July 20, 2011

Re: Hearing on Tax Reform and Consumption-Based Tax Systems, July 26, 2011

To: Chairman the Ways and Means Committee of the 112th Congress and Honorable Members:

Introduction

I am writing today to offer my support of the FairTax (H.R. 25) after giving alternative plans all due consideration. My educational background includes a Masters in Business Administration degree and a Bachelor of Science in Business Administration degree with a major in Accounting. The following is offered for the official record.

Analysis of the Current Tax Code

Title 26 contains over one million words spanning over 20,000 pages (U.S. House of Representatives, 2011). Given that level of sheer complexity, a fair question to ask is, "Is the purpose to collect revenue for the United States government, to micromanage the lives of Americans, or some combination of both?" Clearly the purpose must be to do both. That begs the question "Is the current income tax consistent with the founding principles of this nation, the spirit of 1776?" Clearly this type of legislation is not "American." Then what is it?

The second plank of the Communist Manifesto calls for a "heavy progressive or graduated income tax" (Marx, 1848). The income tax is a tax that was born of class envy and class warfare and has no place in an egalitarian political society such as the United States of America. Thomas Jefferson, in his first inaugural address, apparently foresaw a time when class envy would drive the legislative process when he offered this observation:

> *Still one thing more, fellow-citizens—a wise and frugal Government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government (Jefferson, 1801).*

There exists an institution in American history that routinely took from the mouth of labor the bread that labor had earned. That institution was slavery. Slavery was abolished after a great and terrible civil war between the States.

During the Civil War, the first income tax was enacted by Congress in 1861. It was a flat income tax (3% inside the U.S. / 5% outside the U.S.) with an exemption of the first $800 in income. In 1862, Congress changed the law, made it more progressive and also made the tax temporary until 1866 when it expired (Terrell, 2011). So, Congress used the income tax to take the fruits of the labor and industry of the productive parts of society to help free the slaves who were the victims of having the fruits of their labor and industry confiscated by private interests.

While clearly the catastrophe facing the Union at that time of the U.S. Civil War warranted the use of extraordinary and harsh forms of coercion to secure and maintain the union of the states, the irony of that last sentence above should not be lost on anyone in the committee or in Congress. Necessity may have required the income tax as much as necessity requires conscription at times, but the differences between slavery, conscription and the income tax are differences of degree and not of direction: in each instance force is applied to crush or restrain liberty.

When necessity no longer requires conscription or the income tax, then the Constitution must be returned from one of national emergency to one of peace and tranquility, from one of coercion to one of liberty. Congress, for far too long, to its shame has maintained an income tax system which is a system of tyranny against the people. This is a blunt assessment not intended to offend the current Congress or the committee. However, unless a problem is recognized as it exists, then any proposed solution that fails to recognize the contradiction between a free people and an income tax will likely lead to adopting an incorrect or destructive public policy outcome.

The current income tax system is rife with waste, fraud and abuse. It makes criminals out of the sovereign citizens of the United States of America, and places Congress in charge of the people, rather than maintaining the people in Congress as the servants of the public. In the past, Congress has repeatedly sold favoritism and tax breaks to special interest groups against the public interest. Every form of tax deduction, tax exemption, tax reduction, and tax credit granted means that someone else, an equal sovereign citizen of the United States, must make up the difference.

The current tax system taxes business which leads to higher costs of consumer goods and services. The current tax system taxes employment, raising the marginal cost of hiring new workers. The current tax system taxes wealth which was already taxed when the wealth was accumulated in the form of estate and gift taxes. The current tax system taxes wages, a flat tax up to a certain level that is a regressive tax imposed upon the poor.

The current income tax system taxes income from savings, investment, and work reducing the amounts of these activities within the United States. A graduated tax system is applied to earned income so that the harder a person works, the more they earn, then the greater their share of taxes paid on both a marginal and effective tax rate basis. Within the current tax system are loopholes that allow many to lawfully escape taxation by claiming certain deductions and exemptions while others less fortunate bear a larger marginal and effective tax rate. The current tax system in summary is a complete and total mess, cannot be reformed, cannot be fixed, and has all the moral standing (in a time of relative peace) as slavery.

