A FairTax[SM] White Paper

The FairTax reduces complexity, compliance costs, and noncompliance

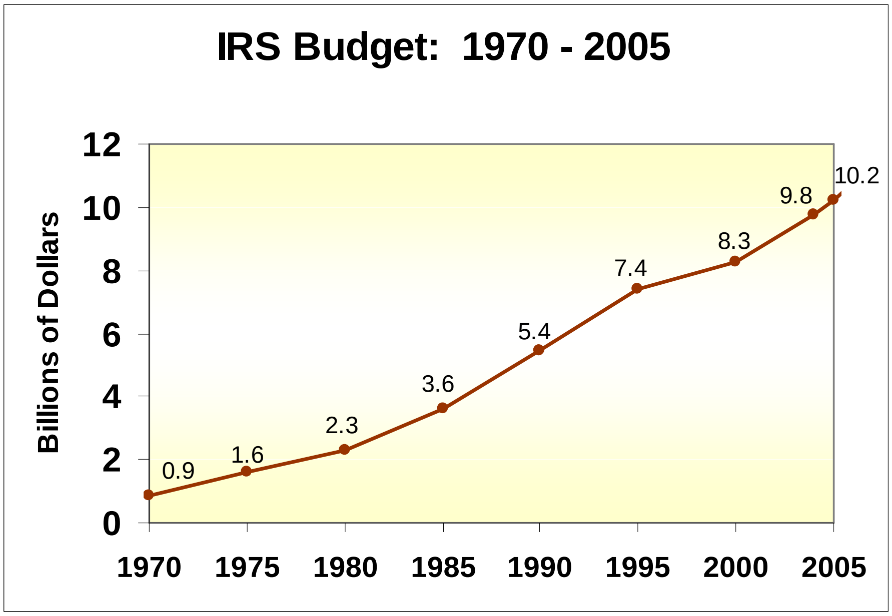
The very nature of the income tax breeds complexity.
In the long-running experiment of the income tax, it is fairly well demonstrated that it is the nature of the income tax that breeds complexity. No one political party can assign blame or take credit: The nature of the income tax as a hidden tax invites complexity through special-interest provisions. 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 signed by both Democrat and Republican members and administrations.

The legendary complexity of the income tax has worsened each year through successive enactments of legislation. In 1927, the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) reported that, "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not." The 1927 staff recognized that at its core, income tax complexity was almost wholly related to tax base questions – that is, questions or uncertainty about the timing or definition of taxable transactions. The inherent complexity of an income tax results from the difficulty of defining income; in determining whose income and expenses, and what tax year for tax purposes. Over time, the political process of give-and-take has made these difficult tax base questions inordinately complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

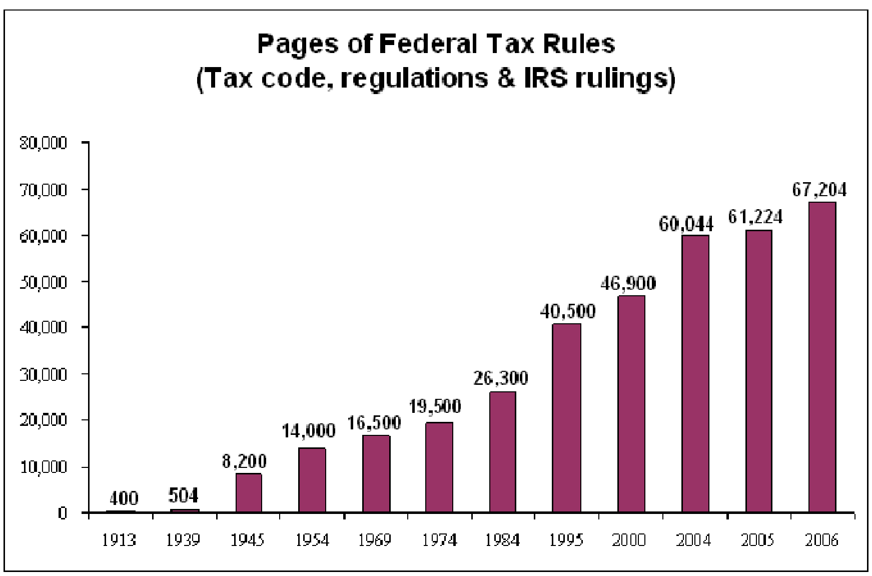
At the same time, throughout U.S. history there has also been considerable resistance, preventing efforts to simplify the code even when a better way appeared clear. Taking a random week in May we can see the complexity. Just after the President's panel retired to write its own complex proposal, dozens of bills to add new complexity were introduced.

Complexity can be seen in the growth in the number of returns, penalties, and even the IRS budget. To take a static figure, consider the sheer volume of returns. In 2010, the total number of U.S. returns is estimated to be 249,688,100. There are also information returns. For Fiscal Year 2003, the total information returns received was 1.313 billion; the IRS made 4.288 billion contacts and sent out 8 billion forms and instructions so taxpayers could attempt to know how much they owed.

The number of penalties provides another good measurement of the complexity and cost. In 2003, Americans were assessed 28,767,480 civil penalties (19.1 million for the individual income tax alone). The corporate income tax required the issuance of 704,012 penalties and the employment tax had 7,649,296 penalties – the frequency of parking tickets – issued to businesses that had the audacity to employ people. To administer the tax laws, the IRS directly employs about one hundred thousand employees. The IRS budget is about $10 billion and has greatly outstripped growth in the economy and the population.



Much of the work to evaluate the complexity of the income tax system has been done by the nonpartisan Tax Foundation. It charted the growth over the past 40 years in the combined number of words that define the body of both the federal income tax laws and their attendant regulations.[1] The combined federal income tax code, regulations, and IRS rulings have grown from 14,000 pages in 1954 to 67,204 pages by 2006 – an increase of 380 percent.



To most Americans, direct expenses of the IRS or abstract measurements are not a central compliance problem. Most important is the mandate imposed on the American taxpayer to act as

[1] Moody, J. Scott, "The Cost of Tax Compliance," House Ways & Means Committee Testimony, Tax Foundation, July 2001.

tax collector. Again, according to the Tax Foundation, in 2005 individuals, businesses, and nonprofits will spend an estimated 6.0 billion hours complying with the federal income tax code (henceforth called "compliance costs"), with an estimated compliance cost of over $265 billion. This amounts to imposing a 22.2-cent tax compliance surcharge for every dollar the income tax system collects. By 2015, compliance costs are expected to grow to $482.7 billion[2] To put the tax compliance burden into perspective, the more than $265 billion tax surcharge is greater than the combined revenue of Sears, Walt Disney, Microsoft, Rite Aid, and McDonald's.

