



December 1, 2003

**Ross Korves, Senior Economist
Economic Analysis Team
American Farm Bureau Federation**

An Economic View of the FairTax Proposal

The FairTax is a national retail sales tax on final consumption of products and services and would replace the individual income tax, the corporate income tax, estate and gift taxes, the Social Security tax and the Medicare tax. It does not replace current federal excise taxes. The plan has been designed so it will be revenue neutral; it will produce the same total dollar amount of taxes as the present tax system. The plan includes repeal of the 16th amendment that provides for the federal income tax.

This plan is such a sharp departure from the existing federal tax structure that it has raised hundreds of questions about the feasibility of the tax, its economic impact and shifts in who pays taxes. This analysis cannot address all the issues. It will focus on general economic impacts of the tax proposal and some specific issues of interest to farmers and ranchers. The proponents of the plan have excellent information about the plan on their website www.fairtax.org.

Economic Growth

The FairTax is promoted as a tax plan that will lead to stronger economic growth for the U.S. economy than under existing tax policy. That is definitely true. The elimination of taxes on business income (some of which is taxed two or three times) will definitely lead to stronger economic growth. It will also encourage investors from other countries to increase investments in this country. Economists can argue about the magnitude of the increase in economic growth, but there is little dispute that the economy would grow faster.

The FairTax is not the only tax reform plan that would produce stronger economic growth. President Bush's plan to completely eliminate the double taxation of dividend income would produce stronger economic growth. Eliminating the corporate income tax completely without changing other portions of the federal tax system would also give a strong boost to the economy. Eliminating estate taxes could be done under the current tax system. Other major tax reform plans that are consumption-based income tax systems, such as the inflow-outflow tax system, would not tax savings and investments and would result in stronger economic growth.

Stronger economic growth is a good reason to support the FairTax, but there are many other approaches to partial or complete tax reform that would also produce much stronger economic growth than the current tax system.

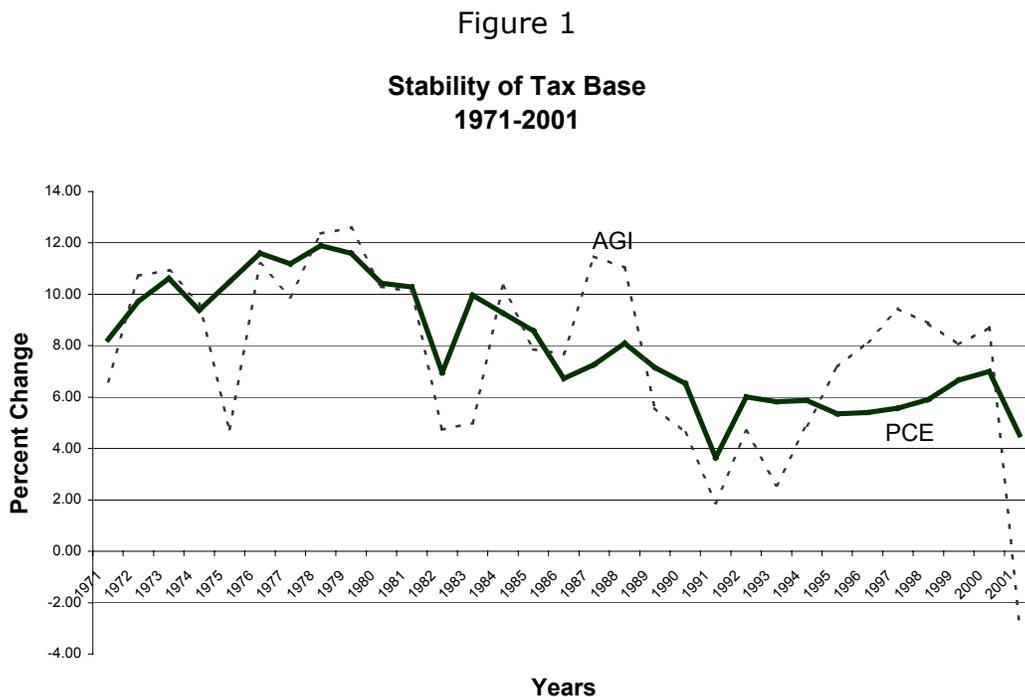
Stability of Revenue Under the FairTax

The slow growth in tax revenue to the federal government over the past two years has raised the issue of the stability of revenue under any tax system. Income tax revenues are, obviously, greatly influenced by the incomes of individuals and businesses.

