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Child Payments and a VAT Are Fairer than the So-Called “Fair Tax”

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INTRODUCTION

Earlier this year, 31 House Republicans released a proposal to replace virtually all federal taxes with a 30% national sales tax.[1] As other analysts have noted, a sales tax would be easy for companies to dodge and difficult for the government to enforce — meaning that to avoid revenue losses, the proposal would require a significantly higher tax rate, possibly as high as 60%.[2]

The bill has also been criticized for being *regressive.* In tax terminology, a tax is "regressive" if it takes a higher share of income from the poor than from the rich; "flat" or "proportional" if it takes the same share of income from everybody; and "progressive" if it takes a higher share from the rich than from the poor.

The Republicans' *overall bill* is certainly regressive and should be rejected on that account. But its core idea — taxing consumption rather than income — is not inherently regressive if properly designed. Much public commentary has mistakenly concluded that a national sales tax would fall predominantly on low-income Americans. But as this analysis demonstrates, taxes on spending fall on everyone roughly equally, and certain elements of the Fair Tax — such as its universal child payments — are actually progressive. While the Fair Tax ought to be rejected due to its *regressive tax cuts* and *poor enforceability,* two elements of it are worth keeping: its flat per-child cash payments and its emphasis on taxing spending rather than saving.

THE "FAIR TAX" PROPOSAL WOULD CUT TAXES FOR THE VERY RICHEST AMERICANS

The Fair Tax would eliminate all income, payroll, corporate profits, estate, and gift taxes — leaving only excise taxes, tariffs, and various minor taxes in place.[3] As shown in the table below, this would represent a significant giveaway to the richest Americans. In 2019, the most recent year for which data are available, households in the top 1% of the income distribution paid 29.8% of their incomes in income, payroll, and corporate profits taxes; by contrast, households in the middle fifth paid just 12.2%. (Estimates are not available for estate and gift taxes, though the Urban-Brookings Tax Policy Center notes that "individuals inheriting over $1 million bear almost all of the burden of the estate tax."[4])

TABLE 1: THE TAXES ELIMINATED BY THE "FAIR TAX" ARE MOSTLY PAID BY THE RICH
FEDERAL INCOME, PAYROLL, AND CORPORATE PROFITS TAXES AS A SHARE OF HOUSEHOLD INCOME, 2019

	BOTTOM 20% OF INCOME-EARNERS	SECOND 20% OF INCOME-EARNERS	MIDDLE 20% OF INCOME-EARNERS	FOURTH 20% OF INCOME-EARNERS	TOP 20% OF INCOME-EARNERS	TOP 1% OF INCOME-EARNERS
Three Largest Taxes Eliminated by the "Fair Tax"	**-1.2%**	**7.9%**	**12.2%**	**16.0%**	**24.0%**	**29.8%**
Households With Children	-5.3%	8.5%	14.0%	18.2%	25.8%	31.0%
Nonelderly Childless Households	4.4%	11.3%	15.8%	18.8%	24.9%	30.2%
Elderly Childless Households	-0.1%	1.4%	4.4%	9.0%	20.3%	27.9%
Income Taxes	**-11.1%**	**-1.7%**	**2.4%**	**6.0%**	**15.4%**	**23.3%**
Households With Children	-18.0%	-3.6%	1.8%	6.0%	16.9%	24.7%
Nonelderly Childless Households	-6.3%	-0.1%	3.7%	6.6%	15.0%	23.9%
Elderly Childless Households	-1.1%	-0.5%	1.4%	5.0%	14.0%	20.9%
Payroll Taxes	**9.4%**	**9.0%**	**9.1%**	**9.3%**	**6.5%**	**2.3%**
Households With Children	12.2%	11.5%	11.5%	11.4%	7.0%	2.6%
Nonelderly Childless Households	10.1%	10.9%	11.4%	11.4%	8.2%	2.7%
Elderly Childless Households	0.7%	1.5%	2.4%	3.0%	3.0%	1.3%
Corporate Profits Taxes	**0.5%**	**0.6%**	**0.7%**	**0.8%**	**2.2%**	**4.2%**
Households With Children	0.6%	0.6%	0.7%	0.7%	1.9%	3.7%
Nonelderly Childless Households	0.6%	0.6%	0.7%	0.7%	1.7%	3.6%
Elderly Childless Households	0.2%	0.4%	0.7%	0.9%	3.3%	5.6%

Source: Congressional Budget Office, "The Distribution of Household Income, 2019," November 15, 2022, https://www.cbo.gov/publication/58353.
Notes: This table depicts the distributional impacts of all tax provisions eliminated by the Fair Tax with the exception of estate and gift taxes. The top 1 percent of households are included in the top quintile. Households are ranked according to the distribution of income before taxes and transfers, which includes market income and social insurance payments (such as Social Security). An equivalence adjustment is applied to household rankings to better compare standards of living across households of different size. For households with negative tax rates, after-tax incomes are higher than pre-tax incomes.

