



A FairTax® whitepaper

## The FairTax: The Key to Restoring America's International Competitiveness<sup>1</sup>

By

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The United States *tax regime influences business from the cradle to the grave*: whether or not to start a business, what business to start, how to organize it, where to locate it (here or abroad), how to fund and run the business, when and how to expand it, when to hire, when to terminate it and how to unwind it.

Over the course of the last 25 years, I have seen how tax policy affects business from many angles: as a practitioner, an advocate, a federal prosecutor, an adjunct professor, an author of treatises and a book on the policy process, and as a Congressional counsel. And from these differing perspectives, I cannot help but see the discouragement of many economists whose voices of reason are ignored; not so much because they are discordant, but because they are drowned out by the deafening din of lobbyists. Our tax system has in a nutshell devolved into an unholy trinity of lobbyists, industry seeking relative advantage and Members who seek campaign contributions, all of whom would sacrifice at the altar of a public auction our national prosperity for relative advantage.

The good news is that Tax reform is coming. It is a tide that if resisted by this Congress will be passed by their replacement. But the bad news is that the direction of tax reform remains to this day uncertain. What will reform look like? What are the criteria by which reform will be adjudged? Will reform be accomplished in name only, to leave to another generation the ultimate fix when the economy has worsened?

Understanding how we have gone astray is as easy as hearing the central chorus of economists. They will tell you that the critical maladies of our current system are three-fold:

- its complexity, prolixity and crushing compliance costs;
- its high marginal rates which trample productive income, stifle growth, job creation and wages;
- an anachronistic international tax system that is self-flagellating.

This paper addresses our anachronistic international tax system. And many will tell you, that the solution to this crisis is a consumption tax that makes the taxes we pay visible, ensures all Americans are stakeholders, is neutral as to savings and investment, lowers marginal rates, reduces compliance costs and removes the anti-competitive nature of our non-border adjustable extraterritorial tax system. The best of these is the FairTax, which stands in such stark contrast to the *causus male* of our current system that it illuminates the path this Nation must take to regain the trajectory of our prosperity.

***A High Corporate Tax Rate Makes the U.S. Noncompetitive in the Global Economy.--*** When the media, pundits and politicians use the term “tax rate,” they often neglect to explain what they mean.

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<sup>1</sup>This whitepaper is taken from the testimony of Dan R. Mastromarco before the Congress of the United States, Joint Economic Committee, Nov. 17, 2011.

When economists refer to the *national statutory rate* they always mean the government’s tax rate imposed by law and assessed on income/profits, and they typically mean the top statutory marginal rate. This is very different from the effective tax rate, which is the total tax paid as a percentage of total income earned, and which accounts for all brackets, deductions, credits, depreciation, and preferences in the tax code and is a function of what the entity actually pays in taxes.

In the U.S., corporations that earn profits of more than \$18.3 million are taxed at an outstanding top statutory marginal rate of 35 percent.<sup>2</sup> The statutory combined rate adds to this state and local tax rates (on average 4.2 percent), yielding a 39.2 percent statutory combined rate. Owners of S corporations, partnerships and sole-proprietorships based on the current budget proposal pay a *national statutory rate* of 39.6 percent (not including payroll taxes) on income over \$383,350. But that same taxpayer pays 10 percent on income up to \$8,600, and 15 percent on income up to \$34,900, etc. Depending on deductions, a taxpayer might pay a relatively modest average tax on total earnings, yet nonetheless face a 39.6 percent marginal tax on any activities that could push income higher—such as extra effort, education, entrepreneurship, or investment. The chart below shows where the U.S. ranks among developed countries when considering corporate rates.

