# Fiscal Federalism:
## The National FairTax and the States

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## Executive Summary

This report presents research on the implications of the FairTax proposal as it affects the economies and politics of the states. The FairTax proposal embodied in H.R. 25/S. 1025, the Fair Tax Act of 2007, replaces the current federal tax system with a national retail sales tax.

In this report, we examine these implications by addressing five questions:

1. Assuming the federal government enacts the FairTax plan, what state FairTax rate would each state have to have in order to repeal their state income taxes and replace the revenues with a state FairTax?

2. Assuming the federal government enacts the FairTax plan, what state FairTax rate would each of the states with a state sales tax have to levy in order to replace their existing state sales tax with a sales tax that conforms to the FairTax base?

3. If states were to introduce their own FairTax plan using the rates computed in (1), what would the effect be on *state-level* economic indicators such as employment, wages, and prices?

4. What logistical and practical challenges do states and their existing state revenue systems face upon the enactment of a national FairTax, and what options are available?

5. What are the political economy implications of the introduction of a national FairTax for the direction of state tax policy?

We have calculated three revenue-neutral state-levied FairTax rates for all 50 state FairTaxes. The first rate calculation assumes that the states would piggyback on the federal FairTax for their state sales taxes by mirroring the national FairTax proposal in 2007. Like the national FairTax, a state-level FairTax would replace state personal and corporate income taxes, gift and estate taxes, and general sales taxes with a tax on all final consumption and would rebate taxes on spending up to the poverty level.[1] We find that the state FairTax rate that would replace state sales, income, and gift and estate taxes varies substantially across the states, from a low of 0.32 percent in Alaska to a high of 8.12 percent in Arkansas. The second calculation assumes that the 45 states that currently levy general sales taxes would adopt the much broader FairTax base for their sales-only taxes and pay a prebate. The final calculation uses the same assumptions as above, except that we assume no prebate is paid.

[1] A state FairTax legislation would apply a retail sales tax on the total transaction value of all final sale purchases by public and private buyers for both products and services; in other words, all consumers pay to the government X cents of every dollar spent (sometimes called *tax-inclusive* – as income taxes are calculated). However, American sales taxes have historically been expressed as a percentage of the original sale price (tax-exclusive); items priced at $100 pre-tax cost $105 with the tax added for a 5 percent sales tax rate. Sales taxes have, for the most part, applied to products only and government and nonprofit purchases have been exempt.

As a result, all states, with the exception of Hawaii, could lower their existing sales tax rates by almost one percentage point. On average, states could more than halve their sales tax rates, or 3.04 percentage points, from 5.25 percent to 2.02 percent.

We find that state economies would benefit greatly from adopting their own state-level FairTax alongside a federal FairTax. Using existing BHI CGE (Computable General Equilibrium) models for five states (Massachusetts, New Jersey, Illinois, Virginia, and Texas), we find that employment, investment, wages, and income would all experience substantial increases under dual federal/state-level FairTaxes. By 2009, these five states would, on average, see a rise of 14 percent in employment, 92 percent in investment, 7 percent in wages, and 11 percent in income. The economic benefits of the FairTax result from removing the tax wedge currently placed on labor, capital, and savings.

Were the federal government to adopt the FairTax, many states would need to make adjustments in their current tax systems. A handful of states would face multiple adjustments. Probably the easiest option would be for states to adopt their own state-level FairTax. The FairTax plan also proposes a federal/state cooperative program similar to the joint federal/state administration of unemployment taxes. States would collect and enforce the tax for the federal government and receive an administrative credit to compensate them for collection costs. Thus, states could substitute a state-level FairTax for their existing tax systems and greatly simplify their own tax collection process.

## I. Introduction

The last successful effort at major tax reform was undertaken during the Reagan administration in 1986. Since then, Congress has changed course and enacted legislation to raise and then lower income tax rates, reduce the tax rates on capital gains and dividends, increase deductions for IRA contributions, create Roth IRA and medical savings accounts, and increase the earned income tax credit. The result is a complex tax code consisting of over 60,000 pages of code, rules, and IRS rulings that can confuse almost everyone, including the best tax professionals.

With the real possibility of major federal tax reform underway, several groups and legislators have proposed alternative plans. The FairTax plan is one such proposal. It aims to replace most federal taxes with a national tax on consumption. Representative John Linder and Senator Saxby Chambliss filed H.R. 25/ S. 1025, the Fair Tax Act of 2007, based on the principles of the FairTax plan.

Federal tax reform has implications for tax policy at the state and local levels. Some states currently tailor their income taxes closely to the federal income tax. For most taxpayers, the FairTax would represent an additional tax on consumption, since most states levy a sales tax, just as state income taxes represent an additional tax on income today. The states would have to deal with differences between their sales tax bases and the federal tax base; however, they have had a similar situation in dealing with the differences in the federal income tax base compared to theirs.

In addition, a large proportion of state sales tax revenue comes from taxing investment and business inputs.[2] Thus, state policy makers would need to make not only technical but also normative adjustments in moving away from the taxation of income to the taxation of consumption as defined by the FairTax.

States that currently levy a sales tax would be tempted to adopt the much broader FairTax base in order to enjoy the simplicity, transparency, and economies of scale from administering two sales taxes that have the same base. Moreover, the broader FairTax base, which includes services as well as goods, would allow these states to lower their own state sales tax rates and capture the fast growing service sector.

Table 1 displays total tax revenues collected by state and local governments in FY 2005; a year in which states collected $1.174 trillion in tax revenues.[3] States derive their current tax revenues from a wide variety of sources. Nevertheless, general sales and uses taxes (40 percent) and personal income taxes (34 percent) combine to comprise 74 percent of state tax revenue today. Property, motor fuels, licensing fees, corporate income, and estate taxes make up the other 26 percent of state tax revenues. In the aggregate, the switch from taxing income to taxing consumption should prove a relatively smooth transition since sales taxes already provide a large source of tax revenue for state and local governments.[4] Nevertheless, states that heavily rely on taxing income to provide most of their revenues might view the transition to the FairTax as

[2] Cline, et al. (2004).
[3] U.S. Census Bureau, State Government Tax Collections: 2005. Available at http://www.census.gov/govs/www/qtax.html. Note: Totals do not include local government.
[4] U.S. Census Bureau, State Government Finance, Table 1. State and Local Government Finances by Level of Government and by State: 2004-05. Available at http://www.census.gov/govs/estimate/0500ussl_1.html.

burdensome. These states would need to make more changes to their tax codes than states that already rely more on a sales tax.

**Table 1. State and Local Government Tax Collections by Major Type of Tax (FY 2005)**

| Type of Tax | State Collections (millions) | Share of Total (percent) | Local Collections (millions) | Share of Total (percent) |
|---|---|---|---|---|
| Total taxes | 648,111 | 100.0 | 448,273 | 100.0 |
| Sales and gross receipts taxes | 259,215 | 40.0 | 69,797 | 15.6 |
| Total income taxes | 258,946 | 40.0 | 25,123 | 5.6 |
| Individual income | 220,255 | 34.0 | 20,676 | 4.6 |
| Corporation net income | 38,691 | 6.0 | 4,457 | 1.0 |
| Tobacco and alcoholic beverages | 17,648 | 2.7 | 834 | 0.2 |
| Motor fuel taxes | 34,570 | 5.3 | 1,199 | 0.3 |
| Property taxes | 11,349 | 1.8 | 324,329 | 72.4 |
| Others | 66,383 | 10.2 | 26,992 | 6.0 |

Then there is the demonstration effect: A significant body of research predicts that the enactment of a pure consumption tax such as the FairTax would simplify taxes and encourage saving and investment with corresponding benefits to the economy. Should the FairTax be adopted and these predicted benefits materialize, states may consider simplifying their own tax structures by conforming their state sales taxes to the FairTax base and using the revenue gained from the base broadening to eliminate state income taxes (or reduce the sales tax rate in those states that have no income taxes to replace). However, some critics have their doubts.

William G. Gale, a tax policy analyst for the Brookings Institution, and the President's Advisory Panel on Federal Tax Reform suggest that the effective (tax-inclusive) tax rate needed to implement H.R. 25 is far higher than the proposed 23 percent rate.[5] William F. Fox and Matthew N. Murray make similar assumptions regarding the price of state and local government services under the federal and state FairTax rates.[6]

Fox and Murray presume that the imposition of a federal and state FairTax will cause consumer prices to rise, implicitly assuming that the Federal Reserve (the Fed) will conduct a monetary expansion to allow factor prices to rise to equal today's consumer prices.

At a macroeconomic level, prices depend on how the monetary authorities react to changes in tax policy, macroeconomic conditions, and other variables affecting prices. In simple terms, the overall price level must be consistent with the "quantity theory" equation, whereby $MV = PY$. Here $M$ is the money supply, $V$ is the velocity at which money circulates, $P$ is the price level, and $Y$ is real income. For the purpose of this analysis, we assume that, under the FairTax, $V$ and $Y$ would remain unchanged. Therefore, a rise in the price level would be possible only if

[5] See Gale (2005) and President's Advisory Panel on Federal Tax Reform (2005).
[6] Fox and Murray (2005).

accommodated by an increase in the money supply.[7] Put another way, without monetary accommodation, prices faced by consumers under the FairTax would not rise. Any changes to the level of monetary accommodation – that is, increase in the money supply – would cause prices to increase in the same proportion.

Moreover, one could also assume that the Fed would not provide monetary accommodation and that consumer prices would then fall to near the level of factor prices. While these assumptions appear to produce different implications for the calculation of FairTax rates, they are in fact compatible since *the FairTax rate is independent of the level of monetary accommodation.* In other words, prices to do not matter in the calculation of FairTax rates.

Fox and Murray say that a national retail sales tax (NRST) "would raise the marginal cost to state and local taxpayers of funding government services through income, property and sales taxes relative to the status quo."[8] Yet, they provide no proof to substantiate this claim. Moreover, in "Taxing Sales under the Fair Tax: What Rate Works?" we prove this statement to be incorrect.[9] The FairTax does not necessarily impose a burden on state and local governments; it simply transfers purchasing power to state and local taxpayers from state and local government. It would be up to state and local government, under the FairTax, to decide whether to permit the transfer identified here to take place or to recapture the lost revenue by raising tax rates to maintain revenues or otherwise change their tax laws. A partial solution would be to take the simple step of imposing state and local sales taxes on the FairTax-inclusive price of consumer goods, as we assume in this paper.

At any rate, it is wrong to suggest that the FairTax is a kind of negative-sum game in which at least one constituency – in this case state and local government – has to lose. It should come as no surprise that a major restructuring of taxes at the federal level would require state and local governments to make some accommodating restructuring of tax policy at their levels as well. With that restructuring, all parties – federal, state, and local government, as well as individuals – would remain whole at the end of the day.

This erroneous supposition leads to the following erroneous statements regarding prices and the consequences for state and local governments:

- States would encounter higher costs of financing service delivery and lose much of their ability to enforce income taxes;
- the loss of mortgage deductibility would raise housing costs, reducing the demand for residential housing;
- the cost of necessities would rise sharply; and
- the tax-inclusive price of new housing would rise.

[7] In fact, *Y* would not remain constant, but would rise, owing to the "dynamic" effects that would arise from replacing the existing tax system with the FairTax. We discuss this further below in connection with the evasion issue.
[8] Fox and Murray, op. cit.
[9] Bachman, et al. (2006) pp. 669-670.

In addition, Fox and Murray echo statements repeated by others regarding the relationship between the enactment of a federal national sales tax and the administration of state government taxes. In each situation, they reach a conclusion and provide little in the way of analysis to substantiate their assertion.

In particular, Fox and Murray contend that the loss of federal deductibility of state and local income, sales, and property taxes would cause states currently with the highest tax burdens to experience the largest increase in post-FairTax burdens. This is not entirely true. Since the FairTax would be implemented on a revenue-neutral basis, the deductions are made permanent in the federal FairTax. Moreover, the benefits of these deductions would be spread across all taxpayers in all states in the form of a lower overall rate; whereas today only those taxpayers who itemize their federal tax deductions – generally high-income filers – and pay higher state and local taxes benefit. Surely, higher-income itemizing taxpayers may face higher burdens, but their loss is passed on as a gain to lower-income taxpayers who don't itemize their deductions and live in states with lower tax burdens.