If the income tax were eliminated, many poor families with children would see their incomes *fall.* This may seem counterintuitive, since people generally *make* rather than *receive* tax payments. However, the federal income tax contains two "refundable" provisions — the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) — which give some families *negative tax liabilities,* meaning that the government is the one paying them. The EITC goes mostly to parents working low-wage jobs, and the CTC goes exclusively to working parents (including those in middle- and high-wage jobs). For households with children in the bottom fifth of the income distribution, average income is 18% higher after income taxes than beforehand (as shown by the -18.0% estimate in the table above). Even after accounting for payroll taxes and corporate profits taxes, after-tax incomes are still 5.3% higher than pre-tax incomes for these families.

By eliminating our country's most progressive taxes, the GOP proposal would put significantly more money in the pockets of the very richest households. The middle class would receive a modest tax cut, and the very lowest-income families — especially low-income families with children — would see their taxes increase.

But this is only one part of the story.

THE FAIR TAX'S CASH PAYMENTS WOULD HELP SOME EXTREMELY POOR FAMILIES

To offset the damage to low-income households, the Fair Tax would provide universal cash payments to all Americans — essentially, a type of Universal Basic Income (UBI). However, the Fair Tax UBI more closely resembles progressive basic income proposals than proposals coming from conservatives such as Charles Murray (who advocates a $13,000 basic income that begins phasing out after $30,000 of wages).[5] For single adults, the payments would be set at 23% of the individual poverty line; for couples, they would be set at twice that amount.[6] Payments for children would be set at 23% of the difference between the one-person poverty line and the two-person poverty line.[7] In 2022, these payments would have amounted to roughly $3,100 per adult and $1,100 per child.[8] However, because households would use part of this aid to pay the new sales tax, the increase in purchasing power would be less than advertised. For example, the $3,100 cash payments per adult would translate to roughly $2,400 in new pre-tax spending and $700 in additional sales tax payments. A single mother with one child would receive a $4,200 payment under the Fair Tax, yet her after-tax spending would only increase by $3,200 as a result.

Because these payments would be available even to households with no income, the Fair Tax would boost after-tax incomes for the poorest of the poor. For example, because they are not working, households with zero earnings receive neither the EITC nor the CTC; yet under the Fair Tax, they would receive the same cash payments going to everyone else.

The $1,100 child payments would help many low-income families in need. However, the $3,100 adult cash payments are a poorly targeted form of aid.[9] In 2022, these payments would have totaled $814 billion nationwide — equivalent to roughly 17% of federal revenues and 13% of federal spending.[10] Yet despite this high price tag, little of the aid would have gone to those in need: Just 10.5% of the adult cash payments would have gone to adults living in poverty, while fully 50% would have gone to adults with above-median incomes.[11] As the Progressive Policy Institute (PPI) has previously argued, there are better ways of spending federal resources to help people in need.[12] In particular, instead of instituting a UBI, Congress should expand the EITC, which encourages work and directs most of its benefits to lower-income Americans.[13] PPI has previously proposed replacing the EITC with an expanded Living Wage Tax Credit (LWTC), which would offset the average cost of new consumption taxes for low-income households while phasing out benefits for high-income households.[14] Compared to the Fair Tax's UBI provision, such a credit would likely be cheaper, better at promoting work, and more well-targeted toward those in need.

OVERALL, THE FAIR TAX WOULD BE LESS PROGRESSIVE THAN THE CURRENT TAX CODE

However, most low-income households would still be hurt by the Fair Tax. The figure below shows how much after-tax incomes would rise or fall at different points along the wage distribution for married couples with two children. The Fair Tax would raise taxes on such families if they earn between $10,700 and $53,700. This is because many of these families are eligible for tax credits which can be worth up to $9,200 under the current system, and their combined income and payroll tax rates are lower than the sales tax rate implemented under the Fair Tax. Couples making between $25,200 and $27,100 would experience the greatest losses, with their after-tax incomes falling by over $5,000.

FIGURE 1: THE "FAIR TAX" WOULD RAISE TAXES ON MANY DISADVANTAGED FAMILIES
CHANGE IN AFTER-TAX INCOME FOR A TWO-EARNER, TWO-CHILD FAMILY, BY ANNUAL WAGE, 2022

Notes: Figure assumes that wages are 100% of income and that families spend their entire incomes. Under the status quo, it is assumed that families claim the standard deduction, the earned income tax credit, and the child tax credit, and that they pay the 0.6% FUTA on their first $14,0000 of joint wages. The figure assumes that employer-side payroll taxes are effectively paid by workers and that workers would pay sales taxes on this income under the Fair Tax.

As the graph shows, some low-income households would be better off under the Fair Tax. Yet the group of low-income losers is much larger than the group of low-income winners: Census Bureau data show that in 2021 (the most recent year for which data are available), just 2.1% of married couples made less than $10,700, whereas 18.1% made between $10,700 and $53,700.[15] In other words, while the Fair Tax helps a small number of very poor families, it hurts a much larger number of families who still have relatively low incomes.

