A FairTax[SM] White Paper

Why the FairTax Taxes Final Government Consumption

The philosophy of the FairTax is to tax final consumption, without exception or exclusion. Therefore, the tax must include a tax on final consumption even when the cost or service is paid for by a proxy (i.e. government). If one does not tax this consumption, it would encourage more government activity thereby crowding out private sector activity. For example, if the government, at any level, built cars and then gave them to the consumer free, before long all cars would be made by the government. The private sector could not compete. When the proxy can pass the cost on to others by using the income/payroll tax as the source of revenue to cover the cost of providing a government service, such activity is hidden from the final consumer. The FairTax taxes all proxy buying whether it occurs in the public sector or the private sector. For example, if a business buys a car for an employee to use (consume), it is final consumption that is taxed under the FairTax.

To explain how the FairTax taxes government, it is necessary to understand how government output/consumption is taxed today. Just like private sector goods and services, the cost of the existing federal tax system is embedded in the cost of providing government services. This happens in two ways:

1) Government employees are subject to the same income tax withholding and employee payroll taxes (Social Security & Medicare) as private sector employees. Likewise, government employers have to pay the employer share of these taxes. And just like the private sector, governments pay their workers higher wages than they would otherwise have to pay if these taxes did not exist.

2) Governments also purchase substantial amounts of goods and services from government contractors. A road contractor, for example, must pay corporate income and employer payroll taxes, and also has to pay its employees higher wages than it would otherwise have to pay if there were no individual federal income and payroll taxes.

So the federal government is already paying taxes today, albeit, indirectly through higher wages paid to government employees and higher payments to contractors because of the federal income/payroll tax system. In effect, taking money out of one pocket and putting it in the other.

This is true for state and local government as well.

The FairTax changes the federal tax system from one based on income/payroll to one based on consumption. The primary benefit of this switch is that taxing consumption removes the distortions in the economy caused by the existing federal tax system. Savings and investment are not taxed. This is what creates the much higher increase in economic growth under the FairTax.

Thus, it is important to make sure that the relative tax burden on the government sector of the economy and the private sector remain approximately the same. Therefore, the FairTax does not exempt government output or government consumption from taxation. Doing so would create a strong incentive to consume through the medium of government rather than the private sector.

Let's look at a real world example: the provision of employment agency services, i.e. services to help an individual get a job or to help an employer find a person to fill a position.

Under the current system. Take a private sector employment agency, "Jobs Are Us". Today, the private employment agency pays it workers wages and then withholds income taxes and payroll taxes and sends them to the federal government. Therefore, these taxes are currently built into its costs of doing business. The same holds true for the government employment agency, "State Job Center". It pays it workers wages and then withholds income taxes and payroll taxes and sends them to the federal government. Therefore, these taxes are also currently built into the government employment agency's cost of doing business. Thus "Jobs Are Us" and "State Job Services Center" are on a level playing field, each having the income tax and payroll tax system built into their costs.

Under the FairTax. "Jobs Are Us" sells services to its customers and charges the FairTax on each sale. Each month it adds up the gross payments it receives for its services (including the FairTax), and remits 23% of this amount as national sales taxes to the tax collection authority. This is the FairTax burden on consumption through the private sector.

What about the "State Job Services Center?" This government agency provides services to its "customers" for free. It does not charge its customers a fee for the job counseling services it provides. Therefore there is no "retail sale" to impose the FairTax on. [The government could figure out what it costs to provide one hour of job counseling, and require the person to pay it and charge the FairTax on that amount. However, for many reasons, only one of which would be the lack of cost accounting procedures necessary to correctly price the service, government does not do this.] So at this point, there is no FairTax burden on the services provided by "State Job Services Center". This gives "State Job Services Center" a cost advantage over "Jobs Are Us". This is the case for any government service that does not directly charge the customer for its services.

Thus, to level the playing field, the FairTax must continue to tax government as the current system does. Since there is no market price on the provision of services by the "State Job Services Center" government employment agency, how do we figure out what the FairTax should be?

The FairTax determines the taxable value of governmental consumption to be equal to the sum of:

(1) the dollar value of the labor used to provide the government service, and
(2) the cost of what the government purchases in order to provide the service.

Therefore, to tax (1), The FairTax Act of 2011 (HR25) requires each governmental unit to pay the FairTax on the total compensation paid to all its employees. To tax (2), HR25 imposes the FairTax on government purchases of all goods and services from businesses.

Under the FairTax, each month the State Job Services Center adds up the total wages it pays to its employees and multiplies that total by 23% to compute the tax amount to send to the federal government. The State Jobs Center also pays the FairTax when it purchases goods and services from private sector vendors who collect the tax and then remit it to the federal government. This method essentially equalizes the tax burden of the private sector employment agency and the government employment agency. This is the method used to tax government consumption for governmental entities that do not charge consumers for their services.

