



Grading the Tax Reform Plans: Who is the Fairest of Them All?

A Briefing Document by FairTax.org

“The nation’s largest grass roots citizens’ organization dedicated to fundamental tax reform.”

With the exception of tax lawyers, tax preparation firms, some bureaucrats, tax lobbyists, tax software firms and more than a few tax professors, almost everyone embraces tax reform. So the Congress is bent on effecting “reform.” The problem is that nobody really knows how to define reform.

Because the Internal Revenue Code and the U.S. tax system in general are so universally derided, an uninitiated observer might think it odd that a proper analysis of tax reform must begin by understanding the problems tax reform is meant to address. However, although business owners and executives and all American engaged in the tax reform debate may share a fervent disdain for the tax system, but they do so for a wide array of reasons. The tax reform debate today is not about one problem. It is about a bundle of competing problems searching out competing solutions.

Before we can make true progress in discussing the effectiveness of various alternatives in achieving tax reform goals -- before we can properly analyze the relative benefits of competing plans -- we must agree upon the common issues tax reform is meant to address. Stated another way, we must decide ‘what the salient problems with the current system are?’ before we can ask ‘how well the various competing ideas for reform address those problems?’

Without establishing criteria describing what constitutes genuine tax “reform,” it is impossible to assess the relative merits of the various plans or even to decide whether a plan would be constructive. Reform can be embraced by Democrats as well as Republicans. It can be embraced by pro-growth proponents or those who simply want to see wealth redistribution. In other words, reform is a promiscuous term that can be exploited and currently is in the political context. And if “reform” is not defined, then it becomes a political football that can be used by any politicians. It is both nothing and everything at the same time. What the American people need to do is to define for their public servants what they see as true reform.

I. So What is the True Meaning of “Reform”?

This paper sets forth the suggested criteria policymakers might use for purposes of assessing fundamental tax reform plans, including the President’s poorly received Tax Panel’s proposals. These criteria are not exhaustive but they are the most important. In general, a reformed tax system should minimize the adverse economic impact of raising the revenue that Congress decides is necessary to fund the federal government and do so in a fair manner. A tax reform plan that meets the following twelve specific criteria will accomplish the twin goals of fairness

and maximizing the economic prosperity of the American people.

The Criteria for Fundamental Tax Reform ought to be the following:

Prosperity Criteria

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

Fairness Criteria

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

Civic Criteria

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

The answer is that true reform is the plan that best fulfills these criteria. The prosperity criteria are those that will maximize economic growth and the economic well-being of all Americans. The fairness criteria are those that we believe most Americans accept. The civic criteria are those that promote a healthy body politic and improve our political process.

II. Brief Description of the FairTax and the Flat Tax.

FairTax: The FairTax has been introduced in the House by Representative Rob Woodall and in the Senate by Senator Saxby Chambliss as H.R. 25 and S. 13, with 66 cosponsors in the House and eight in the Senate. 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 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.

Flat Tax: The Freedom Flat Tax, HR1040 has been introduced in the House of Representatives by Rep. Burgess. The bill has 10 cosponsors. There is no Senate companion bill. The flat income tax is essentially a modified version of the existing federal income tax that has a single or flat tax rate, using the current system of payroll deductions and the Internal Revenue Service. It can be considered a consumption-based tax because it does not tax income from investments or savings. The tax would be collected in lieu of the current income tax on both individuals and businesses.

It would allow individuals and businesses to make an irrevocable election to be subject to a flat tax of 19 percent of taxable income for the first two years and 17 percent thereafter. Taxable income is calculated by subtracting a basic standard deduction and an additional standard deduction for each dependent from the total of wages, retirement distributions, and unemployment compensation. The flat tax is in addition to the 7.65 percent Social Security/Medicare/Medicaid payroll tax.

The tax base for the business portion of the flat tax is total gross income minus deductions: Wages paid to employees, pension payments, and purchases from other businesses. It is actually a form of value added tax (VAT) where capital value-added is taxed at the business level and labor value-added is taxed at the individual level, although its proponents often skirt this issue. Since investment is expensed and savings are accorded Roth IRA type treatment, it is a form of consumption tax. Like the income tax imports are exempt from tax and exports are taxed. The administrative means used to collect the tax is similar to the current tax system.

Like the FairTax, it repeals the estate, gift, and generation-skipping transfer taxes.

III. How well do these plans meet the criteria?

To What Degree are They Neutral between Consumption and Savings?