Income tax simplification efforts of the past have led us to this point, and if the income tax code was yet again simplified, then in the due course of time, Congress would amend the simplified code to again resemble what exists today, just as what exists today resembles what existed before the reforms of the 1980s. I urgently recommend the complete repeal of the current tax regime (for all the reasons stated above) and its replacement with the FairTax (H.R. 25) rather that the flat income tax or Value-Added Tax (VAT) for reasons that will become abundantly clear shortly.

The Flat Tax or VAT

The Flat Tax has been proposed in many different configurations. As proposed by persons such as Steve Forbes and former majority leader Dick Armey, the flat income tax is really a value added tax (VAT). Labor, after an exemption, is taxed like a flat income tax for the value it adds to production, while each stage of production is taxed for the net value it adds to the creation of goods and services where all taxes are ultimately paid by the end-consumer although everyone involved is a tax collector and remits the taxes paid by consumers and files and required paperwork or forms. Because most but not all of the tax breaks, deductions, credits, exemptions are swept away to obtain a lower tax rate which is claimed to be flat, the flat tax is not flat. However, since each stage of production is taxed, the cascading effect of multiple points of taxation leads to a not very flat flat-income tax. However, in case the above is not a fair representation of the flat tax proposal, please see the following:

> *Replaces the income tax with a 17 percent flat tax*
>
> *The bill repeals today's complicated income tax system in toto and replaces it with a low, simple flat tax. Under the bill, every dollar of income in the economy is taxed, with wage and pension income collected from individuals and all other income collected from businesses. Individuals pay 17 percent of wage income calculated on a return so simple it can fit on a postcard (see Form 1). Businesses pay 17 percent of business income, calculated on an equally simple return.*
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> *Individual Wage Tax. Individuals pay 17 percent of all wages, salaries, and pensions, after subtracting family allowances. When fully phased in 1998, the family allowances will be $11,350 for a single person, $22,700 for a married couple filing jointly, and $5,300 for each dependent. These allowances are indexed to inflation. The flat tax replaces the current income tax system, but not Social Security and Medicare payroll taxes. Social Security benefits would not be taxed.*
>
> *Business Tax. All business income, whatever the source (corporate, partnership, sole proprietor, professional, farm, and rental profits and royalties) is taxed at the one low rate. Businesses pay 17 percent of the difference, if positive, between revenues and expenses. Expenses are defined as purchases of goods and services, capital equipment, structures, land, wages and contributions to employee retirement plans. No deductions are permitted for fringe benefits, interest, or payments to owners. Collecting business income earned by individuals at its source -- the business -- allows for a simple, airtight system that ensures all income in the economy is taxed* (Armey, Shelby, 1995)

The 17% rate does not include FICA wage taxes which would be additional. Businesses are forced to account for taxes at each stage of production, leading to the same effect as a VAT. Consumers pay all the taxes, regardless of the tax system or who collects and remits the payments to the government. The flat income tax keeps all the machinery of government in place, and while simplifying tax filing does not consider what may be some dire economic consequences for families who own homes with mortgages who presently claim mortgage interest and property tax deductions.

An example may be in order. Say a family of four owns a home, where there's a $280,000 mortgage, and the annual interest is 5% and the property taxes are $10,000. A rough calculation would suggest that there may be as much as $22,000 in claimable itemized deductions under the current tax code. Add to that the personal exemptions, child credits and all the other goodies Congress has gifted into the current tax code. Now this family has built their financial life around the assumption that these deductions against income would be there for the foreseeable future. Now take it all away under the flat income tax, and they cannot make ends meet. Add to that the cascading 17% of profits at each stage of production and American goods are going to be much more expensive both at home and abroad.

If the intention is not to destroy middle America then the flat income tax or VAT is a non-starter. It is neither flat nor fair. It destroys American jobs and makes American goods less competitive in the domestic and global markets when compared to imported or foreign goods and services. I urge the committee to reject the flat income tax / VAT proposal for all the reasons outlined above and to support the repeal of the current tax regime and the enactment of the FairTax (H.R. 25) for reasons that will become clear in due course below.