The figure above also implies that tax revenues would fall significantly under the Fair Tax. It simply isn't possible to cut taxes for more than three-quarters of households without losing money. This problem is further compounded by the fact that the Fair Tax's largest tax cuts go to the richest households, who take home a large share of the country's taxable income. According to Brookings economist Bill Gale and American Enterprise Institute senior fellow Kyle Pomerleau, even if tax avoidance and evasion do not increase, the Fair Tax will cost $18 trillion over the next decade — a 31% decrease in federal revenues.[16] If these massive losses force policymakers to cut programs such as Medicaid or Supplemental Security Income, the hit to low-income people will be even more severe than depicted above.[17]

So when the Fair Tax proposal is considered on the whole — taking account of its tax cuts, its tax hikes, its cash payments, and its revenue losses — it is clearly regressive. However, many commentators have overstated the regressivity of one key element of the plan: its 30% national sales tax.

SALES TAXES AND VALUE-ADDED TAXES ARE FLAT, NOT REGRESSIVE

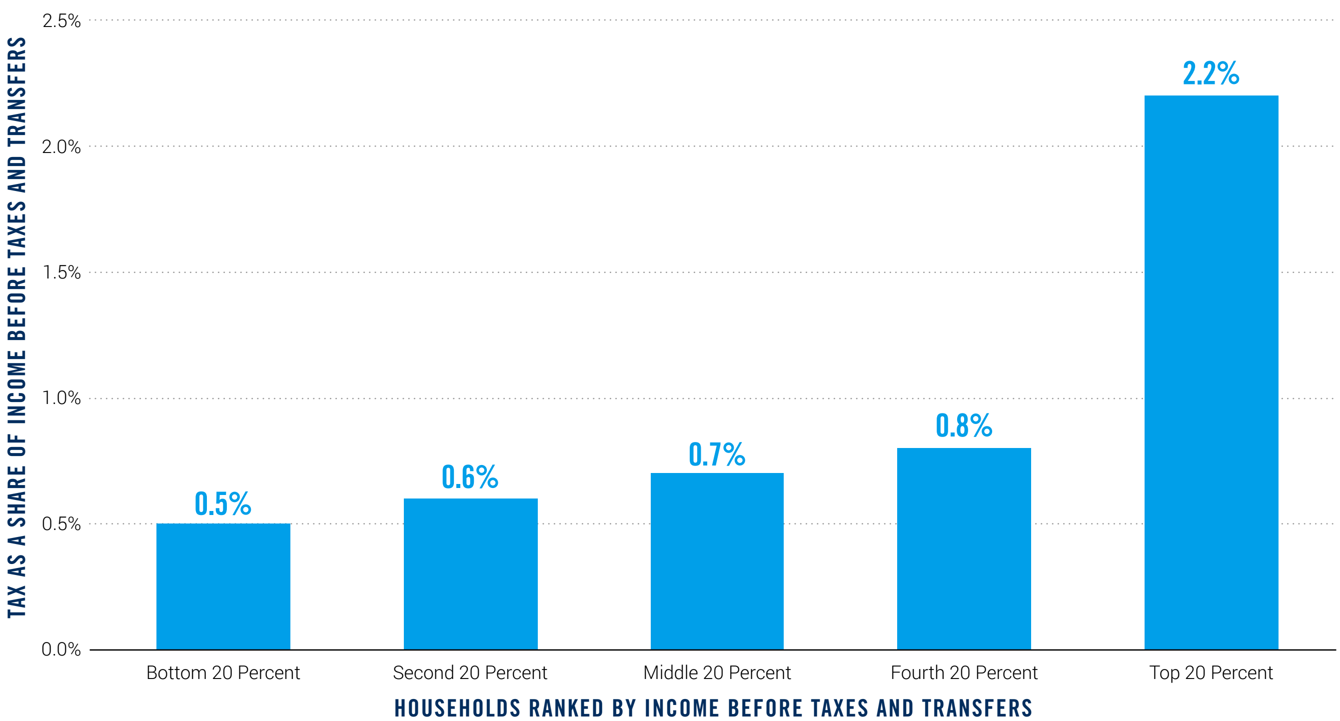
Due to its enormous tax cuts for the rich, the Fair Tax proposal can rightly be characterized as regressive. The bill would eliminate all mostly progressive federal taxes and replace them with a new tax that is only mildly progressive (after accounting for its cash payments). Because the tax code would become *less progressive than it is now,* the *change* from our current system to the Fair Tax would be regressive.

Nonetheless, the bill's critics have overstepped in one important way: They have argued that the 30% sales tax, as a standalone provision, would be regressive. Yet when the distributional impacts of sales taxes are measured more accurately, they appear roughly proportional. This distinction is important because the confusion dominating our current debate could influence whether the United States adopts a value-added tax (or "VAT") at some point in the future.

The misunderstanding about the distributional impact of sales taxes is understandable. When evaluating who pays a given tax, economists often cite *annual income distribution charts* (or *tables*). These charts sort households into low-, middle-, and high-income groups, then portray the given tax as a share of income for each group. For example, the figure below shows the progressive nature of the corporate profits tax, which takes a higher share of income from the rich than from the poor.

