



A FairTaxSM White Paper

The FairTax (real reform) vs. the flat tax (more of the same): A comparison

This letter from *The Wall Street Journal* accurately summarizes the future of the flat tax or any tax that relies on an intrusive, income-tax infrastructure:

Flat Tax Will Get Bumps

January 12, 2005; Page A11

Your Jan. 6 editorial "Flat-Tax Club" stated that several European countries have chosen "the simplest, most efficient system available." In 1913, the U.S. chose that same system, and look where it is today. It will be interesting to see what the European tax codes will look like in 20 or 30 years, or even if they still have a tax on income. After they witness the economic boom created by the FairTax in this country, they will probably have implemented the same system. A flat tax will not remain flat.

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Irony: Eastern Europe and Russia have Steve Forbes' flat tax while the U.S.A. has Karl Marx's heavy, progressive income and estate taxes.

While much of the world has repudiated Marx and his failed economic ideas, we do cling to some of his manifesto planks here at home. In contrast to our progressive income tax, there is no question that the flat tax has been successful when applied in Eastern Europe and Russia; it should continue to be successful in the near future. Thinking about the tax systems it replaced, their flat tax (as proposed by FairTax proponent Richard K. Vedder, Ph.D. in conversations with Russian President Vladimir Putin) has been a breath of economic fresh air. The FairTax was not an option, as their retail infrastructure is simply not sophisticated enough to apply such a tax; they chose the best alternative.

Steppes tax to Urals tax: How long will it take?

The U.S.A. has its Great Plains; Russia has its broad, flat steppes. The U.S.A. once had a flat tax with its first income tax in 1913. With President Kennedy bringing down 90-percent rates in the early 1960s, through President Reagan's 1986 reform, our tax code got flatter again. But the times between 1913 and 1962 and since 1986 look more like our Rocky Mountains than our Great Plains. Former Iron Curtain countries with economies booming under their new flat income taxes will quickly learn that special interests and well-heeled lobbyists are not exclusive to Washington, D.C.

When the special interests weigh in, it is only a matter of time before Russia's steppes tax becomes its Urals tax. We can only hope that the citizens of Eastern Europe will recognize the similarities between their former totalitarian lives and the intrusiveness of any income tax



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system, before they are once again victims of such tyranny. By then, their retail infrastructure will be enhanced and the FairTax boom in the U.S.A. will provide them with the ultimate example for ensuring and enhancing civil liberties while providing sufficient funds for government operations. A simple consumption tax, collected only under the bright lights of the retail counter, easily understood by consumers of any age, is the sole inoculation, if imperfect, against the lobbyist cancer.

FairTax and flat tax: Both consumption taxes, yet one dispenses with the income tax infrastructure and pervasive intrusion. One does not.

Robert Hall and Alvin Rabushka are the fathers of Steve Forbes' or Dick Armeys' or Jack Kemp's flat tax with their book *The Flat Tax*. In that book, both economists introduce their flat tax concept as a value-added tax or VAT, a form of consumption tax common in Europe and much of the rest of the world. However, unlike the rest of the world's VATs, Hall and Rabushka suggest implementing it through our existing income tax infrastructure: The IRS, withholding, and citizen record keeping, filing, audits, and enforcement. They could have implemented their consumption tax with a point-of-purchase sales tax, like most states have today. Or, though more complex, they could have done it with a European-style VAT, which adds the additional burden of tax collections throughout every good's supply chain as well as at the point of purchase. No, it appears that their flat tax could also be called the Government Tax Bureaucracy Full Employment & Expansion Act (GTBFEEA). Rather than state sales tax returns from retail businesses, they would continue to require returns from every wage earner, while exempting all other forms of income. Rather than ensuring compliance with a modest number of retailers via existing state sales tax authorities, the federal government would continue to chase all of your co-workers, those next to you in the pews, and every one of your neighbors.

The flat tax once appeared to have some grassroots support, but the FairTax has it now.

