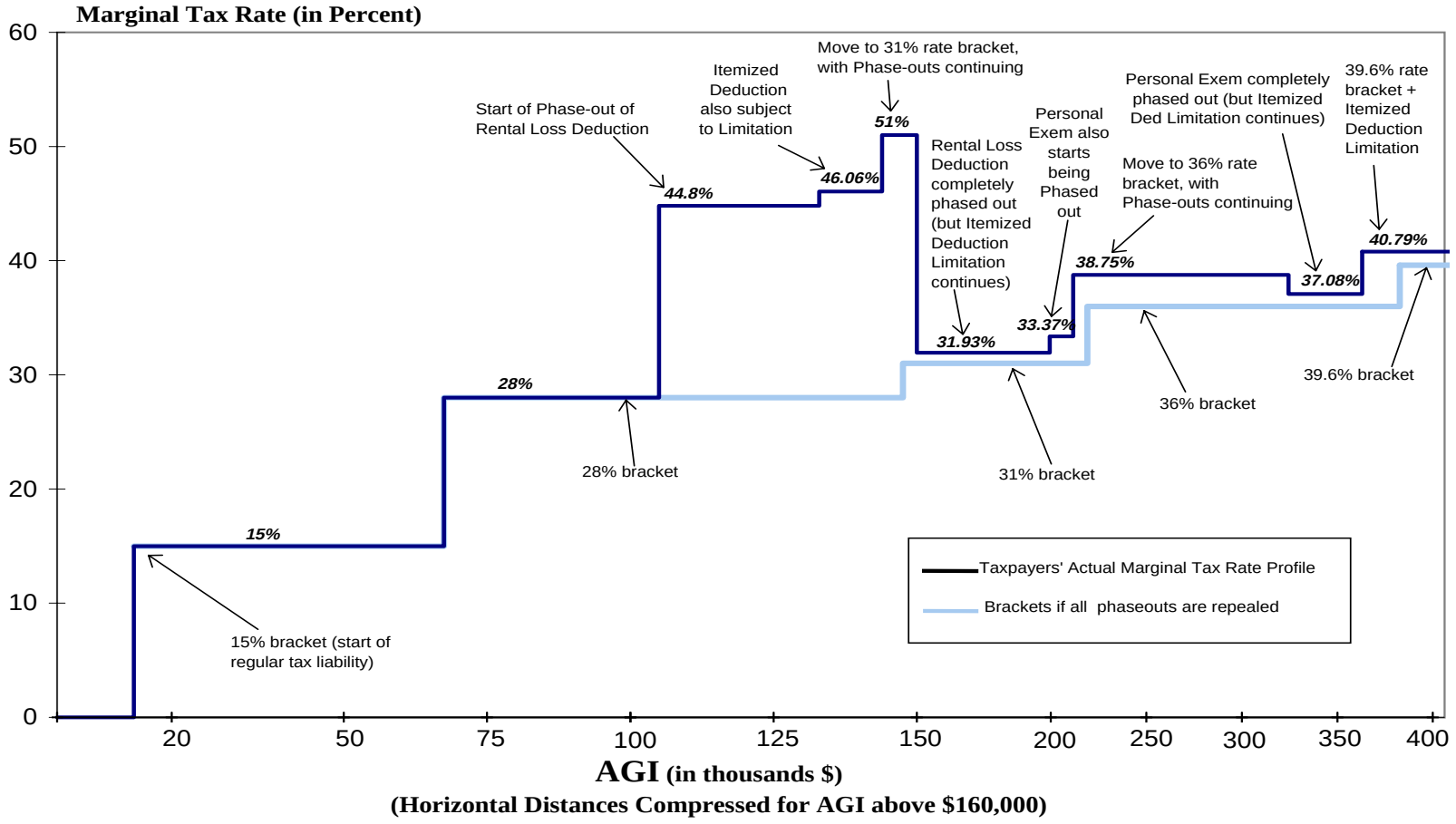
If not for phase-outs, the charts would be relatively straightforward. Consider Chart 2, which shows the marginal tax rate profile at various incomes of a single individual receiving Social Security benefits.[13] The gray line is the marginal tax rate "skyline" the person would have in the absence of phase-outs. It has just a few marginal-tax-rate steps, each corresponding to a statutory rate bracket. At very low AGIs, the person would owe no tax and have a 0% marginal tax rate; then, as the person's income rose, he or she would reach marginal tax rates of 15%, 28%, 31%, 36%, and finally 39.6%.

***[F]or a single parent with one child ... [t]he EITC ... phases out at a 15.98% rate as income rises from $13,090 to $28,281. Combining the 15.98% EITC phase-out with the 15% income tax rate, the 7.65% payroll tax rate, and a 5% state income tax rate, the single parent with one child faces a tax rate of nearly 44% on additional earnings... [For 2 children] the EITC phases out at a 21.06% rate... and may produce a combined marginal tax rate of nearly 49%.***

With phase-outs, the pattern is more complicated and, at many income levels, the marginal tax rate much higher. That is shown by the black line. Over much of what is nominally the 15% rate bracket, the person's effective marginal tax rate is 22.5% or 27.75% because of the phase-out with rising income of the exemption from tax of Social Security benefits. At the start of the 28% rate bracket, the person's actual marginal tax rate soars to 51.8% because of the combination of the 28% regular tax rate and the 2nd tier of the Social-Security-benefit-exemption phase-out. Because of this phase-out, the government can hit a moderate-income Social Security recipient with a marginal tax rate that is 12.2 percentage points higher than the top statutory rate bracket of 39.6%. The next phase-out begins when the person's AGI reaches $132,950 in 2001. At that income, the government begins taking away the person's itemized deductions and his or her personal exemption. The twin phase-outs lift the person's marginal tax rate to 32.65% (while the person is in the 31% statutory rate bracket) and then to 37.92% (once the person reaches the 36% statutory rate bracket). After the personal exemption is no longer being phased out (because the government has taken all of it away), the taxpayer's marginal tax rate drops to 37.08% (itemized deductions are still being lost with rising income), but it then climbs to 40.79% when the taxpayer moves into the 39.6% statutory rate bracket.

[13] The exact results depend on the specific assumptions made about the taxpayer. They are as follows: (1) the person is a single filer; (2) the person receives Social Security benefits during the year of $12,000; (3) the person is 65 or over; (4) the person's itemized deductions are 20% of AGI (and do not include medical or miscellaneous expense deductions); (5) the person claims the larger of itemized deductions or the standard deduction; and (6) the calculations use year 2001 tax thresholds.

# Chart 3 Marginal Tax Rate Profile of Couple with No Dependent Children and Rental Loss




• The marginal tax rate "skyline" for a specific taxpayer depends on amounts and types of income, expenses, and other tax-related factors. In this illustration, the assumptions are as follows: (1) a married couple file jointly; (2) they have no children; (3) they have losses on a rental property they actively manage of $15,000; (4) they have sufficient interest and dividend income to be disqualified from the EITC; (5) their itemized deductions are 20% of AGI (and do not include medical, miscellaneous expense, or casualty loss deductions); (6) they claim the larger of itemized deductions or the standard deduction; and (7) the calculations use year 2001 tax thresholds.

• AGI (line 34 of Tax Form 1040) is on the horizontal axis.