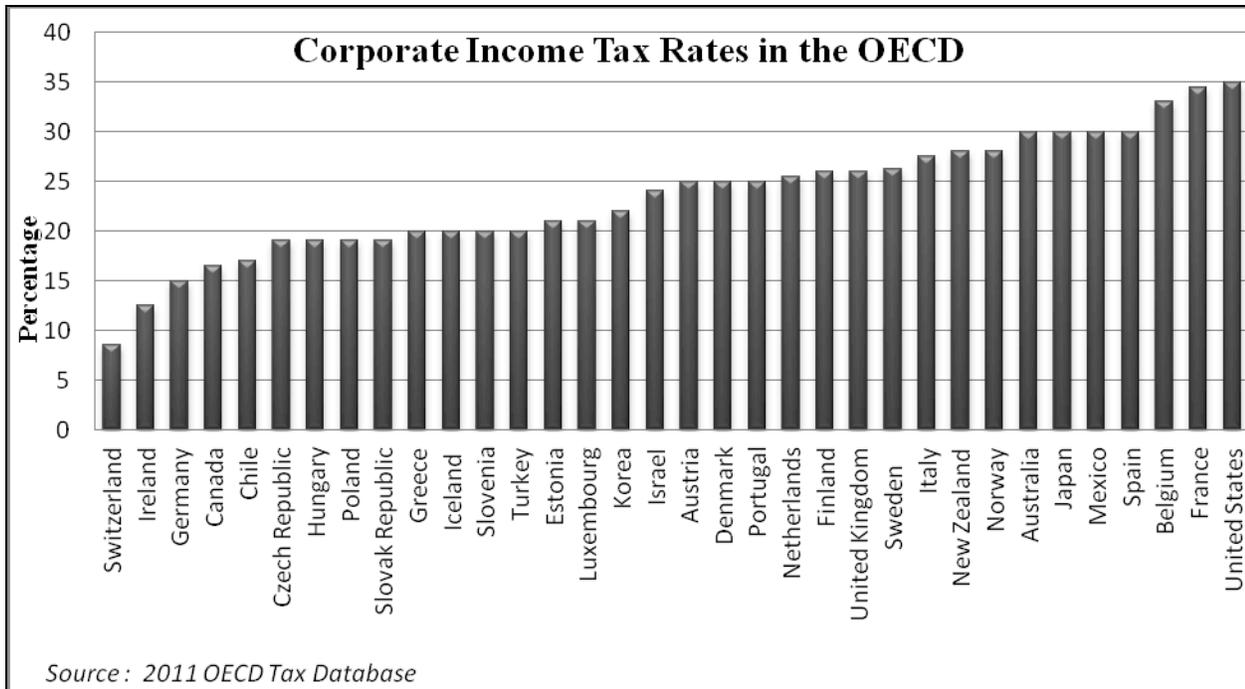
**2010 Corporate Tax Rates, U.S. vs. OECD Countries**

	<i>U.S.</i>	<i>OECD Average</i>	<i>U.S. Rank</i>
National Statutory Rate	35.0%	23.4%	34th out of 34
Statutory Combined Rate	39.2%	25.1%	33rd out of 34
Effective Rate	29.0%	20.5%	33rd out of 34

In short, the U.S. has the dubious distinction of sporting a national statutory rate of 35 percent and a statutory combined rate of 39.2 percent, compared with average OECD rates of 23.4 percent and 25.1 percent, respectively. For tax policy considerations, marginal decisions (such as extra effort or investment) depend mainly on marginal incentives (extra income, after taxes). For this reason, it is the marginal rate that has the greatest negative effect on the economy.

Mercatus Center Senior Research Fellow Veronique de Rugy has done excellent work in charting corporate income tax rates. According to her findings, the U.S. has the highest national statutory corporate tax rate in the OECD. In 2011, national statutory corporate tax rates among the thirty-four members of the OECD will range from 8.5 percent in Switzerland to 35 percent in the U.S. When sub-national taxes are added, the U.S. has the second-highest statutory combined corporate tax rate – 39.2 percent – after Japan’s rate of 39.5 percent. Marginal tax rates became the central theme of a revolution in economic policy that swept the globe during the last two decades of the twentieth century, with more than fifty nations significantly reducing their highest marginal tax rates.

<sup>2</sup> According to the 2008 SOI, there were 1.8 million C Corporations for that year, 4.05M S Corporations, 3.14M Partnerships (LLCs, LLPs, LP’s, et. cet.) and 22M sole-proprietorships.



