



## A FairTax<sup>SM</sup> Rebuttal

### Excerpts from the FairTax response to the Mack/Breaux tax panel report and recommendations

Hundreds of thousands of FairTax supporters were deeply dismayed and angered to learn that this panel ignored millions of dollars worth of solid, independent research on the FairTax legislation, research completed by some of the nation's top economists over the last decade. Despite access to the FairTax legislation and related research, the panel itself – virtually overnight – created an alternate and deeply flawed national retail sales tax plan, which they then scored and condemned.

This is exactly the kind of misdirection that the American people see as the hallmark of Washington lobbyists who put their own careers ahead of the clear national interest to develop a simple, fair, and transparent *replacement* tax system.

The panel failed the American people in the two most fundamental tasks: 1) They failed to define true criteria by which reform should be evaluated; and 2) They failed to grade tax reform plans against those criteria.

Instead of the fundamental reforms the panel was charged with developing, they recommended changes that further complicate an already overly complex and impenetrable tax system, that is also too expensive to operate and an unfair burden to taxpayers. This panel failed to address:

- The estimated \$265 billion in current tax compliance costs
- The routine lobbyist/legislative manipulations of the tax code that ill-serve the national interests
- The embedded corporate income and payroll tax costs that are hidden from the consuming public
- The truly dramatic advantages of switching to a transparent and simple national retail consumption tax, as detailed by HR 25, the FairTax.

The public has demanded change away from a system that makes debt more favorable than savings, taxes wages rather than wealth, favors spending over investment, and that has put American companies and agriculture at a severe disadvantage against foreign competitors. These legitimate pleas from the public were simply ignored by this panel and most of its witnesses.

**In the following pages, the FairTax rebuts the major points of the tax panel's analysis of consumption taxation and the FairTax.**



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**Here is a summary of the main criticisms of the FairTax by the President's tax panel, plus a short response to each.**

### **Panel statement #1**

A consumption tax would be regressive without a plan to exempt low-income individuals and households.

### **FairTax response**

Absolutely true, which is why the FairTax, a *progressive* national retail sales tax, does have a plan to completely “untax” spending up to the poverty level. Under the FairTax no resident, legal, American citizen pays any federal taxes (obvious or hidden/overt or covert) on spending for necessities. The catchphrase for this part of the FairTax legislation is the “prebate,” as it is a rebate that arrives *before* a consumer spends any money, timing which is critical to paycheck-to-paycheck families. It is also true that consumers, spending wisely, can spend tax free well above the poverty level through astute purchase of used goods. The FairTax is not levied on used goods. A family of four is able to purchase \$27,380 worth of new goods and services tax free.

To further distort the picture, the tax panel's tax burden measurement did not include the fact that the FairTax also repeals all payroll taxes – the most regressive taxes – with three out of four taxpayers paying more payroll taxes than income taxes.

Furthermore, detailed research by Laurence Kotlikoff, noted public finance economist at Boston University,<sup>1</sup> shows that average remaining lifetime tax rates under the FairTax are lower for all 42 representative income/age/marital status household types considered than they would be if the current system remains in place. Average remaining lifetime tax rates measure what percentage of remaining lifetime resources the taxpayer pays to the government, netting all future federal tax payments against Social Security benefits received and the FairTax prebate. These rates provide a much more realistic estimate of the true effective tax burden than comparisons of taxes versus income for a single year as done in the panel's report.

The FairTax entails either a significant or a substantial reduction in the remaining lifetime tax rates of all of our stylized households (married vs. single, seven income categories, and three age groups – young adult, middle aged, and seniors). For example, the single age 45 household with \$35,000 in annual income pays, on average, 20.7 percent of its remaining lifetime resources to the government under our current tax system, but only 5.4 percent under the FairTax. The same aged married couple in which both spouses earn \$35,000 faces a 21.3 percent current average tax rate, but only an 11.6 percent average tax rate under the FairTax.<sup>2</sup>

### **Panel statement #2**

Using a cash grant (the prebate) program would create the largest entitlement in the history of the United States and that would not be a good precedent as it would make most American families

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<sup>1</sup> Kotlikoff, Laurence J. and David Rapson, “Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation,” October, 2006.

<sup>2</sup> Op. cit., Table 5.



