The American Citizens' FairTax Plan
vs.
the current income & payroll tax systems:

A Retort to the Democratic Staff Report of the
Ways & Means Committee

The price of doing nothing is too high.

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I. Introduction

It is a troubling sign of the times when a serious public policy matter – critically important to the long-term well-being of the American people – cannot be intelligently discussed in the public forum without it becoming cannon fodder for political partisanship. But that is what happened even when the House Ways and Means Committee Democratic staff took up what Americans For Fair Taxation believe, and the American people in general consider, their most important obligation. Rather than using taxpayer dollars to study ways to rid the American people of a broken, costly, intrusive, inefficient, and unfair tax system, some staff believe it prudent to spend those dollars in political rhetoric designed to defend the income tax, criticize the other political party, and denigrate those who seek a better system as partisan.

A report issued on September 24, 2002 at taxpayer's expense, prepared by the Democratic staff of the Committee on Ways and Means and published on their web site, purports to "analyze" a national retail sales tax. However, the report does nothing of the kind in any objective sense. The highly political 25-page "study" contains many errors and misrepresentations that make their report more a "study" in political discourse than an objective "analysis" of a national sales tax. The staff's report offers no constructive criticism of the current system; in fact, it implies by default that the current income tax is the best the American people can do. It is replete with errors and misrepresentations. And of course, the "study" offers no solution, except perhaps more tireless tinkering and further complexities.

Americans For Fair Taxation has a message for the Democratic staff of the Ways and Means Committee: We have a more important goal in mind than the election of Members of Congress that belong to one or the other political party. We seek the defeat of the income tax. And we urge you to take seriously the demands of Americans For Fair Taxation – the largest taxpayer group ever assembled in the history of the U.S. – to use the taxpayer's resources to consider and deliberate in good faith the overwhelming virtues of our plan and to establish the criteria against which tax reform should be measured.

We would note that the politically charged nature of the report not only lacks even the loose rules of decorum Americans have come to regret in our political process, but may cross the line established by the House rules which are meant to ensure Members do the people's business. There is a distinction between when Members of Congress engage in appropriate policy discourse, and when they use Committee resources to engage in politicking.

At a basic political level, the staff's rabid defense of the current tax system is understandable. There is good reason for vested interests – including Members of Congress – to support the income tax and to fear change. The current tax system has made a good life for generations of politicians and the special interests that support them. For instance, today there are more than 40,000 lobbyists (many of whom were Congressional staff or Members of Congress), and each day they jockey to give their industries and their causes a special advantage over other taxpayers. That is why the tax Code has become the new Tammany Hall, a means of dispensing pork without the need to write a check directly to the recipients of Congressional largess. Simply exempt them

from income. Defer income. Create a deduction. Create a credit. But the problem is, almost every one of these causes is considered worthy in the abstract.

There are so many vested beneficiaries for each sentence in each Code section that the Code itself represents an employment security act for the many Members of Congress who represent those special interests and for the legions of accountants, tax collectors, and others necessary to prop up the unstable system. The 7,000 Code sections and the 10,000 pages represent hours upon hours of efforts of advocates to mold the Code to their desires. But, while the lobbyists and the Members of Congress that defend the income tax have benefited, and the industries like tax lawyers feed off the complexity, the American people suffer under the weight of its inefficiency, complexity, and unfairness. There is a reason why Members of the Ways and Means Committee receive more campaign contributions than other Members of the House.

If the Democratic Ways and Means staff report were only another shot by those whose livelihood depends on the current system, AFFT would not have bothered to respond. We believe our proposal and the skyrocketing growth in membership of AFFT speak for the need for change. But the errors in the report are regrettable because the report purports to bear the sanction of an allegedly objective House staff and comes at a time when Americans need solid and truthful information about tax reform alternatives. The report is especially disturbing because it emanates from the staff of a key Congressional committee – the Ways and Means Committee – whom the American people are asking to seriously deliberate and consider these proposals.

The politicization of the Congressional report is regrettable; but it is also in a strange way constructive. By fleshing out the best arguments defenders of the income tax can muster, and by addressing these arguments, it enables us to show just how bad the current system has become and just how ill-equipped the income tax is as a suitable alternative.

This response is in several parts. So that the reader can follow the arguments and understand the errors in the Democratic staff's report. We begin at the logical point by summarizing the arguments (using their arguments first) as to why the FairTax is a far better plan than current law.

Next we address their partisan historical commentary that the Republicans have been responsible for the income tax code as we know it. We explain that no single group is responsible for the state of the income tax system; rather, it is the system itself that has bred its own malignant complexity. And, truth be told, the current debacle we call the income tax has developed under both Democrats and Republicans. There is enough blame to go around. And there is no advantage in assigning blame. Blame should be placed on the shoulders of those who stand in the way of progress. The staff needs to have a longer view and a more accurate historical summary of how we got here from there. Simply blaming the party in office is not sufficient.

In the second part, we present the FairTax proposal in terms that accurately represent to the American people how it works. In doing so, we explain why the rate is what it has to be to maintain revenue neutrality. Americans For Fair Taxation seek a

system that raises the same amount of tax as is currently raised, but in a manner that is fair, obvious, visible, efficient, pro-growth, respectful of privacy rights, and not an impediment to savings and upward mobility.

Third, we discuss the "General Impact" of the FairTax, by discussing the issues raised in the report. These include distributional issues, the effect on state and local governments, the effects on seniors, and on families, housing, and charitable activities. As does the report, we then move to discuss the effect on specific sectors of the economy, which includes the automobile industry and farmers. Contrary to what the report argues, the FairTax would literally revitalize American manufacturing since, among other reasons, it is the only plan that imposes the same tax on imports as on domestically produced products (unlike today, allowing imports to compete against U.S. products with an unfair advantage). We note that it is the plan that is endorsed by the American Farm Bureau Federation and many state farm bureaus, which more than belies the arrogant position that the plan would hurt farmers and ranchers.

Finally, however, we make a number of points conveniently left out in the report, such as the effect of the FairTax on U.S. competitiveness, on individual privacy interests, on our ability to save, and on the general well-being of the American people. These are the issues on which a true tax reform debate should center. We beseech the Congress – particularly those Democratic Members – not to cast off the serious national debate over tax reform as political rhetoric. Look beyond that rhetoric. Take the high road. Do the hard work. And work to rid the American people of a tax on the sweat of our brows and toils of our labor.

II. The Uncontrollable Urge of Elected Representatives to Complicate the Tax Code with Special Interest Provisions, and then Blame the Other Party

The report states that the income tax Code became complicated after 1994 and cites statistics that it takes the average middle-income American family 7.5 hours to fill out their Federal income tax return. The report also cites that more Americans are subjected to the Alternative Minimum Tax, that 42 tax laws were passed in 10 years, and that more individuals use professional tax return preparers.

All of that complexity would disappear with the FairTax.

Anyone who professes to despise the complexity of the income tax should embrace the FairTax. No other plan that has been developed or could be developed would eliminate wasteful compliance costs quite like the FairTax. By imposing taxes at the cash register, the FairTax would wholly exempt individuals from ever having to file a return. Since business-to-business transactions would be fully exempt, businesses that serve other businesses will neither collect nor pay taxes. Retailers, most of which already pay state sales taxes (in the 45 states that have them) would be provided a credit compensating them for the costs of sales tax compliance. The FairTax would reduce fixed compliance costs by as much as 90 percent, according to the Tax Foundation, the oldest national tax research organization. It would eliminate entirely the need for individuals to file tax returns (unless they were in business for themselves). It would reduce the more than 700 incomprehensible sections of the Internal Revenue Code to one simple question asked of retailers: how much did you sell to consumers? The twin advantages of simplicity and visibility would produce another benefit: greater enforceability with less intrusiveness.

In fact, it is this simplicity that recommends the FairTax over the flat tax. For example, the populist appeal of the flat tax is mostly in simplified returns, but the flat tax ends up with a slightly more simplified tax return than the current 1040 EZ for individuals. Income still must be tracked and reported; indeed, one must continue to determine taxable income. Returns must be filed by both individuals and businesses. Although the flat tax would be simpler than the current tax system, it will require overlapping tax systems with state sales tax laws and therefore would not be harmonized with state law. There will be an existing fear (and actual possibility) that the tax will eventually revert to an income tax system or complexity will be added. Under the FairTax, there is no need to track income and expenses, no need for an IRS, and a high probability the tax will stay simple, since it cannot revert to an income tax.

Finger-pointing isn't historically accurate or helpful.

The political staff is obviously correct in stating that the Code is complex, but they show poor judgment when making this point merely for the sake of blamesmanship. The complexity of the Code did not begin with the control of the House of

Representatives by the Republicans. The constantly growing complexity of our tax system is part of a trend that began in 1913 and has only accelerated with the nearly perennial enactment of new tax legislation signed by both Democrat and Republican Members and Presidents.

If the history of our tax system teaches us two universal rules, they are these: Like the ever expanding universe, the Congress cannot control itself in its relentless quest to complicate the tax Code, regardless of who is in power. Second, the Congress seems to relish only one thing more than legislating social programs through the tax Code: Blaming someone else for making it complex.

One need not be a rocket scientist to know the system is complex today, but as this 1929 cartoon, paraphrasing a quote from Albert Einstein, shows …

Title: "Try to Make Out My Theory and Your Income Tax Work Will Look Simple!"
Artist: Clifford Berrryman
Date: 1929
Location: Library of Congress, Prints and Photographs Division

one political party does not have a monopoly on complexity.

The Democratic staff of Congress ought to understand their unfortunate role in the cycle of history. The scourge of the income tax has been around for a long time, and its legendary complexity has worsened each year through successive enactments of legislation. The constant march towards more complexity is at the very heart of the income tax system. In 1927, the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) reported that, "It must be recognized that while a degree of simplification is

possible, a simple income tax for complex business is not." The 1927 staff recognized that at its core, income tax complexity was almost wholly related to tax base questions – that is, questions or uncertainty about the timing or definition of taxable transactions. The inherent complexity of an income tax results from the difficulty of defining income; in determining when and to whom, to recognize income and expense, for tax purposes. Over time, the political process of give-and-take has made these difficult tax base questions inordinately complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

Throughout U.S history, there has also been considerable resistance, preventing efforts to simplify the Code even when a better way appeared clear.

Title: "No, No! Not That Way!"
Artist: Clifford Berryman
Date: June 3, 1933
Location: Library of Congress, Prints and Photographs Division

The truth is that the inexorable and implacable march to complexity dates from the act signed by Democratic President Wilson on October 3, 1913. That act was made possible by the ratification of the Sixteenth Amendment to the Constitution adopted on February 3, 1913. Seventeen internal revenue acts passed from 1913 until they were first codified in 1939. The decade of the 1940s saw the income tax become a mass tax covering a large portion of the population. The individual income tax, which had applied to only a small percentage of the population until the early 1940s, was levied on most of the working population by the end of the war.

With the tax applying to the masses, the withholding system was introduced in the Current Tax Payment Act of 1943 to facilitate the payment and collection of personal income taxes. In addition, quarterly estimated tax payments were introduced for those individuals whose income was from sources not covered by the withholding system. For the years 1944-45, individual income rates ranged from 23 percent to 94 percent, the highest rates ever imposed in the entire history of the federal income tax. Despite concern over its undue complexity, the income tax was formally placed at the core of the federal tax system by the Internal Revenue Act of 1954 during Eisenhower's Republican Presidency.

The staff needs a truer measurement of the complexity they helped create.

While the staff appears certain about who is to blame for this newly discovered complexity, they are apoplectic on the degree of complexity. While, on the one hand the staff blames the Republican control of Congress for the Code's complexity, on the other hand it defends the income tax, as … well … not quite so complex as to require an overhaul.

In trying to perform this delicate balancing act, the political staff is highly selective in the use of the statistics that define complexity. For example, the study cites the Alternative Minimum Tax (AMT) as adding to complexity.[1] That was probably a bad choice for two reasons. Ironically, the AMT was enacted during a Democratic administration through the Democratic Chairmanship of Wilbur D. Mills, the longest consecutive sitting Chairman in the history of Ways and Means. Second, for many Americans the AMT is not really the poster child of complexity. It is simply one more form. It is an odious tax increase in a backhanded way, but it is no more complex than many of the other provisions to which taxpayers are subjected. If the staff were serious about measuring the complexity of the Code, then the staff should look to the collective burden of the income tax system. Complexity is a difficult measurement, because it is qualitative in nature; but it can be measured in a number of ways.

Complexity can be seen in the growth in the number of returns, penalties and even the IRS budget.

To take a static figure, the staff might have cited the sheer volume of returns. For Fiscal Year 2003, the IRS reports the following returns were filed:

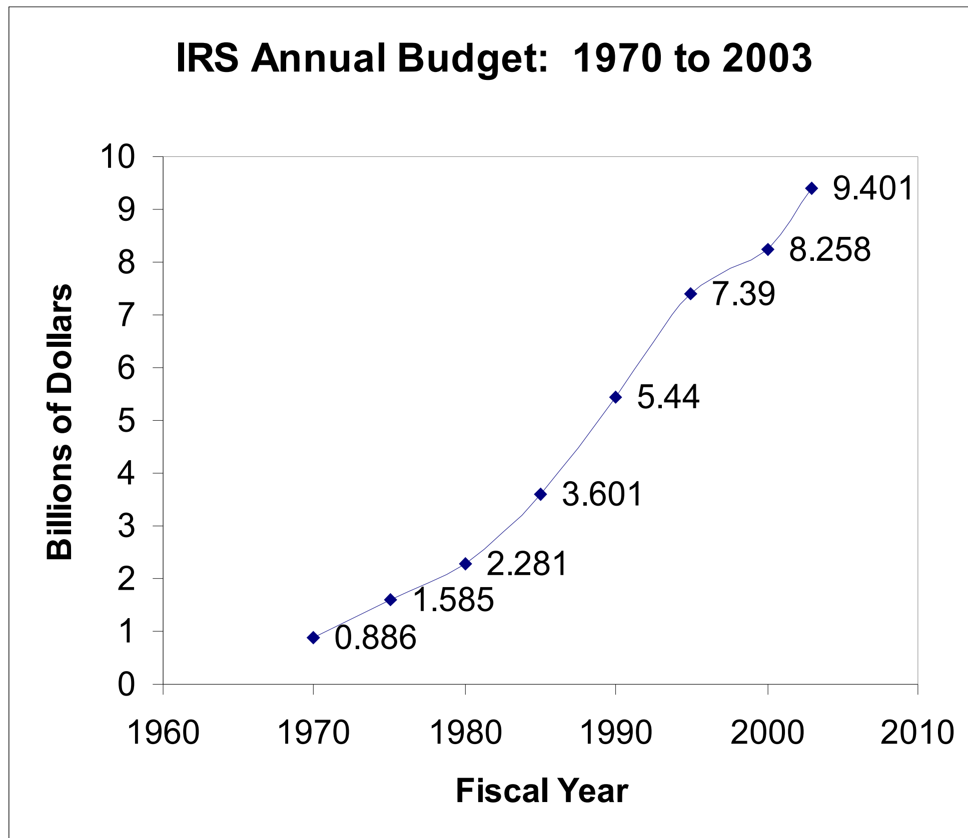
Individual returns filed	130,728,360
Estate & Trust Income Tax Returns filed	3,688,043
Partnership Returns filed	2,380,618
Corporate Returns Filed	5,890,821
Estate Tax Returns Filed	91,679
Gift Tax Returns Filed	287,456
Employment Tax Returns Filed	29,916,033
Tax Exempt Organization Returns filed	789,381

[1] The AMT laws began in 1969. Since that time, the laws surrounding the computation of the tax have been modified through various tax revision acts. The 1969 law subjected individuals to an add-on tax at a 10 percent rate in addition to their regular tax. The Tax Revision Act (TRA) of 1976 increased the rate from 10 to 15 percent and decreased the exemption amount.

Excise Tax Returns filed 812,483

In 2010, the total number of U.S. returns is estimated to be 249,688,100. There are also information returns. For Fiscal Year 2003, the total information returns received was 1.313 billion; the IRS made 4.288 billion contacts and sent out 8 billion forms and instructions so taxpayers could attempt to know how much they owe.

Citing the number of penalties might be a good measurement of the complexity too. Last year, Americans endured 28,767,480 civil penalties (19.1 million for the individual income tax alone). The corporation income tax required the issuance of 704,012 penalties and the employment tax 7,649,296 penalties, with the frequency of parking tickets, issued to businesses that had the audacity to employ people. To administer the tax laws, the IRS directly employs about one hundred thousand employees. The IRS budget is about $10 billion and has greatly outstripped growth in the economy and the population.



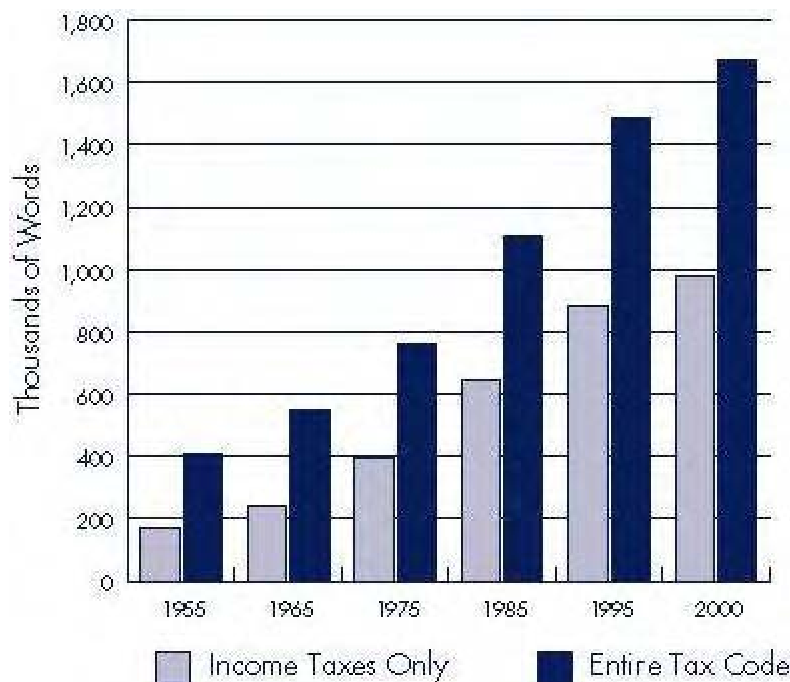
The staff could have looked to the growth in the number of words Congress enacted.

Much of the work to evaluate the complexity of the income tax system has been done by the nonpartisan Tax Foundation. As one means of measuring complexity, the Tax Foundation charted the growth over the past 40 years in the combined number of

words that define the body of both the federal income tax laws and their attendant regulations.[2] According to testimony of the Tax Foundation, the number of words in the tax Code has been steadily increasing. In 1955, there were 409 thousand words in the Internal Revenue Code and 40 years later in 1995 there were more than 1.4 million words. Today, there are more than 1.6 million words. The number of sections in the code has been rising even faster than the word count.

Indeed, the Tax Foundation determined that the number of words detailing the income tax laws has grown almost on a linear basis whether a Democrat or Republican was in the White House or which party controlled the Congress. The income tax regulations, which provide taxpayers with the "guidance" they need to calculate their taxable income, have grown at an even faster pace. Words in the regulations increased from 572,000 words in 1955 to 5,947,000 words today – an increase of 939 percent. Combined, the federal income tax code and regulations grew from 744,000 words in 1955 to 6,929,000 today – an increase of 831 percent.

Figure 1
Growth in the Internal Revenue Code as measured by the estimated number of words



[2] http://taxfoundation.org/compliance2002.html *The Cost of Tax Compliance,* Scott Moody, Senior Economist – Tax Foundation

The staff might have also looked to growth in the number of sections.

Word counts are one way to measure complexity. If the Ways and Means political staff had really sought to measure tax code complexity they might have also looked at the multiplication of the subchapters and subsections that comprise the Internal Revenue Code. In 1954, federal income tax law was comprised of 103 Code sections. Today, there are at least 725 income tax Code sections, a 604 percent increase.[3]

The growth in the volume of the income tax laws and regulations is a direct result of the 32 significant federal tax enactments that have taken place since 1954 – or approximately one every 1.4 years, again throughout both Republican and Democratic control. Previous Tax Foundation research (based on a sample of one-fifth of the core sections of the income tax code) found that these enactments have not only increased the volume of the tax code, but resulted, on average, in the amendment of each section once ever four years.

Costs pushed forward

To most Americans, direct expenses of the IRS are not a central compliance problem. Most important is the unfunded mandate imposed on the American taxpayer to become the ultimate tax collector.

Again, according to the Tax Foundation, in 2002 individuals, businesses, and non-profits will spend an estimated 5.8 billion hours complying with the federal income tax Code (henceforth called "compliance costs"), with an estimated compliance cost of over $194 billion. This amounts to imposing a 20.4-cent tax compliance surcharge for every dollar the income tax system collects. By 2007, the compliance cost is estimated, conservatively, at $244.3 billion. However, this estimate does not take into account the recently enacted Economic Growth and Tax Reform Reconciliation Act (EGTRRA) of 2001. Taking EGTRRA into account shows that the compliance cost could soar as high as $350.2 billion by 2007.

To put the tax compliance burden into perspective, the more than $200 billion tax surcharge is greater than the combined revenue of Sears, Walt Disney, Microsoft, Rite Aid, and McDonald's. Put another way, the 5.8 billion hours per year represents a work force of over 2.5 million people, larger than the populations of Dallas and Detroit combined, and more people than work in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined. Or as a sad comparison, more than ten times that spent on the National Institutes of Health for disease research. This is also more people than would reside in four Congressional districts. The cumulative compliance cost over the 2001-2006 period will come to almost $930 billion.

[3] Since 1954, the number of sections dealing with the "Determination of Tax Liability" has grown 1,150 percent; the number of sections dealing with "Capital Gains and Losses" has grown 1,300 percent; the number of sections dealing with "Deferred Compensation" (e.g., pension plans) has grown 1,450 percent; and the number of sections dealing with the "Computation of Taxable Income" has grown by more than 1,589 percent.

Or looked upon another way, we can consider the wasted money in comparison to worthy causes. According to the *Independent Sector,* [4] 83.9 million American adults volunteer, representing the equivalent of over 9 million full-time employees at a value of $239 billion. So put another way, Americans spend as much time complying with their taxes as they do volunteering for charitable causes.

These costs are incorporated into the price of everything that we buy – about $750 for each man, woman and child in America. Small firms bear the lion's share of these fixed costs that stem from paperwork and record keeping, tracking wages, and interpreting the law — costs which, while disproportionately falling upon them, cannot be passed along. Small firms in particular, according to the National Commission on Economic Growth and Tax Reform , are forced to waste 3 to 4 dollars complying with the law for every dollar they pay in taxes.

Paperwork is the most visible compliance cost, but it is clearly not the only cost, and perhaps not the largest cost. Return processing, determining liability, recordkeeping and other burdens are an estimated 19 to 33 percent of the total revenue raised by the income tax system and 2.0 to 3.5 percent of the Gross Domestic Product (GDP). We waste money each year on seeking to avoid taxes, avoid trouble with the IRS, interpret the laws or determine the best course of actions with the laws.

Figure 2
Economic impact of income tax compliance costs vs. the Tax Relief Act of 2001

[4] http://www.independentsector.org/programs/research/gv01main.html ***Independent Sector*** *Measures the Everyday Generosity of Americans.*

Neither the IRS nor the taxpayer understands the code.

The Democratic staff may find the current income tax tolerable, but the IRS itself is having trouble understanding it. Another way of looking at the complexity is by looking at the dismal record of the IRS's own centers established to help people prepare their tax returns. These centers gave incorrect answers – or no answer at all – to 43 percent of the questions asked by Treasury Department investigators posing as taxpayers. The investigators concluded that half a million taxpayers may have been given wrong information between July and December 2002. Auditors were given correct answers to 57 percent of their tax law questions during the course of the study. Less than half, or 45 percent, of the questions were answered correctly and completely. In 12 percent of the cases, the answer was correct but incomplete.