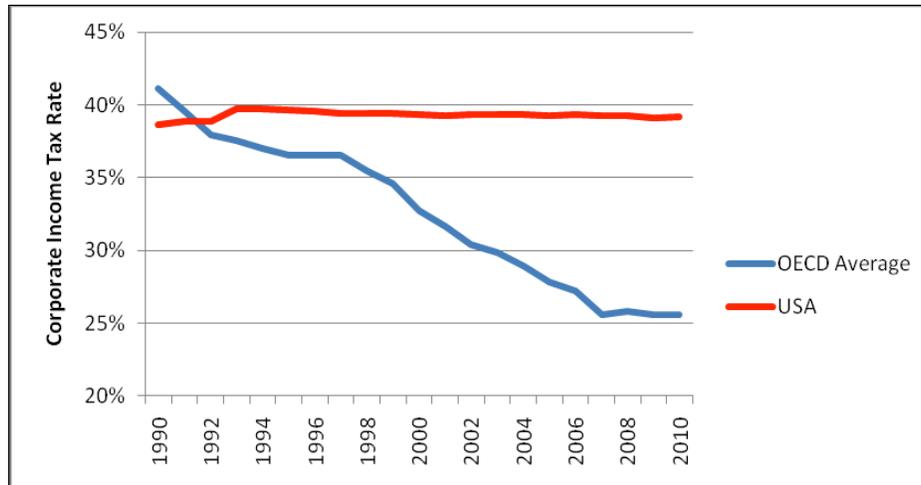
According to World Bank rankings, the U.S.' relative ranking on the "total tax cost" imposed on businesses has gone from bad to worse, falling from 118th in 2010 to 124th in 2011. The total tax cost expressed as a percent of before-tax profits is 46.8%.<sup>3</sup> The U.S. effective corporate tax rate on new investment was 34.6 percent in 2010, which was the highest rate in the OECD and the fifth-highest rate among 83 countries. The average OECD rate was 18.6 percent, and the average rate for 83 countries was 17.7 percent.<sup>4</sup>

How did we arrive at this point? We arrived here because it appears that Congress would rather trade influence in doling out special interests tax breaks that reduce the tax base and raise marginal rates than hear the chorus of economists. In 1990, the Organization for Economic Co-operation and Development (OECD) average statutory combined corporate tax rate was 41.1 percent, higher than the U.S.' rate of 38.7 percent. But while other nations have been racing over the past few decades to slash corporate tax rates to welcome multinational corporations, the U.S. has stagnated.

Lowering marginal tax rates is part of a revolution in economic policy that swept the globe during the last two decades of the twentieth century. More than fifty nations significantly reduced their highest marginal tax rates on individual income. The U.S. sat on the sidelines.

<sup>3</sup> The World Bank, Paying Taxes in 2011: The Global Picture, Table 4.

<sup>4</sup> Chen, D. and Mintz, J. "New Estimates of Effective Corporate Tax Rates on Business Investment." Tax and Budget Bulletin, No. 64, February 2011.



**The U.S. International System is Anachronistic.**

The U.S. international tax system is today an embarrassing anachronism. When it was shiny and new in 1918 – the year President Woodrow Wilson donned his top hat to become the first president to leave North America -- we led the way in enacting a system where income taxes duly paid to a foreign country could be credited against U.S. income taxes. Ten years after that, in 1928, the League of Nations introduced draft model income tax treaties, based on this formulation.

Time has passed us by. As our tax code remains anchored in the past, developed at a time when the U.S. was more insular in trade and a dominant capital exporter, before the age of consumption taxes, the world economy and our role within it has transformed. Throughout the 1920s, the U.S. was running budget surpluses. Today, of course, the U.S. is a net debtor nation running huge budget deficits, and trade deficits with nearly every major partner in nearly every traded good. In the 1920s, we were a net creditor nation. While in 1961, the U.S. exported just under \$21 billion (\$159 billion real terms today) and imported approximately \$14.5 billion in merchandise (\$110 billion today), we exported \$1.4 trillion of goods and services and imported \$1.8 trillion from January to August of this year alone.<sup>5</sup> During the 1920s, federal revenues averaged about 4 percent of GDP. In recent history, from 1971 to 2010, revenues have averaged 18 percent of GDP. Technological improvements in communications and transportation, and the opening of formerly closed markets have created permanent interdependencies among nations that will exponentially increase this volume of trade and with it the need to get our international tax regime right with the times.