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dependent on monthly checks from the federal government for a substantial portion of their incomes.

### **FairTax response**

While we deplore the use of loaded words like “entitlement,” the current system spends about \$456 billion *more* than the FairTax on just such spending. The FairTax prebate is a rebate of taxes paid (albeit, in advance) on spending up to the poverty level based on family size. The prebate cost is estimated by The Beacon Hill Institute (a Massachusetts free-market think tank) to be \$489 billion (assuming 100 percent participation). Compare that to the \$945 billion of income tax deductions, tax preferences, loopholes, credits, etc. that we have under the current system (a Joint Committee on Taxation estimate).<sup>3</sup> In stark contrast to the current system, and in concert with the constitutional concept of uniformity of taxation across all citizens, the FairTax treats all taxpayers equally compared to the way the current system rewards friends and punishes enemies with its \$945 billion.

Furthermore, the tax panel grossly overestimates the FairTax prebate because it grossly underestimated the FairTax base, resulting in a rate that is much too high. (See response to statement #3.)

### **Panel statement #3**

The FairTax proponents’ calculations used faulty assumptions and a higher sales tax rate would be needed to be revenue neutral.

### **FairTax response**

The Treasury estimates for a national retail sales tax reported by the panel were not an estimate of the FairTax legislation. The panel concocted a base of their own, one apparently designed to produce the highest possible rate. Rather than follow the FairTax legislation, they apparently used a typical state sales tax base that is far, far narrower (many exemptions) than the single-rate/no exemptions FairTax. This is the equivalent of asking a contractor to estimate the painting of the White House. But rather than doing so, they build the Winchester Mystery House, and estimate painting that.

The Treasury also quite arbitrarily assumed a rate of tax evasion of twice the current system (30 percent compared to today’s 16 percent). This clearly fallacious assumption entirely ignores the following facts:

- Virtually any sales tax would reduce the number of points of collection (and enforcement) dramatically; the FairTax reduces them by about 80 percent.
- Virtually any sales tax would concentrate the lion’s share of revenue collection to fewer than 10 percent of retailers, further simplifying collection and enforcement.
- Any sales tax would reduce form and filing complexity from today’s Rube Goldberg contraption to a simple sales tax return, largely completed by point-of-purchase software.

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<sup>3</sup> Congressional Research Service, “Tax Expenditures: Trends and Critiques,” September 13, 2006.



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In addition, the Treasury refused to compare rate quotes on an apples-to-apples basis. Rather than quote the rates for replacement systems in a direct comparison to the income/payroll tax rates they replace, they used “econspeak” sleight of hand to compare apples to oranges. Since the ill-fated beginning of the income tax, it has been quoted by government (and taxpayers) in what economists call a “tax-inclusive” manner. “My tax rate was 23 percent” means if you earned \$100, the government kept \$23. If you talk about that rate as if it were a sales tax, which is added on to a purchase (tax exclusive), the income tax rate is 30 percent. No matter what, the government gets \$23.

Finally, the Treasury refuses to make public its scoring methodology – estimating the tax base and revenues – for these plans. Providing such methodology is standard operating procedure in the academic world, yet the Treasury has ignored requests for this information from both FairTax.org and academia. We do know the Treasury did not follow President Bush’s wishes for dynamic scoring – estimates that take into account the effects of tax changes as they feed back into the economy. Instead, they used static models similar to those infamously used by the Treasury’s peers at the Joint Committee on Taxation, recently labeled as “hapless” by *The Wall Street Journal* editorial page. Such scores are notoriously incorrect, time after time after time. In the studied opinion of many independent economists with the most sophisticated dynamic models available to them, these scores of the pseudo-FairTax are way off the mark.

And most important of all, The Beacon Hill Institute at Suffolk University and Laurence Kotlikoff, Professor of Economics at Boston University, have teamed up to provide a sound methodology for estimating the FairTax base and computing the FairTax rate.<sup>4</sup> Their paper demonstrates that the 23 percent rate specified by the Fair Tax Act (HR 25) is eminently feasible and suggests what led Gale<sup>5</sup> and the President’s Advisory Panel on Federal Tax Reform<sup>6</sup> to reach the opposite – *and incorrect* – conclusion. (Paper available at <http://www.fairtax.org/PDF/TaxingSalesUnderFairTax.pdf>.)