To compare further, Americans spend over ten times more on compliance than we spend on the National Institutes of Health for disease research. The man-hours spent represent more people than would reside in four congressional districts. The cumulative compliance cost over the 2001-2006 period will come to almost $930 billion. Or looked upon still another way, according to the *Independent Sector,*[3] 83.9 million American adults volunteer, representing the equivalent of over 9 million full-time employees at a value of $239 billion. Americans spend as much time complying with their taxes as they do volunteering for charitable causes.

These costs are incorporated into the price of everything that we buy – nearly $900 for each man, woman, and child in America. Small firms bear the lion's share of these fixed costs that stem from paperwork and record keeping, tracking wages, and interpreting the law – costs which, while disproportionately falling upon them, cannot be passed along. Small firms in particular, according to the National Commission on Economic Growth and Tax Reform, are forced to waste 3 to 4 dollars complying with the law for every dollar they pay in taxes.

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 19 to 33 percent of the total revenue raised by the income tax system and 2.0 to 3.5 percent of the Gross Domestic Product (GDP). We waste money each year on seeking to avoid taxes, avoid trouble with the IRS, interpret the laws or determine the best course of actions with the laws.

The monetary cost of compliance with the income tax code is only half of the problem. We pay for our income tax system in equally wasteful ways. The income tax is collected with a heavy hand and much contention. Our government has embroiled its citizens in more than 35,000 litigation actions.[4] Taxpayers sustained more than 3 million levies.

Complexity is one cause of the compliance costs. A method of measuring complexity is by looking at the record of the IRS's own centers established to help people prepare their tax returns. In a study conducted by Treasury Department investigators posing as taxpayers, the investigators found these centers gave incorrect answers – or no answer at all – to 43 percent of

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[2] Hodge, Scott A., J. Scott Moody, and Wendy P. Warcholik, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation, Special Report No. 138, January 10, 2006.

[3] "Giving and Volunteering in the United States, 2001" Independent Sector survey, http://www.independentsector.org/programs/research/gv01main.html.

[4] The contrast between the income tax system and our historical notions of privacy is perhaps most vivid when we consider just how few real rights taxpayers have during an audit. Two prominent examples to consider are the IRS summons authority and the burden of proof (although the burden of proof to a certain extent in certain cases will rest with the government as a result of recent legislation).

the questions. The investigators concluded that half a million taxpayers may have been given wrong information between July and December 2002. Auditors were given correct answers to 57 percent of their tax law questions during the course of the study. Less than half, or 45 percent, of the questions were answered correctly and completely. In 12 percent of the cases, the answer was correct but incomplete. The IRS disputed these results. Using the raw numbers gathered by Treasury investigators, the IRS recalculated the error rate and ignored any instance when a taxpayer was denied service or told to do his own research. Of the questions answered, they calculated that 67 percent were answered accurately.[5]

All of that complexity disappears with the FairTax.
With a national retail sales tax, the Tax Foundation has estimated that compliance costs drop more than 90 percent – equivalent to one good year of economic growth.

Anyone who professes to despise the complexity of the income tax should embrace the FairTax. No other plan that has been developed or could be developed would eliminate wasteful compliance costs quite like the FairTax. By imposing taxes at the cash register, the FairTax wholly exempts individuals from ever having to file a return. Since business-to-business transactions are fully exempt, businesses that serve other businesses will neither collect nor pay taxes. Retailers, most of which already pay state sales taxes (in the 45 states that have them) are provided a credit compensating them for the costs of sales tax compliance. The FairTax reduces fixed compliance costs by as much as 90 percent, according to the Tax Foundation, the oldest national tax research organization. It eliminates entirely the need for individuals to file tax returns (unless they are in business for themselves). It reduces the more than 700 incomprehensible sections of the Internal Revenue Code to one simple question asked of retailers: How much did you sell to consumers? The twin advantages of simplicity and visibility produce another benefit: Greater enforceability with less intrusiveness.

In fact, it is this simplicity that recommends the FairTax over the flat tax. For example, the populist appeal of the flat tax is mostly in simplified returns, but the flat tax ends up with a slightly more simplified tax return than the current 1040 EZ for individuals. Income still must be tracked and reported; indeed, one must continue to determine taxable income. Returns must be filed by both individuals and businesses. Although the flat tax would be simpler than the current tax system, it would require overlapping tax systems with state sales tax laws and therefore would not be harmonized with state law. There would be an existing fear (and actual possibility) that the tax would eventually revert to an income tax system or complexity would be added. Under the FairTax, there is no need to track income and expenses, no need for an IRS, and a high probability the tax will stay simple, since it cannot revert to an income tax.

The FairTax reduces rates and the incentive for tax evasion.
Some supporters of steeply progressive marginal rates assert that a national sales tax that would replace the entire tax system would suffer from a lack of compliance. One statement that has gained currency among income tax proponents – often repeated by William Gale of The

[5] An amusing way to look at the complexity of the code is to consider the number of members of the House that serve on the Ways & Means Committee because they are, in the final analysis, responsible for the state of the code. An historical review shows that in the 1st Congress there were 11 members of the committee, including James Madison. Today there are 41 members.

Brookings Institution – is that the sales tax would not be complied with beyond 10 percent. This statement has been repeated by Mr. Gale so often in fact, that some perceive the statement to be based on rigorous academic research.

However, FairTax.org has traced the origins of that statement to Vito Tanzi, former Director of Fiscal Studies at the International Monetary Fund, who simply offered this opinion in a Brookings Institution publication. In particular, he stated, "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under an RST."[6] From these narrow premises, his quote formed the basis for the opinion of Mr. Gale. However, Mr. Tanzi's statements have no foundation in scholarly research apart from a referral of unsubstantiated opinion.

Taxes are unpopular and breed resentment today – as they undoubtedly always have and to some degree probably always will. Accordingly, some people will evade taxes no matter what the governing tax system, but there is no evidence – empirical[7] or analytical – to suggest that the sales tax would not be complied with at a national level. Extant research and the empirical evidence suggest that the tax would increase voluntary compliance while reducing compliance costs. For example, much of the tax gap today is attributable to mistakes caused by the complexity of the law. Mistakes and confusion would be all but eliminated under a system that creates no exemptions and dispenses with the complex issues present today. And the FairTax improves all the known factors that bear upon noncompliance, including reducing the rate and the number of focal points. The more than 60 years of practical experience in administering sales taxes at the state level supports the assertion that the FairTax would be administrable at higher compliance rates relative to administrative and compliance costs.

