An Analysis of Fiscal Effects from the MI FairTax

By
Gary Wolfram, Ph.D.
Bruce Ikawa, Ph.D.
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Hillsdale Policy Group, Ltd.
Specializing in Taxation & Public Policy Analysis

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Executive Summary

In this analysis we attempt to estimate the potential effects of implementing the Michigan FairTax (MI FairTax) as defined by House Joint Resolution L (HR1). This bill would replace existing business taxes and individual income taxes with a broadly based tax on consumer purchases of goods and services. The bill ameliorates any potentially regressive effects to a sales tax by providing for a "prebate" designed to equal the tax on purchases of necessities. We evaluate whether revenues raised through the MI FairTax would be adequate to replace the taxes it eliminates and fund the prebate it requires. Our analysis is static in that we do not purport to model any behavioral effects.

We find that the MI FairTax would fully replace the Michigan Sales and Use Tax, Michigan Business Tax, the Individual Income Tax, the Property Tax on personal property, and the business portion of the State Education Tax, as levied in the 2007 Fiscal Year, as well as reduce the rate on the Insurance Premiums Tax, when levied at a rate of 9.75% and providing a prebate that would effectively eliminate the tax on expenditures up to Federal Poverty Income.

The rate of 9.75% is an upper bound, as those states without income taxes have grown at a rate significantly above that of Michigan and other income tax states. Over the past five years those states have an average annual growth of state GDP that is 4.5% greater than Michigan's. Should the MI FairTax increase state GDP growth by half of this, the rate would fall to approximately 9.5%.

The prebate effectively eliminates the MI FairTax for families spending at the Federal Poverty level. Since the prebate is given to all families, it has a significant reduction in the effective MI FairTax rate for even middle income families. For example, a family of two adults and two children, earning the median household income and using the recently released 2008 poverty Guideline, would have a prebate that reduced its effective MI FairTax rate to 5.6%.

[1] Gary Wolfram is the George Munson Professor of Political Economy at Hillsdale College and a former Michigan Deputy State Treasurer for Taxation and Economic Policy. He holds his Ph.D. in economics from the University of California at Berkeley. Bruce Ikawa holds the McIntyre Chair in Business Administration and is Professor of Accounting at Hillsdale College. He holds his Ph.D. in accounting from the University of Michigan. The authors would like to thank the Michigan Department of Treasury Office of Revenue and Tax Analysis for its assistance in gathering data and comments on the paper.

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In this analysis we attempt to estimate the potential effects of implementing the Michigan FairTax (MI FairTax) as defined by House Joint Resolution L (HR1). This bill would replace existing business taxes and individual income taxes with a broadly based tax on consumer purchases of goods and services.[2] The bill ameliorates any potentially regressive effects to a sales tax by providing for a "prebate" designed to equal the tax on purchases of necessities. We evaluate whether revenues raised through the MI FairTax would be adequate to replace the taxes it eliminates and fund the prebate it requires. Our analysis is static in that we do not purport to model any behavioral effects.

Exhibit I shows revenues from the taxes that would be replaced by the MI FairTax. As we know in 2008 the Michigan Business Tax will replace the Single Business Tax but this change is projected to be revenue neutral. This suggests that the MI FairTax would need to raise $18.4 billion without the prebate.

Exhibit I
Revenues (in millions) to be Replaced by MI FairTax
Unless Otherwise Noted from Senate Fiscal Agency Revenue Report for Oct., 2007

Sales and Use Tax	$7,942
Single Business Tax	1,799[3]
Insurance Premiums Tax	346[4]
Individual Income Tax	6,456
Personal Property Tax	1,507[5]
Business Portion of State Education Tax	391[6]
Total	**$18,441**

Exhibit II calculates projected revenues from the MI FairTax. We start with the existing sales tax base, which we estimate to be $132.3 billion. Some of this, however, represents business purchases. The Tax Analysis Division of the Michigan Department of Treasury (Tax Analysis) estimates that 30% of purchases are from businesses that would not be

