

FairTax Facts and Fallacies: Doing the Math Once More

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Thomas Hobbes and the Consumption Tax

“When impositions are laid upon those things which men consume, every man pays equally for what he uses: Nor is the Commonwealth defrauded by the luxurious waste of private men.” *Leviathan*, 1651.



Consumption Tax

- The essence of a consumption tax is that it
 - taxes consumption, not saving or the return to saving,
 - taxes all consumption at a single rate.
- Rationale:
 - Removes bias against saving.
 - Does not penalize success or reward sloth.
 - Avoids concentrating cost of government on a minority of taxpayers.
- But a consumption tax need not be a sales tax, and a sales tax need not be a consumption tax.



Types of Consumption Taxes



FairTax

- Taxes almost all expenditures under NIPA definition of “personal consumption expenditures.”
- Taxes consumption at a single rate.
- Introduces “progressivity” through prebate.
- Pitfalls?
 - Enforcement?
 - Administration?



Flat Tax

- Hall-Rabushka and Steve Forbes have offered proposals.*
- Like FairTax, untaxes net investment.
- Achieves progressivity through personal allowance.
- Pitfalls?
 - Vulnerable to creation of multiple rates (“X-Tax”).
 - Does not protect against new taxes.
 - Leaves many taxpayers untaxed.

*See <http://www.hoover.org/publications/books/3602666.html> and http://www.forbes.com/2005/08/15/taxes-forbes-webcast-cx_tm_0815flatax.html.



Value-Added Tax

- Under a “pure” regime, imposed as a single rate on value added at different stages of production. Then, the same result as the FairTax.
- Major pitfall: In practice, seldom imposed at a single rate on all consumption. Twenty-four of twenty-nine OECD countries have a “VRR” below 0.65 and seven a ratio below 0.50. “This means that, globally, VAT regimes, with their multiple reduced rates and exemptions result in significant tax expenditures compared to a ‘pure’ VAT regime.”*

*See http://www.oecd.org/document/20/0,3343,en_2649_33739_41751636_1_1_1_1,00.html.



Irwin Stelzer on UK VAT*

- “Crackers made from tapioca starch carry no tax; prawn crackers made from cereals do. Frozen yogurt that needs to be thawed before eating is zero rated, frozen yogurt bears the tax....”
- “Food for animals creates other problems. If it is ‘suitable for all breeds’ it is taxed, but if ‘it is held out for sale exclusively for working dogs’ it is not, unless, of course, ‘it is biscuit or meal,’ in which case it is taxed....”
- “Since children's clothing is zero-rated, what fits into that category?
Bras up to and including size 34B; body stockings that measure no more than 27½ inches shoulder to crotch; babies' shawls but not ‘mother-and-baby shawls intended to wrap around both mother and child.’”

*“Small bras and the Value-Added Tax,” *Wall Street Journal*, April 5, 2010,
http://www.hudson.org/index.cfm?fuseaction=publication_details&id=6891.



Why the FairTax?

- Promotes saving and growth.
 - By removing the bias against saving, it increases investment.
 - By increasing investment, it strengthens the economy.
- Simplifies tax system.
 - No more 1040.
 - No more IRS code.
- Instills fiscal discipline.
 - Just one tax rate: 23%.
 - De-politicizes the tax code.



Purpose of This Presentation

- Outline the fundamentals of the FairTax.
- Review some of the findings of BHI's analysis of the FairTax Act of 2007 (now the FairTax Act of 2009).
 - What rate would be needed in order to keep government spending constant in real terms?
 - What are the economic effects of the FairTax?
- Separate fact from fallacy regarding the FairTax.



FairTax Fundamentals



The FairTax Act I

- Replaces federal personal and corporate income taxes, the gift and estate taxes, the capital gains tax, the alternative minimum tax and federal payroll taxes with one federal retail sales tax administered by state governments. Does not repeal tariffs and excise taxes.
- The rate is set at 23% on a tax-inclusive basis.
- Untaxes:
 - net business investment and net exports,
 - spending at poverty level via the prebate.
- Does not tax education.
- Tax is collected by states.



The FairTax Act II

- Imposed on personal consumption expenditures and government consumption.
- Calculated to be spending-neutral in real terms (it's close to revenue-neutral net of prebate).
- Compensates state governments and retailers for their collection and administration costs.
- Indexes Social Security spending.