FIGURE 2: THE CORPORATE PROFITS TAX IS PROGRESSIVE

FEDERAL CORPORATE PROFITS TAX AS A SHARE OF INCOME, 2019



Source: Congressional Budget Office, "The Distribution of Household Income, 2019," Nov. 15, 2022, https://www.cbo.gov/publication/58353.

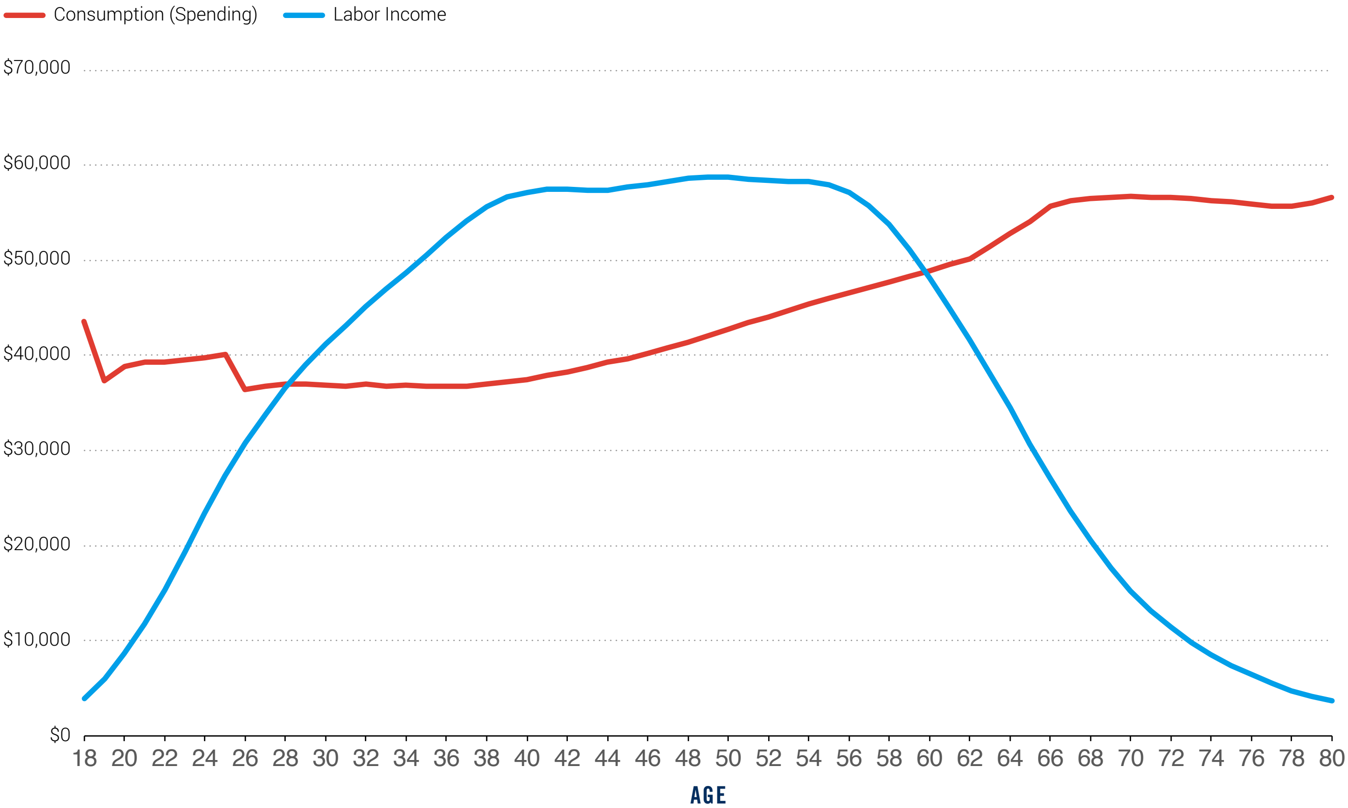
When sales taxes are evaluated the same way, they appear strongly regressive. Distributional tables and charts consistently show that sales taxes take a greater portion of income from high-income households than from low-income ones.[18] (Because their incomes are higher, the rich still pay more in absolute dollars, however.)

But this seeming regressivity is mostly due to a measurement quirk. Specifically, annual income distribution tables measure the impact of sales taxes as a share of one year's income. But people's incomes fluctuate significantly over time, and typical patterns of saving and spending make sales taxes look more regressive than they actually are.