Several years ago, former Majority Leader Dick Armeys and former Congressman Billy Tauzin hit the road with their Scrap the Code Tour. In more than 30 debates in front of grassroots audiences across the nation, Dick explained the flat tax and Billy explained the national retail sales tax. At the end of each debate, Dick received polite applause and Billy received a thunderous ovation. Poll after poll has demonstrated a similar result: While voters may indicate initial support for a flat tax simply by virtue of the name, only a minor explanation (e.g., "gross pay = net pay") moves support overwhelmingly to the FairTax. Finally, no self-respecting Democrat would ever have voted for a plan that appears to tax only wage earners. Simply put, outside of Steve Forbes and his very small circle, there is no substantive support for the flat tax, period. Alternatively, support for FairTax-style taxation, from state political party platforms to farm bureau policy to talk show hosts to professional economists to state legislators, is broad and deep in our nation's fabric.

Both the FairTax and the flat tax reduce marginal tax rates dramatically, though the FairTax does more so.

Flat tax supporters often emphasize, correctly, that marginal tax rates, rather than average or effective, are the most economically relevant tax rates. It is the marginal tax rate that affects an individual's decision about what to do.



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A consumption tax can be viewed as imposing a zero marginal tax rate on labor and capital income, if the economic incidence of the tax is on consumers. Alternatively, one can view the incidence of the consumption tax on the factors of production (labor and capital). The comparison below is based on the view that the consumption tax is incident on the factors of production.

The most commonly quoted flat tax legislation would reduce the top marginal income tax rate to 17 percent. This rate, however, is not revenue neutral. The flat tax is revenue neutral at about 21 to 22 percent, not taking into account the impact of the plan on economic growth. In the real world, the flat tax would cause economic growth that would increase the tax base, perhaps reducing the revenue-neutral tax rate to 20 percent (within a few years). The flat tax would not affect the employer or employee Social Security or Medicare payroll tax. Those that have earnings below the Social Security wage base (\$90,000 per worker in 2005) would, therefore, face a marginal tax rate of 32.3 percent. Taxpayers over the Social Security wage base would face a marginal tax rate of 19.9 percent on wage income and 17 percent on capital income. These figures are about 3 to 5 percentage points higher in a revenue-neutral flat tax.

Under the FairTax, the poor experience negative effective tax rates because of the universal rebate. No American pays any tax on spending up to the poverty level, but this is most telling with the poor. Affluent taxpayers pay 23 percent at the margin.

Thus, middle-income taxpayers pay a much lower marginal tax rate under the consumption tax than under the flat tax. This is because the FairTax replaces payroll taxes as well as the income tax. Affluent taxpayers pay comparable marginal tax rates under the consumption tax and the flat tax. These differences are summarized in the table below.

Comparative marginal tax rates

Type of person	Flat tax	Revenue-neutral flat tax (+3)	FairTax	Difference
Poor	15.3	15.3	0	-15.3
Middle class	32.3	35.3	23	-12.3
Affluent (capital)	17	20	23	+ 3.0
Affluent (salary)	19.9	22.9	23	+ 0.1

The FairTax generally has a more positive impact on marginal tax rates than does the flat tax.

Both the FairTax and the flat tax are neutral toward savings and investment.

The FairTax and the flat tax both remove the income tax bias against savings and investment. The flat tax accomplishes this result with complexities well known to today’s income tax sufferers: Expensing capital costs and exempting the return on savings. The consumption tax accomplishes this same result by only taxing final consumption sales, a simple task common in



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45 states. Each solution would result in higher levels of savings and investment, higher rates of capital formation, higher productivity, and higher real incomes.

According to a broad range of studies, the FairTax has a significant positive effect on economic growth. The flat tax should have some positive effect.

Since the FairTax has a better impact on marginal tax rates and an arguably equivalent tax on capital investment, the FairTax has a more positive impact on economic growth. Moreover, because U.S. and foreign producers for overseas markets can produce goods and services tax free under the FairTax, but not under a flat tax, the FairTax has a relatively more positive impact on economic activity in the U.S.

