

**Testimony of
David R. Burton
on behalf of
Americans For Fair Taxation
before the
House Committee on Small Business
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Mister Chairman and Members of the Committee,

My name is David Burton. I am a partner in the Argus Group, a small public policy firm based in Virginia. I have a particular interest in, and awareness of, the problems of small businesses for a number of reasons. I worked for many years in my family's furniture and pool table manufacturing business, stopping only once I was well into law school. I worked as the CFO and general counsel of a small 80 employee multinational manufacturing company. I also regard small businesses and farmers as the greatest source of dynamism, innovation, upward mobility, and community strength in this country.

I appear today on behalf of Americans For Fair Taxation, also known as Fairtax.org. It is the nation's largest grassroots citizens' organization dedicated to fundamental tax reform. We appreciate the opportunity to present our views regarding the proposals offered by the President's Advisory Panel on Federal Tax Reform and on fundamental tax reform generally.

With the exception of tax lawyers, tax preparation firms, tax software firms, and more than a few tax professors, almost everyone supports tax reform. However, without establishing criteria describing what constitutes genuine and constructive tax reform, it is impossible to assess the relative merits of the various plans or even to decide whether a plan would be constructive. This testimony sets forth criteria we believe that policy makers should adopt for purposes of assessing fundamental tax reform plans, including the tax panel's proposals. These criteria are not exhaustive but they are the most important.

In general, a reformed tax system should be fair and should minimize the adverse economic impact of raising the revenue that Congress decides is necessary to fund the federal government. A tax reform plan that meets the following 12 specific criteria will accomplish the twin goals of being fair and maximizing the economic prosperity of the American people. The FairTax best meets these criteria and, indeed, was designed to do so. Assuming the tax panel's proposals were enacted as proposed, they would constitute only a modest improvement over current law and would likely degenerate quickly into something barely distinguishable from the present system.

The criteria for fundamental tax reform:

Prosperity criteria

1. The plan should not be biased toward consumption and against savings and investment but rather it should be neutral between different types of consumption, savings, and investment.
2. The plan should have the lowest possible marginal tax rates, removing to the greatest extent possible the disincentive to work, save, and invest and providing the greatest opportunity for upward mobility.
3. The plan should be neutral between whether to produce in the U.S. or abroad; it should not provide an artificial incentive to move jobs and production overseas.
4. The plan should impose the same tax burden on all forms of productive activity and should tax each activity at a uniform rate.
5. The plan should treat human capital formation and physical capital formation alike.
6. The plan should dramatically reduce the administrative and compliance burden on the public.

Fairness criteria

1. The plan should exempt the poor from tax and allow everyone to meet the necessities of life before paying tax.
2. Once the necessities of life have been met, however, the plan should treat people equally without favoring one set of taxpayers over another, and by taxing the same proportion of goods and services they purchase for their own personal use.
3. The plan should not play favorites or reward the politically powerful or well connected.

Civic criteria

1. The plan should be transparent and understandable so the public understands the tax system; it should not hide the true tax burden or obfuscate.
2. The plan should be politically stable so that the reform will last.
3. The plan should have a manageable transition.

The prosperity criteria are those that will maximize economic growth and prosperity. The fairness criteria are those that we believe most Americans accept. The civic criteria are those that promote a healthy body politic and improve our political process.

The plans

This testimony will consider:

1. The tax panel's Simplified Income Tax Plan (chapter six of the report)
2. The tax panel's Growth and Investment Plan (chapter seven of the report)
3. The FairTax (H.R. 25/S. 25)
4. A business transfer tax (BTT)
5. The flat tax (of the Hall-Rabushka type)

The FairTax has been introduced in the House and the Senate. It replaces the individual and corporate income taxes, all payroll taxes, capital gains, alternative minimum, self-employment,

and the estate and gift taxes with a national retail sales tax of 23 cents out of every dollar spent on all consumption of new goods and services without exception. A rebate is provided monthly in advance to all qualified households equal to the poverty level times 23 percent. An extra amount is provided to married couples to prevent a marriage penalty.

The Business Transfer Tax is a subtraction-method value-added tax. The overall tax base is the value of all goods and services produced minus investment. It is collected from businesses using administrative means similar to the corporate tax. It is border adjusted. It has the same tax base, in principle, as a retail sales tax.

