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The "Fair Tax" is Fundamentally Flawed

A Proposed Sales Tax Would Tax Just About Everything You Buy

By Amy Blouin

If there's an issue "most likely to be debated" in the 2011 session of the Missouri General Assembly, it's a proposal to replace state income taxes – both individual and corporate – with a greatly expanded sales tax. Proponents of the legislation refer to it as the "fair tax." But Missourians should think twice because the "fair tax" is anything but.

Missourians know that if it sounds too good to be true, it probably is. And that's exactly the case with the proposal to change how the state collects revenue. No income tax might sound great at first blush. But reality dictates that the revenue that would be lost has to be made up. Someone has to pay, and that "someone" is the average Missouri family. In fact, 95 percent of Missourians would pay considerably more in taxes under the "fair tax."

How does that happen? Missouri would become completely reliant on a greatly expanded sales tax. This would be a sales tax like none ever seen before in any state. Far more things would become taxable – in fact, almost all goods and services would be taxed.

The devil is in the details, but the details of the so-called "fair tax" are hard to pin down. Not only have proponents of this idea submitted SJR 1 in the legislature, but they have filed nine initiative petitions with the Secretary of State's office. Each initiative is different, but while some exempt a specific service, all would apply the greatly expanded sales tax to the vast majority of spending on products and services by Missourians. The intent of the proponents is clear. The various versions of the proposal are meant to confuse Missourians and pick off one or more of the opponents to the measure. However, as described further below, the basic tenets of both the initiative and legislative proposals remain fundamentally flawed, and Missourians should not be fooled by this gamesmanship.

The way the legislative proposal is written, the new sales tax would apply to nearly everything anyone buys. That means food, prescription medicine, utilities and even new homes. It would also apply to services, including child care, nursing homes and assisted living for seniors, doctor's office visits, legal counseling, financial services and more — even funerals. No other state taxes services to that extent.

"We estimate that an 11 percent state sales tax rate would be necessary to make up for lost revenue."

Moreover, even with all those new items added to what's taxable, the sales tax rate itself would need to be considerably higher to make up for revenue lost from the income tax. Proponents of the plan indicate that a 5 to 7 percent state tax rate would be required (in addition to local sales taxes). SJR 1 specifically cites a rate of 5.11 percent, and the initiative petitions cap the state rate at 7 percent.

However, we at the Missouri Budget Project, in partnership with the Institute on Taxation and Economic Policy, estimate that an 11 percent state sales tax rate would be necessary to make up for lost revenue. Ours isn't the only analysis that parts ways with what the legislation contends. The nonpartisan Missouri Joint Tax Policy Committee's research says that the state sales tax rate would be about 10 percent, depending on which version of the legislation would pass. Even proponents of the legislation are beginning to acknowledge the need for a much higher rate than what is in the legislation. For example, the Show-Me Institute's most recent analysis indicates that a 10.9 percent sales tax rate would be necessary under the plan. None of these estimates include local sales taxes, which would add an additional 2 percent.

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Tennessee: No Panacea With "Fair Tax"

By Rita Linhardt

"A November 2009 report by the Institute on Taxation and Economic Policy found that the poorest 20 percent of Tennesseans paid on average 11.7 percent of their income in Tennessee taxes, while the wealthiest one percent of taxpayers paid an average of only 3.1 percent."

Proponents of the "fair tax" often point to Tennessee as a model state because its tax structure embodies some principles of their proposal. Since Tennessee is similar to Missouri in geographic region and demographics, it can provide a good case study for the "fair tax." Unfortunately, Tennessee is not the success story that advocates in Missouri claim it to be.

Despite the state's beautiful mountain vistas and country music fame, there is much to be desired about Tennessee's quality of life. According to Morgan Quitno ratings, Tennessee ranks near the bottom of the 50 states in key areas of public school spending, graduation rates and higher education enrollment. The state ranks near the top in crime rate and was considered the 47th most livable state. Census Data from 2008 shows the state ranked 11th highest in the nation in the number of persons living below the poverty level. The median household income is well below the national average and unemployment is currently hovering at 9.4 percent. Missouri generally ranks ahead of Tennessee in statewide rankings measuring quality of life issues.

