The Gimmicks Government Uses to Tax You

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To make tax day more fun, let's replace the tax code with a national lottery. The IRS can issue scratch-offs to each household. Winners get rebates and losers have to cut the IRS a check. The tax code is so complex that most people already have no idea whether they will get money back or owe the government more. From the average taxpayer's perspective, tax day is already a lottery—just one that takes hours to play and requires that you hire an accountant to scratch off the numbers.

For taxpayers, complexity makes the tax code a lottery. For politicians, complexity is a fog that hides the true nature of tax policies. For example, politicians told us that the Alternative Minimum Tax was going to be a tax on the rich. But, because the Alternative Minimum Tax was not indexed for inflation, today it hits many middle-class households. Sleights of hand like this are called tax gimmicks. Tax gimmicks give politicians political cover by allowing them to hide what they are doing to you.

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One of the most effective gimmicks is tax withholding. By making employers withhold taxes from your paycheck, the government encourages you to believe that the withheld money was never yours in the first place. If you don't think the money is yours, you'll pay less attention to how much of it is siphoned off. For example, most people are very aware of how much they spend a month on gasoline, yet have no idea of how much they spend on Social Security and Medicare taxes—despite the fact that the average American spends more on Social Security and Medicare than he does on gas. Self-employed people, on the other hand, are very aware of how much they spend on Social Security and Medicare taxes because no one withholds their taxes. They actually cut the government a check.

The "Buffett Rule" employs a new gimmick that misleads Americans through a bait-and-switch tactic. Politicians who say that the tax rate applied to the middle-class is twice the tax rate applied to the rich are lying. It is true that the typical taxpayer in the top 1 percent pays a marginal rate of 15 percent while the typical middle-class taxpayer pays a marginal rate of around 30 percent, but marginal tax rates are meaningless in this context and politicians know it.

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When it comes to figuring out who has paid how much, it's the average tax rates that matter. The Congressional Budget Office reports that the typical American in the top 1 percent pays an average tax rate (for all federal taxes combined) of almost 30 percent while the typical middle-class American pays an average rate of 14 percent. Whether you believe the rich should pay more or not isn't the point. The point is that politicians either don't know the difference between marginal and average tax rates or they are deliberately lying to you. Neither option should make you feel comfortable with their leadership.

Looking at the marginal tax rate instead of the average tax rate is like checking the speedometer instead of the odometer to see how far you've traveled. Marginal tax rates are the speedometer. While the speedometer tells you how fast you are currently going, the marginal tax rate tells you the rate at which taxes are currently coming out of your paycheck. Average tax rates are the car's odometer—they tell you how much you've already paid. If you want to know how far you've traveled, you look at the odometer. If you want to know how much you've paid in taxes, you look at average tax rates.

	Average Income	Marginal Tax Rate	Average Tax Rate	Increase in Tax Bill From Earning Another $100	Total Taxes Paid
Top 1%	$1,873,000	15.0%	29.5%	$15.00	$552,535
Middle-Income	$64,500	32.7%	14.3%	$32.65	$9,224

Data in the chart above is from 2007, the last available year. Average tax rates include all federal taxes: income, payroll, corporate, and excise. The marginal tax rate for the top 1 percent is the long-term capital gains tax rate. The marginal tax rate for the middle-income is the applicable income tax rate plus the percent employee's half of the payroll tax rates.

Another popular gimmick is the temporary tax. Temporary taxes are supposed to be happy taxes—they come in, they fix a problem, and they leave. Sadly, most temporary taxes end up like dinner guests who won't leave when the party's over. The Johnstown Flood Tax, the poster child for temporary taxes, is a tax on alcohol sales in Pennsylvania that paid for rebuilding Johnstown after the devastating flood. Don't recall the devastating flood? You aren't alone. It occurred more than 75 years ago. Adjusting for inflation, the Johnstown Flood Tax has so far raised enough money to pay for the flood damage 25 times over. Because it now generates a cool $200 million a year for state coffers, it likely won't be going away any time soon.

Politicians want more tax revenue. The more money they take in, the more money they can dole out to favored voters. But to bring in money, politicians have to risk voters' wrath by enacting new and higher taxes. The politician's solution is complexity. The more complex the tax code, the more tax gimmicks politicians can create to hide tax increases. Tax gimmicks are one area in which government shows a surprising ability to innovate.

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