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**To the House Ways and Means Committee  
Hearing on Tax Reform and Consumption-Based Tax Systems  
July 26, 2011**

***Chairman Camp, Ranking Member Levin, and Members of the Committee on Ways and Means:***

The Americans for Fair Taxation (Fairtax.org) welcome the chance to submit this written testimony to the Committee on the FairTax, a national consumption tax.

With more than 600,000 supporters, Fairtax.org is the nation's largest grass roots citizens' organization dedicated to fundamental tax reform. As a nonpartisan organization, we have engaged some of the nation's leading scholars and tax policy analysts to explore the infirmities of the existing system and the best means of correcting them. The product of our effort is the FairTax, which has been introduced by Representative Rob Woodall as H.R. 25 and in the Senate as S 13 by Senator Saxby Chambliss. The House bill now has 63 cosponsors and the Senate bill has 8. With the benefit of our research and our efforts towards fundamental tax reform, we respectfully offer the following insights within the scope of this hearing.

**What is the FairTax?**

**The FairTax Act of 2011 (H.R. 25)** is comprehensive legislation that replaces all federal income and payroll 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 (H.R. 16), repeal of the 16<sup>th</sup> Amendment. The FairTax 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, single-rate federal retail sales tax – collected and administered in cooperation with the federal government by existing state sales tax authorities.

**Purchase of Living Essentials Tax-Free via the Prebate**

Under the FairTax, all Americans consume what they see as their necessities of life free of tax. While permitting no exemptions, the FairTax (HR25) provides a monthly, universal prebate to ensure that each family unit can consume tax-free at or beyond the poverty level, with the overall effect of making the FairTax progressive in application. This is not an entitlement, but a rebate (in advance) of taxes paid – thus the term prebate. Everyone pays taxes at the cash register.

Although everyone pays the same tax rate at the cash register, the effect of the prebate is to increase effective tax rates (annual taxes paid divided by annual spending) as the level of spending increases, a progressive tax rate structure. For example, a person spending at the poverty level (\$29,420 for a family of four) has a 0% effective tax rate, the prebate rebates all of the taxes they paid. Whereas someone spending at twice the poverty level has an effective tax rate of 11.5%, and so on.

Administering the prebate under the FairTax would also be far simpler than administering the EITC, credits, or deductions under the current system – far cheaper and far less intrusive. The cost to administer the prebate is miniscule compared with the combined compliance costs and administrative burden of the income tax. When the state sales tax authorities process the prebate applications they will validate all names and Social Security numbers against the Social Security Administration (SSA) database. States already do this in relation to the administration of other state/federal cooperative programs such as unemployment benefits and child support enforcement. The states will submit the prebate distribution file to the SSA which will provide the prebate in the form of a paper check via U.S. Mail, an electronic funds transfer to a bank account, or a “smartcard” that can be used much like a bank debit card—already in use to provide other federal benefits.

The prebate is estimated to be about \$500 billion, which is a much smaller figure than the estimated cost of all the deductions, exemptions, and tax credits under the current income tax system. For 2006, the total of all of these tax breaks exceeded \$945 billion (estimate by the Joint Committee on Taxation). The FairTax provides for both civil and criminal penalties for knowingly filing a fraudulent prebate application. The civil penalty is equal to the greater of \$500 or 50 percent of the claimed annual prebate amount not actually due plus repayment of any falsely due prebate amounts. A criminal penalty of imprisonment for up to one year may also be imposed.

### **Taxation of Government Consumption**

Public finance economists realize that the current system imposes taxes on government, albeit indirectly through the higher wages government must pay its employees, the payroll taxes it must pay, and the higher payments it makes to government contractors, than would otherwise be the case if there were no federal income tax system. They further realize that when you shift from an income tax to a consumption tax you must maintain the same “tax wedge” in government. Not doing so would distort the private marketplace, creating an incentive to consume through the medium of government. Federal taxation of units of government has already been upheld by the Supreme Court when it affirmed that the federal government could require all units of government to pay payroll taxes on wages paid to its employees.