Our failure to evolve with the international economy has been succeeded only by our failure to keep pace with evolutions in its tax laws. Today, the U.S. is:

- in the minority in trying to tax its multinational corporations on their foreign earnings.
- virtually alone in imposing some of the highest tax rates in the world
- and virtually alone in failing to adopt a border-adjustable destination based consumption tax.

<sup>5</sup> [http://www.census.gov/foreign-trade/Press-Release/current\\_press\\_release/ft900.pdf](http://www.census.gov/foreign-trade/Press-Release/current_press_release/ft900.pdf)

***High Rates Diminish Foreign Investment and Discourage Repatriation.***— How do these anachronisms perversely influence corporate decision-making and impede competitiveness? At the core of our international tax system, as most tax policy gurus know, is the principal of extraterritoriality. What this principal means in the context of outbound transactions is that the U.S. system will tax its individual residents and citizens, and corporations on their worldwide income under the rates specified in IRC section 1 and 11 (the individual and corporate rates), regardless of where that income is derived. U.S. taxpayers engaged in activities abroad generally compute taxable income in the same manner as U.S. taxpayer producing solely with the U.S. Because the norm of international juridical taxation, with the U.S. generally follows, cedes the primary taxing authority to the country or territorial connection (i.e., where the income is earned) and the residual taxing authority to the county of residence, the U.S. seeks to avoid double taxation by crediting any income taxes paid to the foreign country, against the income tax otherwise due in the U.S.<sup>6</sup> One of the largest exceptions to deferral is, of course, Subpart F, which was introduced in the Kennedy Administration in exchange for lowering rates, and is intended to discourage U.S. corporations from redirecting income outside the U.S. in order to avoid immediate U.S. taxation.

While the extraterritorial credit system is at least in theory straightforward -- by crediting the foreign taxes paid on the foreign income up to the rate of tax imposed on that income we seek to avoid taxing the same income twice -- it is ridiculously complex in application. That is because before one can determine what credit can apply, the U.S. resident, citizen or corporation must first determine where the income and deductions are sourced under an elaborate set of rules, modified further by treaty and the intercompany transfer pricing rules. One must determine whether and to what extent the foreign taxes are even creditable. One must then compute the direct and indirect credit (on dividends) by distributing the income within more than nine separate “baskets” for which the foreign tax credit is individually limited – enough baskets to turn any sane individual into a “basket” case. And neither least nor last, before determining the credit to which one is entitled, one must determine if deferral from a subsidiary must yield to any one of the separate rules under Subpart F pertaining to Controlled Foreign Corporations.

Because the U.S. is virtually alone in trying to tax its multinational corporations on their foreign earnings, it incentivizes companies to avoid those taxes indefinitely by keeping profits overseas. That in turn encourages companies to use accounting maneuvers to shift profits to low-tax countries and to invest profits offshore. However badly U.S. multinational corporations who earn money overseas want to bring that money back home to the U.S., our international tax system discourages, and some would say “penalizes” repatriation of foreign earnings by imposing a 35 percent residual U.S. tax at the time of repatriation. As a result, several high-profile U.S. multinational corporations are sitting on large piles of cash earned from foreign operations. Yet these same corporations are actually borrowing money rather than repatriating their offshore cash.

How much money is trapped offshore? U.S. multinational companies MNCs currently hold an estimated \$1.4 trillion in foreign earnings overseas. About \$581 billion in after-tax dividends will be

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<sup>6</sup> A U.S. parent of a foreign subsidiary is generally not taxed on the earnings of the subsidiary until distributed at which time the credit is imputed. (IRC section 951-960.)

distributed to U.S. shareholders, according to one recent study.<sup>7</sup> And that same study stated that spending could increase gross domestic product by \$178 billion to \$336 billion and will add 1.3 million to 2.5 million jobs if we were to offer a temporary reprieve from the repatriation tax, as well as boost U.S. tax revenues. About half of OECD nations do not have this problem because they have "territorial" tax systems.

