

TAX REFORM AND CONSUMPTION-BASED TAX SYSTEMS

HEARING BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

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TAX REFORM AND CONSUMPTION-BASED TAX SYSTEMS

TUESDAY, JULY 26, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in Room 1100, Longworth House Office Building, the Honorable Dave Camp [chairman of the committee] presiding.
[The advisory of the hearing follows:]

HEARING ADVISORY

Camp Announces Hearing on Tax Reform and Consumption-Based Tax Systems

Tuesday, July 26, 2011

Congressman Dave Camp (R-MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on alternative tax systems, with a focus on tax systems that are based on taxing consumption rather than income. Specifically, the Committee will consider the FairTax—a proposal to replace existing federal taxes with a national retail sales tax—and the Value-Added Tax (VAT), a type of consumption tax used by many other countries as a supplement to other taxes, such as taxes on individual and corporate income. **The hearing will take place on Tuesday, July 26, 2011, in Room 1100 of the Longworth House Office Building, beginning at 10:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND

For several consecutive Congresses, legislation to repeal existing federal taxes on income, payroll, estates and gifts and replace them with a single national retail sales tax has been introduced as the Fair Tax Act. The bill would grant states the primary authority for the collection of sales tax revenues and the remittance of such revenues to the Treasury. It also would abolish the Internal Revenue Service after fiscal year 2015, replacing it with a Sales Tax Bureau to administer the FairTax and an Excise Tax Bureau to administer remaining excise taxes formerly under the jurisdiction of the IRS. In the 112th Congress, the Fair Tax Act has been introduced as H.R. 25.

Many countries have adopted a different kind of consumption tax—the Value-Added Tax—in addition to their income and other taxes. Under a VAT, a business pays tax on the value it adds during its stage in the production, distribution, and sales processes. Generally, “value added” is measured as the difference between the price for which a business sells a good or service and the cost of the inputs the business incurred to produce it. Economically, however, a VAT is considered equivalent to a retail sales tax, in that the VAT paid at each stage of the process is passed on to the ultimate consumer in the form of a higher retail price.

In announcing this hearing, Chairman Camp said, **“While the Committee thus far has focused on reforming the income tax, tax proposals that would move us away from an income base and instead adopt consumption as the tax base have continued to generate interest as well. Supporters of such approaches believe that taxing consumption rather than income could have important economic benefits, and so as part of our efforts to reform the Tax Code, the Committee needs to examine those proposals. This hearing will allow the Committee to learn more about two of the most-discussed consumption tax proposals, the FairTax and the VAT.”**

FOCUS OF THE HEARING:

The hearing will consider separately two different consumption tax models. One panel will examine the advantages and disadvantages of a VAT, whether as a supplement to or full replacement for existing taxes. Another panel will discuss the policy arguments for and against adopting the FairTax as a replacement for existing federal taxes. The hearing will explore the economic impact of consumption tax systems, as well as issues surrounding administration and compliance.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Tuesday, August 9, 2011.** Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and **MUST NOT** exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://www.waysandmeans.house.gov/>.

Chairman CAMP. Good morning. And thank you all for joining us today.

Today is the ninth hearing that we have held on comprehensive tax reform, not counting the roundtable discussion held by the Joint Committee on Taxation, where we were joined by key architects of the Tax Reform Act of 1986. During our very first hearing of the year, which was also our first hearing on tax reform, we discussed the need to transform our Tax Code so that it would encourage, rather than inhibit job creation.

Six months later, as we continue to struggle in an economy where unemployment remains high, and growth is virtually stagnant, the need to overhaul Americans' broken Tax Code has never been greater. Clearly, the Tax Code is too complex, too costly, and takes too much time to comply with. All this adds more burdens

on families and employers, making it more difficult to create the jobs that 14 million men and women in this country need.

Since the beginning of our discussions on comprehensive tax reform, I have cited three things I am certain of, as we take on this endeavor. First, I have no illusions that this will be an easy task. But then, most things that are worth doing never are. Second, I don't think this should be a partisan exercise. And third, and most importantly, we will talk to the American people: individuals, families, employers, both large and small, who are actually affected by the laws we pass here in Washington. They are the real experts, and that is why their voices are critical, as we explore and develop tax reform policy.

That brings us to why we are here today. Although our current tax system does include some elements that are consumption-based, such as excise taxes, for the most part our Tax Code is thought of as being based on the taxation of income. To this point, our hearings this year, including the joint hearing we held with the Senate Finance Committee two weeks ago, explore tax reform with an eye toward maintaining an income-focused tax base. We have explored how the current tax system works and, in many cases, doesn't work for employers and families.

Today we are shifting gears just a bit to explore a different basis for taxation: consumption. We will examine two different consumption tax models that have emerged as potential alternatives to our current income tax system: the fair tax, and the value-added tax. Our first panel will discuss the policy arguments for and against adopting the fair tax as a replacement for existing federal taxes. Our second panel will examine the advantages and disadvantages of a value-added tax, or VAT, whether as a supplement to or a full replacement for existing taxes.

We have some terrific witnesses on our panels, and I would like to thank them for being here today. We are anxious to hear from them, and look forward to engaging in discussion. And with that, I will yield to Ranking Member Levin for the purposes of his opening statement.

Mr. LEVIN. Thank you very much. First, I would like to join in welcoming this panel. You are very active and distinguished people. If I might, I would like to say a special hello to Mr. Huckabee, the Honorable Huckabee. It says H-o-n in front of your name, and we are glad to see you.

This hearing may take on a number of sparks, in view of the crisis that we face today, but I don't want anyone to feel that we anything but welcome all of you here today.

Yesterday the Speaker put forward what he calls a two-step approach, and I quote, "to hold President Obama accountable." Under that proposal, the Speaker states that there will be, and I quote, "no tax hikes." But what would the proposals before us today mean for millions of working American families? A tax hike.

At the same time, the Speaker's proposal establishes a commission that cannot recommend reducing the deficit by ending tax breaks for people making over \$1 million a year, or ending tax loopholes that encourage companies to shift jobs overseas, or shutting down tax havens. This prohibition on a commission even considering revenues, along with the spending caps in the Speaker's

proposal would mean major cuts in vital programs like Social Security, Medicare, and Medicaid.

So, today, while our nation is facing a severe crisis, the majority is holding this hearing on proposals that do not address this immediate crisis, and would raise taxes for millions of middle and low-income families. And at the same time, they are insisting on a deficit package that protects tax breaks for very wealthy households.

What we must focus on right now, and I emphasize this, is avoiding a default that would risk another financial crisis and millions of jobs. It could delay the Social Security checks that millions of seniors depend on. It could permanently call into question the full faith and credit of the U.S., and make it even more difficult to reduce the deficit.

Our President has called again and again for a balanced approach to getting a handle on our nation's debt. This committee has jurisdiction over many of the elements of such an approach. It is the committee in the House with jurisdiction over legislation on the debt ceiling. We on this committee have a solemn obligation, a solemn obligation, to step up to the plate and address the matter at hand; avoiding a default, and finding a balanced approach to deficit reduction.

Thank you, Mr. Chairman.

Chairman CAMP. Well, thank you, Mr. Levin. Today we will hear from two distinguished panels of witnesses. Our witnesses bring a wealth of knowledge with combined experience in government, academia, and the private sector.

Our first panel includes four experts on the fair tax embodied in this Congress in H.R. 25, as introduced by Representative Rob Woodall. Our second panel will include six experts on value-added taxes. We begin with our fair tax experts.

First, I would like to welcome the Honorable Mike Huckabee. From 1996 until 2007, Governor Huckabee served as the 44th governor of Arkansas. He ran for the Republican nomination for President in 2008, and currently is the host of the television show, "Huckabee," and the radio program, "The Huckabee Report." Governor, we extend a warm welcome to you, and look forward to your testimony.

Next we will hear from Laurence Kotlikoff. Mr. Kotlikoff is a professor of economics at Boston University. He has authored or co-authored 14 different books, and from 1981 to 1982, served as a senior economist on the President's Council of Economic Advisors.

Mr. Kotlikoff is accompanied this morning by Mr. David Tuerck. Mr. Tuerck is a professor, and chairman of the department of economics at Suffolk University in Boston, Massachusetts. He is also the chairman of the Beacon Hill Institute, a research center that develops and performs economic and statistical analysis of current and emerging public policy issues.

And finally, we welcome Mr. Bruce Bartlett. Mr. Bartlett has served as the staff director of the Joint Economic Committee, as a senior policy advisor for President Reagan, and as the deputy assistant secretary for economic policy at the U.S. Treasury Department. Mr. Bartlett is currently a columnist for Tax Notes, and The Fiscal Times, and also contributes to the New York Times economics blog.

Thank you all, again, for being with us today. The committee has received each of your written statements, and they will be made part of the formal hearing record. Each of you will be recognized for 5 minutes for your oral remarks.

And, Governor Huckabee, we will begin with you. Welcome, again, and you are recognized for 5 minutes.

**STATEMENT OF MIKE HUCKABEE, FORMER GOVERNOR OF
ARKANSAS, HOPE, ARKANSAS**

Mr. HUCKABEE. Chairman Camp and Ranking Member Levin, Members of the Committee, it is an honor and privilege to be able to be with you today to talk about the fair tax.

Let me just begin with a personal observation. Having raised three children, all of whom are now adults—and when they moved out my wife and I ended up with three dogs—my kids think we replaced them with the dogs, they also think we treat the dogs better than we ever treated them. I tell them it's because the dogs behave better than the kids ever did.

But I learned something about behavior, both from raising children and training dogs. And the basic premise is this. If you want a certain behavior, you reward it, and you will get more of it. And if you want to stop a certain behavior, you consequence it and you get less of it. It's a principle of life that we all understand. The fair tax is based on the simple idea that we ought to reward good economic behavior, and we should not reward irresponsible and reckless economic behavior.

The sort of behaviors that will create a stronger economy, grow jobs, make it possible for people to be independent, is that we reward them for their work, we reward them for their investments, their risk-taking. We reward them for saving something, because that puts something aside for those unexpected moments in life, so that they won't be dependent upon somebody else's charity, they will be dependent upon their own thoughtfulness in preparing for the unforeseen circumstances that, frankly, all of us have experienced.

The fair tax doesn't punish people for their productivity, and it does not reward them for their irresponsibility, and that is the essence of it.

I must be honest with you. I didn't know what the fair tax was when I was campaigning four years ago. People would come up to me and say, "Do you believe in the fair tax?" I said, "Well, of course I believe that taxes ought to be fair." They said, "No, the fair tax." And I had no idea what they were talking about.

Somebody finally handed me a book and the bill, the fair tax bill. I read it. Made too much sense. So I read it again. And then I met with a group of economists to ask them, and to spend several hours peppering them with questions about how it would functionally work. And I came away as a strong proponent. And I wish I could take credit for some of the creation, but I am not the chemist that designed it, I'm just the pharmacist that is trying to dispense it.

And so, today I come with a sense of recognizing that the fair tax is, in fact, a transformational approach to the government getting revenue. It is revenue-neutral, as it is designed. It is not intended to raise taxes or lower taxes. It is, I believe, an approach that could

be equally embraced by Democrats and Republicans, because it accomplishes something both want to do. It helps people at the bottom end of the economic spectrum, because of a unique feature that is often overlooked or misunderstood, called the prebate. And it is fundamental to its effectiveness. But it also makes it possible to bring manufacturing jobs and other types of economic models back to the United States from its offshore infusion, because of the fact that people are not going to be punished for actually producing.

There are so many things that I would like to present, and I hope you will have an opportunity to look at some of the written testimony. But the fair tax, in many ways, I want to contend, works because of its fundamental idea that it is flat, it's based on the consumption of things purchased at the retail level. It is fair, because it does not adjust itself to any particular demographic group. It is finite, because it's a fixed rate with total transparency, which is one of the things that I find most appealing about it. There is an absolute transparency about what people would pay. And it's family friendly, and it doesn't penalize marriage or raising children, as sometimes the Tax Code does.

I think it's clear to say that there are very few people, if anyone, in the entire country who understands the 67,000 pages of the Tax Code. It is extraordinarily convoluted. It is so convoluted that, for the most part, the reason that there are 35,000 lobbyists in this city are to influence the Tax Code, so that there can be winners and losers. What I would like to suggest is that the fair tax means that every American, in essence, becomes his or her own lobbyist, because there is no need to always be manipulating the Tax Code to create special favors for one against another.

All of us who watch sporting events know this one thing, that the guys in the striped shirts are not there to determine the outcome of the game, they are just there to make sure that the game is played fairly. When the guys in the striped shirts start determining the outcome of the game, we no longer respect them. The purpose, I believe, of the tax system is not to determine the outcome of the game, but to make sure that there is a fair and absolutely objective playing field. And that is what the fair tax does.

And I come today with over 75,000 online signatures of people who, just in the past 3 or 4 days, have urged me to appeal to you to give consideration to it, notwithstanding any political or partisan consideration.

And I thank you very much for the opportunity to be here.

[The prepared statement of Mr. Huckabee follows:]

**Testimony of
Governor Mike Huckabee
Before the
House Committee on Ways and Means
Hearing on Tax Reform and Consumption-Based Tax Systems**

Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for the opportunity to testify before you today about the FairTax.

The fundamental flaw in the current tax system is that it penalizes work and productivity.

Common sense tells us that we get more of what we reward and we get less of what we penalize. If work and productivity are the foundation of a strong economy, then to penalize them is counterintuitive and damaging to a sound economic system. And yet our current tax structure as regulated by the IRS does exactly that.

Under the FairTax, no one would be taxed -- that is, penalized -- for their work, investments, savings, or earnings. After all, we want people to work, save, invest, and create capital, so we should cease to penalize it at all.

Income tax rates would be zero. Corporate tax would be zero. Payroll taxes would disappear. Savings and investments would no longer be subject to complicated tax codes. The tax rate on capital gains would be zero. There would be no paycheck deductions.

We could and should then eliminate the IRS.

The FairTax would shift taxes from what we earn to what we buy -- to a consumption tax. We would pay taxes when we bought something at the retail level that was new and therefore had not already been subject to the tax. You only pay taxes when you purchase something new, whether it's a product or it's a service.

The point is it's a completely transparent tax system. It doesn't increase taxes. It's revenue neutral. But here's what it will do. It will lower the tax burden and bring business back to the United States that's leaving our shores because our tax laws make it impossible for an American-based business to compete.

Under the FairTax we get rid of corporate taxes completely and totally -- because we all know those taxes are not really paid by the corporations. They're passed on to the customer. By eliminating the corporate tax and employer payroll taxes, the prices of what you purchase will go down.

As I mentioned earlier, the FairTax is revenue neutral, and if you eliminate the existing federal income tax system you would need to replace it with a 23 percent consumption tax. That might sound high, but please don't let that 23 percent fool you -- remember, you only pay when you purchase something new.

By taxing consumption instead of production, we encourage earning, work, risk taking in the marketplace, investment, savings, selling for a profit, and entrepreneurial activity. No one will have to try to find a way of hiding his or her efforts because we will finally reward people for their output.

For that reason, the FairTax would also virtually eliminate the underground economy. Do you think that drug dealers, prostitutes, pimps, gamblers, or people in this country illegally are filling out the same IRS tax forms each year and reporting the money they illegally earned? Of course not.

And because they don't pay tax on what they earn, you pay the taxes for them and for those who cheat the system.

The FairTax was designed based on research by noted economists and some of the country's leading think tanks. These are people without a political agenda. They came in with an idea of taking a blank slate and coming up with the fairest, most equitable way to create a tax structure that Americans could not only live with, but that would spur real growth in the economy. And the result was the FairTax.

Economists estimate that the FairTax would have a positive impact on the economy, in the first year and even 25 years after implementation.

In the first year:

- Real Gross Domestic Product would increase by 7.9 percent
- Domestic Investment would increase by 74.5 percent
- Labor supply would increase by 11.9 percent
- Real wages would increase by 10.3 percent

The bottom line is that the FairTax is Flat, Fair, Finite, and Family Friendly.

Here's how:

- **Flat:** It is a flat tax on consumption of new things we purchase at the retail level.
- **Fair:** It is oblivious to any demographic group's special interests.
- **Finite:** It has a single fixed rate with total transparency and no hidden costs.
- **Family Friendly:** It doesn't penalize people for being married and having children.

We the American people spend half a trillion dollars on compliance with current tax laws. Also, those who are at the bottom of the economic scale don't have 35,000 lobbyists in Washington working for them to create tax loopholes – like other people and groups do.

So I'm convinced that there's a reason 80 percent of the American people think we need a major overhaul of the tax structure – most American's realize it's wrong-headed thinking to penalize someone's productivity.

The FairTax will affect everyone across the economic spectrum in a positive way. It's even fair to the people at the lowest end because it gives them a real shot to reach the next rung on the ladder, a much fairer tax system than the current one, which penalizes them for trying to do better.

People below the poverty line won't be taxed at all. In fact, the genius of the FairTax is its' prebate. Every month, we'll get a monthly rebate that will reimburse us for taxes on purchases up to the poverty line, so that we're not taxed on necessities. That's why it's really fair. In fact, I believe it's a progressive tax for people at the lower end of the economic spectrum.

If you don't consume a whole lot — if you, for example, want to save money — you're not penalized for saving money like our current system.

One of my favorite benefits of the FairTax is that when you get your paycheck, you get the whole thing. The average American doesn't understand exactly what's going on with his paycheck so the FairTax eliminates confusion.

Many of you know that I strongly believe the FairTax is the best way for taxpayers and businesses to participate in the federal tax process because it's the only solution that's truly fair, finite and family friendly.

I campaigned on this issue in 2008 and my passion on this issue has only grown since then.

We as taxpayers can continue down this complex troublesome tax road, or we can adopt the FairTax and finally put the "out-of-business" sign on the door of the IRS. With Americans and Congressional leaders calling for major tax reform, never has there been a better political climate for the FairTax than right now.

I'd love to say April 15th has become just another beautiful spring day. I'd also like to be the person who helps nail the "going-out-of-business" sign on the Internal Revenue Service doors — a \$12 billion a year industry.

It's not only smart; it's the right thing to do. Thank You and I'll answer any questions you may have.

Chairman CAMP. Well, thank you very much, Governor.
Mr. Kotlikoff and Mr. Tuerck, you each have, together, 5 minutes. And you are recognized now. Thank you. Your written statements are part of the record.

STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY, BOSTON, MASSACHUSETTS; ACCOMPANIED BY DAVID TUERCK, EXECUTIVE DIRECTOR, THE BEACON HILL INSTITUTE, PROFESSOR AND CHAIRMAN, DEPARTMENT OF ECONOMICS, SUFFOLK UNIVERSITY, BOSTON, MASSACHUSETTS

Mr. KOTLIKOFF. Thank you, Chairman Camp and Ranking Member Levin, and Members of the Committee. We are honored by this invitation to testify today about the fair tax. This is one of several different ways we could implement consumption taxation.

We think the fair tax has a number of reasons to recommend it over the other alternatives. I want to talk to you about that. I, myself, have an alternative to the fair tax, which is called the purple tax, which I put forth recently. But today I am here to talk about the fair tax, together with my co-author, David Tuerck.

So, the fair tax would replace the personal income tax, the federal personal income tax, and the federal corporate income tax, and the estate and gift tax with a federal retail sales tax that would tax all consumption goods and services, with the exception of imputed rent on existing houses at a 23 percent effective rate, a 30 percent nominal rate. And it would have—as Governor Huckabee indicated, there would be a demigrant to make that tax progressive.

But I want to point out that, as an economist, my profession doesn't believe that a consumption tax is regressive. I know that a number of you folks do believe that a consumption tax is regressive, even without a—for—leaving aside the issue of the rebate or the prebate, a number of you believe that a consumption tax is regressive. We economists don't believe you're right. We think you are looking at it the wrong way, we think you are measuring progressivity the wrong way. We think, when you look at it correctly, and measure progressivity against lifetime resources, lifetime—think about lifetime tax burdens as a share of lifetime resources—you will see that a consumption tax is actually more progressive than you think.

Now, what is a consumption, tax, actually? I think there is a lot of misunderstanding, not just about the progressivity, but what actually it is taxing. A consumption tax is really taxing what is used to pay for consumption. And what is used to pay for consumption are two things: wealth and wages, not just your current wages, but also your future wages.

So, your consumption over your lifetime is being financed, being paid for, by your taxes on your wealth—well, by your wealth and your wages. So if you taxed your consumption, you're, in effect, taxing what is used to pay for your consumption.

So, economists believe—and this is just mathematically the case; it's not really a belief, it's just a mathematical proposition—that a tax on wealth plus a tax on wages is equivalent to a tax on consumption. So if you're an advocating of taxing wealth, and using the proceeds from taxing wealth to lower the tax rate on workers—and I think a lot of Democrats would say, "That sounds very progressive to me, taxing wealth, using the revenues to lower the tax rate on wages"—then you have to be, logically speaking, a proponent of consumption tax, because that is what a consumption tax

does, it taxes wealth, and it uses the revenues to lower the tax on workers—on wages.

Now, a fair tax, consumption tax, also, compared to an existing income tax, is much more favorable toward saving, insofar as it doesn't prejudice you towards consuming in the present, relative to the future. That is what an income tax does.

If you look at this chart in our testimony—my testimony, joint with David—you will see that the national saving rate last year was exactly zero, except for a decimal place. It was 0.1 percent last year, that's our national saving rate last year. Our domestic investment rate was 4.4 percent. So we're not saving, as a nation. We are saving nothing as a nation. We are investing next to nothing. We need to have a tax system that gives people incentives to save, and also puts the burden on people fairly, so that we get equity, as well as the right incentives.

So, that is a couple points, of what exactly the fair tax taxes and its incentives. The other thing is it's—that we have in this testimony is a table on the—we're going to have two tables, one on effective tax rates, which show that the effective tax rates, marginal effective tax rates, are much lower under the fair tax than under the existing tax structure, and that the—there is also a table showing you lifetime progressivity. And we show in this table that the fair tax on lifetime tax basis is actually more progressive than the existing tax system, basically because it does do this thing that I mentioned, which is tax wealth and use the proceeds to lower the tax on wages.

Let me now turn the time over to David that I took away from him. Sorry.

Chairman CAMP. Well, I will make an exception, Mr. Tuerck. I will give you a minute to sum up.

Mr. Tuerck. Well, thank you. All economics professors are long-winded, and I am no exception.

I think that Larry covered the main points about the issue of regressivity versus progressivity. He is right. No modern economist believes any longer that consumption taxes are regressive—something for the analysts in Washington to start thinking about.

I am simply going to draw attention to one of the tables in our combined testimony that relates to the effect of the fair tax on investment. Economic theory tells us that consumption taxes untax net investment. That should be intuitively obvious, because of the fact that the corporate income tax goes away. So, lots of us have done estimates on this. I will tell you something about our estimates.

We show that in the first year of implementation, real GDP would go up by about eight percent. Domestic investment would go up by a whopping 75 percent, employment by 12 percent, real wages by 10 percent, and eventually consumption would go up, too, by about 6 percent. These are numbers on which there is widespread agreement by people who have modeled this issue. And it should be no surprise. You untax investment, you get more investment; you get more investment, you get more growth.

Thank you. And I thank the committee, too, for inviting me.

[The prepared statement of Mr. Kotlikoff and Mr. Tuerck follows:]

The Case for the FairTax

Testimony Submitted to the House Ways and Means Committee,
July 26, 2011

Laurence J. Kotlikoff
Professor of Economics
Boston University

David G. Tuerck
Chairman and Professor of Economics
Executive Director, Beacon Hill Institute
Suffolk University

Chairman Camp, Ranking Member Levin, and Members of the Committee, we are honored by your invitation to testify about tax reform at this critical juncture in our fiscal policy debate. Our testimony focuses on the need for consumption taxation and the manner in which the FairTax, as proposed in H.R. 25, can implement consumption taxation. We strongly support the FairTax, but recognize that there are many ways to tax consumption. In this regard, one of us, Professor Kotlikoff, has proposed a variant of the FairTax, called the Purple Tax (see www.thepurpletaxplan.org), which is also worth your consideration.

In the interest of full disclosure, we need to indicate that we have both done research on the FairTax under contract with Americans for Fair Taxation.¹ Several of our studies have been published in *Tax Notes* and other outlets. We are not currently under contract with Americans for Fair Taxation or any other organization or individual to do research on the FairTax. Nor are we being compensated for our time in testifying today.

The FairTax would replace the federal personal income tax (including the capital gains and the alternative minimum tax), the corporate income tax, the FICA employee and self-employment tax, and the estate and gift tax with a retail sales tax levied on consumption goods and services. H.R. 25 specifies an effective (tax-inclusive) rate of 23 percent – a rate set to maintain revenue neutrality. To ensure that those living at or below the poverty line pay no sales tax, on net, the FairTax provides all families with a monthly demogrant, also called a prebate, whose size depends on the family's composition. This feature transforms the FairTax from a proportional tax to a progressive tax.

The most important criteria for judging tax systems are efficiency, equity, growth, simplicity, transparency, political sustainability, and compliance. Compared with income taxation, consumption taxation has a number of advantages along each of these dimensions. And among

¹ The Beacon Hill Institute's work can be accessed at <http://www.beaconhill.org/FairTaxPapers.htm>.

alternative ways to tax consumption, the FairTax ranks particularly high with respect to transparency and political sustainability, of which we say more below.

What Does Consumption Taxation Tax?

In thinking about taxing consumption and how it meets each of these criteria, it's important to realize that taxing current and future consumption is equivalent to taxing what's used to pay for consumption, namely one's current and future wages and one's current wealth. In fact, a consumption tax is mathematically equivalent to a one-time tax on current wealth, the proceeds of which are used to reduce the ongoing tax on labor income.

In contrast, the income tax taxes, on an ongoing basis, labor income as well as the income earned on one's wealth. So if you earn money, you pay taxes on that income immediately, and then if you save that money, the income earned on that additional savings will also be subject to the income tax. This is the sense in which an income tax represents a double tax on the use of one's labor income and why it embodies, in part, a tax on new saving.

A consumption tax, in contrast, does not include a tax on new saving. If you earn money under a consumption tax and save it, you hand the government no tax payments until you spend that money. (We're assuming here that the consumption tax is implemented as a retail sales tax.) Hence, your labor income is taxed only once regardless of when you spend that labor income.

Under a consumption tax, if you have existing wealth, you hand the government taxes on that wealth whenever you spend it. That's why the consumption tax also embodies a tax on existing or current wealth.

Delaying One's Spending Does Not Lower the Present Value of the Consumption Tax

An income tax provides an incentive to consume right away because doing so avoids the second tax hit. In contrast, a consumption tax provides no such incentive. If you have \$X in wages you just earned or in wealth that you accumulated in the past, you hand the government taxes just once – when you spend these funds.

But does that mean that one can reduce the consumption tax hit by delaying one's spending? The answer is no. If you delay spending your current wages and wealth and save it and spend it plus the asset income you've earned, say, next year, you'll pay consumption taxes not just on the original money, but also on the additional asset income. In present-value terms, your tax payment will be the same. I.e., the additional consumption taxes paid on the asset's income makes you indifferent, in terms of taxes, between spending now and spending tomorrow.

To summarize, a consumption tax is neutral with respect to when you spend your money. Whether that money is newly earned or was earned in the past and saved, you hand the

government tax payments just once. An income tax is not neutral with respect to when you spend your money. The sooner you spend it, the more you avoid having it taxed again.

A Consumption Tax Is Effectively Levied Immediately

If the government hands you a bill and says you need to pay it either now or in the future, but that if you pay it in the future, you have to pay interest as well, you've been hurt right away. Whether you pay the bill now or pay it in ten years with interest, you're in the same boat in terms of the present-value impact.

This is true of the consumption tax. Even though the government gives us the option of when we want to hand over the tax on our current wages and existing wealth, it effectively charges interest if we wait to hand over the tax. Hence, we're hurt immediately when the tax is imposed.

An example will help. Suppose Joe has \$1 billion and the government implements a 30 percent nominal sales tax. Let's assume, for simplicity (the point doesn't hinge on this) that the Fed accommodates this tax and lets consumer prices rise by 30 percent. If Joe spends his \$1 billion today, he'll wind up with only \$770 million in goods and services since 23 percent of each dollar he spends goes to pay the sales tax. This is why we say that a 30 percent nominal tax entails an effective tax of 23 percent.²

Clearly, if Joe spends now, he's hurt. But suppose Joe waits and spends his \$1 billion in a year. Does this lower Joe's tax liability? No. Joe knows that the tax will still be in place in a year, so even though he still has his \$1 billion sitting in his pocket, he realizes its purchasing power has already been reduced by 23 percent.

Joe's not happy, and waiting to spend won't change his demeanor. Whenever he spends his wealth plus the income earned from saving it, he'll need to pay taxes on the total expenditure, which is the original principal of his wealth plus the income earned on his wealth. So he can spend today and hand over less in taxes or spend tomorrow and hand over more in taxes. Either way, he's out the same 23 percent of his current wealth. And if he gives his kids his wealth, either before or at his death, he's giving them less real wealth because the dollars he hands them entail less purchasing power.

In the Weimar Republic, even billionaires were poor. Our real wealth is not just a matter of the number of pieces of currency in our pocket. Our real wealth depends on what that currency can buy. And if the wealthy can buy less today than yesterday because of a switch to consumption taxation, then they are poorer in real terms. With this background on

² Alternatively, we can say that a 30% "tax-exclusive" rate entails a 23% "tax-inclusive" rate.

consumption taxation, we now evaluate the consumption tax in light of each of the aforementioned criterion.

Tax Efficiency

To economists, tax efficiency means limiting the degree to which the tax system distorts economic decisions, particularly decisions to work, save, and invest. Unlike income taxation, which distorts both the decisions to work and save, consumption taxation affects only the incentive to work; i.e., as just discussed, the income tax biases you to spend your wages and wealth immediately.

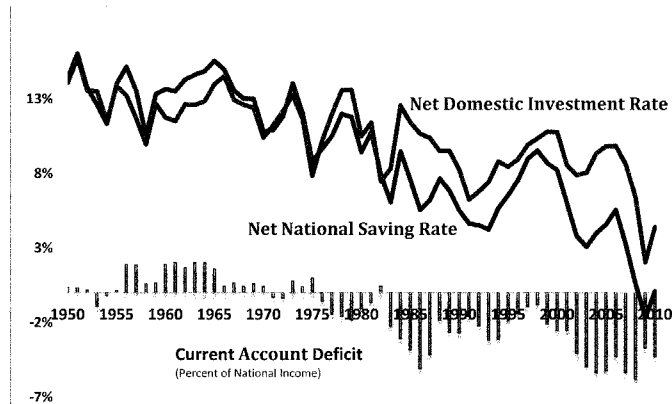
Take Judy, who earns \$100,000 this year and wants to spend it all in ten years. Under a 23 percent wage tax, Judy hands Uncle Sam \$23,000 this year and also hands Uncle Sam, *each year for the next ten years*, 23 percent in taxes of each dollar of asset income she earns by saving her remaining \$77,000.

Under a retail sales tax imposed at a 23 percent effective rate, Judy hands over nothing to Uncle Sam for 10 years, at which point she is taxed on the principal plus interest. In present-value terms this is equivalent to Judy's simply handing over \$23,000 to the government now and not paying any taxes in the future.

By letting her defer taxes on the original \$100,000 of labor income earned as well as on the asset income earned along the way, the consumption tax effectively taxes her once to the tune of \$23,000, when measured in present-value terms. To summarize, an income tax biases people to spend now, whereas a consumption tax does not. This means that an income tax penalizes saving, whereas a consumption tax does not.

As Figure 1 shows, our country has a terrible saving problem. We are currently saving literally nothing and, as a consequence investing next to nothing, and, as a further consequence, inducing foreigners to invest in our stead. Foreign net investment references our current account deficit.

Figure 1: U.S. National Saving and Domestic Investment Rates: 1950-2010



Effective Marginal Tax Rates

Economists measure the disincentive to work in terms of people's marginal tax rates (marginal tax brackets). Table 1 below shows the dramatic impact of switching to the FairTax on federal marginal taxes on working.

The impact of The FairTax on the incentives to save, at the margin, would also be substantial. Under The FairTax, the federal government's taxation of saving at the margin is zero.

Under the current federal tax, the size of the marginal tax a household faces on saving depends on whether it is using retirement accounts to shelter its saving. If so, it will face a low marginal tax from the federal personal income tax, but a potentially quite hefty marginal tax from the corporate income tax. If the household is saving outside of a 401(k), IRA, or similar tax-favored saving vehicle, the current federal marginal tax can be substantial depending on the household's tax bracket and whether it is receiving its asset income as tax-preferred capital gains and dividends or in non-tax preferred dividends.

Table 1: Marginal Effective Federal Tax Rates on Working, FairTax vs. the Current System³

Single Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$10,000	-23.1%	23.0%	-23.2%	23.0%	29.8%	23.0%
\$15,000	33.3%	23.0%	33.8%	23.0%	22.4%	23.0%
\$25,000	34.2%	23.0%	47.7%	23.0%	26.2%	23.0%
\$35,000	50.2%	23.0%	28.3%	23.0%	29.0%	23.0%
\$50,000	28.2%	23.0%	22.4%	23.0%	36.5%	23.0%
\$100,000	27.6%	23.0%	27.5%	23.0%	28.6%	23.0%
\$250,000	41.5%	23.0%	37.2%	23.0%	35.5%	23.0%
Married Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$20,000	33.8%	23.0%	41.4%	23.0%	23.5%	23.0%
\$30,000	33.7%	23.0%	47.6%	23.0%	28.2%	23.0%
\$50,000	28.0%	23.0%	28.2%	23.0%	28.2%	23.0%
\$70,000	28.3%	23.0%	28.2%	23.0%	32.7%	23.0%
\$100,000	33.5%	23.0%	33.7%	23.0%	34.3%	23.0%
\$200,000	35.3%	23.0%	31.2%	23.0%	37.5%	23.0%
\$500,000	38.4%	23.0%	38.4%	23.0%	37.2%	23.0%

Equity – The Consumption Tax is Not Regressive

Many people view moving to consumption taxation as regressive. These same people would view switching from our current system to a tax on existing wealth, whose proceeds are used to lower the taxation of labor income, as highly progressive. But it is not possible to hold both beliefs since a consumption tax is identical to a tax on existing wealth and current and future wages, and a tax on existing wealth and current and future wages is identical to a tax on consumption.

³ Laurence J. Kotlikoff and David Rapson, "Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Income Taxation," October, 2006.

If people who oppose a consumption tax understood that it embeds a significant wealth tax, they would likely support it. In this regard, it is paradoxical that Democrats appear to oppose consumption taxation, whereas Republicans appear to support it.

Economists measure tax progressivity in terms of lifetime net tax rates, specifically as the ratio of the present value of lifetime net tax payments divided by the present value of lifetime resources (initial wealth plus the present value of future labor earnings).

Politicians like to measure tax progressivity in terms of current taxes divided by current income. But current income is not a useful measure of a person or household's economic resources. Warren Buffett may have zero current income this year if his capital losses are large enough to offset his capital gains, but his personal resources are immense. By measuring tax progressivity incorrectly, politicians conclude that a consumption tax is regressive, whereas economists view it as proportional. This makes sense. Since a consumption tax is, in essence a tax on existing wealth and the present value of wages, taxing consumption at a fixed rate is taxing economic resources (existing wealth and the present value of wages) in proportion to the level of those resources.

By adding its demogrant/prebate, the FairTax transforms a proportional consumption tax into a progressive one. Table 2 below shows that the FairTax reduces lifetime net tax rates substantially (thanks to its base broadening), while enhancing tax progressivity.⁴

Growth

In the course of its work on the FairTax, the Beacon Hill Institute built a computer model aimed at determining the effects of the FairTax on economic growth. The model was constructed in 2006 for a hypothetical implementation date of January 1, 2007.⁵ The findings for 2007 through 2031 are summarized in Table 3. The table shows the percentage difference in each indicator resulting from implementation of the FairTax for selected years 2007 to 2031. For example, real GDP would have been 7.9 percent higher in 2007 under the FairTax than under the "baseline" current law and 10.3 percent higher by 2031.

⁴ Ibid. See also David G. Tuerck, Jonathan Haughton, Paul Bachman, Alfonso Sanchez-Penalver, Phuong Viet Ngo, A Distributional Analysis of Adopting the FairTax: A Comparison of the Current Tax System and the FairTax Plan (February 2007):4, <http://www.beaconhill.org/FairTax2007/DistributionalAnalysisFairTaxBHI4-25-07.pdf>.

⁵ See David G. Tuerck, Jonathan Haughton, Keshab Bhattarai, Phuong Viet Ngo, Alfonso Sanchez-Penalver, *The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model* (February 2007):1, <http://www.beaconhill.org/FairTax2007/EconomicEffectsFTBHCCEModel4-30-07.pdf>.

**Table 2: Average Remaining Federal Lifetime Tax Rates –
Current System vs. the FairTax**

Single Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$10,000	-12.3%	-17.6%	6.2%	-13.5%	6.5%	-27.1%
\$15,000	-4.0%	-5.0%	11.3%	-10.0%	9.8%	-28.0%
\$25,000	10.2%	5.6%	17.7%	4.7%	14.1%	-6.2%
\$35,000	18.5%	10.1%	20.7%	5.4%	16.7%	-5.9%
\$50,000	21.1%	13.5%	23.5%	11.4%	21.5%	3.9%
\$100,000	27.5%	17.8%	30.3%	14.7%	32.1%	9.2%
\$250,000	27.9%	20.8%	33.6%	19.7%	40.8%	18.2%
Married Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$20,000	3.1%	1.3%	11.0%	1.5%	7.2%	-11.0%
\$30,000	12.5%	7.8%	15.3%	3.4%	10.1%	-10.5%
\$50,000	19.1%	13.4%	19.6%	11.1%	14.2%	1.4%
\$70,000	21.1%	15.6%	21.3%	11.6%	17.0%	2.2%
\$100,000	23.2%	17.4%	24.0%	14.7%	22.4%	7.9%
\$200,000	27.2%	19.7%	29.0%	17.0%	32.2%	12.3%
\$500,000	30.6%	21.6%	35.6%	20.5%	41.5%	19.3%

The capital stock would remain unchanged in the first year because incremental investment in that year would add only to the usable capital stock in the following year. However, the capital stock would begin to increase in the second year and eventually rise to 17.3 percent above baseline 24 years out. Consumption would fall slightly at first, as agents found it in their interest to take full advantage of the FairTax and substantially increase their saving. Investment would rise to 88.4 percent above baseline in the second year. Consumption would rise steadily to 6.0 percent above baseline for the last year, as households took advantage of the increased income made possible by the increased capital formation.

Table 3: Summary of Effects of the FairTax Relative to Current Law (% change), 2007-2031

	2007	2008	2009	2010	2011	2016	2021	2026	2031
Year	1	2	3	4	5	10	15	20	25
Real GDP	7.9	9.3	9.9	10.3	10.7	10.9	10.7	10.5	10.3
Domestic investment	74.5	88.4	88.0	87.1	86.3	75.9	69.0	65.7	65.2
Capital stock	0.0	2.8	5.3	7.5	9.3	14.1	16.0	16.9	17.3
Employment	11.9	12.0	11.2	10.5	9.9	7.6	6.1	5.3	4.7
Real wages	10.3	10.6	10.4	10.3	10.2	9.5	9.1	9.0	9.2
Consumption	-0.6	-0.8	0.2	1.1	1.8	4.3	5.5	5.9	6.0

Sabine Jokisch and Laurence J. Kotlikoff, using an overlapping-generations open-economy simulation model, estimate that in 25 years the introduction of a FairTax would raise the capital stock by 43.8 percent, the real pre-tax wage by 11.5 percent and national income by 9.4 percent.⁶ Arduin, Laffer & Moore Econometrics find that the FairTax would raise total economic output by 11.3 percent ten years out. Investment would be 41 percent higher and employment 9 percent higher.⁷

Simplicity

Under The FairTax, American households and businesses file no tax returns. Taxes on final purchases of goods and services are collected at the store and transmitted to the government. There would be no need for tax accountants or tax lawyers. These hundreds of thousand highly skilled professionals would be freed up to lead socially productive work lives.

Transparency

Under the FairTax, the tax system is very simple and, therefore, very clear. There is a single 23 percent effective sales tax, which everyone pays.

Compliance

The Beacon Hill Institute estimated that the cost of complying with the current system in 2005 was \$407.11 billion, whereas the net cost to business and federal and state government of

⁶ Sabine Jokisch and Laurence J. Kotlikoff, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007, <http://people.bu.edu/kotlikoff/FairTax%20NTJ%20Final%20Version,%20April%2024,%202007.pdf>.

⁷ Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal," (June 2006):28, <http://www.fairtax.org/PDF/MacroeconomicAnalysisofFairTax.pdf>.

administering the FairTax in the same year would have been \$60.6 billion. Thus, there would have been a net saving of \$346.51 billion.⁸

Sustainability

Because The FairTax has one tax rate, everyone will know that spending more on anyone or anything will entail raising that single tax rate. Everyone will also know that tinkering with the tax rate schedule will damage this tight link between what's spent and what people have to pay. That will make it harder to hide new taxes or to hand out tax breaks to special pleaders. The FairTax is more likely than other taxes, including other consumption taxes, to sustain itself in the face of political pressure to undo what it sets out to accomplish.

The FairTax Rate

In 2006, we showed that the FairTax rate would have to be 23.82% in 2007 in order to raise the revenue needed to replace the revenue lost by eliminating existing taxes and to fund the demogrant.⁹ More recent calculations show that the 23% rate called for in the statute would have raised more revenue than needed in 2009 and 2010.

Opponents claim that evasion would require the rate to be much higher. By our estimate, however, the evasion to be expected under the FairTax would trim the base by only about two percent. And this effect would eventually be offset by the rise in consumption that implementation of the FairTax would bring about.

Moreover, the considerable expertise of state sales tax agencies developed over many decades, combined with the services of newly rehired IRS agents, would be available to enforce the tax. Because the FairTax reduces the number of tax filers by at least 80 percent, enforcement authorities will have to monitor far fewer taxpayers, allowing a much higher audit rate (per dollar of enforcement spending), thereby increasing the likelihood of apprehension. The perception of risk as a deterrent to evasion would increase commensurately.

Conclusion

Compared with the existing federal tax system, The FairTax is a sure winner. It's more efficient, equitable, transparent, sustainable, and growth-and-jobs oriented. It will help revitalize investment, and with it, expand our economy, create jobs and bring in new revenues.

⁸ David G. Tuerck, Paul Bachman, Alfonso Sanchez-Penalver, "Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System (September 2007)
<http://www.beaconhill.org/FairTax2007/TaxAdminCollectionCosts071025%20.pdf>.

⁹ Paul Bachman, Jonathan Haughton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck, "Taxing Sales under the FairTax: What Rate Works?" *Tax Notes* (November 13, 2006):672
<http://www.beaconhill.org/FairTax2006/TaxingSalesundertheFairTaxWhatRateWorks061005.pdf>.

Chairman CAMP. All right, thank you. Thank you both. Mr. Bartlett, you are recognized for 5 minutes.

STATEMENT OF BRUCE BARTLETT, COLUMNIST, "TAX NOTES," AND "THE FISCAL TIMES"

Mr. BARTLETT. Thank you, Mr. Chairman. First of all, I would like to say that I do support, in principle, the concept of a consumption-based tax system. But I think that many economists—perhaps including those to my right—gloss over the critical administrative aspects of consumption taxes, and they want to take all of the benefits that you would get from any consumption-based tax system,

and attribute them exclusively to the fair tax, which I think is wrong.

My main objection to the FairTax has always been one simple thing: it simply won't work. It is a ridiculously pie-in-the-sky proposal. Let me point to a couple of things.

It would abolish the Internal Revenue Service and all of the collection machinery that has been built up over the last 100 years for collecting taxes, and force the states to collect the Federal Government's revenues for it. Now, this strikes me as unconstitutional, but I don't want to argue that point. The main thing is that it won't work. We tried this during the Articles of Confederation, and we ended up with the Constitution.

Secondly, the tax would apply to all governments. State and local governments would have to pay the tax to the Federal Government, as well as collecting the tax for the Federal Government. This makes no sense. The Federal Government would have to pay the tax to itself. The cost of every single thing the Federal Government buys will be 30 percent higher. But the proponents somehow or other assume that federal spending is fixed in nominal terms. So you get a huge cut in spending that helps finance this whole operation.

Third, housing. If you buy a new house, you are going to have to pay 30 percent more. But if you buy a used house, you don't have to pay anything. This strikes me as administratively impossible, whatever its virtues may be.

The problem of evasion is always glossed over. The reason why—I mean we all know we have a very serious evasion problem right now, when we have a huge amount of taxes withheld from people's paychecks and so on. But under the fair tax, you would eliminate all that machinery, you would collect taxes at exactly one point in the entire economic system: at the retail outlet. There is too much incentive for people to go to the wholesale level and buy out of the factory door. The retail store owner has just as much incentive to evade the tax as the buyer, they just do their sales off the books.

The idea of having a national retail sales tax has been studied by other countries. They always rejected it, because there would be too high a degree of evasion. Instead, they have all favored the value-added tax, which is a form of consumption tax that will work. We know it works because every other country except us has one. It was designed to deal with all of the administrative and evasion problems that are inherent in the nature of a retail sales tax.

Finally, I want to mention something about the rebate, which the FairTax supporters say is necessary to offset the regressivity of the tax. But, as the George W. Bush administration's tax reform report pointed out, this would involve the creation of the largest entitlement program in the history of the United States. They estimated that its cost would be \$800 billion per year in 2005 dollars. And these checks would go out to people with Social Security numbers on a monthly basis.

Now, as this committee knows perfectly well, we have a huge problem of people with fake Social Security numbers now. Can you imagine what it will be like if, by getting a fake Social Security number, you can get monthly checks from the government? Large checks, too. This is just a license for abuse waiting to happen.

A couple of technical points. Getting rid of the corporate income tax may sound very good to the corporate community, but what's going to happen to all their unused depreciation the day the corporate income tax disappears? They have nothing to deduct it against. And if you think this isn't a problem, it is.

When Professor Kotlikoff talks about taxing wealth, you have to understand that the people whose wealth would essentially be taxed by this proposal are the elderly. They saved all during their lifetimes when there was no broad-based consumption tax, and in retirement they had this anticipation that they would be able to withdraw that saving, tax free. But, in fact, they will have to pay a 30 percent tax on everything at that point.

Thank you very much.

[The prepared statement of Mr. Bartlett follows:]

**Statement by
Bruce Bartlett
Before the
Committee on Ways and Means
U.S. House of Representatives
July 26, 2011**

Thank you for the opportunity to testify this morning on tax reform and consumption-based tax systems.

First, I would like to say that I have always supported a consumption-based tax system in principle.¹ Income taxes, by their nature, double tax saving and investment, which imposes a large deadweight or efficiency cost on the economy. This is the economic burden over and above the tax itself. A 2005 Government Accountability Office study estimated the total efficiency cost of the federal tax system at between 2 percent and 5 percent of GDP.²

Second, I think it matters a lot how a consumption tax or consumption-based system is imposed. Many economists gloss over the administrative problems inherent in different forms of consumption taxes; from a purely economic point of view, they reason, it makes no difference whether you have a retail sales tax, a value-added tax, or some kind of consumed income tax. All that really matters is that saving and investment are excluded from the tax base because that is what raises economic growth.

Unfortunately, as this committee knows better than I do, technical details and administrability are important considerations in developing tax policy. Over the years, your hearing record has been filled with proposals that sounded good on paper but were just utterly impractical. Sometimes these good-on-paper ideas were enacted into law and had to be delayed and repealed before they could even take effect.

A good example is carryover basis, which was enacted as part of the Tax Reform Act of 1976. Although it is a perfectly good idea in principle, it was just not workable.³ This is still a problem for the estates of those who died last year.⁴

This brings me to my core disagreement with the FairTax. I just don't think it will work. It is the most pie-in-the-sky major tax reform I have ever heard of. Even by tax policy standards, it is grossly complex, a virtual Rube Goldberg contraption of pieces that are unworkable individually and become exponentially more unworkable as they are layered on top of each other. The idea that this is a simple form of taxation is nonsense.

¹ Bruce Bartlett, "Tax Spending, Not Savings," *New York Times* (July 6, 1997).

² GAO, *Summary Estimates of the Costs of the Federal Tax System*, GAO-05-878 (Aug. 2005).

³ Bruce Bartlett, "Carryover Basis: A Cure Worse Than the Disease?" *Tax Notes* (Oct. 18, 2010).

⁴ "Carryover Basis Rules Top Estate Tax Guidance Needs," *Tax Notes* (Jan. 10, 2011); "IRS Delays Filing Deadline for Basis Allocation," *Tax Notes* (April 11, 2011).

The FairTax would abolish virtually all federal taxes, including the payroll tax and the income tax, and replace them with a 23 percent retail sales tax like those levied by the states. Indeed, the states would actually be required to collect the tax for the federal government, thus allowing for abolition of the Internal Revenue Service. To relieve the burden on the poor, everyone would receive a monthly rebate on the tax equal to the tax rate on a poverty level income.

FairTax supporters are well financed. They have no difficulty buying the services of academics like Prof. Kotlikoff to produce studies on their behalf. FairTax supporters are also evangelical in the belief that their plan will be an enormous blessing for Americans not to have to file income tax returns or keep all the associated financial records. As Gov. Huckabee has said, "When the FairTax becomes law, it will be like waving a magic wand releasing us from pain and unfairness."⁵

There are, however, a number of problems with the FairTax that its supporters tend to dismiss or downplay. Here are a few.⁶

The true rate is not really 23 percent. Thought of the way people think of state retail sales taxes, the rate is actually 30 percent. The 23 percent figure is derived this way. On a \$1 purchase, the tax would be 30 cents for a total price of \$1.30. Since the 30 cent tax is 23 percent of \$1.30, FairTax supporters argue that the true tax rate is 23 percent. Non-supporters are more inclined to think that this is just a trick to make the tax rate appear lower than it really is in order to increase support for the FairTax.

Another oddity is that the FairTax would apply to all government spending, including federal spending, as well as private spending. This will undoubtedly force state and local governments to raise their taxes. And it serves no logical purpose for the federal government to tax itself.⁷

The FairTax would apply to new home sales as well as rent. And of course, mortgage interest and local property taxes would not be deductible because there would be nothing to deduct them from. However, sales of used homes would be exempt, as would sales of homes to businesses. Prof. George Yin, who is well known to this committee, described the tax treatment of housing under the FairTax this way:

If a person buys a new house from Barry Rutenberg Homes to be used as a family residence, the buyer would owe sales tax on the purchase because it is a sale by a business to a household. If, instead, the person purchases the same new house from Rutenberg Homes to be used for a new law practice, that transaction would not be taxed because it is a business-to-business

⁵ Mike Huckabee for President, Issues: Taxes/Economy, www.mikehuckabee.com, accessed Dec. 10, 2007.

⁶ I discuss these and other problems at more length in Bruce Bartlett, "Why the FairTax Won't Work," *Tax Notes* (Dec. 24, 2007): 1241-54.

⁷ William G. Gale et al., "Taxing Government in a National Retail Sales Tax," *Tax Notes* (October 5, 1998); Evan F. Koenig, "Achieving 'Program Neutrality' Under a National Retail Sales Tax," *National Tax Journal* (Dec. 1999).

transaction. Rather, the cost of the person's legal services, which should presumably incorporate the cost of the building in which the practice is located, will be taxed when the services are consumed by a household. Finally, if a person purchases a used house from another family, the transaction again would not be taxed because it would be one between households.⁸

FairTax supporters argue that the prices of all goods and services will fall by about as much as the 23 percent tax that would be imposed because of the elimination of existing federal taxes. It is all a wash, they say. As prominent FairTax advocates talk show host Neal Boortz and former Rep. John Linder explain:

Once the FairTax takes effect, you'll be receiving 100 percent of every paycheck, with no withholding of federal income, Social Security taxes, or Medicare taxes – and you'll be paying just about the same price for T-shirts and other consumer goods and services that you were paying before the FairTax.⁹

The principal documentation for this assertion appears to be a paper commissioned by Americans for Fair Taxation by Harvard economist Dale Jorgenson that is unavailable on its web site or anywhere else as far as I can tell. Although it is often implied by FairTax supporters that Prof. Jorgenson supports their proposal, this is not the case. He has his own tax reform plan that bears no resemblance to the FairTax.¹⁰ Jorgenson has also been publicly critical of the FairTax. In 2007, he called it "reform by focus group."¹¹ In 2008, Jorgenson said, "The main weakness of the FairTax is its comprehensiveness. It tries to roll everything into one tax, which simply can't carry all that weight."¹² He has also testified before this committee that a national retail sales tax would need a rate of 40 percent to equal all federal revenues.¹³ And in a 2005 academic article, Jorgenson said, "The very high tax rate of the national retail sales tax provides powerful incentives for tax evasion and renders effective tax administration difficult."¹⁴

While Jorgenson's published work does indeed show that prices would decline if all existing federal taxes suddenly vanished, a key reason is that all workers would have to

⁸ George K. Yin, "Is the Tax System Beyond Reform?" *Florida Law Review* (Dec. 2006): 983.

⁹ Neal Boortz and John Linder, *The FairTax Book* (Regan Books, 2005): 59.

¹⁰ Dale Jorgenson, "Efficient Taxation of Income," *Harvard Magazine* (March-April 2003); "A Smarter Type of Tax," *Financial Times* (June 19, 2002).

¹¹ Quoted in Jonathan Weisman, "Criticism Aside, 'FairTax' Boosts Huckabee Campaign," *Washington Post* (Dec. 28, 2007).

¹² Quoted in Tom Redburn, "Huckabee Sales Tax Plan Appeals, but Is It Fair?" *New York Times* (Jan. 6, 2008).

¹³ Subcommittee on Select Revenue Measures, *Second in Series on the Extraterritorial Income Regime*, 107th Cong., 2nd sess. (May 9, 2002): 73.

¹⁴ Dale Jorgenson and Kun-Young Yun, "Efficient Taxation of Income," in Timothy J. Kehoe, T.N. Srinivasan, and John Whalley, eds., *Frontiers in Applied General Equilibrium Modeling* (Cambridge University Press, 2005): 193.

cut their wages by the amount of the tax for this to happen.¹⁵ This fact is conceded by Prof. Kotlikoff, who has said, if the Federal Reserve does not accommodate the FairTax by increasing the money supply to create a one-time inflation rate of 23 percent, “producer prices, wage rates, and rental rates would all fall.”¹⁶ Of course, 23 percent inflation would cause real wages to fall if they are fixed in nominal terms. How else would businesses be able to reduce their prices unless all their costs fell, and labor is the largest cost any business has. But there is nothing in the FairTax proposal to compel workers to take a pay cut and no reason to think that they won’t resist doing so strenuously.

FairTax supporters have always glossed over the huge incentive for evasion once the existing machinery of tax compliance is abolished and all federal revenues are collected at exactly one point: retail sales. This is a key reason why the Reagan administration rejected the idea. In its 1984 tax reform report it said, “A federal retail sales tax, when combined with the retail sales taxes levied by most states, would provide irresistible inducement to tax evasion at the retail level.”¹⁷

Furthermore, the idea of replacing existing taxes with a retail sales tax has been studied by foreign countries and international organizations. An Organization for Economic Cooperation and Development report had this to say, “Governments have gone on record as saying a RST of more than 10 percent to 12 percent is too fragile to tax evasion possibilities.”¹⁸

Finally, FairTax supporters have always maintained that their plan would neither raise nor lower aggregate federal revenues. Yet revenues have fluctuated between 14.8 percent of GDP and 20.6 percent of GDP over the time the FairTax has been under consideration without any change in the proposed 23 percent rate. In any case, every serious effort to score the FairTax by the Treasury Department, Joint Committee on Taxation, and the Brookings Institution has concluded that a rate significantly higher than 23 percent would be necessary for it to be fiscally neutral.¹⁹

There are many other technical problems with the FairTax as well such as the interaction between a national retail sales tax and state and local sales taxes that are collected on different goods and services; the problem of exempting sales between businesses so that taxes aren’t levied on top of taxes, a problem economists call cascading; how the states will be compelled to collect federal sales taxes, especially in states that have no sales tax; and the fact that state income taxes will require people to still file returns and keep the

¹⁵ Dale W. Jorgenson and Kun-Young Yun, *Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (MIT Press, 2001): 317-407.

¹⁶ Laurence J. Kotlikoff, “Why the FairTax Will Work: A Response to Bartlett,” *Tax Notes* (Feb. 4, 2008): 647.

¹⁷ *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 1 (USGPO, 1984): 34.

¹⁸ *Taxation in OECD Countries* (OECD, 1993): 78. See also, *Taxing Consumption* (OECD, 1988): 103.

¹⁹ William G. Gale, “The National Retail Sales Tax: What Would the Rate Have to Be?” *Tax Notes* (May 16, 2005); Lindy Paull to John Buckley, “Budget Neutral Tax Rate for H.R. 2525,” (April 7, 2000); *Simple, Fair, & Pro-Growth: Report of the President’s Advisory Panel on Federal Tax Reform* (November 2005): 207-57.

necessary records.²⁰ There is nothing in the FairTax legislation requiring the states to abandon their income taxes. Nor is there any requirement that the federal government permanently abandon the taxation of income; that would require not just repeal of the 16th Amendment, but passage of a new amendment explicitly banning the taxation of income in a way that will be enforced by the courts.

Another problem area is the cash grant that would be sent to every household to offset the regressivity of the FairTax. These grants would be based on Social Security numbers and this committee well knows that we already have a serious problem in this country with illegal aliens obtaining such numbers improperly.²¹ Imagine the abuse when every American has an incentive to get multiple numbers to obtain multiple rebates. Or the enormous incentive Congress will have to use the rebates to deal with various problems particular groups might be having, to give them a little bit more – maybe around election day.

No wonder the tax reform report issued by the George W. Bush administration called the FairTax rebate the largest new entitlement program in history. It estimated the cost of the program at between \$600 and \$800 billion per year in 2005 dollars and would make most American families “dependent on monthly checks from the federal government for a substantial portion of their incomes.” Prof. Michael Graetz has also commented on the effects of the FairTax rebate program:

It is ironic that the self-described advocates of a smaller government, who have invented the FairTax proposal, have put forth a program involving a massive new check-writing scheme from the federal treasury to all Americans. One can readily imagine the possibilities for fraud and abuse, much as conservatives have long complained about such problems in our now shrunken welfare system.²²

Every serious study of imposing some sort of national consumption tax in the U.S. has concluded that a value-added tax would work much better. That is because it was designed to overcome the administrative problems inherent in the nature of the FairTax. In other words, if the FairTax is a good idea, the VAT is a far better idea.²³ As the Reagan administration concluded, “On balance the administrative advantages of the

²⁰ William F. Fox and Matthew N. Perry, “A National Retail Sales Tax: Consequences for the States,” *State Tax Notes* (July 25, 2005); Robert Cline et al., *Sales Taxation of Business Inputs* (Council of State Taxation, 2005).

²¹ GAO, *Individual Taxpayer Identification Numbers Can Be Improperly Obtained and Used*, GAO-04-529 (March 10, 2004).

²² Michael J. Graetz, *100 Million Unnecessary Returns* (Yale University Press, 2008): 170.

²³ Sijbren Cnossen, “Evaluating the National Retail Sales Tax from a VAT Perspective,” in George R. Zodrow and Peter Mieszkowski, eds., *United States Tax Reform in the 21st Century* (Cambridge University Press, 2002); James M. Bickley, “A Value-Added Tax Contrasted With a National Sales Tax,” CRS Issue Brief for Congress No. IB92069 (Sept. 30, 2004); George Zodrow, “The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a ‘VAT in Drag’?” *National Tax Journal* (Sept. 1999); John L. Mikesell, “Changing the Federal Tax Philosophy: A National Value-Added Tax or Retail Sales Tax?” *Public Budgeting and Finance* (Summer 1998).

value-added tax appear to outweigh the primary administrative advantage of the retail sales tax.”²⁴

Finally, I think it is revealing that a former chairman of this committee, Bill Archer, was a very strong supporter of the FairTax during a time when his party held both houses of Congress and the White House, yet he never even introduced a bill to implement it. He held many, many days of hearings on the subject, but never attempted to get legislation through committee and onto the House floor for debate. I don’t know why, but I suspect that the more he thought about it, the more unworkable the FairTax seemed to him.

Another lesson from Mr. Archer’s experience is that excessive attention to a tax reform proposal that has not the remotest chance of enactment drains time and resources that are better spent on achievable reforms. This point was recently made eloquently by prominent conservative talk show host Hugh Hewitt. “The FairTax movement hurts the tax reform movement in the way that quack medicine hurts the real thing,” he said. “All the effort and debate (and money) that goes into promoting this ultimately fruitless effort is wasted, and worse than wasted, is damaging to the real deal – genuine tax reform and simplification.”²⁵

In conclusion, I would strongly urge the committee to reject the FairTax and concentrate its attention on real world reforms that will actually work and have at least a fighting chance of enactment by Congress.

²⁴ *Tax Reform for Fairness, Simplicity, and Economic Growth*, p. 225.

²⁵ Hank Adler and Hugh Hewitt, *The FairTax Fantasy: An Honest Look at a Very, Very Bad Idea* (Townhall Press, 2009): 150.

Chairman CAMP. Thank you. Thank you all very much. Governor Huckabee, as you know, our nation’s unemployment is unacceptably high. And how would the fair tax, if we adopted that, how would that bring about more jobs in this country?

Mr. HUCKABEE. Well, Congressman, one of the ways that it will happen, manufacturing has moved offshore in large measure because corporations are having a difficult time, and job creators have a difficult time when they are competing with countries with a lower tax rate. If our tax rate is zero, and there is no tax assessed at the production level, then it is obvious that we then become more competitive.

If we have a zero capital gains tax, capital not only that has been parked offshore—and it has been estimated that there is as much as \$14 trillion of U.S. money—that’s as much as the debt—\$14 trillion parked offshore to protect it from the Tax Code, legally and legitimately. But what would happen if that money came back to the United States because there was no penalty for parking it here? That would certainly be a far better situation.

Let me—if I could, very quickly—give this anecdotal mention, because it was one of the things that sold me on the fair tax. I was in New Hampshire four years ago, and visiting with a gentleman who was working at a machine shop, working two shifts because he wanted to help his daughter through grad school at Cornell. And he said that was costing \$53,000 a year, which caused me to gasp.

But he said—this is a guy with a high school education, working two shifts—he said when he took on the second shift he thought he would make twice as much money. But, as it turned out, it put him in a different tax bracket, and a lot of what he was making in the second shift was going to taxes, not to his daughter. He said, “I don’t understand this.” And the honest answer is neither do I. Why should you punish a person who is working twice as hard?

Truth is, if he quit both jobs, then his daughter would qualify for some assistance that he and her would not qualify for under the current Tax Code. I think, for most of us, regardless of our political persuasion, that seems insane.

Chairman CAMP. I have a question for both you and Mr. Kotlikoff. Different states have different laws and rules. For example, in Michigan, my home state, there is a sales tax, but the sales tax doesn’t apply to groceries, for example. Under the fair tax, groceries are not exempt. How would that impact stores in Michigan?

And if they don’t currently collect sales taxes, would they now be required to do that? And would there be any transition rules or similar relief available to help sort of ease the administrative burden on those businesses and employers?

And either one of you can answer. If, Mr. Kotlikoff, you want to go first—

Mr. KOTLIKOFF. Yes, they would be required to collect the tax at the store. Whether there was some transition relief would be up to you folks to provide, if you felt it was necessary.

But let’s think about the people coming into the store to actually buy these consumption goods: the food, the bread, eggs. Well, they are going to get—if they are working, they are going to get a paycheck that has no income tax withheld from it. And there is also going to be no FICA tax withheld. So they are going to have more wherewithal. And they are also going to get a monthly rebate check.

We are sending out lots of checks to lots of people, older retirees, through Social Security, Bruce, and we do have some fraud, I’m sure. But I don’t think it’s a reason to eliminate Social Security, for example.

So, just to answer—back to your question, I think it’s not going to be—you know, all the prices of all the goods and services are going to uniformly go up because of this. People are still going to

need to buy groceries, and I think that store will still be able to function.

Chairman CAMP. But you envision the collection point being at the grocery store?

Mr. KOTLIKOFF. At the store, yes. We're going to go from about—with the fair tax, one would go from about 120 million tax-paying entities to about 700,000. So that's really relevant to the issue of enforcement and evasion. If you have an entire IRS—I'm not particularly so keen on abolishing the IRS. I think we have a lot of people there that could be used to enforce the fair tax, if that's what you folks implement.

So, if you go to 700,000, rather than 120 million tax returns, you have a lot more ability to enforce that—the tax collection, because you have fewer tax payers.

Chairman CAMP. Okay, Governor.

Mr. HUCKABEE. Congressman, if I could address the administrative issue, as a governor for 10½ years, I mean we certainly understand how to collect taxes. But the reality is that every business owner who is collecting taxes has that set up electronically, and it is programmed in. And the idea that this is going to be a monstrous task is simply not the case. This is not Mom and Pop jotting down on a pad, this is a computer program that easily can be programmed, and the states and localities would be getting basis points for their collections.

So they're going to get, in essence, a cash windfall as a result of their part of the collection process. And that will make it more attractive to them, because they are not doing it without some compensation for their administrative efforts.

Chairman CAMP. All right, thank you. Mr. Levin is recognized.

Mr. LEVIN. Well, this is called a fair tax. By the way, people worked for their Social Security. It's not a hand-out from the government.

But I want to get to one of the basic issues here relating to the so-called fair tax. And, Mr. Bartlett, I read from your special report dated December 24, 2007 on why the fair tax won't work. And I just want to get to this issue of regressivity. So I'm just reading from this tax report of yours.

But what if a worker is currently paying less than 23 percent of his income in federal taxes? In this case, he is clearly worse off under that so-called FairTax. The prices of the things he buys will rise by more than his income rises, from the elimination of elimination and payroll taxes. Conversely, if one is wealthy and in a tax bracket above 23 percent, that person would be much better off. His income and payroll taxes would fall by much more than the prices of goods and services he consumes would rise.

I want to ask you about this, because here we are in this battle over raising the debt ceiling. And the majority position in the House is no taxes, that you can't touch the tax rates for people who are making over \$1 million. This is annual income of \$150,000. Most of that is income over \$1 million.

So, just reading this analysis of yours, it seems to me that it is clear that for people who already are doing very, very well, in most cases this helps them, while for middle-income taxpayers who would not receive a check in most cases, from the government, this

would mean an increase in their taxes. I don't see how you escape this.

And, therefore, I think it is absolutely (what should I say?)—inappropriate, to be charitable, to call this a fair taxation proposal. Could you comment on that?

Mr. BARTLETT. Let me make a point that is very seldom discussed by FairTax supporters, although Professor Kotlikoff alluded to it.

If you impose a sales tax, the Federal Reserve accommodates this tax—then the price level is going to rise by the amount of the tax. If it's a 23 percent or 30 percent sales tax, the price of every single consumption good is going to rise by 30 percent. So, while it's true you will have more cash income because you will no longer have to pay income and payroll taxes, the cost of everything you buy is going to cost more. That's where the burden of the tax comes from.

Now, alternatively, if you assume that the Federal Reserve will not accommodate this one-time inflation rate that would be the highest in our history, then real wages have to fall, because they always make the argument that the prices of goods will fall by enough to compensate for the tax. They basically make two simultaneous and contrary arguments: the prices will fall, but then they will rise. But if you assume a fixed price level, then wages have to fall. Otherwise, the producers will not be able to reduce their prices. Their costs have to be lower.

Mr. LEVIN. So who bears the burden of this? From your analysis, the very wealthy more or less, in most cases, are helped, while many, many mostly middle-income tax brackets are hurt. Isn't that correct?

Mr. BARTLETT. The burden is borne by consumption. And so, it depends on what your consumption is relative to your income. People with low incomes consume virtually all of their income. People in the middle bracket save some. That would not be taxed. People in the upper brackets save almost all of their income. So it would be proportional to your consumption.

Mr. LEVIN. Yes, so I think this is an unfair tax proposal. Thank you.

Chairman CAMP. Mr. Johnson is recognized.

Mr. JOHNSON of Texas. Thank you, Mr. Chairman. Governor, welcome.

Governor, as you well know, there has been a lot of debate when it comes to the real fair tax rate. And Mr. Bartlett argues the true rate is not really 23 percent but 30 percent. How would you answer that charge on a true rate?

Mr. HUCKABEE. Well, I think the economists are probably better equipped to get into the specifics. They are trained for that.

But I would say that one of the things that is being missed is that there is an embedded tax in everything that we purchase that is hidden. It is estimated to be approximately 22 percent of everything that we buy, because if we buy a loaf of bread, the taxes that were built in to the people who planted the wheat, harvested the wheat, manufactured the process, delivered it, all the taxes that go into the process are hidden. And the consumer doesn't know that that tax is embedded.

When that tax is taken out of the process, and it is paid at the consumption level, you already have a dramatically different situation, in terms of the price of the goods that will likely go down. Plus, when the consumer goes to purchase that item, the consumer is going with his or her entire paycheck. Most Americans have never gone to the marketplace with their entire paycheck. Their paycheck has all the extractions from the Federal Government, and they never see what their paycheck is.

But the other thing, it provides a more stable funding for Social Security, because it is based on the consumption that all of us make, not just the wages that wage-earners are making, which is, I think, another good reason for the fair tax to be a strong consideration.

Mr. JOHNSON of Texas. Mr. Bartlett, you care to respond?

Mr. BARTLETT. Well, it is very confusing. So if you just eliminated all existing federal taxation and it just disappeared forever, then clearly, all prices and wages would eventually fall by the amount of the tax, and you would be better off. But if you then put the tax back on in a different form, then the prices go back up again.

So, at times, the FairTax people make it sound like it's all a wash. Okay? You take out the income taxes, prices fall by 23 percent. You put a 23 percent tax on. Then everything is exactly is the way it is right now. No change in the price level.

But if that is true, there is no need for the rebate, because there is no regressivity to offset. Everything has been a wash. You get more take-home pay, you pay a little bit more at the checkout of exactly the amount that is now being withheld for the goods and services you buy. You are no worse off. So there is no need for the rebate because there is no regressivity. And the truth is that, obviously, there is regressivity. You can't have a consumption-based tax system without it.

And whether having some kind of monthly check that goes to every person in the United States is the way to deal with that is a debatable point.

Mr. JOHNSON of Texas. Well, you stated in your testimony that, given that tax revenues have averaged around 18 percent of GDP since World War II, what, in your view, would the fair tax have to be to generate that level of revenue?

Mr. BARTLETT. I honestly don't know, for this reason. For as long as I have heard of the FairTax, which is more than 20 years, they have always said that a rate of 23 percent would equal current revenues, and not increase them and not reduce them. But during that time period, revenues have been as high as 20.6 percent of GDP in the year 2000. And right now they are about 14.8 percent of GDP.

So, if it would equal revenues in 2000 at 23 percent, then it would have to be a massive tax increase today. Either that, or it never would come anywhere close to have equaled the revenues that we had in the year 2000. If they were honest, the rate would vary, depending on taxes as a share of GDP. But they always say, year after year, it is always 23 percent.

Mr. JOHNSON of Texas. Governor and Professor, would you care to comment?

Mr. KOTLIKOFF. Yes, I would. First of all, let me say I am not, you know, the fair tax guys that Bruce is alluding to. Well, I'm not one of them. I am a professional economist, okay? And I am here to talk to you folks as a professional economist, not as "the fair tax guy," all right? Let's just start there.

Now, a lot of—

Mr. JOHNSON of Texas. So you don't want to pay a fair tax.

Mr. KOTLIKOFF. What? Well, I want to tell you what I know, as an economist, okay?

Mr. JOHNSON of Texas. Okay.

Mr. KOTLIKOFF. And a lot of the statements that have just been made would not get through my course—that Bruce just made, and even a couple that Governor Huckabee made were not really appropriate about the fair tax, because we don't really think that the current tax system is embedded in prices. We don't think the current prices embed the current taxes.

We do think that if you put on a fair tax, prices will go up. If the Fed accommodates—we think the Federal Reserve determines the price level. It does.

