

**Submission of Americans For Fair Taxation
on the FairTax Comprehensive Tax Reform Proposal
to
The President's Advisory Panel on Federal Tax Reform
April 29, 2005**

Submitter's name: Leo Linbeck, Jr., Chairman
Organization name: Americans For Fair Taxation
Date of submission: April 29, 2005
Contact information: Web site address: www.fairtax.org
E-mail address: leo_jr@fairtax.org
Telephone number: 1-800-FAIRTAX
Category of submitter: Association

<u>Issue</u>	<u>Answer</u>	<u>Page</u>
1. The tax base	Retail consumption	3,4
a. Revenue neutrality	Yes. 23 percent of new goods & services	4,5
2. Exemptions, deductions, credits, exclusions.....	Held inventory credit, expires with first turnover	4,15,16
3. Tax rates.....	23 percent tax inclusive	
a. Progressive	Yes	10
4. Distribution of the tax burden.....	Taxes consumption of new goods & services above the poverty level	10
5. Treatment of charitable giving.....	Giving with “pretax” dollars	9
6. Treatment of homeownership	Entire house payment made with “pretax” dollars	7
7. Collection methods	Via state sales tax organizations	4
8. Treatment of business (long run economic growth and job creation).....	Business fully untaxed, significant GDP growth; growth in capital stock and real wages, significant job creation	13,15
9. Simplicity (including transparency and stability).....	Simple and entirely transparent with a more stable tax base than income	5,15
10. Fairness	Yes, according to thorough polling	15
11. Economic growth and competitiveness	Significant GDP growth; tax-haven status with maximum border adjustability	5,13
12. Compliance and administrative costs.....	Significantly lower costs with higher compliance	12,14

Table of contents

Introduction	3
A. Brief description of the FairTax plan.....	3
A1. <i>The FairTax plan taxes all personal consumption at the point of final, retail consumption.....</i>	3
A2. <i>The FairTax rate is revenue neutral at 23 cents from every dollar spent.</i>	4
A3. <i>The collection mechanism of the FairTax builds on existing state structures.....</i>	4
B. Advantages of the FairTax over any other tax system.....	5
B1. <i>The FairTax imposes the lowest possible marginal rate of any revenue-neutral system.</i>	5
B2. <i>The FairTax stimulates economic growth.....</i>	5
B3. <i>The FairTax untaxes and simplifies saving.....</i>	6
B4. <i>The FairTax benefits homeownership more than the current tax system.....</i>	7
B5. <i>The FairTax results in greater charitable giving than the current tax system.....</i>	9
B6. <i>The FairTax untaxes education.....</i>	9
B7. <i>The FairTax reverses the built-in regressivity of the current tax system.....</i>	10
B8. <i>The FairTax reduces compliance (and administrative) costs more than the current tax system.....</i>	12
B9. <i>The FairTax ensures greater compliance with less intrusiveness.....</i>	12
B10. <i>The FairTax eradicates the current tariff against American producers.....</i>	13
B11. <i>The FairTax provides a template for solving many state and local tax revenue problems.....</i>	14
B12. <i>The FairTax cannot morph into an income tax.....</i>	14
B13. <i>The FairTax makes the cost of government transparent.....</i>	15
B14. <i>The FairTax enhances civil liberties more than the current tax system.....</i>	15
B15. <i>The FairTax is supported by small enterprises</i>	15
C. Transition rules and special considerations.....	16
Conclusion.....	17

Introduction

Americans For Fair Taxation (FairTax.org) is the nation's largest, single-issue grassroots organization dedicated to fundamental tax replacement. FairTax.org is the collective voice of more than 500,000 Americans of all ages, ethnic backgrounds, political affiliations and walks of life who share two views on tax reform:

- That Americans can rise above the failed income and payroll tax regimes to develop a more visible, more globally competitive, administrable, fairer, understandable and less costly and intrusive system of collection; and
- That when educated about alternatives in an unbiased way, regardless of ideology and political affiliation, Americans consider the FairTax as the best plan for our national and individual prosperity and freedom.

As a nonpartisan organization, FairTax.org is unique in tax policy history. Fairtax.org did not cobble a tax system to meet assumed needs. Instead, we conducted extensive opinion research to determine what Americans desired in a tax system. FairTax.org analyzed the failures of the current tax system – its unfairness, its propensity to reward special interests, its bias against U.S. producers, its unenforceability, its intrusiveness, its invisibility, its complexity, its cost and its anti-growth design. We engaged legal and economic scholars to systematically determine the best means of correcting these failures. In short, FairTax.org developed a plan worthy of America in the 21st century.

