A FairTax[SM] rebuttal to a paper on the national sales tax by the Institute on Taxation and Economic Policy 2004[1]

Thorough economic analysis debunks the ITEP paper often quoted in campaigns when a national retail sales tax is mentioned. According to sophisticated research by Dr. Laurence Kotlikoff (http://people.bu.edu/kotlikof/), noted public finance economist of Boston University, the FairTax national retail sales tax at a rate of 23 percent significantly *reduces* marginal taxes on work and saving, substantially lowers overall average lifetime burdens on current and future workers at all income levels, and enhances overall progressivity.[2]

Background

Much quoted in campaigns where a national sales tax is mentioned is an unsigned "research" document published in 2004 by the Institute on Taxation and Economic Policy of Citizens for Tax Justice (CTJ). The FairTax (HR 25) is the sole legislation in Congress today bent on replacing all forms of federal income and payroll taxes with a national retail sales tax. Thus, it is only natural that FairTax.org is concerned that Americans know just what this legislation really says and does, contrasted with the concoction reviewed in the Institute on Taxation and Economic Policy (ITEP) paper.

The summary of recently completed research which follows provides compelling evidence to refute the "disinformation" propagated by the ITEP paper. Noted public finance economist Laurence Kotlikoff finds that the FairTax lowers marginal tax rates on work and saving, cuts remaining average lifetime tax rates[3] and enhances overall progressivity. This occurs because the reduction in these rates is proportionately much greater at the low end of the earnings distribution than at the high end. Consider a middle-aged couple with two children earning $20,000 per year compared to that same couple earning $500,000 per year. In switching to the FairTax, the low-income couple's rate is only 1.5 percent versus 11.0 percent under the current system. The high-income couple's rate is 20.5 percent versus 35.6 percent under the current system. The low-income couple gets an 86 percent cut in its average remaining lifetime tax rate, whereas the high-income couple gets a 42 percent cut.

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[1] "The Effects of Replacing Most Federal Taxes with a National Sales Tax: A State-by-State Distributional Analysis," Institute on Taxation and Economic Policy (ITEP), Citizens for Tax Justice, September 2004.

[2] Condensed version of Kotlikoff, Laurence J. and David Rapson, "Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation," October, 2006.

[3] Average remaining lifetime tax rates are based on the total tax payments net of Social Security benefits that the household will pay in its remaining years of life. They measure the household's future tax burden under the FairTax compared to what it would have to pay if the current tax system remains in place.

What is the origin of the ITEP paper?
In August of 2004, President Bush went off script at a campaign rally in Niceville, Florida and demonstrated knowledge of and curiosity about the FairTax. Immediately, the Kerry campaign's instant response team spun up election-year-driven opposition to the legislation, despite its many features quite beneficial to the Democratic Party's traditional constituency. This theme was picked up and expanded in the South Carolina Senate race by the Inez Tenenbaum campaign organization. Ms. Tenenbaum was the Democratic Party's candidate in opposition to Republican/then-Congressman Jim DeMint for the open Senate seat. At the time, DeMint was a House co-sponsor of the FairTax, HR 25. In short, Senator DeMint won a bitter, hard-fought race by double digits and post-election polling found that tax-interested voters were driven to vote for DeMint by the Tenenbaum campaign, which relied largely on the ITEP paper.

Now, two years later the ITEP paper has resurfaced again as a tool to attack the FairTax in national campaigns.

The flaws in the ITEP study are many.