Note on Price Effects

The tax-inclusive rate of 23% imposed by the FairTax Act:

- Implies a tax-exclusive rate of 30%.
- Implies nothing about what happens to prices. That's up to the Fed. Prices could rise by 0% or 30% or anything in between.
- All a matter of Federal Reserve accommodation or non-accommodation.



Example

- Pre-FairTax Assumptions:
 - Price of pizza = \$10.00, hourly wage = \$10.00.
 - Income tax = 20%.
 - One hour of work yields \$8.00 in disposable income, so that the worker buys 0.8 of a pizza, with 0.2 going to government.
- FairTax inclusive rate = 20%, exclusive rate = 25%.
 - Full Accommodation:
 - Price of pizza rises to \$12.50, inclusive of tax.
 - Wage rate remains at \$10.00.
 - Worker gets 0.8 (= $10/12.50$) pizza, government 0.2 (= $2.50/12.50$) pizza.
 - Non-accommodation:
 - Price of pizza remains at \$10.00.
 - Wage rate falls to \$8.00.
 - Worker gets 0.8 (= $8.00/10.00$) pizza, government 0.2 (= $2.00/10.00$) pizza.



Comparison with Current Law: Another Example

Two families of four. Family A makes \$20,000 and Family B makes \$100,000. Assume a 23% inclusive rate and full accommodation. Families consume all income.

Family A	Income Tax	FairTax
Income	20,000	20,000
Standard Deduction	11,400	0
Dependents Exemption	7,300	0
Taxable Income	1,300	20,000
Tax	130	6,095
Prebate	0	6,499
After-Tax Income/Before-Tax Consumption	19,870	26,499
Net Tax	130	-404
After-Tax Consumption	19,870	20,404

Family B	Income Tax	FairTax
Income	100,000	100,000
Standard Deduction	11,400	0
Dependents Exemption	7,300	0
Taxable Income	81,300	100,000
Tax	12,700	24,495
Prebate	0	6,499
After-Tax Income/Before-Tax Consumption	87,300	106,499
Net Tax	12,700	17,996
After-Tax Consumption	87,300	82,004



The FairTax Rate



Assumptions

- Results of four studies performed by Beacon Hill Institute in 2005-06 and conducted for AFFT.*
- BHI's calculation of the rate:
 - assumed that the Bush tax cuts were permanent,
 - ignored dynamic effects and enforcement problems,
 - used CBO revenue estimates for 2007.
- Details can be found in BHI studies, the journal *Tax Notes* and an AEI presentation by BHI and Laurence Kotlikoff.**

*See <http://www.beaconhill.org/FairTaxPapers.htm> and article in *Tax Notes*, [http://www.beaconhill.org/FairTax2006/TaxingSalesundertheFairTaxWhatRateWorks061005.p](http://www.beaconhill.org/FairTax2006/TaxingSalesundertheFairTaxWhatRateWorks061005.pdf)

df. ** See http://www.aei.org/docLib/20070302_kotlikoffPresentation.pdf.



The Rate Calculation

Revenue (\$ trillions)		Base (\$ trillions)	
Revenue to be		Personal Consumption	9.243
Replaced	2.228	Fed. Govt. Consumption	.908
Prebate	.503	State & Local Govt.	
Other adjustments	-.053	Consumption	1.094
Total	2.678	Total	11.245

Tax-inclusive rate = Revenue / Base = 2.678 / 11.245 = 23.82%

Tax-exclusive rate = .2382 / (1 - .2382) = 31.27%



Further Details Concerning the Rate

- In order for a 23% rate to have worked in 2007, it would have required a spending cut of \$76 billion, or 2.73% of all spending other than Social Security.
- \$65 billion (86% of \$76 billion) could have been saved if non-Social Security spending had been kept at 2006 levels.