The clearest way to see this is by looking at a graph of per capita incomes and spending by age. Based on data compiled by researcher Gretchen Donehower for the National Transfer Accounts, the figure below shows average earnings and consumption by age in 2011 (the most recent year for which data are available).[19] As the graph shows, people typically spend above their incomes early in their lives, especially if they are in school and not working; they spend below their incomes during their highest-earning years; and then they spend above their incomes in retirement as they draw down on past savings.[20]

FIGURE 3: CONSUMPTION TAXES ARE PAID IN DIFFERENT YEARS THAN INCOME TAXES, BUT THEIR LIFETIME BURDEN IS NOT NECESSARILY HIGHER

LABOR INCOME AND CONSUMPTION BY AGE, 2011



Source: Ronald Lee and Andrew Mason, lead authors and editors (2011) Population Aging and the Generational Economy: A Global Perspective Cheltenham, UK: Edward Elger. Data accessed February 17, 2023, at www.ntaccounts.org. Data prepared by Gretchen Donehower of the University of California, Berkeley.

These patterns of earning and spending distort annual income distribution tables in two ways. First, they cause people to be misranked along the annual income distribution. For example, in 2011, the average 70-year-old made $15,300 of labor income (in 2011 dollars) but spent $57,000. Judging by the amount of money this retiree had at her disposal, she was solidly middle-class. Yet because her annual income was just $15,300, she would be ranked near the bottom of the annual income distribution.

Second, after being sorted into a low-income group, this retiree's sales tax payments would be measured as a share of her annual income. If the sales tax rate were set at 15%, she would pay nearly $7,400 in sales taxes, equivalent to 48% of her income. An annual income distribution table would therefore portray this retiree as a low-income individual paying nearly half her income in sales taxes; in reality, she is a middle-class retiree devoting just 13% of her spending to sales taxes.[21]

This measurement problem is not unique to retirees. Nonworking college students with affluent, supportive parents will also be portrayed as low-income, and their sales tax burdens will look high relative to their near-zero incomes. Yet presumably this is not the image that people have in mind when they think of struggling people near the bottom of the income distribution. Similarly, during people's highest-income years, they often save an unusually high percentage of their incomes; this makes sales taxes look like a trivial share of income for high-earning individuals. But these individuals will not necessarily be high-income for their entire lives, nor are they dodging the sales tax: They will simply pay the sales taxes during their retirements when they spend down their savings. For an individual with the income and spending patterns depicted in the graph above, a sales tax will be paid in different years than an income tax, buts its overall lifetime burden will not necessarily be higher or lower.

One way of adjusting for this problem is by measuring the burden of sales taxes along a simulated lifetime income distribution.[22] Under this approach, researchers estimate people's total lifetime incomes, then rank-order people along that estimated lifetime distribution — an approach that corrects for the problem of annual income fluctuations. By this measure, sales taxes are flat or slightly regressive — a far cry from the wildly regressive depictions in annual distribution tables.[23] However, the downside to this approach is that simulations are just that — *simulations*. They are highly dependent on the assumptions made by the simulator, and no established data source fully tracks people's tax payments and incomes over their entire lifetimes.

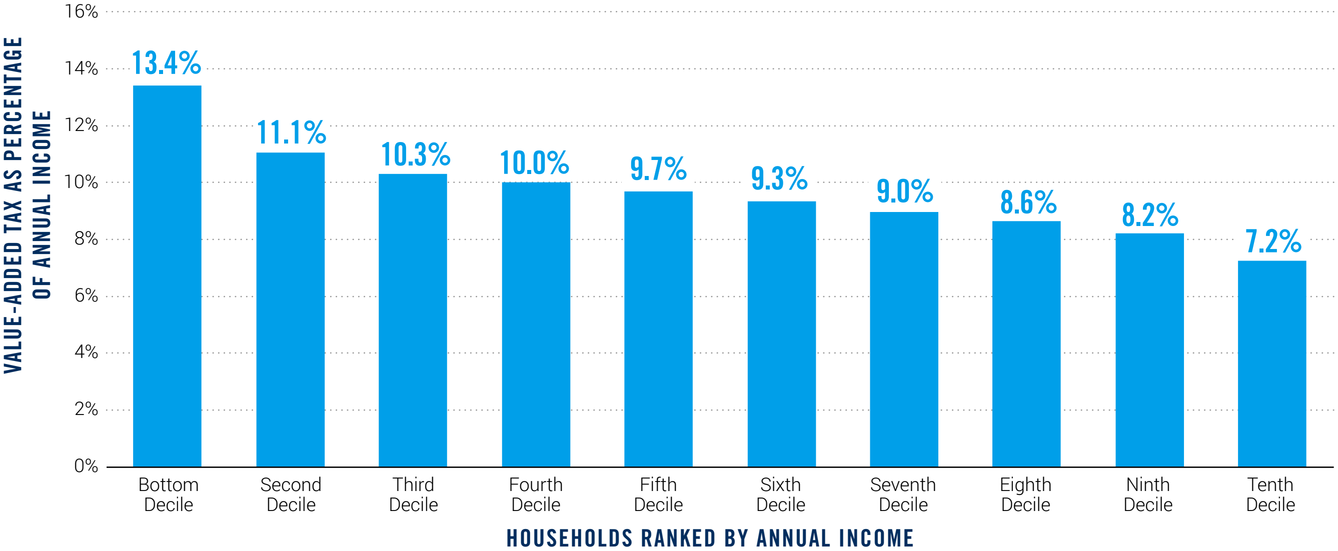
A second way of adjusting for this problem is by measuring the tax burden along the spending distribution itself. Under this methodology, households are ranked in terms of how much they spend, and the tax burden is measured as a share of that spending.This approach would correctly portray the aforementioned 70-year-old as a middle-class retiree paying a 13% sales tax rate, not as an impoverished low-income individual paying a 48% tax rate.

