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THE FAIR TAX AND ITS EFFECT ON GEORGIA

Recent federal legislation, H.R. 25 and S. 25, calls for a national retail sales tax.[1] This tax is intended to replace the existing federal individual and corporate income taxes, the payroll tax which is used to fund the Social Security trust fund, and the estate and gift tax. One of the goals of the national sales tax is to reduce the compliance burden associated with the existing federal income tax system. The current version of the proposed national retail sales tax is called the Fair Tax Act of 2005 (henceforth referred to as the Fair Tax).

The purpose of this brief is to outline the provisions of the Fair Tax and its implications for the citizens of Georgia and the Georgia state government. It is important to understand that in theory the Fair Tax, like most tax reform proposals, is designed as a revenue neutral tax reform effort, meaning that the overall amount of tax paid by individuals under the Fair Tax system would be no more or less than that paid under the current system. What will be dramatically different is who pays the tax and how the tax is administered.

There are at least three important economic and policy implications of a national retail sales tax. First, broad-based sales taxes (as opposed to direct taxes on wages, interest, and dividends) tend to be "economically efficient." This means that these types of taxes have a smaller impact on decisions like saving and working than our current system of income and payroll taxes. Secondly, although total revenue collected is not designed to change with the implementation of the Fair Tax, the distribution of the tax burden will likely change. New winners and losers will be created under a new tax system as the tax burden shifts among groups of consumers. The timing of tax payments may also change. Third, a new tax such as the Fair Tax necessitates a new form of tax administration and transition rules to move from the existing tax system to a new tax.

Any tax reform debate should consider the efficiency, equity and administration costs and benefits. In this policy brief, we provide an overview of the implications of the Fair Tax.

Description of the Fair Tax

As currently drafted, the Fair Tax eliminates the current tax on incomes of individuals and corporations. It eliminates the current payroll tax on compensation used to finance the Social Security trust fund. It also eliminates taxes paid on estates and gifts. The proposed tax rate of the Fair Tax is 23 percent.

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This is the rate, estimated by the authors of the proposal, necessary to maintain the current level of federal government expenditures, i.e. the revenue neutral rate.

The 23 percent is a tax-inclusive rate; the tax-exclusive rate is 30 percent. "Tax inclusive rate" is the tax rate expressed as the ratio of taxes paid to the sum of the item's price and the tax paid. On the other hand, a tax-exclusive rate is expressed as the ratio of the taxes paid to the purchase price of the item without tax. Usually sales tax rates are expressed in their tax-exclusive form. For example, a 5 percent tax-exclusive rate means that for every $1 spent, the consumer pays 5 cents in tax. (5 percent = $0.05/$1.00) Expressing the same tax in a tax-inclusive form lowers the rate to 4.8 percent. (4.8 percent = $0.05/$1.05)

Items subject to the tax under the Fair Tax include all food, except that produced for personal consumption, all purchases of new tangible personal items such as clothing, computers, cars, and books. Purchases of new houses and rent, health care insurance premiums, and all medical services are subject to tax. In addition to new tangible purchases, all services including financial services are included in the tax base, many of which are not currently subject to state sales tax.

Taxing financial services such as checking accounts, safety deposit boxes, mortgage servicing, 401(k) account management, and loan management, is very difficult. The fee for these services is often reflected in lower (higher) interest rates paid to (by) the consumer in the case of depositors (borrowers). Under the Fair Tax, financial services of this nature are taxed on the difference between the interest rate paid to or by the consumer and the Federal interest rate. Used items, intangibles, and tuition expenses are exempt from the tax.[2] Tuition is viewed as an investment and is not subject to tax.

Businesses are not taxed on their business purchases under the Fair Tax. They will be able to register with the government and receive a letter of exemption. With this proof of exemption, their purchases are excluded from taxation. Purchases by non-profit organizations are not exempt from the sales tax but all contributions to non-profit organizations are exempt from the tax. Likewise, all final purchases of state and local governments are subject to tax, including the labor costs (wages and benefits) of employees.[3] The rationale is that all government purchases will eventually be consumed by the citizens and often in situations where there is no market transaction to capture the final consumption of these services. All government goods and services provided for an explicit fee, such as water and electricity or bus fares, are subject to tax in the same way as sales made by for-profit businesses.

