

The FairTax and the Federal Income Tax: A Comparative Analysis

The Americans for Fair Taxation plan proposes to replace the federal income tax, including capital gains taxes, *all* payroll taxes, the estate and gift tax, and corporate and self-employment taxes, with a single stage, 23 percent federal sales tax – the FairTax – on the sale of all new goods and services at the final point of purchase. No family will pay taxes on basic necessities, because of a generous rebate system built into the FairTax plan. The rebate system, which makes the FairTax as progressive as the current income tax system, will refund, in advance, the sales taxes paid on consumption expenditures up to the poverty level for families of various sizes.¹

The Current Tax System is Too Complex and Too Costly

The federal income tax is extremely complex and imposes vast compliance costs on the private sector. Arthur Hall, a Tax Foundation economist, estimated compliance costs at \$225 billion for the year 1996.² Dr. Hall estimates that the average small business spent seven times more money complying with the tax system than it paid in taxes. James L. Payne, author of Costly Returns, estimates compliance costs for 1993 at about \$300 billion.³

In a study commissioned by the Internal Revenue Service, Arthur D. Little Co. in 1985 estimated that businesses and individuals spent a combined 5.4 billion hours complying with the tax system. Since then, the number of taxpayers (business and individual) has increased approximately 20 percent. Moreover, as any tax professional will testify, the tax code is dramatically more complex today than it was in 1985, largely because of the Tax Reform Act of 1986. Taking these factors into account, Payne estimates that in 1995, Americans spent 10.2 billion hours complying with the tax code. This is the equivalent of 5.1 million full-time workers doing nothing but tracking income and preparing tax returns. In contrast, the entire U.S. automobile manufacturing industry employs about 850 thousand people and the U.S. aircraft manufacturing industry employs about 550 thousand people.⁴

The FairTax will reduce the compliance costs of most people to *zero*. Ordinary Americans will *never again* need to file a federal tax return, and businesses will see their compliance costs fall dramatically. After passage of the FairTax, businesses will simply need to keep track of their sales to consumers, a much simpler task than what they are required to do under the current income and payroll tax system. The Tax Foundation estimates that the FairTax will reduce compliance costs by more than 90 percent.⁵

¹ For a detailed description of the FairTax plan see, “The FairTax Plan,” Americans for Fair Taxation.

² “Federal Tax Compliance Costs Climb to \$225 Billion,” Tax Features, Tax Foundation, March 1996. See also, March 20, 1996, Dr. Hall’s testimony before the House Ways and Means Committee.

³ Testimony of James L. Payne, “Replacing the Federal Income Tax,” Hearings before the Committee on Ways and Means, House of Representatives, June 6, 7 and 8, 1995, Serial 104-28, p. 183-187. Also see, James L. Payne, “Costly Returns: The Burden of the U.S. Tax System,” ICS Press (San Francisco, 1993).

⁴ Statistical Abstract of the U.S., 1995, Table no. 655, p. 418.

⁵ “Federal Tax Compliance Costs Climb to \$225 Billion,” Tax Features, Tax Foundation, March 1996, p. 3.

The Current System Imposes High Tax Rates on All Americans

The federal income tax is imposed at rates ranging from 15 to 39.6 percent. In 1997, single persons begin paying income tax at \$6,800 per year of income. A married couple begins paying income tax at \$12,200.

Payroll taxes are imposed at a rate of 15.3 percent on wages up to \$65,400 (the 1997 Social Security wage base), and at a rate of 2.9 percent on wages above that amount. In addition, a federal unemployment tax is imposed on the first \$7,000 of wages. The unemployment tax is modified for experience but the standard rate is 6.2 percent. For many Americans, payroll taxes are a larger tax burden than the income tax. Table 1 shows the payroll tax structure under current law.

Up to	\$ 7,000	21.5%	The first \$7,000 is subject to FUTA ⁶
\$7,001 to	\$65,400	15.3%	The first \$65,400 is subject to OASDI ⁷
Over	\$65,400	2.9%	All wages are subject to HI ⁸

The individual income tax imposes tax rates ranging from 15 to 39.6 percent on taxable income. The 1997 schedules for single and married persons are set in Table 2 and 3. The standard deductions in 1997 (used for purposes of determining taxable income) were \$4,150 (single) and \$6,900 (married). The personal and dependent exemption in 1997 stood at \$2,650.

