

The Honorable John Lewis
343 Cannon House Office Building
Washington, D.C. 20515

Dear Representative Lewis:

Thank you for your letter of Friday, October 13, 2006. I appreciate the thoughtfulness of your reply and your commitment to tax reform. However, your analysis of the FairTax appears to be a rote repetition of inaccuracies that opponents of the FairTax have incorrectly disseminated. I direct your attention to www.FairTax.org where you can find the detailed academic research that addresses your stated concerns and answers other questions about the FairTax. Additionally, you can find a rebuttal to ITEP's "study" on FairTax rates.¹ The ITEP study, through its sister lobbying organization Citizens for Tax Justice, has been disseminating misleading information about the FairTax Plan in order to influence political races.

The central distortion of critics is an ill-considered attack on the rate. The attack is wrong in several respects, beginning with the assumption that the 23 percent rate is misleading. It is correct to note that if the FairTax rate is considered from a particular perspective (the tax-exclusive perspective) it would have a 30 percent rate rather than a 23 percent rate. However, competing tax reform plans must be examined from the same perspective. For example, when applying the tax-exclusive analysis to the current tax brackets, a taxpayer in the 10 percent bracket would be paying a 34 percent rate as measured on a tax-exclusive basis² and a middle-class taxpayer in the 25 percent tax bracket would be paying a 68 percent rate. Would it be fair to conclude that you support a rate of 34 percent on the income of lower-income Americans and a 68 percent rate on the income of the middle class, but oppose a 30 percent rate on purchases made beyond the necessities of life?

To understand how the different measurements work, consider a worker who earns \$125, pays \$25 in taxes, and spends his entire after-tax earnings at a store. What would we say was the rate of taxation on that worker? If the income tax were in place, we would determine the rate of tax by dividing taxes by income ($\$25/\125) to conclude the worker paid at a 20 percent rate. If a sales tax were in place, however, many would draw comparisons with state sales taxes and conclude the rate was 25 percent (taxes divided by price ($\$25/\100)). Yet, in fact, the worker's tax burden (\$25) and purchasing power (\$100) are the same in both cases. Income tax and payroll tax rates include a tax on the tax and are said to be tax-inclusive. Sales tax rates normally are expressed in a tax-exclusive manner. An intellectually honest approach must compare tax-inclusive rates to tax-inclusive rates and tax-exclusive rates to tax-exclusive rates, and therefore, in order to properly present the rate, whenever possible FairTax supporters try to explain this difference.

Your analysis appears to also make the common mistake of failing to consider that the FairTax repeals the income tax and payroll taxes. Payroll taxes are the largest tax burden for about three-quarters of American taxpayers, especially the low income. You also fail to note that, unlike the current tax system and any other reform proposal, the FairTax is structured to entirely lift the tax burden from poor Americans. The FairTax prebate refunds, in advance, the amount of sales tax

¹ http://www.fairtax.org/pdf/A_FairTax_rebuttal_to_ITEP-110706.pdf

² $(10 \text{ percent} + 15.3 \text{ percent (payroll taxes)}) / (100 \text{ percent} - 25.3 \text{ percent}) = 33.9$

that would be paid on spending up to the federal poverty level, plus an extra amount in the case of a married couple to prevent a marriage penalty.³

In your letter you state that, “the Linder bill repeals all income tax deductions and credits enjoyed by countless Americans. These include deductions for mortgage interest, charitable giving, traditional IRA contributions, state and local income tax and medical expenses, as well as credits such as the child credit, the Earned Income Tax Credit (EITC) and the dependent care credit, just to name a few.” This statement is literally correct but is misleading in that it fails to point out how much better off the American taxpayer would be under the FairTax.

Allow me to explain further. The FairTax does repeal all deductions and credits “enjoyed” by the American people because it repeals the income tax that makes such deductions and credits relevant. Under the FairTax, mortgage interest, charitable giving, and retirement savings are treated more favorably than under current law: Americans will find it much more affordable to buy a home,⁴ give to their favorite charity⁵ or save for retirement.⁶

Under the current code, the mortgage interest deduction (MID) allows mortgage payments to be paid with pre-income tax money only if you itemize. Similarly, if you itemize, you can make contributions to your favorite charity with pre-income tax money. However, only one-quarter of Americans itemize their deductions. An IRA deduction does the same thing; it allows you to avoid paying current income taxes on your savings placed in the IRA. Neither the mortgage interest deduction, charitable contribution deduction nor the IRA deduction allows you to make those payments with pre-payroll tax money. But the FairTax allows you to pay your mortgage interest, make your charitable gift or contribute to your IRA with pre-income tax, pre-payroll tax, and pre-sales tax money. In these three cases, the FairTax, in effect, gives a supercharged deduction far superior to the deductions you note.