Chairman CAMP. I'm going to have to stop you here, because the 5 minutes has expired. Mr. Rangel is recognized.

Mr. RANGEL. Thank you, Mr. Chairman, and thank you, experts, for sharing your views with us. But I just want to take this opportunity to thank Governor Huckabee. He was kind enough to invite me to his very popular TV show, and was more than fair to me in the differences that we had politically.

And I really thought I had you when I gave you the scenario of a debate between how you protect the vulnerable. And I put on one side the naked and the thirsty and the hungry and those who were jobless, and wanted to protect these people. They were unemployed and they were poor. And then I put on the other side that we can kind of protect them a little better if we made an appeal to the very rich, and kind of said, "Could you help us out a little bit to protect the vulnerable?" And I really thought I had you.

But you went to Divinity School, and you came up with some verses that I never heard of, where the rich were entitled to empower the whatever, humanity, and that the poor was here to stay. Could you restate that? Because most of that was done when I was asked to leave the show.

[Laughter.]

Mr. HUCKABEE. Congressman, it is a pleasure to see you again. I hope you will come back to the show.

But in the meantime, let me just say that what I believe you are referencing is—my understanding of the scripture is that—do we have an obligation to the poor? Absolutely. Should we reach out and help people and lift them up? Absolutely. One of my reasons for the advocacy for the fair tax is because I believe that, ultimately, it does more to give people the opportunity to rise above where they have come from.

I did not grow up with a silver spoon. I grew up dirt poor, paid my own way through college, paid my way through graduate school. First male in my entire family lineage to graduate high school, much less go to college. I have lived the American Dream, and I didn't live it by having all of the aspects of attempting to get

to the next rung on the ladder pushed back by a tax system that punished me for trying to get to the next rung on the ladder.

I feel a great sense of personal responsibility to help those who struggle, and continue to feel strongly.

Mr. RANGEL. But?

Mr. HUCKABEE. If I did not feel the tax system could be improved, I wouldn't be here today. I believe this approach does, in fact, empower the people at the lowest part of—

Mr. RANGEL. Well, thank you—

Mr. HUCKABEE [continuing]. the spectrum.

Mr. RANGEL [continuing]. Governor Huckabee. I am going to have to go back to the scriptures. Because if the tax burden is what I am talking about with the sick, the poor, and the lesser among us—

Mr. HUCKABEE. No, I don't—

Mr. RANGEL [continuing]. I got a learning to do. Mr.—let me ask the fair tax people, quickly.

This rebate this, does the rich get a rebate, as well as the poor?

Mr. TUERCK. Everybody gets the rebate, depending on the—

Mr. RANGEL. Very—okay.

Mr. TUERCK [continuing]. composition of their family.

Mr. RANGEL. That's good enough for me. How much—would the rebate be called an entitlement program, or what name would you have? Just "rebate"?

Mr. TUERCK. I think "rebate" does just fine. It's no more an entitlement than the existing—

Mr. RANGEL. No, okay, that's good. And that would mean that—would the governors operate the rebate, or the Federal Government?

Mr. KOTLIKOFF. Federal Government.

Mr. RANGEL. And who would pay the people to operate this massive trillion-dollar rebate to everybody, including the rich? Who would pay that?

Mr. KOTLIKOFF. I would leave the IRS in place until we got everything working.

Mr. RANGEL. Okay. Now, how about those who would eliminate the IRS completely?

Mr. KOTLIKOFF. Well, I think—

Mr. RANGEL. Because that goes over big in every community.

Mr. KOTLIKOFF. I think we've got to—you know, if you start picking on every little detail of—

Mr. RANGEL. No, no, that's not a—IRS is more than a detail in my community.

Mr. KOTLIKOFF. Yes, I agree. And I agree, and I think it's—all right, it's more than a detail. I think abolishing the IRS is not a clever idea, and not something I support—

Mr. RANGEL. Mr. Tuerck, do you agree that we have to keep the IRS?

Mr. TUERCK. No, I don't agree that we have to keep it. But somebody has to send out the checks.

Mr. RANGEL. Good. I just want to make certain I'm not the only guy out here. So, with you, we will have the IRS plus this massive program to give back money and not collect it. Right? Right. That's okay.

Mr. KOTLIKOFF. I would have the IRS hand out—yes, the rebate, exactly.

Mr. RANGEL. Oh, I see. They would be the giver and the taker.

Mr. KOTLIKOFF. Yes.

Mr. RANGEL. Okay.

Mr. KOTLIKOFF. The way they are now.

Mr. RANGEL. Mr. Bartlett, one question I want to ask you. Because when I saw your background, you worked for every Republican that I have ever served under, including my friend Jack Kemp, and Reagan, and Bush. And they gave tax cuts, and they said that these tax cuts paid for themselves, and went beyond that, and created jobs.

And yet, when you look at the ledger, it seems as though the tax cuts that were given by President Bush and Reagan actually were part of the deficit, and not the job creation. What were your observations?

Chairman CAMP. And if you could, just answer briefly because time has expired.

Mr. BARTLETT. Well, I think the Reagan tax cut in 1981, which I had some personal involvement with, was exactly the right thing to do under those economic circumstances. But I think it's wrong to assume that just doing the same thing over and over again, you're going to get the same results.

I think current economic circumstances, you would not get any economic benefits from any tax cut that I am aware of, because our fundamental problem is a lack of aggregate demand, and tax cuts are essentially passive.

Chairman CAMP. All right, thank you. Mr. Tiberi is recognized.

Mr. TIBERI. Thank you, Mr. Chairman, and thank you for holding this hearing today on the fair tax.

Professor, kind of expanding upon Mr. Rangel's questioning, can you envision—or how do you envision the Federal Government being involved—giving you a little bit of time to respond to this—in the manner of either sending out these rebates, or some enforcement mechanism? Is it the IRS, or is it something different? Either one of you, or both.

Mr. KOTLIKOFF. I mean I envision the states doing—the Federal Government working with the states to collect the tax, and the Federal Government, whether it's through the IRS or some other agency, mailing the rebate checks or distributing those to all Americans. So Bill Gates is going to get the same-sized check as somebody with his size family.

But the check is going to be big enough so that poor people won't have to pay any sales tax on net. That is very important. This is going to produce a zero net tax liability for poor people. That is one of the reasons why this is a progressive tax structure.

There is a table two in this testimony that we have that shows very clearly that Congressman Levin's statements about progressivity are not correct. It shows a very clear table of progressivity. It shows that Mr. Bartlett's statements are not correct, either, about the progressivity of the system.

Let me just say one thing about this which may get your attention. Suppose you have Warren Buffet here, and he has \$30 billion. Suppose that Mr. Rangel were sitting here in front of Mr. Buffett.

Mr. Buffett has \$30 billion. And you ask Mr. Buffett and Mr. Rangel, "Gee, Mr. Buffett, if you were to spend your \$30 billion today on 30 billion steaks, maybe you could buy them at \$1 a steak. How many steaks would you get?" Mr. Buffett would say, "Thirty billion steaks."

Now, Mr. Buffett, what if you had to face a 30 percent retail sales tax? How many steaks would you get? Well, you do the calculation, find out he had—got 23 percent fewer steaks. In effect, the sales tax taxes Mr. Buffett's wealth. That's why I keep saying that the sale tax is a tax partly on wealth and partly on wages.

So, are we taxing wealth right now under the current system? No. Mr. Buffett's wealth is not taxed. We don't tax principal. We tax the income from it. If Mr. Buffett actually realizes his capital gains, which he probably doesn't—he probably borrows against it to do consumption. So do a lot of other rich people.

So, you have to realize that the rich aren't paying a lot of taxes in the system—you know that as well as I, Mr. Rangel. But if you have a way to tax their wealth—and even if they don't spend their wealth today, whenever he does spend it he is going to be facing this tax. And present value, he is going to be out 23 percent of his wages. That's why the effective tax rate is 23 percent. That's the rate we need to use to compare the current income tax with the fair tax, because it's an apples-to-apples comparison.

That's why you want to look at the effective tax rate, not the nominal tax rate.

Mr. TIBERI. Let me try to take this back. The governor mentioned about the IRS, and mentioned about the—or mentioned the Tax Code, and how lengthy it was. This obviously is very much simpler than our current system. Would you need the current bureaucracy that we have in place? Wouldn't you just need something much smaller? Professor?

Mr. TUERCK. We have done some estimates of the impact on administration of the system. And it is vastly more expensive to have the existing income tax system, when you count all the compliance costs that taxpayers have to bear, compared to the fair tax.

The only reason the fair tax architects want the states to collect the money is because almost all states have a sales tax, and it would be a simple extension of that mechanism to collecting the fair tax and passing it on to the government.

But on the other hand, it would be perfectly okay too if the Federal Government could do it more efficiently. So I'm with Larry on that. Why not let them—whoever can do it more efficiently, they should collect the tax.

And I have to say one thing about Mr. Bartlett's comments. His analysis is a welter of confusion in mathematical error. There is no new burden on state and local governments. There is no burden on the Federal Government. There is no basis for the rebate in whatever happens to prices. The rebate is there to make—take this from a proportional tax to a progressive tax.

In fact, there is so much that we could begin with here as a baseline to—that would eliminate this confused thinking, that would take us much further along toward getting to a good answer to this problem. And I would hope that there would be a future hearing some time where your economists would look at the discussion that

has gone back and forth between Mr. Bartlett and me and Larry on this, and start from a baseline where we have at least the basic algebra correct. Thank you.

Mr. TIBERI. I yield back.

Chairman CAMP. Thank you. Mr. Stark is recognized.

Mr. STARK. Thank you, Mr. Chairman. Thank you for holding this hearing. I guess I have my credentials. Somebody down there said they were poor; I was, too. As a youngster—I never slept alone until I was married. And that defines how the Stark family got along in the deep depression.

The value-added tax, or fair tax, as you call it, I would just like to talk a little bit about why I would oppose it.

One, I would no longer be able to go to Europe and meet with American CPAs as they studied the value-added tax and complained about the complexities that it imposed on American companies. Those are nice trips, and they are interesting. But I would like to just talk about some of the issues that would affect the Uniform Commercial Code.

A transfer of title. Where do you pay the tax then, when the title transfers, or when you collect? How every lawyer who provides a service to a client would owe the tax, at the time he provided the service or she provided the service, not at the time when they collected the money. So, you would suddenly find an awful lot of our professionals—lawyers, dentists, others—who may not collect in cash on the spot suddenly owing tax immediately, yet not having collected the revenue to pay for it.

So, in dealing with the Uniform Commercial Code that we are used to in this country, bankers would have a problem getting title to goods to lend against. All of these things would have to be restructured for the value-added tax to work. And that is one of the problems that I see in providing this.

I wanted to ask the chairman if—is this a provision that might be in your suggestions for tax reform?

Chairman CAMP. We are——

Mr. STARK. You don't know yet, but——

Chairman CAMP. We are holding a number of hearings on tax reform, and this is one of them.

Mr. STARK. So this is just one of the things you are——

Chairman CAMP. Yes.

Mr. STARK. Okay. So, I don't know. I would ask Mr. Bartlett. What would you have to do to accommodate all of the changes in the way we conduct business in this country, if you had a fair tax or value-added tax?

Mr. BARTLETT. Well, it would be extremely difficult, but I presume we could get some guidance from other countries as to how they operate. And I believe that Mr. White from the GAO may be able to talk about that.

But let me make a point, a more general point, which is that one of the reasons why the FairTax is administratively difficult is because it will tax all services. Now, no state makes any effort to tax more than a tiny fraction of services because there is no tangible exchange. There is no good involved. So it is ridiculously simple to go to somebody who is doing some work for you, whether it is a lawyer or a doctor or somebody who is doing landscaping for you,

and say, "Let's just do this off the books. I will pay you cash," and there will be nothing for Uncle Sam, because there will be no records.

Mr. STARK. Well, it's also—in Europe, where they have it, they talk about tax collection. In other words, if the tax collector doesn't find you, you don't pay. So the European tax collectors have to run around from door to door, see if you bought a new car, remodeled your house, and then levy a tax and extract it from you. Here we still, for the most part, have a voluntary tax system. And I think, under a fair tax or a VAT, that would disappear and no longer—did—were—how many of you on the panel here have been paid for your research in the area of fair tax or value-added tax? Just two of you? Okay.

Governor Huckabee, you didn't collect anything for all the good work you are doing?

Mr. HUCKABEE. I have received not a penny from anyone associated with the fair tax. It is simply a position I have taken out of my wonderful charity for the United States of America, and my consideration for the fine Members of Congress.

Mr. STARK. Well, I want to thank you particularly for your kind words about me some weeks ago. I hope they don't come back to haunt you. And thank the witnesses for participating today. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Davis is recognized.

Mr. DAVIS. Thank you, Mr. Chairman. It was interesting, hearing the scripture tossed around here earlier. Different people try to fit these perceptions into their sense of world view. The thing I would remind everybody is we are told not to add to or take away from the Word.

And it reminds me of something the chairman likes to say: "The Tax Code is 10 times bigger than the bible with no good news."

[Laughter.]

Mr. DAVIS. Which brings me to a question when we relate to this issue of process, the huge cost of tax compliance. And compliance in any tax system is going to be an issue, because there are those who are going to attempt to comply with the plan in the most advantageous way to themselves, and then there are those who will simply try to skirt the system.

And I guess the question I would like to start with, Professor Kotlikoff, is because all systems have a certain amount of non-compliance, first, who is going to enforce the fair tax? And is this a job for—that current IRS employees might handle?

Mr. KOTLIKOFF. Well, I have nothing against the current IRS employees. I think they are pretty efficient. They come on the phone these days.

I mean, look. Lots of the—the vast majority of the sales are going to be in places like Wal-Marts, where there is not going to be much issue of compliance. So then the question is—and you are reducing dramatically the number of taxpayers, from 120 million down to 700,000.

So then the question is how do you go after—deal with compliance where somebody comes up to mow your lawn. And that kind of issue arises under the income tax. These people that are selling services aren't reporting their—for cash—aren't reporting their in-

come under the income tax. So the question is whether the evasion will be worse, and whether the compliance—the cost of getting people to comply will be higher.

We think the cost will be smaller. We think the evasion should be smaller, because we are going to have more people to dedicate to a smaller number of taxpayers to work on that problem.

But there is also some new ways you can think about dealing with evasion. I mean suppose you tell the home owner who is getting his lawn mowed: “When you get your lawn mowed, you are supposed to get a receipt with a bar code and the amount that you paid for the lawn.”

You are supposed to put that into the mail box, and also the person who mowed your lawn is supposed to put it in the mail box, so the IRS or whatever agency can then compare.

Mr. DAVIS. Just as an aside, would that not give us something similar to what we had to un-do with the 1099 situation earlier?

Mr. KOTLIKOFF. I do not know about the 1099 situation you are referring to.

Mr. DAVIS. I am referring to buried in the health care bill was that all business transactions over \$600 would require the filing of 1099s, which would have inundated the very retail outlets that we are talking about.

I am not sharp shooting you with the question, but coming down to a deeper process issue, any time we reduce complexity, we reduce cost of compliance, because the overhead component is reduced, and in that case, money in the economy.

I am just trying to understand how we would have a legitimate enforcement mechanism from a process standpoint—I am an engineer, not a politician.

I am interested in how the flow would work in order to cut that cost and——

Mr. KOTLIKOFF. The stores, the retail outlets, would be responsible for collecting the taxes and mailing it in.

Again, most of the sales collection or tax collection would be done by big outlets like Wal-Mart.

It is likely to be an easier collection process than we now have with millions and millions of taxpayers having to decide really what income they want to report under income taxes. It is pretty much a voluntary tax the way it is set up.

Nobody is checking my expenses or income very carefully from one year to the next. The Government is relying on me to be honest, basically, which I am.

Mr. DAVIS. Governor Huckabee.

Mr. HUCKABEE. What I would like to point out is there is an extraordinary amount of underground economy that is currently not taxed.

I doubt that many gamblers, prostitutes, pimps, and drug dealers are filling out 1040 forms and sending in their due tax.

When you base taxation on retail consumption, people who purchase things in the marketplace, even if they are drug dealers, prostitutes, pimps and others, are going to be paying the tax like the rest of us who honestly pay our taxes.

Dishonest people are still going to be dishonest. We have a greater level or mechanism of collecting tax, and the compliance issue is a huge one.

It has been estimated that as much as \$500 billion a year is spent just complying with the Tax Code in this country. That is money that does not produce a thing except paperwork.

That is why I think FairTax brings simplicity to a system that is overwhelmingly complicated.

Mr. DAVIS. Thank you all very much. I yield back.

Chairman CAMP. Thank you. Mr. Lewis is recognized.

Mr. LEWIS. Thank you, Mr. Chairman, for holding this hearing. I appreciate any opportunity we have to discuss comprehensive tax reform.

However, I must express my disappointment that we are not gathered here to discuss the most pressing issue of the day, the ongoing debt ceiling negotiation.

What worries me even more is that House Republicans seem to be making a habit of this.

Last week, the House Republicans allowed FAA authorization to expire, freezing airport projects nationwide, sending hundreds and thousands of hard working Americans home indefinitely.

We are just days away from August 2, yet we are here talking about everything but the debt limit. There seems to be no sense of urgency to help get Americans back to work.

Mr. Bartlett, you have been around for a while, in two Administrations. You are a very smart, gifted man.

Could you tell us about the dangers of not raising the debt ceiling, what it will really mean for workers and their families if we do not raise the debt ceiling?

Mr. BARTLETT. The worst case scenario, quite frankly, is that the financial markets will completely seize up the way they did when Lehman Brothers collapsed, except it would be far worse.

The market for U.S. Treasury securities is essentially the foundation upon which the entire world financial system rests. It is the one asset that everybody has always believed has zero risk of default.

You introduce into that system the tiniest little risk of default, and all of a sudden you have enormous problems.

The rating agencies have repeatedly said our debt may be downgraded, and this sets in motion a number of forces, because there are certain banks that are only allowed to hold AAA rated debt. If it goes down to BB, they have to get rid of some things.

There are many securities that use U.S. Treasuries as their backing. If the Treasury security falls in price, they have problems. It becomes a ripple effect that we may not know the full consequences of unless it happens.

Everybody thought the fall of Lehman—certainly the Treasury and the Federal Reserve—was not that big a deal, otherwise they would have bailed them out. They said let it go. We know what happened. Financial markets seized up.

I think we could see something potentially worse if we allow a default to occur.

Mr. LEWIS. Thank you very much.

Professor, do you care to respond?

Mr. TUERCK. Yes. I envision a meeting with the President and the Majority Leader of the Senate and the Speaker of the House in which they say we have come up with a way to raise more revenue, to increase the fairness of the tax system, and have spending cuts, too.

If you want to come up with that plan, adopt the FairTax. If you impose the FairTax rate at the statutory rate we have today, the Government would bring in about \$200 billion more than it is currently bringing in. That would be the new revenue.

We would create jobs, ten percent growth in jobs. Spur investment. Then we would have the revenue increases that the President wants, and we could get the spending cuts that the Speaker of the House wants.

That is the way to solve this problem. We could end this whole discussion right now, and I suggest that is the way we do it.

Mr. LEWIS. Let me ask your friend here who is assisting you.

Mr. TUERCK. I think I am assisting him, actually.

Mr. LEWIS. If a family of four at the poverty level lost the benefit of the EITC and child credit, had to pay 23 percent more for everything they purchased, would they really be better off?

Mr. KOTLIKOFF. That is addressed in table two, Congressman Lewis. Let me say my sensibilities about the poor are identical to yours. I think if you spent time with me, you would understand that I have the same views.

Mr. LEWIS. There are some numbers that came out today or maybe late last night that the gap has widened. The rich are getting richer and the poor are getting poorer.

Mr. KOTLIKOFF. I am concerned about that. I have cited this carefully. It is included in a framework where the EITC, the child tax credit, all the provisions of the Federal income tax are incorporated. I have done my homework on this.

In Table 2, if we look at the table, if we look at a married couple earning \$30,000—not Table 2—sorry, it is Table 2.

A family that is now middle aged, \$30,000. Their lifetime average tax rate under the current system is 15.3 percent. That incorporates the EITC and the child tax credit.

Under the FairTax, it is 3.4 percent. I did not know the answer before I did the calculation, just so you know. I did get paid for the research, but I did not know the answer, and the research is what the research shows.

I said let's take this framework, which is a lifetime life cycle framework. Let's look at the taxes that this couple is going to pay every year for the rest of their lives.

Let's figure out as a share of the present value of the remaining lifetime resources the labor income and their initial wealth, what is their tax rate, the average tax rate under the current tax system, and then let's do it again under the FairTax.

It turns out to be lower under the FairTax. If you look at the results in Table 2 of the testimony, you will see that this is actually a highly progressive tax, and it does lower the taxes on working people because it is coming up with another source of revenue, which is Warren Buffett's steak dinners.

That is what I am trying to get across here. This is embedding a wealth tax. If I came to you and said you Democrats here on this

panel, how would you feel about having a 23 percent effective tax on wealth and use the proceeds, a tax on all the wealthy people in this country, use the proceeds to lower the taxes on workers?

You would say that is fantastic, it will never get through. No Republican would ever propose it.

That is what Republicans are proposing in the FairTax. That is mathematical. You take any first rate economist from any top department, ask them that question, and he will say that is the answer.

Chairman CAMP. Thank you. Mr. Reichert is recognized for 5 minutes.

Mr. REICHERT. Thank you, Mr. Chairman.

Professor, I do agree with you. Mr. Chairman, thank you for holding this.

This debt ceiling discussion is certainly centered around as we watch taxes and spending, and I think everyone recognizes there needs to be tax reform. We would like a simpler Tax Code and tax process.

I think more than anything, Americans across this country recognize that we have a spending problem. We are spending money we do not have.

As we look at tax reform as a part of our economic solution, financial solution, I was listening to Mr. Bartlett who mentioned used houses were not taxed and new homes are taxed.

I want to ask the Professor and Mr. Bartlett what would be the impact to new construction of homes under this plan if used homes are not taxed and new construction is taxed?

Home buyers would be obviously directed toward buying used homes. Is that not correct? What would be the impact to new construction in the home buying industry?

Mr. KOTLIKOFF. The price of new homes would go up in the marketplace relative to—I mean old homes would go up in the marketplace, so it would lead to a capital gain on old homes.

That is why under the purple tax plan I have put forward, I tax housing uniformly, no matter whether it is new or old, by taxing the imputed rent, the consumption services from the housing.

Whether it is new housing or old housing, under the purple tax, which is a modification of the FairTax proposal, this problem that I see with the FairTax gets corrected, and we have a bigger tax base, and also tax imputed rent on yachts, private airplanes.

I think all consumption should be taxed. That is what is part of the purple tax.

I also deal with one of Bruce's concerns in the purple tax, if I might just take a second to mention it. He is concerned and I think there is a concern about evasion, because the tax rate under the FairTax is 30 percent, relatively high.

What I propose in the purple tax is to have a FairTax at 17.5 percent nominal rate, 15 percent effective rate, and then take the FICA tax and make that progressive. Get rid of the ceiling on the FICA tax and exempt the first \$40,000 of the employee part of the FICA tax from taxation. Get rid of the first \$40,000 employee based taxes or the first \$40,000 of earnings.

Now you have a progressive FICA tax, a lower rated FairTax, two progressive elements, and also a 15 percent inheritance tax. That is what the purple tax plan is.

I think we need to think broadly about consumption taxation. We can implement it in a lot of different ways. We should not say just because somebody is trying to talk about the merits and demerits of the FairTax, you are the FairTax guy, therefore, you are the enemy.

Let's try to understand what we really care about. We care about incentives. We care about fair treatment between generations. We want to make sure we can get our fiscal policy in order.

Mr. REICHERT. Professor, under a clean FairTax, this old versus new language would apply to homes, it would apply to boats, it would apply to yachts. Would it apply to commercial construction? Would your purple tax cover commercial construction?

Mr. KOTLIKOFF. No. Construction for buildings that are used in production of goods and services, that is not taxed. It is just consumption of goods and services by households and purchases of consumption items by governments and non-profits. All of consumption, what the national income accounts record as consumption. That would be the tax base.

I am saying take the FairTax, if you like the FairTax, think about maybe modifying it so that all of housing consumption services are subject to taxation, so that all the services from private jets and yachts are subject to taxation.

Mr. REICHERT. Used cars, new cars?

Mr. KOTLIKOFF. I have an excise tax I have to pay every year to my local town in Massachusetts; yes.

Mr. REICHERT. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Bartlett, one of the arguments our Republican friends have made here over decades is that tax cuts pay for themselves.

I noted in the blog you recently wrote that indeed, you suggest that tax cuts do not pay for themselves.

As a Treasury official who served with President Reagan, can you explain to the committee why you do not believe that tax cuts pay for themselves?

Mr. BARTLETT. First of all, nobody in the Reagan Administration said that the Reagan tax cut would pay for itself. The documents that the administration sent to Capitol Hill in February of 1981 all showed standard revenue losses based on Joint Committee/Treasury methodology that has been around forever.

In fact, if you check Congressional Budget Office documents from that time period and keep in mind the CBO was then headed by Mrs. Rivlin, I believe, it showed revenue losses almost identical to those projected by the administration.

The argument that we were making when I was working for Jack Kemp was that you would not lose as much as the static revenue loss because if you got some growth in the economy, that would enlarge the tax base and you would get back some of that money.

Eventually, Larry Lindsey, an economist who is probably known to this committee, wrote a book and he concluded you got back

maybe a third. You lose two-thirds. I think that is pretty standard public finance theory.

The only tax cut that I have ever heard anybody credibly assert pays for itself is occasionally you can cut the capital gains tax. But that is because capital gains involves gains that may have taken place over a long period of time, and if you realize them all at once, then you can get an unlocking effect and possibly pay for itself.

In general, tax cuts lose revenue. I do not know anyone who really argues that point.

Mr. NEAL. Thank you. Governor Huckabee, the Treasury Department and the Joint Committee on Taxation have concluded that a rate significantly higher than 23 percent would be necessary for FairTax to be fiscally neutral.

I cite the examples of Joint Tax and Treasury because they tend to be made up of Democrats and Republicans who in the next life want to be known for their honesty, as they secure a position in the private sector.

They have suggested that—by the way, they are not paid for their advocacy, as you know, other than by the taxpayer—rate would actually have to be closer to 50 percent to make up for lost revenue.

I have listened to Dick Armey and others over many years talk about transition costs, and they are substantial.

Mr. HUCKABEE. I have never heard the 50 percent figure, and I think that would be frankly one of the issues that one of the economists could better address.

I do know that politically speaking, the simplification of the Tax Code would be much preferable to a Tax Code that is beyond anyone's comprehension.

What I believe is without the ability to refute is that the complications of our current Tax Code make it so that business owners no longer are making business decisions. They are making tax decisions.

Mr. NEAL. Even Dick Armey, as the Majority Leader, stated as he offered his sales tax proposal at the time, which is a bit different than what we are discussing here—Dick Armey used to say not only would there be a substantial transition cost that was slightly enormous, but he also stated we had to be in the vicinity of 28 to 30 percent.

Mr. TUERCK. Congressman.

Mr. NEAL. Yes, just a moment for me to question Professor Kotlikoff, but go ahead.

Mr. TUERCK. I would make this simple. Our research is on line. It is simply a matter of going to the National Income and Product accounts and going through the statute and figuring out what the base is, and then figuring out what the rate is.

We could all sit down over a spreadsheet and resolve this question in a few minutes. To be more realistic, in a few days.

We came up with a rate of 23.82 percent for a hypothetical 2007 tax year. We re-did the calculation and in 2010, we think a lower rate would work.

It is not rocket science. It is simply getting the base correct, which we think we have done. I would like to see the other calculations that lead to a different rate.

Mr. NEAL. Professor Kotlikoff, I appreciate your testimony. You mentioned the phrase "transitional cost." That is a fair statement. There is a transitional cost, and that has been part of the discussion we have had for a long period of time.

You mentioned lawn care as an example. Are you satisfied in Wellesley, Sudbury, Gloucester, Haverhill, Springfield and Worcester, these people there cutting lawns during the Summer, they are all currently complying with IRS regulations?

Mr. KOTLIKOFF. No, I am sure they are not. I am saying we have to think out of the box. Technology is available now, I think, to help us to enforce even their paying taxes.

Chairman CAMP. Time has expired. Thank you. Dr. Boustany is recognized.

Mr. BOUSTANY. Thank you, Mr. Chairman. I am glad we are having this hearing. I am finding it helpful given that I am certainly getting a lot of calls from constituents back home in Louisiana about the FairTax. I am finding this very helpful to flesh out some of the issues.

I want to explore the issue of small business compliance and potential burdens on small businesses if we go to this type of tax system.

Right now, we are very concerned about jobs and job creation, especially with small businesses, as we look at our economy.

Mr. Bartlett, as I understand it, small businesses across the U.S. would be responsible for collecting this FairTax. In addition, small businesses would have to maintain certain segregated accounts for the payment of taxes, and larger sellers would actually have to provide a security deposit equal to or greater than \$100,000 or 1.5 times the seller's average monthly tax liability during the previous six calendar months.

Given all that, if we went to this type of system, talk to me a little bit about the compliance burden on small businesses and the impact this might have on jobs.

Mr. BARTLETT. It is hard to say what the impact on jobs would be. There is no question there will be a vast increase in the compliance burden on small businesses. Basically, to reduce the compliance burden on individuals, you have to increase it on businesses.

They are the ones who are going to be responsible for being the IRS' tax collectors. They are going to have to collect the revenue and transmit it to the Treasury.

As we know, we already have enormous problems in that area, in the small business area, where they are having great difficulty complying with the taxes. It is very well known.

They have to collect already Social Security and payroll taxes and transmit them. And often times, small businesses need that cash flow and they use it to cover other expenses, and they end up being in trouble with the IRS.

There is no question there will be an increased burden on small businesses. No question.

Mr. BOUSTANY. Thank you. Professor Kotlikoff?

Mr. KOTLIKOFF. Under the FairTax proposal, you are getting rid of the FICA tax, so they will not have to comply with that.

I presume they would be able to get software that would help them deal with segregation of the accounts.

I do not see this as a huge thing. I go to a lot of small stores. They are in operation, even though they are paying the Massachusetts' sales tax when I buy something.

This is just going to be an extra sales tax that is collected. It is going to be the software's job to get this right. It is not going to be the actual owner, that he is actually going to have to do calculations. It will all be automated, I believe.

The Federal Government can certainly assist small businesses with that technology if need be.

Mr. BOUSTANY. Governor Huckabee, you have traveled around the country a great bit and spoken to many, many people across this great country of ours. Have you heard those concerns in the context of FairTax among small business owners?

Mr. HUCKABEE. Congressman, small business owners love the FairTax because of the simplicity of it. Right now, they are eaten up with complying with an incredibly impossible to understand Tax Code that requires them to hire lawyers and accountants at a good deal of their profit.

The FairTax means anyone can figure out 23 percent. It does not take a lawyer and accountant to come up with figuring that.

This idea that it is complicated, I would contest that. I think it is quite the opposite. It is the simplicity of it that causes small business owners, with whom I have spoken all over the country, to embrace this, because they would rather put their money into putting products on the shelves and employees on their floors as opposed to sending checks to accountants and lawyers in order to help be a part of this half a trillion dollar compliance cost that we currently have with the 67,000 page complex Tax Code.

Mr. BOUSTANY. Thank you. Professor Kotlikoff, the goal of the FairTax is to remove the taxes embedded within prices and replace them with a clear simple tax of 23 percent.

Give me a little breakdown again on the price/wage issue. It came up earlier.

Mr. KOTLIKOFF. The notion that prices in the current system, tax system, embed the current tax system, is not correct. Supporters of FairTax have come up with that proposition. It is not based on economics. It is just not right.

The basic story is this, there is a price level, a price for let's say a chicken, and the retail price level is set by the Federal Reserve by how much money it has in the economy, and what is going to happen is if we went to FairTax, workers would receive more pay in their checks because they would not have to pay the FICA tax or the income tax. They would also get the prebate check.

Then they are going to go the store, and the prices will be 30 percent higher, as Bruce indicated, that is correct, and then the question is are they worse off or better off.

The answer is if you look at Table 2 and other calculations, you find out that working people, poor people, are better off. They pay less taxes over their lifetime, measure of present value lifetime tax rate, under this FairTax system, than they do under the current system. They also have lower marginal effective tax rates.

The marginal effective tax rate on saving becomes zero under the FairTax. Our national savings rate is zero this year—last year. It was 15 percent in 1965. We have driven it down to zero.

That is why we are importing so much capital from abroad, from China and other places. That is why we are running the current account deficits we are, because our national saving rate is so low.

You have better incentives and more prospects for growth from this system.

As David was indicating, having no corporate income tax, and as the Governor was indicating, is going to be a great boom.

Chairman CAMP. Thank you. Time has expired. Mr. Becerra is recognized.

Mr. BECERRA. Thank you, Mr. Chairman. Thank you all for your testimony. It is a great conversation to have, and we will need to have a conversation like this if we ever hope to be able to reform the Tax Code, although I am not sure how fair this so-called "FairTax proposal" is. It is converging more on the fairy tale side of fair than real fairness.

My understanding is there is no country, no state, that has ever implemented anything along the lines of this so-called "FairTax proposal," probably because it is unworkable for the reasons that have been discussed, and that I think Mr. Neal pointed out.

How do you get compliance up to a point where you really have everyone paying truly their fair share.

Mr. Bartlett, I know you have done a number of studies on this. I know you worked in the administration and Government and outside of it in the past.

Are you familiar with any country or any place in the world ever where a proposal like the so-called "FairTax proposal" has been put in place?

Mr. BARTLETT. No country to my knowledge has anything remotely like this. They have studied the idea of something like a FairTax, and in every case they concluded that a value added tax makes more sense if that is the route you want to go.

Mr. BECERRA. That is because it is a lot easier to try to get compliance.

Mr. BARTLETT. I do not want to jump on what they will be talking about on the next panel, but the VAT is easier to administer and much harder to evade because it is embedded in the prices.

Let me make another point, which is——

Mr. BECERRA. Very quickly.

Mr. BARTLETT. There are no two states that have exactly the same sales tax base, and no state has a sales tax base that is anywhere near as comprehensive as the FairTax.

Mr. BECERRA. Take a state like mine, California, which has a fairly high sales tax rate, but it is still under ten percent. To buy a house in California, you are looking at \$200,000 to \$500,000, depending on what part of the state you live in, to have to pay a 30 percent tax on top of the price of that home, or whether it is just to buy a computer or car, all of a sudden, you are calculating 30 percent more on a tax.

If you go to a state like Virginia that has a far lower sales tax than my state of California, I think it is around five or six percent, you go to 30 percent, all of a sudden, somebody making \$50,000 is looking at how you purchase that house or that new dishwasher or clothes washer, it makes it a little bit more difficult.

As interesting a conversation this is, it is still academic. We are a week away from something that is not academic, and that is this whole discussion of whether or not the country will pay its debts.

I am hoping I can get you all to concentrate a bit more on the revenue aspect of this crisis that has been manufactured, because the reality is we have always found a way to get past this issue of paying our bills, yet this time, it seems like we have hit an intractable resolution to this.

Mr. Bartlett, you wrote an interesting article recently, where you talked about what happens when you deal with the Tax Code, tinker with the Tax Code, and make it sound like it is going to do one thing and have it do something totally different.

Back in the early 2000s, we were running budget surpluses. President Bush at that point told us we could actually reduce the size of those surpluses by returning money to the American people for the taxes they had paid because we had these massive surpluses, \$5.6 trillion in surpluses over the coming ten years. These tax cuts were passed.

You wrote this article that points out that not only as a result have we drained the Treasury of trillions of dollars of revenue, which now makes these deficits far larger, but at the same time, we did not see the commensurate growth in the economy that would help produce jobs that would help produce more revenue by people paying more taxes.

Can you comment a bit on what you found?

Mr. BARTLETT. Yes. There is an article in the New York Times this morning on exactly that point. I note that according to the CBO, the Bush tax cuts reduced Federal revenues by about \$3 trillion below what they would have otherwise been, and you got about another \$3 trillion loss of revenues due to slower than expected economic growth. And then you have about \$6 trillion of additional spending for unpaid wars and various things of that sort.

You went from a \$6 trillion surplus to a \$6 trillion deficit, which is a turnaround of \$12 trillion.

I think the argument is very commonly made that we cannot raise taxes because it will destroy the economy. That same identical argument was made in 1982 when Ronald Reagan put forward the largest peacetime tax increase in American history. We had massive growth thereafter.

The same argument was made in 1993 when President Clinton raised taxes. We had a very strong economy.

The argument for the Bush tax cuts, at least one of them, was we would have faster growth. We had the worse ten years, economic years, since the Great Depression.

It seems at least superficially the relationship is the opposite. Higher taxes actually raised economic growth and tax cuts caused the economy to collapse.

I am just saying you can make that argument based on history.

Chairman CAMP. Thank you. Dr. Price is recognized.

Mr. PRICE. Thank you. I want to thank the panelists as well. This has been an exciting conversation to have. I want to commend the chairman for holding this hearing because I think it is important to talk about solutions, and I believe this is one of those types of programs that could truly be a solution for our country.

The current tax system, as so many have said, is incredibly broke and it is remarkably complex. The costs of compliance are massive. It has the Government picking winners and losers, which all of us say we do not want, which makes the FairTax, I think, the national retail sales tax, remarkably attractive.

It is simpler. The cost of compliance is less. It certainly is much more fair.

As the Governor pointed out in his comments, we say we want success. We say we want hard work. We say we want vision. We say we want entrepreneurship. We say we want savings. We say we want job creation.

Yet, in our tax system, we punish every single one of them. Every single one of them. Again, I think that makes the FairTax something that we all ought to take a very serious look at.

It rewards savings. It rewards hard work. It rewards entrepreneurship. It rewards job creation.

In addition, it does a couple of things that I think are important to point out. One is that it captures all the underground economy that we currently are not capturing right now. That is estimated to be a third of our economy by some folks.

It would decrease the cost of doing business by 23 percent, virtually overnight. I beg to differ with Mr. Bartlett. I will touch on that in a moment.

It is a less regressive system. It is more fair to individuals at the bottom end of the economic spectrum.

I am excited by having this conversation. I am concerned that some to be imprisoned by their past deeds and comments. I am enthused and excited by folks actually gaining a greater understanding of what I believe to be, as Mr. Tuerck said, a solution to the challenges that we have right now.

Mr. Bartlett mentioned that the proponents of this say that it decreases the cost of services or goods by 23 percent, adds in 23 percent, so the consumer sees basically a wash, which I think is accurate.

Why on earth would you need the rebate if that is so? The fact of the matter is we believe the rebate is appropriate because the current system is unfair. The current system is remarkably regressive and punishing those individuals at the lower end of the economic spectrum.

That is the reason the rebate is needed, and then those individuals actually have a much more fair system.

Mr. Tuerck, I want to touch on Table 2, because I think it is incredibly important.

Mr. Tuerck. Which table? I am sorry.

Mr. PRICE. Table 2. This is the one that talks about lifetime tax rates. This is for young adults, middle aged, seniors, married, individuals, single households.

For every single line that you have here, whether it is \$10,000, \$50,000, \$100,000, \$250,000, et cetera, for every single line compared to the current system and their lifetime tax rates compared to the FairTax, every single one of them has individuals paying less under the FairTax system. Every single one. How can that be?

Mr. Tuerck. First of all, that is Larry's table, so I am going to ask him to comment on that.

We did our own calculation and we broke individuals down by spending deciles, which is in a way mirroring Larry's own approach, and what we find is that the people in the lowest spending deciles would all gain, and more so over time as the economy expanded, and the people who would lose were the ones in the top spending deciles.

That reflects current economic thinking about the way to address the progressivity/regressivity issue.

I would only add to that I wonder what this committee would say if somebody walked into this room and said I have a plan for broadening the base, cutting the rate, and by every economic standard imaginable drilling the economy, what do you think about that?

That is what the FairTax does. It has a broader base, and therefore, it has a lower rate, and if you read any economics textbook, I do not know whether you believe them or not, but if you read them, moving toward a consumption tax un-taxes net investment and expands the economy.

Mr. PRICE. I could not agree more. Mr. Kotlikoff, everybody here wins. How is that possible?

Mr. KOTLIKOFF. There is a tax on wealth associated. This is really a tax, on what happens to workers, what happens to their lifetime tax payments as a share of their lifetime labor income.

It assumes some wealth holdings, but the super wealthy in this country, a lot of them do not pay any taxes, and they would pay taxes under the FairTax.

Whenever they buy their yachts or their jets, homes, cars, villa's, they would pay taxes on what I am proposing on the imputed rent from those services, from those durables. When they bought expensive restaurant meals, they would pay tax.

This is a Democrat's fantasy, this proposal.

Chairman CAMP. Thank you. Time has expired. Mr. Thompson is recognized for 5 minutes.

Mr. THOMPSON. Thank you, Mr. Chairman. I have a couple of questions on the particulars of the FairTax, that maybe one of the professors could answer.

Internet purchases would be taxed?

Mr. KOTLIKOFF. Yes, if it is consumption.

Mr. THOMPSON. Would churches be taxed?

Mr. KOTLIKOFF. Consumption, non-profits; yes.

Mr. TUERCK. Church payments to their employees would not, as I recall. I can get that answer to you. I may be wrong on that.

Mr. THOMPSON. Churches would or would not be taxed?

Mr. TUERCK. To that extent. As I recall, I will have to check, payments to their employees would not be taxed.

Mr. THOMPSON. The taxes to their employees would not be, but any of their purchases would be?

Mr. TUERCK. That is correct. That is what I recall.

Mr. THOMPSON. Corporations, how are they handled? They are taxed?

Mr. KOTLIKOFF. There is no corporate income tax. Corporations are not buying consumption.

Mr. THOMPSON. No corporate tax. What if I worked for a corporation and the corporation buys me my car. Is that purchase taxed?

Mr. KOTLIKOFF. I think the way the FairTax would handle that is it would assess taxes and the corporation would have to affirmatively show that this was used for business purposes.

I think they would take the money at the dealership, the tax would be charged.

Mr. THOMPSON. From who? Who would they take the money from?

Mr. KOTLIKOFF. From the corporation that buys the car. They would send the corporation excise tax for the car, and then the corporation would have to show this was actually used for business purposes.

Mr. THOMPSON. If I am not working for a corporation and went down and bought a car, I would be taxed?

Mr. KOTLIKOFF. Again, I am proposing the taxes on durables, on homes, cars, be done like an excise tax, computed rent, tax on what we call the imputed services from these durables, like the car, you would be paying each year. You pay a tax on it.

Mr. THOMPSON. I just am having a hard time understanding how this is at all progressive if I as a regular person buy a car and I am taxed but the corporations avoid that.

Mr. KOTLIKOFF. Corporations—

Mr. THOMPSON. Let me finish my question so you know how to answer.

Mr. KOTLIKOFF. Yes, sir.

Mr. THOMPSON. If I worked for a corporation, somebody else, I guess nobody pays the tax, and people who get meals, computers or cars from their employer, which would probably be wealthier people, getting back to what Mr. Lewis was talking about, that division between the rich and the poor, they would be—

Mr. KOTLIKOFF. I see your concern. I think the way to handle that would be to basically tax the purchases. If the corporation pays to give lunch to its employees, that should be subject to tax.

Mr. THOMPSON. It sounds pretty confusing.

Mr. KOTLIKOFF. If it buys lunch for its employees, it should be subject to taxation.

Mr. THOMPSON. It does not look very progressive nor very fair to me. Everyone gets the same rebate and everybody pays the same tax rate, unless of course, somebody else is buying your stuff for you, then you get a break.

Mr. Bartlett, you had talked about the problems associated with default or the threat of default and what this would do to our economic system.

Would higher interest rates be part of this?

Mr. BARTLETT. People on Wall Street, and there is a report out from J.P. Morgan that has been widely cited, have said that interest rates would probably rise by about 60 basis points. That is .6 percentage points in the event of a default.

I really think that focusing on interest rates may understate what really may happen. My great fear is a complete nuclear-type meltdown.

Mr. THOMPSON. I do not want to understate. I just want to point out that if it is a little bit or a lot, that means car loans, the price of a car loan goes up, the price of a home loan goes up, the price of a small business loan goes up.

This all impacts regular people working, trying to make a living. It would be an incredible increase on them personally, on their finances.

The article that you referenced, I was trying to read through it. You talked about what is commonly called the “Bush tax cuts,” and you mentioned that they did not pay for themselves.

Did they bring us a higher rate of economic growth?

Mr. BARTLETT. No, they did not.

Mr. THOMPSON. They did not pay for themselves, and we did not see any economic growth as a result of those Bush tax cuts?

Mr. BARTLETT. That is correct.

Chairman CAMP. Thank you. Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chairman, for holding this hearing, and thank you all for being here. I find this very helpful, and I am sure the American people do, too.

As our committee continues to hold hearings on fundamental tax reform, one motivation we have behind our efforts is to stimulate economic growth through lower taxes and to lessen the burden on the taxpayers, and to reduce complexity.

FairTax advocates have claimed that after implementation of the FairTax, the economy would grow at 10.5 percent. Exports would grow by 26 percent, and investment by 41 percent, and employment would be nine percent higher, and that real pre-tax wages would increase by 11.5 percent.

I would just like each of the panel members to maybe comment for us about the claims and why they believe that we might see increased exports, increased employment, and growth in GDP and investment in the economy.

If the Governor would like to go first.

Mr. HUCKABEE. There has been a lot of talk about this system would be complex. The reality is it is not complex, not compared to what we have now.

Are there some complications? Of course, there are. Always when I say if we compare the complications to the complications of the current Tax Code, I cannot imagine how anyone would defend the current Tax Code against the proposals of FairTax, which is in its worse description much simpler.

The reason that some of these numbers that the economists have come up with—again, as I said at the beginning, I do not pretend to be the chemist, just the pharmacist, I cannot tell you how they arrived at some of the numbers, but I trust their numbers are carefully researched.

It makes perfect sense to me that if you simplify anything, it is going to be less expensive.

The reason so much of what you see in the FairTax is effective is because it does simplify things for the individual, who now stays up until midnight rushing down to the post office on April 15 trying to get the tax form in the mail, or generally goes to a tax preparer, and hopes they get it right, and often CPAs are trying to figure out every year all the changes in the Tax Code that may come from this city.

Would it not be much simpler if in fact there was a pretty straightforward approach, here is the percentage of tax on the things you purchase.

It is the transparency of it that makes it more effective. When I hear people say things will cost more, we cannot even say that unless you equally say people show up at the marketplace with their entire paychecks, something they have never done before.

It is not going to change dramatically except for the people at the lowest end of the economic spectrum, as has been pointed out. They are going to come out better off.

Ms. JENKINS. Thank you.

Mr. KOTLIKOFF. Congresswoman, the calculations for the growth of the economy are based on simulating a large scale life cycle model that takes into account people's incentives, but also what we economists call "income effects."

We have to realize that this decline in the national saving rate that has occurred over five or six decades now, has corresponded to a major increase in the absolute and relative consumption of the elderly.

There has been a huge transfer from young savers to old spenders, systematically, through time, through the retirement programs we have been running.

If you really want to understand why consumption has gone up, why national saving has gone down, why investment has gone down, it has to do with this redistribution from the young savers to old spenders.

Why are people who are older spenders? They are closer to the end of their lives.

When you have the FairTax and you go to a consumption tax, the older people hold disproportionate amounts of the wealth, they are going to be hit with a relatively higher tax burden, so their consumption is going to be reduced relative to that of younger people.

Part of the advantage of FairTax is it un-does some of the redistribution away from the young towards the old that we have been engaged in in this economy, and it gets the older people to consume less, and consequently, the total economy consumes less, saves more, and there is more investment. More funds to be invested.

In addition, there are better incentives to save because you move away from an income tax which discourages saving to one that is neutral with respect to consuming today versus tomorrow.

The third thing is that you eliminate the corporate income tax, so that companies, international companies, are thinking about whether to invest here or there, gee, if we invest in the U.S., there is no corporate income tax any more.

These three elements are the main reason why you see in these simulations some very significant effects through time. It is not supply side magic. It is not that at all. There is no supply side gobbledy-gook here. I am not a supply side nut.

I think a lot of those folks have done a lot of disservice to economics. This is just old fashioned economics that delivers the goods if you actually look at what has gone on in terms of who gets what under this system.

Ms. JENKINS. Thank you. I yield back.

Chairman CAMP. Thank you. I also want to thank Governor Huckabee for being here before I recognize Mr. Pascrell. I understand you have a plane to catch.

I would just say some members may wish to submit questions in writing to you that have not had an opportunity to question you, if you could be kind enough to respond in writing, and they will be part of the formal hearing record.

Mr. HUCKABEE. Mr. Chairman, I would be delighted to. I want to thank all of the members for the opportunity to be here. I wish I could stay. Unfortunately, the airlines will not hold the plane for me. Maybe for you, but not for me.

Chairman CAMP. No, that is not the case at all.

Mr. HUCKABEE. I appreciate very much the opportunity to be here, and thank you for your kind attention.

Chairman CAMP. Thank you very, very much, Governor. Mr. Pascrell is recognized.

Mr. PASCRELL. Mr. Chairman, I have heard a lot mentioned today of the current tax system. I certainly hope that the two of you remain. Of course, you are not speaking for the poor.

We have had a lot of people come in front of us that want to make life a lot better for the poor. We have seen it over decades.

I do not have to bring to your attention the figures that came out this morning, and the gap has grown greater, and this foolish proposal that is before us makes the matter hideous in my eyes.

The poor and the middle class do not make the Tax Code Moby Dick.

Two thousand of the 2,300 pages are there because folks who have want to keep what they have. They have every right under the law to do that.

The Tax Code. A lot of folks have to hire lawyers to keep what they have. It is a shame they have to hire all those lawyers.

You are saying that if we put this into effect in this nation, we will not go through that.

The tax cuts of 2001 and 2003 did not increase employment in the United States of America. Did not increase productivity in the United States of America, the trickle down that was promised then is promised now and has never worked.

Why in God's name do we continue on that path which does not make any sense? Further more, it was not until 2005 that we even increase the revenue. Right, Mr. Bartlett? Is that correct?

Mr. BARTLETT. I believe that was the first year that revenues, nominal revenues, were higher than they had been in 2000.

Mr. PASCRELL. Then we saw what happened after that.

Mr. BARTLETT. We had a crash.

Mr. PASCRELL. Let's be clear. A national sales tax would be nothing more, in my perception, than an enormous windfall for the very wealthy of this country. Plain and simple, the wealthy do not spend as much as lower income families and the middle class. They just do not, as a percentage of their income.

Mr. Bartlett, how much more would the national sales tax have to be in order to be revenue neutral? How much more would it have to increase?

Mr. BARTLETT. Actually, you have a panelist on the next panel who can answer that better than me, Rosanne Altshuler, who was a chief economist for the Bush administration's Tax Reform Panel. They did calculations on exactly this subject that showed you—

Mr. PASCRELL. What did they conclude?

Mr. BARTLETT. It depends on how much evasion you think you would get if it was about the same as the median state, 39 percent or 47 percent.

Mr. PASCRELL. My next question is this, what would be the effect on the debt? Someone asked you about this very briefly before. If we were to create the largest entitlement program, and it would become the largest entitlement program, it would supersede Social Security and Medicare, if we had this prebate program they are talking about in FairTax, what would happen to the debt of this nation?

Mr. BARTLETT. The prebate is in the base. They have calculated that cost. It is not over and above.

Mr. PASCRELL. What does it do to the debt?

Mr. BARTLETT. It would increase Government spending is what it would do.

Mr. PASCRELL. What would it increase the debt exactly?

Mr. BARTLETT. The estimates of the cost of the rebate that the Bush Tax Reform Panel made were there would be upwards of \$800 billion a year.

Mr. PASCRELL. What did President Bush say about this plan, by the way? Back in the mid-2000s.

Mr. BARTLETT. About the FairTax?

Mr. PASCRELL. Yes.

Mr. BARTLETT. I do not know that he ever said anything about it. I could be mistaken. He certainly did not endorse it. He did not endorse his own tax reform.

Mr. PASCRELL. As a former Reagan Treasury official, how many times did Mr. Reagan raise the debt ceiling?

Mr. BARTLETT. It was either 17 or 18 times, I believe.

Mr. PASCRELL. Can you briefly explain how the value of a Treasury note affects the life of every day Americans?

Mr. BARTLETT. As I said before, it is the foundation upon which much of the financial system rests.

If you go to the market to sell corporate bonds, for example, they are historically priced off the equivalent Treasury. It is absolutely essential to have some asset for which there is no default risk in order to establish prices for a great many other financial products.

Chairman CAMP. Thank you.

Mr. PASCRELL. Thank you, Mr. Bartlett.

Chairman CAMP. Mr. Paulsen is recognized.

Mr. PAULSEN. Thank you, Mr. Chairman. I appreciate the panelists taking the time to talk about consumption tax. We have had a multitude of hearings in the Tax Committee laying the foundation for tax reform.

This is the first chance we have really had to engage in some of the consumption tax ideas, and FairTax being one.

I like some of the concepts that were brought forward about the transparency, about driving investment. We are all, I think, in favor of promoting job creation, which is so desperately needed when we have 18,000 jobs coming out a month.

I do have some concerns. Tell me how this would work. The impact of tax reform for those who are already retired is something we are paying attention to, and how do you encourage retirement savings in the long run.

If the FairTax gets implemented, how do you transition or move forward for the folks that have already essentially worked all their lives and paid income tax. They move into a new system where now they are going to pay under consumption, and they only have their retirement savings.

How do you kind of make that work for them? Mr. Kotlikoff, first.

Mr. KOTLIKOFF. It is a good challenge. You have people with 401(k) accounts who have not paid taxes yet on those balances. I think you would have to tax those during the transition so we would get the right amount of revenue from them, a fair amount of revenue from them, and not just give them carte blanche or scott free.

You have to have that occur. Capital gains that have not been realized, I think they would have to be realized and subject to taxation.

You are immediately taxing consumption. Again, I think it should be all consumption, including imputed rent on housing and other durables.

Is this going to absolutely help everybody? It is not going to be a free lunch; no. I am saying the people who are really going to get hurt differentially are the rich.

If I came here and told Mr. Pascrell that I was advocating a tax on wealth, using the tax revenues to lower the tax on wages, you would think I am a pretty far left person, economist. You might. Some other people might.

I am saying please let's talk after the hearing and converse, and let me try to persuade you what economics has to say. There are lots of things said about the FairTax that is not about economics. Lots of statements that are not being made by economists.

It is a really progressive tax structure. I think it is more progressive than the current system.

Mr. PAULSEN. Mr. Tuerck, do you have any follow up on that, just in terms of retirement savings or promoting retirement savings as a part of the Tax Code?

Mr. TUERCK. I am currently drawing down some of my pension, which I did not pay taxes when it was being accumulated. Now the IRS is taking a chunk of that as I draw it down. In my case, it would be a wash.

Either I am going to let the IRS grab a chunk of it and I might end up paying more for consumption goods because the price has gone up. It seems to me it is neutral in that respect.

Larry makes a persuasive argument and he does it better than anybody else that this is a tax on the wealthy. I think there would be people who have saved over their lifetime who would find this is a burden, and that is part of his argument, as I understand it.

Mr. PAULSEN. I know you have characterized it as being a tax on the wealthy. Governor Huckabee had to leave. I think there is an exemption for educational services as part of the proposal.

How do you avoid having a situation where folks come forward and say, we would like to exempt this? How do you avoid that in the long term?

Mr. KOTLIKOFF. What I propose, no exemptions of any kind. I am an educator and I am urging that we tax educational expendi-

tures. I think a good chunk of what people pay for in college is consumption, not education, from what I can tell.

The rebate is there to deal with concerns about proclivity. If somebody says look, let's exempt bread and eggs. Well, the rebate is here to make sure that poor people, anybody living at the poverty line or lower, is going to have enough money from the rebate to cover all their FairTax payments at the store.

So that would be the way that you can try and avoid having the tax undone. And the whole idea of the FairTax is to have one tax break that everybody can look at and say everybody is paying this tax rate, so that if we spend more money on anything or anybody, that tax rate has to go up.

Under the current system, nobody knows when we spend more money down here in congress who's paying the bill. The whole connection, the whole value of having a single tax rate has to do with trying to connect our spending to our revenue source in a very concrete manner.

Chairman CAMP. All right. Thank you. Mr. Larson is recognized.

Mr. LARSON. Thank you, Chairman Camp, and thank the panelists for being here this morning. Let me start, first of all, with Mr. Bartlett; and I know others have gone down this line of questioning. But defaulting on the federal debt I believe you said would be analogous to what transpired when Lehmans went down, except on—perhaps Lehmans on steroids. In the Reagan Administration you took a balanced approach, both in terms of dealing with debt ceilings but also making cuts, but also balancing them off of revenues. Is that pretty much how this current situation should be approached?

Mr. BARTLETT. Well I personally would favor a balanced approach. I think one of the biggest problems we have right now is that revenues are too low. They are less than 15 percent of GDP and have been for the last three years. So if there is any truth to the idea that low taxes spur growth, we should be growing like crazy, and obviously we are not. We have other problems.

One point I would like to make that hasn't really quite come out here is when Professor Kotlikoff talks about the importance of national savings, he is of course correct, but the deficit is negative saving. Therefore, if we raise revenues in such a way as to reduce the deficit, that will add to national savings; and, that was what happened, frankly, during the Clinton Administration. That is why we had budget surpluses and the added saving is what created a lot of the economic growth that I wish we still had.

Mr. LARSON. Another question that comes up often, and I'm glad that we have two economists here, et cetera. And let me say I think the current system that we operate under is flawed.

Mr. Neal has been trying to simplify this system for some time now in a number of his proposals, but there's a debate that rages on here with respect to the very fragile recovery that we're in in terms of both cuts and taxes. Now, people will say, and I don't disagree with them, that raising taxes at this time in a frail economy is not a wise thing, because of the fragility.

Is cuts a wise thing, or do cuts result in hurting a fragile economy. Do cuts that result in layoffs and people on unemployment

and furthering what has to come out of the federal proceeds, how would you categorize those as the difference between the two?

Mr. TUERCK. You mean cuts in spending or cuts in taxes?

Mr. LARSON. Cuts in general; taxes, you know, being raised or cuts to programs that lay off people.

Mr. TUERCK. I'm sure that all spending cuts hurt people, and in many cases people that we don't want to hurt. But the problem is that we're having the wrong conversation. I personally don't have a clue as to whether canceling some of the Bush tax cuts would affect the economy one way or another, but I do know that we have a hopelessly convoluted tax system where we can't get the base straight, when what we ought to do is we ought to change the base into a consumption base, so that then we know that we're on taxing and growing the economy.

Mr. LARSON. Let's say that could be if we would be willing to look at a hybrid. Or how long of a transition period do you think that that would take?

Mr. TUERCK. I think that the transition would require a lot of adjustments.

Mr. LARSON. How long would you say that might take?

Mr. TUERCK. I think we could transition to a FairTax within a year or two.

Mr. LARSON. Within a year?

Mr. TUERCK. Yes.

Mr. LARSON. And during that time, what would you do with the existing tax system?

Mr. TUERCK. Well the existing tax system would go away and we would then impose the tax on consumption to replace those revenues; and the date we impose it, if the statutory 23—

Mr. LARSON. So I'm trying to figure this out. Just so within a year's time we would move out of the Internal Revenue system and go to a collection of consumption taxes; and how would that end up in a neutral situation. Don't you think you ought to give yourself a little more time than that?

Mr. KOTLIKOFF. I give it as much time as needed.

Mr. LARSON. Well then let me ask you this, because that's where I was leading. I would think that you would need more time. Would you be willing to put in your consumption tax and have that consumption tax be dedicated only to reducing the deficit as you try to figure out just in fact what its implications will be and have an economic model that's out there?

Mr. KOTLIKOFF. Well, as I've indicated, I have this proposal called the Purple Tax, which retains the FICA tax, makes it progressive, very progressive, as a FairTax that basically half the level, at a 15 percent effective rate, and has an inheritance tax of 15 percent.

So 15 percent solution is a very simple tax structure. I think it is more progressive than the current system. I think it will generate at least two percent more of GDP than the current system. We need more revenue. So why don't you folks pass that today?

Mr. LARSON. But as you are working the modeling out with that specific tax, would you let that money all go while you are running almost tandem systems to reduce the national debt?

Chairman CAMP. All right. Time has expired. Mr. Marchant is recognized.

Mr. MARCHANT. Thank you, Mr. Chairman, and I appreciate the fact that the chairman is having these hearings with the goal of a simpler Tax Code, a lower tax rate, and as a result of that having increased revenues to the government. I think that that is something this panel should discuss at length and I appreciate the fact we are doing that.

I would like to talk about an average family in my district and how this FairTax proposal would affect that family. Let's say it is a man and wife. They are both working. One is a school teacher. One is a fireman. They have two kids. They have a gross income of about \$8,000 a month. Will they have any FICA tax withheld?

Mr. KOTLIKOFF. No FICA tax.

Mr. MARCHANT. Will their employer have FICA tax?

Mr. KOTLIKOFF. No FICA tax.

Mr. MARCHANT. So their income would go up about 7½ percent. Their take home would be about 7½ percent higher.

Mr. KOTLIKOFF. Well, it would be 15.3, because the employer portion is also going to be available to be handed out to the employee.

Mr. MARCHANT. Is that in the proposal?

Mr. KOTLIKOFF. Well economists think the employers aren't paying our taxes for us out of the goodness of their hearts. We think workers pay both the employee's share and the employer's share. And then when you eliminate the FICA tax, all 15.3 percent is going to end up in the hands of the employee.

Mr. MARCHANT. Okay. And so then whatever tax rate they had, let's say 20 percent.

Mr. KOTLIKOFF. Right.

Mr. MARCHANT. Will they lose their mortgage deductions?

Mr. KOTLIKOFF. Well there won't be any mortgage deductions, because there won't be any income tax against which you can adjust it.

Mr. MARCHANT. There shall be no income taxes so perhaps they'll get 25 percent. Maybe they will get \$20,000 of income tax they won't pay.

Mr. KOTLIKOFF. Yeah. And this Table 2 in this testimony dealt with all the issues of mortgage deductibility and the earning of tax credit and the child tax credit.

Mr. MARCHANT. Well a lot of the people that are going to be watching this hearing in my district are not going to have the ability to have those tables. So would their take-home pay be as high as \$20,000 more a year?

Mr. KOTLIKOFF. Well, you know, it is a hypothetical. I don't want to be imprecise and give you the wrong answer to that specific question. But if we looked at the table that I have here, which was—what was the income of the family?

Mr. MARCHANT. Around 4,000 each a month.

Mr. KOTLIKOFF. So we are talking about 8,000. So we are talking about—

Mr. MARCHANT. About \$96,000.

Mr. KOTLIKOFF. A hundred thousand a year, so let's look at a married couple who's 45 with a couple kids and a house, a mod-

erate size house, mortgage deduction. They are currently paying 24 percent of their lifetime resources to the Federal Government in FICA and income taxes under the current system. Under the FairTax, it would be 14.7 percent.

Mr. MARCHANT. I am trying to talk about their month to month.

Mr. KOTLIKOFF. Yeah. Their month to month take home pay would go up.

Mr. MARCHANT. So will this family qualify for a prebate?

Mr. KOTLIKOFF. Everybody gets a prebate. Yes, they would.

Mr. MARCHANT. So what number of checks would the Federal Government be cutting a month?

Mr. KOTLIKOFF. One month to that family based on their household size.

Mr. MARCHANT. Okay. So how many is that? Would that be a hundred million rebate checks a month?

Mr. KOTLIKOFF. Well, yeah. It might be 130 million checks. Every American household will get a check.

Mr. MARCHANT. So adding to the in the last—

Mr. KOTLIKOFF. You could send electronically, by the way.

Mr. MARCHANT. Right. I understand. And then when they go to the grocery store they are going to pay 23 percent more.

Mr. KOTLIKOFF. Well, they pay 30. The nominal rate is 30 percent. In effect every dollar that you spend, 23 cents out of that dollar is going to go to taxes. So that's what it cost.

Mr. MARCHANT. How about utilities?

Mr. KOTLIKOFF. Yeah. That's also consumption.

Mr. MARCHANT. Rent.

Mr. KOTLIKOFF. Rent, yes.

Mr. MARCHANT. Gasoline.

Mr. KOTLIKOFF. Yes.

Mr. MARCHANT. So everything that they consume then they will pay the extra 23 to 30 percent on.

Mr. KOTLIKOFF. Yes.

Mr. MARCHANT. And the theory being that this family, together with the amount of money that they keep, that they were paying plus the prebate are going to come out.

Mr. KOTLIKOFF. Better off.

Mr. MARCHANT. Better off or hold?

Mr. KOTLIKOFF. Better off. And I didn't know the answer to the question until I did the calculations. And this is my best judgment based on pretty careful, serious. You know. It wasn't a two-day study, either.

Mr. MARCHANT. Well, I have a tremendous number of people in my district that support the FairTax. I've read every book that I can available on the FairTax, and the prebate is my single largest mechanical problem that I haven't been able to work through, but this will help me in answering the questions that I get on that.

Chairman CAMP. All right. Thank you. Time is expired. Ms. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman. I want to go back to the prebate, rebate, whatever the acronym is for that, but I am not sure that I understand exactly how the information gets to the government to identify what their income is. If you don't have an

income tax, how does the information get from the employer to the government to know what that salary is and how to figure that?

Mr. TUERCK. It doesn't have anything to do with the salary. It has to do with the composition of the family, whether it is a married couple, how many kids they have. And then that is a mechanical formula. And once that is determined, then that determines the size of the prebate, the philosophy being that if that family were at the poverty level they would pay no taxes under the FairTax.

Mr. KOTLIKOFF. So the prebate doesn't depend on your income. If you have a family of four, you get one size demograph. That is the word that Pat Moynihan used to use, I believe, when he advocated the negative income tax, he quoted a demograph, a monthly payment. So if you have got a family of four, you get one size. If you have got a family of three, it would be a smaller check, but it wouldn't depend on your income.

Mrs. BLACK. So then how does that help those who are at the lower income?

Mr. KOTLIKOFF. Because for people that are low income, it is going to be a much bigger deal than for Bill Gates as a proportion. So progressivity is always tax is a proportion of resources, and so that's why this would be progressive as conventionally defined in terms of what progressivity means.

Mrs. BLACK. All right. That makes sense. That clears that piece up. This may or may not be a question that you as an economist can answer, but I am curious. In all of the information that I have here I can't find anything that indicates what percentage of those are not paying any tax whatsoever at this point in time. We keep hearing there is about 47 to 50 percent of the people who pay nothing. Is that something that you can help with?

Mr. TUERCK. Close to 50 percent of individual taxpayers pay no personal income tax. That is correct, close to that.

Mr. BARTLETT. Yes, that is correct. But I want to make a point here that is relevant to your point, which is that if you are right now at a poverty level income, you have a negative tax because of the earned income tax credit. You get a check from the government and pay zero. Okay? And for most people in the bottom quintile, that rebate or the EITC is more than enough to compensate for your payroll taxes as well. So that you are literally paying zero, but you may still be getting more on top of that.

But just keep in mind that if you are under the FairTax, if you are now at the poverty level income, the rebate compensates you for your consumption, but you are going from negative to zero, which is a tax increase, you see. You are not getting the EITC anymore. And keep in mind also, there is a lot of confusion about the difference between consumption and income.

If you look at the Consumer Expenditure Survey, you will see that people in the bottom quintile spend about twice as much as their income. So the tax base that applies to consumption for people with low income is going to be higher, precisely because a lot of those people are the elderly who are drawing down saving.

That's the point Professor Kotlikoff keeps getting at when he talks about taxing wealth. That's basically where the incidence of that wealth tax comes from.

Mr. KOTLIKOFF. Let me respond, if I could.

Mrs. BLACK. Yes, thank you.

Mr. KOTLIKOFF. We have I think some segment of very poor people who might, because the EITC might end up with a somewhat higher tax rate, but at the table incorporated the EITC. And there is not a whole lot of selves here where the average tax rate actually goes up under the FairTax. It basically goes down. There is a lot of very poor people that don't get the ITC because they don't have kids or they're not working.

We have to also think about in terms of the tax burden on older people, poor older people, the older people are going to get this rebate, just like everybody else; and their social security benefits are also going to be CPI indexed. So they're going to get an extra bonus here, because when the price level goes up, their Social Security benefits are going to rise by 30 percent, and then they are also going to get the rebate.

So this is actually going to redistribute toward the poorer elderly away from the rich and middle class elderly, and get a bigger burden, tax burden on the rich and middle class elderly; and, therefore lower the burden on younger people. We have had a mass of redistribution away from younger people towards older people. That is a large part of this deeper conversation we need to have about how to fix the fiscal system of the country.

Chairman CAMP. All right. Thank you. Mr. Reed is recognized.

Mr. REED. No questions.

Chairman CAMP. All right. Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman. Two questions: one question is on stability.

I mean what we want is a revenue source that is stable. That is how we need to plan, and I guess my question is how would you compare the stability of, again, just one of the new consumption tax versus our current revenue.

Mr. TUERCK. Well consumption taxes are going to be more stable than the current tax system, because consumption is more stable of the economic cycle than income is. I don't have—maybe Larry's done some estimates of the difference it makes; but, we found for example, that if you have the 23 percent FairTax in effect in 2010, which is obviously a period of depressed economic circumstances, then we would have brought in more revenue than needed in order to pay the government's bills; and that's just largely because consumption was better than the rest of the economy.

Mr. KOTLIKOFF. Well, I concur with that. The consumption is more stable than income. It is more stable than investment, so it is a more stable tax base and more reliable.

Mr. BERG. Then my follow-up question really relates to the transactions that would be conducted by local and state government. I understand the individual, but as we go into local and state government, and they're paying an additional 23 percent tax, how does that filter through the formula.

It seems to me that they're not paying income now; they would pay this. And so many of them are exempted now, but that would have an increased cost in local services or state services.

Mr. KOTLIKOFF. Well in our calculations for revenue neutrality, we incorporate paying back, compensating the governments state

and federal for the extra taxes that they're going to incur. So that the idea is to keep this revenue neutral and not to force governments to have a bigger burden through the back door.

Mr. TUERCK. It is a little tricky. The tax base at the state and local level would go down, slightly, and that would represent a temporary boon to state and local taxpayers. But the states and local governments could compensate for that by adjusting their Tax Codes. They would have to do that, but an easy fix, for example, would be for the state to impose its own sales tax on top of the FairTax rate.

That would adjust for that part of the problem, and then they might have to also make some adjustments in their income tax rates. At the end of the day after everything was worked out everybody would be whole. Everybody would be where they started out.

Mr. KOTLIKOFF. Let me just say we spent with several other economists at Suffolk University, we spent a good part of the year very carefully trying to figure out what tax rate would be relatively neutral. And we didn't know the answer before we sat down, and whatever the answer was going to come out, we were going to report it. And so when other people testify about the sales tax, let's make sure that the methodology was the same.

I mean we use the same methodology as Bill Gale, who is a major critic of the sales tax. He reviewed our study. He said it is the same methodology. There are some different assumptions here and there, but I think this is a very careful study. It is on line, available to anybody to look at.

Mr. BERG. Thank you. Thank you, Mr. Chairman.

Chairman CAMP. Well, thank you, and I want to thank our first panel for their testimony today. It has been very helpful, and I hope we will be able to engage with you as we continue this discussion on fundamental tax reform.

Members may wish to submit additional questions to you in writing for inclusion in the formal record, and I would just ask that you be prompt in responding to those questions if you do receive them. Again, let me thank you again for being here today, and I would now invite our second panel to come to the witness table.

We are pleased to welcome our second panel, which features six individuals who are highly regarded as experts in value added taxes. First I would like to welcome and introduce Mr. Michael Graetz. Mr. Graetz is the Columbia alumni professor of tax law at Columbia Law School, and is a professor emeritus of law at the Yale Law School. In addition to his teaching career, Mr. Graetz served at the Treasury Department from 1990 to 1992.

And, second, we will hear from Rosanne Altshuler. Ms. Altshuler is a professor in the economics department at Rutgers University. She has previously served as the director of the Urban Brookings Tax Policy Center as a Senior economist to the President's Advisory Panel on Federal Tax Reform in 2005, and as a special advisor to the Joint Committee on Taxation.

