A FairTax rebuttal
to the PricewaterhouseCoopers study on tax reform for
the National Retail Federation, April 2000[1]

by Robert K. Dean
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What is the FairTax plan?

The FairTax plan is a comprehensive proposal that replaces all federal income and payroll taxes with an integrated approach including a progressive national retail sales tax, a rebate to ensure no American pays federal taxes up to the poverty level, dollar-for-dollar revenue neutrality, and the repeal of the 16th Amendment. This non-partisan legislation (HR 25/S 25) abolishes all federal income taxes, personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them all with one simple, visible, federal retail sales tax – collected by existing state sales tax authorities. 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 cost neutral – the final cost for goods and services changes little under the FairTax. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

How might the FairTax plan affect retailers?

- Lower their corporate costs by an average of 22 percent with the abolishment of corporate income taxes (ending their accompanying compliance costs) and termination of Social Security matching.
- Lower their domestic suppliers' costs by an average of 22 percent for the same reasons, though products currently sourced overseas may not be as price competitive as they are today.
- Provide a net reduction in paperwork and overhead by the elimination of corporate tax planning, record keeping, compliance, and litigation, though such burdens for their ongoing collection of sales taxes may increase slightly. Only five states do not currently require sales tax collection.
- Receive ¼ of one percent of collections as compensation for collection expenses, including point-of-purchase software upgrades.

- Allow retailers to make business decisions based solely on the benefits to shareholders, customers, and suppliers – with no artificial situations created by convoluted tax rigmarole.
- Increase the take-home pay for many of their customers by the amount of federal income and Social Security taxes no longer withheld from paychecks.
- Drive a gross domestic product increase of 7 to 14 percent in the first year, considerably increasing employment and related retail spending.
- Broaden competitive domestic sources of supply as significant amounts of manufacturing return to the U.S.A., though such increases in manufacturing jobs may occasion a regionalized reduction in retailers' available hiring pool.

The issue

In 2000, the National Retail Federation hired PricewaterhouseCoopers to do a study of the impact of replacing current federal personal and corporate income taxes, and the estate and gift tax with a national retail sales tax. This study did not address the FairTax legislation, though the study has since been used to criticize the FairTax. The predictions of this study were significantly negative, in direct contradiction of the many studies done by a wide range of academic institutions and think tanks with an equally wide range of political leanings – all of which directly address the FairTax legislation as written. It is equally interesting that since completing this work, PwC has hired the former chairman of the Committee on Ways and Means, Bill Archer, as their most prominent spokesperson on tax issues. Mr. Archer is quite publicly on record as supporting a concept such as the FairTax for replacing our current abominable tax system, and is equally respected as one of the few living Americans who does comprehend most of that code.

The following is a point-by-point rebuttal of the issues raised in the PwC paper.

PwC Issue #1: Retailers are the tax collector.

Response: Retailers are tax collectors for the federal government *already*. Retailers collect both income and payroll withholding taxes from employees' paychecks and remit those taxes to the federal government every payday. Moreover, most businesses find federal income tax and payroll withholding so time consuming, complicated, and vexing, that they outsource payroll preparations and withholding at considerable cost – cost that businesses must recover in their prices from the ultimate consumer.[2] With the FairTax, the additional cost of doing business due to collecting federal income tax and payroll withholding taxes will be a thing of the past.

PwC Issue #2: Retailers will have collection costs.

Response: Costs compared to what? It is already *very* costly for retail businesses to comply with the income tax code and with payroll withholding rules and regulations. The real question is not whether it costs something to collect taxes; it does. The real question is which tax system is *more* costly. Clearly, administering the FairTax is less costly than what retailers must do today. The record keeping and reporting requirements for retail businesses are simpler for a sales tax, compared to the current federal income/payroll tax system. Furthermore, the FairTax provides that retailers receive ¼ of one percent of collections as compensation for collection expenses, including point-of-purchase software upgrades (In fact, PwC estimated that, in 1995, this compensation would have provided a return of nearly $4 billion dollars to retailers).

Retailers already collect sales taxes in 45 states and the District of Columbia. The record keeping and processing burden required of retailers to collect and remit state sales taxes are child's play compared to current federal requirements for collection and remission of federal corporate income tax and payroll withholding taxes. Ask any business owner – particularly one of the hundreds of thousands of small businesses that drive new jobs in our economy. They will tell you that complying with federal income tax and payroll withholding taxes is a time consuming, frustrating, and costly burden. But businesses don't pay those costs; consumers (or employees or owners/shareholders) do. Businesses must pass those costs on to consumers in the prices they charge, just like they must pass on the cost of the electricity, office supplies, and other inputs to production they use.