The tax gap is very large and growing.

Before policy makers can criticize the administrability of any tax policy, they must consider the enforcement difficulty experienced today. Our income tax system is not only gamed, but also increasingly disregarded. Recent IRS estimates indicate that more than $300 billion in taxes owed are not voluntarily paid.[8] Specifically, the official IRS estimate of the tax gap[9] is $345

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[6] Tanzi, Vito, *Taxation in an Integrating World,* Washington: Brookings Institution Press, 1995, pp. 50–51.

[7] Indeed, state sales taxes have been imposed at rates as high as 20 percent on travel and tourism activities, chiefly hotels.

[8] In March 2005, the IRS released a preliminary estimate of the tax gap based on the recent National Research Program study. The new study put the 2001 tax gap at somewhere between $312 billion and $353 billion. See IRS News Release, "New IRS Study Provides Preliminary Tax Gap Estimate," IR–2005–38, March 29, 2005.

[9] The notion of "compliance" is simple. Webster's lexicographers define it as "the act of conforming, acquiescing, or yielding." On the tax front it is simply the voluntary rate of payment over what should have been paid. The simplest manner of viewing compliance is by measuring the size of the gap; however, that greatly oversimplifies the analysis starting with the definition of the "tax gap." When we think of the methods of improving compliance, or of analyzing how successful we are with achieving compliance, or in comparing relative compliance ratios of various plans to reform the tax system, this concept is not so simple. For example, the noncompliance rate (NCR) is defined as the ratio of the gross tax gap to the total "true" tax liability, expressed in percentage terms. The noncompliance rate is considered the "gross tax gap" as a percentage of the "true" tax liability. Both gross and net tax gaps consist of three main components: Non-filing, underreporting, and underpayment. The non-filing gap is the amount of tax liability owed by taxpayers who do not voluntarily and timely file returns. The underreporting gap is the amount of tax liability not voluntarily reported by taxpayers who do file returns. The underpayment gap is the amount of tax liability that individuals report on their tax returns, but do not pay voluntarily and timely.

billion.[10] These figures are based on the IRS's latest finding from the National Research Program (NRP), now completed for its initial assessment of individual taxpayer compliance for Tax Year 2001.[11] The voluntary compliance rate is only 84 percent.[12] An estimated 18 million wage-earning Americans have dropped out of the income tax system entirely as "non-filers" which are estimated to be attributable to a loss of $30 billion, an increase of nearly 300 percent since 1992.[13] According to the IRS, of the nation's 130 million individual taxpayers, each one is paying, on average, a "surtax" of at least $2,680 a year to subsidize noncompliance.[14]

Noncompliance is not only accelerating in absolute terms, but as a share of GDP. Tax evasion is at an all-time high and getting higher. In 1992, the tax gap was estimated to be $127 billion.[15] The tax gap was in the range of 22 to 23 percent of income taxes collected for that year. The tax gap is now around 30 percent as a function of income taxes collected.[16] These IRS figures do not include all taxes lost on illegal sources of income that are not recorded. The tax gap increased by 67 percent solely in the decade between 1982 and 1992 as a percentage of GDP. As a percentage of GDP the tax gap has risen from to 1.6 percent in 1991 to 2.8 percent today, a 75 percent increase in a decade and one-half.[17]

	1981	**1992**	**2004**
Total tax gap (real 1992 $ billions)	$75	$127	$332
As a percent of income taxes collected	23.3%	22.0%	29.0%
As a percent of gross domestic product	1.6%	2.0%	2.8%

Digital technology will cause evasion to increase.
Policy makers should not ignore an even more significant point: The difficulty of enforcing the income tax (a tax based on a complicated legal concept of income, deductions, credits, exclusions, deferrals, exemptions, and allocations) will only worsen in the digital age without much more stringent and onerous regulation. Tax policy makers have an obligation to transcend

[10] The difference between what taxpayers should pay and what they actually pay on a timely basis.
[11] The research sample covered 46,000 tax returns, including an over sampling of high income returns. The research provides a statistically valid representation of the overall population. NRP has not updated the corporate tax gap.
[12] IRS Fact Sheet, "Understanding the Tax Gap," FS-2005-14, March 2005.
[13] See generally, Rosage, Laura R., "Nonfiler Profiles, Fiscal Year 1993: A Focus on Repeaters," http://www.irs.gov/pub/irs-soi/93nf01rp.pdf . Also see IR-2005-38 and the PDF Compliance Data Tables.
[14] See Olson, Nina E., National Taxpayer Advocate, statement before the Senate Finance Committee, Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, April 7, 2005, reproduced in TNT 67–28.
[15] "Reducing the Tax Gap: Results of a GAO-Sponsored Symposium," United States General Accounting Office, Report to the Joint Committee on Taxation, U.S. Congress, GAO/GGD-95-157, June 1995.
[16] FS-2005-14, supra. For Tax Year 2001, all taxpayers paid $1.767 trillion on time, a figure that represents from 83.4 percent to 85 percent of the total amount due. The 2001 tax gap, the difference between taxes owed and taxes paid on time is from $312 billion to $353 billion for all types of taxes. According to the IRS, the overall noncompliance rate is from 15 percent to 16.6 percent of the true tax liability. The old estimate derived from compliance data for Tax Year 1988 and earlier, was 14.9 percent.
[17] GDP estimated to be $11.75 trillion in 2004.

the impassioned rhetoric that has characterized the debate over Internet taxation to address the very real problems that the income tax system will increasingly bring to electronic commerce on the movement of "income" as opposed to "goods" around the world.

How will an income tax system fare compared to a consumption tax when the Internet has fully bloomed? What will be the extent of income tax evasion under the Internet? The short answer is that the Internet may soon make tax evasion more commonplace. As Dr. Richard Rahn (former Chief Economist of the U.S. Chamber of Commerce) points out in his book, *The End of Money*:

> *In order to understand what is about to happen, remember that the revolution taking place in electronic commerce means that banks and other organizations will be able to create their own money for transactional or investment purposes and literally move these monies around the globe at the speed of electrons. The definition of money as a government-created legal tender will become less and less relevant.*

And:

> *Things that can be transformed instantaneously into something else and moved to anyplace in the world with no paper or electronic trail will become nearly impossible to tax. By using public key cryptography, one can have electronic bank notes certified without the issuer knowing to whom they were issued.*

The personal holding company rules, passive foreign investment company rules, indeed, much of the protections Congress has tried to construct to preserve the limited compliance that exists in the international arena will become as quaint as a pedestrian stoplight at rush hour. When taxpayers can avoid reporting particular types of income or transactions with little danger of detection, our entire income tax will depend largely upon those who pay out of a sense of public duty, or are paid in wages (working class Americans) or own publicly traded investments. Compliance will fall largely upon wage earners.