The FairTax provides this treatment to *all* Americans, not just those with enough income to warrant itemizing on an income tax return and access to sophisticated lawyers and tax accountants. According to recent estimates by the Joint Committee on Taxation, the benefit of the deductions for charitable contributions, mortgage interest, and state and local taxes supposedly enjoyed by countless Americans actually only accrues to the small percentage of individuals that earn more than \$75,000, whereas filers earning under \$20,000 very rarely reap any benefit from such deductions.⁷

The EITC was intended to reduce the payroll tax burden on low-income Americans through a refundable income tax credit. However, the fact is that the EITC has failed its intended beneficiaries. During its phase-out range, the 15.3 percent payroll tax, state and federal income taxes, and commuting and other work-related costs combine to impose some of the highest marginal tax rates on the working poor and the lower middle class. Under the FairTax, the prebate is not phased out so the penalty imposed on the working poor or middle class for working is removed, and as noted all Americans can consume up to the poverty level free of tax.

³ <http://www.fairtax.org/fairtax/faqanswers.htm#3>

⁴ <http://www.fairtax.org/fairtax/faqanswers.htm#21>

⁵ <http://www.fairtax.org/fairtax/faqanswers.htm#22>

⁶ Neither savings nor the returns from savings are taxed.

⁷ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010* (JCS-2-06), April 25, 2006. See Table 3, pages 45 and 49 at <http://www.house.gov/jct/s-2-06.pdf>.

How could we develop a better solution to the problem the EITC was designed to address than to completely untax the working poor?⁸

The FairTax is far more progressive than the current system. The FairTax achieves distributional equity by focusing the tax on what we choose to consume beyond the necessities of life and not on the fruits of our work and savings. It does this by eliminating the regressive payroll taxes, by reducing regressive compliance costs by 95 percent, by ensuring our tax system is understandable to everyone, and by imposing a tax without exception on the broadest possible base.⁹ In fact, average lifetime tax rates are lower for everyone under the FairTax and, while all income groups benefit, the poor get the greatest benefit, the middle class the next largest benefit, and the upper income the lowest benefit, yielding a very progressive outcome.¹⁰

By opposing the FairTax, one can only presume that you support a tax system which exacts a regressive 15.3 percent wage tax on the first \$90,000 of earnings over effectively untaxing the poor; favor the current system that punishes upward mobility by imposing the highest marginal rates on those escaping poverty over a system that effectively exempts savings, charitable contributions or tuition; endorse a system that wastes \$300 billion in compliance costs only to leave \$350 billion in unpaid taxes over the FairTax, which exempts individuals from filing responsibilities; and advocate a system that hides taxes and compliance costs that businesses pass through to consumers as fairer than a system that makes taxes explicit with a rebate.

You state that the bill would further jeopardize our nation's financial health causing a dramatic increase in our national debt. Such a conclusion is not what researchers from MIT, the National Bureau of Economic Research, the University of California at Berkeley, the Council of Economic Advisers, the Economics Departments at Harvard University and Boston University, or even the Joint Committee on Taxation have found. In a study of the specifics of the FairTax Plan, for example, Professor Laurence Kotlikoff of Boston University recently found the capital stock will be 13 percent higher under the FairTax system than under the current system by 2010, and 41.4 percent higher by 2030, and that long-run interest rates will be 150 basis points lower than under the current system. His study states 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. Therefore, a vote against the FairTax is actually a vote for lower wages and greater poverty."

You imply that the FairTax generates less federal revenue than our current tax system. This is not true. Even on a static basis, the FairTax base is much larger than current law. In 2004 (the latest year for which these figures are available), total personal consumption expenditures were \$8.212 trillion or 21.4 percent larger than total adjusted gross income of \$6.765 trillion. Taxable income under the current system was \$4.649 trillion in 2004, only 56.6 percent of total consumption. Stated differently, consumption is almost twice that of taxable income under the current system.¹¹

⁸ See Table 5, page 27 of <http://www.fairtax.org/PDF/ComparingAverageandMarginalTaxRates.pdf>.

⁹ See discussion below.

¹⁰ See pages 6 and 7 of http://www.fairtax.org/pdf/A_FairTax_rebuttal_to ITEP-110706.pdf.

¹¹ See IRS tax return data at <http://www.irs.gov/pub/irs-soi/04in01pl.xls> and consumption data at <http://www.bea.gov/bea/dn/nipaweb/TableView.asp?SelectedTable=5&FirstYear=2004&LastYear=2006&Freq=Qtr>

The straightforward static basis rate calculation can be found on the FairTax.org Web site. On that site, you may wish to read the research paper recently published on the rate analysis by the Beacon Hill Institute and Dr. Kotlikoff which validates the 23 percent rate.¹² Neither the Joint Committee on Taxation nor the President's Advisory Panel on Federal Tax Reform actually estimated the FairTax. They estimated their own version of a national sales tax. Moreover, neither body has released its calculations despite repeated requests so that outside analysts can review their work. Perhaps, Rep. Lewis, you could assist in this matter. Requiring JCT and the Treasury to show their methodologies can do nothing more than help shed sunlight on this important issue and help lead to a consensus on what the revenue-neutral rate must be.