Government enterprises that operate as quasi-businesses and charge consumers for their services are treated the same as the private sector. Examples are the US Post Office and Amtrak. Both of these charge fees for their services (e.g., express mail and train tickets). These governmental entities add the FairTax to the price they charge their customers for their services and remit the FairTax that they collect on a monthly basis just like the private sector. Because they charge sales tax on what they sell, government enterprises will not have to pay the FairTax on the wages paid to their employees; and, like private sector businesses, they do not have to pay the FairTax on what they purchase.

The FairTax expressly states that no State government functions that do not constitute the final consumption of taxable goods and services shall be taxed. For example, any State pass-through funds to local governments are not considered final consumption and not taxable.

Language from HR25 making government consumption taxable

The definitions of **taxable employer** and **taxable service (appearing below)** operate together to require that wages paid by a government agency (as a taxable employer) are taxable and the tax must be remitted by the government agency to the state sales tax authority. The section on the imposition of the tax says that the tax shall be remitted by government employers. [Sections from HR25 that apply are present on the following.]

Compensation paid to employees who are employed by a government enterprise (an entity that charges for its services), and government educational institutions directly providing education and training are not taxable.

The above definitions of "taxable employer" and "taxable service" have the effect of taxing government consumption. Since governments generally provide services free to the public, the value of the consumption is the value of the services used to provide services to the public, i.e. the services of labor or wages paid.

Taxable employer – Generally, the term taxable employer includes (1) any household employing domestic services (nannies, housekeepers, gardeners, etc.), and (2) any government. Excluded from the definition of taxable employers are: (1) any employer engaged in a trade or business, (2) an employer that is a not-for-profit organization, or (3) a government enterprise (a *quasi* business entity that charges a fee for their services, such as the U.S. Post Office and Amtrak, solid waste pickup, etc.).

Taxable service – any service (including financial intermediation services). It also includes any service performed by an employee for whom the employee is paid **wages or salary** by a taxable employer (as defined above).

Wages and salary mean all compensation paid for employment service including cash compensation, employee benefits, disability insurance, or wage replacement insurance payments, unemployment compensation insurance, workers' compensation insurance, and the fair market value of any other consideration paid by an employer to an employee in consideration for employment services rendered.

Applicable Excerpts from HR25

`SEC. 2. DEFINITIONS.

(a) In General- For purposes of this subtitle--

(12) **TAXABLE EMPLOYER-**

(A) IN GENERAL- The term `taxable employer' includes--

(i) any household employing domestic servants, and

(ii) any government except for government enterprises (as defined in section 704).

(B) EXCEPTIONS- The term `taxable employer' does not include any employer that is--

(i) engaged in a trade or business,

(ii) a not-for-profit organization (as defined in section 706), or

(iii) a government enterprise (as defined in section 704).

(C) CROSS REFERENCE- **For rules relating to collection and remittance of tax on wages by taxable employers, see section 103(b)(2).**

(14) TAXABLE PROPERTY OR SERVICE-

(B) SERVICE- For purposes of subparagraph (A), the term `service'--

(i) shall include any service performed by an employee for which the employee is paid wages or a salary by a taxable employer, and

(ii) **shall not include** any service performed by an employee for which the employee is paid wages or a salary--

(I) by an employer in the regular course of the employer's trade or business,

(II) by an employer that is a not-for-profit organization (as defined in section 706),

(III) by an employer that is a government enterprise (as

defined in section 704), and
(IV) by taxable employers to employees directly providing education and training.

SEC. 102. INTERMEDIATE AND EXPORT SALES.

(3) STATE GOVERNMENT FUNCTIONS- No tax shall be imposed under section 101 on State government functions that do not constitute the final consumption of property or services.

SEC. 103. RULES RELATING TO COLLECTION AND REMITTANCE OF TAX.

(b) Tax To Be Remitted by Purchaser in Certain Circumstances-

(2) CERTAIN WAGES OR SALARY- In the case of wages or salary paid by a taxable employer that are taxable services, the employer shall remit the tax imposed by section 101.

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll taxes with an integrated approach including a progressive national retail sales tax, a rebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, repeal of the 16^{th} Amendment. This nonpartisan legislation (HR 25) abolishes all federal personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes and replaces them with one simple, visible, federal retail sales tax – collected by existing state sales tax authorities. The FairTax taxes us only on what we choose to spend, not on what we earn. It does not raise any more or less revenue; it is designed to be revenue neutral. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?

FairTax.org is a nonprofit, nonpartisan, grassroots organization 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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