The FairTax (H.R. 25)

The FairTax (H.R. 25) is a national progressive retail luxury consumption tax. H.R. 25 repeals most of the existing tax code. The FairTax is national because it is imposed on all new goods and services sold in the United States with the exception of education. The FairTax is progressive because as consumption spending increases so does the effective tax rate and the amount of taxes remitted under the FairTax. The FairTax is a retail tax because the main point of tax collection is retailers who remit the taxes which consumers pay. The FairTax is a luxury tax because a monthly consumption allowance exempts the necessities of life from the FairTax up to the poverty limit level of spending by household. The FairTax is a consumption tax because all business and income taxes are repealed, and the main point of tax collection is at the point of consumption where the tax is imposed on consumers and collected by retailers. The FairTax is designed to be revenue neutral on a static analysis, but on a dynamic analysis the FairTax increases GDP faster than the current tax regime and / or the Flat Income Tax / VAT. The FairTax is a consumption tax suitable for a modern economy competing globally with nearly instantaneous global communications.

The FairTax (H.R. 25) repeals the corporate and personal income tax, Self-Employment, FICA taxes and FUTA taxes. The FairTax repeals gift and estate taxes, capital gains taxes, and the alternative minimum tax. The taxes repealed are imposed currently on net business income, employment, wages, personal incomes, savings incomes, investment incomes, property, and incomes from property. H.R. 25 taxes all income and wealth at the retail point of consumption.

All new goods and services except education are subject to the uniform flat tax rate imposed by the FairTax. Education is treated like investment spending and not taxed. Investment services are taxed under the FairTax. The FairTax is imposed once and only once unlike the current tax system and the proposed flat income tax / VAT. This avoids cascading taxation and unnecessary variances in the tax collected from consumers. The existing stock of non-business use property is exempted from the FairTax because this property was already taxed once under the current tax system. Businesses will have a transitional tax credit for taxes imposed by the current tax system and embedded in business inventory costs. If a durable good is purchased used, then a part of the price paid for the used item includes a reimbursement to the owner for the taxes paid under the FairTax or under the current tax system. This is unlike many current State sales tax systems which impose cascading Sales taxes upon the sale of both new and used items.

Although the FairTax imposes a flat tax rate upon the retail sale, the complete FairTax proposal results in a progressive tax where both the amount of tax collected and the individual consumer's effective consumption tax rate increases as consumption spending increases. The reason for the increase in taxes collected is because the imposed tax rate is flat, and the more that is spent on consumption, the more tax will be collected under the FairTax. The reason why the effective tax rate is less than the imposed tax rate, and why the effective tax rate rises as consumption spending increases is due to the effects of the monthly consumption allowance. However, the effective tax rate will not exceed the flat tax rate imposed on retail sales.

The monthly consumption allowance is based upon the annual poverty limit in terms of income based upon size of household. The annual poverty limit is first adjusted to eliminate any marriage penalty. The result is divided by twelve to determine the monthly poverty limit. The monthly poverty limit is multiplied by the FairTax tax rate to determine the monthly consumption allowance by household size. This amount is provided to every household each month to offset the amount of the FairTax imposed up to the monthly poverty limit consumption. Thus all the necessities of life are exempted from the FairTax for everyone covered by the monthly consumption allowance. Only households willing to register for the monthly consumption allowance will receive it and only residents with valid social security numbers are eligible to receive the monthly consumption allowance. All others in the country would be subject to the full FairTax tax rate when they make a retail purchase of new goods and services.

The current tax system imposes taxes upon necessities. The proposed flat income tax / VAT imposes taxes upon necessities. Only the FairTax fully exempts the necessities of life and education from taxation. Only the FairTax fully exempts the poor who consume less than poverty limit spending from federal taxation. The result may be an effective consumption tax rate that is negative, zero or greater than 0% depending upon how much consumption spending the consumer does. This method of administering the exemption of necessities from taxation eliminates the need to maintain distinct lists of categories of tax-exempted items, and ends all debate about what should or should not be upon that list. The result is administrative simplicity where the FairTax is flat (uniform) for all items whether considered a necessity or not. The effect is to prepay the tax on (exempt from the FairTax) all necessity spending whether the funds are spent or not.