A. Brief description of the FairTax plan

A1. The FairTax taxes all personal consumption at the point of final, retail consumption.

The FairTax is embodied currently in S. 25 and H.R. 25. The FairTax is an integrated replacement system that repeals all current taxes imposed by the Internal Revenue Code on income and wages, including personal, gift, estate, capital gains, alternative minimum, Social Security/Medicare, self-employment, earned-income tax credit and corporate taxes. In place of these taxes, the FairTax imposes a single-rate tax on the final retail sale of new goods and services used or consumed in the U.S. at the revenue-neutral rate of about 23 cents from every dollar spent. The FairTax plan also amends the U.S. Constitution so that the income tax chapter of American taxation is closed.

To ensure the FairTax does not cascade, business-to-business transactions are not taxed. Intermediate goods and services are properly treated as inputs into goods and services sold at

retail. Unlike the current system that taxes income multiple times and on an inconsistent basis, the FairTax taxes income only once, upon consumption. Furthermore, the FairTax does not tax used goods under the principle that the hidden taxes on production were paid when initially purchased. There are no exemptions for goods or services in order to ensure the broadest conceivable base without building in special interest exemptions or drawing distinctions that generate compliance problems and regressivity. While permitting no exemptions, the FairTax benefits low-income Americans through a monthly, universal **prebate** equal to 23 percent times the HHS poverty level by family size, plus an additional amount in the case of married couples to avoid a marriage penalty. The **prebate** ensures each family unit can consume tax free at or beyond the poverty limit, with the overall effect of making the FairTax progressive in application. Under the FairTax, all Americans consume what they see as their necessities of life free of tax. In essence, the FairTax allows every American to keep his or her income and elect when and if they are to be taxed.

A2. The FairTax rate is revenue neutral at a rate of 23 percent on new goods and services.

Several independent researchers confirm the FairTax plan is revenue neutral at 23 percent (tax inclusive)¹ or 30 percent (tax exclusive). As the starting point for this rate calculation, consider that in fiscal year 2003, the total taxes the FairTax repeals accounted for about \$1.67 trillion. The economy in 2003 produced goods and services valued at \$11 trillion. Of this, 7/8ths or \$9.6 trillion was consumed. Once various technical adjustments are made, the FairTax base is \$8.7 trillion. To raise the taxes it repealed in that year (\$1.67 trillion), the rate on this base without any exemptions would be 19.2 percent, derived by dividing the taxes replaced by the total consumption in the U.S. The basic rate must be increased to 23 percent to accommodate the FairTax's **prebate**. FairTax.org would be pleased to provide the Panel our detailed base calculations and work with the Office of Tax Analysis to review the rate.

A3. The collection mechanism of the FairTax builds on existing state structures. Under the FairTax, retailers collect and forward taxes to state governments. In the states with an existing sales tax system, the FairTax simply adds a line to the current sales tax reporting form. For their trouble, retailers receive a fee of ¼ of one percent of the taxes collected to offset their greatly

¹ All taxes the FairTax replaces are measured on the “tax-inclusive” basis. Dale Jorgenson, Ph.D. of Harvard University found it revenue neutral at a tax-inclusive rate of 22.9%; Laurence Kotlikoff, Boston University, found it revenue neutral at a tax-inclusive rate of 24%; James Poterba of Massachusetts Institute of Technology found it revenue neutral at a tax-inclusive rate of 23.1%.

diminished administrative costs. State governments, which are allowed to collect and remit the revenues to the federal government, also receive a payment equal to ¼ of one percent of the tax collected. State governments are not required to adopt the same tax base for state and local sales taxes as the FairTax, but gain efficiencies and broaden their base if they do.

B. Advantages of the FairTax

The FairTax is an extensively researched tax plan and research continues on many aspects of the plan. For example, further research is being conducted on issues such as the economic effects of the FairTax on wages, the effects of border-adjustability and transition. Therefore, we encourage the Panel or interested parties to visit our web site to be apprised of these further studies. Many of the advantages are summarized below.

B1. The FairTax imposes the lowest possible marginal rate of any revenue-neutral system.

