



A FairTax® Whitepaper

## Research Brief

### The FairTax Reduces the Tax Burden for Low and Middle Income Households

When evaluating various tax plans most people want to know how it affects them. That is a difficult question to answer; it depends. It depends on how you measure the tax burden. Ideally, the true measure of the burden of a tax is the change in the individual's economic situations as a result of the change in the tax. "The changes should be measured as the effects on everyone's net-of-tax income after all economic adjustments have run their courses. The burden measure should include not only changes in people's after-tax incomes in a single year, but the lifetime consequences of the tax change as well."<sup>1</sup>

#### **Average remaining lifetime tax rates are a best estimate of these "lifetime consequences."**

To calculate the average lifetime tax rate we add up all the federal income and payroll taxes that a person will pay over the rest of their life and subtract from it the benefits they receive to get a net taxes to be paid. In the case of the income tax, Social Security benefits<sup>2</sup> are subtracted from taxes paid and in the case of the FairTax, the FairTax prebate<sup>3</sup> is likewise subtracted. We then compare the net taxes to be paid to the income that they are expected to earn during the rest of their life.

Household income varies greatly from year to year as the household progresses through the life cycle: single earner, married, children, retirement. Thus average lifetime tax rates provide a more realistic estimate of the true effective tax burden and its effect on an individual's economic well-being than comparisons of taxes paid versus income earned for a single year.

The chart below displays the results from a research study by Dr. Laurence Kotlikoff which compares net average lifetime tax rates for households from various income categories for both the income tax system and the FairTax. Dr. Kotlikoff created a typical lifetime income stream and expenditure pattern for each household income category using his financial planning simulation model for families in each income category. Then using this representative lifetime income stream, he computes the income and payroll taxes that would be paid by the household over its remaining lifetime.

For the income tax system, the net average lifetime tax rate = net income and payroll taxes paid on the lifetime income – Social Security benefits received divided by the household's lifetime income.

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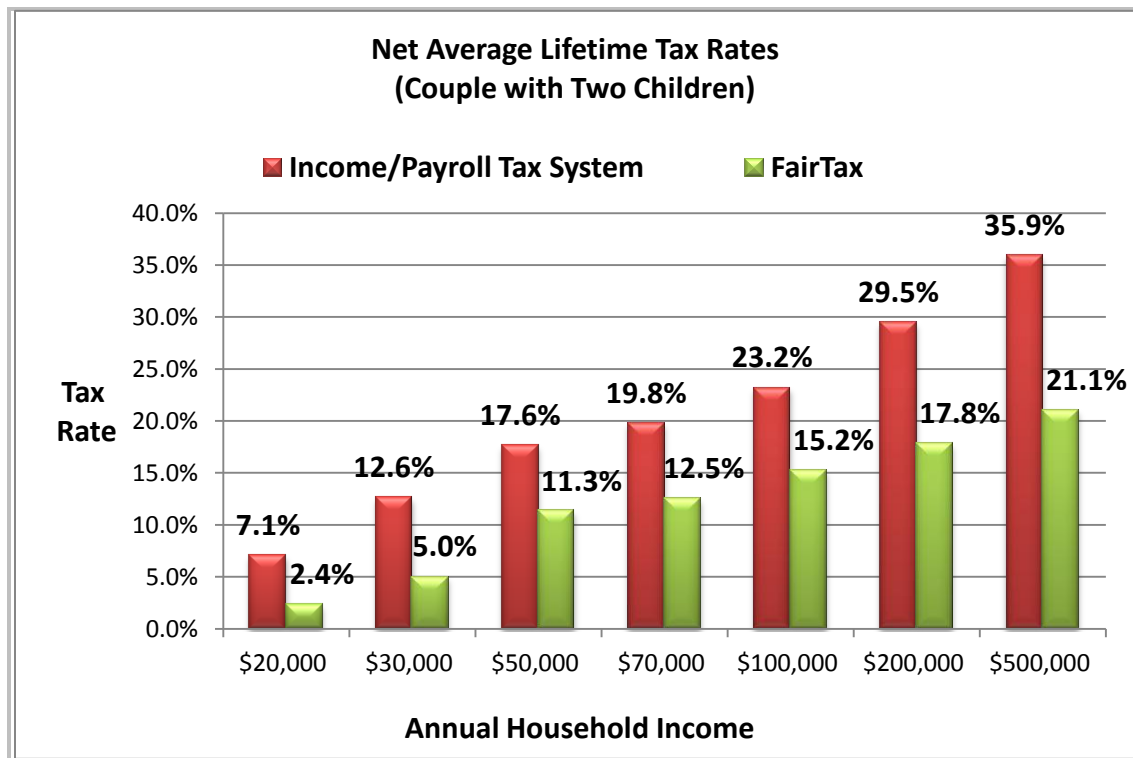
<sup>1</sup> Stephen J. Entin, Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?, The Heritage Foundation, Nov. 5, 2004, p. 1.