If the level of consumption spending is below the poverty limit, then the effective consumption tax rate will be less than 0%. If the level of consumption spending equals the poverty limit, then the effective consumption tax rate will be 0%. If the level of consumption spending is above the poverty limit, then the effective consumption tax rate will rise but not equal the FairTax tax rate imposed at the retail point of sale. At twice the poverty limit spending level, the effective consumption tax rate is half the retail FairTax rate. At four times the poverty limit spending level, the effective consumption tax rate is three-fourths of the retail FairTax rate. At eight times the poverty limit spending level, the effective consumption tax rate is 87.5% of the retail FairTax rate. At sixteen times the poverty limit spending level, the effective consumption tax rate is 93.75% of the retail FairTax rate. While these examples are given at distinct points of consumption, the progressive increase in the effective consumption tax rate follows a smooth curve. Nobody needs tax tables or calculate these rates to file a tax return. The effective tax rate simply follows from the interaction effects of the FairTax retail tax rate and the monthly consumption allowance.

The FairTax taxes the underground economy and non-residents of the United States within the United States at the full retail FairTax tax rate at the retail point of sale. The current income tax and proposed flat income tax / VAT are not as broadly conceived and miss collecting some revenue that the FairTax would capture.

Because the FairTax repeals current taxes representing the great body of work handled currently by the Internal Revenue Service, the need for the IRS ceases to exist. Consumers would pay the FairTax to registered retailers who would collect it. For the most the part taxes collected would be remitted to State taxing authorities who would then remit these taxes to the U.S. Treasury. States without sales tax agencies or States not participating would have a much smaller bureau within the Treasury Department act as the administrative taxing authority where tax collections would be remitted by retailers. H.R. 25 also allows states without sales taxes to contract with neighboring states for the administration of the tax collection process with the approval of the Secretary of the Treasury.

Retailers and State tax agencies would be entitled to retain 0.25% each for acting as tax collection agents to offset their administrative handling costs. This 0.25% is expressed as a part of the total FairTax retail tax rate, not as a percent of the total taxes paid by the consumer.

For example, H.R. 25 initially sets the retail FairTax rate at 23% of retail sales net of any sales returns. The retailer may claim a credit for 0.25% and the State tax agency may deduct another 0.25% leaving a remainder of 22.5% for submission to the U.S. Treasury. If the net retail sale was $1,000 then the amount of tax remitted to the Treasury would be $225. The administrative handling charges would be $2.50 for each the retailer and the agency. The consumer paid $230 in taxes and 0.25% of $230 would be considerably less than the $2.50 per $1,000 intended (i.e., $0.575 per $1,000) under H.R. 25.

The FairTax is a luxury tax because the monthly consumption allowance exempts the necessities of life from the FairTax up to the poverty limit level of spending by household. Not everyone is entitled to have spending on the necessities of life exempted from the FairTax. Those who do not register for it will not receive the monthly consumption allowance. Those who do not have valid social security numbers will not receive the monthly consumption allowance. Persons in the country unlawfully or visiting the U.S.A. pay the full retail FairTax rate. This provides a disincentive for undocumented workers to enter the U.S. unlawfully and work here. Because no wage, employment, or income taxes are due for employing people, businesses have no financial incentive to hire unlawful residents in preference to lawful residents. Because undocumented unlawful residents pay the full retail FairTax rate the economic reasons for people to unlawfully enter and remain in the country are reduced significantly.

By enacting the FairTax and repealing the existing income and employment taxes, Congress will be placing lawful U.S. residents on an equal playing field with undocumented foreign workers within all labor markets. Because of the significant penalties involved for hiring unlawful undocumented workers, no business would consider the financial benefits of doing so to outweigh the risk. The FairTax will thus increase employment opportunities for lawful U.S. residents. In contrast, the flat income tax / VAT proposal maintains many of the same financial incentives for violating the law. These alternatives are not luxury taxes but embed tax costs within all products made in the United States creating a regressive rather than a progressive tax system for everyone.