It follows logically that broadening the base and imposing a single rate of tax reduces average marginal rates. Because the FairTax plan uses a consumption base significantly larger than the income tax base and any other alternative, it imposes the lowest tax rate of any revenue-neutral alternative without doubly taxing the same income. In 2001 (the latest year data is available), total adjusted gross income was \$6.17 trillion. Thus, the basic building block of the FairTax base – total consumption – is 38 percent larger than the current tax system’s starting point – adjusted gross income. Taxable income under the current system was only \$4.22 trillion in 2001, only 49 percent of total consumption. Because it is a single-rate system, it removes the penalty that progressive marginal rates impose on income fluctuation. And using all measures of variance, consumption is less variable than taxable income as a base, which is why it is a more stable source of revenue.

B2. The FairTax stimulates economic growth. Economists estimate that the FairTax plan improves wages and the economic well-being of all Americans. For example, Boston University economist Laurence Kotlikoff estimates the shift to consumption taxation raises the stock of U.S. capital by at least 29 percent (potentially by as much as 49 percent) and U.S. living standards by at least seven percent and potentially by as much as 14 percent. Work by Gary Robbins, Ph.D. of Fiscal Associates shows that replacing the current tax system with a single-rate system that treats capital and labor income equally – such as the FairTax – increases the GDP 36.3 percent and private output by 48.4 percent over the long run. Higher investment levels increase the productivity of employees, demand for workers and real wages.

The FairTax does not encourage savings at the expense of retailers. While Federal Reserve Chairman Alan Greenspan correctly states that consumption taxes encourage saving and capital formation, which in turn drive economic expansion, this takes time. Strong rates of economic growth and higher employment lead to higher investment and higher consumption. Because, however, the FairTax reduces the tax bias against savings and investment, savings and investment initially grow more rapidly than consumption. This increased capital stock results in higher output, higher productivity and higher consumption. Retailers also enjoy lower costs with the abolishment of corporate income taxes (eventually winding down concomitant compliance costs) and termination of employer payroll taxes. Their domestic suppliers also enjoy similar, lower costs, though products currently sourced overseas may not have the price advantage they do today (since they bear the same tax burden as domestically produced goods). The FairTax also provides a net reduction in paperwork and overhead by eliminating the need for corporate tax planning, tax record keeping, compliance and litigation, though such burdens for their ongoing collection of sales taxes may increase slightly. Only five states do not currently require sales tax collection. Under the FairTax, retailers, and all businesses for that matter, make decisions based solely on the benefits to shareholders, customers and suppliers. Finally, retailers can broaden competitive domestic sources of supply as significant amounts of manufacturing return to the U.S.A.

B3. The FairTax untaxes and simplifies saving. Americans today save at Depression-era levels because our current income tax regime punishes saving and investment. When savings are made with what remains after payroll and income taxes, returns on those investments are taxed multiple times: The income-producing asset is taxed, corporate income (including capital gains) is taxed and dividends are taxed. Although assets in qualified pension accounts approach being taxed in a manner consistent with a consumption tax, the thousands of pages of pension regulations impose further costs that discourage pension plans and a myriad of restrictions on who can save. The ability to save should never be considered a privilege to be bestowed by the Internal Revenue Code. We advocate adoption of the simplest pension plan in the world; one in which everyone can participate – if you do not spend your earnings on yourself after meeting life’s necessities, you do not pay taxes on those earnings. The FairTax offers the equivalent of a universal, unlimited merger of front- and back-loaded IRAs with no restrictions on how much to

save or on who can save. Savings are encouraged because they are not taxed. Economic studies prove savings rates are responsive to after-tax returns on savings.²

B4. The FairTax benefits homeownership more than the current tax system. The FairTax lowers the true costs of buying a home. As the table below shows, the purchase of new property is taxed as a consumption item under the FairTax, in a manner not unlike today. The current code requires homebuyers to pay for their new home with after payroll and income tax dollars. No deduction is allowed for the purchase of a home, and the price of that home already reflects the taxes and compliance costs imposed upstream. Unlike the current regime, the FairTax imposes a lower marginal rate of tax, fully untaxes capital gains from the sales of used or new property and terminates cost-raising tax and compliance expenses imposed on upstream labor and materials. More importantly still, the FairTax imposes no tax on purchasers of existing homes (the most common properties bought by first-time homebuyers). The seasonally adjusted statistics for 2005 show that about three-quarters of all home sales are projected to be existing homes and existing homes most often provide the resources for the sale of new homes.

