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MAKE IT JUST ANOTHER DAY

Americans For Fair Taxation

The FairTax:
Opportunities to replace or reform state and local government tax systems

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In short, should state and local governments elect to harmonize their taxation programs with the federal FairTax legislation, they would have an opportunity to:

- Install a progressive sales tax system that honestly and transparently detaxes low- and fixed-income Americans up to the poverty level
- Successfully tax the wealthy according to their lifestyles
- Successfully tax accumulated wealth
- Simplify their sales tax laws by eliminating hundreds of confusing exemptions
- Simplify their sales tax laws by eliminating a welter of inter-business taxes that only serve to drive up the retail prices or reduce job opportunities or reduce small business profits, harming citizens who can least afford to pay
- Avail future revenue streams of the fastest growing segment of our economy – services
- Eliminate reliance on enforcement-intensive income taxes with extremely volatile revenue streams

The FairTax is a revenue-neutral replacement for federal income and payroll taxes.
At the federal level, the FairTax replaces personal, gift, estate, capital gains, alternative minimum, earned-income, Social Security, Medicare, payroll, and corporate taxes with a progressive national retail sales tax on all new goods and services on a dollar-for-dollar, revenue-neutral basis. While there are substantial differences between the FairTax plan and current state sales taxes (such as the FairTax's progressivity), the points and methods of collection are substantially alike. These specific similarities are so close that the FairTax legislation (HR 25/S 1493) provides state sales tax authorities the option of collecting the FairTax on behalf of the federal government. Simply put, nothing is taken out of paychecks. All tax planning is done with the decision to purchase. Buy diamonds, pay more tax. Buy cubic zirconium, pay less tax. Buy estate (used) jewelry, pay no tax. And because corporations cease to calculate or pay federal taxes, there are no such costs hidden in the retail price of goods and services.

The FairTax strategy is to neither raise nor lower taxes, but it does broaden the base.
The FairTax proposal is a revenue-neutral proposal – replacing the revenues from federal income and Social Security taxes on a dollar-for-dollar basis. There is no intention to raise taxes here or to lower them or to redistribute the burden. The senior intention is to replace a broken, expensive, intrusive system of taxation with a workable, efficient, unobtrusive system that applies to a tax base (consumption) roughly twice the size of the current (income) base.

State revenue generating options:
Which tax system promotes the general welfare and competitiveness?

We are Americans. We hate taxes. No tax is perfect. We will never like paying them. That said, states generate revenues with retail sales taxes, personal and corporate income taxes, and property taxes, or some combination thereof, and via fees.

In his book *For Good and Evil: The Impact of Taxes on the Course of Civilization,* Charles Adams recounts that direct taxes (e.g., income taxes, head taxes, poll taxes, property taxes) have been forever used by despots as tools of tyranny to control the lives of their subjects. He also observes that such taxes shrink and eventually collapse the economies to which they are applied. Alternatively, indirect taxes (e.g., sales taxes, consumption taxes, value-added taxes, imposts/exposts, transaction-based taxes) enhance the civil liberties of the citizenry, expand the economies in which they are applied, and support democratic/republican governments. In the Constitution (unamended) and *Federalist Papers*, particularly *Federalist 21*, our Founding Fathers express a similar view.

Personal and corporate income taxes: Tools of tyranny

After the apparent passage of the 16th Amendment in 1913, personal income taxes became legal in our country. This led to the growth of the largest domestic surveillance organization in the history of the world. To apply this tax, such an organization is required to ensure some semblance of compliance with the federal government's overly complex, often conflicting, special-interest-laden legislation, upon which some 36 states rely as a starting point for their income tax systems. But state or federal, there are two significant flaws with any income tax. The first, pointed out by our Founding Fathers, is its imposition on the civil liberties of individual Americans, to say nothing of their churches and businesses. The second is the sheer complexity of the legislation, allowing moneyed, special interests to drill the system with loopholes to the benefit of an influential few and to the detriment of the man on the street.