Most of the current state sales taxes were enacted during the Great Depression of the 1930s. Incomes were down sharply and property owners often could not pay yearly property taxes. While sales were down, they were down less than incomes. A small tax rate on a large sales tax base was deemed to be the best option available.

Without a national sales tax in place, a direct comparison to the present federal income tax base cannot be made. A reasonable proxy, personal consumption expenditures (PCE) as calculated by the Bureau of Economic Analysis in the Department of Commerce, can be used. (See the last section of this analysis for an example of how personal consumption expenditures are the starting point for estimating the tax base under the FairTax.)

Figure 1 shows the yearly changes in the tax base, adjusted gross income (AGI), under the current tax system for 1971-2001 and changes in personal consumption expenditures of the same time period.



The PCE shows less yearly variation than the AGI, but they both follow the same general trends. While the PCE did not suffer the drastic decline that occurred in the AGI in 2001, it also did not have the high growth rates that occurred in the AGI in the late 1990s. Since the issue is stability, it would be reasonable to say that the PCE is a more stable base for taxation than the AGI.

Decline of Prices with the FairTax

The FairTax proponents have stated that the prices of goods and services would decline by about 25 percent with the implementation of their plan. That would be offset by the sales tax that would be added when purchases are made.

Consumers of goods and services pay all of the current taxes imposed on productive activity in the economy. The retail price of a bar of soap has embedded in it all of the property taxes, payroll taxes, income taxes and excise taxes paid by the manufacturing company, the wholesale company and the retail company. The same is true for the taxes paid by a dentist and all of his or her suppliers that are involved in filling a tooth. Studies from Harvard University estimate that about 22 percent of the prices of goods are taxes and 26 percent of the prices of services are taxes.

Competition will force companies to lower prices by the full amount of the reduction in embedded taxes. Consumers will be able to make a direct comparison between the old prices with embedded taxes and the new prices plus the retail sales tax.

Interest Rates

Proponents of the FairTax have argued that interest rates will decline by roughly 25 percent under the FairTax. There are sound economic reasons to believe a 25 percent reduction is a reasonable expectation.

There are three explanations for why this is likely to occur. Not taxing savings and investments while taxing consumption will lead to more savings. The U.S. economy will be much more attractive to foreign investors for direct investment in plants and equipment and for lending money to others for investing. The supply of savings will increase relative to the demand for savings, and this will drive interest rates down.

The second explanation involves the components of an interest rate. An interest rate is composed of three factors: the real return to the saver, the inflation premium and the cost of taxes. Savers want a real return after inflation and taxes. A normal real return is considered to be about 1-2 percent. Since current interest rates are extremely low, assume that the real return goal is 1 percent. Inflation is also relatively low, so assume a two percent inflation premium. To have a 1 percent real return, the saver needs a three percent return after taxes. Most savers are in at least the 25 percent tax bracket. With a 25 percent tax rate, a saver needs to have a four percent interest rate before taxes to have three percent left after taxes. Note that income taxes are paid on both the real return and on the inflation premium. Without the income tax, interest rates would be 25 percent lower than with the income tax, but the real return to savers would be the same.

Of course, borrowers usually do not borrow directly from savers. Financial intermediaries, such as banks, mortgage companies and credit unions, provide services to borrowers. Those institutions would also have lower costs because they would not have to pay payroll taxes and income taxes.