We address several other topics in section IV: "Logistical and Practical Implications Associated with Combining a National FairTax with State and Local Taxes."

## II. Measuring State-Level FairTax Rates

A national FairTax would encourage state policy makers to implement their own state-level FairTax systems, enjoying the same benefits of tax simplification, neutrality, and a stable revenue base that is less contingent upon volatile financial markets than current income taxes. In that event, Texas, Florida, Wyoming, Alaska, Washington, South Dakota, and Nevada, which impose no personal income tax today, would find the transition to a state FairTax to be relatively straightforward. Because these states (except Alaska) already depend on a sales tax for a large share of their revenue, this transition would consist largely of bringing the existing sales tax base into line with that required by the FairTax.

On the one hand, states like Massachusetts, which depend largely on income taxes, might view the transition as more difficult. Texas, on the other hand, might embrace the FairTax since the FairTax eliminates the federal income tax and imposes a tax similar to their state sales tax. Moreover, on average, state governments derive 40 percent of their revenues from income taxes (individual and corporate), as shown in Table 1.[10]

A state considering a transition to a state FairTax would need to know the tax rate required, given that it would need to expand the sales tax base in order to match the base defined by the FairTax and that it would be substituting the FairTax for other, existing taxes. BHI has therefore calculated three revenue-neutral state-levied FairTax rates for each of the 50 states based on the national FairTax proposal. These rate calculations assume that the states would implement such changes in 2007 simultaneously with the federal FairTax and that each state would provide a monthly rebate, known as a "prebate," equal to the state FairTax rate times poverty level spending to all taxpayers. The first rate calculation assumes that the states would piggyback on the prebate mechanism at the federal level, since they will already be administering the federal

[10] U.S. Census Bureau, State and Local Government Finances, Table 1. State and Local Government Finances by Level of Government and by State: 2001-02.

prebate qualification process. The second calculation assumes that the 45 states that currently levy general sales taxes would adopt the much broader FairTax base for their sales-only taxes and pay a prebate. The final calculation uses the same assumptions as above, except that we assume no prebate is paid, which allows us to see the magnitude to which paying a prebate affects the rate.

### *A. Tax-inclusive versus Tax-exclusive Rates*

It is worth noting the difference between a tax-inclusive and a tax-exclusive rate. Suppose that Joe earns $125 and spends all of his earnings. Suppose further that he pays a tax of $25. If he were subject to an income tax, he would earn $125 before tax, $100 after tax, and spend $100 at the store. Thus, he would need to earn $125 to spend $100. In the case of a sales tax, he would earn $125 and pay $125 at the store for $100 of goods. Of the $125 paid by Joe at the store, the store would remit $25 in sales tax. We may think of the tax rate as $25/$100 = 25 percent, which is the *tax-exclusive* rate ($t_{se}$); alternatively, we may report the tax rate as $25/$125 = 20 percent, which is the *tax-inclusive* rate ($t_{si}$). In this paper, we used the variables $t_{se}$ and $t_{si}$ to denote the state-level *tax-exclusive* and *tax-inclusive FairTax rates, respectively*. The 23 percent FairTax rate in H.R. 25 is a tax-inclusive rate, as is the current personal income tax; whereas, most state-level sales taxes are quoted on a tax-exclusive basis.

The federal FairTax proposal of 23 percent uses a tax-inclusive rate to compare it to the federal income tax it replaces. State sales tax rates, on the other hand, are tax exclusive. So for the sake of comparison to existing state sales tax rates, the state FairTax rates are presented here on a tax-exclusive basis.

### *B. Determining the FairTax Rate*

In this section, we determine the rate at which the state-level FairTax would need to be levied in 2007. We assume that the FairTax would be neutral in the sense that it would permit the same real expenditures by federal, state, and local government as well as cover the costs of a state-level prebate.

Under current law, the states' budget balance for 2007 may be written as:

$$(1) \qquad RS_{07} + RN_{07} + TR_{07} + Def_{07} = GS_{07} + GTP_{07} + GN_{07} .$$

Here:

- $RS_{07}$ is the revenue from taxes that would be eliminated under the state FairTax (including income, payroll, general sales, and estate and gift taxes);
- $RN_{07}$ is the revenue not replaced by the state-level FairTax, such as excise taxes and charges for services;
- $TR_{07}$ measures federal transfer payments to the states;
- $Def_{07}$ is the state budget deficits;
- $GS_{07}$ is taxable state government spending on goods and services;

$GTP_{07}$ measures state transfer payments to individuals for which the recipients are not taxed under current law and would not be taxed under the FairTax; and

$GN_{07}$ represents state spending and transfers for which the recipients would not be taxed under the federal and state-level FairTax, but for which they are taxed under current law – essentially, wage and salary costs of education plus cash payments to individuals such as unemployment insurance.

Note that all the terms in equation (1) can be measured by using estimates for 2007.

Now consider what happens with the introduction of the FairTax. Under the FairTax, equation (1) becomes:

$$(2) \qquad RS_{FT} + RN_{FT} + TR_{FT} + Def_{FT} + AC_{FT} = GS_{FT} + GN_{FT} + PRE_{FT} + GTP_{FT} .$$

In equation (2) the *FT* subscript indicates values under the FairTax, and the components that have the same basic names as in equation (1) – *RS, RN, TR, Def, GS, GN, and GTP* – represent the same revenue or expenditure components as in equation (1). Also in equation (2) we have two new terms, which are:

$AC_{FT:}$ The administrative credit that the federal government will pay states for collecting the federal FairTax. We assume that both the federal and state governments adopt the FairTax at the same time and that the federal government will only provide compensation for collecting the federal FairTax.

$PRE_{FT:}$ The prebate. This is a rebate (in advance) of taxes paid on spending up to the poverty level to be financed by new tax revenue raised by the state FairTax.

Unlike the terms in equation (1), the terms in equation (2) are not directly measurable. Two issues that arise in determining the FairTax values are the reaction of the monetary authorities to the switch to the FairTax and the amount of revenue needed for the FairTax to cover the real expenditures that had previously been financed by the existing state taxes. For a detailed discussion of these issues, see "Taxing Sales under The Fair Tax: What Rate Works?" The paper finds that prices are irrelevant to the determination of the FairTax rate.[11]

Government spending, however, must be treated differently depending on its treatment under current law and the federal and state FairTax. For any government spending which is taxed under current law and under the state or federal FairTax, the values would remain the same under each system. For example, if a state government employs a janitor today, the state must pay the federal and state income and payroll taxes on that worker's salary. Under the FairTax, the state would have to pay the federal and state FairTax on the worker's salary. Therefore, the values are roughly similar. If a state employs a teacher today, it must pay the federal and state income and payroll taxes on the teacher's salary. However, the salary for the teacher would be exempt from the federal and state FairTax, and thus must be adjusted accordingly. However, we are implicitly assuming that the state-level FairTax rate would be levied on top of the federal FairTax, just as the state sales taxes today are levied on the price of goods that includes federal and state income taxes.

[11] Bachman, et al., op. cit.

Let us now consider the individual components of equation (2). We start with nominal state government expenditures *GS* (on the right-hand side of the equation) of goods and services. Those expenditures must buy the same real goods and services under the FairTax as they would under current law.

(3) $GS_{FT} = GS_{07}$.

Nominal federal transfer payments *TR* that are not taxed under current law must remain high enough to command the same goods and services under the FairTax as they do under current law. Because the states receiving these payments in 2007 would not be taxed under current law and because the state and federal FairTax would not fall on transfer payments, $TR_{FT}$ bears a similar relationship to $TR_{07}$:

(4) $TR_{FT} = TR_{07}$.

Now let us consider transfer payments to individuals that are not purchases of goods and services but are like transfer payments except insofar as individuals receiving these payments pay income taxes on them under current law. Consider, for example, a federal government bond held by a U.S. bondholder on which the before-tax yield is *r*. The producer price, or after-tax yield, received by the bondholder holding a bond worth \$1.00 is $r(1-t_i)$ in interest after taxes, assuming his federal tax rate is $t_i$ and ignoring state and local taxes. If the market price of goods is $P_{07}$ under current law, then the bondholder's consumption in real terms is $\$\frac{r(1-t_i)}{P_{07}}$.

Under the FairTax, with the federal income tax removed, the real value of the interest received by the bondholder, barring any adjustment, becomes $\$\frac{r}{P_{07}}$. Thus, the government can now induce the taxpayer to buy the same \$1.00 in bonds by reducing the before-tax yield from *r* to $r'$, where $r' = r(1-t_i)$.

Another example is unemployment insurance benefits on which the recipients pay taxes. A recipient who receives a benefit of \$1.00 currently keeps \$1(1 – $t_i$), permitting the purchase of $\$\frac{(1-t_i)}{P_{07}}$ in goods. It costs the state government \$1.00 in before-tax benefits to provide $\$\frac{(1-t_i)}{P_{07}}$ in after-tax benefits. Once the income tax is removed and the FairTax imposed, the recipient can receive the same goods at a cost to the government of only \$1(1 – $t_i$) in real dollars.

We can think of any government expenditure – a taxable expenditure falling under the rubric of *GS*, or a transfer-like payment falling under the rubric of *GTP* or *GN* – as the purchase of a service. The difference is that services bought under the rubric of *GS* are taxable to the federal government, whereas those purchased under the rubric of *GTP* or *GN* are not. Another difference is that the receipt of *GTP* is not taxed under current law to the recipient, whereas the receipt of *GN* is.

We label, as *GN*, state government spending for services on which the government will not pay a FairTax (state or federal) but on which the recipient does pay income tax under current law. Under the FairTax, government can obtain the same volume of services by reducing the real value of *GN* to $GN\left(1-t_i-t_{si}\right)$. Whether the services being provided are those of government worker time or of a bondholder, the real value of the payment received by the individual providing those services remains the same. The difference between the worker and the bondholder is that, while the government must pay the FairTax on its purchases of the worker's services, it does not pay the FairTax on its purchases of the services of the bond. It can thus reduce its payment by $t_i$ and $t_{si}$.

Thus:

(5) $$GN_{FT} = GN_{07}\left(1-t_i-t_{si}\right).$$

We now consider the revenue side of equation (2) and begin with $RS_{FT}$, the revenue raised by the state-level FairTax. We know that the tax is levied on consumption; personal consumption and the consumption of federal, state, and local governments. Therefore:

(6) $$RS_{FT} = \left(C_{FT} + G_{FT} + GS_{FT}\right)t_{si}.$$

In the above equation, we have two new terms:

$C_{FT}$: Personal consumption at market value in 2007 under the FairTax.

$G_{FT}$: Taxable federal government consumption at market value in 2007 under the FairTax.

We assume that the terms $C_{FT}$, $G_{FT}$, and $GS_{FT}$ are inclusive of the federal FairTax in order to keep the revenue raised by the state-level FairTax constant in real terms in the presence of the FairTax. We extend the assumption that the variables under the FairTax and the current system are equal due to the presence of the federal and state-level FairTax. Therefore:

(7) $$C_{FT} = C_{07},$$

(8) $$G_{FT} = G_{07}.$$

Substituting the relationships in equations (3), (7), and (8) into equation (6):

(9) $$RS_{FT} = \left(C_{07} + G_{07} + GS_{07}\right)t_{si}.$$

Now consider $RN_{FT}$. The revenue in this category is raised by excise taxes and payment for services, such as a Medicaid co-pay. As we have mentioned previously, the revenue must buy the same goods and services for the government as it did previously. Therefore, the real revenue from those sources under the FairTax must be the same as it would be under the current law.

Hence:

(10) $RN_{FT} = RN_{07}$.

Let us now consider the state deficits. It must be noted that most states have balanced budget amendments, and therefore the deficits are quite small ($47 billion in 2005, according to NIPA Table 3.3, line 30). We assume the deficits to be financed by private saving. We continue to assume that household purchasing power remains fixed. In particular, we assume that wages will adjust to keep purchasing power constant in real terms. Therefore, we further assume saving to be constant in real terms. That means that the state deficits in 2007 will be the same under the FairTax, without monetary accommodation, as they would be under the current law. Thus:

(11) $DEF_{FT} = DEF_{07}$.