Many in Tennessee would say that the state's problems are due in part to its tax structure. Tennessee does have a very limited income tax on investments, which falls particularly hard on retirees. It also has a corporate tax similar to Missouri's current rate. However the greatest source of Tennessee's revenue (almost 60 percent) comes from its sales tax, thus its similarity to Missouri's "fair tax" proposal.

Tennessee enacted its first sales tax in 1946 at a rate of 2 percent and has steadily increased to the current rate of 7 percent. Combined with taxes imposed by local government, Tennessee residents can pay a tax rate of 9.35 percent on their purchases. While many states have eliminated their sales tax on food, Tennessee taxes food purchases at a rate of 5.5 percent — the highest in the country.

Tennessee also charges a sales tax on 55 services, including dry-cleaning and home satellite set-up services. The state is considering taxing more services.

Relying so heavily on a sales tax can lead to problems, especially during times of economic recession. As people have less money to spend, they buy less, thus decreasing the revenue from the sales tax. That's what happened in Tennessee. The state had 23 straight months of decreased sales tax revenue. Sales tax revenue finally started to increase in the spring of 2010, but the state is still facing an estimated $1.5 billion shortfall in the upcoming fiscal year.

Part of the problem with the heavy reliance on sales tax has to do with the state's geography. Tennessee is a long narrow state that borders eight other states. With half of the state's population living in counties that border other states, it's very enticing for residents to shop across the border or on the Internet. This has a negative effect on local businesses and job stability. (If Missouri enacted the "fair tax," it would experience similar problems; the "fair tax" is especially unpopular in the Kansas City area.)

One of the messages being used in the campaign for "fair tax" in Missouri is that Tennessee is a "low tax" state. That is true but only when you consider certain taxes.

According to the Institute on Taxation and Economic Policy in Washington, D.C., Tennessee is third lowest in the nation as a share of personal income primarily because of its limited personal income tax. Tennessee property taxes are also quite low, in fact 36 percent below the national average. Where Tennessee makes up the difference is with its sales and excise taxes, which are 38 percent above the national average. The state ranks eighth highest in terms of sales and excise taxes as a share of income.

This imbalance in Tennessee's tax structure results in regressive taxation felt by those least able to pay. A November 2009 report by the Institute on Taxation and Economic Policy found that the poorest 20 percent of Tennesseans paid on average 11.7 percent of their income in Tennessee taxes, while the wealthiest one percent of taxpayers paid an average of only 3.1 percent.

As much as Missouri proponents of "fair tax" admire what Tennessee is doing, they may want to take a second look. In 2002, then Republican Governor Don Sundquist supported a progressive income tax as part of a tax reform package in Tennessee.

While the tax reform package failed, the Tennessee legislature in 2004 did authorize a commission comprised of several economists to examine the state's tax structure and make recommendations. Among their findings was that Tennessee's current tax structure is anti-competitive, the sales tax rate is too high, and the current tax structure lacks balance and stability. In the end the Tax Structure Study Commission report stated, "… the current tax structure is seriously flawed, and that the implementation of a program of total tax reform is necessary to enhance the competitiveness, fairness, and revenue stability of the Tennessee tax structure."

As proponents of the "fair tax" continue to push their issue forward, Missouri taxpayers should seriously consider the implications of eliminating personal income and corporate tax and relying exclusively on an enhanced sales tax. Tennessee's modified version of the "fair tax" has systemic flaws, which have negatively impacted the quality of life for many residents of the state. Missouri should not emulate Tennessee.

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In addition, it is important to understand that if the sales tax rate were indeed capped at the 5 to 7 percent called for in the legislation or the initiative petitions, the services and infrastructure that provide the foundation for our economy would be jeopardized. Critical programs that represent the state's investment in its workforce, such as education, transportation and health services would face deeper cuts, endangering the state's economic recovery.

Low and middle-income Missourians (including most seniors) have to spend a higher portion of their incomes on essential products and services than do wealthier people. These taxpayers would be hit hardest by the increased sales taxes required under this proposal. Missouri's families are already hurting enough during these tough economic times. An increased sales tax would push even more families struggling to make ends meet over a financial cliff.

While supporters of the proposal point out that there are other states without income taxes, those states collect considerably more revenue from things like oil and mineral extraction or tourism taxes than Missouri could. No state has a system like what's been proposed for Missouri, so there's no comparison to assess the economic ramifications.