[2] The MI FairTax is not designed to replace local levies, other than the personal property tax. In particular, it will not replace taxes levied under The City Uniform Income Tax Act, 1964 PA 284.
[3] In 2008 the Single Business Tax will repealed and replaced by the Michigan Business Tax. According to the Senate Fiscal Agency this change will be revenue neutral.
[4] Appendix I
[5] The Michigan Property Tax Real and Personal 2006 Statistical Update Office of Revenue and Tax Analysis, October 2007
[6] Tax Analysis estimate

collected under the MI FairTax. On the other hand the MI FairTax would tax purchases not taxed under the current system. Tax Analysis estimates that eliminating sales tax expenditures, by which it means the various deductions in the current Sales and Use Tax Acts, would add $64.5 billion. Since part of this relates to "industrial processing" representing business purchases, we need back this portion out, leaving $49.9 billion. The existing sales tax does not apply to services. Tax Analysis estimates that subjecting services to taxation would broaden the sales tax base by $144.4 billion. This total, however, includes business to business services which would be exempt from the MI FairTax. Tax Analysis estimates that approximately 42% of purchases of services may be business to business.

Exhibit II
Projected Revenues from MI FairTax (in Billions)

Current sales and use tax base	$92.70[7]
Sales tax expenditures	49.9[8]
Tax expenditures for services	83.7[9]
New homes	7.6[10]
Gain on sale of existing homes	1.5[11]
Gambling	4.7[12]
Additional residential rent	4.7
Business type services from city governments	**1.2**
Service fees to Liquor Control Commission	**.7**
Base for MI FairTax	**$246.7**
MI FairTax rate	9.75%
Tax revenues besides insurance	$24.1
Tax on insurance	0.4
Projected MI FairTax revenues	**$24.5**

[7] Sales and use tax revenue of $7.236 billion divided by .06 less 30% estimated business purchases
[8]) Executive Budget Appendix on Tax Credits, Deductions, and Exemptions Fiscal Year 2008 Excludes expenditures for "industrial processing"
[9] Ibid. Excludes portion estimated by Tax Analysis for btb purchases.
[10] According to the Census Bureau's January 2008 press release 774,000 new homes were sold in 2007 at an average sales price of $267,000. Since Michigan homes are 3.6% of nation's total we used this to estimate the portion of national sales taking place in Michigan.
[11] Executive Budget Appendix on Tax Credits, Deductions, and Exemptions Fiscal Year 2008 includes "tax expenditures" for exclusion of gain on sale of personal residence of $226 million. This implies the amount of these gains is $5.8 billion. The MI FairTax would not be applied to all this gain but only the inflation adjusted portion. We estimate this portion to be 25% of the total gain.
[12] Total from lottery sales, Detroit gambling, Tribal slots and race track wagering.

The exhibit includes a few smaller sources of revenue under the MI FairTax. The sale of new homes will be subject to the MI FairTax. We estimate that would add $7.6 billion to the base. The addition to the base might be approximated by the value of building permits. In addition the gain from the sale of existing homes will be taxed after allowing for a 2% annual increase. We attempted to estimate this source of revenue. We also assumed that gambling would be subject to the tax. We totaled lottery sales, Detroit net casino receipts, horse racing wagers and revenues tribal slots.

The MI FairTax would also be applied to payments for government services to the extent these services represent a "business type" activity[13]. Appendix III shows the amounts of these activities provided by cities with a population over 10,000. This suggests the tax could raise another $100 million from city services. We feel that this estimate is conservative. Appendix III only includes cities with a population over 10,000 that had sufficient financial data on their websites. Including other cities and other governmental units could increase this revenue source.

We also think that in some cases the MI FairTax on services might raise revenues greater than the amounts included in Tax Analysis' "tax expenditures" amount. For example, according to the U.S. Census Bureau's 2006 American Community Survey contract rent for housing in Michigan was $6.3 billion. Tax Analysis includes only $1.6 billion in payments to residential buildings.[14]The difference would add $4.7 billion to the MI FairTax base.

The proposed MI FairTax reduces the tax on insurance premiums from 1.25% to 1.1% but would tax the premiums on nonprofit insurers. As shown in Appendix II, this would result in a net increase in collections from insurance companies.

We've thus estimated the MI FairTax base to be $241 billion. Applying the rate of 9.75% projects that the MI FairTax would raise $23.8 billion. In addition the 1.1% tax on insurance premiums would raise approximately $304 million.

When we compare the projected MI FairTax from Exhibit II of $23.8 billion with the taxes to be replaced from Exhibit I of $18.4 billion it appears that the MI FairTax raises more than enough revenue to replace all existing taxes. Thus far, however, we have not allowed for the prebate.