- **The work does not model the FairTax at all.**
  ITEP fabricated its own version of a national retail sales tax, rather than analyzing HR 25, even though various campaigns have very specifically named this legislation in their campaign language, literature, and graphics.
- **The work keeps the sales tax rate a mystery.**
  In analyzing a "national sales tax," ITEP clearly substituted its own sales tax base and rate, though just what's in the tax base and what the rate was remains a mystery, right along with the identities of the work's authors.
- **The work does not share the details of its methodology.**
  The ITEP state-by-state analysis presents tables purporting to show which states and income groups gain or lose with the ITEP sales tax. Data from this table is being liberally quoted in various campaigns. The study does not, however, choose to explain how these results were determined. Nor does the study show totals that sum to the total revenue raised. It is, therefore, impossible to analyze the methodology of the study, let alone assure that the amounts add up.
- **The work relies on static modeling that "assumes away" the behavioral effects of tax law changes.**
  It is impossible to make a change in anything as integral to individual economic behavior as tax policy without affecting that behavior. Only a dynamic model can assess the economic changes that replacing the current income tax system with a consumption tax system will surely bring about – nearly all economists agree the switch to a consumption tax will result in higher real incomes.
- **Such static models are not designed to model consumption taxes.**
  Since consumption taxes do not tax returns on investment multiple times (which, under an income tax, is considered a normal part of the income base), and since lower wage earners in the aggregate spend a disproportionate amount of their earnings on consumption; the more a tax is based on consumption the more it is a foregone – *and incorrect* – conclusion (based on such a methodology) that the tax is "regressive" or less "fair."

A condensed version of Dr. Kotlikoff's recent, sophisticated, and thorough analyses follows.

The FairTax rate of 23 percent works.

The Beacon Hill Institute at Suffolk University and Laurence Kotlikoff, Professor of Economics at Boston University, have teamed up to provide a sound methodology for estimating the FairTax base and computing the FairTax rate.[4] Their paper demonstrates that the 23 percent rate specified by the Fair Tax Act (HR 25) is eminently feasible and suggests what led Gale[5] and the President's Advisory Panel on Federal Tax Reform[6] to reach the opposite – *and incorrect* – conclusion.

Beacon Hill Institute and Dr. Kotlikoff estimate the FairTax base for 2007 to be $11,244 billion. Implementing the FairTax rate of 23 percent on this base would generate federal tax revenues of $2,586 billion – $358 billion more than the $2,228 billion in tax revenues generated by the taxes it repeals. Because the FairTax prebate makes spending up to the poverty level tax free, the FairTax base needs to be adjusted for this. Likewise the FairTax base must be adjusted for the administrative credit paid to states and businesses collecting the FairTax. These adjustments to the base total $1,889 billion, resulting in a net FairTax base of $9,355 billion.

In 2007, spending at current levels is projected to be $3,285 billion. Revenues from the FairTax at a 23 percent tax rate ($2,586 billion), plus other federal revenues not repealed by the FairTax, are estimated to yield $3,209 billion – an amount $76 billion less than the current CBO spending projection for 2007. The $76 billion figure equates to only 2.73 percent of non-Social Security spending ($2,177 – $2,101). This is a remarkably small adjustment when set against the more than 30 percent rise in the real value of these expenditures since 2000.[7]

The FairTax (the *national retail sales tax) lowers average lifetime tax rates for most Americans.*

This paper compares the total effective marginal[8] and remaining lifetime average[9] tax rates under the current system with those under the FairTax, also known as the national retail sales tax. Kotlikoff's analysis considers 42 typical income/age/marital status categories: Two marital status groups (single individuals or married couples); three age groups (ages 30, 45, and 60) whose spouses are the same age; and seven income groups. Both the single-headed households

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[4] Bachman, Paul, Jonathan Haughton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck, "Taxing Sales under the FairTax: What Rate Works?" Beacon Hill Institute, September, 2006.
[5] Gale, William, "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Break*, May 16, 2005, pp. 889-911.
[6] The President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," November, 2005, http://www.taxreformpanel.gov/final-report/.
[7] Edwards, Chris, "How to Spend 2.8 Trillion," Cato Institute, Tax & Budget Bulletin No. 39, August, 2006.
[8] The rate of tax on the last dollar of taxable income; the top FairTax marginal rate is 23 percent, maximum.
[9] Generally total taxes paid divided by total lifetime taxable income for a given period of time; Kotlikoff's definition is total taxes paid net of Social Security benefits and the FairTax prebate divided by total taxable income over one's lifetime. The marginal FairTax rate is 23 percent above the poverty level.

and the married households have two children to whom they gave birth at ages 27 and 29. Their earnings between now and retirement are assumed to remain fixed in real terms and each household is assumed to have a home, a mortgage, and non-mortgage housing expenses.