FairTax.org acknowledges that increased revenue from taxing federal government consumption is exactly canceled by increased costs in the federal budget (as pointed out by the tax panel). What the tax panel neglected to point out is that this accounting method is used today by the Office of Management and Budget and Congressional Budget Office.

The FairTax taxes all consumption, including government consumption, once. Today, the income tax and payroll tax are imposed on government consumption by taxing government employees and government contractors, making government pay more than it would in the absence of these taxes. This tax revenue appears in the receipts column in the federal budget, and the added expense is counted in the federal budget as spending (exactly canceling each other out). Fortunately, at least in this respect, the federal budget is honestly presented.

This tax revenue currently “paid” by the federal government is part of the tax revenue that the FairTax replaces. The federal government could artificially reduce both spending and tax revenues by exempting its workers and contractors from both income and payroll taxes and lowering wages paid to employees and amounts paid to contractors accordingly. Similarly, the FairTax taxes government consumption and, like today, the expense and revenue would be reflected on the federal budget as such. If the FairTax were to exempt government from tax and if federal spending were held constant, then the purchasing power and size of the federal government as a share of the economy would be dramatically increased. Further, not taxing government consumption would artificially make government consumption appear cheaper and promote increased consumption via government. So, though a wash, there would be negative economic consequences if the FairTax did not continue the practice of taxing government consumption.<sup>1</sup>

### **Transition**

Transition issues under the FairTax are more easily handled than under a flat tax or business transfer tax (subtraction method VAT). To prevent the double taxation of inventory held on the effective date of the sales tax, the FairTax provides a credit when the inventory is sold at retail. With respect to unused income tax credits and deductions, some form of transition relief is appropriate under a flat tax or reformed income tax, since firms and investors are going to continue paying tax. Under the FairTax, corporations and investors don’t need transition relief; after all, how can a corporation or an investor be worse off because it has been relieved from having to pay income tax altogether?

With respect to property owned when the sales tax is enacted, the FairTax exempts the sale of used property from tax as the simplest approach. The upshot of this is that market demand will bid up the price of used

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<sup>1</sup> For a detailed description of the FairTax base and step-by-step explanation of the rate calculation methodology, see Paul Bachman, et al., “Taxing Sales Under the FairTax: What Rate Works.”

property, especially homes, until the price of the exempt used property (adjusting for wear and tear) is the same as the cost of new taxable property (inclusive of the tax). Taxing used property as well as new property would eliminate these windfall gains; however it would violate a basic tenet of the sales tax: that the value of the property be taxed only once. It would also result in tax cascading every time the same property were sold. No transition relief is necessary for savings distributed from pension plans, IRAS and other qualified plans because neither the contributions nor the earnings on the plan would have been subjected to income tax. Income earning assets that are currently subject to income tax will not now be paying tax, causing the market value of these assets to climb considerably to reflect the repeal of the income tax. And finally, the FairTax provides that the cost of living adjustment for Social Security benefits be computed on a tax inclusive basis. The Fair Tax does incorporate two transition rules. First, since inventory is not deductible under the income tax until it is sold, that inventory will have been acquired from after-tax dollars. To then subject that inventory to a sales tax would constitute double taxation and disrupt markets. Accordingly, the FairTax provides a credit to businesses for the inventory equal to the value of the inventory on the last income tax return and the sales tax rate. Second, the FairTax pushes forward the effective date in order to allow time for the economy to adjust to a consumption tax.

