A FairTax℠ White Paper

The FairTax: Fundamentals and facts

FairTax.org is a research-based organization. Over the course of more than a decade, the organization has invested millions of dollars in fundamental tax research. Some of this investment went into polling the American public on the nature of taxes they find the least offensive and intrusive. Much of the balance of this investment went into studies by some of the nation's top economists to ensure such a system can work and to model how it does work. From the early work, FairTax.org drafted its legislation (HR 25); later research has used this legislation as a baseline.

The organization is fortunate that Rep. John Linder signed on to forward the legislation and that talk show host Neal Boortz became an outspoken advocate. Their book (*The FairTax Book*), which is their own work written with our grateful knowledge, has accelerated the movement tremendously. We certainly appreciate and support their efforts.

The axioms of taxation have never changed and never will.

It may be amusing to some that with all of the brilliant minds behind the FairTax and all of the effort put into studying the issue, FairTax.org ended up in the same place as did our Founding Fathers. From their study of history, these men (without the benefit of computers or advanced degrees in economics) determined to build a tax system that had at its base these never-changing fundamentals of taxation:

- Only people pay taxes.
- Consumption taxes are the oldest form of taxation for many good reasons.
- Consumption tax rates are self-limiting.
- Consumption taxes, throughout history, have enhanced civil liberties and more.
- Direct taxes (income taxes/poll taxes/head taxes), throughout history, have been the tools of tyranny.
- Uniformity of taxation wards off special interest manipulation.

These points address common questions regarding the FairTax plan:

- ✓ **The FairTax is revenue neutral at $0.23 out of every retail dollar spent.**
- ✓ **The FairTax lowers the lifetime tax burden for most Americans.**
- ✓ **The FairTax benefits retirees who depend mostly on Social Security.**
- ✓ **The FairTax preserves the overall progressivity of the federal tax burden.**
- ✓ **The FairTax dramatically improves the U.S. economy.**
- ✓ **The FairTax improves the international competitiveness of American producers.**
- ✓ **The FairTax promotes home ownership better than the current system.**
- ✓ **The FairTax simplifies tax compliance, thereby reducing tax evasion.**

The FairTax is revenue neutral at $0.23 out of every retail dollar spent.
The FairTax is imposed on a base indisputably twice as large as the base of taxable income today. The truth is that the FairTax rate is the lowest rate possible for any tax plan that does not tax returns on capital more than once or tax the necessities of life, and is far less than the marginal rates on labor or capital required by the current system.

The FairTax rate of $0.23 out of every retail dollar spent on new goods or services works. The Beacon Hill Institute at Suffolk University and Laurence Kotlikoff, Professor of Economics and noted public finance expert at Boston University, recently teamed up to provide a sound methodology for estimating the FairTax base and computing the FairTax rate.[1] Their report:

- Demonstrates that the 23 percent rate (as compared to current rate terminology for the taxes the FairTax replaces) specified by the Fair Tax Act (HR 25) is eminently feasible.
- Suggests what led Gale[2] and the President's Advisory Panel on Federal Tax Reform[3] to reach the opposite – *and incorrect* – conclusion.

Beacon Hill Institute and Dr. Kotlikoff estimate the FairTax base for 2007 to be $11.244 trillion. Implementing the FairTax rate of 23 percent on this base would generate federal tax revenues equal to $2.586 trillion – $358 billion more than the $2.228 trillion in tax revenues generated by the taxes it repeals. According to the Congressional Budget Office, 2007 spending (assuming current levels) is projected to be $3.285 trillion. Revenues from the FairTax at a 23 percent tax rate ($2.586 trillion) plus other federal revenues not repealed by the FairTax are estimated to yield $3.209 trillion – an amount $76 billion less than the CBO projection. The $76 billion figure is remarkably small when set against the more than 30 percent increase in the real value of discretionary spending since 2004.[4] At 23 percent, non-Social Security spending in 2007 would be $2.102 trillion compared to $2.113 trillion in 2006, a difference of only $12 billion or less than one percent.