Chart 3 shows the marginal tax rate "skyline" of a couple with no dependent children who have a loss on a rental property.[14] As before, the gray line shows their marginal tax profile in the absence of phase-outs and is straightforward. There are five non-zero steps, each corresponding to one of the statutory rate brackets. (Because this is a couple, each of the marginal tax rate steps begins at a considerably higher AGI than it did with the single filer.) The black line shows their actual marginal tax rate profile, which includes phase-outs. Beyond an AGI of slightly more than $100,000, it is permanently above the statutory-rate line. First, the couple start losing their rental loss deduction, and their marginal tax rate jumps from 28% to 44.8%. It climbs to 46.06% when the couple reach the threshold where the government starts limiting their itemized deductions, and leaps to 51% when their statutory bracket moves to 31%. After the government has finished phasing out their rental loss (by refusing to let the couple deduct any of it), their marginal tax rate drops to 31.93%. (The extra 0.93% is due to the phase-out of itemized deductions.) It rises further to 33.37% when the government begins disallowing their personal exemptions. (The personal exemption disallowance increases the marginal tax rate of the couple by more than it did for the single filer because two exemptions, rather than one, are being phased out.) The couple's marginal tax rate rises again to 38.75% when they move to the 36% statutory rate bracket. It falls to 37.08% after their personal exemptions have been completely phased out, and rises to 40.79% after they move into the 39.6% statutory rate bracket (still above the statutory rate due to the continued phase-out of itemized deductions.)[15]

Chart 4 displays the marginal tax rate profile for a single parent with one child who has several thousand dollars of medical bills and contributes to a deductible IRA.[16] This is the most complicated of the cases presented here. At very low incomes, the single parent receives a check from the government via the EITC. The government's matching rate on the first $7,140 of earnings is 34% for a parent with one child, which accounts for the -34% marginal tax rate. As the person's income rises, the check from the U.S. Treasury grows in size. It reaches a plateau at incomes between $7,140 and $13,090. The EITC then phases out at a 15.98% rate as income rises from $13,090 to $28,281. Combining the 15.98% EITC phase-out with the 15% income tax rate, the 7.65% payroll tax rate, and a 5% state income tax rate, the single parent with one

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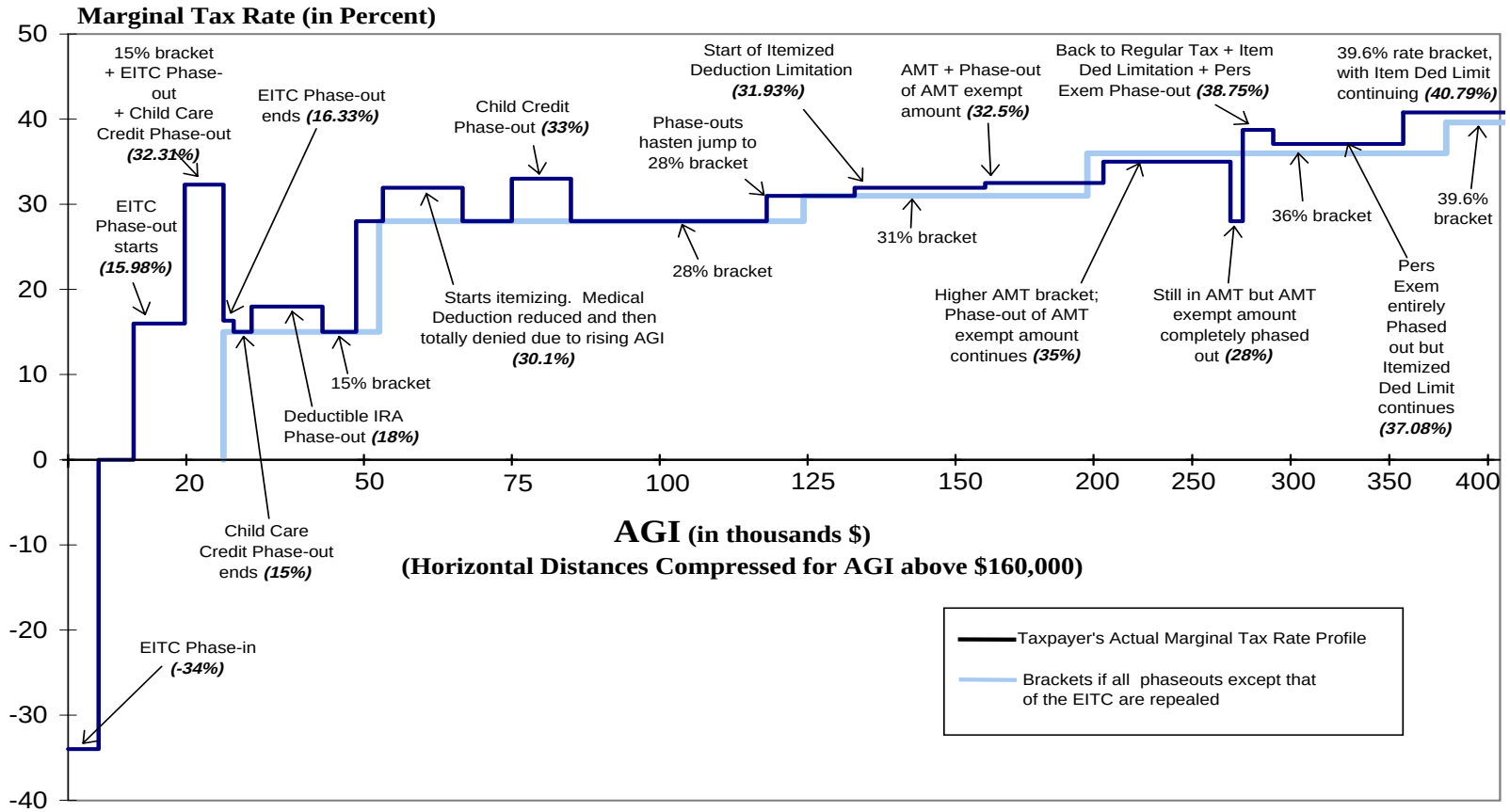
[14] Again the exact results depend on the specific assumptions made about the couple. They are as follows: (1) the couple file jointly; (2) they have no children; (3) they have losses on a rental property they actively manage of $15,000; (4) they have sufficient interest and dividend income to be disqualified from the EITC; (5) their itemized deductions are 20% of AGI (and do not include medical or miscellaneous expense deductions); (6) they claim the larger of itemized deductions or the standard deduction; and (7) the calculations use year 2001 tax thresholds.

[15] Notice that phase-outs frequently push a taxpayer from one rate bracket to the next at a lower AGI than would be required in the absence of phase-outs. That is because the disallowance of deductions and exemptions increases taxable income, which causes a given AGI to translate into a higher taxable income than otherwise.

[16] The specific assumptions made about this taxpayer are as follows: (1) the single parent files as head of household; (2) the child is under age 13; (3) the parent reports work-related child care expenses of $2,400; (4) the family has $5,000 of medical bills; (5) the person wishes to contribute $2,000 to a deductible IRA; (6) the person has state and local taxes equal to 10% of AGI in the income range in which the AMT is relevant; (7) the person's itemized deductions are the greater of $5,000 or 20% of AGI; (8) the person claims the larger of itemized deductions or the standard deduction; and (9) the calculations use year 2001 tax thresholds.