The IRS disputed the results. Using the raw numbers gathered by Treasury investigators, the IRS recalculated the error rate and ignored any instance when a taxpayer was denied service or told to do his own research. Of the questions answered, they calculated that 67 percent were answered accurately.[5]

Those who are schooled in tax enforcement statistics might point out another disturbing trend: our current tax system is not faring too well. According to the IRS Commissioner's Annual Report, more than $200 billion – 20 percent of all income taxes collected – are evaded. Tax evasion has increased almost 70 percent as a function of GDP over the last decade. Tax evasion represents more than 2 percent of GDP or nearly one good year of economic growth. We all pay about 20 percent more than we need to because cheaters do not pay. Because more and more taxpayers view the system as unfair, compliance is decreasing further.

Despite this poor compliance rate, we may have reached the limits of what we are willing to pay in monetary and non-monetary costs to increase compliance. More than 34 million civil penalties are assessed each year, 2 million accounts are levied (seized) and more than 1 billion information returns are filed. Individual returns request information so invasive that we must confess more of our private lives to the IRS than many of us would tell our children. Every few years, the Congress parades the victims in the public view so that we might all criticize a thankless agency charged with enforcing the complex laws, passed by Congress, which is really at the root of the problem. Every few years, we reenact another episode of the Taxpayer Bill of Rights, when the genesis of the problem is the complexity bred by the income tax system itself.

Some final thoughts on complexity

The Democratic Staff of the Committee that writes our tax laws just might truly believe that complying with the income tax is a reasonable burden, but then they do not represent the American taxpayer. About the only thing a taxpayer can be sure of when he or she files his or her tax return is that the amount of tax shown on the return is not the

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[5] An amusing way to look at the complexity of the Code is to consider the number of Members of the House that serve on the Committee because they are, in the final analysis, responsible for the state of the Code. An historical review shows that in the 1st Congress there were 11 members of the Committee, including James Madison. Today there are 41 Members.

right amount. The tax system is now so monstrously complex that it is beyond the ability of any one person to understand it. Understanding the system is certainly beyond the reach of most mere tax lawyers, accountants, and tax administrators. A system that is so complex must be administered in an arbitrary and unfair way. If no one really understands what the law is, it is impossible to administer it fairly and uniformly – and of course, it is not so administered.

The blame does not lie with the tax collectors, as some in Congress would like to argue. It lies at the feet of Congress, because the cavalcades of laws that are passed almost every year heap layer upon layer of complexity into our tax laws. More accurately, the problem does not entirely reside with Congress. Lobbyists who are jockeying for a competitive advantage for their industry or company write most of the tax laws. There are more than 40,000 registered lobbyists in Washington, D.C. and nearly half consider themselves tax lobbyists. Our tax Code has become a modern-day Tamany Hall, where taxpayer resources are doled out to special interests.

In most cases, the small changes to the Code that shift tens of millions of dollars to particular taxpayers are not as visible as direct appropriations, but are a useful tool for benefiting favored constituents. With each special exemption, credit, deferral, deduction or definition that results, the tax burden on everyone else must be increased to raise a given amount of tax revenue. It is the hide-and-disguise method of taxation.

The monetary cost of compliance with the income tax code is only half of the problem. We pay for our income tax system in equally wasteful ways. The income tax is collected with a heavy hand and much contention. Our government has embroiled its citizens in more than 35,000 litigation actions.[6] Taxpayers sustained more than 3 million levies.

As long as we insist upon an income tax system, the system needs to be complex. The system needs to be enforced with a heavy hand. The system needs to have all of the 28 million civil penalties. The system needs to be intrusive. It is the heavy price we have to pay for an income tax system.

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[6] The contrast between the income tax system and our historical notions of privacy is perhaps most vivid when we consider just how few real rights taxpayers have during an audit. Two prominent examples to consider are the IRS summons authority and the burden of proof (although the burden of proof to a certain extent in certain cases will rest with the government as a result of recent legislation).

III. Growing Endorsements of the Bipartisan FairTax Plan Scare Defenders of the Income Tax

AFFT is an ever-expanding grassroots citizen's organization of nearly 600,000 – the largest taxpayer group ever assembled in the history of our Nation. We resent the staff's implication that our organization is either Democrat or Republican. Our ranks have been formed by taxpayers of every walk of life. We are Republicans, but we are also Democrats and Independents. We are the young and the old. The retired and the college student. The poor and the rich. Immigrant and 5th generation. We are fiercely nonpartisan. And we resent as well the belittling of the issue of tax reform – one of the most important issues to face the American people – as a political football. We have never asked one's political affiliation for membership. And while we are of course pleased that we have the support of Majority Leader Tom DeLay and the attention of President Bush and Speaker Hastert, we would be equally pleased if we had the enthusiastic support of the Minority Leader Nancy Pelosi or Democratic Ranking Minority Member of the Ways and Means Committee, Charlie Rangel, to assist us in lifting the yoke of our income tax from the beleaguered back of the American taxpayer.

We, the Americans For Fair Taxation, ask Members of Congress to take as seriously our Declaration of Independence from the income tax as our forefathers debated the separation from another tyrannical power. We seek repeal of the onerous tax system and its replacement with the FairTax. Instead of partisanship, we seek honest debate. Instead of bickering, we seek consensus. Instead of politics, we seek policy discussion. We view our constituency as the American people, and we are staunch defenders of an equal opportunity tax reform idea. It is time we had an honest national debate over the FairTax, and it is time that debate took place without the continual political demagoguery that trivializes its significance in this nation's and the world's economic history.

The FairTax welcomes the endorsement of any enlightened Members of Congress who have the courage to remove the shackles of the income tax from the feet of the American taxpayer. We would add that by no means do all Republicans endorse the plan as yet. Some endorse a flat tax. A flat tax differs from a national retail sales tax in that it would require every business to collect and pay taxes up the chain of production as noted. It differs in other respects. For example, it would not be border adjustable. It also would not repeal payroll taxes, which are the current law's flat tax on jobs and wage income. The FairTax would tax consumption only at the final point of sale.

For the most part, those that support a flat tax do so only because they share a belief that it is easier to pass a tax bill if part of the tax is hidden from the American people or if the American people are not told that the flat tax is a consumption tax. Others simply lack the courage to enter into the debate. This is understandable. Each attack like that of the Democratic Ways & Means Committee staff further confirms their fears that the issue has become a political minefield. They choose not to get in front of their constituents; even if that requires that their constituents are burdened with current law. In these cases, it is Americans For Fair Taxation's job to encourage the Member and to educate his constituents.

IV. An Objective Description of the FairTax Plan

The staff fails to objectively describe the nonpartisan FairTax plan or its required rate.

The staff tries to complicate what can be a very simple explanation of a comprehensive tax plan. In a nutshell, the FairTax taxes only consumption, and not savings and investment. It taxes income only once as it is spent, not several times as we do today. It is neutral as to savings and investment, not punitive. The staff is correct in stating it would replace most Federal taxes; including the payroll taxes (both FICA and SECA), the personal income taxes, the corporate income taxes, capital gains taxes, and transfer taxes (death taxes). However, the staff neglects to point out that the FairTax would not replace the so-called sin taxes, or trust fund taxes, that serve a purpose other than funding general revenues. It also fails to point out that the FairTax does not tax used goods.[7] The FairTax does not tax business inputs, only retail sales for final consumption. It also does not tax educational expenditures. And equally important, as discussed below, it does not tax property that is exported, while ensuring that goods manufactured elsewhere are placed on a level playing field with U.S. produced goods.

In describing the FairTax, the staff also failed to state that it is the only plan that compensates taxpayers for being tax collectors: something the current system could not do unless the rate were increased dramatically. Under the FairTax, retailers are compensated for being tax collectors by allowing them keep 0.25 percent of the taxes collected. Since the FairTax adds an economy of scale to what retailers are already doing in 45 states (and hopefully harmonizes a balkanization [broken into small, hostile, political groups] of costly and sporadic rules), this rebate would often be a windfall. Second, it entices states to be collecting apparatuses by allowing them to keep 0.25 percent of tax collections if they administer the tax. Since most states have long experience administering state sales taxes, it is expected that most will take on this challenge.

The staff misrepresents the FairTax rate.

Perhaps the most glaring example of the staff's errors in describing the FairTax plan is their misrepresentation of the FairTax rate. First, the staff asserts that the budget-neutral rate for the FairTax would have to be 50 percent. The idea that a national sales tax would have to have a rate anywhere near 50 percent is just a fabrication, pure and simple. The staff cannot defeat the idea of a national sales tax by arbitrarily assigning it a higher rate that it believes the American people will not support. Noted researchers would refute the staff's biased analysis. Dale Jorgenson (Harvard) found that the FairTax plan was revenue neutral at 22.9 percent.[8] Jim Poterba (MIT) found that the FairTax plan

[7] There are two principal ways in which a sales tax can treat used property – property that had been purchased at the retail level by a consumer previously: a sales tax can exempt used property from tax or it can tax used property sold for consumption purposes. Exempting used property from tax is certainly the simplest approach. If used property is exempt from tax, then owners of property which exists at the time the sales tax is enacted, particularly homeowners, will experience a large increase in the value of their property.

[8] *The Economic Impact of the National Retail Sales Tax,* Dale W. Jorgenson

was revenue neutral at 23.1 percent.[9] Laurence Kotlikoff (Boston University) found that the revenue-neutral tax rate was 24 percent.[10]

But so would simple common sense analysis. The FairTax repeals the individual and corporate income tax, payroll taxes, and the estate and gift tax. The FairTax would tax all consumption, without exception. In fiscal year 2003, these taxes accounted for about $1.67 trillion.[11] The economy in 2003 produced goods and services valued at 10.4 trillion.[12] Consumption in the U.S. economy is a little under 7/8 of economic output or $8.6 trillion. If we take the taxes replaced and divide by total consumption in the U.S.- $1.67 trillion (the taxes replaced) divided by $8.6 trillion (all consumption) we find the rate at 19.4 percent. This is the starting point for thinking about the sales tax rate. There is simply no way that replacing taxes equal to 19.4 percent of consumption with a tax – the FairTax – that taxes all consumption is going to have to be imposed at a rate of 50 percent.

Looked at another way, there is no way that the FairTax with a base much broader than the income tax, would be at a rate greater than the income tax. In 2001 (the latest year available), total adjusted gross income (i.e., income before personal and dependent exemptions, itemized deductions, and the like) was $6.17 trillion.[13] Total consumption in that same year was $8.54 trillion or 38 percent larger. 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. Or, stated differently, total consumption is more than twice the taxable income under the current system.

The reason the FairTax can lower marginal tax rates is that the tax base of the FairTax is broader than the current tax system. The reason the FairTax base is broader is that the FairTax has no loopholes and no exclusions, whereas the current tax system is full of loopholes, exceptions, and exclusions.

Calculating a true tax rate is a bit more complex because of three things. The federal fiscal year runs from October 1 to September 30, whereas the National Income Product Accounts are maintained on a calendar year basis. The National Income Product Accounts definition of consumption and the FairTax definition are different and adjustments (going both ways) have to be made. Lastly, and most significantly, the

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[9] Letter to Americans For Fair Taxation, April 4, 1997

[10] *Replacing the U.S. Federal Tax System with a Retail Sales Tax – Macroeconomics and Distributional Impacts.*

[11] As follows (fiscal years, billions of dollars):

20022003Individual Income Tax$858.3$793.7Corporate Income Tax148131.8Payroll Taxes700.8713Estate and Gift Taxes2622$1,733.1$1,660.5Economic Report of the President, Table B-81, p. 380 (available at http://www.whitehouse.gov/cea/pubs.html) or the Budget of the United States (available at http://www.whitehouse.gov/omb/budget/fy2005/).

[12] News Release: Gross Domestic Product and Corporate Profits, Commerce Department, Bureau of Economic Analysis, August 27, 2004 (available at http://www.bea.gov/bea/newsrel/gdpnewsrelease.htm). The $8.6 trillion figure is the sum of personal consumption expenditures ($7.36 trillion) and government consumption ($1.29 trillion).

[13] IRS Statistics of Income, Table A, Individual Income Tax Returns, Selected Income and Tax Items forSeSelected Years, 1997-2001 (available at http://www.irs.gov/taxstats/article/0,,id=96586,00.html).

FairTax includes a rebate that exempts each household's spending up to the poverty level from tax. Primarily because of this last point, the FairTax rate must be higher than the 19.4 percent described above. Depending on the year, the tax level, and the economy, the required rate has varied from 23 to 25 percent over the past ten years.

A tax rate of 23 to 25 percent may sound high but it is important to remember that the FairTax (unlike any other reform plan) repeals the payroll taxes. This amounts to 15.3 percent of most workers' wages. Consider the low bracket 15 percent wage earners. They pay 15 percent in income taxes (after personal and dependent exemptions and the standard deduction) and 7.65 percent in payroll tax paid from the first dollar earned. That is 22.65 percent before considering the employer payroll tax (which most economists believe employees actually pay). The FairTax, instead of personal exemptions and a standard deduction, rebates the sales tax on spending up to the poverty level to each household.

If the staff finds the FairTax rate too high, they have said nothing about existing tax rates. Apart from double taxing, the current tax system is full of loopholes, credits, exclusions, and deductions that dramatically reduce the tax base. Contrary to the inference the staff wants the reader to draw; it is a mathematical certainty that broadening the base and imposing a single rate of tax will have to reduce average marginal rates. If the staff complains about the FairTax rate, they would have much more to complain about under the rate that must be imposed under the current system. Most importantly, the proponents of H.R. 25 seek to eliminate the punitive tax system in a revenue-neutral manner. They see the debate over the best way to collect taxes as distinctly different from the debate over tax cuts.

The staff confuses the reader as to the proper measurement to be used for the rate.

As a second line of attack, the Democratic staff assert that when AFFT says the rate is " '23 percent' it means '30 percent' to the consumer." This is very disingenous. The staff knows that when considering the rate of a national sales tax, or any tax for that matter, one must always decide which of two distinct means of portraying this rate – the "tax-inclusive rate" or "tax-exclusive rate" – best expresses the tax burden. Which one we employ changes absolutely nothing in terms of the taxes that are actually raised or paid by the taxpayer under the taxing regime examined any more than describing the distance to a gas station in kilometers or miles changes the length of a walk. But how the rate is presented changes how the relative tax burden is perceived by those who wish to compare the merits of competing tax proposals – and the staff knows this. In effect, the staff wants the American people to believe that walking 11 kilometers to a gas station is farther than 10 miles.

When making comparisons between alternative taxing systems, it is important to ensure that these comparisons are consistent, fair in terms of expectations, and are well explained. Fair comparisons eliminate rather than exacerbate confusion over a relatively critical point as the means of expressing the tax rate.[14] The AFFT plan ensures that the

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[14] Some authors have already sought to enhance the public's perception of the flat tax by wrongly comparing the tax-inclusive rate of the flat tax with a tax-exclusive sales tax rate. See Bruce Bartlett, "Replacing Federal Taxes with a Sales Tax," Tax Notes, August 21, 1995, pp. 997-1003, arguing that a 32

rate of the sales tax is properly being measured by using the same scale for the flat, income, and sales taxes. The only means to do so is to compare the tax-inclusive income tax rate to a tax-inclusive sales tax rate. Whether that tax rate is described as tax-exclusive or tax-inclusive has no bearing on the ultimate tax paid – the same as whether the distance to the corner store is 100 yards or 300 feet does not change the length of the walk.

To compare apples to apples the FairTax is, unlike most state sales taxes, imposed on a tax-inclusive basis. The staff is correct that on a tax-exclusive basis, the FairTax would be imposed at a 29.9 percent rate. But on that basis, the current tax system would impose tax rates on middle-class taxpayers of 76 percent, if you take into account the hidden employer payroll tax that most economists believe is borne by workers.

Two examples may help readers cut through the morass of the staff's obfuscation.

Assume a worker earns $100 and uses the entire amount to pay for a CD player at Wal-Mart. Under the income tax, the worker would earn $100, pay $20 dollars in income tax, and have $80 left over to buy the CD player. We would say this tax rate is 20 percent. In a typical sales tax we would say the worker earned $100, paid $80 for the CD player and paid $20 in sales tax. We would divide $20 by $80 and say the rate is 25 percent. Using this method, we would say the sales tax rate is 25 percent and the income tax rate is 20 percent even though the tax burden is precisely the same. This is misleading. Thus, the FairTax uses the same method of stating its rate (the tax-inclusive rate) as the current system it is designed to replace.

The way of looking at the income tax from a tax-exclusive point of view is to ask how much a worker must earn to spend $100. Today, a 28 percent taxpayer (who must also pay 15.3 percent in payroll taxes) must earn $155 to pay for $100 in goods.

What a worker must earn to spend $100

Earnings	$155.40
Income tax (28 percent of $155)	43.51
Employee Portion Payroll Tax (7.65% of $155)	$ 11.89
Remaining to Spend	$100.00

If the employer's share of the payroll tax is considered, this worker must earn $176 to spend $100. A 15 percent income tax bracket taxpayer must earn $129 to spend $100. This figure would be $143 if the employer's share of payroll taxes is taken into account.

Since there are distinctly two different means of portraying the tax rate, it is appropriate for purposes of comparison to contrast the various marginal rates under each taxing scheme in a manner that allows the public to make these comparisons. Let us look at a taxpayer who is at the top marginal rate under each taxing scheme. The tax-inclusive and tax-exclusive rates would be compared as follows.[15]

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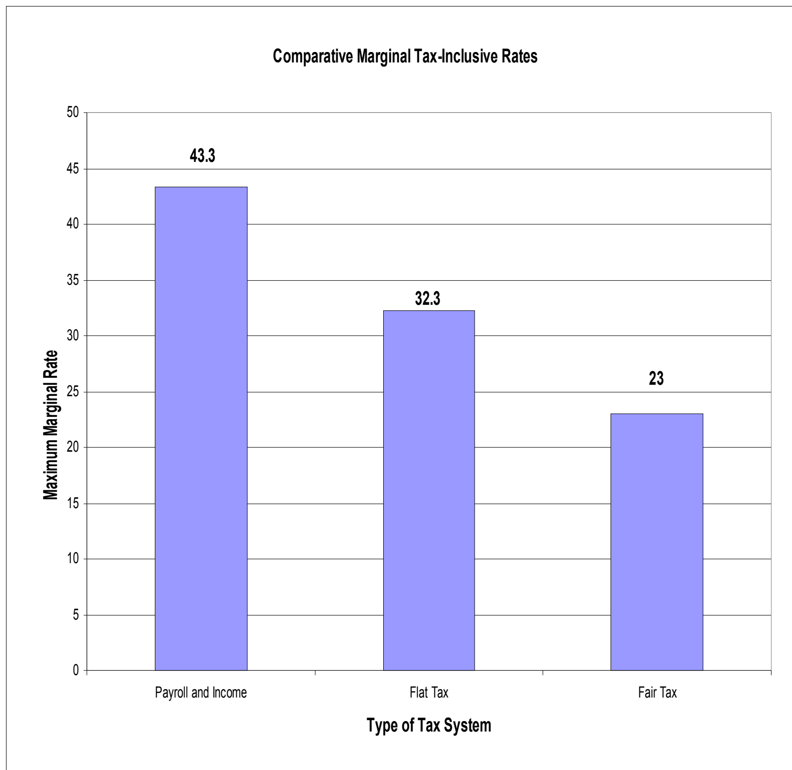
percent sales tax rate would be required to raise the same revenue as a 17 percent flat tax.

[15] Marginal rates are the rates at which the last dollar of income is taxed. They are distinguishable from effective rates, which portray the amount of taxes paid over the entire base. Marginal rates can lower as income rises (as in the regressive payroll tax that imposes a 15.3 percent tax on the first $68,400 in earned income and 2.9 percent thereafter), and they can also increase dramatically (as in the case of steeply

In the first chart, we see comparisons which we are used to seeing. This chart reflects the maximum marginal rate of the current personal income tax system as 43.3 percent.[16] Here the sales tax rate is 23 percent and the flat tax rate is 32.3 percent, reflecting the combined payroll and flat tax burdens.[17]

Chart 1



However, Chart 2 indicates that the income tax with the payroll tax bears a maximum marginal rate that is 75.8 percent of the tax-exclusive base. Even the Federal individual income tax alone reflects a maximum marginal tax-exclusive base of 43.3 percent. According to this chart, the flat tax bears a maximum marginal rate of 47.7.[18] the FairTax

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progressive income tax brackets). Under the sales tax the top marginal rate is 23 percent, but the marginal rate will never be exceeded by the effective rate.

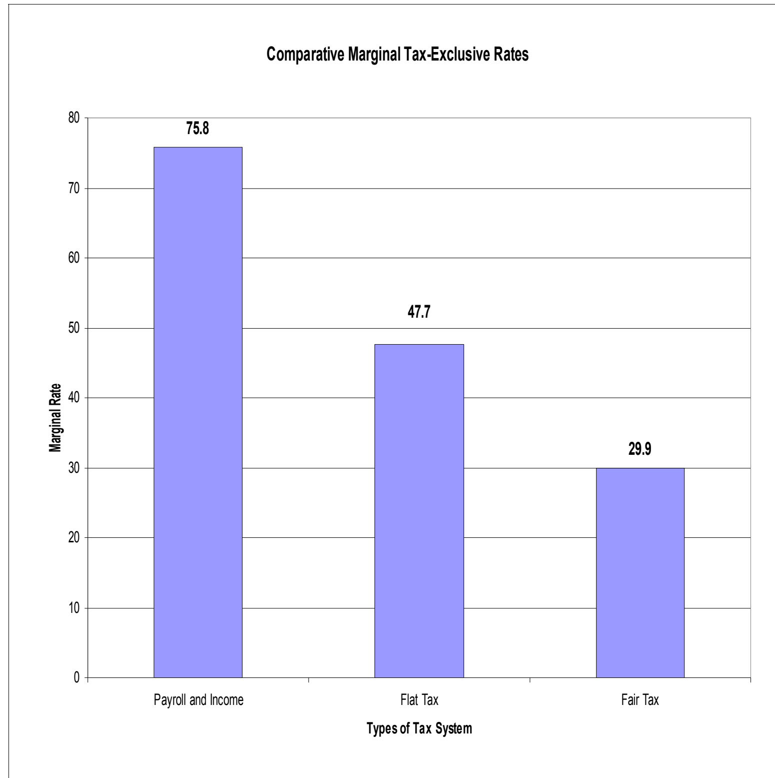
[16] The maximum marginal payroll rate is 15.3 percent, but this rate applies regressively between $0 and $68,400 for 1998. When this rate attaches, it is possible for a tax to apply at a maximum marginal rate of 43.3 percent (28 percent individual income tax rate plus 15.3 percent payroll tax rate).

[17] While it is beyond the scope of this memorandum, it is important to understand that the flat tax rate of 17 percent assumes a substantial reduction in government revenues. In other words, it is not fair to compare a revenue-neutral sales tax rate with a non-revenue-neutral flat tax rate.

[18] The flat tax does not repeal the payroll tax like the FairTax does. Therefore the maximum marginal flat tax rate must include the standard 17 percent rate plus the 15.3 percent payroll rate. We should note that even this comparison may unfairly represent the rate of the flat tax, however, since a revenue-neutral flat tax rate may be about 20 percent, given the large personal exemptions in the flat tax. Neither the current system nor the FairTax assumes a reduction in government expenditures.

plan bears a maximum marginal rate of 29.9 percent. In this chart, the taxes paid are calculated as a percentage of what remains after tax.