The prebate is a new category of spending by including it on the right-hand side in equation (2). This new category presents a unique problem, because the size of the prebate cannot be determined until the state FairTax rate ($t_{si}$) is determined. But $t_{si}$ cannot be determined without knowing the prebate. The solution is to measure the base on which the prebate is founded – poverty-line expenditure levels for each household, including the FairTax – which we will call $B_{07}$ and then to multiply it by the tax-inclusive rate ($t_{si}$).

(12) $PRE_{FT} = B_{07} t_{si}$.

The administrative credit that will be paid to vendors and state government for collecting the federal FairTax (and thus a new source of revenue for states under the FairTax), $AC_{FT}$, is set at a quarter of one percent (0.25 percent) of the revenue collected by the retailer, and another quarter of one percent of the revenue collected by the state and local government. To see detailed calculations of the prebate base and administrative credit, see "Taxing Sales under The FairTax: What Rate Works?" [12]

We are finally ready to set up a budget equation under the FairTax using readily available estimates of the current-law terms for 2007. Substituting expressions (3), (4), (5), (6), (7), (8), and (9) in equation (2) gives the equation for budget balance under the FairTax:

(13)

$$\left(C_{07} + G_{07} + GS_{07}\right)t_{si} + RN_{07} + TR_{07} + Def_{07} + AC_{07} = GS_{07} + GTP_{07} + GN_{07}(1 - t_i - t_{si}) + B_{07}t_{si}$$

We now group the terms that are multiplied by $t_{si}$ to get:

$$(C_{07} + GS_{07} + G_{07} + GN_{07} - B_{07})t_{si} =$$
$$GS_{07} + GN_{07} - GN_{07}t_i + GTP_{07} - RN_{07} - TR_{07} - Def_{07} - AC_{07}$$

[12] Ibid., pp. 669-671.

$$(14) \qquad t_{si} = \frac{GS_{07} + GN_{07} - GN_{07}t_i + GTP_{07} - RN_{07} - TR_{07} - Def_{07} - AC_{07}}{C_{07} + GS_{07} + G_{07} + GN_{07} - B_{07}}$$

Using (1):

$$(15) \qquad t_{si} = \frac{RS_{07} - GN_{07}t_i - AC_{07}}{C_{07} + GS_{07} + G_{07} + GN_{07} - B_{07}}$$

Inserting values from Tables 2 and 3 for the denominator and revenue values from the U.S. Census Bureau for the numerator and solving gives:

$$(16) \qquad t_{si} = \frac{495,771}{9,497,589 + 1,093,324 + 915,922 + 266,656 - 2,112,067}$$

$$(17) \qquad t_{si} = \frac{495,771}{9,661,424} = 5.13\%.$$ [13]

We could also want to estimate the tax-exclusive rate ($t_{se}$), for a better basis of comparison with existing state sales taxes. For that matter, we have to use the following relationship:

$$(18) \qquad t_{si} = \frac{t_{se}}{1 + t_{se}}$$

Since we calculated $t_{si}$, then we need to solve for $t_{se}$ in (18):

$$t_{si} \times (1 + t_{se}) = t_{se}$$
$$t_{si} = t_{se} - t_{se} \times t_{si}$$
$$t_{se} = \frac{t_{si}}{1 - t_{si}}$$

Therefore, the tax-exclusive rate is calculated in (19):

$$(19) \qquad t_{se} = \frac{5.13\%}{1 - 4.96\%} = 5.41\%$$

Table 2 contains the values for the above FairTax base variables distributed to each state. We use state variables for the revenues and distribute the federal FairTax base to each state in proportion to the state's share of the total state GDP.

[13] The value for private consumption ($C_{07}$) was adjusted by adding back in state and local sales taxes on intermediate goods. Non-taxed government spending (*GN*) includes state spending for teachers' wages and salaries.

Table 3 contains the results of the above calculations. The first calculation contained in Table 3 mirrors the national FairTax proposal at the state level by substituting a new state FairTax for existing state corporate and personal income taxes, general sales taxes, and gift and estate taxes and by instituting a state prebate. The second calculation shows what the rate would be if those states that currently impose a sales tax adopt the broader FairTax base and provide a prebate or family allowance. The third calculation duplicates the second calculation but assumes that states do not pay a prebate, as states do not today with their sales taxes. This makes it clear how much higher the rate must be to fund the prebate and allows for a better basis for comparing to today's sales tax rates.

All three calculations assume that the national FairTax is already in place, allowing state governments to save on their expenditures under *GN* (salaries and wages for teachers and unemployment benefit payments) and that states receive payment of the federal FairTax administrative credit. We also assume that states will tax federal government consumption spending within their borders, since they conform their state sales taxes to the FairTax base.

**Table 2. State FairTax Gross and Net Bases, 2007**

| State | Private Consumption (*C*) | Federal Government Consumption (*G*) | State Government Consumption (*GS*) | Gross Base (*C+G+GS*) | Prebate Base (*B*) | Non-taxable Government Spending (*GN*) | Net FairTax Base with Prebate (*C+G+GS+GN-B*) |
|---|---|---|---|---|---|---|---|
| | ($ millions) | ($ millions) | ($ millions) | ($ millions) | ($ millions) | ($ millions) | ($ millions) |
| Alabama | 115,966 | 11,183 | 15,428 | 142,577 | 33,411 | 5,153 | 114,318 |
| Alaska | 29,522 | 2,847 | 6,136 | 38,505 | 4,470 | 1,538 | 35,573 |
| Arizona | 159,345 | 15,367 | 17,371 | 192,083 | 42,915 | 3,604 | 152,772 |
| Arkansas | 67,851 | 6,543 | 9,999 | 84,393 | 20,631 | 2,754 | 66,517 |
| California | 1,246,240 | 120,184 | 157,192 | 1,523,616 | 235,039 | 29,226 | 1,317,802 |
| Colorado | 165,207 | 15,932 | 13,998 | 195,137 | 34,053 | 4,315 | 165,399 |
| Connecticut | 149,683 | 14,435 | 15,099 | 179,217 | 25,376 | 3,472 | 157,313 |
| Delaware | 42,901 | 4,137 | 4,292 | 51,331 | 6,129 | 1,182 | 46,383 |
| Florida | 499,883 | 48,207 | 49,558 | 597,649 | 135,422 | 8,297 | 470,524 |
| Georgia | 278,689 | 26,876 | 25,846 | 331,411 | 63,395 | 7,762 | 275,778 |
| Hawaii | 41,212 | 3,974 | 6,181 | 51,366 | 8,154 | 3,122 | 46,334 |
| Idaho | 35,692 | 3,442 | 4,523 | 43,656 | 9,886 | 1,181 | 34,952 |
| Illinois | 437,837 | 42,224 | 41,464 | 521,525 | 88,815 | 11,484 | 444,193 |
| Indiana | 188,223 | 18,152 | 19,697 | 226,072 | 45,519 | 6,300 | 186,852 |
| Iowa | 90,408 | 8,719 | 10,477 | 109,604 | 22,053 | 3,094 | 90,645 |
| Kansas | 81,152 | 7,826 | 8,731 | 97,710 | 20,109 | 2,803 | 80,404 |
| Kentucky | 109,106 | 10,522 | 15,305 | 134,932 | 31,085 | 4,383 | 108,230 |
| Louisiana | 131,405 | 12,672 | 15,915 | 159,992 | 31,787 | 3,914 | 132,119 |
| Maine | 35,486 | 3,422 | 5,628 | 44,535 | 10,186 | 1,118 | 35,468 |
| Maryland | 189,247 | 18,251 | 19,820 | 227,318 | 40,189 | 4,817 | 191,946 |
| Massachusetts | 256,516 | 24,738 | 29,049 | 310,303 | 47,520 | 7,343 | 270,126 |
| Michigan | 300,732 | 29,002 | 39,563 | 369,297 | 73,679 | 11,900 | 307,518 |
| Minnesota | 184,262 | 17,770 | 22,425 | 224,456 | 38,140 | 5,405 | 191,721 |
| Mississippi | 63,253 | 6,100 | 11,035 | 80,388 | 20,305 | 2,278 | 62,361 |
| Missouri | 168,862 | 16,285 | 17,174 | 202,320 | 42,931 | 3,799 | 163,188 |
| Montana | 22,627 | 2,182 | 3,607 | 28,417 | 7,073 | 914 | 22,257 |
| Nebraska | 55,773 | 5,379 | 5,417 | 66,569 | 12,829 | 1,629 | 55,369 |
| Nevada | 81,330 | 7,843 | 6,782 | 95,955 | 17,536 | 1,682 | 80,101 |
| New Hampshire | 42,726 | 4,120 | 4,347 | 51,193 | 9,686 | 946 | 42,454 |
| New Jersey | 336,585 | 32,459 | 36,368 | 405,412 | 60,603 | 10,134 | 354,943 |
| New Mexico | 52,210 | 5,035 | 8,979 | 66,223 | 13,546 | 2,058 | 54,735 |
| New York | 743,857 | 71,736 | 102,493 | 918,086 | 135,097 | 13,884 | 796,874 |
| North Carolina | 265,754 | 25,629 | 29,088 | 320,471 | 65,452 | 8,613 | 263,633 |
| North Dakota | 18,615 | 1,795 | 2,542 | 22,952 | 4,784 | 802 | 18,971 |
| Ohio | 348,780 | 33,635 | 45,391 | 427,807 | 84,721 | 10,492 | 353,578 |
| Oklahoma | 91,744 | 8,848 | 11,640 | 112,231 | 25,930 | 3,455 | 89,756 |
| Oregon | 110,428 | 10,649 | 14,444 | 135,522 | 26,870 | 3,733 | 112,385 |
| Pennsylvania | 380,428 | 36,687 | 45,680 | 462,795 | 91,255 | 13,188 | 384,727 |
| Rhode Island | 34,326 | 3,310 | 4,994 | 42,630 | 8,044 | 1,118 | 35,705 |
| South Carolina | 107,866 | 10,402 | 16,775 | 135,044 | 31,039 | 4,327 | 108,331 |
| South Dakota | 24,363 | 2,349 | 2,376 | 29,088 | 5,617 | 531 | 24,002 |
| Tennessee | 177,821 | 17,149 | 17,542 | 212,512 | 44,744 | 4,354 | 172,121 |
| Texas | 740,925 | 71,453 | 60,320 | 872,697 | 156,623 | 17,685 | 733,759 |
| Utah | 67,715 | 6,530 | 8,340 | 82,585 | 14,671 | 3,141 | 71,054 |
| Vermont | 18,041 | 1,740 | 3,173 | 22,954 | 4,747 | 830 | 19,037 |
| Virginia | 268,273 | 25,872 | 24,005 | 318,150 | 55,394 | 6,516 | 269,271 |
| Washington | 207,612 | 20,022 | 24,921 | 252,555 | 45,819 | 8,654 | 215,390 |
| West Virginia | 40,937 | 3,948 | 7,489 | 52,374 | 13,959 | 1,789 | 40,204 |
| Wisconsin | 170,414 | 16,434 | 21,818 | 208,666 | 41,051 | 5,477 | 173,092 |
| Wyoming | 19,763 | 1,906 | 2,887 | 24,556 | 3,776 | 462 | 21,242 |
| Total | 9,497,589 | 915,922 | 1,093,324 | 11,506,836 | 2,112,068 | 266,656 | 9,661,425 |