Capital formation promotes greater productivity and output, higher rates of economic growth, and improved competitiveness. More capital per worker, embodying the latest technical

innovations means more output, greater competitiveness and higher real wages. The current tax system, however, is very biased against savings and investment, often taxing the returns to savings or investment three or four times. This results in slower economic growth, reduced competitiveness and lower real wages. The solution is to adopt a tax system that is neutral toward savings and investment. The FairTaxsm and the flat tax would address this issue decisively. In both plans, labor and capital output is taxed equally and one time.

FairTax: In the FairTax, this result is achieved simply by taxing only final consumption and not taxing business inputs. Unlike most state sales taxes, the FairTax does not hide taxes and impose a tax on a tax. It taxes goods and service once when sold to consumers.

Flat Tax: In the flat tax this is accomplished by expensing capital investment and treating all savings effectively as if they were in Roth IRAs.

To what degree do they lower or raise marginal tax rates?

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

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

When comparing the FairTax to other tax plans it is important to remember that the FairTax repeals the 15.3 percent payroll taxes (both Social Security and Medicare employment taxes and self-employment taxes).

Flat Tax: A flat tax with a rate of 17 or 20 percent, for example, is really a 32.3 or 35.3 percent tax on labor or self-employment income, because it is in addition to both individual and employer payroll taxes. .

To what degree do they continue to hurt American producers?

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

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

here but impose no tax on goods produced abroad and imported into the U.S.

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

FairTax: The FairTax would by the very nature of a sales tax remediate this problem by taxing foreign and U.S. goods alike when sold at retail. It would, for the first time, eliminate the advantage accorded to foreign producers by current federal tax policy.

Flat Tax: The flat tax does not address the problem.

To what degree are they neutral between different types of productive activity?

FairTax: The FairTax treats all goods and services alike. Thus, it does not distort the marketplace and allows businesses to adopt the most efficient economic means to meet consumer demands. A plan that taxes economic activity uniformly will promote the most efficient, productive economy.

Flat Tax: The flat tax does so to a lesser extent (because of its retention of payroll taxes).

To what degree are they neutral as between human and physical capital?

Human capital is a critical element in productivity and innovation.

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

Flat Tax: The flat tax does not address this problem. Education is treated like a consumption good and must be purchased with after-flat-tax and after-payroll-tax dollars.

To what degree do they reduce the compliance burden on the public?

The current tax system has major tax evasion problems notwithstanding billions of tax and information returns filed each year, roughly 6 billion hours spent figuring out the tax due, and an army of tax preparers, tax accountants, tax lawyers and IRS personnel. We waste nearly \$300 billion annually complying with the current tax system. The time spent figuring our taxes is more people than the hours spent working in the auto industry, the computer manufacturing industry, the airline manufacturing industry and the steel industry combined.

FairTax: The FairTax would radically reduce these costs and the complexity of the system. Individuals who were not in business for themselves would never need to file a tax return again. Moreover, the FairTax compensates businesses for the time required to file sales tax returns with a credit equal to $\frac{1}{4}$ of one percent of the sales tax remitted.

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

Small businesses are disproportionately harmed today by the large compliance burden imposed by the current tax system, often bearing compliance costs that exceed three times the tax remitted. They would disproportionately gain from implementation of the FairTax.

Flat Tax: The flat tax would reduce it substantially; at least until the political process turned it back into something similar to what we have today. However, the flat tax does require all Americans to file tax returns and would retain income tax withholding and payroll tax rules.

To what degree do they exempt the poor?

It does not make a great deal of sense to impose taxes on poor people. Neither, however, does it make sense to hide from them the cost of government. The poor cannot even meet their basic needs and are receiving financial assistance in many ways. Yet today, they pay significant taxes. Part of those taxes is the payroll tax imposed on the working poor. But the poor also bear the burden of paying higher prices for the goods they buy because of the taxes imposed on businesses and the cost incurred by businesses to comply with the tax system. Businesses, after all, must recover all of their costs, including taxes, in the price of the goods they sell. If they do not, they will quickly go out of business.

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

The rebate makes the FairTax progressive. The effective tax rate climbs as expenditures climb. The effective tax rate is negative or zero for the poor, it is quite low for the lower middle class. The effective tax rate for a married couple with two children with taxable spending of \$58,360 would be 11 ½ percent in 2011.¹ The very rich would pay nearly 23 percent on their spending. By repealing the payroll tax, the FairTax eliminates the greatest burden on the working poor and reduces the cost of hiring new, entry level workers. By repealing business taxes, hidden taxes that must be recovered by businesses in the price of goods sold are repealed. No other plan is structured to ensure that no poor person will pay any tax. No other plan ensures that all households may meet the necessities of life without paying tax.