Chart 2



The FairTax is expressed on a tax-inclusive basis because, while the rate of the tax is expressed differently than state sales taxes, the staff knows that the price of adherence to the way state sales taxes are expressed would be misrepresentation at the national level. If we were to express the sales tax rate as a tax-exclusive rate, we would be comparing apples to oranges and either overestimating the relative burden of the sales tax or underestimating the burden of the flat or income tax. The staff is free to consider the FairTax as a 30 percent tax, but to do so, the staff should accurately consider the income tax at a 78 percent rate.[19]

The staff asserts that the FairTax "attempts to mitigate the regressivity of the new tax by exempting consumption." That is a half-truth. The FairTax is progressive. The FairTax rate eliminates the built-in regressivity of the current system by: 1) eliminating hidden taxes passed along to consumers in the price of goods and services today, 2) accommodating a rebate mechanism which provides that each individual or family unit

[19] Second, it is impossible to consistently apply the measurement the other way around. Federal taxes are only expressed in tax-inclusive terms. The income tax has been expressed in this manner since its inception. The public would be most confused by an attempt to express the income and flat taxes on a tax-exclusive basis. Expressing the FairTax in a tax-inclusive manner is consistent with the way in which we measure the burden of the income tax, is consistent with the manner in which we perceive the burden of the flat tax, and is the only way in which the rates can be fairly compared.

effectively receives a rebate of all the taxes they will pay in the next month on an amount determined to fund essentials, and 3) virtually eliminating regressive compliance costs. The rebate is equal to 23 percent times the Department of Health and Human Services (HHS) poverty guidelines. This is a way of non-paternalistically providing that each person or family unit can consume tax free up to the poverty level; or alternatively said, can consume tax free what they see as the necessities of life at a level HHS sees as the cost of the necessities of life. The "rebate" may be more accurately portrayed as a "refund" in advance of the taxes that individuals or family units will pay. However, it is not the regressivity of the new tax that the FairTax seeks to offset; it is the regressivity of the current tax which, *among other things*, imposes hidden taxes in the goods and services everyone buys, as well as a flat tax on wages of 15.3 percent (which after the 2004 Social Security Taxable Wage Limit of $87,900 is then reduced to zero).

The staff ignores the benefits of the FairTax base relative to state and local sales taxes.

In describing the FairTax, the staff criticizes the FairTax for differing from state sales taxes. However, what the staff fails to tell the reader is that the departure from state sales taxes is intentional and beneficial. Most importantly, while some states tax services most states err by imposing a different tax rate on goods than they do on services. Whether consumption takes place in the form of a good or a service should make no difference economically. We do not, for example, eliminate service industries from the income tax. States err by taxing business inputs, so that taxes cascade the more businesses (read, small firms) are involved in the production process. The FairTax eliminates all upstream taxes and does not tax business inputs.

State sales tax bases are also replete with exemptions. The FairTax untaxes the consumption of necessities through a rebate rather than by exempting individual goods and services for four reasons: 1) exemption by category of food, clothing or medicine ends up affording a greater exemption to the wealthy who consume more expensive items within these categories and more of them, 2) such exemptions require a higher tax rate on all non-exempt consumption, 3) specific exemptions will open the door for lobbying for other "necessities," and 4) exemptions add complexity to the system and increase compliance costs. We also seek to provide a federal incentive for states to eliminate such state-to-state discrepancies. The issue of distributional equity is discussed more below.

Other errors in representing the FairTax

The staff makes several other errors in describing the FairTax that are covered elsewhere in this rebuttal. Their report is replete with half-truths. For example, in its description of the plan, the staff asserts the FairTax is regressive, when the staff knows the FairTax is the only plan that fully untaxes the poor. The staff asserts that the FairTax would tax government, but purposefully neglects to point out that the current system taxes both the wages of government workers and government purchases. They say that the FairTax would tax prescription drugs, healthcare, apartment rents, and insurance, but omit the fact that each of these items is taxed today because the income tax taxes drug

manufacturers, healthcare providers, landlords, and insurance companies that pass these taxes forward on to consumers who must pay for these goods and services with after-tax dollars. The staff asserts that families would have to register to receive the rebate. This requirement is trivial when compared to the 2.8 billion hours that individual taxpayers spend each year to satisfy federal income tax filing and recordkeeping requirements. These and other items are discussed more fully below.

I. Increasing the Contributions to Charity

Some 150 years ago, Alexis de Tocqueville marveled at Americans' propensity to "found seminaries, build churches, distribute books … [He] … often admired the extreme skill they show in proposing a common object for the exertions of many and inducing them voluntarily to pursue it." If he were to visit America for a third time, he would find that charitable, nonprofit organizations continue to play a vital role in meeting needs unmet by the private sector or by governmental agencies. From centers of learning, to health care facilities, to poverty relief organizations, to public policy research institutions; these institutions are an indispensable part of the American economic and social landscape – and thankfully so.

However, when it comes to evaluating various tax reform proposals, the Democratic staff assumes a vast change that is unsupported by history or logic. They believe Americans donative goodwill is driven by the tax code's deductions for charitable contributions, and if charitable donations are not deductible because we don't have an income tax then charity itself might cease to exist. Nothing could be further from the truth. In summary, consider:

- Americans are a generous people, and their generosity is historically and presently not contingent on a tax deduction
- Contributions to charity have historically comprised a nearly fixed share of GDP which will increase with economic growth stimulated by the FairTax
- The FairTax allows every taxpayer, not just itemizers to gain the same advantage that the charitable contribution provides, i.e., allowing the taxpayer to give with pre-income tax dollars
- The FairTax does so without limitation and does something the income tax could not do – it allows a supercharged charitable contribution, since under the FairTax a taxpayer can contribute with pre-payroll tax dollars as well

Contributions increased in the past when marginal rates decreased.

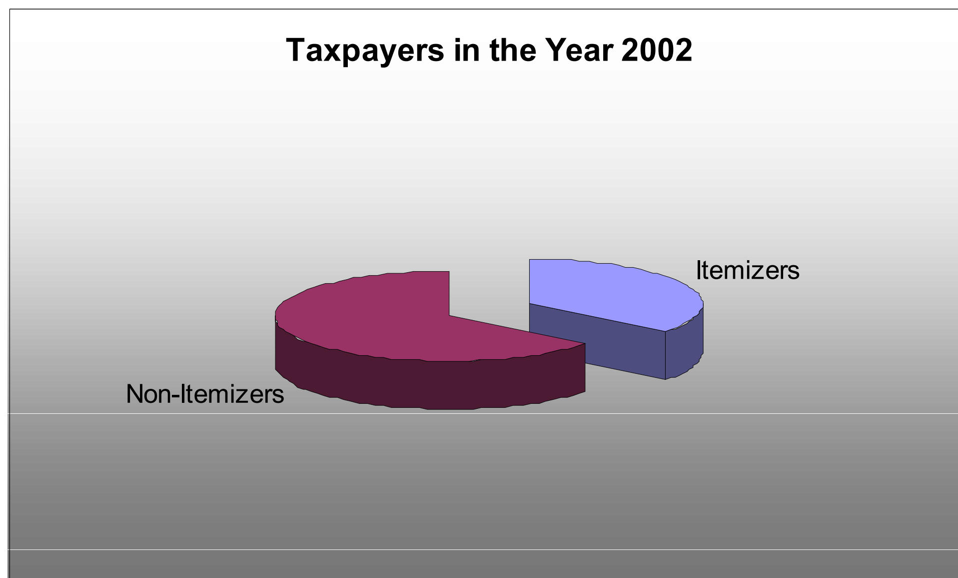
The staff is demonstrably wrong again, this time in their endeavor to scare charities into defending the income tax and to cajole the generous American taxpayer into thinking that charities will suffer. Consider the following points, starting with this historical fact. The Democratic staff's view that high marginal rates (the penalty to hang on to your savings) are an inducement for charity (for the deduction) was tested in 1986 to prevent the Congress from considering rate reductions that reduced the top marginal rate to 28 percent. The historical facts proved them incorrect then as they will now. After the 1986 Tax Reform Act, charitable giving increased rather than decreased, despite the lowering of marginal income and transfer tax rates. Charitable giving rose by $6.4 billion, or 7.6 percent, in 1987 after the top tax rate fell from 50 percent to 28 percent (nearly doubling the tax price of giving). Likewise, the growth of charitable bequests was most rapid from 1980 to 1987 when estate taxes were coming down.[1]

Indeed, we don't even need to look far back. Marginal rates are on their way down now. Contributions to the nation's biggest charities rose slightly last year after falling in 2002, according to an annual survey by a publication that tracks nonprofit

groups. The study released by *The Chronicle of Philanthropy* found that donations to the 400 largest nonprofit organizations increased by 2.3 percent in 2003, to more than $47 billion. In the previous year, donations fell 1.2 percent, primarily because of troubled economic times.

The FairTax brings equity to charitable contributions and creates a supercharged charitable contribution.

Even if we assume that taxpayers are encouraged to give only because of the charitable contribution deduction, the staff neglects to note that the vast majority of contributors to charity today do not receive any tax advantage for their donations. The charitable contribution is limited to those who happen to itemize (typically those who are affluent enough to own real estate). According to the IRS Statistics of Income, there were 45,572,589 out of 82,909,453 tax payers that took the standard deduction.



Indeed, only 40,443,074 taxpayers took the charitable deduction.[1] Since only itemizers may take the charitable contribution, only about 31 percent of all taxpayers who filed returns were eligible to take the charitable deduction.[2] The relative ratio of itemizers to non-itemizers has remained relatively stable over the near term. Under current income tax law, the staff should be consistent and point out that most taxpayers have the greatest disincentive to give under their logic: they *cannot* deduct charitable contributions but must contribute with after-income tax and after-payroll tax dollars.

If the staff were honest, they would embrace the FairTax. The majority of charitable contributions today come from *non-itemizers* who would, for the first time under the FairTax, not have to make charitable contributions with after-tax dollars. Under the FairTax, all wage earners will be taking home their entire paycheck, and have

[1] Individual Income Tax Returns: Selected Income and Tax Items for Specified Tax Years, 1985-2002. SOI Bulletin, Historical Table, Spring 2004.

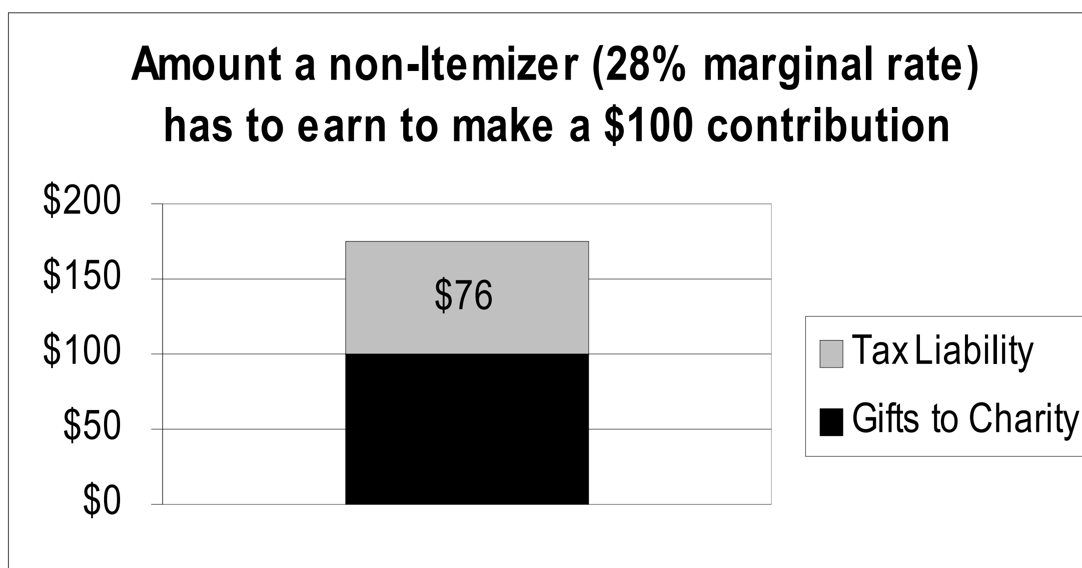
[2] Ibid

that entire paycheck from which to give. For families of modest means, whose charitable giving is often a very high percentage of their income, this is a substantial increase in available funds.

Under the current system, the charitable deduction tries to accomplish the same thing with the deduction, but falls measurably short. Even for the minority of Americans who are itemizers, the deduction weakly offsets only a portion of the donor's tax liability. For example, percentage ceilings limit individual contributions today – even if a taxpayer itemizes. Contributions are limited to 50 percent or less of adjusted gross income. This percentage is ten percent for corporations. These ceilings all disappear under the FairTax. And most importantly, under the current law taxpayers lucky enough to be able to deduct charitable contributions still can't deduct them against payroll taxes. Thus, the incentive for giving to charitable organizations will not be diminished in any respect by the FairTax. It will increase. For both less affluent taxpayers who do not itemize and itemizers alike, *the cost of charitable giving will actually go down* under The Fair Tax because everyone will be able to give to their churches or other charitable organizations from *pre-tax dollars*. Most taxpayers, especially lower income individuals, therefore, simply pay a greater portion of their tax liability in payroll taxes as opposed to income taxes.

Let's visualize this effect through the use of a chart. To begin with, the most important question with respect to the charitable contributions is not how the tax code treats a contribution, but rather how much a taxpayer has at his or her disposal to contribute. In other words, what must a taxpayer earn in order to make that contribution?

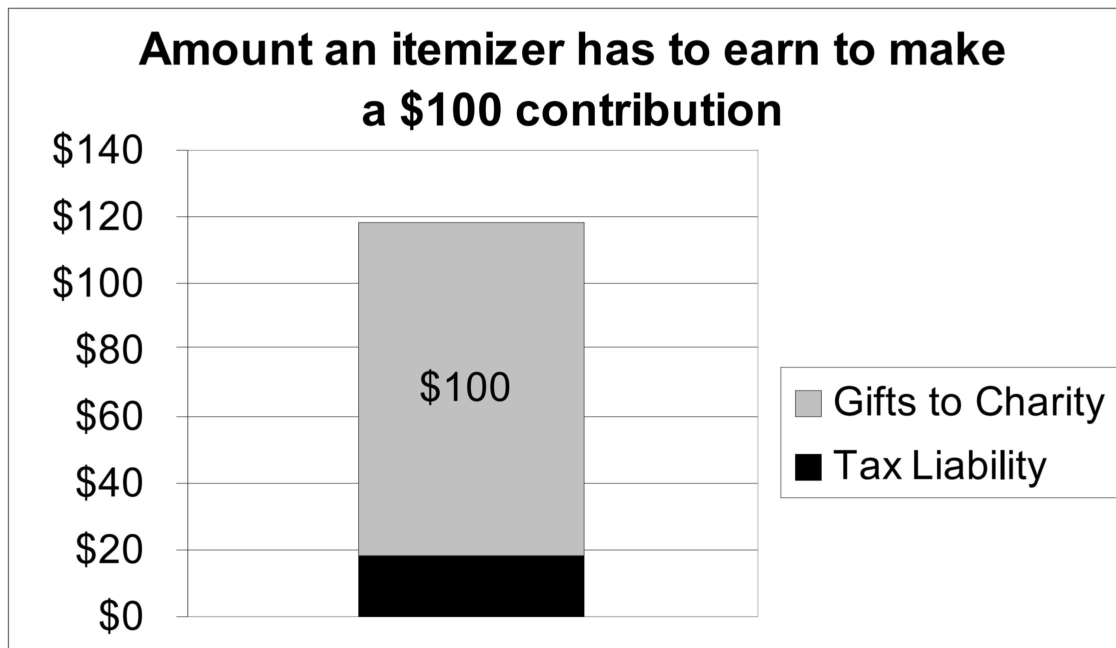
The graph below depicts the effect of the income tax and the payroll tax on the earnings of a taxpayer who does not itemize, but who is in a 28 percent tax bracket. The combined effect of the 15.3 percent payroll tax (assuming the employee pays it) and the 28 percent marginal tax bracket means that the taxpayer must earn $176 to make a $100 contribution to charity. In other words, the government effectively imposes a $76 excise tax on the taxpayer's gift to the charitable organization.



Of taxpayers who are eligible to itemize, the interaction of complex additional restrictions apply to further erode the benefit of the deduction. For example, if a donor contributes appreciated property that is considered "ordinary income-type property,"[3] as opposed to a long-term capital gain, the donor must reduce the gift by the amount of ordinary income that would have been recognized if the property were sold. Hence, gifts of inventory, art works, letters, and other similar property created by or for the taxpayer are severely limited to exclude appreciation.

Corporations are limited when making contributions of inventory or depreciable real property to one-half of the ordinary gain that would have been realized if sold.[4] Moreover, the value of gifts of tangible personal property and gifts to certain private foundations must be reduced by the "total amount of the gain that would have been long-term capital gains if the property were sold for its then fair market value on the date it was contributed".[5] Gifts to the top 400 charities accounted for nearly one-fifth of the $241 billion given to all of the nation's 850,000 charities last year. Most of the donations come from individuals; the rest are from foundations and private companies. Individuals are subject to a deduction ceiling based on the type of property contributed and the type of charity to which the contribution is made – a ceiling that can be as low as 20 percent of the individual's adjusted gross income. These are just a few of the restrictions.

The graph below depicts what an itemizing taxpayer must earn today to donate $100 to charity.



Now let us consider what happens under the FairTax consumption tax. Under the FairTax, as we noted, charitable contributions are not taxed – not at all. Under the FairTax that taxpayer would only need to earn $100 to contribute $100.

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[3]This provision is defined in Internal Revenue Code section 170(a) and the regulations thereunder.
[4] This complex provision is contained in IRC section 170(e)(3).
[5] IRC section 170(e)(1).

Charitable giving is closely tied to economic prosperity, not the deduction.

The linkage assumed by the staff between deductions and giving leads to absurd results. Since the staff believes a deduction is key, would the staff recommend a tax of 90 percent of income or an extraordinarily high death tax rate? At a 90 percent tax rate, giving – as opposed to consuming – would only cost 10 cents on the dollar. We could make the proceeds of our labor as painful as holding on to a hot pan. Of course, when taxpayers did "give," other taxpayers would have their taxes increased to make up the benefit the donors received.[6] Thus, the Democratic staff is saying that a taxpayer is inclined to be charitable since he can, in a sense, be charitable with other taxpayers' money. Under the Democratic staff's plan, the wealthier you are, the greater the government values your opinion, the greater your matching resources from the pool of unwitting accomplices, and the more other taxpayers need to subsidize your generosity.

Such reasoning is not only wrongheaded, it makes no sense economically. As the fortunes of the country go, so go the contributions to philanthropic causes. In fact, after years of analysis, we can be a whole lot more specific: as the Gross Domestic Product changes, so goes approximately 2 percent of the total value of the goods and services to philanthropic causes. Total philanthropy as a percentage of GDP has held steady at around 2 percent for at least two decades.[7] Although the tax code has changed frequently and dramatically over the past 23 years, giving as a share of personal income has hovered around 1.83 percent. This measure reached as high as 1.95 percent (in 1989) and as low as 1.71 percent (in 1985, the year before non-itemizers' ability to deduct charitable contributions was permitted). The narrow range has persisted even though the top marginal rate has fluctuated in that period between 28 and 70 percent.

Because of the importance of the relationship between giving and income, slight shifts in GDP represent considerable dollars in charitable giving. For example, one quarter of 1 percent of GDP at $11 trillion (the 2003 level) equals $27.5 billion.[8] As GDP goes, so eventually does voluntary support.

So at least the data suggest that in order to consider the effect of tax reform on charities, we must consider the effect of tax reform on economic growth. Giving is more dependent on how much donors have to give than how much the government will match their contributions with the taxes of middle income taxpayers. Replacing the income tax with the FairTax will dramatically improve the standard of living of the American people. Economic studies have been done on this as well. Work by Harvard economist Dale Jorgenson shows a quick 9 to 13 percent increase in the GDP after passage of the Fair Tax[9]; similarly, Boston University economist Laurence Kotlikoff predicts a 7 to 14 percent increase.[10] These gains are in addition to the increases that would have been achieved under current income tax law. Even a study by Nathan Associates funded by

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[6] Charitable contributions are, of course, a tax expenditure.

[7] Giving USA Foundation, 1997. AAFRC Trust for Philanthropy, 1997,

[8]Voluntary Support of Education 1996, Council for Aid to Education. Other indicators include the stock market. The trough in giving between 1971 and 1984 coincided with a poorly performing stock market during the 1974-1982 period and two recessions. The dips and rises of the stock market are said to be mirrored by charitable support within a year

[9] Jorgenson, Dale W. National Tax Research Committee. See also, "The Economic Impact of Fundamental Taxing Consumption", Dale W. Jorgenson, Testimony before the House Ways and Means Committee, March 27, 1996 and "The Economic Impact of Fundamental Tax Reform", Dale W. Jorgenson, Testimony before the House Ways and Means Committee, June 6, 1995.

sales tax opponents at the National Retail Institute shows that the economy would be one to five percent larger under a sales tax than in the absence of reform.[11] Americans are always generous, but the key to sustaining their giving is a booming economy.

Several more points should be mentioned.

A large source of income for universities, colleges, and other training institutions is tuition payments. Under current law, tuition payments are not deductible, not creditable, and must be paid with after-tax dollars. Under The Fair Tax, all payments for tuition and training are considered investments in human capital and not taxable. Voluntary services provided to non-profits today under the income tax system are discouraged because out-of-pocket expenditures are not fully deductible. Under the FairTax, such expenditures would be from pre-tax earnings.

Non-religious charities such as universities and museums, for example, rely little on donative sources of giving. The large non-profits (whose assets account for more than three-fourths of the total assets of tax exempt charitable organizations) received only 7.8 percent of their income in 1998 from direct public contributions. Revenues from program services and membership, on the other hand, made up 74.5 percent of total revenues.[13, 14]

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[10] Kotlikoff, Lawrence J.National Tax Research Committee. See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute Policy Analysis.

[11] "Replacing the Federal Income Tax with a Consumption-Based Tax System", prepared by Nathan Associates for the National Retail Institute (1996), p. 29. To achieve results as modest as they did, Nathan Associates made virtually every judgment call in a way that would show lower gains from implementing a sales tax. They assumed away international capital flows (p. 30) so all increased investment in their model must be financed by lower domestic consumption rather than partially by foreign investment, assumed low elasticities, seemingly made no acknowledgment of the reduction in the tax bias against work and the concomitant increase in employment and hours worked and so on. The study shows, even with all of these adverse assumptions, that consumption will return to levels that would be achieved in the absence of reform by the fourth year and will be higher every year thereafter (after having fallen a maximum of less than one percent (p. 32)).

[13]Large non-profits are those 501(c)(3)s with over $50 million in assets. Percentages are calculated from data in Table 16.—Nonprofit Charitable Organization and Domestic Private Foundation Information Returns, and Tax-Exempt Organization Business Income Tax Returns: Selected Financial Data for Specified Years, 1985-2002.

[14]For tax exempt charitable organizations, as a whole, contributions from direct public support accounted for 11.12% of total revenue for reporting year 1998. Revenues from program services and membership accounted for 68% of total revenues. Percentages are calculated from data in Table 16.—Nonprofit Charitable Organization and Domestic Private Foundation Information Returns, and Tax-Exempt Organization Business Income Tax Returns: Selected Financial Data for Specified Years, 1985-2002.

[13] Large non-profits are those with over $50 million in assets and account for 2% of all 501(c)(3)s. Percentages are calculated from source data presented in Table 16.--Nonprofit Charitable Organization and Domestic Private Foundation Information Returns, and Tax-Exempt Organization Business Income Tax Returns: Selected Financial Data for Specified Income Years, 1985-2000. [14] For tax exempt charitable organizations, as a whole, contributions from direct public support accounted for 11.12% of total revenue for reporting year 1998. Revenues from program services and membership accounted for 68% of total revenues. Percentages are calculated from source data presented in IRS Statistics of Income, Fall, 2001.

H. Encouraging Savings

It leaves one scratching one's head with incredulity, but the Democratic staff also argues the FairTax would put America's retirement security at risk. They make this claim even though:

- The FairTax is the only plan that removes the penalty on savings by taxing consumption and not the returns to capital multiple times
- Americans today are saving at what only can be considered Depression Era levels,
- The complexity of our pension laws is one large detriment to savings,
- America's beleaguered Social Security system will come under extreme pressure as the leading edge of the baby boom starts retiring in 2008

Is America's savings rate dependent on the income tax and the morass of pension laws now installed in the Code as the Democratic staff would have us believe? Would savings really decline as a result of a reduction in marginal rates and a shift to a simple tax system that treats all savings as if they were in IRAs, as the Democratic staff asserts?