*Note: Totals may not add due to rounding.*

**Table 3. FairTax Rates for Replacing Selected State Taxes, 2007**[14]

| State | Net FairTax Base with Prebate | Gross Revenues to be Replaced (*RS*) | Adjustment for GN (*GN* x $t_i$) | Admin. Credit (*AC*) | Net Revenues to be Replaced (Sales, Income, Gift & Estate Tax ) | Sales & Gross Receipts Tax Revenue | FairTax Tax-exclusive Replacement Rates | | | Existing Sales Tax Rate |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Sales, Income, Estate & Gift Taxes | Sales & Gross Receipts Taxes | Sales & Gross Receipts (no prebate) | |
| | $ millions | $ millions | $ millions | $ millions | $ millions | $ millions | percent | percent | percent | percent |
| Alabama | 114,318 | 5,697 | 1,185 | 73 | 4,439 | 2,266 | 4.04 | 0.93 | 0.71 | 4.00 |
| Alaska | 35,573 | 483 | 354 | 19 | 110 | NA | 0.32 | NA | NA | NA |
| Arizona | 152,772 | 10,545 | 829 | 100 | 9,616 | 6,391 | 6.72 | 3.80 | 2.93 | 5.60 |
| Arkansas | 66,517 | 5,669 | 634 | 43 | 4,993 | 3,123 | 8.12 | 3.99 | 2.98 | 6.00 |
| California | 1,317,802 | 102,102 | 6,722 | 782 | 94,598 | 34,536 | 7.73 | 2.14 | 1.81 | 6.25 |
| Colorado | 165,399 | 7,253 | 992 | 104 | 6,157 | 2,348 | 3.87 | 0.78 | 0.65 | 2.90 |
| Connecticut | 157,313 | 10,617 | 798 | 94 | 9,725 | 3,576 | 6.59 | 1.78 | 1.52 | 6.00 |
| Delaware | 46,383 | 1,346 | 272 | 27 | 1,047 | NA | 2.31 | NA | NA | NA |
| Florida | 470,524 | 28,433 | 1,908 | 314 | 26,211 | 22,717 | 6.01 | 4.64 | 3.55 | 6.00 |
| Georgia | 275,778 | 15,794 | 1,785 | 175 | 13,834 | 5,923 | 5.28 | 1.50 | 1.21 | 4.00 |
| Hawaii | 46,334 | 4,026 | 718 | 26 | 3,283 | 2,382 | 7.63 | 3.94 | 3.29 | 4.00 |
| Idaho | 34,952 | 2,763 | 272 | 22 | 2,469 | 1,425 | 7.60 | 3.47 | 2.66 | 6.00 |
| Illinois | 444,193 | 19,117 | 2,641 | 275 | 16,201 | 8,058 | 3.79 | 1.20 | 1.00 | 6.25 |
| Indiana | 186,852 | 11,463 | 1,449 | 118 | 9,895 | 6,226 | 5.59 | 2.65 | 2.10 | 6.00 |
| Iowa | 90,645 | 4,338 | 712 | 57 | 3,570 | 1,760 | 4.10 | 1.14 | 0.91 | 5.00 |
| Kansas | 80,404 | 4,891 | 645 | 51 | 4,196 | 2,235 | 5.51 | 2.02 | 1.60 | 5.30 |
| Kentucky | 108,230 | 6,955 | 1,008 | 68 | 5,879 | 2,966 | 5.74 | 1.85 | 1.42 | 6.00 |
| Louisiana | 132,119 | 7,238 | 900 | 82 | 6,256 | 3,609 | 4.97 | 2.09 | 1.67 | 4.00 |
| Maine | 35,468 | 2,935 | 257 | 22 | 2,656 | 1,053 | 8.09 | 2.31 | 1.77 | 5.00 |
| Maryland | 191,946 | 11,161 | 1,108 | 119 | 9,935 | 3,222 | 5.46 | 1.08 | 0.89 | 5.00 |
| Massachusetts | 270,126 | 17,403 | 1,689 | 161 | 15,553 | 4,505 | 6.11 | 1.02 | 0.86 | 5.00 |
| Michigan | 307,518 | 17,332 | 2,737 | 189 | 14,406 | 8,920 | 4.91 | 2.07 | 1.65 | 6.00 |
| Minnesota | 191,721 | 13,602 | 1,243 | 116 | 12,243 | 4,833 | 6.82 | 1.90 | 1.57 | 6.50 |
| Mississippi | 62,361 | 4,648 | 524 | 40 | 4,084 | 2,960 | 7.01 | 4.15 | 3.07 | 7.00 |
| Missouri | 163,188 | 8,122 | 874 | 106 | 7,142 | 3,264 | 4.58 | 1.45 | 1.14 | 4.23 |
| Montana | 22,257 | 960 | 210 | 14 | 736 | NA | 3.42 | NA | NA | NA |
| Nebraska | 55,369 | 3,944 | 375 | 35 | 3,534 | 1,992 | 6.82 | 3.03 | 2.43 | 5.50 |
| Nevada | 80,101 | 3,579 | 387 | 51 | 3,141 | 3,458 | 4.17 | 4.01 | 3.25 | 6.50 |
| New Hampshire | 42,454 | 991 | 218 | 27 | 746 | NA | 1.79 | NA | NA | NA |
| New Jersey | 354,943 | 21,100 | 2,331 | 211 | 18,558 | 7,599 | 5.52 | 1.49 | 1.26 | 7.00 |
| New Mexico | 54,735 | 3,195 | 473 | 33 | 2,688 | 1,628 | 5.16 | 2.18 | 1.72 | 5.00 |
| New York | 796,874 | 47,824 | 3,193 | 467 | 44,164 | 12,564 | 5.87 | 1.15 | 0.98 | 4.00 |
| North Carolina | 263,633 | 16,812 | 1,981 | 167 | 14,664 | 5,403 | 5.89 | 1.29 | 1.03 | 4.25 |
| North Dakota | 18,971 | 789 | 185 | 12 | 593 | 443 | 3.23 | 1.37 | 1.08 | 5.00 |
| Ohio | 353,578 | 22,617 | 2,413 | 219 | 19,985 | 9,914 | 5.99 | 2.17 | 1.73 | 5.50 |
| Oklahoma | 89,756 | 5,101 | 795 | 58 | 4,249 | 1,859 | 4.97 | 1.18 | 0.90 | 4.50 |
| Oregon | 112,385 | 5,903 | 859 | 69 | 4,975 | NA | 4.63 | NA | NA | NA |
| Pennsylvania | 384,727 | 21,390 | 3,033 | 239 | 18,118 | 9,045 | 4.94 | 1.58 | 1.26 | 6.00 |
| Rhode Island | 35,705 | 2,415 | 257 | 22 | 2,137 | 1,053 | 6.37 | 2.29 | 1.85 | 7.00 |
| South Carolina | 108,331 | 6,751 | 995 | 68 | 5,688 | 3,370 | 5.54 | 2.27 | 1.74 | 5.00 |
| South Dakota | 24,002 | 808 | 122 | 15 | 670 | 747 | 2.94 | 2.67 | 2.14 | 4.00 |
| Tennessee | 172,121 | 8,923 | 1,001 | 112 | 7,810 | 7,578 | 4.75 | 4.01 | 3.14 | 7.00 |
| Texas | 733,759 | 19,055 | 4,068 | 465 | 14,522 | 18,904 | 2.07 | 2.05 | 1.67 | 6.25 |
| Utah | 71,054 | 4,472 | 722 | 43 | 3,708 | 1,950 | 5.51 | 1.78 | 1.46 | 4.75 |
| Vermont | 19,037 | 1,086 | 191 | 11 | 883 | 357 | 4.86 | 0.86 | 0.68 | 6.00 |
| Virginia | 269,271 | 15,051 | 1,499 | 168 | 13,384 | 3,626 | 5.23 | 0.75 | 0.62 | 4.00 |
| Washington | 215,390 | 10,987 | 1,991 | 130 | 8,866 | 10,207 | 4.48 | 4.07 | 3.31 | 6.50 |
| West Virginia | 40,204 | 3,000 | 411 | 26 | 2,563 | 1,184 | 6.81 | 1.98 | 1.45 | 6.00 |
| Wisconsin | 173,092 | 11,620 | 1,260 | 107 | 10,253 | 4,688 | 6.30 | 2.02 | 1.62 | 5.00 |
| Wyoming | 21,242 | 757 | 106 | 12 | 639 | 751 | 3.17 | 3.14 | 2.65 | 4.00 |
| Total | 9,661,425 | 563,063 | 61,331 | 5,961 | 495,771 | 246,619 | | | | |
| Average* | | | | | | | 5.43 | 2.02 | 1.64 | 5.25 |

*Note: Totals may not add due to rounding, weighted by tax base.*

[14] U.S. Census Bureau, Governments Division, 2004 and 2005 Survey of State Government Finances, February 2007. Available at http://ftp2.census.gov/govs/state/05statess.xls.

The rate imposed by a state version of the FairTax varies substantially across the states, from a low of 0.32 percent in Alaska, which levies neither a state sales nor income tax, to a high of 8.12 percent in Arkansas. On average, the states would be able to levy a FairTax rate of 5.43 percent to replace their current income, sales, and gift and estate taxes and provide a prebate of taxes on spending up to the poverty level. Other states that already enjoy low levels of taxation, and thus could impose low FairTax rates, include New Hampshire (state-level FairTax rate of 1.79 percent), Texas (2.07 percent), Delaware (2.31 percent), South Dakota (2.94 percent), Wyoming (3.17 percent) and North Dakota (3.23 percent). Four of these states (New Hampshire, Texas, Wyoming, and South Dakota) do not currently levy a personal income tax, with the result that their FairTax rates would be comparatively low.

The states that would require a higher FairTax rate include a mix of high-tax states, such as Arkansas (state-level FairTax rate 8.12 percent), Maine (8.09 percent), Hawaii (7.63 percent), California (7.73 percent), and Minnesota (6.82 percent) and states that already rely more on sales taxes, such as Mississippi (7.01 percent). The states of West Virginia (6.81 percent) and Idaho (7.60 percent) already levy relatively high sales tax rates, while their per capita income, which is a good proxy for their base, is relatively low. States would require higher FairTax rates if their state-level tax burdens are high, if they currently impose a high sales tax rate, or if their FairTax base would be relatively low.

The second calculation is shown in Table 3, in which those 45 states that levy state sales and gross receipts taxes would adopt the FairTax base including the payment of the prebate to all qualified citizens. Since the calculation assumes that states would not replace their income taxes with the FairTax, states would still have to pay state income taxes on expenditures *GN*, but would still enjoy the savings from the repeal of the federal income and payroll taxes. As a result, we remove *GN* from the state FairTax base, but retain the adjustment to state spending under *GN* to account for the removal of federal taxes ($GN \times t_i$). The FairTax base that includes services and items commonly exempt from sales taxes, such as food and clothing, would allow states to substantially reduce their sales tax rates while making spending up to the poverty level tax free.

Finally, we calculate the sales and gross receipts tax rate for each state assuming the broader FairTax base is adopted and, as is the case today, the states do not make spending up to the federal poverty level tax free through the payment of a prebate. As the second to last column in Table 3 shows, the average rate would fall by almost an additional 0.4 percent, to 1.64 percent, from the FairTax rate that includes the payment of a prebate. State sales tax rates would drop, on average, by over 3.5 percentage points, and yet raise the same revenue as existing sales taxes.

The biggest winner from moving to the FairTax base would be New Jersey, which would be able to reduce its sales tax rate by 5.51 percentage points. Other winners include Vermont (5.14 percentage point reduction), Illinois (5.05), Rhode Island (4.71), Minnesota (4.60), Pennsylvania (4.42), and Connecticut (4.22), all of which could reduce their sales tax rates by over 3.5 percentage points and still bring in the same amount of revenue as under their current systems. Wyoming (0.86 percentage point reduction), Florida (1.36), South Dakota (1.33), and Arizona (1.80) would experience the smallest drop in their sales tax rates by adopting the FairTax base, yet each of these states would experience a sales tax cut of about one percentage point. All 45 states would be able to cut their sales and general receipts tax rate, on average, by 3.5 percentage points, even as they pay the prebate to all citizens. States could provide their citizens with a substantial reduction in their sales tax rates without sacrificing revenue, and this would serve to

remove the bias toward the taxation of goods as opposed to services that is present in state sales tax systems today.

Before deciding to move to a state FairTax system, states should also know how the switch would impact their economies. The next section provides estimates for five representative states.

## III. The Economic Effects of Federal and State FairTaxes on Select State Economies

The implementation of a state-level FairTax would produce economic effects that differ from a national FairTax. Local economic activity is more sensitive to changes in state taxes than federal taxes, in part due to the interstate mobility of capital and labor. If Massachusetts were to raise its income tax by a percentage point, for instance, people and investment would migrate to Rhode Island and New Hampshire. On the other hand, if the national income tax were raised by a percentage point, firms and people would be less likely to migrate to other states or countries.

The implementation of a FairTax would increase saving, whether the tax were implemented at the national or the state level. The benefits derived from increased saving are, however, almost entirely national in scope. There is no guarantee that increased saving by Iowans, whatever the cause, will lead to more investment and job creation in Iowa.