The report goes on to prove that implementation of the FairTax, including the requirement that state and local governments pay the tax on their purchases, entails no reduction in state and local real spending, provided that these governments adjust their tax structure to maintain the same state/local tax burden on taxpayers under the current system.

The FairTax lowers the lifetime tax burden for most Americans.
In other research, Dr. Kotlikoff finds that the FairTax lowers marginal tax rates on work and saving, cuts remaining average lifetime tax rates,[5] and enhances overall progressivity. This

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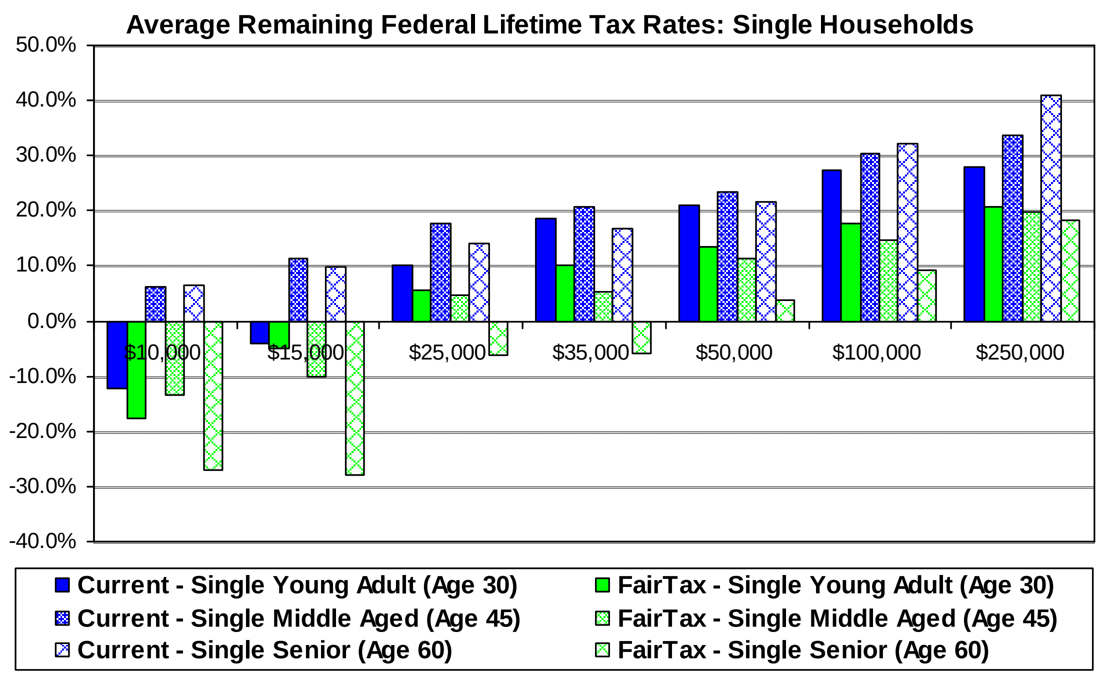
[1] Bachman, Paul, Jonathan Haughton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck, "Taxing Sales Under the FairTax: What Rate Works?" Beacon Hill Institute, published in *Tax Notes*, November 13, 2006.
[2] Gale, William, "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Notes*, May 16, 2005, pp. 889-911.
[3] 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/).
[4] Edwards, Chris, "How to Spend $2.8 Trillion," Cato Institute, Tax & Budget Bulletin No. 39, August 2006.
[5] 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

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 FairTax rate is only 1.5 percent versus 11.0 percent under the current system. The high-income couple's FairTax rate is 20.5 percent versus 35.6 percent under the current system. The low-income couple gets an 86 percent cut in their average remaining lifetime tax rate, whereas the high-income couple gets a 42 percent cut.

Kotlikoff's analysis compares the total effective marginal[6] and remaining lifetime average[7] tax rates under the current system with those under the FairTax for 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 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.