# Chart 4 Marginal Tax Rate Profile of Single Parent with 1 Child, Deductible IRA, and Medical Bills




• The marginal tax rate "skyline" for a specific taxpayer depends on amounts and types of income, expenses, and other tax-related factors. In this illustration, the assumptions are as follows: (1) a single parent files as head of household; (2) the parent has one child, who is under age 13; (3) the parent reports work-related child care expenses of $2,400; (4) the family has $5,000 of medical bills; (5) the taxpayer wishes to contribute $2,000 to a deductible IRA; (6) the taxpayer has state and local taxes equal to 10% of AGI in the income range in which the AMT is relevant; (7) the taxpayer's itemized deductions are the greater of $5,000 or 20% of AGI; (8) the person claims the larger of itemized deductions or the standard deduction; and (9) the calculations use year 2001 tax thresholds.
• AGI (line 34 of Tax Form 1040) is on the horizontal axis.

child faces a tax rate of nearly 44% on additional earnings. Assuming the EITC stays on the books in its present form but other phase-outs are repealed, the gray line shows the person's marginal federal income tax rate profile at incomes above the EITC phase-out. It has the usual steps of 15%, 28%, 31%, 36%, and 39.6%. Phase-outs, however, generate a strange and complex pattern of increased effective marginal tax rates, as shown by the black line. As income rises, the single parent's marginal tax rate profile is elevated by the partial phase-out of the child care expense credit, the disallowance of the IRA deduction, the phase-out of the medical deduction, the loss of the child credit, the limitation on itemized deductions, and the phase-out of the parent's and child's personal exemptions. Further, with increasing income, this taxpayer gradually loses the Alternative Minimum Tax (AMT) exempt amount, and the phase-out of the AMT exempt amount pushes the taxpayer into the AMT over a long stretch of income.[17]

***[A]lthough 36% and 39.6% are advertised as the top two individual income tax rates, most upper-income individuals are actually taxed roughly 1 to 6 percentage points higher, depending on family size, due to phase-outs. In many cases, the marginal tax rate exceeds 40%. It is in the middle forties if the Medicare tax on wages is factored in and is in the neighborhood of 50% in high-tax jurisdictions if state and local income taxes are included.***

Chart 5 shows the marginal tax rate profile of a couple with a child in the first two years of college and a younger child at home.[18] At very low earnings (up to $10,020), the government matches their earnings at a 40% rate through the EITC. The EITC reaches a plateau between $10,020 and $13,090. At incomes above $13,090, the EITC phases out at a 21.06% rate. Because this couple's regular tax is zero throughout the EITC phase-out range, the couple's effective marginal income tax rate in that range is simply the EITC phase-out rate. (They also face a payroll tax and state income tax.)[19] Then at higher incomes, in the 28% rate bracket, the couple lose, first, the Hope Scholarship credit and, second, the child credit. Those phase-outs produce marginal tax rate spikes of 35.5% and 33%, respectively. Farther up the income scale, phase-outs again elevate the couple's marginal tax rate profile as the government partially disallows the couple's itemized deductions and gradually takes away their personal exemptions.

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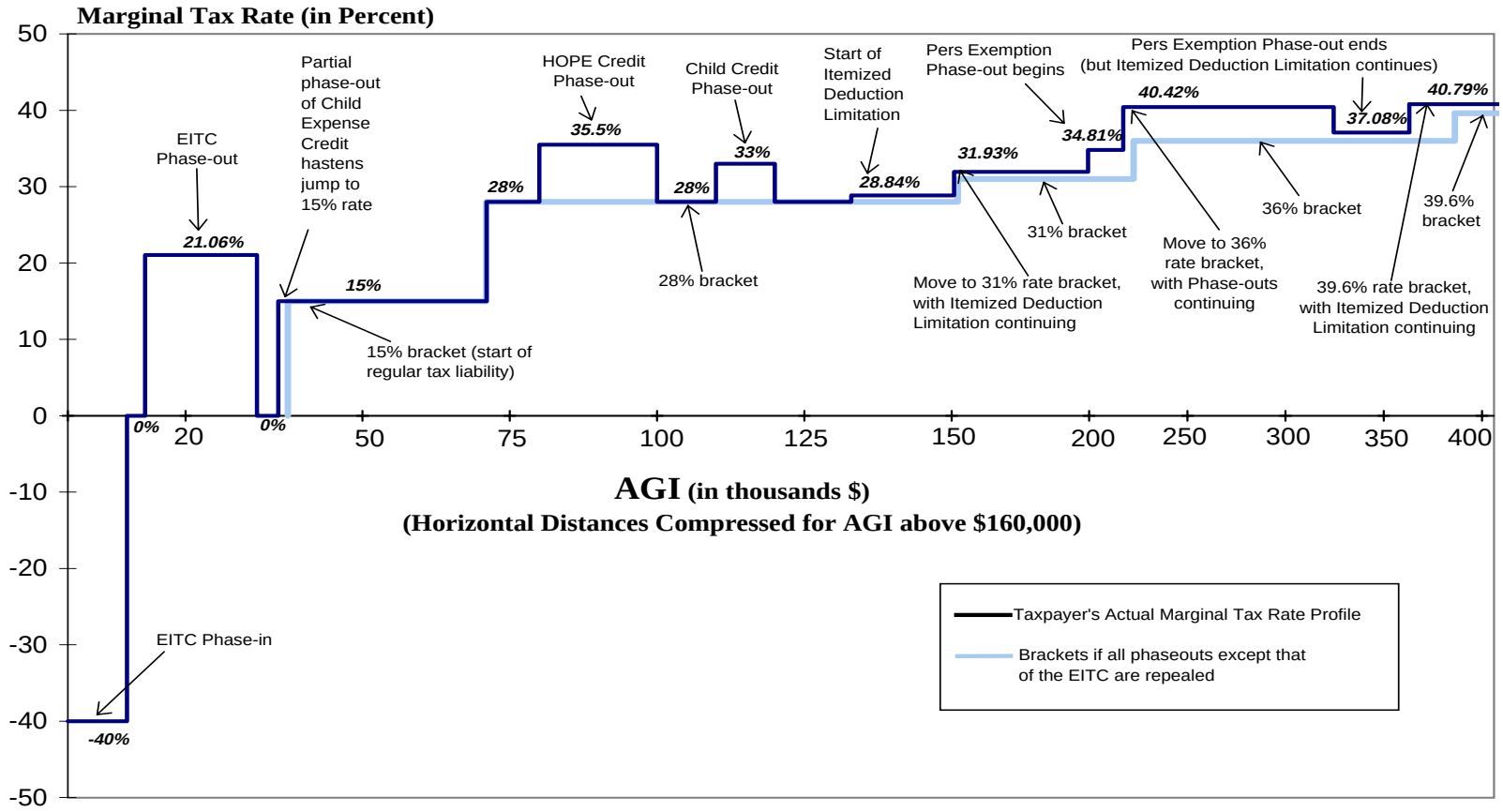
[17] Although the AMT has statutory rate brackets of 26% and 28%, the phase-out of its exempt amount creates two additional, hidden marginal rates of 32.5% and 35%.

[18] The specific assumptions made about the couple are as follows: (1) they file jointly; (2) the older child is in the first two years of college and has at least $2,000 of expenses eligible for the Hope Scholarship tax credit but is not eligible for the child credit (because over age 16); (3) the younger child is under age 13, and the parents report child care expenses of $2,400; (4) the couple's itemized deductions are 20% of AGI; (5) the couple claim the larger of itemized deductions or the standard deduction; and (6) the calculations use year 2001 tax thresholds.

[19] Some couples with two children are in the income tax's 15% statutory bracket in the EITC phase-out range. Adding on payroll and state income taxes may produce a combined marginal tax rate of nearly 49%.