And, third, we welcome back Robert Carroll, a principal with Ernst & Young's quantitative economics and statistics group in the National Tax Department. Before joining Ernst & Young, Mr. Carroll served as the deputy assistant secretary for tax analysis at the Treasury Department.

And, fourth, we will hear from Jim White, the director of tax issues for the U.S. Government Accountability Office. As a Director of Tax issues, Mr. White is responsible for work on IRS, tax administration and tax policy. He has been with GAO since 1990.

And, fifth, we welcome Dan Mitchell, a senior fellow at the Cato Institute. Prior to joining Cato, Mr. Mitchell was a senior fellow with the Heritage Foundation and previously served as an economist for the Senate Finance Committee. And, finally, we welcome back Simon Johnson, the Ronald A. Kurtz professor of entrepreneurship at the Massachusetts Institute of Technology. He is also a senior fellow at the Peterson Institute for International Economics in Washington, D.C., and from March 2007 to August 2008 Mr. Johnson was the economic counselor and director of the research department at the International Monetary Fund.

Thank you all for your time today. The committee has received each of your written statements, and they will be made part of the formal hearing record. Each of you will be recognized for 5 minutes for your oral remarks. There will be a yellow light one minute out in which you can sum-up before the red light comes on.

Again, I look forward to hearing from all of you. Mr. Graetz, we'll begin with you. You are recognized for 5 minutes.

**STATEMENT OF MICHAEL J. GRAETZ, COLUMBIA ALUMNI
PROFESSOR OF TAX LAW, COLUMBIA UNIVERSITY**

Mr. GRAETZ. Thank you, Mr. Chairman. Thank you, Mr. Levin and Members of the Committee for inviting me to testify on this important subject.

We know our tax system is broken. Nobody argues with that. The question is what should we do about it. Until World War II we had a consumption tax on most Americans, and an income tax only on high income individuals. And it was only the revenue needs of the Second World War that extended the income tax to the masses. Today, the U.S. is a low tax country, but we are not a low income tax country. So we have sacrificed our advantage from our low taxes by having income taxes that are comparable to those of other nations in the OECD.

The biggest difference between the U.S. and everybody else in the world is that we have no national level consumption tax, which 156 nations, at last count, do have. We know the problems with the income tax. The congress uses the income tax the way my mother used to use chicken soup—as a solution to every ill facing the country. We know that we haven't solved the nation's health problems. We haven't solved the nation's education problems. We haven't solved the nation's energy problems, despite the many billions of dollars a year in tax deductions and credits that go in those directions. The Tax Reform Act of 1986 was a great success; it gave the income tax a good cleansing, but it has not proved stable. We can cleanse it again, as many people have proposed, and as most of the conversation around this committee has suggested over the last couple of years. But we know that the Tax Code is going to get dirty rather quickly again.

The other thing that has happened since the 1986 Act is that we are now a world economy. Given the internationalization of the world economy, in my view, we need to have a low income tax, par-

ticularly a low corporate tax rate in order to attract jobs to the United States, to attract investment to the United States, and to allow American workers and businesses to compete worldwide.

I have advanced a tax reform plan in my book, *One Hundred Million Unnecessary Returns: A Simple, Fair and Competitive Tax System for the United States*. I am certainly happy to get a copy for any member or staff person that would like to read it. I know some of you have. Let me just review the pieces of my proposal.

First, add a value added tax, which is basically a retail sales tax with withholding. The idea that you would not have withholding on an income tax strikes me as foolish. We are the only OECD country that does not have a value added tax. Sometimes it is called a goods and services tax.

Second, use the revenues from that tax to finance an income tax exemption of \$100,000 and to lower substantially the rates above that amount. Third, lower the corporate income tax rate to 15 percent; and, fourth, replace the earned income tax credit and provide low and middle income families with tax relief from the VAT burden through payroll tax offsets and through debit cards that allow them to avoid VAT on their purchases.

This plan has many advantages over existing law. It would be more favorable to savings and investment, and economic growth in America. It would take advantage of our status as a low tax country: a 15 percent tax on corporate income would be among the lowest in the world. It would solve the problems of transfer pricing, and other tax planning that goes on in the international community.

Third, it would eliminate more than a hundred million of the 140 million tax returns the IRS gets every year. 150 million Americans would never have to face the income tax. Fourth, there would be less temptation under such a small income tax for Congress to view tax exclusions, deductions and credits as if they were solutions to America's problems. We know they're not.

Fifth, a value added tax would be border adjustable under WTO international trade rules, which means that it could tax imports and exempt exports, which an income tax cannot. Given the size of our trade imbalances, we would likely produce hundreds of billions of dollars in additional revenue from taxes on imports alone over the next 10 years.

Sixth, it would avoid most of the difficult issues of transition that virtually all of the other tax reform proposals have. And, finally, by using taxes that are common throughout the world, it would fit well with international standards.

The Tax Policy Center, pursuant to a contract with the Pew Charitable Trust, has estimated the plan. They've determined some preliminary numbers. They have given me permission to share them with the committee today. Basically, they estimate that for the year 2015, my plan is revenue neutral with a value added tax of under 12½ percent, a 15 percent corporate income tax rate, a 16 percent tax on married couples between \$100,000 and \$200,000 of income, and a 25 or 26 percent rate on families above \$200,000. This shows that you could dramatically reduce income tax rates.

My proposal is also distributionally neutral; that is, unlike the so-called FairTax, it does not shift the burden of taxes down the

income scale. Given its widespread application around the world, it is clear that the U.S. can readily administer a value-added tax. I have been working over the last two years with a number of VAT managers, accounting firms, and law firms around the world in an effort to design a model value added tax for the United States. And I would be happy to share some of that learning with the committee.

[The prepared statement of Mr. Graetz follows:]

**Statement of Michael J. Graetz
Professor of Law, Columbia Law School
At a Hearing of the House Ways and Means Committee
on Tax Reform and Consumption-Based Tax Systems
July 26, 2011**

Mr. Chairman and Members of the Committee---

It is a great pleasure for me to have this opportunity to testify again before this committee, especially on such an important subject¹.

Our nation's tax system is badly broken. No one quarrels with that. The economic distortions due to our income tax law are numerous and substantial. The only area of the economy where the tax system creates jobs is tax return preparation and software, tax planning, tax controversies and tax compliance. Astounding income tax complexities confront taxpayers at every income level. They sow confusion and create the perception that the well-advised escape paying their fair share of taxes. All of this, in turn, makes a tax system that depends as heavily as ours on the goodwill and honesty of the American people ever more vulnerable to deliberate noncompliance.

In a recent report, the National Taxpayer Advocate, Nina Olson, estimated that individuals and businesses spend 6.1 billion hours a year—full-time work for more than 3 million employees—on tax compliance alone. I am surprised the number is that small. The Form 1040 instruction booklet spans more than 100 pages and the form itself has more than 10 schedules and 20 worksheets. No wonder more than 60 percent of income tax filers hire tax preparers and so many of the rest rely on computer programs to tell them what to do. The tax profession is not inventing new drugs or medical devices, streamlining manufacturing or creating useful new products. They are not, to borrow the President's phrase, helping this nation to "win the future." Even low and moderate income Americans waste enormous amounts of time and dollars complying with the income tax, time that could be much better spent with one's family, dollars that might pay for rent, utilities, gasoline, or groceries.

Although the income tax now affects nearly everyone, that hasn't always been so. It wasn't until World War II that the federal government expanded the income tax beyond wealthy individuals to tax nearly all middle and moderate income Americans. Seventy years later, this system is badly broken and unable to produce adequate revenues for the future without threatening economic growth. Relying as heavily as we do on income tax revenues to fund our government has become a liability in the current international marketplace.

¹ I am appearing here today on my own behalf, expressing solely my own views, not those of any institution or group with which I am or have been affiliated as an employee, counsel, or academic advisor.

In a world now immeasurably more interdependent than the mid-twentieth century, when our current system of taxation took shape, a vital question for any reform proposal is: Will it make American workers and businesses more competitive in the global economy, while maintaining the progressive structure that fits with our nation's historical insistence on fairness?

When it comes to meeting its funding requirements, a government has four basic choices as to what it can tax: income, wages, consumption or wealth. From these four basic categories of revenue, we in the United States have since World War II chosen two—income and wages—as our primary forms of government funding. While it is true that our Federal government has at one time or another imposed more than fifty kinds of taxes on everything from filled cheese to cotton futures, from telegraph messages to the manufacture of tires, none of these revenue streams could ever suffice to fund today's government budget. Put together, our individual and corporate income taxes along with our payroll tax on wages account for more than 90 percent of federal revenues annually. State and local governments rely on their own versions of these taxes in addition to taxes on sales and property. And while the federal government imposes a handful of excise taxes—on alcohol, tobacco and gasoline, for example—unlike the rest of the world, we do not have a national tax on the third category, consumption.

U.S. Reliance on the Income Tax

Overall, the U.S. is a relatively low tax country. But we are not a low income tax country. Looking at total taxes including federal, state and local taxes, as a percentage of total economic output (GDP) the U.S. at about 25 percent (including state taxes) has considerably lower taxes than the EU, which averaged about 40 percent before the recent addition of 10 new lower-tax members, mostly from eastern Europe. Our taxes are also lower than the approximately 36 percent of GDP average of the thirty countries of the Organization for Economic Cooperation and Development (OECD).

Our income tax level is comparable, however. We typically collect about 12 percent of our GDP in corporate and individual income taxes, while the OECD nations average about 13 percent. The biggest difference in our tax structure is that most other nations rely much more heavily on consumption taxes than we do: 11 percent of GDP in the OECD compared to less than 5 percent in the U.S. Indeed, we are the only OECD nation that does not impose a national level tax on sales of goods and services.

Although an income tax was used to help finance the Civil War, it did not become a permanent part of our nation's financial picture until World War I. The corporate income tax dates from 1909, but it was not until after the 16th Amendment was ratified in 1913 that a tax on individual incomes was enacted.

From the end of the Civil War until 1913, the federal government raised its revenue almost exclusively from tariffs on imported goods and excise taxes on this or that. By the beginning of the 20th Century, however, there was great dissatisfaction with this system. Tariffs and excise taxes raised the costs of goods for everyone, while large fortunes accumulating in real estate, corporate stock and other investments were left untaxed. The income tax was adopted—with the extraordinary public support necessary to amend our constitution—to fund a reduction in tariffs and to counterbalance the effect of taxes on consumption with a tax more closely linked to people's ability to pay. When first enacted, the income tax was expected to contribute only a small portion of ordinary government revenues and to supplement other revenue sources in times of emergency.

So the income tax was not originally supposed to play the central role in financing the federal government that it now does. Until World War II our income tax had exemptions that shielded most Americans from having to pay it. The income tax played a crucial role in financing World War I, but after that war ended, the tax was rolled back to its original limited scope. From 1918 to 1932 only 5.6 percent of the population filed taxable income tax returns, and from 1933 to 1939 that number dropped so that on average only 3.7 percent of the total population filed taxable returns. Public opinion polls in 1938 and 1939 showed large majorities of Americans favored an exemption level that would exclude at least 75% of the population from income taxes. Thus, through the economic shocks of the Great Depression and the creation and expansion of the New Deal, the reach of the income tax remained quite limited: true to its original conception, it was a low-rate tax on a relatively small group of higher-income Americans. But World War II changed that.

Legislation in 1940 and 1941 increased the number of Americans subject to the income tax by 400 percent, from 7.4 million to 27.6 million. After the U.S. entered the war, the number of income tax payers expanded dramatically. By 1943, taking into account both the regular income tax and a so-called "Victory Tax" (a 5 percent tax on incomes over \$624) 50 million Americans—nearly 70 percent of the population—were required to file income tax returns.

Our nation's basic tax structure—with its reliance on income taxation of the masses—came into place, therefore, in the World War II era, when the United States essentially had all the money there was. Even a horrid tax system – with income tax rates up to 91% – could not then stall our economic progress. From 1946 through 1973, when OPEC quadrupled the price of oil, the economy grew by an average of 3.8% a year and unemployment averaged 4.5 percent. Since 1973, our economy has grown more slowly and so have the wages of middle income Americans. Now, the United States' economy must compete for the investment capital essential for economic growth – capital necessary to produce a rising standard of living for the American people – with many countries throughout the world, including not only Europe and Japan, but also countries

such as Brazil, Russia, China, and India. Now, the venerable New York Stock Exchange can be transformed virtually overnight into an enterprise with a majority ownership in Germany and headquartered in the Netherlands. This was unthinkable when our nation's tax system was designed.

As we now know, the imposition of the income tax on nearly the entire population has led to perverse results in terms of complexity. It has also badly distorted presidential and congressional policy making.

One reason that our current individual income tax is such a mess is because our elected officials ask it to do too much. Presidents and members of Congress from both political parties have come to believe that an income tax credit or deduction is the best prescription for virtually every economic and social problem our nation faces. In the process, we have turned the Internal Revenue Service from a tax collector into the administrator of many of the nation's most important spending programs.

To keep track of all the tax benefits, the federal budget each year is required to contain a list of "tax expenditures," defined as all tax credits, deductions or exclusions that deviate from a "normal" income tax. The basic idea is that many tax benefits are substitutes for and the equivalent of direct government spending. According to a February 2011 report of the Staff of the Joint Committee on Taxation, the number of these tax expenditures has grown enormously since 1986, from 128 to 202. The JCT staff also points out that, once enacted, no matter how ineffective or distortive, tax expenditures "tend to stay in place." Their total cost in lost revenues is estimated to exceed \$1 trillion a year.²

When we talk about tax expenditures, we are not talking here about narrow special-interest tax loopholes. Mostly, these are tax breaks widely available to broad segments of the general public—tax cuts for the large population of middle and upper income folks. The largest tax expenditures are very popular: tax advantages for employees' payments for health insurance and retirement savings, deductions for home mortgage interest, state and local taxes, and charitable contributions, and low or zero rates on capital gains.

And yet we know that trying to solve the nation's problems through "targeted tax breaks" typically does not work. Take health insurance, for example. Our nation, contrary to others throughout the world, has long relied on a tax benefit for employers and employees as its main mechanism for covering Americans who are neither poor nor aged. What has been the result? Our health-care costs are the highest in the world and about 50 million Americans have been uninsured. Moreover, these costs make American businesses and products less competitive in the world economy and gobble up wage increases of

² Staff of the Joint Committee on Taxation, "Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-15-11, February 28, 2011.

American workers. Nor have our tax-based energy tax breaks produced better results. Nor do tax credits for working parents produce affordable childcare. I could go on and on, but I shall not.

Historically when competing policy ideas aimed at a common goal emerged in Congress, the leaders of the tax writing committees would fashion a compromise provision. Now, Congress often compromises by enacting *all* of the ideas, leaving unsophisticated taxpayers bewildered about how to cope. For a vivid illustration, consider the income tax incentives for paying for higher education. There are eight tax breaks for current year education expenses: two tax credits, three deductions and three exclusions from income. Five other provisions promote savings for college expenses. In 1987, there were only three provisions encouraging college expenditures or savings. The 1997 Act alone added five provisions that were estimated to cost \$41 billion over five years; together they represented the largest increase in federal funding for higher education since the GI Bill.

Comprehending the tax savings provided by these provisions, their various eligibility requirements, how they interact, and their recordkeeping and reporting requirements is mind-boggling. Each of the provisions has its own eligibility criteria and definition of qualified expenses. For example, they do not provide consistent treatment of room and board, books and supplies, sports equipment and related expenses, other nonacademic fees, or the class of relatives whose expenses may be taken into account. A student convicted of a felony for possession or distribution of a controlled substance is not eligible for one of the education credits, but such a conviction is no bar to another one. And this is just the tip of the iceberg.

Relying, as we do, on income tax deductions and credits is about as successful a solution to our national needs as handing out more gunpowder at the Alamo. We must be weaned away from using tax deductions or credits as a cure-all for our nation's ills. But the largest tax expenditures are very popular with the public. To be sure, they may be trimmed: a floor on deductions here, a ceiling or haircut there, but I am convinced that the only path to real tax reform success is to remove most Americans from the income tax altogether.

Proposals for Income Tax Reform

The tax reform proposals most prominent today would reprise the 1986 Tax Reform Act and attempt only to improve the income tax. To be sure, the 1986 Act was a major improvement. It substantially increased the permissible amount of tax-free income; lowered and flattened income tax rates; shut down mass-marketed tax shelters for high income individuals; and curtailed the ability to shift income to lower-income family members subject to lower tax rates. However, an increase in corporate tax revenues was used to finance an overall reduction in individual income taxes (even though, by cutting back on deductions

for plant and equipment, Congress found enough money to reduce the corporate tax rate from 46 to 34 percent). Hundreds of scatter-shot "transition" rules were enacted to give special tax breaks to particular companies or individuals.

Since 1986, Congress has amended the code annually, adding thousands of pages of new legislation. In retrospect, the inherent weaknesses of the 1986 Tax Reform Act have become easy to identify. First, despite the tremendous leadership and ingenuity of President Reagan along with the chairmen of this committee and the Senate Finance Committee, the fragile political coalition that enacted the law left in place a variety of ongoing complexities, inequities, and inefficiencies. Second, the 1986 Act had little public support even when it was passed. Third, and most importantly, the 1986 tax act was based on retaining and strengthening the income tax itself, rather than heeding the calls of many economists and politicians to replace all or part of it with some form of consumption tax on purchases of goods and services.

Given the internationalization of economic activity during the past twenty-five years and the increased competition from abroad, the 1986 Act's reliance on increased taxation of income from capital and of corporate income now seems inapt. We need to attract capital to create better conditions for American workers and businesses. In order to do that, the United States must be an attractive place for both foreign and domestic investments, and American companies need to be positioned to take full advantage of the global market for goods and services, labor and capital. But our tax system does not advance the well being of American workers and businesses; it stifles it.

Our system of taxing international business income is truly archaic. The structure for taxing international business income came into the tax law in 1918 and 1921.³ It was substantially modified in 1962 and again in 1986, and there has been quite a lot of tinkering since then. But we are in a very different world economy today. Corporations and other investors, including sovereign wealth funds investing on behalf of other nations, now move money quickly and easily around the world, making it much more difficult for any nation—including the United States—to tax their income.

How to tax multinational business enterprises has long been controversial. Recent disputes over the Obama Administration international tax proposals, dealing, for example, with cross-crediting of foreign taxes, the treatment of domestic expenditures that help produce foreign income, the treatment of U.S.-owned foreign entities, and transfer pricing, alongside the recent trend of countries with foreign tax credit systems to move to international business tax regimes that exempt foreign dividends, amply illustrate differences in policy preferences. The thrust of the 1986 Tax Reform Act was to limit the ability of U.S. companies to offset U.S. taxes on unrelated income and to restrict

³ See Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke Law Journal* 1021 (1997).

somewhat deductions for companies that invest abroad. Elsewhere around the world, however, nations have embraced low corporate income tax rates, both to attract investments and to reduce the temptations of their domestic companies to shift income abroad through intercompany pricing or other techniques.

The difficulties we face in taxing international income are even more fundamental. As I have observed elsewhere, the basic building blocks of international income taxation—the concepts of residence and source—are now foundations built on quicksand.⁴ They may have drawn reasonable lines when they first became the basis for international income taxation early in the 20th Century, but in today's global economy, with all of its technology and innovative financial transactions, both corporate residence and the source of income and deductions are easily manipulated. And there is only a little the United States can do unilaterally to address this problem.

Businesses now not only have the ability to elect *whether* to be taxed as corporations, they also can elect *where* to be taxed. If you ask a law student in an international tax class where to incorporate a new business enterprise and he or she answers, "the United States," the student deserves a failing grade. As one savvy tax lawyer recently put it: deductions flock to high tax-rate countries and income flocks to those with low rates.

I have come to believe that, absent broad international agreement and cooperation foregoing tax competition to attract capital—a transformation that is certainly not on the horizon—a low statutory corporate tax rate is essential. This year we will have the highest statutory corporate tax rate in the developed world.

Economists and many government officials often tell us not to pay any attention to the statutory tax rate, that we should look instead at the lower "effective" tax rates. But, of course, average tax rates are meaningless when one is being asked about where to borrow or invest the next dollars. And the more relevant "marginal effective tax rates" are subject to debate and often difficult to calculate. Corporations respond to their knowledge that we tax corporate income at a 35 percent rate, while another country imposes tax at a much lower rate, say 15 to 20 percent. They do not need a computer to tell them where to locate their deductions and where to locate their income. Foreign-owned multinationals understand this as well as the U.S. companies.

To be sure, businesses often shift their income and deductions around the world without necessarily also shifting their employees or real investments in plant and equipment. But not always. Other governments may require that real economic activity actually take place there. In such cases, and whenever

⁴ See Michael J. Graetz, "The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax Law Review* 261, 320 (2001) and Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expense," *Bulletin for International Taxation*, November, 2008.

business activity is located abroad for business rather than tax reasons, there may be incentives for companies to shift their foreign income to even lower tax countries—to so-called tax havens. Complicating matters further, it may well be in the U.S. national interest for our multinational corporations to engage in tax planning strategies that reduce their foreign income taxes and increase their cash flow. But when such strategies are turned on the U.S. tax system by either domestic or foreign-owned enterprises, our fisc and our economy is the loser.

As if the substantive difficulties of designing sound corporate income tax policies for today's global economy were not hard enough, taking political considerations into account—as you must—makes the task positively herculean. Corporate income taxes are popular with the public despite the virtually unanimous view among economists and other tax policy analysts that the corporate tax is a bad tax, if the goal is to enhance our nation's economic wellbeing. People believe that taxes remitted by corporations, especially large multinational companies, are paid by someone other than themselves. Years ago, this committee's chairman Dan Rostenkowski suggested adding a second verse to the tax reform classic coined by Senate Finance Committee chairman Russell Long: "Don't tax you; don't tax me; tax the fellow behind the tree." Congressman Rostenkowski added: "Don't tax you; don't tax me, tax the corporations across the sea." Not long ago, Treasury Secretary Geithner contributed to the confusion when he insisted that Americans should not have to pay one additional cent of taxes to reduce taxes on businesses. But as Paul H. O'Neill, George W. Bush's first Treasury secretary, observed, "Corporations don't pay taxes, they collect them."

The question of who actually bears the economic burden of corporate income taxes—who ultimately pays them—has tormented public-finance economists since the tax first came into existence. Three candidates come instantly to the fore: people who own the companies, people who work for the companies, or people who buy the companies' products. Since the tax may affect wages, prices, and/or returns to capital, economists believe that workers, consumers, and/or owners of capital generally may bear the economic costs of the tax. For many years, the conventional wisdom among economists was that the tax principally reduced returns to capital, at least in the short run, and thus the tax was considered to be progressive, even if economically distortional. Government distributional tables have therefore tended to allocate the corporate tax burden to owners of capital. Even so, ultimately, however, any reduction in capital due to the tax might result in lower wages, so in the long run, workers may pay.

As the economy has become more open internationally, a number of recent economic studies have concluded that the corporate income tax is less likely borne by capital generally, but rather—at least in some substantial part—by workers in the form of lower wages. Owners of capital today have the ability to

move their money anywhere in the world, but workers and consumers are less mobile.

All the uncertainty in the economics profession contributes to the public view that the tax is probably paid by someone else. And it is child's play to characterize large corporations, especially large multinational corporations, as if they are villains. This is probably why the public seems to like a tax that economists hate. But high tax rates on corporate income in today's global economy are a very bad way to try to achieve economic growth or to obtain and maintain progressivity in the distribution of the tax burden. (Indeed, simply shifting the tax burden from corporations to shareholders and bondholders could increase progressivity.)

Tax experts now regard the 1986 Act as a promise failed. Surprisingly, many people continue to think that the best path for tax reform is simply to improve the income tax. But, while many income tax reform proposals might improve current law, they do not, in my view, go far enough. As we know, it doesn't take very long after a good cleansing of the income tax for things to get very dirty again. Even those who applauded the 1986 Act as a wildly successful tax reform must concede now that this legislation was not a stable solution. Over time, many of its reforms have been reversed: its broad base and low rates have been transformed into a narrower base with higher rates. How can anyone remain optimistic about fixing the income tax without radical surgery? What our nation needs is a new and better tax system, one that is far simpler, fair, and more conducive to economic growth.

It is the central contention of my book, and the centerpiece of my proposal, that the fundamental reform required to create an internationally competitive, administratively efficient, and viable long-term solution to our funding requirements is to make a different choice. We should eliminate the income tax for the overwhelming majority of Americans and replace it with a broad-based tax on sales of goods and services. We should return the income tax to its original, manageable purpose: the collection of a simpler tax on high-income earners who tend to have multiple income sources. And we should dramatically lower our corporate income tax rate. In order to do that, we need to tax consumption, sales of goods and services.

A Plan for the Future

Mr. Chairman, a tax reform following the income tax base-broadening and rate-lowering precedent of the 1986 Tax Reform Act is not an adequate response to the tax policy challenges this nation faces in the 21st century. My main ideas about tax reform and my analysis and views about many alternative suggestions are described in my book *100 Million Unnecessary Returns: A Simple, Fair and Competitive Tax System for the United States* – the paperback edition of which was published last spring.

For those unfamiliar with my Competitive Tax plan, it has four key pieces:

- First, enact a value added tax – a broad based tax on sales of goods and services now used by more than 150 countries worldwide. We are the only OECD country that does not have a VAT or, as it is sometimes called, a goods and services tax.
- Second, use the revenues produced by that consumption tax to finance an income tax exemption of \$100,000 of family income and to lower substantially the individual income tax rate on income above that amount.
- Third, lower the corporate income tax rate to 15%, or at most 20%.
- Fourth, replace the earned income tax credit and provide low and middle income families with tax relief from the VAT burden through payroll tax offsets and debit cards.

This plan has many significant advantages over current law and other tax reform alternatives:

- First, this competitive tax system would encourage saving and investment in the United States, stimulating economic growth and creating additional opportunities for American workers. This plan would take advantage of our status as a low-tax country by making us a *low-income tax* country.
- Second, a 15% corporate income tax rate would be among the lowest in the world and would solve the most vexing issues of international tax policy.
- Third, the plan would eliminate more than 100 million of the 140 million income tax returns and would free more than 150 million Americans from ever having to deal with the IRS.
- Fourth, with only a relatively few high-income Americans filing tax returns, there would be far less temptation for Congress to use income tax exclusions, deductions, and credits as if they offered adequate or appropriate solutions to the nation's most pressing social and economic problems. They do not.
- Fifth, a value-added tax would be border adjustable under WTO international trade rules, which means that we could tax imports and exempt exports. VATs can be imposed on such a "destination-basis," but business income taxes cannot. (As this Committee well knows

from longstanding WTO disputes over the DISC, the FSC, and ETI, income taxes must be imposed on an "origin" basis which means that we must tax goods produced here, even for export, and we cannot tax imports.) Economic theory and most economists insist that border adjustments make no difference in international trade due to offsetting changes in exchange rates, but business owners do not accept that exchange-rate adjustments happen as readily in practice as theory suggests. China certainly seems to confirm the business view. In any event, destination-based consumption taxes do not depend on either the "residence" of multinational corporations or the "source" of income but rather on where consumption takes place. As a result, they have major advantages for tax compliance (for example, with regard to transfer pricing). Moreover, given the size of our nation's trade imbalances, border adjustments would likely result in hundreds of billions of dollars of additional revenues to the U.S. Treasury over the 10-year budget period and beyond.

- Sixth, this plan would avoid most of the difficult issues of transition to an entirely new system that have haunted other proposals to replace the income tax with consumption taxation.
- Finally, by combining taxes commonly used throughout the world, this system would facilitate international coordination and fit well with existing tax and trade agreements—something that most other consumption tax proposals fail to do.

Opponents of value-added taxes often complain that they are regressive, and if such a sales tax were to fully replace our income tax, as proponents of the so-called Fairtax urge, tax burdens would indeed be shifted down the income scale. So I designed my Competitive Tax Plan in a manner generally to change neither the progressivity of the tax system nor the amount of revenue produced under current law. This allows my proposal to be evaluated by comparing it directly to the current system, and it follows the important precedent of both distributional and revenue neutrality that facilitated enactment of the 1986 Tax Reform Act, our last major tax reform.

The Tax Policy Center, pursuant to a contract with Pew Charitable Trusts, is currently in the process of estimating the revenue and distributional consequences of my plan and has given me permission to describe their *preliminary* results. These estimates are for the year 2015. They suggest that my proposal is essentially revenue and distributionally neutral with a VAT rate under 12.5 percent, a 15 percent corporate income tax rate, and tax rates for married couples of 16 percent on income between the \$100,000 family allowance and \$200,000 and 25 or 26 percent for income above \$200,000. Offsets are provided for low and moderate income families. The Tax Policy Center, under this contract, is now working on a paper that will provide more detailed final results.

Consumption Tax Alternatives⁵

Our federal government has previously considered imposing a national consumption tax. For example, in 1921, when the income tax was only eight years old and a fraction of its current size, Ogden Mills, then a Congressman from New York, who later served as Herbert Hoover's Secretary of the Treasury, argued that Congress should substitute a tax on "spendings" for the income tax. Mills' proposal for taxing consumption rather than income was not a new idea, even in the 1920s. John Stuart Mill had urged taxing consumption, and Alexander Hamilton had only praise for consumption taxes.

In 1942 Franklin Roosevelt's Treasury Secretary Henry Morgenthau advanced a progressive, graduated rate tax on spendings to finance the Second World War, but Congress rejected it. Instead, the Revenue Act of 1942 began the conversion of the income tax, which had applied only to high income people, into a tax on the masses. Had this episode turned out differently, the income tax might have remained narrowly targeted to high income people, and a consumption tax, rather than the income tax, might have become the federal government's main revenue raiser. After that, from time to time, presidents and many members of Congress have considered taxing consumption rather than income, but no national tax on consumption has been enacted.

The simplification advantages of a consumption tax depend on how it is implemented. Retail sales taxes and VATs are collected from businesses rather than families, greatly easing the compliance burdens of households and freeing them from having to deal with the tax collector. Other forms of consumption taxes such as the so-called "flat tax" (which is a consumption tax although the public may believe it to be an income tax) tax the wage element of value added to individuals and thus require households to file tax returns. Since under the "flat tax" only wages would be taxed to individuals, and all deductions, exclusions and credits would be eliminated, its proponents claim that the annual tax return would shrink to a postcard that everyone would be able to fill in quickly and easily. Adding more than one tax rate as, for example, President Bush's tax reform panel recommended, does not substantially complicate matters.

The fact is that the flat tax (along with its cousin, the "Growth and Investment Tax" proposed by President Bush's tax reform panel in 2005), economist Alan Auerbach's "Modern Corporate Tax" and Congressman Paul Ryan's Business Consumption Tax are all variations on a form of value-added tax that resembles an income tax. They are what is called "subtraction-method value-added taxes." This kind of VAT taxes the difference between the total receipts from a business's sales of goods or services and the total amount of the business's purchases of goods or services from other businesses. The difference between sales and purchases is the business's value added and the

⁵ I discuss these issues in much greater detail in my book, *100 Million Unnecessary Returns*.

tax rate is applied to that amount. Variations on a subtraction-method VAT seem to enjoy great favor among some consumption tax advocates.

At the same tax rate and with no exceptions, a retail sales tax, a subtraction-method VAT and the much more common credit-method VAT should produce similar results. But exemptions for particular goods or services or for small businesses, for example, are far more troublesome under a subtraction-method VAT than in the more common credit-invoice method.

The flat tax (and President Bush's panel's GIT) proposals essentially split the collection of a single rate subtraction-method value-added tax between businesses and individuals. Rather than denying businesses any deduction for wages, as is usual under a subtraction-method value-added tax, the flat-tax allows businesses to deduct wages in addition to purchases from other businesses. This type of consumption tax is collected at each stage of production, as under a typical value-added tax, except that the tax on wages is directly remitted by individual wage-earners. In combination, the total of the business and individual tax bases should equal total sales, putting aside any exemptions.

The principal advantage of dividing a value-added tax between businesses and individuals is that it enables the exemption of a certain amount of wages from tax and may thereby eliminate, for wage earners, the regressivity at the bottom of the income scale of a standard flat-rate tax on consumption. The amount of the exemption or standard deduction will, of course, vary depending on the flat tax rate and the other exclusions, deductions or tax credits allowed. (As my proposal and my recent book detail, there are other methods of addressing this issue under a VAT or retail sales tax.) This division of the consumption tax base also allows the imposition of progressive rates on wages, although it is mysterious why only wages and not investment income should be subjected to progressive tax rates.

Three problems remain, however. First, the flat tax (and its variations) are consumption taxes invented by academics, which are untried and untested elsewhere in the world. They do not work well internationally. Second, all experience warns us that even if such a tax could be enacted in its pure form with all deductions, exclusions and credits eliminated—a real long shot—the tax would stay neither pure nor flat for very long. Tax breaks for homeownership, charitable gifts and education expenses, to name only a few, would soon make their way back into the tax code. Third, as the president's panel discovered, taxing only individuals' wages and not their income from investments offends our notions of tax justice. This is why the panel—hardly a bunch of liberals and none of whom, as John Breaux has reminded us, was standing for re-election—coupled their consumption tax proposal with a tax on interest, dividends and capital gains, albeit at a lower 15% rate. The panel concluded -- correctly in my

view -- that the American public will not accept taxing families only on their wages and not on the income they receive from their investments or savings.

In the 1990s Senators Sam Nunn and Pete Domenici proposed coupling a VAT with a progressive rate tax on consumption—a so-called expenditure tax. The Senators called their tax a "Uniform Savings Allowance," or "USA" tax. The senators designed their proposal this way to avoid the substantial tax cut for high-income families which would occur under flat-rate consumption taxes that entirely replace the income tax. Again, unlike the VAT or retail sales tax, a progressive consumption tax is essentially untested, although it has long been discussed and often applauded in academic circles. Only India and Sri Lanka ever enacted an expenditure tax, and both repealed the tax shortly after it was enacted.⁶

Many of these consumption tax alternatives do not work well internationally. While my proposal would harmonize our tax system with international standards and thus open up the possibility of real cost-savings for companies doing business in more than one nation, the unusual nature of the methods used to collect subtraction-method VATs and their variations may create large difficulties under our international tax and trade treaties. Indeed, President Bush's tax reform panel admitted that their favorite consumption tax would require renegotiation of our trade and tax treaties. Value added taxes of the standard credit-invoice sort fit well with these international agreements. They can be --and always are--border adjusted: imposed only by the country where the consumption takes place. They therefore tax imports and exempt exports, so that the location where a good is produced is irrelevant. In contrast, income taxes are typically imposed on all domestic production and the tax on production abroad is generally ceded to the country where the production occurs.

Mostly for compliance reasons, the president's panel decided—rightly in my view—that any U.S. consumption tax should be border adjusted and imposed in the standard manner: on a destination basis. Otherwise, imports

⁶ Senators Nunn and Domenici modified the standard form of expenditure tax in an effort to make their proposal more appealing politically. Their proposals would exempt, for example, much consumption financed out of sales of people's existing assets and would defer the tax on consumption from borrowed funds. These modifications required complex rules to track both borrowing-financed consumption and consumption from dispositions of pre-enactment assets. Indeed, the Nunn-Domenici plan floundered because of its inability to solve problems of transition from an income tax to this type of consumption tax and its failure to tax consumption financed with borrowing. In combination, these two problems allowed people with assets or the ability to borrow to avoid the tax. The personal tax was essentially a tax on wages, but by borrowing for consumption and reinvesting the proceeds of asset sales, people could have avoided even the wage tax. Senators Nunn and Domenici also concluded that it was necessary politically to retain a number of existing income tax preferences, including, for example, not taxing interest on state and local bonds. This created other opportunities to consume tax free. The Nunn-Domenici experiment suggests that enacting a coherent progressive tax on consumption is probably not politically viable. This is hardly surprising since no other nation relies on such a tax.

would not be taxed but exports would. The latter kind of tax is said to be imposed on an "origin" basis.⁷

Economists claim that we should be indifferent to the distinction between origin-based and border adjusted taxes because currency exchange rates — the value of the dollar relative to other currencies — will adjust to compensate for these tax differences. But U.S. manufacturers and other U.S. companies that compete with products from abroad will not readily accept the economists' assurances that exchange rates will adjust so perfectly. Especially when the country with whom we have the largest trade deficit, China, has yet to allow its currency to float freely against the dollar.⁸ Moreover, President Bush's panel determined that imposing a consumption tax on an origin basis would raise major enforcement difficulties. In my view, border adjustments of a consumption tax will be an important -- perhaps even decisive -- issue.⁹

It is puzzling to me that U.S. economists and policy-makers have struggled to fashion novel consumption tax alternatives when there is a well-functioning consumption tax—the value-added tax—being used throughout the OECD and in more than 150 countries worldwide. Given the interconnectedness of the world economy, consumption tax design does not seem the right place to insist on American exceptionalism.

The So-Called FairTax

The retail sales tax, which is the form of consumption tax being advanced by the Fairtax proponents on today's other panel, is, of course, the type of consumption tax levied by our states and is therefore quite familiar. As the simple example attached to my statement demonstrates, a credit-method VAT

⁷ This occurs, for example, under the flat tax. Thus, if Ford sells cars manufactured in the United States to be used in the United States, their full retail sales value would be included in the flat tax base. Likewise, if Ford or any other U.S. automobile manufacturer sells automobiles in the U.S. to a foreign dealer for use abroad, the manufacturer's sales price would be subject to the U.S. flat tax. But a U.S. dealer of cars made in Japan, Germany or another foreign country would be taxed only on the excess of the dealer's total receipts from its sales over the costs of the cars from the foreign manufacturer. As a result, the costs of manufacturing cars abroad would not be included in the U.S. consumption tax base; only the foreign car dealer's markup would be subject to U.S. taxation.

⁸ Domestic businesses undoubtedly will resist rules that impose a U.S. tax on the full retail price of products manufactured in the United States, but tax only the dealer markup of products manufactured abroad. They will view such a tax as fundamentally unfair to American businesses and, perhaps, as seriously disadvantaging U.S. manufacturers competitively.

⁹ The president's panel acknowledged that its recommended consumption tax along with other consumption taxes such as the flat tax, which allow businesses to deduct wages and tax the wages to individuals, cannot be imposed on a destination basis without violating our major trade treaty (the GATT) and all of our existing bilateral income tax treaties. Tax reform proposals so out of sync with international trade and tax arrangements to require renegotiation of all our trade and tax treaties are essentially unrealistic.

and a retail sales tax at the same rate and with the same coverage are the same economically. A VAT is essentially a retail sales tax with withholding at earlier stages of the production, import, and sales process. Experience demonstrates that such a VAT works well. Since sellers of goods and services collect taxes and receive credits for VATs paid on their purchases, tax revenues are collected regularly throughout the year from companies at all levels of production, rather than just from retailers, thereby easing enforcement. A credit-method VAT also facilitates exemptions for small businesses (and for specific goods or services if such exemptions become necessary politically). The VAT's withholding feature improves tax compliance and limits the revenue cost of exceptions in the supply chain. This enables a VAT to exempt most businesses through a high registration threshold, such as \$500,000 of gross receipts. (A similarly high exemption is used in Singapore's VAT, for example.)

While it is true that a retail sales tax might be simpler than a VAT, no country has a retail sales tax at a rate above 10 percent (compared to the more than 150 countries with VATs). At the 30 percent rate proposed by Fairtax advocates, the greater compliance risks of a retail sales tax are substantial.¹⁰

In addition, unlike VATs around the world, retail sales taxes often do not apply to services, so they are imposed on a much smaller consumption tax base. Moreover, retail sales taxes in the United States do apply to many purchases by businesses—which they should not—causing double or multiple taxation (known as “tax cascading”). While there are no reliable estimates of how much of this occurs, the only two extant estimates suggest that as much as 40 percent of U.S. retail sales tax revenues are from sales to businesses rather than final consumers. This causes significant economic costs and distortions. A credit-method VAT avoids any such cascading.

The “FairTax” proposal would reduce taxes on those at the top and make up the lost taxes from people with less income or wealth. This seems particularly inappropriate when gains in income and wealth have been so skewed toward the top.¹¹ To be sure, people move in and out of wealth and income classes over

¹⁰ Fairtax advocates claim that their tax rate is 23 percent, but unlike every retail sales tax we have ever paid, they are calculating the tax rate on a tax-inclusive, rather than the normal tax-exclusive basis. This is just a matter of disguising how high the rate is. For example, if one were to pay a total of \$3.90 for a retail purchase where the amount of tax is 0.90, the standard way of describing the retail sales tax rate would be 30 percent, 90 cents on a \$3.00 purchase. In the Fairtax world, however, this is described as a 23 percent rate, 90 cents of the total \$3.90 paid. Generally, income tax rates are described on a tax-inclusive basis and VATs and retail sales tax rates are described on a tax-exclusive basis and that is the practice I am following here.

¹¹ For example, between 1979 and 2006 the income of the richest one percent of Americans nearly doubled, while the income of middle-class Americans increased by only about 11½ percent, according to the most reliable numbers. Over the same period, the wage at the 10th percentile, near the bottom of the wage distribution, rose just 4 percent, while the wage at the 90th percentile, near the top of the distribution, rose 34 percent. The share of after-tax income garnered by the top 1% of households increased from 8 percent in 1979 to 14 percent in 2004. Even within the top 1 percent the distribution of income has recently widened. And although the

time; some of the rich lose money and some poor people become rich over time. But, while Americans can debate forever what constitutes a fair distribution of taxes, surely it is not appropriate to shift the tax burden downwards now when those at the very top are doing so very much better than everyone else. This, however, is exactly what the FairTax proposal would do.

In addition, the promise of Fairtax advocates to eliminate the IRS and turn the assessment and collection of virtually all federal revenues over to the states is just a political ploy, a fanciful illusion. How can Americans believe that the federal government can collect trillions of dollars of taxes annually without a tax collection agency? However, to the extent that the revenues from either a VAT or a retail sales tax are used to remove individuals and families from the income tax rolls—as my Competitive Tax Plan does for 150 million Americans—April 15 will become just another spring day.

FairTax advocates have claimed that under their plan workers would receive 100 percent of their paychecks with no taxes withheld *and* that the sales tax would not increase prices. Thus, they claim wages will not fall nor will prices go up. Now, while either of these claims might be true, they cannot both be true simultaneously. A sales tax either must be paid out of people's wages, like the income tax, or at the store when people buy goods and services. You can find economists who believe one or the other would happen, but no respectable economist believes that *neither* of these occur. Nevertheless, FairTax advocates claim to have discovered a pain-free tax reform.

Moreover, no independent analysis—whether from President Bush's tax reform panel or the Tax Policy Center—has confirmed that a 30% retail sales tax (or a VAT at that rate) would generate revenues adequate to fund repealing all of the taxes that FairTax advocates claim they would eliminate. (In fact, I wish the Fairtax advocates' revenue claims were correct; they would allow my Competitive Tax Plan to replace the bulk of payroll taxes as well as income taxes at the VAT rate I have suggested, or allow my plan to have a much lower VAT rate.) Given the wildly unrealistic claims of FairTax proponents (along with their insistence on disguising a 30% sales tax rate as 23%), it is hardly surprising that they have generated considerable enthusiasm for their plan, especially among higher-income folks who would enjoy a large tax cut. Unlike the FairTax, my Competitive

nation's economy grew by 11.7% in the period 2001-2005, the income of the median household fell by 0.5% in that period.

Wealth is even more unevenly distributed than income, with the wealthiest one percent owning about one-third of all wealth in the United States. The bottom 50 percent hold just 2% percent of all wealth. As Austan Goolsbee has pointed out, "The average net worth of the top 10 percent of American families is almost 30 times greater than the average net worth of families in the middle 50 percent of the spectrum -- and these disparities in net worth have been growing even faster than the disparities in income."

Tax Plan is a realistic proposal that would neither reduce federal revenues nor shift the distribution of federal taxes down the income scale.

Conclusion

What all this history of attempts to enact a consumption tax teaches us is that in order for such a tax to become a politically viable alternative to our current income tax system it must produce a practical outcome that is better for businesses, better for savings and investment, feasible, and fair to moderate-income Americans. I believe that my proposal meets these criteria. Unfortunately, other plans currently popular in Washington don't.

Given its widespread application around the world, it is clear that the U.S. can readily administer and comply with a VAT. Since my book was published, I have worked closely with private-sector legal, accounting, and corporate VAT experts from around the world in an effort to determine what a model VAT might look like in the United States. Clearly, the best VAT practices are not to be found in Europe, but rather in the more modern VATs enacted in places such as Singapore, New Zealand, Canada, Australia and South Africa. These taxes are imposed on broad consumption tax bases at a single rate to minimize distortions. As in my proposal, regressivity is mitigated through measures directed at low and moderate income households, rather than through VAT exemptions for items such as food and clothing. These kinds of exemptions add complexity to VAT administration and compliance and are wasteful since they also apply to purchases by high-income households.

The Canadian experience, in particular, demonstrates that a national VAT and state retail sales taxes can live side-by-side, but it also demonstrates the efficiencies that can be achieved by encouraging states to replace their retail sales taxes with a harmonized VAT that minimizes compliance and administrative costs.

And, as I have said, any VAT should be border-adjusted to tax imports and exempt exports and should have quite a high registration threshold so that small businesses can avoid reporting VAT (although bona fide small businesses below the threshold should be allowed to register if they elect to do so). Experience shows that VATs are much less costly to administer and comply with than income taxes per dollar of revenue.

Finally, while many countries do not publicize their VAT rates to consumers, Canada requires its VAT to be separately stated on sales receipts. This creates resistance to rate increases. In Canada, federal revenues and spending have fallen relative to GDP since a VAT was introduced in 1991.

Consumption taxes clearly have a role to play as a part of a modern tax system. They are used in the states and throughout the industrial world as a part

of tax systems that typically also contain progressive income taxes. Enacting a VAT—a national sales tax with withholding by businesses other than retailers—would permit a major restructuring of our tax system into one that is vastly simpler and far more conducive to savings, investment and economic growth. And, as my competitive Tax Plan demonstrates, this can be accomplished in a way that is fair—a way that neither increases the tax burden of low and moderate-income taxpayers nor shifts taxes away from those at the top of the income scale.

As a result of the recent financial crisis, the most significant recession since the Great Depression (with unemployment reaching a 25-year high), and a vast amount of government spending aimed at combating these problems, our nation's short and long-term financial condition has deteriorated dramatically since I first advanced my Competitive Tax proposal. Now our nation's financial position is perilous. We have never in modern times faced such a dangerous ongoing imbalance between the levels of federal spending and revenues. Our federal debt as a percentage of our economic output is greater than it has been at any time since the end of World War II. And then Europe and Japan were in shambles and China was entering into a dark communist era. Our economy was poised to grow for decades at an unprecedented pace. And our government owed 98 percent of the money it had borrowed to finance the war to Americans. The Congressional Budget Office now projects that in a decade our national debt will exceed \$20 trillion—roughly equal to our annual economic output (GDP)—with more than half owed to foreigners, many of whom we cannot count as friends. If we are able then to borrow at a 5% interest rate, interest on the federal debt alone would cost us a trillion dollars a year.

As you well know, our long term fiscal situation is even more dire. Our population is aging with fewer workers for each retiree, and we still have no credible plan to control excessive and rapidly rising health care costs. So the nation's financial situation is projected to get even gloomier in the longer term. If we fail to get control of the federal budget, rising interest costs will gobble up an ever-larger share of our economic output. Public debt growing to such levels will also decrease the value of the dollar and lead to challenges to its role as the world's reserve currency. Our growing national debt increases the risks of substantially higher interest rates, inflation, and another financial crisis. Over time, it will threaten the living standards of the American people. These are facts, not forecasts. We are currently heading toward a cliff, risking the economic wellbeing of our children and grandchildren.

Deficit finance increases our economic vulnerability when it is coupled with a substantial imbalance in trade. Because we import far more than we export, other nations accumulate dollars, which they use to purchase U.S. assets, including government debt. And they are accumulating many more dollars every day. If they were to dump those bonds or dollars on the market, it would cause a precipitous decline in the value of the dollar and might destabilize our economy.

Allowing foreign governments such control over our economic well being may ultimately prove harmful not only to our economic health but also our national interest and security. As Harvard economist Benjamin Friedman puts it: "Government deficits sustained year after year even when the economy is operating at full employment, reduce net capital formation and induce foreign borrowing. Both effects accumulate over time. Both are harmful."

A great advantage of my Competitive Tax plan is that, by introducing a border-adjustable value added tax on sales of goods and services and thereby decreasing our nation's need to rely so heavily on the income tax to finance our government's spending, we can have a tax system that is fair and yet substantially more favorable to economic growth than our current system.

There has been much talk lately, in connection with the debt ceiling, that Congress might enact a six-month deadline for major tax reform. Because most countries have taken 18 months or even two years after enactment to put a VAT into effect, this may suggest to some that my Competitive Tax Plan is not realistic in the short-term. This is wrong. Experience in other countries, such as Japan and New Zealand, shows that consumption rises in anticipation of a VAT coming into effect. Thus, enactment this year or next, with a VAT phased in slowly, could serve to spur consumption in the short-run. And, over the long-run, a VAT would be far more favorable to economic growth (and therefore increased consumption) than the corporate and individual income taxes it would be replacing.

Former Treasury Secretary Larry Summers once remarked that Republicans don't like value-added taxes because they are a revenue machine and Democrats don't like them because they are regressive. "We will get a VAT," he said, "when Democrats realize that they are a revenue machine and Republicans realize that they are regressive." To the contrary, I believe that we will only get a VAT when a VAT is included as part of a tax reform designed to ensure that it is *neither* regressive nor a money machine. That is what my Competitive Tax Plan does.

Despite the daunting challenges of our fiscal situation—challenges that a VAT can surely help to ease—I believe that it would be a mistake to enact a VAT without using a substantial portion of its revenues to help finance major reform and simplification of income taxes. That would indeed be an opportunity wasted.

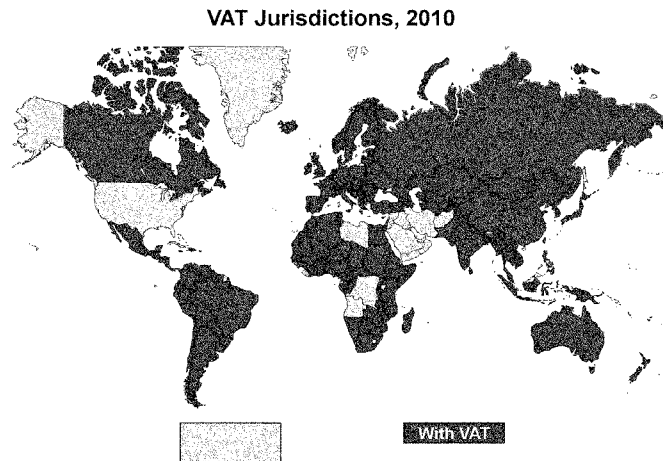
Our nation's tax system is badly broken. No one quarrels with that. If we don't solve the problems of our grossly inefficient system of raising revenues, all the other challenges our government faces will eventually be overwhelmed by one over-arching reality: we will have too little money and will lack the means to raise it without damaging our economy. Doing nothing is no option.

Example of Retail Sales Tax and VAT

VAT vs. RST: Domestic Sale, No Exemptions
 [Illustration with 10% tax-exclusive rate]

	Farmer	Miller	Baker	Total
Business transactions				
Sales	\$300	\$700	\$1,000	
Purchases	\$0	\$300	\$700	
Value added	\$300	\$400	\$300	\$1,000
1. RST calculation				
Tax base	\$0	\$0	\$1,000	\$1,000
Tax	\$0	\$0	\$100	\$100
2. VAT calculation				
Tax on sales	\$30	\$70	\$100	
Credit for tax on inputs	\$0	-\$30	-\$70	
Net tax	\$30	\$40	\$30	\$100

- A retail sales tax and a VAT with the same tax base and rate both collect the same amount of revenue on sales to final customers, but with a VAT much of the tax is withheld prior to the retail sale.



Chairman CAMP. Thank you. I am afraid we are going to have to keep the hearing moving, and your time has expired. So we will move on to Ms. Altshuler.

You have 5 minutes.

**STATEMENT OF ROSANNE ALTSHULER, PROFESSOR AND
CHAIR, ECONOMIC DEPARTMENT, RUTGERS UNIVERSITY**

Ms. ALTSHULER. Thank you, Chairman Camp, Ranking Member Levin and Members of the Committee, it's an honor to appear before you today.

CBO analysis shows that the government began this year with the projected budget deficit of almost 10 percent of GDP, and its future growth is driven by rising healthcare costs, an aging population, and the interest payments on an ever increasing public debt. Reducing the deficit to an economically sustainable level will require both the scaling back of expenditure programs and an increase in tax revenues.

In work I've done with economists at the Tax Policy Center, we find that raising significantly more revenue from our current tax system, however, would be politically difficult, and likely damaging to economic growth. The substantial near and long term fiscal pressures facing the Federal Government require that we both reform our income tax system and consider new revenue sources, including federal taxes on consumption.

That is a type of consumption tax that is similar to a retail sales tax, but it is collected in smaller increments throughout the production process. That is part of the tax systems of nearly 150 countries around the world, including all OECD member countries except the United States. Adding a VAT to the U.S. federal tax system could help address the medium and long term revenue shortfalls forecast for the United States. That is particularly effective in raising substantial amounts of revenue in a relatively efficient manner, and has proven to be an administrable tax.

If we were to adopt a VAT, we could rely on the experience and best practices of other countries in setting up and administering the tax. In addition to these attributes, the VAT has a number of other advantages. First, a portion of the revenues from a VAT could be used to finance reductions in statutory income tax rates, as Michael Graetz has just told us.

Two, tax systems: a VAT, and an income tax, with low tax rates, may be superior from an efficiency and administration perspective to an income tax system with higher statutory rates. Second, given the size of projected future budget deficits, adding a VAT to our current system to generate revenues for deficit reduction alone would likely have positive effects on economic growth.

Third, a preannounced and phased-in VAT might stimulate the economy by encouraging consumption in anticipation of the imposition of the tax. Finally, while the states are likely to protest, a properly designed VAT may actually help force them to redesign or improve their retail sales taxes.

There are a number of issues that need to be addressed in designing and implementing a VAT, and I will hit on a few of these issues in my remaining time—distributional issues. The VAT is equivalent to a retail sales tax, but it is collected at different stages of the production process. Since higher income households save more than those with lower or moderate incomes, the burden of the tax increases with current income, reducing the overall progressivity of the tax system.

The additional VAT burden, however, can be relieved for low and middle income households through refundable credits. This approach to relieving the VAT burden is more effective than exempting food and other necessities from taxation or applying preferential rates, since it can be targeted to lower and middle income households rather than all households.

TPC has recently released a report that illustrates the impact of a five percent VAT in the distribution of income. While regressive in the absence of a rebate, the authors show that the impact on low and middle income households could be offset by allowing a rebate in the form of a refundable credit claimed on income tax returns. With the rebate, the VAT is progressive throughout almost the entire income distribution.

The TPC study shows that one should not look at the distributional impact of the VAT in isolation. The progressiveness of the complete federal tax system with that rebate, for example, must be taken into account. What about revenue? Well, policy analysts point out that given the fixed administrative costs of the VAT, if the U.S. adopts a VAT, it should be at a fairly substantial rate. Work again out of the Tax Policy Center suggests that with a ten percent rate, a VAT with a broad base and a rebate to offset the regressivity of the tax could raise about two percent of GDP.

It is important to think about how any tax instrument we use to raise additional revenue will affect economic growth. Recent work from economists at the OECD suggested the VAT is more pro-growth than personal and corporate income taxes. Revenues from the VAT could be used to buy down the deficit and/or reduce individual and corporate statutory tax rates.

Large and persistent deficits can have negative affects on economic growth by reducing national savings, driving up interest rates, and increasing our reliance on foreign investors. A single rate VAT on a broad base at a rate of ten percent could go a long way towards reducing the economic burden of our large and growing debt.

Using some VAT revenues to buy down statutory income tax rates would also have positive effects on growth. Lower marginal income tax rates on individuals and businesses would strengthen the incentive to save, invest, work and innovate, while making our tax system more efficient. The fiscal challenges ahead are daunting. The VAT on its own cannot solve the country's fiscal problems, and introducing a VAT has its own problems.

If we adopted the VAT, we would have to institute some form of rebate to offset its regressivity and make every effort to adopt the broadest possible base. We would need to increase IRS resources for administration, and be attentive to a range of compliance issues. But, we must recognize that near and long-term fiscal pressures require that we raise more revenue from our tax system. The VAT is an efficient revenue raiser that is likely to be significantly less damaging to economic growth than increasing personal and corporate statutory rates.

Thank you. I am happy to answer any questions.

[The prepared statement of Ms. Altshuler follows:]

**Testimony of Dr. Rosanne Altshuler
Professor, Department of Economics, Rutgers University**

**Before the
Committee on Ways and Means
U.S. House of Representatives**

Hearing on Tax Reform and Consumption-Based Tax Systems

July 26, 2011

Chairman Camp, Ranking Member Levin, and Members of the Committee, it is an honor to appear today to discuss the advantages and disadvantages of adding a value-added tax (VAT) to the current U.S. federal tax system.

I am Professor and Chair of the Economics Department of Rutgers University. During various leaves from Rutgers University, I have served as Special Advisor to the Joint Committee on Taxation, Chief Economist for the President's Advisory Panel on Federal Tax Reform in 2005, and Director of the Urban-Brookings Tax Policy Center. I have worked on building the case for tax reform, evaluated the economic consequences of different tax reforms (including ones that would add a VAT to the current U.S. income tax system), and studied the implementation issues and transition costs associated with various reforms.

Congressional Budget Office (CBO) analysis shows that the government began this year with a projected budget deficit of 9.8 percent of GDP and its future growth is driven by rising health care costs, an aging population, and the interest payments on an ever-increasing public debt. Reducing the deficit to an economically sustainable level will require both a scaling back of expenditure programs and an increase in tax revenues. Raising significantly more revenue from the current tax system, however, is politically difficult and would be damaging to economic growth. The substantial near and long-term fiscal pressures facing the federal government require that we both reform our income tax system and consider new revenue sources including federal taxes on consumption.

A VAT is a type of consumption tax that is similar to a retail sales tax but is collected in smaller increments throughout the production process. This form of consumption tax is part of the tax systems of nearly 150 countries worldwide. All OECD member countries except the United States have VATs. In 2007, revenues generated by the VAT represented almost 19 percent of the total tax revenues of OECD countries and about 20 percent of the total tax revenues of European OECD countries.¹

Adding a VAT to the U.S. federal tax system could help address the medium and long-term revenue shortfalls forecast for the United States. The VAT is particularly effective in raising substantial amounts of revenue in a relatively efficient manner and has proven to be an

¹ <http://stats.oecd.org/Index.aspx?DataSetCode=REV>.

administrable tax.² If the U.S. were to adopt a VAT, it could rely on the experience and best practices of other countries in setting up and administering the tax. In addition to these attributes, the VAT has a number of other advantages. First, a portion of the revenues from a VAT could be used to finance reductions in statutory income tax rates. Two tax systems (a VAT and an income tax) with low tax rates may be superior from an efficiency and administration perspective to an income tax system with higher statutory rates. Second, given the size of projected future budget deficits, adding a VAT to our current system to generate revenues for deficit reduction alone would likely have positive effects on economic growth. Third, a pre-announced and phased in VAT might stimulate the economy by encouraging consumption in anticipation of the imposition of the tax.³ Finally, while the states are likely to protest, a properly designed VAT may actually help force them to redesign or improve their retail sales taxes.⁴

There are a number of issues that need to be addressed in designing and implementing a VAT. While a detailed discussion is beyond the scope of my testimony, there are several issues that deserve attention: the distributional impact of a VAT, the revenue effects, the interaction of a federal VAT with the retail sales taxes in place in almost every U.S. state, the impact of a VAT on economic growth, possible inflationary impacts of adopting a VAT, compliance and administrative costs, and the concern that the VAT is a “money machine” that would drive the growth of government.

Introducing a new tax to the federal tax system is a major undertaking that would increase the compliance and administrative costs of our tax system by imposing new reporting requirements on businesses and new responsibilities for tax collection on the Internal Revenue Service (IRS). Before moving to a discussion of the advantages and disadvantages of adopting a VAT, I briefly motivate why I believe it is necessary to consider adding this new revenue source to our current system.

Must we consider alternative revenue sources to meet the fiscal challenges ahead?

A natural question is whether the current U.S. tax system can simply be “dialed up” through increases in statutory marginal tax rates to raise the revenues required to bring the deficit under control. A 2010 study I coauthored with Katherine Lim and Robertson Williams of the Urban-Brookings Tax Policy Center suggests that raising significantly more revenue from the current system is politically and economically infeasible.⁵ We considered illustrative incremental

² See, for example, Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (Washington, D.C.: International Monetary Fund, 2001).

³ For a discussion of the possible stimulus effects of a VAT, see William Gale and Benjamin Harris, “A VAT for the United States: Part of the Solution,” in *The VAT Reader: What a Federal Consumption Tax Would Mean for America*, (Tax Analysts, 2010).

⁴ Richard Bird and Pierre-Pascal Gendron, “Sales Taxes in Canada: The GST-HST-QST-RST ‘System,’” *Tax Law Review*, Vol. 63, No. 3 (Spring 2010).

⁵ See Rosanne Altshuler, Katherine Lim, and Robertson Williams, “Desperately Seeking Revenues,” *National Tax Journal*, June 2010. The estimates discussed in this testimony were recalculated from the original article using the March 2010 CBO budget update.

changes to the current income tax system aimed at reducing the deficit to an average of three percent of GDP over the years 2015 to 2019 (the last five years of the 2010 budget window).⁶

Using figures from the March 2010 CBO budget update, we found that no tax increases would be necessary to reach our three percent average deficit target if the 2001 and 2003 tax cuts were to sunset as scheduled in 2010 and Congress stops “patching” the alternative minimum tax (AMT). While tax policy under this scenario raises substantial revenue, it would subject almost one-third of taxpayers to the AMT by 2019⁷ and remove some significant benefits for lower and middle income taxpayers.⁸

If the 2001 and 2003 tax cuts were extended, the AMT were patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the 2010 healthcare reform act are taken into account, all income tax rates would have to increase proportionally by 30 percent to reach the 3 percent deficit target. The proportional increase in statutory rates would have to be 50 percent if, in addition, several expiring provisions that were enacted in the American Recovery and Reinvestment Act of 2009⁹ and other expiring provisions that have been in effect for a number of years were extended. This would increase the top 35 percent rate to 51 percent.

Protecting low and middle income taxpayers from these marginal tax increases would result in top rates that would stifle economic activity. If families with income under \$250,000 were protected from the required rate increase, the top two rates would need to rise from their current 33 and 35 percent rates to 66 and 70 percent if the 2001 and 2003 tax cuts were extended (and the AMT were patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the recent healthcare reform act were taken into account) and to 84 and 89 percent if the other expiring tax provisions described above were also extended.¹⁰

Our exercise demonstrates that simply increasing statutory marginal income tax rates within our current system is not a realistic approach to reducing the deficit. Further, it shows that raising revenue solely from high income individuals is not the answer to the revenue problem going forward.¹¹ Changes must be made to the tax base or new revenue sources must be adopted if we hope to raise significant additional revenue from the current income tax system.

⁶ The three percent of GDP target is sometimes put forth as consistent with stabilizing the debt to GDP ratio at current levels.

⁷ See Katherine Lim and Jeffrey Rohaly, “The Individual Alternative Minimum Tax: Historical Data and Projections, Updated October 2009,” Urban-Brookings Tax Policy Center Working Paper (October 2010), for estimates of the number of taxpayers subject to the AMT under different baselines.

⁸ The Urban-Brookings Tax Policy Center website provides detailed information on the Bush tax cuts at http://www.taxpolicycenter.org/taxtopics/Expiration_Bush_Tax_Cuts.cfm.

⁹ These provisions include the Making Work Pay tax credit, the American Opportunity tax credit, and the exclusion from taxable income of certain amounts of unemployment benefits.

¹⁰ We did not take behavioral effects into account in our analysis. Tax rates would have to be even higher if changes in taxpayer behavior in response to the increased rates were factored into the analysis.

¹¹ A CBO revenue option finds that raising the tax rate on ordinary taxable income in excess of \$1 million for joint filers (\$500,000 for other filers) by five percentage points would raise about 223 billion over the ten year period 2010-2019 (see CBO, *Budget Options: Volume II*, August 2009). That amounts to less than one-third of the revenue required to hit the 3 percent deficit target if the Bush tax cuts are extended, the AMT is patched, the estate tax was

Broadening the base through tax expenditure reform would raise revenue. In addition, limiting or eliminating tax expenditures would simplify the system, increase transparency, make it less distortive by both allowing for a lower rate and reducing tax-induced biases towards certain activity, and improve the fairness of the system. However, the biggest tax expenditures in terms of lost revenues are the most popular ones, making it politically challenging to broaden the base in a way that raises significant revenue.

Increased revenues from the corporate tax could be a target for deficit reduction. However, raising the statutory corporate tax rate will do little to buy down the deficit. In 2010, corporate revenues were less than ten percent of total revenues and one percent of GDP. Going forward, CBO forecasts corporate revenues as averaging about ten percent of total revenues and two percent of GDP for the period 2012-2021. Moreover, any increase in the corporate income tax rate will reduce domestic income and lower wages (through an outflow of capital) and adversely affect economic efficiency. In addition, any increase in the corporate tax rate can be expected to induce additional U.S. tax avoidance through transfer pricing and other methods of income shifting by multinational corporations.¹² The leakage in revenue, along with the small role played by the corporate tax in the U.S. revenue structure, suggests that corporate rate increases can, at best, move the deficit only marginally toward a sustainable path.¹³ Ameliorating the United States' fiscal challenges will require either more comprehensive and politically difficult personal income tax reforms or tapping new sources of revenues.

What is the VAT?

The VAT can be thought of as a retail sales tax that is collected in stages instead of all at once from the final consumer. The tax is collected by all businesses that provide (taxable) goods and services and is imposed on (taxable) sales to all purchasers. A business calculates its liability by taking the total value of its sales and multiplying by the VAT rate. The business is then permitted to offset its VAT liability by the amount of VAT paid for its purchases of goods and services. In this way, the tax is placed on the value added at each stage of production.

maintained at 2009 parameters, and the budgetary effects of the recent healthcare reform act were taken into account and less than one-fifth of the revenue required if other expiring tax cuts are extended as well.

¹² Clausing (2009) finds that every one percentage point differential between the U.S. and a particular foreign corporate tax rate is associated with a 0.5 percentage point increase in reported profits abroad. Clausing notes that an effect of this magnitude implies that, in 2004, the corporate tax rate differential induced U.S. and foreign-owned multinational corporations to shift over \$180 billion in profits—and over \$60 billion in tax revenues—out of the United States. See Kimberly Clausing, “Multinational Firm Tax Avoidance and Tax Policy,” *National Tax Journal*, December 2009.

¹³ In the domestic context in particular, the corporate income tax is essentially optional for all nonpublic companies because they can use legal forms of business that provide limited liability but that are taxed at the individual level as pass-through entities. As a result, only about one-half of domestic net business income is subject to the corporate income tax (U.S. Department of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness Background Paper*, July 2007).

The 2005 report of the President's Advisory Panel on Federal Tax Reform contains a simple example of how the VAT works.¹⁴ Imagine a boot maker that produces cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of \$200 before taxes. (For simplicity, assume the leather shop has no input costs). The boot maker sells each pair of boots he makes for \$500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add the tax to the cost of the \$500 pair of boots, and the consumer would pay \$550 per pair. The leather shop would not impose a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a 10 percent VAT, the tax calculation works differently. The VAT is charged on all sales of goods and services, not just sales to consumers. While there are different ways to administer the VAT, almost every country with a VAT uses the credit-invoice method.¹⁵ Under this method, the leather shop would collect a VAT of 10 percent, or \$20 on the \$200 of supplies purchased by the boot maker. The boot maker would pay the leather shop \$220, and the leather shop would send the \$20 to the government. When the boot maker sells the boots, he computes the VAT as \$50, and charges the purchaser \$550 for the boots. Instead of sending \$50 to the government, however, the boot maker would subtract the \$20 of VAT already paid to the leather shop and remit \$30 to the government.

The \$20 credit that the boot maker applies against his VAT liability is called an "input credit." The invoice received from the leather shop would show \$20 of VAT paid and serve as proof that the boot maker can take the credit. The government would receive \$20 from the leather shop and \$30 from the boot maker. Note that the government receives the same revenue under a VAT as it would under a retail sales tax (\$50), and from the consumer's perspective the taxes look identical.

This example illustrates one of the advantages of the VAT over the retail sales tax. Compliance risk is lower under the VAT because revenue is secured while collected throughout the chain of production, unlike a retail sales tax, under which all tax is lost if there is evasion at the final stage. In addition, retail sales taxes can have cascading effects (i.e. multiple levels of tax on an item as it makes its way from production to final retail sale) since it can be difficult administratively to separate business-to-business sales from final sales. In fact, in many countries that have adopted a VAT, the tax has replaced inefficient sales-type taxes collected at the wholesale or manufacturing level.

Border adjustments

Like retail sales taxes, VATs throughout the world are set up to tax domestic consumption. This means that exports should be outside the VAT tax base. Because the VAT is assessed at every level of production and distribution, a "border adjustment" is necessary to exclude exports from

¹⁴ President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, (Washington, DC: U.S. Government Printing Office, 2005).

¹⁵ Japan is the only country to impose a VAT with subtraction-method features. For a discussion of the advantages of using a credit-invoice method VAT, see Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," <http://www.american taxpolicyinstitute.org/pdf/VAT/Grinberg.pdf>.

the VAT. These adjustments are made by allowing businesses to claim input credits on exports while exempting their sales from the VAT. While it is commonly believed to provide trade benefits, exempting exports and taxing imports on its own would not enhance our trade competitiveness. Economists generally believe that exchange rate adjustments or other price level changes offset border tax adjustments in the long-term and eliminate any advantage or disadvantage border adjustments might otherwise create.¹⁶ During the adjustment period there could be real trade effects, however, and specific industries and markets could be affected if the VAT excluded many goods and services.

Distributional effects

As explained above, the VAT is equivalent to a retail sales tax but is collected at different stages of the production process. Since higher income households save more than those with lower or moderate incomes, the burden of the tax increases with current income reducing the overall progressivity of the tax system.¹⁷ The additional VAT burden, however, can be relieved for low and middle income households through refundable credits. When Canada implemented a VAT in 1991, called the Goods and Services Tax (GST), it added a refundable sales tax credit based on family size that phases out with income to relieve the burden on lower and middle income families.¹⁸ This approach to relieving the VAT burden is more effective than exempting food and other necessities from taxation (or applying preferential rates) since it can be targeted to lower and middle income households rather than all households. In addition, practical experience with VATs shows that having preferential or zero rates for some goods and services creates complexity, affects compliance, can invite tax evasion as products are deliberately misclassified to avoid tax, and produces legal uncertainty as policymakers struggle to classify goods for special treatment.¹⁹

It is important to note that the indexation of transfer payments also mitigates the burden of the VAT for low income households. Any price-level adjustments associated with the introduction or change in the VAT (and any sales tax) will automatically trigger increases in transfer payments that offset the regressive impact of the tax.

One concern with introducing a VAT is that it would hurt the elderly since they have high consumption relative to their income. However, since Social Security and Medicare benefits are effectively indexed for inflation, low income elderly households would be largely protected from any VAT induced increases in the price of consumer goods or healthcare services.

¹⁶ For a good discussion of the impact of border-adjustments on trade see Alan Viard, *Keynes at the Border*, <http://www.american.com/archive/2009/april-2009/keynes-at-the-border>.

¹⁷ When measured as a percent of life-cycle spending, the degree of regressivity of the VAT would be reduced.

¹⁸ Canada both provides a rebate to offset regressivity and zero-rates some necessities (basic groceries, prescription drugs, and medical devices). In addition, residential rents are exempt from the Canadian GST.

¹⁹ See Alain Charlet and Jeffrey Owens, "An International Perspective on VAT," *Tax Notes International*, September 20, 2010.

