The FairTax and Middle Americans – A Case Study

By

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Meet Frank and Mary Middle, an illustrative forty-year-old Kansas couple with two children, Jeff and Suzy, ages 8 and 10. Frank and Mary both earn $25,000 per year, which puts their household's annual income right at the median/middle value for all American households.

Frank and Mary jointly own $50,000 in regular assets, and each has a $50,000 IRA to which they will each contribute $2,000 per year through retirement at age 65. Frank and Mary intend to help their children attend four-year colleges by paying $10,000 (measured in today's dollars) per year in tuition for each child.

Finally, the couple has a $200,000 house with a twenty-year $150,000 mortgage. Their monthly mortgage payment is $1,500. Property taxes total $2,000 a year, homeowner's insurance comes to $1,000 a year, and other housing expenses total $2,000 a year. Frank and Mary are expecting to remain in their home until they die. Their maximum age of life is 100.

How do Frank and Mary fare under the current tax system and the FairTax? To answer this question, we need to understand what the Middles will pay in taxes under both tax regimes and not just in the current year, but in all future years. The Middles have more income when working than when they are retired. So considering only the taxes they pay currently, when they are working, would bias the comparison against the current tax system.

We also need to translate annual tax differences in net taxes into differences in what really matters – what the couple gets to consume in real goods and services now and in the future. To make this spending comparison, I've used *ESPlanner* (Economic Security Planner) -- a commercial life-cycle financial planning program that I and other economists developed. This program determines a path of spending that will provide the household with its smoothest possible living standard path per household member. Such *consumption-smoothing* is predicted by economic theory and supported empirically by household spending and saving behavior.

The table below compares the couple's annual federal net tax payments and real consumption expenditures under each tax system. These expenditures don't include housing expenditures, which, I assume, are the same in each tax regime.

Findings

As the table indicates, the Middle's net taxes are dramatically lower at all ages under the FairTax. And thanks to this lifetime tax cuts, the Middles are able to enjoy increases in their annual living standards ranging from 27.9 percent to 33.5 percent!

Let's dig into these numbers, all of which are displayed in real terms (at current produce-prices), to understand what's going on. First, consider consumption expenditure under the current tax system. Notice that it drops when Jeff goes to college in 2017 and again when Suzy does the same in 2019. Between 2008 and 2022, when Suzy graduates, the Middles enjoy a constant living standard per person and simply spend less when there are fewer mouths to feed. Once Suzy graduates and the tuition bills stop, Frank and Mary can enjoy a higher living standard.

In 2027, they make their final mortgage payment and with that financial burden off their backs, the Middles can spend even more -- $23,212 annually through age 100 should they both live that long. This consumption expenditure plan offers the Middles the smoothest path of living standard per resident household member that can be achieved without borrowing. Under the FairTax you see a similar pattern.

Next consider the Middle's federal taxes. Under the current system, the Middles pay $7,258 in federal taxes in 2008. This figure is the sum of their 2008 personal federal income taxes, their "employee-paid" FICA taxes, and their "employer-paid." I've placed quotes around "employee-paid" and "employer-paid" because economics makes no distinction between the two types of FICA payments. They both represent amounts of Frank's and Mary's total compensation that is given to the government rather than to Frank and Mary. Indeed, apart from the different labels, both parts of the FICA tax are "paid" by the employer if, by "paid," we mean transmitted to the Uncle Sam.

Here's how the $7,258 breaks down. The Middle's personal income taxes are actually negative $392 thanks to their eligibility for the Additional Child Tax Credit and because their taxable income places them in a zero tax bracket. Their employer- and employee-paid FICA, on the other hand, are positive, totaling $7,650. Together, the two taxes total $7,258.

The net FairTax for 2008 is much smaller – only $3,868. This represents the difference between the real FairTax retails sales taxes paid by the Middles in 2008 of $8,716 and $4,849 – the real value of the $6,297 nominal FairTax rebate that the Middles receive in that year. When Jeff and then Suzy leave home, the nominal FairTax rebate is reduced to $4,697, which has a real value of $3,617 (.77 times $4,697).

Once Frank and Mary begin collecting Social Security they'll receive a nominal Social Security benefit that is 30 percent higher since the FairTax will be treated by Social Security as an increase in the CPI. In real terms, this 30 percent-higher Social Security benefit is worth $6,167 per year to the two of them combined. This too is part of the Middle's net tax and explains why they pay lower net taxes in retirement under a FairTax.

Who Pays More?

Although the FairTax raises the same amount of real revenue as the current income tax system, there is a difference in the amount of taxes collected from the middle class and the very wealthy. One should also bear in mind that the FairTax is more efficient than the current income tax system and these efficiency gains will redound to all Americans.

Those that pay more under the FairTax are the super wealthy who typically invest their wealth in stock. Such households earn income on their stock primarily in the form of long-term capital gains, which are nominally taxed at a 15 percent rate, but are typically taxed at a much lower rate. The reason is that capital gains taxes don't have to be paid until the stock with the capital gain is sold, i.e., the gain is *realized*. The ability to defer the gain can lower the effective capital gains tax rate dramatically.[1]

To see what's involved, suppose Frank's and Mary's last name isn't Middle, but Rich. And suppose they have $10 million in regular assets, rather than $50,000, and that they earn the historic average real return on their stock. Finally, assume that, thanks to deferral, their effective marginal tax rate on capital gains is 7.5 percent – half of the nominal 15 percent.