The FairTax does a better job of eliminating work disincentives for low-income Americans.

Since the FairTax plan removes the payroll tax while the flat tax keeps the payroll tax (and repeals the earned income tax credit), the FairTax makes it easier for the working poor to climb out of the dependency trap. In contrast, the working poor will continue to pay the 15.3 percent payroll tax on their first dollar earned under the flat tax. Under the FairTax, payroll taxes are repealed, a rebate of the consumption tax on expenditures up to the poverty level is provided, and all tax costs currently embedded in the retail supply chain are eliminated. Thus, the marginal tax rate the poor face is zero up to poverty level spending, and therefore, lower under the consumption tax than under the flat tax.

While the earned income tax credit may properly be credited with successfully encouraging work, it is also true that 72 percent of workers filing for these benefits are forced to pay a tax preparer. Those preparers are notorious for tempting such taxpayers with usurious loans disguised as “instant refunds.” Finally, the IRS targets these returns for audit. Under the FairTax, one simple registration ensures similar negative tax rates with a first-day-of-the-month rebate, every month, with no withholding, no returns, no compliance costs, no audits, and no enforcement efforts.

Finally, the flat tax is apparently biased against workers because only those earning wages pay the tax. Those that earn income from capital gains (such as those with personal wealth) apparently avoid paying their fair share of taxes. This makes it less palatable to the American public. With the FairTax, income from any source and accumulated wealth are taxed when spent.

A flat tax is easy to convert back into an income tax.

The flat tax fully preserves the Internal Revenue Service infrastructure; it is totally dependent upon it. They would administer a system that is not structurally different from the income tax. All individuals and businesses would file tax returns.

With five simple changes, the flat tax can be converted into a graduated income tax, steps that should be all too familiar with any student of the 20th century.

- Step one is to depreciate rather than expense capital costs.
- Step two is to make interest expenses deductible and interest income taxable.



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- Step three is to tax capital income (such as dividends and rent) and capital gains.
- Step four is not to allow inventory purchases to be deducted until the inventory is sold.
- A fifth step is to impose graduated rates, which would complete the transition back to a graduated income tax.

After the FairTax is enacted, it is very difficult – though admittedly not entirely impossible – to go back to an income tax. The federal infrastructure necessary for the FairTax has its attention directed at the 50 states, rather than every American citizen. The states administer the FairTax through their existing sales tax authorities, though five states have to initiate such systems. The entire income tax apparatus is dismantled and the expertise in administering this present Byzantine system is dispersed. People will get used to the freedom of not filing returns and will not want to go back to the old system. People will have gotten used to keeping what they earn and will not want to go back to withholding.

As a final step, the FairTax Plan includes repealing the 16th Amendment through companion legislation, returning the law of our land to our Founding Fathers' original intentions to outlaw any form of federal direct taxation on citizens.

Under the FairTax, state sales tax authorities collect from retailers, as they do today in 45 states.

In general, states administer the FairTax because they already have the expertise. States are not required to administer the tax; however, in most cases, they will choose to do so. States are provided with a generous administration fee of one-quarter of one percent for their services. A similar amount is paid to retailers. Since 45 states already administer sales tax systems, the incremental costs of implementation of the FairTax are low (particularly if the state chooses to conform its tax base to the federal tax base). The FairTax greatly simplifies the states' drive for a streamlined sales tax structure by providing a national template for the base; collection of internet and catalog sales taxes is greatly facilitated. This broadens each state's tax base and puts all retailers on an equal footing.

The flat tax may require only a postcard return for wage earners, but the FairTax requires no return at all.

Flat tax proponents are proud that their individual tax form will fit on a postcard, though this simplicity belies the record keeping behind such a return. So, of course, could today's 1040 EZ. Under the FairTax, individuals who are not involved in retail business file no return. No return is preferable to a postcard; no record keeping is preferable to any record keeping.