The Urban-Brookings Tax Policy Center (TPC) has recently released a report that describes a new methodology for distributing the VAT.²⁰ The report illustrates the distributional impact of a 5 percent VAT. The authors use a VAT base that covers about 57 percent of domestic consumption. While regressive in the absence of a rebate, the authors show that the impact on low and middle income households could be offset by allowing a rebate in the form of a refundable credit claimed on income tax returns. With the rebate, the VAT is progressive throughout almost the entire income distribution.²¹ The TPC study shows that one should not look at the distributional impact of the VAT in isolation. The progressiveness of the complete federal tax system --- with VAT rebates, for example --- must be taken into account.

Revenue effects

The broader the base of any VAT imposed, the more efficient it will be at collecting revenue. The revenues collected, of course, depend on the base and the rate. One measure of the efficiency of a VAT that takes both parameters into account is the ratio of VAT revenue to the product of aggregate consumption and the standard VAT rate. This measure, the “C-efficiency” of a VAT, would be 100 percent if the VAT were levied uniformly on all consumption. Imposing zero or reduced rates and/or exempting final consumption from the VAT will lower its C-efficiency. This measure varies considerably over OECD countries from 30 percent in Mexico to almost 100 percent in New Zealand (the gold standard of VATs) in 2005. The average C-efficiency of all OECD country VATs was 53 percent in 2005.²²

Toder and Rosenberg (2010) develop a prototype broad VAT base for the U.S. that would cover almost 80 percent of consumption.²³ They estimate that with a 5 percent rate, the VAT would raise \$355 billion in 2012 which translates to a C-efficiency of 63 percent. Toder and Rosenberg follow government estimating conventions and assume that GDP remains fixed when tax policy is changed. If a consumption tax is imposed and nominal GDP and prices are fixed, factor incomes must fall. As a result, decreases in revenues from the individual income, corporate income, and payroll tax revenues will partially offset the revenue gains of the VAT. Toder and Rosenberg estimate a 27 percent decrease in revenues from these taxes bringing the revenue gain from the VAT down to \$259 billion in 2012. A refundable tax credit for all households --- designed to generate the same revenue loss as exempting rent, new home purchases, food consumed at home, and private health expenditures from the VAT base --- brings the yield down to \$161 billion or about 1 percent of GDP.

²⁰ Eric Toder, Jim Nunns, and Joseph Rosenberg, *Methodology for Distributing a VAT*, Urban-Brookings Tax Policy Center, April 2011, <http://www.urban.org/uploadedpdf/1001533-Methodology-Distributing-VAT.pdf>.

²¹ The VAT burden as a share of income increases from 0.4 percent for the lowest quintile to 2.4 percent for the top quintile. In the top quintile, the VAT burden is roughly proportional to income.

²² OECD, *Consumption Tax Trends 2006: VAT/GST and Excise Rates, Trends and Administration Issues*, 2006.

²³ The broad base includes all domestic consumption, except for education, government-financed health care (Medicare and Medicaid), services of charitable organizations, and services performed by sub-national governments. State and local sales taxes and the imputed value of financial services are exempted from the base. See Eric Toder and Joseph Rosenberg, “Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes,” Urban-Brookings Tax Policy Center (March 2010).

Policy analysts point out that given the fixed administrative costs of the VAT the U.S. should adopt a VAT at a fairly substantial rate.²⁴ The Toder and Rosenberg study suggests that with a 10 percent rate, a VAT that covers almost 80 percent of consumption and includes a rebate to offset the regressivity of the tax could raise about 2 percent of GDP.

Interaction with the states

Coordinating states' retail sales taxes with the VAT would be a major challenge. States would likely view a VAT as an intrusion on their traditional sales tax base. If states were to bring their sales tax bases into conformity with the broad federal base and coordinate their sales tax collection systems with the federal regime, however, they could improve the efficiency of their sales taxes. Compliance burdens for multistate businesses and administrative costs for states could be reduced. And if the states moved to impose state level VATs, even greater gains in terms of simplicity and lower compliance burdens might be achieved.

The Canadian experience is particularly relevant to the U.S. case. Canada introduced a federal VAT in 1991 to replace a federal manufacturing sales tax that had many serious administrative deficiencies and undesirable economic effects.²⁵ At the time, retail sales taxes similar to those found in the United States existed in all of Canada's provinces except Alberta.

Quebec followed the lead of the federal government and replaced its retail sales tax with a provincial VAT (called the Quebec Sales Tax or QST) when the VAT was introduced. Quebec administers both the QST and the GST. In 1997, after much negotiation, the three Atlantic provinces of New Brunswick, Nova Scotia, and Newfoundland and Labrador replaced their retail sales taxes with VATs. Unlike in the Quebec case, the three provinces decided to adopt the federal GST base and have the federal government collect both the federal and provincial VATs. In July 2010, Ontario and British Columbia replaced their sales taxes with VATs. Five provinces have kept their sales taxes.

While the Canadian system is a bit messy, it functions well and demonstrates that a federal VAT can exist side by side with different state sales taxes. Canadian tax scholars Richard Bird and Pierre-Pascal Gendron (2010) conclude that²⁶:

“The Canadian experience shows that the existence or non-existence of sub national retail sales taxes is, in both technical and economic terms, a matter of indifference when considering a federal VAT. On the other hand, the existence of a federal VAT may be extremely important from the perspective of sub national governments that wish to improve their sales taxes.” (page 2)

²⁴ See William Gale and Benjamin Harris “A VAT for the United States: Part of the Solution,” in *The VAT Reader: What a Federal Consumption Tax Would Mean for America*. (Tax Analysts, 2010) and Eric Toder and Joseph Rosenberg, “Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes,” Urban-Brookings Tax Policy Center (March 2010).

²⁵ *Ibid* 4, at 2.

²⁶ *Ibid*.

The Canadian experience shows that concerns about the states should not prevent the U.S. from adopting a VAT. William Gale and Benjamin Harris suggest that if all states dropped their sales taxes and harmonized and if the federal VAT rate were 10 percent, the combined state and federal VAT rate would be around 15 to 17 percent.²⁷ This combined rate would be slightly below the OECD average of about 18 percent but, according to Gale and Harris, sufficient to close much of the long-term fiscal gap and replace or improve state-level sales taxes.

Economic Growth

A substantial body of economic research finds that replacing an income tax with a broad-based consumption tax would have a positive effect on economic growth.²⁸ Recent work from the economists at the OECD suggests that the VAT is more pro-growth than personal and corporate income taxes.²⁹

A broad-based VAT applied at a single rate is economically efficient because it generally does not distort consumers' choices among goods and services and does not discourage household savings choices (if the rate is constant over time). Like income and payroll taxes, a VAT does, however, distort households' work/leisure decisions. The VAT would have no impact on business decisions. The presence of a VAT would not distort business choices relating to how much to invest, what types of assets to purchase, where to invest, how to finance investment, and whether to incorporate or operate outside the corporate form.

While adopting the VAT would increase distortions to the work/leisure decision, the VAT would impose an efficiency enhancing one-time tax on existing wealth. And revenues from the VAT could be used buy down the deficit and/or reduce individual and corporate statutory tax rates. Large and persistent deficits can have negative effects on economic growth by reducing national savings, driving up interest rates, and increasing our reliance on foreign investors. A single-rate VAT on a broad-base at a rate of 10 percent could go a long way towards closing our fiscal gap. Using some VAT revenues to buy down statutory income tax rates would also have positive effects on growth. Lower marginal income tax rates on individuals and businesses would strengthen incentives to save, invest, work, and innovate while making our tax system more efficient.

Compliance and Administration Costs

Having to collect and pay both VAT and a business income tax would likely increase total compliance costs for businesses. It would also create an additional set of administrative

²⁷ *Ibid* 23, at 7.

²⁸ See, for example, Alan Auerbach, "Tax Reform, Capital Allocation, Efficiency, and Growth," in *Economic Effects of Fundamental Tax Reform*, (Washington, DC: Brookings Institution Press, 1996); Don Fullerton and Diane Lim Rogers, "Lifetime Effects of Fundamental Tax Reform" also in *Economics Effects of Fundamental Tax Reform*; and David Altig, Alan Auerbach, Laurence Kotlikoff, Kent Smetters, and Jan Walliser, "Simulating Fundamental Tax Reform in the United States," *American Economic Review*, June 2001.

²⁹ See Jens Arnold, Bert Brys, Christopher Heady, Asa Johansson, Cyrille Schwellnus and Laura Vartia, "Tax Policy Reform and Economic Growth," *Economic Journal*, Volume 121, Issue 550, February 2011.

responsibilities and costs for the IRS. A 2008 Government Accountability Office (GAO) study includes data that indicates that a VAT may be less expensive to administer than an income tax.³⁰ GAO reports that in the United Kingdom, administrative costs of the VAT are 0.55 percent of revenue collected compared to 1.27 percent for the income tax. Further evidence comes from New Zealand. Officials at the New Zealand Inland Revenue Department told GAO that administering their VAT was simpler than administering some of their other taxes.

Some noncompliance is inevitable in any tax system. Evasion in a VAT can range from simple non-filing and non-payment of tax by businesses to complex schemes in which goods pass through a series of transactions designed to generate counterfeit input tax refunds. The OECD reports noncompliance rates ranging from 4 percent to 17.5 percent in major developed economies with VAT systems.³¹ The United Kingdom Revenue and Customs reports a tax gap of 13 percent for the VAT and 8 percent for all direct taxes.³² This compares to a tax gap for the entire U.S. tax system (with mostly direct taxes) of 16 percent.³³

Small business

Because the compliance costs associated with a VAT may require a significant investment for some small businesses, it would be important to consider how to treat such businesses in a VAT. Most countries with VATs address these concerns by exempting them from collecting the VAT. In 2007, 24 of the 29 OECD countries with a VAT exempted businesses with gross receipts beneath specified thresholds, varying from \$4,800 to \$93,600.³⁴ It is possible to exempt many small businesses from collecting the tax without significant revenue loss. There are two reasons for this result. First, because the VAT is collected in fractions at every stage of production (rather than once at the retail level like a sales tax), and many small businesses buy many of their inputs from larger businesses, exempted small businesses would still pay tax on their inputs. As a result, much of the tax on any final good sold by a small business would still be collected. Second, exempted small businesses would be allowed to voluntarily register to collect a VAT. Some exempted businesses that sell primarily to other businesses would choose to collect VAT voluntarily in order for them and their customers to be able to claim input tax credits on their purchases.

The GAO estimated in 1993 that a VAT collection threshold of \$100,000 in taxable annual gross receipts would reduce the number of businesses filing VAT returns from about 24 million to about 9 million.³⁵ They further concluded that approximately 19 percent of small businesses qualifying for the exemption would nonetheless voluntarily collect the VAT. Estimates for 2003 suggest that only 1.8 percent of gross receipts are collected by businesses with less than

³⁰ GAO, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden and Transition*, GAO-08-566, 2008.

³¹ OECD, *Recent Policy and Administration Developments in VAT/GST*, March 2005.

³² HM Revenues and Customs, *Measuring Tax Gaps 2009*, (March 2010, revised).

³³ IRS, "Tax Gap Figures," February 2006.

³⁴ OECD, *Consumption Tax Trends*, 2008.

³⁵ GAO, *Tax Policy: Value-Added Tax: Administrative Costs Vary with Complexity and Number of Businesses*, GGD-93-78, 1993.

\$100,000 in annual gross receipts.³⁶ Thus, a VAT collection threshold at this level likely would not lose significant revenue, particularly when voluntary collection is taken into account.

To summarize, the VAT compares favorably with other taxes in terms of costs of administration, compliance burdens, and opportunities for evasion. Small business concerns could be addressed by exempting them from collecting the VAT with relatively minor revenue consequences.

Inflationary concerns

Some observers worry about the pressure that adopting a VAT would have on prices. The Federal Reserve Board could accommodate the one-time increase in price that would result when the VAT is added to the tax system by expanding the money supply. As Gale and Harris have pointed out, not doing so would create significant and unnecessary adjustment costs in terms of lost jobs and wages.³⁷ One question is whether the VAT would be associated with continually increasing prices. Economic research suggests that this should not be a concern. International experience with recent VAT increases suggests that tax-induced increases in the inflation rate are temporary and are reversed once the tax increase passes through.³⁸

Political Economy Concerns

The 2005 President's Advisory Panel on Federal Tax Reform studied an add-on VAT but did not recommend it as an option. One important factor in the Panel's decision not to recommend the add-on VAT option was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP.

There are relatively few empirical studies on the relationship between the adoption of a VAT and the growth of government spending.³⁹ Simple country comparisons suggest that countries without VATs, like the United States, have a smaller government sector than countries with VATs. However, more sophisticated statistical studies that control for other factors that may affect the relationship between the size of government and the presence of a VAT yield mixed results. The most recent study finds weak evidence that governments with VATs raise more revenue, all else equal, than those without.⁴⁰ This study finds no strong evidence, however, that the VAT in itself has caused the growth of government. The authors conclude that the VAT has

³⁶ Kelly Luttrell, Patrice Treubert, and Michael Parisi, *Integrated Business Data 2003*, Statistics of Income, IRS, <http://www.irs.gov/pub/irs-soi/03intbus.pdf>.

³⁷ *Ibid* 3, at 2.

³⁸ Michael Keen, Mahmood Pradhan, Kenneth Kang, and Ruud de Mooij, "Raising the Consumption Tax in Japan: Why, When, How?" *IMF Staff Discussion Note*, June 2011.

³⁹ For the most recent, and rigorous, empirical study of the "money machine" hypothesis see Michael Keen and Ben Lockwood, "Is the VAT a Money Machine?" *National Tax Journal*, December 2006.

⁴⁰ *Ibid*.

been proved to be a particularly effective form of taxation that has reduced the use of less effective tax instruments.⁴¹

Studies of VATs in other nations may not provide much guidance on the effect of adopting a VAT in the United States. Most developed countries initially used a VAT to reduce or eliminate other consumption taxes, such as existing sales or excise taxes. The United States has no broad-based pre-existing federal consumption tax to replace. Thus, whether adopting a VAT would fuel the growth of U.S. federal spending remains an open question. What is clear, however, is that the VAT is an efficient instrument to raise revenue.

Given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government some panelists did not support recommending an add-on VAT. Other panelists were more confident that voters could be relied upon to understand the amount of tax being paid through a VAT, in part because the proposal studied by the Panel would have the VAT separately stated on each sales receipt provided to consumers (as does Canada). These panelists envisioned that voters would appropriately control growth in the size of the federal government through the electoral process.

Conclusions

The fiscal challenges ahead are daunting. Instead of spending the next two years engaging in an endless debate of whether to extend the 2001 and 2003 tax cuts, I urge you to focus on building support for and designing a reform of the current system that can reduce our future unsustainable debt burdens and enhance the growth of the U.S. economy and the well-being of Americans.

The VAT on its own cannot solve the country's fiscal problems. And introducing a VAT has its own problems. If we adopted the VAT, we would have to institute some form of rebate to offset its regressivity and make every effort to adopt the broadest possible base. We would need to increase IRS resources for administration and be attentive to a range of compliance issues. But we must recognize that near and long-term fiscal pressures will require that we raise more revenue from our tax system. The VAT is an efficient revenue raiser that is likely to be significantly less damaging to economic growth than increasing personal and corporate statutory rates. After considering the range of issues associated with adopting a VAT, I conclude that the United States may be best served by combining a base-broadening reform of the current income tax system with the introduction of a VAT.

Thank you. I would be happy to answer any questions you may have.

⁴¹ *Ibid.*

Chairman CAMP. Thank you, Ms. Altshuler.
Mr. Carroll, you are recognized for 5 minutes.

STATEMENT OF ROBERT CARROLL, ERNST & YOUNG

Mr. CARROLL. Thank you. Chairman Camp, Ranking Member Levin, distinguished Members of the Committee, I thank you for the opportunity to testify today regarding considerations for value added tax in the United States.

The U.S. faces serious fiscal challenges over the next several decades as the federal deficit and debt are projected to rise to unsustainable levels. At the same time, many view the existing tax

system as overly complex, and an obstacle to economic growth. These issues have led to some discussion of a value added tax.

Some view a VAT as a possible source of additional revenue to help reduce the deficit and stabilize the debt. Others view a VAT as a means to help improve the competitiveness of the U.S. by providing revenue to permit a reduction in the corporate income tax rate, or a reduction in the scope of the income tax system.

VATs are the norm in most of the countries. More than 150 countries rely on VATs, and in these countries VATs account for nearly one-fifth of total government revenue. Consideration of a VAT in the United States is not a new issue. VATs have been discussed and considered in the U.S. for more than four decades. A VAT was considered by a task force appointed by President Nixon in 1970 and an advisory panel appointed by President Bush in 2005.

A VAT in the U.S. would raise a number of issues, and they can have very different economic effects depending on a number of key considerations. For example, would the VAT be a replacement tax or an add-on tax? Which features of the income tax would be replaced by a replacement VAT? How would the revenue from an add-on VAT be used? Would it be used to reduce the deficit, reform the existing tax system, or fund additional spending?

Would the VAT apply broadly to consumption, or would a large portion of household consumption be excluded from the VAT base? Answers to these questions would have a significant impact on the economic effects of a VAT. A broad-based VAT that replaces the worst features of the income tax has the potential to provide significant economic benefits. A VAT is fundamentally a tax on consumption, and does not tax the return to saving and investment, thereby reducing the cost of capital and increasing investment.

Greater investment means more capital formation, and ultimately higher labor productivity and living standards than otherwise would be the case. Estimates suggest that the economic gains from replacing all or a portion of the income tax with a consumption type tax, such as a VAT, could be significant. One study found that complete replacement of the individual and corporate income taxes could increase the size of the economy in the long run by six to ten percent.

The December 2007 Treasury Department study on approaches to make the U.S. more competitive found that replacement of the corporate income tax with a VAT could increase long run output by two percent to two point five percent. But it is important to emphasize that these potential, economic benefits arise from a VAT that is replacing all or the worst features of the income tax.

A deficient reducing, add-on VAT could have significantly different economic effects, using the revenue from an add-on VAT to reduce the deficit would put downward pressure on long-term interest rates, as deficit financed government spending is replaced with VAT financed government spending. And deficits that would otherwise crowd out private savings are reduced.

Lower long-term interest rates would reduce borrowing costs for both households and businesses, and eventually boost output; however, the rise in prices that would accompany an add-on VAT would also likely lower consumer spending. And there is evidence

that consumer spending and employment would be permanently reduced.

Another key consideration is how broad a VAT base would actually be in practice. The VATs in most other countries and the state sales taxes in the U.S. are generally not broad-based and exclude significant amounts of consumption from the tax base through exemptions and preferential rates. They might be better termed partial VATs. A more narrow base requires a higher tax rate to raise a given amount of revenue, and can lead to differential taxation of consumption. Both can reduce the economic benefits of a VAT, and adversely affect the sectors of the economy that are taxed.

Additionally, an add-on VAT, while possibly addressing the nation's long-term fiscal imbalance, would represent a new tax with additional compliance costs. Businesses would have to collect the VAT on behalf of the government, keep and maintain records of their VAT payments and collection, and prepare VAT returns. The extent of these costs would depend on factors such as the number of transactions involved, the complexity of the VAT base, rate structure, definitions and administrative enforcement regimes.

VATs can also impose extra, non-recoverable costs on businesses. Under a VAT, businesses act as tax collectors. A business is liable for VAT on its gross sales, but receives credits for a VAT previously paid on its purchases. There may be circumstances, in which VAT crediting may be incomplete, thereby imposing a direct tax cost on businesses. Because the gross flows are so large, imperfections in the VAT system can be greatly amplified.

Finally, the transition as a VAT is introduced would be crucial. Introduction of a VAT involves a lump sum tax on existing assets, plus there could be large, near-term economic effects as the economy adjusts to a large, new revenue source. In summary, the specific design of a VAT is critical to its economic effects. All VATs are not equal, and they could have very different economic effects depending on key design elements.

I thank you again for the opportunity to testify, and look forward to responding to any questions you may have.

[The prepared statement of Mr. Carroll follows:]

Considerations for a Value-Added Tax in the United States

Testimony before the

Ways and Means Committee

United States House of Representatives

Robert Carroll¹

July 26, 2011

Chairman Camp, Ranking Member Levin, and distinguished members on the Committee, thank you for the opportunity to testify today regarding considerations for a value-added tax in the United States.

The United States faces serious fiscal challenges over the next several decades as the federal deficit and debt are projected to rise to unsustainable levels. At the same time, many view the existing tax system as overly complex and an obstacle to economic growth. These issues have led to some discussion of a value-added tax (VAT) as a possible source of new revenue or as a replacement for a portion of the existing income tax.

Some view a VAT as a possible source of additional revenues to reduce the deficit and help stabilize the federal debt. Others view a VAT as means to help improve the competitiveness of the United States by providing revenue to permit a reduction in the corporate income tax rate or reduction in the scope of the income tax system.

Consideration of a VAT in the United States is not a new issue. More than 150 countries rely on VATs, and in these countries, VATs account for nearly one-fifth of total government revenue. VATs have been discussed and considered in the United States for more than four decades. Two recent proposals include the 6.5 percent VAT proposed by the Bipartisan Policy Center's Debt Reduction Task Force in November 2010 and the 8.5 percent VAT included in Congressman's Ryan's Road Map for America's Future released in January 2010.

A VAT in the United States would raise a number of issues and can have very different effects depending upon a number of key considerations. For example:

- Would the VAT be a replacement tax or an add-on tax?
- Which features of the income tax would be replaced by a replacement VAT?
- How would the revenue from an add-on tax used, to reduce the deficit, reform the tax system, or fund additional spending?
- Would the VAT apply broadly to consumption or are many consumption items excluded from the VAT base?

The answer to these questions will have a significant influence on the economic effects of a VAT. A broad-based VAT that replaces the worst features of the income tax has the potential to

¹ Principal, in the Ernst & Young LLP's Quantitative and Economics Statistics Group and Center for Tax Policy. Formerly, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, November 2003 through January 2008. The views expressed do not necessarily reflect those of Ernst & Young LLP.

provide significant economic benefits. A VAT is fundamentally a tax on consumption and does not tax the return to saving and investment. The nation's output could be increased in the long-term by reducing the tax on saving and investment and by more even or economically neutral treatment of economic activity.

The revenue from an add-on VAT could be used to reduce the deficit, putting downward pressure on long-term interest rates as deficit-financed government spending is replaced with VAT-financed government spending, and deficits that would otherwise crowd out private saving are reduced. Lower long-term interest rates would reduce the borrowing costs for both households and businesses. However, the rise in prices that would accompany a VAT would also likely lower consumer spending and there is evidence that consumer spending and employment would be permanently reduced as compared to deficit reduction financed by a reduction in certain types of government spending.

A more narrow VAT base would require a higher tax rate to raise a given amount of revenue, which would reduce the potential economic benefits from a VAT. It is also important to observe that the VATs in most other countries and state sales taxes in the United States are generally not broad-based, and exclude significant amounts of consumption from the tax base through exemptions and preferential rates. Differential taxation of consumption under a narrow-based VAT can also have significant distortive effects on households' consumption choices that further reduce a VAT's economic benefits and adversely affect the sectors of the economy that are taxed.

Additionally, an add-on VAT, while possibly addressing the nation's long-term fiscal imbalance, would represent a new tax with additional compliance, administrative and other costs. Other important issues include how a VAT would be applied to financial services, whether small businesses would be exempt, and whether transition relief would be provided.

I have had the opportunity to consider value-added taxes from a number of perspectives, inside and outside of government, in the context of broad reform of the Internal Revenue Code as a replacement tax and as an additional source of revenue. Today I will start by focusing on the mechanics of a VAT and its potential economic benefits. Then I will focus on issues related to the design of the VAT base, the reliance on VATs in other countries, and potential compliance and other costs. Finally, I will discuss border adjustments and transition issues.

Mechanics of a VAT

A VAT is similar to a retail sales tax in that it applies to goods and services sold to consumers and, therefore, is a tax on consumption. The two taxes, however, have an important difference. A retail sales tax is collected once on final sales to consumers, while a VAT is collected at every stage in the production and distribution chain. Also, a VAT may have somewhat less evasion than a retail sales tax because all collection is not concentrated at the retail level.

Net VAT revenue collected by the government is generally the difference between the gross tax on sales and gross credits for tax previously paid and may be only a small fraction of the gross cash flows involved.

Types of VATs that could be considered in the United States

Two types of VATs have been discussed in the United States: the subtraction-method VAT and the credit-method VAT, also known as the credit invoice-method VAT. The subtraction-method VAT has received attention in the United States, in part, because of its similarity to the current corporate income tax. The credit-method VAT, however, is used in virtually all 150 countries with a VAT. Japan is the only country that uses a subtraction-method VAT.²

Under a subtraction-method VAT (sometimes referred to as a "business activity tax" or "business transfer tax"), the tax base for each firm is receipts from sales of taxable goods and services minus purchases of taxable goods and services from other businesses.³ Businesses aggregate their receipts, subtract permitted deductions and file a periodic return.

In contrast, under a credit-method VAT, the tax on intermediate inputs or production is eliminated differently. Instead of deducting purchases from other firms, each firm is fully taxed on its sales but also receives a credit for the tax paid by suppliers on the firm's purchases, as shown on the suppliers' invoices. Businesses remit tax on sales and claim refunds for tax previously paid. The credit method uses the invoices to show the VAT paid on purchases and charged on sales, which creates a paper trail that helps make the VAT more enforceable.

Both the credit-method VAT and subtraction-method VAT collect the same amount of tax overall and at each stage of production. Under the subtraction method, each firm subtracts its pretax purchases from its pretax sales and pays tax on the difference. Under the credit method, each firm subtracts tax previously paid when determining how much tax to remit to the government.

Although arithmetically equivalent in theory, the credit method, unlike the subtraction method, can result in over-taxation (tax cascading) if exemptions are provided before the retail stage. The exemption, in effect, breaks the VAT chain and increases the total burden on the final consumer good. In contrast, however, the subtraction method, unlike the credit method, cannot easily accommodate multiple tax rates which may help explain the prevalence of the credit method.

Comparison of a VAT base to the corporate income tax base

There are several important differences between the tax base of a VAT and the corporate income tax that help illustrate from where a VAT derives its potential economic benefits. These points are clearest with a subtraction-method VAT but also apply to a credit-method VAT.

First, under a VAT, businesses would not deduct wages or other worker compensation. Unlike under the corporate income tax, employee compensation is included as part of the VAT base and is therefore taxed. Economy-wide, roughly two-thirds of value added is actually workers' wages and other compensation. This is one reason why a VAT is generally thought to be regressive, meaning it is borne disproportionately by low-income and moderate-income households. A VAT is, in large part, similar to an employer tax on worker compensation.

² Several countries have subtraction-method VATs at the regional level, in addition to their federal credit-method VATs. See Tom Neubig, Robert Cline and Estelle Dauchy, "Non-VAT taxes on value added: the European Union experience," Ernst & Young LLP *Tax Insights*, June 2010.

³ The computation of VAT under a subtraction and credit method VAT and related issues are discussed in Robert Carroll and Alan Viard, "Value-added taxation: basic concepts and unresolved issues," *Tax Notes*, (March 1, 2010), pp. 1117-1126, and Robert Carroll, "Value-added tax primer: What US companies should know about value-added tax," Ernst & Young LLP, May 2011.

Second, a VAT applies to all businesses, not just C corporations. The tax base would include the value added of all businesses, although many countries exempt small businesses from the VAT due to high compliance costs. In this respect, all businesses would be treated the same, although investor level taxes on capital gains and dividends and the associated double tax on corporate profits might well persist under an add-on VAT that retained the major features of the current income tax.

Third, under a VAT, businesses deduct all purchases from all other businesses. This means that businesses' write-off or expense all investment immediately. This includes not only all equipment but also buildings and other structures. A VAT allows a full deduction for the cost of new investment and then taxes the return to this investment over its life. This feature has the effect of removing the tax on the economically important portion of the return to investment, which encourages additional capital formation as compared to the income tax, and is a major source of a VAT's economic benefits.⁴

It is important to note that the current U.S. income tax includes provisions that move in the direction of a VAT's treatment of investment.⁵ Accelerated depreciation, for example, reduces the cost of capital for new investment and moves towards the immediate deduction for all new investment provided under a VAT. Further, certain other investments, such as those made by certain small businesses, already receive full expensing, which is the same treatment under a VAT. In this respect, the current U.S. income tax is not a pure income tax, but a hybrid consumption-income tax with some VAT-like features.

Fourth, income and expenses related to financial intermediation are often excluded from the VAT base. This means that companies neither include interest income nor exclude interest expenses from net income for VAT purposes. This feature of a VAT can have large effects on the VAT remitted by firms active in financial intermediation or heavily reliant on debt financing. Moreover, a VAT that disallows interest deductions and provides expensing for new investment may increase the cost of capital for highly leveraged firms as compared to the current income tax. Also, a VAT that replaced the income tax or provided a means to reduce the corporate income tax would result in more even treatment of debt and equity finance.

Fifth, firms with little or no income tax liability may have substantial VAT liability and vice versa. The VAT base, in simplest terms, is defined as receipts less purchases from other businesses and could be quite large even if a firm is not currently profitable. For example, a firm with large interest expenses might be unprofitable but may pay substantial VAT. Alternatively, a firm that is profitable from an income tax perspective might have little or no VAT (or even be in a refund position) if it is making large capital purchases. Because capital expenditures are expensed, they can drive VAT liability down in anticipation of future profits.

Finally, VATs are typically border adjustable, with exports exempt but imports taxable. While, as discussed below, adjustments in exchange rates likely mitigate the aggregate effects of border

⁴ It is important to note that even though a VAT allows businesses to expense all new investment both income taxes and VATs continue to tax a significant portion of the return to investment. An income tax taxes the full return to an investment, while VATs only relieve from tax a portion of the return – what economists call the "normal return" to an investment or the minimum required return that investors demand to forgo current consumption. Returns that exceed this minimum required return – supra-normal returns – continue to be taxed under a VAT.

⁵ These issues are also discussed by U.S. Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 2007, p. 28. (http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf).

adjustments on the U.S. balance of trade, VATs can have near-term and potentially longer-lasting effects on companies and industries.

The combination of these points suggests how some businesses might be affected by a VAT. If a firm's value added arises primarily from workers' contribution to production, that firm will tend to remit more VAT than a firm that has substantial investment in equipment and structures (i.e., tangible property). Labor-intensive firms, such as personal service companies, will remit more VAT than capital-intensive firms, such as manufacturing companies.

Comparison of value-added to corporate profits

As shown in Table 1, value added is considerably larger than corporate profits, the basis for the corporate income tax. The larger size partially reflects the fact that about two-thirds of value added reflects workers' wages. Thus, labor-intensive companies and industries would generally pay more VAT than capital-intensive industries and more than they would in corporate income tax. There are also special issues that would arise for certain industries and sectors, such as financial services and the flow-through or non-corporate sector.

If VAT revenue were used to lower the corporate tax rate (i.e., with a partial replacement VAT), the effects of the lower corporate tax rate could benefit many firms. Firms with substantial foreign operations might see their competitive position improve relative to foreign firms, as the U.S. corporate rate becomes more closely aligned with the international norm.

Table 1. Composition of corporate profits and valued added, by US industry, 2007

Private Industries	Corporate Profits		Value Added*	
	\$Billions	Percent	\$Billions	Percent
Agriculture, forestry, fishing & hunting	3	0%	70	1%
Mining	49	4%	55	1%
Utilities	42	3%	143	2%
Construction	17	1%	609	7%
Manufacturing	451	36%	701	8%
Wholesale trade	82	7%	632	8%
Retail trade	84	7%	823	10%
Transportation and warehousing	19	1%	224	3%
Information	95	8%	463	6%
Finance, insurance, real estate, rental & leasing**	222	18%	1,445	17%
Professional and business services	149	12%	1,427	17%
Educational services, health care & social assistance	11	1%	925	11%
Arts, entertainment, recreation, accommodation & food services	19	2%	467	6%
Other services, except government	3	0%	331	4%
Total Private	1,246	100%	8,315	100%

*Excludes exports. Taxes on imports assumed to be remitted by foreign companies importing to the United States.

**Less imputed rental value of owner-occupied housing

Source: Computations by Ernst & Young LLP using Bureau of Economic Analysis data.

Potential economic benefits of a VAT and other consumption-type taxes

The effects of a VAT on economic performance depend on how the revenue from the VAT is used. A VAT that replaces or reduces the worst features of the income tax could increase economic growth, while the effects of an add-on VAT can be more varied depending on the alternative policies for reducing the deficit.

Many economists have long held that the income tax imposes a drag on the economy by taxing the return to saving and investment. This "tax penalty" on saving and investment could manifest itself in many ways; for example, businesses might provide less equipment to workers or use older technologies and be slower to incorporate new technologies, thereby decreasing worker productivity and their real wages and, ultimately, lowering living standards.

Greater reliance on value-added taxes, or other consumption-type taxes, to fund government can help improve economic performance because consumption taxes do not tax the return to saving and investment. By not taxing the return to saving and investment, these taxes reduce the cost of capital and lead to greater investment. Greater investment means more capital formation, and, ultimately, higher labor productivity and living standards than otherwise.

Some estimates suggest that the economic gains from replacing all or a portion of the income tax with a consumption-type tax, such as a VAT, could be significant. One study found that complete replacement of the individual and corporate income tax could increase the size of the economy in the long-run by between 6 percent and 10 percent.⁶ Another study found that replacement of the corporate income tax with a VAT could increase long-run output by 2.0 percent to 2.5 percent.⁷

The effects of a deficit-reducing add-on VAT would be more varied. A deficit reducing add-on VAT increases private savings, but does so primarily by replacing deficit-financed government spending with VAT-financed government spending, which frees up private saving to finance private investment rather than financing government spending. Over time interest rates and the cost of capital would fall, thereby further stimulating investment and the larger capital stock would increase labor productivity and nominal wages. As a consumption-based tax, the VAT would also encourage saving and investment and additional capital formation. Both channels contribute to an increase in capital intensity and stimulate long-term economic growth.

Even though a deficit-reducing add-on VAT increases long-term economic growth, a recent study found that taxable consumption and employment would fall in both the near-term and the long-term under a deficit-financing add-on VAT as compared to a policy that reduced the deficit through a reduction in certain types of government spending.⁸ The analysis also found that the add-on VAT would reduce output for several years after enactment with only negligible positive effects over the following several years, before increasing output in the longer-term.

⁶ David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, (2001) "Simulating fundamental tax reform in the United States," *American Economic Review* 91 (3), pp. 574–95.

⁷ This approach for reform would not only replace the income tax, but also individual income taxes collected from pass-through businesses (e.g., S corporations, partnerships and sole proprietorships), and conform the tax treatment of interest to that of dividends. U.S. Department of the Treasury, *supra* note 5, p. 32.

⁸ Robert Carroll, Robert Cline and Tom Neubig, "The Macroeconomic Effects of an Add-on Value Added Tax," An Ernst & Young LLP report prepared on behalf of the National Retail Federation, October 2010.

Defining the VAT base

In principle, the base of a VAT should include all final household consumption and exclude all investment purchases to minimize economic distortions and maximize its economic benefits. However, in practice, VATs are seldom applied to all consumption expenditures and frequently exclude a variety of goods and services from the tax base or provide preferential rates.⁹

A concern with VATs is that they are borne disproportionately by low-income and moderate-income households. Discussions of VATs are typically combined with discussions of policies to address their regressivity relative to an income tax. The narrowing of the VAT base through exemptions and preferential rates is typically intended to address these regressivity concerns. In addition, for social reasons, the tax is often reduced or eliminated on goods such as food consumed at home, education or health care services.

Standard VAT exemptions among OECD countries include health care, education, and financial services and most VATs could more accurately be termed "partial VATs."¹⁰ Exemptions and preferential rates exclude a significant share of household consumption from the VAT. One measure of the narrowness of the VAT base is the OECD's VAT revenue ratio (VRR), which relates actual VAT revenues to potential VAT revenues assuming all household consumption is subject to a country's standard VAT rate. As shown in Chart 1, the weighted average VRR is 53.9 percent with New Zealand with the highest VRR (98 percent) and Mexico the lowest VRR (35 percent). Only five countries have a VRR above 70 percent, reinforcing the view that other developed nations tend to exclude or provide preferential rates to a significant portion of household consumption.

Experience with sales taxes in the United States also suggests that certain consumption goods would likely be exempt from a new VAT. Virtually all states exempt prescription drugs and most do not tax health care. Thirty states exempt food for home consumption or tax it at a lower preferential rate. One study estimated that 38 percent of personal consumption expenditures were subject to state and local sales taxes.¹¹

A recent study by Toder and Rosenberg (2010) considering two potential VAT bases for the United States – a "broader" base that includes most purchases of final goods and services to consumers (i.e., personal consumption) that might reasonably be expected to be subject to tax under a new VAT in the United States and a "narrow" base or partial VAT that includes several additional exemptions.¹² Both bases assume that the VAT would not be applied to educational expenses, government-financed medical expenses (primarily Medicare and Medicaid), services provided by charitable and religious organizations, the imputed value of financial services, existing residential housing, and services provided by state and local governments. The VRR for the narrow-based VAT and broad-based VAT are calculated at about 41 percent and 67 percent, respectively, suggesting a substantial portion of consumption is likely to be excluded.

⁹ Some VAT proposals suggest a VAT rebate as a mechanism to offset in whole or part the VAT paid by low-income households, but there are few if any examples of the provision of such rebates in other countries. For an example of a study that considers refundable credits targeted to low-income households see: Eric Toder and Joseph Rosenberg, "Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes," Tax Policy Center, Urban Institute and Brookings Institution, 2010.

¹⁰ For example, see Organisation for Economic Co-operation and Development, *Consumption Tax Trends, 2010*, 2011.

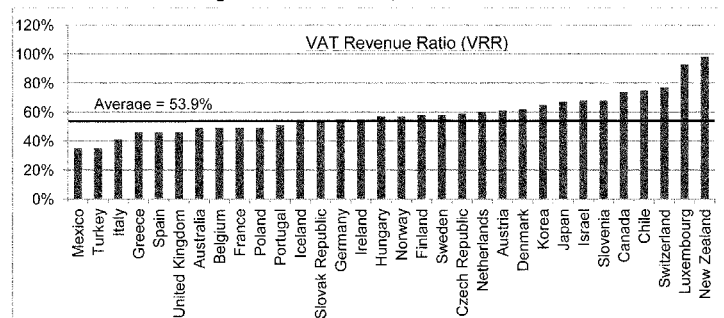
¹¹ See Robert Cline, John Mikesell, Tom Neubig and Andrew Phillips, "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," Council on State Taxation, January 25, 2005, p. 1.

¹² Toder and Rosenberg, *supra* note 9.

The narrow VAT base excludes a number of additional consumption items that have traditionally received special treatment in the United States, either under the federal income tax or under state sales taxes. The exclusion of housing is extended to both rental housing and new home purchases in recognition of the special status housing has received under the U.S. tax system. Purchases of groceries and other food items are also excluded, following the practice among most states. Finally, private health care spending is excluded, including both out-of-pocket expenses and health insurance premiums, which follows the special tax treatment health care spending generally receives under the federal income and payroll taxes and under state sales taxes.

One recent study analyzed the differential effects of a broad-based and narrow-based VAT as defined by Toder and Rosenberg (2010) on consumption patterns and found large differential effects on household consumption. Taxable retail spending was found to initially fall by 4.3 percent to 5.0 percent, while nontaxable retail spending would initially rise by 0.8 percent to 2.3 percent, both relative to a policy that lowered the deficit by an equivalent amount through a decline in government spending and depending on the specific VAT-policy scenario.¹³ These results suggest that VATs that exclude a significant portion of consumption from the tax base can distort consumption patterns.

Chart 1. VAT base coverage of OECD countries, 2008



Note: VAT revenue ratio is calculated as VAT revenue divided by the product of the standard rate and final consumption expenditures less VAT revenue. Average is weighted by personal consumption expenditures. Source: Organisation for Economic Co-operation and Development, *Consumption Tax Trends 2010, 2011*.

Reliance on VATs abroad

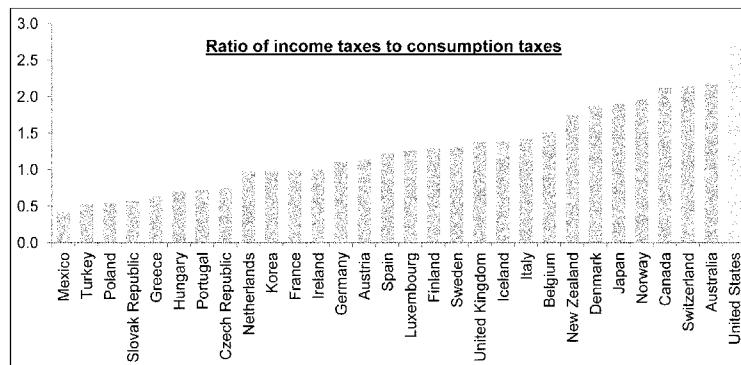
The United States relies more heavily on income taxes as compared to consumption-type taxes to raise revenue than other major developed nations, even when taking into account state sales taxes in the United States (Chart 2).

One factor that may trigger increased interest in a VAT in the United States is the difficulty of raising substantially more revenue through the current income tax system. Higher tax rates may be problematic because they have been found to be damaging to the economy. A recent OECD

¹³ Carroll et al., *supra* note 8.

study suggests that income taxes are among the least conducive types of taxes to economic growth,¹⁴ which may partly explain the growth of consumption-type taxes abroad.

Chart 2. United States more reliant on income taxes than other nations, 2008



Source: Organisation for Economic Co-operation and Development, 2010.

Among the nearly 150 countries that have implemented VATs, the VATs account for nearly one-fifth of total government revenue. The United States is the only major developed nation without a VAT. As shown in Table 2, the average VAT rate among member nations of the OECD in 2011 was 18.5 percent. Japan has the lowest VAT rate (5 percent), while several countries have combined federal/sub-national rates approaching 40 percent (e.g., Austria, Norway, Sweden). The rates have also risen over time. Not only is there considerable variation in the top-line VAT rates across countries but also in the breadth of their tax bases and the use of multiple rates to address distributional concerns.

¹⁴ Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and economic growth," *Economics Department Working Paper No. 620, ECO/WKP(2008)29*, Organisation for Economic Co-operation and Development, 11 July 2008 and OECD, "Tax Policy Reform and Economic Growth", *OECD Tax Policy Studies*, No. 20, OECD, Paris.

Table 2. VAT rates for member nations of the OECD, 2011

	Year implemented	Federal VAT rates		Select sub-national rates
		Standard rates	Reduced rates*	
Australia	2000	10	0	—
Austria	1973	20	10/12	19
Belgium	1971	21	0/6/12	—
Canada	1991	5	0	13
Chile	1975	19	—	—
Czech Republic	1993	20	10	—
Denmark	1967	25	0	—
Finland	1994	23	0/9/13	—
France	1968	19.6	2.1/5.5	—
Germany	1968	19	7	—
Greece	1987	23	6.5/13	3/6/13
Hungary	1988	25	18/5	—
Iceland	1989	25.5	0/7	—
Ireland	1972	21	0/4.8/13.5	—
Italy	1973	20	0/4/10	—
Japan	1989	5	—	—
Korea	1977	10	0	—
Luxembourg	1970	15	3/6/12	—
Mexico	1980	16	0	11
Netherlands	1969	19	6	—
New Zealand	1986	15	0	—
Norway	1970	25	0/8/14	—
Poland	1993	23	0/5/8	—
Portugal	1986	23	6/13	4/8/14
Slovak Republic	1993	20	10	—
Spain	1986	18	4/8	—
Sweden	1969	25	0/6/12	—
Switzerland	1995	8	0/2.5/3.8	—
Turkey	1985	18	1/8	—
United Kingdom	1973	20	0/5	—
Average		18.5		

*A number of countries apply a domestic zero rate (or an exemption with right to deduct input tax) on certain goods and services. This is shown as 0 in this table. This does not include zero-rated exports.

Source: "Indirect Tax in 2011: A review of global indirect tax developments and issues," Ernst & Young LLP, 2011; and Organisation for Economic Co-operation and Development.

A general overview of the VAT tax systems for 10 large OECD economies that have adopted the tax is provided in Table 3.¹⁵ Nine of the countries use a credit-method VAT, while Japan uses the subtraction method with a single tax rate of 5 percent. The table shows the year of adoption, as well as original and current tax rates.

Most of the countries listed in Table 3 adopted VATs that, at least initially, replaced existing turnover or sales-type taxes collected at the wholesale or manufacturing level. Their VATs replaced what was viewed as relatively inefficient turnover taxes with considerable cascading and uneven taxation of consumption.

¹⁵ Note that the VAT is referred to as a GST in Australia, Canada and New Zealand.

Table 3. VAT tax adoptions and rates for selected countries

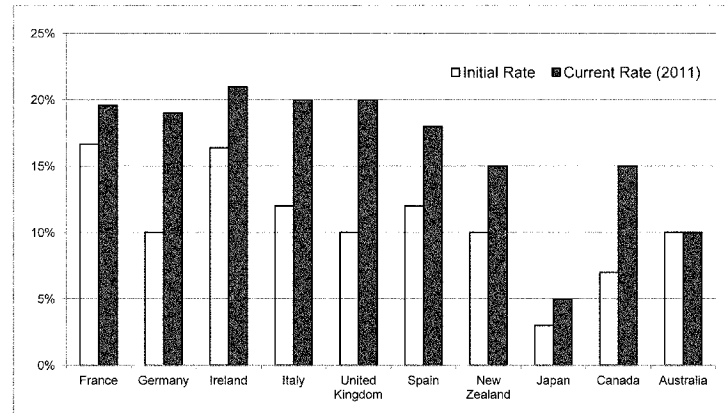
	Type of VAT	Date enacted	Initial general rate	Current general rate	VAT as percentage of GDP	Type of tax replaced	Additional information
France	Credit invoice	1954	16.66%	19.6%	7.2%	Turnover tax	Applied to services in 1968; peak rate of 20.6% in 1999
Germany	Credit invoice	1968	10%	19%	6.3%	Turnover tax	
Ireland	Credit invoice	1972	16.37%	21%	7.9%	Turnover tax	Peak rate of 25% in 1989; 22% rate in 2013 and 23% rate in 2014
Italy	Credit invoice	1973	12%	20%	6.3%	General tax on consumption (IGE)	
United Kingdom	Credit invoice	1973	10%	20%	6.7%	Selective employment purchase taxes	Rate was 15% in 2009; 17.5% in 2010; 20% in January 2011
Spain	Credit invoice	1986	12%	18%	6.4%	23 indirect taxes	Rate increase from 15% in January 2010
New Zealand (GST)	Credit invoice	1986	10%	15%	9%	Wholesale sales tax	Rate increased to 15% in October 2010
Japan	Subtraction	1989	3%	5%	2.6%	Selective excise taxes	
Canada (GST)	Credit invoice	1991	7%	5% GST; 12% to 15% HST	3.1%	Federal manufacturers' sales tax	HST is combined federal and provincial tax (nine provinces)
Australia (GST)	Credit invoice	2000	10%	10%	3.9%	Wholesale sales tax	

Source: "Indirect Tax in 2011: A review of global indirect tax developments and issues," Ernst & Young LLP, 2011; Organisation for Economic Co-operation and Development, *Consumption Tax Trends, 2010* (2011); and European Commission, *VAT Rates* (May 2010).

VATs and the growth of government

Despite the perceived shortcomings of the income tax, one concern with a VAT is that reliance on this revenue source might increase over time. VATs abroad have generally grown over time. As shown in Chart 3, VAT rates have increased substantially over time. With the increase of the general VAT rate from 17.5 percent to 20 percent in January 2011, the United Kingdom is the first country shown in Chart 3 to double its tax rate since adopting a VAT in 1973. Germany follows closely with a 90 percent tax rate increase since the inception of its VAT in 1968. The 10 countries shown in Chart 3 have increased their VAT rates by nearly 50 percent since they adopted VATs.

Chart 3. VAT rates abroad have risen over time



Source: Ernst & Young LLP, "Indirect Tax in 2011: A review of global indirect tax developments and issues," 2011; Organisation for Economic Co-operation and Development, *Consumption Tax Trends 2010*, (2011); and European Commission, *VAT Rates*, (May 2010).

Some have also observed that the growth of VATs abroad may have enabled or even led to an increase in the size and scope of government; that is, a VAT may be a "money machine." There is little empirical research on this issue. Nevertheless, one study finds empirical evidence that more efficient tax systems contribute to an expansion of government¹⁶ and another lends some credence to the idea that reliance on the VAT leads to increased government spending.¹⁷ Various efforts to analyze and consider a U.S. VAT over the past four decades have cited the

¹⁶ Gary S. Becker and Casey B. Mulligan, "Deadweight Costs and the Size of Government," *Journal of Law and Economics*, 46(2), October 2003, pp. 293-340.

¹⁷ Michael Keen and Ben Lockwood, "Is the VAT a Money Machine?" *National Tax Journal*, 54(4), December 2006, pp. 905-928.

possibility that even if a VAT were initially small, a VAT might grow over time and potentially expand to finance an expansion in the size of government.¹⁸

Other issues

Compliance costs

A VAT imposes collection obligations, and the associated compliance costs, across all firms. While compliance costs are spread across firms, total compliance costs under a VAT are generally higher than under a sales tax or even the corporate income tax.¹⁹

An add-on VAT, or a VAT that only reduced but did not replace the corporate income tax, would require businesses to comply with an entirely new tax. Businesses would have to collect the VAT on behalf of the government, keep and maintain records of their VAT payments and collection, and prepare VAT returns. The extent of these costs would be based on factors such as the number of transactions involved, the complexity of the VAT base, rate structure, definitions, and administrative and enforcement regime. Also, for an add-on VAT, businesses would have to continue to comply with the federal and state corporate income taxes, as well as state retail sales taxes.

Surprisingly, there is little recent research on the actual compliance costs businesses face under a VAT. The international experience is primarily with credit method VATs, and so the research pertains primarily to this type of VAT. The compliance costs associated with a subtraction method VAT could be different.

A 1992 CBO study reported that VAT compliance costs were substantial, especially for small businesses.²⁰ In an analysis of the United Kingdom's VAT from the late 1980s, the CBO estimated that the cost for complying with a VAT with a \$25,000 small business exemption would be between \$4 billion and \$7 billion (in 1988).

The CBO estimated that about 90 percent of that cost would be incurred by businesses with annual sales of less than \$1 million. A 1998 study of the State of Washington's sales and use tax found that the compliance burden for small firms was more than six times that of large firms.²¹ Because VAT compliance costs can be high, small businesses are often exempted from registering for VATs.

Large multinational enterprises already need to manage their VATs from a global perspective whereby they comply with VAT systems that vary, sometimes substantially, from one country to another with different VAT bases, different rate structures, definitions, administrative and enforcement regimes, and registration requirements.

¹⁸ Two notable examples are President Nixon's 1970 Task Force on Business Taxation and President Bush's 2005 Advisory Panel on Federal Tax Reform.

¹⁹ A recent World Bank study found that compliance costs for VATs were 26% higher than for corporate income tax. World Bank, *Paying Taxes 2010*, November 2009, Appendix 1.3.

²⁰ Congressional Budget Office, "Effects of adopting a Value-Added Tax," February 1992, pp. 70–72.

²¹ Washington State Department of Revenue, "Retailers' cost of collecting and remitting sales tax," 1998.

The start-up costs for businesses to comply with a new VAT could be considerably more substantial than suggested by the experience in the United Kingdom in the late 1980s. A 1999 Ernst & Young LLP study of the implementation of Australia's GST estimated the start-up costs for the largest corporations to be 0.75 percent to 1 percent of annual revenue and 10 percent of annual revenue for small businesses.²²

The use of multiple rates and exemptions likely comes at a significant cost. These items increase administrative and compliance costs for both tax agencies and taxpayers. For the nine countries included in Table 3 that use a credit-invoice method VAT, the hours needed to comply with consumption taxes (primarily their VATs) exceed the hours needed to comply with the corporate income tax by 26 percent.²³

Non-compliance is also a significant by-product of the complexity introduced by multiple rates and exemptions. A study of VAT compliance in the EU found that, on average, the VAT gap in 2006 was 12 percent of the potential tax liability, translating into a total gap of 106 billion euros. The estimated VAT gap ranged from 30 percent in Greece to 2 percent in Ireland.²⁴

These studies suggest that, in practice, the view of a credit-invoice method VAT as a self-enforcing tax system whereby the presence of invoices ensures voluntary compliance may be incomplete. Rather, it could be viewed as a transaction-based tax on very large gross flows producing much smaller net tax collections, requiring substantial tax agency resources and imposing significant compliance costs on businesses. Notwithstanding these concerns, the presence of invoices under a credit-invoice method VAT could well help with enforcement of the current income tax by providing a paper trail that helps address underreporting of income, a major component of the tax gap.

Non-recoverable costs for businesses

Under a VAT, businesses act as tax collectors. In addition to the compliance costs, businesses may often bear extra costs associated with VATs. A business is liable for VAT on its gross receipts but receives credits for VAT previously paid on purchases. Businesses have found that, in the United Kingdom, the tax on these gross flows — the tax on gross sales and the credits on purchases — has been 10 times the net VAT collected.²⁵ There may be circumstances in which VAT crediting may be incomplete, which would impose a direct tax cost on businesses and might be difficult to pass on to consumers. Because the gross flows are so large, imperfections in the VAT system can be greatly amplified.

The more complex a VAT (e.g., the more exemptions and greater use of multiple rates) the more likely that businesses will have difficulties. Mischaracterizing sales items (i.e., applying the wrong rate) can affect credits for businesses downstream. Different jurisdictions or countries may have different requirements for substantiation of invoices that can affect the ability of businesses to claim credits. There may also be issues related to the timing of VAT taxes and credits. Delays in the issuance of invoices can affect the timing of businesses' claims for credits

²² "Preparing for the GST: an Australian survey," Ernst & Young LLP, 1999, p. 6.

²³ World Bank, *supra* note 19.

²⁴ Reckon LLP, "Study to quantify and analyze the VAT gap in the EU-25 member states," report prepared on behalf of the EU Directorate-General for Taxation and Customs Union, 21 September 2009, p. 22.

²⁵ Richard Summersgill, HM Revenue & Customs, "Improving VAT compliance in the United Kingdom," Presentation to the OECD Forum on Tax Administration (September 2006).

against their VAT taxes. This can create variability in net tax payments over time and affect the cash flow of a company. Delays in issuing invoices to businesses further down the production chain could also have implications for other businesses.

Border adjustments

An important consideration is whether a VAT could be used to foster U.S. exports. Many hold the view that border adjustments, whereby VAT is imposed on imports but not exports, will encourage exports and help improve the balance of trade. Economists view this position with considerable skepticism.

VATs are typically levied on a destination basis, with goods taxed where they are consumed. A destination-based VAT taxes imports but not exports (i.e., it taxes what is consumed within a country). Border adjustments are used to implement a destination-based VAT. A refund is received for the VAT paid on business purchases used in the production of exported goods, and VAT is imposed on imports. In contrast, an origin-based VAT taxes goods where they are produced, taxing exports but not imports.

Many economists argue that border adjustments do not improve the balance of trade because any apparent cost advantage would be offset by differences in the real price levels across nations as reflected through changes in exchange rates or other prices. These price adjustments work over time to negate any permanent improvement in the balance of trade.²⁶ While there may be no significant long-term effects on a nation's balance of trade, there may be effects on specific industries and markets, especially if the VAT excludes many consumption items, as is the case in most other countries' VATs.

Transition issues

A VAT would raise significant transition issues because of the potential effects on the value of existing assets. An add-on VAT, for example, would reduce the value of existing assets by the same fraction as the VAT tax rate, presuming the VAT is broad-based.²⁷ For example, a 10 percent comprehensive VAT would make existing assets worth 10 percent less in after-tax terms. This occurs because the consumption eventually financed by the assets ultimately would be taxed at 10 percent.

Some view this one-time tax as desirable and as a way to address the so-called "entitlement problem," which has been characterized as a large transfer of wealth to the baby boomers from future generations. The one-time tax or levy on existing assets, however, is viewed as falling primarily on the baby boomers as they currently hold a substantial fraction of existing assets. So, a one-time tax through a VAT could be viewed as an indirect way to reduce the baby boomers' entitlement benefits. From this perspective, the one-time tax represents an intergenerational transfer from generations alive when the tax is adopted, especially the elderly, to future generations.

²⁶ For example, see Carroll and Viard, *supra* note 3, pp. 1123-1124.

²⁷ In present value, Americans' future consumption is equal to their future wages plus the current market value of their existing assets. A 10 percent VAT is therefore equivalent to a 10 percent tax on wages plus a one-time 10 percent tax on existing assets. The VAT makes existing assets worth 10 percent less in after-tax terms, because the consumption financed by these assets will ultimately be taxed at 10 percent. For a more detailed discussion, see Carroll and Viard, *supra* note 3, p. 1122-1123.

In addition, to the extent this one-time tax is unexpected and reduces the value of existing assets, most economists assert that it has no effect on economic decision-making. However, to the extent a one-time tax is expected to be repeated (if, for example, the tax is introduced at 5 percent but is anticipated to rise to 10 percent and then 15 percent over time), the tax could affect household and business behavior, as taxpayers modify their spending patterns in response to the expected rate increase. Subsequent increases in the VAT rate would cause corresponding reductions in asset values.

Summary

Some view a VAT as a possible source of additional revenues to reduce the deficit and help stabilize the federal debt, while others view it as a potential source of revenue to help redress shortcomings with the current tax system, such as the high U.S. corporate tax rate.

A VAT in the United States raises a number of issues. Importantly, a VAT's economic effects depend critically on key design issues and how VAT revenue is used. Vastly different conclusions can be reached, for example, depending on whether the VAT replaces the worst features of the income tax or is an add-on VAT used for deficit reduction or additional government spending.

Many analyses of VATs assume a broad-based VAT that applies to most consumption, even though in practice, most VAT and state sales taxes are narrow-based. The exclusion of significant portions of consumption would require a higher rate to raise a given amount of revenue and also distort household consumption patterns, thereby reducing the economic benefits of a VAT.

Other important issues include whether VATs lead to an increase in the size of government over time, as some evidence suggests, and the extent to which an add-on or partial replacement VAT can impose significant compliance and other costs on businesses as they are required to comply with a new additional revenue source, border adjustments and transition.

I commend the Committee for holding this hearing to explore the issues concerning potential consideration of a VAT.

Thank you and I would be pleased to address any questions you may have.

Chairman CAMP. Thank you, Mr. Carroll.
Mr. White, you are recognized for 5 minutes.

STATEMENT OF JAMES R. WHITE, DIRECTOR, TAX ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WHITE. Thank you. Chairman Camp, Ranking Member Levin and Members of the Committee, I am pleased to be here to discuss value added taxes. Others will discuss the economics of a VAT.

I would note in passing, though, that a VAT and a retail sales tax are both consumption taxes. The economics are essentially the

same. The administration is different. I will focus on how a VAT is administered. Specifically, five countries' experiences with a VAT: New Zealand, Australia, Canada, France and the United Kingdom. They represent a range of VAT designs from relatively simple to complex, including some with both national and provincial taxes and some that recently enacted a VAT.

I will discuss, one, how VAT designed choices such as the number of tax rates and exemptions affect compliance, administrative costs and taxpayers compliance burdens; how Canada combined a national VAT with provincial consumption taxes; how countries transition to a VAT, and some possible lessons for the U.S. My main point is that VATs, like income taxes and sales taxes, require a robust administrative presence. I illustrate a simple VAT on page 3 of my statement.

Each business in the chain that produces and sells furniture to a consumer owes a VAT of ten percent on its sales, but gets a credit for VAT paid on its purchases of inputs. The figure shows how the tax is paid by each company in the chain add up to a VAT of ten percent on the price the consumer pays, exactly equivalent to a sales tax of the same rate.

In my example, each business is taxed at the same rate. There are no exemptions. However, even such a simple VAT has compliance risks, which I show on page 5. Unscrupulous businesses may not collect VAT owed or may not remit it to the government, by for example, not reporting cash sales or falsely reporting imports. Or, they may over claim credit for tax paid on inputs.

Some of these compliance risks, such as under reporting cash, are also problems with an income tax. Others, such as fraudulent refunds are probably more of an issue with a VAT, because unlike our current income tax, most of these VAT credits are refundable.

Under a VAT, large numbers of businesses such as start-ups are legitimately entitled to refunds making it a challenge to detect refund fraud. In fact, some VAT fraud schemes are common enough to have earned names. One is called "carousel fraud," because goods move in a circle between countries with tax cheats collecting VAT but not remitting it to the government. Not surprisingly, adding complexity to a VAT through tax preferences increases the challenges of tax administration and loses revenue.

France and the United Kingdom built so many exemptions, special rates and other preferences into their VATs that it is estimated they collect less than half the revenue they could have with a very simple VAT. While all taxes require an administration system, there is some evidence from our study countries that VATs are easier to administer than an income tax.

The U.K. found its VAT cheaper to administer, measured as a percent of revenue collected, than the U.K. income tax. New Zealand with a relatively simple VAT found many fewer errors on VAT returns than on income tax returns. As with other taxes, the VAT compliance burden on taxpayers is mostly driven by recordkeeping requirements, the number of times a year returns must be filed, and the time needed to deal with audits.

Studies in the U.K., Canada, and New Zealand show VAT compliance cost as a percent of sales are greatest for small businesses and much lower for large businesses. For this reason, some coun-

tries exempt small businesses from VAT. Interestingly, however, many small businesses in Australia and Canada volunteer to be subject to VAT. Some want credit for taxes paid on their inputs. Some fear being outside the system will cost them customers. Large businesses don't like the extra recordkeeping required when dealing with exempt businesses.

Canada shows how a VAT can work in a federal system. Some provinces adopted a provincial VAT and harmonized it with the federal VAT. Others adopted VATs but with different exemptions and other preferences. Still others kept their provincial sales taxes. Canada shows those different options are workable, but the amount of burden on businesses to comply vary depending on the amount of harmonization.

Australia, Canada and New Zealand all introduced their VATs since 1986. All three had the advantage that their VATs replace preexisting national consumption taxes. Nevertheless, implementation took up to two years, required significant resources for outreach, and the country still had difficulty getting businesses to register for the VAT system before the implementation date.

In summary, one lesson about VAT design is that like our income tax, tax preferences reduce revenue and add complexity, compliance risks and compliance burden. Having said that, tax design is influenced by criteria in addition to administerability, such as revenue needs, the effect on the economy and distributional concerns.

That concludes my statement. I'd be happy to answer questions.
[The prepared statement of Mr. White follows:]



United States Government Accountability Office

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VALUE-ADDED TAXES

Potential Lessons for the United States from Other Countries' Experiences

Statement of James R. White, Director
Strategic Issues





Highlights of GAO-11-867T, a testimony before the House Committee on Ways and Means

July 26, 2011

VALUE-ADDED TAXES

Potential Lessons for the United States from Other Countries' Experiences

Why GAO Did This Study

Dissatisfaction with the federal tax system has led to a debate about U.S. tax reform, including proposals for a national consumption tax. One type of proposed consumption tax is a value-added tax (VAT), widely used around the world. A VAT is levied on the difference between a business's sales and its purchases of goods and services. Typically, a business calculates the tax due on its sales, subtracts a credit for taxes paid on its purchases, and remits the difference to the government. While the economic and distributional effects of a U.S. VAT type tax have been studied, GAO issued a report in 2008 that looked at lessons learned from VAT administration in Australia, Canada, France, New Zealand, and the United Kingdom. These countries provided a range of VAT designs from relatively simple to more complex.

This statement, which is based on the 2008 report, focuses on (1) the effect VAT design choices, such as exemptions and enforcement mechanisms, have on compliance, administrative costs, and compliance burden; (2) Canada's experience with administering a VAT in conjunction with several different subnational consumption tax arrangements; and (3) the experience that some countries had transitioning to a VAT.

What GAO Found

VATs have grown in popularity over the past five decades with recent estimates showing more than 130 countries worldwide using a VAT. Nonetheless, like other tax systems, even a simple VAT—one that exempts no goods or services—has compliance risks and, largely as a consequence, generates administrative costs and compliance burden. For example, all of the study countries reported devoting significant enforcement resources to compliance issues. Like an income tax, VATs can be vulnerable to compliance schemes that either result in undercollection of taxes due or overclaiming of credits for taxes paid. Also, as with other taxes, adding tax preferences—such as exempting certain goods or services from tax—generally decreases revenue, increases complexity, and increases compliance risks. Increased complexity also increases the record-keeping burden on businesses and government resources needed for enforcement.

Major Types of Compliance Risks for a VAT			
Undercollection of tax due on sales		Overclaiming of tax paid on inputs	
Missing-trader fraud	A business is created for purposes of collecting VAT on sales and disappears without remitting VAT to the government.	Fraudulent refunds	A business or fraudster submits false returns requesting VAT refunds from the government.
Failed businesses	A business fails or goes bankrupt before remitting VAT collected to the government.	Misclassifying purchases	A business falsely claims input tax credits by misclassifying personal consumption expenses as business expenses.
Underreporting cash transactions	A business either charges a lower, VAT-free price for cash transactions or underreports cash sales and retains VAT collected.	Fictitious or altered invoices	A business creates or alters invoices to inflate the amount of input tax credits it can claim.
Import fraud	A business or individual imports items for personal consumption and undervalues them for VAT purposes.	Export fraud	A business creates fraudulent export invoices for goods that are not exported to claim input tax credits.

Source: GAO.

Canada's experience administering a national VAT along with a variety of provincial VATs and sales taxes demonstrates that multiple arrangements in a federal system are feasible, but increase administrative costs and compliance challenges for both governments and businesses. Businesses, particularly retailers, in provinces with a sales tax face greater compliance burdens than those in other provinces because they are subject to dual reporting, filing, and remittance requirements.

When implementing their VAT, Australia, Canada, and New Zealand all devoted considerable resources to educate and assist businesses subject to the new tax. Both Australia and Canada provided direct monetary assistance to qualifying small businesses to help meet new bookkeeping and reporting requirements. Both had trouble getting businesses to register for the VAT by the implementation date.

View GAO-11-867T or key components. For more information, contact Jim White at (202) 512-9110 or whitej@gao.gov.

Chairman Camp, Ranking Member Levin, and Members of the Committee:

I am pleased to be here to discuss our prior work on the lessons the United States can learn from other countries' experiences with a value-added tax, or VAT.¹ VATs have grown in popularity over the past five decades with recent estimates showing more than 130 countries worldwide using a VAT. The United States is the only member of the Organisation for Economic Co-operation and Development (OECD) without a VAT.

Dissatisfaction with our current federal tax system has fueled a debate about fundamental tax reform due to concerns about the current federal tax system's economic inefficiency, unfairness, and complexity. Part of this debate has involved switching to a consumption tax or combining a consumption tax with an income tax. One type of consumption tax that some have proposed is a VAT. A VAT is applied to the difference between a business's sales of goods and services and its purchases of goods and services (excluding wages). Thus, businesses pay tax only on the value they add to the goods or services they sell. Unlike retail sales taxes, VATs are collected at all stages of production and distribution process. All types of businesses, not just retail businesses, are subject to the tax, and sales to both consumers and other businesses are taxable.

My testimony today will discuss five countries' experiences with their VATs. These study countries are Australia, Canada, France, New Zealand, and the United Kingdom. They represent a range of VAT design options from relatively simple to more complex and include some with federal systems and some that recently implemented a VAT. Specifically, I will cover (1) the effect that VAT design choices, such as the number of tax rates and tax exemptions, have on compliance, administrative costs, and compliance burden; (2) Canada's experiences with administering a national VAT in conjunction with several different subnational consumption tax arrangements; (3) the experiences that countries had transitioning to a VAT; and (4) our concluding observations on the lessons the United States can learn from these countries' experiences.

¹See GAO, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, GAO-08-566 (Washington, D.C.: Apr. 4, 2008).

This testimony is based on our report issued in 2008. Although some time has passed since our report was released, the challenges that our study countries encountered in implementing and administering VAT systems remain insightful to the United States should it consider a national consumption tax. For that report we selected our study countries based on several criteria, including the complexity of VAT design, the age of the VAT system, and whether the country had a federal system. For each country, we performed in-depth literature reviews and conducted extensive interviews of government officials and VAT experts. We also collected and analyzed documents and data on the countries and their VAT systems. Additional information on our scope and methodology is available in our published report.

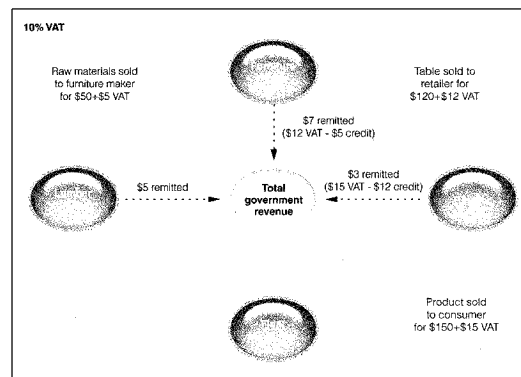
We conducted the performance audit work that supports this statement in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provided a reasonable basis for our findings and conclusions based on our audit objectives. We did not make any recommendations.

Background: How a Simple VAT Works

Under a VAT, businesses pay tax on the value they add to the goods and services they purchase from other businesses. VAT liability is typically calculated in industrialized countries using what is known as the credit-invoice method. Under this method, businesses apply the VAT rate to their sales but claim a credit for VAT paid on purchases of inputs from other businesses (shown on purchase invoices). The difference between the VAT collected on sales and the credit for VAT paid on input purchases is remitted to the government.

Figure 1 illustrates a VAT with a 10 percent rate. A lumber company cuts and mills trees and has sales of \$50 to a furniture maker. Assuming no input purchases from other businesses, to keep the illustration simple, the company adds the tax to the price of the goods sold and remits \$5 in tax to the government. The purchase invoice received by the furniture maker would list \$50 in purchases plus \$5 in VAT paid.

Figure 1: Example of How a VAT Works



Source: GAO.

If the furniture maker has sales of \$120 to a retail store, \$12 of VAT would be added to the sales price but the furniture maker could subtract a credit for the \$5 VAT paid on purchases and remit \$7 to the government. The retailer would receive an invoice showing purchases of \$120 and \$12 of VAT. Similarly, if the retailer then has sales of \$150, \$15 of VAT would be added but the retailer could subtract a credit for the \$12 paid on purchases and remit \$3 to the government.

In total, the government would receive VAT equal to 10 percent of the final sales price to consumers. Thus, a 10 percent VAT is equivalent to a 10 percent retail sales tax in terms of revenue. Under both taxes, the final consumer ultimately bears the economic burden of the tax (\$15), except in a VAT, the tax is collected in stages, not just in the final sale.

**Like Other Taxes,
VATs Have
Compliance Risks,
Administrative Costs,
and Compliance
Burden That Increase
with the Complexity
of the Design**

Our study countries' experiences with noncompliance suggest that even a conceptually simple VAT—one that applies a single tax rate to all goods and services—would have compliance risks and would generate significant administrative costs and compliance burden. Further, like other types of taxes, adding complexity through preferences increases these risks, costs, and burden. While our study countries had VATs of varied designs and complexity at the time of our original review in 2008, they all devoted significant enforcement resources to addressing compliance issues that would be found in even a simple VAT.

Compliance Risks

As shown in table 1, compliance risks for a VAT can stem from either underpayment of taxes owed on sales, or overstating taxes paid on purchases.² These risks include refund fraud and missing-trader fraud. VATs are vulnerable to refund fraud because businesses with taxable sales less than taxable purchases are entitled to refunds. All of our study countries were concerned about illegitimate businesses or fraudsters submitting fraudulent refund claims that result in the theft of funds from the government. In the case of a missing trader, a business is set up for the sole purpose of collecting VAT on sales and then disappearing with the proceeds.

²Similar compliance risks exist for an income tax stemming from either understating income or overstating deductible expenses.