BHI has built dynamic Computable General Equilibrium (CGE) models for over 20 different states to simulate the effects of changing tax policy on economic variables such as employment, wages, investment, and disposable income.[15] A CGE model is a formal description of the economic relationships among producers, households, government, and the rest of the world. It is general in the sense that it takes all the important markets and flows into account. It is an equilibrium model because it assumes that demand equals supply in every market (goods and services, labor and capital); this is achieved by allowing prices to adjust within the model (i.e., they are endogenous). It is computable because it can be used to generate numeric solutions to concrete policy and tax changes with the help of a computer. And it is a tax model because it pays particular attention to identifying the role played by different taxes.

BHI uses CGE models for five states (Massachusetts, Illinois, Texas, Virginia, and New Jersey), that represent diverse political and economic environments, to simulate the effects of each state conforming its state sales tax base to the federal FairTax base and replacing the revenues derived from its current income taxes with state-level FairTaxes. Each simulation was conducted assuming implementation of the national FairTax in 2007. Each state model also captures the changes to private employment, investment, wages, and disposable income. The models generally cover a time period of five years beginning in 2005, and we report the changes in the variables for the year 2009. Table 4 contains the results.

For Massachusetts, Illinois, Virginia, and New Jersey, the simulation was conducted by replacing the projected revenue generated by each state's personal and corporate income taxes with a state-level FairTax. However, Texas does not levy personal income taxes and collects most of its revenue from its current sales tax. Texas does tax corporations through a business franchise tax, thus for the Texas simulation, we only remove the business franchise tax and adjust the base of

[15] For an introduction to CGE tax models, see Shoven and Whalley (1984). Shoven and Whalley have also written a useful book on the practice of CGE modeling entitled *Applying General Equilibrium*.

the state sales tax to closely mirror that of the FairTax. The current sales tax in Texas raises a large proportion of its revenue from taxing business inputs and does not tax services. The FairTax does not tax business inputs but does tax the final consumption of all goods and services without exemptions like food and clothing. A broader base enables lower tax rates. These effects show up in large investment and wage increases for Texas. Nonetheless, the simulations result in similar changes in the economic variables across all the five states. Table 4 below presents the changes to each economic indicator resulting from the simulation.

The simulations for Massachusetts, Illinois, and Virginia show private sector employment gains of well over 15 percent, while New Jersey and Texas experience smaller increases of 12.5 and 10.9 percent, respectively. The removal of the personal income tax boosts the reward for labor by increasing the take-home pay of workers, which in turn provides a strong incentive for residents currently not in the labor force, such as retirees and stay-at-home parents, to reenter the labor force, as well as encourage nonresidents to migrate to the FairTax state.

**Table 4. The Economic Impact of Implementing State-level FairTax on Selected States, 2009**

| Economic Indicator | Massachusetts | Illinois | Virginia | New Jersey | Texas |
|---|---|---|---|---|---|
| Private employment (jobs) | | | | | |
| Baseline | 3,102,564 | 5,694,429 | 3,215,998 | 3,595,077 | 8,982,667 |
| FairTax | 3,571,853 | 6,572,841 | 3,723,284 | 4,045,390 | 9,964,097 |
| Percentage change | 15.1 | 15.4 | 15.8 | 12.5 | 10.9 |
| Investment ($ millions) | | | | | |
| Baseline | 64,408 | 142,037 | 68,500 | 89,060 | 239,265 |
| FairTax | 125,681 | 270,909 | 129,075 | 173,427 | 458,027 |
| Percentage change | 95.1 | 90.7 | 88.4 | 94.7 | 91.4 |
| Gross annual wage rates ($ per year) | | | | | |
| Baseline | 58,429 | 48,571 | 46,478 | 57,286 | 46,500 |
| FairTax | 61,233 | 51,583 | 48,197 | 61,639 | 51,522 |
| Percentage change | 4.8 | 6.2 | 3.7 | 7.6 | 10.8 |
| Real disposable income ($ millions) | | | | | |
| Baseline | 290,482 | 488,794 | 304,014 | 402,026 | 884,660 |
| FairTax | 324,651 | 548,184 | 333,426 | 444,384 | 972,244 |
| Percentage change | 11.8 | 12.2 | 9.7 | 10.5 | 9.9 |

*Note: Totals may not sum due to rounding.*

This influx of new workers increases the labor supply, initially putting downward pressure on wages and thus lowering labor costs for producers and providing them with an incentive to hire more workers. Employers would also see the removal of their portion of the payroll taxes at the federal level which further drives down the cost of labor, providing another powerful incentive to hire more workers. The combined federal and state tax changes under a combined FairTax would produce strong employment growth in the states.

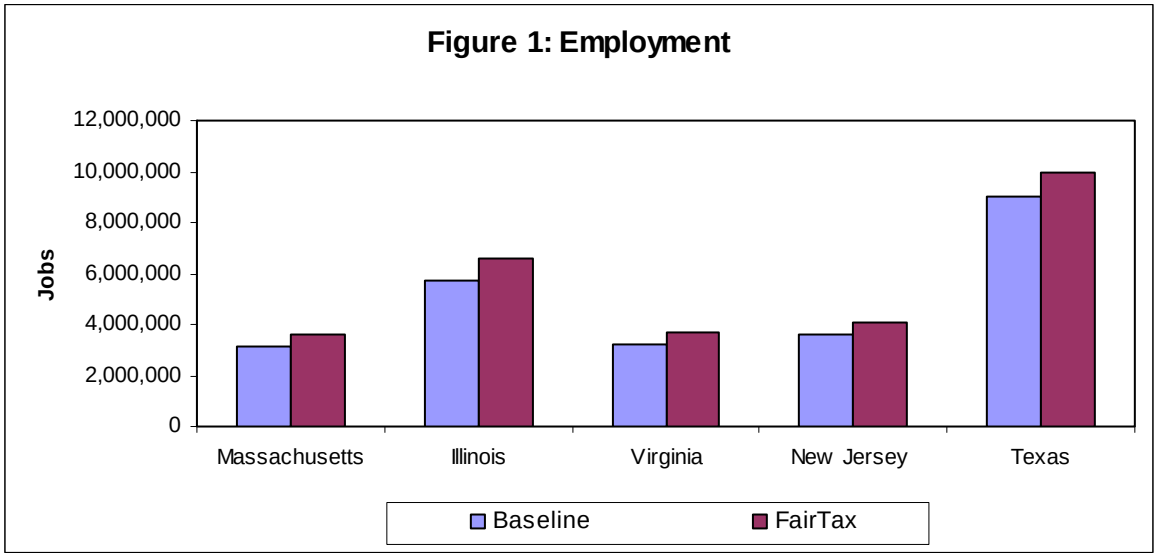
As one would expect, the switch to federal and state-level FairTaxes produces a large positive impact on investment levels. All five states see levels leap by roughly 90 percent by 2009. The vast majority of the new investment derives from the change to the federal FairTax system, because investment increases due to changes in state taxes would not necessarily be deployed locally.

The increase in employment produces negative pressures on gross annual wages, because the increase in the labor supply brought about by the introduction of the FairTax, described above, increases competition between workers in the labor market, which in turn triggers a drop in the price of labor. However, the removal of the state and federal taxes on capital (corporate income taxes) produces a dramatic increase in investment and translates into a similar boost to labor productivity, which in turn increases the demand for labor and allows wages rise. The effects on wages are distributed unevenly across the five states: Texas would enjoy a 10.8 percent increase in wages, followed by New Jersey (7.6 percent), Illinois (6.2 percent), and Massachusetts (4.8 percent) with similar impacts; and in Virginia wages rise by 3.7 percent.

The removal of the federal and state income taxes from the paychecks of workers and earnings of business owners provides a direct boost to real personal income in these states. In all states, real disposable incomes increase by nearly 10 percent or more.

The implementation of federal and state-level FairTaxes produces large, positive effects on state economies. These effects, however, will not be uniform. Some states would see more job growth and higher investment levels than others, depending on the structure of their economies and existing tax systems. Nevertheless, citizens of every state should see a large boost to their wages and disposable incomes.

Figures 1 through 4 provide a graphical representation of the figures in Table 4.



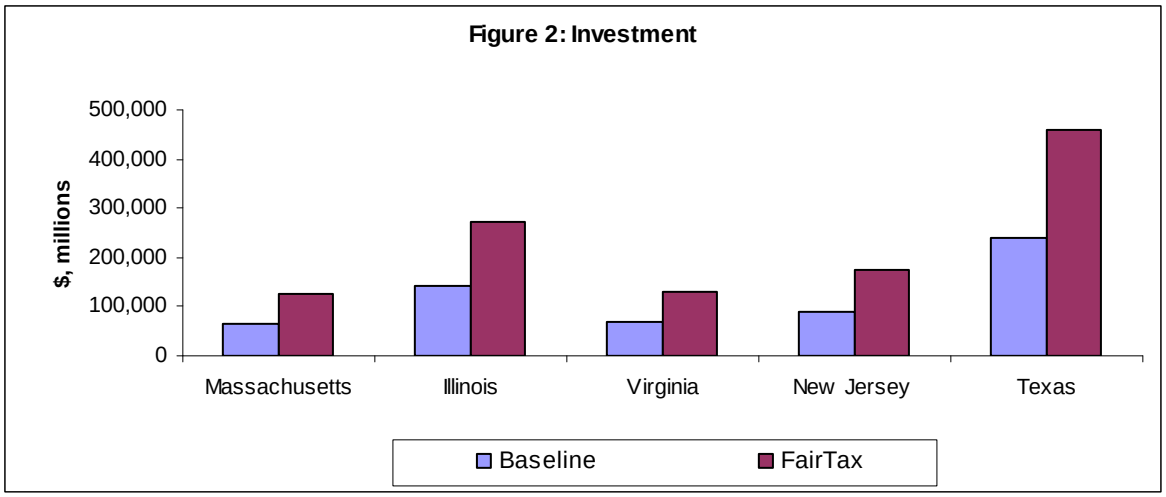


Figure 2: Investment
$, millions
500,000
400,000
300,000
200,000
100,000
0
Massachusetts
Illinois
Virginia
New Jersey
Texas
Baseline
FairTax