The use of offshore institutions to avoid paying U.S. income tax is a burgeoning problem. Because it is far easier to move or create a financial portfolio anywhere in the world with total anonymity with the Internet, the Internet will be the host to trillions of transactions that shift capital instantly, encrypted as to the owner, anonymous because of the sheer volume of transactions, and protected from disclosure by the many willing tax havens of the world. If the U.S. continues to rely on taxing mobile income multiple times, financial regulation must be increased so that global transactions are monitored, and new treaties will have to be negotiated so that collection agencies throughout the world can assist us in collecting multiple taxes on savings and investment. Americans, already weary of the degradation of taxpayer rights, will have to be willing to relinquish their right to financial privacy over the Internet. Non-U.S. Internet companies with no minimum contacts with the U.S. must be willing to freely exchange information with the U.S. government. In fact, the OECD already plans to develop new information technology capabilities that will permit both the "detection of suspicious on-line transactions and verification of the customer" and "ensure that electronic commerce technologies, including electronic payment systems, are not used to undermine the ability of revenue authorities to properly administer tax law."[18] The cost of trying to enforce taxation of highly mobile financial capital probably will exceed the revenue collected and certainly will exact a price in terms of lost efficiency and lost privacy rights that exceeds the benefits of their continued taxation.

Compliance rates must be seen as a function of enforcement costs, and those costs are at their limit.

Compliance is, in truth, a relativistic notion that compares the rate of voluntary payments of taxes to the costs imposed on taxpayers to make those taxpayers acquiesce, conform, or yield. To understand this relationship in the extreme, consider how we may be able to achieve an acceptable compliance rate, even if a tax system is widely viewed as unfair – such as a *per capita* tax – if we were only willing to impose enough penalties at a high rate, take away civil liberties, require enough substantiation, or provide enough resources for detection.

If we were to try to reduce the interrelationship between compliance and enforcement to a very simple balancing act, we might express our goal for the tax system as trying to minimize one function (compliance costs) at the same time we maximize another (the voluntary compliance rate). Then, in optimizing the compliance rate, we would choose a system for which the voluntary compliance payment rate is acceptably high relative to the costs required to obtain that compliance. Hence, as policy makers evaluate our current system and various reform initiatives, they must do so under a framework that takes into account how much revenue the current system raises as a function of the costs to maintain that system.

You can begin to understand how poorly the current system achieves its compliance rate by comparing the compliance rate to the high administrative and, more importantly, compliance costs (see below). And it can only speak about compliance if it recognizes that the correct manner of viewing compliance is as a function of compliance and administrative costs.

Compliance costs are at an all-time high and dwarf the administrative costs of the IRS. The tax gap is a major, continuing and growing problem. Notwithstanding a much larger IRS, more burdensome information reporting requirements, increasingly stiff and numerous penalties and a host of legislative initiatives, the problem is getting worse. The current system requires taxpayers not only to absorb substantial cost but to yield fundamental civil liberties. Further escalation of compliance costs may actually spawn further noncompliance. As the GAO has stated, "…some of the 'tax gap' may not be collectible at an acceptable cost. Such collection might require either more intrusive record keeping or reporting than the public is willing to accept or more resources than IRS can commit."[19] Despite this poor compliance rate, we may have reached the limits of what we are willing to pay in monetary and non-monetary costs to increase compliance. In a report on the tax gap, the General Accounting Office stated:

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[18] For example, "Report on Money Laundering Typologies 1999-2000," Financial Action Task Force on Money Laundering, February 3, 2000, http://www.fatf-gafi.org/dataoecd/29/37/34038120.pdf.

[19] Willis, Lynda D., "Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap," United States General Accounting Office, Testimony Before the National Commission on Restructuring the Internal Revenue Service, GAO/T-GGD-97-35, January 9, 1997. Higher compliance costs can reduce voluntary compliance at a certain level. See, e.g., Sheffrin, Steven M., and Robert K. Triest, "Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance," in *Why People Pay Taxes: Tax Compliance and Enforcement*, Joel Slemrod, ed., Ann Arbor: University of Michigan Press, 1992, pp. 193-222.

> Almost every year since 1981 has witnessed legislation to address tax gap issues. These legislative actions generally required information returns [1099's] reporting on income and deductions, imposed penalties for tax noncompliance, or reduced the opportunity for noncompliance by eliminating certain tax write-offs. [The] IRS estimated that some of these provisions resulted in additional 1990 tax revenue of $3.4 billion. Even so, [the] IRS' estimated tax gap increased $50.7 billion in current dollars from tax years 1981 to 1992.[20]

With roughly 30 million civil penalties assessed each year, 2 million accounts levied (seized) and more than 1 billion information returns filed,[21] there is little question that the FairTax plan would inspire greater compliance at lower cost.

The FairTax: Higher compliance rates at lower cost

Empirical evidence: State sales taxes are enforced at an equal or higher compliance rate than the income tax with lower overall administrative and compliance cost.
One means of looking at the possible compliance rate of the FairTax is to compare relative compliance rates of various tax policies with the administrative and compliance costs of those forms of taxation.[22] Researchers have found the administrative costs of state sales taxes vary as a percent of revenue received from between 0.4 and 1.0 percent, and average 0.7 percent of revenues received.[23] The compliance costs imposed on businesses from state sales taxes have been estimated to fall between 2.0 and 3.8 percent of revenues.[24] Based on similar methodology, researchers have estimated that the costs to comply with a national sales tax would be as low as 1.0 percent of collections, compared with the flat tax at 1.2 percent of collections and a consumed-income tax at 4.6 percent of collections.[25]

The cost to collect federal individual and corporate income taxes has been estimated as 9 percent of revenues in 1995 by income tax supporters.[26] But actual costs of collection are probably much higher. If compliance costs are estimated to be $200 billion, then to collect $990.2 billion of individual taxes collected in FY 2004, the costs of collection would be 20 cents on the dollar. If we assume those compliance costs against the full $1,952,929,045 of collections, the collection costs would still be 10 cents on the dollar. This is roughly what the Tax Foundation found. They stated, "In 2002 individuals, businesses and non-profits will spend an estimated 6.0 billion hours complying with the federal income tax code (henceforth called

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[20] "Tax Gap: Many Actions Taken, But A Cohesive Compliance Strategy Needed," United States General Accounting Office, GAO/GGD-94-123, May 1994.
[21] Internal Revenue Service, Statistics of Income, Table 27 -- Civil Penalties Assessed and Abated, by Type of Penalty and Type of Tax, Fiscal Year 2004.
[22] Admittedly, this is not ideal since state sales taxes are designed in a manner that requires greater compliance costs than the FairTax.
[23] Due, John F., and John L. Mikesell, *Sales Taxation, State and Local Structure and Administration*, Second edition, Washington, D.C.: Urban Institute Press, 1994.
[24] Research summarized by Cnossen. Cnossen, Sijbren, "Administrative and Compliance Costs of the VAT: A Review of the Evidence." *Tax Notes International*, Vol. 8, No. 25, June 20, 1994, pp. 1649-68.
[25] Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation Special Brief before the House Ways & Means Committee, June 1995.
[26] Slemrod, Joel, "Which is the Simplest Tax System of Them All?" in *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale, Washington, D.C.: Brookings Institution Press, 1996.