Marginal tax rates on working taxpayers are higher under the current income tax system. The FairTax taxes both existing wealth and current and future labor earnings at a 23 percent marginal rate. The total effective marginal tax rates of the current federal tax system on working taxpayers appear to be either higher or much higher for almost all American households than they are under the FairTax.

FairTax marginal tax rates are lower for a family of four earning $35,000.
Table One shows that the current system's marginal wage tax rate exceeds the FairTax's 23 percent marginal rate for 38 of the 42 considered households. For some low- and middle-income households, the marginal tax on working under our current tax system is more than twice the 23 percent FairTax rate. As an example, let's look at a middle-class married couple earning $30,000 per year with two children. Given their federal marginal tax bracket, their loss, at the margin, of the earned income tax credit (EITC) from earning extra income, and their exposure to marginal payroll taxation, their current total marginal effect tax on earning an extra dollar is 47.6 percent.

FairTax rates are lower for couples earning $100,000.
As another example, take a 45-year-old couple in which each spouse earns $50,000. Each spouse faces a 33.7 percent marginal tax on an extra dollar earned, which is almost 50 percent higher than the 23 percent rate they'd face under the FairTax. Since the efficiency cost of the distortion in work and other economic choices rises with the square of the tax levied on the choice, the welfare loss visited on this stylized couple simply from distorting its work/leisure decision is 2.15 times higher with today's tax system than it would be under the FairTax. As a second example, consider the 45-year-old single household with $25,000 in earnings. The current marginal work tax is 47.7 percent. This rate is more than twice the FairTax rate and engenders 4.3 times the amount of economic distortion. The rate is so high because each dollar of earnings lowers this individual's EITC by roughly 22 cents.

The EITC explains the negative effective tax rate on working for single households earning $10,000 or less. By the time the single household reaches age 60, he/she can no longer receive the credit because his/her asset income exceeds the eligibility limit, yielding a marginal tax rate of 29.8 percent.

The striking pattern in Table One is that, under our current tax system, there is no pattern, or at least no monotonic[10] pattern, connecting the size of marginal tax rates on working with the level of earnings. Take 45-year-old married couples. When total household earnings equal $20,000 per year (in today's dollars), the marginal work tax rate is 41.4 percent. This rises to 47.6 percent at $30,000 of earnings, falls to 28.2 percent at $70,000 of earnings, and then rises to 38.4 percent at $500,000 of earnings.

Table One: Marginal federal tax rates on working						
Single households						
Total household income	**Young adult (Age 30)**		**Middle aged (Age 45)**		**Senior (Age 60)**	
	Current system	**FairTax**	**Current system**	**FairTax**	**Current system**	**FairTax**
$10,000	-23.1%	23.0%*	-23.2%	23.0%	29.8%	23.0%
$15,000	33.3%	23.0%	33.8%	23.0%	22.4%	23.0%
$25,000	34.2%	23.0%	47.7%	23.0%	26.2%	23.0%
$35,000	50.2%	23.0%	28.3%	23.0%	29.0%	23.0%
$50,000	28.2%	23.0%	22.4%	23.0%	36.5%	23.0%
$100,000	27.6%	23.0%	27.5%	23.0%	28.6%	23.0%
$250,000	41.5%	23.0%	37.2%	23.0%	35.5%	23.0%
*Note the important difference between *marginal* rates (the rate of tax paid in the last dollar spent) and actual *average* rates. Under the FairTax, *no* taxpayer in this chart pays any FairTax at all until they spend above the poverty level, whereas the first dollar spent above the poverty level has a marginal rate of 23 percent.						

[10] A sequence of values increases monotonically if and only if they never decrease. Conversely, a sequence decreases monotonically if and only if they never increase. For example, the sequence 1, 3, 5, 6, 6, 7, 8 increases monotonically but the sequence 1, 3, 5, 4, 6 neither increases nor decreases monotonically because we have the sub-sequence 3, 5, 4. The significance of this is that a progressive tax structure dictates that rates monotonically increase as income increases; the marginal tax rate is higher for each successive income category as one precedes from low incomes to high incomes.