The FairTax taxes consumption. Under any tax system, consumers pay all taxes regardless of how complex the tax calculation, the filing of tax returns, or who remits the tax collected. Everyone understands a simple retail sales tax. A consumer goes to a store, purchases an item and pays an amount of money that includes the sales tax. The retailer remits the tax and files any paper work with the taxing authority. The consumer pays the tax but has no obligation to file forms or maintain records. If the story ended there, then this would be the simplest, most irreducible, efficient and economical method of the true taxpayers paying taxes and the taxes collected being remitted to the taxing authorities. Unfortunately, the story does not end there as it should.

The retailer collects all the taxes paid by the consumers. The retailer calculates and remits additional taxes and remits those to taxing authorities. From what remains, the retailer distributes the remaining portion of the taxes collected from the consumers to all the suppliers of goods and services used in conducting the retail business within the prices paid for labor, goods and services. These vendors then repeat this same process, remitting some portion of the taxes paid by the consumer and forwarding the rest to their vendors for the same redundant effort of determining how much of the taxes paid by the consumer will be remitted to the taxing authorities. Eventually profits including taxes paid by the consumer are distributed to owners who again perform a complex calculation to determine how much of the taxes paid by consumers must be remitted to taxing authorities. The preceding describes the waste inherent in the current tax system as well as what would be the case under any flat income tax / VAT tax system.

Because the retailer collects all the consumer-paid taxes, the retailer should remit all the taxes collected and relieve everyone else in the value chain of that chore. That’s what the FairTax does. That’s what competing tax systems fail to do, and what leads to unnecessarily detrimental economic outcomes under those alternatives.

The FairTax initially replaces the revenue from the taxes repealed but over time increased economic activity is expected to result in increased revenue for the U.S. government. This will happen because consumption will increase. Consumption will increase when there exists greater levels of employment and with that employment greater amounts of aggregate income available for saving, investing and consuming. How does the FairTax grow the economy better than the alternatives?

First income from savings, investment and capital gains are not taxed so the United States becomes a tax haven for business. Businesses invest here, wealthy foreigners invest here, and lawful residents of the United States invest here. All these investments create projects to build plants to make business equipment and consumer goods. That creates more jobs in the USA. With more jobs come more incomes, more savings, and more investment in the USA. To the extent that the Flat Income Tax / VAT do not tax income from savings, investment and capital gains, the alternative matches the FairTax. However, the FairTax beats the Flat Income Tax / VAT because the FairTax does not embed tax costs into the price of goods and services made in the USA. This makes the FairTax have a clear advantage in terms of supporting U.S. export industries because all U.S. goods will be exported without any embedded federal taxes. The flat income tax / VAT cannot make that claim. Neither can the current tax system. So, economic growth from exports will be at a greater rate from exports under the FairTax when compared to competing tax systems.

Second, because the FairTax removes or strips off all layers of cascading federal taxation from goods and services made in the USA before applying the same retail tax rate to both imported and domestic products sold in the USA, the FairTax positions American made goods and services more favorably on a full-cost comparison basis with imported consumer items. American made will cost less on a relative basis when compares with the price of imported goods that come loaded with embedded foreign taxes. The FairTax thus positions American made products most favorably and should lead to increased domestic production and employment. Again, more employment means more incomes, savings, investments, consumption, and tax revenues.

Third, because tax barriers to employment are removed by the FairTax but not so much under the current tax system or the proposed flat income tax / VAT, employers will hire more people, people will have more disposable income, and consumption will rise along with tax revenues. Under the FairTax, employees will take home all of their income free from federal taxation and when added to the consumption allowance will enjoy a much increased purchasing power leading to more consumption spending, a growing economy, and increased tax revenues for the government. The other alternatives may inhibit economic growth, consumption and investment relative to the FairTax.

Finally, because the FairTax eliminates 80% or more of the tax filers and about 99% of the complexity when compared to either the current tax system or the flat income tax / VAT, the tax system becomes less costly and easier to enforce as resources can be more focused. Removing tax compliance costs will also make American products more competitive and lead to more sales and jobs in the USA.