Our extraterritorial income tax system affects U.S. entities and corporations in more ways than by frustrating their effort to repatriate earnings like their competitors based in lower taxed jurisdictions can do. That is, in a manner of speaking, just a symptom. The greater infirmity is that rate of the tax we impose makes the U.S. one of the least favorable locations to base international operations.

Again an understanding of the U.S. international tax system is critical. Broadly stated, nonresident alien individuals, unincorporated entities even corporations are taxed like U.S. taxpayers on most U.S. Business income. An individual is taxed when it is engaged in a trade or business on income effectively connected to that trade or business (IRC section 871(b)). A foreign corporation is likely taxed under IRS section 11 on its taxable income effectively connected with the conduct of a U.S. trade or business (IRC section 882). But nonresident individuals are also subject to U.S. taxation on some types of recurring investment income. And a corporation who is conducting a trade or business may be also subject to the Branch Profits Tax.<sup>8</sup>

Paradoxically, despite having the highest national statutory rate, the U.S. raises less revenue from its corporate tax than do the other members of the OECD on average. In fact, federal corporate income taxes raise little revenue compared with other federal taxes; roughly comprising 11.6% of total federal tax revenues. At \$191 billion, they were equal to 1.3 percent of the nation's gross domestic product.

The combination of high rates, worldwide taxation and a competitive global marketplace makes our corporate tax system extremely punishing. But it is the marginal tax rate -- the rate on the last dollar of income earned (which is very different from the average tax rate, which is the total tax paid as a percentage of total income earned) -- that matters the most. The rate at which we tax decisions at the margin matters in at least two regards: (1) it discourages foreign corporations from locating their corporate offices or subsidiaries in the U.S. and in locating plants, facilities here for production purposes (i.e., it influences the location where capital is deployed), and (2) it encourages outsourcing of plants, facilities and production facilities of domestic multinationals to jurisdictions where the taxes imposed are less.<sup>9</sup>

**Border Adjustable Taxes Act as Unanswered Trade Subsidies.--** Add to this the fact most of our trading partners effectively rebate their taxes at the border and provide for themselves a powerful export trade subsidy and benefit for consumption of domestic goods that is unanswered by the U.S. It is a widely understood proposition that the U.S. should not target a particular trade deficit level, subsidize its

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<sup>7</sup> "The Benefits for the U.S. Economy of a Temporary Tax Reduction on the Repatriation of Foreign Subsidiary Earnings," by Laura D'Andrea Tyson, Ph.D.; Kenneth Serwin, Ph.D.; Eric Drabkin, Ph.D. (October 13, 2011).

<sup>8</sup> The branch profits tax is an extra income tax imposed by the U.S. on foreign corporations that earn profit from their U.S. investments or U.S. business operations.

<sup>9</sup> Salvador Barrios (European Commission), Harry Huizinga\* (Tilburg University and CEPR) Luc Laeven (International Monetary Fund and CEPR) and Gaëtan Nicodème (European Commission, CEB, CESifo and ECARES), International Taxation and Multinational Firm Location Decisions (April 2009). See also Claudio A. Agostini, "The Impact of State Corporate Taxes on FDI Location," *Public Finance Review* 2007; 35; 335.

exporters or impose tariffs on imports. The reason, established clearly in economic theory, is that doing so interferes with mutually beneficial transnational economic exchanges, to the disadvantage, in the aggregate, of both countries’ economies. However, the U.S. government should not, as a matter of policy, accord a huge advantage to foreign companies competing in the U.S. market or impose a huge disadvantage on American producers and workers selling their goods and services in the U.S. and foreign markets. That has been the effect, however, of border adjustable VATs.

Consider this. The U.S. tax system imposes heavy income and payroll taxes on U.S. workers and businesses producing goods in the U.S. whether those goods are sold in the U.S. market or abroad. Recall U.S. corporate taxes are the about nine percentage points higher than the OECD average.<sup>10</sup> The U.S., however, imposes no corresponding tax burden on foreign goods sold in the U.S. market. Moreover, foreign VATs -- a major component of the revenue raised in most developed countries -- are rebated if 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.

