A FairTax® White Paper

The FairTax: Good for taxpayers, good for businesses, good for the economy[1]

The national debate over taxation is shifting from the question of *whether* to alter our current tax system to the question of *how* to alter it. Today, polls indicate that a large majority of Americans are extremely frustrated with the current federal income tax system. The income tax discourages personal savings and investments by taxing capital gains, dividends, and interest earned. Wage earners struggle under the burden of a very regressive payroll tax. The income tax is complex – so complex that no one, not even the experts, truly understands it. Moreover, for the tax to be enforced, the taxpayer must sacrifice significant privacy. As a result, our citizens are governed by needlessly burdensome tax laws that they cannot understand and that are intrusive, complex, costly, and often invisible.

The tremendous undertaking of replacing the income tax requires the American people to put aside partisan politics to arrive at a consensus on how our government should tax its citizens. Any new system of taxation must fairly and efficiently distribute the burden of funding our government, promote economic growth, present less of a compliance burden, and offer every American better economic opportunity.

Americans for Fair Taxation® (FairTax.org), a non-profit, non-partisan organization, believes that replacing the current tax system with a single rate, federal sales tax levied on all new goods and services with no exceptions or exclusions, best meets this challenge. Research has shown that the FairTax is a fair and progressive system of taxation that increases economic growth, investment, capital formation, and the creation of jobs and savings.[2]

The FairTax plan

The FairTax plan involves three specific actions:

- Passage of legislation that repeals the income tax, the payroll tax in its entirety, the estate tax, the gift tax, the capital gains tax, the alternative minimum tax, the self-employment tax, and the corporate tax.

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[1]First published as "A Single Rate, Federal Sales Tax is the Best" in Tax Reform, Opposing Viewpoint Series, Greenhaven Press, 2011, pages 157-166.

[2]Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007; David G. Tuerck, et.al., "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model," The Beacon Hill Institute at Suffolk University, February 2007; Arduin, Laffer & Moore Econometrics, A Macroeconomic Analysis of the FairTax Proposal, June, 2006; David G. Tuerck, Jonathan Haughton, Paul Bachman, and Alfonso Sanchez-Penalver, "A Comparison of the FairTax Base and Rate with Other National Tax Reform Proposals," The Beacon Hill Institute at Suffolk University, February, 2007; Laurence J. Kotlikoff, and David G. Tuerck, *et. al.,* "Taxing Sales under the FairTax: What Rate Works?, *Tax Notes*, November 13, 2006. These papers are available at www.fairtax.org/AboutTheFairTax/ResearchPapers.

- Passage of legislation that installs a single rate, national sales tax on all new goods and services at the point of final purchase for consumption, and that provides for a universal rebate in an amount equal to the sales tax on essential goods and services up to poverty level spending.
- Adoption of a constitutional amendment to repeal the 16th Amendment and to prohibit income taxes. The FairTax will sunset if the 16th Amendment has not been repealed within seven years following enactment, preventing the possibility of having both the income tax and a national sales tax.

The FairTax has been introduced as "The Fair Tax Act of 2013" in the 113th Congress (H.R. 25 in the House of Representatives and S. 122 in the Senate).[3]

Fairness

Throughout the history of our country, our citizens and government have had an objective to increase every American's chance to achieve economic independence by providing greater opportunities to share in our country's growth and prosperity. The FairTax helps us achieve this goal. Americans are better off under the FairTax. Although every taxpayer is subject to the same sales tax rate with no exceptions or exclusions, those least able to share in the cost of government will carry no federal tax burden at all.[4] Under the current system, the more your income is derived from wages, the more you are affected by payroll taxes. In addition, under the FairTax, no one will pay tax on the cost of essential purchases, and those who demonstrate their greater ability to pay by consuming more, will pay more taxes.[5]