	FairTax	Current System
Purchase (new home)	Taxed at 23% (inclusive)	Taxed at higher rate (combined payroll and income rate of more than 30%)
Purchase (existing home)	Not taxed	Taxed at higher rate (combined payroll and income rate of more than 30%)
Home mortgage interest	Paid with pre-income and pre-payroll tax dollars	At least after-payroll tax of 7.65% (15.3% if employer share considered)
Gains (existing home)	Not taxed	Possibly taxed
Gains (new home)	Not taxed	Possibly taxed

When compared to the FairTax, the mortgage interest deduction (MID) – only permitted for servicing the interest on mortgage debt by itemizing homeowners – is often touted as a substantial benefit to homebuyers (along with the limited exclusion on capital gains (\$22.9 billion) and the write off for local property taxes (\$19.6 billion)). The staff of the Joint Committee on Taxation estimates of Federal Tax Expenditures for 2005 are that 38.8 million

² Source: See Gary Robbins and Aldona Robbins, "Eating Out Our Substance: How Taxation Affects Savings," Institute for Policy Innovation, Policy Report No. 131, September, 1995. Mr. Robbins is the former Chief of the Applied Econometrics Staff at the U.S. Treasury Department. This paper updates the work of Stanford University economist and former Council of Economic Advisors Chairman Michael J. Boskin, "Taxation, Saving and the Rate of Interest," *Journal of Political Economy*, Vol. 86, No. 2, Part 2, April 1978, pp. S3–S28.

taxpayers will take the MID worth about \$72.6 billion³. The intended result of the MID is the *non-income taxation* of mortgage interest (or more precisely, the funds used to pay mortgage interest). However, the MID pales in comparison to the full non-taxation of interest to the buyer and the lender under the FairTax. Through its repeal of income and payroll taxes coupled with the non-taxation of interest, the FairTax ensures mortgage interest payments are made with totally untaxed earnings. The MID cannot be taken against payroll taxes, which represent about 43 percent of income taxes by receipt. More than three-quarters of all Americans pay more payroll taxes than income taxes and they are the first-time homebuyers. By not taxing lenders on interest they receive, the FairTax is estimated to result in a lowering of interest rates by about 250 basis points, which further reduces the carrying costs of purchasing a home. Finally, the FairTax further benefits homeownership by enabling homebuyers to save the down payment without swimming against the tide of taxation.

To put these advantages in real terms, consider the wages a family must earn to purchase a new \$153,800 home *today*. Assuming a 27-year term and mortgage rate of 6.0 percent, FairTax.org calculates that the average homebuyer pays an additional \$157,139 in interest and must earn \$377,790 before taxes to pay off that home. Under the FairTax, he or she would need to earn at least \$65,691 (or -17.4 percent) less. A buyer of a previously owned home, of course, would need to earn \$265,959 (\$153,800 + \$112,159 interest) or 70 percent of what he or she would need to earn today.

In order to match the power of the FairTax for encouraging homeownership, the current tax system would have to at the very least (1) allow all taxpayers to fully deduct the purchase of used property against income and payroll taxes, (2) expand the MID so that it permits a deduction against payroll taxes, (3) fully untax the sale of homes; and (4) fully untax returns on savings used to buy homes.

³ Joint Committee on Taxation, *Correction of Error in Table 3 of JCS-1-05, Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCX-13-05), March 17, 2005.

B5. *The FairTax results in greater charitable giving than the current tax system.* The FairTax enhances resources available to charities by: (1) improving the primary determinant of charitable giving – economic growth and national income; and (2) giving every taxpayer the equivalent of a supercharged charitable contribution by enabling contributions free of income, payroll and sales taxes.

Empirical data confirm the major correlation governing the degree of charitable giving is not the tax deduction, but the level of national income and wealth.⁴ Total philanthropy has held steady as a nearly constant proportion of personal income and GDP over four decades even while the top marginal rate has fluctuated between 90 and 28 percent. To the degree there is a “price effect” from the contribution deduction, it is because deductibility lowers the net-of-tax cost of making contributions. The FairTax lowers that cost for all taxpayers in ways unattainable by an income tax.