The flat tax is a form of value-added tax where the tax on capital value added is taxed at the business level and labor value added is taxed at the individual level. Since investment is expensed and savings are accorded Roth IRA-type treatment, it is a form of consumption tax. It is, like the income tax, an origin-principle tax; thus imports are exempt from tax and exports are taxed. The administrative means used to collect the tax is similar to the current tax system.

Neutrality between consumption and savings

Capital formation promotes greater productivity and output, higher rates of economic growth, and improved competitiveness. More capital per worker, embodying the latest technical innovations, means more output, greater competitiveness, and higher real wages. The current tax system, however, is very biased against savings and investment, often taxing the returns to savings or investment three or four times. This results in slower economic growth, reduced competitiveness, and lower real wages. The solution is to adopt a tax system that is neutral toward savings and investment. Either the FairTax, the flat tax, or a business transfer tax would address this issue decisively. In all three plans, labor and capital output is taxed equally and one time. In the flat tax and BTT this is accomplished by expensing capital investment and treating all savings effectively as if they were in Roth IRAs. In the FairTax, this result is achieved simply by taxing only final consumption and not taxing business inputs. Unlike in most state sales taxes, the FairTax does not hide taxes and impose a tax on a tax. It taxes goods and services once when sold to consumers.

The tax panel's Growth and Investment Plan reduces the bias against savings and investment. However, the imposition of an extra 15 percent tax – over and above the 30 percent business tax – on dividends, interest, and capital gains and the retention of the estate and gift tax constitutes a significant bias against investment and savings. The Simplified Income Tax Plan reduces the double taxation of corporate income but otherwise retains much of the bias against savings and investment inherent in current law.

Lowest possible marginal tax rates

High marginal tax rates reduce the incentive to work, save, and invest and therefore reduce the amount people choose to work, to save, and to invest. As tax rates are raised, overall economic output declines. Conversely, reducing marginal tax rates has dramatic positive economic effects.

The FairTax has the lowest marginal tax rates of any plan and is the most pro-growth of any plan considered. It has the broadest possible consumption tax base and a single tax rate. The FairTax base is equal to that of the BTT. It is larger than the flat tax, primarily due to the fact that the U.S. currently imports dramatically more than it exports. The FairTax is unique in that it replaces the 15.3 percent payroll tax and since the FairTax base is broader than the payroll tax

base, it reduces marginal tax rates further than any tax plan being considered.

When comparing the FairTax to other tax plans it is important to remember that the FairTax repeals the 15.3 percent payroll taxes (both Social Security and Medicare employment taxes and self-employment taxes). A flat tax with a rate of 17 or 20 percent, for example, is really a 32.3 or 35.3 percent tax on labor or self-employment income. Similarly, the tax panel's two proposals have top tax rates on labor income of 45.3 percent. In some cases, the tax panel's plans raise marginal tax rates. In most, the reductions are quite minor.

Neutrality between U.S. and foreign producers

The current tax system imposes high income and payroll taxes on U.S. producers and workers whether they are selling in the U.S. market or abroad. The current tax system imposes little or no tax on goods imported into the U.S. or services provided to U.S. consumers from abroad. Compared to our OECD trading partners, this places American producers at a roughly 18 percent competitive disadvantage, courtesy of the U.S. tax system.

It is no wonder that firms that remain in the U.S. find it difficult to compete. It is no wonder that manufacturing output and employment have fallen roughly since our competitors started adopting border-adjusted taxes. Even our agricultural surplus has largely disappeared. The U.S. government, through its tax policy, is telling American firms that they are idiots to continue producing in the U.S. since the U.S. government will tax them heavily if they produce goods here but impose no tax on goods produced abroad.

In contrast to the U.S., every other significant trading country in the world raises a large part of its revenue from destination-principle, border-adjusted consumption taxes. Most use the value-added tax but some (for example, Canada) rely to some extent on sales taxes. These taxes are not levied on exports from those countries to the U.S. but are imposed on U.S. goods imported into their country.

The FairTax would, by the very nature of a sales tax, remediate this problem by taxing foreign and U.S. goods alike when sold at retail. It would, for the first time, eliminate the advantage accorded to foreign producers by current federal tax policy. A BTT would also address this issue by excluding exports from its tax base and by imposing the tax on imports. The tax panel's Growth and Investment Plan would also be border adjusted. However, since the WTO only allows indirect taxes to be border adjusted, it is doubtful whether the tax panel's plan, which is structured like a direct tax, would survive a challenge at the WTO. Sales taxes are explicitly permitted under WTO rules. Neither the flat tax nor the Simplified Income Tax Plan would address the problem. Even the tax panel itself recognized that its proposal would probably fail WTO scrutiny.