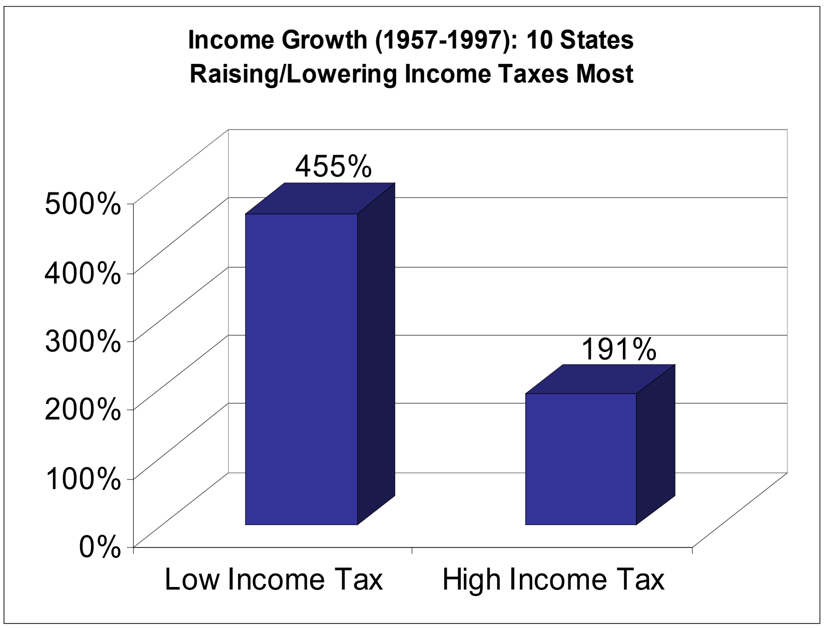
Property taxes: The right of kings

Property taxes have their origins in the rents paid by serfs to their liege lord. Some landlords were reasonable, seeking only a percentage of the harvest. Today's property taxes are analogs to oppressive landlords requiring a fixed payment, regardless of a harvest's bounty or lack thereof. This moves property taxes from being a transaction-based tax to a direct tax, just what our Founding Fathers and history's lessons warn against.

Sales taxes: Self-limiting and harder to lobby

As recounted in *Federalist 21*, sales taxes have the "signal" advantage of being self-limiting. Should government raise the rate with the intention of raising revenue, there comes a point where consumers reduce spending, thus reducing government revenue. Thus consumption taxes self-enforce lower rates, which naturally expand the economy. An expanding economy enhances government revenues, rather than ever-more-punishing rate hikes and draconian enforcement. Sales taxes also include an inherent impediment to special interest lobbying. Because they are simple and obvious – everyone can know the rules, the rate, and the base – backroom deals are much more difficult (though not impossible) to hide from taxpayers.

Should states harmonize to the federal FairTax, what might their choices be?
While the FairTax legislation does not require states to harmonize with their legislation, there will be some requirements and options. The 36 of the 41 states that collect an income tax which is calculated based on a federal starting point (which may be adjusted gross income, total taxable income or federal tax liability)[1] will no longer have that point. These states will have to make a decision to implement a full income tax infrastructure, or implement an alternative. It is interesting to note that when comparing the ten states with the lowest or no income tax burden to the ten highest income tax states, the personal income growth in the low/no income tax states was more than twice as high as in the high income tax states.[2]



Many states are also having considerable problems both with the fairness and the constitutionality of property tax funding of educational costs, often known as “Robin Hood” agendas.

A rule of thumb
FairTax.org, the grassroots organization proposing and supporting the FairTax legislation, has done some simple, static modeling of revenues from state sales taxes, state income taxes, and property taxes for the four largest states. Here are the results:

- If these states move to the FairTax base (all new goods and services at final retail/end user delivery) with a universal rebate to protect low- and fixed-income citizens, these states could reduce their current sales tax rates by about half or more, and collect the same revenue.
- If these states move to the FairTax base and do not reduce their current sales tax rates, they can eliminate both their income taxes and property taxes, while collecting the same revenue.