# Chart 5 Marginal Tax Rate Profile of Couple with 1 Child in College and 1 Younger Child at Home




• The marginal tax rate "skyline" for a specific taxpayer depends on amounts and types of income, expenses, and other tax-related factors. In this illustration, the assumptions are as follows: (1) a couple file jointly; (2) they have one child who is in the first two years of college and has at least $2,000 of higher-education expenses eligible for the Hope Scholarship tax credit; (3) they have a younger child who is under age 13, and the parents report work-related child care expenses of $2,400; (4) the couple's itemized deductions are 20% of AGI (and do not include medical, miscellaneous expense, or casualty loss deductions); (5) the couple claim the larger of itemized deductions or the standard deduction; and (6) the calculations use year 2001 tax thresholds.

• AGI (line 34 of Tax Form 1040) is on the horizontal axis.

These examples have illustrated just some of the phase-outs that affect marginal tax rates. The factors that trigger phase-outs (Social Security benefits, IRA contributions, children in the home, college expenses, rental losses, itemized deductions, etc.) are common to millions of taxpayers. Phase-outs produce a bewildering succession of tax rate spikes that have no basis in logic or rational tax design. Phase-outs generate some very high marginal tax rates at low and medium incomes. At larger incomes, they force most upper-income taxpayers (AGIs above $132,950 in 2001) into hidden, higher-than-statutory marginal tax rate brackets. In other words, although 36% and 39.6% are advertised as the top two individual income tax rates, most upper-income individuals are actually taxed roughly 1 to 6 percentage points higher, depending on family size, due to phase-outs. In many cases, the marginal tax rate exceeds 40%. It is in the middle forties if the Medicare tax on wages is factored in and is in the neighborhood of 50% in high-tax jurisdictions if state and local income taxes are included.

**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. For example, during the Clinton years, then Acting Assistant Treasury Secretary Donald Lubick touched on both these themes when he argued before a Congressional committee 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-income 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."[20] Associating higher revenues with fiscal responsibility, he also testified, "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, taking more tax dollars from wage earners, savers, and entrepreneurs is not necessarily a good thing. First, 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. Second, even if the spending represents the best use of the resources it consumes, that does not justify a particular phase-out rule unless the tax spike created by the phase-out has fewer undesirable side effects regarding economic efficiency, simplicity, and equity than any alternative means of collecting the tax revenues.

Standard estimation models, furthermore, usually exaggerate the ability of phase-outs to increase tax collections (and the revenue cost of eliminating phase-outs). The problem is that the increased marginal tax rates produced by phase-outs discourage work, saving, and investment by the affected taxpayers, and reduce economic output. The smaller levels of output and income reduce tax collections. Standard revenue estimation models, though, are static in the sense that

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

they assume taxes have no effect on the overall economy. Hence, a phase-out that weakens the economy tends to save less revenue for the Treasury than advertised.

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 hands the money to other people. Even if greater tax progressivity is desired, there are generally less damaging ways of achieving it than phase-outs.

**Phase-Outs Worsen Tax Distortions**

As explained above, when the government reduces a taxpayer's deductions, exemptions, or credits because the taxpayer's income is increasing, the loss produces a higher marginal tax rate throughout the income range 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 who has yearly Social Security benefits of $12,000, receives private pension, interest, and dividend income of $32,000, and claims the standard deduction. This taxpayer would normally be in the 28% tax bracket. Due to the income-based phase-out of the exemption for Social Security benefits, however, each additional dollar of income requires the individual to add 85¢ 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¢: 28¢ due to regular tax and 23.8¢ 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 — a marginal tax rate of 51.8% — 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.

When people continue working after they begin receiving Social Security benefits, their wage and salary income may similarly trigger taxation of benefits. Such wages are subject to payroll taxes as well as to the income tax and its added tax spike on benefits. Even worse, if the Social Security recipients are between the ages of 62 and what the government defines as the "normal retirement age" (which the government is gradually raising to ages 66 and 67), their earnings can trigger the Social Security earnings test, and reduce their Social Security benefits by 50¢ for each

$1 earned over certain limits. Their tax penalty will then be much harsher, often exceeding 100% of added wages. It is difficult to think of a stronger work disincentive.[21]

**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 carefully reading often confusing 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.

***In the Form 1040 Instructions for 2000 ... 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, the worksheet for the phase-out of the IRA deduction took 10 lines, the worksheet for the phase-out of the student loan interest deduction occupied 10 lines, and the worksheet for the total itemized deduction limitation required 10 lines.***

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 2000, 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, the worksheet for the phase-out of the IRA deduction took 10 lines, the worksheet for the phase-out of the student loan interest deduction occupied 10 lines, and the worksheet for the total itemized deduction limitation required 10 lines. With regard to computation procedures for many phase-outs, the Form 1040 Instructions also told taxpayers to consult a variety of technical IRS publications.

Deductible IRAs illustrate the complexity attributable to phase-outs. From 1981 to 1986, deductible IRAs did not have a phase-out, and each worker could make yearly contributions of up to $2,000, subject to a few qualifications. Contributing was a simple matter, and deductible IRAs became hugely popular. The 1986 tax act suddenly changed that. It decreed that the IRA deduction would be reduced or eliminated if the worker's modified AGI exceeded a certain (low)

[21] 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 between ages 62 and the "normal retirement age" lose $1 of benefits for every $2 in wages (a 50% tax rate). In 2000, the government repealed the Social Security earnings test for beneficiaries above the "normal retirement age" but left it intact for those below that age. 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 over 100% for people between age 62 and the "normal retirement age" are routinely possible.

level and the worker was an active participant in an employer-sponsored pension plan.[22] 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.[23] No longer was making a deductible IRA contribution a simple matter. Not surprisingly, IRA contributions plummeted. Although this was mostly because many workers were now ineligible, the fact that many workers who remained fully eligible also reduced their contributions suggests that they found the new rules sufficiently confusing and intimidating that they avoided deductible 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. Coordinating phase-out thresholds would reduce complexity only slightly; a taxpayer would still have to investigate the rules, then perform all the calculations for that specific phase-out. A major drawback to the proposal is that bunching the phase-outs would increase the odds that taxpayers would be subject to two or more phase-outs simultaneously. Marginal tax rate spikes are higher when one phase-out comes on top of another and, if the phase-outs are interrelated (some are), calculating them simultaneously tends to be intricate and confusing.

**Fairness**

Advocates of a progressive tax system tend to favor phase-outs as a means of increasing tax progressivity. Phase-outs seek to limit the benefit of credits, deductions, and exemptions available to upper-income taxpayers, and reserve them for lower-income taxpayers. 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 tax the person pays to the government *more* than doubles.[24] If one believes in progressivity, an essential follow-up question — but one that

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[22] The Tax Reform Act of 1986 set the start of the phase-out at only $25,000 for single filers and $40,000 for couples. The Taxpayer Relief Act of 1997 raised the limits, but they are still sufficiently low that they exclude much of the middle class.

[23] 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.

[24] It is often taken for granted in policy discussions that progressivity is fair, but the arguments supporting it are surprisingly weak. See Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case For Progressive Taxation* (Chicago & London: The University Of Chicago Press, 1953).

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 strong case can be made for a proportional system. For the most part, a person earns income by providing labor and capital services to the market, and the person's income is based on the value added to production by his or her contributions. It can be argued that if a person adds twice the value to production as another person and, accordingly, receives twice the pre-tax compensation, it is only fair that the person should also receive twice the compensation after tax, which implies a proportional tax system.