Neutrality between different types of productive activity

The FairTax treats all goods and services alike. Thus, it does not distort the marketplace and allows businesses to adopt the most efficient economic means to meet consumer wants. A plan that taxes economic activity uniformly will promote the most efficient, productive economy. The flat tax and BTT would also do this (except, as mentioned below, as to labor income because of the retention of the payroll tax). Although the tax panel's plans would reduce these distortions, they retain major distortions in the marketplace, including the health care, housing, and investment markets.

Neutrality between human capital and physical capital

Human capital is a critical element in productivity and innovation. The FairTax is the only tax reform plan to grant human capital parity with physical capital. The FairTax accomplishes this result by not taxing tuition or job training or educational wages in either the government or private sector. This is appropriate since the primary reason most people pursue an education is to increase their future earnings capacity and the expenditures generated by those future earnings will be taxed. Tuition and job training are an investment in human capital.

The flat tax does not address this problem. Education is treated like a consumption good and must be purchased with after-flat-tax and after-payroll-tax dollars. The tax panel's proposals do not really address this issue; all they do is afford some savings for consumption tax treatment for educational purposes.

Reduce the compliance burden on the public

The current tax system has major tax evasion problems, notwithstanding billions of tax and information returns filed each year, roughly 6 billion hours spent figuring out the tax due, and an army of tax preparers, tax accountants, tax lawyers and IRS personnel. We waste over \$265 billion annually complying with the current tax system. The time spent figuring our taxes is more people than the hours spent working in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined.

The tax panel's proposals would reduce this waste slightly. The flat tax would reduce it substantially, at least until the political process turned it back into something similar to what we have today. However, the flat tax does require all Americans to file tax returns and would retain withholding and payroll tax rules.

The FairTax radically reduces these costs and the complexity of the system. Individuals who are not in business for themselves never need to fill out a tax return again. Moreover, the FairTax compensates businesses for the time required to fill out sales tax returns with a credit equal to one-quarter of one percent of the sales tax remitted.

Under the FairTax, the question a business or auditor needs to answer is how much was sold to consumers. This is a simple question, not that different from line 1 on a tax return today. Under the FairTax, that is effectively that. All of the major sources of complexity today are repealed. Gone are payroll and income tax withholding, 1099 reporting, inventory tax accounting (including the uniform capitalization rules), tax depreciation accounting and recapture rules, tracking tax basis, the alternative minimum tax, qualified plan rules (including top-heavy, participation, and vesting rules), international tax rules, capital gains rules, passive loss limitations, estate and gift tax planning, and a host of other rules.

Small businesses are disproportionately harmed today by the large compliance burden imposed by the current tax system. They disproportionately gain from implementation of the FairTax.

Exempt the poor

It does not make a great deal of sense to impose taxes on poor people. Neither, however, does it make sense to hide from them the cost of government. The poor cannot even meet their basic needs and are receiving financial assistance in many ways. Yet today, they pay significant taxes. Part of those taxes is the payroll tax imposed on the working poor. But the poor also bear the

burden of paying higher prices for the goods they buy because of the taxes imposed on businesses and the cost incurred by businesses to comply with the tax system. Businesses, after all, must recover all of their costs, including taxes, in the price of the goods they sell. If they do not, they will quickly go out of business.

Because of the rebate, the FairTax is progressive. The effective tax rate climbs as expenditures climb. The effective tax rate is negative or zero for the poor; it is quite low for the lower middle class. The effective tax rate for a married couple with two children with taxable spending of \$51,320 would have been 11½ percent in 2005. The very rich would pay nearly 23 percent on their spending.

The FairTax is the only plan that entirely untaxes the poor. It accomplishes this by providing every qualified household in America with a rebate paid monthly in advance equal to 23 percent of the poverty level (plus an extra amount in the case of married couples to prevent a marriage penalty). This, in effect, protects every household in America from paying any tax on spending up to the poverty level, which means that no poor person is paying any sales tax and that no household is paying sales tax on the necessities of life.

By repealing the payroll tax, the FairTax eliminates the greatest burden on the working poor and reduces the cost of hiring new, entry level workers. By repealing business taxes, hidden taxes that must be recovered by businesses in the price of goods sold are repealed.