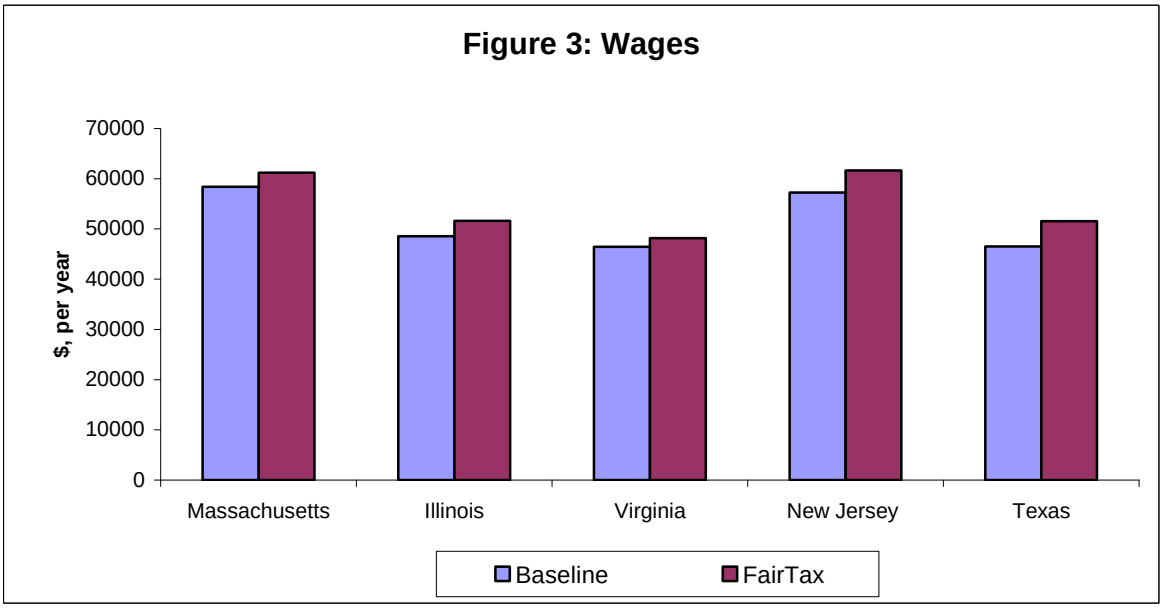
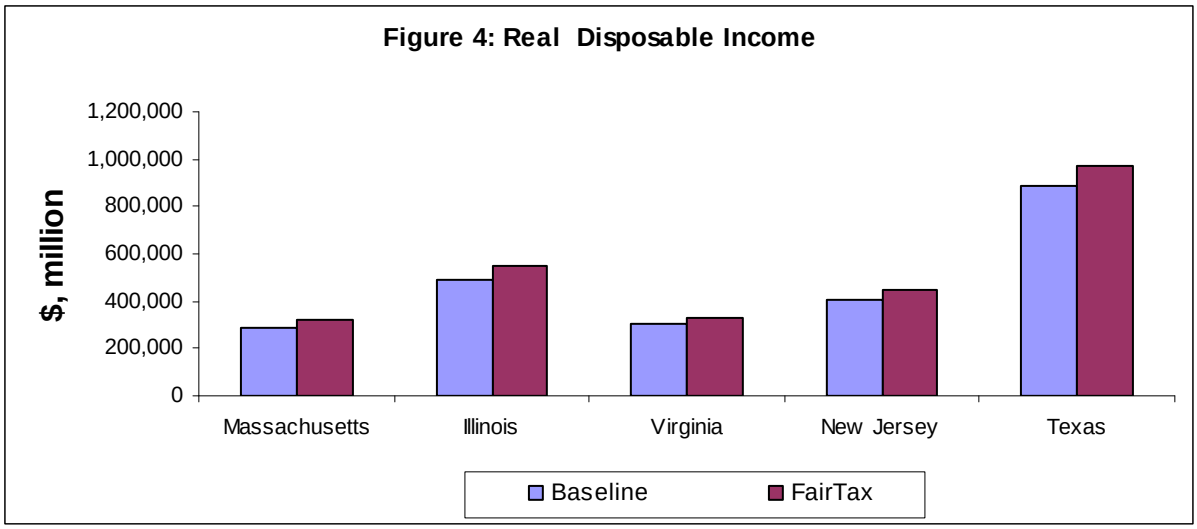


Figure 3: Wages
$, per year
70000
60000
50000
40000
30000
20000
10000
0
Massachusetts
Illinois
Virginia
New Jersey
Texas
Baseline
FairTax




## IV. Logistical and Practical Implications Associated with Combining a National FairTax with State and Local Taxes

As discussed in the previous section, the introduction of a federal FairTax would affect various state-level economic magnitudes differently. Some state tax officials have expressed concern that the implementation of a national FairTax combined with existing state taxes would pose a number of logistical and practical challenges to state taxpayers and policy makers.[16] This section catalogues, discusses, and evaluates these arguments.

### *A. The Current State Tax Structure*

Table 5 highlights the major taxes imposed by the states and those states that use the federal income tax as a starting point for the calculation of state personal income taxes. The states vary in the type and mix of taxes they employ. Forty-five states levy some form of statewide sales tax, while 43 states tax a portion of personal income. Of these, 36 states use the federal tax code as a starting point to simplify their tax calculations and forms. New Hampshire and Tennessee tax only dividend and interest income. Nevada, Texas, Washington, and Wyoming do not tax the earnings of their corporations. It has been argued that this mix of taxes would provide states with different challenges and opportunities under a national FairTax system, some of which are discussed below.

[16] See Fox and Murray (2005).

## Table 5. Sales and Income Taxes by State

| State | Sales Tax | Levy Income Tax | | Federal Starting Points |
|---|---|---|---|---|
| | | Corporate | Personal | |
| Alabama | 4.00 | Yes | Yes | NA (state defined) |
| Alaska | NA | Yes | No | NA |
| Arizona | 5.60 | Yes | Yes | Federal AGI |
| Arkansas | 6.00 | Yes | Yes | NA (state defined) |
| California | 6.25 | Yes | Yes | Federal AGI |
| Colorado | 2.9 | Yes | Yes | Federal taxable income |
| Connecticut | 6.00 | Yes | Yes | Federal AGI |
| Delaware | NA | Yes | Yes | Federal AGI |
| Florida | 6.00 | Yes | No | NA |
| Georgia | 4.00 | Yes | Yes | Federal AGI |
| Hawaii | 4.00 | Yes | Yes | Federal taxable income |
| Idaho | 6.00 | Yes | Yes | Federal taxable income |
| Illinois | 6.25 | Yes | Yes | Federal AGI |
| Indiana | 6.00 | Yes | Yes | Federal AGI |
| Iowa | 5.00 | Yes | Yes | Federal AGI |
| Kansas | 5.30 | Yes | Yes | Federal AGI |
| Kentucky | 6.00 | Yes | Yes | Federal AGI |
| Louisiana | 4.00 | Yes | Yes | Federal AGI |
| Maine | 5.00 | Yes | Yes | Federal AGI |
| Maryland | 5.00 | Yes | Yes | Federal AGI |
| Massachusetts | 5.00 | Yes | Yes | Federal AGI |
| Michigan | 6.00 | Yes | Yes | Federal AGI |
| Minnesota | 6.50 | Yes | Yes | Federal taxable income |
| Mississippi | 7.00 | Yes | Yes | NA (state defined) |
| Missouri | 4.23 | Yes | Yes | Federal AGI |
| Montana | NA | Yes | Yes | Federal AGI |
| Nebraska | 5.50 | Yes | Yes | Federal AGI |
| Nevada | 6.50 | No | No | NA |
| New Hampshire | NA | Yes | Yes | NA (state defined) |
| New Jersey | 7.00 | Yes | Yes | NA |
| New Mexico | 5.00 | Yes | Yes | Federal AGI |
| New York | 4.00 | Yes | Yes | Federal AGI |
| North Carolina | 4.25 | Yes | Yes | Federal taxable income |
| North Dakota | 5.00 | Yes | Yes | Federal taxable income |
| Ohio | 5.5 | Yes | Yes | Federal AGI |
| Oklahoma | 4.5 | Yes | Yes | Federal AGI |
| Oregon | NA | Yes | Yes | Federal taxable income |
| Pennsylvania | 6.00 | Yes | Yes | NA (state defined) |
| Rhode Island | 7.00 | Yes | Yes | Federal AGI |
| South Carolina | 5.00 | Yes | Yes | Federal taxable income |
| South Dakota | 4.00 | Yes | No | NA |
| Tennessee | 7.00 | Yes | Yes | NA |
| Texas | 6.25 | No | No | NA |
| Utah | 4.75 | Yes | Yes | Federal taxable income |
| Vermont | 6.00 | Yes | Yes | Federal taxable income |
| Virginia | 4.00 | Yes | Yes | Federal AGI |
| Washington | 6.50 | Yes | No | NA |
| West Virginia | 6.00 | Yes | Yes | Federal AGI |
| Wisconsin | 5.00 | Yes | Yes | Federal AGI |
| Wyoming | 4.00 | No | No | NA |

### *B. State Piggybacking of the Federal System*

Some states link their income tax systems to the federal income tax structure by using the calculation of federal adjusted gross income (AGI) or taxable income as a starting point for calculating state income taxes. Federal AGI is defined as gross income minus adjustments to income and does not include standard or itemized deductions, while federal taxable income does include exemptions and standard or itemized deductions.[17] As shown in Table 4, in 2004, 26 states used the federal AGI as the starting point for the calculation of taxable income, while 10 additional states used federal taxable income. Five other states use their own methods for calculating personal income taxes.

The use of AGI and federal taxable income as starting points for the calculation of state income taxes allows for simpler and faster tax preparation and abbreviated state tax forms. Taxpayers need only calculate their taxable income once – on their federal form – and then simply use this number for calculating state taxes.

Policy makers in the 36 states that currently piggyback on the federal income tax code to simplify the calculation of state income taxes would need to make significant administrative and legislative changes to their tax systems under a national FairTax. With the federal starting points eliminated, these states would no longer have a common basis for calculating taxable income and would need to establish new starting points as well as redesign tax forms to accommodate the changes. This additional work that would be required under a national FairTax might not engender goodwill toward the proposal by citizens, lawmakers, and tax administrators of these states were they to stick with the status quo of their current systems.

Under the current system, however, states are accustomed to adjusting their tax systems to frequent changes in the federal tax structure. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phases out the federal estate tax and culminates in a full repeal in 2010. This legislation also repealed the federal estate tax credit. In most states, estate and inheritance taxes are designed in such a way that states face either a full or partial loss of estate tax revenues as this credit is phased out. Several states averted this loss of revenue by decoupling their tax code from the changes in the federal tax code, in most cases by remaining linked to federal law as it existed prior to the change.

Seventeen states and the District of Columbia have retained their estate taxes after the federal changes. Of these, 15 states (Illinois, Kansas, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Ohio, Oregon, Rhode Island, Vermont, Virginia, and Wisconsin) and the District of Columbia decoupled from the federal changes. Two states (Nebraska and Washington) retained their tax by enacting similar but separate estate taxes. Thus, under the current federal tax code, states must adapt their tax codes to an ever-changing and evolving federal tax code.

Moreover, since states have exhibited a penchant to piggyback on the federal tax system, they would now have even more incentive to adopt a state-level FairTax that closely mirrors the federal FairTax. States can take advantage of the relative simplicity of administering a single state and federal FairTax relative to the intricacy of administering the current state tax system (which involves any combination of personal and corporate income taxes, gift and estate taxes,

[17] Internal Revenue Service, Instructions for Form 1040, Publication 17, Catalogue Number 10311G.

and sales taxes). Furthermore, a combined federal and state FairTax would liberate residents from the agonizing task of filling out complex and opaque annual tax returns that are often time consuming and expensive, especially when using professional tax preparation. Once citizens experience the benefits of the federal FairTax, such as the elimination of the federal 1040 tax form, they may lobby in favor of a state FairTax.

### *C. Federal Taxes (National Sales Taxes) Would Not Be Deductible from State Taxes*

Eight states currently allow for the deductibility of at least a portion of federal income taxes from their state income taxes. The details are summarized in Table 6. Of these states, only four states allow for the full deductibility of federal personal income tax (Alabama, Iowa, Louisiana, and Montana); two states allow for specific deductions for joint and individual filers (Missouri and Oregon) and two states allow the deduction of a specific portion of the federal personal income tax (Oklahoma and Utah).

**Table 6. States with Federal Personal Income Tax Deduction**

| State | Detail of Deductibility |
|---|---|
| Alabama | Full deductibility of federal personal income tax |
| Iowa | Full deductibility of federal personal income tax |
| Louisiana | Full deductibility of federal personal income tax |
| Montana | Full deductibility of federal personal income tax |
| Missouri | Deduction is limited to $10,000 for joint returns and $5,000 for individuals. |
| Oklahoma | Separate schedules, with rates ranging from 0.5 to 10, apply to taxpayers deducting federal income taxes or married persons filing jointly; the same rates apply to income brackets that are twice the dollar amounts as for individual payers. |
| Oregon | Deduction is limited to $5,000 for joint and individual returns. |
| Utah | One-half of the federal income taxes are deductible. |

*Source: Federation of Tax Administrators, www.taxadmin.org.*

Should these eight states decide to keep their income taxes, the elimination of federal income taxes under the FairTax would remove a major deduction from state personal income taxes. In response, these states would need to find some other mechanism to provide a deduction that is similar to the federal income tax deduction – a move which would require legislative and administrative action by state officials. If these states do nothing, then some taxpayers would, in effect, face a state tax increase which would likely cause them to protest the choice. On the other hand, these states could simply reduce their tax rates to compensate their taxpayers for the loss of the deduction. This might present the simplest and best solution and afford state political leaders the opportunity to reduce tax rates and earn political capital with their constituents.

Conversely, these eight states could choose to align their state tax systems to the federal FairTax or simply allow for the deduction of the federal FairTax from state taxes – a process that would closely mirror the current practice of deducting federal taxes from state taxes. This move would call for some changes in administrative policies, but for the most part a majority of these eight states already have the necessary mechanisms set up to accommodate federal deductions from state taxes. Moreover, all of these eight states could replace their current sales, income, and

estate taxes with a state-level FairTax rate of 5.5 percent or less. While the bureaucracies and their allies in these states, who instinctively resist change, may oppose the change to a state FairTax, the switch would produce the economic benefits seen above and the simplification of one standard tax.