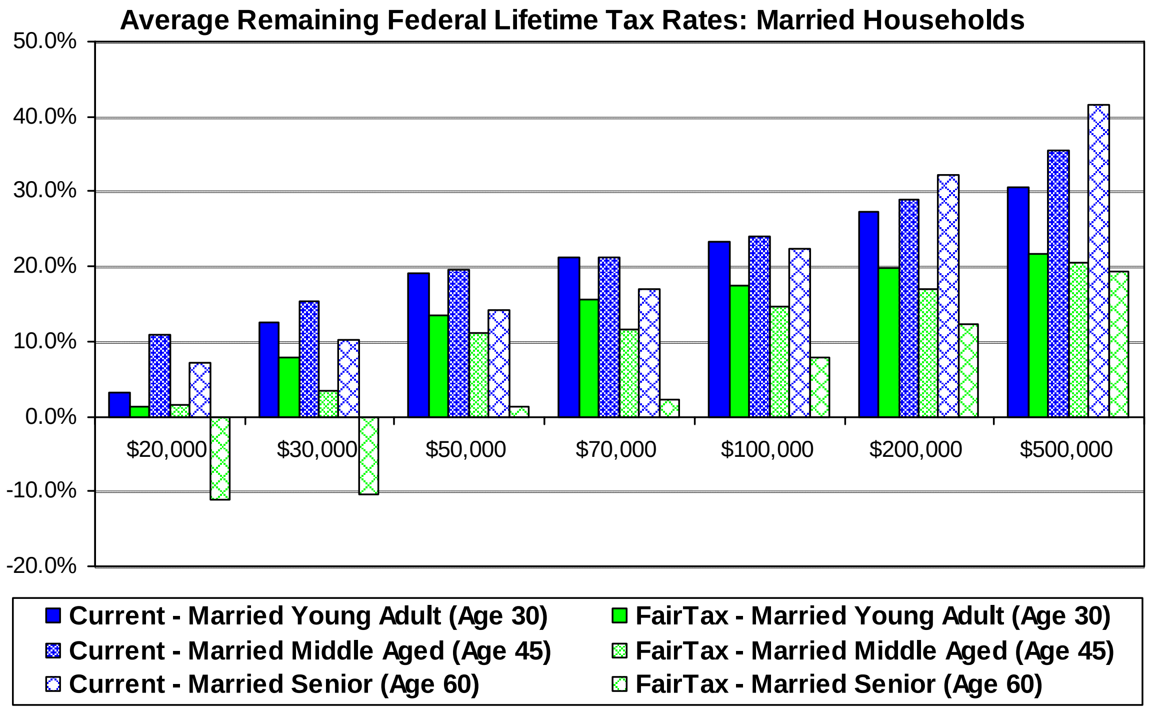


compared to what it would have to pay if the current tax system remains in place. See Kotlikoff, Laurence J. and David Rapson, "Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation," NBER Working Paper No. 12533, Revised October 2006.

[6] The rate of tax on the last dollar of taxable income; the top FairTax marginal rate is 23 percent, maximum.

[7] 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.

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 more realistic estimate of the true effective tax burden than comparisons of taxes versus income for a single year (as done by the tax panel). These findings indicate 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 (see table below) 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.



The FairTax benefits retirees who depend mostly on Social Security.
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. The average Social Security benefits for a retired couple living solely on Social Security are $18,776. The FairTax prebate for this couple is $4,697 which is $381 more than the FairTaxes the couple would have to pay if they spent the entire $18,776 on taxable consumption.

Let's look at 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! Middle-income and upper-income seniors also experience lower average lifetime tax rates under the FairTax compared to the current tax system. High-income seniors experience average remaining lifetime tax rates under the FairTax of 18.2 percent for singles and 19.3 percent for couples. However, these rates are significantly lower than what they would experience under the current system: 40.8 percent for singles and 41.5 percent for couples.