When many jobs can be sent overseas and the products returned and sold in the USA without any tax collected or in many cases with income tax deductions or credits given for exporting this work, the income tax system is destructive of American industry and labor. The FairTax assures that all foreign goods and services are taxed equally with domestic goods and services. This levels the playing field for everyone. The FairTax removes almost all tax consequence considerations from every business decision. The one glaring beneficial exception is the business decision to locate facilities outside the USA where those facilities would be subject to foreign taxation or to locate those facilities in the USA where such facilities and investments would not be subject to any form of U.S. government taxation. All else remaining equal, under the FairTax, the natural choice would be to locate the facility in the USA where more jobs would be created than under any other tax system alternative because all the other alternatives hold negative tax consequences that would be detrimental to profits and returns on investments.

Retail prices will have all embedded taxes removed before the offsetting addition of the FairTax. There may be a wide variation in terms of total price changes, including the retail FairTax. Not every object of consumption comes loaded with the same level of embedded or hidden taxes. Some total costs may increase while others may fall depending upon the number of points of cascading taxation and any offsetting tax benefits contained within the existing tax system. However, when combined with effects of increased take-home pay, the monthly consumption allowance, and the reduced compliance costs, the result should be a net wash for the economy even on a static analysis basis because the FairTax is not intended to raise more revenue than the current taxes it replaces. On average, purchasing power parity is maintained, but with any change some will do better than others depending upon how advantaged they had been (or not) under the current tax system.

Criteria for Evaluating a Tax System

I offer this section and the analysis based upon the recommendations of Adam Smith (1776) and the American Institute of Certified Public Accountants (AICPA) regarding the criteria that should be used to judge a tax system. Ten criteria in total are proposed, the first four of which were suggested by Adam Smith (1776) and the remainder AICPA (2001):

1. Equality. Each taxpayer enjoys a fair or equitable treatment by paying taxes in proportion to the resources being taxed. Ability to pay is the measure of how equitably a tax is distributed among taxpayers
2. Convenience. Administrative simplicity and low costs of collection.
3. Certainty. A tax system is good if the taxpayer can readily predict where, when and how a tax will be collected.
4. Economy. A good tax system involves nominal collection costs and imposes minimal tax compliance costs.
5. The tax system should be simple.
6. The tax should be neutral in terms of its effect on business decisions.
7. The tax system should not reduce economic growth and efficiency more than necessary.
8. Clarity and ease of comprehension. Taxpayers should know about the tax and when it applies.
9. Structured to minimize non-compliance.
10. The government should be able to readily predict the amount and timing of revenue.

For the sake of the next discussion, I am going to assume that each of these criteria should obtain a more or less equal weighting in terms of the Committee's consideration of the competing tax system proposals. The following table summarizes each tax system based upon the application of each criterion on a scale of 1 to 10 where 10 is perfection.

	Ratings	(on a balanced scale max = 100 points)		
Criteria	**Current Tax System**	**Flat Income Tax**	**Value-Added Tax**	**FairTax**
Equality.	2	7	4	9
Convenience.	4	9	2	9
Certainty.	2	9	6	9
Economy	3	8	1	9
Simplicity	1	9	1	8
Neutrality	2	9	2	9
Growth	2	4	3	9
Clarity	4	9	6	9
Compliance	3	4	6	7
Predictability	6	6	4	8
Total	29	74	35	86

For the above analysis, the Flat Income Tax is a hypothetical flat tax that has not been seriously proposed, while the column labeled Value-Added Tax represents the flat income tax as proposed. While the above are my subjective judgments, I would encourage the reader to evaluate the competing tax proposals and resolve to the best possible choice. In my view, the FairTax is clearly superior.

For all of the above reasons, I urge the Committee to favorably report H.R. 25 to the House of Representatives. On so many levels H.R. 25 is the right thing to do for the benefit of the nation, the economy, and the people. My hope is that this tax system analysis was neither too high-level nor too detailed. There are many details that could have been added regarding economic forecasts that are not within my field of expertise which I hope the Committee and Congress will consider further from appropriate economic experts.

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Respectfully submitted,

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