The table below illustrates this point. American producers pay two sets of taxes when selling into foreign markets. Conversely, in U.S. markets, foreign goods bear no U.S. tax and the foreign value added tax is forgiven. Thus, a most manifest unfairness in the U.S. tax system is that it places U.S. producers – including businesses and workers in manufacturing, agriculture, mining, and forestry – at a large competitive disadvantage relative to their foreign competitors here and abroad. Our failure to counteract these border-adjusted taxes explicitly encourages consumption of foreign, goods. And it converts many of our nation’s retailers into tax free trade zones for foreign produced goods.

**Advantage for Foreign Producers**

	Sold in U.S. market	Sold in foreign markets
U.S. production	Pays U.S. income and payroll taxes.	Pays U.S. income and payroll tax & foreign VATs.
Foreign production	Pays no U.S. income or payroll tax and no foreign VAT.	Pays foreign value-added tax.

The U.S. has adopted this self-destructive policy, in part, because of our entirely laudable commitment to free enterprise and our rejection of mercantilism. At least since WWII, American business and political leaders have viewed free trade as the basis for international peace and prosperity. As the dominant economic and military power, the U.S. led the movement to dismantle trade barriers, both by setting the example and by supporting a New World Order of international trade regulation (GATT and WTO), economic cooperation (OECD), and customs unions (such as the European Union and NAFTA). According to the OECD, its members have reduced their average tariff rates from 40 percent at the end of World War II to 4 percent today. The average import duty on goods in the U.S. is currently 1.7 percent.

Today, the 29 of 30 OECD countries have enacted border-adjustable tax regimes. America stands nearly alone as the sole developed economy, which refuses to adopt a border-adjustable tax system. The

<sup>10</sup> Edwards, Chris, “The U.S. Corporate Tax and the Global Economy,” Cato Institute, September 2003.

European Union 15 has an average standard VAT of 19 percent, and the average OECD standard VAT is 18.5 percent. During the 1990s, Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent, respectively, and China adopted a 17-percent VAT in 1994. As foreign governments have increased the VAT, they have also reduced effective corporate income taxes. Meanwhile, high U.S. corporate tax rates today coupled with our custom of taxing the foreign income of corporations based in the states causes the flight of corporations' headquarters to countries that exempt taxation of overseas income. In effect, the U.S. tax system is distorting the international marketplace and literally driving plants and good jobs out of this country at a devastating and unsustainable pace. There are, after all, only so many assets we can sell to foreigners before the entire financial system enters into a severe crisis.

Some economists mistakenly argue that if America adopted a border-adjusted tax system, *any* relative price change would be eliminated by an offsetting appreciation in the dollar. If the FairTax were implemented, for example, they hypothesize that the price change would be offset by a 23 percent immediate appreciation in the dollar. The appreciation in this case, they contend, would be caused by a reduction in U.S. demand for foreign currency to acquire (the now more expensive) foreign goods and an increase in foreign demand for U.S. currency to acquire (the now less expensive) U.S. goods. However, the arguments are dubious. The problem with that logic is that the demand for U.S. dollars is not limited to the traded-goods market. Nearly \$90 trillion in U.S. assets owned by households and non-financial businesses are denominated in dollars. Financial institutions trade trillions of dollars in securities and currency each day based on expectations and guesses. Furthermore, the non-traded goods and services sector is also denominated in dollars and exceeds the traded-goods sector in size.<sup>11</sup> A study by Professor Jim Hausman of the Massachusetts Institute of Technology is helpful to understanding this problem.<sup>12</sup>

Border-adjustable taxes are, quite simply, the most powerful weapons foreign producers have against U.S. producers and workers. Our failure to adopt a destination-based consumption tax sends a clear message to American producers: Please, move your plants and facilities overseas, hire foreign workers, and then market your products back to the American consumers who are punished for saving and

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<sup>11</sup> If, however, these economists are right and there is no increase in the competitiveness of U.S. goods because of a 23-percent increase in the price of the dollar (more or less precisely) relative to foreign currency, then that means the FairTax will have succeeded in increasing the wealth of the American people by something on the order of \$20 trillion (23 percent of \$90 trillion) relative to the rest of the world, an instantaneous increase nearly equal to the value of all the goods and services produced in the U.S. over two years. That would be reason enough to enact the FairTax. Unfortunately for American asset owners, it is impossible for the traded-goods sector to dominate the currency movements, since the dollar-asset markets are perhaps 100 times as large as the annual traded-goods market (net basis). See B. 100 and B. 102, Flow of Funds Accounts, U.S. of America, Fourth Quarter 2004, Federal Reserve System, for statistical information on asset markets.