If one thinks that people's tax liabilities should be proportional, rising in step with their incomes, then phase-outs and other methods of taxing people in excess of proportionality would certainly have to be judged unfair. Suppose, however, that one believes in progressivity. The income tax system is already progressive because of its exempt amounts and ascending schedule of statutory rate brackets. Consequently, if one believes in progressivity but thinks the income tax is progressive enough, the use of phase-outs to inject additional progressivity must also be rejected on fairness grounds. Even if one believes that the current rate structure does not provide enough progressivity, phase-outs are probably an inferior choice for increasing progressivity because of their strong disincentive effects, complexity, and lack of openness. If the tax code needs to be more progressive, it would be better just to steepen the rate schedule or to increase the standard deduction and/or personal exemption. This would avoid sharp marginal tax rate spikes at a variety of incomes that phase-outs produce.

***Even if one believes that the current rate structure does not provide enough progressivity, phase-outs are probably an inferior choice for increasing progressivity because of their strong disincentive effects, complexity, and lack of openness.***

Nor are phase-outs equitable if they are motivated by class envy or a desire to use differential taxation as a spoils system. For fairness, income tax rules should not be based on what groups a policymaker wants to help or hurt, but on the impartial treatment of all taxpayers. The notion that phase-outs must automatically be fair as long as they give the poor and middle class a tax advantage over people with higher incomes is thinly disguised class warfare.[25]

[25] In practice, many people in the middle class find that phase-out rules treat them as though they were wealthy, causing them to receive less tax relief than they had expected based on lawmakers' promises. What happens is that many provisions that supposedly start phasing out as people leave the middle class actually begin at such low income levels that millions of taxpayers who regard themselves as solidly middle class are subject to full or partial phase-

(continued...)

Phase-outs also are unfair if they mismeasure income. Income, properly measured, is revenue less the costs incurred in earning the revenue. To measure income accurately, every taxpayer with income-related expenses should be allowed to deduct those expenses. The costs of earning income are as real for high-income earners as for low-income earners. Some phase-outs, however, curtail deductions or credits associated with the costs of earning income. Two examples are the partial phase-out of the child care expense credit and the disallowance of part or all of the miscellaneous business expense deduction.

A number of deductions, exemptions, and credits are intended to adjust people's taxes, often only partially, for certain basic living costs. Three examples are the personal exemption, the child credit, and the medical deduction. By the standard of equal treatment, if the tax code contains an allowance for a certain basic living cost and a taxpayer incurs that cost, it is only fair that the taxpayer be allowed to claim the allowance. Yet, the tax code currently phases out many living-cost allowances, including the three mentioned above, for upper-income citizens.

***The notion that phase-outs must automatically be fair as long as they give the poor and middle class a tax advantage over people with higher incomes is thinly disguised class warfare.***

Another fairness-based criticism of phase-outs is that although they can produce big tax increases, their complicated rules and arithmetic tend to obscure the full extent of the extra charges. People may legitimately object to the hidden taxes generated by phase-outs in much the same manner that they dislike having concealed charges tacked onto other bills they receive. If a private merchant adds such charges to bills, customers at least have the option of going to other merchants who practice more open billing. With tax bills from the government, people do not have that choice. A rising schedule of rate brackets is a much more above-board method of taxing away an increasing share of people's incomes as their incomes grow than are phase-outs.

Sometimes, however, there is an obvious program-related reason for a phase-out. For example, suppose that a provision is a quasi-welfare program grafted onto the tax code for expediency. Because there is a general consensus that welfare should be limited to the poor, most people think it is fair to reduce welfare payments as recipients incomes increase.

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[25](...continued)
outs. For instance, the second tier of the tax on Social Security benefits begins at a modified AGI of $34,000 ($44,000 for couples), the phase-out of deductible IRAs begins at a modified AGI of $33,000 in 2001( $53,000 for couples), and the loss of the Hope Scholarship and Lifetime Learning credits starts at a modified AGI of $40,000 ($80,000 for couples). When those in government say they are lowering the revenue cost of a provision by denying it to the wealthy, they have a strong temptation also to exclude many in the middle class because that where the money is.

The prime example of this in the individual income tax may be the EITC. The EITC began as a modest, back-door means of offsetting the payroll tax for low-wage workers. (A better approach, both simpler and more visible, would have been to cut the payroll tax directly.) But the EITC quickly evolved into a large quasi-welfare program. It has the commendable feature, consistent with welfare reform, of pegging aid to work, at least up to a certain level of income. Because people expect welfare to be limited to the poor and near poor, means testing of the EITC probably does not violate most people's subjective sense of fairness. Nevertheless, the EITC's phase-out causes serious problems. By encouraging people to work up to a certain point but penalizing them if they work much beyond it, it creates a powerful disincentive against additional work effort for people within its phase-out range. It also increases tax complexity.

**Opportunities For Reform**

During his election campaign, President George W. Bush incorporated two proposals to blunt the disincentive effects of phase-outs as they relate to the EITC and the child credit.

***People may legitimately object to the hidden taxes generated by phase-outs in much the same manner that they dislike having concealed charges tacked onto other bills they receive.***

Some of the people with the highest marginal tax rates, surprisingly, are poor and near poor families who are within the EITC phase-out range and who owe federal income tax prior to subtracting the EITC. The marginal federal income tax rate of such a family (*before* adding payroll taxes and state income taxes) is 30.98% if it has one child (15% rate bracket + 15.98% EITC phase-out rate) and 36.06% if it has two or more children (15% rate bracket + 21.06% EITC phase-out rate). The EITC became a campaign issue when Mr. Bush observed that the EITC phase-out, in combination with other taxes, acts:

> "as a tollgate, limiting the access of low and moderate income earners to the middle class... For example, because the benefit of the Earned Income Credit diminishes as a worker's income increases, a single mother with two children on the outskirts of poverty will lose half of any additional dollar she earns (taking into account social insurance taxes and state income taxes). The benefit of taking an extra training course or working an extra shift is cut in half by the government."[26]

Unfortunately, reducing these high marginal rates through direct reform of the EITC phase-out is blocked by arithmetic. If the EITC remains as big as it is at present and if it continues to be thought of as a welfare program that should be phased out with rising income, its phase-out

[26] George W. Bush, "A Tax Cut With A Purpose," Bush for President Campaign, December 1, 1999.

will necessarily be steep and long because the credit amount to be phased out is very large. Although the height of the rate spike could be decreased by reducing the phase-out rate, that option is unattractive because it would further lengthen the phase-out zone, thereby exposing more of the population to the phase-out's complexity and elevated marginal tax rate. Mr. Bush and his economic advisors took a different approach. His tax plan would zero out the pre-EITC ordinary income tax liabilities of almost all families within the EITC's phase-out range. For those who now have positive pre-EITC income tax liabilities, that would lower their marginal tax rates by 15 percentage points.[27] Two elements of the Bush plan would accomplish this. One part is cutting the 15% tax bracket to 10% on the first $12,000 of taxable income for married couples ($10,000 for heads of households, $6,000 for singles). The second part is doubling the child credit from $500 to $1,000.[28] Together, these changes would wipe out the ordinary income tax liability for those families experiencing the EITC phase-out. Whether zeroing out the income tax liabilities of a significant block of voters is a good idea is a legitimate question (it might encourage many voters to think of government services as free and to demand large quantities of the "free" services), but the Bush proposal does show a sensitivity to the high marginal tax rates many poor and near poor families experience due to the EITC phase-out.