The answer is clearly "no". The whole idea of the FairTax is to shift the tax system away from favoring consumption, and towards a neutral tax system that encourages taxpayers to work, create income, and save the fruits of their labor. High marginal rates, multiple taxation of income, and the punitive treatment of savings, coupled with the thousands of pages of pension regulations they support and nurture, actually reduce our national savings rate. America's pension laws may compile a weighty book, but they are a poor pedestal from which to criticize a tax system based on not taxing savings.

To try to understand the Democratic staff's tortuous and dubious conclusion, one must consider the source – a "1996" (sic) study[1] by the American Academy of Actuaries (AAA) which the staff commissioned. The collaboration between the partisan Democratic staff and the somewhat more objective AAA is not difficult to understand when one considers both share a desperation to defend the complicated barrage of laws we call our private pension system. Consider just how vital America's pension rules are to the actuarial profession and one begins to see why the AAA has such a vested interest in preserving that complexity off which their members feed. Actuaries serve many purposes, but a great number are independent consultants advising private companies (and sometimes governments as well) on pension programs and on a variety of other employee benefit arrangements. They not only help the staff of Congress design these complex programs by laying out the minefield, but they then hire themselves out as tax lawyers do to ensure that those employers wishing to save for their employees navigate through the thousands of pages of IRS regulations relating to pension law. Actuaries may serve many useful functions, but in the tax reform debate AAA scuttles its objectivity to act as a self-serving special interest group in the same way companies that produce tax preparation software, tax lawyers, tax accountants, and Treasury union employees might

[1] American Academy of Actuaries, Public Policy Monograph (Spring 1997 "Tax Reform and Impact on Employee Benefits."

be expected to oppose tax reform. Consider this statement from the AAA's public policy vision. Their mission is to (among other things):

> *… [P]rotect the profession and to increase the influence of the Academy and the actuarial profession in the creation of public policy that affects the profession.*
>
> *Advocate on behalf of the actuarial profession … to increase the recognition, appreciation, and use of actuaries in new areas of practice.*

Nothing could be of greater moment to the future of their profession than to defend the readily changing, complex, and confusing morass of laws and regulations that govern the employer provided pensions. One of these laws, "ERISA" the Employee Retirement Income Security Act,[2] was so complicated that even tax lawyers and actuaries referred to it as the "Every Ridiculous Idea Since Adam" Act. Because compliance with the nation's pension laws is complex, actuaries see their livelihood as dependent on the taxpayer's struggle to save tax free.

To use an industry specific analogy: the self-serving conclusion drawn by the actuaries is akin to failing to smell the coffee for want of counting the beans.

Arguments against the Democratic staff's position begin with the obvious bias of their chief witness but don't end there. Before indicting the association for conspiring with the Democratic staff to complicate a Code so the latter can blame it on Republicans, consider that what the Democratic staff implies the AAA concluded, isn't really what they concluded. Here is what they said in their conclusions:

> *The proposals could be helpful in simplifying the tax code, reducing tax rates, reducing inflationary pressures on health care costs, reducing government regulation of our lives, freeing up businesses to focus on their primary mission, and making people more independent and responsible for themselves. The tax code would be less likely to distort economic decision-making and might result in a more efficient allocation of our resources. The hoped-for efficiencies may depend on whether individuals, in the absence of incentives, will truly make decisions that are in their long-term best interest and whether individually optimal decisions are best for the society as a whole.*

While the conclusions they drew about fundamental tax reform are considerably more favorable than the partisan Congressional staff implied, the AAA and by extension the Democratic staff are still wrong in their analysis. This last sentence is of course the most telling. The hypothesis is that the government can increase savings by regulation, far better than the private sector can. The AAA went further.

> *Without clear tax advantages, many small employers would drop their pension plan. Larger employers also might follow suit if their competitors offered higher wages instead of pensions.*

The AAA has several recommendations for Congress.

> *Congress also might consider increasing excise taxes on early withdrawal from pension funds to preserve those funds for retirement income. An increased excise tax would increase both national savings and tax revenue.*

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[2] 29 U. S. C. §§ 1000 *et seq*.

And to make tax-deferred savings even more attractive, the AAA recommends that the tax advantages for pension funding would also be greater if Congress were only to impose higher marginal rates.[3] According to the philosophy of the staff, the higher the marginal rates (the penalty for not putting funds in a retirement account), the higher a penalty for early withdrawal, and the more regulation there is, the more people will want to save. And just as important: the more they will need the advice of actuaries to save.

The conclusion drawn by the Democratic staff and the AAA stems from their shared erroneous concept of the role of government with respect to private savings. Under the staff's view of the world, the government is considered to have given the taxpayer a gift by allowing us to save free of immediate income taxation. That is why they consider pensions a "tax expenditure" to encourage private plans in the form of foregone revenue from a tax based on a broad definition of income. Deductions for savings – like employer provided pension coverage – are an exception to the rule that all income is taxable. Private savings are encouraged by making the prospect of keeping that income, or of withdrawing that income from savings, punitive. The fact that the staff gives taxpayers special dispensation from taxation gives them the right by executive decree to justify whether the retirement plan serves what they consider to be the public interest, and to impose a complex regime of limitations and restrictions to ensure the plan matches their view of equity and redistribution.

Perhaps the greatest distinction can be drawn between the Democratic staff's world view here and the view of supporters of a national sales tax. FairTax supporters do not see the ability of someone to save as a privilege to be bestowed by the Congress, as a king would grant a charter. AFFT believes that pension plans and savings in general would benefit from lower marginal rates on work and productivity, and no taxation on any form of savings. FairTax has the simplest pension plan in the world; one in which everyone can participate without having to hire a pension actuary; and one simple rule – if you don't spend it on yourself, after you've met life's necessities, they don't get to tax it. AFFT believes that income is not truly income until we consume it for our own well being. If we invest it, our income is not taxed. If we bank it, our income is not taxed. If we give it to charity, our income is not taxed. If we educate ourselves with it (another form of investment – in ourselves), our income is not taxed. If we put it in a pension fund, our income is not taxed. If we stuff it in our mattresses, our income is not taxed.

AFFT believes national savings would improve if we remove the impediments to savings, adopt neutral tax rules, foster continued public education, and allow "the invisible hand of greed" described by Adam Smith to encourage employers and labor to pursue their enlightened self-interest. AFFT sees the justification of employer pension plans as emanating from a business choice to attract and maintain good employees, and savings in general as a personal choice to improve retirement security for one's family.

The view shared by the Democratic staff is not only wrong philosophically, it is demonstrably wrong in practice. The staff's view is incorrect because the restrictions on savings have failed to encourage greater savings. As noted above and elsewhere, the income tax retards economic performance by creating a significant bias against saving

[3] Id. at p. 3.

and investment by double, triple or even quadruple taxing it. First, wage and salary income is included in the income tax base when it is earned originally. If wages and salaries are saved or invested, the benefits of that deferred consumption are taxed again and again and sometimes again still.[4] The income of any investment is taxed. If an income-producing asset, such as a stock or bond, equipment or real estate, is sold for more than it was purchased, the increase in the value of the capital investment – the capital gain – is taxed a third time.[5] Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Inter-corporate dividends are also often subject to tax, creating yet another level of taxation. When the taxpayer dies, the estate and gift tax may tax his or her investments yet again.[6]

Harvard economist Dale Jorgenson estimates that yearly real investment would initially increase 80 percent relative to the investment that would be made under present law. This relative increase would gradually decline over the period of a decade to 20 percent.[7] Boston University economist Laurence Kotlikoff also predicts an investment boom. Measuring the change in the size of the overall capital stock (rather than annual investment), he predicts that the capital stock will be 17 percent larger than it would be under the present tax system within 10 years.[8] Because the FairTax is neutral toward savings and an income tax is not, the attractiveness of savings relative to consumption will increase.

Moreover, economic studies show that savings are responsive to changes in tax treatment and that savings rates are closely correlated to the return on savings, although savings is not nearly as responsive as investment.[9] The chart on the following page illustrates the close connection between savings rates and the return to savings. After having fallen steadily for almost two decades, U.S. savings rates – the U.S. supply of capital – will improve under the FairTax because the return to savings will increase.[10]

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[4] This aspect of the income tax alters the relative price of present versus future consumption in favor of current consumption.

[5] This actually amounts to taxing the same income twice. An increase in the value of the asset is caused by an increase in the present value of expected future income stream. That income will be taxed when earned. The capital gains tax is a tax on the capitalization of that future income stream. The income tax then taxes both the capitalization of a future income stream and the future income stream itself.

[6] For a more detailed discussion of the impact of a sales tax on investment see "Impact of the FairTax on Investment," Americans For Fair Taxation.

[7] Jorgenson, Dale W. Harvard University, "The Impact of Taxing Consumption," Testimony before the Committee on Ways and Means, U.S. House of Representatives, March 27, 1996.

[8] Kotlikoff, Laurence J. Boston University, Testimony before the Committee on Ways and Means, U.S. House of Representatives, June 6, 1995. See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute.

[9] Robbins, Gary and Aldona "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.

[10] For a more detailed discussion of the impact of a sales tax on savings and interest rates, see "Impact of the FairTax on Interest Rates," Americans For Fair Taxation.

The partisan staff's position is also wrong as a matter of equity. Under the very study the staff cited, the AAA still felt inclined to offer this valid but subdued criticism for our current laws:

- Gaps in coverage are quite pronounced among small employers and also part-time and temporary workers
- Pensions can be inadequate for those employees who cannot contribute much to their 401(k) plan
- Defined benefit plans can lock people into jobs they don't like (or they will lose their pension benefits; while lump-sum cash-out provisions can encourage employees to change jobs just to get the lump sum
- Pension plans discourage employees from being responsible about saving for their own retirement

To take a specific example of these inequities, nondiscrimination rules, key-employee clauses, and plan administration costs drive many small business owners away from pension plans offered by larger firms. Congress recognized this problem and created, in 1996, the Savings Incentive Match Plan (SIMPLE). SIMPLE pension plans allow small business owners with less than 100 employees to save, in pre-tax dollars, for retirement without the costly administrative burden associated with traditional 401(k) plans. Unfortunately, while acknowledging the heavy burden that the smallest businesses face in administering popular pension plans, legislators only went halfway. Under current rules, SIMPLE participants can only contribute half the amount in pre-tax dollars that 401 (k) plans allow. Is this fair? Probably not, under the Democratic staff's view that savings is a gift to be bestowed by Congress, they have difficulty leveling the playing field because it would "cost too much."

And even the staff's own boss, Ranking Member Charlie Rangel, must agree on the inequities. On Tuesday, May 6, 2003, he wrote a "Dear Colleague letter" pointing out that companies protect millions of dollars in pension benefits for a few top executives - out of the reach of creditors and immune from stock market volatility – while the retirement savings of thousands of loyal employees are negotiated away or undercut. In his own words:

- Delta Air Lines set aside $4.5 million in a pension trust for CEO Leo Mullin, even as the company's stock tanked, the company lost over a billion dollars, and thousands of employees were laid off
- United Airlines gave its CEO, Glenn Tilton, a $4.5 million pension just before the company went into bankruptcy
- US Airways gave its CEO, Stephen Wolf, a $15 million golden nest egg last year, six months before the company filed for bankruptcy

Meanwhile, the Congress places severe limits on how many rank-and-file employees (who had no role in management) may earn in pension benefits, they are often kept in the dark about complex pension schemes set up exclusively for executives at their

companies. Further, older workers may have their hard-earned nest eggs decimated when their employer converts their traditional pension plan to cash balance plans.

The complexity itself is a roadblock. As the secretary of the retirement committee at Loyola University told *Institutional Investor* magazine, "I've been in the pension business twenty years, and we're reaching the point where I can't even understand my actuary." A host of new laws has made pension design an increasingly tedious maze. Although the reward for passing through the maze is a substantial tax benefit, many employers are deciding the price is excessive. The percentage of workers covered by a pension, which grew fairly steadily since World War II, has come to a virtual standstill. And the roadblock caused by complexity can't be eased by more complexity. In a 1999 Employee Benefit Research Institute survey of small business, employers with 5 to 100 employees cited uncertain revenue and workforce characteristics as primary reasons for not offering a plan.[11] Indeed, 55 percent of firms cited revenue-related or employee-related reasons as the most important reason for not offering a plan. Although only 10 percent cited the expense of company contributions as the most important reason for not offering a plan, 51 percent said it was a major reason.

[11] David L. Kennell, Arnold T. Brooks, and Terry Savela, Retirement Plan Coverage in Small and Large Firms, final report submitted to the Office of Advocacy, U.S. Small Business Administration (Vienna, Va.: Lewin-ICF, June 1992), p. III.27.

If the staff were honest with themselves and, more importantly, took off the mantle of their important role, they would agree with AFFT. When income is placed in pension savings, the extra layer of personal tax that is otherwise imposed on saving is avoided and there is neutrality between current and deferred consumption. That is, the assets in qualified pension accounts can be largely considered to be taxed in a manner consistent with a consumption tax.[12] Why not extend that treatment to the society as a whole in the fairest manner possible?

[12] This analogy breaks down, however, since a large fraction of pension assets are corporate equities which returns have already been subject to the corporate income tax.

V. The General Impact of the FairTax Proposal

A. The FairTax: The Only Plan that Untaxes the Poor
B. State and Local Governments
C. Why Seniors Support the FairTax
D. Benefits to Families with Children
E. Lowering the Cost of Health Care
F. Making Housing More Affordable
G. Effect on Energy
H. Encouraging Savings
I. Increasing the Contributions to Charity

A. The FairTax: All the Name Implies

The staff makes the blanket assertion that the FairTax would cause a regressive shift of the tax burden. To justify that assertion, they dust off a 1983 statement by designers of the flat tax, Robert E. Hall and Alvin Rabushka. They assert an absurd claim that the effective rate of the FairTax would have to be 30 percent for the lowest income individuals, who have consumption expenditures in excess of income. However, Drs. Hall and Rabushka's quote was about the flat tax not the FairTax, and decades-old statements about a completely separate tax plan are not only disingenuous, they are irrelevant.

The "unfairness" claim is used as a form of "fly-by policy shooting" without defining it

While the statements of the staff as to distribution of the FairTax may be irrelevant, the question of distributional fairness is not irrelevant to the tax reform debate. Distribution is one of the key issues of the reform debate. "Who are the winners?" and "Who are the losers?" will be the resounding questions. Unfortunately, they will most be raised by politicians who want a quick answer, TV commentators and pundits who demand six-second sound bites to equal their audience's attention span, think tanks who want to raise funds based on their spin on injustice, trade groups who want to rile their members, journalists seeking to answer the question within the confines of an 800-word essay, and advocates who want to commit the equivalent of a fly-by policy shooting.

What makes the issue of fairness so contentious is that it has always been more susceptible to politics than economic analysis because politicians fail to define what it means Anyone can assert that their plans are "fairly distributed" in an absence of criteria regarding what 'fairness' means or how to measure it. Like God in warfare, fairness is invoked by all sides in tax reform debates, with each advocate confident that fairness is theirs alone. The larger the tax policy issue – from expansion of private pension plans, to repeal of the corporate tax, to lowering marginal rates – the more important the question of distribution.

Examine a bit of history. Consider the following exclamations of two politicians who share the first name of Richard.

While one fumed:

> *Our current income tax system is broken…. It is complex and unfair, and robs working families of the benefits of a growing and prosperous economy. … [My plan] would be fair, simple and tame the IRS.*[1]

The other retorted:

> *[They] are now calling for abolishing the tax code – they're trying to divert attention away from their own plans, which are unfair… I showed that you could reform the system making it fair …. Today I'm calling [on them] to get serious about reform – to stop demagogueing (sic) and start acting. My plan would … mak[e] the tax system fair ….*[2]

Although both Richards were adamant about the 'fairness' of their reform plans, that is where the commonality ceased. The first Richard was Dick Armey; the latter, Dick Gephardt. And their enthusiasm about the "fairness" of their own tax reform plan (with their chorus of journalists and lobbyists singing the refrain)[3] was only to be matched by their vitriolic maligning of the 'unfairness' of their opponent's plan.[4]

Consider the Bush-Kerry Presidential debate. Mr. Bush wants an undefined tax system and we are pleased to say that he believes the FairTax is "an interesting idea." Mr. Kerry believes that a 40 percent tax is fair for working Americans. However, multi-millionaire Vice Presidential candidate John Edwards paid at a mere 7 percent rate last year. While Mr. Kerry has failed to produce complete income tax returns for both he and Mrs. Kerry, the information they did produce indicates that his wife's effective federal income tax rate was around 12 percent (less than that for the average American even though she was reported to be among the 400 richest Americans). We doubt that she paid payroll taxes. Moreover, if their tax rate proposals were current law, Senator and Mrs. Kerry would likely not pay much more in taxes. That is because most of the Kerry's

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[1] March 12, 1997 press release of Richard Armey.

[2] Address by House Democratic Leader Richard A. Gephardt, Commonwealth Club of California (as set forth in http://www.house.gov/democrats/taxplan/ref980120.html).

[3] N.Y. Times, July 11, 1995, "[Gephardt's tax plan] establishes an important principle that Republicans would like to ignore. True tax reform should preserve fairness by making high-income families bear a heavier burden than poor families."
Also - Oliphant, Thomas, *Gephardt's Version of Flat Tax is Fairer to Middle Class,* Boston Globe, July 11, 1995 ("Gephardt's proposal is in the context of an economic strategy aimed at boosting the living standards of working families."
Also - Saunders, Debra, *Gephardt's Genius*, San Francisco Chronicle, February 8, 1998, "[W]hen the Cato Institute held a forum on taxation last week, I felt I was doing wonk penance just by showing up...Then, surprise, surprise: Gephardt's proposed tax reform package made me sit tall in my seat.... Hallelujah." Also - Democratic Leadership Council Update, Simple But Fair: Gephardt Gets It Right On Tax Reform (December 12, 1997).

[4] "Under a pure flat tax, everyone receives equal treatment under the law because they pay the same flat tax rate. However, most flat tax proposals allow individuals to deduct a standard allowance (based on family size) from their wages in determining their taxable income. Individuals only owe taxes on the income above the standard allowance. Those earning low or middle-income wages receive the largest reduction in average tax rates because the family allowance constitutes a large portion of their total income. Therefore, progressivity – not regressivity – better defines most of the proposed flat tax systems."
http://flattax.house.gov/stratlk.htm

wealth is in tax-sheltered investments – such as tax free municipal bonds – which would not be affected by Mr. Kerry's tax increase proposals.

Politicians must define what they mean by fairness before stating a plan isn't fair

While in the flurry of their "fly-by-shooting" report, the Democratic staff of the Ways and Means Committee failed to define what they mean by 'fairness' in a tax system. However, an honest inquiry into fairness – if a tax reform debate is to be an honest debate – must be preceded by a declaration of the criteria on which that evaluation is based.

There are many ways to look at fairness. To a small business owner, 'fairness' is defined partly as simplicity (even at the expense of occasional arbitrariness). The tax laws must be comprehensible enough to at least not trap the wary. Small firms might think it unfair, for example, because they endure the lion's share of the 34 million civil penalties issued with the frequency of parking tickets. 'Fairness' might also mean lower compliance costs to small businesses. To a family firm it might mean parity, so they are allowed the same tax-favored fringe benefits available to the executives of a Fortune 100 company, like an allowance for commuting expenses or cafeteria plans, which in the case of small firms are automatically considered discriminatory. To a farmer, it might mean that U.S. taxes wouldn't be buried in the price of their produce when they sell that produce at prices established by international commodity markets. For families seeking to get ahead, it might mean greater control over their paychecks to determine when to pay tax and how much to pay, instead of delegating assumptions over tax credits and other benefits to the best lobbyists. To someone seeking to save for a home, it might mean a system that allows them to save with pre-tax earnings or to pay home mortgage interest with pre-payroll tax dollars (as under one national sales tax plan, the FairTax).[5] It might mean that the taxes we pay – the highest in U.S. history – should be transparent. For other taxpayers, it might mean equal treatment for similarly situated taxpayers or equitable enforcement or less intrusiveness.

Although the income tax system cannot be considered truly 'fair' under any of these criteria, the debate will most likely center around vertical distributional fairness: is the tax burden distributed 'fairly?' Will each of us pay our 'fair' share?

However, this begs other questions the staff fails to answer. If we are all products of dead philosophers, as Keynes once said, the Democratic staff might want to try to explain which theory of intellectual history – from Locke, to Mill, to Adam Smith, to Wicksell to Pigou – it ascribes to. One theory of distributive justice is the so-called *benefit rule*, where one's taxes should equate to the *benefit* received in return. Other economists have also noted the theory of 'least total sacrifice,' which argued that we

[5]The FairTax has been outlined in previous issues of Tax Notes. It is the pure consumption tax. In sum, it would repeal all Federal taxes except excise taxes in favor a national sales tax. It would therefore repeal the payroll taxes and self-employment taxes, the individual income taxes, the corporate taxes, the capital gains taxes and the death taxes. *See* Mastromarco and Burton, *Criticism of the Sales Tax for Residential Real Estate Isn't Built on a Solid Foundation*, Tax Notes, July 6, 1998, p. 1779. *See* also Mastromarco, *The FairTax and Tax Compliance: An Analytical Perspective*, Tax Notes, April 20, 1998, p. 379. Also, see http://www.fairtax.org.

should distribute the tax burden so as to minimize the aggregate loss. Others tout welfare maximization; the greatest good for the greatest number.

Each of these approaches to tax fairness is at some odds with each other,[6] but each seems to be better served by a sales tax. One's personal consumption might be congruous with government apparatus that supports that consumption. Consumption of energy and products might also cause certain externalities that can only be captured by the consumption tax.[7] As for welfare maximization, no tax reform plan could reach Pareto optimality because somewhere, someone might actually lose; however, a consumption tax comes closer to creating greater good for the greatest number because of its effect on economic growth. There is an almost universal view of economists that a consumption tax will result in higher real wages and disposable income for almost everyone over time (except perhaps tax lawyers, tax lobbyists, tax shelter promoters and former members of the tax-writing committees) and result in greater collection efficiency.

In the final analysis, the question of equity in distribution may boil down to three inquiries. The first inquiry resides within the realm of philosophy or politics, beyond the expertise of tax lawyers or economists. It is simply this: if we could accurately estimate the economic incidence of the tax, how much *should* people of varying wealth, income or consumption pay and on what basis? One would be surprised to discover that few politicians and other participants in the debate seem able or willing to answer that basic question. Certainly, the Democratic staff has not done so. Then again, neither do they have to answer that question. They can hide behind the fact that nobody agrees upon the answer to the next inquiry: how much *do* people of varying wealth, income or consumption pay under today's plan or alternative plans? And finally, perhaps, there ought to be a third inquiry: does the tax system curtail or improve prospects for upward mobility?

Evaluating Distributional Equity is Far More Involved than the Staff Implies

Proponents of the income tax system would like the standards of distributional equity to be pre-ordained by framing the question. In the view of proponents of the income tax system (and a large number of disciples), an alternative tax system can be 'fair' only if is based on income; more particularly, if it is progressive as to income; more particularly still, if taxpayers within certain income brackets write checks at least as large as they do today. They would argue the more we increase the legal obligation to pay taxes based upon income earned during a closed annual period, the fairer the tax will be. However, many false assumptions buttress this view because they have not yet been questioned by those institutions which serve the role of advising policymakers.

Americans For Fair Taxation has a few questions to ask of these assumptions:

- Why must we take for granted that distributional equity must be judged from an income tax point of view? Why doesn't what we consume for personal gratification beyond the necessities of life more accurately define our ability to pay tax than what we earn in a given year?

[6] Ballard, Charles L., *The Marginal Efficiency Cost of Redistribution*, 78 American Economic Review 1019 (1988).
[7] Mussgrave, *Progressive Taxation, Equity and Tax Design*, in Tax Progressivity and Income Inequality, Chapter 10, p. 342 (Cambridge University Press, J. Slemrod ed. (1996).