<sup>12</sup>Professor Hausman found:

1. That the existing disparity in treatment of corporate income taxes and VATs for purposes of border adjustment leads to extremely large economic distortions.
2. That U.S. exporters typically bear both domestic income taxes and foreign VATs in selling abroad.
3. That foreign exporters in countries relying largely on VATs typically receive a full rebate of such taxes upon export to the U.S., and are not subject to U.S. corporate income taxes.
4. That this situation creates a very significant tax and cost disadvantage for U.S. producers in international trade with significant impact on investment decisions – leading to the location of major manufacturing and other production facilities in countries that benefit from current rules on the border adjustment of taxes.
5. That elimination of the current disparity in WTO rules (by eliminating border adjustment for either direct or indirect taxes) would increase U.S. exports by 14 to 15 percent, or approximately \$100 billion based upon 2004 import levels.

rewarded for overspending. It sends a clear signal to retailers: stock foreign inventory. It sends a clear signal to consumers: buy foreign products. The problem is that American industry and consumers are taking the Congress' tax policy advice. Market forces do work. And the burgeoning trade deficit is one of the consequences of our failure to confront this reality. The decimation of our domestic producer base results in job losses for America's middle class, lost opportunities for the young, suffering for the poor and a widening wealth gap.

### **The Solution: Three Ways the FairTax Helps Businesses**

As we lament the maladies of the current system, Congress has clear options. The best example of a tax regime that would permanently save compliance costs is the FairTax. The FairTax has been introduced in the House by Representative Rob Woodall as H.R. 25 and in the Senate as S. 122 by Senator Saxby Chambliss. The House bill now has 66 cosponsors, more than any other tax replacement plan in a century. The Senate bill has 8 cosponsors. Some are on this Committee.

The FairTax is an integrated tax replacement system that repeals all current taxes imposed by the Internal Revenue Code on income and wages, including personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes. In place of these taxes, the FairTax imposes a single-rate tax on the final retail sale of new goods and services used or consumed in the U.S. at the revenue-neutral rate of about 23 cents from every dollar spent.<sup>13</sup> The FairTax plan also amends the U.S. Constitution so that the income tax chapter of American taxation is closed forever.

To ensure the FairTax does not cascade, business-to-business transactions are not taxed under the FairTax. Intermediate goods and services are properly treated as inputs into goods and services sold at retail. Unlike the current system that taxes income multiple times and on an inconsistent basis, the FairTax taxes income only once, upon consumption.

### **The FairTax Would Give the U.S. the Most Internally Sound and Competitive Tax System**

***Effect on Direct Investment, Locational Decisions, and Repatriation.***— Consider what would happen to the current international tax problems posed above if the FairTax were adopted beginning with the consequences of the U.S. being the world's largest national market with a zero marginal rate of tax on productive activity, investment and capital returns. Such a change would have profound relevance for both foreign direct investment and domestic locational choices.

The U.S. would become the most attractive jurisdiction in the world from which to export, attracting both foreign direct investment and domestic investment to base operations here. This, of course, satisfies the fundamental policy goal of those who are considering a territorial taxing regime for the U.S., as many countries have adopted: that goal is to ensure that a choice between headquartering a company in the U.S. or overseas would not be influenced through the application of high U.S. marginal tax rates to global income with no connection to the U.S. save the fact that the location of the headquarters of the company. The FairTax provides the equivalent of a territorial taxing regime because it does not tax foreign sourced income at all, and therefore cedes taxing jurisdiction to the country of income source.

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<sup>13</sup> This is a *tax-inclusive* rate, the same means by which the income, payroll and capital gains taxes it replaces are measured.