Table One: Marginal federal tax rates on working (continued)						
Married households						
Total household income	**Young adult (Age 30)**		**Middle aged (Age 45)**		**Senior (Age 60)**	
	Current system	**FairTax**	**Current system**	**FairTax**	**Current system**	**FairTax**
$20,000	33.8%	23.0%	41.4%	23.0%	23.5%	23.0%
$30,000	33.7%	23.0%	47.6%	23.0%	28.2%	23.0%
$50,000	28.0%	23.0%	28.2%	23.0%	28.2%	23.0%
$70,000	28.3%	23.0%	28.2%	23.0%	32.7%	23.0%
$100,000	33.5%	23.0%	33.7%	23.0%	34.3%	23.0%
$200,000	35.3%	23.0%	31.2%	23.0%	37.5%	23.0%
$500,000	38.4%	23.0%	38.4%	23.0%	37.2%	23.0%
*Note the important difference between *marginal* rates (the rate of tax paid in the last dollar spent) and actual *average* rates. Under the FairTax, *no* taxpayer in this chart pays any FairTax at all until they spend above the poverty level, whereas the first dollar spent above the poverty level has a marginal rate of 23 percent.						

Average remaining lifetime tax rates

Average remaining lifetime tax rates measure what percentage of remaining lifetime resources the taxpayer pays to the government, netting all future federal tax payments against Social Security benefits received and the FairTax prebate. These rates provide a much more realistic estimate of the true effective tax burden than comparisons of taxes versus income for a single year (as done in the ITEP[11] study).

Table Two presents our calculation of average remaining lifetime tax rates, both those now prevailing and those that would prevail under the FairTax. These tax rates measure what percentage of remaining lifetime resources the taxpayer pays to the government, netting out all future federal tax payments against Social Security benefits received and the FairTax prebate. In the case of the FairTax, the Social Security benefits are adjusted upward to maintain the real purchasing power of the benefits as provided for in the FairTax legislation, HR 25.

The FairTax imposes much lower lifetime average taxes.

A glance at Table Two indicates that the FairTax entails either a significant or a substantial reduction in the remaining lifetime tax rates of all of our stylized households. For example, the stylized single age 45 household with $35,000 in annual income pays, on average, 20.7 percent of its remaining lifetime resources to the government under our current tax system, but only 5.4 percent under the FairTax. The same aged married couple in which both spouses earn $35,000 faces a 21.3 percent current average tax rate, but only an 11.6 percent average tax rate under the FairTax.

[11] "The Effects of Replacing Most Federal Taxes with a National Sales Tax: A State-by-State Distributional Analysis," op. cit. It is important to note here that in addition to providing only a single year look at the effect of the FairTax, the ITEP study did not correctly estimate the FairTax that would be paid by each income group.

Table Two: Average remaining federal lifetime tax rates						
Single households						
Total household income	**Young adult (Age 30)**		**Middle aged (Age 45)**		**Senior (Age 60)**	
	Current system	**FairTax**	**Current system**	**FairTax**	**Current system**	**FairTax**
$10,000	-12.3%	-17.6%	6.2%	-13.5%	6.5%	-27.1%
$15,000	-4.0%	-5.0%	11.3%	-10.0%	9.8%	-28.0%
$25,000	10.2%	5.6%	17.7%	4.7%	14.1%	-6.2%
$35,000	18.5%	10.1%	20.7%	5.4%	16.7%	-5.9%
$50,000	21.1%	13.5%	23.5%	11.4%	21.5%	3.9%
$100,000	27.5%	17.8%	30.3%	14.7%	32.1%	9.2%
$250,000	27.9%	20.8%	33.6%	19.7%	40.8%	18.2%
Married households						
Total household income	**Young adult (Age 30)**		**Middle aged (Age 45)**		**Senior (Age 60)**	
	Current system	**FairTax**	**Current system**	**FairTax**	**Current system**	**FairTax**
$20,000	3.1%	1.3%	11.0%	1.5%	7.2%	-11.0%
$30,000	12.5%	7.8%	15.3%	3.4%	10.1%	-10.5%
$50,000	19.1%	13.4%	19.6%	11.1%	14.2%	1.4%
$70,000	21.1%	15.6%	21.3%	11.6%	17.0%	2.2%
$100,000	23.2%	17.4%	24.0%	14.7%	22.4%	7.9%
$200,000	27.2%	19.7%	29.0%	17.0%	32.2%	12.3%
$500,000	30.6%	21.6%	35.6%	20.5%	41.5%	19.3%