Family Consumption Allowance

The Fair Tax proposal includes a "Family Consumption Allowance" (FCA). This is a monthly rebate check sent to all individuals or families regardless of income. The purpose of the rebate is to protect consumption below the poverty level from taxation, and is analogous to the personal exemption granted in the individual income tax.[4] The size of the rebate is equal to the sales tax rate times the federal poverty rate for that family size unit, adjusted to eliminate any penalty for marriage. For example, the poverty level for a family of 4 is $19,350 in 2005. To this amount is added $6,310, which represents the difference between twice the poverty level for a one person family and the poverty level for a two person family.[5] In this way, there is no economic penalty for marriage. The monthly Family Consumption Allowance is then computed as shown in Example 1.

EXAMPLE 1. CALCULATION OF THE MONTHLY FAMILY CONSUMPTION (FCA) ALLOWANCE

Official poverty level for a 4 person family in 2005 = $19,350
Annual Marriage Penalty Elimination Amount
= 2*$9,570 - $12,830 = $6,310
Monthly poverty level = ($19,350+$6,310)/12 = $2,138.33
Family Consumption Allowance = 0.23*$2,138.33 = $491.82

The Magnitude and Distribution of the FCA for Georgians

Using the most recent microdata file from the Census, we analyze the value of the FCA (annualized) by family size and also by family income decile. These distributions are presented in Tables 1 and 2. The average annualized FCA increases as the number of children in a household increases, as seen in column 5 of Table 1. If we look at the distribution by income (Table 2), we notice that while the average monthly rebate remains approximately constant over the income distribution (except at the lowest end), the rebate as a share of income decreases from almost 11 percent of total income for families in the first income decile to about 0.5 percent for the highest income families. The average annual rebate of approximately $5,000 is about 14 percent of average annual expenditures of consumer units in the South region of the U.S. in 1999 (total average expenditures reported by the U.S. Bureau of Labor Statistics was $35,000 for 1999). This varies greatly by income group. The total family consumption

TABLE 1: DISTRIBUTION OF FAMILY CONSUMPTION ALLOWANCE BY FAMILY SIZE FOR GEORGIA, 1999 LEVELS

# of Children	% Head of ------Households-----		Average HH Income	Average Monthly Rebate	Total Monthly Rebate	Total Annual Rebate
	Male	Female				
0	62.3	37.6	$51,102	$246.64	$404,886,813	$4,858,641,759
1	61.9	38.0	$60,786	$334.71	$209,622,750	$2,515,472,995
2	69.7	30.2	$67,007	$407.75	$199,943,829	$2,399,325,951
3	68.6	31.3	$62,965	$467.38	$85,086,472	$1,021,037,669
4	65.6	34.3	$56,089	$510.41	$24,688,626	$296,263,515
5	56.9	43.0	$55,144	$559.54	$7,609,167	$91,310,007
6	68.9	31.0	$74,099	$630.24	$2,125,784	$25,509,405
7+	58.1	41.8	$40,062	$685.21	$1,125,796	$13,509,555
Total					$935,089,238	$11,221,070,855

Source: Tabulations from the U.S. Census, PUMS, 2000.
Notes: Children are natural born sons/daughters, adopted sons/daughters and step sons/ daughters.

