

Fairness and Federal Tax Reform

The notion of fairness in a tax system means many things to many people. The Webster's Dictionary defines "fairness" as "just and honest, impartial, unprejudiced," which connotes an abstract sense of equity.

The average taxpayer, however, sees fairness as much less abstract. Small businesses see fairness as the equitable distribution of compliance costs, or as similarly situated businesses being similarly treated. To those who must plan for the future, fairness means stability or consistency in the tax code. To individuals, fairness means that the tax structure imposes costs based on ability to pay, or that the system is enforced evenhandedly. By any standard of fairness we wish to apply, the FairTax is superior to the present tax system.

The FairTax is Simpler

As a starting point towards understanding the advantages of the FairTax over the income tax, we can contrast the complexities of our current system, with the simplicity of the Americans for Fair Taxation's FairTax plan.

The simplicity of a tax system affects fairness in several respects. A fundamental notion of fairness is that citizens should be able to comprehend the laws that affect them. However, current tax law is beyond the comprehension of most taxpayers, including many of those who devote their entire professional lives to it. Today, we hold taxpayers accountable for knowing and complying with an intricate web of more than 7,000 individual Internal Revenue Code Sections, 10,000 pages of text, hundreds of thousands of pages of regulations and other pronouncements, and an equally weighty verbiage of court opinions interpreting the law. This complexity translates into frustration, unnecessary cost, and wasted time and needlessly lost productivity. The complexity of the tax code disproportionately affects smaller businesses that do not have the time or the resources to delve into its mysteries. When taxpayers fail to adhere to the complexities of the law – often through innocent mistakes – they are punished with penalties, interest, and a great deal of frustration.

The complexity of current tax law disproportionately rewards those who can afford to aggressively pursue tax planning. The well-advised often view tax planning as a game that they can afford to play, using sophisticated tax planning devices, the cost of which is justified by the resulting tax savings. Skillful manipulation of the tax code can lead to huge gains in competitiveness, or to substantial increases in individual wealth. The ongoing manipulation of the tax code for financial gain can be seen in estate planning, in trust planning for children's education, in pension coverage and in many other facets of tax

planning. In contrast, the FairTax is a highly visible tax system that cannot be avoided by sophisticated devices. Under the FairTax only one question is typically relevant: how much did the consumer spend on the purchase of a final good or service?

The complexity of the current system adds to unfairness in at least one more respect. By necessity under the current system, different industries, different sizes of firms, and different taxpayers will be treated differently, adding unfair distortions to the economy.

In summary, the complexities that exist in the form of thousands of critical distinctions under the current income tax system place an unfair, costly burden on most taxpayers and create unfair, cost-saving advantages for those taxpayers who can afford to aggressively exploit the system to their advantage.

The Income Tax Disproportionately Injures the Upwardly Mobile

The income tax is unfair because it taxes the principal means by which Americans can improve the standard of living for themselves and for their children. The income tax is biased against those who are seeking to improve their families' lot in life through savings, investment, and hard work, while it favors those with assets to consume.

The FairTax would improve the standard of living of the vast majority of Americans by rewarding an individual's decision to work, save and invest. Under current law, however, consumption of goods and services is favored over savings and investment. A taxpayer often enjoys no immediate benefit from savings and investing, and the fact that the taxpayer has already been taxed on his or her income means that there is also no incentive *not* to consume. The income tax system rewards the here and now, and penalizes taxpayers who seek to save for the future by taxing income when it is earned and also when it grows. Under the FairTax, those who benefit from tax-sheltered income, as well as those who profit handsomely from the complexities and confusion of the tax system, would no longer benefit from advantages that are not available to most taxpayers.

The FairTax would additionally benefit lower income families through increased economic growth. Slow economic growth or recessions have a disproportionately adverse impact on the poor. Breadwinners in these families are more likely to lose their jobs, are less likely to have the resources to weather bad economic times and are more in need of the initial employment opportunities that a dynamic, growing economy provides. The FairTax would dramatically improve economic growth and improve wage rates, while retaining the present tax system would needlessly delay economic progress.

The FairTax is Based on Fairer Measures of the “Ability to Pay”

The FairTax plan is fairer because, much more than an income tax, it is based on “ability to pay.” Under an income tax, taxing *income* at graduated rates has been the means for achieving progressivity in taxation. A tax on income, however, no matter how steeply graduated, does not necessarily make an income tax progressive over the course of one’s lifetime.¹

The ability to pay is not properly defined solely by how much income someone happens to make in any given period, such as a year. On the contrary, income is merely the means by which productive members of society try to increase their personal wealth so that they have better economic security, can provide better for their family and have the ability to pay for things they wish to purchase. Often wealth – which in and of itself may not be a fair determination of the ability to pay – is not captured by an income tax. Individuals rich in personal wealth may actually have very little income, because wealth is defined in assets that they hold – their homes, properties, securities, collectibles and other items – which may or may not have been earned by them and which may or may not generate taxable income streams. These wealthy individuals can often choose whether or not to create taxable income, since they can restructure their affairs to avoid receiving current taxable income.