Amy Blouin

The "fair tax" proposal is fraught with problems. Not only is there consensus that the legislation's proposed tax rate is inaccurate, but most people agree that certain services (rent or nursing home care, for example) should be exempt from sales taxes. We can expect that during legislative debate, public outcry and private lobbying will result in various goods and services being exempted from the tax. However, every time something is exempted, the sales tax rate applied to everything else would need to increase to make up for lost revenue.

No tax structure is perfect, and Missouri's definitely needs some reforms. But this flawed, untested concept threatens Missouri's well-being. Legislators should examine other tested and proven effective ways to update our state's tax structure.

Amy Blouin is the Founder and Executive Director of the Missouri Budget Project. The mission of the MBP is to advance public policies that improve economic opportunities for all Missourians, particularly low and middle income families, by providing reliable and objective research, analysis and advocacy. Amy also serves as an Adjunct Professor at Saint Louis University. She is a member of Saint Margaret of Scotland parish in St. Louis.

Taxes Raise Question of Justice

By Mike Hoey

Taxes are to government what engines are to cars: government can't run without them. Since ancient times, governments have taxed their subjects (or later citizens) in order to raise funds to operate. But taxes have never been popular, especially when imposed without the consent of the governed. One of the rallying cries of the American Revolution was: "No taxation without representation."

In a perfect world there would be no taxes; all common undertakings would be financed by free-will offerings. If there must be taxes, however, they ought to be fair. Blessed John XXIII put it this way: "In a system of taxation based on justice and equity it is fundamental that the burdens be proportioned to the capacity of the people contributing." (*Mater Et Magistra, par. 132, 1961*).

A sales tax, as is proposed by the "fair tax," is not sensitive to the economic circumstances of the taxpayer. Both the millionaire and the pauper pay at the same tax rate. Paying the same tax rate might seem "fair," but what it means is the poor person pays a higher percentage of their income in taxes than the more affluent person. Proponents of the "fair tax" try to address the inequities in their proposal by offering a monthly prebate check to taxpayers, but it is a clumsy way of addressing inequities and might create additional administrative problems for state government.

Sales taxes can be efficient ways to raise revenue, but they are not designed to distribute tax burdens in an equitable manner. In contrast, a graduated income tax has income brackets with tax rates that rise as income rises. According to Harvard economist Louis Kaplow, if you want to create equity in a tax system, choose the income tax for your tool.

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In a major work on tax reform, *The Theory of Taxation and Public Economics*, Kaplow argues a tax system must be evaluated in a comprehensive fashion. Too often policymakers look at each tax in isolation, he observes. Trying to remedy the inequity in a sales tax by adding a luxury tax, for example, doesn't address the issue: "Such a tax will distort consumption expenditures of the rich; they will spend less on yachts and more on mansions, air travel, and other diversions."

Kaplow suggests it would be better to stick with a uniform sales tax and address any inequities by an adjustment to the income tax. Unfortunately, the "fair tax" eliminates the income tax.

Mike Hoey is the Executive Director of the Missouri Catholic Conference.

Catholics and the (un)Fair Tax

A proposed amendment to the Missouri Constitution (SJR 1) would enact a new kind of state sales tax that would tax not just goods purchased but services rendered. The proposal raises several concerns of interest to Missouri Catholics.

Taxing Catholic Churches

SJR I eliminates almost all of the current sales tax exemptions. At present churches don't pay sales tax on goods purchased. Church renovations, supplies for the church picnic, etc. are all exempt from the current state sales tax. If SJR 1 is enacted, churches will pay sales taxes, adding to their current fiscal challenges. The rationale for exempting churches from taxation has always been that they further the common good by raising the moral fiber of society and providing charitable services not effectively provided by government. SJR 1 rejects this approach and taxes churches.

Taxing Catholic School Parents

As initially introduced, SJR I requires K-12 Catholic school parents to pay a sales tax on top of their school tuition payment. Meanwhile, higher education tuition is one of the few items exempted from the so-called "fair tax," on the basis that higher education is an "investment" that should not be taxed. To fully replace existing state revenue, as SJR 1 claims to do, it may take a tax rate of as much as 10 to 11 percent. At a 10 percent tax rate, a parent would pay $400 in sales tax on $4,000 of school tuition.

