A FairTax^sm White Paper

The FairTax: What's in it for the states?

In a nutshell, states have the opportunity to address negative aspects of their current tax systems and create a more stable revenue stream that keeps pace with economic growth, and in so doing, foster enhanced economic growth and solid job creation. Sound too good to be true? Let's take a look at the facts.

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) 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 are the initial FairTax statutory effects on the states?

Those 45 states with sales taxes have the option of collecting the FairTax. States without sales taxes have the option of initiating such an agency, contracting with another state to provide such services, or contracting with the federal government. The 38 states with state income taxes that use the federal 1040 as a starting point will have to amend their tax codes.

What's in it for the states?

- State economies benefit from the increase in national economic growth (7 to 14 percent in the first year) as a result of replacing the federal income and payroll tax systems with the FairTax. Job creation is widespread, deep, and long lasting.
- Many research studies have documented the negative impact of state income taxes on state economic growth, and that sales taxes are more pro-growth than income taxes. In general, states with no or low income taxes have higher rates of economic growth than states with high income taxes.
- States are given the option to administer the FairTax on behalf of the federal government. If they do so, they keep one-quarter of one percent of the federal sales taxes that they collect to defray collection costs. Since 45 states can combine the collection of the FairTax with their

existing state sales taxes, this creates economic efficiencies – even more so if they opt to conform to the FairTax base: All new goods and services sold at retail to the final end user.

- The FairTax also gives businesses one-quarter of one percent of what they collect as a collection allowance. And if states conform to the FairTax base, business compliance costs are minimized, reducing pressure on pricing, salaries, and/or profits.
- A number of research studies have pointed out the shortcomings of current state sales taxes (riddled with exemptions) from an equity and efficiency point of view.
- Under the FairTax, state sales tax revenues grow in proportion to the economy as retail services are taxed along with new retail goods.
    1) Tax neutrality requires that there be no discrimination between the taxation of goods and the taxation of services. However, most states tax few services, exempting all professional services such as legal, health care, accounting, engineering, and personal services. This results in only about 38 percent of consumption being taxed under the current system of state sales taxes. Smaller bases require higher rates; higher rates increase noncompliance.[1]
    2) State sales tax revenues often lag economic growth because goods are becoming a smaller percentage of the economy, or conversely, services (which are not taxed) are becoming a bigger share of the economy. Today, services account for 59.4 percent of national personal consumption expenditures. Fifty years ago, services only accounted for 32.9 percent of personal consumption.
    3) State sales taxes tax intermediate purchases by businesses that result in considerable tax cascading or pyramiding of sales taxes in the price of goods sold to consumers. Studies estimate sales taxes paid by businesses to be about 40 percent of sales tax collections on average. That represents a substantial amount of state taxes hidden in the price of consumer goods.[2]
    4) State sales taxes are replete with exemptions in an attempt to reduce the cost of necessities and/or to placate special interests. Such exemptions for necessities invariably provide high-spending/high-income taxpayers with a disproportionate (some may say undeserved) benefit. All such exemptions result in higher rates on taxed items (punishing low-, fixed-, and middle-income consumers), greater complexity, and compliance cost increases for retail businesses that collect the tax on behalf of the state government.
    5) There is considerable variation in tax base definition from state to state that creates significant compliance costs for businesses with multi-state operations. This led the National Conference of State Legislatures (NCSL) and others to establish the Streamlined Sales Tax Project (SSTP) in order to get agreement among states on

[1] Cline, Robert J., John L. Mikesell, Thomas S. Neubig, and Andrew Phillips, "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," *State Tax Notes*, Vol. 35, No. 7, February 14, 2005, pp. 457-470.

[2] Cline, Robert J., William F. Fox, Thomas S. Neubig, and Andrew Phillips, "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in Fiscal 2003," *State Tax Notes*, Vol. 31, No. 9, March 1, 2004.

uniform rules for assigning transactions to jurisdictions, common definitions, state-level administration of all state/local sales taxes, and certification of software that sellers may to use to determine tax due; and to get a system that would apply both to "brick-and-mortar" and online vendors. Forty states have signed the agreement. Of those, 21 states, constituting over 35 percent of the U.S. population, have enacted implementing legislation conforming their state sales tax laws to the SSTP (as of Feb. 21, 2005). The project is now governed by the 21 Streamlined Sales Tax Implementing States (SSTIS). This body is the ideal group to represent the states in regard to information sharing and facilitating the taxation of online sales under Sec. 402 of the FairTax.

6) Although state sales and use taxes are owed on all online transactions, states are prohibited from requiring remote sellers to collect and remit those levies. A 1992 U.S. Supreme Court decision (*Quill Corporation v. North Dakota, 112 S.CT. 1904*) said states can only require sellers that have a physical presence or nexus in the same state as the consumer to collect so-called use taxes. When a seller does not have nexus, consumers are required to calculate and remit the taxes owed to their home states at the end of the year; however, most people are unaware of this and states lack an effective enforcement mechanism. Online and catalog sellers, thereby, have a significant price advantage over Main Street (tax-paying, community-based) businesses and other traditional retailers that must collect a sales tax on all transactions. Along with the faster growth of services compared to goods, this further contributes to the erosion of state sales tax bases.

- Conforming the state sales tax base to the FairTax base addresses these problems.
    1) The FairTax base is the retail sale to final end users of all new goods and services, leveling the playing field between service-providing businesses and goods-producing businesses and between Main Street retailers and online vendors; thereby eliminating the economic distortion caused by differential treatment.
    2) State sales tax bases, and therefore revenues, can also be expected to be more elastic under the FairTax base. The total sales tax base for all states has grown much more slowly than the economy, as the base has fallen from 43.8 to 33.1 percent of GDP between 1979 and 2003. The FairTax base, on the other hand, has risen faster than GDP, growing from 68.6 to 71.5 percent of GDP over the same time period.
    3) The FairTax is a final consumption tax. It does not tax any business purchases (intermediate consumption), thereby removing tax cascading or pyramiding and removing the tax-cost pressure on pricing, salaries, and/or profits.
    4) The states have the option to piggyback onto the FairTax prebate which makes the federal tax progressive, by prebating taxes on spending up to the poverty level monthly. For example, any family of four may spend up to $27,380 per year untaxed, made possible via a prebate of $525 per month. A state prebate is calculated by multiplying the state FairTax rate times poverty level spending (Each year, the Department of Health and Human Services estimates the poverty level spending for households by household size. This basket of basic expenses provides the basis for

the amount of spending that is tax free under the FairTax – the prebate pays for the taxes on this amount of spending.).

5) The FairTax legislation allows states that conform their sales tax base to the FairTax base to tax Internet and mail order sales to purchasers resident in their states. Internet sales are expected to experience huge growth in the future. According to Bruce and Fox, the revenue losses to states from electronic commerce will be between $21.5 billion and $33.7 billion for 2008.[3]
6) Including such sales in state tax bases greatly improves the ability of state tax revenues to keep pace with economic growth.
7) On average, state sales tax bases are doubled by adopting the FairTax base. This significant base broadening gives states the option to roll back state sales tax rates or use the revenue gain to reform their state tax systems. If states choose to conform their state sales tax base to the FairTax base, they can use the revenue gain to replace their state income taxes and/or property taxes, and, in many cases, have a sales tax rate no higher than the one they have today.

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.

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(AFFT Documents\Papers on a specific subject\The FairTax-Whats in it for the states)

[3] Bruce, Donald and William F. Fox, "State and Local Tax Revenue Losses from E-Commerce: Estimates as of July 2004," *State Tax Notes*, Vol. 33, No. 7, August 16, 2004.