Economic Effects



BHI's Estimated Macro Effects

(% Change from Baseline)

Calendar Year	2007	2008	2009	2031
Implementation Year	1	2	3	25
Real GDP	7.9	9.3	9.9	10.3
INVESTMENT	74.5	88.4	88.0	65.2
CAPITAL STOCK	0.0	2.8	5.3	17.3
EMPLOYMENT	11.9	12.0	11.2	4.7
WAGE	10.3	10.6	10.4	9.2
CONSUMPTION	-0.6	-0.8	0.2	6.0



Other Studies

- Jokisch and Kotlikoff find both losses and gains:
 - Older, middle and high-income individuals lose. Younger individuals all gain and, of them, the poor gain the most.
 - Welfare would fall by 1.18% for middle-income people now turning 60 but rise by 9.84% for people born in 2010, who become middle-income earners.*
- Arduin, Laffer and Moore find that economic growth would spike at 5.8% in the early years, and GDP would be 11.3% higher than baseline by year 10.**

* See Table 5, <http://www.fairtax.org/PDF/FairTax-NTJ-Final-042407.pdf>.

** See page 28, <http://www.fairtax.org/PDF/MacroeconomicAnalysisofFairTax.pdf>.



Administrative/Compliance Costs

BHI estimated the savings in administration, collection and filing costs that would have been brought about by the FairTax to be \$346.52 billion for 2005.

Cost Changes (\$ billions)

No more 1040s or corporate returns	-407.11
Net Cost to Retailers of Collecting FairTax	60.31
Net Cost to State Govt. of Collecting FairTax	9.66
Net Cost to Federal Government of Collecting Sales Tax and Paying Prebate	-9.38
Total	-346.52



Effects on Charitable Giving

- BHI estimates that charitable contributions would increase by \$2.06 billion (0.89%) in 2007 and by \$18.87 billion (2.99%) in 2026.
- Elimination of tax deduction causes the price of giving to rise and contributions to fall.
- But because the FairTax exerts a positive effect on income, contributions would rise, on balance.



Effects on State & Local Government

- The FairTax does not impose a new tax burden on state & local government .
- But state & local government must adjust tax rates in order to avoid a real transfer to households.
- E.g., impose the state sales tax on the (federal) tax-inclusive price of goods.



Enforcement Problems

- The existing tax code already gives rise to huge gap.
 - In 2005, the IRS estimated the gap to be \$290 billion in 2001.*
 - Our estimate for 2008 is \$418 billion.
- The economy and the tax base would ultimately expand by an estimated 6%. That would *reduce* the required rate.
- Perhaps not a big problem, anyway:
 - Brent Moulton, Director of NIPA: “1.3%-2.0% of PCE represents adjustments for economic activities not reported to IRS.”
 - If 2% of PCE escapes the FairTax, the revised tax-inclusive rate is 24.30% (32.10 %, tax-exclusive basis).

*See [http://www.irs.gov/pub/newsroom/tax_gap_report - final version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf).