TABLE 2: DISTRIBUTION OF ANNUAL HOUSEHOLD CONSUMPTION ALLOWANCE BY HOUSEHOLD DECILES

Family Income Deciles	Average HH Income	Average Annual Rebate	Total Annual Rebate	Total HH Income	Rebate As a Share of Total Income
1	$32,234	$3,496	$7,752,587,341	$71,483,820,820	10.85
2	$97,298	$4,396	$2,898,044,700	$64,138,213,906	4.52
3	$185,695	$4,341	$296,846,967	$12,699,521,870	2.34
4	$303,437	$4,355	$155,122,026	$10,807,829,476	1.44
5	$367,232	$4,462	$80,049,920	$6,588,147,714	1.22
6	$462,583	$4,382	$26,478,153	$2,795,390,164	0.95
7	$567,850	$5,012	$6,475,255	$733,662,750	0.88
8	$636,584	$4,560	$3,656,858	$510,540,390	0.72
9	$729,251	$4,720	$1,203,710	$185,958,900	0.65
10	$923,593	$4,847	$605,927	$115,449,090	0.52
Total			$11,221,070,855	$170,058,535,080	6.60

Source: Tabulations from the U.S. Census, PUMS, 2000.

allowance in 1999 dollars is estimated to be about $11 billion for Georgians. This is nearly equivalent to twice the Georgia sales tax revenue for the same period, or equal to approximately 175 percent of Georgia personal income tax revenue.[6]

Effect of the Fair Tax on Business

The effect of the Fair Tax on business will be substantial. First, nonretail firms are relieved of their responsibility to file an annual return with the IRS.[7] They can register as sellers so that their purchases are exempt from the tax. Retail organizations do not have to file annual federal income tax returns but have to submit monthly sales tax reports. As compensation for the administrative burden of collecting and remitting the sales tax, every business filing a monthly report is eligible for an administrative fee equal to the greater of $200 or 0.25 percent of the remitted tax.[8] Based on Internal Revenue Service, Statistics of Income data of business tax returns and data from Georgia Department of Revenue, this reduces the number of tax filers from almost 800,000 income tax filers to 155,000 filers of monthly or quarterly sales tax returns. If states keep their current income tax systems, businesses will be required to maintain the necessary information for state corporate and individual income tax returns in addition to the sales tax return information.

While business purchases are intended to be exempt from the tax, experience with the state sales tax shows that this is easier said than done. Two studies by Ring (1989, 1999) find that as much as 40 percent of state sales tax is paid by businesses on their inputs (on average). This taxation of business inputs creates a cascading effect where tax is layered on tax at the various stages of production and leads to increased costs of production and final consumer prices. Of course, states do not explicitly exempt all business purchases.

There is the potential for an increase in investment and employment in the state due to the switch to the Fair Tax. It is believed that at least some of the existing federal income tax is borne by owners of capital, some by labor in the form of reduced wages, and some by consumers in the form of increased consumer prices. It is widely accepted that much of a national retail sales tax would be borne by consumers, largely in the form of higher final prices. In this way, moving to a sales tax could result in increasing the return on capital and labor, and may result in an increase in investment and employment throughout the country. These are known as efficiency effects—reducing the tax burden on capital and labor should reduce the impacts of the tax system on the use of capital versus labor and on overall investment. By reducing taxes paid, businesses would have more funds to invest in their business which could lead to an increase in employment and investment nationally. This effect is expected to be relatively small because existing federal taxes are a small component of a firm's cost structure.[9] In addition, some of the existing business taxes are already believed to be borne by consumers and labor.

Some industries will see more of an effect than others under the Fair Tax system. Under the Fair Tax, all financial services are taxed. Most of these services are currently untaxed by state sales taxes. The Fair Tax taxes all financial services that are sold for an explicit fee and also imposes a tax on the implicit management fees of 401(k) plans, IRAs, and other savings and pension plans. The Fair Tax also taxes all insurance premiums. A refund for taxes paid would be available to the taxpayer for reimbursements made by the insurance company to the policy holder.

Effect on Individuals

Under a Fair Tax system, individuals are relieved of their responsibility to file a federal income tax return. This simplicity of the system is one of the major goals of the Fair Tax. In 2004, Georgians filed 4.3 million individual federal returns. Under the Fair Tax, this number falls to zero. If Georgia continues to impose its own state income tax though, Georgians would have to continue to file state income taxes and maintain the same records they do currently to comply with the state income tax.