The third explanation is the comparison of interest rates for federal government taxable bonds to interest rates for municipal bonds that are exempt from federal income taxes. Interest rates on high quality municipal bonds generally carry rates that are about 25 percent lower than the rates on federal treasury bonds of similar maturity. In mid-November 2003, AAA rated municipal bonds five years from maturity had an effective interest rate of 2.4 percent compared to similar Treasury bonds with an effective interest rate of 3.4 percent.

Tax Rebate

To avoid increasing taxes on low-income people, the FairTax would provide a monthly rebate to all taxpayers based on the number of family members in the household. This rebate would go to rich and poor alike so the federal government would not need to know financial information about individual families to establish eligibility for the tax rebate.

While the federal government would not need financial information about individual taxpayers and families, they would need to know the number of people in each family and the Social Security number of each family member. Those families who did not wish to provide this information to the federal government would likely not receive the correct monthly rebate check. A similar issue came up a few years ago when the IRS started requiring Social Security numbers for dependents listed on individual federal income tax returns.

For millionaires, foregoing the rebate check to maintain family confidentiality would not mean much. For a low-income family it would make a huge difference.

Inclusive Tax Rate and Exclusive Tax Rate

The current income rates of 10-35 percent are inclusive tax rates. This means that the tax is included in the base income. If a taxpayer has \$100 of income that is subject to the 25 percent income tax rate, the taxpayer sends \$25 to the federal government and keeps \$75 to spend or save. The tax is included in the tax base.

A sales tax is calculated on a tax exclusive basis. A purchase is made and the tax is then calculated as a percentage of the purchase price. Using the same \$100 of income from the above example to purchase food, the entire \$100 is available because there is no income tax. But the consumer only has \$100 in total to spend on goods and taxes, not \$125. To get the same \$25 in federal government tax revenue, the consumer can only spend \$75 on food because the sales tax needs to be 33 percent of the purchase price to produce the same \$25 in tax revenue ($0.33 \times \75).

The FairTax proponents have stated that a 23 percent national sales tax is needed to produce the same revenue as the existing income and payroll taxes. That is

stated on a tax inclusive basis so that an easy comparison can be made to the tax rates under the current tax system. The tax exclusive rate, the rate that will actually be used at the checkout counter at the grocery store, will be 30 percent.

The math is straight forward: $0.23 \times \$100 = \23 and $0.30 \times \$77 = \23

A 23 percent tax inclusive rate (income tax) is the same as a 30 percent tax exclusive rate (sales tax).

Coordination of Collection of State and Federal Sales Tax

Under the FairTax, state governments would be allowed to collect the national sales tax and remit that money to the federal government. They would receive a payment equal to 0.25 percent of the national sales tax collected. State governments would not be required to adopt the same sales tax base for state and local sales taxes as the FairTax.

Sales taxes are now collected by 45 states. Five state governments rely on the sales tax for over 50 percent of their state tax revenues. State sales taxes range from 2.9 percent to 7.0 percent. Food is exempt from state sales taxes in 29 states. Three states tax food at a lower rate, and four states have an income tax credit to offset sales taxes on food.

Most state sales taxes do not cover services. No state sales tax has as broad a tax base as the FairTax and many of them tax some items that are used in further productions. Many state Farm Bureaus have worked hard to get all, or almost all, agricultural production items excluded from state sales taxes.

Differentiating Between Business Expenses and Personal Consumption

The FairTax would apply only to items consumed by individuals. Items used for further production in a business would not be taxed. With a 30 percent national sales tax and, for example, a 5 percent combined state and local sales tax, the total sales tax could be 35 percent.

Many items are used in both further production and for final consumption. Consider a fan belt purchased at a local auto parts store for a truck or SUV engine. If that fan belt were used on a farm truck, it would be tax exempt. If a grocery store worker purchased the fan belt for use on a personal vehicle, it would be taxable. A farmer may have a farm truck and a car that use the same fan belt. One is taxable and one is not.

A 35 percent tax rate may be high enough to cause tax evasion by claiming a tax-exempt use when it is for final consumption. Some auditing procedures would likely be needed to ensure an acceptable level of compliance. That will be a compliance cost that generally is not discussed by supporters of the FairTax.