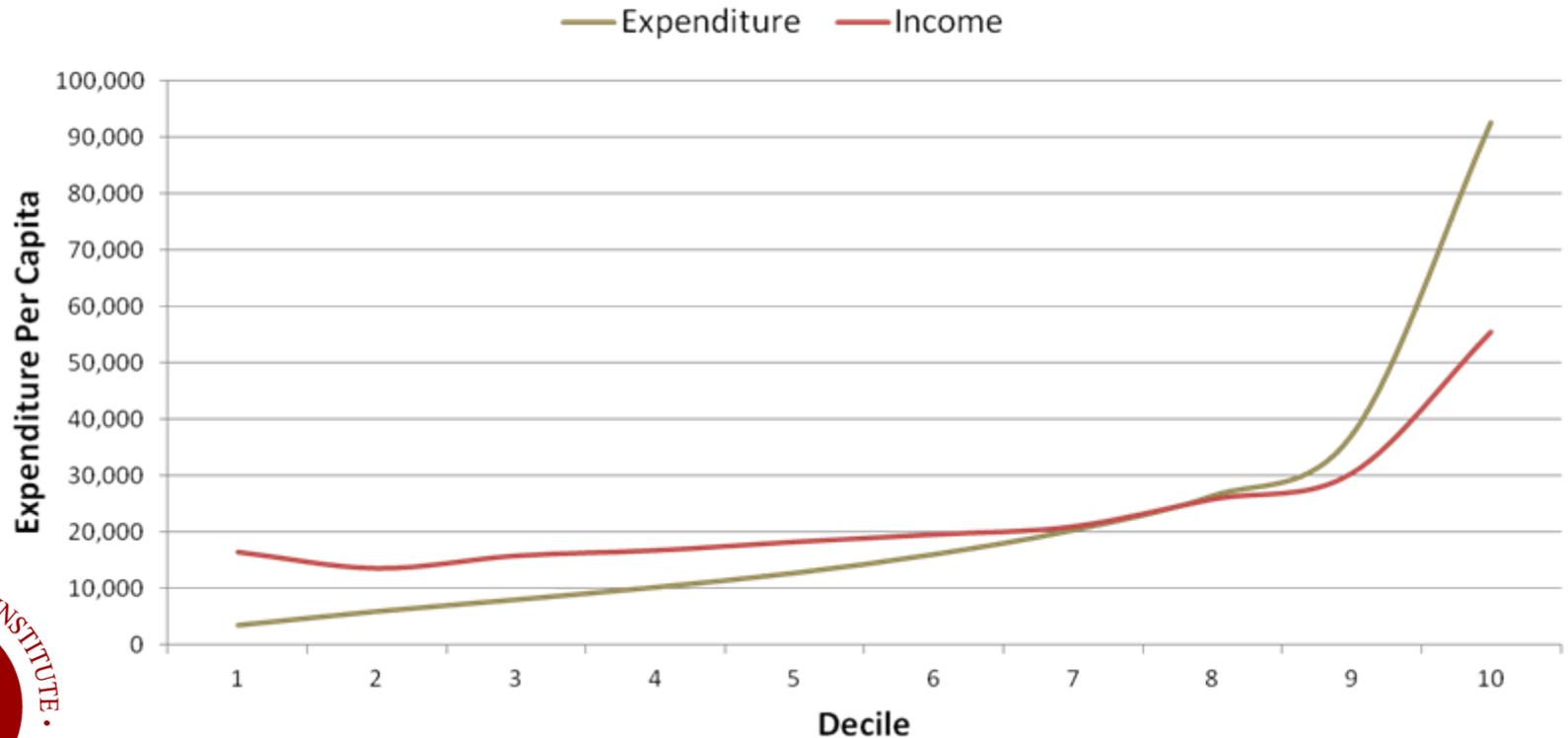
Distributional Effects I

- Standard approach is to group individuals by income.
- A better approach is to group individuals by expenditure.
- Reminds us that taxes on consumption are less volatile than taxes on income.
- This is because spending per capita exceeds income per capita for people in low-income groups, vice versa for high-income groups.
 - Low-income groups borrow (when young) and burn up assets (when old); high-income groups save (when middle aged).
 - Thus spending remains relative constant across income (and age) groups.