Table 1: 2011 Income and Payroll Taxes Includes only Employee portion of federal payroll taxes						**FairTax**	
Family Gross Income	Income Tax	Social Security	Medicare	Total Tax	**Effective Tax Rate[a]**	Sales Tax	**Effective Tax Rate[b]**
$29,420	-$3,048	$1,824	$427	-$797	-2.7%	$0.00	0.0%
$58,840	$4,016	$3,648	$853	$8,517	14.5%	$6,767	11.5%
$88,260	$8,429	$5,472	$1,280	$15,181	17.2%	$13,533	15.3%
$117,680	$15,181	$6,622	$1,706	$23,509	20.0%	$20,300	17.3%

[a] Effective R ate = total taxes / family income. The total taxes are computed for a family of four claiming the standard deduction for joint returns ($11,600) and four personal exemptions ($3,700 each). Taxpayers who itemize (1/3 of taxpayers) would have lower effective rates; higher income taxpayers are more likely to itemize.

[b] Assumes that the family spends all income earned, saving nothing and receives monthly FairTax prebate checks totaling $6,767 annually (equal to 23% of poverty level spending ($29,420 for a family of four).

[3] H.R. 25 is sponsored by Congressman Rob Woodall, with 58 co-sponsors in the House as of January 23, 2013. The Senate companion bill, S122, is sponsored by Senator Saxby Chambliss and has 7 co-sponsors.

[4] Kotlikoff, Laurence J. and David Rapson, "Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation," NBER Working Paper No. 12533, revised October 2006; Kahn, Joseph, "Examining a Change to a National Retail Sales Tax Regime: Impact on Households," Decisions and Ethics Center, Stanford University, November, 1996.

[5] The analysis shown in Tables 1 and 2 does not include the 2 percentage points payroll tax reduction for employees which expired on Dec. 31, 2012.

Table 1 shows that a sample family of four with a poverty level income of $29,420[6] has an effective federal tax rate of -2.7 percent of their gross income, when the Earned Income Credit of $3,350 is taken into account. A sample family earning $58,840 pays 14.5 percent of their gross income in federal taxes. Under the FairTax, the family of four earning $29,420 (spending all of their income) pays zero federal taxes (after the prebate[7]), and the same family of four earning and spending $58,840 pays an effective tax rate of only 11.5 percent on their taxable purchases.

However, this is not the whole picture. While payroll taxes are levied equally between employers and employees, it is the broad consensus among economists, including those at the Congressional Budget Office and the Joint Committee on Taxation, that it is really the *employee* that bears the burden of the *employer* portions of Social Security and Medicare payroll taxes, and federal unemployment taxes through *lower wages than would otherwise be paid*.[8] On this basis, the true burden of the current federal income tax system on taxpayers becomes even more dramatic. (See Table 2.)

Table 2: 2011 Income and Payroll Taxes (Includes Employee and Employer portions of federal payroll taxes)							**FairTax**	
Family Gross Income[a]	Income Tax	Federal Unemployment Tax	Social Security	Medicare	Total Taxes	**Effective Tax Rate[b]**	Sales Tax	**Effective Tax Rate[c]**
$32,105	-$3,048	$434	$3,648	$854	$1,888	5.9%	$617	1.9%
$63,775	$4,016	$434	$7,296	$1,706	$13,452	21.1%	$7,901	12.4%
$95,446	$8,429	$434	$10,944	$2,560	$22,367	23.4%	$15,186	15.9%
$126,442	$15,181	$434	$13,243	$3,413	$32,271	25.5%	$22,315	17.6%

[a] Employer payroll taxes (federal unemployment, Social Security and Medicare) have been added to family gross income to measure the true burden of the federal tax system on families.

[b] The rate assumes that the employee pays both the employee and the employer portions of Social Security and Medicare payroll taxes and federal unemployment taxes through lower wages. The rate = total taxes / family income. The total taxes are computed for a family of four claiming the standard deduction for joint returns ($11,600) and four personal exemptions ($3,700 each). Taxpayers who itemize (1/3 of taxpayers) would have lower effective rates; higher income taxpayers are more likely to itemize.