Prebate

The MI FairTax proposes giving each householder a prebate equal to 9.75% of the Federal poverty level for a single person. For each additional person, a household would also receive a prebate equal to 9.75% of the incremental addition to the poverty level

[13] For purposes of governmental reporting a "business-type" activities are financed through fees charged to external parties for goods and services.
[14] One source of the difference might be that Tax Analysis excludes payments to individually owned rental properties.

attributable to each additional person. Based on just released 2008 Federal Poverty Guidelines the amount of these prebates would be[15]:

	Poverty Guideline	MI FairTax Rate	Prebate
Person Over 18	$10,400	9.75%	$1014
Each additional person	$3,600	9.75%	$351

According to 2006 Census data the average Michigan household has 2.54 persons[16]. We can thus estimate the average prebate per household to be:

Householder	1	995	$1014
Additional persons	1.54	351	$541
Prebate per household			$1555

Since Michigan has 3,869.117 households[17] we can estimate the total prebate needed as:

Number of households	Prebate per household	Total Prebate
3,869,117	$1,555	$6.0 billion

We add the prebate to the previously calculated revenues to be replaced.

Projected revenue from MI FairTax	$24.5 billion
Revenues to be replaced	($18.4) billion
Prebate	($ 6.) billion
Difference	.1 billion

This suggests that the net effects of changing to the MI FairTax would be essentially revenue neutral. As we'll see later incorporating very modest behavioral responses will increase projected revenues.

It is worth noting that the prebate effectively eliminates the MI FairTax for families that meet the Federal Poverty Guideline. Since the prebate is given to all families, it has a significant reduction in the effective MI FairTax rate for even middle income families. For example, a family of two adults and two children, using the recently released 2008 Guideline, would have a prebate of the 9.75% on $21,200 of expenditure, or $2067. If their income were $50,000 (Michigan Median Household Income for 2006 was $48,451), and they spent all of their income on taxable items, then their tax would be $4875. However, their net tax would be $2808, or 5.6%.

[15] United States Department of Health & Human Services, available at http://aspe.hhs.gov/poverty/08poverty.shtml.
[16] 2006 American Community Survey, s1101.
[17] Ibid.

ALTERNATIVES FOR RAISING MORE REVENUES

Raise the Rate

The MI FairTax base was previously calculated at $247 billion. Raising the tax rate would increase revenues but would also increase the prebate. The following shows the net after prebate for increases in the FairTax rate, assuming no net behavioral effects.[18]

	Percentage Increase in the Tax Rate					
	0.25	0.5	0.75	1	1.25	1.5
Increase in Revenues (in billions) net of increase in prebate	0.5	0.9	1.4	1.9	2.4	2.8

Expand the Base

Government Consumption

The national HR25 bill taxes a broader base than H1 (the MI FairTax). The single most significant difference is that HR25 taxes “government consumption”, largely consisting of wages and salaries paid to government employees. FairTax.Org calculated total national government consumption to be $2 trillion and apportioned 3.2% of this to Michigan based on the ratio of Michigan households to total US households. This would increase the MI FairTax base by $64 billion. If we took 9.75% of this it would raise $6.2 billion.

Insurance

Leaving the insurance premium tax at 1.25 instead of reducing the rate would raise $42 million.

Possible Change	**Increase in Revenue (in billions)**
Increase tax rate by 1%	2.5
Tax government consumption	6.1
Keep 1.25 insurance tax	.04

[18] Since the tax raises the effective price of goods and services it’s likely less would be purchased. This is generally referred to as the “substitution effect”. Taxpayers would, however, be able to afford more purchases because of the elimination of the income tax. This is known as the “income effect”. We assume these two effects offset.

DYNAMIC EFFECTS

This analysis is static without attempting to include any dynamic effects from the shift to the MI FairTax. It's quite possible that the change to the MI FairTax would stimulate the economy and increase projected revenues. Currently there are seven states that rely on sales taxes to the exclusion of income taxes to produce tax revenue. Appendix II shows the rate of growth in nominal Gross Domestic Product for each of these states over the last five years. These states have averaged an annual year over year increase of 7.16% which substantially exceeds Michigan's 2.65% in the same period. We think it's reasonable to project that Michigan's growth could approach that of the other states but very unlikely that it would exceed it. The following are the increases (in billion $) in tax receipts corresponding to projected rates of growth:

