

Honorable Lamar Smith
U.S. House of Representatives
Washington, D.C. 20515

Subject: H.R. 25, The FairTax (Confirmation number 1246414)

Dear Congressman Smith:

I am in receipt of your October 12th response to my letter in support of the FairTax. In your response, you expressed several concerns that prevent you from supporting the FairTax at this time. This follow-up letter is intended to address each of your concerns, and urges you to reconsider both your support for the FairTax and the accuracy of the messages you are disseminating to interested constituents about this legislation.

The FairTax improves enforcement at lower costs to the government and the taxpayer.

Allow me to begin with your question about the enforceability of the FairTax; particularly your suggestion that the FairTax would “create” a barter economy. Section 103(f) of the Fair Tax Act (reintroduced in the 110th Congress on January 4, 2007) makes bartering under the FairTax a taxable event enforceable by penalties, just as the income tax does today:

(f) Barter Transactions- If gross payment for taxable property or services is made in other than money, then the person responsible for collecting and remitting the tax shall remit the tax to the sales tax administering authority in money as if gross payment had been made in money at the tax inclusive fair market value of the taxable property or services purchased.

Taxpayers barter today for the same reasons they evade taxes in other ways – because they perceive the reward from cheating to be worth the risk. But since a single FairTax rate is applied to a base nearly twice the size of taxable income, the average marginal rate under the FairTax is much lower than today. This means the reward from cheating is less. Although businesses also cheat through bartering today, since business-to-business transactions are not taxable under the FairTax, bartering for these purposes would not contribute to the tax gap either.

You fear the distinction between new and used goods might create a tax loophole, but you fail to acknowledge that the miniscule interpretive issues under the FairTax become infinitesimal when compared to those under every known alternative, especially current law. The FairTax untaxes used goods as a transition rule, since the prices of used goods already bear the taxes imposed upstream. And you incorrectly assert the FairTax will require the same level of federal resource. The FairTax will be largely administered by the states that have been able to enforce state sales taxes at a rate which literally embarrasses the IRS.

As you consider how to ease “the burden on the American taxpayer,” I would be interested in hearing how you might go about this task? Consider that five years ago, the tax gap – the difference between taxes owed and collected – was estimated to exceed

\$345 billion. That figure did not include taxes not paid on illegal sources of income (i.e., what economists refer to as the true “underground economy”). And consider that the income tax system has been able to achieve this dismal performance only by forcing Americans to struggle under a despotic system which requires them to confess every detail of their private lives and waste more than \$300 billion on compliance costs. Even after 1.5 billion information returns, 224 million tax returns, 4 billion contacts, and 30 million civil penalties, the current system still has a net tax gap of greater than 3.5 percent of GDP. Today’s tax system is not just broken, it is Orwellian and the Congress will seek to close this gap only by ratcheting down the screws, by more intrusions, more penalties, and more sacrifice of civil liberties.

The FairTax would greatly reduce this unsustainable tax gap while imposing much lower administrative and compliance costs. Under the FairTax, non-willful noncompliance can be expected to nearly vanish as the complexity of the system evaporates. Much of the tax gap today is attributable to mistake, not fraud. And the FairTax reduces the gap attributable to fraud as well. Today, the estimated 18 million wage-earning Americans that have dropped out of the income tax system entirely as “non-filers” will pay the FairTax, as will illegal aliens who are paid “under the table” today. And because of the dramatic 90 percent reduction in the number of tax filers, tax evaders will be more easily monitored and caught under the FairTax system. Today, taxpayers can cheat in the privacy of their homes and bury their cheating on 227 million tax returns in the unnavigable 7,000 code sections with plausible deniability that they even understood the law. Contrast the current system with the FairTax, where individuals would no longer need to file returns, and retailers would be provided a credit compensating them for the costs of sales tax compliance. Even if all approximately 25 million business establishments in the U.S. were retailers, the number of returns filed would decline 86 percent.

The FairTax makes it so that far fewer taxpayers will have much less incentive to cheat and much greater chance of getting caught if they do.

And one more consideration on enforcement bears stating. Congress itself is responsible for an economic tax gap, which may be larger than the tax gap the IRS measures. This economic gap can be defined as the difference between the amounts of revenue the government would receive but for the dead weight economic loss from the thousands of loopholes Congress creates, the double and treble taxation of savings, and the high marginal rates that discourage work. The reduced marginal rates under the FairTax contribute to economic growth, which itself increases revenues.

The FairTax increases giving.

You state that the FairTax will harm charities because “under the income tax such contributions offset the income tax paid by individuals.” However, you err in this assertion as well. The FairTax (unlike the flat tax) has what can be described as a “supercharged” charitable deduction. The FairTax allows all taxpayers to give money to their favorite charity free of any income tax, any payroll tax, or any sales tax.

By way of example, suppose a donor earns \$100 and seeks to contribute that amount to charity today. A taxpayer who does not itemize (and that is three-quarters of all taxpayers) must give with what remains after the government has taken its share. A donor who pays at a 28 percent rate plus the 15.3 percent payroll tax rate must earn \$167.50 to give \$100 to charity. Similarly, an itemizing taxpayer must give with what remains after payroll tax dollars are paid. A donor who pays at the 15.3 percent rate must earn \$118 to give \$100 to charity. Under the FairTax, in contrast, that donor would need only to earn that \$100 to give \$100. All taxpayers will gain from being able to give to charity free of payroll tax, which is better treatment than even itemizers receive today. The FairTax therefore untaxes charitable gifts as well as the payroll of charitable organizations.