***One can question whether Social Security benefits should be taxed at all, but if they are taxed, the method of doing so should be reformed so as not to produce a phase-out and a tax spike.***

The other phase-out-related reform proposal in the Bush tax plan is to raise the threshold at which the child credit phase-out begins (currently $110,000 for couples and $75,000 for single parents) to $200,000. That sensible change would greatly reduce the number of families subject to the complexity and disincentives generated by the phase-out of the child credit.[29]

The President has correctly identified the flaws in these two phase-outs — their complexity and the adverse incentives they create. His view is the correct intellectual framework for analyzing other phase-outs that litter the tax code. The goal should be to eliminate phase-outs whenever possible. If a particular phase-out cannot immediately be repealed, several strategies for moving in that direction might be considered.

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[27] The story is more complicated for some families with three or more children because of the refundable Additional Child Tax credit. That is not discussed here.

[28] Although the doubled child credit would reduce people's marginal tax rates in the case described here, it would not lower marginal tax rates for people who still owed income tax. In most cases, therefore, the doubled child credit would not ease tax disincentives against work, saving, and investing.

[29] The Bush plan also recommends doubling the credit's size. By itself, the bigger child credit would worsen the problems caused by the phase-out because twice the amount of credit would be subject to phase-out, meaning a higher phase-out rate and/or a longer phase-out range. Fortunately, fewer taxpayers would still be subject to the phase-out.

• Raise the thresholds at which phase-outs begin. In most cases (the EITC is an exception), a higher threshold will reduce the number of taxpayers subject to the phase-out, reducing the problems the phase-out causes. The phase-out threshold should be raised repeatedly until the phase-out is abolished.

• If it is politically impossible to eliminate thresholds in any other way, consider trading the abolition of thresholds for a slightly higher top tax rate bracket. President Bush calls for lowering the top rate bracket to 33%. Most upper-income taxpayers would have as much of a reduction in their effective marginal tax rate if the top rate were cut only to 34% or 35% but the many "stealth" taxes that increase their effective tax rates were eliminated. (As was seen in Charts 2 through 5, the top statutory rate brackets are largely a fiction for most upper-income taxpayers; phase-outs bump most of those taxpayers into higher effective marginal rate brackets.[30]) Such a tradeoff would have the benefits of increasing tax visibility and simplicity. (Ideally, the top tax rate would be cut to 33% ***and*** the phase-outs would be ended, for an even larger rate reduction.)

***The President and the Congress should work to remove most current-law phase-outs from the tax code. They should refuse to add new ones... Whenever a new phase-out is suggested, the simple and honest approach is to ask whether it could still pass muster if marketed, in the open, as a complicated, under-the-table increase in marginal tax rates.***

• One can question whether Social Security benefits should be taxed at all, but if they are taxed, the method of doing so should be reformed so as not to produce a phase-out and a tax spike. Currently, the tax is triggered as non-Social Security income exceeds certain thresholds. This makes the tax on benefits effectively a tax on that other income, and at a super-normal rate. (A dollar of additional other income creates a $1.50 or $1.85 increase in taxable income, for an effective rate of 42% or 51.8% for someone in the 28% rate bracket.) If Social Security benefits continue to be taxed, the tax should be based squarely on benefits, without reference to other income. One possibility, for example, would simply be to add half of benefits to taxable income. Employees paid income tax on their part of their Social Security contributions; only the employer's half was tax deductible. Therefore, it can be argued that half of Social Security benefits should be taxable and simply added to taxable income. Those benefits would not "poison" other income with a tax spike. (To protect low-income retirees, some additional amount of benefits could be made exempt. For example, the first $4,000 for a single retiree, $6,000 for a couple with a spousal benefit, and $8,000 for a couple where each is drawing his and her own benefit check could be tax free, with half of any benefits over these amounts added to taxable

[30] For example, if the top rate is cut to 33% but a higher-income couple remain subject to the 3% itemized deduction limitation and the personal exemption phase-out, their effective marginal tax rate would be 35.52% (33% + 0.99% due to total itemized deduction limitation + 1.52% due to phase-out of two personal exemptions).

income.) The advantages of this approach, which could be structured to collect about the same amount of revenue as does current law, are that it would be simple for taxpayers, would generally exempt people whose incomes are small, and would not produce a marginal tax rate spike.

The Administration and the Congress should be wary of "targeted" proposals to add new phase-outs to the tax code. Whenever a new phase-out is suggested, the simple and honest approach is to ask whether it could still pass muster if marketed, in the open, as a complicated, under-the-table increase in marginal tax rates.

Another reason not to add new phase-outs is that there are already so many phase-outs in the tax code that it would be difficult to position new ones so they did not overlap some exiting ones; overlapping phase-outs compound increases in marginal tax rates and tax complexity.

**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 misrepresented as "fair", they are bad tax policy — distorting, complicated, and unfair. The President and the Congress should work to remove most current-law phase-outs from the tax code. They should refuse to add new ones. Ideally, all phase-outs should be swept aside in a fundamental overhaul of the tax system.

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 are sorely needed.

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Senior Economist

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## APPENDIX

## INCOME-BASED PHASE-OUTS IN THE INDIVIDUAL INCOME TAX

### A. CREDITS

| Item Being Phased Out With Rising Income | Start of Phase-Out | Phase-Out Range | May Increase Marginal Tax Rate In Phase-Out Range By Up To[31, 32, 33] |
|---|---|---|---|
| **$500 Child Credit**<br>(Introduced in Taxpayer Relief Act of 1997) | *Head of Household*: Modified AGI of $75,000 | *Head of Household*: Phased out by $50 for each $1,000 of modified AGI above the threshold. Thus, phase-out range is $10,000 for each qualifying child. | *Head of Household*: 5 percentage points (e.g., 28% marginal tax rate would rise to 33%, 31% would rise to 36%) |
| | *Joint Filer*: Modified AGI of $110,000. | *Joint Filer*: Phased out by $50 for each $1,000 of modified AGI above the threshold. Thus, phase-out range is $10,000 for each qualifying child. | *Joint Filer*: 5 percentage points (e.g., 28% would rise to 33%) |
| **HOPE Scholarship Credit**<br>(Up to $1,500 yearly tax credit per student for each of first 2 years of college.)<br>(Introduced in TRA-97) | *Single*: Modified AGI of $40,000. | *Single*: Phased out over $10,000 range from $40,000 to $50,000. | *Single*: 15 percentage points (e.g., 28% becomes 43%; with 2 students, it hits 58%) |
| | *Joint Filer*: Modified AGI of $80,000. | *Joint Filer*: Phased out over $20,000 range from $80,000 to $100,000. | *Joint Filer*: 7.5 percentage points per student (e.g., 28% rises to 35.5%)<br>(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**<br>(Up to $1,000 yearly tax credit per taxpayer.)<br>(Introduced in TRA-97) | *Single*: Modified AGI of $40,000. | *Single*: Phased out over $10,000 range from $40,000 to $50,000. | *Single*: 10 percentage points per taxpayer (e.g., 15% becomes 25%, 28% rises to 38%) |
| | *Joint Filer*: Modified AGI of $80,000. | *Joint Filer*: Phased out over $20,000 range from $80,000 to $100,000. | *Joint Filer*: 5 percentage points per taxpayer (e.g., 28% becomes 33%) |

[31] In some cases, taxpayers may be hit with more than one phase-out at a time. When that happens, the increase in the marginal tax rate could be greater than the numbers presented here, which describe each phase-out in isolation from others.