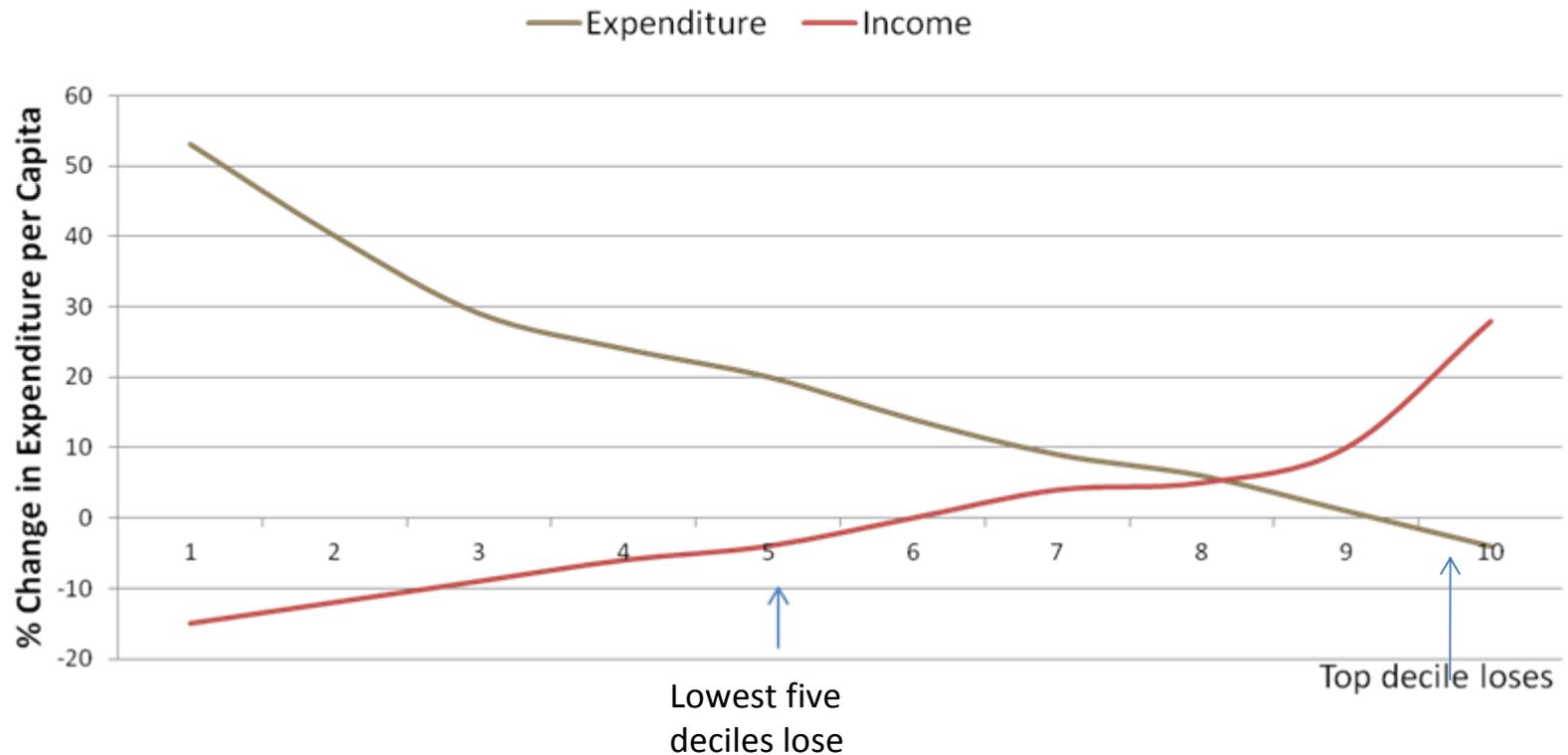
Distributional Effects II:

Comparative Expenditures Per Capita:
Individuals Ranked by Expenditure and by Income



Distributional Effects III

Changes in Expenditure per Capita under FairTax:
Individuals Ranked by Expenditure and by Income



Distributional Effects IV

- If we group taxpayers by income per capita, the bottom five deciles lose under the FairTax.
- But if we group taxpayers by expenditure per capita, only the top decile loses under the FairTax.



Facts and Fallacies I

- The FairTax rate:
 - Fallacy: The FairTax would require a tax-exclusive rate of 34% to 100% (JCT, Bruce Bartlett, William Gale, President's Advisory Panel on Tax Reform).
 - Fact: A tax-exclusive rate of 30% (inclusive rate of 23%) is close to being spending neutral, when all effects are considered.
- Prices:
 - Fallacy: The FairTax inevitably leads to higher retail prices.
 - Fact: What happens to prices is a matter of Federal Reserve policy.



Facts and Fallacies II

- Administrative costs:
 - Fallacy: The FairTax will be costly to administer.
 - Fact: It reduces *overall* administrative costs.
- Charitable contributions:
 - Fallacy: They will fall.
 - Fact: They will rise.
- Enforcement:
 - Fallacy: Enforcement issues will require the inclusive-rate to be much higher than 23%.
 - Fact: Dynamic effects mean that the rate will ultimately be less than 23% (but enforcement remains an issue).



Facts and Fallacies III

- Burden on State and local government.
 - Fallacy: The FairTax “deceptively” forces state and local government to raise taxes.
 - Fact: State and local government would have to raise tax rates only to avoid a transfer to taxpayers (but administrative costs remain an issue).
- Distribution/equity
 - Fallacy: The FairTax is regressive.
 - Fact: It is moderately progressive.



In Conclusion

- By untaxing net investment, the FairTax expands economic growth and living standards.
- The FairTax
 - vastly simplifies tax compliance,
 - is moderately progressive
 - imposes fiscal discipline *but*
 - give more thought to enforcement and to administrative costs.



For Further Information

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