Compared to the existing federal tax system, consumers bear a larger direct share of the cost of government under the Fair Tax. This is because all revenues currently raised by taxing businesses and gains from investments would now be raised from the taxation of consumption. Therefore, under a Fair Tax system most of the cost of the federal government is borne directly by consumers versus the current situation where consumers, labor and owners of capital are believed to share, though not equally, the burden of the tax system. Under the Fair Tax system, businesses (and therefore the individuals that own businesses directly or through stock) directly bear some burden of the tax in terms of lower profits as consumers shift from consumption to savings, but the burden may eventually be shifted to labor or consumers. Because consumption constitutes a larger portion of income for low-income individuals than high-income individuals, this tax will place a relatively greater burden on low-income

individuals than high-income individuals. At the same time, the Fair Tax will eliminate programs such as the Earned Income Tax Credit (EITC) and the Dependant Care credit, designed to provide extra support to low and lower middle income individuals. It will also eliminate payroll taxes, which impose a heavier burden for low-income households. Households out of the tax net (by working outside of the formal sector) will see an increase in tax payment via a sales tax, which may be more difficult for informal workers to evade. The net impact on the distribution of the tax burden is not obvious.

Effect on Governments

Under the Fair Tax, federal, state, and local governments are subject to the tax on all their final purchases of tangible property and services including labor. Independent government entities such as transportation authorities or municipal energy providers are treated for purposes of the tax as if they are a for-profit business. That is, the tax is added to the consumer's bill at the time of consumption. Therefore, under the Fair Tax, the cost of state and local government increases unless the input costs are reduced commensurate with the sales tax increase. State and local government expenditures in 2000 in Georgia were $38 billion.[10] If half of these expenditures were for delivery of final services (the other half being purchases of inputs), taxing these expenditures at a 30 percent tax-exclusive rate results in an upper bound payment of $5.7 billion in sales tax from the state and localities to the federal government. If the level of public services of the state and local government is to remain the same after the implementation of the Fair Tax, state and local tax revenues would have to increase by that amount to support the sale tax paid to the federal government. If input costs fell as a result of the impacts of the Fair Tax, state and local governments could see a reduction in the "price" of their services. Such cost savings would most likely not offset the sales tax increase in the short run.

The loss of federal deductibility of state and local taxes serves to further increase the relative price of state and local services. Under current law, individuals receive an income tax deduction for state and local income taxes paid (as well as property taxes).[11] The federal deduction serves to reduce the cost of government services at the state and local level for those taxpayers who itemize their federal tax return. Eliminating this deduction increases the cost of government services even without including government purchases in the tax base. The same is also true for revenues from the taxation of business.[12] Proponents of the national sales tax argue that a deduction for state and local taxes paid and the taxation of businesses hide the true cost of government from the voting public and result in an overconsumption of government-provided goods and services. Sales taxes paid by consumers provide a more realistic picture of the true cost of government services.

Lastly is the issue of whether the state will keep its personal and corporate income tax when the federal income tax disappears. Currently, the state income tax is layered on top of the federal income tax system. That is, the state tax calculation begins with the definition of federal AGI or taxable income in the case of corporate returns. In the Fair Tax world, individuals and corporations do not file a federal return. Therefore, the state return becomes more complex because it must include a calculation of AGI or taxable income. This could lead to different definitions in different states. Furthermore, state and local governments rely on the Federal government to aid with auditing returns and to issue regulations concerning interpretation of tax law. Without a federal income tax system, income tax definitions among the states may become more diverse. This will add complexity and cost to the state tax system, even though the imposition of the Fair Tax may add simplicity to the federal system.

The states may, for the sake of simplicity and administrative ease, eliminate their current income tax systems and rely solely on revenue generated from a state sales tax. Some policymakers have expressed concern that costs of administration and consumer and business confusion may necessitate that states conform to the federal tax base. On the other hand, much variety currently exists between states and between the state and federal income tax systems and between state and local sales tax systems. Thus there is no reason to believe that, unless forced, the states sales tax systems would necessarily conform to that of the federal sales tax system.