Retirees depending mostly on Social Security are dramatically better off under the FairTax. For older, low-income households, the FairTax generates a major reduction in remaining lifetime taxes. Again, the reason is that the elderly not only continue, under the FairTax, to receive the same real Social Security benefits, they also receive the FairTax prebate. Take a single 60-year-old earning $15,000 a year. His or her average remaining lifetime tax rate falls from 9.8 percent to -28.0 percent!

Another key feature is how much lower average lifetime tax rates under the FairTax are for middle- and upper-income seniors compared to the current tax system. With the FairTax, high-income seniors experience average remaining lifetime tax rates of 18.2 percent for singles and 19.3 percent for couples. These rates are significantly lower than what they would experience under the current income tax system: 40.8 percent for singles and 41.5 percent for couples.

The FairTax enhances overall progressivity.
The FairTax not only lowers remaining average lifetime net tax rates, it also maintains and, indeed, enhances overall progressivity in the tax system. Consider middle-aged married households. The FairTax average lifetime tax rate is very low – only 1.5 percent – for the couple with $20,000 in annual earnings, and much higher – 20.5 percent – for the couple with $500,000 in annual earnings. The reduction in the tax rate at low earnings is proportionately much greater at the lower end of the earnings distribution than at the high end. In switching to the FairTax, the $20,000-earning couple experiences an 86 percent cut in its average tax rate, whereas the $500,000-earning couple experiences a 42 percent cut.

Americans are better off under the FairTax – the *national retail sales tax.*[12]

To get a meaningful picture of how persons in various income groups fare under the FairTax, Dr. Kotlikoff models the dynamic macroeconomic and microeconomic effects of replacing the income tax system with the FairTax. His model considers three income classes within each generation. It compares what the economy is like under the FairTax versus what it would be like if the current system were to remain in place. This approach gives a realistic view of the impact of America's aging population, coupled with high and growing health and pension benefits that necessitate much higher payroll taxes, with potentially damaging effects on the U.S. economy. The FairTax offers a solution to this dismal economic future.

The FairTax: A very progressive long-run outcome
The shift to the FairTax raises marginal labor productivity and real wages over the course of the century by 18.9 percent and long-run output by 10.6 percent. Moreover, the FairTax reduces by half the long-run increase in the effective rate of wage taxation needed to pay the Social Security and health care benefits of an aging population. These macroeconomic gains have important microeconomic welfare implications. In the long run:

- Low-income households experience a 26.7 percent welfare gain under the FairTax
- Middle-income households experience a 10.9 percent welfare gain
- High-income households experience a 4.7 percent welfare gain

This is a very progressive long-run outcome. (See Figure One below.)

Progressivity also marks the entire transition. Low-income households, which are initially alive at the time of the reform, whether they are young, middle age, or old, all experience welfare gains ranging from 8.3 to over 20 percent. Who pays for these gains? The answer is hardly anyone. The initial rich elderly and rich middle aged, as well as some middle age/middle-income households are somewhat affected, but their welfare losses are quite small compared to the welfare gains experienced by the current poor and future generations.