Tax rates under the present system are high. High rates are required because the current tax system is replete with exemptions, deductions, credits and loopholes that narrow the tax base to benefit the lobbies that have the political clout to enact and retain their special treatment. The FairTax will tax all goods and services at one rate with no exceptions. *Tax* lobbying as an “industry” will virtually disappear.

⁶ Federal Unemployment Tax Act (FUTA).

⁷ Old-age, Survivors and Disability Insurance (OASDI) or Social Security.

⁸ Hospital Insurance or Medicare. OASDI and HI are known together as FICA (Federal Insurance Contributions Act) taxes.

Table 2
Current Law, Federal Marginal Tax Rates (1997)⁹
Single - Individuals

Wage Income		Income Tax Rates	Rate Including Payroll Tax
Not over	\$ 6,800	0%	21.5%
\$ 6,801	\$ 7,000	15%	36.5%
\$ 7,001 to	\$ 31,450	15%	30.3%
\$ 31,451 to	\$ 65,400	28%	43.3%
\$ 65,401 to	\$ 66,550	28%	30.9%
\$ 66,551 to	\$131,450	31%	33.9%
\$131,451 to	\$277,850	36%	38.9%
Over	\$277,850	39.6%	42.5%

Including payroll taxes, the current federal tax system imposes a relatively flat (but high) marginal tax rate on wage income. Combined tax rates range from 30.3 percent to 43.3 percent for all but the very lowest income Americans. Wage income is the primary source of income for most American households. The highest marginal tax rate imposed on single persons is for those earning \$31,450-65,400 per year. The highest marginal rates experienced by married couples (with two children) are for those with incomes between \$58,700-130,800. The most affluent taxpayers face a marginal tax rate on their wage income somewhat less than most middle class taxpayers. Of course, investment income is a much larger fraction of affluent taxpayers' income. Although capital income is generally taxed at high rates, tax-planning devices can be used to reduce the effective tax rate considerably.¹⁰ Tables 2 and 3 show the marginal tax bracket faced by various taxpayers under current law.

⁹ Payroll tax breakpoints for a particular taxable income are calculated assuming use of the standard deduction and two dependent exemptions in the case of the married couple. All income is assumed to be from wages. In the case of the married couple, it's assumed that both earned at least \$7,000 and, for purposes of calculating the Social Security portion of the payroll tax, that both spouses earn equal incomes. Families with one spouse above the Social Security wage base and another below it pay fewer payroll taxes than families earning the same income with both spouses at or below the Social Security wage base. This analysis abstracts away from the phase-out of the personal and dependent exemption and the earned income tax credit (EITC). The EITC would reduce marginal tax rates for some low-income individuals by 7.65 percent and raise them by 7.65 to 21.06 percent for lower-middle income individuals. The marginal rate reducing effect of the EITC occurs with wages up to \$4,220 to \$8,890 depending on the number of children and the marginal rate increasing effect occurs between \$4,220 and \$28,495 depending on the number of children. The phase-out of the dependent and personal exemptions occurs for single persons with adjusted gross income between \$121,200 and \$243,700 and married persons with joint adjusted gross income between \$181,800 and \$304,300. The phase-out increases a taxpayer's effective marginal rate by slightly more than 2 percent *per exemption* at current exemption levels. Once the exemption is phased-out, it would have no effect on marginal tax rates. The analysis does not examine state taxes.

¹⁰ The high effective tax rate on capital income is caused by many factors, but two of the most important are the double and sometimes triple taxation of income earned by corporations and inadequate capital cost recovery allowances.