- Don't income tax distribution models underestimate the regressivity of the current system by failing to account for a number of features, such as hidden (i.e., implicit) corporate and personal income taxes, payroll taxes, self-employment taxes, and compliance costs that are embedded in the price of consumables but don't show up as taxes paid by the consumer on their Form 1040? Doesn't this make the current income tax system also partly a consumption tax without a rebate mechanism?
- Don't income tax distribution tables fail to account for the higher user cost of capital when we tax savings and investment multiple times today? Is the tax always paid by the person who writes the check to the 'I.R.S.'?
- Don't studies on consumption taxes fail to accurately measure the progressiveness of a sales tax by assuming that taxpayers are frozen in perpetuity in income brackets when, in fact, there is significant movement up and down the income scale year-to-year?
- Is not an equally important determinant of 'fairness' whether a particular tax scheme affords greater or lesser upward mobility?
- Shouldn't the impact on disposable income be more relevant than taxes paid? If a proposal will improve the standard of living of most Americans (rich, middle class, and poor alike) should we really oppose it because of a static distributional table we know is biased or worse, grossly inaccurate and misleading?

Yet, under any reasonable definition of fairness, the FairTax wins

Americans For Fair Taxation has no problem defining the criteria on which we measure fairness because, under any definition, the plan is superior to the current income tax.

The FairTax untaxes the poor. A fair tax relieves tax on those who need it most – the working poor – and imposes tax on the idle rich. The current tax system taxes the poor and even those who live only on social Security because of the hidden taxes built into the prices of all products. The working poor also pay heavy payroll taxes. The FairTax completely untaxes the poor and allows everyone to buy their necessities tax-free. That the FairTax untaxes the poor is not just a nice slogan the Democratic staff forgot to mention, it reflects our view that a tax system should be based on the ability to pay – that it should not burden individuals before they have met their own sustenance in life.

The FairTax would give every citizen a tax rebate at the beginning of each month. For example, the rebate would be $479 per month for a family of four.[8] With the rebate, no American would pay taxes on the purchase of basic necessities. The poor and those who get only Social Security would pay no tax at all. The idle rich who spend inherited wealth will pay their share under the FairTax because, in contrast to today, when heirs spend inherited wealth they will pay FairTax on each item purchased.

The income tax system seeks to attain progressivity by taxing savings and investment as well as income, by taxing income (which includes savings and investment) at steeply progressive rates and by credits and exemptions, like the Earned Income Tax Credit. Progressivity in the FairTax is achieved in several other ways: by taxing

[8]The HHS poverty level for a family of four is $24,980. By providing a monthly rebate equal to 23 percent of $24,980 divided by 12, the FairTax exempts the first $24,980 of consumption by every family from tax.

consumed wealth, by not taxing savings (since that only takes resources from the economy necessary to promote growth and productivity), by repealing the payroll taxes, by effectively repealing the hidden taxes in goods and services, by giving individuals maximum choice to pay the tax or to save or invest, and by basing the tax on consumption above the poverty line to ensure that only those with the ability to pay, actually pay.

The rebate of the sales tax on necessities means that higher consumption families would pay higher average tax rates. For example, because their first $24,980 was not taxed, a family of four spending $49,960 would pay an 11½ percent tax on their taxable purchases. A family that spent four times the poverty level ($99,920) would pay an average tax rate of 17 ¼ percent.

The FairTax taxes consumption: the best measure of one's ability to pay.

Taxes paid as a function of some concept of annual taxable income or adjusted gross income or net income is the way in which the Democratic staff would prefer to look at the distribution of taxes. However, it is a flawed way.

Often wealth – which itself may or may not be a fairer determination of one's ability to pay – is not even captured in the income tax. Individuals rich in personal wealth may have very little income. That is because wealth is defined in assets that they hold – their homes, properties, securities, collectibles, and other items – which may or may not have been earned by them and which may or may not generate income. These wealthy individuals can often choose whether or not to create taxable income, since they can restructure their affairs to avoid receiving current taxable income. Far more than the poor or the middle class, the wealthy have the ability to control income flows (as we legally define it) appreciation vs. consumption. It is one of the reasons why Mrs. Kerry paid at a tax rate that is less than a college student on a summer job.

How much income someone happens to make in any given period is, at best, an incomplete measure of one's ability to pay. In individual cases it is not even roughly accurate. Proponents of a consumption tax propose that there is no greater measurement of the equity of a tax system than what one individual consumes for their own personal well-being over the course of their lifetime. When you think about it, why would we ever tax income in the first place? Why punish what we need – work, savings, production, and self-sufficiency? If, instead of consuming his income, a rich person gives his money to charity or builds a job-producing factory, why should we punish that choice by taxing it? We should tax what people take out of the economy for their own personal use, not what people produce for society. That's exactly what the FairTax does.

If income is not consumed, then it is either saved or invested or provided to charitable causes (or government) to fund the consumption of others. The return on savings and investment will either be used to fund future consumption or reinvested to increase productivity and output. If it is saved or invested and is not profitable, it has at least been available to the economy. If we tax income and savings, we have simply taxed deferred consumption. And those that are deferring consumption are doing so because they elect not to consume it for themselves immediately, but to make the resource available for others.

The FairTax removes the tax on upward mobility. One of the key questions concerning distribution is glossed over in the Democratic "study": Does the tax system curtail or improve prospects for upward mobility? No more fundamental question exists. Whether our tax system holds someone down or helps them to advance should underlie all of our considerations on distributional fairness and our notions of justice. It is one of the reasons why our current income tax is so repugnant to immigrants and the hard-working poor. While there is much mobility today – due both to life cycle changes in income and movements up and down the wealth slope – the truth is that we could hardly have devised a tax system that does a better job of locking an individual within an income group while making it appear that we are helping those who want to excel. If we intentionally set out to make it difficult for a taxpayer to advance to another income level, we would design a system exactly as we have done.

To improve one's material position, to move from one income level to another, one must typically make more money or save more money in a given period of time than others. But the income tax zeroes in on those who try to improve their financial condition, not those who have already obtained wealth. To improve one's standard of living, to 'catch up' to a wealthier pool, it is self evident that – unless one wins the lottery, marries well, or is born with a silver spoon in their mouth – one must earn greater income in a shorter period of time or save more. However, through the application of steeply progressive rates and by taxing savings multiple times, our income tax system provides increased resistance when someone seeks to better his or her lot in life through higher wages or earnings. The income tax does not really tax the ability to pay; instead, it taxes changes in wealth that occur generally from income and it favors consumption over savings that would help amass wealth.

To make this point clearer, we can take a simple example with manufactured data. Let us take the case of two imaginary individuals, Mr. Bjorn Silverspoon and Mr. Justin Struggles, who are true to their names. Bjorn is born to a silver spoon, so to speak. He spends all that he earns in consumption. Struggles is a successful small business person, whose income fluctuates and who struggles to save what is a considerably high rate of savings only to seek to approach Silverspoon's wealth.

Under the existing system, Mr. Struggles would pay much more tax than Mr. Silverspoon. Is Mr. Struggles somehow in a better financial condition than Mr. Silverspoon? Should he be penalized because he was seeking to advance his material wealth for himself and his children? For every foot Mr. Silverspoon climbed; Mr. Struggles had to take more steps to acquire the same wealth, he didn't spend in an extravagant manner. In fact, his "spending" was really mostly savings, plowed back into his business. A sales tax would not impose this disproportionate burden upon Mr. Struggles. In fact, under the FairTax the opposite occurs: Silverspoon would actually pay more in taxes because he is consuming more. That is why the income tax plan is the best plan for the already established who fear competition from those who seek to join their ranks.

For many, wage income is the only vehicle of transport to a more prosperous life – apart from perhaps a lucky childbirth or a financially rewarding marriage that are often themselves by-products of wealth. Yet our income and payroll tax system targets those

who try to improve their lot in life by disproportionately penalizing those that have the longest distance to travel and the highest mountain to climb from one financial tier to another. The income tax literally taxes our vehicle of transport from one standard of living to another. In contrast, the FairTax exempts education, recognizing that education is an investment in our nation's intellectual capital, is every bit as important as our investment in physical capital and allows the American people to save and invest in their families' future without being punished by punitive taxation.

The resistance to excel is increased for the poorest Americans seeking to escape poverty. To see the fallacy of the progressive rate structure as a 'fair' tax system, look at the Earned Income Tax Credit. The EITC is supposed to entice families to stay in the working world at low income levels. But, if decisions are made at the margin, what is most disturbing is what happens to marginal rates under the income tax with the EITC. Marginal rates for those qualified under the EITC are perhaps the highest marginal rates applicable to almost any other income group. Under current law, marginal tax rates for single parents with incomes above $12,260 are 36 percent and for those over $14,350, 51.4 percent. These rates would be 29 and 44 percent, respectively, if only the employee share of the payroll tax is considered. Since, however, most economists believe that the employer's share is borne by employees as lower wages, it is appropriate to consider all payroll taxes. These marginal rates fall to 30.3 percent at $30,095.

Such steeply progressive marginal tax rates punish lower middle class workers. Once state taxes are considered, many lower middle income single parents keep only 40 cents of each dollar they earn. Once the costs of commuting, child care and other work-related expenses are considered, choosing to work makes very little economic sense for single parent families. Under the FairTax, marginal tax rates are lower for all workers in this group earning over $9,930 (in many cases the marginal tax rates under the FairTax are about half of current law).

The FairTax removes the tax on upward mobility. While we could hardly have devised a worse system for upward mobility than the income tax, we could hardly devise a system that permits greater mobility than a sales tax. Once we have exempted the necessities of life from tax, a sales tax, by design, permits maximum maneuverability.

The FairTax enables taxpayers to save tax free, as if there were in effect a universal, unlimited IRA. There will be no more restrictions on what to save or how to save or on who can save. One will pay a tax only if one chooses to spend beyond the necessities of life. However, if one chooses to earn more, save for the future, give away wealth so others can advance, or educate themselves, one will pay no tax. The FairTax places the choice to pay taxes largely in the hands of the taxpayer. It provides individuals with maximum choice over what to do with their income: they can consume or save and their untaxed savings can accumulate faster. If one chooses to consume for his or her own benefit, beyond the necessities of life, one will pay a tax.

When compliance costs are considered in addition to examining how taxes are distributed, the staff should also look to who bears the burden of the $86 billion compliance cost imposed on individuals. Compliance costs are highly regressive. Because complying with tax laws represents a fixed cost for many individuals, lower income individuals bear a greater relative compliance burden than higher income individuals. A Tax Foundation study for 2002 has found that taxpayers with adjusted

gross incomes under $20,000 incur a compliance cost of 4.53 percent of income compared to only 0.29 percent for taxpayers with adjusted gross incomes over $200,000. Nearly half of all the cost savings resulting from tax simplification would go to taxpayers with less than $40,000 adjusted gross income. In previous research, the Tax Foundation found this to be true in corporate compliance costs as well. In fact, in 1996, small corporations – those with less than $1 million in assets – spent at least 27 times more on compliance costs as a percentage of assets than the largest U.S. corporations.

When the drag the current system imposes on the economy is considered, as explained further above and below**,** most economists believe there would be a tangible benefit from a shift to a consumption tax – a boost to economic growth, real wages, and the capital stock. The battle to replace the current tax system with a consumption tax is partly a battle to improve the standard of living of the average American family. The poor are disproportionately hurt by economic downturns. They are the first to be laid off, the last to be rehired, and the least capable of weathering economic storms. The effect of a consumption tax on alleviating this hardship is not measured in tax distributional tables nor is the unnecessary deleterious effect of today's system. If the staff wants to accurately portray the income tax, it must take into account that retention of the current system will reduce real wages and economic well-being, having a regressive distributional impact.

B. State and Local Governments

The staff argues that the bill would impose a tax on all non-education expenditures of state and local governments. They argue that the bill would blow a tremendous hole in all state and local government budgets, and that it would be difficult for states to increase their local sales taxes given the new large Federal tax. They are wrong yet again.

For one thing, it is preferable to have a relatively stable source of federal tax revenue since it makes budgeting and planning easier and deficits less likely.

The sales tax base is unambiguously more stable than the income tax base.[9] Therefore, sales tax revenues would be more stable than income tax revenues. Consumption tax revenues would be roughly as stable as payroll tax revenues, but not more so. Some measures of variance show consumption to be less variable than payroll and some show payroll to be less variable than consumption.[10]

The staff is also incorrect in implying that the FairTax imposes a tax that does not currently exist. Government output is taxed today. We do not exempt government workers from the federal income and payroll taxes even though we could reduce both federal spending and federal tax revenues by paying them a lower tax-free wage. Workers for the government pay income taxes. We do not exempt defense contractors

[9] "The Relative Stability of a Consumption Tax Base and an Income Tax Base," Americans for Fair Taxation, June, 1997.

[10] The correlation between a steady growth rate exponential function and actual data is higher for consumption than payroll during the period 1959-1995. The correlation and Pearson statistic was .994 for consumption and .988 for wages. However, the standard deviation of consumption was 34% of the average and 29% of average for wages over the same period.

from tax in exchange for a lower price (and lower federal spending). Suppliers to the government pay income taxes and payroll taxes. It is in this way that the true opportunity cost of the spending is reflected in federal budgets.

Similarly, in a sales tax we do not want to exempt government output or consumption through government from tax. Otherwise there will be a strong incentive to consume through the medium of government. Government purchases should be taxed. And government output as measured by the wages paid to its employees should be taxed. This tax, of course, is being paid by the government to itself just like the income and payroll taxes on government employees today. This process is really an accounting mechanism that forces the government to strip out the imbedded costs and prevents the government from underpricing its services compared to private industry.[11]

Finally, the staff errs when it asserts that it would be difficult for states to increase their local sales taxes given the new large federal tax.

The staff overlooks that many American taxpayers would consider that a benefit. The staff also overlooks that states would likely not have to increase their sales tax rate; they would instead flatten their base by taxing services. While it is true the early sales taxes in the 1930's were applicable only to tangible goods, it is now settled that the consumption of services ought to be part of the base. For example, why would we want to tax a riding lawnmower, but fail to tax a lawn cutting service? Or, more germane to our "discussion," why would we want to tax the purchase of a software system to assist a taxpayer in complying with the income tax, but fail to tax expensive advice from tax lawyers on how to minimize tax? The national retail sales tax, unlike some state taxes, disposes of this issue by assuming that services and goods are interchangeable, taxing services in the same way as our income tax or a VAT taxes services.

If states adopted a FairTax base, they would also eliminate the need to draw a distinction between taxable and nontaxable services. Difficulties in the definition of taxable services at the state level have resulted from states' tendencies to unnecessarily exempt certain services from the taxing net, to include business inputs as taxable items, and to apply the service tax to interstate services. None of these problems is present under the FairTax. It requires little more than the application of the sales tax rate to the price of the consumed item, irrespective of its nature as a good or service.

The FairTax offers state and local governments the opportunity to repeal their income taxes as well. The chart below shows, on an aggregate basis, that if all states conformed the definition of their respective state sales tax base to the FairTax definition, states could maintain existing revenue from their state and local general sales taxes *and*

[11] If the sales tax exempted government output from tax, unlike the income and payroll taxes and government spending was held constant, we would in effect see an increase in government's claim on the rest of society roughly equal to the income and payroll taxes paid by government, government suppliers and government workers today. The sales tax on government output would not require more spending. Since the tax is imposed by government on itself, if the tax is no net higher than the income and payroll taxes imposed today, revenues will go up by that amount. In fact, we could triple the sales tax on federal government output and it would not cost the government anything since its revenues would go up by a corresponding amount, but this would inaccurately reflect the true opportunity cost of the labor and capital that is being used by the government.

provide a rebate to all of their residents *and* replace the revenue from both state and local income taxes with a rate of 6.97 percent.

State/Local Revenue Options under the FairTax

Combined Totals for all State and Local Governments	Amount
General Sales Taxes	222,986,687,000
Income Taxes (individual & corporate)	231,009,996,000
Taxes to be replaced	**453,996,683,000**
Total FairTax Base	8,264,000,000,000
Total FairTax Base (after rebate)	6,517,900,000,000
Aggregate state FairTax Rate to replace income taxes	5.49%
Aggregate state FairTax Rate to replace income taxes and provide rebate	**6.97%**

Source: Revenue data from the US Census, State and Local Government Finances, 2001-2002, Table 1. FairTax base and rebate computations based on Burton, D. and Mastromarco, D.,"Emancipating America From the Income Tax: How A National Sales Tax Would Work," Cato Policy Analysis No. 272, April 15, 1997.

C. Why Seniors Support the FairTax

The Democratic staff makes a number of errors concerning seniors. They state that seniors would be subject to "double taxation." To tout the virtues of the income tax, they falsely claim that seniors are exempt from the payment of tax on pensions and that they can deduct medical care and long-term care. They further mislead the reader stating that seniors would be taxed on their Social Security benefits and would have to pay tax on drugs, hospital, and nursing home care, as well as doctor visits.

This is just plain wrong once again. Americans For Fair Taxation has many seniors as members, and for good reason. The greatest gift these seniors can give is not to saddle succeeding generations with a broken tax system. But there are other reasons many seniors support the FairTax. For seniors, our broken system presents unusual conundrums. For example, consider a senior who is sitting on a capital asset. If they sell it, they will be hit with capital gains taxes and any unspent capital eventually with the death tax. If they don't sell it, their heirs will be hit with the death tax. That is why many seniors are sitting on bad investments because the tax laws tell them there is a penalty for getting out.

Senior citizens are becoming a larger portion of the overall population. In 1970, those over 65 years of age were 9.8 percent of the population. By 1995, seniors were 12.7 percent of the population. 13 years from now, seniors will account for 13.3 percent of the population and in 2020, they will account for 16.5 percent.[12]

[12] Middle Series, U.S. Bureau of the Census, Statistical Abstract of the United States, 1996, Tables 814 and 17, pp. 15 and 17.

The average household money income of those over 65 is about 63 percent of the average of all households.[13] At any given time, a lower proportion of seniors are poor than in any other age group. However, seniors are more represented in the long-term poor than other adults but less represented than children.[14] In terms of financial assets held, those 55 - 64 years old are the wealthiest age group, with those 65-74 years old next.[15] In terms of non-financial assets held, those 55 - 64 years old are the wealthiest age group, with those aged 65 - 74 slightly below the 35 - 44 year old group.[16]

Under the FairTax plan, senior citizens, like others, will receive a cash rebate effectively exempting consumption up to the poverty level from tax. The sales tax rebate is equal to the sales tax that would be paid on expenditures up to the federal poverty level. It is paid monthly in advance. Thus, poor seniors will pay no sales tax. A household spending twice the federal poverty level would pay an effective tax rate of 11½ percent.[17]

Because income and payroll taxes are embedded in the price of everything we purchase, it is unclear whether prices will increase once the income and payroll taxes are removed and the sales tax is added. They may not increase at all because pre-sales-tax prices may fall once the income and payroll taxes are repealed. Nevertheless, the FairTax plan makes sure that the Social Security benefits would be adjusted so that benefits will increase to the extent, if any, that the sales tax results in higher tax-inclusive prices. The income tax imposed on Social Security benefits will be repealed.

The income tax imposed on investment income and pension benefits or IRA withdrawals will be repealed. An income tax deduction was taken for contributions to most of these plans. All beneficiaries and owners of these plans expected to pay trillions of dollars in income tax on them upon withdrawal and will not be required to do so since the income tax is being repealed.

Repeal of the corporate and individual income tax and the estate and gift tax will have a substantial positive impact on the stock market.[18] Those seniors that own stocks either directly or through mutual funds, Individual Retirement Accounts, 401(k) plans or otherwise will experience significant gains. More seniors own stocks, mutual funds or have IRAs than other age groups.[18] In addition, unrealized capital gains that would have been subject to the income tax when realized will no longer be taxed.

The FairTax plan imposes a sales tax on newly constructed homes but exempts existing homes and other used property from any sales tax. Currently, equity payments on homes must be paid from after-income tax and after-payroll tax earnings (i.e., principal payments are not deductible). The purchase of existing housing is thus subject to the income tax. All owners of existing homes will experience large capital gains due to the repeal of the income tax and implementation of the FairTax plan. Seniors have

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[13] U.S. Bureau of the Census, Statistical Abstract of the United States, 1996, Table 712, p. 463.
[14] U.S. Bureau of the Census, Statistical Abstract of the United States, 1996, Table 737, p. 475.
[15] U.S. Bureau of Labor Statistics, Statistical Abstract of the United States, 1996, Table 773, p. 509.
[16] U.S. Bureau of Labor Statistics, Statistical Abstract of the United States, 1996, Table 741, p. 477.
[17] For a more detailed discussion of the rebate and fairness issues generally, "The National Retail Sales Tax: Fair, Simple, Efficient," AFFT Position Paper and "Effective Tax Rates under Present Tax Law, the NRST and the Armey Flat Tax," AFFT Position Paper.
[18] "The Impact of a National Retail Sales Tax on the Stock and Bond Market," AFFT position paper.
[18] U.S. Bureau of Labor Statistics, Statistical Abstract of the United States, 1996, Table 773, p. 509.

dramatically higher homeownership rates than other age groups (81 percent for seniors compared to 65 percent on average).[19] Homes are often a family's largest asset.[20] Gains are likely to be in the 20 percent range.

Under the FairTax plan, the estate and gift tax would be repealed. The need for small businesses and farmers to engage in expensive estate planning involving attorneys, complex estate freeze transactions, and expensive life insurance plans in anticipation of future estate and gift tax liability would disappear.[21] Heirs would no longer need to sell the business or farm out of the family or borrow heavily, putting the business at risk, to pay the estate tax.

A sales tax will make the economy much more dynamic and prosperous. Consequently, federal tax revenues will grow and spending will be under less upward pressure and the deficit will decline. Budget pressure on entitlement spending, already significant, will become much more pronounced once the baby boom starts retiring in 2008 in 4 short years. The economic growth a sales tax would cause would make it substantially less likely that federal budget pressures will result in Medicare or Social Security benefits cuts or reduce their severity.

According to work by Stanford University economist Joseph Kahn, those seniors with a net worth over $400 thousand (nearly four times the median) may see a reduction in their purchasing power. The largest decline in purchasing power, about 3.5 percent, is for those with a net worth above about $700 thousand. The primary reason for this effect is that wealth, spent for consumption purposes, which is held in non-tax deferred accounts like IRAs will be taxed when spent under a sales tax and would not be taxed further under an income tax.[22]

Seniors will be able to take comfort in the fact that their children and grandchildren will no longer be laboring under the yoke of the income tax and will once again be able to see their standard of living improve, one generation to the next.

Although the FairTax national sales tax plan would repeal both the federal income tax and payroll taxes, social Security or Medicare benefits would remain the same under the FairTax plan as they are under present law.[23] Currently the Social Security system is funded by a 12.4 percent payroll tax imposed on the first $87,900 of wages (2004). The Medicare program is funded by a 2.9 percent payroll tax on all wages. Both of these

[19] Statistical Abstract of the United States, 1996, Table 1192, p. 720. Seniors age 65-69 (81%), age 70-74 ~~(80.9%) and age 75 and ab~~ove (74.6%).
[20] Statistical Abstract of the United States, 1996, Table
[21] Beach,William W. "The Case for Repealing the Estate Tax," The Heritage Foundation, August 21, 1996, estimates using both the Washington University Macro Model and the U.S. Macro Model of Wharton Econometric Forecasting that repeal of the estate and gift tax would increase Gross Domestic Product by $11 billion per year, create 145,000 new jobs, increase personal income by $8 billion per year and increase federal revenues marginally.
[22] "Examining a Change to a National Retail Sales Tax Regime: Impact on Households," November 1996.
[23] Social Security benefits would be calculated using the same method as present law, based on an annual report from employers to the Social Security Administration indicating wages paid. The definition of self-employment income is changed slightly.

taxes are evenly divided between employers and employees.[24] Self-employed persons pay a separate tax equal to the combined employer and employee tax.