'compliance costs'), with an estimated compliance cost of over $265 billion. This amounts to imposing a 22.2-cent tax compliance surcharge for every dollar the income tax system collects." [27]

Not only are the administrative and compliance costs of a sales tax much lower than an income tax per dollar of revenue received, the compliance rate is higher. A Minnesota study in the year 2000 compared input-output data to taxable sales and estimated how much tax should have been collected. The difference between estimated and actual collections was 9.9 percent. The sales tax gap was therefore an estimated 9.9 percent in Minnesota. This compares favorably to a federal tax compliance gap (and therefore a state income tax compliance gap) nearly double that amount, despite the imposition of much higher administrative and compliance costs. Overall, the noncompliance rate is from 15 percent to 16.6 percent of the true tax liability, according to the IRS, and that same rate of noncompliance can be expected to apply to the state tax system that relies on the federal enforcement apparatus.[28] In the broadest aggregate, assuming the gap of $353 billion, gross noncompliance is about 18 percent of revenues.[29] The evidence at the state level suggests sales taxes – even those at the state level that are largely very complicated and which cascade – have twice the compliance rate of the income tax at a fraction of the cost.

The tax gap not attributable to fraud will clearly improve through the FairTax's simplification of the system.

To understand how a simple plan reduces the tax gap, policy makers must distinguish between two components of the tax gap: Fraud and non-fraud contributions. There are, in effect, two distinct components of the tax gap. The tax gap is certainly comprised of taxes not voluntarily paid because the taxpayer violated a known legal duty (evasion), but it is also comprised of failures to pay that are unintentional, such as those caused by mathematical errors or confusion. The tax gap is at the same time a measure of the burden and frustration of taxpayers who want to comply but are tripped by tax code complexity and of willful tax cheating by a minority who want the benefits of government services without paying their fair share.[30]

The portion of the tax gap attributable to mistake and confusion is high, as high as 80 percent. Almost 40 percent of the public, according to the IRS, is out of compliance with the current tax system, some unintentionally due to its enormous complexity. Periodically, the IRS conducts a series of extremely intrusive audits of taxpayers selected at random and requires those taxpayers to document every item on their tax return to the minutest detail. These audits are part of the Taxpayer Compliance Measurement Program or TCMP. The 1988 TCMP statistical sample included audits of over 54,000 individual taxpayers, theoretically representing 104 million taxpayers. TCMP data showed that if all 104 million taxpayers had been audited, 42 million (40 percent) of them would have seen increases in their tax liabilities.[31]

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[27] Hodge, et al., op. cit.
[28] FS-2005-14, supra.
[29] The income tax gap of $353 billion/$1,952 trillion in collections for FY 2004.
[30] The IRS defines the tax gap as "the difference between the tax that taxpayers should pay and what they actually pay on a timely basis." The gap is broken down into three components by the IRS: Non-filing (failure to file a tax return), underreporting (understating income, overstating deductions) and underpayment (failure to fully pay reported taxes owed).
[31] GAO, supra.

The General Accounting Office, in its recent tax gap report said, "The TCMP data showed that an estimated 33 million of the 42 million taxpayers (82 percent) were not assessed a fraud or negligence penalty, suggesting that much of their noncompliance was unintentional."

Tax evasion under the income tax 1981-1992 [32]
Internal Revenue Service estimates
($ millions, inflation-adjusted 1992 dollars)

Source of tax gap	1981 tax gap amount	1992 tax gap amount	Percentage increase
Individual tax gap	$61,900	$93,994	51.8%
Unreported income	40,433	62,759	55.2
Sole proprietors	18,714	30,173	61.2
All other income	21,719	32,586	50.0
Overstated deductions	7,449	8,081	8.5
Individual non-filers	5,231	10,233	95.6
Individual remittance gap	8,300	11,400	37.3
Math errors	487	1,521	212.3
Corporate tax gap	14,066	33,135	135.6
Small corporations	4,461	6,999	56.9
Large corporations	8,638	23,716	174.6
Others	167	420	151.5
Corporate remittance gap	800	2,000	150.0
Total tax gap	$75,966	$127,129	67.2%

The reasons for noncompliance are instructive: (1) taxpayers lack the requisite knowledge of the tax law – of course, even tax lawyers and IRS agents cannot grasp the entire tax code these days; (2) taxpayers interpret the law differently than the IRS – but you can depend on the IRS to almost always make aggressive interpretations in favor of the government; (3) taxpayers lack record keeping sufficient to satisfy the IRS – this from an agency that has such poor internal records that it cannot even be audited; (4) taxpayers do their math wrong or they rely on professional return preparers who get it wrong – if professional tax preparers can't get it right, how are ordinary Americans to do so?[33] The table above shows that the largest percentage increase in the tax gap from 1981 to 1992 was attributable to math errors, a 212.3 percent increase.

Again, the GAO as well as others have indicated that the simpler the rules, the better. According to the GAO, "[t]his reflects the basic principle that the simpler the tax code, the more certain the results in applying it and the fewer the opportunities for disagreements over the 'fine

[32] GAO, supra.
[33] The annual *Money* magazine survey in which 50 accountants prepare a hypothetical middle-class couple's tax return and come up with at least 45 different answers each year is a major indication that our tax system is simply not administrable.

points' of tax law."[34] What are the opportunities today? Our tax code is awash with prolixity. Given the complexity of the code, taxpayers are given significant room to maneuver, depending on one's "aggressiveness," and out-and-out cheating is too often effectuated with plausible deniability that the law was not broken intentionally. Consider for example, the documented contribution of complexity to the tax gap. The IRS's own centers labor hard to help people prepare their tax returns; however, even the IRS gave incorrect answers – or no answer at all – to 43 percent of the questions asked by Treasury Department investigators posing as taxpayers. The investigators concluded that half a million taxpayers may have been given wrong information between July and December 2002. Auditors were given correct answers to 57 percent of their tax law questions during the course of the study. Less than half, or 45 percent, of the questions were answered correctly and completely. In 12 percent of the cases, the answer was correct but incomplete. The IRS disputed the results. Using the raw numbers gathered by Treasury investigators, the IRS recalculated the error rate and ignored any instance when a taxpayer was denied service or told to do his own research. Of the questions answered, they calculated that 67 percent were answered accurately.