- While initially setting such rates on a revenue-neutral basis, the taxation of services will enhance revenues in the near term as this is a significant and growing segment of our economy generally untouched by most state sales tax systems.[3]

Let's look at the four largest states: California, Florida, New York and Texas. Each of these states has a different state revenue structure. California has a high sales tax rate (7.25%) for a state that utilizes both individual and corporate income taxes. Florida's rate of 6% and Texas' rate of 6.25% are expected, given that these states do not rely on income taxes. Florida has a relatively low corporate income tax and no individual income tax, whereas Texas has no state income taxes. New York's sales tax rate of 4.0% is typical of states that utilize both sales taxes and income taxes.

Despite the wide differences in tax structure, the states have similar results (see Table 1 below). Line 2 shows that by conforming the state sales tax base to the broader FairTax base, these states would be able to raise the same amount of sales tax revenue with a far lower rate.

The FairTax repeals the federal income tax, but its broader base would give states the ability to maintain existing state sales tax revenues and repeal/replace state income taxes.
Line 3 of Table 1 shows that both California and Florida could do this with a state FairTax rate that is lower than its current sales tax rate. New York would have to increase its sales tax rate from 4.0 to 5.46%, which still compares favorably to the average state rate of 5.3%. The state FairTax rate necessary to replace all state sales, income, and property taxes appears in line 5. California state government, which makes use of all three taxes, could replace existing revenues with a state FairTax rate of 6.71%, which is less than its existing rate of 7.25%.

Table 1:
Estimated revenue-neutral rates if replacing current state government taxes with a state FairTax

Rate Description	California	Florida	New York	Texas
1. Current law state sales tax rate	7.25%	6.00%	4.00%	6.25%
2. Revenue-neutral state FairTax rate (with rebate[4])	2.52%	4.66%	1.44%	2.65%
3. State FairTax rate to replace state income taxes	6.52%	5.03%	5.46%	N/A
4. State FairTax rate to replace state property taxes	2.71%	N/A	N/A	N/A
5. Cumulative rate necessary to replace all	6.71%	5.03%	5.46%	2.65%

Calculations based on State Tax Collections for 2003 from Tax Foundation.org, BEA national accounts (2003), and regional accounts (2001). See methodology appendix for detailed calculations.

Table 2 calculates revenue-neutral FairTax rates taking into account both state and local government taxes. The findings are similar to the state-taxes-only example. All four states, by adopting a combined state/local FairTax, could generate the current amount of total general sales taxes with much lower rates (compare lines 1 and 2 of Table 2 below). Again, the lower state/local FairTax rates give state and local governments the opportunity to levy a rate above the revenue-neutral rate and use the surplus revenues to repeal/replace other state and local taxes. For example, California, Florida, and New York could maintain existing state and local sales tax revenues and replace all income taxes with state/local FairTax rates less than their existing state/local combined sales tax rate.

But what about states that don't rely on income taxes? By adopting the FairTax base and maintaining its current sales tax rate, Texas, having no income taxes to replace, could maintain existing state/local sales tax revenue and replace all property taxes with a state/local FairTax rate of 7.08% which is less than its current, highest, local-option-inclusive rate of 8.25% (see line 6). Likewise, Florida could maintain its state and local sales tax revenue and replace both its state corporate income tax and school district property taxes with a state/local FairTax rate of 7.47%, just under its existing state/local sales tax rate of 7.5%.

Table 2:
Estimated revenue-neutral rates if replacing current state and local government taxes with a combined state/local FairTax

Rate Description	California	Florida	New York	Texas
1. Current law combined state/local sales tax rate[5]	8.75%	7.50%	8.75%	8.25%
2. Revenue-neutral state/local FairTax rate (with rebate)	3.31%	4.97%	2.789%	3.33%
3. FairTax rate to replace all income taxes	7.31%	5.34%	7.47%	N/A
4. FairTax rate to replace school district property taxes	4.86%	7.10%	4.79%	6.36%
5. FairTax rate to replace all property taxes	6.48%	11.10%	7.54%	7.08%
6. Cumulative rate necessary to replace all	10.47%	11.47%	12.23%	7.08%

Local government tax revenues for each state come from that state's annual financial report or similar document for 2003.

What is the FairTax?