Compliance costs are lower under the FairTax than under the flat tax.

It is absolutely true that any flat tax would simplify the tax code considerably. However, many of the complexities of current tax law would remain. For example, tremendous pressure would be placed on inter-company pricing rules since offshore income is exempt from tax. Manipulating the prices at which goods change hands between a U.S. company and its foreign affiliate could zero out the U.S. source income under a flat tax. Under a flat tax, the cost of employee benefits, interest, insurance, and other costs must be segregated since they are not



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deductible. The current complex pension system stays largely intact. Under the FairTax, the question is simply, "How much did a retailer sell to consumers?"

Every factor known to bear upon compliance is improved under the FairTax. Some of these have been discussed in congressional testimony by the General Accounting Office, the most important of which are:

- Number of taxpayers – down by some 80 percent under the FairTax
- Marginal tax rates – lowest under the FairTax
- Complexity of the system – taken to an irreducible minimum under the FairTax as written
- Number of opportunities for each taxpayer to cheat – reduced solely to retail transactions
- Transparency or the risk of detection – more than 80 percent of retail sales taxes are collected by less than 10 percent of retailers
- Magnitude of punishment if caught – similar to the current system
- Perceptions of unfairness – the FairTax returns to the Constitutional concept of uniformity of taxation: All citizens are treated the same
- Enforcement resources and safeguards in place – as if states were not already efficient enough, an 80-percent reduction in taxpayers brings new scrutiny to scofflaws

The flat tax would reduce tax evasion when compared to the current system; the FairTax does better than both.

Under the FairTax, the number of filers on which tax administration authorities must focus is reduced by 80 percent or more. Only retail businesses are in the tax system. Dramatically lower marginal tax rates – lower for most than with the flat tax – reduce the marginal benefit to cheat. If enforcement and associated penalties remain comparable, and the marginal benefit to cheating falls, evasion declines. The overall legitimacy of the system improves and noncompliance generated by frustration or hostility declines. Individuals who are not in business and non-retail businesses do not cheat on their tax returns because they file none.

Retailers benefit equally from cheating under the flat tax and the FairTax (assuming the rate is the same). Let's take a bar owner who pockets \$1,000 per week and fails to report his sales either to the income tax, flat tax, or consumption tax authorities. In the world of either the income tax or the flat tax, that pocketed \$1,000 will reduce the owner's gross revenues, and therefore, his profits by \$1,000 per week. He will, of course, continue to report all of his expenses. He will retain the documentation for the wages he paid and the liquor he bought. The government will lose revenue equal to the tax rate times the \$1,000 per week. In the FairTax world, the government loses revenue equal to the consumption tax rate times the \$1,000 per week. In both cases, the loss to the government is the same.

The FairTax is much easier for taxpayers to understand than is the flat tax.

The FairTax is easily explained and understood by the taxpayers. Flat tax proponents have had difficulty explaining their plan to the American people, notwithstanding large budgets, Steve Forbes' presidential campaign, the efforts of Majority Leader Armev, the Heritage Foundation, Citizens for a Sound Economy, and others.



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Perhaps the most obvious problem with explaining the flat tax is the issue of income from capital (interest and dividends) as opposed to that from wages. Again and again, it has been argued that the flat tax does not tax "coupon clippers" such as Steve Forbes. This argument is made in response to the allegation that rich people can live well and tax free on interest and dividends and pay no tax while the *working stiff* has to pay tax. Although this allegation is false because the tax on that income is effectively withheld at the business level, flat tax proponents have failed in their efforts to get their message across.

The FairTax is very, very visible.

Under the flat tax, much of the tax burden is hidden in the business tax, as it is with today's income tax. Will recipients of dividend and interest payments actually understand that a withholding tax has been imposed by denying a deduction to the business making the payment? Will recipients of employer-provided fringe benefits understand that a withholding tax has been imposed by denying the employer a deduction for the benefits? Will the non-deductibility of employer taxes be understood as tax increases? In all cases, it is highly doubtful. Thus, hundreds of billions of dollars in taxes are hidden under a flat tax.