Because it will minimize cost and administrative burden, state governments will elect to integrate collection of a federal sales tax with their ongoing state sales tax collections. They will do this with only nominal transition costs. For example, in Florida, the state sales tax is already split into a state component and a local component, but retailers use a single form to report and submit to the state department of revenue their monthly sales tax collections. With the FairTax, states simply add a new line or two to their existing sales tax reporting forms, which of course also requires a software upgrade for point-of-purchase terminals.

PwC Issue #3: Retailers will have to adjust their operations and employment to changes in consumption behavior.

Response: The PwC study assumes, incorrectly, that consumption spending will decline following the move to the FairTax. However, a wide array of economists estimate that pre-sales-tax retail *prices* (not spending) actually fall by 20 to 25 percent under the FairTax, driving an overall increase in consumption spending. Retail prices fall because businesses no longer have to pass on to consumers the cost of complying with the federal income tax code, and because corporations no longer have to pay federal income tax on earnings or payroll taxes on employee wages and salaries. The cost of goods sold by retailers falls, and competition in the market place forces retailers to pass on those cost savings to consumers in the form of lower retail prices.

Consequently, retail goods with an income-tax-era price of $100 have a FairTax-era price of $77.50, assuming that pre-sales-tax retail prices fall by 22.5 percent (the midpoint of the range estimated by economists). Adding the 30-percent, tax-exclusive FairTax (what is now estimated to be the required rate for revenue neutrality) would bring the price-plus-sales-tax to $100.75. If pre-sales-tax retail prices fall by a full 25 percent (the top end of the range estimated by economists), the price-plus-sales-tax comes to just $97.50 for the same goods that previously cost $100 under the current federal tax code.

Another important point to understand is that under the FairTax, wage earners will have 100 percent of their wage income to spend – no more withholding for federal income taxes or Social Security payroll tax deductions. An example makes this clear.

An example: A single wage earner with a pre-tax wage of $5,000.
Suppose that under the current federal tax code, a single wage earner has monthly pre-tax wage income of $5,000. The current federal income tax code makes it challenging at best to say what this wage earner's after-tax, disposable income would be. Even the IRS is unwilling to say what it would be, and then stand ready to be held to its own pronouncement during an audit! But suppose the wage earner's take-home pay is $4,005, after subtracting $382 for Social Security taxes and Medicare taxes, plus $613 for federal income tax (you can calculate this estimate for yourself at the web site http://moneycentral.msn.com/investor/calcs/n_tax/main.asp). The $100 purchase of retail goods is then about 2.5 percent ($100 ÷ $4005) of monthly take-home pay. Under the FairTax, even if pre-sales-tax retail prices fall only by 20 percent, the low end of the range estimated by economists, the same goods purchased under the FairTax will be just 2.1 percent ($104 ÷ $5,000 of the wage earner's monthly income.

Exhibit 1: A comparison of spending as a percentage of spendable income

	Income tax	FairTax
Income	$5,000	$5,000
Payroll taxes	-382	0
Income taxes	-613	0
Take-home pay	4,005	5,000
Final post-FairTax purchase @ 20%	*100	104
Percent of spendable income	2.5%	2.1%

*Assuming a 20-percent drop in retail prices

Now the good news: Effective tax rates after the FairTax prebate
Under the FairTax, our single, unmarried wage earner with $5,000 of monthly wage income also receives a check from the federal government at the beginning of the month for $172. Called a "prebate" because it arrives at the beginning of the month before money is spent, it is to compensate our wage earner for federal sales tax paid on the first $9,310 of retail consumption spending. This $9,310 is the Department of Health and Human Services' estimate of the poverty level, a basket of medical care, food, clothing, shelter, transportation, and entertainment, etc. Another boost for retail consumption spending.

Consumption spending rises under the FairTax.

It's hard to see how consumption spending would fall under the FairTax compared to the current tax system. Not only will pre-sales-tax prices fall, consumers will have more income to spend on consumer goods. In the short run following implementation of the FairTax, consumers will likely keep their retail spending about the same, but they will save more of their take-home pay for two reasons. First, their take-home pay will be larger, and second, savings, which are not taxed under the FairTax until they are consumed in the future during retirement, will be more attractive to consumers. All this, to say nothing of the newly and better-employed workers, all benefiting from economic growth.