Figure 1

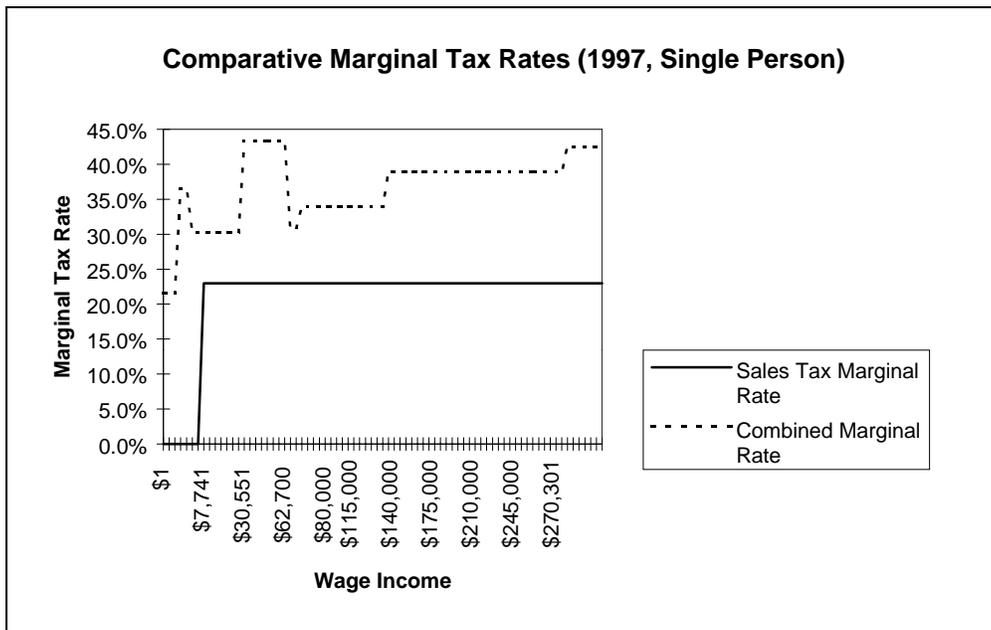
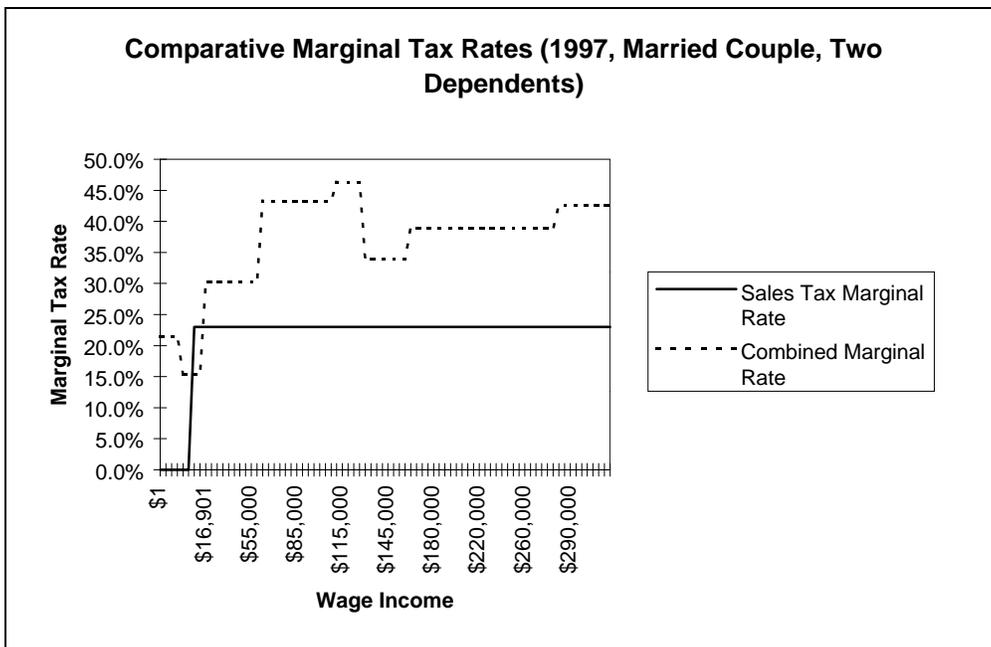


Figure 2



Figures 1 and 2 show that virtually all taxpayers will experience lower marginal tax rates under a national sales tax, including those with relatively modest incomes.

Table 3 Current Law, Federal Marginal Tax Rates (1997)¹¹ <i>Married, Filing Jointly (two dependents)</i>		
Wage Income	Income Tax Rates	Rate Including Payroll Tax
Not over \$ 14,000	0%	21.5%
\$ 14,001 to \$ 17,500	0%	15.3%
\$ 17,501 to \$ 58,700	15%	30.3%
\$ 58,701 to \$117,100	28%	43.3%
\$117,101 to \$130,800	31%	46.3%
\$130,801 to \$169,250	31%	33.9%
\$169,251 to \$288,550	36%	38.9%
Over \$288,550	39.6%	42.5%

Under the FairTax, the marginal tax rate will be a flat 23 percent above the poverty level. The marginal tax rate for a family of four is illustrated in Figure 3. For most wage earners, this would represent a *substantial reduction* in the marginal tax rate.

Although the marginal sales tax rate is a flat, 23 percent above the poverty level, the average rate would be quite different for persons at different expenditure levels. A family of four can spend \$16,050 tax-free. If they spend twice the poverty level (\$32,100), then they will pay an effective tax rate of only 11½ percent. A family that spends four times the poverty level (\$64,200) will pay an effective sales tax rate of only 17¼ percent. Figure 4 illustrates the effective sales tax rate for different expenditure levels.