[c] Assumes that the family spends all income earned, saving nothing and receives monthly FairTax prebate checks totaling $6,767 annually (equal to 23% of poverty level spending ($29,420 for a family of four).

[6] This income level is derived from the poverty level guideline for a family of four, two adults, two children. See Federal Register, Vol. 76, No. 13, January 20, 2011.

[7] The prebate is a rebate paid at the beginning of each month, in twelve equal installments. The amount of the prebate is determined by the Department of Health & Human Services' poverty level guideline multiplied by the FairTax rate. The poverty guidelines are a well established measurement of the poverty level based on expenditures for necessities such as food, clothing, shelter, transportation, medical care, etc.

[8] See The Corporate Income Tax and Workers' Wages: New Evidence from the 50 States, Tax Foundation Special Report No. 169, August 2009; Congressional Budget Office, "Historical Effective Federal Tax Rates, 1979-2006," April 2009 and Joint Committee on Taxation, "Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposals," March 6, 2001.

Given that the employer share of payroll taxes in actuality reflects a reduction of the employee's potential wages, we can determine the "actual" tax burden as shown in Table 2. First, we increase the gross family income amounts from Table 1 by the amount of employer payroll taxes (Federal Unemployment Tax, Social Security and Medicare taxes). Employer payroll taxes of $434 (FUT), $1,824 (SS), and $427 (Med) are added to the employee's income of $29,420 to obtain a "potential" income of $32,105. The total taxes paid are then compared to the total potential income to determine the actual tax burden which in this case is an effective tax rate of 5.9 percent of their gross income even after deduction of the Earned Income Credit.

The FairTax amount is calculated by multiplying the rate of 23 percent times family income, assuming that all income is spent. This amount is divided by income to yield and effective tax rate. For comparable income levels, the FairTax effective tax rate is substantially less than under the current system. In the case of the family with potential income of $32,105, the effective rate is only 1.9 percent. The tax rate for the $63,775 income level jumps to 12.4 percent but that is still much less than the 21.1 percent rate for the income tax system. The results show that the FairTax is progressive; i.e., the effective tax rate rises as income rises.

Our current tax system is also unfair because it is highly responsive to political influence on behalf of special interest groups. Average taxpayers without the means or organization to influence tax policy are at a clear disadvantage. The inextricable relationship between the tax code and lobbyists is evidenced by the fact that more than half of Washington lobbyists are registered on tax matters. Under the FairTax, there are no exceptions and there are no exclusions – there are no loopholes to be exploited by special interests. Under the FairTax, all taxpayers have an equal voice.

Simplicity

A fundamental notion of fairness is that citizens should be able to comprehend the laws that affect them. However, current tax law is beyond the comprehension of most taxpayers, including many of those who devote their entire professional lives to it. In the long-running experiment of the income tax, it is fairly well demonstrated that it is the nature of the income tax as a hidden tax that breeds complexity. 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 with 4,428 changes to the tax code in just the last decade. The continuous tinkering with the tax code has resulted in tripling the length of the tax code, now a mind-boggling 3.8 million words, and that, on average, has more than one new provision added to it daily.[9] The combined federal income tax code, regulations, and IRS rulings have mushroomed from 14,000 pages in 1954 to 73,954 pages by 2013 – an increase of 428 percent.[10] To cope with this complexity, nearly 60 percent of taxpayers hire paid preparers and another 30 percent rely on commercial software to prepare their returns.

The FairTax is simple: One single rate, with no exceptions and no exclusions, collected at the point of purchase. The simplicity of the FairTax means that tax planning is now within the reach of the ordinary taxpayer, who can choose the amount and timing of federal tax payments by deciding when to make purchases and whether to buy new or used products.

[9] Taxpayer Advocate Service, 2012 Annual Report to Congress, Executive Summary, Dec. 31, 2012, p. vii.
[10] As measured by the number of pages in the CCH Standard Federal Tax Reporter, 2013.