The FairTax is non-partisan legislation (HR 25/S 1493) that abolishes personal, gift, estate, capital gains, alternative minimum, earned income, Social Security/Medicare, self-employment, and corporate income taxes and replaces them all with one simple, visible, progressive, federal retail sales tax. The FairTax dramatically changes the basis for taxation by eliminating the root of the problem: Taxing income. The FairTax taxes us only on what we choose to spend, not on what we earn. It does not raise any more or less revenue; it is designed to be revenue neutral, so it is also price neutral. The final cost for goods and services changes little under the FairTax. The FairTax is a fair, efficient, and intelligent solution to the frustration and inequity of our current tax system.

Who is Americans For Fair Taxation (FairTax.org)?
FairTax.org is a non-profit, non-partisan, grassroots organization dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the web page: www.fairtax.org or call 1-800-FAIRTAX.

More about Dr. Walby
Karen Walby, Ph.D. is the Chief Economist and Director of Research for Americans For Fair Taxation. Prior to joining AFFT, she held positions in Florida state government including State Economist, Deputy State Budget Director, Chief of Tax, and Senior Tax Policy Analyst for the Florida Tax and Budget Reform Commission. She also served as the Director of Research for Florida TaxWatch, Inc., a government tax/spending watchdog organization, and as a Senior Consultant for PricewaterhouseCoopers LLP. She is a graduate of Ohio State University with a Ph.D. in Politico-Economic Geography.

Endnotes

[1] McLaughlin, Alysoun "State Income Taxes: Conforming to the Federal Code," NCSL *LegisBrief*, Nov/Dec 2001.

[2] Vedder, R. "Taxing Texans: A Six Part Series Examining Taxes in the Lone Star State," Part One, Comparing Income, Property, Sales and Corporate Taxes," Texas Public Policy Foundation, 2002.

[3] Mazerov, Michael "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, June, 2003.

[4] State FairTax rate computations assume a state version of the FairTax rebate – which rebates the sales taxes paid on spending up to the poverty level based on the U.S. Department of Health and Human Services' poverty guidelines.

[5] Highest local rate known to be actually levied by at least one jurisdiction. Includes local taxes for general purposes and those earmarked for specific purposes (e.g. transit). Taxes applying only to specified sales (e.g. lodging or meals) are excluded.

Methodology Appendix

While every effort has been made to provide useful and representative data in this analysis, this is not an exhaustive, dynamic work. We have used the most recently available data from third-party sources for this static analysis. We encourage its use as a starting point for more comprehensive modeling and analysis. Significant work by respected institutions has been done to model the effects of replacing existing income and Social Security systems with the FairTax, many concluding that significant economic growth would be the result. While we can logically conclude that states using a FairTax system would benefit comparatively, the academic work for a state FairTax has not been undertaken.

In order to estimate the state FairTax rates for Florida, Texas, California, and New York, the following steps were undertaken:

1. Estimate the FairTax base of each state.
2. Calculate the base reduction that occurs from rebating the FairTax on spending up to the poverty level.
3. Determine the revenue to be replaced.
4. Calculate the state FairTax rate by dividing the revenue to be replaced in each state by the net state FairTax base.

Step One: Estimating the FairTax base for each state
The national FairTax rate is calculated according to the methodology explained in David R. Burton and Dan R. Mastromarco, "Emancipating America From the Income Tax: How a National Sales Tax Would Work," Cato Institute, Policy Analysis No. 272, April 15, 1997. A spreadsheet showing this computation for 2003 appears on the last page. Lacking such detailed data at the state level, the national FairTax base was apportioned to the four states based on the ratio of each state's Gross State Product (line 1) to the national GDP. The reason it is referred to as the gross base is because it does not take into account the FairTax rebate (the line references refer to Table one: state FairTax calculations: Florida, Texas, California, and New York, 2003 on the following page).

Step Two: Lowering the FairTax base to account for the rebate
This analysis assumes that states will provide for a rebate of spending up to the poverty level, the same as the national FairTax. To adjust the FairTax base for the rebate at the national level, the total poverty level consumption allowance (as determined by the Dept. of Health and Human Services poverty guidelines) is subtracted from the base. To derive the comparable base reduction for each state, the national poverty level consumption is apportioned to each state based on the ratio of that state's population to total U.S. population (line 3) and then subtracted from the "gross" base resulting in the FairTax base with rebate (line 4).