Businesses that have inventory held on the date prior to the enactment of the FairTax qualify for a **transitional inventory credit** if the inventory is sold subject to the FairTax within a two period. Qualified inventory shall have the cost that it had for federal income tax purposes for the active trade or business as of the end of the final income tax year. The credit is equal to the cost of the qualified inventory times the FairTax rate. Businesses may sell the right to receive the inventory credit, so the credit can follow qualified inventory through the supply chain. Qualified inventory includes work in process. The transition credit indirectly allows for a transitional period for production and retail to adjust to pricing without the inclusion of income and payroll taxes, corporate taxes, and compliance costs that before the FairTax were a large percentage of the cost passed along to the consumer. This means being able to keep some prices the same immediately after the effective date and then change prices over time consistent with newfound production and retail savings as tax burdens are lifted.

### **Administration of the FairTax by the States**

The simplicity and efficiency of the sales tax is what has caused its spread from its inception in 1932 in Mississippi to 45 states and Washington, D.C. Today, 98 percent of the population is covered by state or – in Alaska – local sales taxes. State governments have the structure and databases required for implementing sales taxes, which would definitely lower the “startup” costs of administering a national retail sales tax than if it were done by the IRS.<sup>2</sup> State sales tax authorities have amassed great expertise in the administration and collection of sales taxes, performing these activities much more efficiently than could be done by a centralized agency of the federal government. Likewise, there is no reason why the states cannot keep the data on households necessary to administer the prebate. Federal-state cooperative programs already exist for the verification of social security numbers, a noteworthy example is the federal unemployment compensation program, which is federally funded but has been administered by the states for more sixty years. To provide federal oversight, the FairTax creates an office in the Treasury Department to monitor enforcement of the FairTax by the states, to resolve disputes between states and a place to appeal enforcement actions. The Secretary of the Treasury is given the authority to promulgate regulations, to provide guidelines, to assist states in administering the FairTax, to provide for uniformity in the administration of the tax, and to provide guidance to the general public. States are provided an administrative credit of ¼ of one percent of the sales taxes they collect, totaling about \$6 billion overall, to compensate them for the costs of administration.

Research demonstrates that if the FairTax was in place and administered by state sales tax agencies, it would have saved \$346.5 billion in administrative costs in 2005 when compared to the administrative costs associated with the federal taxes it replaces. This implies a saving of \$14.70 per \$100 of the gross revenue the FairTax would collect. These estimates are robust enough to ensure that even if any additional spending is needed under the

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<sup>2</sup> Dronenburg, Ernest J. SAFCT: State Administered Federal Consumption Tax: The Case for State Administration of a Federal Consumption Tax, paper presented at NYU Annual State and Local Taxation Conference, New York, Nov. 30, 1995.

FairTax to have the levels of avoidance and evasion needed to bring in the estimated revenue, it would never overcome the savings it provides in lower administrative costs when compared against the current federal system of taxation it replaces.<sup>3</sup>

Administering states would enter into a cooperative agreement with the U.S. Treasury Department governing the administration of the FairTax by such state. Such an agreement includes provisions for the speedy transfer of tax monies collected, contact persons, dispute resolution, information exchange, confidentiality, and taxpayer rights. States that do not have a state sales tax or states that do not want to administer the FairTax have two options: They may contract with another state that has a state sales tax to administer the tax, they may contract with the federal government to administer the tax or they may do nothing and the federal government will directly administer the FairTax within that state. If a state is collecting the FairTax on behalf of another state, both states and the federal government must sign the agreement.

Each state may choose whether or not to conform its state sales tax base to the FairTax base; however, doing so enables the conforming states to collect state sales tax on sales made by remote sellers outside the state to a destination within that state. In, 2008, the revenue losses to states from this prohibition are estimated to be between \$21.5 billion and \$33.7 billion.

### **What about the IRS?**

The IRS will remain in place until September 30<sup>th</sup>, three years after the FairTax is enacted. This allows the IRS to carry out all tax processing and enforcement activities relating to income tax returns for the final income tax year, and prior years. The IRS will be processing annual income tax returns for the individual income tax, corporate income tax, estate and gift tax, and the self-employment tax. It will conduct its normal collection and enforcement activities, including audits. The IRS can focus its attention on collecting taxes for the final income tax year taxes since there will be no time devoted to getting ready for another income tax year. At the end of the three years, no appropriations for expenses of the Internal Revenue Service, including processing tax returns for years prior to the repeal of the taxes repealed by HR25, shall be authorized.