<sup>2</sup> In the case of the FairTax, the Social Security benefits are adjusted upward to maintain the real purchasing power of the benefits as provided for in the FairTax legislation, HR 25 / S 122.

<sup>3</sup> The FairTax prebate is a monthly refund of taxes paid to each household set to ensure that households living at or below the poverty level pay no taxes on net. Poverty level spending is determined by household size. For a detailed explanation, see The FairTax Prebate Explained. <http://www.fairtax.org/PDF/PrebateExplained2012.pdf>

For the FairTax, the net average lifetime tax rate = national sales taxes paid on lifetime expenditures – the FairTax prebate - Social Security benefits received divided by lifetime income.

The chart below compares the average remaining lifetime tax rates for the current income/payroll tax system to the tax rates that would occur under the FairTax.<sup>4</sup> Specifically, it displays the results for a fairly typical two-adult, two child household at various income levels.



The net average lifetime tax rate = net payroll/income taxes paid minus social security benefits received divided by annual household income. For the FairTax, net taxes = taxes paid minus the sum of Social Security benefits received and the prebate.

**The FairTax lowers net average lifetime tax rates across all income categories.**

A glance at the chart shows that the FairTax entails either a significant or a substantial reduction in the remaining average lifetime tax rates for each income category. The two-adult, two child household with annual income of \$20,000 would pay on average 2.4% of its remaining lifetime income to the federal government under the FairTax compared to 7.1% under the current income/payroll tax system – a 67% decrease. The same family with an annual income of \$50,000 would pay 11.3% of lifetime income in

<sup>4</sup>The study estimated remaining lifetime taxes paid, lifetime benefits received, and lifetime income earned for 42 different types of households in various income, marital status, and age groups. Kotlikoff, Laurence J. and David Rapson, “Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation,” NBER Working Paper No. 12533, revised October 2006.

<http://www.fairtax.org/PDF/Comparing%20AverageandMarginalTaxRates-110206.pdf>

taxes under the FairTax compared to 17.6% under the current system – a 36% decrease. And finally, the same household earning \$500,000 would see taxes as a percent of lifetime income decrease from 35.9% under the income/payroll tax system to 21.1% under the FairTax – a decrease of 41%.

**The FairTax enhances progressivity of the tax system.**

As can be readily observed the percentage decrease in tax rates for households in the lowest two income categories exceeds the percentage decrease in tax rates for households in the highest two income categories. In fact, the reduction in the tax rate is proportionately much greater with the average lifetime tax rate reduction for the lowest income category (\$20,000) being 1.6 times the tax rate reduction for the highest category (\$500,000) – thereby improving progressivity of the tax system.

**Net Average Remaining Lifetime Tax Rates  
(Two Adult, Two Child Household)**

Income	Income/Payroll Tax System	FairTax	Percent Rate Decrease
\$20,000	7.1%	2.4%	-67%
\$30,000	12.6%	5.0%	-60%
\$50,000	17.6%	11.3%	-36%
\$70,000	19.8%	12.5%	-37%
\$100,000	23.2%	15.2%	-34%
\$200,000	29.5%	17.8%	-40%
\$500,000	35.9%	21.1%	-41%

**What is the FairTax Plan?**

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16<sup>th</sup> Amendment. This nonpartisan legislation (HR 25) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

**What is Americans for Fair Taxation® (FairTax.org)?**

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: [www.FairTax.org](http://www.FairTax.org) or call 1-800-FAIRTAX.

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