Step Three: Determining revenue to be replaced in each state
State tax revenues are from State Tax Collections, U.S. Bureau of the Census, 2003 and local tax revenues for each state come from the various state annual financial reports or similar documents for 2003. These data are reported separately for each type of tax (sales, income, and property) at both the state and local government level (see lines 17 through 30).

Step Four – Part A: Calculating the revenue-neutral state FairTax rate
Line 6 shows what the state FairTax rate would be if each state conformed their sales tax base to the much broader FairTax base (one that taxes all new goods and services). This rate is calculated by taking existing state sales tax revenues and dividing by the FairTax base. These rates are much lower than current rates (line 5). The rate is revenue neutral in that it would generate the same amount of revenue currently collected by state sales taxes in each of the states. The revenue-neutral rate being much lower than the current rates allows states to increase the state FairTax rate and use the "surplus" revenue generated to repeal/replace other taxes, such as income and property taxes. Line 7 shows the rate that would generate sufficient revenues to maintain current state sales taxes plus replace state income taxes – the rate calculation being: (state sales taxes + state income taxes) divided by the state FairTax base (line 4). Similarly, line 8 calculates the rate necessary to maintain state sales tax revenues and replace state property taxes: (state sales taxes + state property taxes) divided by the state FairTax base. Likewise, line 9 gives the rate necessary to maintain state sales taxes and repeal/replace both state income and state property taxes.
Part B: Calculating the revenue-neutral state/local FairTax rate
Line 11 shows the combined state/local FairTax rate that would maintain existing state and local general sales tax revenues that can be compared to the current state/local sales tax rates (line 10). Again, the lower state/local FairTax rates afford the opportunity to a state and its local government to levy a rate above the revenue-neutral rate and use the surplus revenues to repeal/replace other state/local taxes. The various revenue-neutral replacement tax rates are calculated in the same manner: (current state/local general sales tax revenues + total state and local taxes to be repealed/replaced) divided by the State FairTax base (line 4).

Table one: state FairTax calculations: Florida, Texas, California and New York, 2003				
Description	**Florida**	**Texas**	**California**	**New York**
1) Gross state product	491,488,000,000	763,874,000,000	1,359,265,000,000	826,488,000,000
2) FairTax base (gross or without rebate)	434,286,109,443	674,970,431,759	1,201,066,777,931	730,297,093,766
3) Rebate base reduction	102,187,054,855	115,222,604,093	213,058,185,397	115,222,604,093
4) FairTax base (net or with rebate)	332,099,054,587	542,164,963,651	988,008,592,534	615,074,489,674
5) Current state general sales tax rate	6.00%	6.25%	7.25%	4.00%
6) State FairTax rate with rebate	4.66%	2.65%	2.52%	1.44%
7) To replace state income taxes	5.03%	N/A	6.52%	5.46%
8) To replace state property taxes	N/A	N/A	2.71%	N/A
9) To replace state sales-income-property taxes	5.03%	2.65%	6.71%	5.46%
10) Current maximum state/local sales tax rate	7.50%	8.25%	8.75%	8.75%
11) To replace state and local general sales taxes	4.97%	3.33%	3.31%	2.78%
12) To replace state/local sales and property taxes	11.10%	7.08%	6.48%	7.54%
13) To replace state income taxes	5.34%	N/A	7.31%	6.80%
14) To replace state/local sales and income taxes	5.34%	N/A	7.31%	7.47%
15) To replace state/local sales, income, property taxes	11.47%	7.08%	10.47%	12.23%
16) To replace state/local sales and school district property taxes	7.10%	6.36%	4.86%	4.79%
Tax revenues for potential replacement				
17) Total state sales, income, and property taxes	16,701,439,402	14,347,144,000	66,321,899,000	33,579,340,000
18) Total state/local sales, income, and property taxes	38,101,637,971	38,410,895,339	103,488,968,948	75,248,806,262
19) State and local general sales tax revenues	16,518,208,642	18,054,446,010	32,714,828,948	17,082,596,166
20) State general sales taxes	15,474,459,402	14,347,144,000	24,899,025,000	8,841,872,000
21) Local general sales taxes	1,043,749,240	3,707,302,010	7,815,803,948	8,240,724,166
22) State and local property taxes	20,356,449,329	20,356,449,329	31,260,820,000	29,324,700,000
23) State property taxes	0	0	1,909,554,000	0
24) Local property taxes	20,356,449,329	27,319,767,524	29,351,266,000	29,324,700,000
25) School district property taxes	7,072,777,412	16,418,788,831	15,340,914,000	12,393,800,000
26) State and local total income taxes	1,226,980,000	0	39,513,320,000	28,841,510,095
27) State individual income taxes	0	0	32,709,761,000	22,648,364,000
28) Local individual income taxes	0	0	0	4,104,042,095
29) State corporate income taxes	1,226,980,000	0	6,803,559,000	2,089,104,000
30) Local corporate income taxes	0	0	0	2606783971