[32] This is the marginal rate spike that would be experienced by a taxpayer who, in the absence of the phase-out, would claim the maximum deduction, exemption, or credit. If the taxpayer would not qualify for the maximum amount for other reasons, the marginal tax rate increase due to the phase-out would generally be less or the phase-out range shorter.

[33] For simplicity, these numbers assume that phase-outs occur smoothly over the phase-out range. In fact, many phase-outs proceed in steps, which produces a more complicated and uneven pattern of marginal tax rate changes within the income phase-out zone.

| Item Being Phased Out With Rising Income | Start of Phase-Out | Phase-Out Range | May Increase Marginal Tax Rate In Phase-Out Range By Up To |
|---|---|---|---|
| **Earned Income Tax Credit (EITC)**<br>(For 2001, credit of up to $368 if no children, $2,428 if 1 qualifying child, and $4,008 if 2 or more qualifying children.) | *No Children*: Modified earned income (or AGI, if greater) of $5,950. | *No Children*: Phased out over $4,760 range from $5,950 to $10,710. | *No Children*: 7.65 percentage points |
| | *1 Child*: Modified earned income (or AGI, if greater) of $13,090. | *1 Child*: Phased out over $15,190 range from $13,090 to $28,280. | *1 Child*: 15.98 percentage points |
| | *2 or More Children*: Modified earned income (or AGI, if greater) of $13,090. | *2 or More Children*: Phased out over $19,030 range from $13,090 to $32,120. | *2 or More Children*: 21.06 percentage points |
| | ALSO: EITC entirely denied if individual has "excessive" investment income: over $2,450 in 2001. | Restriction takes effect suddenly at $2,450 threshold. | At investment-income cutoff point, one more dollar of investment income can cost the individual thousands of dollars of tax credits. |
| **Dependent Care Credit**<br>(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. | *1 child*: 1.33 percentage points |
| | | *For 2 or more children*: Maximum credit reduced from $1,440 to $960 over $10,000 to $28,000 range. | *2 or more children*: 2.67 percentage points |
| **Adoption Credit**<br>(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 added to marginal tax rate (e.g., 28% rises to 40.5%).<br>15 percentage points if "special needs" child |
| **Tax Credit for the Elderly or Disabled**<br>(Up to $750 if single, up to $1,125 if joint) | *Single*: AGI of $7,500. | *Single*: Phased out over $10,000 range from $7,500 to $17,500. | 7.5 percentage points added to marginal tax rate (e.g., 15% rises to 22.5%). But due to other limitations on credit, it is usually phased out before person owes tax and, thus, does not affect marginal tax rate. |
| | *Joint Filer*: AGI of $10,000. | *Joint Filer*: Phased out over $15,000 range from $10,000 to $25,000. | |
| **Tax Credit for First Time Homebuyer In District of Columbia**<br>(Up to $5,000 credit)<br>(Introduced in TRA-97) | *Single*: Modified AGI of $70,000. | *Single*: Phased out over $20,000 range from $70,000 to $90,000. | *Single*: 25 percentage points (e.g., 28% becomes 53%, 31% becomes 56%). |
| | *Joint Filer*: Modified AGI of $110,000. | *Joint Filer*: Phased out over $20,000 range from $110,000 to $130,000. | *Joint Filer*: 25 percentage points (e.g., 28% becomes 53%). |

## B. DEDUCTIONS

| Item Being Phased Out With Rising Income | Start of Phase-Out | Phase-Out Range | May Increase Marginal Tax Rate In Phase-Out Range By Up To |
|---|---|---|---|
| **Loss of Tax Exemption on up to 85% of Social Security Benefits**<br><br>As income rises, Social Security benefits become subject to income taxation. This tax was introduced by the Social Security Amendments of 1983. Then, the 1993 tax hike added a second tier that sharply increases the potential tax. | *Single*: For the 1st tier, modified AGI of $25,000. For the 2nd tier, modified AGI of $34,000. | *Single*: Lose 50¢ of tax exemption for each $1 of modified AGI between $25,000 and $34,000 (capped at 50% of social security benefits being subject to income tax); lose 85¢ of tax exemption for each $1 of modified AGI over $34,000 (capped at 85% of social security benefits being subject to income tax). | *Single*: Modified AGI between 25,000 and $34,000 (1st tier): 7.5 percentage points if in 15% tax bracket.<br>Modified AGI over $34,000 (2nd tier): 12.75 percentage points if in 15% tax bracket; 23.8 percentage points if in 28% tax bracket. |
| | *Joint Filer*: For the 1st tier, modified AGI of $32,000. For the 2nd tier, modified AGI of $44,000. | *Joint Filer*: Lose 50¢ of tax exemption for each $1 of modified AGI between $32,000 and $44,000 (capped at 50% of social security benefits being subject to income tax); lose 85¢ of tax exemption for each $1 of modified AGI over $44,000 (capped at 85% of social security benefits being subject to income tax). | *Joint Filer*: Modified AGI between $32,000 and $44,000 (1st tier): 7.5 percentage points, assuming couple in 15% tax bracket.<br>Modified AGI over $44,000 (2nd tier): 12.75 percentage points assuming couple in 15% tax bracket. |
| **Regular Deductible IRA**<br><br>(Up to $2,000 deduction for single filer; up to $4,000 deduction for couple, but deductibility phased out if active participant in employer-provided pension plan and AGI above certain level.)<br><br>(Amounts for 2001 listed at right. Amounts are slated to rise in subsequent years.) | *Single*: Modified AGI of $33,000 in 2001. | *Single*: Phased out over $10,000 range from $33,000 to $43,000. | *Single*: 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 33.6%) |
| | *Joint Filer*: Modified AGI of $53,000 in 2001. | *Joint Filer*: Phased out over $10,000 range from $53,000 to $63,000. | *Joint Filer*: 6.0 percentage points if in 15% rate bracket (e.g., 15% becomes 21%). |
| **Regular Deductible IRA, if individual is not active participant in employer-sponsored retirement plan but spouse is** | Modified 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 |