Primary Taxpayer Compliance Measurement Program (TCMP) reasons for tax increase[35] when taxpayers were not assessed a negligence or fraud penalty for 1988 (Dollars in millions)

Reason for noncompliance	Number of taxpayers	Amount of tax increase
Multiple interpretations of tax law	1,230,202	$1,237
Lack of substantiation	9,074,690	3,765
Incorrect accounting or computational procedures	5,215,212	2,710
Relied on return preparer and did not help with preparation	4,964,121	3,166
Lacked knowledge of tax laws to prepare accurate return	7,648,492	3,259
Other	5,004,042	1,549
Totals	33,136,759	$15,686

This portion of the tax gap attributable to confusion and mistakes is largely dependent on the number of taxpayers and the level of complexity, and both diminish under the FairTax. Under the Fair Tax, certain transactional areas still require special rules. For example, the treatment of financial intermediation services, the treatment of mixed-use property, and transitional considerations will add some complexity. However, when fully operational, the main decisional juncture is reduced to the analysis under one current code section – Section 162. Was a purchase an "ordinary and necessary" business expense? Any tax system that does not seek to tax business inputs (meaning any well-considered tax system) must make this essential distinction. The FairTax need not make the tens of thousands of other distinctions we now draw in the code. In place of an almost incomprehensible regime of statutes and regulations,

[34] Willis, supra.
[35] GAO, supra.

businesses will need to answer one question to determine the tax due: "How much was sold to consumers?"

Furthermore, two other factors reduce this non-fraud component of the tax gap. The increased transparency of the system induces more compliance because it increases the likelihood that tax evasion is uncovered. The FairTax draws a clear line between cheating and innocent mistake, and eliminates the plausible deniability that taxpayers misunderstood the law. Few, if any, taxpayers will be confused by the FairTax requirements. Second, the roughly 90 percent reduction in filers enables tax administrators to address more effectively instances of noncompliance and under the FairTax, there are fewer confused taxpayers and fewer game players that take risks with avoidance schemes.

The FairTax improves upon all known factors that bear upon compliance.
Even if we are looking at the portion of the tax gap attributable to fraud, the FairTax reduces the tax gap. To understand how it does so, policy makers need to look at the several factors that bear upon compliance – both fraud and non-fraud – from the scholarly research.[36] Some of these have been discussed in Congressional testimony by the GAO.[37] The most important of these are as follows:

- the number of taxpayers;
- the marginal tax rates;
- the complexity of the system (already discussed);
- the number of decisional junctures (opportunities for each taxpayer);
- transparency or the risk of detection/ability to hide defalcation;
- the magnitude of punishment if caught;
- non-financial motivation to cheat (including perceptions of unfairness); and
- enforcement resources and safeguards in place.

An objective analysis of the FairTax demonstrates that it would have a much higher compliance rate than current law (i.e., substantially reducing the current $345 billion "tax gap"[38])

[36] Here are just a few: Thomas, Jim J., *Informal Economic Activity*, London School of Economics, Handbooks in Economics, London: Harvester Wheatsheaf, 1992; Schneider, Friedrich "Measuring the size and development of the shadow economy. Can the causes be found and the obstacles be overcome?" in Brandstaetter, Hermann, and Werner Güth eds., *Essays on Economic Psychology*, Berlin: Springer Publishing Company, 1994, pp. 193-212; Schneider, Friedrich, "The Shadow Economies of Western Europe," *Journal of the Institute of Economic Affairs*, Vol. 17, No. 3, 1997, pp. 42-48; Schneider, Friedrich, "The Shadow Economy," in Rowley, Charles K. and Friedrich Schneider eds., *Encyclopedia of Public Choice*, Dordrecht: Kluwer Academic Publishers, 2003; Pozo, Susan, ed., *Exploring the Underground Economy: Studies of Illegal and Unreported Activity*, Michigan: W.E. Upjohn, Institute for Employment Research, 1996; Johnson, Simon, Daniel Kaufmann, and Pablo Zoido-Lobatón, "Regulatory discretion and the unofficial economy," *The American Economic Review*, Vol. 88 No. 2, 1998, pp. 387-392; Johnson, Simon; Daniel Kaufmann, and Pablo Zoido-Lobatón, *Corruption, Public Finances and the Unofficial Economy*, discussion paper, Washington, D.C.: World Bank, 1998; Giles, David, E.A., and Lindsay M. Tedds, "Taxes and the Canadian Underground Economy," Canadian Tax Foundation, Tax Paper No. 106, Toronto, Ontario, 2001; and Dell'Anno, Roberto, "Estimating the Shadow Economy in Italy: A Structural Equation Approach," discussion paper, Department of Economics and Statistics, University of Salerno, 2003.
[37] Willis, supra.
[38] The difference between what taxpayers should pay and what they actually pay on a timely basis.

– even with respect to those taxpayers who seek to intentionally violate a known legal duty – because it improves upon the following factors.

First, the number of non-filers is reduced substantially. The General Accounting Office, among others, has specifically identified the inverse relationship between compliance costs and the number of focal points for collection. Consider, for example, how many taxpayers there are today compared to what there would be under the FairTax. The chart below shows the number of returns filed by type of taxpayer.