In a comprehensive cross-country study, the Organisation for Economic Co-operation and Development (OECD) measured the impact of VATs — which are essentially more easily-enforced sales taxes — across the distributions of both income and spending.[24] The OECD noted that, using annual data, the distributional impact of a VAT or sales tax can be measured in one of four ways:

- The tax burden can be measured as a share of income, with households ranked along the income distribution (measure #1);
- The tax burden can be measured as a share of income, with households ranked along the spending distribution (measure #2);
- The tax burden can be measured as a share of spending, with households ranked along the income distribution (measure #3); and
- The tax burden can be measured as a share of spending, with households ranked along the spending distribution (measure #4).[25]

The OECD's findings are quite striking: They show that the distributional impact of a VAT differs wildly depending on which of the four methodologies one chooses. VATs are extremely progressive according to measure #2 and are mildly progressive according to measure #3.[26] Of the four measures studied by the OECD, only measure #1 — *VAT payments as a share of income, with households ranked along the income distribution* — shows VATs to be regressive:

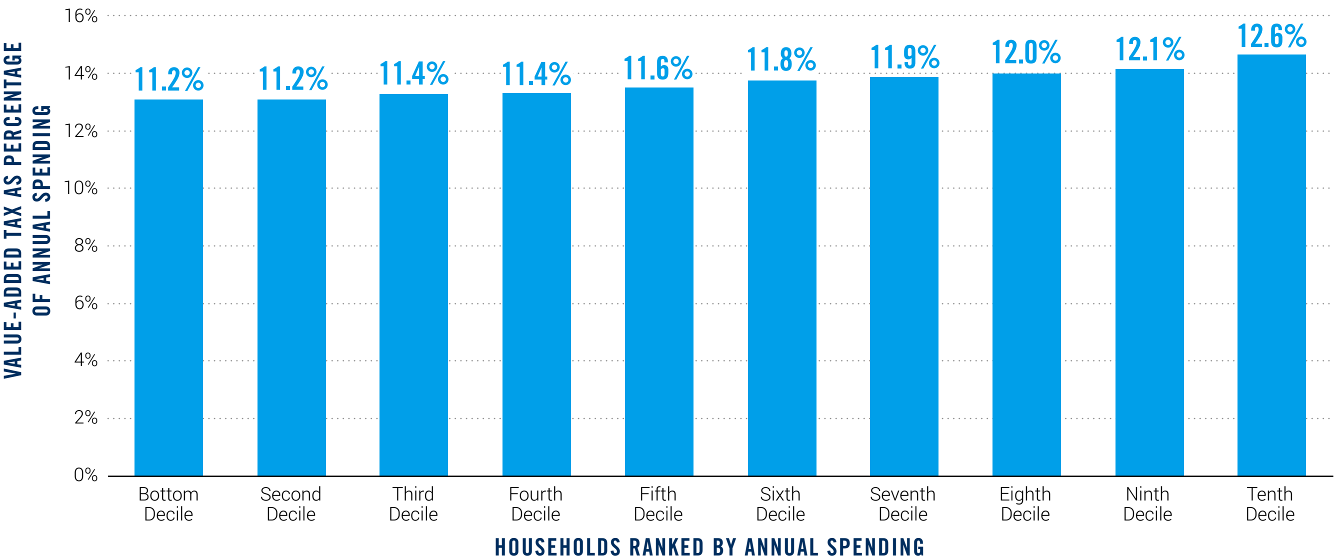
FIGURE 4: OECD VALUE-ADDED TAXES ARE REGRESSIVE ALONG THE INCOME DISTRIBUTION
VATS AS A SHARE OF DISPOSABLE INCOME, HOUSEHOLDS RANKED BY INCOME, OECD AVERAGE



Source: Organisation for Economic Co-operation and Development, "The Distributional Effects of Consumption Taxes in OECD Countries," pages 37-41, December 10, 2014, available at https://www.oecd.org/ctp/the-distributional-effects-of-consumption-taxes-in-oecd-countries-9789264224520-en.htm.

The script flips when one switches to measure #4. When VATs are instead measured as a share of spending, with households ranked along the spending distribution, they are very slightly progressive:

FIGURE 5: OECD VALUE-ADDED TAXES ARE MILDLY PROGRESSIVE ALONG THE SPENDING DISTRIBUTION
VATS AS A SHARE OF CONSUMPTION, HOUSEHOLDS RANKED BY CONSUMPTION, OECD AVERAGE



Source: Organisation for Economic Co-operation and Development, "The Distributional Effects of Consumption Taxes in OECD Countries," pages 37-42, December 10, 2014, available at https://www.oecd.org/ctp/the-distributional-effects-of-consumption-taxes-in-oecd-countries-9789264224520-en.htm.

