National Center for Policy Analysis

BRIEF ANALYSIS
No. 445
For immediate release:
Friday, June 27, 2003

Marriage Penalty Relief in the New Tax Law

by Edward J. McCaffery

Some things never seem to die. The marriage penalty is one of them. The new tax law benefits most married couples somewhat, but it does not eliminate the so-called marriage penalty for lower- and upper-income couples. Even more important, the new law does not address other tax rules that financially penalize married couples and two-income couples.

A marriage penalty results when a married couple pays more income taxes than they would if they remained single. A marriage bonus results when a married couple pays less tax than they would if they remained single.

Origin of Marriage Penalties and Bonuses. The marriage penalty is often called a tax code quirk, implying that it is an inadvertent byproduct of other legislation. In fact, it is due to the conscious policy decision to treat a married couple as a single economic unit for income tax purposes. In the United States before 1948, as in many other countries today, the income tax code ignored marriage, and married individuals filed separately. A hypothetical tax system with two income brackets illustrates the problem under separate filing that led to later changes and the creation of marriage penalties. [See the Table.]

Marriage Penalties and Bonuses
(Hypothetical Two-Rate Income Tax)

Earnings	Separate Filing	Identical Brackets	Double Brackets	1.6x Brackets
Harry $10,000, Sally $10,000	Zero Tax	$2,000	Zero Tax	$800
Ozzie $20,000, Harriet $0	$2,000	$2,000	Zero Tax	$800

Note: Assumes individuals could earn $10,000 tax free and then enter a flat 20 percent tax-rate bracket on any income above $10,000.

Suppose the first $10,000 of earnings is tax free, and individuals are taxed at a flat 20 percent rate on income above $10,000. Consider what happens under separate filing:

- When Harry meets Sally, each earns $10,000 and pays no tax; after marrying, they still pay no tax although their combined income is $20,000.
- Ozzie, who makes $20,000, pays $2,000 in income taxes as a single man; if he marries Harriet, who has no income, the couple continues to pay $2,000 on their combined income of $20,000.

Separate filing is marriage neutral, but violates the ideal of "couples neutrality" because couples with the same cumulative income pay different amounts of tax. In 1948, this situation was addressed by adopting *joint filing* for married couples.

The challenge became how to address the income levels — brackets — for various rates. If identical brackets applied to couples and single people, under our hypothetical two-rate tax system, Harry and Sally would pay a *marriage penalty*. Their cumulative $20,000 in income would generate $2,000 in taxes after marriage.

If instead the rate bracket for couples was double the bracket for singles — in our example, no tax for married couples until their income exceeded $20,000 — Harry and Sally would be unaffected. They would still pay no tax. Ozzie and Harriet, however, would get a *marriage bonus*. Their taxes would decrease from $2,000, unmarried, to $0, married. In 1948, Congress chose this "2x solution," which only has marriage bonuses.

A marriage bonus, however, means that singles are penalized. Under the double bracket system, Ozzie saved $2,000 a year by marrying Harriet. That means he paid $2,000 a year for *not* marrying her. To remove this penalty, in 1969 Congress set the rate brackets for married couples at 1.6 — not 2 — times the single-person rate schedules. This created *both* marriage penalties *and* marriage bonuses. In the example, the zero bracket for married couples rose to $16,000. This change:

- *Penalizes* Harry and Sally; earning $10,000 each, they paid $0 in taxes when unmarried but pay $800 in taxes when married (20 percent of the $4,000 of their combined income over $16,000).
- *Rewards* Ozzie and Harriet; they paid $2,000 in taxes on Ozzie's income while unmarried but pay only $800 when married.

Thus the 1.6x solution treats both couples the same, upholding couples' neutrality, but gives bonuses to one-earner couples (about 40 percent of all married households today) while generating marriage penalties

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for two-earner couples (about 55 percent of all married households). The option of "married, filing separately" does not address the problem because those rate brackets are set at .8 times (one-half of 1.6) the single persons' brackets.

Congress has addressed this perceived inequity by reverting to the 1948 2x solution, but only for some rate brackets.

Marriage Penalty Relief in the New Tax Law. The 2001 tax act created a new 10 percent tax rate. The income bracket for married couples to pay that rate is twice that of single filers. The 2001 tax act also doubled the standard deduction for nonitemizing couples, but only gradually, reaching the 2x solution in 2009. The new law accelerates the doubling to 2003 and 2004.

The 2001 tax act also doubled the income bracket for all married couples in the 15 percent bracket, phasing in these changes between 2005 and 2008. The new law speeds up these tax reforms to take place in 2003 and 2004.

These provisions will eliminate the marriage penalty for most taxpayers; all taxpaying couples above its income levels will benefit from the expanded lower bracket. But marriage penalties have not died. The penalty kicks in again for married two-earner households in the 25 percent bracket (beginning at $114,650 of taxable income), where the income bracket is still 1.6 times as wide as the bracket for single filers.

Other Marriage Penalties. What Congress partially taketh away, it also partially giveth, for the new tax law creates other marriage penalties. For example, the increased $1,000-per child credit phases out at a rate of 5 percent, or $5 for every $100 earned, starting at $110,000 for joint filers, until it disappears. This creates a marriage penalty because the phaseout starts at $75,000 for single taxpayers: The married persons' level is far less than double that of a single person.

Furthermore, since the wealthy are more likely to itemize rather than take the standard deduction, they do not benefit from doubling the standard deduction. Worse, the uppermost bracket, which begins at $311,950 of taxable income, has *no* adjustment whatsoever for marriage: The tax bracket is the same for singles and married couples. Such provisions as capital loss offset rules and phaseouts of itemized deductions and personal exemptions also penalize married persons.

At the lower end of the income spectrum, 40 percent of adult Americans pay no income taxes. But many qualify for the earned income tax credit (EITC), America's leading form of "workfare." The EITC has steep marriage penalties in the form of phaseouts. Two earners, each making $10,000, can pay marriage penalties of more than $4,000 due to the EITC penalties alone.

Disincentives to Marry or Work. Worst of all, the talk of marriage penalties misses some major points. A marriage penalty may well affect the decision of poor people to marry. They cannot afford to marry and, by and large, don't — one of the reasons why approximately one out of four American children live in single-parent households.

In the middle- and upper-income classes, people do marry. The tax-influenced decision for them is whether to have one or two wage earners. Here they are bitten by the *two-worker penalty* rather than the marriage penalty. This penalty follows from joint filing, which makes a potential second earner, usually the wife, fall into a rate bracket dictated by the first worker. Once she marries, a woman can easily see her first dollar of earnings cut by more than one-half, considering all federal and state income and payroll taxes. [For a more detailed discussion of marginal taxes on working women, see Edward J. McCaffery, "Women and Taxes," in *Women's Agenda,* Celeste Colgan, ed. (Dallas: NCPA, 2003).]

The result? Married women either stay at home or fall into the two-income trap of working for low pay after taxes. Indeed, a little-noted feature of the new law is that, by expanding the 5 percent phaseout range for the per child credit, it actually increases the marginal rates facing many second workers.

Conclusion. Undoing entrenched tax policy takes time. The marriage penalty relief in this tax bill is a small step in a right direction. Allowing separate filing or reducing the marginal tax rates on second workers would remove provisions of the tax code that distort people's decisions to work, to marry and to have families. Although serious restructuring of entrenched tax policy is time-consuming, fairness — and sound economic analysis — demand it.

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