All other plans keep the payroll tax, which is the largest tax paid by poor Americans. No other plan is structured to ensure that no poor person will pay any tax. No other plan ensures that all households may meet the necessities of life without paying tax.

Equality of treatment

The FairTax treats people equally on spending over the poverty level. It does not favor one set of taxpayers over another or one type of producer over another. It taxes everyone at a uniform rate on new goods and services they purchase for their own personal use.

The flat tax moves in the right direction but retains the payroll tax which taxes labor income at different tax rates depending on the level of their income and does not tax capital income. The tax panel's proposals retain many tax preferences and treat people differently depending on the degree to which they are willing to structure their lives in a way approved of by government. In addition, the tax panel retains graduated tax rates which punish people who choose to work hard, study hard, save, and invest.

Should not play favorites

It is unfair for the government to play favorites, rewarding certain politically powerful and well-connected interests over others that do not have the same political pull. The tax system *should* be about doing what is right and just rather than what will help fill campaign coffers and satisfy interest groups. The FairTax treats everyone alike and does not exempt any person, any new good, or any service from tax. The rules are simple and clear and apply to everyone.

The tax panel's proposals continue the practice of rewarding certain interests, although the proposals do reduce the scope of tax preferences compared to current law. The flat tax would largely eliminate the favoritism of current law. It does, however, retain one major favorite.

Foreign produced goods are favored over U.S. produced goods. A BTT would not play favorites either and would treat foreign and U.S. produced goods and services alike.

Transparency and comprehensibility

The FairTax is the easiest of any tax reform plan to understand. That is its virtue and its vice. It is a simple sales tax with a single tax rate.

It does not divide up the public's tax burden among four or five "low" tax rate taxes, some of which are hidden from view, that add up to very high tax rates. The FairTax has one very transparent tax rate which, in reality, is the lowest marginal tax rate by far of any tax reform plan. Yet, because the FairTax is honest and transparent and the current tax system is anything but honest and transparent, FairTax detractors are able to obfuscate, demagogue, and confuse by misrepresenting the facts.

Who knows who pays the corporate tax? Most people – small businesses and self-employed people being obvious exceptions – do not even know about the massive employer payroll taxes that drive their wages down. Most people have only the vaguest idea of what they pay in income taxes today and why, since the taxes are withheld and, as often as not, they used paid preparers or software to figure their tax.

The tax panel's plans are complex and retain most of the complexity of the current system. The flat tax is relatively simple, yet even many of its most vocal proponents seem to think it is an income tax rather than a consumption tax. They do not even understand their own proposal.

Only the FairTax is simple and can be easily understood by anyone. Under the FairTax, people will understand for the first time in their lifetime how the federal government is actually paid for and who is paying for it.

Political stability

If the flat tax is kept as it is but with graduated rates, it becomes what is often called the X-tax, a graduated rate consumption tax. The flat tax can be easily changed to an income tax. Starting with the flat tax, if we depreciate capital rather than expense it, make inventory purchases deductible when the inventory is sold rather than when purchased, make interest taxable and deductible, then we have largely converted the flat tax into an income tax. Add a few special interest deductions, credits, and exclusions and we are very nearly back to where we started. That is a very real problem with the flat tax. It is very easy to corrupt its design and eliminate many of the gains to be had from adopting the proposal in the first place. The entire administrative apparatus of the income and payroll tax system is retained and it would be very easy to go back. Attempts to do so would start immediately.

If the FairTax were enacted, it would be much more difficult to go back to an income tax system. The entire massive and expensive administrative apparatus built up over nine decades would be dismantled. It is doubtful that people would want to go back. It is doubtful that they would want to invest the massive resources necessary to do so. The FairTax, then, is a stable reform. There will, of course, be the necessity to fend off those who want to exempt one category or another of goods or services. But if the rebate system is in place, the most commonly used line of argument (we need to help the poor) will fall flat. There will always be better ways to help the poor than exempting some category of goods.

Transition

The flat tax sidesteps transition issues. It is, however, unlikely that in the final analysis Congress will force businesses to lose trillions of dollars of basis on capital assets if the income generated by those assets remains subject to tax. To do so would amount to wealth loss for existing capital owners of well over a trillion dollars to American businesses. Addressing this transition issue will force the flat tax rate (or a BTT rate) to climb considerably.