SJR I taxes parents for choosing Catholic schools. This is a tax a parent can avoid by not choosing Catholic schools. This tax is troubling when one considers Catholic teaching, as enunciated in the Catechism of the Catholic Church:

"As those first responsible for the education of their children, parents have the right to choose a school for them which corresponds to their own convictions. This right is fundamental ... Public authorities have the duty of guaranteeing this parental right and of ensuring the concrete conditions for its exercise." (par. 2229)

Government therefore has a duty to ensure that parents can, in fact, exercise their right to choose a school for their children. The MCC has long sought tax relief for Catholic school parents, such as a state income tax credit for school tuition. Instead of pursuing this kind of tax relief, SJR I moves in exactly the opposite direction. For the first time, a tax is specifically imposed on Catholic school parents.

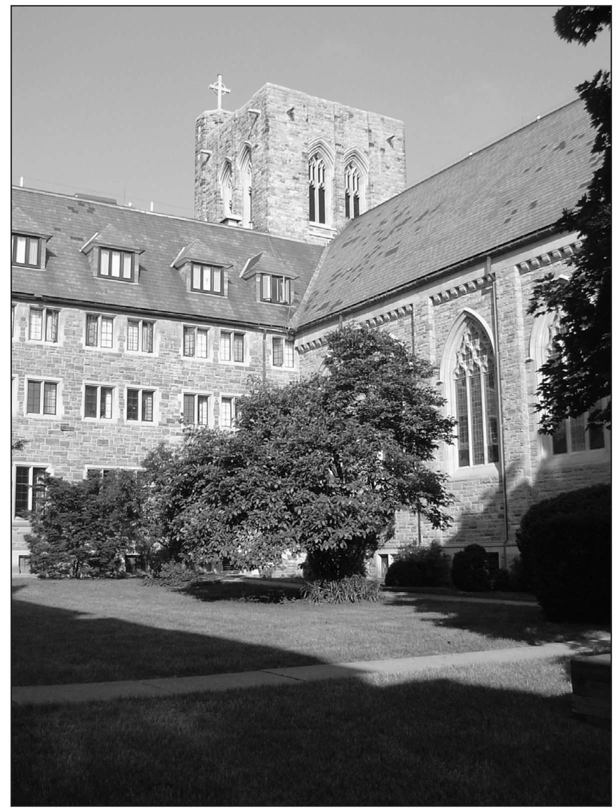
Taxing Catholic Charities

SJR I would impose a sales tax on many of the services provided by Catholic charities. If a service is offered entirely for free, then no tax would be imposed; but in many instances fees are charged on a sliding scale based on the person's income. Some of the services provided by the Catholic Church that could be taxed include: nursing home and assisted living services; child care; family counseling; and, pro-life counseling and emergency assistance.

In addition, because SJR I eliminates the state income tax, a number of tax credits that benefit the Church's charitable ministries would be eliminated. At present, for example, donors can obtain tax credits for contributions made to maternity homes, pregnancy resource centers, domestic violence shelters and other agencies that help people in crisis situations. For example, a donor who may have been considering a donation of $300 may decide to give $600 if he knows he can claim a $300 tax credit. If the credit is eliminated, this same donor may go back to giving just the $300. This kind of drop in charitable giving would hinder the extent of assistance Catholic charities could provide.

Taxing Knights of Columbus

Under current state law fraternal organizations like the Knights of Columbus do not have to pay sales tax for their sales or purchases. SJR 1, however, removes the sales tax exemption for fraternal organizations. The Knights, for example, would have to collect sales tax on their tootsie roll sales.



SJR I requires Catholic school parents to pay a sales tax on top of their tuition payment.

Why Are All These Things Taxed?

SJR 1, the so-called "fair tax," repeals all of Missouri's current taxes, including the personal and corporate income tax, the corporate and bank franchise tax and the current sales tax. All of the current taxes are replaced by one tax: a new state sales tax. But to replace all the revenue lost from abolishing the current taxes, the "fair tax" must have a very large tax base; hence, the taxes on Catholic churches, schools and fraternal organizations.

Proponents could exempt some things from their tax. But every time an exemption is granted, it will be necessary to hike the tax rate. And if the tax rate is too high voters will likely reject the new tax. That is why in many of the versions of the "fair tax" filed with the Secretary of State for circulation to voters the tax rate is capped at 7 percent. But the 7 percent tax rate will not replace current state revenue and will result in severe cuts in vital state services.