The FairTax, far more than an income tax, is based upon a taxpayer's ability to pay *precisely* because it is based upon consumption. Whether or not a taxpayer can consume for personal enjoyment is a more accurate litmus test for whether or not that taxpayer has the ability to pay. When taxpayers do not consume for personal enjoyment, but have income, they must be saving or investing those resources. When taxpayers save and invest, they contribute to the public welfare. They generate benefits to the community, for their future and their children’s future, well beyond personal gratification.

In addition, to compliance cost burdens, the income tax is already invisibly embedded in the price of the goods we consume. In addition to the payments we make directly to the government, we are already paying hidden income taxes that are incorporated into every product we buy. We just do not see them. Almost every product or service we purchase has already been taxed once and often numerous times. When we purchase bread for our sustenance, we are

¹ “Examining a Change to a National Retail Sales Tax Regime: Impact on Households” Joseph Kahn, Decisions and Ethics Center, Stanford University, unpublished draft position paper, November 1996.

paying a price to recover the income tax imposed on the farmer that produced the wheat, on the miller that milled the wheat, the baker that baked the dough, and on the retail outlets that brought the final product to your grocery shelf. Therefore, an accurate appraisal of the burden of the income tax must examine the hidden taxes paid on consumable items. The income tax system literally cloaks the cascading nature of the tax, its true economic effects, and its real burdens on the purchase price of the final goods and services.

The FairTax is Progressive

The distribution of the FairTax proposal is fairer than present tax law because the FairTax only taxes consumption above the poverty line, assuring each family the ability to spend, tax-free, for their basic needs. In this way, the FairTax, unlike the current system, exempts from taxation the basic necessities of life. This is accomplished by providing a rebate to each family equal to the taxes paid on the purchase of essential goods and services as determined by the HHS Poverty Level. The rebate would be paid monthly in advance to every family. The monthly family allowance for 2000 can be found in Table 1.

Table 1 FairTax Annual Allowances and Rebates							
		Single Person	Single Person	Single Person	Married Couple	Married Couple	Married Couple
Family Size	HHS Annual Poverty Level ²	Fair Tax Annual Consumption Allowance	Annual Rebate	Monthly Rebate	Fair Tax Annual Consumption Allowance	Annual Rebate	Monthly Rebate
1	\$ 8,350	\$ 8,350	\$ 1,921	\$ 160	\$ 8,350	\$ 1,921	\$ 160
2	\$ 11,250	\$ 11,250	\$ 2,588	\$ 216	\$ 16,700 ³	\$ 3,841	\$ 320
3	\$ 14,150	\$ 14,150	\$ 3,255	\$ 271	\$ 19,600	\$ 4,508	\$ 376
4	\$ 17,050	\$ 17,050	\$ 3,922	\$ 327	\$ 22,500	\$ 5,175	\$ 431
5	\$ 19,950	\$ 19,950	\$ 4,589	\$ 382	\$ 25,400	\$ 5,842	\$ 487
6	\$ 22,850	\$ 22,850	\$ 5,256	\$ 438	\$ 28,300	\$ 6,509	\$ 542
7	\$ 25,750	\$ 25,750	\$ 5,923	\$ 494	\$ 31,200	\$ 7,176	\$ 598
8	\$ 28,650	\$ 28,650	\$ 6,590	\$ 549	\$ 34,100	\$ 7,843	\$ 654

Table 1: This table shows the monthly rebate that families would be entitled to under the FairTax Bill. The family allowance is based on family size and is determined by the government’s Poverty Level. All lawful residents of the U.S. holding valid Social Security numbers would be eligible for the rebate. Monthly rebates would be sent out in advance of purchases to assure that no taxpayer pays taxes on essential goods and services.

² Federal Register: February 15, 2000 (Volume 65, Number 31, Pages 7555-7557).

The FairTax would also replace the payroll tax. The payroll tax is imposed on the first dollar of wages earned, and therefore has a disproportionate impact on lower wage earners. In contrast, the FairTax would exempt all expenditures up to poverty level through a rebate system. Additionally, unlike the Social Security component of the payroll tax, which is only imposed on the first \$76,200 of wages (2000), the FairTax would be imposed on all consumption over the poverty level, and would tax the consumption of affluent taxpayers.

The FairTax would eliminate the graduated income tax rate structure that penalizes people as they strive to earn more for their families. Because of the rebate system, however, high-consumption families would pay higher average tax rates. For example, because their first \$22,500 was not taxed, a family of four spending \$45,000 would pay an effective rate of only 11½ percent tax on their taxable purchases. A family that spent four times the poverty level (\$90,000) would pay an average tax rate of 17 ¼ percent. The graph found in Figure 1 shows the effective tax rates that a family of four with various consumption levels would pay.