There is no need to be concerned with basis per se in the FairTax since income streams are no longer subject to tax. Businesses will not get far complaining that their tax rate has been reduced to zero. The analogous problem in the FairTax is the sale of goods subject to the FairTax that were not deducted for income tax purposes. Collecting sales tax and failing to allow an income tax deduction would effectively be double taxation. The FairTax legislation addresses this issue by providing a credit to businesses selling inventory held on the changeover date to prevent the double taxation.

There is a general danger, however, when considering transition to want to compensate every loss. In fact, in most cases where there are losses, there is someone experiencing an equal and offsetting windfall gain on the other side of the transaction. These gains should be taxed to compensate losses (if they exist) because if the loss is unjust then so is the unexpected and windfall gain at another's expense. Moreover, many of the claimed losses on capital assets will in reality be illusory because an asset's price will, in general, increase due to according consumption tax treatment to investment.

Some specific notes on the impact on small businesses and farms

The current system has a disproportionately adverse impact on small businesses because of the high compliance costs that consume a relatively large share of small business income and because of the many ways the current system singles out small businesses for discriminatory tax treatment.

The FairTax addresses this issue by radically simplifying the tax law, reducing compliance costs, and compensating businesses for their time complying with the system. The FairTax also repeals payroll taxes, which have a disproportionately negative impact on small businesses because of administrative cost, the self-employment tax, and the increased cost of labor. Finally, the FairTax helps small manufacturers and farmers compete against foreign goods in U.S. or foreign markets by taking the taxes out of exports and by taxing U.S. and foreign goods alike in U.S. markets. Many larger U.S. companies have already outsourced a huge portion of their manufacturing or are planning to do so. Small companies located here do not really have the option of outsourcing their manufacturing since they do not generally have both manufacturing and distributional divisions.

No other plan addresses these needs of small businesses as directly and effectively as the FairTax. BTT proposals tend not to address payroll tax issues. The flat tax does not address either payroll tax issues or level the playing field with imports. The tax panel's proposals would only moderately improve the current system.

Grading the plans

The analysis above demonstrates that the FairTax is the most pro-growth and most fair tax plan being considered in Congress. It shows that the tax panel's proposals were seriously deficient. It

shows that the BTT and the flat tax would constitute a significant improvement over current law. The chart below is a summary of these findings.

Conclusion

The proposals offered by the President's tax panel are a major disappointment. They represent modest progress compared to present law. But the progress they offer is quite small and unlikely to last very long given the nature of the political process.

The flat tax is a highly constructive proposal, but compares unfavorably where it differs from either a sales tax or a BTT. Moreover, because it retains the administrative apparatus of the income and payroll tax, it is likely to revert back toward an income tax. Finally, by retaining payroll taxes, its rates on labor income are unnecessarily high and the tax burden on poor and lower middle-income persons is higher than the FairTax.

The FairTax is the best plan being considered. It is extremely pro-growth. It will cause dramatically higher investment, large productivity gains and higher real wages. It will improve the competitiveness of U.S. producers. It will improve the well-being of the average American dramatically. It will dramatically reduce the vast amount wasted each year on compliance costs. It will untax the poor and be progressive. It will tax people based on what they consume for themselves rather than what they invest in the community or give to charities. It will get the government out of the business of playing favorites and rewarding politically powerful interests. It is transparent and understandable. It will lead to a more just and more prosperous America. It is the best plan.

We urge you to co-sponsor the legislation and to work with your colleagues to enact it into law so that the American people can, at last, have the tax system they deserve.

Tax reform report card

Criteria	Tax panel Income Tax	Tax panel Growth	Flat tax	Business Transfer Tax	FairTax
P1. Neutral toward savings and investment	C	C+	A	A+	A+
P2. Low marginal tax rates	C	C	B+	A-	A+
P3. Neutral between foreign and U.S. producers	F	A	D	A+	A+
P4. Taxing economic activity uniformly	C+	C+	A-	A-	A
P5. Neutral between human and physical capital	F	F	F	F (usually)	A
P6. Reduce compliance costs	C-	C	B	B	A+
F1. Poor untaxed	B	B	B-	B-	A+
F2. Equal and uniform taxation	D	D+	B	B+	A+
F3. No favorites or special exceptions	D	D	A-	A-	A+
C1. Transparency and understandability	C	C	B	B-	A+
C2. Politically stable	F	D	C	B	A
C3. Manageable transition	A	A	B	B	B+
Overall grade	D	C	B	B+	A+