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Marginal versus Effective Personal Income Tax Rates:
Understanding what you actually pay (paid) in income taxes

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A great deal of confusion abounds in discussions about state personal income tax rates and how they apply to income. This policy basic clarifies the difference between marginal and effective tax rates, and gives a North Carolina-specific example of how these rates work in action.

A taxpayer's **marginal tax rate** is the tax rate imposed on his or her last dollar of income. In a progressive personal income tax system, the tax rate applied to higher levels of income is higher than the rate applied to lower levels of income. Such a graduated rate structure is better able to keep up with a growing economy and ensure that those at the bottom of the income distribution don't have to carry a heavier tax load than the wealthy.

How Marginal & Effective Tax Rates Worked in North Carolina Prior to 2013

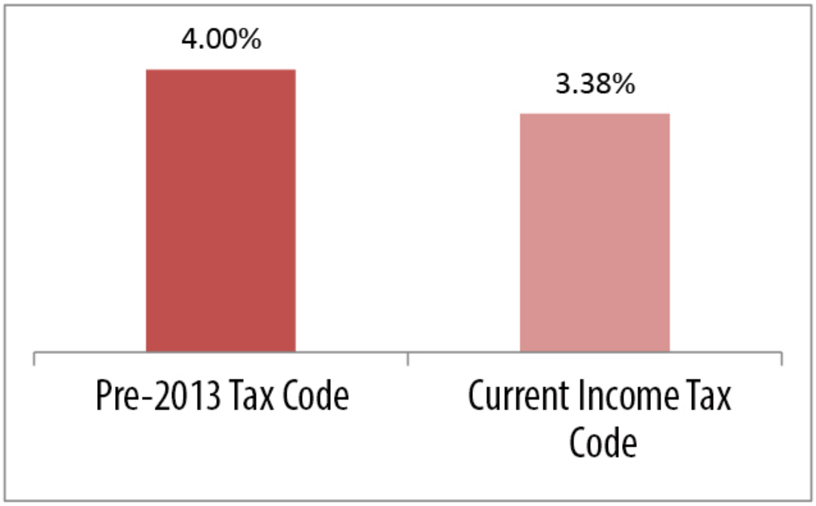
Before 2013 tax changes, the first $21,250 of any taxpayer's taxable income in North Carolina was taxed at 6 percent, the next $78,750 was taxed at 7 percent, and any taxable income earned over $100,000 was taxed at a top marginal rate of 7.75 percent. It is fundamental to remember that only income over the marginal tax bracket, or income level, is taxed at the next higher rate. Put differently, this means that no taxpayer actually pays the top marginal tax rate of their entire taxable income in state personal income taxes.

So how great of a share of total income do North Carolina taxpayers actually pay in personal income taxes? This question is answered by calculating a taxpayer's **effective tax rate**, which is the share of total income that he or she pays in taxes. Taxpayers' effective tax rates are usually much lower than their marginal rates. Confusion about how exactly marginal tax rates are applied to personal income can lead individuals to believe that their taxes are much higher than they actually are.

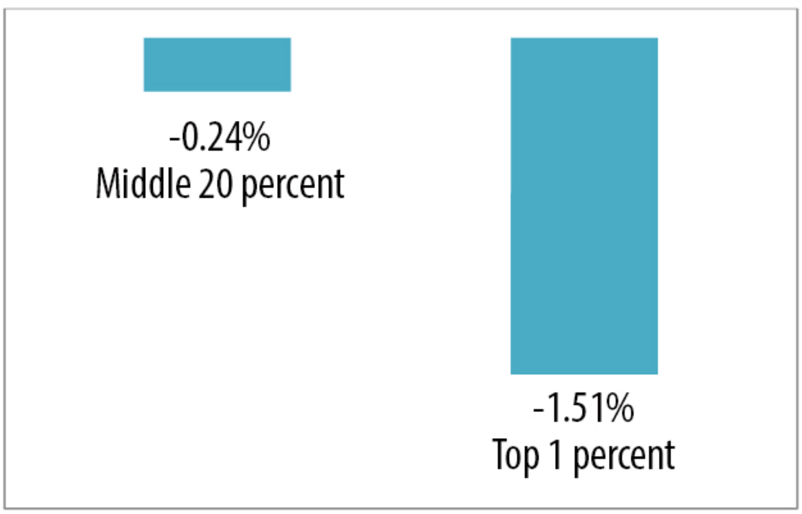
How Marginal & Effective Tax Rates Work Today in North Carolina

In 2013, North Carolina policymakers adopted a low, flat income tax rate and did away with a graduated rate structure. While some credits and deductions were eliminated or reformed, not all were and many have since been added back to the tax code. At the same time, policymakers have adopted a higher standard deduction that they often call a zero tax bracket. In 2017, the income tax rate dropped to 5.499 percent and the standard deduction increased to $17,500 for taxpayers married filing jointly. Under these tax policies, the effective tax rate on income now of 3.38 percent is far lower than the

Average Effective Tax Rates on Income Pre-2013 Tax Changes and in 2017



Change in Effective Tax Rate on Income is Greatest for Millionaires



5.499 percent tax rate and still lower than the effective tax rate of 4 percent paid on average by taxpayers before the 2013 tax changes.

The change in the effective income tax rate since the adoption of the low, flat rate was not as great as the statutory rate cut alone would suggest because many credits and deductions were eliminated to pay for the rate cut thus broadening the base of income subject to taxation. The elimination of credits and deductions and the capping of the value of itemized deductions, specifically mortgage interest and property tax deductions at the state level, mean that different taxpayers even within the same income group could pay different effective rates. This would be based on decisions they make about housing, college attainment, among other choices.

It is also important to note that the effective income tax rate varies by income level. The decline in the effective tax rate has been greatest for millionaires. As is evidenced in the graph below, the change in the effective tax rate since 2013 for millionaires has been far greater than for middle income taxpayers.