Effect on Housing

While prices of all commodities are affected by the tax, new housing is arguably the consumption item that will witness the largest price effect at least in the short run—and it is arguably one of the most important consumption items in terms of supporting economic growth. Under the Fair Tax, new housing purchases are subject to tax but sales of existing housing stock are not. This treatment is similar to that found in value added tax systems. This discrimination between new and used

housing is a transition issue if the following scenario is considered. After implementation of a national retail sales tax, new house sales are subject to tax, which increases the after-tax price for new homes. On the other hand, no tax is levied on the sale of existing homes. Assuming a high degree of substitution between new and existing housing, this gap in gross sales prices causes the demand for existing housing to increase and that of new houses to decrease until the prices, net of taxes, equilibrate. Additionally, if the price of capital falls due to the alleviation of income tax burden, new home construction will become relatively cheaper.

The shift in demand in the short run towards existing homes creates a windfall for the owners of the existing housing stock at the time of the imposition of the Fair Tax. Because of the imposition of the tax on new housing, the value of existing housing stock rises and creates a benefit to the owners of the existing housing stock. The burden of the Fair Tax on new homes is shared by the purchasers of both new and existing housing and producers of new houses. Some tax revenue is lost as the tax is avoided by purchasers of existing housing. The windfall to the owners of existing housing is a one time occurrence that accrues only to the owner of the house at the time the tax is imposed and before the housing market has adjusted to the new tax and prices.

In addition to the transition problem discussed above, taxing the sale of housing at such high rates creates a liquidity issue. For example, at 30 percent the tax on the sale of a $250,000 home is $75,000. This tax is due upon the sale of the property. Such a large sum would most likely be rolled into the home owner's mortgage, significantly increasing the cost of the home not only due to the presence of the tax but also due to the cost of financing the tax.

Controversies of the Fair Tax

There are several well discussed problems associated with the Fair Tax and its administration. First is the use of the 23 percent tax-inclusive rate. As stated earlier, it is common practice to express sales taxes by their tax-exclusive rate. The corresponding tax-exclusive rate for the Fair Tax is 30 percent. But there is much research to support the need for a higher rate if the size of the existing government is expected to remain constant.[13] Work by Gale (2005) finds that the original tax-exclusive estimate of 30 percent was based on conflicting assumptions about the resulting after-tax price level in the economy. Correcting for this error, Gale estimates a 44 percent tax-exclusive rate is necessary to keep federal government spending at its current level.

Another assumption made in the estimation of the Fair Tax rate is that there is no reduction in the tax base either through tax avoidance by individuals or by tax evasion on the part of retailers. Because the rate is high and obvious to consumers, consumers have a large incentive to avoid the tax by purchasing used goods, purchasing goods on-line from overseas, or by purchasing personal items with a business exemption. This potential for tax evasion also exists in the case of the state sales tax. For large ticket items such as a new house or car, it would be straightforward for the seller and buyer to agree publicly on a lower price in order to reduce the tax payment and pay the difference outside of the public transaction. This type of evasion occurs now and will only increase with a larger sales tax rate in effect. Aside from physical audits, there exist no paper trails or cross checks to monitor the amount of tax collected by retailers. Many states have a poor audit history with sales taxes that have much lower rates than those contemplated here.[14] Higher rates will only increase the incentive to evade the tax.

In addition to the issues of avoidance and evasion, the proposed Fair Tax will tax all services and final purchases of state and local governments. Traditionally, most services, government and non-government, have been exempt from state sales taxes. In the past, services have been exempt because it is hard to place a value on the service, such as the service of loan or financial account management. Services are also exempted because society wants to encourage the consumption of a particular item such as health care, or because taxing such items is unfair. Under the Fair Tax, all services with the exception of education are subject to tax--including all medical services and all financial services. In addition to services, all final purchases of state and local governments are subject to tax including expenses for government employed labor. Government services represent consumption but without an explicit price in many cases. The tax base includes all government purchases in an effort to capture this consumption and reduce the incentive to increase the scope of government production. Imposing a federal tax on state and local government operations raises the cost of government by the tax-exclusive rate.[15] Gale (2005) estimates that a reduction in the proposed base by 20 percent due to taxpayer avoidance, tax evasion, and additional exemptions requires a revenue neutral tax-exclusive rate of 65 percent instead of 30 percent. Exempting state and local government

expenditures from the tax is estimated to raise the revenue neutral federal tax-exclusive rate to 82 percent.