Beacon Hill Institute and Dr. Kotlikoff estimate the FairTax base for 2007 to be \$11,244 billion. Implementing the FairTax rate of 23 percent on this base would generate federal tax revenues of \$2,586 billion – \$358 billion more than the \$2,228 billion in tax revenues generated by the taxes it repeals. Because the FairTax prebate makes spending up to the poverty level tax free, the FairTax base needs to be adjusted for this. Likewise the FairTax base must be adjusted for the administrative credit paid to states and businesses collecting the FairTax. These adjustments to the base total \$1,889 billion, resulting in a net FairTax base of \$9,355 billion.

In 2007, spending at current levels is projected to be \$3,285 billion. Revenues from the FairTax at a 23 percent tax rate (\$2,586 billion), plus other federal revenues not repealed by the FairTax, are estimated to yield \$3,209 billion – an amount \$76 billion less than the current CBO

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<sup>4</sup> Bachman, Paul, Jonathan Haughton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck, “Taxing Sales under the FairTax: What Rate Works?” Beacon Hill Institute, September, 2006.

<sup>5</sup> Gale, William, “The National Retail Sales Tax: What Would the Rate Have to Be?” *Tax Break*, May 16, 2005, pp. 889-911.

<sup>6</sup> The President’s Advisory Panel on Federal Tax Reform, “Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System,” November, 2005. Available at <http://www.taxreformpanel.gov/final-report/>.



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spending projection for 2007. The \$76 billion figure equates to only 2.73 percent of non-Social Security spending (\$2,177 – \$2,101). This is a remarkably small adjustment when set against the more than 30 percent rise in the real value of these expenditures since 2000.

#### **Panel statement #4**

The taxation of federal and state government expenditures makes no sense and may be illegal in the federal system.

#### **FairTax response**

Public finance economists realize that the current system imposes taxes on government, albeit indirectly, in exactly the same manner corporate and payroll tax expenses are imposed on consumers with each and every retail purchase. Because there are federal income and payroll tax systems, the government must pay its employees higher wages, must match payroll taxes, and cover all corporate and payroll tax expenses of its contractors and all of their suppliers. Such economists further realize that when you shift from an income tax to a consumption tax you must maintain the same “tax wedge” or tax burden on government. To make government “tax free” is to give government enterprises a significant advantage over private enterprise, naturally moving the market away from private enterprise and toward government providers.

As to the constitutionality of the taxation of government, it has already been upheld by the Supreme Court that the federal government could levy taxes on units of government, including state and local, when it required all units of government to pay payroll taxes on wages paid to their employees.

#### **Panel statement #5**

The federal government should not rely on the states to collect the taxes. There would have to be an agency, like the IRS, to administer the rules and regulations, collect the tax, and to keep track of the data on households receiving the monthly prebate checks.

#### **FairTax response**

Sales taxes have been collected in 45 states (46 if you include the local government sales taxes in Alaska) and the District of Columbia for decades. These agencies have amassed great expertise in the administration, collection, and enforcement of sales taxes, performing these activities much more efficiently than a centralized agency of the federal government. Likewise, federal/state cooperative programs already exist for the verification of Social Security numbers; a notable example is the federal unemployment compensation program, which is federally funded but administered totally by the states. This is quite comparable to the administration of the prebate. Yes, there would be an office necessary to resolve disputes between states, and a place to appeal enforcement actions and monitor the enforcement of the tax by the states.

#### **Panel statement #6**

Sales taxes have traditionally been the vehicle used by the states to generate a significant amount of their revenues and thus a national sales tax would encroach on the states’ sources of revenue. The panel concluded that the states would increase their reliance on income taxes and thus households and individuals would still need to track their incomes, deductions, exemptions, etc.



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and this would reduce the net positive effect from switching from the federal income tax to a federal sales tax.

### **FairTax response**

Since the facts are that state and local governments derive almost equal proportions of their revenue from sales taxes and income taxes (about 25 percent each), this red herring is entirely false. States have successfully piggybacked the federal income tax system for years; the federal government has never let this consideration get in the way of federal income tax policy. The states could also choose to conform their state sales taxes to the FairTax and cut their state sales tax rates in half (on average).