Farmers and ranchers as sellers of products may face some of those compliance procedures. A corn, soybean and cotton producer may easily argue that he or she is not likely to have sold any products for final consumption. The same is not likely

to be true for producers of fruits and vegetables or for livestock producers who produce just a few animals.

Compliance with tax laws is always an issue. The need to differentiate uses of common items and the tax rate will make it an issue for the FairTax.

Taxing Government Purchases of Goods and Services

One of the more innovative and confusing concepts of the FairTax is that governments would pay the federal sales tax when goods and services are purchased. Keep in mind that governments now pay taxes when they purchase goods and services. A gallon of diesel fuel used by a state highway truck removing snow has all of the federal income and payroll taxes built into the price, just as is true for a farmer buying the same diesel fuel. The same is true for a state government contract for computer consulting services. Based on work at Harvard University, 22-26 percent of the prices of goods and services are accounted for by taxes.

With the removal of federal income and payroll taxes, prices of goods and services purchased by state governments will decline by between 22 percent and 26 percent. These items would then be taxed under the FairTax plan. The reduction in prices for goods and services will be roughly equal to the new taxes paid, thus leaving state and local governments outlays relatively unaffected by the change in tax structure.

Reporting Social Security and Medicare Wages

Under the FairTax, employers would no longer be required to calculate Social Security and Medicare taxes for employees, withhold the employee portion from wages and then send the employee and employer taxes to the federal government. They would have to continue to report wages earned so that future Social Security and Medicare benefits can be calculated.

The FairTax plan does not change the Social Security and Medicare programs; it only eliminates the separate taxes for the programs. Employers will still need to know the Social Security numbers of employees and report wages to the federal government so employees can be credited for those wages.

Reforms of Social Security and Medicare

Countless studies have been done that show that the current Social Security and Medicare programs cannot survive at the current tax rates as the number of recipients increases in relation to the number of workers paying taxes into the programs. Proponents of reforms, including Farm Bureau, have used the future funding deficits as one argument in favor of reforms of the programs. These reforms include carving out some of the money paid in Social Security taxes to establish private individual accounts as a way to lessen the potential for future tax increases to fund the program. If Social Security and Medicare were funded out of general revenue from the sales tax, this leverage for reform would likely be reduced.

Even proponents of keeping the existing Social Security and Medicare programs may be uncomfortable with the shift to funding these programs out of general revenue. Under current law, these programs are credited for the dedicated taxes for Social Security and Medicare programs (the taxes actually go to the general account of the federal government, but that is a separate issue). With the loss of dedicated funds, these programs may be more subject to spending cuts when they have to compete for money with defense, education, agriculture and hundreds of other federal programs.

Taxing Health Care

About 14 percent of the economic activity of the country is associated with health care. A look at how the FairTax system would tax health care provides an opportunity to understand how changing the tax system could change the incentives in health care.

The current tax system favors employer provided health care plans by allowing employers to deduct health care premiums as a cost of doing business and not requiring employees to report this "fringe benefit" as taxable income. Under the FairTax plan there would be no federal income taxes or payroll taxes on employers or employees.

Health care products and services directly purchased by consumers would have the national sales tax calculated based on the purchase price, just as other goods and services would be taxed. Health care plan premiums would also be taxed, whether purchased by an employer or by an individual. Health care products and services received by an individual and paid for by a health care plan would not be taxed, because the tax would have already been paid on the plan premium. As noted several other times in the analysis, health care prices would be lower because the income taxes and social insurance taxes embedded in the current prices would no longer exist.

This change in the tax structure could provide an incentive for employers to choose to no longer provide health care plans.

Calculating the FairTax Base

The FairTax would be applied to all new consumer goods and services at the final point of consumption. Used items would not be taxed. New homes would be taxed (keep in mind that the building costs would be roughly 25 percent lower because the embedded costs of the current tax code would be removed). Education expenses would be treated as an investment and not be part of the tax base, just as business investments and savings by individuals would not be part of the tax base. Government purchases of goods and services would be part of the tax base.