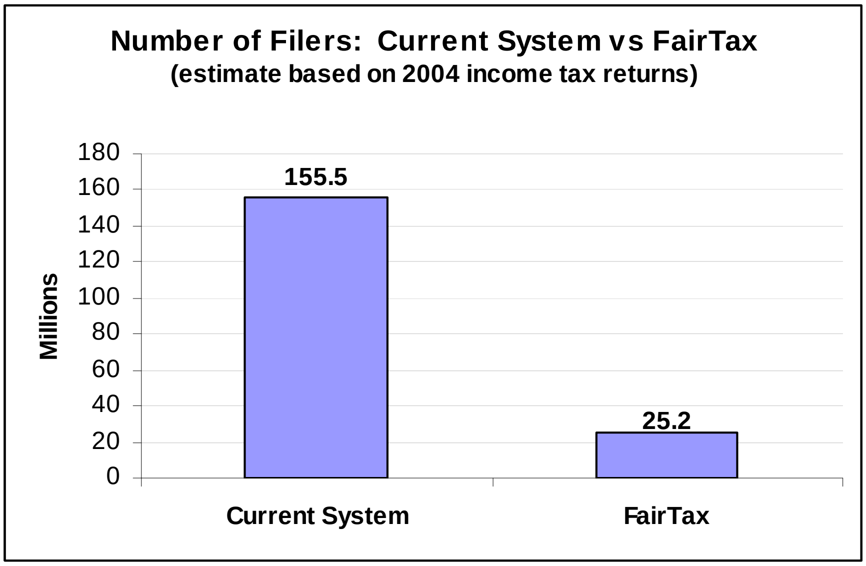
According to the IRS, in 2002 about 12 percent of all C Corporation returns (222,295 out of 1,906,968) were filed by retail firms.[39] Likewise, for the year 2002, about 12 percent (360,961 out of 3,154,377) of S Corporation returns were filed by retailers.[40] Retail trade accounts for about 12.9 percent of all business establishments in the United States, according to the industry statistics as well. Since there are approximately 25,007,505 business establishments in the U.S., we could expect the number of businesses remitting the FairTax to be at a minimum of 3.2 million firms. Only these retailers are in a position to cheat.

Summary of collections before refunds by type of return, FY 2003

Type of return	**Number**	**Gross collections (millions of $)**
Individual income tax	130,728,360	987,209
Corporate income tax	5,890,821	194,146
Employment taxes	29,916,033	695,976
Gift tax	287,456	1,939
Estate tax	91,679	20,888
Total	**166,914,349**	**1,900,158**

Because the FairTax reduces the number of tax filers by as much as 80 percent, as individuals are removed entirely from the tax system, enforcement authorities can catch cheats by monitoring far fewer taxpayers. Because the number of collection points is so much lower under the Fair Tax, if enforcement funding is held equal then the audit rate for potential evaders increases considerably and the likelihood of apprehension is correspondingly higher. The perception of risk as a deterrent should also increase commensurately. In other words, the risk of detection increases and the risk-adjusted cost of evasion increases.

[39] IRS Statistics of Income, 2002 Returns of Active Corporations, Form 1120, Table 16.--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry.
[40] IRS Statistics of Income, Table 1.--2002, S Corporations: Total Receipts and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Major Industrial Group.



It should be noted that income tax supporters make too much of the fact that a federal sales tax would place the responsibility for tax collection with the retailer, a sector of the economy in which small businesses are more represented. Small businesses are viewed as more likely to evade taxes since the owner, and beneficiary of tax evasion, is more likely to also be responsible for keeping the books and filing the tax returns. A number of factors, however, reduce the importance of this consideration. First, those small businesspersons that are inclined to cheat on their sales tax are probably already cheating on their income tax and would be inclined to do so under any tax system. Second, the economic importance of small firms in the retail sector is usually grossly overstated. According to the Joint Committee on Taxation (JCT), small firms only account for 14.9 percent of gross receipts by all retailers, wholesalers, and service providers.[41] Since the gross receipts of wholesalers would not typically be subject to tax, the true scope of the small "problem" companies is smaller still.

More than 85 percent of the sales tax is collected by less than 15 percent of the retailers.

[41] IRS Statistics of Income, reported in "Impact on Small Business of Replacing the Federal Income Tax," Joint Committee on Taxation, April 23, 1996, JCS-3-96, pp. 109-127.

Share of total gross receipts by firms with less than $1 million of gross receipts[42]
($ millions, 1993)

Industry	Entity type	Firm sales <1 million	Firm sales all firms	Small share percent
Retail and wholesale trade	C Corp.	116,929	2,663,541	4.4%
Services	C Corp.	91,383	610,438	15.0
Retail and wholesale trade	S Corp.	358,566	959,501	37.4
Services	S Corp.	98,721	283,680	34.8
Retail and wholesale trade	Partnership	22,938	112,112	20.5
Services	Partnership	30,783	187,588	16.4
Total	Combined	719,319	4,816,860	14.9%

Second, compliance is inversely proportional to the marginal rate or the reward for being noncompliant.[43] Because marginal tax rates are the lowest they can be under any sound tax system, cheaters profit less from cheating. Marginal rates are also important as a factor of evasion, since they set the reward for cheating. All other things being equal, the motto that "every man has his price" applies to encourage more attempted evasions as the reward increases. Lower marginal rates, if the risk and motivation are the same, imply lower evasion rates because the benefit from evasion declines while the cost of evasion remains comparable. Research has confirmed the intuitive relationship between higher marginal tax rates and higher rates of evasion.[44] Lower rates, all other things being equal, imply lower evasion because the benefits from evasion decline while the costs of evasion remain comparable. However, precisely because of the larger base and lower marginal tax rates, the benefit from lawful tax avoidance or illegal tax evasion under the FairTax is much less at the margin relative to either the current system or competing alternative tax systems that have higher marginal tax rates. And this analysis does not take into consideration avoidance of the costs of compliance, which today fall disproportionately on small firms.

To illustrate more plainly, let us take a small business restaurateur who has $1,000,000 in sales and is considering not reporting $10,000 per month of income. If he does not declare the income, he has a higher marginal incentive to cheat under the income tax since, by not claiming income, he enjoys a benefit equal to say, 43.3 percent times $10,000 if that proprietor is in a 28-percent income tax bracket. In a sales tax realm, this is simply the same situation, except the

[42] Ibid.

[43] Clotfelter, Charles T., "Tax Evasion and Tax Rates: An Analysis of Individual Returns," *The Review of Economics and Statistics*, Vol. 65, No. 3, 1983, pp. 363-373.

[44] See, e.g., Spiro, Peter S., "Estimating the Underground Economy: A Critical Evaluation of the Monetary Approach," *Canadian Tax Journal*, Vol. 42, No. 4, 1994, pp. 1059-1081; Tanzi, Vito, "The Underground Economy in the United States: Annual Estimates, 1930-80," International Monetary Fund Staff Paper, Vol. 30, No. 2, June 1983, pp. 283-305.

taxpayer fails to report $10,000 multiplied by the FairTax rate. If that rate is 23 percent, his incentive to cheat is reduced by 42 percent.[45]

Consider the relevance of the rates on underreporting. The IRS three-year NRP study audited 46,000 individual income tax returns for 2001. The preliminary findings allow for a better understanding of the nature of the tax gap:

- Underreporting noncompliance is the largest component of the tax gap. Preliminary estimates show underreporting accounts for more than 80 percent of the total tax gap, with non-filing and underpayment at about 10 percent each.
- Individual income tax is the single largest source of the annual tax gap, accounting for about two-thirds of the total.
- For individual underreporting, more than 80 percent comes from understated income, not overstated deductions.