### **Why the FairTax?**

The FairTax is a fair, efficient, transparent, and greatly reduces tax code 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 with 4,428 changes to the tax code in just the last decade. In 2010 alone there were 579 changes, more than one per day!<sup>4</sup> The continuous tinkering with the tax code has resulted in tripling the length of the tax code, now a mind-boggling 3.8 million words.<sup>5</sup> The combined federal income tax code, regulations, and IRS rulings have grown from 14,000 pages in 1954 to 72,536 pages by 2011 – an increase of 518 percent.

To most Americans, the direct expenses of the IRS or abstract measurements are not the central compliance problem. Most important is the mandate imposed on the American taxpayer to act as tax collector. According to an analysis of IRS data by the Taxpayer Advocate Service (TAS), individual taxpayers and businesses spend an estimated 6.1 billion hours each year complying with the filing requirements of the Internal Revenue Code (henceforth called “compliance costs”). The Tax Foundation estimated compliance costs to

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<sup>3</sup> Tuerck, David, Paul Bachman, and Alfonso Sanchez-Penalver, *Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System*, The Beacon Hill Institute at Suffolk University, Sept. 2007.

<sup>4</sup> Taxpayer Advocate Service, 2010 Annual Report to Congress, “The Time for Tax Reform is Now,” Dec. 31, 2010, p. 4.

<sup>5</sup> *Ibid.*

exceed \$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<sup>6</sup> 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.

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 13 to 22 percent of the total revenue raised by the income tax system.

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. In 2009, our government has embroiled its citizens in more than 71,705 litigation actions, with 75 percent of them involving small businesses. Taxpayers sustained more than 3 million levies.

Another measure of complexity is shown by looking at the record of the IRS's own centers established to help people prepare their tax returns. According to the Taxpayer Advocate Service, the IRS received 110 million calls in each of the last two fiscal years; 25 percent of which the IRS was unable to answer. In addition to the telephone calls, the IRS must process more than 11 million pieces of taxpayer correspondence annually.

The efficiency costs of the federal tax system dwarf compliance costs. Efficiency costs occur when tax rules distort the decisions of individuals and businesses regarding work, savings, consumption, and investment. By changing the relative attractiveness of highly taxed and lightly taxed activities, taxes alter decisions such as what to consume and how to invest. When taxpayers alter their behavior in response to tax rules, they often end up with a combination of consumption and leisure that they value less than the combination they could have achieved if they made decisions free of any tax influences. This reduction in value is a welfare loss or efficiency cost. According to research by the Government Accountability Office, efficiency costs are on the order of magnitude of two to five percent of Gross Domestic Product (GDP).<sup>7</sup> Based on GDP of \$14.119 trillion in 2009, efficiency costs are an additional \$282 to \$706 billion.

### **All of that complexity disappears with the FairTax.**

With a national retail sales tax, the Tax Foundation, the oldest national tax research organization, has estimated that compliance costs drop more than 90 percent.<sup>8</sup> Anyone who professes to despise the complexity of the income tax should embrace the FairTax. No other tax reform plan 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 another tax return. The FairTax taxes only final consumption making business-to-business transactions fully exempt; thus, businesses that serve other businesses will neither collect nor pay taxes. Sellers of retail goods and services, most of which already pay state sales taxes (in the 45 states that have them) are provided an administrative credit compensating them for the costs of sales tax compliance. The self-employed engaged in providing goods and services for final consumption are the only individuals that would have to file tax returns.

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<sup>6</sup> Moody, J. Scott, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation, Special Report No. 138, December 2005.