Table 1: Major Types of Compliance Risks in a Conceptually Simple VAT System

Undercollection of tax due on sales		Overclaiming of tax paid on inputs	
Missing-trader fraud	A business is created for purposes of collecting VAT on sales and disappears without remitting VAT to the government.	Fraudulent refunds	A business or fraudster submits false returns requesting VAT refunds from the government.
Failed businesses	A business fails or goes bankrupt before remitting VAT collected to the government.	Misclassifying purchases	A business falsely claims input tax credits by misclassifying personal consumption expenses as business expenses.
Underreporting cash transactions	A business either charges a lower, VAT-free price for cash transactions or underreports cash sales and retains VAT collected.	Fictitious or altered invoices	A business creates or alters invoices to inflate the amount of input tax credits it can claim.
Import fraud	A business or individual imports items for personal consumption and undervalues them for VAT purposes.	Export fraud	A business creates fraudulent export invoices for goods that are not exported to claim input tax credits.

Source: GAO.

Because of compliance risks, even simple VATs require enforcement activities, such as audits and record keeping by businesses, that create administrative costs for the government and compliance burden for businesses. Of course, compliance risks and the associated administrative costs and compliance burdens are not peculiar to VATs. While the specifics may vary, other types of taxes also carry compliance risks.

Administrative Costs

A VAT, like any tax system, will require government resources to administer. The drivers of administrative costs in many tax systems include the number of taxpayers (businesses, individuals, or both) subject to the tax, how often they file returns, and the percentage of taxpayers audited. In the case of a VAT, administration requires the government to process tax returns and provide certain services to businesses. Even a simple VAT warrants education and assistance services, in part to address compliance risks. Tax administrators also need to spend significant resources on audit and enforcement activities.

Some available data from our study countries indicate a VAT may be less expensive and easier to administer than an income tax. In 2006, the tax administration agency in the United Kingdom measured administrative costs for the VAT to be approximately half a percent of revenue collected compared to over one and a quarter percent for the income tax. Officials

	at the New Zealand Inland Revenue Department also told us that administering their VAT was easier than administering some of their other taxes. For example, only 3 percent of VAT returns submitted to New Zealand's revenue agency are found to have errors, compared to approximately 25 percent for income tax returns.
Compliance Burden on Taxpayers	As with other taxes, compliance burden with a VAT is mostly driven by record-keeping requirements, filing-frequency requirements, and time and resources to deal with audits. The "fixed cost" nature of many compliance costs associated with a VAT means that smaller businesses often face a proportionally higher burden than larger businesses in complying with the VAT. The three most comparable studies we identified estimated that the compliance burden as a percentage of annual sales in Canada, New Zealand, and the United Kingdom ranged from approximately 2 percent for businesses with less than \$50,000 in sales to as low as 0.04 percent for businesses with over \$1,000,000 in sales. Private accounting and tax experts we spoke with also agreed that as the size of the business grows, the VAT compliance burden decreases per dollar of sales.
Adding Complexity through VAT Preferences Decreases Revenue and Generally Increases Compliance Risks, Administrative Costs, and Compliance Burden	All of the countries we studied have added complexity to their VAT designs, mainly through the use of tax preferences. Tax preferences—also called tax expenditures—result in foregone tax revenue due to preferential provisions that generally shrink the tax base. Tax preferences can also exist in other tax systems, such as income taxes or retail sales taxes. In our study countries, some economic sectors, such as certain consumer essentials like food and health care and public-sector organizations are often provided VAT preferences because of social or political considerations. Other sectors, such as financial services, insurance, and real estate, are provided exemptions or exclusions because they are inherently hard to tax under a VAT system. Countries' use of VAT preferences—such as exemptions and reduced rates—generally results in reduced revenue and greater compliance risks, administrative costs, and compliance burden.³ However, some

³In some instances where an exempt good or service is used in the production of a taxable good or service, exemptions can produce a cascading effect, whereby a good or service is sold with an embedded tax in the price, resulting in a tax on the tax. In this case, the exemption may lead to an increase in tax revenue.

preferences, such as thresholds for businesses, may not increase administrative costs and compliance burden because they reduce the number of entities subject to VAT requirements. Additionally, in most study countries, certain financial-services and real-estate transactions are exempt for administrative purposes, which could result in reduced compliance burden.

VAT preferences used in our study countries included exemptions, exclusions, and thresholds. An exempt good or service is not taxed when sold, and businesses that sell exempt goods or services cannot claim input tax credits for inputs used in producing the exempt output. While no VAT is collected with the final sale, the government still collects tax revenue throughout the stages of production. Tax is paid and collected on inputs. In contrast, excluding a good or service, more commonly referred to as zero rating, removes it entirely from the tax base resulting in an effective tax rate of zero. For goods and services that are zero-rated, VAT that was paid in the production of the good or service can be fully recovered through input tax credits. As a consequence, no net VAT revenue is actually collected by the government from the sale of zero-rated goods and services.

A threshold is a type of exemption that excludes businesses below a certain size from collecting and remitting VAT and from being able to claim input tax credits. Businesses with sales below the threshold are not required to charge VAT on their sales and cannot claim input tax credits for VAT paid on purchases. Businesses with annual sales above the threshold level are required to register with the tax agency, and collect and remit the VAT.

**In Canada, Tax
System Complexity
and Compliance
Burden Varied among
Provinces Depending
on Level of
Coordination with a
Federal VAT**

One issue the United States would face if it adopted a national VAT is its interaction with retail sale taxes levied by states and localities. Although there are several countries with a federal system of government, Canada is the only country that we identified that has a national VAT administered alongside a variety of subnational consumption taxes. Canada administers its federal VAT and provincial consumption tax systems differently in different provinces. The four types of national/subnational consumption tax structures in Canada are:

- a separate federal and provincial VAT, both of which are administered by the province;
- a joint federal and provincial VAT administered by the federal government;

-
- a separate federal VAT and provincial retail sales tax administered separately; and
 - a federal VAT only.

Canada's experience administering a national VAT along with a variety of provincial VATs and sales taxes demonstrates that multiple arrangements in a federal system are feasible, but results in increased administrative costs and compliance challenges for both government and business. Businesses in provinces where the provincial and federal VATs tax the same goods and services and are administered by the federal government have a relatively lower compliance burden since they only have to comply with one set of requirements. In contrast, businesses, particularly retailers, in provinces with a sales tax face greater compliance burdens than those in other provinces because they are subject to dual reporting, filing, and remittance requirements.

VAT Implementation Involved Considerable Resources to Educate, Assist, and Register Businesses

Australia, Canada, and New Zealand, the study countries that most recently implemented a VAT, all built on preexisting administrative structures. All had national consumption taxes that were paid by businesses prior to transitioning to a VAT. Despite the preexisting structure, implementation of the new tax in these countries involved multiple agencies, the development of new policies and processes, and the hiring of additional staff. Interagency committees were also established in all three countries to facilitate and coordinate implementation efforts. These three study countries took 15 to 24 months to implement the VAT and devoted a great deal of time and effort to education activities.

Before entities subject to VAT requirements can be expected to comply, they must know what those requirements are and what they mean to specific economic and industry sectors. According to International Monetary Fund guidance on VAT implementation, development and testing of tax forms early in the implementation process is important because they are a key part of the education effort. For Australia, Canada, and New Zealand, this also included extensive outreach efforts through a variety of direct and indirect assistance. For example, Australian officials said a key part of their education and outreach strategy was to target key players in various industry sectors, such as local chambers of commerce. Both Canada and Australia also provided direct monetary assistance to qualifying small businesses to defray the costs of acquiring the necessary supplies needed to meet new bookkeeping and reporting requirements.

Despite significant efforts to encourage businesses to submit materials early for VAT registration, both Australia and Canada still had difficulty getting businesses to register prior to the VAT implementation date. In both countries, this resulted in significant spikes in registration and education-related workload just prior to implementation. In Canada, for example, only 500,000 or 31 percent of the 1.6 million total registrants had voluntarily registered 3 months prior to VAT implementation.

Potential Lessons for the United States

The experiences of our five study countries show that all VAT designs have compliance risks that generate considerable administrative costs and compliance burden and that, similar to the U.S. tax system, adding complexity to the tax's design increases these risks, costs, and burden. While our study countries had VATs of varied designs and complexity, they all devoted significant enforcement resources to addressing compliance that would be found in even a simple VAT. Enforcement activities, such as audits, and record keeping by businesses create administrative costs for the government and compliance burden for businesses. Of course, compliance risks and the associated administrative costs and compliance burden are not peculiar to VATs. While the specifics may vary, other types of taxes also carry compliance risks.

One overriding lesson about VAT design is that, like our income tax system, adding tax preferences to the system may satisfy economic, distributional, or other policy goals but at a cost. Tax preferences—in the form of exemptions, zero rates, or reduced rates—often reduce revenue, add complexity, and increase compliance risks. To mitigate the increased risk, countries have imposed additional record-keeping and reporting requirements on businesses, delayed refunds, and done more auditing of businesses. The end result is an increase in compliance burden for businesses and administrative costs for the government.

The choice of tax type is typically heavily influenced by criteria other than administrability. Revenue needs, effect on economic performance, and distributional consequences are prominent considerations and have been at the forefront of the debate in the United States about tax reform.⁴

⁴See GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

Administrability and the details of how a new tax would be implemented often get less attention. However, administrability and design details do matter. The benefits of a new or reformed tax system, in terms of revenue, economic performance, or equity, would be at least partially offset by poor design that unnecessarily increased compliance risks, administrative costs, and compliance burden.

Chairman Camp, Ranking Member Levin, and Members of the Committee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

Contacts and Acknowledgments

For further information on this testimony, please contact James R. White at (202) 512-9110 or whitej@gao.gov. In addition, contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. In addition to the individual named above, Jay McTigue, Assistant Director; Brian James; and Danielle Novak made key contributions to this testimony.

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Chairman CAMP. Thank you, Mr. White.
Mr. Mitchell, you are recognized for 5 minutes.

STATEMENT OF DANIEL J. MITCHELL, SENIOR FELLOW, CATO INSTITUTE

Mr. MITCHELL. Thank you, Mr. Chairman, Ranking Members, and Members of the Committee.

In my summation of my testimony I want to focus on what I would call the real world versus the theory. I agree with the theory that a value added tax, compared to our current income tax, is a less destructive way of raising revenue. It doesn't do as much dam-

age per dollar raised. And so, in theory, if you replaced or got rid of other taxes, or if you somehow paid down deficits or debt with the value added tax, you might get some benefits.

But if you look at the experience in Europe and other countries, you find that this is not what happens. The question that I always pose is, why on earth would we want to copy the fiscal policy of Greece, Portugal and other countries that are now teetering on the edge of financial collapse? Because what you find in those countries—and I'll walk through some of the data—is that they did not reduce other taxes. They did not reduce deficits and debt. Instead, the VAT became, as it is sometimes referred to, a money machine or for larger government.

Now, to touch on the theory for just a little bit, the shortcut way of understanding a VAT is that it is a system that doesn't allow for the deductibility of wages at the business level. You can get into the details on credit, invoice, subtraction method; but, if you think about a tax system that doesn't allow deductibility of wages, that is really what a VAT is all about, and it is important to realize what that means.

It means that, in effect, you have an entirely additional system for taxing income. If you don't allow businesses to deduct the wages and salaries they pay their workers, their employees, you have a withholding tax that is in addition to the income tax that they already pay. Now, in the language of public finance economists, the VAT is a consumption tax, but this term requires some elaboration.

A consumption, or consumption based tax does not mean, necessarily, that the tax is actually paid by consumers. It simply means that it's a tax system where there is no double taxation of income that is saved and invested. The Social Security payroll tax is a consumption based tax, since it is not imposed on dividends, interest and capital gains.

Likewise, the flat tax, popularized by a former house majority leader, Dick Armey, is a consumption tax, since dividends, interest, capital gains are not subject to a second layer of tax. In short, a consumption tax is a system where income is taxed only once. It might be taxed only one time when the income is earned. It might be taxed only one time when the income is spent. And this is in contrast to our current system, the Haig-Simons or comprehensive income tax system, which does have pervasive double and triple taxation of income that is saved and invested.

Now, because a VAT does not have all this double taxation, it often gets favorable reviews from economists, but that is only if you assume that you are getting rid of other taxes. That's not what anybody is talking about. A VAT is always being discussed as an add-on tax. And what would it mean?

Well, if you look at the experience from Europe, you will see that an add-on value-added tax basically leads to two things. It leads to higher, overall tax burdens, and it leads to a higher burden of government spending. If you look at the OECD data, you will see that government spending in Europe back in the mid-60s before a VAT became pervasive was not that different than government spending in the U.S., when measured as a share of GDP.

But, ever since the VAT was adopted government spending in Europe has increased dramatically. Of course they've had higher

payroll taxes, energy taxes and things like that. So it is not always a one to one relationship, but the correlation still exists. The other thing that you find in Europe since the adoption of a value-added tax is that we do not see any improvements in fiscal balance.

If anything, deficits and debt have gotten much higher in Europe since the adoption of the value-added tax. In some sense, they are confirming what Milton Friedman said back in the 1990s, that governments will spend everything that the revenue system will generate, plus as much as they can get away with.

Another one of the big assertions about a value added tax is that you can use it to reduce or lower other taxes. Well, let's look at what happened in Europe. Let's look at what happened to taxes on income and profits as a share of GDP in Europe. Ever since the VAT was adopted, the tax on income and profits in Europe as a share of GDP has gone up, not down.

If we look just at the tax on corporate income as a share of GDP in Europe, you will see that it has gone up, not down. By contrast, in the United States, which doesn't have a value added tax, the overall tax burden on income and profits has stayed relatively flat over the last 40 or 50 years, and our tax burden on corporations as a share of GDP has actually fallen. So, the assertion that a value added tax can somehow lead us to a better tax system certainly hasn't applied in any countries in the world right now, although I will say that in some of the more recent countries, like Australia, Japan, that have adopted a VAT or goods and services tax, you don't find the same problems.

But, I am out of time, and so I will stop there. Thank you very much.

[The prepared statement of Mr. Mitchell follows:]

The Case against the Value-Added Tax

By Daniel J. Mitchell, senior fellow, Cato Institute

Testimony to the Committee on Ways and Means, United States House of Representatives

Rapid increases in the burden of federal spending over the past decade have led to large budget deficits and rising levels of government debt. But this is just the tip of the iceberg. In the absence of reform, the combination of an aging population and entitlement programs will lead to even higher levels of government spending. And even though tax revenues are expected to climb above historical norms, the rise in receipts will be much smaller than the increase in outlays,

There is no magic point at which deficits and debt become too large, but Greece, Ireland, and Portugal are sobering examples of what happens when investors decide a government has reached a tipping point. To avoid a similar meltdown in the United States, policy makers almost certainly will be forced to take steps to staunch rising levels of red ink.

Unfortunately, even though more than 100 percent of the long-run fiscal imbalance is because of higher spending, it is quite likely that politicians will seek additional revenue, and a value-added tax will be one of the most tempting options. The VAT is a broad-based levy that has become ubiquitous elsewhere in the world. It is known as a consumption tax, but money is collected at the business level rather than at the cash register. This means the tax is built into the price of affected goods and services and largely hidden from taxpayers

Politicians are attracted to the VAT because it is capable of raising enormous amounts of revenue. Consumption is close to 70 percent of gross domestic product, or about \$10 trillion. As such, even relatively modest tax rates would divert large amounts of money to Washington – even if lawmakers decide to include loopholes that shrink the tax base.

But this is why a VAT would be the wrong policy. America's fiscal problem is too much spending, not insufficient tax revenue. Imposing a new tax – particularly one capable of generating so much money – would be akin pouring gasoline on a fire and ensuring that America will become a European-style welfare state. In other words, bigger government and lower living standards.

Perversely, it is quite likely that a VAT would exacerbate rather than solve the problem of too much government borrowing. The nations in Europe that have been bailed out, as well as those teetering on the edge of fiscal collapse – including Greece, Spain, Portugal, Ireland, and Italy – all have VATs. Indeed, the average level of debt for all Western European nations is higher than the U.S. debt level. Imposing VATs, beginning in the 1960s, obviously didn't keep politicians from spending too much. For all intents and purposes, the experience in Europe confirms Milton Friedman's famous warning that, "In the long run government will spend whatever the tax system will raise, plus as much more as it can get away with."

What is a VAT?

There are a couple of ways of defining a VAT, but the easy shortcut method is to ask one simple question: Are businesses allowed to deduct labor costs? This is a blunt definition, but the non-deductibility of wages is a key characteristic of a VAT. Indeed, much of the revenue from a VAT is generated because it imposes, for all intents and purposes, a withholding tax on wages and salaries. But with the exception of a few tiny jurisdictions such as Monaco, this hidden tax on wages and salaries in all nations is in addition to the regular income tax.

In the language of public finance economists, the VAT is a consumption tax. But this term requires elaboration. A consumption (or consumption-base) tax does not mean a levy that is paid by consumers. Instead, it is the term applied to any revenue system that does not double tax income that is saved and invested. The Social Security payroll tax, for instance, is a consumption tax since it is not imposed on dividends, interest, and capital gains. Likewise, the flat tax popularized by former House Majority Leader Dick Armey and magazine publisher Steve Forbes is a consumption tax since dividends, interest, and capital gains are not subject to a second layer of tax.

In short, a consumption tax is a system where income is taxed only one time. That income might be taxed only one time when it is earned, as is the case with the flat tax. Or it might be taxed only one time when it is spent, as with a VAT or national retail sales tax. The current tax system, by contrast, is based on the “Haig-Simons” approach, which is sometimes referred to as a “comprehensive” tax base.

The Economics of a VAT

The VAT sometimes gets positive reviews from economists. This is not because it is pro-growth, but rather because the VAT – when compared to a comprehensive income tax – is a less-destructive way of raising revenue. This would be a compelling argument for the VAT, but only if politicians were considering a plan to completely eliminate the income tax:

Moreover, saying that VATs are not as destructive as the traditional income tax is damning with faint praise. It certainly does not mean that a VATs have a positive impact on economic performance. Indeed, the economic benefits of replacing the income tax with a VAT are completely attributable to getting rid of the current internal revenue code.

Unfortunately, such a swap is not a real-world option. No political jurisdiction anywhere in the world has ever repealed an income tax and replaced it with a value-added tax. Moreover, no VAT proponent in the United States is proposing to eliminate the income tax.

This means the only realistic way of assessing a VAT is to examine the economic impact of layering such a levy on top of the current system – what is generally referred to as an

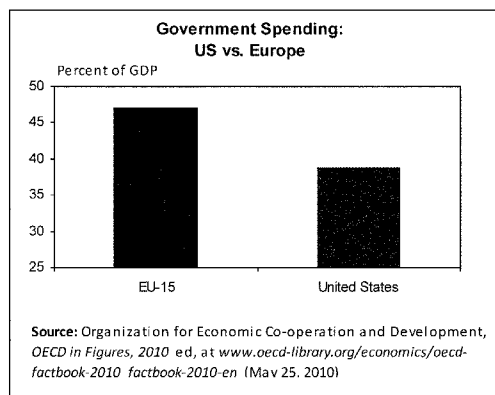
“add-on” VAT. In this scenario, the VAT is unambiguously harmful to economic performance. It reduces incentives for productive behavior by further increasing the wedge between pre-tax income and post-tax consumption. Simply stated, people have less incentive to earn income when there is less ability to enjoy the fruits of their labor.

As the OECD has acknowledged, “Because they lower the purchasing power of real after-tax wages, consumption taxes may curb labour supply in much the same way as a proportional income tax.”

VATs are associated with bigger government

Reviewing the experience of other developed nations is probably the best way to assess the likely impact of a VAT in the United States. Western European nations are especially useful case studies since the VAT was implemented in that late 1960s and early 1970s, thus providing about 40 years of evidence. Unfortunately, that data suggests a VAT means bigger government.

As seen in chart, the burden of government spending in “EU-15” nations is significantly larger than it is in the United States.

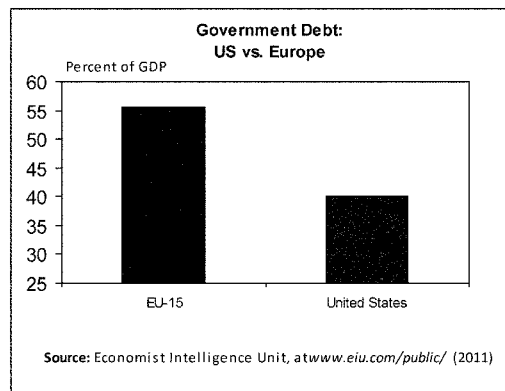


What makes this comparison especially revealing is that government spending in EU-15 nations was quite similar to U.S. spending levels back in the mid-1960s, shortly before VATs were implemented. The burden of government spending has increased in both the United States and Europe, but the increase in Europe has been larger (though government spending has jumped significantly in the Bush-Obama years, thus making the comparison less dramatic than it was 10 years ago).

There is a debate in the academic literature about whether the VAT causes higher spending, or whether the relationship is the other way around. In other words, do higher taxes lead to higher spending or does higher spending lead to higher taxes? That is an interesting question, but largely irrelevant. A bigger burden of government spending is misguided, and that is true if politicians implement a VAT (or increase the rate) so they can spend more in the future. And it is true if politicians implement a VAT (or increase a rate) because they spent more in the past. In either case, the additional spending is made possible by the VAT.

Proponents of an add-on VAT often claim that their goal is to reduce deficits and debt. This presumably makes the idea of a new tax more politically palatable. This may be a clever strategy, but even a superficial look at the data shows that European nations with VATs heavily rely on borrowed money. Indeed, the sovereign debt crisis in Greece, Ireland and other European nations only exists because deficits and debt got out of control.

Deficits in Europe are much higher today than they were in the pre-VAT days. But one-year snapshots of red ink can generate unfair comparisons because most nations today have unusually high levels of government borrowing because of a weak global economy. Government debt figures are more appropriate since they represent accumulated fiscal balances, so they capture both good years and bad years. But this approach is even more damning for VAT advocates. Average government debt is much higher today in EU-15 nations than it was before VATs were adopted.



Moreover, the chart shows that the average level of debt in EU-15 VAT nations is higher than it is in the United States. These numbers are especially significant given that the U.S. has just finished a 10-year period featuring record deficits. Yet even with all the

additional red ink caused by the Bush-Obama spending binge, VAT nations in Western Europe still have more higher levels of debt.

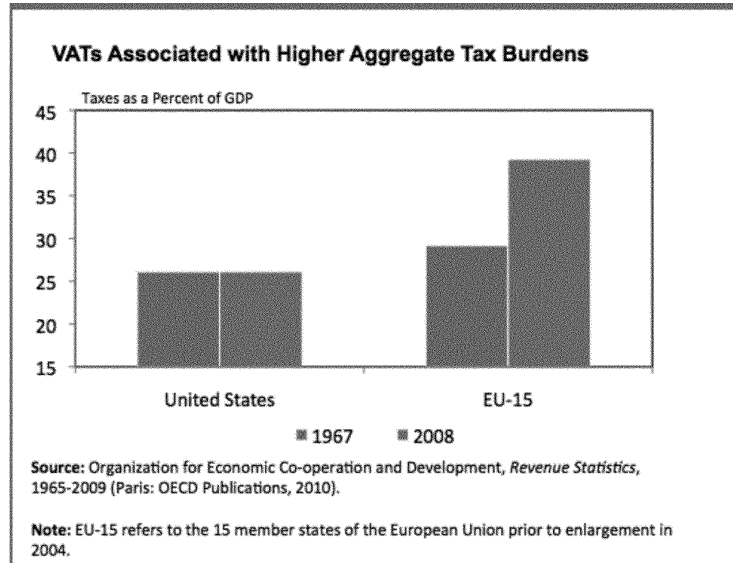
Some argue that this means that VATs cause higher deficits. That may be true, but it is difficult to prove or disprove such a hypothesis. Another plausible explanation is that VATs have no impact on red ink. According to this hypothesis, the propensity to use debt-financed spending varies across nations based on political and cultural tolerances for red ink. Southern European nations, for instance, almost always have higher levels of deficits and debt than Nordic nations. That was true before the VAT was implemented, and that is true now that all of the nations have a VAT.

This means that the real impact of a VAT is to allow governments to finance more spending, while still maintaining whatever level of red ink that they can get away with given varying national circumstances.

The VAT is associated with higher tax burdens.

Proponents often claim that a VAT is a form of tax reform rather than a tax increase. This certainly is a theoretical possibility, but there is no real-world evidence for this hypothesis. No political jurisdiction anywhere on the planet has ever adopted a VAT and eliminated an income tax. It has always been an “add-on” tax.

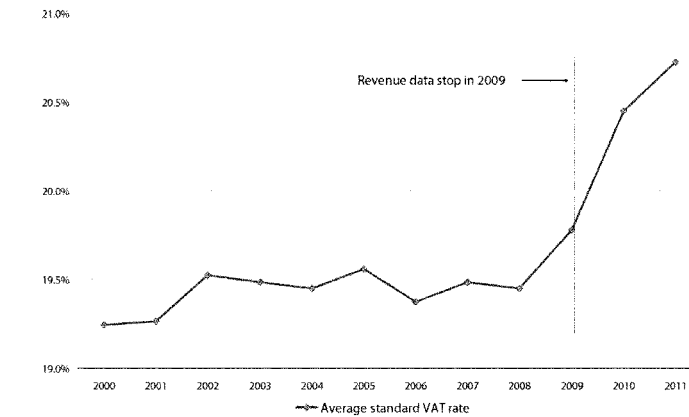
Not surprisingly, this is why VATs are associated with higher overall tax burdens. The chart shows what happened in EU-15 nations. Prior to the VAT’s adoption, European nations had average tax burdens of less than 30 percent of GDP. Today, tax burdens consume nearly 40 percent of GDP.



The tax burden in non-VAT nations also has increased, but not nearly as much. The chart also compares the increase in the share of output taken by tax authorities in the United States and EU-15 nations. The chart shows that Western European nations in 1965 had slightly higher taxes, on average, than the United States. Following the enactment of the VAT, however, the gap widened dramatically.

It's possible, of course, that the overall tax burden in Europe would have climbed just as rapidly in the absence of a VAT. But it is difficult to see how this could have happened. Income tax rates already are very high, and may even be at or above the "revenue-maximizing" level, suggesting that higher tax rates could backfire because of reductions in taxable income. Payroll tax rates also are high, as are taxes on energy, alcohol, and tobacco.

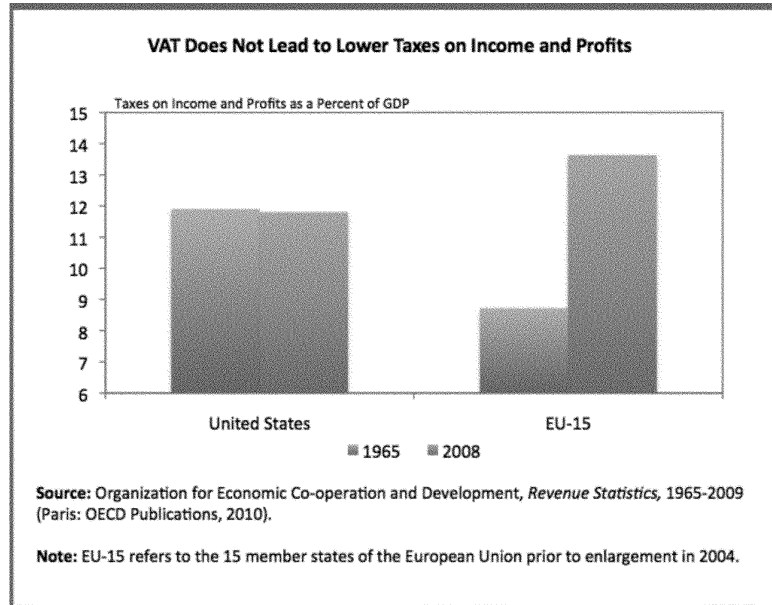
The past couple of years certainly suggest that politicians view the VAT as a convenient tax to increase. The following chart, from a recent European Commission report, shows that the average VAT rate has jumped significantly since 2008. There's every reason to believe US lawmakers also would view the VAT as a money machine that would enable them to avoid much-needed belt tightening of the federal budget.

Graph 16: **Development of average standard VAT rate, EU-27**

Source: Commission services

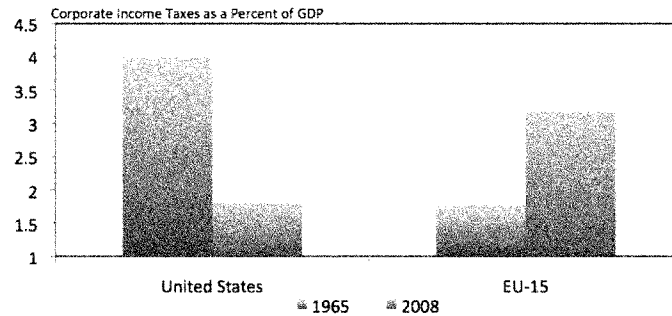
The VAT is associated with higher tax burdens on income and profits.

Proponents sometimes admit that a VAT increases the overall tax burden, but they claim that some of the new revenue is used to finance lower personal and/or business income taxes. This certainly is a potential result. Unfortunately, that's not what has happened in Europe. The chart shows that the tax burden on income and profits has climbed since the VAT was implemented.



Some people in the business community are being lured to support the VAT by promises of better tax treatment of corporate income. Yet the data on corporate taxation shows that the adoption of a VAT was followed by a steeper burden on profits in EU-15 nations.

VAT Does Not Lead to Lower Taxes on Corporate Income



Source: Organization for Economic Co-operation and Development, *Revenue Statistics, 1965-2009* (Paris OECD Publications, 2010).

Note: EU-15 refers to the 15 member states of the European Union prior to enlargement in 2004.

To be sure, corporate tax rates have dropped in recent decades, so it's possible that some of the added corporate tax revenue is a "Laffer Curve" response to better tax policy. But the lower tax rates are the result of tax competition beginning in the 1980s, whereas VATs were implemented starting in the 1960s.

The VAT is not good for trade

Some proponents claim that a VAT is good for trade because it is "border adjusted." This means that the VAT is imposed on imports and there is no VAT on exports (all previous VAT payments are rebated when products are sold to foreigners). For mercantilists worried about trade deficits, this is seen as a positive feature. But not only are they wrong on trade, they do not understand how a VAT works.

Protectionists seem to think a VAT is akin to a tariff. It is true that the VAT is imposed on imports, but this does not discriminate against foreign-produced goods because the VAT also is imposed on domestic-produced goods.

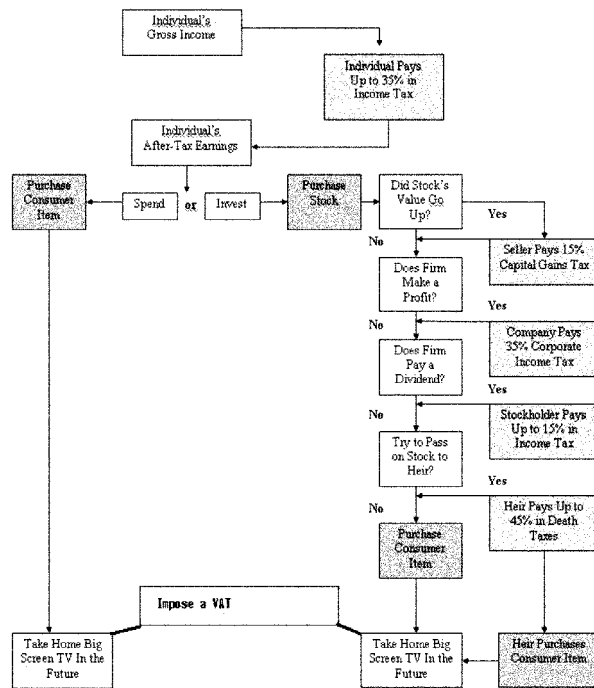
Under current law, American goods sold in America do not pay a VAT, but neither do German-produced goods that are sold in America. Likewise, any American-produced goods sold in Germany are hit by a VAT, but so are German-produced goods. There is a level playing field. The only difference is that German politicians seize a greater share of people's income, which helps explain why per-capita living standards are only about two-thirds of U.S. levels according to OECD data.

So what happens if America adopts a VAT? There is no change in Germany. The government continues to tax American-produced goods in Germany, just as it taxes German-produced goods sold in Germany. There is no reason to expect a VAT to cause any change in the level of imports or exports from a German perspective. In the United States, there is a similar story. There is now a tax on imports, including imports from Germany. But there is an identical tax on domestically-produced goods. And since the playing field remains level, protectionists will be disappointed. Politicians in Washington, by contrast, will be delighted since they get more money whenever any products are sold.

Notwithstanding this analysis, some people doggedly assert that a VAT must be good for trade and competitiveness because the rebate ensures that there is no tax built into the price of America exports. It is true that the corporate income tax undermines competitiveness and makes America a less-attractive location for producing goods and services, particularly since the United States has one of the world's highest tax rates on business income. This is an argument for lowering or repealing the corporate income tax, not an argument for a VAT.

The VAT is anti-saving, not pro-saving

Advocates of the value-added tax commonly claim that the levy would boost saving. The superficially compelling argument for this assertion is that the VAT is a tax on consumption, so the imposition of such a tax will make saving relatively more attractive. But this simple analysis overlooks the fact that saving is simply deferred consumption. The tax is simply postponed until the point when consumption occurs. There is no avoiding the tax.



People who save usually earn some sort of return (such as interest, dividends, or capital gains). This means they will be able to enjoy more consumption in the future. But that does not change the calculation. The above chart compares a consumption-based tax system (on the left side) and a comprehensive-type tax regime such as the current internal revenue code (on the right side). In either case, the imposition of a VAT does not alter incentives to consume today or consume in the future.

To be sure, incentives to save would be boosted if all of the double taxation on the right side was eliminated. But that's because anti-savings provisions embedded in the current tax system would be repealed. Imposing a VAT would have no impact. Simply stated, the VAT is not pro-saving.

But this is not the end of the story. A VAT, like an income tax or payroll tax, drives a wedge between pre-tax income and post-tax income. This means, of course, that a VAT also drives a wedge between pre-tax income and post-tax consumption – and this is true for current consumption and future consumption. This tax wedge means less incentive to earn income, and if there is less total income, this reduces both total saving and total consumption.

Honest VAT proponents often admit that the levy will not boost the savings rate or the total level of savings, but they say that other potential tax increases will have a much worse impact on incentives to save. This is true, at least if the other tax options are higher income tax rates, higher corporate taxes, higher capital gains taxes, and other options that would exacerbate the double taxation in the current tax code.

But this is not an argument for a VAT. It's an argument against raising other taxes.

Conclusion

Enacting a value-added tax would be a costly mistake for American consumers and workers. Once adopted, the VAT would prove irresistible to politicians eagerly looking for money to pay for new programs. The VAT would also undermine entitlement reform because politicians could gradually increase the tax to finance promised benefits. The tax rate would doubtlessly climb, financing a surge of new federal spending. The result would be a stagnating economy, higher budget deficits, and fewer jobs for American workers. The value-added tax may have some attractive theoretical qualities compared to taxes on income and production, but in the real world, it would simply be another burden on an already overtaxed economy.

Chairman CAMP. Thank you, Mr. Mitchell.
Mr. Johnson, you are recognized for 5 minutes.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. JOHNSON. Thank you, Mr. Chairman.

I would like to make three points that have not come out in the discussion so far. First of all, while I support the VAT on efficiency grounds in terms of the ability to raise revenue as the previous panelists have indicated—and I broadly would agree with the numbers they put forward—I think we should stress that the VAT is an inherently regressive tax.

Income distribution in this country has become much more skewed since the tax reform of 1986. These are striking and dramatic numbers, and this is a very hard trend to reverse in many ways. It is certainly possible, as some of the previous panelists said, to address the regressivity of VAT through various forms, some sort of refundable tax credit, and also addressing, perhaps, Social Security payments.

But I would point everyone to the report made by President Bush's advisory panel when they looked carefully at this issue. Even when trying to address this issue, they present numbers that show you the amount of tax being paid at the top of income distribution goes down dramatically. And the amount of tax being paid in the middle of the income distribution goes up. So I think this is a very serious issue that has to be taken fully on board.

The second point is, and I don't think this has been mentioned so far, is the way that financial services are treated in a VAT system has to be viewed carefully. The one problem with the European VAT system is that it has typically—because it is a relatively old

system and this problem wasn't especially thought through—it is under taxed financial services.

The IMF proposed in light of the financial crisis at the behest of the G20 a new form of taxation, which is called, rather memorably, the FAT financial activities tax. So we have the VAT and the FAT. I didn't pick the name. It was after I left the IMF. But the point of the fact is to redress this balance, and the latest thinking, although this has not been done fully and properly in any country so far, but it is doable, is to have a version of FAT that would fully integrate with VAT and would result in a fair, equitable taxation on the same basis of financial services.

Now, in this context and completely consistent with that FAT, I would stress that we should also be addressing the excess leverage in the financial system in this country, and I would commend to you a speech made recently by the President of the Minneapolis Fed, Mr. Cocha Lakota, who goes through in detail why the Tax Code is encouraging excessive leverage for the corporate sector, particularly for the financial sector. This can be addressed at the same time as moving to a VAT, plus FAT, system.

The third point I would like to make or the question I think I would like to raise is when exactly is the fiscal crisis that we need to address with tax reform? And, of course, there are several possibilities. One is the crisis next week, which I certainly hope we will avert. I don't think that is going to happen. We'll see.

Another is a crisis over the next 10 years, and that, of course, is part of the discussion around the CBO's forecast window, but the numbers there are quite string. If the CBO is correct, and they certainly are the projections that we all use, the United States under reasonable assumptions will have a small, primary surplus at the end of the 10 years. This is not a dramatic budget crisis by any means.

There is a budget problem, which has already been mentioned, which is in the longer term spending. And the IMF also has very good, comparative numbers; but, this is mostly about increase in medical cost, medical spending over a 30-year period. On this scale we stand out relative to other countries. So I think the good news part of this is that we have time for proper tax reform.

At the same time as we are thinking about tax reform and thinking about the appropriate level and extent of a consumption tax, or a VAT plus financial activities tax, I would stress we need to think about the changing nature of our society over these 30 years. The society is aging in a way that needs the robust provision of public goods, for example, for education and health, for children and for lower income people. And we also live in a very dangerous world in which having a robust income base for military spending is absolutely important.

One very important feature of these consumption taxes—this is actually mentioned also in the last panel, at least in passing, is that consumption goes down less than does income when you have a major crisis. Now to the extent that we don't reduce the risks in our financial system, I am very worried about future crises that will damage the receipts from income tax and cause a big increase in debt.

The reason why debt has surged over the past four years is primarily due to the effect of banks, big banks in particular, blowing themselves up at great cost to the American taxpayer. Thank you.
[The prepared statement of Mr. Johnson follows:]

Testimony submitted to the House Ways and Means Committee, hearing on “Tax Reform and Consumption-based Tax Systems,” July 26, 2011 (embargoed until 10am).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; co-founder of <http://BaselineScenario.com>; member of the CBO’s Panel of Economic Advisers; and member of the FDIC’s Systemic Resolution Advisory Committee.¹

Main Points

- 1) This is a precarious moment for the world economy. Growth is likely slowing in China and other emerging markets, at the same time as a serious sovereign debt crisis continues unresolved in Europe’s euro area. Financial markets remain unsettled as they work through the implications of a default on government debt in Greece and how that will spread to other countries.²
- 2) In this context, even a partial shutdown of federal government in the United States would have a major negative effect on the economy. In the aftermath of any major financial crisis, government spending plays a significant stabilizing role. The private sector – particularly small business – would be greatly damaged by any lack of clarity about when and how the government will pay for goods and services purchased or make the transfer payments promised to consumers.
- 3) Even worse, a failure to increase the U.S. debt ceiling could seriously and permanently undermine our standing in credit markets, increasing interest rates, and worsening the budget deficit. This would have an immediate negative effect on all parts of the private sector. The debt ceiling impasse so far has already created a degree of uncertainty that is not helpful to job creation.
- 4) Standard solvency analysis confirms there is no prospect of an immediate fiscal crisis in the United States, in the sense that there is plenty of “fiscal space” – meaning there is strong global demand for Treasury obligations in the foreseeable future.³ This is reflected in the fact that, until the debt negotiations became stuck, long-term interest rates were low and remarkably stable. U.S. government securities are a safe haven for international investors – until they see a rising probability that we will not pay our debts as contracted.
- 5) Over the CBO’s 10-year forecast window, assuming the “Bush tax cuts” expire at the end of 2012 (as scheduled), there is no serious budget problem.⁴ Under realistic assumptions, the primary budget balance (before interest payments) will be a small surplus and debt will have stabilized around 75 percent of GDP. There is no fiscal emergency over this time horizon.

¹ This testimony draws on joint work with Peter Boone and James Kwak. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at <http://BaselineScenario.com>, where we also provide daily updates and detailed policy assessments for the global economy.

² See Peter Boone and Simon Johnson, “Europe on the Brink,” Policy Brief 11-13, Peterson Institute for International Economics, <http://www.iie.com/publications/interstitial.cfm?ResearchID=1883>.

³ Comparative cross-country estimates are provided in Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Qureshi, “Fiscal Space,” IMF Staff Position Note, September 1, 2010, SPN/10/11.

⁴ See James Kwak, “The Weirdness of 10-Year Deficit Reduction,” <http://baselinescenario.com/2011/07/21/the-weirdness-of-10-year-deficit-reduction/>.

- 6) Our most important budget problems come *after* the ten-year horizon, because Medicare spending accelerates due to an aging population and increasing health care costs. We should aim to find a way to control healthcare costs as soon as possible – every year of high health care cost inflation makes the problem worse.
- 7) The United States is in the midst of a significant demographic transition. We need to invest in education and ensure access to affordable healthcare to everyone if we are to increase productivity as the population ages. Ultimately, this is the only way to ensure that older, retired workers can receive a sustainable level of reasonable benefits (including pensions and healthcare).
- 8) In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. Part of that should include additional tax revenues.⁵
- 9) Most other industrialized countries also have to engage in a process of fiscal adjustment and for related reasons.⁶ Compared with other countries at roughly our income level and with similar demographics, the United States has a major advantage in the sense that we collect relatively little in taxes; in addition, our tax system is relatively antiquated and would benefit from modernization. Using the IMF's numbers – which are for “general government” (i.e., the entire government sector, including federal, state, and local) – the US collected 31.8 percent of GDP in 2000 (compared with the UK at 38 percent, Germany at 46 percent, and France at 50 percent).⁷ In both 2009 and 2010 the US collected 30.4 percent of GDP; over the cycle, our revenue relative to other leading industrialized countries remains about the same.
- 10) Even Greece, in the midst of severe economic crisis in 2011 and with a badly broken revenue system, is expected to have general government revenue at 42.6 percent of GDP. The United States general government revenue will likely be just 30.5 percent this year.⁸

⁵ Scrapping the existing tax system would not make sense, for example under the so-called “Fair Tax” proposal – this would be a huge undertaking with big downside risks. The benefits of such a system have been greatly exaggerated by some of its proponents. See Bruce Bartlett, “Why the Fair Tax Won't Work,” *Tax Notes*, December 24, 2007, pp.1241-1254, and Chapter 9 in the President's Advisory Panel on Tax Reform (http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf), a report prepared during the administration of President George W. Bush.

⁶ See Table 6 in the IMF's May 2010 Fiscal Monitor for budget deficit financing needs across advanced countries (<http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>). The US has relatively short maturity debt (4.4 years by this measure), but it is broadly comparable with other industrialized nations on this and other deficit measures. Table 11 in the same report provides estimates of effects from raising revenue in various sources across the advanced G20 economies. Again, the US is in the middle of the pack – there is nothing unusually difficult (on paper) about the adjustment required. However, our projected increase in healthcare costs as a percent of GDP through 2030 is on the high side relative to comparable countries. See also “From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies,” International Monetary Fund, Fiscal Affairs Department, April 30, 2010.

⁷ Statistical Table 5 in the IMF's May 2010 Fiscal Monitor has general government revenue as a percent of GDP since 2000 and forecast through 2015; in the April 2011 edition of the Fiscal Monitor, the series starts in 2006 and the forecasts run through 2016 (Statistical Table 6).

⁸ International Monetary Fund, Fiscal Monitor, April 2011, Statistical Table 6, p.126.

- 11) Collecting some additional revenue from a Value Added Tax could make sense, but only if this is implemented using a sensible design – for example, New Zealand’s VAT system may provide a useful model.⁹ This would be a relatively efficient way to raise several percentage points of GDP in additional revenue.¹⁰
- 12) By itself, VAT is typically regressive and would be significantly more regressive than our existing income tax system. It should be supplemented with an increase in the earned income tax credit and with other adjustments (for people who are retired or otherwise do not work) that reduce the burden on those at the lower end of the income distribution.¹¹
- 13) It is striking the extent to which income equality has increased dramatically since the last tax reform in 1986.¹² From 1986 to 2006, there was little change in average income for the bottom 90 percent of wage earners while the top 1 percent experienced a gain of around 50 percent. The gains for the top one-tenth of one percent were even higher.
- 14) The returns to higher education have greatly increased over this time period and there are not good income prospects for anyone with only a high school education (or less). If anything, the tax system should lean towards becoming more progressive – and investing the proceeds in public goods that are not sufficiently provided by the private sector, like early childhood education and the kind of preventive healthcare that helps prevent disruption to education (e.g., due to asthma).
- 15) At the same time, we must not lose sight of the very large fiscal risks posed by the nature and structure of our financial system. The recent increase in government spending is due almost entirely to the way the financial sector imploded and damaged the rest of the private sector in 2007-08.¹³

⁹ Most European VAT systems are less attractive as design models; we should particularly avoid systems that have different VAT rates for different kinds of goods and services. See Ian Crawford, Michael Keen, and Stephen Smith, “Value Added Tax and Excises,” Chapter 4 in the *Mirrlees Review: Dimensions of Tax Design*, <http://www.ifs.org.uk/mirrleesReview/dimensions>, published in 2010. For more background on how VAT systems operate around the world, see “The Value Added Tax: Experiences and Issues,” paper prepared for the International Tax Dialogue Conference on the VAT, Rome, March 15-16, 2005, <http://www.itdweb.org/vatconference/Documents/VAT%20-%20EXPERIENCE%20AND%20ISSUES.pdf>.

¹⁰ The cross-country evidence suggests that “the VAT has proved to be a particularly effective form of taxation” and it has also been used, to some extent, to reduce the use of less effective tax instruments (Michael Keen and Ben Lockwood, “Is the VAT a Money Machine?” *National Tax Journal*, Vol. LIX, No. 4, December 2006, p.925). Similar conclusions were reached during the George W. Bush administration by the President’s Advisory Panel on Federal Tax Reform (Chapter 8: Value-Added Tax, http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf).

¹¹ For more discussion, see William G. Gale and Benjamin H. Harris, “A Value-Added Tax for the United States: Part of the Solution,” Brookings Institution and Tax Policy Center, July 2010.

¹² For more details and discussion of what accounts for the increase in inequality, see David Autor and Daron Acemoglu, “Skills, Tasks and Technologies: Implications for Employment and Earnings,” <http://econ-www.mit.edu/files/5571>.

¹³ Over the past decade, foreign wars also contributed to increased government spending. But the negative fiscal effect of the financial crisis was much larger than the cost of the Iraq and Afghanistan wars combined.

- 16) To see the fiscal impact of the last finance-induced recession, look at changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to \$5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years debt will rise to \$13.7 trillion (over 65% of GDP)—a difference of \$8.6 trillion.
- 17) Most of this fiscal impact is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the “automatic stabilizers” in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.¹⁴
- 18) We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk.¹⁵ The fact that this is not currently scored by the Congressional Budget Office does reduce this risk or make it any smaller.
- 19) In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.¹⁶ This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what the Bank of England refers to as a “doom loop”.
- 20) The remainder of this testimony reviews in more detail: the catastrophic outcomes likely if there is any kind of default on US government debt; why spending cuts – either from a government shutdown or from some immediate form of immediate austerity – will be contractionary in the current US context; and why the US fiscal balance sheet and efficient provision of public goods remains threatened by a dangerous financial system.

Effects of Defaulting on US Government Debt

The consequences of any default on the US debt would, ironically, actually increase the size of government relative to the US economy.

The reason is simple: If the government defaults, this will destroy the credit system as we know it. The fundamental benchmark interest rates in modern financial markets are the so-called “risk-

¹⁴ See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

¹⁵ See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.

¹⁶ See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive,” Stanford University, March 2011 (revised), <https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf>.

free” rates on government bonds. Removing this from the picture – or creating a high degree of risk around US Treasuries – would disrupt many private contracts and all kinds of transactions.

In addition, many people and firms hold their “rainy day money” in the form of US Treasuries. The safest money market funds, for example, are those that hold only US government debt. At least, these are the funds perceived as safe – if the US government defaults, all these funds will “break the buck”, meaning that they will be unable to maintain the principal value of money that has been placed with them.

The result would be a flight of capital – but to where? Banks will have a similar problem; many of their balance sheets will be destroyed by the collapse in US Treasury prices (the counterpart of an increase in interest rates on such debt, as bond prices and interest rates move in opposite directions).

There is no company in the United States that would be unaffected by a government default – and no bank or other financial institution that could provide a safe haven for savings.

There would be a massive run into cash, with everyone withdrawing as much as possible from their banks. Imagine the lines at ATM machines and teller windows – something we have not seen on a grand system since the Great Depression.

And private credit would disappear from our economic system, which then gives the Federal Reserve an unpleasant choice. Either it can step in and provide an enormous amount of credit directly to households and firms – very much as the central bank, Gosbank, did in the Soviet Union. Or the Fed can stand idly by while GDP falls 20-30 percent, the kinds of decline we have seen in modern economies when credit suddenly dries up.

With the private economy in free fall, consumption and investment would decline sharply. Our ability to export would also be down – foreign markets would likely be affected also and, in any case, if firms trying to export cannot get credit then most likely they cannot produce.

Government spending would contract in real terms, without a doubt. But what would fall more – government spending or the size of the private sector? Almost certainly the answer is the private sector, because this is so dependent on credit to buy its inputs. Think about the contraction that happened in fall 2008 but multiply by 10.

The government, on the other hand, in the last resort has access to the Federal Reserve and can therefore get its hands on cash money to pay wages. With the debt ceiling not increased, this would require some legal sleight of hand. But the alternative would clearly be a collapse of US national security – the military and the border guards have to be paid; the transportation system needs to operate, and so on.

Issuing money in this situation would almost certainly be inflationary but, the Fed would reason, perhaps not – because we have never been in this situation before, credit is now imploding, and the desperate credit expansion measures in fall 2008 proved not to be as bad as the critics feared.

This is what a US debt default would look like. The private sector would collapse, unemployment would quickly exceed 20 percent and, while the government would shrink, it would also remain the employer of last resort.

Anyone who does not want to raise the debt ceiling is playing with fire. Some people expressing this position are also advocating a policy that would have dire effects – and do the exact opposite

of what they want to the structure of our economy. The government would become more important, not less important.

Spending Cuts Would Be Contractionary

Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."¹⁷

The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today

If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the US is currently one of the lowest perceived risk countries in the world – hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the US today due to fiscal concerns, these are mostly about the longer-term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 5 percent below its pre-crisis level. The US still has a significant "output gap" between actual and potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the US today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of "quantitative easing" to bring down interest rates on longer-term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again – for example because fiscal contraction involves laying off government workers.

Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency – thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy contraction. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control – and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

¹⁷ *World Economic Outlook*, October 2010, Chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases.

The available evidence, including international experience, suggests it is very unlikely that the United States could experience an “expansionary fiscal contraction” as a result of short-term cuts in discretionary federal government spending.

The Real Dangers and Costs of Fiscal Crisis

The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. There is no precise debt-GDP level at which a crisis is triggered, but with net debt relative to GDP in or above the range of 90-100 percent, a country becomes much more vulnerable to external shocks – particularly if it is relying on foreign investors to buy a substantial part of its debt.

If any shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect – as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious – or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

It is important not to oversimplify fiscal concerns into precise cut-offs for “dangerous” debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

Greece ran into trouble in 2010 with gross debt relative to GDP of 142 percent; its debt levels in 2006 and 2007 were around 105 percent. This is a classic case of too much debt by any measure – although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece.

Portugal faces a fiscal crisis with gross debt at 90.6 percent of GDP in 2011, but its debt was only 62.7 percent in 2007. The issue for Portugal is low achieved and expected growth relative to fiscal deficits – the markets have become unwilling to support debt that continues to increase as a percent of GDP.

Ireland, the third eurozone country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on-balance sheet government debt was low (25 percent of GDP in 2006-07 for gross debt) but there was a big build up in off-balance sheet obligations – in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and supporting the economy during severe recession has pushed up gross debt to 114 percent of GDP in 2011 and debt levels will reach at least 125 percent (in our estimates, even higher) before stabilizing.

Compared with other industrialized countries, Japan stands out as an extreme. Government debt relative to GDP is expected to reach 229.1 percent in 2011 (on a gross basis) and rise to 250.5 percent in 2016. On a net basis – taking out government debt held by other parts of the public sector – the equivalent figures are 127.8 percent in 2011 and 163.9 percent for 2016. But nearly 95 percent of Japanese government debt is held by residents – and, at least for the time being, Japanese household and business savings remain high. Countries with greater reliance on foreign savers, such as the US (where nonresidents held over 30 percent of general government debt in 2010) and the UK (nonresidents held 26.7 percent of general government debt in 2010)

need to be much more careful. Within the eurozone, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40-90 percent of all outstanding government debt (mostly held by other eurozone financial institutions).

The increase in debt relative to GDP in industrialized countries from 2007 to 2011 was about 28 percent (of GDP; unweighted average across countries, as calculated by the IMF) – most of which was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

Seen in that context, the increase in the US gross debt – from 62.2 percent of GDP in 2006 to 91.6 percent at the end of 2010 – was very much in line with experience in other countries. But the current trajectory of debt now, rising to 111.9 percent in 2016, is on the high end (the average debt-GDP for industrialized countries is projected to rise by about 5 percent over this period.)

In terms of net general government debt held by the private sector, at the end of 2011, the US is expected to have around 72.4 percent of GDP – up from 42.6 in 2007. This is not yet at a dangerous level but the future projections are not encouraging – this number will rise to 85.7 percent in 2016, according to the IMF. And in the Congressional Budget Office's longer-term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050.

The role of the US dollar as the world's preeminent reserve currency means there is a strong demand for our government securities in the foreseeable future. But it is not clear how far this will carry us – particularly as alternative reserve assets typically develop in a diverse world economy with competing national interests. It would be wise to undertake medium-term fiscal consolidation. Rising healthcare costs and a weak tax base could well undermine our long-term potential growth.

In addition, the United States continues to face very large implicit liabilities in the form of implicit support available to the financial sector, both directly – if “too big to fail” global banks get into trouble – and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis.

If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector executives and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage. If sharp spending cuts follow that reduce public services (e.g., government-funded education), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.

There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for “too big to fail” global financial institutions. Such firms are likely to damage themselves with some regularity – their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce.

Chairman CAMP. All right. Thank you.

We expect a series of votes in about 15 minutes that will last about an hour. So, as a result, Mr. Levin and I have yielded back our time and we are going to go to a three-minute questioning period.

So at this point, Mr. Rangel, you are recognized for 3 minutes.

Mr. RANGEL. I just want to ask Mr. Johnson. All the time during his testimony I was thinking of a possible crises, if the congress and the President can't get together.

Now, Mr. Johnson, I think some people believe that if we do have a default that we'll have a smaller government; and I think I read

somewhere that you had indicated that a default would increase the size of government. Is that correct?

Mr. JOHNSON. Yes, Mr. Rangel, that is my opinion, because government debt as a triple A rated securities, the basis of our credit system, so much of the private sector depends on credit one way or another. If you have any kind of government default, and that could be next week—it could be at any point—you’ll destroy the credit system. You make the private sector smaller. And the government, whatever you think about it, has an ability to operate. You saw this in the great depression, even as the private sector crumbles around it.

So, ironically, one effect, and tragically, I could say, because I certainly don’t want to default, and I would argue very strongly against anything that would take you down the road. But one ironic effect would be to make the private sector much, much smaller. Therefore, government as a share of GDP will become bigger while GDP was getting smaller.

Mr. RANGEL. Thank you, Mr. Johnson. I yield back the balance of my time.

Chairman CAMP. Thank you, Mr. Rangel.

Mr. Davis, you are recognized for 3 minutes.

Mr. DAVIS. Thank you, Mr. Chairman. I would like to ask a hypothetical question, open it up to the panel. If the VAT were imposed, how wide ranging should this be if you were to do something like this in the United States? I have heard a range of different opinions here.

I mean should some products and services be excluded as they are in the current retail economy from sales tax or professional services? You know. How are you concerned that implementation of VAT will be no different than our current Tax Code in terms of complexity and compliance issues that exempt certain income and taxes others. I’d just like to throw it open to the group there.

Mr. WHITE. That’s a very good question; and, as I mentioned, the European VATs are quite complex. They’ve got a lot of exemptions, special rates, other tax preferences or tax expenditures built in, so many that they lose roughly half the revenue that they could have collected from a simpler version. So that the overall point is that just like an income tax, you can add a lot of complexity with exemptions, deductions, special rates, those kinds of—

Mr. DAVIS. So hypothetically you could have a simpler VAT with a lower rate and actually make more money.

Mr. WHITE. New Zealand is an example of a country that’s got a much simpler VAT; many fewer exemptions, fewer special rates.

Mr. DAVIS. Anybody else?

Mr. GRAETZ. Mr. Davis.

Mr. DAVIS. I will come back to you, Mr. Johnson. We will get Mr. Graetz and come back to you briefly.

Mr. GRAETZ. We have been looking at this very carefully, and the VATs to use as your models are Singapore, South Africa, New Zealand, Australia and Canada.

Talking about Europe is non-sensical, because Europe’s VATs are ancient and because of the European treaties. They can’t change them without agreement throughout Europe, so Europe is really not the right comparison. These are all modern value added taxes.

They are very broad-based. They are very simple. Their compliance costs are relatively low.

Singapore has a very large exemption for small businesses. If I were recommending an exemption for small businesses, I would say that any business under \$500,000 of receipts doesn't need to come into the VAT, unless it elects to come into the VAT. Some of them will elect to come in because they will get refunds, because of where they are in the chain. I agree with Mr. Johnson, Professor Johnson, that the financial services problem is a big one, under many VATs.

Financial services transactions with businesses are over taxed, and their transactions with customers, with retail customers, are under-taxed, and we have come up with some solutions that we think will work on that front. These problems of implementation are solvable and the advantages of having a value added tax are large and eliminating, if we can eliminate a large part of the income tax in the process and get our corporate rate down.

You can't solve the corporate income tax problem in this country by tinkering with the international tax rules. It's not going to work.

Mr. DAVIS. I am sorry, Mr. Johnson, but the clock has run out on me there. Hopefully, someone else will pick up on this.

Chairman CAMP. Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

Dr. Altshuler, the relationship of the VAT or proposed VAT and exports is a lot of conflicting advice on whether or not the VAT actually would help our exporting industries.

Ms. ALTSHULER. Well, I think as you know we economists don't think that the border adjusting attacks will have an affect in the long-term on trade. What we think will happen is that there'll be exchange rate adjustments that will take away any advantage or disadvantage that we would gain from adopting a board or adjustable tax.

That said, it's possible that during the transition period there could be advantages or disadvantages in terms of trade; and, if you were to do what I think we would all advise that you should not do and adopt a VAT that has lots of holes and lots of exemptions, you'd create a system in which there would be some disadvantages and advantages in terms of export and import. But, again, a reason to adopt the VAT is not because it will be a positive for trade or negative for trade.

Mr. GRAETZ. An export driver. Can I make just one quick comment on that, Mr. Neal? Not all exchange rates are moving freely. As we know, China does not, and exempting exports and taxing imports from a country like that might make a real difference, in addition to its other advantages and compliance.

Mr. CARROLL. I would just add to that. The economic theories would suggest that it's the relative price levels between nations that would adjust for countries where there are flexible exchange rates that would happen through the flexible exchange rates, for countries with fixed exchange rates or where they're pegged. It would probably happen in other ways, but it would happen much more slowly. There was a lot of inflexibility in labor contracts and so on, but I would agree with Rosanne that it would still happen, but it would happen more slowly.

And I would just reiterate one of the points that Rosanne made, that border adjustments could have significant differential effects if you were to enact a narrow base such as they have in Europe, or even as they have at the state level in this country through kind of the partial sales taxes that are in effect.

Mr. NEAL. Mr. Chairman, given DOHA and the fact we have three pending bilateral agreements, I think this would be worth pursuing as we go forward. So I think these panels have been helpful, and I think something along those lines could be more helpful.

Chairman CAMP. All right. Thank you.

Ms. Jenkins is recognized for 3 minutes.

Ms. JENKINS. Thank you, Mr. Chairman. Thank you all for being here.

I think most of us in this room acknowledge that the current Tax Code is broken. Pro growth tax system should be simpler, more efficient, fair. A simple Tax Code is essential in my belief to promoting economic efficiency and reducing the interference of taxes with families' everyday business making decisions. It seems that the layering of a VAT tax in addition to this already complex personal and business tax would only produce an ever more burdensome Tax Code.

Instead of promoting widespread economic growth promised by fundamental tax reform, it would promote two sectors above all others: accountants and tax lawyers. That continues to be highly contentions and controversies over virtually every aspect of that includes a laundry list: the determination of what activities fall within the scope of that; the delineation of exempt and zero-related supplies; the characterization of supplies and determination of where they're provided; treatment of the composite supplies; apportionment of input taxes to tax exempt supplies as VAT tax is immune from controversy. I'd just like you all to comment briefly or elaborate on which aspects of that tend to invite controversy and litigation, and are there any particular cases that should caution the United States from following other countries in an acting VAT.

Mr. GRAETZ. Well, I would say two things. One is I do think if you have a broad base, these issues are much, much simpler. New Zealand and those countries, Singapore, are not having a great controversy over their value added taxes; and, if you used the revenues from a value added tax to remove 150 million Americans from the income tax and you use it to get a 15 percent rate on income above \$100,000 and 25 percent above \$200,000, which is distributionally neutral and can have a 15 percent corporate income tax rate, we will have put the United States in a much better position, and I think you'll find that the amounts of money that are being spent by businesses on tax planning and tax advice, this is the only sector in which the current system creates jobs is the tax planning, tax return preparation, tax advice sector. And I think a value added tax from all experience, if it is used to buy down the income tax significantly, would make a big difference, a positive difference.

Ms. JENKINS. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Ms. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman, and I know that my time is very limited with just 3 minutes, but having just had the

presentation prior to you on the FairTax, and what I would like each of the panelists to do as briefly as you can with a little comment on why you would support or not support the difference between the VAT and the FairTax.

So maybe we could start on this end, since Mr. Johnson seems to be left out. Mr. Johnson, let's do that and go down.

Mr. JOHNSON. Yeah. I actually would echo again what President Bush's advisory panel said, which is they came out strongly against FairTax or national sales tax. So they were split, but they were rather more favoring the VAT in terms of how you administer the system, in terms of the compliance risks that you have, in terms of the burden that you have on small business; and, of course, in terms of the inherent regressivity and how easy it is to do with it. You are creating a massive new entitlement plan with the prebates. Why would you want to do that when we have enough difficulty managing our existing structure?

Mrs. BLACK. Thank you. Mr. Mitchell.

Mr. MITCHELL. And if we could repeal the 16th Amendment and put it so deep under the ground that no Supreme Court could possibly let an income tax ever spring up to haunt us again, then either a VAT or some sort of national retail sales tax would be a less destructive way of raising revenue. That's not going to happen, and therefore I hope that we keep a VAT or a national retail sales tax deep under the ground.

Mrs. BLACK. Thank you. Mr. White.

Mr. WHITE. As I noted, both a sales tax and a VAT are consumption taxes, so the economics is the same for the two. The administration of them is quite different; and so you've got different issues concerning compliance, non-compliance, risks of non-compliance.

That would have to be addressed. I would note that with a sales tax, our experience has been with relatively low rate sales taxes. I don't think around the world there's been any experience with very high rate sales taxes and the compliance risks there.

Mrs. BLACK. Thank you. Mr. Carroll.

Mr. CARROLL. I would make the same point. I think one of the two major differences that I would highlight, some of which have already been made, one is the collection of a retail sales tax that is focused at the retail level. That makes evasion a much more significant problem, and so that is one area.

The second point I would make is it is probably the case that would be much more likely to have base erosion with the retail sales tax than with the value added tax, and it is much more likely that the experience that we would follow over time would be more typical of what we have seen at the state level where there has been a very significant erosion of the base by excluding various consumption items.

Maybe the third point I would make, it is much more likely we would tax, we would include some intermediate inputs in a sales tax base but not in a VAT, and that would lead to cascading and undermine the efficiency benefits of the sales tax.

Mrs. BLACK. Time is running out. Ms. Altshuler.

Ms. ALTSHULER. I'll echo what everybody else said. Well, not what everybody else said, but I was the chief economist for the tax

reform panel. We looked closely at the FairTax. We looked fairly at the FairTax. The FairTax is not a FairTax and it just doesn't work.

Chairman CAMP. All right. Thank you.

Mr. Herger is recognized for 3 minutes to conclude this session.

Mr. HERGER. Thank you very much, Mr. Chairman. I want to thank our witnesses. I feel the consumption part tax of the VAT is very admirable. I have some very strong concerns about the lack of transparency, and also the fact that it hides the true cost of government from voters.

Mr. Mitchell, you mentioned in your testimony that value added taxes are typically built into the price of goods and services. Can you elaborate on why this is a problem?

Mr. MITCHELL. If the tax system is supposed to be the price of government, and you want prices to be transparent so voters can understand what they're getting and whether it is worth it, then you want a tax system that is very visible. You don't want it hidden. And we certainly have seen in Europe—I included a chart that I took out of a European Commission report that just was released, showing that just in the last couple of years alone value added tax rates have jumped by something like two percentage points.

And, of course, because they're such broad-based taxes, that is a huge increase and a burden on the people of Europe. And one of the reasons why that tax is always so easy to raise is precisely because it is hidden. And one of my concerns is if we put in a VAT at five or ten percent in the U.S., as we get further and further into this entitlement tsunami, we will try to keep up with that wave by just raising the VAT rate one or two percentage points every other year. And, of course, we will make the same mistake that the Europeans made, higher taxes, following higher spending, leading to more stagnation, leading to higher deficits and debt.

As I said in my oral testimony, I don't want a copy of the fiscal policy of countries that are on the verge of collapse, especially when we have—if want a single rate consumption based tax, we already have a harabuska system that would be much easier and safer to implement.

Mr. GRAETZ. Mr. Herger, Canada separately states their value added tax just like a retail sales tax. There's no reason why in legislation if you want people to know what they're paying. You just don't have it separately stated, just like a retail sales tax. And Canada's spending has gone down and its rate actually went down. So, you know, there are ways to control these issues.

Mr. HERGER. I admire what Canada has done. I also remember back in the days when I am old enough to remember when you bought gasoline, and you had when you filled your tank exactly how many cents of tax you were paying. We don't see that anymore. My concern is future congresses that will hide it. So, therefore, again I share your concern, Mr. Mitchell. I thank you. It could be right if we had the perfect people in. Regrettably, we more times than not do not have that be the case. But, Mr. Chairman, again I thank you for this hearing, and I thank each of the witnesses.

Chairman CAMP. All right. Thank you. I heard the bells. We are having a series of votes, and we are having a series of votes on the floor. So I want to thank you all.

Members who did not get a chance to question may want to submit some questions to you in writing. If you would be kind enough to respond to those promptly, we could make those part of the formal hearing record. And I would very much appreciate you all being here. This was a very strong panel, and I really appreciate the good information that you brought to the committee.

Thank you. This hearing is now adjourned.

[Whereupon, at 1:20 p.m., the committee was adjourned.]

[Submissions for the Record follow:]

Prepared Statement of Honorable Steve King

Testimony of
Congressman Steve King

Before the House Ways and Means Hearing On
Tax Reform and Consumption-Based Tax Systems

July 25, 2011

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

You are to be commended for your commitment to fundamental tax reform as demonstrated by this hearing and others throughout this first session of the 112th Congress. Tax reform, however, is far too important an issue for us to simply explore. It is imperative for the future of the American economy that this Congress to enact fundamental tax reform and get it right. Ronald Reagan once said, "if you want less of something, tax it." It is vitally important that we keep this axiom in mind as we discuss various proposals to reform our tax code. With our current income tax system, the federal government has the first lien on all productivity in America. Because of this, as Ronald Reagan predicted, our economy is less productive than it otherwise could be. The simple fact is that our tax code inhibits our production.

As a former small business-owner, I know the profound negative affect our tax code has on our economy. I owned and ran a construction company for 28 years. Tax-code compliance can be one of the single greatest annual expenses for an American business. Wading through the nearly 70,000 pages of the tax-code has become an impossible tasks for business owners to accomplish on their own. They are forced to employ armies of accountants just to calculate how much they owe the federal government. In fact, estimates place the total cost for tax-compliance each year in America is around \$300 billion and growing. The truth is, with our current tax-code, we have placed an unacceptable burden on the backs of American businesses.

With the current state of our economy, the impending calamity surrounding our national debt, and the complex and burdensome nature of our tax-code, the time for tax-reform is now. The FairTax represents a way for the federal government to collect more revenue, from a broader base, with a simpler, more transparent, and pro-growth method.

The FairTax, which is embodied in H.R. 25, will completely alter the federal government's tax collection practices, taxing consumption rather than production. By doing this, we could completely untax productive behavior in the United States and give Americans all the incentive in the world to earn all that they can, invest all that they can, save all that they can, keep all that they wish, and decide when and how much to pay in taxes each year.

H.R. 25 would replace all federal income taxes, payroll taxes, excise taxes, estate taxes, and gift taxes with a national sales tax of 23 percent on the consumption of new goods and services. With a shift from taxation of productive behavior to consumption, Americans will be able to take home their entire paycheck. This will have an enormous stimulus effect on our economy.

The FairTax will also have an important impact on the relationship between American citizens and their government. Under our current income tax code, most Americans have no idea how much they pay each year in taxes. Because their contributions to the federal coffers are made through withholding, there is a large disconnect between what they're supposed to be paid and what they actually take home. Most earners don't pay much attention to the share of their paycheck the government takes. For too many, the only time they spend any serious time considering the amount of money taken by the IRS is the time they spend each spring determining how much they'll get back in their refund check. This environment has unfortunately produced generations of Americans who are completely disconnected from the amount of their money it takes to run our bloated, inefficient, and wasteful federal government. On day one after enactment, the FairTax would begin to remedy this.

Every American who pulls out his wallet to pay the cashier at the Grocery Store or the movie theater will be given an instant reminder of the contribution he must make to keep the federal bureaucracy afloat. This, in turn, will give every voter reason to question the expensive promises made by politicians competing for his vote and will make him constantly question whether the money he is sending to Washington every day through his purchases is being used wisely. More importantly, however, the FairTax will reverse the effect that withholding and our income tax code has had on generations of Americans. Every young child who eagerly uses his allowance to buy a pack of skittles will face the stark reality that his precious dollar doesn't go as far as he'd like – because the federal government must take its share. This scenario, which will play out all across this nation everyday for millions of young Americans, can have no other impact than to begin the process of raising a new generation of fiscally conservative Americans who have a natural distrust of the growth of government.

We also cannot underestimate the incredible impact that the FairTax will have on our economy. Not only will Americans have more money to spend, they will have more money to save and invest—which will give American businesses more access to capital. This, in turn, will allow greater investment in research and development and allow for economic expansion throughout every sector of our economy.

A shift away from our income tax system will also increase the competitiveness of our manufacturers abroad. Right now American producers must pay payroll taxes and embedded taxes and compliance costs in this country and then export products overseas, pitting their products at a disadvantage when compared to the products sold by companies from abroad who do not have to pay these taxes. And so, when our products are sold overseas, they're more expensive than those in domestic markets.

When foreign producers sell their products here in the US, they often receive a rebate for the Value Added Taxes that they pay in their home countries. Currently, the US tax system gives an approximate advantage of approximately 20 percent to foreign producers. With the FairTax, US producers will no longer be forced to pass on embedded taxes. Exports will leave our shores completely untaxed, and imports will be forced to compete with domestically produced goods that are less expensive because of the fact that producers are no longer forced to pass on embedded taxes and compliance costs.