| Item Being Phased Out With Rising Income | Start of Phase-Out | Phase-Out Range | May Increase Marginal Tax Rate In Phase-Out Range By Up To |
|---|---|---|---|
| **Roth IRA**<br>(Up to $2,000 contribution for single filer; up to $4,000 contribution for couple. Roth IRA contributions not deductible but distributions not taxed if certain conditions met.)<br>(Introduced in TRA-97) | *Single*: Modified AGI of $95,000. | *Single*: Phased out over $15,000 range from $95,000 to $110,000. | Losing eligibility to contribute to a Roth IRA equal in present value to losing eligibility to contribute to a conventional, deductible IRA.<br>*Single*: 3.73 percentage point in 28% rate bracket; 4.13 percentage points in 31% rate bracket (e.g., 28% becomes 31.73% and 31% becomes 35.13%). |
| | *Joint Filer*: Modified AGI of $150,000. | *Joint Filer*: Phased out over $10,000 range from $150,000 to $160,000. | *Joint Filer*: 11.2 percentage points in 28% rate bracket; 12.4 percentage points in 31% rate bracket (e.g., 28% jumps to 39.2% and 31% climbs to 43.4%). |
| **Conversion of Regular IRA to Roth IRA** | Prohibited if modified AGI exceeds $100,000. | Restriction takes effect suddenly at $100,000 threshold. | Highly variable, depending on specific facts for taxpayer. |
| **Education IRA**<br>(Up to $500 per beneficiary. Contributions not deductible but distributions not taxed if certain conditions met.)<br>(Introduced in TRA-97) | *Single*: Modified AGI of $95,000. | *Single*: Phased out over $15,000 range from $95,000 to $110,000. | Losing eligibility to contribute to an Education IRA is equal in present value to losing eligibility to contribute the same amount to a conventional, deductible IRA.<br>*Single*: 0.93 percentage point in 28% rate bracket; 1.03 percentage points 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*: 1.40 percentage points in 28% rate bracket; 1.55 percentage points in 31% rate bracket (e.g., 28% rises to 32.03%, 31% rises to 32.03%). |
| **Personal Exemption**<br>($2,900 per exemption in 2001) | *Single Filer*: AGI of $132,950 in 2001.<br>(*Head of Hsd*: AGI of $166,200 in 2001.) | *Single Filer*: Phased out over $125,000 range from $132,950 to $257,950.<br>(*Head of Household*: Phased out over $125,000 range from $166,200 to $291,200) | In 31% rate bracket, 0.72 percentage point per exemption.<br>In 36% rate bracket, 0.84 percentage point per exemption. |
| | *Joint Filer*: AGI of $199,450 in 2001. | *Joint Filer*: Phased out over $125,000 range from $199,450 to $324,450.2 | Rises with the number of exemptions (e.g., in 36% bracket, 0.84 percent pts for one person, 1.67 percent pts for couple with no children, 5.01 percent pts for couple with 4 children). |

| Item Being Phased Out With Rising Income | Start of Phase-Out | Phase-Out Range | May Increase Marginal Tax Rate In Phase-Out Range By Up To |
|---|---|---|---|
| **Limitation on Medical Deduction** | From first dollar of AGI. | Only medical expenses in excess of 7.5% of AGI are deductible. (Disallowance rises to 10% of income for taxpayers caught by Alternative Minimum Tax.) | 1.13, 2.10, 2.33, 2.70, or 2.97 percentage points depending on whether in the 15%, 28%, 31%, 36%, or 39.6% rate bracket. |
| **Limitation on Miscellaneous Business Expense Deduction** | From first dollar of AGI. | Only miscellaneous business expenses in excess of 2% of AGI are deductible. | 0.30, 0.56, 0.62, 0.72, or 0.79 percentage point depending on whether in the 15%, 28%, 31%, 36%, or 39.6% rate bracket. |
| **Limitation on Casualty Loss Deduction** | From first dollar of AGI. | Only casualty losses in excess of 10% of AGI + $100 are deductible. | 1.5, 2.8, 3.1, 3.6, or 3.96 percentage points depending on whether in the 15%, 28%, 31%, 36%, or 39.6% rate bracket. |
| **Limitation on Total Itemized Deductions** | AGI of $132,950 in 2001. | Total itemized deductions reduced by 3% of AGI in excess of $132,950. (Disallowance not to exceed 80% of certain itemized deductions.) This disallowance is *in addition to* the preceding disallowances for specific itemized deductions. | 0.84, 0.93, 0.62, 1.08, or 1.19 percentage point depending on whether in the 28%, 31%, 36%, or 39.6% rate bracket. |
| **Deduction for Losses on Rental Real Estate**<br>(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. | 14.0 or 15.5 percentage points depending on whether in 28% or 31% rate bracket. |
| **Interest on Education Loans**<br>(Up to $2,500 of interest on education loans meeting certain conditions deductible.)<br>(Introduced in TRA-97) | *Single*: Modified AGI of $40,000. | *Single*: Phased out over $15,000 range from $40,000 to $55,000. | 2.5 percentage points if taxpayer in 15% rate bracket; 4.67 percentage points if taxpayer in 28% rate bracket (e.g., 15% rises to 17.5% and 28% becomes 32.67%). |
| | *Joint Filer*: Modified AGI of $60,000. | *Joint Filer*: Phased out over $15,000 range from $60,000 to $75,000. | |
| **Exclusion for Interest Income on US Savings Bonds Used for Higher Education Expenses** | *Single*: Modified AGI of $55,750 in 2001. | *Single*: Phased out over $15,000 range from $55,750 to $70,750. | Marginal rate spike depends on amount of U.S. Savings Bond interest, as well as filing status and tax bracket.<br>Example: 5.6 percentage points marginal tax rate increase if *single filer* in 28% rate bracket has $3,000 of U.S. Savings Bond interest, but 11.2 percentage points marginal tax rate increase if same taxpayer has $6,000 of U.S. Savings Bond interest. |
| | *Joint Filer*: Modified AGI of $83,650 in 2001. | *Joint Filer*: Phased out over $30,000 range from $83,650 to $113,650. | |

## C. OTHER INDIVIDUAL INCOME TAX PHASE-OUTS[34]

| Item Being Phased Out With Rising Income | Start of Phase-Out | Phase-Out Range | May Increase Marginal Tax Rate In Phase-Out Range By Up To |
|---|---|---|---|
| **Alternative Minimum Tax (AMT) for Individuals, Exemption Amount** | *Single*: Alternative minimum taxable income (AMTI) of $112,500. | *Single*: Phased out over $135,000 range from $112,500 to $247,500. | Raises AMT tax rate by 6.5 percentage points if in 26% AMT tax bracket (to an effective marginal AMT rate of 32.5%).<br>Raises AMT tax rate by 7.0 percentage points if in 28% AMT tax bracket (to an effective marginal AMT rate of 35.0%). |
| | *Joint Filer*: AMTI of $150,000. | *Joint Filer*: Phased out over $180,000 range from $150,000 to $330,000. | |
| Under IRS Code **Section 179**, a limited amount of depreciable equipment that is purchased for the active conduct of a trade or business may be deducted in the current year (expensed) rather than having to be depreciated over many future years. (Section 179 is available to corporate income taxpayers as well as individual income taxpayers.) | In 2001, up to $24,000 of depreciable business investments may be expensed. | The amount the taxpayer may expense under Section 179 is reduced by $1 for every $1 that the taxpayer's investments during the year exceed $200,000. Taxpayers whose investments exceed $224,000 in 2001 may expense nothing under Section 179. | Depends on the delay in cost recovery when the taxpayer must depreciate the property instead of deducting its current cost immediately and also on the taxpayer's tax bracket. |
| **Estimated Tax Payments, Safe Harbor from Underpayment Penalty**<br>(More stringent requirement for upper-income taxpayers than for other taxpayers)<br>(Last modified by the Tax Relief Extension Act of 1999.) | AGI of $150,000 | Restriction takes effect suddenly at $150,000 threshold.<br>(Normally, one way taxpayers can protect themselves from an underpayment penalty is by basing estimated tax payments on 100% of the prior year's tax, but individuals whose prior year's AGI exceeded $150,000 can only use this safe harbor by basing estimated taxes on 110% of the prior year's tax.) | Depends on specific facts for taxpayer. |

[34] The tax code also contains a number of *de minimus* provisions under which small or incidental amounts of various types of income do not have to be reported. Because larger amounts of income lose the exemption and must be reported in full, *de minimus* provisions, in a very technical sense, involve phase-outs. But *de minimus* provisions are not included here because, unlike the phase-outs shown in the table, their primary motivation is tax simplification: they spare taxpayers from the potentially large paperwork costs of tracking and recording income and expenses on small or negligible amounts of income and often avoid difficult measurement and enforcement problems.