But it improves upon this choice dramatically. The FairTax would not also encourage investment overseas as the territorial tax movement, by its own rationale, admits would occur. In fact, a zero rate of U.S. tax would give foreign jurisdictions two choices: Reduce their tax rate on savings and investment (which will stimulate global economic reform and growth) or lose investment to America. Companies now American in name only would repatriate investment and jobs back to our shores.

Adoption of the FairTax would also end the problem posed by deferral – which imposes a penalty for repatriating income earned overseas. Companies here now in name only would repatriate investment and jobs back to our shores without penalty, since the earnings of subsidiaries would not be taxed to the parent at all and the taxes paid to foreign nations would not be limited by the complex foreign tax credit rules. And since the U.S. would not tax foreign returns to capital (as it would not tax U.S. returns) the U.S. market for investment in stocks, in business, in real estate and otherwise would effectively become the world's largest tax haven for investment capital.

***Answering the Problem Posed by Border-Adjustable Tax Subsidies.***-- There are two ways tax-writers could confront the reality of global border-adjustable taxes: (1) encourage our trade representatives and trading partners to allow income taxes to be border-adjusted, or (2) adopt our own destination-based consumption tax. The first will never happen.

To get some sense of the Herculean task involved with the former tack, consider convincing the WTO's Member countries to eliminate the admittedly artificial distinction now drawn by the WTO between direct taxes (income taxes) and indirect taxes (consumption taxes) on which their trade subsidies depend. These are the same nations willing to sue in international courts to get the U.S. to abandon its relatively minor export incentive worth about \$4 billion annually (the Foreign Sales Corporations) so as to preserve for themselves this unilateral advantage.

Even if such diplomacy were to miraculously prevail, eliminating the indirect/direct distinction would only countervail a sliver of the trade subsidy, and then only for exporters. If the direct/indirect distinction were fully eliminated, an export subsidy would only allow exporters to defer or exempt a portion of their *income tax*, when payroll taxes constitute about 36 percent of the gross collections by type of tax. And lest we forget, since America has record trade deficits, this does nothing to level the playing field on imports which continue to compete against domestic producers unfairly on our own soil.

The best alternative is to enact what the rest of the world has enacted – a destination-principle tax system (also known as a border-adjusted tax system) – that incorporates our entire tax burden. We need to move to a tax system that taxes all goods consumed in the U.S. alike, whether the goods are produced in the U.S. or abroad. We need to eliminate those aspects of the U.S. tax system that artificially place U.S. production at a competitive disadvantage compared to foreign production.

How would the FairTax accomplish this full-scale border adjustability? As an indirect tax, fully WTO-compliant, the FairTax would:

- repeal *all* upstream federal taxes now embedded in the product price of U.S. goods and eliminates any business-to-business taxes, including payroll taxes,
- completely exempt foreign consumption from taxation. Only goods and services for final retail sale in the U.S. are taxed, and



- impose the FairTax on foreign goods entering our shores for final consumption.

Recall the table above which showed the unfair application of foreign and U.S. taxes on exports and imports restively. In essence, under current law, foreign and U.S. taxes are doubly imposed on goods produced in the U.S., while imports that compete against U.S. produced goods are exempted from taxation. Now consider how under the FairTax, the table would look entirely neutral as to whether foreign or U.S. goods were consumed here or abroad.

**The U.S. Tax System Under the FairTax**

	<b>Sold in U.S. market</b>	<b>Sold in foreign markets</b>
U.S. production	Pays the FairTax.	Pays foreign value-added tax
Foreign production	Is exempted from the source country VAT, but pays <i>the FairTax</i>	Pays foreign value-added tax

**Conclusion**

Only the FairTax plan can claim that under its regime, foreign manufactured goods and U.S. manufactured goods will pay the same tax when the goods are sold at retail.

Only the FairTax can make the claim that U.S. businesses selling goods or services in foreign markets will be fully relieved of federal tax (including payroll taxes).

**What is the FairTax Plan?**

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16<sup>th</sup> Amendment. This nonpartisan legislation (HR25/S13) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

**What is Americans for Fair Taxation® (FairTax.org)?**

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: [www.FairTax.org](http://www.FairTax.org) or call 1-800-FAIRTAX.