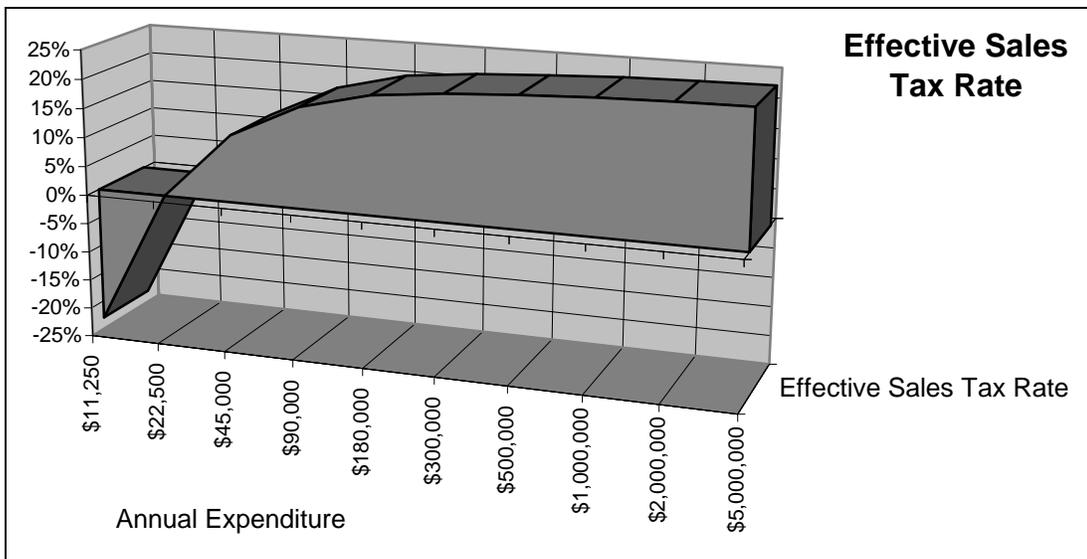


Figure 1: This figure represents the effective sales tax rate of a family of four at various levels of annual expenditure or consumption. At an annual expenditure level of \$22,500, the effective tax rate is zero, and at an annual expenditure level of \$180,000, the effective tax rate for a family of four is 20 percent.

The FairTax Will Eliminate Excessive Compliance Costs Borne Disproportionately by Small Business and the Middle Class

The question of whether or not a tax system is fair must also take into consideration the incidence of compliance costs. Presently, it is estimated that approximately \$225 billion is spent per year complying with the federal income

tax system.⁴ Compliance costs are an estimated 29 percent of the total revenue raised by the income tax system, and three percent of the Gross Domestic Product (GDP). Relative to asset size, small corporations bear a compliance cost burden at least 27.2 times greater than the largest corporation. In 1992, as a group, these small corporations had to pay at a minimum \$724 in compliance costs for every \$100 they paid in income taxes.⁵ These huge compliance costs are a pronounced drag on our standard of living and the international competitiveness of U.S.--based firms. Although duly included in the national income product accounts, the payments made to tax lawyers, accountants, IRS agents and other tax professionals do not improve our collective standard of living. Under an income tax system, these compliance costs are disproportionately borne by small businesses and therefore the middle class, the principle owners of small businesses.

The FairTax would reduce tax compliance costs very substantially. In fact, the Tax Foundation has estimated that compliance costs would fall from \$225 billion under the present tax system to about \$8 billion. This amounts to a 96 percent reduction in compliance costs; this saving is the equivalent to a free year of strong economic growth.⁶ These compliance costs savings will inure to the middle-class and to entrepreneurs (the owners and operators of the majority of small business). The FairTax would also compensate businesses for their compliance costs by providing a fee to businesses that collect and remit sales taxes.

The FairTax is Visible to All

The Americans for Fair Taxation plan is also fairer because it is more visible. One of the greatest attributes of a sales tax regime – an attribute that enhances compliance and assures fairness for all – is its resolute clarity. The FairTax allows – indeed one might say, forces – each and every taxpayer to take notice of the actual burden of government in every purchase that taxpayer makes. In this way, the FairTax is notably distinguished from an income tax and virtually every other form of tax.

The transparency of the FairTax adds to the reality and perception of fairness and compliance in one final respect – the tax paid by others is easily seen. When one purchases a good or service for personal consumption, it is clear at the retail level that each taxpayer is pulling his or her load for the tax system. Currently, the IRS

⁴ “Compliance Cost of Alternative Tax Systems II”, House Ways & Means Committee Testimony, Arthur P. Hall, the Tax Foundation, March 1996.

⁵ Ibid.

⁶ Among business compliance cost savings: there would be no more alternative minimum tax, no more multiple depreciation schedules, no more complex international tax provisions, no more complex pension and deferred compensation rules and no more uniform capitalization rules. Because individuals who are not engaged in business would no longer file tax returns, the number of tax returns filed may fall as much as 80 percent. Businesses would experience a dramatic decline in compliance costs as well.

estimates that the “tax gap” – unpaid taxes – amounts to about \$200 billion per year under current law. This gap will never be fully closed, but it is more likely to be reduced under the FairTax, because the FairTax will be understood and viewed as fair and legitimate by most Americans.