In general, the FairTax offers several other benefits to seniors. The FairTax repeals the taxation of Social Security benefits and adjusts Social Security indexing to preserve the purchasing power of seniors. The FairTax ends all record keeping and income tax filings of any kind for seniors, totally insulating them from the high costs and abusive tactics of tax preparers. The FairTax repeals the income tax imposed on investment income and pension benefits or IRA withdrawals. No form of savings or investment is taxed. The beneficiaries and owners of pension funds, IRAs, and 401(k) plans (with assets of over $11 trillion in 2003) will not have to pay taxes on these plans upon withdrawal, despite taking an income tax deduction for the contributions to most of these plans. (For a complete discussion of these benefits, please see "The FairTax Benefits Seniors," available at http://www.fairtax.org/PDF/The_FairTax_benefits_seniors_11-7-06.pdf).

The FairTax preserves the overall progressivity of the federal tax burden.
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 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 their average tax rate, whereas the $500,000-earning couple experiences a 42 percent cut.[8]

The FairTax: A very progressive long-run outcome
To get another meaningful picture of how persons in various income groups fare under the FairTax in the aggregate, Dr. Kotlikoff models the dynamic macroeconomic and microeconomic effects of replacing the income tax system with the FairTax.[9]

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 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

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[8] Kotlikoff and Rapson, see footnote 5.
[9] 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.

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 chart below.)

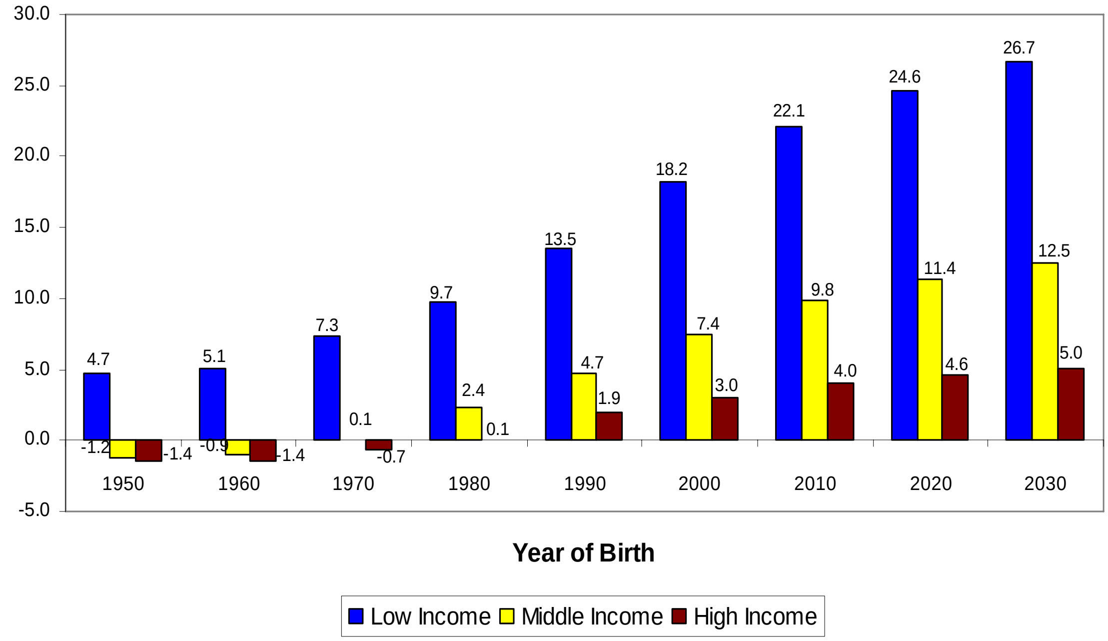
Progressivity also marks the entire transition. Low-income households, which are initially alive at the time of the reform, whether they are young, middle age, or old, all experience welfare gains ranging from 8.3 to over 20 percent. Who pays for these gains? The answer is hardly anyone. The initial 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.

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.

Welfare Gain* by Income & Year of Birth
(*percent increase in purchasing power)



The FairTax dramatically improves the U.S. economy.
New economic research shows that the economy fares much better under the FairTax. The economy as measured by GDP is 2.4 percent higher in the first year and 11.3 percent higher by the tenth year than it would otherwise be. Consumption increases by 2.4 percent more in the first year than it would be if the current system were to remain in place. The increase in consumption is fueled by the 1.7 percent increase in disposable (after tax) personal income that accompanies the rise in incomes from capital and labor once the FairTax is enacted. By the tenth year consumption increases by 11.7 percent over what it would be if the current tax system remained in place, and disposable income will be up by 11.8 percent.