The National Income and Product Accounts (NIPA) developed by the Bureau of Economic Analysis of the U.S. Department of Commerce provide much of the data needed to estimate the size of the tax base under the FairTax and the tax rate needed to replace current tax revenues. While these are estimates based on assumptions about how the tax would be applied, they provide a good indicator of

the tax rate needed to generate the same amount of revenue as the existing taxes. NIPA data for this analysis are for the calendar year 2001. These will be compared to federal tax receipts for fiscal year 2001, October 1, 2000 to September 30, 2001.

The starting point is total personal consumption expenditures of \$6.987 trillion. These include \$853.9 billion for durable goods (cars, furniture, etc.), \$2,041.3 billion for nondurable goods (food, clothing, gasoline, etc.) and \$4,109.9 billion for services (household operations, transportation, medical care, recreation, etc.). The size of the services category explains why the sales tax has to apply to more than just goods.

Some items need to be removed from the NIPA personal consumption expenditures. Included in the accounts are estimates of the rental value of owner occupied farm and non-farm dwellings that total \$759 billion. The rental equivalent is removed from the personal consumption expenditures for calculating the revenue raised by the FairTax because owner-occupied housing will be taxed when constructed.

The value of single-family homes built in 2001 was \$232.1 billion. New manufactured homes were valued at \$8.8 billion. Another \$104.6 billion was spent on home improvements. These three items total \$345.5 billion and would all be taxed.

Education expenses are removed from the FairTax base. The NIPA accounts show private expenditures on higher education at \$87.6 billion. Spending on nursery, elementary and secondary schools (but not day care) was estimated at \$35.5 billion for 2001. These two items total \$123.1 billion and would be subtracted from the tax base.

As noted earlier, federal and state government purchases would be taxed so that governments would not have a tax advantage over private activities. Keep in mind that government purchases are now taxed because the current income and payroll taxes are embedded in all government purchases. They are taxed in both systems; it is only more obvious under the FairTax.

Federal government consumption expenditures are estimated at \$528.5 billion for 2001. Gross investments in structures and equipment by the federal government were an additional \$99.7 billion. State and local government consumption expenditures are estimated at \$993.7 billion for 2001. An additional \$236.2 billion was spent on structures and equipment. These expenditures together total \$1,858.1 trillion. About \$350 billion of these expenditures were for education and would not be taxed under the FairTax.

State and local general sales taxes would not be part of the tax base. This avoids having taxes paid on taxes paid to other units of government. In 2001 these were estimated at \$224.2 billion.

Several other adjustments would be made in the tax base to account for foreign travel by U.S. citizens, spending in the U.S. by visitors from other countries, taxing financial intermediation services and other activities. For 2001 all of these combined would add about \$170 billion to the FairTax base.

Netting out all of these additions and subtractions results in a FairTax base of \$7,904.3 billion for calendar year 2001. One additional item would be removed from the tax base. As outlined earlier, each household would receive a monthly sales tax rebate so that no taxes would be paid on purchases made with income below the federal government set poverty rate. That would reduce the tax base by an estimated \$1,675.0 billion. The revised tax base would be \$6,229.3 billion.

Total federal personal and corporate income taxes, social insurance taxes and estate taxes in fiscal year 2001 were \$1,867.8 billion. The tax rate on a tax exclusive basis (sales tax) would be 30.0 percent. On a tax inclusive basis (income tax) would be 23.1 percent.

The fact that the tax rates came out at 23 percent and 30 percent (the same rate as suggested by the FairTax supporters) is purely a coincidence. The percentages could have been higher or lower depending on the year chosen or the assumptions used for the adjustments to personal consumption expenditures. Also, we do not know for certain how consumers will adjust to the transition from the current tax system to the FairTax. What can be said is that the 23 percent on a tax inclusive basis and 30 percent on a tax exclusive basis are reasonable rates for public policy discussion purposes.