The FairTax also maintains a level of progressivity. A prebate would be provided monthly in advance payments to all households. The prebate amount would be equal to the poverty level times 23 percent. An extra amount is provided to married couples to prevent a marriage penalty. This check will be delivered at the first of the month and will ensure that no American family is forced to pay any federal taxes for the necessities of life.

The FairTax completely untaxes the poor. No poor American will pay tax on his or her consumption expenditures. The progressivity remains, however, for those who earn wages above the poverty level. For instance, a family that earns twice the poverty level is only going to pay half the tax rate.

H.R. 25 is called the FairTax because it is truly that—FAIR. Every American will be treated exactly the same at the cash register. While the prebate, coupled with levels of consumption, will ultimately determine Americans' tax liability, every American, regardless of age, race, or creed will be faced with the true cost of government every time they check out at the cash register. Every American will be reminded on a daily basis just how much it costs to keep our federal government running. And I will submit that there is no better way to ensure that the role of the federal government in our lives is minimized and our own individual freedom is maximized.



Prepared Statement of The Honorable Rob Woodall

**House Committee on Ways and Means
Full Committee Hearing
on
Tax Reform and Consumption-Based Tax Systems**

**Written Statement for Inclusion in the Printed Record
The Honorable Rob Woodall (R-GA)**

Tuesday, July 26, 2011

Chairman Camp, Ranking Member Levin, and Members of the Committee,

For decades, our tax code has been an impediment to our nation's sustained economic growth. Less a coherent system than a patchwork of loopholes, preferences, and penalties, our tax code has become an enormous drain on America's businesses, entrepreneurs, and taxpaying individuals. This year alone, Americans will spend \$431 billion on tax code compliance.¹ It has been projected that by 2015, those compliance costs will rise to \$482.7 billion.² This means businesses and individuals have fewer resources to create jobs and grow our economy. When one factors in the amount of time spent and productivity lost in order to complete the convoluted process of paying one's federal taxes, every dollar collected by the federal government as tax revenue costs the law-abiding taxpayer considerably more than the one dollar owed in taxes. These are hundreds of billions of dollars that businesses could be spending on new hires, job training, and investment in new capital; money that American consumers could be using for higher and better purposes.

We all agree that our tax code is broken. The President himself has acknowledged that we must overhaul our tax system to remain competitive in the global economy. However, the question before this Committee is how to do it. The tax reform discussions today in Congress sometimes consider the current tax structure as the basis for reform rather than the root of the problem. I have introduced H.R. 25, the FairTax, in the 112th Congress because I believe that we need to completely dismantle our current tax structure and start over. The FairTax eliminates all federal personal and corporate income taxes. It abolishes the gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes as well, and replaces them all with one simple, transparent, 23 percent personal consumption tax. In passing the FairTax, we would unshackle the American entrepreneur and turn our nation into a magnet for capital investment overnight.

Opponents say the FairTax is untested and unknown. To those individuals, I would point to the fact that the FairTax is supported by \$20 million in research conducted by some of the nation's preeminent economists, over 70 members of Congress, and tens of thousands of business owners, consumers, families, and private citizens across the nation. It is, by far, the most widely supported and most thoroughly-vetted tax reform proposal before Congress today.

Sixteen years ago, a group of concerned citizens decided to dream a big dream and ask the question, "If America could write its tax code anew, starting with a blank sheet of paper, what should we do?" That is how the FairTax started. How the FairTax grew, however, is through the passionate and tireless work of its grassroots leaders, and I want to express my gratitude today for their efforts. To the supporters who have sacrificed their time and treasure to advance the FairTax, thank you. To the believers who have over the years volunteered their time, energy, and passion in advancing the cause, I am grateful. It is often said that great change could be accomplished if only Americans had the political will to demand it. I would argue that

¹ <http://www.laffercenter.com/2011/04/press-release-dr-arthur-laffer-compliance-with-complex-tax-code-costs-taxpayers-431-1-billion-a-year-2/>

² 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.

Americans do have that will. It has been demonstrated time and time again through the hundreds of thousands of e-mails, phone calls, and yard signs placed by FairTax advocates. The impediment to change is not the people; it is Washington, D.C.

I would also like to thank Chairman Camp for his leadership on the often divisive but always important issue of tax reform. It is time to stop kicking the can down the road, and I am pleased that the Committee is boldly leading this Congress and working diligently to find new, creative solutions so that we do not force the broken and destructive system that exists today onto our children tomorrow.

Prepared Statement of The Honorable Jeff Miller

Mr. Chairman,

I want to thank you and the Ranking Member for holding this very important hearing on Tax Reform and Consumption-Based Tax Systems. In this time of economic uncertainty and fiscal difficulty, Congress must look at reforming our tax system to make it simpler, fairer, and more efficient.

I believe the best way to achieve these goals of a better tax code is the Fair Tax. I have supported and co-sponsored Fair Tax legislation since coming to Congress. This legislation promotes freedom, fairness, and economic opportunity.

As you know, the current tax code is thousands of pages long, and people spend countless wasted days preparing their complicated tax returns each year. The income tax rates and corporate tax rates are too high, and tax expenditures exist for a wide variety of industries, allowing the government to pick and choose winners, instead of the marketplace. We can do much better for the honest, hard-working American taxpayer.

I support simplifying the tax code, making the government less intrusive, and creating an environment more conducive to saving. The Fair Tax as proposed would abolish the Internal Revenue Service, would repeal the income tax and a host of other taxes, and would eliminate the alternative minimum tax and death tax. In its place, this legislation enacts a national sales tax to be administered primarily by the states.

While some might argue that consumption taxes like the Fair Tax would penalize Americans who spend most of their income, this pro-family legislation allocates a sales tax rebate for low-income families based on family size and income. Every family would receive a rebate of the sales tax up to the federal poverty level, plus any amount to prevent a marriage penalty. In short, the Fair Tax ensures our tax system remains equitable for all.

Under our current tax system by which our own U.S. Treasury Secretary Timothy Geithner is so confused that he fails to pay some of his taxes, the need for a comprehensive overhaul is now. By creating a simpler tax code, the government becomes less intrusive, giving Americans more freedom over their finances. I wholeheartedly support the Committee's efforts to closely examine the need for a better tax structure, and I urge my colleagues to carefully consider the Fair Tax as part of any broad tax system overhaul.

JEFF MILLER
Member of Congress
First District of Florida

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Full Committee Hearing on Tax Reform and Consumption-Based Tax Systems, July 26, 2011

Prepared Statement of American Manufacturing Trade Action Coalition

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STATEMENT FOR THE RECORD**Committee on Ways and Means Hearing on Tax Reform and Consumption-Based Tax Systems**

Submitted by the American Manufacturing Trade Action Coalition
Auggie Tantillo, Executive Director
August 9, 2011

The mission of the American Manufacturing Trade Action Coalition (AMTAC) is to preserve and create American manufacturing jobs through the establishment of trade policy and other measures necessary for the U.S. manufacturing sector to stabilize and grow. Among other companies, AMTAC represents a substantial portion of the U.S. textile industry.

Introduction – Solving Manufacturing Crisis Requires Tax Reform

Manufacturing provides millions of American jobs, enables a diverse workforce, and sustains communities and families in both urban and rural America. It also contributes an irreplaceable component to the nation's gross domestic product (GDP) and is vital to the armed forces and overall national security of the United States.

The crisis that has engulfed American manufacturing in the first decade of the 21st century is historic and unprecedented since the Great Depression. It places both our national and economic security at risk.

The crisis has cost the U.S. economy almost 5.5 million manufacturing jobs, many major company bankruptcies and thousands of plant closures. In addition, the hemorrhage in the U.S. manufacturing sector has had a ripple effect throughout the economy due to the fact that several other non-manufacturing jobs are lost for every single manufacturing job lost.

In addition, the crisis is manifested in America's unsustainable current account deficit. The \$5.8 trillion deficit of the last decade represents the standard of living desired by Americans compared to the shortfall in wealth that we have produced. The combined trade deficits of \$5.6 trillion in manufactured goods and of \$1.7 trillion in oil and gas exceed America's entire current account shortfall. To finance our consumption, America has been forced either to borrow from or sell assets to foreign interests at a rate of nearly \$1.6 billion per day.

Consequences of this huge deficit include markedly slower U.S. economic growth, skyrocketing public and private debt, havoc with the lives of individual Americans and their families and communities, a weakening of the underlying strength of the dollar, large capital inflows for additional production capacity in low-wage nations, increasing foreign ownership of U.S. assets and companies, and the condoning of pollution, unfair labor and other reprehensible production practices around the globe.

A single policy problem is not responsible for the fix that the U.S. economy is in and a single solution will not solve the problem. To turn the economy around, AMTAC believes a comprehensive overhaul to U.S. trade policy is needed among other policy changes. A sound trade policy overhaul would include, but not be limited to, the rejection of flawed free trade agreements like the U.S.-Korea Free Trade Agreement (KORUS), enactment of strong anti-currency manipulation legislation, strengthened Buy-American laws, repeal of "first sale" treatment for the purpose of determining the basis to apply duties, and more effective customs enforcement.

Another key component of the necessary overhaul is embedded in the subject of this hearing – tax reform that would make U.S. producers more competitive by eliminating the disadvantage caused by foreign border-adjusted taxes.

The Foreign VAT Problem and Its Scope

Virtually all of our foreign trade competitors maintain border-adjusted tax regimes that significantly disadvantage U.S. manufacturers and service providers. Commonly referred to as value-added taxes (VAT) or goods and services taxes (GST) (from now on VAT and GST are simply labeled "VAT"), they give our overseas competitors a material advantage over their U.S. competitors.

The VAT is a general, broad-based consumption tax that is assessed on the incremental value added to goods and services at each phase of production. It applies more or less to all goods and services that are bought and sold for use or consumption in the nations that use a VAT.

Foreign countries with VATs rebate those taxes whenever their manufacturers export products to the United States. In addition, these foreign countries also apply VAT taxes on products shipped to their market. Foreign governments compound the disadvantage to U.S. producers by applying value added taxes on all costs associated with exports into their market such as freight, insurance and tariff costs in addition to the actual value of the exported item. In contrast, the United States does not have a VAT or any other border tax system. The United States does not apply any similar federal taxes to goods shipped to our market from a foreign competitor. Nor do U.S. exporters receive any tax rebates when they ship products to foreign markets.

As a result, the 150+ countries that use border-adjusted tax regimes heavily subsidize their exports while at the same time erecting massive trade barriers to U.S. goods. Through a combination of foreign export subsidies and import assessments, it is estimated that foreign border tax schemes resulted in a \$518 billion disadvantage to U.S. manufacturers and service providers in the year 2008.

To appreciate the enormity of this problem, the \$518 billion border tax problem was 2.8 times more costly in 2008 than the estimated \$185 billion spent on wars in Iraq and Afghanistan. Moreover, the border tax problem was nearly two times greater than the entire U.S./China trade deficit which reached \$266 billion in 2008.

The Origin of the Foreign VAT Problem

Noting that VAT regimes place U.S. producers at a significant disadvantage in the global marketplace, it is essential to review the history of value-added taxes. Moreover, it is important to understand how global trading rules have come to sanction this massive, trade-distorting loophole contrary to GATT/WTO founding principles.

Shortly after the conclusion of World War II, the General Agreement on Tariffs and Trade (GATT), the precursor to the World Trade Organization (WTO), was established in 1947. The original purpose of the GATT was to facilitate international trade through the establishment of fair and transparent rules. In order to meet this fundamental objective, it was critical for the GATT to assure that countries' tax systems would be treated in a manner that was trade neutral. At the time, countries employed both direct and indirect tax systems, the two major categories of taxation.

- Direct Taxes (such as property or income taxes) are taxes that cannot be shifted onto others. These taxes are paid by the individual generating income or possessing property.
- Indirect Taxes (such as excise or value-added taxes) are taxes that are shifted onto another party, generally onto a consumer as a component of the price paid for goods or services.

Failure to properly address these differences would have allowed tax systems to serve as de-facto subsidies or trade barriers. However, at the inception of the GATT members held little more than general discussions on tax-related subsidies as an issue of concern. These initial discussions led only to general notification and consultation requirements as opposed to firm definitions of prohibited subsidies. Consequently, there was no definition of a prohibited export subsidy included in the 1947 Agreement.

In 1955, GATT members agreed to ban export subsidies to manufactured goods. However, the 1955 amendment included an interpretive note to Article XVI which provided that the "exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy." In other words, indirect taxes such as a VAT could be rebated to manufacturers who exported their goods. At the time, indirect tax systems were not widespread and typically had quite small tax rates.

In 1960, based on a proposal put forward by France, GATT members approved a Working Party report that identified a detailed but non-exhaustive list of prohibited export subsidies. The report specified that the rebate or deferral of direct taxes on exports

was considered a prohibited export subsidy (now codified in Annex 1 of the Agreement on Subsidies and Countervailing Measures). At the same time, the GATT allowed the rebate of indirect taxes (such as value-added taxes) on exports and also the collection of value-added taxes on imports. Because indirect tax rates were generally low, the U.S. underestimated the impact of allowing disparate treatment of different tax systems under GATT rules.

Economists, however, quickly recognized the potential for trade distortion. For example, M.I.T. Professor Charles Kindleberger, writing in 1963 when France had its TVA (or VAT) system operating as both an export subsidy and an import penalty, but Germany did not, said: "...German sales to France get taxed twice, once by Germany and once by France, whereas French exports to Germany escape tax in both jurisdictions... This distorts production in favor of France and against Germany..." Today that distortion does not exist between France and Germany, but it does favor the 150+ countries with VATs and disadvantages the U.S. when we trade with them.

The series of GATT decisions on the definition of export subsidies resulted in a severe distortion in global competition that would grow as more countries adopted indirect tax systems over time. In addition, countries also substantially increased their indirect tax rates, in some cases at rates comparable to the reductions in import duties required from GATT negotiations. These critical GATT articles and decisions include the following:

- GATT Articles II & III -- The application of indirect taxes, such as value-added taxes to imports are allowable and such taxes are not considered as part of a country's bound duty rates. [1947]
- GATT Article XVI -- Rebates of indirect consumption taxes, such as value-added taxes on exports are not considered export subsidies. [1947]
- GATT Article VI -- Anti-Dumping and Countervailing Duty (CVD) duties may not be imposed to counteract the rebate of such taxes on exports. [1955]

Moreover, in 1979, the prohibition of rebates and remission for direct taxes and the permissibility of exempting or rebating indirect taxes were incorporated into the Tokyo Round Subsidies Code through inclusion in the Illustrative List of Export Subsidies. In 1994, that list was carried over to the Uruguay Round Agreement on Subsidies and Countervailing Measures.

In sum, these rulings allowed GATT trading partners to rebate value-added taxes on their exports, and to also collect value-added taxes on imports. GATT rules were also structured to prohibit such border adjustments for direct taxes like the U.S. corporate income tax. Although these decisions clearly presented a substantial advantage to countries operating indirect tax systems (such as VAT), U.S. representatives to the GATT failed to object in the 1950s to the discrimination created for two main reasons.

1. Indirect taxes were not major taxes in most countries and therefore were viewed as a minor nuisance.

2. The U.S. was by far the dominant industrial superpower during this post-World War II period. Operating under a Marshall Plan mentality, U.S. foreign policy was to pursue measures helpful to other countries even at considerable sacrifice to itself. In that light, approval of the indirect tax loophole under GATT was viewed as a necessary concession designed to bolster the economies of key strategic allies.

In retrospect, the failure to classify VAT rebate schemes as an unfair subsidy within the context of the GATT has proven to be a monumental error on the part of U.S. trade negotiators. Upon confirmation that the rebate of indirect taxes would not be considered a subsidy under the GATT and with the ability to apply indirect taxes to the full value of imports at the border, virtually every major participant in the global trading arena adopted indirect tax schemes, predominantly VAT-type systems. While many countries had indirect tax systems in place at the initiation of the GATT, no country had a VAT in 1947. France was the first country to implement a VAT system in 1948, which they called the TVA (*tax sur la valeur ajoutée*). No other country had a VAT until 1960. Consequently, it is no surprise that VAT schemes were not initially identified by political leaders in the U.S. as a major problem. Today however, including France, there are 150+ countries that now have some type of VAT arrangement. This list includes all of Western Europe along with key trading partners such as China, India, Brazil, Japan, Taiwan, Vietnam and South Korea.

Not only has there been an exponential growth in the number of countries that now utilize a VAT, the actual rate of the tax applied by these countries is not regulated by the WTO. Consequently, countries are free to increase their value-added taxes to whatever level they desire, regardless of the distortion on international trade flows. In practice, it appears that the trend has indeed been for countries to raise their standard VAT rates over time. For example, France started with a VAT rate in the late 1940s of 2 percent and today has a rate of almost 20 percent. The average border tax rate for all VAT countries is in excess of 15 percent.

All of these countries recognize that a VAT gives their manufacturers and exporters a dramatic competitive advantage. For some, like the members of the European Union, declines in applied tariff rates have been mirrored by increases in standard VAT rates, such that the total charges to imports from a country like the United States are remarkably similar today to what they were forty years ago despite declining tariffs.

In addition, VAT rates are typically applied on a landed cost, duty-paid basis, meaning the tax is imposed not just on the price of the good from the U.S., but also on movement charges from the U.S. to the importing country and on the duties that are charged on importation. At the same time, imports into the U.S. from countries with VAT systems have been freed of the VAT imposed in country, resulting in massive refunds (or tax liability reductions) to exporters. Moreover, the U.S. applies duties on the simple value of the imported product as opposed to the value plus all transportation, insurance and handling charges. Since the U.S. does not impose a national-added tax at the border and does not rebate taxes to exporters, U.S. producers are disadvantaged in export markets and in our own domestic market when competing against imports from a VAT country.

U.S. Reaction to the Proliferation of Foreign VAT Subsidies

As noted above, the United States made a major negotiating blunder in approving an exemption for value-added taxes under the GATT and its successor, the World Trade Organization (WTO), subsidy provisions. The U.S. has compounded this serious error over the ensuing decades through further missteps and a failure to correct this problem although explicitly instructed to do so by Congress on several occasions.

As more countries adopted a VAT in the 1960s, U.S. dominance in the global marketplace began to fade. The unfair advantage garnered through the indirect tax (VAT) loophole was specifically identified as a key aspect of our growing international trade problem. The following is a quote from President Johnson in 1968:

American commerce is at a disadvantage because of the tax systems of some of our trading partners. Some nations give across-the-board tax rebates on exports which leave their ports and impose special border tax charges on our goods entering their country. ... I have initiated discussions at a high level with our friends abroad on these critical matters...

-- Statement by the President Outlining a Program of Action to Deal with the Balance of Payments Problem. January 1, 1968.

Despite President Johnson's decision to initiate "high level" discussions, no progress was made on this issue during his Administration. In the 1970s, the U.S. began to sustain consistent trade deficits. At that time, Congressional reviews specifically acknowledged the impact of the VAT loophole on U.S. producers.

...the failure [of the U.S.] to appreciate the consequences of excluding the so-called 'indirect tax' rebates in 1960 from the general [GATT] prohibition against export subsidies while including a specific prohibition against rebating 'direct taxes', was a major blunder ... Giving away commercial advantages to prosperous Europe for the sake of their own internal tax harmonization objectives was an unwise and costly move, in which vague political objectives out-weighted clear commercial considerations.

-- Senate Finance Committee Staff Report on the Trade Reform Act of 1973

Noting the blatant unfairness of the VAT loophole and in response to growing industry concerns, Congress has repeatedly instructed the Executive Branch to negotiate a remedy to the differential treatment of direct and indirect taxes under the GATT/WTO. The following are examples of provisions included in three trade bills that were passed and signed into law.

1974: Trade Act directed the President to seek to revise GATT articles "to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs."

1988: Trade Act included nearly identical language as a principal negotiating objective.

2002: Trade Promotion Authority included a similar negotiating objective to revise WTO rules to “redress the disadvantage to countries relying primarily on direct taxes for revenue rather than indirect taxes.”

Despite these Congressional mandates, the U.S. government has to date failed to remedy the distortions caused by the GATT’s differential treatment of indirect tax systems such as the VAT, since it was first identified as a significant problem by President Johnson. In each ensuing GATT/WTO negotiation, U.S. negotiators raised the issue, but little if any serious discussion or negotiations appear to have occurred. As an example, in the Doha Round of WTO negotiations, the 2003 U.S. proposal to the Rules Group states:

... an essential part of the work of the Rules Group should be to work toward greater equalization in the treatment of various tax systems The current distinction [between direct and indirect taxes in the SCM Agreement] risks ignoring the potential trade-distorting effect that certain practices involving indirect taxes may have on trade, and may unfairly disadvantage competitors operating under a direct taxation system.

Although there have been a decade of negotiations under the Doha Round, absolutely no progress has transpired on the above proposal or VAT issue in general. This is demonstrated by the fact that no country has presented suggested language changes to Article XVI or the Subsidies Agreement to eliminate the distortions. Nor have any proposals been put forward to redress the massive disadvantage faced by countries that do not utilize VAT systems, such as the U.S.

The failure to remedy the VAT loophole is compounded by the fact that the GATT/WTO has overturned every revision to the U.S. tax code designed to eliminate these inequalities.

DISC: In 1971, a partial tax deferral system for U.S. exports, called the Domestic International Sales Corporation (DISC), was approved by Congress. European communities challenged DISC under the GATT in 1974. Although a GATT panel ruled that it was a prohibited export subsidy, the U.S. blocked adoption until 1981 after reaching an understanding with the European countries. The U.S. subsequently committed to dismantling the DISC.

FSC: In 1984, Congress repealed the DISC program and replaced it with the Foreign Sales Corporation (FSC). In 1997, after having been in force for 13 years, the European countries challenged the FSC, and it was struck down as a prohibited export subsidy by a WTO panel in October 1999. The decision was affirmed by the Appellate Body in February 2000.

ETI: In April 2000, the U.S. announced that it would comply with the WTO rulings but would also ensure that “U.S. exports are not disadvantaged in relation to their foreign counterparts.” In November 2000, Congress enacted the Extraterritorial Income Exclusion Act (ETI) to replace the FSC. Europe immediately sought

consultations and then challenged the ETI at the WTO. In August 2001, a WTO panel ruled that the ETI was a prohibited export subsidy, and the Appellate Body affirmed the decision in January 2002. The U.S. delayed addressing the WTO ruling, and in 2004 began applying retaliatory tariffs that would have eventually totaled over \$4 billion.

JOBS Act: Enacted in October 2004, the American JOBS Creation Act (JOBS Act) repealed the ETI tax benefits, but it also allowed certain benefits to continue over a transitional period. In November 2004, the European Commission requested consultations regarding the transition provisions. A dispute panel was established in February 2005, and, in September 2005, the panel ruled that the prohibited FSC/ETI subsidies were maintained through the transitional provisions. The U.S. appealed but the Appellate Body affirmed the panel in February 2006. Based on the ruling, the European Union threatened to reimpose sanctions, and Congress passed a bill eliminating the “grandfather” provisions.

Consequently, the GATT/WTO by its terms and through its decisions has established a playing field on taxation issues that is seriously disadvantageous to US manufacturers, farmers and service providers.

The indirect tax loophole which was once viewed as nothing more than a minor irritant by U.S. trade negotiators has evolved into a hugely significant impediment to U.S. exports and the most extensive non-actionable subsidy for foreign manufacturers who ship their goods to the U.S. Until the United States makes this issue a top priority, the existing trade disadvantage for U.S. producers will not only remain in place, but will almost certainly grow worse.

The GATT/WTO articles and decisions allowing the rebate of indirect taxes, most notably today value-added taxes, to be exempt from actionability as a subsidy while also permitting such taxes to be added at the border to the full value of imports has created a fundamental imbalance within the international trading arena. U.S. exports face high costs in the forms of indirect taxes on importation and U.S. producers of all goods face subsidized competition in the U.S. market with no existing remedies to offset the advantages provided. Strangely, a system designed to level the playing field through reducing barriers to trade has managed to negatively skew the playing field against the U.S. and other economies which do not rely on indirect taxes.

The existence of the VAT loophole clearly violates the original intent of the GATT, which was to ensure that international trade would be governed under a set of transparent rules that would negate unfair advantages. In short, the original purpose was to establish a more level playing field for trade between nations. As it has evolved, the use border tax inequities, such as the VAT regimes, in other countries has allowed them to maintain massive trade distorting export subsidies and import barriers. Such regimes exist to the profound disadvantage of countries like the United States as can be seen.

A Generic Example of the Foreign VAT Disadvantage

Below is an analysis produced by the law offices of Stewart and Stewart in 2010 of a generic example of the foreign VAT disadvantage:

- A hypothetical German exporter can sell the same car for 9% less in the U.S. due to differential tax treatment – a U.S. exporter must charge 26% more on the same car exported to Germany to recoup its costs.
- The German producer enjoys a \$2,648 price advantage on its export to the U.S., while the U.S. producer bears a \$7,674 penalty on its export to Germany.

	German Car		U.S. Car	
	Domestic Sale	Export to U.S.	Domestic Sale	Export to Germany
Factory Price	\$30,000	\$25,210	\$30,000	\$28,571
Indirect Taxes in Country of Origin	19% VAT Included in Factory Price	19% VAT Refunded, Not Included in Factory Price	5% Sales Tax Included in Factory Price	No Sales Tax Assessed
Cost, Insurance & Freight Charges		\$209		\$209
Duties		\$630 (2.5%)		\$2,878 (10%)
Landed Cost, Duty-Paid Price		\$26,049		\$31,658
Indirect Taxes in Destination Country		5% Sales Tax		19% VAT
Total Price to Consumer	\$30,000	\$27,352	\$30,000	\$37,674
	Price Advantage for German Car vs. U.S. Car in the U.S.	\$2,648	Price Penalty for U.S. Car vs. German Car in Germany	\$7,674

What Can Be Done to Offset the Foreign VAT Disadvantage?

While AMTAC is not prepared to endorse a VAT at this time, it is clear that the detrimental impact of foreign VATs must be offset. AMTAC has endorsed H.R. 2666, the Border Tax Equity Act, legislation introduced by a member of the Committee on Ways and Means, Cong. Bill Pascrell that would accomplish this goal. The bill is straight-forward and its provisions include:

Declaration of congressional policy that instructs USTR to negotiate a settlement within the WTO: Congress deems it critically necessary that the issue of border taxes be addressed and resolved during current or future WTO negotiations. If such WTO negotiations fail to achieve the United States trade negotiating objective of revising WTO rules with respect to the treatment of border taxes in order to redress the disadvantage to countries relying primarily on direct taxes for revenue rather than indirect taxes, then effective action through legislation is warranted given the massive and inequitable distortions to trade that United States agricultural producers, manufacturers, and service providers face as a result of border taxes.

Report: After 60 days upon completion of WTO negotiations or by January 1, 2013, whenever is earlier, USTR must certify to Congress whether negotiating goals in our trade law mandating equitable border tax treatment for goods and services have been met.

Import tax: If these goals are not met by a date certain, a tax is imposed on imports from countries that rebate indirect taxes, like the VAT, upon the export of goods and services.

- The amount of tax imposed on the imported good or service by the United States is equal to the amount of tax rebated by the exporting country.
- Import taxes are paid into a special account.
- Importer pays the import tax.
- Tax remains in effect until USTR certifies that negotiating goals have been met.

Payment to U.S. exporters: Neutralizes the discriminatory effect of border taxes, like the VAT, by compensating U.S. exporters.

- The amount paid by the U.S. government to the U.S. exporter is equal to the amount of indirect tax imposed on the U.S. good or service by the importing foreign country at their border, minus any U.S. taxes rebated upon export of the good or service.
- Payments to services exporters begin January 1, 2012; payments to goods exporters begin upon the failure to meet negotiating goals by a date certain.
- Payments remain in effect until USTR certifies that negotiating goals have been met.

WTO consistency: This Act grants the U.S. government sufficient time to achieve these negotiating goals in WTO negotiations and gives U.S. negotiators important added leverage with trading partners. The bill authorizes both an import tax and payments to U.S. exporters to eliminate the discriminatory effect of disparate border tax treatment only in the event that negotiations are unsuccessful. Under current WTO rules, equalizing compensation to U.S. exporters of services is already WTO-legal. Thus,

earlier implementation of this provision helps to promote achievement of U.S. negotiating objectives on border equity tax.

Conclusion

If the United States truly wants to fix our runaway trade deficit, maintain our remaining manufacturing base, and preserve the critical middle class jobs provided by this manufacturing base, the U.S. government must fix international trade rules that have so generously and unfairly allowed our foreign competitors to develop and capitalize on their \$518 billion border tax advantage. The time for action is now.

Prepared Statement of Americans for Fair Taxation

Testimony Submitted by Dr. Karen Walby
Chief Economist, Americans For Fair Taxation

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 16th 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.¹

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

¹ For a detailed description of the FairTax base and step-by-step explanation of the rate calculation methodology, see PaulBachman, 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.² 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

² 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.³

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 30th, 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!⁴ 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.⁵ 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

³ Tuereck, 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.

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

⁵ *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 billion⁶. 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).⁷ 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.⁸ 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.

⁶ 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.

⁷ "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.

⁸ 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 16th 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."⁹ Despite this poor compliance rate, we may have reached the limits of

⁹ 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 [1099'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 1992.¹⁰

With more than 3 billion informational returns filed and roughly 36 million civil penalties assessed each year,¹¹ 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.¹² 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.¹³ The compliance costs imposed on businesses from state sales taxes have been estimated to fall between 2.0 and 3.8 percent of revenues.¹⁴ 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.¹⁵

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.¹⁶ In the broadest aggregate, assuming the gap of \$353 billion, gross noncompliance is about 18 percent of revenues.¹⁷ 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.

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.

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

¹¹ IRS Data Book, 2009. See Tables 14 and 17 respectively.

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

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

¹⁴ 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.

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

¹⁶ FS-2005-14, *supra*.

¹⁷ 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.¹⁸

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.¹⁹

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?²⁰ 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

¹⁸ 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).

¹⁹ GAO, *supra*.

²⁰ 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.²¹ 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”²²) – 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.²³ 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.

²¹ Willis, *supra*.

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

²³ 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.²⁴ 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."²⁵ And, it would put American producers on an equal footing with their foreign competitors, fostering economic growth and job creation.

²⁴ Edwards, Chris, "The U.S. Corporate Tax and the Global Economy," Cato Institute, September 2003.

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

Prepared Statement of Bay County Florida Executive Committee

BAY COUNTY (FLORIDA) EXECUTIVE COMMITTEE

FairTax Resolution

To endorse a federal retail sales tax as a complete replacement for all forms of income and Social Security taxation.

1. **Since** *The FairTax Book* (by Congressman John Linder and talk show host Neal Boortz) went from unavailable to #1 on the New York Times best sellers list in nine days and stayed there for two months makes it clear that tax-concerned voters support the ideas in the book of a consumption tax that is *simple* and fair; and
2. **Since** the overwhelming majority of all communication received by President Bush's tax reform panel supported the FairTax; and
3. **Since** the current income tax system requires individual taxpayers to prepare annual tax returns using many complicated forms, where innocent errors will and can happen end up with punishment by the IRS; and
4. **Since** the current income tax system actually *punishes* marriage and the family, the very foundation of our country's moral strength; and
5. **Since** our founding fathers knew income taxes gave government too much power over the citizens, the founding fathers specifically outlawed such taxes in the constitution; and
6. **Since** a national retail sales tax is constitutional and would restore the founding fathers' description of an ideal tax system (*Federalist 21*) and ends income taxes, annual tax filing and the IRS and since citizens pay sales taxes to sellers of goods and services; the sellers send collected taxes to state agencies; and only state sales tax agency deals with the federal tax collectors; and
7. **Since** a question placed on the Georgia primary ballots of Cobb, Fayette and Gwinnett counties in June 2006 showed that 85% of these voters approved of the FairTax and reflects the attitude of most voters in Northwest Florida; and
8. **Since** there are presently nine Florida Congressman co-sponsoring the FairTax bill with Congressman Miller of district 1 being one of the sponsors;

We, the Republican Party of Bay County Florida, of U. S. congressional district 2 urge the State and National Parties to adopt the tax reform policy HR25 (The FairTax Act of 2007) sponsored by Congressman John Linder of Georgia and primary co-sponsor Congressman Dan Boren of Oklahoma. This act is a well researched and meaningful platform that will be for the good of the American people and our country.

We recommend that the platform contain the follow wording;

Federal tax reform is required and should support free enterprise, economic growth, be simple, fair and support job retention in the United States. The Internal Revenue Service is unacceptable to the U. S. taxpayers! The party urges that the IRS be abolished and the sixteenth amendment to the constitution be repealed. We further urge that the personal income tax, inheritance tax, gift tax, capital gains tax, corporate income tax and payroll taxes be eliminated. We recommend the implementation of a national retail sales tax, with the provision that two-thirds majority of the U.S. House and U.S. Senate is required to raise the rate or make changes to the Bill HR25 upon approval. Such reform should encourage investment and economic growth. Lastly, such a tax plan must ensure no citizen of the U. S. pays taxes on the necessities of life, ensuring opportunity and quality of life for low and fixed income people. We believe that every tax at every level should be separate and clearly visible in the support of visibility.

Adopted by The Bay County (Florida) Republican Executive Committee in Regular Session This ____ Day of _____, 2008

BAY COUNTY REPUBLICAN EXECUTIVE COMMITTEE;

ATTEST: _____	BY: _____
ANITA SALAK	TED HANEY
Secretary	Chairman

Prepared Statement of Bobby L. Austin

**Submission for the House Ways and Means Hearing
"Consumption Tax – Fair Tax Panel"**

By Bobby L. Austin
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25 July 2011

Introduction –

Corporations do not pay tax...consumers pay tax.

America has a complex tax system taxing both businesses' and individuals' income. However, consumers are double taxed. Business tax becomes a consumption tax for individuals as well since the business tax is a hidden tax in the price of goods and services.

In reality, businesses do not pay tax...they are simply tax collectors for the government.

A Georgia commission studying taxation for the state said this, "We currently tax the wrong things (income) versus taxing consumption and personal choices in discretionary spending."²³

IRS Broken - It is widely agreed that the IRS tax system is totally broken beyond repair.

Former presidential candidate Steve Forbes stated very plainly. "We can't tinkler with this tax code monstrosity or try to reform around the edges. The only thing we can do with this hideous beast is kill it, drive a stake through its heart, bury it, and hope that it never rises again to terrorize the American people."³

Problems with the tax code include: It is so large and complex it is incomprehensible; unfair, filled with loopholes; costly to administer; costly to comply with; not transparent; and subject to political influence from lobbyists, etc.

In **2002** Americans spent roughly \$194 billion dollars on tax compliance. That amounts to **20 cents of compliance cost for every dollar collected** by the tax system.⁷

The Tax Advocate Service (TAS) estimates that the costs of complying with the individual and corporate income tax requirements for **2008** amounted to **\$163 billion – or a staggering 11 percent of aggregate income tax receipts**.¹⁸

"Now more than ever, Americans want to see policies that will help create increased growth, more jobs, and higher standards of living – exactly the things that a lower and

more streamlined corporate tax system can help achieve." Tax Foundation president and study author Scott A. Hodge, March 11, 2011.⁸

U.S. Highest Corporate Tax Rate – For the past 20 years America has stubbornly held the average federal, state, and local U.S. corporate tax rate at 39.2% while other countries have been reducing their corporate tax rate.

Transfer Pricing – American companies with offshore earnings are taxed at a total rate of 35% if funds are brought to the United States. Consequently, many multinational companies take advantage of a process called "transfer pricing." Companies with facilities in countries with high tax rates use paperwork transactions to double transfer funds through Ireland or the Netherlands to countries such as the Cayman Islands and Bermuda, which depend primarily on tourist trade, and have no corporate tax, in order to avoid most taxes in all countries. Google reduced its taxes by \$3.1B using this method and Facebook is working on implementing the process.¹⁴

Competitors Reducing Corporate Tax Rates –

"Dozens of countries around the world – including many of the United States' closest trading partners – have realized that sky-high corporate tax rates are an economic dead end."

"Since 2006, some 75 nations have cut their rates, many multiple times."^{8, 17}

Between 2000 and 2010, nine (9) countries cut their corporate tax rates by double-digit figures including: Germany (22 points), Canada (13 points), Greece (16 points), Turkey (13 points), Poland (11 points), the Slovak Republic (10 points), Iceland (15 points), and Ireland (11.5 points). The Canadian government has explicitly set the goal of having the lowest corporate tax rate among the major G-7 nations.^{8, 17}

"Here's the truth, Britain used to have the third lowest corporate tax rate in Europe," George Osborne said in his budget speech. "It now has the sixth highest... So I can today announce that from April this year corporation tax will be reduced not just by 1% as I previously announced but by 2%..... Companies have naturally responded favorably to the move."¹³

High U.S. Taxes Moves Jobs Offshore -- 3M moved its plant abroad in order to reduce the tax load.¹⁰

Low U.S. Taxes Will Create American Jobs -- Two independent studies concluded that U.S. exports will increase by 18%, and \$100 billion annually, respectively, if the corporate taxes based on income were eliminated. Much of the \$12 trillion dollars American multinational companies hold off shore, rather than pay 35% tax, will come flooding to America. Thus, creating millions of American jobs.⁵

Reducing Corporate Taxes Increases Revenue -- Contrary to popular belief, reducing taxes actually increases revenue rather than reducing revenue and creates American jobs.

Referring to the 2003 tax reduction legislation the Joint Economic Committee, United States Congress, Report, January 2007 states, "This research paper presents the case that JGTRRA played a key role in the turnaround in investment and the turnaround in the economy."²¹

"Every time in American history that we've lowered the tax burden, the American people have responded with energy, imagination, and innovation. The standard of living has improved, better jobs were created, and government revenues have gone up, not down." Publisher and Former Presidential candidate Steve Forbes.³

Economist Victor Canto, Ph.D. explains it this way.

"On paper, a lower tax rate collects less per dollar of taxable income. But what politicians fail to see is that lower taxes bring more earners above ground while increasing the incentives to save, work, and invest. The net result is that both the economy and the tax base expand, which in turn allows for the provision of additional services and/or a further reduction of tax rates."¹¹
(I suggest debt reduction)

Example 1 -- Increased Revenue and Increased Business Investment -- American companies hold an estimated \$12 T in off shore accounts rather than pay a total of 35% tax on funds brought to the United States.⁵

Former Federal Reserve Chairman, Alan Greenspan, said that most of the offshore funds would come to America in months if the tax rate were reduced to zero.⁵ **And he was right.**

The Wall Street Journal reported that Congress passed the American Jobs Creation Act of 2004, reducing the 35% rate to 5.25% for one year only, 2005, estimating that \$200 B would be repatriated, generating \$2.8 B in revenue. The IRS reported that 800 companies actually repatriated \$362 B (1.8X estimate) generating \$18 B (6.4X estimate) in revenue. Business investment increased 9.6%, the highest in ten-years.¹²

Example 2 -- Increased Business Investment -- in 1998, Ireland with its 50% corporate tax rate and near 20% unemployment rate initiated a phased reduction of the tax rate to 12.5% over five years. The GDP increased by 9.6% the first year.¹⁶

Summary -- So, it is very clear that **major tax reform is urgently needed.** The IRS tax system is completely broken and beyond repair. It is also clear that the corporate tax rate dramatically affects economic growth, the movement of jobs, and government revenue. **The optimum tax plan is a consumption tax with a zero corporate tax rate.**

Fair Tax Optimum Solution –

I studying the requirements for the optimum tax system I have found 13 criteria that have been put forth by various individuals and groups.

The Fair Tax is the **only** tax plan that meets all 13 criteria. The Fair Tax has been endorsed by 150 economists.²⁵

The Fair Tax, H.R. 25 and S. 13, are perhaps the most thoroughly researched legislation ever presented to Congress for consideration. Its sole goal was to develop the optimum tax plan. The Americans for fair taxation invested \$22 million in **totally non-partisan** research. The goal was to develop the optimum tax system. The research was led by prominent American economists with no input from politicians or lobbyist.

Fair Tax Meets 13 Tax Plan Criteria

Simple - 134 pages versus 70,000-plus pages

Fair - All business are treated the same and all individuals are treated same

Progressive, not increase tax for low income people – A prebate off tax owed on expenditures at the poverty level makes the tax progressive.

Low marginal tax rate – The corporate tax rate is zero providing the ultimate economic stimulus and job creation through tax policy. Although all consumers pay the same 23% sales tax at the register, the effective rate varies from zero at poverty level to a maximum of 23% regardless of expenditures.

Broad economic base - The tax base is doubled as all consumers, including those in the current underground cash economy and 30 - 40 million annual visitors to America now pay tax.

Abolishes IRS - The IRS is abolished

Repeal the 16th amendment - Repeal of the 16th amendment is required in order to prevent double taxation

Minimize administrative costs - Elimination of the IRS reduces both administrative and compliance costs. Businesses and states will receive one quarter of 1% fee. Forty-five states already have income taxes, thus making implementation easy.

Reduce disincentives to work, save, and invest - Individuals take home more pay since there are no federal withholdings and all taxes based on income are eliminated.

Transparent - The tax paid is printed on each purchase receipt so that it is easy for the consumer to see how much tax he is paying.

Widespread support - More than 1 million people had endorsed the Fair Taxx concept before the Fair Tax webpage was created. There are Fair Tax support organizations in all 50 states. In February 2011, House Speaker Boehner sent a letter to the president with a list of 150 economists who endorse the Fair Tax.

Avoid unintended of consequences of AMT - All income base taxes are eliminated.

Revenue neutral - The 23% tax sales rate was calculated to provide the same income as currently received, during the first year. However, due to economic growth, revenue will increase in succeeding years.

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Prepared Statement of Bruce Burton

The Hearing on the VAT Tax

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I have several reasons I distrust and reject the idea of a VAT tax. Some of them are:

1. The VAT tax is by its very nature untransparent. Taxation becomes imbedded into consumer prices and the amount of taxation to the citizens is effectively hidden.
2. The VAT tax, because of its hidden nature, can be manipulated by those claiming to be social engineers. Government picks winners and losers and the system eventually will be corrupted as the avoidance of VAT taxes becomes embedded into the political fundraising process.
3. The VAT tax, as clearly demonstrated in Western Europe, may have proponents that claim it has the ability to raise a significant amount of revenue but even a cursory evaluation reveals its flaws. The VAT tax has not done much to fund the rampant spending by Western European governments. Enabled for a while, these economies are now on the verge of bankruptcy.
4. The VAT tax could never be employed with used products if the necessity arose. It also puts a heavy burden on high value added products that are the lifeline of a mature, advanced economy. It also would be difficult to employ with services if the necessity arises.
5. The VAT tax will become infinitely complex as producers scurry to avoid the tax and develop a competitive advantage. With complexity comes its handmaiden: corruption.

The VAT tax is mischief, corruption and social stagnation waiting to happen. It will prove to be a poor revenue provider and an onerous anchor to the economies that employ it.



Prepared Statement of Center for Fiscal Equity

Comments for the Record

House Committee on Ways and Means

Hearing on Tax Reform and Consumption-Based Tax Systems

Tuesday, July 26, 2011, 10:00 AM

by Michael G. Bindner

The Center for Fiscal Equity

Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit my comments on the advantages and disadvantages of a Value Added Tax (VAT), whether as a supplement to or full replacement for existing taxes and the policy arguments for and against adopting the FairTax as a replacement for existing federal taxes. These comments will start with consideration of the FairTax, move to the VAT and then expand upon the VAT-like Net Business Receipts Tax and the need to retain some level of income taxation. In describing each tax, we will address their economic impact and administration and compliance issues.

The FairTax

The main advantage of the FairTax is that it ends the requirement for individuals to report their personal financial information to the government on an annual basis in order to either pay additional taxes or claim a refund due to scheduled overpayment, with the attendant possibility of their return being audited and, in the case of unresolved disputes, having their property subject to seizure and their wages subject to garnishment if taxes have been under-reported or unpaid. It is no accident that a key feature of this proposal is the symbolic abolition of the Internal Revenue Service. (Students of reorganization know that no agency is really abolished, its mission is adjusted and it gets a new name, but it never really goes away).

Many FairTax critics point to the taxation of government purchases as a flaw in its methodology, however this is simply the method used to recover revenues lost from government employees and contractors not paying income and payroll taxes individually. The other purpose in such taxation is to not suddenly give added purchasing power to government employees and contractors who would not otherwise receive wage cuts, which FairTax sponsors insist private sector employers will do in an effort to keep product prices at current levels.

This attempt comes from an apparent unwillingness to simply mandate wage cuts rather than relying on employers to do the right thing. Whether they would cut wages to such levels depends upon the tax elasticity of demand for their industry. Less competitive industries can raise prices a fair bit without loss of sales volume, in which case taxes are simply added to the cost of a product. Others are highly price sensitive and will absorb any tax increase, decreasing either costs or profit to compensate. Likewise, industries which rely heavily on tax subsidies will be impacted, although their prices may not be.

The main flaw in the FairTax comes from its baseline. Proposed FairTax rates are based on current policy rather than permanent law. Many, including the President and a large proportion of the population believe that current tax rates favor the wealthy at the expense of future generations. Enacting a FairTax using these rates as a baseline would lock in those gains, and this is not acceptable. Additionally, while there is progress on a “Grand Bargain” to preserve current middle class tax rates through spending cuts, its success is by no means assured.

A balanced budget FairTax would require a much higher rate, as President Bush’s Tax Reform Task Force found. At this rate, and even at the proposed rate, attempts would be made to game the system by claiming wholesale use for retail goods. The need to police such attempts will require an enforcement structure that will be seen as onerous to taxpayers as the Internal Revenue Service is now.

Another problem with the Fair Tax is that it complicates the possibility of Personal Accounts for Social Security. Creation of such accounts assumes a payroll tax to be diverted. If the payroll tax is abolished Social Security is an entirely governmental affair. While such accounts could, of course, be created using the information provided by employers to the Social Security Administration using FairTax revenue, this adds complexity to a system designed to be simple and largely leaves governmental sharing of financial information in place (as does the mechanism for funding the proposed Prebate).

A main strength of the FairTax is its cancellation of all tax subsidies. This is also its main weakness. While many tax subsidies can be considered the abusive results of campaign finance and the putting of local interest ahead of the national interest, others serve a social good and could conceivably lessen the impact of government on the lives of citizens while still providing much needed benefits, like support for families through the Child Tax Credit. Under the Fair Tax, and to a lesser extent the VAT, all such subsidies and services must be either foregone or provided by the government. While ending the exclusion for health insurance may well level the playing field for purchasing insurance, it could as easily lead to a demand for single-payer health care or even a National Health Service on the British model.

Some claim that the Fair Tax would close the Tax Gap by forcing everyone to pay. We marvel at strength of the myth that if only the Tax Gap were eliminated, all would be right with the world of federal finance. Indeed, part of the mythos behind the Fair Tax is that finally prostitutes and drug dealers would be paying their fair share of taxes under this plan.

This assertion is patently false and misunderstands the relationship between consumption taxes and income taxes. Income taxes are essentially a hidden consumption tax, especially when one is purchasing from a business with federal and state tax identification numbers. Most employees in these cases never see that portion of their earnings which go to pay Federal Income, State Income, FICA, and Hospital Insurance payroll taxes. These monies essentially go from sales or other revenues right to federal and state governments, along with any sales taxes collected.

Unless prostitutes and drug dealers obtain tax ID numbers and report taxes as businesses under a Fair Tax, a VAT or a VAT-like NBRT, their payment of such taxes as consumers will likely be no different than their current indirect payment of the income and payroll taxes of those from whom they purchase goods and services.

Waiters, bartenders and the self-employed are also no more likely to pay more under tax reforms designed to eliminate the tax gap. Rather, these reforms can best close the tax gap by simply trying to collect taxes from them if their income falls under a certain threshold. This allows the government to set appropriate rates without the expectation that better enforcement might lead to a balanced budget.

The question of taxing waiters raises the question of who is an employee and who is an independent contractor. Waiters are often considered semi-independents, especially when tips are left in cash rather than added to the bill and paid with credit cards. In many more advanced companies, part time contractors and even essentially full time employees are hired as contractors or independent brokers, even though all of their efforts are dedicated to a single wholesaler or customer. The insurance and home cosmetic industries are prime examples of workers who are essentially employees operating and reporting as if they were independents. This is done to minimize benefits paid and to force the burden of tax reporting onto these employees, thus fueling the problem of low compliance.

Limits on revenue could be used to essentially keep these vendors outside the tax collection system. It could be called an Avon Lady exemption. In a VAT system, enacting such an exemption would lead to little tax loss, as the entire supply chain leading up to these vendors would still pay tax. This would not be the case under a Fair Tax system. Indeed, in a Fair Tax system, Congress would likely be required to consider such vendors employees of the supplying firm in order to realize all potential tax revenue from these industries.

Value Added Tax (VAT)

The question of whether a Value Added Tax (VAT) will be part of the solution comes up with more frequency than what was expected even a year ago. It is among the main solutions offered by the Bipartisan Policy Commission in its debt reduction plan, among others. As this discussion goes forward, we need to raise the question of whether the VAT will provide enough value added for this to be a good idea.

One key advantage a VAT shares with the FairTax is that it makes everyone conscious of being taxed. This is especially important given conservative objections to the fact that 51% of families pay no income tax at all. While most pay payroll taxes, at the lower end, the Earned Income Tax Credit essentially cancels out that payment provided the primary wage earner actually files taxes. Instituting a VAT makes everyone conscious of paying taxes, especially if the tax is made visible on the receipt, as if it were a retail sales tax, like the proposed Fair Tax.

The key objection to both the Fair Tax and a VAT is that it forces the poor to pay taxes, to which advocates for both plans counter with a proposed “prebate” to give a direct subsidy to some or all families an amount equal to what they would pay in taxes at a subsistence level. Of course, making households file for a prebate may defeat another purpose of the VAT – the desire to spare families, especially poor, less literate, families from having to file any kind of disclosure – which often requires that they pay a preparer to help them – with preparers often offering refund anticipation loans at rates that more savvy borrowers would not pay. Indeed, if a prebate were enacted, would prebate anticipation loans be far behind?

One reason many are for a VAT is the hope that it will increase revenues. This can be done much easier by literally doing nothing and letting the Clinton era tax rates return for everyone on January 1, 2013. Most forecasters predict that would bring the budget into primary balance (where we merely borrow to cover the interest but not operations). I suspect that, because forecasters tend to estimate conservatively, going back to Clinton era rates may even balance the budget and allow the country to begin paying down the debt (and repatriating American jobs, since without a debt to buy, our trading partners would have to start buying American products).

Another major benefit of a VAT is that it functions as a tariff because it is fully collected on imports and zero-rated for exports. It is an implicit transfer to American workers, who could use a transfer right now – especially because many of our trading partners have a VAT which functions in this way, making our income tax based system a hidden tax which makes our products uncompetitive. Labor should be for this tax in a big way, but so far has not been – probably because organized labor has been converted to a movement for workers into an arm of the Democratic Party establishment. This brings us back to the question of why the left has not embraced it?

The reason tax reform with a VAT has not caught fire on the left is because it deals in half measures. It is not enough to simply increase visibility if the cost of doing so keeps the current paperwork burden largely in place, or to merely hold the poor and the middle class harmless, especially given the transition costs for doing comprehensive tax reform.

In Europe, which has a strong VAT and income tax system, families with children receive a sizeable subsidy that goes farther than offsetting tax liability for the VAT – as Bruce Bartlett reports in his New York Times Economix column of June 7, 2011, it offsets nearly all tax liability for the average family and essentially gives everyone a middle class life style. (<http://economix.blogs.nytimes.com/2011/06/07/health-care-costs-and-the-tax-burden/>). That level of subsidy is what it would take to make the effort of enacting a VAT worthwhile. It must, in effect, raise all families out of poverty or it is simply changing the tax system for the sake of change.

The Center for Fiscal Equity agrees with the Bipartisan Policy Center that a VAT should be part of the solution for our fiscal woes – both budgetary and economic. We propose a four pronged tax reform:

- a VAT that everyone pays, except exporters,

- a VAT-like Net Business Receipts Tax (NBRT) that is paid by employers but, because it has offsets for providing health care, education benefits and family support, does not show up on the receipt and is not avoidable at the border,
- a payroll tax to for Old Age and Survivors Insurance (OASI) (unless, of course, we move from an income based contribution to an equal contribution for all seniors), and
- an income and inheritance surtax on high income individuals so that in the short term they are not paying less of a tax burden because they are more likely to save than spend – and thus avoid the VAT and indirect payment of the NBRT.

The VAT would fund domestic military and civil discretionary spending, but not overseas deployments or strategic nuclear forces. Ideally, this spending would be considered regionally, with regionally specific VAT rates (which would require a constitutional amendment to enact) along with a balance requirement with automatic rate increases and sequestration should balance not be met (also requiring an amendment). Until regional excises are permitted, we estimate a national balanced budget VAT of 13%.

Before moving on, there are other objections to VAT that must be addressed. It is likely that for many, this unavoidability of payment is one of the reasons such taxes are opposed. This features is likely one of the main reasons that VAT is superior to the Fair Tax, which will likely increase the tax gap because many items which are in fact purchased for end use will be accounted for as wholesale in order to avoid taxation. If taxes are paid at each stage of production, this problem does not exist. Of course, analysis of how VAT systems are actually implemented suggests that the VAT is no panacea in stemming tax avoidance, especially if multiple rates and loopholes are present in the system.

Net Business Receipts Tax (NBRT)

The NBRT base is similar to a Value Added Tax (VAT), but not identical. Unlike a VAT, and NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The NBRT would replace payroll taxes for Hospital Insurance, Disability Insurance, Survivors Insurance for spouses under 60, Unemployment Insurance, the Business Income Taxes, on corporations, business income taxes now collected under the personal income tax system, as well as most of the revenue collected under the personal income and inheritance taxes, less the amount collected under a VAT. The health insurance exclusion now included in the Business Income Tax and other subsidies under the Affordable Care Act. Most importantly, it would fund an expanded and refundable Child Tax Credit.

The expansion of the Child Tax Credit is what makes tax reform worthwhile. Adding it to the employer levy rather than retaining it under personal income taxes saves families the cost of going to a tax preparer to fully take advantage of the credit and allows the credit to be distributed throughout the year with payroll. The only tax reconciliation required would be for the employer to send each beneficiary a statement of how much tax was paid, which would be shared with the government. The government would then transmit this information to each recipient family with the instruction to notify the IRS if their employer short-changes them. This also helps prevent payments to non-existent payees.

The expansion of the child tax credit to \$520 per child per month is paid for by ending the tax exemption for children, the home mortgage interest deduction and the property tax deduction. This is more attractive to the housing industry than the alternative proposal, which is to end or limit the credit and use the proceeds to help bring the budget into primary balance. Shifting the benefit in this way holds the housing industry harmless, since studies show that the most expensive cost of adding a child is the need for additional housing.

Assistance at this level, especially if matched by state governments may very well trigger another baby boom, especially since adding children will add the additional income now added by buying a bigger house. Such a baby boom is the only real long term solution to the demographic problems facing Social Security, Medicare and Medicaid, which are more demographic than fiscal. Fixing that problem in the right way definitely adds value to tax reform.

This tax should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

This tax could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. ***This is a feature that is impossible with the FairTax or a VAT alone.***

If cost savings under and NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed.

Enacting the NBRT is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

The Center calculates an NBRT rate of 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a “balanced budget” rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

The last question is whether the income and inheritance surtax can be incorporated into the NBRT, as proposed by Lawrence B. Lindsey. While it is feasible, I reject it because it will either lead some to be overtaxed while others are under-taxed or will require a personal financial reporting system that many employees and investors would regard as intrusive if it came at the hands of employers or investments. While there is resistance to letting the government know all of one’s financial details, I am quite certain letting your employer into all your business would be considered worse. What bartender wants to work for a lower wage (if he or she could even find a job) if part of being hired was the requirement to disclose family trust fund income to management, who would have to pay taxes on behalf of that employee at a higher rate? Better to leave the personal income tax in place so that only the government knows who is really rich.

Income and Inheritance Surtax

Retaining an income surtax could have few rates or many rates, although I suspect as rates go up, taxpayers of more modest means would prefer a more graduated rate structure. The need for some form of surtax at all is necessary both to preserve the progressivity of the system overall, especially if permanent tax law enacted before 2001 is considered the baseline (which it should be) and to take into account the fact that at the higher levels, income is less likely to be spent so that higher tax rates are necessary to ensure progressivity.

This tax would fund net interest on the debt, repayment of the Social Security Trust fund, any other debt reduction and overseas civilian, military, naval and marine activities, most especially international conflicts, which would otherwise require borrowing to fund. It would also fund transfers to discretionary and entitlement spending funds when tax revenue loss is due to economic recession or depression, as is currently the case. Unlike the other parts of the system, this fund would allow the running of deficits.

Explicitly identifying this tax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other nations. While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion's share of rewards.

The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit. Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1961 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall. Additionally, as foreign labor markets mature, foreign workers will demand more of their own productive product as consumers, so depending on globalization for funding the deficit is not wise in the long term.

Identifying deficit reduction with this tax recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using an income tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

Thank you for this opportunity to provide comments to the Committee.

Contact Sheet

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Hearing on Tax Reform and Consumption-Based Tax Systems

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.

Prepared Statement of Charlene Westgate

America Deserves the FairTax

By Charlene Westgate

The economy has been a constant focus for the past few years. Recently, the Department of Labor reported that unemployment rates rose for the fourth month in row. And no one avoid the wrangling over the budget and debt ceiling.

Who's to blame for the state of the economy? Was it George W. Bush and the Republicans? Is it Barack Obama and the Democrats?

Consider that regardless of any impact that either party has had on the economy, it is the tax code that has most acutely affected our present economic stagnation: the high unemployment, loss of manufacturing jobs, diminishing tax base and plummeting savings levels.

The problem? The tax code punishes the very things we need to get our derailed economy back on track. By taxing productivity, savings and investment, the tax code discourages the capital formation needed by banks for lending and by companies to create jobs. It also prevents American workers from getting ahead.

The problem? The tax code shackles U.S. corporations trying to compete in a global economy. Other nations, remove their taxes from products before they are exported. But our tax code has no such provision. Our exports arrive overseas with built-in taxes, only to be taxed again by the importing country, making them double-taxed compared to their local competition.

The solution? The FairTax (HR25/S13).

The FairTax eliminates all taxes on income (income, gift, estate, capital gains, alternative minimum, Social Security, Medicare and self-employment taxes). It **replaces** them with a single-rate sales tax.

Imagine individuals under the FairTax who now bring home their paychecks free of all federal taxes, and who have receive a monthly rebate check to cover their taxes on necessities. Consider the boon to our economy as workers experience this instant raise and have additional funds to spend or save!

Imagine companies who also have a new influx of cash under the FairTax. Freed from their employee payroll tax payments, and no longer having to spend billions of dollars to comply with our complex tax system. These companies would have a bonanza of funds available to invest in job creation.

Imagine, too, the benefit to U.S. companies under the FairTax entering the international marketplace with a competitive edge instead of a disadvantage. "Made in America" would once again be in demand!

Now imagine our government with a broader (rather than a shrinking) tax base. Those involved in illegal activities, undocumented immigrants and foreign tourists who at present do not contribute to our tax system, and wealthy individuals who currently shelter their income from taxation, would all become taxpayers each time they make purchases.

And, imagine the U.S. as the newest tax haven, as foreign companies flock to our shores to take advantage of the opportunity to pay taxes only when they spend, but NOT when they invest here in the U.S.!

This broader base, influx of capital and growth in jobs would once again restore America to its economic prominence.

A hearing on the FairTax is scheduled before the Committee on Ways and Means on July 26. Learn more about the economic research behind the FairTax at www.fairtax.org / www.azfairtax.org. Then contact the Committee and request they release HR 25 from committee so that it can be brought up for a vote.

America deserves a growing economy. America deserves the FairTax!

Charlene Westgate is Volunteer State Director for Arizonans for the FairTax. She can be contacted at info@AZFairTax.org



Prepared Statement of Dan Horton

Submission for Consideration
U.S. House of Representatives
Committee on Ways and Means
Chairman Dave Camp

Honorable Mister Camp,

I would like to provide my input to the Committee record on the Hearing on Tax Reform and Consumption-Based Tax Systems (specifically the referred to Fair Tax).

I, and many of the people I have talked to, do not agree this is a fair tax. A tax on consumption only applies to purchases by the low and middle income buyers. High income persons that purchase a yacht will buy it outside the U.S. and dock it outside also until a specific time allows them to bring it home without tax. Consider the action of Senator John Kerry last year to avoid sales tax in Massachusetts.

As owner of several businesses in the past, I have seen this type of action several times applied to different items and situations. Also as an Air Traffic Controller and Airports Manager for 25 years I have seen it numerous times with aviation. It is also the reason most of the heavy equipment is displayed and sold along 1 major street in Portland Oregon. This approach of final assembly and sales in Oregon avoids the tax in most of the states of manufacture.

A family of low or modest income will pay the tax on furniture for the family while most of the rich will purchase the furniture manufactured in Mexico, Canada or Europe where the tax is not paid on furniture valued at 10 to 100 times the value of that purchased by the local Service Station attendant.

If the goal is a FAIR TAX, institute a flat rate tax of 17% on all income over \$50,000 and 10% on all income below that level. Do away with the IRS and provide penalties with teeth for avoidance of that Tax.

Make our Country Fair. Provide a Fair tax that General Electric has the same vested interest as our local business owners.

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Hearing on Tax Reform and Consumption-Based Tax Systems

Prepared Statement of David E. Miller

I am by no means an economics expert, legal expert or tax expert. I am just an individual in the country that is tired of a system that does not treat everyone the same. The Fair Tax will at least bring equality to everyone's tax responsibility.

I would like to relate an event that occurred probably 35 years ago, maybe a few more. I was listening to a call in radio show on income tax advice. I can still remember one caller's conversation with the host as though it were yesterday. I remember that I and my wife made approximately \$15,000 - \$18,000 that year. The caller stated his situation and then his question to the host who was supposed to be very knowledgeable on income tax. The caller stated that he was an accountant and that his salary that year was approximately \$30,000 and that his wife also made about \$30,000 that year. He then stated that he had protected his income to the point that he owed almost no taxes that year. My (and my spouse's) tax obligation that year was around \$1100 after taking the exemptions and deductions and I was listening to an individual that made between 3 and 4 times what I had made, stating openly his tax obligation was less than mine. Then on top of that, his question to the host completely flabbergasted me. He asked the host that since he was able to avoid paying almost any income tax was there a way to avoid paying fica tax? It wasn't enough that he paid zero or almost zero in income tax while the majority of working people paid their "share" (you'll please take note of the avoidance of the word "fair"), he wanted to reduce or eliminate paying any tax for any reason. I cannot remember the host's response as I was in shock. I don't care what anyone says, a system that allows this type of taxation is wrong and that is what we have today. The Fair Tax would obligate everyone to their "fair" share. Please don't just consider the Fair Tax. Implement it today.

Respectfully Yours,
David E. Miller

92 County Road 2131
Pittsburg, TX
75686

Prepared Statement of David H. Leake

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Title of Hearing
Tax Reform and Consumption-Based Tax Systems

Democratic members of your committee, in particular, appear predisposed to dismiss the FairTax as too costly or damaging to their constituents. I would like to draw your attention to the tables in a new blog titled "What You Will Actually Pay Under the FairTax" (<http://whatyoupayunderfairtax.blogspot.com/>).

If you wish, I can make these tables available to the committee in xcel, pdf or jpeg formats.

Thank you.

Prepared Statement of Dr. Nanette Parratto-Wagner

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July 21, 2011

TO: U.S. House Ways and Means Committee
 RE: FairTax Hearing

Please consider the analyses provided below, and at the websites referenced below, as you consider the FairTax. Please refer this bill out of Committee for consideration by the full House. This tax reform will provide the revenues needed to operate the Federal government in the most equitable way possible – citizens and non-citizens pay; legal and non-legal residents pay; underground economies pay; the poor are shielded from paying; the rich must pay. It is predicated upon the most basic of our founding principles.

A **consumption tax** is a tax on spending on goods and services. The term refers to a system with a tax base of consumption. The “FairTax” creates it in the form of an inclusive tax that is part of the price of the goods and services. The “FairTax” is NOT an exclusive tax that would be added at the point of sale, i.e., at the time of purchase at the cash register, such as a state or local sales tax is added at the cash register.

Throughout most of American history, taxes were levied principally on consumption. Alexander Hamilton, one of the two chief authors of the anonymous Federalist Papers, favored consumption taxes in part because they are harder to raise to confiscatory levels than incomes taxes. In the Federalist Papers (No. 21), Hamilton wrote:

“It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. They prescribe their own limit, which cannot be exceeded without defeating the end proposed—that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty that, ‘in political arithmetic, two and two do not always make four.’ If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them.”

Need more proof? Check out Boston University Economist, Dr. Kotlikoff’s comments at <http://www.fairtaxblog.com/20080116/lawrence-kotlikoff-why-the-fairtax-will-work/>.

The following is an example to illustrate the difference between tax-inclusive and tax-exclusive tax rates. Assume there is a worker named Joe who earns \$125 and spends all of his earnings. Let’s further assume that the government requires him to pay \$25 in taxes. If the government put a tax on Joe’s income, he would earn \$125 before tax and would have \$100 after tax to spend at the General Store. Thus, Joe has to earn \$125 to have \$100 to spend. Joe would also have to file

an income tax return. Now consider what happens if the government taxed Joe based on what he spends and not on what he earns. Joe would earn \$125 and would have \$125 to spend at the store. Joe decides to spend \$125 at the store. The storekeeper would keep \$100 for the goods sold at the store and send \$25 to the Federal government to pay for the 25% tax on the \$100 worth of goods sold. Joe would not have to file a tax return. The storekeeper collects and sends the tax receipts. Either way, Joe pays \$25 in taxes and the government gets \$25 in taxes. With a tax on income, Joe pays the \$25 directly to the government, and with the tax on spending (sales tax), he pays the \$25 in taxes indirectly when he buys a good or service. The provider of the good or service sends the tax that Joe paid to the Federal government, using the sales tax collection systems already in place in the States.

Joe	Taxation under the Income Tax system		Taxation under the Consumption Tax system	
	Joe	Federal Government	Joe	Federal Government
Gross pay	\$125		\$125	
Pays tax on income	-\$25	+\$25	\$0	
Has left to spend	\$100		\$125	
Pays tax on consumption	\$0		-\$25	+\$25
Amount of goods purchased	\$100		\$100	
Taxes as a % of pay (\$25/\$125)	20%		20%	
Taxes as a % of consumption (\$25/\$100)	25%		25%	

We may report the tax rate as $\$25/\$125 = 20\%$, which is the tax-inclusive rate (meaning that the tax is included in the base cost of the good or service). Alternately, we may think of the tax rate as $\$25/\$100 = 25\%$, which is the tax-exclusive rate (meaning the tax is excluded from the base cost of the good or service). The 23% FairTax rate set out in H.R. 25 / S. 1025 is a tax-inclusive rate, as is the current personal income tax, whereas most state and local sales taxes are quoted on a tax-exclusive basis (the tax shows up as a separate line item on the receipt from the provider of the good or service). The Federal government collects \$25 for every \$100 spent, regardless of whether we call the FairTax an inclusive or exclusive tax. Both rates are relevant, since the FairTax is replacing an income tax system, and 23% correctly represents the tax burden compared to the current system. **To review some of the research that determined a 23% (inclusive) rate is correct, please read Taxing Sales Under the FairTax: What Rate Works? This paper is a collaborative effort of 5 respected and independent economists.**
<http://www.fairtax.org/PDF/Tax%20Notes%20article%20on%20FT%20rate.pdf>.

The consumer benefits by being able to control entire income. The economy benefits by allowing consumers to have more income to spend. Businesses benefit by having more capital to invest and more businesses will come home to take advantage of the newly created competitive advantage. The poor are exempted from pay the tax on the necessities of living indexed to the poverty rate and inflation. All households receive a monthly pre-bate. Credit card companies have volunteered to issue monthly pre-bates, because it benefits them to have the data from all

households. There are built in consumer safeguards, because the credit card companies are already regulated by existing privacy and FTC regulations.

FairTax FACTS

1. **Creates jobs** by stripping out hidden federal income taxes and compliance costs. The FairTax makes U.S. goods more competitive overseas and more affordable at home, thereby sharply increasing job creation while sharply reducing our balance of payments deficit.
2. **No federal withholding!** Workers receive their entire paycheck.
3. **Eliminates Social Security withholding**, the most regressive tax of all, while ensuring the system fulfills its promise to one generation without being a terrible burden on the next.
4. **Eliminates the corporate taxes and cost of compliance** hidden in both wholesale and retail prices.
5. **Dramatically lowers effective tax rates** for lower- and middle-income households, because a pre-bate *ends* taxes up to the poverty level.
6. **Allows families to save more and faster** for home owner-ship, education, and retirement.
7. **Allows homeowners to pay their *entire* house payment with pretax dollars**, a great improvement over the current home interest deduction.
8. **Frees up time and money wasted** on filling out cumbersome and inscrutable IRS forms throughout the economy, which currently costs \$325 billion or more.
9. **Raises the same amount of revenue** for the federal government. **THE FAIRTAX IS REVENUE NEUTRAL.**
10. **Abolishes the IRS.**

The FairTax Plan features:

- no federal income taxes,
- no payroll taxes,
- no self-employment taxes,
- no capital gains taxes,
- no gift or estate taxes,
- no alternative minimum taxes,
- no corporate taxes,
- no payroll withholding,
- no taxes on Social Security benefits or pension benefits,
- no personal tax forms,
- no personal or business income tax record keeping, and
- no personal income tax filing whatsoever.

Looking for your support,



Dr. Nanette Parratto-Wagner
npw



Prepared Statement of Dr. Roger Sdao

As this committee and panel begin to undertake, gather and act on what I believe to be an extremely important piece of legislation, I ask that you not only listen with open ears but with an open conscience leaving all politics, ideology and demagoguery at the door.

I ask this of everyone because I believe HR 25 is not about politics. It's about reform... reform to a system that penalizes productivity, creativity, investment and capital. A system such as this in my strong opinion is BROKEN. Politicians in Washington talk about reform but no one besides a few have taken up the challenge to offer concrete ideas to transform this country into the great nation it has been known to become.

I believe that HR 25 (Fair tax) can begin to transform this country and bring back the prosperity that I believe we've lost. People around the world who come to this country know that with hard work and perserverance that you can truly live the American dream.

If the USA wants to continue being that "beacon on the hill" for prosperity, and wants to continue showing the world why it is a great country, it will employ an innovative form of taxation. One that rewards hard work and doesn't penalize it. I have followed the Fair Tax issue for some time and believe it is America's next economic boom!

I say these words not as a Democrat or Republican, not as a Conservative or a Liberal and not even as an American citizen. I am a Permanent Resident with a Canadian citizenship. However, I will one day be an American citizen but currently am thinking about my wife and 3 children (all of whom are American) of why I think this legislation is important.

Respectfully,

Dr. Roger Sdao



Prepared Statement of E. Ray McKee, Jr.

July 20, 2011

TO: Committee on Ways and Means

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

Gentlemen:

Every two years, all we voters hear is raise taxes on the rich on one side of the political spectrum and lower taxes on the other side. We, the People, are getting tired of this broken record. The end of each election is followed by two more years of submitting bills, debating, writing the legislation, and voting on one tax bill after the other to add to our tens of thousands of pages of tax code, which is then followed by hundreds of pages of new regulations. I dare guess that more than 90% of Congressional action is devoted to tax discussions. I, for one, don't want to hear any more tax debates.

Enter the FairTax Bill (H.R. 25). This one bill frees the people from our current insane, politically motivated tax code. During this hearing, you will hear many things that the FairTax can accomplish, but I want to mention a couple that probably won't be mentioned:

1. No more eating up 535 Congressmen's time debating tax bills. The FairTax is one inclusive tax rate on consumption. The only possible new tax debate would be simply to lower or raise this rate. No more explaining on the campaign trail why you are campaigning on taxes when you could have solved that issue forever, not to mention the fact that the Congress passing the FairTax Bill will someday be praised as the greatest Congress of all time.