Although the Social Security and Medicare payroll taxes would be repealed, the funds necessary to support these programs would come from a portion of the revenues raised by the national sales tax. Under the FairTax plan, the same amount of revenue as would have been raised by existing payroll taxes would be deposited in the Social Security and Medicare Trust Funds.

Thus, the FairTax plan does not affect the Social Security or Medicare programs except that these programs will be funded by sales tax revenues instead of payroll taxes.

D. Benefits to Families with Children

The Democratic staff asserts the FairTax would be bad for families with children mainly because under the FairTax, there would be no need for the $1,000 per child credit.

However, it is hard to determine how the staff could again make such a blanket assertion. The national retail sales tax would repeal the 15.3 percent payroll tax, which is the largest tax that many families bear, as well as the income tax. What families earn would be what they keep. Interest rates will fall by 25 to 30 percent as the tax premium is removed from interest rates so homeownership would be easier. Families would no longer be compelled to deal with an intrusive, complex income tax system. Only businesses would need to fill out federal tax forms. Families will be able to save for children's educations without being forced to buy that education with what remains after taxes. Currently, a family must finance primary, secondary or university level educational expenses out of after-income tax dollars. Under the national sales tax, education expenditures are treated as an investment in human capital and not taxed. A national sales tax would dramatically reduce the compliance burden on family-owned small businesses. The repeal of the estate and gift tax would eliminate the need for family-owned small businesses to be sold out of the family to pay the estate tax.

And of course, the FairTax is indexed by family size. No family would pay tax on the purchase of basic necessities. A rebate of sales tax would be provided to all families on expenditures up to the federal poverty level. The rebate would be paid monthly in advance to every family. A family of four spending $24,980 per year would have an effective FairTax rate of 0% since they would receive an annual rebate equal to the taxes owed on that amount. Likewise, a family of four spending $50,000, would pay an effective tax rate of 11.5 percent on their taxable purchases, since their first $24,980 of spending was not taxed.

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[24] Most economists believe that the employer portion of the payroll tax is actually borne by employees in the form of lower wages.

FairTax Rebate Schedule: 2004

Single head of household			Married couple		
Family size	Annual consumption allowance	Annual rebate	Family size	Annual consumption allowance	Annual rebate
1 person	$9,310	$2,141	N/A	N/A	N/A
Plus 1 child	$12,490	$2,873	Couple	$18,620	$4,283
Plus 2 children	$15,670	$3,604	Plus 1 child	$21,800	$5,014
Plus 3 children	$18,850	$4,336	Plus 2 children	$24,980	$5,745
Plus 4 children	$22,030	$5,067	Plus 3 children	$28,160	$6,477
Plus 5 children	$25,210	$5,798	Plus 4 children	$31,340	$7,208
Plus 6 children	$28,390	$6,530	Plus 5 children	$34,520	$7,940
Plus 7 children	$31,570	$7,261	Plus 6 children	$37,700	$8,671

Source: Department of Health and Human Services, Poverty Level Guidelines, 2004.

But perhaps most importantly, families would benefit from a growing economy and more and better jobs. Real wages would increase. Families would once again start to see significant, sustained improvement in their standard of living. All known economic studies predict a much healthier economy under the FairTax. Typical estimates are that the economy will be 10 to 14 percent larger than it would have been under the income tax within 10 years. Consumption, savings, and investment will grow very substantially. Some studies show the potential gains to be much higher. Real wages will increase.

E. Lowering the Cost of Health Care

The staff believes that the Fair Tax would cause the health care sky to fall down. That is because they claim the FairTax would tax doctor's services, hospitals or long term care and prescription drugs, tax Medicare and eliminate current law incentives for employer provided healthcare.

Once again, their analysis is at the same time wrong and overly simplistic. Today we do tax doctor's services, hospitals and long term care facilities, as well as prescription drugs. That is because we tax the wages of doctors, hospital employees, and long term health facilities. For-profit hospitals, health insurance companies, and pharmaceutical companies are subject to the corporate income tax. Of course, the most fundamental change would be that all participants in the health care industry whether hospitals, pharmaceutical companies, insurance companies, doctors, nurses or other workers would pay neither individual nor corporate income taxes, nor payroll taxes. The income tax is embedded in the price of everything we buy. Once the current tax system is repealed, pre-sales tax prices will come down because these embedded tax costs will have been removed. Harvard economist Dale Jorgenson estimates that the pre-tax prices in the services industry generally would fall by 25 percent after a sales tax replaced the current tax system.[26] Prices in most other industries will fall 20 to 25 percent as well.

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[26] . Jorgenson, Dale W. "The Economic Impact of the National Retail Sales Tax," May 1997 prepared for the National Tax Research Committee.

The staff is correct, however, in that the FairTax would change the system of incentives from current law. The value of employer provided health insurance and the benefits received thereunder are today not taxable to the employee as income.[27] In contrast, if an individual purchases health insurance for himself, he must purchase it out of after-tax dollars. Accordingly, there is a large tax advantage to employer-provided health insurance as opposed to either employee-purchased insurance or cash compensation.

Under a national retail sales tax, purchases of health care services made directly by an individual would be subject to sales tax just as they generally must be paid from after-income tax dollars today. Health insurance premiums would be subject to tax.[25] Reimbursements to the insured person would be eligible for a tax credit (in effect refunding the tax paid when the individual paid for the medical services directly).[26] If the insurance company paid a doctor or hospital directly, the transaction would not be subject to tax (since the tax on those medical services would have been paid by taxing the entire insurance premium which funded the purchase of the services).[27]

The staff's analysis, however, must go much deeper because many experts believe these incentives have perversely driven up the cost of health care today to the point where it is unaffordable to employers, to the unemployed or to those who are working uninsured. There is no question that the current tax system drives the structure of the existing health care system, but there is also little question that this has been a key factor in increasing health care costs. This effect of the FairTax would be for the better.

Consider these statistics. In 1980, the U.S. spent 9.2 percent of its Gross Domestic Product (GDP) on health care. In 1994, the United States spent more than 14 percent of GDP on health care (or one in every seven dollars spent).[28] We spend a higher percentage of our income on health care than any other country on earth, including Canada (9.8), Great Britain (6.9), France (9.7), Germany (8.6) or Japan (7.3).[29] The U.S spends $3,498 per person, 52 percent more per person than the next highest, Switzerland, at $2,294.[30] U.S. *public* health care expenditures are comparable to those of other industrialized countries. Government in the U.S. spent 6.7 percent of GDP on health care compared to Canada (7.0) Great Britain (5.8), France (7.6), Germany (6.0), or Japan (6.3).[31] U.S. life expectancy at birth is 76.0 years compared to Canada (79.1) Great Britain (76.4), France (78.4), Germany (76.0) or Japan (79.6).[32] The infant mortality rate in the U.S. is 6.7, compared to Canada (6.1) Great Britain (6.4), France (6.2), Germany

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[27] Internal Revenue Code §104(a)(3).

[25] This would be equally true of health insurance policies purchased by an employer on behalf of an employee.

[26] Administratively, the insurer would include the credit in the claim payment to the insured and receive a refund on its return. The insurer could elect not to do so and have the insured file for the credit.

[27] For a more detailed discussion, see "The Impact of a National Sales Tax on the Financial Services Industries," AFFT position paper.

[28] Organization for Cooperation and Economic Development (OECD), Statistical Abstract of the United States, 1996, Table 1332, p. 834.

[29] Ibid.

[30] Ibid. 1994 figures. *Compare:* Sweden ($1,348), Canada ($2,010), Great Britain ($1,211), France ($1,866), Germany ($1,816), Japan ($1,481) or Spain ($971).

[31] Ibid.

[32] U.S. Bureau of the Census, Statistical Abstract of the United States, 1996, Table 1327, p. 831. 1996 figures. *Compare:* Hong Kong (82.8 years), Australia (80.4 years), Burkina (43.2 years), Malawi (36.2 years), Zambia (36.3 years).

(6.0) or Japan (6.9).[33] The U.S. spends about 50 percent more than other industrialized countries on health care but has lower life expectancies and higher infant mortality than comparable countries. These are, admittedly, crude measures of the efficacy of a health care delivery system and in some respects the U.S. health care system is superior but it is a fact that the U.S. spends much more on health care than other industrialized countries and by at least two measures U.S. citizens fare worse.

A reasonable hypothesis is that the nature of the U.S. health care delivery system bears at least part of the responsibility for its relatively high costs.[34] More than half of health care expenditures in the U.S. are funded by the private marketplace. But, in large measure due to the distortions introduced by the tax system, it is not a normal market. Insured persons do not bear directly the costs of the insurance, employers do. More importantly, for insured persons once relatively small deductibles are met, the marginal cost of consuming health care services is quite small, reaching almost zero once the typical 80/20 co-payment is exhausted (typically at $1,000 to 2,000 out of pocket). There is very, very little cost consciousness among insured consumers of health care services. If the marginal cost of consuming a good is low relative to other goods, consumers will consume relatively more of it. Moreover, a consumer gains little or nothing, financially speaking, by minimizing the consumption of health care services. The recent Medical Savings Account (MSA) legislation is an attempt to address this problem. The advent of health maintenance organizations (HMOs) and preferred provider organizations or networks (PPOs) has introduced more significant price competition to the marketplace. Neither, however, have had a sustained impact on the high rate of health care cost increases.

The fact that most health insurance is employer provided means that employees experience reduced choice (the employer buys the insurance not the employee). The health insurance purchased by the employer is unlikely to meet the preferences of all or even many of its employees. It is, as one commentator put it, as if Ford Motor Company could tell you what car to drive.[35] In addition, since health insurance is linked to employment, those that develop health problems may experience health insurance problems relating to "pre-existing conditions" if they attempt to change jobs.

In summary, we have a market where there is restrained price competition, almost no publicly available information about the quality of health care providers, where insured consumers do not bear the financial burden of their purchase decisions and have virtually no incentive to economize in their use of health care services. To carry the car analogy a bit further, it would be as if your employer purchased your car for you but you can decide what extras you want at no cost to yourself (except for the first few hundred dollars). Moreover, you and your employer would have almost no information about the quality of the cars; except what you may have heard from your friends and the price of cars was set by a third party so there wasn't much your employer could do to cut his costs. Trying to compare the health care market to a more conventional market like the automobile market helps illustrate how unusual a market it really is.

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[33] Ibid. 1996 figures. Per 1,000 live births.

[34] See, e.g. David M. Cutler, "A Guide to Health Care Reform," Journal of Economic Perspective, Summer 1994, Vol. 8, No. 3, pp. 13-29.

[35] Bert Loftman, M.D., "Taxes and Health Care," Physicians Who Care Newsletter, Vol. 7, No. 1, Winter 1997, p.3.

A sales tax would eliminate the tax preference for health insurance. Health insurance and medical care would be treated for tax purposes like all other goods and services. This would change considerably the structure of the health care delivery system over time. There would no longer be a large tax reason for employers to provide health insurance. Many would continue to do so. Others would undoubtedly choose to get out of the health insurance purchasing business and provide money to their employees to buy their own. Employees that preferred to work for an employer that took care of this chore would tend to work for employers that did. Others would value the right to purchase the kind of insurance that they wanted rather than the kind that was bought for them by employers. Individual health insurance policies would probably come down in price as they become more common. Insurers would want to get their share of this growing, although highly price conscious market. Some individuals might purchase high deductible policies and use their time to shop more aggressively on price or minimize their use of health care, introducing more aggressive price competition to the health care marketplace.

Yes, the staff is correct that the health care marketplace would be very different than it is today. Health care providers that are more creative and more flexible will fare well in this new competitive environment. Those that are less able to adapt will not do as well. Equally as important, the introduction of a more fluid, competitive marketplace is likely to hold down health care costs and better and more efficiently meet consumers' needs.

F. Making Housing More Affordable

The staff continues its oversimplification of the FairTax and its unfair critique by stating that the FairTax would impose a "30 percent retail sales tax on all purchases of newly constructed homes" and repeals the ability to "deduct interest on home mortgages." What the staff failed to inform the reader is that under the FairTax, home purchases will be more tax advantaged than they are today. For working Americans, the "true cost" of buying a home will simply go down, making the American dream not only a reality, but an affordable reality sooner.

Consider that the mortgage interest deduction is truly very limited today. For instance, the intended result of the mortgage interest deduction is the non-taxation of mortgage interest (or more precisely, the funds used to pay mortgage interest). It offsets the income taxes that would otherwise be paid on income used to pay mortgage interest. It allows the payment of mortgage interest with "pre-tax" money. However, only 28 percent of all taxpayers utilized this exemption on their 2001 tax returns, and those who did still had to make their interest payments from after-payroll tax dollars. Because payroll taxes account for 43 percent of total income/payroll taxes, a taxpayer cannot take the mortgage interest deduction against the most significant form of taxes that apply to them – payroll taxes.

Under the FairTax plan, mortgage interest is simply not taxed – not at all. Because the FairTax repeals both the income tax and payroll taxes, interest payments would be made with both pre-income and pre-payroll tax dollars. In order for the income tax to treat interest that favorably, the mortgage interest deduction the staff referred to

would have to be applied to the payroll taxes as well as income taxes. Likewise, principal payments would be made with both pre-income tax and pre-payroll tax dollars. This dramatically reduces the true cost of purchasing a home. Investment property can be effectively expensed, since it is not subject to tax, and when sold, is not subject to capital gains. Used homes are not taxable to the buyer.

If the staff had done their homework, they would have understood that the most important measurement of the true cost of a home is the wages that the family has to earn to be able to purchase that home. Let's compare this for a family who buys a $153,800 home[36] today under the income/payroll tax system and under the FairTax. In the chart below we compare how much today's mortgage interest deduction benefits the homebuyer relative to the full nontaxation of interest and principal payments on mortgages under the FairTax. To purchase the $153,800 home mentioned above (assuming a 27 year term and mortgage rate of 6.0 percent), the prospective home buyer would have to pay $157,139 in interest in addition to the price of the home. To completely pay off this loan, our couple would have to earn $377,790 once employee payroll taxes and income taxes are taken into account.

Under the FairTax, our couple would need to earn $65,691 (or -17.4 percent) less income to buy the average U.S. house. That is a result of several factors. First, there is projected to be a 25 percent drop in home mortgage rates. Also, the interest payment would not have to be paid with after-payroll tax dollars.

Actual cost of purchasing $153,800 home
(Wages that must be earned to buy home)

Components of housing cost	**Income and payroll tax system**	**FairTax (25% mortgage interest rate drop)**
Home purchase price	**$ 153,800**	**$ 153,800**
Interest @ 6.0 for 27 years	**$ 157,139**	**$ 112,159**
FairTax on home purchase	**$ -**	**$ 46,140**
Payroll taxes on interest	**$ 12,021**	
Payroll taxes on principal	**$ 11,766**	
Income taxes on principal	**$ 43,064**	
Total taxes	**$ 66,851**	**$ 46,140**
Total housing cost including taxes	**$ 377,790**	**$ 312,099**

It is important to understand that this chart is extremely conservative because it does not take into account that the Fair Tax would reduce the cost of new home construction by eliminating the embedded income and payroll taxes. Like other businesses, homebuilders pay corporate taxes and payroll taxes that are embedded in

[36] This is the median price of existing homes in 2002 according to the National Assoc. of Home Builders.

producer prices. Economic research shows that with the repeal of the corporate income tax and payroll tax system, producer prices in the construction industry will decline by 24 percent.[37]

And it is also important to note that potential home buyers can save for the purchase of a home faster, which will increase and accelerate the volume of home sales. The current tax system takes three bites out of the savings apple. First, it taxes wages and salary income from which savings are generated. Second, it taxes the income earned from savings as that income is generated. And third, if the investment (a stock, bond, real property interest) is sold for more than it cost, the capital gain is taxed again.[43] Under the Fair Tax, a family can save for a down payment without fighting against cascading taxes on savings.

The FairTax is favorable for housing in other respects as well. For instance, the FairTax effectively permits the expensing of investment property, reducing its carrying costs. And the FairTax would not tax the returns to rental property, forcing landlords to reduce the rent they charge while receiving the same after-tax rate of return. Of course, the FairTax would also eliminate capital gains taxes as well.

G. Effect on Energy

The staff complains about the effect of the FairTax on energy and again errs when it states the FairTax would increase energy costs to consumers. There are two parts to the issue concerning the FairTax and energy: 1) what is the effect at the point of sale? and 2) what is the economic effect on the industry which influences price at the point of sale? The staff fails to understand that the two questions are related.

With respect to the effect on consumers at the point of retail sale, the staff again focuses on the fact that consumers would pay the FairTax on the purchase of energy, including gasoline, home heating oil, electricity and natural gas, and errs in implying this increases the cost to the consumer by 30 percent. Again, the staff fails to point out that consumers would also have more money in their pockets in which to purchase gasoline, home heating oil, electricity, and natural gas. That is because consumers would get to keep their entire paycheck under a system that does not impose payroll or income taxes. Today, consumers must pay for those services with what they have remaining after the tax has been applied to their earnings. Even taxpayers in the lowest 10 percent tax bracket would have to earn $1.34 to pay $1.00 under the current system, due to income and payroll taxes. Moreover, inasmuch as gasoline, home heating oil, electricity, and natural gas are factored into the poverty rebate as a necessary cost, consumers may actually view these services as untaxed under the FairTax. That is because the prebate provided by the FairTax is meant to hold the consumer harmless against purchases that comprise the necessities of life (without defining them).

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[37] Jorgenson, Dale, The Economic Impact of the National Retail Sales Tax, Final Report to Americans For Fair Taxation, May 18, 1997.

[43] Jorgenson, Dale, The Economic Impact of the National Retail Sales Tax, Final Report to Americans For Fair Taxation, May 18, 1997.

With respect to the effect on the industry, the staff ignores that the FairTax will repeal upstream taxes and onerous compliance costs. According to the latest SOI statistics, just to look at one facet of the energy business, oil and gas extraction, we find that there were 15,602 corporations engaged in that industry, with total receipts of $73.9 billion, which paid a tax of about $1.5 billion on $4 billion of income subject to tax.[38]

The taxes are only half of the story because the way they are levied imposes risks on the industry that consumers pay for. Oil and gas is a high risk enterprise, which makes the industry extremely sensitive to tax and other cost variations.[39] It is also a capital-intensive industry, with traditionally long term fixed costs. The oil and gas industry is disadvantaged by current tax law because the industry's high risk, highly capital-intensive character is adversely affected by unfavorable capital cost recovery rules. Some taxpayers may elect to use the relatively favorable "percentage depletion" method with respect to certain exploratory costs.[40] Intangible oil and gas geothermal well drilling and development costs are also capital expenditures.[41] Many oil and gas firms are also subject to the alternative minimum tax. The alternative minimum tax treats as a preference item the excess of percentage depletion over cost basis[42] and excess intangible drilling costs.[43] A significant fraction of oil and gas firms operate abroad. The international tax provisions of the income tax, besides being inordinately complex and expensive with which to comply, contain several adverse provisions directed at the oil and gas industry. For example, oil-related income of foreign controlled corporations is specifically targeted for taxation and is currently charged to the parent company.[44] In addition, the foreign tax credit is aggressively limited with respect to oil and gas income.[45]

The FairTax would improve the tax situation for the oil and gas industry in several respects. First, oil and gas would benefit, as all domestic industries, from sustained growth in the economy. All known economic studies predict growth from replacing the income tax with a consumption tax; indeed, economists typically estimate additional growth 10 to 14 percent greater within a decade.[46] Because the economy will grow, industrial production, travel, housing size, and the like will grow and demand for crude oil and gas will increase.

The oil and gas industry would benefit by never again having to pay U.S. corporate income taxes on either domestic or foreign production. Business-to-business

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[38] 2001 RETURNS OF ACTIVE CORPORATIONS Table 1–Number of Returns, Selected Receipts, Cost of Goods Sold, Net Income, Deficit, Income Subject to Tax, Total Income Tax Before Credits, Selected Credits, Total Income Tax After Credits, Total Assets, Net Worth, Depreciable Assets, Depreciation Deduction, and Coefficients of Variation, by Minor Industry

[39] Oil and gas prices are primarily set in international commodities products.

[40] See IRC §613.

[41] However, the law allows amortization (i.e. cost recovery) over a period of five years. See IRC §291(b).

[42] Except for independent oil and gas producers. See IRC §57(a)(1).

[43] See IRC §57(a)(2).

[44] Oil related income of controlled foreign corporations (CFCs) is generally treated as subpart F income and taxed currently to the parent even if the parent received no dividend or other income from the CFC. IRC §954(a)(5) and §954(g).

[45] See IRC §901(f) and §907.

[46] Dale W. Jorgenson, Harvard University, "The Economic Impact of the National Retail Sales Tax," unpublished report to Americans for Fair Taxation, November 25, 1996 estimates a 10.5 percent GDP increase; Laurence J Kotlikoff, Boston University, "Replacing the U.S. Federal Tax System with a Retail Sales Tax – The Macroeconomic and Distributional Impacts," unpublished report to Americans for Fair Taxation, December, 1996 estimates a 12 increase in GDP.

transactions would fall out of the taxing net. The retail sale of oil products and gas would be subject to sales tax, just like all other retail goods, but given the increase in consumers' after-tax income due to the repeal of the income tax and the increased demand resulting from a growing economy, demand for oil and gas will increase.

The industry would also be advantaged by more favorable interest rates. As noted previously, interest rates are expected to be reduced by between 25 to 30 percent under a national sales tax.[47] Although the costs of borrowing would no longer be "deductible", interest income would be paid from pre-tax earnings. Interest would also not be taxed to the recipient. As a result, investors will no longer need to charge a tax premium to achieve a particular after-tax rate of return, and interest rates fall toward the current tax-exempt rate.[48]

And oil and gas would enjoy a substantial reduction in cost stemming from transactional and compliance costs. For example, oil and gas companies who engage in international transactions will no longer need to be concerned with foreign sourcing rules, whether a foreign charge is an income tax or the calculation of the foreign tax credit. They will no longer be concerned with unfavorable capital cost recovery or alternative minimum tax rules. They would no longer need to spend resources complying with complex employee benefit, pension, and similar tax rules. They will not have to endure the unnecessary recordkeeping requirements, tax accounting and audits costs associated with the corporate income tax.

All of this means that oil and gas providers will have lower operating costs. In this competitive industry, these cost savings will be seen at the pump and on the American consumer's fuel bills.

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[47] For an more detailed discussion of the impact on a national sales tax on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?," Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27). See also, Martin Feldstein, "Effect of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research, Working Paper No. 5397 (December, 1995).

[48] This is sometimes described as removing the "tax wedge" from interest rates – the tax serves as a wedge between the gross or pre-tax return and the after-tax return.

VI. Effect on Specific Sectors of the Economy

A. Revitalizing U.S. Manufacturing

The Democratic staff expresses the opinion that the FairTax would be bad for the automobile industry. However, they do the American people a great disservice in their wrongful portrayal of how the FairTax affects American manufacturing and the automotive industry in particular. The FairTax is the best plan to revitalize the American manufacturing base lost to foreign competition, and return to America the high-wage manufacturing jobs that have been driven overseas – largely as a result of our current system.

The staff underestimated the problem of manufacturing today.

By stating that the FairTax would hurt domestic manufacturers, the Democratic staff ignores that there is literally a crisis in manufacturing today. As David Hartman has eloquently presented in his recent Tax Notes article:[1]

> *"...for the U.S. manufacturing sector the employment recession has been the longest and most severe since the Great Depression. Employment in manufacturing jobs fell 3.5 million workers, 19.7 percent of peak payroll in June 1998. As of May 2004, only 187,000 were re-employed, just 1 out of every 19 laid-off employees.[2] Manufacturing's dollar share of the U.S. economy has been in a relentless decline to less than 50 percent of what its share of Gross Domestic Product was in the 1950s."*

This trend is excused by sophisticates who tout the relatively greater productivity in manufacturing than experienced in the rest of the U.S. economy. But from the 1970s to present, an additional factor joined to exacerbate this trend: the growing relative competitive advantage of foreign competitors due to border-adjustable taxation not afforded U.S. manufacturers under the federal tax code. Today, U.S. companies are only producing the equivalent of $4 worth of every $5 of manufactured goods consumed in the U.S. The past full year, 2003, the U.S. trade deficit in goods was $549 billion, the bulk of which was due to the $469 billion manufacturing trade deficit.

