



Terms

Average Tax Rate: The average tax rate is the total tax paid divided by taxable income. While marginal tax rates show the amount of tax paid on the next dollar earned, average tax rates show the overall share of income paid in taxes.

What it measures: tax burden

$$\text{ATR} = \text{TOTAL TAXES PAID} \div \text{INCOME}$$

How Is Tax Liability Calculated?









Line Item	Scenario 1: Using the Standard Deduction	Scenario 2: Using Itemized Deductions	
Adjusted Gross Income	\$125,000	\$125,000	← Their Adjusted Gross Income (AGI) is their combined income but not the amount they pay taxes on
Minus the Standard Deduction	\$24,800] Their standard or itemized deductions reduce the amount of income they pay taxes on
or Minus Itemized Deductions		\$28,000	
Equals their Taxable Income	\$100,200	\$97,000	← This is their new " taxable income. " Note the \$3,200 difference because of the itemized deductions
Pay 10% up to \$19,749	\$1,975	\$1,975] The tax brackets apply a different or "marginal" rate to progressively higher levels of their taxable income.
Pay 12% from \$19,750 to \$80,249	\$7,260	\$7,260	
Pay 22% from \$80,250 to \$171,050	\$4,389	\$3,685	
Total Tax Liability Before Credits	\$13,624	\$12,920	← Adding up their "marginal" tax amounts equals their tax liability before credits
Minus Child Tax Credit (2 x \$2,000)	\$4,000	\$4,000	← Tax credits reduce their tax liability by the amount of the credit
Income Tax After Credits	\$9,624	\$8,920	← This is their final tax bill after taking their deductions and credits into account
Average Tax Rate	9.6%	9.2%	

Marginal Tax Rate: The marginal tax rate is the amount of additional tax paid for every additional dollar earned as income. A 10 percent marginal tax rate means that 10 cents of every next dollar earned would be taken as tax.

There are statutory and effective marginal tax rates. Statutory marginal tax rates do not tell the entire story, whereas effective marginal tax rates account for layers of taxes (example: income tax and payroll tax) and relevant deductions and credits.

What it measures: impact on incentives to earn, save, invest, or spend.

Key Points

-  Marginal tax rates only apply to income above a certain threshold.
-  The average tax rate for individuals is typically lower than the top marginal tax rate.
-  Not all income is subject to taxation due to tax credits and deductions.
-  A taxpayer's tax liability is determined by their taxable income.
-  The U.S. has a progressive federal income tax system
-  In the U.S. income tax system, high-income taxpayers typically pay a higher average tax rate and are subject to higher top marginal income tax rates as their income climbs.
-  Effective marginal tax rates are important to calculate because they show how workers may be discouraged to work additional hours and earn higher incomes.
-  Higher effective marginal tax rates disincentivize additional work at the margin, which translates into lower productivity and economic growth overall.