<sup>7</sup> "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System," U.S. Government Accountability Office Report No. GAO-05-878, August, 2005, p. 20.

<sup>8</sup> Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation, Testimony before the House Ways and Means Committee, June 6, 1995.

The FairTax reduces the more than 700 incomprehensible sections of the Internal Revenue Code to one simple question. As all goods and services for final consumption are taxable, the retailer need answer only “how much did I 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 VAT. Under a VAT, all businesses would be forced to keep records on every purchase and submit detailed forms to the government with much higher compliance costs than the FairTax. The administrative burden of the VAT would be especially severe if policymakers chose to exempt certain goods and services. Compliance costs would also rise if politicians chose to apply different rates to different goods and services. Most nations with VATs not only exempt certain products altogether, but also tax certain goods and services at different rates. The FairTax prebate untaxes living essentials thereby eliminating the need for exemptions and differential rates and the resulting complexity.

Likewise, 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. Both individuals and businesses must file returns. The fear that the flat tax would eventually revert to a complex income tax system would remain. 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 sales taxes are by their nature single rate taxes, and cannot be reverted to an income tax (as it repeals the income tax code and has companion legislation to repeal the 16<sup>th</sup> amendment).

**Compliance rates are 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 payment 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 policymakers evaluate our current system and various reform initiatives, they must do so within 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 which is getting worse, notwithstanding a much larger Internal Revenue Service (IRS), more burdensome information reporting requirements, increasingly stiff and numerous penalties and a host of legislative initiatives. The current system requires taxpayers not only to absorb substantial cost but also to lose 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.”<sup>9</sup> Despite this poor compliance rate, we may have reached the limits of

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<sup>9</sup> 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.,

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:

Almost every year since 1981 has witnessed legislation to address tax gap issues. These legislative actions generally required information returns [1999's] reporting on income and deductions, imposed penalties for tax noncompliance, or reduced 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.<sup>10</sup>

With more than 3 billion informational returns filed and roughly 36 million civil penalties assessed each year,<sup>11</sup> 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.<sup>12</sup> Researchers have found the administrative costs of state sales tax vary as a percent of revenue received from between 0.4 and 1.0 percent, and average 0.7 percent of revenues received.<sup>13</sup> The compliance costs imposed on businesses from state sales taxes have been estimated to fall between 2.0 and 3.8 percent of revenues.<sup>14</sup> 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.<sup>15</sup>

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.<sup>16</sup> In the broadest aggregate, assuming the gap of \$353 billion, gross noncompliance is about 18 percent of revenues.<sup>17</sup> The evidence at the state level suggests that income taxes have twice the noncompliance level of sales taxes – even those at the state level that are largely very complicated and which cascade – at a fraction of the cost.

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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.

<sup>10</sup> "Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed," United States General Accounting Office, GAO/GGD-94-123, May 1994 (hereinafter "GAO").

<sup>11</sup> IRS Data Book, 2009. See Tables 14 and 17 respectively.

<sup>12</sup> Admittedly, this is not ideal since state sales taxes are designed in a manner that requires greater compliance costs than the FairTax.

<sup>13</sup> Due, John F., and John L. Mikesell, *Sales Taxation, State and Local Structure and Administration*, Second edition, Washington, D.C.: Urban Institute Press, 1994.

<sup>14</sup> 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.

<sup>15</sup> Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation Special Brief before the House Ways & Means Committee, June 1995.

<sup>16</sup> FS-2005-14, *supra*.

<sup>17</sup> Estimated by dividing the income tax gap of \$353 billion by \$1,952 trillion in collections for FY 2004.

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

To understand how a simple plan reduces the tax gap, policymakers 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.<sup>18</sup>

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.<sup>19</sup>

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.”

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?<sup>20</sup> The largest percentage increase in the tax gap from 1981 to 1992 was attributable to math errors, a 212.3 percent increase.

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, 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

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<sup>18</sup> 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).