### **Panel statement #7**

The FairTax has never been enacted in the world and is risky and untried.

### **FairTax response**

Consumption taxes are the oldest form of taxes on this planet; they require very little government overhead in comparison to direct/income/poll/head taxes. Phoenician traders paid a percent of each ship's cargo for the privilege of using safe Mediterranean ports. The greatest expansion in the history of the British Empire followed the repeal of the detested, only-to-beat-Napoleon income tax with the subsequent use of consumption taxes. Florida and Texas, two of the largest economies in the world, rely primarily on sales taxes.

The FairTax is a pure consumption tax with a tax base virtually identical to value-added taxes used by 29 of the 30 OECD<sup>7</sup> nations. Distinguished from these systems, however, the FairTax *replaces* all forms of income and payroll taxes, where these VATs are add-ons to existing income taxes. And the FairTax is a visible tax being separately stated on the retail receipt, whereas VATs are usually hidden in retail prices.

Based on 2005 VAT rates, the average rate is 20 percent with 14 countries having rates of 20 percent or more. Five countries have rates equal to or greater than 23 percent; again, these rates *are in addition to their income/payroll tax systems* (Belgium: 21 percent; Denmark: 25 percent; France: 19.6 percent; Ireland: 21 percent; Italy: 20 percent; Hungary: 25 percent; Austria: 20 percent; Poland: 22 percent; Portugal: 21 percent; Slovenia: 20 percent; Finland: 22 percent; Sweden: 25 percent; Iceland: 24.5 percent; Norway: 23 percent). The FairTax rate of about \$0.23 out of every dollar spent is a revenue-neutral *replacement* for our income/payroll tax system.

### **Panel statement #8**

It is too generous to the poor and lets the wealthy off.

### **FairTax response**

Too generous to the poor? Too generous to the poor? By simply ensuring that no legal American citizen pays any federal tax until they spend above the poverty level, we are being *too*

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<sup>7</sup> Organisation for Economic Co-operation and Development.



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generous to the poor? How can ensuring that no one in such straits pays any tax, and is solely required to simply register for the prebate, be considered too generous?

It is true that there are some wealthy citizens who cannot spend at retail fast enough to match what their lifetime income tax burden may be today. And they are unlikely to be paying any significant payroll taxes.

These are the same citizens who have the wherewithal to plan around the current estate tax laws, ensuring that their estates pay relatively little and often no taxes in the future. Under the FairTax, these citizens may simply hand the shekels over to their heirs, who will spend them, who will hand leftover shekels to their heirs who will spend them . . . In three generations (shirtsleeves to shirtsleeves), the FairTax collects more tax revenues from the wealthy than the income tax plus the estate tax, to say nothing of how much *more* payroll tax they pay in their lifetimes.

Further research by Dr. Kotlikoff finds that the shift to the FairTax raises marginal labor productivity and real wages over the course of the century by 18.9 percent and long-run output by 10.6 percent. Moreover, the FairTax reduces by half the long-run increase in the effective rate of wage taxation needed to pay the Social Security and health care benefits of an aging population. These macroeconomic gains have important microeconomic welfare implications. In the long run:

- Low-income households experience a 26.7 percent welfare gain under the FairTax
- Middle-income households experience a 10.9 percent welfare gain
- High-income households experience a 4.7 percent welfare gain

This is a very progressive long-run outcome.<sup>8</sup>

The panel's analysis neglects to mention that their comparison of the FairTax to the current system does not include the fact that the FairTax also repeals all payroll taxes, which are the most regressive taxes. Nearly three-fourths of taxpayers pay more payroll taxes than they do income taxes. Further, their report completely ignores the greatest benefit of the FairTax in that it is the only tax plan that taxes accumulated wealth and hits the upper income group while ensuring base wages – up to the poverty level – are completely untaxed.

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<sup>8</sup> Jokisch, Sabine and Laurence J. Kotlikoff, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," NBER Working Paper No. 11858, December, 2005.



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**What is the FairTax Plan?**

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16<sup>th</sup> Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

**What is Americans For Fair Taxation (FairTax.org)?**

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: [www.FairTax.org](http://www.FairTax.org) or call 1-800-FAIRTAX.

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(AFFT Documents\Papers on a specific subject\Excerpts from the response to the Mack-Breaux tax panel)