2. The FairTax untaxes the necessities of life with the prebate provision, but it does more. It is unlikely that more than just a few citizens will not sign up for the prebate, and most certainly much fewer than our current census procedures miss. That's right! No more census every ten years, because you have almost a continuous census with the role of persons covered by the prebate; that is, unless you want to count people here illegally (or legally, but not citizens). In this one aspect alone, this Bill would have saved approximately \$13,000,000 last year.

I can go on and on, but you will hear many good things about the FairTax during your hearing, and probably some bad things from people whose only goal in life is to demagogue the Bill.

We know that Congress wants the value added tax (VAT). Another hidden tax designed to rob the people of as much of their resources as possible without them even knowing it. We also know that Congress wants this tax in addition to the income tax, unlike the FairTax which

completely does away with all other taxes. However, I can assure you that this VAT will not be enacted without a lot of Congressmen getting voted out of office.

Finally, the Flat Tax is what we had in 1913 and which has ballooned into what we have today. I believe that the Tax Simplification Act of 1986 resulted in only two tax rates. This Act has now been amended more than 25,000 times. The people are not going to let this nonsense go on much longer. Now is the time to change this country's course with the FairTax.

With best regards,

E. Ray McKee, Jr.

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Prepared Statement of Elizabeth Yingling

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Fair Tax Hearing July 26, 2011

Working together, as Democrats, Republicans, Independents, we can fix America's tax system. Here are some of the "fixes" we can expect by passing the FairTax Act:

- Returns control of the family purse to the family.
- Income tax withholding ended.
- Federal gov't paid, only as families spend and benefit.
- "The rate" is an easily-graspable indicator of fed. costs to families.
- Only those who are genuinely subsistent pay no tax.
- The income tax code is gone.
- Social engineering gone with the tax code.
- Lobbyist numbers shrink by half - no more tax favors.
- FairTax far less prone to corruptible manipulation.
- The wealthy pay their fair share.
- Taxpayers have "new at retail" purchasing "strike" power to express displeasure.
- Externalizes taxes that are buried in prices - makes true tax load visible.
- FairTax can be jettisoned prior to export, enhancing our exports, and correcting current border problems.
- Trillions of dollars resting off-shore is repatriated.
- The U.S. becomes the global home of business formation, and will set the pace for other nations.
- Prebate replaces bureaucratically code-mediated credits, deductions with cold hard cash against EVERY CITIZEN's basic needs.
- No more income tax returns.
- No more IRS.
- No more threats by IRS (audits, interest, penalties, and worse!)
- Minimizes ability of gov't to compete against private enterprise (non-tax exempt) thereby encouraging "limited gov't."

- Eliminates the current "permission to live" income tax (i.e., tax liability ceases to be incurred by working).
- Purported 4th Amendment violations of income tax system, fixed.
- Purported 5th Amendment violations of income tax system, fixed.
- Purported 1st Amendment violations of income tax system, fixed.
- FairTax clears away the confusion and clutter (and intended Congressional obfuscation) that hampers a clearer focus on Congressional spending because it ends the ability of pitting poor against rich.

The FairTax does not purport to fix Congress's spending problem (that is not its domain); it does, however, remove impediments to focusing on the issue, increases taxpayer's ascension to wealth, and provides options to express their displeasure (other than ceasing to make income).

Respectfully submitted,
Elizabeth Yingling



Prepared Statement of Garret Swayne

Why We Need the FairTax™

by Garret Swayne
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It is no secret that our system of taxation in the United States is fatally flawed. It is unfair, witheringly complicated, and practically incomprehensible to all but a few "tax professionals". Moreover, it creates an overwhelming sense of alienation from our government, which we perceive as a huge adversarial entity, reaching greedily into our pockets. This is no way for people in a democracy to feel about their government! Clearly, to carry out its agenda, whatever that may be, government must have a way of generating revenue. But the long-entrenched practice of taxing *income* has left us with a tax code so unwieldy, so byzantine, so *oppressive* that it profoundly disturbs the quality of life for all its citizens. Even those who may escape owing taxes per se can't escape the hair-tearing aggravation of simply having to prepare and file a tax return each year. And these problems are systemic—they're inherent in the Income Tax. No amount of tweaking can fix them. What's needed is a real overhaul of the system, a dramatic new approach to the problem of how to finance Government. The FairTax, a bipartisan plan embraceable by Democrats and Republicans alike, represents the brightest hope for such reform.

The FairTax Bill (HR25) essentially calls for the elimination of all income, payroll, Social Security, Medicare, estate, and gift taxes, and replacing them instead with a National Sales Tax at the retail (consumptive) level. The rate of this tax would be set so as to make it *revenue-neutral*. That is, it would generate the same amount of revenue as our current income-based tax system. Aside from its "fairness", the beauty of the FairTax is its simplicity. If you *buy* something as the final consumer of the thing—a pack of gum, a pair of swimming trunks, or a Boeing 747—you'll pay a federal sales tax on it. Of course, that will add a little to the final cost of the item. But if people now get to keep their entire paycheck with no deductions ever withheld, if they never have to pay tax on what they earn, or even file a tax return ever again, that's a trade-off most people would be happy to make.

The implications of such a shift would be staggering. For one thing, it would widen the tax base to include all consumers, even the so-called "underground economy"—drug dealers, prostitutes, and others, who earn and spend money in our society but don't report their income or pay taxes because their earnings are *illegal*. These "deadbeat" taxpayers would now have to pay their fair share of tax like everybody else...because they buy clothes, cars, and toilet paper just like the rest of us. And whatever you buy, you'll pay tax on! Their tax contribution alone would be a pretty good argument in favor of the FairTax. But there are so many other good reasons why a consumption tax like the FairTax is infinitely better than an income tax.

What We Tax, We Discourage...

The FairTax represents a bold step forward in the way we think about taxation. At the heart of it is the notion, that it **makes more sense to tax consumption than to tax income**. It is a fundamental truism that whatever we tax, we discourage. So if we tax *income*, it will have an inhibitory effect on people's enterprise. Isn't it a disincentive to working harder, if a large part of the income derived from such effort must be given up in taxes? Is this something desirable for our society, to discourage enterprise? No, ideally we want to encourage our citizens to be as hardworking and enterprising as possible! On the other hand, if we tax *consumption* instead of income, it will discourage consumption. Again it doesn't *stop* consumption (people will still buy and consume what they need or want), but it will tend to encourage thrift and savings. Is this what we want as a society? Well, yes! It is exactly what we want! It's what we need, especially at this time.

The FairTax Is a Progressive Tax

There is a general consensus in our society that the Rich should pay a greater portion of the tax burden than the Poor. Assuming we want to create such a *progressive* tax system, how do we measure "rich" and "poor"? Is *income* the best measure of wealth? Consider Mr. Frugal who earns \$500,000 a year but lives very modestly, spending only say \$25,000 annually of his substantial income. Now consider Mr. Lavish who earns \$250,000 a year (half of Mr. Frugal's income), but he spends almost all of it on every indulgence that strikes his fancy. Which of the two are "richer"? Well, Mr. Frugal has more money in the bank. But Mr. Lavish certainly *experiences* more of what wealth feels like. Why? Because he *spends* his money more! Mr. Frugal does not. Mr. Frugal experiences essentially the same level of affluence as someone earning and spending \$25,000 a year. And yet under our current tax laws, he would generally owe much more in taxes than Mr. Lavish, simply because his enterprise creates more *income*. This is neither *fair* nor *progressive* nor does it *benefit* society in general. Mr. Frugal's enterprise and hard work should not be "rewarded" with a bigger tax bill simply because they earn him more money which he squirrels away in a bank. Until he starts spending that money, he's not really deriving much *benefit* from his "wealth". Mr. Lavish should pay more taxes than

Mr. Frugal, because he *enjoys* his wealth more—by spending it more extravagantly. The point here is this: **The true metric of affluence is not how much we *earn*, it's how much we *spend*!** Because it's only when we *spend* our money that we get to experience the benefit of our wealth! Taxing income discourages enterprise itself. It's not something we should seek to do as a society. But that's precisely what our Income Tax does. Taxing *consumption* makes a lot more sense. It should also be noted that by saving his money in a bank and not spending it, Mr. Frugal actually helps to make more capital available to entrepreneurs, which ultimately expands the economy and creates more jobs. Society as a whole is much better served by a system that encourages thrift and savings over waste and spending. The FairTax does just that.

The Entrenched "Culture" of Taxation

The bureaucracy and inefficiency in administering the current tax system is another compelling argument in favor of the FairTax. Tracking income for every citizen of this country is a hopelessly impractical task. There are too many ways to hide or disguise income, not to mention the cases where earnings might simply have been innocently or unintentionally forgotten. The resources wasted in trying to enforce compliance with the tax laws are truly staggering, not only on the government side with the IRS, but also on the private side as well, with ubiquitous tax advisors, tax preparers, attorneys, accountants, and other auxiliary services that comprise the so-called Tax Industry. It's true, if the FairTax were enacted, there would be some serious economic displacement of workers currently employed in this significant sector of our economy. With no need for an individual or corporation to ever file a tax return, calculate salary withholdings, or prepare for an audit, many of these workers would be out of a job. Consider, however, that these people don't contribute anything of real value to the economy or society-at-large, other than to advise people how to avoid paying taxes! (And what kind of convoluted "benefit to Society" is that?!) These workers just sustain an antiquated and hopelessly inefficient tax system. If a much better tax system that requires far fewer people to administer is available, isn't Society much better served in the long run if these workers are migrated into other vocations that might actually contribute to the GNP? The FairTax does not require a huge IRS-type bureaucracy. Monitoring sales on the retail level and requiring retailers to send in the taxes collected (as they already do now with state sales tax) is much simpler than the herculean task of monitoring the earnings of every man, woman, and child in the country and requiring them to file and pay their income taxes. The simplicity of a retail sales tax would make it very difficult for retailers to cheat without being caught. The IRS could be replaced by an organization a small fraction of its current size.

Imagine...

So with the FairTax, there'd be far greater administrative efficiency, less cheating, wider inclusion of all citizens in the tax base, and significant cost savings realized by businesses throughout the economy. Indeed, **the FairTax fixes almost all systemic problems associated with the Income Tax!** Imagine an economy where corporate decisions are based entirely on whether something makes sense from a *market* point of view, not so-called "tax considerations". Imagine the competitive advantage our products would enjoy both here and abroad if the costs associated with corporate income tax were eliminated as a price element. Imagine the influx of capital into this country as foreign corporations rushed to bring their operations here to enjoy that same competitive advantage. There'd be jobs, growth, opportunity, and above all, a sense of relief from the crushing burden of having to annually account for ourselves to our government. Indeed, imagine a system where our lives don't have to stop each year around April 15th while we tear our hair out trying to maneuver through our tax returns. April 15th would become just an ordinary day, like any other...

Protecting the Poorest Among Us

A sales or consumption tax is inherently a *progressive* tax—the Rich will pay more because they spend more; the Poor will pay less because they spend less. But there are legitimate concerns that, even though the wealthy will certainly pay more tax in absolute dollars, poor people, who often must spend everything they earn just for basic necessities, will end up paying a greater *portion* of their modest incomes on tax. Well, the FairTax bill has a built-in feature that shields the less affluent from any adverse effects of the sales tax. It's called the Family Consumption Allowance, commonly referred to as the *Prebate*. It works like this: The government sets and maintains guidelines as to what level of income constitutes the "poverty line"—i.e., what it costs to afford the bare necessities of life. In 2005, for example, for a family of four, this was determined to be \$19,758 a year, *exclusive* of any consumption tax that would be paid, or \$25,660 a year, *inclusive* of the tax. Under the FairTax, if that entire \$25,660 were spent during the year, presumably on basic necessities, \$5902 of it would constitute the amount of consumption tax paid ($23\% \times 25660 \approx 5902$). The FairTax provides that every family of four in the United States would automatically receive \$5902 rebated back to them over the course of the year, or more accurately, "pre-bated" (ahead of time), in the form of a monthly check for approximately \$492 ($5902 \div 12 \approx 492$). So every family of four would receive this \$492 prebate check each month. There's no "poverty requirement" to qualify; every family of four gets it, regardless of income. For a family of one, it's figured to be \$183 per month; and for each dependent child, it works out to around \$62 (again, based on data for the year 2005). These monthly checks will compensate taxpayers for

the taxes paid on basic necessities. In other words, under the FairTax, we only pay tax on spending over and above the essential expenditures of life. This will insulate the poorest among us from having to pay any tax at all, and indeed some may find the monthly payments afford them an actual surplus.

The Analysis Has Been Done...

The FairTax Bill is one of the most thoroughly researched pieces of legislation ever introduced. Economists at Harvard, MIT, Stanford, Rice and Boston University, as well as several private economics research foundations, were all consulted on the FairTax. They've studied it, constructed elaborate computer models, run sophisticated simulations, analyzed results, and come to the definitive conclusion that a National Sales Tax, as an alternative to the Income Tax, would create almost incalculable positive effects on the National Economy. The authors of the FairTax bill, in consultation with the economists from these institutions, have chosen a very conservative "worst-case" initial inclusive tax rate of 23% to guarantee that the Sales Tax would be revenue-neutral *from the outset*, yet it would still preserve the Prebate that reimburses consumers for the taxes paid on baseline necessities. Although 23% is the initial rate specified in the bill, it is believed that this figure is probably too high, and there is provision for the tax rate to be very quickly adjusted down from this initial figure if swelling treasury surpluses start to indicate that we've overshot the mark of revenue-neutrality.

There is disagreement as to how low this rate could fall. It is estimated that on average, 22% of the cost of a retail item represents the cost for the manufacturer, wholesaler, and retailer of that item to comply with the income tax laws. (And less than half of that actually ends up in government coffers—the rest is wasted in red tape and paperwork, maintaining a staff, keeping records, reporting earnings, deductions, withholdings, etc. to the imperious IRS.) Imagine if tax compliance were eliminated as a cost in the supply chain of manufactured goods. Competition would force manufacturers to pass those savings along to the consumer. Consider a widget that now costs \$1.00. If the widget maker no longer had to report or pay any tax on income, it would cost them 22% less to bring the product to market. So instead of a dollar, the item could sell in the store for \$.78, before any taxes were added on ($\$1.00 - .22 = .78$). The tax on such an item would be 23 cents, for a total cost to the consumer of \$1.01. Now how was that figured? Well the rate represented by that 23 cents of tax can be characterized in two ways—exclusively or inclusively. In *exclusive* terms, the 23 cents is 29.87% of the pure cost of the item, *exclusive* of the tax ($29.87\% \text{ of } .78 = .23$). So the *exclusive* rate of the FairTax is 29.87%. Alternatively, you can think of that 23 cents as 23% of the *total* cost of the item—inclusive of the tax ($23\% \text{ of } 1.01 = .23$). So the *inclusive* rate of the FairTax is 23%. It's the same tax, just two different ways of describing the rate. If you figure the rate *exclusively*, with respect to just the pre-tax cost of the item itself, it's 29.87%. If you figure it *inclusively*, with respect to the total cost of the item, it's 23%. Income tax rates are generally figured inclusively. (If you make \$100,000 and you pay \$30,000 in income tax, you figure you've paid 30% in tax, right?) So to compare apples-to-apples, we usually quote FairTax rates inclusively too—23%. In any case, the out-the-door cost of the widget would be around \$1.01—only 1% more than we're paying right now! And in exchange, we get to keep all the money we earn, never have to pay income tax or file a tax return ever again, **and** receive a Prebate check every month to compensate for the consumption taxes paid on basic necessities! Is that a trade-off worth making? Most would say, absolutely!

No one knows for sure what the final savings would be. There is no way to estimate all the secondary effects from the efficiencies that would result from the FairTax. When a company no longer needs to maintain a team of tax accountants working in "Legal" (all they'd really need is one or two people to keep the books for their internal purposes), how much cheaper could they then sell their widgets? And really, do all those tax specialists add anything of value to the widget? No, their sole purpose is just to guide the company through the minefield of corporate taxation! Once these efficiencies take hold and propagate through the economy, increasing productivity and lowering costs, there's no telling how much cheaper the cost of goods out-the-door may end up, *even with the FairTax added on*. **And if we made it the practice that items priced in a store would carry the final, out-the-door cost to consumers (i.e., inclusive of all sales tax), the whole burden of paying taxes would become virtually painless and transparent!** We'd just get used to the idea that the cost of items we buy in the store also includes a little something to keep the government afloat, and we'd accept that—because now, *we get to keep all the money we earn!* There'd be a lot more positive feeling toward the government and its relationship with us.

It's time...

When properly explained, there is virtually no counter-argument to the FairTax. Yet its elegance and practicality have been ignored by politicians and pundits alike for way too long. As we witness the rancorous divisions taking place now over deficits and debt, spending and revenues, those of us who understand the FairTax can only watch in horror as our so-called "leaders" dither back and forth over loopholes and marginal tax rates, trying to "fix" a hopelessly flawed and inefficient income tax code, when in fact, there is a much better way to go...the FairTax. Please stop ignoring this obvious solution to our nation's fiscal problems.

Prepared Statement of Hugh J. Campbell

**Submission for the Record by Hugh J. Campbell, Jr. CPA (No Affiliation)
Hearing on Tax Reform and Consumption-Based Tax Systems
Committee on Ways and Means U.S. House of Representatives
July 26, 2011**

Mr. Chairman and Members of the Committee,

It is a great pleasure for me to have this opportunity to submit this written testimony to the committee on a very important subject.

In announcing this hearing, Chairman Camp said, "While the Committee thus far has focused on reforming the income tax, tax proposals that would move us away from an income base and instead adopt consumption as the tax base have continued to generate interest as well. Supporters of such approaches believe that taxing consumption rather than income could have important economic benefits, and so as part of our efforts to reform the tax code, the Committee needs to examine those proposals. This hearing will allow the Committee to learn more about two of the most-discussed consumption tax proposals, the FairTax and the VAT."

A reading of the aforementioned paragraph indicates that the Committee's willingness to learn more about consumption tax proposals is based, in no small part, on the prospect of economic benefit. The Committee recognizes that in addition to generating revenue, an important purpose of a tax system is to generate economic benefit. Since eight of the nine individuals who testified in-person at the July 26th hearing mentioned growth, it is reasonable to assume that one of important economic benefits of a tax system should be growth.

Since growth requires increasing rates of productivity and competitiveness, the following Jean Baptiste Say quote is highly relevant to a tax system with an aim of growth: "It is the aim of good government to stimulate production, of bad government to encourage consumption."

Featured in the June 24, 1980 NBC White Paper *If Japan Can...Why Can't We?*, was W. Edwards Deming, whose blueprint for transformation was instrumental to the Japanese economic miracle after World War II. The NBC documentary asserted that "America's declining competitiveness and rate of productivity would make the United States' "guns and butter" policies of the past unsustainable and our children will be the first generation of American to have a lower standard of living than their parents". Since this documentary aired over 31 years ago, the prospect of our children being the first generation of American to have a lower standard of living than their parents is not a new concern. Unfortunately, the shock-value this should have had, in 1980, did little to reverse our declining productivity and competitiveness.

More than one of those testifying on July 26th referred to VATs being considered in the United States for more than four decades. This indicates that there has been over four decades of complacency in considering a tax system discouraging consumption and stimulating productivity.

In Chapter 19 of the 1817 classic *On the Principles of Political Economy, and Taxation*, David Ricardo mentions, in addition to war, the removal of capital and a new tax as destroyers of the comparative advantage which a country before possessed in manufacturing. Ricardo's inclusion of a new tax(s) among his destroyers of competitiveness speaks volumes regarding the increasing numbers of U.S. trading partners enacting consumption taxes over the last 40+ years and the increasing tax rates of these consumption taxes. Especially over the last 20 years, both the number of trading partners with consumption taxes and increased tax rates assessed on imports have accelerated. A key take-away is that the new tax(s) referred to by David Ricardo do not need to be new U.S. tax(s). New and increasingly higher taxes on U.S. exports being assessed by our trading partners, qualify as new taxes. Unresponsiveness of prior Congresses/Administrations over more than four decades has kept a consumption tax element out of the U.S. Federal Tax System. As David Ricardo, the father of classical political economics warned, ignoring change has subjected U.S. businesses and workers to a similar plight as the frog in the boiling water parable.

The U.S. trade deficit is America's "leak in the dike" stunting our growth. As a result, favorable effects of: the Bush tax-cuts or Obama's stimulus or monetary easing, have been disappointing and sub-prime. A U.S. Consumption tax, alone, is not the silver bullet for closing our trade gap, but it is an important start. Other Ricardian destroyers have reared their ugly heads, over the last two decades, de-coupling comparative advantage from free trade. These destroyers will be the subject of future submissions to the Committee, when hearings on the applicable subject matter take place.

The committee has two options: hold on to the old or embrace the new.

I hope that the following relevant quotes from luminaries, will be helpful to the Committee:

"The U.S. trade deficit is a bigger threat to the domestic economy than either the federal budget deficit or consumer debt and could lead to 'political turmoil.' Pretty soon, I think there will be a big adjustment." – Warren Buffett, January, 2006

"It is not the strongest species that survives, or the most intelligent but the most responsive to change" - Charles Darwin

"It is not necessary to change...survival is not mandatory" - W. Edwards Deming

A commonality possessed by Ricardo, Buffett, Darwin and Deming is their ability to be systems thinkers and therefore dots-connectors. The 40+ years of unresponsiveness by prior U.S. Congresses/Administrations must be overcome to restore the United States to its former greatness.

Supplemental sheet listing the name, company, address, telephone and fax numbers of each witness.

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Title of Hearing: Hearing on Tax Reform and Consumption-Based Tax Systems

Prepared Statement of James M. Bennett

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July 22, 2011

Hon. David Camp, Chairman, and
Hon. Members of the Committee on Ways and Means
United States House of Representatives
Longworth House Office Building
Washington DC 20000

Re: Testimony for the Hearing on Tax Reform and Consumption-
Based Tax Systems

Hearing Date: July 26, 2011

Ladies and Gentlemen,

I would like to offer the following testimony, as a written submission for the record, in support of the FairTax, H.R. 25, over any generic Value Added Tax ("VAT"), focusing on a point that is frequently overlooked.

The nominal differences between the two taxes are less significant than the effective differences - particularly the tendency of a VAT to compound, and the FairTax not to. The FairTax and the VAT are both consumption taxes. The FairTax is collected only at the point of final retail sale, while a VAT is collected in increments each time a product or service changes

hands on the way to the point of final retail sale.

In theory, the same rate applied to each tax should yield the same total amount of tax at retail on any given product or service. The FairTax does call for the calculation of a uniform tax at each step, see H.R.25, Title II, Chapter 1, Definition 8, but gives full credit for all intermediate sales and exports, See Id., Chapter 2, Section 203. The full tax is collected at the end point of retail sale because there are no intermediate sales or export credits to be had. A VAT, by contrast, is collected in smaller increments at each step along the way with full credit for previous VAT paid.

In theory, there should be no compounding with a VAT. But in practice markups tend to be based on the previous seller's costs. Where those costs include tax, the markup is higher. With the VAT, each middle person pays tax on the cumulative tax-inclusive price passed to him or her plus tax on the value he or she adds, and marks the price up correspondingly. Therefore under a VAT, the cost of a good or service at retail is greater than it would be under the FairTax. The benefit to the government of additional revenue from a VAT is less than the incremental burden to the consumer or to foreign trade.

With the FairTax there is no tax paid by each interim distributor on which mark-up can be based. Without the payment of such tax, there is no effective compounding, and mark-up is based strictly on the net price passed on to the next distributor in the chain. Tax calculation by interim distributors becomes uniquely a reporting function, but one which provides the same audit trail as provided by a VAT.

The effect of the FairTax is that the price of a widget on the retail shelf - or on the ship bound for overseas - is lower than it would be with a VAT. Lower prices stripped of all tax components and stripped of all effective compounding make American-produced goods more competitive in world markets and more affordable to consumers. The ability of the FairTax to wring such expense out of the cost base make the FairTax a powerful economic tool.

The Committee will hear from other witnesses about other advantages of the FairTax over a VAT, but Congress should consider compounding as it deliberates tax reform or, more appropriately, tax replacement.

Respectfully submitted,

/s/James M. Bennett
James M. Bennett

AFFIRMATION

I affirm under penalty of perjury that the factual statements contained in the foregoing discussion are true to the best of my knowledge and ability.

Dated: July 22, 2011

/s/James M. Bennett
James M. Bennett

Prepared Statement of John J. Riehecky

Statement for the Record,
Committee on Ways & Means Hearing on Tax Reform and Consumption-Based Tax Systems
Hearing Date: June 26, 2011
Submitted by: John J. Riehecky

Chairman Camp and Members of the Committee,

I support the FairTax over our current tax code and I encourage your support for the passage of and signing into federal law H.R. 25 which calls for:

- Eliminating all federal income taxes for individuals and corporations,
- Eliminating all federal payroll withholding taxes,
- Abolishing estate and capital gains taxes, and
- Repealing the 16th Amendment

The income tax includes some 72,536 pages of tax code, regulations and IRS rulings that are so difficult to understand that the annual cost to taxpayers to comply with the tax is estimated to exceed \$431 billion annually. The income tax system taxes labor and investment making productivity and saving more difficult because of such taxes. The Corporate tax, is essentially a consumer tax, in that the only way corporations can pay it is through embedding that tax in the price of their goods. HR25 cuts out this hidden consumer tax as well as the hidden costs to comply with the tax code that corporations also embed in the price of their goods.

H.R. 25 is revenue neutral, collecting as much federal tax revenue as the current income tax code, including payroll withholding taxes.

As an added benefit an estimated **\$11 trillion** held in foreign accounts (largely for tax purposes), would be repatriated back to U.S. banks if H.R. 25 was enacted, becoming available to U.S. markets, bringing down interest rates, and otherwise promoting economic growth in the United States.

If passed and signed into law, H.R. 25 would:

- Enable workers and retirees to receive 100% of their paychecks and pension benefits,
- Replace all federal income and payroll taxes with a simple, progressive, visible, efficiently collected national retail sales tax, which would be levied on the final sale of newly produced goods and services,
- Collect federal sales tax from every retail consumer in the country, whether citizen or undocumented alien, which will enlarge the federal tax base,
- Rebate to all households each month the federal sales tax they pay on basic necessities, up to an independently determined level of spending (eg., the poverty level, as determined by the Department of Health and Human Services), which removes the burden of federal taxation on the poor and makes the H.R. 25 as progressive as the current tax code,
- Attract foreign equity investment to the United States, as well as encourage U.S. firms to locate new capital projects in the United States that might otherwise go abroad,
- American businesses are at a distinct price disadvantage with foreign competitors because of income

tax costs embedded in the price of American goods. The Fair Tax would dramatically reduce federal tax compliance costs paid by businesses, which are now embedded and hidden in retail prices,

- Bring greater accountability and visibility to federal tax collection,
- Collect the national sales tax at the retail cash register, just as 45 states already do,
- Set a federal sales tax rate that is revenue neutral, thereby raising the same amount of tax revenue as now raised by federal income taxes plus payroll withholding taxes,
- Continue Social Security and Medicare benefits as provided by law; only the means of tax collection changes,
- Eliminate all filing of individual federal tax returns,
- Eliminate the IRS and all audits of individual taxpayers; only audits of retailers would be needed, greatly reducing the cost of enforcing the federal tax code,
- Allow states the option of collecting the national retail sales tax, in return for a fee, along with their state and local sales taxes,
- Collect federal sales tax on all consumption spending on new final goods and services, whether the dollars used to finance the spending are generated legally, illegally, or in the huge "underground economy,"
- Not tax spending for education, since H.R. 25 define expenditure on education to be investment, not consumption, which will make education about half as expensive for American families as it is now.

I believe that the replacement of the income tax system by the FairTax will promote high levels of economic growth and job creation, making the United States economy a worldwide magnet for robust investment and job creation. The FairTax "untaxes" the poor and lowers middle class tax burdens while allowing every wage earner to take home paychecks without federal withholding or payroll taxes deducted

For these reasons and more, I urge you fully support the FairTax legislation, HR 25, at the July 26 hearing and beyond.

Sincerely,

John J. Riehecky



Prepared Statement of Linda M. Jolicoeur

*Linda M. Jolicoeur
1475 Lakewood Rd.
Bloomfield Hills, MI 48302*

July 21, 2011

To the members of the House Ways & Means:

Thank you for holding a hearing on the FairTax Act HR 25. I am writing in full support of the FairTax and ask that you each put your full support behind this legislation as well.

For the past 30 years I have devoted my personal time to tax reform on both a state and national level. As a small business owner I have seen firsthand the abuse of the current system. It is complicated, unfair to those who pay taxes, and puts an undue burden on the productive members of our society. Not to mention the very idea of a "Corporate Tax" and all the deceit that goes with placing our job creators at the largest disadvantage of the industrialized world. (Al Greenspan has testified before you in the past that "Businesses do not pay taxes only people do") which results in lower wages for the workers and higher prices for our citizens.

Our founding fathers never intended for "income" to be taxed. We all acknowledge that our system is broken and needs to be fixed. My belief to return the country to the prosperity it once had is to institute a consumption tax, specifically the FairTax. No other legislation has the financial research behind it that the FairTax has; no other legislation eliminates the compliance cost of the current system; and finally and most importantly the selling of tax favors would cease to exist.

Lastly others would contribute to our tax system such as visitors and non-citizens who are living in our country but go under the radar of the "income" based system. I urge you to read the support information that you will be given by others wiser than me regarding the economic impact and the job creation of HR 25 and I ask you to support it and allow the full Congress to vote on allowing the American people to once again have a say on the most important aspect of their financial lives.

Sincerely,

*Linda Jolicoeur
Former Tax Chair the Detroit Regional Chamber
Small Business Association of Michigan Tax Task Force
NAWBO Greater Detroit, Tax Relations Chair*

Prepared Statement of Linda Scott Cummings

The one thing that no one mentions when they talk about the fair tax is time. My time -- and for small business owners it's all about "my time". I never thought when I started this business that I would end up as my own admin assistant. I never thought that I would spend my days, my evenings, and my weekends doing paperwork because of regulations. I never thought that by following my dream that was instrumental in creating a new field within research science I would sacrifice so much of my time.

It's almost impossible anymore to run a small business and keep records so that we may pay the federal government income taxes. I am now responsible for collecting money for three garnishments on my employees. I must keep records so that I may pay taxes. I have 10 employees who ask me questions every day. I am also point of contact for all of our clients. I am also senior researcher at this business. When, may I ask, might there be time for me to do the research that I trained to do? One by one we must chip away at these extraneous duties if we are to maintain small businesses. The biggest blessing of the fair tax is that I could throw away paper and stop managing expenses for the specific purpose of keeping records so that I may pay taxes. Think of it -- I can have a life! I've spent the last three years working seven days a week off and 14 hours a day. This must stop! My choices? Sell the business. Quit the business. Make keeping the business alive my top priority and fall behind on my record-keeping. This last has been my very necessary strategy and my life is now a living hell. And why is that? The IRS, of course. Not only do I work absolutely insane hours, the IRS calls and harasses me. The work done by bookkeepers that I have paid has had errors that need my time to correct. Can I run my business under this environment? Only -- and I stress only -- if you can manage to be successful and get the 16th amendment repealed and substitute the fair tax. It's about far more than money. It's about my life. Yes, for me, the fair tax is about life or death. It's time must come.

I am holding on in the hopes that the fair tax will pass and the 16th amendment will be repealed. If not, it is my decision to sell my business of 40 years. I still have dreams and aspirations for this business, but they simply cannot be realized under our current system. I'm sure I'm not the only one in this situation. Think of what it means, to have many small businesses close for the primary reason that we cannot keep up with the record-keeping required by the IRS. How sad to think of the people who will lose their jobs because small business owners cannot keep up with the record-keeping required by the IRS. Some of my friends have already gone out of business for this very same reason. They tell me they would do it again in a heartbeat. It was the best decision of their lives. I am currently exploring possibilities for starting a new business that would involve only me -- just in case the fair tax does not pass.

Yes, I would close my business put 10 other people out of work so that I can get my life back. Yes, I feel very strongly about this issue. Some of my very close friends have already closed their businesses for this same reason -- that it takes too much time to keep the records to pay taxes. It is happening. Please pass the Fair Tax bill so that we can keep jobs "at home" and keep people employed in this company. This is one of the few ways that I can think of to offset the migration of jobs out of the US that has occurred as a result of outsourcing to countries that have people willing to work for cheaper wages. As a result of this, we have added millions of people to the unemployment and/or welfare rolls.

Just think of what would happen if 10%, 20%, or 50% of small-business owners that employee other people were to shut their doors because it takes too much time to keep records so that we can pay taxes. That would put millions of people out of work and make millions of people eligible for unemployment. That would add millions of people to the rolls of people receiving federal assistance while they look for work. How many of these business owners have literally

ruined their health, meaning that we would be eligible for disability when we finally close our doors? The economic penalty to the US federal government for maintaining the current taxation system is simply too high. The burden carried by small business owners is, likewise, too high. You might think this does not involve a large segment of the US population. One of the American dreams, however, is to own your own business. That makes this concern of removing the burden of keeping records for the specific purpose of taxation of paramount importance.

Sincerely,

Linda Scott Cummings, PhD
PaleoResearch Institute, Inc.
2675 Youngfield St.
Golden, CO 80401
303-277-9848

Prepared Statement of Lisa Chambers

The following comment on the "Hearing on Tax Reform and Consumption-Based Tax Systems" has been submitted by and should be attributed to Lisa Chambers.

Lisa Chambers
(no organization name)
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Snellville, GA 30078

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The FairTax is a simple consumption tax, where everyone pays the same 23% tax on everything they buy. However, doing the research and arriving at the revenue-neutral 23% figure required economists, mathematicians, and others who are smarter than me; so it took me awhile to understand the 23% vs. 30%, inclusive vs. exclusive argument. Unlike the flat tax or VAT, the FairTax would *replace* the income tax; so the FairTax rate is quoted on an inclusive basis, the same as the income tax. People who claim that the FairTax rate is 30% are thinking of it in exclusive terms, like with other sales taxes that are added on to the cost of a product at the cash register. But the FairTax is already included in the price of an item before it gets to the cash register. Therefore, the price of a \$100 item would include a \$23 FairTax payment. Calculating it as an exclusive rate makes it look like a \$77 item would have a \$23 (30%) tax added to it; so this is the reason for the confusion between 23% vs. 30%. But, again, the FairTax payment is included in the price of items so the rate is, indeed, 23%. But it would not be a hidden tax because your sales receipt would say, "Product: \$77. FairTax: \$23."

Another issue people have with the FairTax is the prebate. But the prebate is what makes the FairTax fair to everyone. All legal households would receive a monthly check equal to the amount that they would pay in FairTax payments for anything they buy, up to poverty level spending. Since the prebate amount is based on family size and not income, a rich family with five members would receive a check for the same amount of money as a poor family with five members.

The FairTax may have a few features that require a little explanation; but it is definitely a simpler, fairer tax system than our current income tax. Our income tax system started out as a simple flat tax, but in its almost 100 years has grown to a 76,000 page graduated tax code filled with exemptions and loopholes. I am not a historian, but I believe it is time for another bold experiment in American history. If I am not mistaken, the United States of America was the first Constitutional Republic in the world; and this system of government has served us well for over 200 years. The same cannot be said about our income tax system because it is actually contributing to the demise of our republic. It has been said that a republic will only exist until the populace realizes they can vote to give themselves money from the public treasury; and this is what is happening under our current tax system. However, we can stop this by abolishing our current income tax system and attempting a bold experiment to change to a new form of taxation – a consumption tax, H.R. 25, the FairTax.

Prepared Statement of Mark Curran

Testimony For House Ways and Means Committee

My name -- Mark Curran

My organization "Americans for Tax Openness"

My address: 360 East Greenwood, Morton IL, 61550

My phone 217 653 6145

My email my bookwork@yahoo.com

As a former Fairtax supporter, I know first hand how wonderful the promises sound. However, I also know the footnotes and fine print that is in Fairtax official documents, such as HR- 25, and their equally deceptive "Taxing Sales, What Rate Works."

In fact, we urge this committee to summon Fairtax officials and ask Fairtax officials who have testified here -- in writing or in person -- about various deceptions in their sworn statements, that while technically perhaps not outright lying, are clearly meant to mislead the public and this committee.

Fairtax would impose a massive tax on all city governments --- as referred to in their own fine print. They would also tax all combat pay, all state government spending, and county government spending (other than tuition and a few other things). The state government of Texas, for example would owe 12 billion dollars, 4 billion in advance. This would be a stunning revelation to the state of Texas.

All states, all cities, all counties, would be subjected to this same tax.

Fairtax officials have said this is "asking city and states to pay". But they are not asking -- they are hiding in this in the fine print, and then when asked about it, pass it off as "asking".

This is like a furnace salesman coming to your house, with a proposed sale of a new furnace for 2300 dollars. Then, in the fine print, you notice it's 2300 dollars a month, for life, regardless if you own the home anymore or not. When you asked about this fine print, they say "Well, we didn't see any harm in asking for 2300 a month"

This tax on government is on top of, and separate from, the Fairtax on people. Fairtax has hidden this from the public, and from this committee by linguistic slight of hand. That may be perfectly legal in political gamesmanship, but it is illegal to deceive this committee under oath.

Fairtax has said in years past that "only people pay taxes" but somehow threw that logic out the window, and have over 1 trillion dollars in taxes that various governments pay, because even the FEDERAL government has to "pay itself" a tax on the wars in Afghanistan, and on combat pay, etc. Astonishingly, Fairtax counts the money the federal government would "pay", as spendable money.

This is like paying yourself 1,000 dollars a day to cut your grass, and then pretending, at the end of the month, that you have 300,000 dollars to spend. Since Fairtax leaders are not delusional, this preposterous math can only be accomplished by willful deception.

This is absurd, deceptive, and Fairtax has done all it can to gloss over this trillion dollar plus absurdity. That may be legal when they deceive the public, it may be legal when they submit such deception in proposed legislation, but it

is criminal, we feel, to do so under oath. The games and deceptions should stop when the oath is given.

They have given misleading representations to the committee, in our opinion, and should be held accountable for it, because their testimony was under oath.

It is one thing to mislead the public, where they are not under oath. It is another to carry these deceptions into the committee and repeat those deceptions under oath.

Fairtax defines "any government" as a person. in HR25. See section 2, subsection 7.

Given this goofy definition, they can be, in their own minds, correct is saying PEOPLE pay this tax. Fairtax legislation HR 25 claims that "The person using or consuming taxable property or services in the United States is liable for the tax imposed by this section."

Fairtax leaders knew full well ull well they have defined "any government" as a "person", most likely in a direct and considered attempt to mislead the public and this committee. It also renders the legislation essentially preposterous, since they have the "government" paying itself vast amounts of money.

By our calculations, Fairtax has 1.6 trillion dollars they attribute as "revenue" that is not just far fetched, but is absurd and deceptive. Texas state government, for example, should be told candidly about the 12 billion dollar tax they would have to pay. This committee should have been informed about it, as well.

Every city in Texas would likewise have to pay this tax, as would every county.

We suggest Fairtax leaders, namely Karen Walby and Dr. Laurence J. Kotlikoff, be summoned to this this committee to explain the apparent deceptions.



Prepared Statement of Mike Kelly

Name: Michael A. Kelly

Organization (if applicable): Not Applicable

Address: 1405 SW 10th Place, Cape Coral, Fl. 33991

Phone Number: 239-415-8111

Contact E-mail Address: paradisedocks@comcast.net

Title of Hearing: House Ways & Means Committee HR 25 (Fair Tax)

Personal Background:

- I am a college graduate with a BA in Business Administration.
- I am a retired USMC LtCol. with over 25 years military service.
- At 50 years old I left Sprint Publishing & Advertising (10 years employment) as a marketing manager to start a construction business and fulfill "The American Dream".
- I successfully ran a marine construction business since 2000. I am now 60 years old and I'm an experienced business owner.

Statement:

I am in favor of the fair tax as submitted by Mr. Mike Huckabee for the following reasons:

- First and foremost, our current tax system is inadequate, broken, and unfair. Most Americans don't understand the current tax codes. This fact is backed up by the huge force of Americans who take tax courses so they can do taxes for the majority of Americans who do not understand how to do them. As a business owner I would not even think of doing my business taxes myself and I'll bet the majority of the heads of our nation in the executive, legislative and judicial branches of our government do not do their taxes either. Why, because the tax codes are so complicated.
- Secondly, the IRS employs Americans whose job it is to enforce codes. How many Americans are you going to send to jail because of an inept system? I am not a fan of the rich and famous or a fan of Wesley Snipes. At first I rooted for him to be locked up, but after watching "60 Minutes" on television I feel differently. He stated that he just signed his tax returns after they were prepared and trusted in those who did his taxes. This sound more like debtor prison to me. If we had the "Fair Tax" he would have paid much more in tax and he would have had no way to get around it. Have you seen his luxury automobiles, homes, jewelry, etc...? Just attach 25 to 30% tax on these items and you'll agree that America would prosper from the Fair Tax. Additionally, you would still need an IRS but probably a 10th of the current size.
- The "Black Market" would be reduced. The cases of individual & corporate tax fraud would be virtually eliminated. Only the hardened criminals would go to jail and not our citizens. This system is fair for the rich, middle class and poor alike.
- Finally, the numerous wasted hours of tax preparation and investigating how I can reduce my tax burden will be eliminated. I will also tell you that the government would have made considerable more revenue from me under the Fair Tax than I have currently paid in taxes both as a business owner, a corporate employee and a government employee. I don't mind paying my fair share if it's fair.

Michael A. Kelly

Prepared Statement of Mike Warlick

Dear Congressman Camp and committee members:

Tomorrow you will hear testimony on HR-25, a vital bill that will positively affect the future of our country.

Will my grandchildren, for all their working lives, be taxed at their most productive level - their paychecks? Will they face a life of forms, files, paper work, compliance cost, deadline date of April 15th, and the dreaded IRS, as I have faced all of my life? If they own a business, will they face the same tax burdens?

FairTaxers are not naïve; we understand the powerful forces that we face from K-Street and the other groups that work the 72,000 pages of the tax codes for a living. We have read books like *So Damn Much Money* by Robert Kaiser. We understand that less than fifty percent of Americans pay no Federal taxes. We all understand the difference between Tax Relief and Tax Reform. We know that when we hear the words, "fundamental tax reform" out of someone's mouth in Washington, they are really saying fundamental relief. We know that the Income Tax "Sys / tem" is a means of social control over the American people, favoring one group of Americans over another. People who take the time to research the bill and have no vested interest in the tax codes will support the FairTax. Those that make a quick, uninformed decision without learning all the facts condemn the bill.

Listen to both sides, those that are advocates for the FairTax and the opponents, but if you also listen to your hearts, and think about the futures your children and grandchildren will face, then you will make the correct decision on this bill. HR-25 will demand the utmost courage from you and the other 37 members of the House Ways and Means Committee, as correct decisions often do.

May God guide you as you review this important bill today.

Mike Warlick VVA
404-625-7993 cell



**Prepared Statement of National Association of
Small Business Investment Companies**



July 27, 2011

The Honorable Max Baucus
Chairman
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Dave Camp
Chairman
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin Hatch
Ranking Member
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sander Levin
Ranking Member
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

Dear Senators Baucus and Hatch and Representatives Camp and Levin:

Thank you for holding this joint hearing on the tax treatment of debt and equity. The current tax code is an immensely complex and burdensome system that directly affects how small businesses access, invest, and retain capital. An optimal tax code is one in which business decisions are based upon the underlying economics and not on the tax implications. We are far from an optimal tax code. Given the mammoth scope and complexity of the tax code, there is a tendency for most of the analysis surrounding taxes to focus on aggregate numbers and big businesses, while overlooking small business investors.

As you review your options for improving the tax code, it is critical to recognize that the economics of accessing capital for small businesses can often be profoundly different than for large or publicly traded businesses. The Joint Committee on Taxation's report is an expansive review of the tax treatment of debt and equity, but it is not focused on small business although the U.S. Small Business Administration's Office of Advocacy cites that over the past 15 years, small companies have created 64% of new net jobs¹. I strongly encourage the Committee to specifically examine how changes to the code, particularly removing the deductibility of interest and raising capital gains taxes on equity investments, will affect the ability of investors to provide capital to small businesses.

¹ SBA Office of Advocacy (2011).

Large businesses have greater flexibility in setting their preferred capital structure. They can easily access capital via the equity markets, debt markets, or use complex structures not readily available to smaller businesses. Small businesses are often unable to create an optimal capital structure because they cannot access capital the way large businesses can. There are many small businesses that would rather attract equity investments and reap the benefits of long term capital. But small businesses are not able to attract equity investment like a public traded company, nor can small businesses access low cost debt like big businesses. These Large businesses can issue long-term, low-interest bonds, but small businesses cannot. While large businesses have access to large financial institutions and to new and complex financial instruments, small businesses are limited primarily to debt and occasionally equity. Small businesses investment is very different from other types of investing and changes to the tax treatment of debt or equity can affect these key job creators differently.

To oversimplify a bit, equity investments provide liquid capital on which the issuer of the equity generally has no requirement to pay interest. Investors taking equity stakes in large businesses view the investments as relatively low risk and fairly liquid investments. Further, because many are publicly traded it is relatively easy to assess market valuations.

None of the aforementioned are true for small businesses investors thus small businesses often have significant challenges accessing all types of investment, particularly equity. Small businesses do not have the balance sheets to withstand market shocks that large businesses can endure. Investors must also deal with the fact that market information is much harder to obtain and to assess when dealing with small businesses. Additionally, equity investments in small business are often illiquid, unlike publicly traded enterprises, therefore requiring more patience and an additional premium to account for this illiquidity.

Equity investments are important, but hard to come by for small businesses. Early stage companies that have not yet matured to produce a significant profit need equity investments as a source of capital because they do not yet have the cash flows to pay off debts. However, equity investors in small businesses generally invest with a relatively short term exit strategy to sell or redeem their equity in order to recover their principal and to realize a profit. Therefore, small businesses that are not going to be sold have a very difficult time accessing equity investments. Many great, job-creating small businesses are never going to go public. Good equity investors will bring significant business acumen and expertise to the business, but many entrepreneurs fear losing total ownership and control. For these reasons, equity alone is not likely to be the only source of capital.

Too much debt can be destructive to any business, but debt is a key component in a healthy capital structure. Debt is often critical to small businesses' ability to survive and thrive because it is the only form of investment the small business can access. Debt has the advantage of allowing the business owner to retain control of their business. Debt can also be refinanced, thereby letting businesses take advantage of changing economic conditions. For the investor, debt instruments are often collateralized, and thus reduce the risk. Debt valuations can be easier to ascertain and therefore can make it easier for an investor to approve the transaction. Investors can, but do not need to, sell their position to make a profit and can often retain the option to sell or transfer the note. These advantages offered by debt instruments are exceptionally important to small business investors who supply this type of capital.

As Congress reviews tax reform and the tax treatment of debt and equity, it will be critical to recognize that any action with the potential to increase the cost of capital must be reviewed with a specific focus on small businesses. Removing the deductibility of interest would be particularly detrimental to small businesses' ability to access and afford their primary lifeline to capital. Further, raising capital gains taxes on equity investments or changing the treatment of carried interest for small business investors would create new barriers to investment.

Tax reform and relief is needed. Good reform can facilitate investment in small businesses, resulting in growth that will create jobs and tax revenues. However, if this discussion is limited to aggregate numbers with large businesses as the sole model, jobs will be lost as small businesses perish.

Sincerely,

Brett T. Palmer
President

Submission for Record**Joint Hearing on Tax Reform and the Tax Treatment of Debt and Equity – July 13, 2011**Submitted on Behalf Of (Attributed To):

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Submitted By:

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Prepared Statement of National Debt Awareness Center

Written Testimony to the U. S. House Ways and Means Committee
Tax Reform and Consumption-Based Tax Systems

25 July 2011

By: National Debt Awareness Center
Eugene B. Simmons, Jr; Director
ndacboss@cox.net
702-927-4918

<http://www.federalbudget.com>

Dear Committee Members,

Since there is no proposed legislation regarding Value Added Tax (VAT), no details are known.

Discussions regarding VAT lead to the conclusion that VAT is proposed as being added to the current income tax.

Discussions regarding VAT lead to the conclusion that a large increase in cost to the IRS and to corporations, would be required to administer it.

HR25, The Fair Tax Act of 2011 **has** been submitted to Congress. It is simple to understand, and provides all necessary details for administration.

The Fair Tax Act of 2011 deletes the IRS and the current income tax code and completely protects Social Security and Medicare.

The National Debt Awareness Center strongly advocates the Fair Tax Act of 2011, HR25.

Sincerely,

Eugene B Simmons Jr



Prepared Statement of National Retail Federation



Submission of the National Retail Federation

to the

House Ways and Means Committee

Hearing on Tax Reform and Consumption-Based Tax Systems

July 26, 2011

Rachelle Bernstein
Vice President, Tax Counsel

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As the world's largest retail trade association and the voice of retail worldwide, NRF's global membership includes retailers of all sizes, formats and channels of distribution as well as chain restaurants and industry partners from the United States and more than 45 countries abroad. In the U.S., NRF represents an industry that includes more than 3.6 million establishments and which directly and indirectly accounts for 42 million jobs – one in four U.S. jobs. The total U.S. GDP impact of retail is \$2.5 trillion annually, and retail is a daily barometer of the health of the nation's economy. www.nrf.com.

Summary of Comments

Members of the National Retail Federation believe that the most important aspect of any tax reform measure is its impact on the economy and jobs. Consumer spending represents two-thirds of GDP. The NRF believes that replacing our current tax system with a consumption tax, or adding a consumption tax to our current tax system, will present an unnecessary risk to our economy. The NRF believes that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency and will stimulate economic growth without causing the economic dislocations inherent in the transition to a new tax system.

According to a study of major consumption tax reform proposals performed for the NRF Foundation, transitioning to a consumption tax system will lead to a decline in the economy for several years and a loss of jobs, without stimulating much additional economic growth for a ten-year period.¹ The United States should not experiment with a brand new tax system that will put our economic future at risk.

The NRF also opposes enacting a value added tax (VAT) in addition to the federal income tax. A recent study performed for NRF by Ernst & Young and Tax Policy Advisors found that if a VAT were added to the federal income tax, it would result in a substantial decline in jobs for decades.²

In addition to the overall impact of consumption taxes on the economy, retailers are particularly concerned with the impact of consumption taxes on our customers. Consumption taxes are highly regressive and will raise the tax burden on lower and middle-income Americans. This occurs because lower-income households tend to spend a higher portion of their incomes, so they will pay a higher tax relative to income level under a consumption tax than will upper income households.

Proposals to Replace the Income Tax with a National Retail Sales Tax

Replacing the federal income tax with a national retail sales tax would result in harmful short-term and mid-term results to our economy. A 2000 study performed for the NRF Foundation by PricewaterhouseCoopers found that following replacement of the federal income

¹ PricewaterhouseCoopers LLP, *Fundamental Tax Reform: Implications for Retailers, Consumers, and the Economy*, April 2000. A copy of the study can be found at:

http://www.nrf.com/modules.php?name=Documents&viewlive&sp_id=6755

² Carroll, Cline, Neubig, Diamond and Zodrow, *The Macroeconomic Effects of an Add-on Value Added Tax*.

October 2010. The Executive Summary for this study is included in the Appendix to this testimony. A copy of the complete study can be found at: http://www.nrf.com/modules.php?name=Documents&op=showlivedoc&sp_id=5564

tax, estate and gift taxes and most federal excise taxes with a national retail sales tax, employment would decline for four years, GDP would decline for three years, and consumer spending would decline for eight years.

In 2005, President George W. Bush's Advisory Panel on Federal Tax Reform studied a national retail sales tax and rejected it because they found that replacing the income tax with a national retail sales tax would place too great a tax burden on lower and middle income Americans, who must consume most of what they earn. Their analysis showed that even if a cash grant were provided to lower income families to offset the regressive nature of the tax, as proposed in the FairTax legislation (H.R. 25), a married couple earning \$39,300 a year would still have a tax increase of 42%. A January 2005 study³ of the distributional impact of H.R. 25 found that if that bill were enacted, families with income less than \$18,000 a year would get a tax cut, and families with income over \$100,000 would get a tax cut. However, families with incomes between \$18,000 and \$100,000 a year would have a tax increase. Families earning between \$18,000 and \$35,000 a year would have the largest percentage increase in taxes.

The Advisory Panel was also concerned that the establishment of a new federal entitlement program to administer the cash grants in the FairTax proposal would cost between \$600 billion and \$780 billion a year, making it the largest entitlement program in American history and causing most American families to be dependent on monthly checks from the federal government for a substantial portion of their income.⁴

Finally, the Advisory Panel concluded a national retail sales tax would be difficult to administer and enforce at the high tax rate necessary to be revenue neutral. The Treasury Department's analysis performed for the Advisory Panel concluded that a federal sales tax rate of at least 34% would be needed for a national sales tax to replace the federal income tax system.

This rate would be in addition to existing state and local sales taxes. This rate assumes that the national retail sales tax would apply to *all* goods and services. Thus, the base would include many goods and services that have never been taxed under any state retail sales tax. The base would include health care services, prescription drugs, new home sales, apartment rents, insurance, and purchases by state and local governments. The Treasury Department estimated that if a tax base were used that more closely approximated a typical state sales tax base, a rate of between 64% and 89% would be needed.

From a retail industry perspective the impact of a national retail sales tax would be particularly severe. Consumer spending would decline for eight years, causing a great contraction of the industry and employment. The impact would be particularly severe for small retailers, who are not as able to respond to what would become a competitive need to reduce prices because of the increased pressure on consumers. In addition, retailers would have the administrative burden of collecting and remitting the tax. Studies have shown that the compliance burden for collecting the tax is disproportionately higher on smaller retailers.⁵

³ The study was performed for the National Retail Federation by the Barcroft Consulting Group.

⁴ President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 208.

⁵ The Advisory Panel cites a 1998 study by the State of Washington to illustrate this point. That study found that the cost of collecting sales tax was 6.5% of the tax collected for retailers with annual gross sales of \$150,000 -

Proposals to Replace the Income Tax with a Value Added Tax

Economists agree that the economic impact of various forms of consumption taxes is similar, although the application of the taxes may differ. The President's Advisory Panel on Federal Tax Reform's objections to replacement of the federal income tax with a VAT are similar to their objections to replacement of the federal income tax with a national retail sales tax. "(T)he increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT."⁶

The 2000 PricewaterhouseCoopers study did not model the macroeconomic impact of replacing the income tax with a European style VAT, but it did analyze the impact of replacing the income tax with a Flat Tax, which is a form of VAT. The study found that following the enactment of a Flat Tax, the economy would decline for five years, employment would decline for five years and consumer spending would decline for six years.

Proposals to Add a Value Added Tax to the Federal Income Tax

Recently, some policymakers have suggested that a VAT be added to the federal income tax to help reduce the federal deficit. This model is similar to that used in many European countries. The 2010 study of The Macroeconomic Effects of an Add-on Value Added Tax, performed for the National Retail Federation by Ernst & Young and Tax Policy Advisors, found that an add-on VAT enacted to reduce the deficit would result in a loss of 850,000 jobs in the year of enactment, a loss of \$260 billion in retail spending in the year of enactment, and a .2% drop in GDP in the year of enactment. The study found that even ten years after enactment, the impact of the VAT would still cause a decline of 700,000 jobs, \$288 billion in retail spending, and GDP would be up a modest .3% because of *deficit reduction* (not specifically because of the VAT).

The 2010 study also found that an add-on VAT would have more adverse macroeconomic effects than a comparable deficit reduction through a reduction in government spending. The study found that deficit reduction through spending cuts would add 250,000 jobs in the year of enactment, whereas raising a similar amount of money through a VAT would cost 850,000 jobs in the year of enactment. Similarly, deficit reduction through spending cuts would cause GDP to rise by .1% in the year of enactment, whereas raising a similar amount of money through a VAT would cause GDP to decline by .2% in the year of enactment.

A VAT is a highly regressive tax, hitting lower and middle income taxpayers much harder than wealthier individuals. Even if exemptions were provided to alleviate the impact of a VAT on lower income households, most families with household income over \$40,000 a year would have a lower standard of living if a VAT were enacted. A family of four at the U.S. median income level would have a 100% increase of the federal income taxes currently paid by that family.

\$400,000. For retailers with annual gross sales greater than \$1.5 million, collection costs were less than 1% of sales tax collected. *Ibid.* at 221.

⁶ *Ibid.* at 222.

Finally, in OECD countries that have VATs in addition to income taxes, the VAT rates have risen greatly as the size of government has grown. The Ernst & Young/ Tax Policy Advisors study examined the experience of ten of the largest countries that have adopted a VAT. The average VAT rate rose in these countries from 10.7 percent at the inception of the VATs to 16 percent, a nearly 50 percent increase. The United Kingdom has doubled its initial VAT rate.

Compliance costs associated with VATs are also significant. A World Bank study found that the hours needed to comply with a VAT exceeded the hours needed to comply with the corporate income tax by 26%.⁷ The dual tax system may be particularly burdensome for small businesses, which have enough trouble meeting the burdens of collecting and remitting payroll and income tax withholdings.

Conclusion

We urge the Committee to enact income tax reform that will broaden the tax base and lower the tax rates. This type of tax reform will simplify administration of the tax system and encourage economic growth. We urge the Committee to oppose enactment of a consumption tax, which would hurt jobs and economic growth and shift the tax burden to those who can least afford to pay.

⁷ World Bank, *Paying Taxes 2010* (November 2009). The compliance hours are presented in Appendix 1.3.

Appendix
Ernst & Young/Tax Policy Advisors
The Macroeconomic Effects of an Add-on Value Added Tax
October 2010
Executive Summary

As U.S. policymakers consider ways to address unsustainably high projected future federal government deficits and debt, significant policy changes to both spending and revenues will be debated. The President's National Commission on Fiscal Responsibility and Reform is charged with making recommendations by December 1, 2010 on how to address near-term as well as long-term projected deficits. The Commission is expected to consider significant changes to federal entitlement programs, defense and non-defense discretionary spending, and the tax system, including the possibility of a new federal value-added tax (VAT).

The National Retail Federation (NRF) engaged Ernst & Young LLP and Tax Policy Advisors LLC to analyze the macroeconomic effects of implementing a VAT to reduce projected federal deficits. Although there have been economic analyses of various policies to reform the existing tax system, a macroeconomic analysis of an "add-on" VAT as a means of reducing the deficit and government debt has not been undertaken.

This report examines the macroeconomic effects of reducing future deficits by two percent of GDP. The report focuses on a narrow-based VAT that is similar to VATs in most other countries. To achieve deficit reduction of two percent of GDP with a narrow-based VAT, a 10.3 percent tax rate would be needed. The report also analyzes the effects of a broad-based VAT with a rebate for tax paid by low-income households, as well as a narrow-based VAT with a rebate. All of the add-on VATs analyzed in this report are similar to those used in other countries or recommended in various proposals currently under discussion. For purposes of the analysis, it is assumed that the VAT is effective January 1, 2012.

The three principal findings of the report are:

1. An add-on VAT would reduce retail spending by \$2.5 trillion over the next decade. Retail spending would decline by almost \$260 billion or 5.0 percent in the first year after enactment of the VAT.
2. An add-on VAT would cause GDP to fall for several years. The economy would lose 850,000 jobs in the first year, and there would be 700,000 fewer jobs ten years later. By comparison, a comparable reduction in the deficit through reduced government spending would have less adverse effects on the economy, and could have positive effects for economic growth.
3. Although lower deficits and debt would have positive long-run effects for the economy, most Americans over 21 years of age when the VAT is enacted would be worse off due to

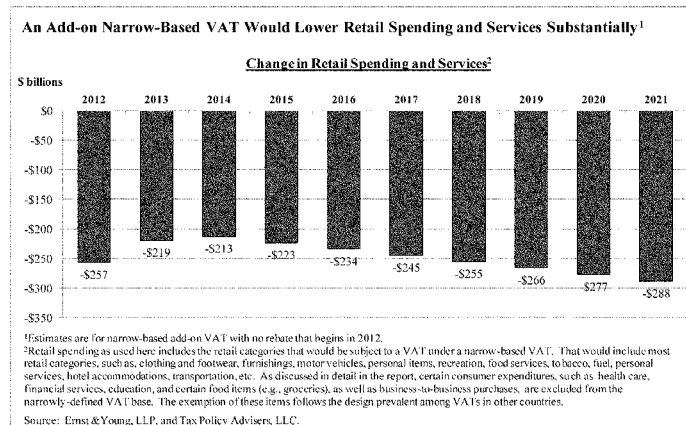
Appendix
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enactment of an add-on VAT. A VAT would have significant redistributive effects across generations, reducing real incomes and employment for current workers.

In the face of an economy that continues to struggle, immediate enactment of an add-on VAT would pose serious risks. The drop in retail spending, jobs, and GDP under an add-on VAT has the potential to further weaken the economy in the near term, rather than strengthen it. Other countries have reduced, not increased, their VATs in the face of the recent economic downturn. Reducing the deficit through lower government spending would have much more favorable economic effects – more jobs, higher GDP, a better standard of living for Americans, and a less depressing effect on retail spending – in both the near term and in the longer term.

Retail Spending Would Fall Significantly Under a VAT

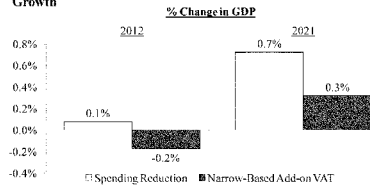
- A VAT would lower household consumption in the short- and long-run, and would reduce GDP for the next several years followed by several years of negligible change.
 - Retail spending subject to the VAT would initially fall by 5.0 percent or almost \$260 billion.
 - Retail spending would fall by \$2.5 trillion over the next decade.



An Add-on VAT Would Have More Adverse Macroeconomic Effects than a Comparable Deficit Reduction through a Reduction in Government Spending

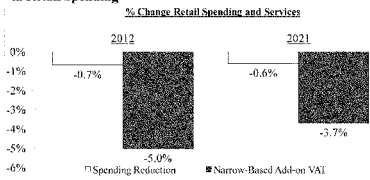
- An add-on VAT would result in less economic growth as compared to a reduction in government spending, when addressing the nation's long-term fiscal imbalance.
 - The level of GDP initially falls when future deficits are financed with a VAT, but would rise almost immediately when reduced through lower government spending on income transfers.
 - A VAT has more adverse effects after ten years as well – reducing the deficit through a VAT cuts the growth of GDP by more than half as much as a reduction in government spending after ten years.
 - The drop in taxable retail spending and services is initially 7.5 times as large under a VAT (-5.0 percent) than after a reduction in government spending (-0.7 percent). After ten years it remains 6 times as large.
 - A deficit-reducing VAT would result in an initial loss of about 850,000 jobs and a loss of 700,000 jobs for more than a decade. In contrast, reducing the deficit through lower government spending could add 250,000 jobs to the economy.
 - The two policies would have different distributional effects, depending on the distribution of the reduction in transfer payments.

A Narrow-based Add-on VAT Results in Far Less Economic Growth



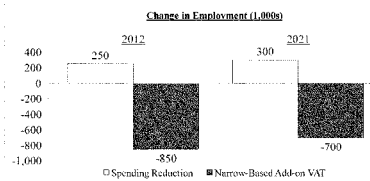
Source: Ernst & Young LLP and Tax Policy Advisors LLC

A Narrow-based Add-on VAT Results in a Much Larger Drop in Retail Spending



Source: Ernst & Young LLP and Tax Policy Advisors LLC

A Narrow-based Add-on VAT Reduces Employment

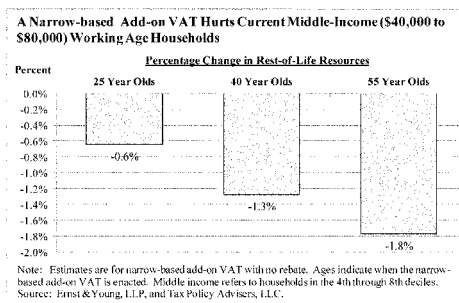


Note: Estimates based on current level of employment.

Source: Ernst & Young LLP and Tax Policy Advisors LLC

Most Americans Alive Today Would Be Worse Off Under an Add-on VAT

- Most Americans over 21 years of age when the VAT is enacted would be worse off due to a decline in their real wages and their inability to consume as much. Households with incomes above \$40,000 and over the age of 21 at the time of enactment would be worse off.
- These losses reflect the costs current generations would bear from using a VAT to reduce the current unsustainable level of deficits and the debt in the United States.



An Add-on VAT Would Result in a Large Tax Increase for Middle-Income Families

The required tax rate for a narrow-based VAT would initially need to be at least 10.3 percent to reduce federal government debt by two percent of GDP. An add-on VAT would be in addition to all existing taxes, such as individual income taxes, corporate income taxes, and the payroll tax.

- Under a narrow-based 10.3 percent VAT, a middle income family-of-four with the U.S. median income of roughly \$70,000 would pay \$2,400 a year in value added taxes. This would be a 100 percent increase over the federal income taxes currently paid by this family.
- A family earning \$40,000 would pay an additional \$1,800 in VAT. A family at this income level has no federal income tax liability.
- A family earning \$100,000 would pay \$2,800 in value added taxes – a tax increase equal to more than 40 percent of their current federal income tax liability.

Moreover, the VAT rate would likely increase over time due to continued political pressure to further narrow the VAT base and/or add some type of rebate to offset VAT paid by lower-income households. This is in addition to the possible increase in rates that would be needed to finance any increase in government spending due to the availability of the VAT; such increased spending would be consistent with international experience.

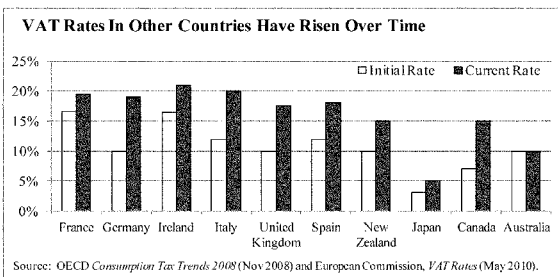
International Experience with VATs

The report examines the experience of ten of the largest countries that have adopted a VAT. All of these countries replaced existing, national consumption-type taxes, such as turnover taxes and manufacturing and wholesale sales taxes, with a VAT.

To address the distributional concerns that VATs are borne disproportionately by lower income households, these VATs have been designed with exemptions and multiple rates. Exemptions and multiple rates increase the administrative and compliance costs of these VATs. Of the ten VATs examined, only Japan imposes a VAT with a single tax rate.

VAT rates in these countries have also increased substantially over time. The average VAT rate has risen from 10.7 percent at the inception of the VATs across all ten countries to 16.0 percent today – a nearly 50 percent increase. The average VAT rate among the 30 member nations of the Organisation for Co-operation and Economic Development (OECD) is 18.0 percent. The United Kingdom will be the first of the ten largest countries analyzed to double its initial VAT rate with its

scheduled increase from 17.5 percent to 20 percent in January 2011. Japan briefly considered raising its VAT rate from 5 percent to 10 percent earlier this year, but has not done so in the face of significant political opposition.



The narrow taxable base for VATs in other countries has resulted in some goods and services being favored relative to other goods and services. This has led to important and sizable sectoral effects favoring tax-preferred sectors. In addition, the enactment of a VAT can have temporary effects on consumption patterns. For example, Australia reduced its excise tax on automobiles and replaced its wholesale sales tax when it enacted its VAT in 2000. Before the effective date, automobile sales fell, but then rose sharply after their excise tax was reduced, while retail spending increased just before the VAT effective date, but fell sharply afterwards.

Prepared Statement of Orient American Ore Co., LLC

Testimony Submitted by Roger W. Buchholtz

Small Business Owner (Orient American Ore Co., LLC)

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 FairTax will harm my business. I am an importer of industrial commodities and today enjoy importing my foreign (mostly Chinese) produced goods without a significant tax component in the cost of the products I sell. This gives me a substantial advantage over my competitors that buy U.S. produced goods as the U.S. products on average have approximately a twenty percent (20%) imbedded tax in their price. (According to research by Dr. Dale Jorgensen while he was the Chairman of the Harvard University Economics Department, this imbedded tax is made up of U.S. corporate taxes, individual income taxes, Social Security and Medicare taxes, etc. that are expenses paid by U.S. businesses and passed on in the form of higher prices of the goods and services being produced.)

I have been quite successful importing foreign commodities and putting my U.S. competitors out of business because of the tax cost that is imbedded in the price of U.S. produced goods. Because the FairTax only taxes final consumption by a retail sales tax, it will eliminate the imbedded taxes from the cost of U.S. produced goods and I will lose my 20% advantage and have to compete on a level playing field with U.S. produced goods. I don't want a level playing field and think giving foreign producers a 20% advantage is the generous thing for rich America to do.

In many cases my foreign suppliers will lose business to American companies and American labor. Although this may be good for America's economy by decreasing unemployment, increasing government revenue, funding Social Security, Medicare and private retirement plans, it is not good for me and my retirement plan or for those poor workers in China.

If the FairTax is adopted I will have to realign my company to sell American produced products in China, as the cost of American goods will no longer be inflated by 20% due to our tax system. Such a realignment will be a burden to me, and because I will no longer have a very favorable tax advantage I will face real competition... and real competition hurts my bottom line.

Let's just leave things the way they are because I can be even more profitable as I eliminate more U.S. competitors. With less U.S. competitors I can increase my profit margins even more. I vote for ignoring the FairTax as I benefit from the tax system just like it is.

I realize that in the long run I will not be able to sell my foreign industrial commodities to American companies as the American companies will continue to go out of business or move offshore because of the 20% competitive disadvantage they incur due to our current tax system. That is a concern for my kids to deal with, as I'm in the game for what I can earn now.

I further realize that as American companies move their production to foreign countries to escape the U.S. tax system, they take their engineering and research with them, and that this is costing us our technological advantage. The loss of U.S. technological advantage, productive capacity and weaker economy also places America at increased risk of inability to defend itself and freedom around the world. However, this is my kids' problem... unless the decline of America is too rapid and disturbs my retirement.

On second thought, I encourage you to adopt the FairTax. I see no other action contemplated or possible that is sufficient in impact to grow America out of its current economic situation. (See below for the impact of the FairTax.) I'll start retraining to sell American goods in China.

Economic research tells us that . . .

- The FairTax rate of 23 percent on a total taxable consumption base of \$11.244 trillion will generate \$2.586 trillion dollars – \$358 billion more than the taxes it replaces. [1]
- The FairTax has the broadest base and the lowest rate of any single-rate tax reform plan. [2]
- Real wages are 10.3 percent, 9.5 percent, and 9.2 percent higher in years 1, 10, and 25, respectively than would otherwise be the case. [3]
- Disposable personal income is higher than if the current tax system remains in place: 1.7 percent in year 1, 8.7 percent in year 5, and 11.8 percent in year 10. [4]
- The economy as measured by GDP is 2.4 percent higher in the first year and 11.3 percent higher by the 10th year than it would otherwise be. [4]
- Consumption increases by 2.4 percent more in the first year, which grows to 11.7 percent more by the tenth year than it would be if the current system were to remain in place. [4]
- The increase in consumption is fueled by the 1.7 percent increase in disposable (after-tax) personal income that accompanies the rise in incomes from capital and labor once the FairTax is enacted. [4]
- By the 10th year, consumption increases by 11.7 percent over what it would be if the current tax system remained in place, and disposable income is up by 11.8 percent. [4]
- Over time, the FairTax benefits all income groups. Of 42 household types (classified by income, marital status, age), all have lower average remaining lifetime tax rates under the FairTax than they would experience under the current tax system. [5]
- Implementing the FairTax at a 23 percent rate gives the poorest members of the generation born in 1990 a 13.5 percent improvement in economic well-being; their middle class and rich contemporaries experience a 5 percent and 2 percent improvement, respectively. [6]
- Based on standard measures of tax burden, the FairTax is more progressive than the individual income tax, payroll tax, and the corporate income tax. [7]
- Charitable giving increases by \$2.1 billion (about 1 percent) in the first year over what it would be if the current system remained in place, by 2.4 percent in year 10, and by 5 percent in year 20. [8]
- On average, states could cut their sales tax rates by more than half, or 3.2 percentage points from 5.4 to 2.2 percent, if they conformed their state sales tax bases to the FairTax base. [9]
- The FairTax provides the equivalent of a supercharged mortgage interest deduction, reducing the true cost of buying a home by 19 percent. [10]

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Prepared Statement of Paul D. Wheaton

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 than 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.