### *D. Substantial Differences Between FairTax and Current State Sales Tax Bases*

Current state sales taxes are primarily applied to durable and nondurable goods, with most states levying sales tax on only a very narrow range of services. The Federation of Tax Administrators estimates that there may be as many as 164 potentially taxable services currently untaxed.[18] The survey found that, on average, states tax 55 services, with business and other services the most frequently taxed and computer and professional services the least taxed. Hawaii and New Mexico have broad-based sales taxes that include almost all the services (160 and 156, respectively). In fact, the survey found that five states already have sales taxes that tax 85 or more of those service categories. Nevertheless, state sales taxes have lagged behind the general trend of the U.S. economy moving away from goods production and toward higher-value service production.

In order to remain economically neutral, the FairTax proposal seeks to tax all sales of new goods and services for final consumption, while exempting used goods that were previously subject to the FairTax and intermediate consumption (i.e., business inputs and investment used to produce goods that will eventually be incorporated into goods and services sold to consumers and are subject to tax).

In other words, the FairTax proposal would tax all sales of new goods and services for personal and government consumption, while used goods and business-to-business purchases would be exempt. However, combining this uniform FairTax system with the haphazard sales taxes employed in many states might cause confusion. In those states determined to maintain their existing sales tax system, for example, to continue the practice of excluding certain necessities like food and clothing, the state sales tax base would be much different than that of the FairTax.

To avoid the problems of administering two sales tax systems, states would be inclined to reconfigure their sales taxes to the broader federal FairTax base to benefit from the administrative simplicity and the economies of scale from administering one sales tax to collect both state and federal sales tax revenues. The FairTax encourages states to do this, authorizing the Secretary of the Treasury to enter into an agreement with conforming states which enables them to collect state sales tax on sales made by sellers outside a particular state to a destination within that state. For example, if Florida were to conform its state sales tax base to the FairTax, then Internet or mail-order sales from outside Florida to Florida residents would be subject to the Florida sales tax. Currently, the U.S. Supreme Court has ruled that states cannot collect state sales taxes on most Internet or mail-order sales to their residents. This is quite a financial incentive, given that the revenue losses to states from this prohibition are estimated to be between $21.5 billion and $33.7 billion for 2008.[19]

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[18] Federation of Tax Administrators, "2004 Survey on State Taxation of Services." Available at http://www.taxadmin.org/fta/pub/services/services04.html.
[19] Bruce and Fox (2004).

States could also avail themselves of the greatly reduced rates, shown in Table 3 above, associated with capturing the service sector, which has grown relative to goods in our economy, and which most current state sales taxes have failed to capture.

Nevertheless, states might see lobbying from vested interests in those industries whose products and services are currently exempt from state sales taxes. Although the FairTax would free these industries – indeed, all industries – of the payroll and corporate income taxes, the industry lobbies might be tempted to use the standby argument that their products are essential for survival, such as food and clothing, and thus should continue their tax-exempt status. But such exemptions for necessities can provide high-spending/high-income taxpayers with a disproportionate 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. Despite their spurious nature, these arguments for tax discrimination have proved powerful in the past and have become so ingrained in the public conventional wisdom that they may be difficult to overcome. On the other hand, once the FairTax is enacted at the federal level, it is probably just as likely that the large multi-state retailers will lobby extensively in state legislatures to keep everything taxable, as they would benefit greatly in reduced compliance costs and would want to see uniformity in the tax base from state to state.

### *E. Interstate Variation in Sales Taxes*

To avoid the complexity of administering two sales taxes as described above, states could choose to mesh their sales taxes with the federal FairTax. Most states that choose this path would also benefit by significantly broadening their sales tax base, which would, in turn, allow them to reduce their state sales tax rates significantly.

Today, considerable variation exists in the sales tax base from state to state, creating significant compliance costs for businesses with multi-state operations. This led the National Conference of State Legislatures (NCSL) to establish the Streamlined Sales Tax Project (SSTP), whose purpose is to get agreement among states on uniform rules for assigning transactions to jurisdictions, on common definitions, on state-level administration of state and local sales taxes, on certification of software that sellers may 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, and 22 states have already implemented the harmonization agreement.[20]

Large interstate differences in tax rates could emerge as some states brought their sales taxes into line with the FairTax standards while others did not. For example, Massachusetts could convert the state sales tax to a FairTax, pay a prebate, and lower the rate from the current rate of 5 percent to 1.74 percent, as shown in Table 3. If, at the same time, neighboring Rhode Island retained its current state sales tax rate of 7 percent, the difference between the sales taxes of the states would widen from 2 percent to 5.24 percent. Such a large variation between states would then encourage comparative shopping – with taxpayers from states with higher combined overall state and federal sales tax rates making their purchases in neighboring states with lower combined overall sales tax rates. This large disparity in sales tax rates and subsequent comparative shopping could cause a domino effect: As states adopted the FairTax base, tax revenue leakage from cross-border purchases would encourage neighboring states to do the

[20] See details of Streamlined Sales Tax Project at http://streamlinedsalestax.org/.

same. The end result might be that all 50 states and the federal government would share the same tax base, making administration and compliance much easier and less costly.

### *F. Federal/State Cooperation to Enforce State Taxes*

Compliance costs of the existing tax system, measured by dollars per employee, are twice as high for small businesses and start-ups as they are for large businesses.[21] Additionally, under the current tax structure, small businesses receive no monetary incentive to comply with the tax code or a credit to compensate for the costs associated with compliance, making evasion an attractive choice. Therefore, tax administrators find it much harder to identify sales tax evaders, since small businesses have a greater incentive to evade taxes due to their small sales volumes and tax burdens. Under the FairTax, the elimination of the federal income tax and the income tax data provided by the Internal Revenue Service would remove one tool currently used by state tax administrators to identify small businesses that fail to remit sales taxes.

Supporters of the income tax may make too much of the fact that a federal sales tax would place the responsibility for tax collection with the retailer, a sector of the economy in which small businesses are more represented. Small businesses are viewed as more likely to evade taxes since the owner, and beneficiary of tax evasion, is more likely to also be responsible for keeping the books and filing the tax returns. A number of factors, however, reduce the importance of this consideration. First, small businesspersons who are inclined to cheat on their sales tax are probably already cheating on their income tax and would be inclined to do so under any tax system. Second, the economic importance of small firms in the retail sector is usually grossly overstated. According to the Joint Committee on Taxation (JCT), small firms only account for 14.9 percent of gross receipts of all retailers, wholesalers, and service providers.[22] Since the gross receipts of wholesalers would not typically be subject to tax, the true scope of the small "problem" companies is smaller still.

#### *1. Administration, collection, and compliance costs*

In a separate study, "Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System," BHI compared the administrative costs of the FairTax to those associated with the current federal tax system.[23] The report accounts, where possible, for changes in efficiency levels due to the introduction of the FairTax but does not address the effects the tax change might have on tax evasion and avoidance.

These estimates show that the FairTax would introduce very significant efficiency gains to the collection system. In 2005, administering the FairTax would have cost the state governments a total of $17.5 billion, or $0.42 per $100 of revenue collected compared with the $0.84 per $100 of net tax revenue that it cost the IRS to collect its revenue. It would also cost the federal government $0.27 per $100 of revenue to collect the FairTax on federal employee wages. Thus, the FairTax is a more efficient tool of tax collection at the government level.

[21] Crain and Hopkins (2001).
[22] IRS Statistics of Income, "Impact on Small Business of Replacing the Federal Income Tax," cited in Joint Committee on Taxation JCS-3-96, April 23, 1996, pp. 109-127.
[23] Tuerck, et al. (forthcoming).

At the retail level, the gains are much more significant. BHI estimated that retailers would spend $60.5 billion to collect and file the FairTax payments, or $2.74 per $100 of the revenue they collected. In comparison, sole proprietors, corporations, and nonprofit organizations face estimated costs of $17.44 per $100 of revenue collected to collect and comply with the taxes that would be replaced by the FairTax.

Finally, we estimated the total FairTax administration, collection, and compliance costs to be $70.1 billion, or $3.43 per $100 of the total revenue raised by the FairTax. The same costs under the current system are $416.6 billion, or $18.13 per $100 of the net revenue collected. These estimates imply that the FairTax would save $346.5 billion in administration, collection, and compliance costs, representing a savings of $14.70 per $100 of the net revenue collected by the taxes that would be replaced by the FairTax.

The study shows that the FairTax is a much more efficient tool of collecting taxes than the current system. These results provide statistical evidence for the efficiency gains that would result from the FairTax. The reasons for these gains are fairly straightforward.

The General Accounting Office, among others, has specifically identified the inverse relationship between compliance costs and the number of focal points for collection. Consider, for example, how many taxpayers there are today compared to what there would be under the FairTax. Under the FairTax, tax evasion thus becomes considerably harder, as the base of tax collection is significantly reduced. In 2004, Americans filed over 200 million federal tax returns that yielded approximately $2 trillion in revenue.[24] Of this, individual income tax filers comprised 76 percent of the total filers and were the largest source of tax revenue. Under the FairTax structure, tax administrators would count on only approximately 4 to 10 million businesses (depending on the definition of retailer under the FairTax) estimated to file taxes, representing only a fraction of the tax returns filed in 2005.[25] This drop in the population of tax filers would make compliance audits much easier for tax administrators. The compliance benefits attributed to reducing the number of tax filers would also be available to states that adopt a state FairTax. Therefore, state governments that adopt the FairTax would likely find the task of detecting tax evaders easier.

Because the FairTax reduces the number of tax filers by as much as 90 percent, as individuals are removed entirely from the tax system, enforcement authorities can catch tax evaders by monitoring far fewer taxpayers. Because the number of collection points is so much lower under the Fair Tax, the audit rate for potential evaders increases considerably, and the likelihood of apprehension is correspondingly higher. The perception of risk as a deterrent should also increase commensurately. In other words, the risk of detection increases and the risk-adjusted cost of evasion also increases. In short, tax collectors focus enforcement resources on far fewer taxpayers. Taxpayers, using consistent and vastly simpler forms, have far fewer opportunities to cheat, diminished incentives to do so, and a far greater chance of getting caught cheating.

[24] See Internal Revenue Service, "Summary Report of Returns Filed for Fiscal Year 2004." Available at http://www.irs.gov/pub/irs-soi/05db02nr.xls.

[25] U.S. Census Bureau, 2002 Economic Census, Comparative Statistics for United States: Summary Statistics by 1997 NIACS. Available at http://www.census.gov/econ/census02/data/comparative/USCS.HTM. Includes all major industries except mining, wholesale, construction, manufacturing, transportation and warehousing, and information. Using the growth rate retailer filing data for the past 10 years, we project the number of retailers that would file in 2007.

Furthermore, under the FairTax, states would have an alternative method of identifying tax evaders. Companies that register as sellers to purchase tax-free business inputs and remit suspiciously low tax collections to the state and federal authorities could be investigated for the possibility of tax evasion. Secondly, cross audits between businesses acting as vendors could also provide relevant information regarding the business activities of a company. With the availability of business input purchase activity information and the reduction of the taxpayer base as discussed above, authorities would be able to investigate and identify suspicious activities in a more timely fashion.

Simplicity and visibility go hand in hand, and a FairTax increases the visibility of transactions. Today, taxpayers can cheat in the privacy of their homes, burying their illicit tax avoidance on 227 million tax returns in the morass of 7,000 code sections with plausible deniability. The FairTax increases the likelihood that tax evasion is uncovered and leaves little room to hide between honesty and outright fraud. When an individual claims exemption, he has to do so in a very visible way at the cash register. Furthermore, under the current system, the taxpayer can hide behind the protection of tax laws such as Section 6103, Confidentiality and disclosure of returns and return information. The GAO reports that the issue of visibility is a major determinant of compliance. [26]

The FairTax abolishes the IRS and, in doing so, eliminates the federal income tax data that state tax administrators currently use to ensure compliance with their own taxes. However, when dealing with the national sales tax, the enforcement process will be aided by the very large proportion of sales transactions that are made with credit/debit cards. However, the fundamental changes to the federal tax code under the FairTax serve to simplify the job of ensuring tax compliance by reducing the number of filers and eliminating the complexity that fosters evasion.