<sup>19</sup> GAO, *supra*.

<sup>20</sup> 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.

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.

**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, policymakers need to look at the several factors that bear upon compliance – both fraud and non-fraud – from the scholarly research. The GAO has discussed some of these in Congressional testimony.<sup>21</sup> 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 higher compliance rate than current law (i.e., substantially reducing the current \$345 billion “tax gap”<sup>22</sup>) – 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. The number of filers by type of taxpayer demonstrates how few points of collection there would be under the FairTax. Individuals file 93.8 percent of income tax returns. Under the FairTax individual filers won’t exist, except for the self-employed engaged in selling goods or services to consumers.

Because the FairTax reduces the number of tax filers by at least 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, both the risk of detection and the risk-adjusted cost of evasion increase.

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. However, 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.<sup>23</sup> Since the gross receipts of wholesalers would not typically be subject to tax, the true scope of the small “problem” companies is smaller still.

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. Visibility of the transaction improves as well, and simplicity and visibility go hand in hand. Under the FairTax, 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 with the full knowledge that he is violating the law (i.e., committing evasion). Few excuses apply.

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<sup>21</sup> Willis, *supra*.

<sup>22</sup> The difference between what taxpayers should pay and what they actually pay on a timely basis.

<sup>23</sup> 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.

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. Complexity of the code is an important driver of noncompliance. Tax code complexity obscures understanding, with the result that taxpayers often have little idea of what they are paying. They worry that they are missing tax breaks while others are benefiting from too many breaks. 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, much of that hostility to the tax system will disappear. In short, tax collectors could 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 above, 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 Central Problem Ignored: Failure to Adopt a Border-Adjusted Tax System**

The decline of U.S. manufacturing and the ascendancy of foreign competition have been due in large part to the failure of the U.S. to adopt a border-adjusted tax base.

*The current tax system harms the competitiveness of domestic producers and workers.* The U.S. tax system imposes heavy income and payroll taxes on U.S. workers and domestic producers whether their products are sold here or abroad. As noted, U.S. corporate taxes are the highest in the industrialized world, with a top corporate rate about nine percentage points higher than the OECD average.<sup>24</sup> At the same time, the U.S. tax system imposes no corresponding tax burden on foreign goods sold in the U.S. market. Moreover, foreign VATs, which are a major component of the total revenue raised elsewhere, are rebated when foreign goods are exported to the U.S. market. This creates a large and artificial relative price advantage for foreign goods, in both the U.S. market and abroad.

Through WTO compliance means, the FairTax exempts exports from taxation, while taxing imports the same as U.S. produced goods for the first time. It is the simplest plan that could be devised, without the intercompany (and intra-company) transfer pricing problems present in an origin-principle income or consumption tax. It reduces U.S. corporate rates to zero, ensuring the U.S. is the most competitive environment in which to produce and from which to export. And it would stimulate economic growth by broadening the tax base and reducing marginal rates well beyond any other proposal and do so in a way that does not tax the poor, punish savings and investment or tax income more than once.

In summing up, we quote the President of the National Small Business Association, “Our members choose the Fair Tax because it is the most efficient and least intrusive form of taxation. It would relieve small business owners from their current role as proxy federal tax collector for income taxes and payroll taxes. Those retail locations that did collect and remit sales taxes to the government would see their overall net tax paperwork burden vastly reduced. The Fair Tax would treat all forms of small business entity the same by eliminating the need for business owners to make the complex and costly choice of business entity for tax purposes.”<sup>25</sup> And, it would put American producers on an equal footing with their foreign competitors, fostering economic growth and job creation.

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<sup>24</sup> Edwards, Chris, “The U.S. Corporate Tax and the Global Economy,” Cato Institute, September 2003.

<sup>25</sup> Prepared Remarks of Mr. Todd McCracken, President National Small Business Association, to the House Small Business Committee, February 1, 2006.