Additionally, you state the FairTax is “not even simpler.... It creates burdensome new paperwork for businesses and would require a huge new government enforcement agency to ensure compliance at every retail purchase.”

This is perhaps the most oft-repeated canard about the FairTax which is also the most easy to dismiss. If sales taxes were so hard to administer, why do 45 states and the District of Columbia use such a taxing system? There would be no more complex employee benefit or qualified plan rules, no more complex inventory accounting and uniform capitalization rules, no more tax basis rules, no more income sourcing and expense allocations rules, no more alternative minimum tax, no more tax withholding rules, no more estate tax planning etc., etc., etc. Small business and farming organizations support the FairTax because it would be such a dramatic simplification.¹³

We are in agreement on one principle. The current system is “an almost unintelligible and incredibly complex tax code.” The compliance costs it imposes are not fair. They are wasteful. However, it is equally unfair to criticize a proposal that would address many of the concerns of the current law, and at the same time fail to suggest a workable alternative. Many Georgians hope that you will use your position on the Ways and Means Committee to look beyond the rhetoric of those who see the tax reform debate as simply a wedge issue for partisan political gain. Please take the time to identify and understand what the problems with the current system are, and how these problems are addressed by the virtues of the FairTax Plan. If you would agree to participate in a thorough, open-minded, balanced discussion on the issue, I think your concerns and perceptions could be fully addressed.

Sincerely,

J. C. N.

¹² <http://www.fairtax.org/PDF/TaxingSalesUnderFairTax.pdf>

¹³ See testimony of the National Small Business Association to the House Small Business Committee at <http://www.fairtax.org/PDF/McCrackenNSBATestimony.pdf>.

In the interest of full disclosure, Congressman Lewis's full letter is included below.

Dear Mr. N:

Thank you for contacting me to express your views on legislation to implement a national retail sales tax. I appreciate hearing from you and am glad to have the benefit of your views. I, too, believe that tax reform is necessary to ensure both fairness and simplicity.

Our current tax structure is far from perfect. In fact, the various changes, reforms and adjustments, over the last two decades, have resulted in an almost unintelligible and incredibly complex tax code. However, the task of developing a solution to this dilemma is equally complex. Nonetheless, the Committee on Ways and Means, on which I serve, has held several hearings focusing on reform proposals to evaluate the various tax reform initiatives that have been proposed as a replacement for the Federal income tax.

One of those hearings examined the provisions of H.R. 25, the "Fair Tax Act." At first glance H.R. 25 seems appealing, promising a simpler and fairer system of taxation. Regrettably, when the plan was exposed to the scrutiny of a Congressional hearing, it became clear that the Linder plan is neither simple nor fair. In response to Committee members questioning, Representative Linder acknowledged that the effective tax rate would actually be closer to 30%, not the 23% that the legislation suggests. So, H.R. 25 effectively imposes a 30 percent sales tax on all goods and services, including healthcare. It would tax many items not typically subject to State retail sales tax, such as prescription drugs, new home sales, apartment rents, and insurance. For example, it would mean that on a \$30,000 car, you would pay an additional \$9,000 in sales tax, and on a \$300,000 new house, you would pay an additional \$90,000 in sales tax. The national retail sales tax plan would also apply to consumer purchases of gasoline, home heating oil, electricity and natural gas. Imagine an additional 30 percent tax on top of already sky high gas prices.

By abolishing the current tax code, the Linder bill repeals all income tax deductions and credits enjoyed by countless Americans. These include deductions for mortgage interest, charitable giving, traditional IRA contributions, state and local income tax and medical expenses, as well as credits such as the child credit, the Earned Income Tax Credit (EITC) and the dependent care credit, just to name a few. Many of these deductions were designed as incentives to encourage beneficial types of behaviors, such as charitable giving, home ownership and retirement savings. Under H.R. 25, those incentives are scrapped along with the deductions.

What's worse is that the bill would further jeopardize our nation's financial health, causing a dramatic increase in our national debt. The 30 percent sales tax proposed in H.R. 25 simply will not raise revenue equal to the amount generated under the current income tax system. According to the Joint Committee on Taxation, to raise the same revenue as the current system, the rate would have to be at least 50 percent. In fact, President Bush's own tax reform panel has concluded that a revenue neutral rate for a retail sales tax, similar to what we have in Georgia, would likely exceed 64 percent.

Furthermore, it's not even simpler. It creates burdensome new paperwork for businesses and would require a huge new government enforcement agency to ensure compliance at every retail

purchase. Unfortunately, this is one bill to which that old saying applies, "if it sounds too good to be true, it probably is."

While I am firmly committed to enacting meaningful tax reform, I cannot support legislation which will end up hurting people instead of helping them. Again, thank you for your interest in this issue. I hope you will continue to contact me on issues of importance to you. Also, please visit my web site at <http://www.house.gov/johnlewis/> for more information.

Sincerely,

John Lewis
Member of Congress