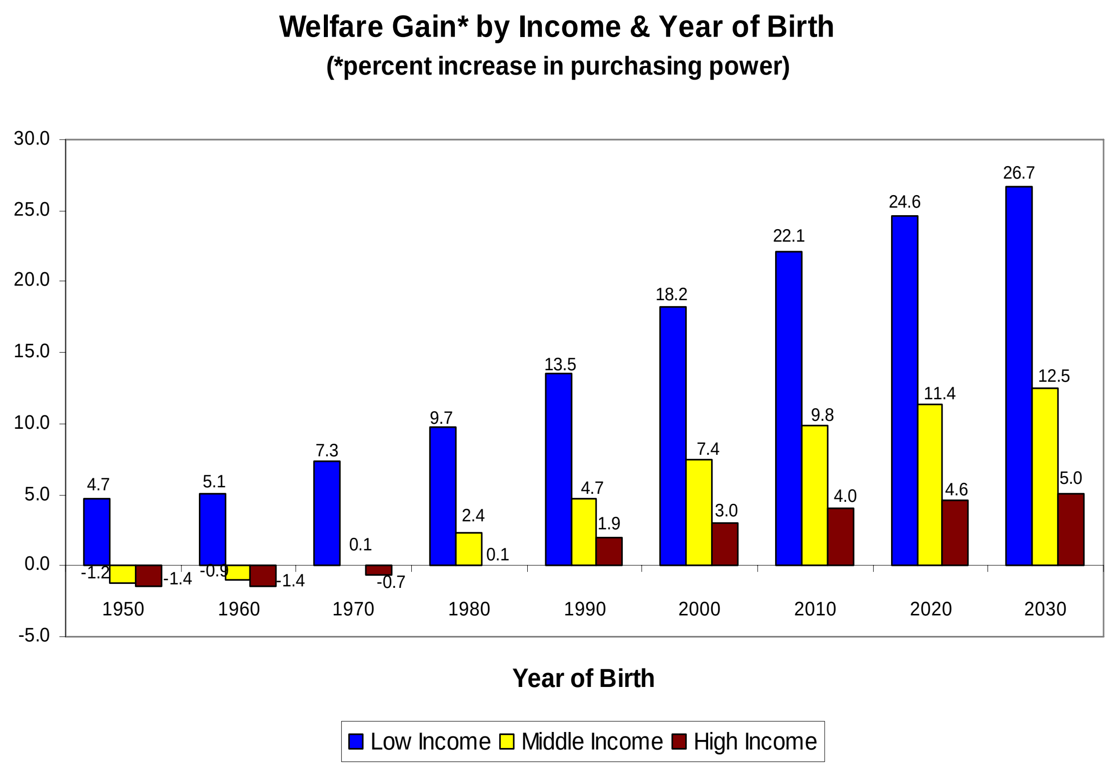
[12] Condensed version of findings presented in Jokisch, Sabine and Laurence J. Kotlikoff, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," NBER Working Paper No. 11858, December, 2005.

In switching from taxing income to taxing consumption and adding high progressivity via a rebate, the FairTax introduces many progressive elements into our fiscal system, removes one very regressive element (the payroll tax), and provides much better incentives to work and save. Switching to the FairTax raises long-run capital intensity, thus raising long-run real wages by 19 percent compared to the base-case alternative. The reform also generates major welfare gains for the poorest members of society, including those now retired and those yet to be born.

In short, according to Dr. Kotlkoff's analysis, the FairTax offers a real opportunity to improve the U.S. economy's performance and the well-being of the vast majority of Americans, regardless of income and when they were born.

The chart below shows that in every age cohort, low-income persons experience the highest increase in welfare (purchasing power), middle-income cohorts experience a positive increase in welfare, but one less than the low-income cohorts, and finally that the high-income cohorts born in 1970 or after experience a positive welfare gain that is less than both the low- and middle-income cohorts. This is a very progressive outcome.

Figure One



Source: FairTax.org chart using data presented in Kotlikoff and Jokisch, December, 2005, op. cit.

Conclusion

Many commentators have considered the FairTax in a vacuum, i.e., without comparing its marginal and average tax rates with the combined income/payroll marginal and average tax rates implicit in our current system. Further, they do not examine the damaging effects on the economy of the doubling of payroll taxes that will be necessary to fund the retirement and health care benefits of an aging society under the current system. The FairTax offers an alternative to this dismal economic future. Compared with our existing federal tax system, the FairTax, as proposed in HR 25, significantly reduces marginal taxes on work and saving, substantially lowers overall tax burdens on current and future workers, and generates major welfare gains for the poorest members of society, including those now retired and those yet to be born. The FairTax offers a real opportunity to improve the U.S. economy's performance. Moreover, it does this without limiting tax progressivity. Indeed, the FairTax makes our tax system more progressive.

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\A FairTax rebuttal to a paper by ITEP)