The appropriate question to ask about charitable contributions is not “how much of a deduction is provided?” but rather “what must a taxpayer earn in order to make that contribution?” A taxpayer needs to earn only \$100 in order to contribute \$100 under the FairTax, but even an itemizing taxpayer today must earn at least \$108 to contribute \$100. A non-itemizing taxpayer (two-thirds of all taxpayers) in the 28-percent bracket must earn \$155 to make a \$100 contribution to charity today.

To match the power of the charitable “incentive” under the FairTax, the income tax would not only have to permit charitable contribution deductions against payroll taxes, but would also have to get rid of the distinction between itemizers and non-itemizers and the many other restrictions on the deduction.

B6. *The FairTax untaxes education.* The FairTax does not tax tuition because we draw no distinction between investment in human capital and investment in plants or equipment. Rather, the FairTax treats education as a personal investment in our nation’s intellectual capital. By way of example, since our current tax system requires tuition to be paid for with after-tax dollars, a 28-percent taxpayer today must earn at least \$15,540 in order to afford \$10,000 in tuition costs. Under the FairTax, paying a \$10,000 tuition bill requires earnings of \$10,000.

⁴ Source: *Giving USA*, 1996, p. 56; “Economic Report of the President”, February 1996, pp. 284, 308. “The Economics of Giving” by Charles T. Clotfelter, Duke University, July 2002. Clotfelter finds charitable giving relatively constant as a function of GDP. The FairTax eliminates tax costs. See also John S. Barry, *How a Flat Tax Would Affect Charitable Contributions*, Heritage Foundation, Background #1093, December 16, 1996.

B7. The FairTax reverses the built-in regressivity of the current tax system. The FairTax plan accomplishes what no other plan can: It **untaxes** the poor while ensuring that only those with the ability to pay actually pay. It eliminates both the payroll tax and hidden tax costs passed along to consumers in the price of goods and services today. Moreover, the **prebate** mechanism ensures that each American can consume tax free up to the poverty level. Under HHS poverty level guidelines for 2005, for example, a family of four could consume \$25,660 tax-free; spending judiciously on used products expands this window. After the poverty threshold is exceeded, taxes escalate according to the best measure of one's ability to pay: What he or she consumes for their own personal well-being. The **prebate** dramatically reduces the effective rate of tax for middle class Americans. A family of four spending \$51,320 annually would have an effective tax rate of only 11.5 percent. Progressivity in the FairTax is achieved by taxing consumed wealth, by repealing regressive payroll taxes and by giving working individuals maximum choice to pay the tax or to save or invest.

The Earned Income Tax Credit (EITC) may be fairly credited with encouraging people to work via a reduced tax rate. The FairTax **prebate** preserves the spirit of the EITC for the working poor but in a simple, straightforward manner: By simply terminating federal paycheck deductions altogether, and by repealing the perverse effect of the highest marginal rates imposed by the code as one escapes the EITC threshold. Gone is the complicated form with 55 pages of instructions that force over 70 percent of EITC filers to hire paid tax preparers, scares 25 percent of eligible recipients from even applying, results in an overpayment rate of 27 percent and causes many IRS audits of our poorest workers. Gone are the high marginal tax rates caused by the refund phase-out and its accompanying disincentive to work more and earn more. The working poor get to keep their whole paycheck (the greatest, if simplest, incentive to work), have no tax returns to file and get a monthly check prepaying the sales tax on their selection of necessities, up to poverty-level spending.

But the FairTax also is progressive in ways not measured by distributional tables, for example, by encouraging upward mobility. By removing the regressive yoke of payroll taxes, hidden taxes, high marginal rates and taxes on savings from those who must rely on their own labor and savings to improve their lot in life, the FairTax does not penalize those who invest in their future in favor of those who consume for today. By removing the economic drag imposed by the income tax, it disproportionately benefits the poor. By removing the more than \$200

billion in compliance costs, it eliminates fixed costs that fall disproportionately on small firms and the middle class. And by taxing consumption, it ensures that tax compliance itself is more equitably distributed.