The U.S. has a sizable negative trade balance in manufactured goods with every principal nation and region. The deficit on trade is approaching $600 billion per year, more than 5 percent of GDP, and the net amount of U.S. assets now owned by foreigners is currently estimated to total $3.5 trillion, roughly comparable in scale to the total privately owned portion of the U.S. federal debt. The National Association of Manufacturers warned earlier this year that "the country may be dropping below critical mass in manufacturing."

The deterioration of the U.S. manufacturing sector will diminish future progress and prosperity of the U.S. economy, and risk loss of a vital source of military security. Moreover, leading researchers and thinkers argue that the declining employment and earnings in U.S. manufacturing is a principal root cause for the declining share of U.S. income earned by blue collar workers. In 1980, the average individual manufacturing

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[1] Hartman, David A., "The Urgency of Border-Adjusted Federal Taxation," Tax Notes, September 6, 2004.

employee earned one-third more income than the median married family; by 2001 the median married U.S. family income was double the average income per manufacturing employee. The average factory wage per hour in real dollars declined 11.3 percent from 1978 to 2001, despite an increase of productivity by one-half in the business sector, and a doubling of productivity in manufacturing.

The staff fails to understand that the income tax system they defend has caused this decline.

The principal problem which lies at the roots of the U.S. manufacturing crisis is the federal tax structure of the U.S. compared to its foreign competitors; most particularly the advantage provided foreign competitors by border-adjustable taxes in the form of value added taxation. The United States, as the dominant economic and military superpower of the "Free World" led the movement to dismantle trade barriers. According to the OECD, its members had average tariff rates of 40 percent at the end of WWII. The U.S. average import duty on goods is currently 1.7 percent.

However, the decline of tariffs masked a trend which started in Europe toward the adoption of "border-adjustable taxation" in the form of Value Added Taxes (VAT). These taxes were purportedly adopted to "level the playing field" for cost of government welfare spending by destination taxation of consumption expenditures principally levied upon manufactured goods. However, because these VATs were determined to be "indirect taxation", the WTO enabled them to be rebated upon exports and levied upon imports. Today, the EU 15 has an average "standard" VAT of 19 percent. During the 1990s Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent respectively, and China adopted a 17 percent VAT in 1994. At the same time foreign governments have increased VATs, they have been reducing effective corporate income taxes. U.S. taxation of resident corporations' foreign income is causing a flight of corporations' headquarters to countries which exempt taxation of overseas income not allowed by the U.S. federal tax code.

The OECD's summary of its members' tax trends in "Revenue Statistics 1965 – 2002" clearly identifies the role of VAT's:

> *Despite a small recent fall, the share of taxes on consumption (general consumption taxes plus specific consumption taxes) hardly changed between 1975 and 1995. But the mix of taxes on goods and services has fundamentally changed. A fast growing revenue source has been general consumption taxes, especially the value-added tax (VAT) which is now found in twenty-nine of the thirty OECD countries. General consumption taxes presently produce 18 per cent of total tax revenue, compared with only 12 per cent in the mid-1960's. In fact, the substantially increased importance of the value added tax has everywhere served to counteract the diminishing share of specific consumption taxes such as excises and custom duties.*[2]

The only nation of the thirty OECD countries without equalizing border-adjustable federal taxation such as the VAT is, of course, the United States.

The U.S. is unnecessarily endangering its security and prosperity, and particularly the economic well-being of blue collar workers and their families, by failing to construct

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[2] Ibid.

a level playing field for U.S. manufacturers and corporations by adopting a destination-based consumption taxation such as the FairTax.

David A. Hartman recently studied how structural costs threaten U.S. manufacturing competitiveness using methodology prepared by the Manufacturing Alliance/MAPI for the National Association of Manufacturers in conjunction with a study they published in December 2003. This study, using labor "raw cost index" per hour, shows that the U.S. cost of $24.30 per labor hour exceeds the $19.30 per hour average of nine principal trade partners by $5.00 per hour. The study goes further to show that cost disadvantages targeted for remediation by NAM saddle U.S. manufacturers with added costs of regulation, energy, employee benefits (particularly health insurance), and difference in effective corporate income tax rates which NAM finds together add an additional equivalent of $4.45 per labor hour burden. However, Hartman argues, the average VAT imposed upon U.S. exports by OECD trade competitors is 17.7 percent , which expressed as MAPI's labor "raw cost" index is the equivalent of $14.76 per hour, over half again more than total MAPI determined labor and burden cost disadvantages. A conservative estimate of the average VAT rebated on OECD exports to the U.S. is $13.04 per hour in labor "raw cost" equivalent, nearly 40 percent more than the total of all MAPI adverse cost factors.

In effect, as the only OECD nation without border-adjustable taxation, the U.S. is the most profitable market for foreign competitors, including their home markets. Their sales have a competitive advantage compared to American firms to the extent of their VAT rebate (on average 17.7 percent). At the same, they enjoy the same advantage in protection in their home markets from U.S. competition as a consequence of the VAT added to U.S. imports. According to Mr. Hartman:

> *"The composite cost disadvantage facing U.S. manufacturers is unlikely to be remediable on any free market basis without effectively addressing the huge price advantage enjoyed by foreign competitors due to border adjustable VAT's. ... Supply side economic prescriptions – lower government spending, lower marginal income tax rates and deferred taxation of saving for investment – will definitely be helpful, but will not be sufficient to overcome VAT tax advantages of 17.7 percent on average for OECD competitors rebated on exports to the U.S., and added to imports from the U.S."*

The tax Code has caused that crisis. Today, there are crumbs of small benefits for manufacturers. Firms conducting research and experimentation are eligible for a paltry credit to the extent they increase their research expenditures over a moving base.[3] Manufacturers are generally subject to taxation on their worldwide income.[4] They receive, however, a credit for foreign income taxes paid, subject to limitation.[5] Manufacturers were eligible for a puny export incentive under the Foreign Sales Corporation (FSC) provisions that has just been repealed because it was ruled WTO illegal, and legions of American lobbyists sought desperately to preserve that small benefit. Congress recently just passed a hugely complex provision that would allow a deduction for U.S. domestic manufacturing activity. Not only will this provision fail of

[3] This credit applies to qualified scientific research and experimentation but not development costs. There are actually two alternative methods and sub-credits. Moreover, this credit has expired and then been re-enacted many times. Currently, research expenses incurred after June 30, 1996 and before June 1, 1997 are eligible. The latest tax bill is expected to renew the credit for some period. Internal Revenue Code §41.

[4] Subchapter N of the Internal Revenue Code.

[5] Internal Revenue Code §§901-908.

its own weight, but it may be WTO illegal just like the predecessor it replaces because it is not an indirect tax like the retail sales tax would be. Ironically, while we struggled to preserve a pittance of a benefit for U.S. manufacturing, every other OECD country removed most of their taxes (border-adjustable VATs) from their exported manufactured goods, including automobiles, in an incentive that is worth more than ten times that of the U.S. The fact is that the Congress is to blame today for outsourcing domestic manufacturing and jobs today because the tax Code has literally driven American manufacturing to foreign shores or caused them to lose market share to foreign manufacturers because the tax system imposes a much higher burden on U.S. production.

And as politicians complain about American companies that outsource to places like Bermuda, what they ought to be more concerned about is the jobs that leave our shores which we do not see. The foreign goods Americans buy that used to be built here. The plants that used to hire American workers now in foreign countries. Why does the Congress believe that Chrysler is now a German company headquartered in Germany?

When Americans For Fair Taxation states that the FairTax would indisputably be the best plan for U.S. manufacturing and labor, we urge the Congress to consider the following:

- The FairTax will repeal not only the corporate income tax, but also the payroll tax, the individual income tax, including capital gains taxes, the estate tax and gift tax, and the self-employment tax. Americans manufacturers will not mourn the loss of a few deductions when they pay no income tax.

By doing so, the U.S. will become the most attractive industrialized country in which to manufacture because it will be the only industrialized country with a zero rate of income tax on productive activity. In a sense, the U.S. will be the world's largest tax haven. Since the United States would be the only industrialized country with a zero rate of tax on investment, jobs lost to foreign producing will repatriate to our shores. American firms will be much more likely to build plants in the U.S. Foreign firms are likely to find the U.S. a highly attractive place to build their plants to serve U.S. and foreign markets, given the stable political environment, an educated workforce, the large domestic market, and the lack of an income tax. The construction and operation of these new plants would generate high-paying jobs.

- Having a zero rate of tax on manufacturers will lure additional capital to our shores.

This will further lower the costs of capital for those who need capital and end the hidden transfer of taxes from capital owners to capital users. The rich with the capital to invest will have more competition for capital markets as foreign investors find the U.S. an increasingly beneficial place to invest, pushing down interest rates further. As a result, the cost of capital will decline dramatically. Capital investment is the life-blood of manufacturing.[6] Replacing the current tax system with the FairTax would eliminate this

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[6]The income tax retards economic performance by creating a significant bias against saving and investment by double, triple or even quadruple taxation. First, wage and salary income is included in the income tax base when it is earned originally. If wages and salaries are saved or invested, the benefits of that deferred consumption are taxed again and again and sometimes again still. The income of any investment is taxed. If an income-producing asset, such as a stock or bond, equipment or real estate, is sold for more than it was

tax bias against investment.[7] Harvard economist Dale Jorgenson estimates that yearly real investment would initially increase 80 percent relative to the investment that would be made under present law. This relative increase would gradually decline over the period of a decade to 20 percent.[8] Boston University economist Laurence Kotlikoff also predicts an investment boom. Measuring the change in the size of the overall capital stock (rather than annual investment), he predicts that the capital stock will be 17 percent larger than it would be under the present tax system within 10 years.[9]

- But perhaps most importantly the FairTax would be the granddad of all border adjustable tax systems: something the report glosses over even while the staff lamented the loss of the FSC incentive.

Under the FairTax, exports would no longer bear the burden of embedded income and payroll taxes and imports would bear the same sales tax burden as domestically produced goods. For the first time, exported and imported goods will have the same tax treatment. Imported goods will no longer be advantaged over domestically produced goods and in effect, U.S. producers will not have to cross-subsidize the favored treatment of foreign made goods. Bottom line: American manufacturers will be more competitive in the global marketplace, both at home and abroad. The FairTax is the most powerful export incentive there could be, and more importantly, it is entirely WTO legal.

The overall U.S. economy will grow dramatically under the FairTax. All known economic projections predict a much healthier economy. Real wages will increase. People will have more money with which to buy manufactured goods. Typical estimates are that the economy will be 10 to 14 percent larger than it would have been under the income tax within 10 years and both production and consumption will grow substantially. Some studies show the potential gains to be much higher. Manufacturers will make more money in a prosperous, growing economy.

The price of automobiles would decline for the American consumer.

In keeping with the shallow depth of analysis of the manufacturing crisis, the Democratic staff state that manufacturers will suffer because an automobile would be more expensive to purchase under the FairTax. They don't seem to care whether that is a domestic automobile or a foreign automobile. Not only have they missed the larger picture on manufacturing, but they fail to understand how the FairTax would benefit U.S. consumers of automobiles, particularly U.S. automobiles.

Consider the following. On the supply side of the equation, consumers who are engaged by domestic manufacturing firms will have the money to buy domestic

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purchased, the increase in the value of the capital investment – the capital gain – is taxed a third time. The income of depreciable property is overstated by very slow capital cost recovery allowances. Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Intercorporate dividends are also often subject to tax, creating yet another level of taxation. When the taxpayer dies, the estate and gift tax may tax his or her investments yet again.

[7] Sales tax treatment of investment is equivalent to expensing capital investment in an income tax.

[8] Jorgenson, Dale W. Harvard University, "The Impact of Taxing Consumption," Testimony before the Committee on Ways and Means, U.S. House of Representatives, March 27, 1996.

[9] Kotlikoff, Laurence J. Boston University, Testimony before the Committee on Ways and Means, U.S. House of Representatives, June 6, 1995. See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute.

manufactured goods, such as autos. But equally important, contrary to what the staff asserts, those goods will be cheaper.

The report points to the price of an automobile as being higher under the FairTax. That is based on several assumptions. First, for example, the staff must believe that the repealed corporate taxes, payroll taxes and capital gains taxes and administrative costs that automobile manufacturers bear today will simply be turned into additional profit when they are repealed, rather than passed along in the lower price of their vehicles. The staff fails to remind the reader that the consumer will have his or her full paycheck to buy the car. And equally important, the report neglects to point out that the major cost of an automobile for a consumer today, is interest. Under the FairTax, purchasers of automobiles on credit will make interest payments from pre-tax dollars and the interest rates will fall 25-30 percent under the FairTax[10] immediately and quickly toward the current tax-exempt rate.[11]

The key question to ask is this: how much would an American wage earner have to earn to buy an automobile under the FairTax versus the income tax. Consider the following math. Using a down payment of 10 percent, and assuming that the owner paid 7.65 percent payroll taxes and was in the 28 percent marginal tax rate, purchasing a new car will become much more affordable under the FairTax. Today, a worker must earn $43,537 to be able to pay for the average new vehicle sold in 2003 (according to NADA) because in order to do so, he first had to give Uncle Sam $11,442 in payroll taxes and income taxes. This leaves $4,545 to pay the interest on the loan and $25,550 for the price of the car.

Under the FairTax, Uncle Sam doesn't take a cut so our buyer would only have to earn $100 to spend $100. The total cost of purchasing the car is $27,550 plus the FairTax of $8,265, or $39,160. This is 10 percent less than today, even after the sales tax is added on. Cost savings increase to 14.9% if the car buyer is self-employed and pays 15.3% payroll taxes instead of 7.65%.

Of course, about 30 percent of a car dealer's sales are for used cars and these would not be taxed at all. Not even the principal would be taxed.

On the other hand, consider a buyer who wants to buy an automobile made by foreign workers. Today, the manufacturer that produced the import rebated their Value Added Taxes at the point of export, when it left the dock. The U.S. imposes no significant tax burden on these goods. In this way, the U.S. tax policy serves as a sort of duty free, income and payroll tax free zone for foreign imports.

The staff will have to be very creative if they want to show the FairTax is bad for domestic manufacturing, labor or even consumers. To recapitulate, the FairTax will

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[10] For a more detailed discussion of the impact on a national sales tax on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?" Fourth Quarter, 1995. He estimates a 25 - 35 percent drop (p. 27). See also, Martin Feldstein, "Effect of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research, Working Paper No. 5397 (December, 1995).

[11] The impact of elimination of the tax wedge or tax premium on interest can be seen every day in the *Wall Street Journal.* Tax-exempt municipal bonds tend to yield about 30 percent less than taxable corporate bonds of similar term and risk. A borrower will not be able to deduct interest but will pay a much lower interest rate. A lender will receive a lower interest rate but will not pay taxes on his interest income.

make the U.S. the manufacturing capital of the world by being the only industrialized nation with a zero rate of tax on manufacturers; it will stimulate greater investment which is the lifeblood of manufacturing, it will exempt all taxes from exported domestically manufactured goods, but tax imports placing them on a level playing field with domestically produced goods, and it will reduce the price of automobiles to the American consumer. A better system would be impossible to design for U.S. manufacturing.

Actual cost of purchasing a new car
(Wages that must be earned to buy new car)

Components of new car cost	**Current tax system**	**FairTax system (25% Interest rate drop)**
NADA average vehicle price*	$ 27,550	$ 27,550
Down payment of 10%	$ 2,755	$ 2,755
Auto loan amount	$ 24,795	$ 24,795
Interest @ 6.79 for 5 years**	$ 4,545	$ 3,345
FairTax on new car purchase	$ -	$ 8,265
Income tax on interest	$ 1,273	
Payroll tax on interest	$ 348	
Payroll tax on principal	$ 2,108	
Income tax on principal***	$ 7,714	
Total Taxes	$ 11,442	$ 8,265
Total New Car Cost Including Taxes	$ 43,537	$ 39,160
Percent Difference		**-10.05%**

*NADA average vehicle price 2003.

**Loan rate based on a survey of 32 cities in August, 2004.
Interest rates will drop by 25% under FairTax. Used rate of 5.09%.

***Assumes purchaser has marginal tax rate of 28%.

B. Why the U.S. Farmer and Rancher Endorse the FairTax

The staff asserts that the plan is bad for farmers, but fails to understand that farming groups have considered the FairTax and have endorsed the FairTax. This includes the American Farm Bureau Federation, as well as many state farm bureaus. The staff may believe they know more than the nation's farmers about the tax system that affects them; however, they ought to consider the following points before putting words in the mouths of the American farmer.

The report errs in downplaying the devastating effect of the income tax system on farmers

The Democratic Committee staff is far too kind on the system they wish to defend. The complexity of the system, including its 15.3 percent self-employment tax, the income tax, the capital gains tax, the alternative minimum tax, and the death tax make our system nothing short of punitive for farmers and ranchers. The current income tax system:

- Makes it difficult, if not impossible to keep family farms in the family because of punitive death taxes
- Taxes 'phantom income' by taxing inflation in property values due to the capital gains tax
- Generates excessively high compliance costs
- Raises the costs of seed and other farming inputs by imposing hidden taxes upstream
- Targets hard work, savings and capital investment;
- hinders exports by making U.S. produced goods less competitive in international markets
- Is riddled with loopholes and exemptions that benefit special interests
- Lowers our standard of living and the income of families
- Is intrusive and unfair
- Leaves our children with less of a future

The report fails to recognize that the unique nature of agriculture creates special problems beyond tax rates.

What the report downplays for obvious reasons is that quite apart from the high effective tax rate (agriculture, forestry, and fishing corporations combined had an effective tax rate of more than 30 percent, inequitably distributed across farming and ranching) our current tax regime is responsible for posing additional problems for farmers and ranchers, stemming from the unique nature of farming as a capital intensive, long-term, high risk effort. Most farms are family owned and operated and involve an investment of capital in assets that are largely illiquid.[12] Although 99 percent of U.S. farms are owned by families, estate taxes due at death often prevent farmers from passing their farms on to their children or leave the children with a crushing debt.

Farmers are hampered by the capital gains tax which doubly taxes investment income while punishing losses over which one has no control. Capital gains taxes discourage farmers from selling less-valued assets and reinvesting the proceeds in more productive activities needed to keep their businesses growing and their operations competitive. Moreover, because farming involves investment and reinvestment in capital assets over many years, capital gains often result more from inflation than appreciation. Since the capital gains tax is not adjusted for inflation, much of the real wealth gains are lost at transfer due to the capital gains tax on "phantom" profits caused purely by the devaluation of the currency. In fact, in most places, agricultural land values have seen only modest *real* gains over the last three decades. If it were not for inflation, the price of

[12] American Farm Bureau Federation web site: www.fb.com/ffindex.htm. 99 percent of U.S. farms and ranches today are owned by individuals, family partnerships or corporations with fewer than 10 stockholders. Only 0.4 percent of farms and ranches are owned by non-family corporations.

much of this nation's farmland would be about the same as it was in the late 1960s. Accordingly, farmers and ranchers pay huge capital gains tax bills on phantom income.

The concentration of wealth and savings in illiquid assets ensures the capital gains tax structure imposes a punitive tax of as much as 30 percent on the sale or exchange of farms and ranches.

The problem is magnified when the farmer or rancher attempts to pass the enterprise to succeeding generations. Since the estate tax imposes steeply graduated taxes on the value of assets, heirs are often forced to sell the farm out of the family to pay death transfer taxes that range from 15 to 55 percent (depending on the year and the size of the estate). These taxes often prevent the transfer of family farms from generation to generation, and amount instead to a leveraged buy-out of the family farm by the Federal government.[13] The FairTax would repeal death taxes. It would repeal self-employment and payroll taxes. It would repeal personal income taxes and corporate income taxes. It would repeal the capital gains tax.

The report errs by misrepresenting the plan as taxing business inputs when it actually would remove taxes imposed upstream.

The report errs in stating that farmers would be at a disadvantage under the FairTax plan because "they purchase many items at retail where the tax is collected." Throughout this debate, opponents will seek to rewrite the FairTax, and then criticize the imaginary plan they created. That tactic is employed here.

Under the FairTax, and not the fictitious plan they would like to criticize, all business-to-business transactions would be exempt from tax. By exempting all business-to-business transactions, the FairTax would lower the costs of seed, implements, herbicides, equipment, and all other materials used in agriculture – because it repeals the hidden income and payroll taxes now buried in the price of goods and services farmers and other producers need.

This should be compared with the income tax where taxes have been imposed on all business inputs. For example, companies that produce fertilizers, herbicides, farm implements, seed, and other inputs are all taxable. Even those businesses that built the barn are taxable. As a result, those business inputs already bear a component of taxes imposed upstream. The price of those goods and services reflects the tax imposed upstream. Under the FairTax all upstream taxes are removed. All of them! And in addition to the removal of those taxes, compliance costs are removed from the business inputs.

The report fails to explain the other unique benefits of the FairTax for farmers.

In fact, for farmers, the benefits are even greater. Recall that to insure no one pays tax on the essentials of life; the FairTax includes a rebate of the tax paid on spending up to the federal poverty level. Part of the essentials of life, comprising the poverty level

[13] Additionally, the Alternative Minimum Tax (AMT) negatively affects farmers and ranchers. In recent years, the IRS has subjected farmers to AMT liability when they use deferred payments contracts in the ordinary course of business.

rebate, is food. As a result, under the FairTax plan farmers would pay no tax on production, no tax on business purchases, and the consumers of farming products would, in a sense, pay no tax on those products. Farmers would almost entirely be removed from the tax base.

From this fundamental shift in the federal tax collection apparatus many other benefits would flow. The FairTax would:

- Allow family farms and businesses to be passed from one generation to another without penalty
- Lower the cost of seed, fertilizer and other farming inputs;
- Reduce interest rates
- Greatly enhance economic performance
- Eliminate the current bias against work, saving and investment;
- Create the equivalent of permanent income averaging (as the FairTax rate on income is zero)
- Eliminate wasteful compliance costs, exempting farmers (except those who sell at retail) from ever having to file a return or concern themselves with the tax system
- Make the tax system understandable, equitable, and simple
- Ensure greater enforceability with less intrusiveness

Quite simply, the FairTax would allow farmers to attract the investment needed or borrow to start or expand business, to grow without the hindrance of the payroll and income tax, to keep the profit from their work, and to pass their business along to their offspring.

The report fails to explain that the current tax system places farmers at a global disadvantage.

There is more, however, that the staff neglected to point out. Our current system is also problematic because much of the burden of the current system is hidden from the American taxpayers who believe that an amorphous entity – business – including the business of farming, must pay its fair share. Upstream taxes ensure that taxpayers cannot see the true cost of our government, but this is just the beginning of the problem. Apart from ensuring the system lacks integrity, hidden taxes buried in goods and services reduce exports and result in lost farms, lower profits, lost productivity and a competitive advantage to foreign commodities.

Why does this occur? Farming products are commodities which price is determined on international exchanges; farmers must absorb tax burdens within set prices rather than passing them along. In effect, when farmers are taxed today and the inputs into their farming operations are taxed today, farmers must try to export these taxes – along with their produce – in international markets. However, foreign suppliers (all OECD countries except the U.S. have border-adjusted taxes) rebate their tax at the border. As a result, American products must compete against foreign produced products with a competitive disadvantage because our exports bear the burden of both U.S. income and payroll taxes and the foreign VATs. The same problem occurs on the flip side. When foreign products are imported into the U.S. they do not bear the tax imposed on their domestic producers. Most countries have rebated that tax at the border. And so again, U.S. products that are fully taxed must compete against foreign products (this time

for the U.S. consumer) that are not taxed. This places farmers at a significant disadvantage in foreign trade as a result of the income tax.