Now the really good news: Economic growth

Over the long term, the economy grows faster with the FairTax than it is able to grow now under the federal income tax. Estimates range from 7 to 14 percent gross domestic product growth in the first year. The national economy (GDP) grows faster for the very reason that the national economy ever grows at all – increased productivity of labor, which is brought about by business spending for new technology, plants, and equipment, as well as the deletion of make-work with no exchangeable value in the economy. Productivity of labor, which is measured by economists as output per hour worked, goes up when workers have more technology, machines, and tools with which to work. Productivity goes up faster when business spending on new technology, plants, and equipment goes up faster. By deleting tax related make-work, the friction it generates disappears, turbocharging productivity.

A good example of how this works is the dramatic increase in productivity fostered by computers over the past 10 years. Very few Americans can say that their wages have not risen over the past 10 years, even after adjusting for inflation. Those wage increases were made possible by business investment in new technology, plants, and equipment. They were also made possible by people investing in themselves through education. By the way, under the FairTax, household spending on education is not taxed. With education made less expensive, people naturally invest in more of it. The predictable result is a faster growth rate of the national economy.

Interest rates decline.

Under the FairTax, economists agree that interest moves to lower average rates, due to increased saving over time from households and the increased availability of capital.[3] Households tend to save a bit more of each dollar of income earned under the FairTax, since they do not have to pay taxes on money saved until they spend it in later years during retirement. Household saving is the wellspring of loanable funds that businesses borrow to finance new technology, research and development, and new plants and equipment.

With lower interest rates, businesses of all types, big and small, are able to finance more new technology, plants, and equipment, which in turn increases the productivity of labor much faster than is now possible with the current tax code and its penalties for saving for future retirement consumption. At the end of the day, with productivity rising faster, not only does the national economy grow faster, but also wage earners enjoy real wages that rise faster than is now possible under the current income tax code.

The FairTax is a win for wage earners. For business. For retail.
The FairTax is a win-win for both businesses and wage earners. People will *choose* to work more, earn more and spend more because marginal tax rates are so much lower. The economic pie will be bigger so even though people will save a higher proportion of their income, the amount of income that is spent will increase. Second, we do not live in a closed economy. Because the FairTax eliminates taxes on capital, foreign capital will flow into the United States to finance increased investment, creating businesses and jobs.

The bottom line:
The FairTax is a win for retail customers, so it is a win for retailers.
The PricewaterhouseCoopers study on tax reform for the National Retail Federation assumes incorrectly that consumption spending will fall immediately following the termination of income taxation and its replacement with a consumption tax. The basis of their assumption is faulty, first, because the PricewaterhouseCoopers study does not even analyze provisions of the FairTax, as laid out in HR 25/S 25. Provisions for a national retail sales tax contained in HR 25, the FairTax, are very different from the national consumption tax assumed in the now outdated report. But even assuming there are similarities between the FairTax legislation and the legislation studied by PwC, their assumptions simply are not supported by competent analysis of professional and university economists. And there are many to choose from who have studied the FairTax legislation as written.

Here are some applied research results of economists who analyzed the likely impact on the U.S. economy of moving from the current federal income tax system to a broad-based consumption tax, such as the national retail sales tax plan called for by HR 25 and S 25, the FairTax.

> Dale Jorgenson, Ph.D., former chair of the economics department at Harvard University estimated a near-term 9 to 13 percent increase in the Gross Domestic Product (GDP).[4]
>
> Laurence Kotlikoff, Ph.D., chair of the economics department at Boston University, estimated a 7 to 14 percent increase in GDP.[5]
>
> Alan Auerbach of the University of California at Berkeley found that long-run GDP per capita would be 9.7 percent higher under a national sales tax.[6]
>
> Michael Boskin, former chairman of the Council of Economic Advisers has stated that the long-term gain to GDP from a consumption-based tax reform would be about 10 percent.[7]

> Finally, a 1997 Joint Committee on Taxation report summarized results from nine different economic models, all finding that a change to a flat rate consumption tax would increase investment and boost economic growth.[8]

The FairTax is the lubricant of the American economy, rather than sand in the gearbox.
Under the FairTax, America would become the most attractive industrialized country in the world in which to build plants to make products for both the U.S market and for exports abroad. The outflow of manufacturing jobs, which tend to pay more than retail sales jobs, will reverse under the FairTax as foreign producers move production facilities to the United States to take advantage of reduced costs of doing business under the FairTax. Employment will boom in most sectors of the economy, except of course, those sectors that now employ the unnecessary services of tax lawyers, tax accountants, and employee benefit consultants.