Seniors benefit even though they are spending from accumulated savings. That is because much accumulated savings today resulted from contributions that were tax deductible as a retirement vehicle, and are not taxed upon withdrawal under the FairTax. There is approximately \$12 trillion in retirement savings assets, and of this amount almost all were contributions from tax-deductible plans. Less than one percent are assets held in Roth IRAs.⁵ Furthermore, under the FairTax, the income tax on Social Security benefits is repealed and benefits remain the same. Although prices are not likely to increase because of the repeal of imbedded taxes, Social Security benefits are nevertheless indexed on a sales-tax-inclusive basis to ensure that seniors are protected. According to recent work by Stanford University economist Joseph Kahn, only wealthy seniors with a net worth over \$700,000 experience a reduction in purchasing power of 3.5 percent; all others remain relatively the same, and many are advantaged when the FairTax **prebate** is taken into account. Moreover, the FairTax also repeals the estate tax, so that seniors can pass along their savings, business or farm free of complexity and transfer taxes.

FairTax.org strongly urges the Panel to adopt the recommendations in past economic reports of this President to not blindly measure distribution on the basis of taxes paid over annual income, because such analyses are biased against flat-rate consumption taxes. As a consumption tax is a viable alternative, we recommend the Panel examine distribution in other ways; such as by measuring distribution by taxes paid over consumption, lifetime income or by evaluating distribution on a dynamic basis by measuring what earnings people have left after taxation. These distribution tables should also include compliance costs and compliance rates that are both regressive under the current tax system, and they should be clear in describing the incidence of corporate taxes and multiple taxes on returns on capital.

⁵ Peter Sailer, "Use of Individual Retirement Arrangements to Save for Retirement--Results From a Matched File of Tax Returns and Information Documents for Tax Year 2001," Internal Revenue Service, SOI Division (*Presented at the 2004 American Statistical Association Meetings*).

B8. *The FairTax reduces compliance (and administrative) costs more than the current tax system.* The current system literally throws away precious economic resources on wasted compliance costs that add no value to the economy. U.S. taxpayers collectively filed 227 million tax returns in FY 2004 and more than 1.4 billion information returns. In 2002, a Tax Foundation study found that individuals, businesses and non-profits spent an estimated 5.8 billion hours complying with the federal income tax code at a cost of over \$194 billion or a 20.4 cent tax compliance surcharge for every dollar the income tax system collected (2.0 to 3.5 percent of the GDP). Less easily quantified are the high intangible costs of enforcement; for example, more than 28.6 million civil penalties were assessed in 2004 to enforce our complex tax system. With a national retail sales tax, the Tax Foundation has estimated that compliance costs drop more than 90 percent – equivalent to one good year of economic growth. Individuals who are not in retail businesses never have to file a tax return again. Instead of the complex morass that is the current tax system, the FairTax asks just one question: How much did you sell to retail consumers?

B9. *The FairTax ensures greater compliance with less intrusiveness.* The FairTax reduces the current \$312 to 353 billion “tax gap”⁶ for several reasons. First, compliance is inversely proportional to the marginal rate or the reward for being non-compliant. Because marginal tax rates are the lowest they can be under any sound tax system, cheaters profit less from cheating. Second, because the FairTax reduces the number of tax filers by as much as 80 percent as individuals are removed entirely from the tax system, enforcement authorities can catch cheats by monitoring far fewer taxpayers. More than 85 percent of the sales tax is collected by less than 15 percent of the retailers. Third, simplicity and visibility add to enforcement. Today, taxpayers can cheat in the privacy of their breakfast table and bury their cheating on 227 million tax returns in the unnavigable 7,000 code sections with plausible deniability that the taxpayer even understood the law. The FairTax increases the likelihood that tax evasion will be uncovered and leaves little room to hide between honesty and outright fraud (to say nothing of the well-established efficiency of current state sales tax authorities, well experienced in detecting such infractions). In short, tax collectors focus enforcement resources on far fewer taxpayers, using consistent and vastly simpler forms, with far fewer opportunities to cheat, diminished incentives to do so and a far greater chance of getting caught if they do. Much of the tax gap today is

⁶ The difference between what taxpayers should pay and what they actually pay on a timely basis.

attributable to confusion and mistakes that are eliminated under the FairTax.

Currently, an estimated 18 million, wage-earning Americans have dropped out of the income tax system entirely as “non-filers”. This aspect of the underground economy is successfully taxed at the retail level under the FairTax.

Finally, no tax is perfect. Although one can cheat under the FairTax, this cannot be viewed in a vacuum. With many fewer returns, all consistently simple returns, a major concentration of points of collection and the fundamental requirement that it takes two to cheat, compliance under the FairTax is vastly improved when compared to the current income tax system.