And apart from lowering the cost of giving, consider this. Giving is most responsive to changes in incomes. Giving tracks GDP growth very closely (staying within 1.8 to 2.2 percent of GDP for many years). When the economy grows, giving grows. The FairTax is very pro-growth; it will increase incomes and giving commensurately.

The FairTax and the 16th Amendment

You raise the additional concern that adoption of the FairTax may impose a risk of both an income tax and a sales tax. However, the FairTax bill does not incorporate the repeal of the 16th Amendment because a constitutional amendment cannot be enrolled in a bill amending the Internal Revenue Code. At the same time, however, the FairTax is the *only* tax reform plan that can withstand a repeal of the 16th Amendment.

Today, taxes and their effect are camouflaged. More precisely, an estimated 43.4 million tax returns, representing 91 million individuals, will report a zero or negative income tax liability in 2006. Adding to this figure the 15 million households and individuals who will file no income tax return at all, roughly 121 million Americans – or 41 percent of the U.S. population – will see themselves as fully “unvested” with the income tax, except for what the revenues can do for them. Regardless of the assumptions we draw over incidence, the portion who pay payroll taxes see these taxes as the employer’s responsibility. Even those who pay income taxes are more or less numb to the more than \$270 billion in compliance costs, \$307 billion in corporate taxes, the \$771 billion in payroll taxes, or the \$26 billion in death taxes that fall back on the factors of production.

Hidden costs go well beyond the question of economic incidence versus legal incidence or the compliance burden. The average taxpayer may be anesthetized to the deleterious economic effects of a tax system that imposes a drag on economic growth, but a severe relative drag on economic growth nonetheless. According to economist Laurence Kotlikoff, *not adopting the FairTax* would reduce capital per unit of human capital 5.0 percent over the course of the century for an 18.0 percent long-run decline in after-tax take-home pay. That is a sizeable tax increase that benefits neither the government nor the taxpayer.

The FairTax corrects these problems in ways no other viable tax replacement plan can. First, it ensures everyone – from the illegal alien to the poorest American – is vested in

the tax system. The way to produce downward pressure on government is to make every participant in the economy an equal stakeholder, exposed to the true cost of the federal government on the receipt of each item they buy. Second, the FairTax makes the current hidden taxes transparent and keeps politicians honest by eliminating the ability to raise taxes on others by hidden loopholes.

Congressman Smith, the FairTax addresses the concerns you raised better than any plan could. It certainly addresses these concerns better than the current system, which is implicitly supported by Members of Congress who fail to advance alternatives.

For too long, Congressman, Republicans and Democrats alike have had it very good. They have tacitly supported the *status quo* merely by placating their constituents with statements that they are thinking deeply about reform or that “there is a long road ahead of us.” If you believe you can develop a proposal that better respects civil liberties and is less intrusive than one which removes individuals as tax collectors, the Congress should hear of it. If you believe you can develop a proposal that is simpler than one which reduces the thousands of pages of gibberish to one question asked of retailers, please introduce it. If you believe you can create a system better for philanthropic activities than one which eliminates fully the tax on charitable institutions, please do so.

But with all due respect, as a constituent and a taxpayer, the time for thinking is over and the time for action has come. I implore you: Go beyond the rhetorical dismissals to seriously examine the criteria by which reform should be measured, and beyond that, to actually test various proposals against those criteria. Take more time to learn about the proposals. The system is broken. And you represent the body that is responsible for fixing it. Please, get to work!

Sincerely,

Norman Cooper

This is the letter sent by Congressman Smith to Mr. Cooper:

Dear Mr. Cooper,

Thank you for your letter about H.R. 25, the “Fair Tax Act of 2005.” I appreciate knowing of your interest in this legislation.

Like you, I believe that Americans are over-taxed and the IRS too frequently intrudes into citizens’ lives. The question is how to fix both.

H.R. 25 repeals the income, estate and gift taxes and replaces them with a national sales tax. Consumers would be taxed on the purchase of taxable property or services in the U.S. This legislation sets the sales tax rate at 23 percent and allows adjustments to the rate in subsequent years.

I agree with the goal of the “Fair Tax” proposal and appreciate this innovative approach. However, I do have several questions about how a new national sales tax would be implemented.

For example, a national sales tax could create an underground economy. Individuals seeking to avoid the sales tax could exchange goods through bartering instead of through purchasing and selling.

In addition, because a sales tax would not apply to used or previously owned products, only to new goods and services, it could create a new tax loophole. Taxes could be avoided if sellers designated their goods and services as “used.” This would require new definitions to clarify what is used or previously owned and possibly create new complexities in the tax code.

Collecting the Fair Tax would require substantial enforcement by the federal government, leaving us with many of the enforcement issues we deal with now under the current tax code.

A national sales tax might also reduce charitable contributions and hurt charities such as museums, religious institutions, and community organizations. Under the current income tax, such contributions offset the income tax paid by individuals but under the Fair Tax there is no similar reduction.

Finally, this bill does not repeal the Sixteenth Amendment, which gives the federal government the authority to tax all income, so there is a risk that Americans could end up paying both a national sales tax and a federal income tax.

We have a long road ahead of us in terms of tax reform and easing the burden on America’s taxpayers. There are several pieces of legislation before the Congress with varied reform approaches. Please be assured that I will keep your views in mind as I continue to monitor H.R. 25 and all legislation designed to reform our tax system.

For more information on my work in Congress and for updates on pending legislation, please visit the 21st District’s Web site, <http://lamarsmith.house.gov>.

Sincerely,

Lamar Smith
Member of Congress

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