2.5%	3%	3.5%	4%	4.5%	5%
.60	.72	.84	.96	1.08	1.21

SUMMARY

Our analysis indicates that the a MI FairTax rate of 9.75% would, even allowing for the prebate, generate enough revenue to replace Michigan's income tax, business tax, personal property taxes and insurance premium taxes as they were levied in the most recent fiscal year. While we've made no attempt incorporate behavioral effects into our projections we think it's very reasonable to project an increase in the tax base due to the switch to the MI FairTax given the experience of other states that do not levy taxes on income. This means that our estimate of a 9.75% rate is a conservative one

Appendix I
Calculation of Proceeds from Tax on Insurance Premiums

Total Michigan Direct Premiums	50268363	
Less: Annuities	-9899019	
Less: Premiums written by nonprofits	-12,693,687	
	27675657	
Premium Tax Rate	1.25%	1.10%
	345,946	304,432
Premiums written by nonprofits		
BlueCross	5865134	
Health Alliance Plan	1581735	
Blue Care Network	1563628	
Priority Health	1084039	
CareChoices HMO	306444	
Community Choice	103906	
Cooperative Optical	9317	
Health Plan of Michigan	218147	
Healthplus of Michigan	402258	
Healthplus Partners	136334	
M-Care	467807	
Midwest Health Plans	129243	
OmniCare Health	148043	
PHP of Mid-Michigan`	35880	
Physicians Health Plans-Mid Michigan	231296	
Physicians Health Plans-South Michigan	81308	
Physicians Health Plans-Southwest Michigan	41543	
Priority Health Government Programs	91424	
Total Health Care	147420	
Upper Peninsula	48781	
	12693687	

Appendix II
Year Over Year Growth in GDP

	2002		2003		2004		2005		2006		Ave Annual Growth
Michigan	349,837	4.61%	359,030	2.63%	363,380	1.21%	372,148	2.41%	381,003	2.38%	2.65%
Nevada	81,274	5.15%	87,828	8.06%	99,342	13.11%	110,158	10.89%	118,399	7.48%	8.94%
South Dakota	26,416	10.48%	27,418	3.79%	29,519	7.66%	30,541	3.46%	32,330	5.86%	6.25%
Tennessee	191,525	6.06%	200,279	4.57%	214,400	7.05%	224,995	4.94%	238,029	5.79%	5.68%
Texas	783,480	2.79%	828,797	5.78%	904,412	9.12%	989,333	9.39%	1,065,891	7.74%	6.96%
Washington	231,463	2.52%	240,813	4.04%	252,384	4.80%	271,381	7.53%	293,531	8.16%	5.41%
Wyoming	19,619	3.58%	21,685	10.53%	23,876	10.10%	27,246	14.11%	29,561	8.50%	9.37%
Florida	522,719	5.09%	559,021	6.94%	607,201	8.62%	666,639	9.79%	713,505	7.03%	7.49%
Non-Michigan											7.16%

Appendix 3
Business Type Services Provided by Michigan Cities

City	Revenue (millions)
Adrian	7.2
Ann Arbor	46.6
Auburn Hills	9.9
Battle Creek	25.2
Bay City	40.5
Big Rapids	4.3
Birmingham	12.2
Cadillac	4
Canton	22
Dearborn	40.1
Detroit	88.1
East Grand Rapids	2.6
East Lansing	14.2
Eastpointe	9.8
Farmington Hills	21.5
Ferndale	7
Flint	53.1
Grand Rapids	91.6
Grosse Pointe Woods	5.1
Hillsdale	12
Holland	96.5
Ionia	3.7
Jackson	12
Kalamazoo	29
Kentwood	4.8
Lansing	46.6
Livonia	26.4
Madison Heights	8.5
Midland	23.7
Monroe	11
Mount Pleasant	5.6
Muskegon	11.4
Niles	14.3
Norton Shores	4.9
Novi	17.9
Pontiac	26.6
Port Huron	15.9
Portage	8.7
Rochester Hills	21.3
Roseville	11.2
Royal Oak	24.1
Saginaw	31
Southfield	28.3
St. Clair Shores	13.2
Sterling Heights	25.4
Traverse City	8.9
Troy	28.4
Warren	33.1
Wayne	69.3
Wyandotte	43.1
Total	**1,221.8**

Compiled for Michigan cities with a population over 10,000 that provided Comprehensive Annual Financial Reports online. Data is from the most recent fiscal year available.