Following the implementation of the FairTax plan, the higher take-home wage provides an immediate incentive for people to work more. During the first year, this will lead to total employment growth of 3.5 percent in excess of the baseline scenario, which continues to grow through year ten such that total employment is 9.0 percent above what it would have been under the baseline scenario.

The impact on total labor income is even more pronounced, increasing due to both an increase in after-tax wages and an increase in the number of people working. Total labor income will rise 27.4 percent in the first year. By year ten, labor income will be over 41 percent higher than what it would have been under the baseline scenario.

FairTax simulation model results[10]						
Cumulative growth over current system	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 10**
Gross domestic product	2.4%	5.2%	7.0%	8.2%	9.0%	11.3%
Employment	3.5%	5.7%	7.0%	7.7%	8.2%	9.0%
Domestic investment	33.0%	35.4%	36.9%	38.0%	38.8%	41.2%
Income from employment (wages)	27.4%	31.8%	34.5%	36.4%	37.7%	41.2%
Consumption	2.4%	4.1%	5.8%	7.1%	8.1%	11.7%
Disposable personal income (adjusted for changes in the price level)	1.7%	4.5%	6.4%	7.7%	8.7%	11.8%

Units scaled 2004 GDP = 1.00. Capital and labor set to equal constant shares of 0.3 and 0.7, respectively.

The FairTax improves the international competitiveness of American producers.
Today, we have a tax system that remarkably subsidizes foreign-content vehicles, assisting Korea, Japan, Germany, and others in competing against the American worker. How do we do so? The U.S. government's failure to remove the tax on exports (as do the other 29 OECD nations) creates a large and artificial relative price advantage (estimated to be over 18 percent) for foreign goods, in both the U.S. market and abroad.[11] A recent MIT report states that the U.S. failure to recognize and confront this problem costs us more than $100 billion in exports annually.[12] In effect, the U.S. tax system is distorting the international marketplace and is literally moving good jobs out of this country at a devastating and unsustainable pace. The FairTax remedies this by taxing foreign-produced goods as U.S.-produced goods are taxed and by exempting exports fully from taxation, thereby restoring a level playing field for U.S. and foreign-produced goods.

The FairTax promotes home ownership better than the current system.
Under the FairTax home purchases are *more* tax advantaged than they are today. For working Americans, the "true cost" of buying a home goes down. In a nutshell, homes are more affordable because:

- The majority of homes are used, thus are not taxed.
- The entire house payment (interest *and* principal) is paid with pretax dollars by *every* homeowner, contrasted with the current system's interest deduction only to itemizers.
- Interest rates no longer bear upstream costs, driving them lower.
- New home prices do not bear taxes and compliance costs imposed upstream.
- Savings and investments needed to buy homes are not taxed multiple times.

[10] Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal," Americans For Fair Taxation Research Monograph, July 2006.
[11] Hartman, David A., "The Case for Border-Adjusted Taxation in the United States," *Tax Notes International*, September 27, 2004, p. 1183.
[12] Hausman, Jerry, "An Economic Analysis of WTO Rules on Border Adjustability of Taxes," Massachusetts Institute of Technology, May 2006 (http://www.standupforsteel.org/hausman.html).

Even though the FairTax makes the mortgage interest deduction irrelevant, housing becomes more affordable and homebuyers have more money with which to purchase their homes. There are several reasons for this: (1) Most home sales are for used homes, and unlike today taxpayers use pretax earnings to buy used homes; (2) unlike the current tax regime, the FairTax does not tax the earnings used to pay mortgage interest. Even if the mortgage interest deduction offset all income taxes, interest would still be paid with what one has left over after payroll taxes; (3) mortgage debt is paid at a lower interest rate since the FairTax lowers the interest rate of such debt; (4) while a new home is taxed, the FairTax imposes a lower marginal tax rate on the earnings used to buy the home; (5) unlike the current tax regime, the FairTax fully untaxes capital gains from the sales of used or new property; (6) the FairTax removes all embedded tax costs of current construction by untaxing the businesses involved in home construction and producing building supplies; and (7) the FairTax enables homeowners to save for a home faster by not taxing savings, unlike today.