Most of the understated income comes from business activities, not wages or investment income.

And because the base is significantly greater, nearly all taxpayers experience lower marginal tax rates under a national sales tax than the income tax, including those with relatively modest incomes. If cheating is a choice motivated by monetary gain, the degree to which a taxpayer can enjoy that return is therefore less under the sales tax. An income tax evader will see his taxable income go down dollar for dollar for every dollar of income not reported.

Visibility of the transaction improves as well, and simplicity and visibility go hand in hand. Today, taxpayers can cheat in the privacy of their breakfast tables and bury their cheating on 227 million tax returns in the unnavigable 7,000 code sections with plausible deniability that the taxpayers even understood the law. The FairTax increases the likelihood that tax evasion is uncovered and leaves little room to hide between honesty and outright fraud (to say nothing of the well-established efficiency of current state sales tax authorities, well experienced in detecting such infractions). When an individual claims exemption, he has to do so in a very visible way at the cash register. Today, a taxpayer can cheat in the privacy of his own home, with the protection of Section 6103 and the morass of the tax laws to hide behind. Again, this factor of visibility was specifically mentioned by the GAO as affecting compliance.

The severity of applicable penalties is also a factor, but this would be expected to increase. This is not to say that the FairTax adds to the impressive array of penalties now in the code; but rather, that it becomes quite transparent when someone is cheating as opposed to "gaming" the system. When a retailer fails to pay over trust funds, he does so at great peril and

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[45] The current federal tax system imposes a relatively flat (but high) marginal tax rate on wage income. Combined tax rates range from 30.3 percent to 43.3 percent for all but the very lowest income Americans. Wage income is the primary source of income for most American households. While there are some anomalies (even ludicrous anomalies), typically the highest marginal tax rate for individuals is on income between $50,000 and $70,000. Married couples experience the highest marginal rates with combined taxable income between about $90,000 and $140,000.

with the knowledge that he is violating the law (i.e., committing evasion). Few excuses apply.

As an additional note, compliance rates are highest where there is third-party reporting or withholding. Preliminary findings show less than 1.5 percent of wages and salaries are misreported. The FairTax is a withholding type of tax. Moreover, if compliance proved to be a problem, information reporting along the lines of present law (1099s) could be implemented to facilitate cross checking by government auditors. These 1099s would reflect the quantity of product sold to retailers. An auditor could then ensure that the retailer's books either reflected a sale of these products or that the products were in inventory. The FairTax plan does require all businesses (including non-retailers) to keep business records kept in the ordinary course of business that would aid cross checking by government auditors.[46]

And there is one other factor not often mentioned. Perception of the fairness of the tax system is increasingly regarded as an important consideration. Studies have persuasively shown that attitudes are important determinants of compliance. Having both a negative attitude towards the tax system and perceiving other taxpayers as dishonest significantly increases the likelihood a person will evade taxes. Today, cheating is encouraged by the perception that one's neighbor is not paying his or her fair share. Under the FairTax, as the costs of compliance shrink and the perceived fairness of the tax system increases, some of the hostility to the tax system will decline. People who are in noncompliance because they perceive the current system as unfair or illegitimate may choose to comply with a sales tax. That 40 percent of the public, according to the IRS, is out of compliance with the present tax system, mostly unintentionally due to the enormous complexity of the present system, breeds disrespect for the tax system and the law and makes a system based on taxpayer self-assessment less and less viable.

In short, tax collectors focus enforcement resources on far fewer taxpayers, using consistent and vastly simpler forms, with far fewer opportunities to cheat, diminished incentives to do so, and a far greater chance of getting caught if they do.

The FairTax eliminates a major problem with non-filers.
Today, an estimated 18 million wage-earning Americans have dropped out of the income tax system entirely as "non-filers." As noted *supra*, non-filers alone accounted for $30 billion of the tax gap in 2001, an increase of nearly 300 percent since 1992. Under the FairTax, nonbusiness non-filers find it very difficult to avoid the tax. This aspect of the underground economy is successfully taxed at the retail level under the FairTax.

The FairTax addresses the main problem of capital mobility.
The FairTax adapts our tax system to the realities of the digital age. Consumption is a more conspicuous base for taxation than is income. While a determined tax evader can easily place income out of reach, it is much harder to place the sale of goods and services out of reach. While income, its timing, and its source are complicated legal concepts that can be nothing more than the entry in an electronic ledger, consumption often involves transport of goods and a paper trail. The future tax base will have to rely on real and tangible property or payments for services or goods. Taxes tied to real property or tangible personal property or the sales of services to the

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[46] This method is currently used by state governments, particularly with respect to tax due on out-of-state purchases by businesses. State sales taxes are often applied to business inputs.

public are much more difficult to evade. As already noted, taxes tied to the operation of businesses dealing with the public or with many business customers are more easily enforced because of the necessarily public and open nature of such businesses. Moreover, the vast majority of retail sales are by large established firms.

Since the FairTax repeals all income-based taxes, including payroll and self-employment taxes, much of the problem areas of enforcement that might apply to some consumption taxes are simply eliminated. While imports can be captured at the border, business-to-business consumption is not taxable under the FairTax – only personal consumption at final retail sale. Exports are not taxable. Used goods are not taxable. Hence, the vast amount of Internet sales is simply not of enforcement concern.[47]

Some of the problems regarding the underground economy that exist under the income tax remain under the FairTax, particularly those involving cash transactions made with the explicit intent of evading taxation or in the illegal economy. However, as the costs of compliance shrink and the perceived fairness of the tax system increases, some of the hostility to the tax system will decline. People who are in noncompliance because they perceive the present system as unfair or illegitimate may choose to comply with the FairTax.

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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(AFFT Documents\Papers on a specific subject\The FairTax reduces complexity compliance costs and noncompliance)

[47] Some services sold over the Internet will cause continuing enforcement concern. For instance, an attorney or an architect might send a product to a client over the Internet. Potential problems exist any time there is a conveyance of intellectual property where the Internet is the medium of exchange. However, this form of tax evasion can occur today and with higher marginal rates and therefore a greater reward for cheating. Moreover, many of these businesses are registered and sales tax audits would reveal these discrepancies. Equally important, the clients would have to enter into the necessary conspiracy in most of these cases. Remember, the sales tax is a withholding tax. The FairTax has greater enforceability and greater compliance with less intrusiveness.