



A FairTaxSM White Paper

What is the difference between statutory, average, marginal, and effective tax rates?

A taxpayer's *statutory tax rate* is the legally imposed rate, i.e., the 23 percent FairTax rate (tax inclusive, as the income tax is). Comparatively, in the personal income tax this would also be the tax rate schedule as shown in Table 1.

Table 1: 2004 federal personal income tax rates

Tax rate	Single filers	Married filing jointly or qualifying widow/widower	Married filing separately	Head of household
10%	Up to \$7,150	Up to \$14,300	Up to \$7,150	Up to \$10,200
15%	\$7,151 - \$29,050	\$14,301 - \$58,100	\$7,151 - \$29,050	\$10,201 - \$38,900
25%	\$29,051 - \$70,350	\$58,101 - \$117,250	\$29,051 - \$58,625	\$38,901 - \$100,500
28%	\$70,351 - \$146,750	\$117,251 - \$178,650	\$58,626 - \$89,325	\$100,501 - 162,700
33%	\$146,751 - 319,100	\$178,651 - \$319,100	\$89,326 - 159,550	\$162,701 - 319,100
35%	\$319,101 or more	\$319,101 or more	\$159,551 or more	\$319,101 or more

A taxpayer's *average tax rate* is the ratio of the amount of taxes paid to taxable income.

In 2004, a single individual who took the standard deduction and had an adjusted gross income of \$29,051 would have been in the 25 percent tax bracket (statutory rate). In comparison, his average tax rate would have been only 10.9 percent.

This is because the standard deduction (\$4,850) and personal exemption (\$3,100) would have made the first \$7,950 of his income free of federal income tax. The next \$21,100 of his income would have been subject to the 15 percent rate. Therefore, only \$1 of his income would have actually been subject to the 25 percent rate. The tax on an additional \$1.00 earned would be \$0.25.



The difference between statutory, average, marginal, and effective tax rates

A taxpayer's *marginal tax rate* is the tax rate that applies to the taxpayer's last dollar of taxable income. In the above example, 25 percent is the taxpayer's marginal tax rate.

A taxpayer's *effective tax rate* means the actual rate, i.e., the rate existing in fact. Both average and marginal tax rates can be expressed as effective tax rates.

An *effective average tax rate* may differ from an average tax rate because some measure of income other than taxable income is used. For example, the Joint Committee on Taxation typically calculates the effective average tax rate as the ratio of taxes paid to a constructed measure of "economic income."

An *effective marginal tax rate* may differ from a marginal tax rate because the taxpayer may be in an income range in which he is subject to a phase-out of some exclusion or deduction.

In assessing the economic effects of a tax system, the appropriate tax rates are the marginal or the effective marginal tax rates. Taxpayers face their highest tax rate, which is their marginal tax rate, at exactly the point at which they are most likely to be influenced by taxes.

What is a progressive tax system?

In a progressive tax system, marginal tax rates increase as income increases. For example, the income tax has statutory tax brackets of 0, 10, 15, 28, 33, and 35 percent, with each higher bracket taking effect at a higher level income than the preceding bracket (see Table 1).

The tax code contains many phase outs of deductions, exemptions, and tax credits that can create a much higher effective marginal income tax rate than is implied by the statutory rates. For example, the per-child tax credit phases out at the rate of 2 percent for each \$1,250 or part of \$1,250 beginning at \$142,700 in adjusted gross income for single filers. This increases the effective marginal tax rate relative to the statutory rate.



The difference between statutory, average, marginal, and effective tax rates

Table 2: Effect on income of a hypothetical progressive income tax

Gross income (1)	Statutory marginal tax rate (2)	Additional tax paid (3)	Cumulative tax paid (4)	Additional after-tax net income (5)	Cumulative after-tax net income (6)	Effective average tax rate (7)
\$0 - \$10,000	5%	\$500	\$500	\$9,500	\$9,500	5.0%
\$10,001 - \$20,000	10%	\$1,000	\$1,500	\$9,000	\$18,500	7.5%
\$20,001 - \$30,000	15%	\$1,500	\$3,000	\$8,500	\$27,000	10.0%
\$30,001 - \$40,000	20%	\$2,000	\$5,000	\$8,000	\$35,000	12.5%
\$40,001 - \$50,000	25%	\$2,500	\$7,500	\$7,500	\$42,500	15.0%
\$50,001 - \$60,000	30%	\$3,000	\$10,500	\$7,000	\$49,500	17.5%
\$60,001 - \$70,000	35%	\$3,500	\$14,000	\$6,500	\$56,000	20.0%
\$70,001 - \$80,000	40%	\$4,000	\$18,000	\$6,000	\$62,000	22.5%
\$80,001 - \$90,000	45%	\$4,500	\$22,500	\$5,500	\$67,500	25.0%
\$90,001 - \$100,000	50%	\$5,000	\$27,500	\$5,000	\$72,500	27.5%

Source, Primer on the Economic Effects of Marginal Tax Rates, Tax Foundation, p. 19.

Table 2 shows the effect of a hypothetical progressive income tax on after-tax income – that the amount of taxes paid increases faster than income. The increasing marginal tax brackets reduce after-tax net income as gross income increases (notice that column 5 decreases as income increases). As a result, the effective average tax rate increases with the rising income (see column 7).

Also notice that the effective average tax rates in column 7 (column 4 divided by the maximum income for that bracket in column 1) are less than the marginal rate. So a taxpayer making over \$100,000 would pay 50 percent of his next dollar earned in taxes but his average tax rate would only be 27.5 percent. It is the marginal rate that will influence the taxpayer’s decision to work and earn more, work more and take nonmonetary compensation, or to go fishing because he has to split that next dollar earned with the government.

It is not necessary to have graduated tax rates to achieve progressivity. A tax which exempts some amount of income at the bottom and imposes a flat marginal tax rate on income above that amount is progressive because the average tax rate rises with income. The FairTax exempts spending up to the poverty level (by means of the FairTax prebate) and imposes a 23 percent tax-inclusive statutory rate on all spending above the poverty level. While all consumers pay the same tax rate on their purchases, because of the prebate, the effective average tax rate differs for persons at different levels of spending. The effective average tax rate increases as consumption increases, making the FairTax a progressive tax. A person spending at the poverty level has an effective average tax rate of 0.0 percent, whereas someone spending at four times the poverty level has an effective average tax rate of 17.2 percent.



The difference between statutory, average, marginal, and effective tax rates

Table 3: FairTax progressive rate structure

Married couple: Two children					
Percent of poverty level	Spending	FairTaxes paid	Amount of rebate	Net taxes paid	Effective average tax rate
25%	\$6,415	\$1,475	\$5,902	(\$4,427)	-69.0%
50%	\$12,830	\$2,951	\$5,902	(\$2,951)	-23.0%
100%	\$25,660	\$5,902	\$5,902	\$0	0.0%
150%	\$38,490	\$8,853	\$5,902	\$2,951	7.7%
200%	\$51,320	\$11,804	\$5,902	\$5,902	11.5%
300%	\$76,980	\$17,705	\$5,902	\$11,803	15.3%
400%	\$102,640	\$23,607	\$5,902	\$17,705	17.2%

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 16th Amendment. This nonpartisan legislation (HR 25/S 1025) 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 or call 1-800-FAIRTAX.

KEW/km 8-05

(AFFT Documents\Papers on a specific subject\What is the difference between statutory, average, marginal and effective tax rates.doc)