¹¹ See previous note.

Figure 3

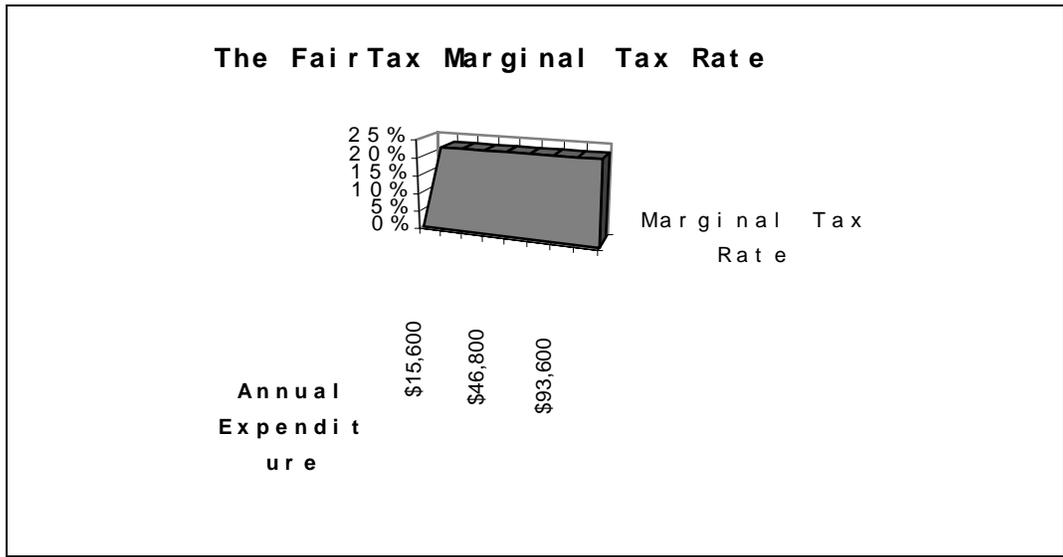
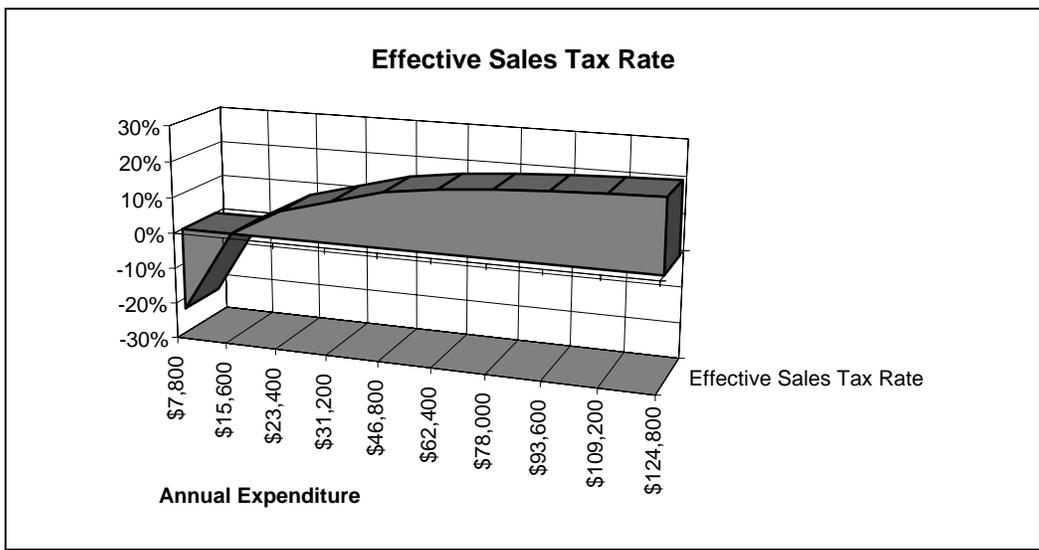


Figure 4



Economic Impact

Replacing the current tax system with the FairTax will unleash America’s economic potential and dramatically improve the standard of living of the American people. Instead of wasting resources complying with the income tax, those resources can be used to provide [redundant] goods and services. As more fully discussed in other FairTax papers, the FairTax will increase real wages, savings, investment and total economic output, reduce real interest rates and enhance the productivity and international competitiveness of American businesses.