PwC Issue #4: There will be a speed-up of consumption in anticipation of the implementation of the national sales tax causing an economic downturn the year the tax is enacted.
The PricewaterhouseCoopers study conducted for the National Retail Federation assumes that consumers will rush out and spend a larger amount of their after-income-tax disposable income about a year in advance of implementation of the FairTax. In the model used by PricewaterhouseCoopers for their study, that means that consumers must cut their spending the year following implementation.

Two points are important here. First, the PricewaterhouseCoopers study does not say how its analysts arrive at the amount of increased retail consumer spending they predict in the year before implementation of the FairTax. The study simply assumes a particular increase. Their study then assumes that the increased spending the year before the implementation will translate into reduced spending the year following implementation of the sales tax – again, just an assumption of the PricewaterhouseCoopers' analysts – an assumption that is not based on sound economic or consumer behavior theory and understanding.

Second, the PricewaterhouseCoopers study does not take into account the reduction in retail prices that competition will force following elimination of federal income taxes, compliance costs, and payroll withholding taxes. Their study also does not take into account the increase in disposable income consumers will enjoy with elimination of federal income taxes and all payroll withholding taxes – not to mention their freedom from recordkeeping, compliance costs of their own, and the time they get back with no taxes to figure and file.

It is really hard to understand why consumers would rush out to speed up the timing of retail purchases one year ahead of implementation of the FairTax – since arrival of the FairTax will immediately put more disposable income in the pockets of consumers, while lowering prices. Holding their purchases until the FairTax begins would seem to make more sense.

Third, there is a transition rule in the FairTax legislation that requires inventory on hand at implementation to be sold without the FairTax levy. Such inventory is assumed to contain the costs of the former tax system, and should not be taxed twice. Only new inventory, which benefits from the termination of income and payroll taxation, is subject to the FairTax. Thus, prices change little upon implementation of the FairTax.

Finally, without the PwC *assumed* decline in consumption spending the year preceding implementation of FairTax, even the PwC model, mistaken as it is in assumptions about future growth of the U.S. economy under the FairTax, would likely show substantially faster growth in gross domestic product following implementation of the FairTax, compared to the status quo.

About the author

Robert K. Dean is currently a political activist and entrepreneur/journalist in the Tidewater area of Virginia. You can read him daily on www.virginianewssource.com, a site for which he is also the co-founder. He is a former mayoral candidate and former city councilman for Virginia Beach. In a previous career, he also spent 17 years in various executive positions with the J. C. Penney Company, Inc., which hired him away from Sears. Finally, Robert also served his country as a Marine.

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What 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.

ENDNOTES

[1]*Fundamental Tax Reform: Implications for Retailers, Consumers, and the Economy*, a report prepared for the National Retail Federation by National Economic Consulting PricewaterhouseCoopers LLP, April, 2000.

[2]Such taxes and their compliance costs are recovered in one or all of three ways. First, through price increases. If competition does not allow price increases, then the cost of labor is reduced – replacing workers via efficiency and/or doing such work outside the country. Third, by reductions in profits/dividends to shareholders.

[3]With the U.S. being a tax haven under the FairTax, capital now trapped offshore will flood our financial services sector, forcing interest rates lower simply due to the availability of capital.

[4]Dale W. Jorgenson, "The Economic Impact of the National Retail Sales Tax," May, 1997.

[5]Laurence J. Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes with A Sales Tax," Cato Institute Policy Analysis No. 193, April 15, 1993.

[6]Alan Auerbach, "Tax Reform, Capital Allocation, Efficiency, and Growth," in *Economic Effects of Fundamental Tax Reform*, ed. Henry Aaron and William Gale (Washington: Brookings Institution Press, 1996), p. 58.

[7]Michael Boskin, "A Framework for the Tax Reform Debate," testimony before Committee on Ways and Means, U.S. House of Representatives, June 1, 1995.

[8] Joint Committee on Taxation, "Tax Modeling Project and 1997 Tax Symposium Papers," JCS-21-97, November 20, 1977.
Symposium Participants:

- Alan J. Auerbach
- Charles L. Ballard
- Michael Boskin
- Roger E. Brinner
- Eric Engen
- William Gale
- Jane G. Gravelle
- Dale W. Jorgenson
- Laurence J. Kotlikoff
- Joel L. Prakken
- David Reifschneider
- Robert D. Reischauer
- Aldona Robbins
- Gary Robbins
- Diane Lim Rogers
- Harvey S. Rosen
- Joel Slemrod
- Ken Smetters
- Jan Walliser
- Peter J. Wilcoxen
- John G. Wilkins

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