¹ The Federal Register, January 20, 2011, Vol. 76. No. 13.

Flat Tax: The flat tax keeps the payroll tax, which is the largest tax paid by poor Americans. For 66 percent of tax filers, the amount of their payroll taxes exceeds their income taxes. Over 80 percent of those earning between \$30,000 and \$50,000, pay higher payroll taxes than income taxes.²

How fairly do they treat taxpayers?

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

Flat Tax: The flat tax moves in the right direction but retains the payroll tax which taxes labor income at different tax rates depending on the level of their income and does not tax capital income.

Do they play favorites?

It is unfair for the government to play favorites, rewarding certain politically powerful and well-connected interests over others that do not have the same political pull. The tax system *should* be about do what is right and just rather than what will help fill campaign coffers and satisfy interest groups.

FairTax: The FairTax treats everyone alike and does not exempt any person, any good or any service from tax. The rules are simple and clear and apply to everyone.

Flat Tax: The flat tax would largely eliminate the favoritism of current law. It does, however, retain on major favorite. Foreign produced goods are favored over U.S. produced goods.

How transparent and comprehensible is the plan?

The current tax system is the antithesis of transparency. It divides up the public's tax burden among four or five "apparently low" tax rate taxes, some of which are hidden from view, that add up to very high aggregate tax rates. Similarly, who knows who pays the corporate tax? Most people – small businesses and self-employed people being obvious exceptions – do not even know about the massive employer payroll taxes that drive their wages down. Most people have only the vaguest idea of what they pay in income taxes today and since their taxes are withheld and, as often as not, they used paid preparers or package software to figure their taxes.

FairTax: The FairTax is the easiest of any tax reform plan to understand. That is its virtue and its vice. It is a simple sales tax with a single tax rate. The FairTax has one very transparent tax rate which, in reality, is the lowest marginal tax rate by far of any tax reform plan. Yet because the FairTax is honest and transparent and the current tax system is anything but honest and transparent, FairTax detractors are able to obfuscate, demagogue and confuse by misrepresenting the facts.

Even the poor will pay the tax at the cash register, albeit with funds provided by the FairTax rebate. Under the FairTax, people will understand for the first time in their lifetime how the federal government is actually paid for and who is paying for it.

² Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).

Flat Tax: The flat tax is relatively simple, yet even many of its most vocal proponents seem to think it is an income tax rather than a consumption tax. In fact, it is the worst of both worlds. It is a VAT in that it does not double tax returns on capital, but it is an income tax in the sense that it requires the 16th Amendment that authorizes the income tax for its enactment. Therefore, it provides no assurance against a secondary income tax.

How politically stable is the plan?

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

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

To what degree are there transition problems?

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

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

Flat Tax: The flat tax sidesteps transition issues. It is, however, unlikely that in the final

analysis Congress will force businesses to lose trillions of dollars of basis on capital assets if the income generated by those assets remains subject to tax. To do so would amount to wealth loss for existing capital owners of well over a trillion dollars to American businesses. Addressing this transition issue, will force the flat tax rate to climb considerably.

How do the plans impact small businesses and farms?

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

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

Flat Tax: Does not address these needs of small businesses as directly and effectively as the FairTax. The flat tax does not address either payroll tax issues or level the playing field with imports.

IV. Conclusion

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

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

The analysis above demonstrated that the FairTax is the most pro-growth and most fair tax plan being considered in Congress. It showed that the BTT and the flat tax would constitute a

significant improvement over current law. The report card below is a summary of these findings.

Tax Reform Report Card

Criteria	Flat Tax	Business Transfer Tax	FairTax
P1. Neutral Toward Savings and Investment	A	A+	A+
P2. Low Marginal Tax Rates	B+	A-	A+
P3. Neutral Between Foreign and U.S. Producers	D	A+	A+
P4. Taxing Economic Activity Uniformly	A-	A-	A
P5. Neutral Between Human and Physical Capital	F	F (usually)	A
P6. Reduce Compliance Costs	B	B	A+
F1. Poor Untaxed	B-	B-	A+
F2. Equal and Uniform Taxation	B	B+	A+
F3. No Favorites or Special Exceptions	A-	A-	A+
C1. Transparency and Understandability	B	B-	A+
C2. Politically Stable	C	B	A
C3. Manageable Transition	B	B	B+
Overall Grade	B	B+	A+

Author: Karen Walby, Ph.D., October 16, 2011. Revision of testimony presented to the House Committee on Small Business by Americans For Fair Taxation, February 1, 2006.