In the chart below, we compare how much today's mortgage interest deduction benefits the homebuyer relative to the full nontaxation of interest and principal payments on mortgages under the FairTax by drawing only the most conservative assumptions. To purchase the $230,000 home mentioned above (assuming a 30-year term and mortgage rate of 6.6 percent), the prospective homebuyer would have to pay $298,806 in interest in addition to the price of the home. Since the current system taxes income and payroll, these taxes must be taken into account when figuring out how much the homebuyer would have to earn over the lifetime of the loan to pay the loan off. Taking these taxes into account, our homebuyer would have to earn $633,660 to completely pay off the loan.

Actual cost of purchasing a $230,000 new home[13]
(wages that must be earned to buy the home)

Component of housing cost	Current law	FairTax
Home purchase price	$230,000	$230,000
Mortgage interest rate[14]	6.6%	4.95%
Interest at rate above for 30 years	$298,806	$211,962
Federal taxes	$104,854	$69,000
Income taxes on principal	$64,400	$0
Payroll taxes on principal	$17,595	$0
Income taxes on interest	$0	$0
Payroll taxes on interest	$22,859	$0
FairTax on home purchase price	$0	$69,000
Total housing cost including taxes	$633,660	$510,962
Difference in total housing costs		-19.4%

In contrast, the FairTax does not tax earnings, and instead taxes consumption – in this case the purchase of the new home. Thus, our homebuyer only has to earn $510,962 to completely pay off the loan – an amount over 19 percent less than he/she does today. This results from two factors: First, the entire mortgage payment is made with untaxed dollars; and second, economics studies project mortgage interest rates to drop by 25 percent.

The FairTax simplifies tax compliance, thereby reducing tax evasion.
Several factors bear upon compliance – both fraud and non-fraud – from the scholarly research. The most important are the number of taxpayers, marginal tax rates, the complexity of the system, the number of decisional junctures (opportunities for each taxpayer), transparency or the risk of detection, the magnitude of punishment if caught, non-financial motivation to cheat (including perceptions of unfairness), and enforcement resources and safeguards in place.

Research reported above shows that the FairTax dramatically lowers marginal tax rates. Lower rates, all other things being equal, imply lower evasion because the benefits from evasion decline while the costs of evasion remain comparable. However, precisely because of the larger base and lower marginal tax rates, the benefit from lawful tax avoidance or illegal tax evasion under the FairTax is much less at the margin relative to either the current system or competing alternative tax systems that have higher marginal tax rates.

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[13] According to the National Association of Realtors, the median price of existing homes in May 2006 was $230,000.
[14] Several economic studies have estimated that switching from an income tax system to a consumption tax system such as the FairTax would result in an interest rate drop of approximately 25 percent. See, e.g., Golob, John E., "How Would Tax Reform Affect Financial Markets?" *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter 1995.

Virtually any sales tax would reduce the number of points of collection (and enforcement) dramatically; the FairTax reduces them by about 80 percent (145 million to 25 million) because individuals no longer have to file annual returns. The Government Accountability Office, among others, has specifically identified the negative relationship between compliance costs and the number of focal points for collection. Virtually any sales tax would concentrate the lion's share of revenue collection to fewer than ten percent of retailers, further simplifying collection and enforcement. Any sales tax would reduce form and filing complexity from today's Rube Goldberg contraption to a simple sales tax return, largely completed by point-of-purchase software.

Perception of the fairness of the tax system is increasingly regarded as an important consideration. Studies have persuasively shown that attitudes are important determinants of compliance. Under the FairTax, as the costs of compliance shrink and the perceived fairness of the tax system increases, some of the hostility to the tax system will decline.

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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