In this case, the Richs will consume in 2008 under current tax law not $21,949, but $932,848. But under the FairTax, their 2008 consumption is much lower – only $785,094. In 2008 the Richs pay only $104,459 in federal taxes. But under the FairTax they pay $229,659 – more than twice as much. The year 2008 is not unique. The Richs pay significantly more taxes under the FairTax than under the current system from age 40 right through age 100.

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1 http://books.google.com/books?id=BrULR5rvno0C&pg=PA6&lpg=PA6&dq=effective+capital+gains+tax+rates+given+deferral&source=web&ots=ya7-M0vLSm&sig=zvE7XH4fiSnQSA1DEzdkqEoP-Lg#PPA6,M1

Frank and Mary Middle –

Changes in Taxes and Consumption in Adopting the FairTax

Year	Frank and Mary's Age	Real Federal Net Tax Payments			Real Consumption Expenditure		
		Current System	FairTax	Percentage Change	Current System	FairTax	Percentage Change
2008	40	7,258	3,868	-46.7	21,949	29,181	32.9
2009	41	7,309	3,868	-47.1	21,949	29,181	32.9
2010	42	7,367	3,868	-47.5	21,949	29,181	32.9
2011	43	7,342	3,868	-47.3	21,949	29,181	32.9
2012	44	7,392	3,868	-47.7	21,949	29,181	32.9
2013	45	7,451	3,868	-48.1	21,949	29,181	32.9
2014	46	7,519	3,868	-48.6	21,949	29,181	32.9
2015	47	8,658	3,868	-55.3	21,949	29,181	32.9
2016	48	8,737	3,868	-55.7	21,949	29,181	32.9
2017	49	10,397	3,222	-69.0	18,773	24,958	32.9
2018	50	10,424	3,222	-69.1	18,773	24,958	32.9
2019	51	10,964	2,466	-77.5	15,316	20,363	33.0
2020	52	10,954	2,466	-77.5	15,316	20,363	33.0
2021	53	10,953	2,466	-77.5	15,316	20,363	33.0
2022	54	11,047	2,486	-77.5	15,316	20,432	33.4
2023	55	11,058	4,849	-56.2	21,223	28,341	33.5
2024	56	11,059	4,908	-55.6	21,544	28,538	32.5
2025	57	11,060	4,963	-55.1	21,783	28,722	31.9
2026	58	11,060	5,030	-54.5	22,077	28,948	31.1
2027	59	11,060	5,099	-53.9	22,376	29,178	30.4
2028	60	11,059	5,255	-52.5	23,212	29,700	27.9
2029	61	11,139	5,255	-52.8	23,212	29,700	27.9
2030	62	11,221	5,255	-53.2	23,212	29,700	27.9
2031	63	11,302	5,255	-53.5	23,212	29,700	27.9
2032	64	9,473	5,255	-44.5	23,212	29,700	27.9
2033	65	2,410	(912)	-137.9	23,212	29,700	27.9
2034	66	2,455	(912)	-137.2	23,212	29,700	27.9
2035	67	2,497	(912)	-136.5	23,212	29,700	27.9
2036	68	2,537	(912)	-136.0	23,212	29,700	27.9
2037	69	2,574	(912)	-135.4	23,212	29,700	27.9
2038	70	2,609	(912)	-135.0	23,212	29,700	27.9
2039	71	2,640	(912)	-134.6	23,212	29,700	27.9
2040	72	2,668	(912)	-134.2	23,212	29,700	27.9
2041	73	2,692	(912)	-133.9	23,212	29,700	27.9
2042	74	2,712	(912)	-133.6	23,212	29,700	27.9
2043	75	2,729	(912)	-133.4	23,212	29,700	27.9
2044	76	2,742	(912)	-133.3	23,212	29,700	27.9
2045	77	2,751	(912)	-133.2	23,212	29,700	27.9
2046	78	2,757	(912)	-133.1	23,212	29,700	27.9
2047	79	2,759	(912)	-133.1	23,212	29,700	27.9

2048	80	2,758	(912)	-133.1	23,212	29,700	27.9
2049	81	2,753	(912)	-133.1	23,212	29,700	27.9
2050	82	2,745	(912)	-133.2	23,212	29,700	27.9
2051	83	2,734	(912)	-133.4	23,212	29,700	27.9
2052	84	2,719	(912)	-133.6	23,212	29,700	27.9
2053	85	2,701	(912)	-133.8	23,212	29,700	27.9
2054	86	2,680	(912)	-134.0	23,212	29,700	27.9
2055	87	2,655	(912)	-134.4	23,212	29,700	27.9
2056	88	2,628	(912)	-134.7	23,212	29,700	27.9
2057	89	2,598	(912)	-135.1	23,212	29,700	27.9
2058	90	2,564	(912)	-135.6	23,212	29,700	27.9
2059	91	2,528	(912)	-136.1	23,212	29,700	27.9
2060	92	2,489	(912)	-136.7	23,212	29,700	27.9
2061	93	2,446	(912)	-137.3	23,212	29,700	27.9
2062	94	2,401	(912)	-138.0	23,212	29,700	27.9
2063	95	2,352	(912)	-138.8	23,212	29,700	27.9
2064	96	2,300	(912)	-139.7	23,212	29,700	27.9
2065	97	2,246	(912)	-140.6	23,212	29,700	27.9
2066	98	2,188	(912)	-141.7	23,212	29,700	27.9
2067	99	2,128	(912)	-142.9	23,212	29,700	27.9
2068	100	2,064	(912)	-144.2	23,212	29,700	27.9