Materials put out by Americans For Fair Taxation quite comprehensively explain the effects on farming and ranching. One of the key effects is the removal of tax on exports.

The report implies that business inputs would be taxed, when it would likely streamline state taxes.

The report further errs in stating that the "attempt to exempt business purchases" would not work, and "that is why 20-40 percent of state and local retail sales taxes currently are attributable to business purchase." As farm bureaus recognize, many state sales tax schemes improperly tax business inputs. Farmers justifiably resent sales taxes that cascade. Americans For Fair Taxation believes it wholly inappropriate to adopt a system that has cascading taxes. If a business buys a good or service from another business, such a purchase would not be taxed. Since no business-to-business inputs are taxed, and no profits or income are taxed, businesses pay an effective rate of zero. The FairTax plan will lead the way in convincing states to abandon their punitive approach towards small businesses because it will encourage conformity with the federal plan. The income tax does not do so.

C. Effect on Insurance

The Democratic staff report makes several assertions with respect to the insurance industry, most of which are incorrect. For example, the report accurately points out that the business reason for individuals and business to purchase insurance coverage is to "reduce" their risk. While the logic of the report is somewhat difficult to follow, it appears to make two arguments. First, that for purposes of property or casualty insurance 1) a retail sales tax would increase the cost of insurance and 2) cause many to go without insurance. Second, that other types of insurance products depend on tax loopholes, such as inside buildup of the gains on life insurance contracts and the exemption of death benefits. It concludes that the insurance industry is an important industry and that the sales tax would have regional negative effects.

The report errs when it states that neither form of insurance is taxable today. Insurance is taxable in three respects. It is taxable because insurance companies are subject to corporate taxes, it is taxable because insurance that is not for a business purpose must be paid for with after-tax dollars, and it is taxable because employees of insurance companies pay payroll and income taxes which are passed forward in the cost of the insurance.

Moreover, a common misconception concerning life insurance is that this type of insurance benefits from a very favorable tax status under current law. In fact, whole life insurance itself does not benefit from a favorable income taxation status. The savings component that is built up from this investment is the only element that benefits from a favorable income tax status. These earnings have a tax deferred treatment, but are still

taxable when savings are drawn down or paid out. Under the FairTax, these earnings are tax exempt. Also, employees of insurance companies will not be taxed on the income they receive for their services.

Finally, insurance would not be taxed under the FairTax to the extent it is purchased for business purposes. While life insurance will not be used under the FairTax regime as a vehicle for federal transfer tax planning, it will remain an essential economic instrument for defusing risk and avoiding state death taxes.

D. Effect on Financial Services

The Democratic staff also opines that the FairTax will have a substantial impact on financial services, including mutual funds, banks, and other institutions. While intimating this is an undeniable result, the staff is does not seem to explain its position, except to state that financial centers will be injured as taxpayers invest overseas.

Since Americans For Fair Taxation has little in the way of substantive remarks by the Democratic staff to analyze, we will begin by explaining the macro effect of the proposal as applied to financial intermediation services. In the year 2001, there were a total of 220,895 corporations providing financial services, which includes about 96,796 insurance carriers and related activities.[14] This includes 53,489 credit intermediation services, 49,916 securities, commodity contracts and other financial investment companies, and 20,694 other companies in the general industry grouping. These firms combined (including insurance and related industries) had gross receipts of approximately $2.6 trillion with deductions of $2.3 trillion. They paid a tax of $34 billion. This is what the salient items on their spreadsheet show ($'s in thousands):

Number of returns	220,895
Total assets	21,088,851,299
Net worth	9,559,259,468
Total receipts	2,621,771,654
Business receipts	1,430,898,834
Interest paid	421,275,484
Net income (less deficit)	268,142,171
Total income tax before credits	39,068,012
Total income tax after credits	34,189,718

Under the FairTax, the corporate tax on these entities, much of which is a result of selling to other businesses, will be repealed. Corporate profits will not be subject to tax. Financial institutions and insurance companies and their shareholders will no longer be taxed. Interest expense will no longer be deductible because there is no income tax liability against which to deduct the expense. Interest income will no longer be taxable since the income tax is repealed. As discussed more fully below, interest rates will fall

[14] 2001 Returns of Active Corporations
Table 6 – Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry.

dramatically. Financial intermediation services sold to businesses will not be subject to tax. To do otherwise would impose a tax on a tax.[15]

Moreover, because the U.S. will be the only nation in the world with no corporate tax on financial intermediation firms, contrary to the staff's assertion, the U.S. will become the financial center of the world. As in the case of automobiles, farming and ranching, America's financial services firms are exporters – exporters of services. By eliminating the tax on providing these services overseas or to businesses in the U.S., the U.S. will become the favored location to base these firms.

To be neutral between types of consumption, the FairTax does tax all goods and services purchased for final consumption, including financial intermediation services.[16] The FairTax taxes these services by getting to the value of the financial intermediation services sold to the consumer.

More often than not, however, financial intermediation services are not separately priced when they are sold. Instead, they are included in the premium paid for an insurance policy or as a higher interest rate to a borrower or a lower interest rate paid on balances to the owner, for example, of a "free" checking account. Banks implicitly charge depositors (especially checking account depositors) by paying a lower rate of interest and charge borrowers an interest rate that is higher than the sum of the normal return to capital and the risk premium. Sometimes, however, financial intermediation services are separately priced. Examples would include a monthly fee checking account, points paid in connection with a mortgage, or sales loads on a financial product. In effect, an interest rate may be viewed as having three components: 1) the normal, risk-free return to capital[17] (divided further into the real return and the inflation premium which combined are the nominal return);[18] 2) a risk premium to compensate the lender for the risk of default;[19] and, 3) payment to the financial institution for the financial intermediation services it provides.[20]

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[15] Imposing a tax on a tax is called "cascading" and leads to an effective tax rate higher than the statutory rate. A cascading or turnover tax hides the true tax burden because taxes are imposed at each stage of production and no credit is given for taxes paid at earlier stages of production. A cascading tax imposes higher rates on goods or services that changed hands more often prior to final retail sale and constitutes a major incentive to vertically integrate. In the FairTax, the tax is imposed once at the point of sale for final consumption. Intermediate goods and services are not taxed.

[16] The National Income Product Accounts (NIPA) puts financial intermediation services purchased by consumers at $293 billion which corresponds to a tax inclusive (pre-tax) base of $380 billion. This figure includes investment counseling, brokerage fees, bank service charges, trust services, imputed bank service charges and the expenses of handling life insurance. See Table 2.4 of National Income and Product Accounts, Survey of Current Business, August 1996, p. 30. The total sales tax base is about $5.98 trillion. Thus, financial intermediation services account for about 6.4 percent of the total base. According to NIPA, financial services industries account for about 20 percent of corporate profits (excluding the federal reserve). A large proportion of the profits of the financial services industries comes from business-to-business transactions.

[17] This may be viewed as the pure time value of money.

[18] In practice, U.S. Treasury securities are a reasonable proxy for the risk-free return to capital. Since the recent advent of indexed Treasury bonds, it has been possible to reliably differentiate the nominal and real returns.

[19] In a competitive capital market, the risk premium on a loan or similar class of loans will equal the present discounted value of expected costs of default expressed as a ratio of the expected costs to the outstanding loan balances.

[20] For example, according to the National Income and Product Accounts, these are some of the explicit services that consumers buy in millions of dollars.

The financial intermediation service provisions of the AFFT plan are more complex than those relating to other goods and services because they must reach both the *explicitly* charged and *implicitly* charged financial intermediation services. *Explicitly* charged financial intermediation services would include points on a loan, origination fees, trust fees, and insurance premiums; to the extent such premiums are not allocable to the investment account of the underlying insurance policy.[21] *Implicitly* charged fees would be the excess of the loan interest rate over the federal applicable rate for a loan of like term. To account for the risk premium portion of the interest rate, lenders would receive a refundable sales tax credit equal to bad debts experienced times the sales tax rate.[22]

For example, if the applicable federal rate for long-term debt were five percent and a mortgage was made at six percent, then one percentage point would be taxable financial intermediation services.[23] A new $100,000 mortgage at 6 percent would have a payment of $600. The first payment would have the largest interest component, $500. This contrasts with $666 that would be payable at today's taxable interest rates. $83 of the $500 (1/6 of the total interest) would be treated as taxable financial intermediation services.[24] The tax would be $19 for the first payment or $228 in the first year, and would decline in each future year.[25] The lender would also receive a credit equal to the sales tax rate times any bad debts experienced.

283	E1EQT1 D	Equities commissions including imputed	31,121
284	E1MUT1 D	Broker charges on mutual fund sales	8,389
285	E1TDS1 D	Trading profits on debt securities	1,522
286	E1TSC1 D	Trust services of commercial banks	2,567
287	E1IAS1 D	Investment advisory services of brokers	11,290
288	E1CMD1 D	Commodities revenue	5,083
289	E1SAX1 D	Investment counseling services	17,297
290	E1BNK1 C	Bank service charges, trust services, etc.	82,531
291	E1DAB1 D	Commercial bank service charges	23,601

[21] It is inappropriate in a consumption tax to tax the portion of a life insurance policy that is attributable to the savings or investment component of the policy. In the case of term life insurance, there is no savings component but in the case of whole life, universal life or variable life insurance there is an investment component.

[22] A bad debt would be defined as a loan more than 90 days in arrears. The financial intermediation relating to bad debts subsequently repaid would be taxed (in effect taking back the credit with respect to loans ultimately paid).

[23] One-sixth (the 1 percent difference divided by six percent) of the interest payment. The interest rates chosen reflect the elimination of the tax wedge from interest rates. See discussion below and "Impact of the FairTax on Interest Rates," Americans For Fair Taxation.

[24] Using comparable interest rates today, with an applicable federal rate of 7 percent and a mortgage rate of 8 percent, the financial intermediation amount would be 1/8 (the 1 percent difference divided by 8 percent interest) of $666 or $83. Thus, the financial service amount is the same in either scenario. The change in real interest rate does not change the financial service intermediation amount.

[25] At the 23 percent AFFT rate. The AFFT plan replaces the income tax, the estate and gift tax and all payroll taxes with the FairTax.

Insurance claims paid would also be removed from the tax base. This is accomplished by providing a credit equal to any claim paid times the sales tax rate for claims paid directly to the insured or, in the case where the insurer makes a payment on behalf of the insured to a third party, exempting from taxes the payment from the insurer to the third party.

All told, the wide variety of complex rules relating to investments, capital gains, pensions, and other deferred compensation, regulated investment companies, banks, insurance companies, various insurance products, withholding and information reporting and the like testifies to the difficulty in taxing these entities today.[26] Under the AFFT FairTax plan, a different taxing regime will be in place vastly simpler than the complex matrix of rules relating to investments, insurance, and banking today.

E. Mail Order and Internet Sales

The Democratic report states that the U.S. businesses engaged in sales of goods by mail order or over the internet would be required to collect new retail sales taxes. Then it puts forth the opinion that because states have had trouble imposing a tax on buyers of goods from out-of-state sellers, that the U.S. would have trouble imposing a tax on foreign suppliers. These claims are not only internally inconsistent, but miss the larger point: the FairTax is a better plan for the Digital Age.

The internet and mail order companies are taxed today.

The staff is correct in stating that internet sales would be subject to the FairTax in the same way a sale at the corner market is taxed. However, the staff fails again to point out that those internet sales are taxed much more heavily today – taxed by multiple layers of federal taxes – and that the FairTax plan would repeal those federal taxes. Investors in mail order and internet order companies are taxed when they invest with after-tax dollars. The companies are taxed on their earnings – resulting in lower profits, higher priced goods or lower wages to workers. The companies must pay state and federal income tax on the income from sales of goods and services. Shareholders are taxed on their dividends and capital gains. Company employees are taxed on their wages with both payroll and income taxes. The companies are taxed when they buy goods and services as business inputs since producer prices reflect hidden taxes imposed upstream. And customers must buy the goods with after-income tax and after-payroll tax income. All told, we are driving; internet business offshore, not through *new* taxes at the state level but through the same *old* multiple and discriminatory taxes at the federal level which the staff ignores.

The income tax is simply incompatible with the electronic age.

The staff ignores an even more significant point: the income tax is simply incompatible with the electronic age. They fail to point out that the Congress has an obligation to transcend the impassioned rhetoric that has characterized the debate over internet taxation to address the very real problems that the income tax system will increasingly bring to electronic commerce on the movement of "income" as opposed to

[26] See discussion with respect to present law above and note 11 *supra*.

"goods" around the world.

Politics move quickly in the Digital Age. In a span of less than a decade, politicians and policymakers have deified the internet and damned it. When the internet was king, in the fervor of the moment, press releases and press accounts decreed with bravado that the Congress has succeeded in making the internet a tax-free zone. The thumps of the chest pounding could even be heard across the Atlantic Ocean. In House Resolution 190, we admonished the Europeans that the U.S. will stand for no internet regulation.

> *It is the sense of the Senate that United States representatives to the World Trade Organization, and any other multilateral trade organization of which the United States is a member, should resolutely advocate that it is the firm position of the United States that electronic commerce conducted via the Internet should not be burdened by national or local regulation, taxation, or the imposition of tariffs on such commerce.*

But before Congress retakes its oath of allegiance to not regulate the internet, it might want to soberly understand the coming need to stem the intolerable level of income tax evasion it will enable on such a large scale and on such non-egalitarian terms.

If the staff has problems with the FairTax that taxes consumption of tangible goods and services, how does the staff believe our current tax system will fare when the internet has fully bloomed? What will be the extent of income tax evasion under the internet? The short answer is that the internet may soon make international tax evasion a household sport. As Dr. Richard Rahn (former Chief Economist of the U.S. Chamber of Commerce) points out in his book, *The End of Money*:

> *In order to understand what is about to happen, remember that the revolution taking place in electronic commerce means that banks and other organizations will be able to create their own money for transactional or investment purposes and literally move these monies around the globe at the speed of electrons. The definition of money as a government-created legal tender will become less and less relevant.*
>
> …
>
> *Things that can be transformed instantaneously into something else and moved to anyplace in the world with no paper or electronic trail will become nearly impossible to tax. By using public key cryptography, one can have electronic bank notes certified without the issuer knowing to whom they were issued. And smart cards used as an electronic purse can have the same anonymity as paper cash.*

The personal holding company rules, passive foreign investment company rules, indeed, much of the window-dressing Congress has built into the tax Code to ensure compliance will become as quaint as a pedestrian stoplight at rush hour. Under the internet, once offshore, income will be free to grow and prosper and tour the world without a passport or a visa. When taxpayers can easily avoid reporting particular types of income or transactions with no danger of being caught, our entire income tax will become voluntary.

The Democratic staff might benefit from a simple illustration. Assume you are a wealthy individual whose income is totally dependent upon stock dividends. Between rounds of golf, you invest over the Internet with electronic money. The internet account is held by your bank in the Turks and Caicos, which provides a prison term and a hefty financial penalty for one who dares to inquire into the ownership of your account. Your

account is also encrypted under constantly evolving encryption systems that make numbered accounts anachronistic. As your income comes in, the electronic bank sends you the money which you download onto your computer and then transfer to your smart card. You can pay your bills. Only you decide what electronic and paper records to create and keep. And of course, when you visit your new home outside of the U.S., you can consume all of that money avoiding the watchful eye of Uncle Sam.

The use of offshore institutions to avoid paying U.S. income tax is a growing sport now. But in the Digital Age, it will become the national sport. Because it is far easier to move or create a financial portfolio anywhere in the world with total anonymity with the internet, the internet will be the host to trillions of transactions that shift capital in nanoseconds, both encrypted as to the owner, anonymous because of the sheer volume of transactions, and protected from disclosure by the many willing tax havens of the world. Moreover, income includes both income from business and individuals, as well as income from investment and savings. The first to evade will be those who are creating inbound transactions into the United States, nonresidents with whom we have but a tangential fiscal relationship. Next will be those with capital to invest or profits to disguise, wealthier Americans or those wanting to launder monies. Before long, our tax system will depend upon those who pay out of a sense of public duty and those who are paid in wages (working class Americans).

The same Democratic staff that implies they want the internet to be unregulated will have to either 1) approve of record levels of financial regulation so that global transactions are monitored and urge our trading partners to go along with these rules so the entire world can assist us in collecting multiple taxes on savings and investment, or 2) adapt new a new tax regime to accommodate the new reality. If the Congress chooses the former, Americans will have to be willing to relinquish their right to privacy over the Internet. Non-U.S. internet companies with no minimum contacts with the U.S. must be willing to freely exchange information with the U.S. government. In fact, the U.S. income tax is already spawning international regulation. The OECD plans to, *among other things*, develop new information technology capabilities that will permit both the "detection of suspicious on-line transactions and verification of the customer" and "ensure that electronic commerce technologies, including electronic payment systems, are not used to undermine the ability of revenue authorities to properly administer tax law."[27]

Most likely this regulation will be very ineffective because those who are developing the means of evasion – in partnership with world secrecy laws – will be one step ahead of those who are tying to restrict it. The cost of trying to enforce taxation of highly mobile financial capital probably will exceed the revenue collected and certainly will exact a price in terms of lost efficiency and lost privacy rights that exceed the benefits of their continued taxation. Finally it will be difficult because many countries of the world do not have extraterritorial taxes and do not wish to help us enforce ours. We will have developed the most extensive net of regulations and checks and international agreements in an attempt to chase financial butterflies of our own imagining.

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[27] For example, *Financial Action Task Force on Money Laundering* (Released February 3, 2000) at http://www.oecd.org/fatf/pdf/2000typ-en.pdf and http://www.oecd.org//publications/pol_brief/9701_POL.HTM#14.

How can the Congress adapt our tax system to the new reality? Americans For Fair Taxation believes it must do away with taxation of savings and investment and the need to move it outside of the U.S. Consumption is a more conspicuous base for taxation than is income. While a determined tax evader can easily place income out of reach, it is much harder to place the sale of goods and services out of reach. While income, its timing, and its source are complicated legal concepts that can be nothing more than the entry in an electronic ledger, consumption often involves transport of goods and a paper trail. The future tax base will have to rely on real and tangible property or payments for services or goods. Taxes tied to real property or tangible personal property or the sales of services to the public are much more difficult to evade.

Second, taxes tied to the operation of businesses dealing with the public or with many business customers are more easily enforced because of the necessarily public and open nature of such businesses. Moreover, the vast majority of retail sales are by large established firms.

Third, under the FairTax plan – a national sales tax that would repeal all income based taxes, including payroll and self-employment taxes – much of the problem areas of enforcement that might apply to some consumption taxes are simply eliminated. While imports can be captured at the border, business-to-business consumption is not taxable under the FairTax – only personal consumption at final retail sale. Exports are not taxable. Used goods are not taxable. Hence, the vast amount of internet sales would simply not be of enforcement concern.

Certainly, some services sold over the internet will cause continuing enforcement concern. For instance, an attorney or an architect might send a product to a client over the internet. Potential problems exist any time there is a conveyance of intellectual property where the Internet is the medium of exchange. However, this form of tax evasion can occur today and with higher marginal rates and therefore a greater reward for cheating. Moreover, many of these businesses are registered and sales tax audits would reveal these discrepancies. Equally important, the clients would have to enter in to the necessary conspiracy in most of these cases. Remember, the sales tax is a withholding tax. The FairTax would have greater enforceability, greater compliance with less intrusiveness.

The FairTax would bring fairness

The staff is correct in concluding that the FairTax would end the unnecessary and improper distinction between brick and mortar facilities and companies that send goods to you over the internet. However, the staff is incorrect in assuming this is counterproductive. On the contrary, the FairTax would tax each company on a level playing field so regional small firms do not suffer at the hands of imported goods and so that consumers don't have to choose between tax-favored imports and brick and mortar retail stores.

The staff fails to point out that the FairTax will work to alleviate the primary burden imposed by states on internet sales: a balkanization of state and local sales tax laws. It will do so by fostering harmonization of state juridical taxation issues and bases by providing a single, national standard. As the states have conformed to the federal

definition of Adjusted Gross Income in order to ease administrative costs on the states for tax collection, the states would be expected to conform to the federal sales tax base, eliminating the concern over double taxation. States that conform to the federal sales tax base and become part of the national sales tax system would be able, for the first time since *National Bellas Hess*, to require vendors to collect and remit sales tax on mail order and internet sales into their state.

F. Tourism

The staff also opines that "additional tax liabilities" under H.R. 25 could create competitive problems for the U.S. tourism industry. They complain that the entire cost of air travel in the United States would be subject to the new tax but that the tax would apply to one-half of the cost of transportation that begins in the United States and ends overseas.

While their opinion is not substantiated, we do observe it is based on two wrongful assumptions. First and most simply, there are no "additional tax liabilities" under the FairTax in a macro sense. Rather, the FairTax is meant to raise the same amount of revenue in a more efficient way.

Second, the FairTax seeks to tax international travel in the same manner as it is treated today. The rule subjecting the international carriers to a FairTax on 50 percent of the sales price of the ticket is based on present Internal Revenue Code section 863 (special rules for determining source) which today provides that 50 percent of the income of international carriers (between a point in the U.S. and outside the U.S.) shall be allocated to U.S. taxation and 50 percent to the foreign jurisdiction. In order to understand how our law is consistent with current law, however, one would have to delve into the bowels of the international sections of the Internal Revenue Code. The relevant section today that pertains to the allocation of income is instructive on the complexity of the Code, because the purpose of knowing where the income is sourced is to determine the foreign tax credit limitation to which the carrier is subjected on its worldwide income. Here is the present Code provision with the relevant section underlined:

> *(a) Allocation under regulations Items of gross income, expenses, losses, and deductions, other than those specified in sections 861 (a) and 862 (a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.*
>
> *(b) Income partly from within and partly from without the United States. In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary. Gains, profits, and income—*
> *(1) from services rendered partly within and partly without the United States,*
> *(2) from the sale or exchange of inventory property (within the meaning of section 865 (i)(1))*

produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States, or
(3) derived from the purchase of inventory property (within the meaning of section 865 (i)(1)) within a possession of the United States and its sale or exchange within the United States, shall be treated as derived partly from sources within and partly from sources without the United States.

(c) Source rule for certain transportation income (1) Transportation beginning and ending in the United State. All transportation income attributable to transportation which begins and ends in the United States shall be treated as derived from sources within the United States.

(2) Other transportation having United States connection (A) In general 50 percent of all transportation income attributable to transportation which—
(i) is not described in paragraph (1), and
(ii) begins or ends in the United States,
shall be treated as from sources in the United States.
…

(3) Transportation income: For purposes of this subsection, the term "transportation income" means any income derived from, or in connection with—
(A) the use (or hiring or leasing for use) of a vessel or aircraft, or
(B) the performance of services directly related to the use of a vessel or aircraft.

Because the leisure travel industry is highly competitive, operates on thin margins, and is highly elastic, the industry stands to gain much from passage of the FairTax. Growth in the economy and in real wages will be the most significant benefit to firms engaged in the travel field. The FairTax will enlarge the industry pie. Consider, for example, the profile of the U.S. traveling customer. Of the 1,140.0 million domestic U.S. person-trips in 2003,[28] the annual median household income was $57,900. That is a taxpayer who under the FairTax would be able to keep his entire paycheck, including the previously withheld payroll taxes. Bettering the economy will increase demand, and that will increase profitability for the industry.

However, the industry would also benefit from repeal of the taxes imposed on it. For instance, while there are many facets of the travel and tourism industry in the U.S., industries that benefit from it consist of small tour operators, travel agencies, and the many companies involved in lodging and transportation. Most of these firms are small and most are beset by the compliance costs they must pay today.

Additionally, however, the market will benefit from the influx of foreign tourists. Europe and most of the rest of the OECD nations, as noted earlier, impose consumption taxes. The imposition of these taxes has not hurt the tourist business; indeed, the ability of tourists to return items VAT-free, has made some Americans view these destinations as a duty free zone.

[28] A person-trip is one person traveling 50 miles (one way) or more away from home and/or overnight . A trip is one or more persons from the same household traveling together.
Source: Travel Industry Association of America; Travelscope®.