B10. The FairTax eradicates the current tariff against American producers. American producers that hire American workers face unprecedented foreign competition. With a negative trade balance in goods with every principal nation and region, the U.S. trade deficit is approaching \$700 billion per year, more than five percent of GDP. Despite this, the U.S. has failed to address the central problem: The increasing reliance of our trading partners on border-adjusted taxes. Of the 30 OECD nations, 29 (with the sole exception of the U.S.) employ border-adjusted consumption taxes that are rebated on exports and levied on imports at an average rate of 17.8 percent *ad valorem*. Border-adjusted taxes enhance, through WTO-compliant means, the competitiveness of domestically produced goods when those goods are exported to countries without border-adjustable taxes (the United States). Since nations that impose border-adjustable taxes in turn levy consumption taxes on imports, they effectively impose double taxation on U.S.-produced goods. Against the prevailing background of border-adjustable taxes, the income tax, therefore, punishes U.S. producers in both domestic and foreign markets.

As the purest version of a destination-principle consumption tax, the FairTax removes the entirety of the tariff imposed on U.S.-produced exports from border-adjustable taxes by not taxing goods or services used or consumed outside the U.S. Conversely, it taxes imports the same as U.S.-produced goods when sold at retail in the U.S. For this reason, the FairTax is the only plan that revitalizes the American manufacturing base lost to foreign competition and returns to America the high-wage manufacturing jobs we have driven overseas.

Under the FairTax, the United States stands alone as the only advanced nation in the world with a zero rate of federal tax on productive income, whether from returns on capital or personal earnings. The U.S. becomes the most attractive, tax-haven venue in the world for

investment, manufacturing and exports. Investment lost to foreign outsourcing repatriates to our shores as the U.S. becomes the global seat of production, management, research and export activity. Capital trapped offshore by our tax morass repatriates as well. Eventually, other nations will be forced to follow suit and reduce marginal tax rates or lose their investment to the U.S.; this global reform stimulates worldwide economic growth to the benefit of the global community, thus providing U.S. producers with larger markets.

B11. The FairTax provides a template for solving many state and local tax revenue problems.

At a minimum, states benefit from the higher rate of economic growth of the national economy brought about by the replacement of the current income and payroll tax systems with the FairTax. As noted, all states are provided the opportunity to collect the FairTax and receive ¼ of one percent of total collections, taking advantage of the efficiencies of sales tax systems now present in 45 states and the District of Columbia.

The 36 states that currently levy a state income tax based on the federal system will no longer be able to rely on the Internal Revenue Service for enforcement support. If such states move to the much broader FairTax base with a universal prebate to protect low- and fixed-income citizens, these states could reduce their current sales tax rates, generally by more than half and still collect the same revenue. If they choose not to reduce their current sales tax rates as dramatically, they can replace their income tax systems and their revenues.

While the FairTax legislation does not require states to conform state sales taxes to the FairTax base, there are additional advantages for doing so: (1) a marked reduction in compliance costs as the FairTax base is much easier to administer than most state sales taxes that are replete with exemptions, special rates, etc.; (2) enhanced ability of state sales tax revenues to keep pace with economic growth as the FairTax base includes the services sector that is an ever-growing segment of our economy generally untouched by most state sales tax systems; and (3) the ability to tax the retail sale of goods and services to state residents via the Internet and mail-order sales. The FairTax offers states an opportunity for uniformity in adopting a common tax base that enables states to reach sales by out-of-state retailers to their residents.

B12. The FairTax cannot morph into an income tax. The FairTax is the sole reform plan that requires elimination of the federal income tax and its infrastructure. In Canada and throughout Europe, VATs were *added* to the existing income tax system, providing a “money machine” in the words of economist William Gale of Brookings Institution. Both systems have grown. The

FairTax offers the only alternative that assures no return of the income tax because its levy does not depend on the 16th Amendment. The FairTax is the sole reform proposal that requires (and can require) the repeal of the 16th Amendment that authorizes the income tax.

B13. The FairTax makes the cost of government transparent. Today, small changes to the code shift tens of millions of dollars to particular taxpayers in ways not as visible as direct appropriations, but just as effective. With each special exemption, credit, deferral, deduction or definition that results, marginal tax rates are increased on everyone else. Complexity adds to the hidden nature of the taxes today. The FairTax is the simplest possible system, and that reinstates the principle that Americans have a right to understand the law to which they are subjected. When taxes are simple and transparent, they more readily reflect the cost of government to taxpayers, are less subject to lobbying and harder to raise. The same cannot be said for the flat tax or for business transfer taxes (BTTs), which while also based on consumption, perpetuate the myth that business entities do not pass the taxes forward.