Granted, the Fair Tax does not implement a VAT. But the more general point still holds: A national sales tax will not be as regressive as depicted in annual income distribution tables. If the 30% sales tax were properly enforced (an assumption called into doubt in the next section), then by definition, it would be equivalent to 23% of spending for all households — *a flat tax,* according to the OECD's fourth measure. When combining this flat tax with the plan's universal cash payments, the GOP's new tax system would likely score as mildly progressive, though it would undoubtedly be less progressive than the status quo.

Finally, it is worth asking if a fairer distributional measurement would change the perception of the GOP's tax *cuts*. For example, table 1 at the beginning of this report shows that income taxes are strongly progressive along the annual income distribution. Would they look significantly less progressive under a different measure? The answer is *no*. In a 1984 study published in the *American Economic Review,* three economists estimated the distributional impact of Canada's tax system based on both annual income and lifetime income.[27] When examining Canada's progressive income tax, the authors found that the gap in tax rates between the rich and the poor was 11.4 percentage-points in annual tables and 13.2 percentage-points in lifetime tables — two highly similar estimates.[28] Similar results were obtained for other taxes.[29] Only sales and excise taxes looked strikingly different in the two tables: Low-income Canadians paid 18.7% more than the rich in the annual tables but just 2.6% more in the lifetime tables.[30] In other words, although annual distribution tables badly overstate the regressivity of sales taxes, they accurately measure the progressivity of other taxes. No matter how they are measured, the tax cuts included in the GOP bill would flow overwhelmingly to the rich.

ANOTHER FLAW WITH THE FAIR TAX: POOR ENFORCEMENT

Proponents of the Fair Tax seem to have put little thought into what their sales tax should accomplish, and sometimes appear to not even understand what a sales tax is. For example, the text of the Fair Tax proposal complains that the federal income tax "embed[s] taxes in the costs of everything Americans buy."[31] This is an odd complaint for the bill's authors to levy, given that sales taxes directly raise prices. The text further claims that the income tax "is not being complied with at satisfactory levels and therefore raises the tax burden on law-abiding citizens" — which is especially galling coming from politicians who are trying to cut IRS enforcement funding.[32]

It is unsurprising that this same bill exacerbates many of the problems it ostensibly tries to solve. For example, to levy a national sales tax, the government would need to track all nationwide sales, then determine which sales had been made to consumers as opposed to other businesses. When President Bush's Advisory Panel on Tax Reform examined a previous version of this proposal in 2005, they bluntly concluded that it would "creat[e] incentives for significant tax evasion" and that "evasion rates could be higher than under the present income tax."[33]

A VAT would be much easier to enforce.[34] A VAT is similar to a sales tax, but instead of levying one tax when businesses sell to customers, it levies a series of incremental taxes at each stage of the production process.

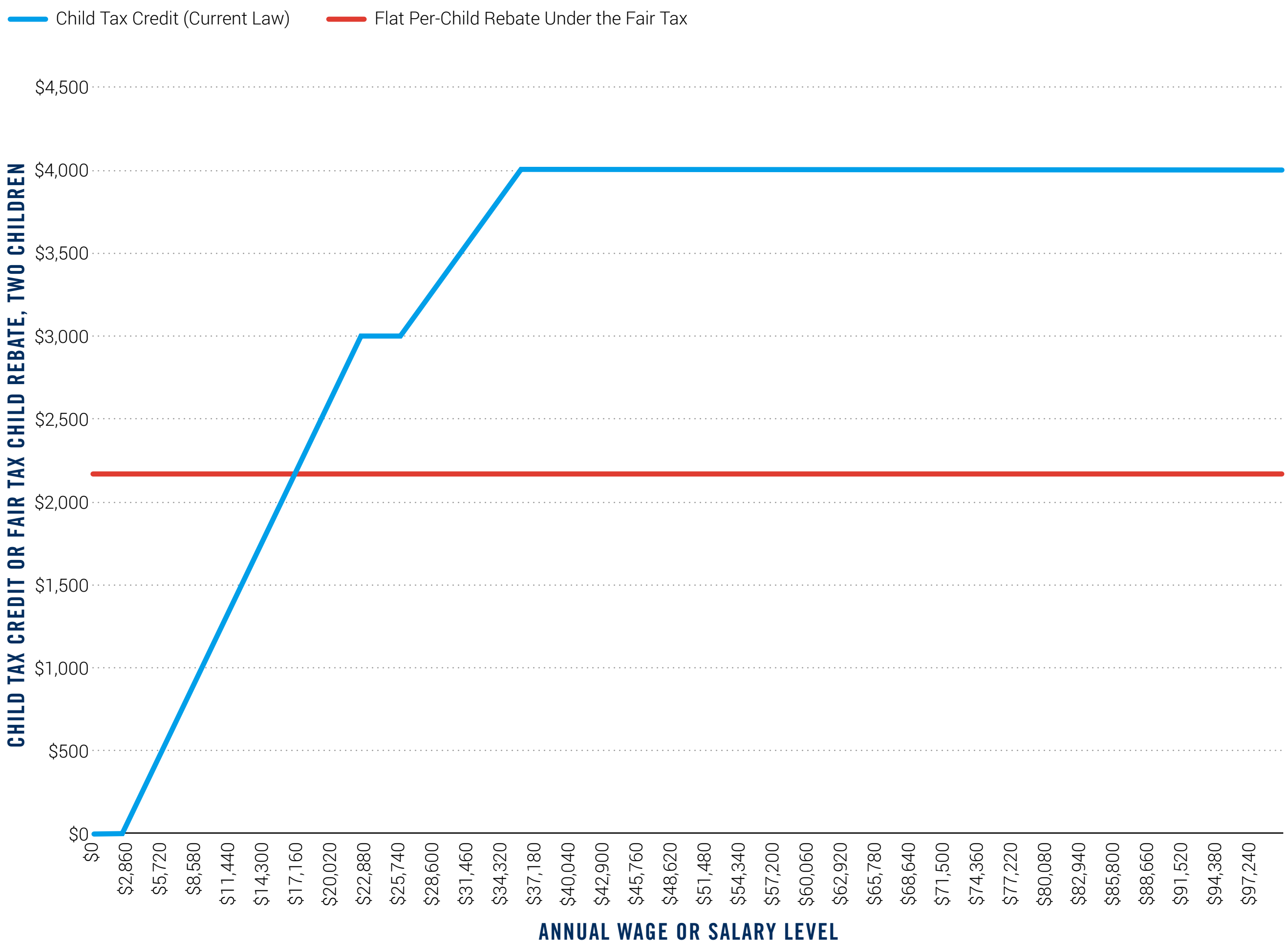
The government would therefore not need to differentiate sales made to individuals from sales made to other businesses, and compliance problems would be minimal: One company's failure to report a sale would raise taxes for the next company along the production chain, giving businesses an incentive to monitor each other and report their transactions faithfully.[35] The GOP's 30% national sales tax would prove far harder to enforce than an otherwise-similar VAT.