Table two: national FairTax rate calculation: 2003

Line	Description	FairTax base	Source
	Taxable item	**Billions**	
1	Personal consumption expenditures	$ 7,760.9	NIPA Table 1.1.5, line 2
2	Purchases of new single-family homes	$ 310.6	NIPA Table 5.3.5, line 20
3	Purchases of new mobile homes	$ 7.1	NIPA Table 5.4.5B, line 40
4	Improvements to single-family homes	$ 132.0	NIPA Table 5.4.5B, line 42
5	Less: imputed rent on owner-occupied housing	$ 859.6	NIPA Table 7.4.5, line 3
6	Less: imputed rent on farm housing	$ 11.9	NIPA Table 7.4.5, line 5
7	Additional financial intermediation services	$ 83.1	Financial & risk Intermediation greater than NIPA definition
8	Foreign travel by U.S. residents	$ 39.6	One half of NIPA Table 2.5.5, line 110
9	Less: expenditures abroad by U.S. residents	$ 6.6	NIPA Table 2.5.5, line 111
10	Less: food produced and consumed on farms	$ 0.5	NIPA Table 2.5.5, line 6
11	State and local government consumption	$ 1,058.5	NIPA Table 3.10.5, line 47
12	Gross purchases of new structures	$ 213.4	NIPA Table 3.9.5, line 24
13	Gross purchases of equipment	$ 51.5	NIPA Table 3.9.5, line 25
14	Federal government consumption	$ 658.6	NIPA Table 3.10.5, line 12
15	Gross purchases of new structures	$ 15.5	NIPA Table 3.9.5, line 9
16	Gross purchases of equipment and software	$ 78.1	NIPA Table 3.9.5, line 10
17	Less: state and local government sales taxes	$ 343.9	NIPA Table 3.3, line 7
18	Less: government education expenditures	$ 414.7	Table 255, SAOUS 2003
19	Less: private education expenditures	$ 151.7	NIPA Table 2.5.5, lines 105 & 106
20	Expenditures in U.S. by non-residents	$ 86.7	NIPA Table 2.5.5, lines 112
21	Travel to U.S. by non-residents	$ 33.3	One half, SAOUS 2003 Table 1280
22	National retail sales tax base	$ 8,740.0	
	Revenues to be replaced		
23	Income tax	$ 927.7	Dept. of Treasury; derived from Table B-81 ERP 2004
24	Estate and gift tax	$ 22.4	Dept. of Treasury; derived from Table B-81 ERP 2004
25	Payroll taxes	$ 717.8	Dept. of Treasury; derived from Table B-81 ERP 2004
26	Excise taxes	$ -	
27	Total	$ 1,667.9	
	Revenue-neutral rate calculation		
28	Tax exclusive rate (no rebate)	19.1%	
29	Tax inclusive rate (no rebate)	15.9%	
30	Base reduction equivalent for rebate	$ 1,746.1	Total consumption allowance for 109 million rebate units
31	Net tax base	$ 6,993.8	
32	Tax exclusive rate (with rebate)	23.8%	
33	Tax inclusive rate (with rebate)	19.3%	