B14. The FairTax enhances civil liberties more than the current tax system. The FairTax eliminates the need for individuals to file tax returns; it makes our tax system consistent with our historically hallowed notions of civil liberty. It is hard to imagine a more intrusive tax system for prying into our homes, our papers, our effects and our lifestyles than the current system. Additionally, because of its many temptations to a large number of filers, its perceived unfairness and its complexity, the current system requires such intrusiveness as a prerequisite to its enforceability. By its own unalterable nature, from the cradle to the grave, the income tax eventually extracts, collates, and chronicles almost every detail of our financial and personal lives as a necessary condition of its enforceability.

B15. The FairTax is supported by small enterprises. The FairTax concept is the only plan specifically endorsed or in the policy of small business groups, including the National Small Business Association, the Small Business Association of Michigan, the Council on Smaller Enterprises, the Associated Builders and Contractors, and the American Farm Bureau Federation. These groups, who consist of retailers as well as manufacturers and service providers, support the FairTax because it eliminates tax on productive income, reduces compliance costs and creates economic growth.

C. Transition rules and special considerations

The FairTax favors no industry or individual. Because the FairTax provides horizontal and vertical equity, all market segments are treated the same. While this is the ideal neutral state for economic growth, any change, especially sweeping change to get there, involves transitional issues.

FairTax.org is in the process of studying transition issues, virtually ignored by other replacement plans. In our first round of academic research, these questions were not directly addressed because it has taken a few years for American public and business interests to move from the question of “will the FairTax happen?” to “how are we going to make the transition to it?” FairTax.org has just issued a request for proposals from top economists nationwide for an independent and comprehensive study of transition and other issues, and will share these results with the Panel upon completion.

Transition issues that do exist under the FairTax are less pronounced and more easily handled than under flat, business transfer or value-added tax regimes. However, an analysis of which transition rules are required must begin with a framework that lays out the goals of the transition. There are several possible standards. For instance, is a taxpayer’s tax liability comparable to what it would have been under the previous law? Is a taxpayer’s after-tax rate-of-return comparable? Is an individual’s standard of living benefited?

FairTax.org approaches transition with a view towards fairness and minimization of market disruption. To prevent the double taxation of inventory held on the effective date, the FairTax provides a credit equal to the FairTax rate when the inventory is sold at retail.⁷ With respect to unused income tax credits and deductions (so-called “tax assets”), the FairTax assumes at the outset that corporations or investors are not worse off because they have been relieved from *all* taxes and costs of the prior tax system. A flat or reformed income tax may demand some form of transition relief, since firms and investors are going to continue paying tax.

No transition relief is likely necessary for savings distributed from pension plans, IRAs and other qualified plans because neither the contributions nor the earnings on such plans would have been subjected to income tax. Proceeds are subject to the FairTax (if spent at retail) as they would have been subject to the income tax. With respect to post-tax savings, interest on such

⁷ There is a transition credit for goods in inventory upon implementation, which essentially expires with the first inventory turnover.

savings is currently subject to income tax; the FairTax ends that. Holders of income-earning assets that are currently subject to income tax do not pay FairTax on those returns, causing the market value of these assets to climb considerably to reflect the repeal of the income tax. The FairTax requires that the cost of living adjustment (COLA) for Social Security benefits be computed on a tax-inclusive basis, fully insulating fixed-income retirees from retail price fluctuations.

Finally, the FairTax legislation pushes forward the effective date in order to allow time for the various sectors of the economy to adjust. This also allows for retailers' point-of-purchase software upgrades in states with existing sales tax authorities, adding retail service businesses to states' tax rolls and the establishment of sales tax authorities in states with none.

Conclusion

The American people overwhelmingly want change. But tax reform is a meaningless objective unless a system is designed that benefits the American people. The general principles articulated by the President – simplicity, fairness and pro-growth – are laudable objectives. Similar objectives articulated by the Democratic leadership are equally laudable. A close examination of the FairTax leads to the inevitable conclusion that it is the one system that benefits all the American people, the American economy and fully achieves these objectives.