Efficiency

In addition to the taxes on income that we pay, we also pay the cost of payroll and corporate taxes that are embedded in every product that we purchase. Businesses pass their costs on to consumers in the form of higher prices. But the burden to the consumer doesn't stop there. We also pay for the cost of complying with the tax code. So complicated has the income tax system become that an analysis of IRS data by the Taxpayer Advocate Service estimated that individual taxpayers and businesses spend 6.1 billion hours each year complying with the filing requirements of the Internal Revenue Code. Massive amounts of our national wealth are consumed merely by measuring, tracking, sheltering, documenting, and filing our annual income. The twin burdens of time and money required for record keeping, tax form preparation, calculating and funding estimated payment schedules, and tracking income and expenses are eliminated by the FairTax.

While the economic burden occasioned by compliance has been estimated many ways by many researchers, with a correspondingly large range of values, the most recent credible study shows that U.S. taxpayers waste an astounding $431.1 billion annually on tax compliance. If this figure is near correct, it means that we pay about 30 percent of total income taxes collected, just to … well … pay those taxes.[11] Of the $431.1 billion, 88% is the time value costs borne by taxpayers: $161.7 billion by businesses and $216.2 billion by individuals.

The FairTax generates the same amount of revenue as the current tax system, but at a much lower administrative cost. Of the 154 million tax returns filed in fiscal year 2011, over nine out of ten were filed by individuals (143.6 million). Under the FairTax, individuals do not file tax returns. Only businesses that sell goods or services at retail are required to file tax returns, reducing the number of tax filers by at least 80%. These businesses remit the FairTaxes they collect on consumer purchases along with their state sales taxes once per month. They no longer have to administer income tax withholding and payroll tax deduction on wages paid to their employees on behalf of the federal government. According to an estimate by the Tax Foundation, the replacement of the income tax with a national retail sales tax would reduce compliance costs by 95 percent.[12]

Economic impact

Slow economic growth and economic stagnation have an adverse impact on low wage earners. These families are more likely to lose their jobs, are less likely to have the resources to weather bad economic times, and are more in need of the initial employment opportunities that a dynamic, growing economy provides. The income tax retards economic performance by creating a significant bias against saving and investment through double, triple, and even quadruple taxation. Under the FairTax, what you earn is what you take home. Americans are able to save more and invest more. The FairTax dramatically increases investment levels compared to levels that would have been achieved under the current income tax system.[13] Increased savings will

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[11] Laffer, Winegarden, and Childs, "The Economic Burden Caused by Tax Code Complexity, April, 2011. 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, record keeping, and other burdens are an estimated 13 to 22 percent of the total revenue raised by the income tax system.

[12] Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation, Testimony before the House Ways and Means Committee, June 6, 1995.

[13] Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007; David G. Tuerck, et.al., "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model," The Beacon Hill Institute at Suffolk University, February 2007.

stimulate investment and productivity and the economy will grow more rapidly, creating demand for workers and improving job opportunities. Because taxes on capital are removed, foreign capital will flow into the United States, creating businesses and jobs. U.S. products competing abroad are free of the hidden costs of taxation while the FairTax is collected on foreign products sold in the United States. Virtually all economic models project a much healthier economy under a broad-based consumption tax such as the FairTax.

Summary

The ever-increasing taxpayer demand for a simpler, less intrusive system of taxation is building daily. The FairTax delivers these benefits to the American people, and more – more government accountability for taxpayer dollars, the elimination of tax returns for individuals, a tax system which is transparent and less susceptible to being manipulated by special interests, and perhaps most importantly, a tax system that promotes economic growth and job creation.

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll taxes with an integrated approach including a progressive national retail sales tax, a rebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S122) abolishes all federal personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes and replaces them with one simple, visible, federal retail sales tax – collected by existing state sales tax authorities. The FairTax taxes us only on what we choose to spend, not on what we earn. It does not raise any more or less revenue; it is designed to be revenue neutral. 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 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 or call 1-800-FAIRTAX.

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