### *G. The FairTax Administrative Credit to the States and Vendors*

The Fair Tax Act of 2007, H.R. 25/S. 1025, calls for an administrative credit (AC) that will be paid to both vendors and state sales tax administering authorities for collecting the FairTax. Vendors, or "registered sellers," can retain one quarter of one percent (0.25) of the revenue they collect and states can retain another quarter of a percent of the revenue they collect. We presume that the federal government would not get an AC for the FairTax it collects.[27] BHI estimates the total amount of AC paid to retail vendors and states as $12.3 billion, $6.3 billion to the vendors and $6 billion to the states.[28] We distribute the AC to each state using the same method we utilized to distribute the FairTax base (see methodology). The results are displayed in Table 5. [29]

To put these figures into perspective, we compare them to total estimated tax administration expenditures for the existing state tax systems. Table 7 displays the results. The AC paid to the states would total 113 percent of the total estimated cost to administer the current state tax systems. Twelve states (Arizona, Arkansas, Colorado, Illinois, Iowa, Nevada, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and Texas) would receive AC payments that more than

[26] U.S. Government Accountability Office, "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System," Report to Congressional Requesters, August, 2005.
[27] The federal government has to remit the FairTax on compensation paid to federal government employees in all federal agencies.
[28] Bachman, et al., op. cit.
[29] U.S. Census Bureau, State Government Finance, Table 1. State and Local Government Finances by Level of Government and by State: 2003-04. Available at http://ftp2.census.gov/govs/estimate/04slsstab1a.xls.

cover their current tax administration expenses. In each of these cases, the FairTax AC provides more than enough revenue to cover the current cost to administer their state taxes. Another five states (Hawaii, Kentucky, Louisiana, South Carolina, and Wyoming) would receive AC payments equal to more than 80 percent of their current administration expenditures. Only in the states of Maine, New Mexico, South Dakota, and Utah would the AC payments not be more than 50 percent of their current tax administration costs.

**Table 7. The Administrative Credit to the States and Vendors, 2007**

| State | AC to Vendors ($ millions) | AC to States ($ millions) | Current State Costs ($ millions) | Ratio of AC to Current Costs (percentage) |
|---|---|---|---|---|
| Alabama | 74.9 | 58.4 | 100.4 | 58.1 |
| Alaska | 18.3 | NA | NA | NA |
| Arizona | 108 | 82.4 | 65.2 | 126.5 |
| Arkansas | 43.3 | 67.2 | 61.8 | 108.8 |
| California | 834.9 | 757.3 | 976.9 | 77.5 |
| Colorado | 108.1 | 105.1 | 82.7 | 127.1 |
| Connecticut | 101.2 | 130.8 | 57.0 | NA |
| Delaware | 29.5 | NA | NA | NA |
| Florida | 321.5 | 329.3 | 527.9 | 62.4 |
| Georgia | 184.3 | 181.8 | 82.7 | NA |
| Hawaii | 27.1 | 18.8 | 20.1 | 93.4 |
| Idaho | 23.4 | 22.4 | 30.8 | 72.9 |
| Illinois | 286 | 325.4 | 130.1 | 250.1 |
| Indiana | 122.9 | 106.5 | 77.8 | NA |
| Iowa | 61.8 | 48.5 | 32.4 | 149.6 |
| Kansas | 53.6 | 48.7 | 84.1 | 57.9 |
| Kentucky | 73.2 | 54.2 | 64.9 | 83.6 |
| Louisiana | 82.2 | 73.1 | 85.4 | 85.6 |
| Maine | 23.4 | 16.2 | 35.3 | 45.9 |
| Maryland | 122.5 | 134.6 | 104.7 | NA |
| Massachusetts | 171.8 | 184.6 | 233.0 | NA |
| Michigan | 201.6 | 194.6 | 89.7 | NA |
| Minnesota | 122 | 187.5 | 106.8 | NA |
| Mississippi | 41.2 | 24.8 | 46.0 | 53.9 |
| Missouri | 109.9 | 109.8 | 101.5 | NA |
| Montana | 15 | NA | NA | NA |
| Nebraska | 36.7 | 45.6 | 71.4 | 63.9 |
| Nevada | 53.7 | 48.0 | 37.0 | 129.7 |
| New Hampshire | 28.2 | NA | NA | NA |
| New Jersey | 224.9 | 290.1 | 90.1 | 322.0 |
| New Mexico | 33 | 19.1 | 64.0 | 29.8 |
| New York | 486.5 | 569.0 | 407.5 | 139.6 |
| North Carolina | 181.4 | 173.6 | 91.3 | NA |
| North Dakota | 12.8 | 8.3 | 10.8 | 77.0 |
| Ohio | 226.2 | 267.4 | 121.4 | 220.2 |
| Oklahoma | 58 | 66.1 | 116.6 | 56.7 |
| Oregon | 69.3 | NA | NA | NA |
| Pennsylvania | 253.5 | 267.5 | 164.0 | 163.2 |
| Rhode Island | 22.7 | 28.0 | 19.5 | 144.0 |
| South Carolina | 73.1 | 48.5 | 48.5 | 99.9 |
| South Dakota | 15.9 | 10.9 | 58.0 | 18.8 |
| Tennessee | 117.3 | 119.0 | 64.1 | NA |
| Texas | 476.4 | 451.2 | 450.3 | 100.2 |
| Utah | 44.5 | 29.8 | 63.8 | 46.8 |
| Vermont | 12 | 9.5 | 13.5 | 70.5 |
| Virginia | 176.6 | 153.0 | 114.3 | NA |
| Washington | 140.5 | 129.8 | 89.1 | NA |
| West Virginia | 26.9 | 15.5 | 24.3 | 63.8 |
| Wisconsin | 114.5 | 107.3 | 86.5 | NA |
| Wyoming | 13.1 | 8.8 | 9.5 | 92.7 |
| Total | 6,259.30 | 6,128.03 | 5,412.3 | NA |
| Average | | | | 113.2 |

Were these states to adopt the FairTax, or at least adopt the FairTax base to their state sales taxes, they would enjoy the economies of scale that would derive from administering one tax and be able to dedicate additional resources to tax compliance.

## V. The Political Economy of a National FairTax on State Tax Policy

The national FairTax proposal will draw both support and opposition from state governments and their residents. A state's likely support or opposition to the FairTax proposal will be determined by the FairTax's impact on the state's economy, its administrative tax system, and the tax burden of its residents.

The FairTax would produce a broad expansion in national economic activity, in which state economies would share. National output, investment, employment, and wages would increase and interest rates would fall. This improved economic performance would be broadly shared with all states.[30]

Prompted by a combination of the economic benefits and the administrative simplicity of aligning their tax systems with the federal government, many states would be induced to levy their own FairTaxes.[31] States in a position to enact a revenue-neutral state FairTax with a low rate would most likely embrace the FairTax proposal, availing themselves of the opportunity to replace state income taxes with a sales tax rate no higher than what they have today. Conversely, states that would require a higher state-level FairTax rate in order to replace the same revenues as under their current system may resist the FairTax.

What about states that do not levy sales taxes? The FairTax legislation allows the five states that currently do not levy a sales tax and lack the necessary infrastructure to administer a federal sales tax to turn to other states with greater sales tax experience. Using the funds provided by the administrative credit, they would have the option of retaining another state tax agency to administer the tax. Having the federal government administer the federal sales tax directly is also an option. Current sales-tax-free states could use revenues generated by the administrative credit to establish the infrastructure from the ground up. However, policy makers in these states may find these choices unattractive because of the administrative uncertainties associated with a new tax. These states are Oregon, Montana, Delaware, New Hampshire, and Alaska (although Alaska has a sales tax at the local level).

The eight states that allow partial or full deduction of federal taxes against state income tax liability, listed in Table 5 above, might also oppose the FairTax proposal on the grounds that they would need to find another deduction or face pressure from taxpayers who would see their state income taxes rise. However, these states could also conform their tax systems to the federal FairTax and enjoy the benefits of simplicity, transparency, efficiency, and increased economic growth that would accompany the change. Moreover, under the current tax system, states must adapt to frequent changes to the federal individual and corporate income taxes enacted by Congress each year.

If a federal FairTax were enacted, some states would need to make multiple administrative and logistical changes. Given the nature of bureaucracies to resist change, these states would most

[30] Several studies support this conclusion. See Tuerck, et al. (2007); Sabine Jokisch and Laurence J. Kotlikoff, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 1, 2007; Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal," February 2006.

[31] For a description of the potential economic and administrative benefits to the states, see Americans For Fair Taxation (2005).

likely oppose a FairTax. For example, Oregon and Montana face four issues created by the FairTax proposal. They do not currently collect state-level sales taxes, and thus lack the infrastructure from which to administer the FairTax. They also use the federal income tax code as a starting point in the calculation of their state income taxes and allow federal taxes to be deducted from state income taxes. On the other hand, both states would face fairly low state-level FairTax rates – 4.6 percent for Oregon and 3.4 percent for Montana, which would make the adoption of a state-level FairTax more attractive.

The FairTax should find strong support in states that would need to make few administrative and logistical changes. As such, these states would be able to adopt their own state FairTax at a relatively low rate. Texas, Tennessee, South Dakota, and Nevada are the leading states that combine low state FairTax rates, an existing state sales tax, and the fewest direct ties to the federal income tax code. While their state FairTax rates would be higher, Pennsylvania and Washington would be naturally attracted to the administrative benefits of this reform. Currently both states do not link their state income taxes to the federal income tax code, and both are familiar with state sales taxes. Thus, both states would also enjoy an easy transition. These states would likely see the larger benefits and lower transition costs associated with the federal FairTax and should provide the strongest support for the proposal.

The FairTax stipulates an administrative credit of one quarter of one percent of the revenue collected by the retailer and state government be paid to each. BHI estimates the amount that would be paid to governments and businesses for each state in 2007. A survey of the 2005-2006 fiscal year budgets finds that the administrative credit would provide more than enough revenue to fund the entire current operations of state tax administration agencies. The administrative credit would likely provide enough revenue to administer their current systems and offset some federal FairTax costs. And, if the states opted to adopt their own state-level FairTax, they would likely see their administrative costs fall further.

## Appendix: Methodology

BHI calculated a 2007 state-level FairTax rate for each state, assuming revenue neutrality. For the purposes of this calculation, revenue neutrality means that the FairTax would replace the revenues collected under the current system for each tax on a dollar-for-dollar basis. The following process was used to calculate the rate for each state.

The FairTax base is estimated for each state. Using the 2007 estimate of the federal FairTax base from previous research as a starting point, the state-level base is calculated utilizing values from the national FairTax base.[32] The base is then distributed to each state based on the ratio of a state's total value of state gross domestic product to the total national value of gross state product reported by the Bureau of Economic Analysis in the gross state product data tables, 2005.[33]

We next calculate the reduction in the base for the FairTax prebate for each state. We calculate the national prebate base for 2007 to be $2.112.1 trillion.[34] We next calculate the prebate base for the four regions of the United States (Northeast, Midwest, South, and West) as defined by the U.S. Census Bureau using 2005 data on family composition to capture regional differences. The figures were inflated to 2007 using the Census Bureau estimate of population growth (2.77) from 2004 to 2007. The prebate base for each region was then distributed to the states within the region using the ratio of the state's population to total population for its respective region.[35]

State tax revenues are supplied by state tax collections from the Census Bureau, FY 2004 and FY 2005, to create values for calendar year 2004.[36] The data were reported for total tax collections and for individual taxes, such as personal and corporate income, sales, and excise taxes. The figures were inflated to 2007 using the ten-year average annual growth rate of state tax revenues for each state from 1995 to 2005.[37]

[32] Bachman, et al., op. cit.
[33] Bureau of Economic Analysis, Regional Economic Accounts, Gross Domestic Product by State. Available at http://www.bea.gov/regional/gsp/.
[34] Ibid.
[35] U.S. Census Bureau, Population Projections, April 21, 2007. Available at http://www.census.gov/population/projections/DownldFile1.xls.
[36] U.S. Census Bureau, State Government Tax Collections report. Available at http://www.census.gov/govs/www/statetax.html.
[37] Ibid.

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