There are those who believe that hiding taxes from the American people is a good thing, because if the people actually understood the true level of the tax burden, they wouldn't stand for it. The FairTax, however, works on the principle that taxes should be visible and fairly convey the true cost of government. The FairTax is, by law, shown on every retail purchase sales receipt, and this provision is mandatory.

The FairTax is not a VAT; the flat tax is.

The FairTax is not a value-added tax (VAT) since it is collected solely at the retail level, and no tax is imposed on intermediate sales upstream in the manufacturing or distribution process.

The flat tax is a VAT. None other than the father of the flat tax, Robert Hall of Stanford University (along with Alvin Rabushka), in his 1995 Ways and Means Committee testimony said, "The Hall-Rabushka flat tax is a value-added tax."

The flat tax is not an income tax because its tax base is not income. Some do characterize it as a flat (income) tax as it uses the income tax infrastructure to collect it.

At the business level, value added by capital is taxed by the flat tax. At the individual level, value added by labor is taxed. The business tax burden under the flat tax is much higher than under current law. Interest expense, most insurance expenses, taxes (including payroll taxes), rent, and other expenses are not deductible under the flat tax. The aim of the flat tax is not to measure net income, but value added.

The flat tax is identical to another proposal's (USA Tax) business tax, an acknowledged subtraction-method VAT, except in two respects. First, the flat tax taxes exports and exempts imports from tax. This makes it an origination-principle VAT instead of the usual destination-principle VAT. The other difference is that businesses can deduct wages in the flat tax, but not in normal VATs. The flat tax individual tax, however, is a wage tax. Thus, the flat tax taxes



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wages just like a normal VAT. However, because it taxes wages at the individual level, the flat tax taxes most value added in the government, while normal VATs do not.

The transition is easier under the FairTax than under a flat tax.

Under the flat tax, the tax liability of the business community increases dramatically, by hundreds of billions of dollars per year. All value added by capital is taxed at the business level. Only wages are taxed at the individual level. About \$5 trillion worth of future deductions (remaining basis), relating to inventory acquisitions, depreciation on capital investment made under the income tax, and so on, exist under the income tax. Since the return on these assets would be in the flat tax taxable base, failure to allow these deductions would amount to a confiscation of nearly one-fifth of existing wealth. The business community, large and small, will not let the flat tax pass without transition rules.

For example, under the Burgess flat tax if you bought a building for \$1 million dollars the day before the bill went into effect and sold it for \$1 million the day after the bill went into effect, you would have taxable income of \$1 million (even though you have no profit) since the bill assumes that you have expensed the building. In the real world, the taxpayer's income tax basis in that building is going to have to be deductible. The revenue from this kind of expropriation is presently counted in flat tax revenue estimates.

Allowing these deductions, however, would increase the revenue-neutral tax rate in the flat tax considerably. Alternatively, the transition could be funded by a complex series of taxes on various windfall gains accruing to certain businesses or taxpayers.

Under the FairTax, corporations and other businesses and investors pay no tax on their income. Accordingly, it is doubtful that any transition "relief" is appropriate. The future income of their assets is tax free. Transition rules are only appropriate with respect to inventory held on the date of the changeover, since those inventory costs would not have been deducted in the income tax and the sale of the inventory is taxed. Rules need to be provided to ensure that the CPI used to index benefit payments includes the consumption tax to protect against any consumption tax-induced price increases (although it is not clear a price increase is likely, since repealed income and payroll taxes account for 20 to 25 percent of the price of goods and services, according to Harvard economist Dale Jorgensen, Ph.D.). That's about it. The transition is a much simpler problem under the FairTax.



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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 16th 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 or call 1-800-FAIRTAX.

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