POLICY CONCLUSIONS: OPPOSE THE FAIR TAX, BUT SUPPORT CHILD CASH PAYMENTS AND A VAT

There are three important policy lessons to take away from this analysis. First, the Fair Tax is clearly quite regressive, though the nature of its regressivity has been misunderstood. The proposal would eliminate one regressive type of tax (payroll taxes) and three highly progressive taxes (income, corporate profits, and estate/gift taxes), replacing them with a mildly progressive tax (a 30% national sales tax with cash payments). The inclusion of universal cash payments would leave a small number of extremely poor Americans better off, but across most of the income distribution, switching to the Fair Tax would prove regressive. Because of the harm it would do to most low-income people, the Fair Tax should be unequivocally rejected.

Second, the fact that some low-income families are better off under the Fair Tax shows the need for a fully refundable CTC. Replacing the EITC with a $3,100 adult UBI would prove expensive and poorly targeted. Moreover, the general purpose of the EITC is to promote work and help low-wage employees — it isn't meant to help jobless adults, some of whom may simply be choosing not to work. By contrast, the CTC is meant to help families with the cost of raising children, yet the convoluted structure of the credit excludes the families who need it most. For example, because the CTC is based on workers' wages, a parent who loses their job will simultaneously lose their child's CTC benefits. For the 1.1 million unemployed parents seeking work or the millions of grandparents raising their grandchildren, the CTC provides little to no aid.[36] As shown in the figure below, the current CTC gives nothing to two-child families with zero earnings, but it gives as much as $4,000 to two-earner, two-child families making $35,900 or more. (The credit only begins phasing out at $400,000 of earnings.[37]) Because they are not linked to work, the $2,200 payments for two-child families under the GOP proposal would actually be more generous than the current CTC for couples earning less than $17,000.[38]

FIGURE 6: FOR THE LOWEST-INCOME FAMILIES, A PER-CHILD PAYMENT IS BETTER THAN THE CHILD TAX CREDIT
CHILD TAX CREDIT VERSUS "FAIR TAX" CHILD REBATE FOR A TWO-EARNER, TWO-CHILD FAMILY, 2022



Source: Author's calculations

Third and finally, sales taxes do not fall disproportionately on poor or working-class people. It's true that sales taxes and VATs appear extremely regressive in annual income distribution tables, but such tables are uniquely bad at portraying these taxes' distributional impacts. Indeed, if a proportional VAT were to replace America's regressive payroll taxes, the tax system as a whole would become more progressive. For this and other reasons, PPI has previously called for eliminating federal payroll taxes and replacing them with a 15% VAT.[39] Unlike the GOP's proposal to eliminate a swath of progressive taxes, PPI's proposal to replace one regressive tax with a VAT would be a win for working-class Americans.

On the whole, the center-left should reject the Republicans' Fair Tax proposal. But a flat-rate VAT and cash payments to all children merit Democrats' support.

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