Lastly, the Fair Tax proposal relies heavily on the experience of the states to administer the tax. While it is true that states have experience with sales taxes, not all states administer a sales tax and none levy such a broad based tax as the one envisioned by the authors of the Fair Tax. In addition, there is great variety among the states as to collection practices. Administration of a national tax must be done consistently by all states and all businesses in all states. Orchestrating such a large number of collectors and collection practices will be no straightforward task.

Conclusion

This short analysis brings to light several issues concerning the Fair Tax that should be addressed in public forums so that public officials may make informed decisions. For instance, we find that the Fair Tax will succeed in its goal of increased simplicity marginally unless the states follow suit and eliminate their state income taxes. Although the Fair Tax makes the federal system simpler, if states continue to levy their income taxes, filing and compliance costs are largely shifted from the federal government to the states. States are notoriously reticent to relinquish control over their fiscal environments and thus may not eliminate their income taxes. If they do, however, they may not levy the same broad based sales tax as that found in the Fair Tax. Having potentially 52 different sales tax bases will erode much of the simplicity that is the impetus behind the Fair Tax.

There may be some gains in employment and investment by businesses as they are relieved of their income tax liabilities. But these gains will probably come with a more regressive tax system. Lastly, we find that individuals will pay a higher price for both housing and government services, at least in the short run, under the Fair Tax system than they do today. While that is not either good or bad, it can have a substantial impact on the economy as individuals shift their consumption patterns in response to the tax. In shifting their consumption patterns, the balance of resources existing currently in the economy will change and that, as with any revenue neutral tax reform, is the portion of the debate on which to stay focused.

NOTES:

1. Similar proposals have been made in the past by Representative Tauzin (R-Louisiana) and by the Americans for Fair Taxation and several others.

2. Intangibles are defined in the legislation to include "copyrights, trademarks, patents, goodwill, financial instruments, securities, commercial paper, debts, notes and bonds, and other property deemed intangible at common law". See S. 25, sec. 2(6).

3. Note that this tax will not be borne by government workers once the labor markets have adjusted to the tax. The wages of nongovernmental workers are exempt from tax. If the wages of government workers are reduced due to the tax, then they will earn less than nongovernmental workers. It is likely that labor is mobile enough that over time governments will not be able to pass this cost onto labor and still attract a sufficient work force.

4. To completely protect this amount from taxation, the monthly consumption allowance should be computed using the tax-exclusive rate of 30 percent which represents the amount of tax paid by the consumers on consumption expenditures equal to the monthly poverty level. By using the tax-inclusive rate of 23 percent only 76 percent of the monthly poverty level expenditures are protected from taxation.

5. The poverty level in 2005 for a one person family is $9,570. The poverty level in 2005 for a two-person family is $12,830.

6. The total annual family consumption allowance is slightly different in the two tables due to rounding differences within the groupings that are used.

7. Employers will still have to track employee earnings for the Social Security Administration and Unemployment Insurance purposes.

8. The administrative compensation may not exceed 20 percent of the amount of tax remitted.

9. Based on SOI corporate data, taxes paid are 4 percent of cost of goods sold. Taxes paid include state and local sales taxes.

10. This represents the total direct, general expenditures for FY2000 minus wage and salary disbursements by state and local governments. See U.S. Statistical Abstract 2004-05, Table 433, p.276 and BEA Regional Economic Accounts for 2000.

11. Under current law only itemizers receive a deduction for taxes paid to state and local governments.

12. This does not imply that businesses should be completely exempt from tax but only that excessive taxation of businesses will mask the true cost of government to the individual.

13. The Joint Committee on Taxation found that a tax-exclusive rate of about 57 percent was needed for a revenue neutral provision of this type.

14. See Murray (1997).

15. This is in addition to the increase in the cost of state and local government which would occur because of the loss of the deduction for state and local taxes paid.

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