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 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 compared 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)		
	Current Tax System	Flat Income Tax	Value-Added Tax	FairTax
Criteria				
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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Title of Hearing: Hearing on Tax Reform and Consumption-Based Tax Systems, July 26, 2011

Respectfully submitted,

/s/ Paul D. Wheaton, MBA

Prepared Statement of Retail Industry Leaders Association



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July 28, 2011

The Honorable Dave Camp
Chairman
Committee on Ways & Means
U.S. House of Representatives
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways & Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Camp and Ranking Member Levin:

On behalf of the Retail Industry Leaders Association (RILA), I write to offer retailers' perspectives on consumption taxes for your committee's hearing on July 26, 2011, on tax reform and consumption-based taxes. RILA supports tax policies that will improve the business climate for retailers, both domestically and internationally, by helping them continue creating jobs and bring price-competitive value to American consumers.

By way of background, RILA is the trade association of the world's largest and most innovative retail companies. RILA promotes consumer choice and economic freedom through public policy and industry operational excellence. Its members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than \$1.5 trillion in annual sales, millions of American jobs and more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

Anti-Growth Tax Reform: National Sales Tax

While tax reform is important and can contribute to economic growth and job creation, we strongly believe that adoption of a national sales or value-added tax (VAT) would be antithetical to those goals. Regardless of whether this tax is imposed through the manufacturing process or at the point of retail sale, the victim of this tax will ultimately be the American consumer who will face higher prices at the register.

Sales taxes are highly regressive and pose particular harm for low- and middle-income consumers who spend a higher percentage of their earnings on basic necessities such as food, clothing, and household products. In addition, state and local governments already apply sales taxes to many goods and services – which a number of states have increased in recent months to address revenue shortfalls resulting from the current economic situation. A similar tax at the national level would simply add to the tax burden consumers are increasingly asked to shoulder. Such a tax would also create significant administrative burdens for retailers already responsible for complying with the complex federal income tax system and the remittance of disparate state and local sales taxes.

The Honorable Dave Camp
 The Honorable Sander Levin
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Moreover, the retail industry represents one of the largest industry sectors in the United States with nearly 15 million jobs and \$3.9 trillion in annual sales overall in 2010. A national sales or value-added tax would by definition increase prices and we believe would significantly depress retail sales. The result would be devastating for the retail sector of our national economy and the critical jobs it provides, especially given the ease with which it would be adjusted in the future to increase federal revenues.

Today, the nation's economy continues its sluggish recovery, with the unemployment rate hovering around 9 percent and more than half of the country's Gross Domestic Product reliant on consumer spending. The last thing this country – our businesses and our consumers – needs is a new supplementary tax system that will increase retail prices, hinder consumer spending, threaten American jobs, and add more barriers to robust economic growth. Accordingly, we do not believe there is any room at the table for a national sales or value-added tax to be added to the current burdensome income-tax regime.

Growth-Orient Tax Reform: Lower Business Tax Rate; Simpler, Permanent and Stable Tax System

As we have submitted in previous testimony, RILA believes that the best approach for tax reform is to retain the income-based system and reduce significantly the rate applicable to U.S. corporations and other forms of business while examining the myriad other aspects of the tax law to broaden the tax base. Such an effort would be a substantial step toward improving the business climate for retailers, both domestically and internationally.

RILA applauds the Committee's recognition that tax reform should not be undertaken piecemeal, but rather comprehensively. And, we urge the Committee to give careful consideration to the effect that tax rates, as well as other components of the individual tax code like the alternative minimum tax, have on consumer spending, which contributes to the growth in the economy and businesses' ability to increase capital for investment and job creation.

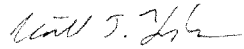
Moreover, we strongly urge the Committee to strive for a tax system that will minimize the burdens and complexities of our current tax system, which stifle innovation and employment, and deter overall economic growth. Fundamental to any successful tax reform is a simple, permanent, and stable tax system – a feature that the current tax system sorely lacks.

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Conclusion

Thank you for this opportunity to present our views on tax reform and consumption-based taxes. RILA and its members look forward to working with the Committee to implement meaningful tax reform that includes provisions that support the retail industry and help it create jobs and grow.

Sincerely,



Bill Hughes
Senior Vice President, Government Affairs



Prepared Statement of Richard Giambruno

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 7-26-11

To the Committee on House Ways and Means:

The national debate over taxation is shifting from the question of *whether* to alter our current tax system to the question of *how* to alter it. Today, polls indicate that a large majority of Americans are extremely frustrated with the current federal income tax system. The income tax discourages personal savings and investments by taxing capital gains, dividends, and interest earned. Wage earners struggle under the burden of a very regressive payroll tax. The income tax is complex – so complex that no one, not even the experts, truly understands it. Moreover, for the tax to be enforced the taxpayer must sacrifice significant privacy. As a result, our citizens are governed by needlessly burdensome tax laws that they cannot understand and that are intrusive, complex, costly, and often invisible.

Throughout the history of our country, our citizens and government have had an objective to increase every American's chance to achieve economic independence by providing greater opportunities to share in our country's growth and prosperity. The FairTax helps us achieve this goal. Americans are better off under the FairTax. Every taxpayer is subject to the same sales tax rate with no exceptions and no exclusions; but those least able to share in the cost of government will carry no federal tax burden at all.

Our current tax system is also unfair because it is highly responsive to political influence on behalf of special interest groups. Average taxpayers without the means or organization to influence tax policy are at a clear disadvantage. The inextricable relationship between the tax code and lobbyists is evidenced by the fact that more than half of Washington lobbyists are registered on tax matters. Under the FairTax, there are no exceptions and there are no exclusions – there are no loopholes to be exploited by special interests. Under the FairTax, all taxpayers have an equal voice.

Slow economic growth and economic stagnation have an adverse impact on low wage earners. These families are more likely to lose their jobs, are less likely to have the resources to weather bad economic times, and are more in need of the initial employment opportunities that a dynamic, growing economy provides. The income tax retards economic performance by creating a significant bias against saving and investment through double, triple, and even quadruple taxation. Under the FairTax, what you earn is what you take home. Americans are able to save more and invest more. The FairTax dramatically increases investment levels compared to levels that would have been achieved under the current income tax system. Increased savings will stimulate investment and productivity and the economy will grow more rapidly, creating demand for workers and improving job opportunities. Because taxes on capital are removed, foreign capital will flow into the United States, creating businesses and jobs. U.S. products competing abroad are free of the hidden costs of taxation while the FairTax is collected on

foreign products sold in the United States. Virtually all economic models project a much healthier economy under a broad-based consumption tax such as the FairTax

As for the panel's discussion of a Flat tax, please consider the following:

The flat tax keeps the IRS, the FairTax does not.

The flat tax does not fix the import/export problem, the FairTax does.

The flat tax continues to tax income (productivity), the FairTax taxes consumption, but rewards productivity .

The flat tax continues to use corporations as tax collectors, discouraging business development, the FairTax frees corporations and stimulates the economy.

The flat tax continues to "hold down" the poor by raising taxes with income; the FairTax allows increased income without penalty.

The flat tax continues the withholding system, the FairTax allows you to keep your whole paycheck.

We have had a flat tax before, and look what it turned into!

The flat tax keeps the roughly \$400 billion in compliance costs now paid under the current system, the FairTax eliminates these costs.

The flat tax continues to favor drug dealers, hookers, and other members of the underground economy; the FairTax taxes them when they make their purchases.

The flat tax only takes one to cheat (like now), the FairTax system is more robust because it requires two parties to cheat the system.

We have a flat tax right now, it's called FICA, and is the most regressive tax of all.

I urge the Committee to take action NOW, while the debate is only what system we should switch to, and not if we should switch at all. A move to adopt the FairTax will make the U.S. the greatest place on earth for a corporation to locate a headquarters and move employees to. Trillions would flow back to our shores from off-shore accounts with the FairTax in place.

The net result? **J-O-B-S!**

Thank you for your time and consideration,

Richard J Giamb Bruno, a voter.



Prepared Statement of Richard T. Ainsworth

NEW YORK ADOPTS A VAT

Richard T. Ainsworth

INTRODUCTION

Virtual intermediaries (enterprises like Priceline.com,¹ Expedia.com,² Orbitz.com,³ and Travelocity.com⁴) are having a significant impact on state and local revenues. These enterprises (room remarketers) acquire lodging at steep discounts and then resell the accommodations to the public. When rooms are resold the discount the public receives is more modest. The difference is the intermediary's profit. Thus, a room listing for \$100 per night might be sold to an intermediary for \$50 and then resold to an online customer for \$70.⁵ The tax question is – should the tax base be \$100, \$70 or \$50?

How this question is answered has a direct impact on the virtual intermediary's profit (because hotel taxes impact the final price). As a result, intermediaries are inclined to arrange transactions to keep the tax base as low as possible (preferring a tax on \$50). Tax authorities feel that a true measure of consumption is \$70 (if not \$100).

To deal with revenue loss in this area state and local jurisdictions have three major options at their disposal: (1) litigate current law and then tinker with statutory or

¹ Priceline.com was founded by Jesse Fink (venture capitalist) and Jay Walker (digital entrepreneur) headquartered in Norwalk Connecticut. The origins of the company are closely tied to Walker's research company Walker Digital. Priceline.com was formed in July 1997, commenced operations on April 6, 1998 and had its first \$1 million day on April 28, 1999 when it sold over 5,000 airline tickets. See: <http://www.priceline.com/>.

² Expedia.com, headquartered in Bellevue, Washington, was founded within Microsoft Corporation in 1995 and was launched on the Internet in October 1996. It offers one-stop travel and reservation services, making over \$17 billion in travel reservations annually. It operates sites in the US, Canada, the United Kingdom, Germany, France, Italy, Spain, the Netherlands, Norway, Sweden, Denmark, Australia, Japan and China. See: <http://www.expedia.com/phoenix.zhtml?c=190013&p=home>.

³ Orbitz.com, headquartered in Chicago, Illinois, has been in operation since 2001. It was founded by Continental Airlines, Delta Air Line, Northwest Airlines, and United Airlines (American Airlines joined later). It is a publicly traded company with an initial public offering in July 2007. See: <http://corp.orbitz.com/>.

⁴ Travelocity, headquartered in Southlake, Texas, was created in 1996 as a wholly owned subsidiary of Sabre Holdings Company which was itself a wholly owned subsidiary of American Airlines. It was a publicly traded company until March 2007 when it was taken private. In 1999 it gained market share when it became associated with the AOL travel portal, but by 2002 it was suffering from competition with Priceline.com and Expedia.com. See: <http://www.travelocitybusiness.com/>.

⁵ Jay Walker, the founder and vice chairman of Priceline.com explains the business model of virtual intermediaries as a "demand collection system."

In the traditional model of commerce, a seller advertises a unit of supply in the marketplace at a specified price, and a buyer takes it or leaves it. Priceline turns that model around. We allow a buyer to advertise a unit of demand to a group of sellers. The seller can then decide whether to fill that demand or not. In effect, we provide a mechanism for collecting and forwarding units of demand to interested sellers – a demand collection system.

N. Carr, *Forethought – Redesigning Business: A Conversation with Jay Walker*, HARVARD BUSINESS REVIEW 19 (Nov.-Dec. 1999).

regulatory provisions if the outcome is not favorable,⁶ (2) abandon *ad valorem* taxation and adopt a flat fee per room scheme,⁷ or (3) adopt a European-style value added tax (VAT).⁸ Somewhat surprisingly, New York has taken the third approach.

This paper considers the New York VAT in hotel accommodations in three sections. The first defines a European-style credit-invoice VAT and applies it to the New York Hotel Room Occupancy Tax, the second considers the critical term – the *operator* – and examines how this term in the context of a hotel tax modeled on the retail sales tax creates problems when virtual intermediaries get involved facilitating accommodation

⁶ This appears to be the approach of many states. The Indiana Office of the Attorney General for example is defending the state's Department of Revenue in six cases brought by various online travel companies in state court. See: Karen Setze, *FTA Panelist: Online Travel Companies Faring Worse than Advertised in Court*, (June 15, 2011) TAX ANALYSIS Doc. No. 2011-12956 or 2011 DSTT 115-2 (referencing the presentation of Indiana Deputy Attorney General Jessica Reagan who explained that when virtual intermediaries were winning cases it was largely based on "... the specific language of the local ordinance or statute, which courts in some cases described as appearing to be a 'tax loophole.'")

Walter Hellerstein suggests how state and local governments might "tinker" with hotel tax statutes to meet the virtual intermediary challenge. He suggests borrowing from the tax treatment of drop shippers. Instead of goods being drop shipped into a jurisdiction by a third party, what is happening with virtual intermediaries under the hotel tax is the "drop shipment" of a service.

In my treatise, in offering a "normative" approach to the issue addressed in this memorandum, [citations omitted] I suggested a "practical approach" [citation omitted] to taxing the travel intermediaries' margin that neither the MTC nor the industry proposal has embraced, namely, requiring the hotel operator to add a presumed markup to the travel intermediary's price, and collect tax on the marked-up price, subject to the hotel's establishment of an actual markup that is different. This would remove the travel intermediary from the tax collection process altogether and was addressed to the concern that there might otherwise be constitutional problems with asserting tax collection nexus over out-of-state travel intermediaries.

Walter Hellerstein, *Letter to the National Conference on State Legislators: Taxation of Travel Intermediary Services*, 2 (July 16, 2009) available at: <http://www.netchoice.org/library/travel-intermediary-tax-proposals.pdf>.

⁷ This is the Quebec approach. Lodging taxes are imposed on the customer. [Quebec Sales Tax, R.S.Q., c. T-0.1, §541.24]. Localities can elect either (a) a flat \$2 per room/ per day tax, or (b) a tax based on 3% of the purchase price – but only if the supply is made by the operator. In cases where a 3% *ad valorem* tax is elected – and if an intermediary makes the supply not an operator – the tax is \$3 per room/ per day. Intermediaries are defined as "... the recipient of a supply of an accommodation unit who receives the supply only to again make a supply of the accommodation unit for consideration." [Quebec Sales Tax, R.S.Q., c. T-0.1, §541.23]. An intermediary cannot be a customer. The customer is defined as "... the recipient of a supply of an accommodation unit, but does not include an intermediary" [Quebec Sales Tax, R.S.Q., c. T-0.1, §541.23]. The key to Quebec's approach to Lodging Taxes is that in the localities where the tax is *ad valorem* based, it is *only an ad valorem based tax when a customer purchases directly from an operator*. [Quebec Sales Tax, R.S.Q., c. T-0.1, §541.24]. Whenever an intermediary purchases rooms from an operator for resale the tax is at a flat rate per room/ per day. The operator selling to the intermediary collects it in advance. [Quebec Sales Tax, R.S.Q., c. T-0.1, §541.25]. New York already does something similar in New York City where a \$1.50 fee per unit/day fee is imposed. New York City and the State of New York also impose an *ad valorem* sales tax on every unit located within New York City. See TSB-M-05(2)S.

⁸ Richard T. Ainsworth, *Virtual Intermediaries in the Lodging Industry: Consumption Tax Problems in the U.S. and Japan*, 57 TAX NOTES INTERNATIONAL 865 (March 8, 2010) (indicating that the virtual intermediary problem is unique to both the US retail sales tax, and the Japanese consumption tax, and that it is not a problem at all under other types of consumption taxes – notably the European VAT generally, and the Canadian GST particularly when it considers cross-border drop shipments of goods or services).

rentals, and the third considers the new term *room remarketer* as it is used in the New York Hotel Room Occupancy Tax.

A short concluding section discusses why in re-designing this tax as a VAT New York has made an insightful tax policy decision. New York will most likely *increase revenue without increasing rates or expanding the tax base* with this decision. Gains will come from increased efficiency, more stable revenue deposits from fractionated payments, and lower enforcement costs from the self-enforcing nature of the VAT.

NEW YORK'S VAT

On August 13, 2010 the New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division released *Amendments Affecting the Application of Sales Tax to Rent Received for Hotel Occupancy by Room Remarketers*.⁹ The legislative revision it considers (Chapter 57 of the Laws of 2010) was effective September 1, 2010. The changes brought in by this Chapter effectively converted New York's Hotel Room Occupancy Tax from a single-stage retail sales tax to multi-stage European-style VAT.

Definition. Like the retail sales tax, a value added tax is an *ad valorem* tax. However, instead of collecting the full tax on value at the point of final consumption, a VAT collects the tax in slices all along the supply chain measured by the value added at each stage. As Schenk and Oldman indicate:

A value added tax (VAT) is a generic name associated with a multistage tax that is levied on the value added by each business firm at every of production of goods and services.¹⁰

In the normal case, when a final consumer secures a room directly from a hotel, a retail sales tax is easy to apply. The consumer pays tax to the operator of the hotel based on the value paid for the accommodations. A retail sales tax “fits” this fact pattern very well.

However, when an intermediary is interposed between the final consumer and the hotel what was formerly a single-stage transaction now becomes multi-staged. A short commercial supply chain is created, and value is added at each stage. Stated another way, the hotel (like a manufacturer) produces inventory each day (vacant rooms). Unfilled rooms are perishable commodities. As the time for occupancy comes closer a certain number of these rooms will be sold (at a discount) to a middleman (a room remarketer) that will add important value (securing rent for the room on short notice). The best middlemen possess what is known as “demand collection systems” to help them find willing renters on short notice.¹¹ A value added tax “fits” this kind of supply chain fact pattern very well.

⁹ TSB-M-10(10)S (August 13, 2010) available at: http://www.tax.ny.gov/pdf/memos/sales/m10_10s.pdf.

¹⁰ Alan Schenk & Oliver Oldman, VALUE ADDED TAX – A COMPARATIVE APPROACH 30 (2007).

¹¹ Jay Walker, *supra* note 5.

Operator. The same problem that New York faced with its Hotel Room Occupancy Tax is replicated in many hotel taxes throughout the US. These taxes are modeled on a retail sales tax, and they pivot on the requirement that the *operator*¹² (like a retail merchant) must collect the tax from an *occupant* (assumed to be a final consumer). Prior to the passage of Chapter 57 of the Laws of 2010 New York defined an *operator* as simply: “Any person operating a hotel.”¹³

New York only had to look to North Carolina to see what would happen if it tried to require a virtual intermediary (a room reseller) to collect the Hotel Room Occupancy Tax on the value they were adding to the final sale of accommodations. Pitt County, North Carolina brought such a suit on behalf of itself and others alleging violation of its Occupancy Tax. The case was removed to federal court and quickly dismissed.¹⁴

The District Court determined that there was no injury in fact. Pitt County had no standing to sue. On appeal the Fourth Circuit agreed, but on different grounds. This time the court said there was a failure to state a claim on which relief can be granted.¹⁵

The key to both decisions is the term *operator*. The essential argument raised in the lower court was: *if* a business is a retailer (a hotel *operator*) under the North Carolina sales tax, *and if* that business rents accommodations within Pitt County, *then* Pitt County should be able to require that business to collect the Pitt County Occupancy Tax. But, online travel companies are not “retailers,” because they do not *operate* hotels in Pitt County. Thus, Pitt County cannot compel them to collect tax on their room re-sales.

The Appeal Court took a different route but reached the same result. Online businesses with no physical presence in North Carolina are not subject to the sales tax, because they are not “retailers” within the meaning of the sales tax. The retailer in the hotel industry is defined as the *operator*.¹⁶ Thus, the Fourth Circuit decided simply:

... an online travel company is not a retailer because it is not a business of a type that is similar to a hotel, motel, or tourist home or camp. As a result, an online travel company is not subject to the Pitt County occupancy tax.¹⁷

Rather than fight this battle,¹⁸ New York has decided to change the definition of an *operator* in Chapter 57 of the Laws of 2010. The expanded definition now includes room remarketers.¹⁹ It states that an *operator* is:

¹² New York Tax Law §1105(e).

¹³ New York Tax Law §1101(c)(4).

¹⁴ *Pitt County, N.C. v. Hotels.com*, 2007 U.S. Dist. LEXIS 85910 (E.D.N.C., Aug. 12, 2007).

¹⁵ *Pitt County, N.C. v. Hotels.com*, 553 F.3d 308 (4th Cir., 2009).

¹⁶ N.C. GEN. STAT. § 105-164.4(a)(3).

¹⁷ *Pitt County*, 553 F.3d 308, 314.

¹⁸ In fact, the State of New York had an inkling of how difficult litigation would be on this issue, because Nassau County had unsuccessfully tried to bring a class action suit against many of the virtual intermediaries. *County of Nassau, NY v. Hotels.com et. al.* 594 F. Supp.2d 251 (E.D.N.Y., 2007) (case dismissed because the county did not exhaust administrative remedies); *County of Nassau, NY v. Hotels.com et. al.* 577 F.3d 89 (2nd Cir., 2009) (vacated and remanded for failure to meet requirements for

Any person operating a hotel. Such term shall include a room remarketer and such room remarketer shall be deemed to operate a hotel, or portion thereof, with respect to which such person has the rights of a room remarketer.²⁰

This solves the problem. Both the owner of the hotel and the virtual intermediary (room remarketers) are *operators*. Both the virtual intermediary and the guest are *occupants*.²¹ Thus, for example, if a room that normally lists for \$100 is sold to a virtual intermediary for \$50, and then resold to a guest for \$70 the tax will be collected twice. The virtual intermediary (as an *occupant*) will pay the hotel owner (as an *operator*) a tax on \$50. In addition, the guest (as an *occupant*) will pay the virtual intermediary (as an *operator*) a tax on \$70.

If this was all there was to the change, then it is clear that New York would be going too far. Where New York may have previously collected tax only on \$50, it would now collect tax on \$120 (\$50 + \$70 = \$120). This aggregate tax base exceeds the \$100 full value of the room by \$20.

New York solves this problem by following the lead of the EU VAT. It allows the virtual intermediary a credit for the full amount of the tax it has paid against the tax it collects from the guest.

Room remarketers. A carrot and stick is applied to virtual intermediaries under the amendments to the Hotel Room Occupancy Tax. Not only is the virtual intermediary (room remarketer) deemed to be an *operator* (required to collect the tax from the guest it resells to) but it is allowed a credit for the full amount of the tax it has paid to the owner

class certification under Fed. R. Civ. P. 23 because it is not clear that all the members of the class imposed a hotel tax that was similar to the Nassau County hotel tax).

¹⁹ A room remarketer is defined in New York Tax Law §1101(c)(8), effective September 1, 2010 as:

A person who reserves, arranges for, conveys, or furnishes occupancy, whether directly or indirectly, to an occupant for rent in an amount determined by the room remarketer, directly or indirectly, whether pursuant to a written or other agreement. Such person's ability or authority to reserve, arrange for, convey, or furnish occupancy, directly or indirectly, and to determine rent therefor, shall be the "Rights of a room remarketer". A room remarketer is not a permanent resident with respect to a room for which such person has the rights of a room remarketer.

²⁰ New York Tax Law §1101(c)(4), effective September 1, 2010.

²¹ In an abundance of caution, New York also modified the definition of *occupant*. Prior to Chapter 57 of the Laws of 2010 an occupant was defined as:

A person who, for a consideration, uses, possesses, or has the right to use or possess, any room in a hotel under any lease, concession, permit, right of access, license to use or other agreement, or otherwise.

After Chapter 57 of the Laws of 2010 an occupant is defined as:

A person who, for a consideration, uses, possesses, or has the right to use or possess, any room in a hotel under any lease, concession, permit, right of access, license to use or other agreement, or otherwise. "Right to use or possess" includes the rights of a room remarketer as described in paragraph eight of this subdivision.

Thus, a room remarketer (virtual intermediary) is an occupant of a New York room when it acquires the right to "use or possess" the room it re-sells to the eventual guest.

of the hotel in its capacity as an *occupant* of the same room. This is precisely how the EU VAT operates.

A simple example using a 10% tax rate is helpful. If a virtual intermediary secures a room in New York for \$50 that it resells to a guest for \$70, it would: (a) pay a tax of \$5 to the hotel owner, (b) collect a tax of \$7 from the guest, and then (c) deduct the \$5 it paid from the \$7 it collected and remit \$2 with its return. In this manner the correct amount of tax (\$7) is remitted on the true consumption base (\$70). However, it is remitted in slices (\$5 from the hotel owner, and \$2 from the virtual intermediary).

Room remarketers must register, and receive a certificate of authority number.²² Returns are due quarterly.²³ Only registered operators qualify for a refund or credit of taxes paid, and they must furnish their certificate of authority number and the number of the *operator* of the hotel to whom they paid tax.²⁴ An application for credit or refund is filed using Form AU-11, *Application for Credit or Refund of Sales or Use Tax*.²⁵ Just as under the EU VAT room remarketers are allowed to immediately take the credit for the tax paid (to the hotel *operator*) on the return where they report the amounts they have collected from the guest. The tax remitted is a net amount.

If an application for credit has been filed, the room remarketer may immediately take the credit on the return that is due coincident with the application for credit, or immediately after the room remarketer files the application for credit. However, the taking of the credit on the return is deemed to be part of the application for credit.²⁶

Thus, just as under the EU VAT,²⁷ a room remarketer in New York remits tax based on the value it has added to the supply. The remarketer's base is the full amount charged to its customer (not merely the amount for the accommodation), and will include any mark-up added by the remarketer.²⁸

²² New York Tax Law §1134(a)(1), effective September 1, 2010. This is equivalent to the requirement under the EU VAT that a taxable person must register [VAT DIRECTIVE, ART. 9(1)], and receive a VAT identification number [VAT ID] [VAT DIRECTIVE, ART. 214]. The SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover tax – Common system of value added tax: uniform basis of assessment (77/388/EEC) 1977 O.J. (L 145) 1 was repealed and replaced on November 28, 2006 with the RECAST VAT DIRECTIVE. Council Directive 2006/112/EC on the Common system of value added tax, O.J. (L 347) 1. Citation throughout this document will be referenced VAT DIRECTIVE.

²³ New York Tax Law §1136(a)(1).

²⁴ TSB-M-10(10)S at 2. A similar requirement to identify taxable persons by VAT ID numbers on invoices is found under VAT DIRECTIVE, ART. 22(3). THE VAT ID has been called the “admission ticket to deduction.” AG Sir Gordon Slynn in ECJ Case 123/87 *Léa Jorion, née Jeunehomme, and Société anonyme d'étude et de gestion immobilière 'EGI' v Belgian State*.

²⁵ Available at: http://www.tax.ny.gov/pdf/current_forms/st/au11_fill_in.pdf

²⁶ TSB-M-10(10)S (August 13, 2010) at 2.

²⁷ VAT DIRECTIVE, ART. 206.

²⁸ New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, *Summary of 2010 Sales and Use Tax Budget Legislation*, TSB-M-10(18)S (December 6, 2010) at 2.

In addition, rent subject to the sales tax on occupancy of a room or rooms in a hotel now includes any service or other charge or amount paid as a condition of occupancy to a

The constitutionality of this tax base has been challenged in the New York Supreme Court of New York County. The challenge was unsuccessful. The virtual intermediary community was particularly concerned that under these rules, "... Remarketers are now liable for informing the consumer of the breakdown of the HROT (Hotel Room Occupancy Tax) between the rent and service fees ..."²⁹

This provision in the law effectively allows consumers to compare fees among remarketers, as well as identify the actual price charged for the room by the hotel. The further contention in the suit was that by including the remarketer's fees in the base that New York was in fact imposing "... new tax on travel booking services ..."³⁰ This argument was also rejected.

CONCLUSION

For all intents and purposes, New York has adopted a limited purpose, European-style, credit-invoice VAT to solve the problem presented in the Hotel Room Occupancy Tax by virtual intermediaries. Without raising rates or expanding the tax base New York City expects to receive significantly more revenue from the Hotel Room Occupancy Tax in 2011 and 2012.³¹

If the amendments to New York's Hotel Room Occupancy Tax (the New York VAT) attract the benefits normally attributed to VAT adoption (as opposed to the retail sales tax) we should see two results: (1) a larger and more stable and revenue flow into the Treasury because of the VAT's fractioned payment mechanism, and (2) a more easily audited tax because of the VAT's self-enforcement characteristic.

room remarketer. Accordingly, the full amount charged by a room remarketer to its customer for the right to occupy a room in a hotel in New York State constitutes rent for occupancy of a room in a hotel, and is subject to sales tax. Furthermore, since the new law provides that in these circumstances, a room remarketer is an operator of a hotel, the room remarketer must collect the sales tax, and where applicable, the fee of \$1.50 per unit, per day imposed in New York City (NYC \$1.50 fee) from its customer, and remit the amount collected to the Tax Department.

²⁹ *Expedia, Inc. v. The City of New York, Department of Finance*, 650761/09 (October 29, 2010) at ¶5.
³⁰ *Id.*, at ¶10.

³¹ New York City Independent Budget Office, *Analysis of the Mayor's Preliminary Budget for 2012 – IBO's Reestimate of the Mayor's Preliminary Budget for 2012 and Financial Plan through 2015*, (March 2011) at 26 indicates that Hotel Room Occupancy Tax revenues are expected to expand significantly. Although attributed in part to increased tourism in New York City, these increases coincide with the conversion of the retail sales tax on hotel accommodations to a VAT. The allegations raised by the virtual intermediaries in *Expedia, Inc. v. The City of New York, Department of Finance* support the inference that the New York VAT is at least partly responsible for these anticipated increases. The New York City Independent Budget Office observes:

Hotel occupancy tax collections for the first seven months of 2011 (July 2010 – January 2011) recorded a 20.9% increase compared to the same period in 2010 and this strong growth is expected to continue through the second half of the year. For 2011, IBO forecasts tax revenue of \$421 million – growth of 16.6% above 2010 revenues of \$361 million.

Available at: <http://www.scribd.com/doc/51113671/13/Hotel-Occupancy-Tax>

Fractioned payments. This principle is so central to the EU VAT that it is generally described as a leading feature of the tax, and a major reason for adopting it.³² In the case of the New York Hotel Room Occupancy Tax revenue will be remitted in two parts (fractioned payments) – the first by the hotel owner after an initial sale to a remarketer, and the second by the remarketer when he makes the onward sale to the guest.

The consumption tax base of the New York Hotel Room Occupancy Tax is not expanded by the amendments. In the example used in this paper, the true measure of consumption, the price the guest actually paid for the room, is \$70. Just because the remarketer pays \$50 and characterizes the additional \$20 he charges for the room as a fee attributable to his “demand collection system,” does not change the guest’s subjective valuation for the room. Both the US retail sales tax and the EU VAT measure the tax base subjectively – the value (in money) placed on the supply by the final consumer.

Self-enforcement. Although this characteristic of the VAT is under serious challenge in the fully developed EU VAT³³ – notably when exemptions, intangibles, and cross-border fact patterns are involved³⁴ – the simplicity of the New York Hotel Room

³² Fractioned payments is considered a bedrock principle by the International Monetary Fund’s study of VAT. See: Liam Ebrill, Michael Keen, Jean-Paul Bodin & Victoria Summers, *THE MODERN VAT* 3, at Box 1.1 indicating that the fractioned payment mechanism makes the VAT stable, secure, and eliminates tax-distortions in the market (emphasis added):

The key features of the Value-Added Tax are that it is a broad-based tax levied at multiple stages of production, with – crucially – taxes on inputs credited against taxes on output. That is, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. The advantage of such a system is that *revenue is secured by being collected throughout the process of production* – unlike a retail sales tax – but without distorting production decisions, as, in particular, a turnover tax does.

The ABA description is similar, but places an emphasis on comparative revenue yield. See: Alan Schenk, reporter, *Value Added Tax – A Model Statute and Commentary* 2:

An invoice method VAT may be viewed as *comparable to a retail sales tax collected in installments* because, with the same tax base and rate, a multistage VAT and a single stage retail sales tax that are shifted to consumers will raise the same of revenue.

³³ European Commission, *Green paper – On the future of VAT: Towards a simpler, more robust and efficient VAT system* (COM(2010) 695/4 indicating at 3-4:

After some 40 years, the time has come to have a critical look at the VAT system with a view to strengthening its coherence with the single market, its capacity as a revenue raiser by improving its economic efficiency and robustness, and its contribution to other policies whilst reducing the cost of compliance and of collection. ... Any such improvements require a comprehensive VAT system that can adapt to changes in the economic and technological environment and is solid enough to resist attacks of fraud of the kind experienced in recent years.

³⁴ For example, consider: Richard T. Ainsworth, *MTIC Fraud Infects Tradable CO2 Permits*, 55 *TAX NOTES INT’L* 733 (Aug. 31, 2009) (discussing structural problems in the EU VAT allowing fraud in cross-border tradable services); Richard T. Ainsworth, *CO2 MTIC Fraud – Technologically Exploiting the EU VAT (Again)*, 57 *TAX NOTES INT’L* 357 (Jan. 25, 2009) (predicting the range of services potentially subject to VAT fraud in the EU); Richard T. Ainsworth, *The Italian Job – Voice Over Internet Protocol MTIC Fraud in Italy*, 58 *TAX NOTES INT’L* 721 (May 31, 2010) (examining the fraud in VoIP at Italia Telecom and Fastweb); Richard T. Ainsworth, *VAT Fraud: The Tradable Service Problem*, 61 *TAX NOTES INT’L*.

Occupancy Tax allows this traditional strength of the VAT to shine.³⁵ Self-enforcement is one of the principle reasons that countries have switched from a retail sales tax to a VAT.³⁶

Self-enforcement in the context of the Hotel Room Occupancy Tax means that because (a) all New York remarketers must register and pay tax on the rooms they purchase for re-sale, and (b) because the tax paid to the hotel is refundable *only if* the remarketer collects and remits tax from the guest, then (c) the structure of the tax compels compliance. In other words, the Hotel Room Occupancy Tax is self-enforcing because remarketers cannot avoid paying tax to the hotel, and would be foolish to forgo a refund of this amount by not collecting tax on the resale.

As a result, in these difficult economic times when the call for “no new taxes” is heard in tandem with a demand for more revenue to pay for necessary programs, New York seems to have accomplished the impossible. By adopting a limited purpose, European-style, credit-invoice VAT in the hotel tax it has increased revenue and decreased enforcement costs without raising rates or expanding the tax base. Other jurisdictions should take notice.

217, 218-20 (January 17, 2011) (discussing the morphing of Missing Trader Intra Community fraud into Missing Trader Extra Community fraud).

³⁵ Liam Ebrill, *supra* note 32, at 140 indicates:

VAT literature initially emphasized the self-checking mechanism of the VAT (through the chain of invoices that are required at each stage through the retailer). This could be seen as consistent with implementing self-assessment procedures – if the VAT is a “self-enforced” tax, it should also be “self-assessed.”

³⁶ Ben Terra, SALES TAXATION – THE CASE OF THE VALUE ADDED TAX IN THE EUROPEAN COMMUNITY (1988) at 149 notes (citing to the Canadian Department of Finance TAX REFORM REPORT (June 1987) at 27:

The difference of VAT, as a multi-stage sales tax and the retail sales tax is one of degree. However, the retail sales tax, by virtue of its technique of levying, has a greater susceptibility to non-compliance. VAT, by dispersing the collection of the tax over a number of points, reduces both the incentive to misreport and the revenue consequences of misreporting. On balance a VAT is superior to a RST in this regard.

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Prepared Statement of Sal Tranchina Jr.

Sal Tranchina, Jr.



18665 Clear Creek Lane
Covington, La 70435
Ph 985-809-7680 Fax 985-809-6958

Reference: Bill HR-25

To Whom,

I want you to know that I am a supporter of this Bill HR25.
Anything that you can do to have this bill come into effect would be greatly appreciated.

E-Mailed by
Salvatore Tranchina, Jr.

Thanks

Prepared Statement of Scott Lombardo

7-26-11

To: Committee on Ways and Means

Greetings,
In considering "The Fair Tax" to replace the present Federal Taxation system for Income Tax and Social Security, please base that consideration on NOT exempting any "Purchase" transaction between any seller and any final retail consumer.

Also include every purchase made for investment. The broadest base for taxation will minimize the now planned 23% Fair Tax rate. Taxation on investment will reduce speculation that now plagues the commodity and stock markets.

Don't exempt any transaction of any type between any seller and any retail consumer.

Include Political Contributions of any type, as "Purchase" transactions, between any giver and any final-consumer receiver, be they a candidate, political party or PAC. That is what they have become.

Donation to a Federal Election Commission de-links contributor from receiver. Those transactions would be donations, not Purchases.

Thanks.

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Prepared Statement of Shawn Murphy

SUBMISSION TO THE HOUSE WAYS AND MEANS COMMITTEE'S HEARING JULY 26, 2011 ON:

Tax Reform and Consumption-Based Tax Systems

Chairman Dave Camp and Committee Members,

I have been a Personnel Director of governmental employees for 28 years, Building Contractor for many years and been married 26 years to my wife, a CPA and partner in her accounting firm. This background, along with much not stated, has given me the opportunity to evaluate our nation's current tax system and compare it to other proposed systems, including HR 25, S 13 or the Fair Tax.

I can state the following as facts:

- All persons I have witnessed interacting with the current federal income tax system believe the system to be unfair, complicated, and tolerated only because of the incorrect belief that an alternate more fair and less complicated system is not available.
- The current federal income tax system produces a very large amount of unintended harmful consequences, most of which have never even been identified, for the constituency of each member of Congress.
- The current federal income tax system produces much uncertainty about future tax liabilities resulting in depressed business activity and less job creation.
- HR 25 (Fair Tax) is an available alternative, to the current federal income tax system, and is fairer (among other reasons, everyone knows what everyone else is paying) and less complicated.
- All members of Congress, regardless of political identity, can reduce unintended harmful consequences of the current federal income tax system on their constituency by adopting HR 25 (Fair Tax).
- And perhaps the most important fact is, HR 25 (Fair Tax) will stabilize and make known, to a much greater degree, future tax liabilities, aiding all future planning and allowing more business risk, because some unknowns have been eliminated, thereby resulting in more job creation.

Shawn Murphy
115 Outrigger Drive
Kill Devil Hills, NC 27948



Prepared Statement of Steven M. Puma

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Title of Hearing: Hearing on Tax Reform and Consumption-Based Tax Systems

On June 7, 2007, the following article, written by myself, appeared on TriplePundit.com, a major business and sustainability blog. I would like to submit the following excerpts, from the article, as my testimony for the Ways and Means Committee's Hearing on Tax Reform and Consumption-Based Tax Systems, explaining why I think the United States Congress should adopt the FairTax legislation.

Promote Sustainability by Rethinking the Income Tax?

As a first-semester student in Presidio School of Management's MBA in Sustainable Management program, I've been learning quite a bit about what sustainability really means, and what it will take for business and our economy to become sustainable. One topic that gets discussed quite a bit is how to encourage people and business to use natural resources more efficiently, while encouraging them to use more of the one resource that isn't in short supply: human labor. Inevitably, the discussion turns to tax policy, specifically, how the US income tax system makes labor more expensive while discouraging savings and encouraging consumption. One professor suggested that a possible solution is to stop taxing labor and begin to tax things that we want less of, like carbon emissions.

This really caught my attention, because I have been a long-time advocate of the FairTax legislation, which would replace the Federal income tax and payroll taxes, and many other federal taxes with a consumption tax. It occurred to me that enacting the FairTax would, in addition to a myriad of other benefits, solve one piece of the puzzle, namely untaxing labor and making labor more attractive in the marketplace. I also realized that there are a number of other benefits, of the FairTax, which apply to sustainability, such as encouraging savings and discouraging consumption, encouraging purchases of used items (re-use), encouraging investment in education, and creating a safety net for the poor. In the remainder of this article, I will explain how the FairTax can be a positive tool in the effort to make the U.S. more sustainable.

The FairTax legislation is a nonpartisan effort to create a simple, fair and transparent tax system which does not favor any particular ideology. The FairTax bill was first introduced into Congress in 1999, and has been re-introduced in each successive congress, substantially unaltered.

I am sure you are painfully aware of the many problems with the IRS and the income and payroll tax system in general, so I will not bore you with a lengthy discussion of those. This article give a good overview of the costs of compliance inherent in the current

system and this article talks about the origins of the income tax.

The greatest benefits of moving away from the current system, based on income and payroll taxes, lie in its effects on wage earners. Under the current system, employees have income, and payroll taxes (social security and medicare), deducted from their paychecks, before they get a chance to decide what they would like to do with that money.

Employers also pay payroll taxes, equal to the amount that each of their employees pay. Since this cost is born by the employer, it is, essentially, a tax on labor. The effects of a labor tax are decreased employment, decreased pay and increased prices on goods. It should also be noted that payroll taxes disproportionately affect low- and middle- income workers, because the tax is only applied to the first \$90,000 of wages. By eliminating income and payroll taxes, real wages will increase, employment will increase as the cost of labor goes down, and, consequently, the price of goods will decrease.

My favorite benefit, of the FairTax, is regaining control over my income. By eliminating the income and payroll taxes, and enacting a sales tax, my income, once again, become "my" money. (Currently, the U.S. government, considers it to be "their" money, until they get their share.) Under the FairTax, I don't have to worry about 401(k)s, medical savings plans, etc., because everything has become pre-tax!! With the FairTax in place, if I want to save my money, to buy a house, I can save as much as I want, and not pay any tax on that savings (at least until I buy the house) This means that I will be able to achieve my savings goal faster. If I simply want to pay less taxes, I can endeavor to purchase less.

When many people think about a sales tax, they assume that the sales tax will not be progressive, and will negatively affect the poor, since poor people spend a much higher percentage of their income on necessities. This is not so, under the FairTax plan, because each legal taxpayer in the U.S. will receive a monthly check, called the "prebate", for the amount of tax they would pay, on purchases up to the poverty level of spending. This prebate would protect all families from paying sales tax on the necessities of life. Thus, a couple, with two children, receives a prebate of \$6,297 per year, allowing them to consume \$27,380 free of tax, and reducing the effective tax rate, on this family's annual spending of \$54,760, to 11.5 percent. In contrast, all families today, even the poor, pay 15.3 percent in payroll taxes.

The FairTax is the only tax reform plan that can entirely eliminate taxes for the most poor among us, because it is the only tax reform plan that repeals the high, and regressive, payroll tax. In addition, taxpayers, who earn well below the poverty level wage, will see their effective tax rate drop, up to the point where they actually have a negative tax rate. This is commonly known as creating a "floor" for the worst off in our society, such as homeless persons, by providing them with a basic level of income.

The FairTax considers education to be an investment, and, as such, it is not taxed. This makes it much easier for people to afford to pay for college, and, with the previously

mentioned incentive to save, helps them to save for college, as well. In creating a sustainable world, we want to make more use of human resources, and less of natural resources, and I can think of no better way to do this than by having more people go to college.

On a final note: elimination of the IRS and the income tax, and implementing a consumption tax will have one very direct environmental impact: a massive reduction in the use of paper. Reportedly, the IRS sends out 8 billion pages of forms and instructions each year. Laid end to end, they would stretch 28 times around the earth. Nearly 300,000 trees are cut down yearly to produce the paper for all the IRS forms and instructions. A consumption tax, administered by the states, has a much smaller bureaucracy and a greatly reduced need for paper consumption.

I feel that the income tax challenge seems as insurmountable as the sustainability challenge. I would like to put forth that they are actually the same struggle: the struggle for a fair and equitable world.



Prepared Statement of Todd Sarmiento

August 8, 2011

U.S. House of Representatives
Ways and Means Committee

Dear Chairman Camp, Ranking Member Levin and members of the Ways and Means Committee:

First, thank you for holding the hearing on Tax Reform and Consumption Based Tax Systems. I watched the entire hearing via the Ways and Means Committee video archive. I was very pleased to hear Chairman Camp say in his opening statements that, "...**most importantly** we will talk to the American people... families who are actually affected by the laws we pass.... **They are the real experts and their voices are critical** as we explore and develop tax reform policy."

I am one such family. I am one such expert. The laws you pass affect the born and unborn in **my family**. Thus I hereby request that you incorporate my comments into the hearing record and ask that you to give due consideration to my submission. I further request that the Committee approve, recommend, vote or otherwise advance the Fair Tax bill to the House floor for a full debate.

To give you a brief background, my name is Todd Sarmiento. I am a private citizen. I am not submitting this information on behalf of any organization. I am making this written submission for the official hearing record because I want my voice to be heard on this matter of incredible importance to my family's freedom and financial independence and security. I have a BS degree in Economics from Pfeiffer University and am a certified internal auditor with 20 years of audit experience in the private sector.

I listened to all of the witnesses that testified during the hearing. I believe the best tax system for me, my family, friends, neighbors, coworkers and fellow Americans is the Fair Tax.

The current tax system penalizes productivity and savings. **The Fair Tax encourages productivity, savings and frugality**, which is exactly what we need and should be encouraging in this country. This is entirely consistent with the spirit of the Constitution of the United States and the federal government's charge to promote the general welfare. Our federal, state, and local governments spend too much. Most Americans live beyond their means.

Living within our means and saving for a rainy day are principles that are critical to our nation's economic wellbeing. I am a prime example of this principle. I was laid-off in December 2008 and even though I immediately initiated an arduous job search it still took me 10 months to find a full time job. During this period, I had to pay my mortgage, property taxes, medical insurance premium, auto insurance premium, utilities, food and other expenses. Most notably, six months after I was laid off, my wife gave birth to a beautiful little boy. With this blessing also came additional medical bills. Due to my frugality, I paid all of my obligations in full and on time.

Aside from the sense of personal accomplishment that comes from being able to pay my bills, my frugality also contributed to America's economic wellbeing. I did not add another house to the foreclosed home inventory. I did not add another car to the repossessed vehicle inventory. I did not default on any credit card debt or medical bills. While the current recession is supposedly the worst in 70 years, I contend that without my fellow fiscally responsible Americans and me, we would be talking about a depression and not a recession.

To add some historical context to this principle of frugality, **Benjamin Franklin**, one of our great Founding Fathers and very successful by any definition, **attributed much of his success to frugality and wrote his autobiography in part to share this belief with his present and future Americans**. His message is of lasting importance and speaks to us today. The Fair Tax is consistent with this principle.

The Fair Tax sets a tax rate that is uniform throughout the United States. The current income tax system charges different rates to different groups of people and gives deductions and credits to others. Article I Section 8 of the Constitution states that taxes should be uniform throughout the United States. The current

income tax system is discriminatory and inconsistent with the Constitution. The Fair Tax is consistent with the Constitution.

The Fair Tax will broaden the tax base, thereby reducing the tax burden on any one American. It will enable the government to collect taxes from individuals who now avoid taxes by "working under the table" or make money from illegal activities, to the extent that these individuals purchase goods and services.

The Fair Tax is clear and simple. The current tax system is broken and incomprehensible. To echo the words of Thomas Jefferson, lawmakers purposely makes laws so complicated that they are not easily understood by the citizenry so as to fatigue them in their efforts to decipher them and increase citizens' reliance on the lawmakers. The current tax code is a perfect example. It is ~70,000 pages and the cost of compliance is ~\$500 billion annually. This ensures power is concentrated in the hands of the lawmakers.

Converting from the current income tax system to the Fair Tax would result in the largest transfer of power in my lifetime, from the federal government and its lawmakers back to the American people. No more tax loopholes for large campaign contributors. No more hidden taxes on unsuspecting or uninformed Americans.

As Congressman Herger made clear during the hearing, a tax system that hides the tax rate is not in the interest of the people. The Fair Tax encourages transparency in the tax rate. This will make it clear to all Americans how much it costs to run our government. This improved visibility, awareness and understanding will enable us to better assess the costs and benefits of our federal spending programs. It will dispel the notion that some Americans hold that they are getting something for nothing and this will change the nature of the debate when new federal spending programs or increases in existing programs are proposed. I contend that it will result in fewer increases in spending and over time will force the federal government to live closer to its means.

The "prebate" provision of the Fair Tax ensures that those who live at or below the poverty level are not unduly burdened by the tax.

I believe the Fair Tax will enable the government to collect taxes more efficiently, will practically eliminate the IRS and will not result in a higher rate of tax evasion as compared to the current tax system.

I would like to include one point of note related to the conduct of certain members of the Committee. As representatives of the people, it is your sworn duty to represent us and uphold the Constitution. In this regard, I was disappointed by and lost respect for a number of Committee members who clearly were unwilling to consider the pros and cons of the Fair Tax in good faith. The Fair Tax is not a ridiculous idea as one member stated. It was apparent that certain members had already made up their minds and used their time to state their beliefs and further their agenda rather than inquire of the witnesses to try to further their understanding of the alternative tax systems being presented. They are clearly interested in preserving the status quo and preserving their power. This is unacceptable.

In closing, I urge all members of the Committee to support the Fair Tax and advance this bill to the House floor for a full debate in this session of Congress. The Fair Tax will help put our economy on a course for prosperity and growth. It will put Americans back to work. It will put money in their pockets and money earned will put pride and confidence in our people. Proud, confident and self-reliant Americans can overcome any difficulty and will be a force for good across this great land and around the world.

I am a proud American. I love this great country and firmly believe that the Fair Tax will fix more than just America's broken tax system.

God Bless You and God Bless America!

Sincerely,
Todd Sarmiento



Prepared Statement of VATinfo.org

VATinfo.org

Submission to Committee on Ways and Means:
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 Hearing on Tax Reform and Consumption-Based Tax Systems

VIA email: waysandmeans.submissions@mail.house.gov

July 24, 2011

Hon. Dave Camp, Chairman
 COMMITTEE ON WAYS AND MEANS

**Re: Hearing on Tax Reform and Consumption-Based Tax Systems
 Value Added Tax; VAT Reference Resource Website**

Dear Chairman Camp and Committee Members:

To assist the COMMITTEE ON WAYS AND MEANS in its consideration of a Value Added Tax, this submission includes a complete list of the VATinfo reference website articles, Op/Ed's, videos and books that explain and advocate a Value Added Tax for the United States. The website contains excerpts and links to the primary sources. It is a resource for informed voices when you seek answers to follow-up questions on the need for and implementation of a VAT.

It is a given that our country, today, is at a pivotal financial moment. We need to restructure our tax system for international competition and for greater economic growth. We need more job creation and more investment, and government should employ a new balanced tax policy that would support business by stimulating both domestic demand and sales to other countries. VAT is part of that picture.

The U.S. is at a competitive disadvantage by not employing a VAT, which would work to create a more level playing field in this era of globalization. Today, all of our trading partners employ a VAT, as do over 150 countries. The VAT concept, approved under GATT rules, is border adjustable and subtracts the burden of government from the price/value competition of goods and services in world trade. Replacing the Corporate Income Tax (in whole/or part) with a VAT would stimulate export growth, and would support domestic production and workers who compete against imports from countries with lower labor costs.

The federal budget is in huge deficit now, with three dollars expended for every two dollars collected in tax revenues. Even after the economy rebounds, deficits are still projected to expand further with the increase in expenditures for Social Security, Medicare and Medicaid as the baby boomers reach retirement age in greater numbers. After all practical spending cuts are made, additional taxes may still be required to achieve a balanced budget. Most economists and most citizens would prefer to have any future tax increase in the form of consumption taxes rather than income taxes.

The VAT could be implemented in a revenue-neutral tax plan that affords flexibility for increases as needed after the economy recovers. But, for political considerations as well as stimulus, a VAT would likely be implemented along with an initial reduction to overall taxes, similar to what Canada and Japan did.

Chairman Dave Camp
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Revenue-neutral replacement of the Corporate Income Tax with a VAT would eliminate a competitive disadvantage in world trade, and there are more stimulative benefits to be gained from this substitution. The VAT, replacing the CIT, would eliminate the incentive for U.S. multi-national corporations to use transfer pricing to shift profits to lower-taxed countries, as the U.S. would become the lowest corporate-taxed country. The U.S. would become a mega-magnet for foreign investment. Gone would be the double-taxation of dividends. And, with a broad-based VAT without preferences, gone would be the endless corrupting of the tax code by lobbying for loopholes.

In addition, the time-certain implementation of a VAT would be an off-budget stimulus, as consumers would likely speed up purchases to avoid the VAT. The VAT would work to restructure the economy by putting a drag on consumption and encouraging savings.

The ideal implementation would replace all tax revenue sources with a VAT balanced by a flat (or tiered) Personal Income Tax with a high standard deduction above median income. The lowest quintiles would be cushioned for the VAT through the EITC. This balanced approach to sweeping tax reform was recently endorsed by Governor Mitch Daniels. It would be a *valuable contribution* to the discussion of tax reform if the COMMITTEE ON WAYS AND MEANS were to have this approach *scored* by OMB at different proportions of revenue from the VAT vs. PIT, plus variable tiers of the PIT and levels of the standard deduction and EITC. Key to this simplification is zero tax preferences for both the CIT and PIT.

Recommended video:

President Bill Clinton on "Deficit and VAT," interview with Maria Bartiromo, CNBC, 05/14/10

Especially recommended reading among the articles listed are:

Hufbauer, Gary Clyde and Woan Foong Wong, "Corporate Tax Reform for a New Century," Policy Brief, Peterson Institute for International Economics, April, 2011

Gale, William G. & Benjamin H. Harris, "A Value-Added Tax for the United States: Part of the Solution," Brookings Institution and Tax Policy Center, 07/2010

Should the Committee have need for contact information or other information, I would be pleased to assist.

Yours truly,

Steve Abramson

About the VATInfo website publisher: Steve Abramson is an entrepreneur and innovator, 1965 NYU MBA, who has created start-up companies in different industries. After his MBA, he worked briefly at Merrill Lynch as a Corporate Planning Analyst, and shifted to pursue his interests in marketing as an advertising executive at the core agency of Saatchi & Saatchi Advertising. Subsequently, Steve pursued opportunities in the printing industry where he founded companies on the leading edge of applied computer technology and where he became a major printer and publisher of pharmaceutical literature. Steve has published books on fine art and the First Amendment, and holds patents for a color communication standard which is licensed to all major computer imaging and design software. His diverse projects post-career have included real estate development in Long Island. He worked for Governor Jerry Brown's 1992 presidential campaign in New York, at which time Governor Brown called for sweeping tax reform with a VAT plus a flat tax on personal income. Steve and his wife live in Southampton, NY, where he is a leader and advisor in local governmental and environmental affairs.

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MATERIAL SUBMITTED FOR THE RECORD

Questions for the Record:

The Honorable Tom Price

COMMITTEE ON WAYS & MEANS

Tax Reform and Consumption-Based Tax Systems

July 26th, 2011

Questions for the Record from Dr. Tom Price

FairTax Panel:

Laurence J. Kotlikoff

Professor of Economics, Boston University

(Accompanied by David Tuerck, Executive Director, Beacon Hill Institute)

Questions to be submitted for the record:

- Dr. Kotlikoff and Dr. Tuerck: What is the size of the FairTax base relative to the income tax and other plans? Would a FairTax base be larger than a VAT base?
- Dr. Kotlikoff and Dr. Tuerck: What impact does a uniform tax rate and a prebate structure as offered in H.R. 25 have on marginal tax rates?
- Dr. Kotlikoff and Dr. Tuerck: According to your testimony the FairTax would be strongly progressive. Critics insist that any form of a national sales tax is a regressive tax structure. How is the FairTax, specifically H.R. 25, progressive in structure?
- Dr. Kotlikoff and Dr. Tuerck: Mr. Bartlett has asserted that the actual rate of the FairTax is 30%, not 23% as proponents say. Many commentators also argue the required rate in order to be revenue neutral would need to be much higher than 23%. Can you explain the tax-inclusive structure and justify the 23% rate as revenue neutral?
- Dr. Kotlikoff and Dr. Tuerck: Critics suggest that because the FairTax taxes government purchases, it would impose a new burden on government, particularly on state and local government. Would you please address that concern?
- Dr. Kotlikoff and Dr. Tuerck: To what extent does the current system hurt American exporters? What affect would the FairTax have on American trade more broadly?

COMMITTEE ON WAYS & MEANS
Tax Reform and Consumption-Based Tax Systems
 July 26, 2011

Answers to Questions for the Record
 Addressed to Drs. Laurence J. Kotlikoff and David G. Tuerck
 September 15, 2011

Question (1):

Dr. Kotlikoff and Dr. Tuerck: What is the size of the FairTax base relative to the income tax and other plans? Would a FairTax base be larger than a VAT base?

Answer:

Table 1 displays the tax base for four tax systems for 2010 and 2005 – the FairTax, the Current System, the flat tax and the business transfer tax, which is a VAT. In 2005, the FairTax had the largest tax base; at \$9.355 trillion, it is \$256 billion greater than the BTT base (\$9.099 trillion), \$1.822 trillion greater than the flat tax base (\$7.533 trillion), and \$2.322 trillion greater than the current system (\$7.033 trillion).

Recent economic performance has altered the results of the base comparison slightly for 2010. On a net basis, the BTT has the largest tax base; at \$9.529 trillion, it is \$18 billion higher than the FairTax base (\$9.511 trillion), \$915 billion larger than the flat tax base (\$8.614 trillion), and \$1.529 trillion more than the current system (\$8.000 trillion). The FairTax and BTT bases are largest because they avoid the exemptions and deductions characteristic of the other systems.

Table 1: A Comparison of the Tax Bases of Different Tax Systems

Tax Plan	Base 2010 (\$ trillions)	Base 2005 (\$ trillions)
FairTax	9.511	9.355
Current System	8.000	7.033
Flat Tax	8.614	7.533
Business Transfer Tax	9.529	9.099

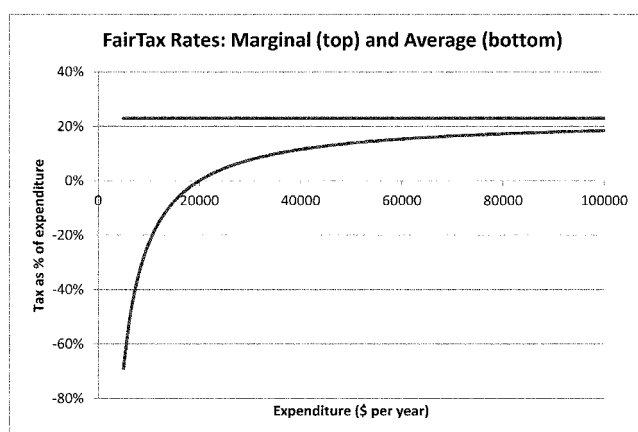
The VAT, flat tax and FairTax bases should be roughly the same, as all are levied on consumption. Differences would arise around details concerning exemptions and the size of the FairTax prebate. The VAT and FairTax are based on the destination principle and therefore tax imports but not exports. The flat tax is based on the origin principle and therefore taxes exports but not imports.

Question (2):

Dr. Kotlikoff and Dr. Tuerck: What impact does a uniform tax rate and a prebate structure as offered in H.R. 25 have on marginal tax rates?

Answer:

The FairTax would have a *marginal* tax rate of 23% (on expenditures) for all individuals, including the poor. However, someone at the poverty line would have a 0% *average* tax rate. This diagram shows the effect:



We may also address the question by comparing the marginal effective federal tax rates on working (i.e. on labor income) between the FairTax and the current system. Laurence Kotlikoff and David Rapson provide Table 2 below, which compares current-system and FairTax marginal rates.¹

¹ Laurence J. Kotlikoff and David Rapson, *Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Income Taxation*, October 2006.

Table 2: Marginal Effective Federal Tax Rates on Working, FairTax vs. the Current System

Single Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$10,000	-23.1%	23.0%	-23.2%	23.0%	29.8%	23.0%
\$15,000	33.3%	23.0%	33.8%	23.0%	22.4%	23.0%
\$25,000	34.2%	23.0%	47.7%	23.0%	26.2%	23.0%
\$35,000	50.2%	23.0%	28.3%	23.0%	29.0%	23.0%
\$50,000	28.2%	23.0%	22.4%	23.0%	36.5%	23.0%
\$100,000	27.6%	23.0%	27.5%	23.0%	28.6%	23.0%
\$250,000	41.5%	23.0%	37.2%	23.0%	35.5%	23.0%
Married Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$20,000	33.8%	23.0%	41.4%	23.0%	23.5%	23.0%
\$30,000	33.7%	23.0%	47.6%	23.0%	28.2%	23.0%
\$50,000	28.0%	23.0%	28.2%	23.0%	28.2%	23.0%
\$70,000	28.3%	23.0%	28.2%	23.0%	32.7%	23.0%
\$100,000	33.5%	23.0%	33.7%	23.0%	34.3%	23.0%
\$200,000	35.3%	23.0%	31.2%	23.0%	37.5%	23.0%
\$500,000	38.4%	23.0%	38.4%	23.0%	37.2%	23.0%

It is also useful to consider the marginal effective federal tax rates on saving. The FairTax rate on savings is 0%, in contrast with the current system, which taxes much of personal saving (unless it is put into an IRA or equivalent vehicle). Kotlikoff and Rapson estimate the marginal effective federal tax rates on saving based on the assumption that the return would be taxed at the capital gains or dividend rate; these are shown in Table 3.

Table 3: Marginal Effective Federal Tax Rates on Savings Assuming Return is Taxed at Capital Gains/Dividend Rate

Single Households				Married Households		
Total Household Income	Young Adult (Age 30)	Middle Aged (Age 45)	Senior (Age 60)	Young Adult (Age 30)	Middle Aged (Age 45)	Senior (Age 60)
\$10,000	24.6%	25.0%	21.5%	26.3%	25.9%	21.3%
\$15,000	24.6%	25.1%	20.7%	26.9%	26.1%	21.4%
\$25,000	24.7%	26.5%	20.1%	27.3%	26.5%	21.1%
\$35,000	25.2%	26.9%	24.0%	27.8%	27.2%	23.7%
\$50,000	25.3%	27.8%	23.9%	31.9%	29.2%	27.6%
\$100,000	28.8%	33.8%	38.1%	32.9%	34.1%	29.7%
\$250,000	30.4%	33.7%	26.9%	39.8%	38.3%	29.8%

Question (3):

Dr. Kotlikoff and Dr. Tuerck: According to your testimony the FairTax would be strongly progressive. Critics insist that any form of a national sales tax is a regressive tax structure. How is the FairTax, specifically H.R. 25, progressive in structure?

Answer:

Many people view moving to consumption taxation as regressive. These same people would view switching from our current system to a tax on existing wealth, whose proceeds are used to lower the taxation of labor income, as highly progressive. But it is not possible to hold both beliefs since a consumption tax is identical to a tax on existing wealth and current and future wages, and a tax on existing wealth and current and future wages is identical to a tax on consumption.

If people who oppose a consumption tax understood that it embeds a significant wealth tax, they would likely support it. In this regard, it is paradoxical that Democrats appear to oppose consumption taxation, whereas Republicans appear to support it.

Economists measure tax progressivity in terms of lifetime net tax rates, specifically as the ratio of the present value of lifetime net tax payments divided by the present value of lifetime resources (initial wealth plus the present value of future labor earnings).

Politicians like to measure tax progressivity in terms of current taxes divided by current income. But current income is not a useful measure of a person or household's economic resources. Warren Buffett may have zero current income this year if his capital losses are large enough to offset his capital gains, but his personal resources are immense. By measuring tax progressivity incorrectly, politicians conclude that a consumption tax is regressive, whereas economists view

it as proportional. The economists are right. Since a consumption tax is, in essence a tax on existing wealth and the present value of wages, taxing consumption at a fixed rate is taxing economic resources (existing wealth and the present value of wages) in proportion to the level of those resources.

By adding its demogrant/prebate, the FairTax transforms a proportional consumption tax into a progressive one. Table 4 below, shows that the FairTax reduces lifetime net tax rates substantially (thanks to its base broadening), while enhancing tax progressivity.²

Table 4: Average Remaining Federal Lifetime Tax Rates – the Current System vs. the FairTax

Single Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$10,000	-12.3%	-17.6%	6.2%	-13.5%	6.5%	-27.1%
\$15,000	-4.0%	-5.0%	11.3%	-10.0%	9.8%	-28.0%
\$25,000	10.2%	5.6%	17.7%	4.7%	14.1%	-6.2%
\$35,000	18.5%	10.1%	20.7%	5.4%	16.7%	-5.9%
\$50,000	21.1%	13.5%	23.5%	11.4%	21.5%	3.9%
\$100,000	27.5%	17.8%	30.3%	14.7%	32.1%	9.2%
\$250,000	27.9%	20.8%	33.6%	19.7%	40.8%	18.2%
Married Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$20,000	3.1%	1.3%	11.0%	1.5%	7.2%	-11.0%
\$30,000	12.5%	7.8%	15.3%	3.4%	10.1%	-10.5%
\$50,000	19.1%	13.4%	19.6%	11.1%	14.2%	1.4%
\$70,000	21.1%	15.6%	21.3%	11.6%	17.0%	2.2%
\$100,000	23.2%	17.4%	24.0%	14.7%	22.4%	7.9%
\$200,000	27.2%	19.7%	29.0%	17.0%	32.2%	12.3%
\$500,000	30.6%	21.6%	35.6%	20.5%	41.5%	19.3%

² Ibid. See also David G. Tuerck, Jonathan Houghton, Paul Bachman, Alfonso Sanchez-Penalver, and Phuong Viet Ngo, *A Distributional Analysis of Adopting the FairTax: A Comparison of the Current Tax System and the FairTax Plan* (February 2007):4, <http://www.beaconhill.org/FairTax2007/DistributionalAnalysisFairTaxBHI4-25-07.pdf>.

The traditional approach to measuring the distributional effects of a tax is (i) to make assumptions about the incidence of individual taxes (e.g. gasoline taxes are paid by those who buy gasoline, personal income taxes are borne by workers, etc.), and then (ii) allocate the taxes by income or expenditure per capita decile. Some results are shown below from a study by Haughton et al. (2009).³ Table 5 displays the results.

The results of the upper left panel show that if we divide people into deciles based on spending per capita, the FairTax would allow more spending for those in the poorest seven deciles, and reduce it for those in the top two deciles; over the long-term, when the FairTax has had time to raise GDP, only the top decile by this measure would lose from the FairTax.

As mentioned, some politicians prefer to show the breakdown of taxes by income (rather than expenditure) per capita. By this measure, the FairTax would hurt the poorest 80% of the income distribution in the short-term, and the poorest half in the long-term. This measure (as also mentioned) runs counter, however, to economic logic.

A second, complementary, approach to the distributional effects of the FairTax is to measure the average remaining federal lifetime tax rates of the current system, and compare them to the FairTax. Using a set of plausible profiles of individuals with different ages, incomes, and wealth, Kotlikoff and Rapson do this calculation. They show that when measured against income, both the current system and FairTax are progressive, with the FairTax favoring low-income households more than the current system.

In a separate study of the economic effects of the FairTax, the Beacon Hill Institute (BHI) attempted to capture the effect of income mobility by households.⁴ The study demonstrates that, over the long term, households in all income categories have a nearly certain probability of being better off under the FairTax compared to the current income tax.

We considered the realistic scenario, in which households experience different income levels over their lifetimes. We know, in fact, that individual households typically experience an increase in income as they advance from youth to middle age, which many taxpayers will do over a 25-year period. For this scenario, we considered the income mobility of households in each group over the 25-year time period. The results are reported on the last line of Table 6 and show that 91% of households will be better off over their lifetimes as a result of the FairTax. Even the losers would not lose by much; the biggest loser would see his or her utility fall by just 1.1%. Moreover, households in all income classes, on average, experience an increase in lifetime utility under the FairTax when compared to the current income tax. The

³ Jonathan Haughton, Paul Bachman, Alfonso Sanchez-Penalver, Ngo Viet Phuong, and David G. Tuerck, 2009, *Is the FairTax Fair?*, Suffolk University.

⁴ See David G. Tuerck, Jonathan Haughton, Keshab Bhattarai, Phuong Viet Ngo, Alfonso Sanchez-Penalver, *The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model* (February 2007):1, <http://www.beaconhill.org/FairTax2007/EconomicEffectsFTBHICGEModel4-30-07.pdf>.

Table 5: Expenditure and Net Income per Capita by Decile, with and without the FairTax

Expenditure per Capita Deciles	Expenditure per Capita					Income per Capita						
	With FairTax					Net of Tax, under						
	Under Current Laws	Net of Tax (Static)	Change (%)	Net of Tax (Year 25)	Change (%)	Gross, under Current Laws	Net of Tax, under Current Laws	Net of Tax, under FairTax (Static)	Change (%)	Net of Tax, under FairTax (Year 25)	Change (%)	
	A	B	C	D	E	F	G	H	I	J	K	
	Laws	(Static)	(%)	(Year 25)	(%)	Laws	Laws	(Static)	(%)	(Year 25)	(%)	
1 (poor)	3,437	5,040	47	5,246	53	11,768	10,245	11,849	16	13,057	27	
2	5,900	7,911	34	8,265	40	17,486	14,903	16,914	13	18,710	26	
3	7,985	9,854	23	10,333	29	19,333	16,235	18,104	12	20,089	24	
4	10,184	11,996	18	12,607	24	21,925	18,183	19,995	10	22,247	22	
5	12,725	14,545	14	15,309	20	25,610	21,048	22,868	9	25,498	21	
6	16,027	17,366	8	18,328	14	27,481	22,340	23,679	6	26,502	19	
7	20,322	20,863	3	22,082	9	29,731	24,012	24,553	2	27,606	15	
8	26,404	26,337	0	27,921	6	34,770	27,769	27,701	0	31,272	13	
9	37,155	35,242	-5	37,471	1	41,862	33,207	31,293	-6	35,592	7	
10 (rich)	92,652	83,638	-10	89,197	-4	82,028	62,612	53,598	-14	62,023	-1	
Total	23,278	23,278	0	24,675	6	31,199	25,055	25,055	0	28,259	13	

Income per Capita Deciles	Expenditure per Capita					Income per Capita						
	With FairTax					Net of Tax, under						
	Under Current Laws	Net of Tax (Static)	Change (%)	Net of Tax (Year 25)	Change (%)	Gross, under Current Laws	Net of Tax, under Current Laws	Net of Tax, under FairTax (Static)	Change (%)	Net of Tax, under FairTax (Year 25)	Change (%)	
	L	M	N	O	P	Q	R	S	T	U	V	
	Laws	(Static)	(%)	(Year 25)	(%)	Laws	Laws	(Static)	(%)	(Year 25)	(%)	
1 (poor)	16,406	12,980	-21	13,964	-15	1,243	619	-2,807		-2,680		
2	13,535	11,133	-18	11,945	-12	8,376	7,584	5,181	-32	6,042	-20	
3	15,761	13,378	-15	14,324	-9	11,540	10,230	7,847	-23	9,032	-12	
4	16,701	14,749	-12	15,751	-6	14,872	12,817	10,865	-15	12,393	-3	
5	18,222	16,483	-10	17,576	-4	18,322	15,626	13,887	-11	15,769	1	
6	19,525	18,399	-6	19,570	0	22,660	19,010	17,884	-6	20,211	6	
7	20,942	20,626	-2	21,883	4	28,229	23,278	22,962	-1	25,862	11	
8	25,801	25,593	-1	27,141	5	35,720	28,967	28,759	-1	32,428	12	
9	30,390	31,697	4	33,520	10	48,460	38,655	39,962	3	44,939	16	
10 (rich)	55,500	67,747	22	71,077	28	122,569	93,765	106,012	13	118,600	26	
Total	23,278	23,278	0	24,675	6	31,199	25,055	25,055	0	28,259	13	

percentage increase in utility, shown in the column labeled "Mean," ranges from 1.4% for the \$50,000 to \$74,999 income class to 3.0% for the more than \$150,000 income class.

We also undertook a second exercise, in which we started with a household in income category "less than \$10,000" (or \$10,000 to \$24,999) instead of picking the income category of the household randomly. We then used a transition matrix to trace out sequences of income over time, again for samples of 10,000. The result is a measure of the expected change in well-being, due to the FairTax, for someone who begins in income category "less than \$10,000" (or \$10,000 to \$24,999) etc.

The results are also shown in Table 6, and differ for each initial income bracket. For instance, if a household is initially in income group \$10,000 to \$24,999, there is a 94% probability that the household will be better off (in a lifetime utility sense) with the FairTax than without. Households who begin in the top bracket are almost certain to see an improvement in their condition (with a probability of 99.7%), as are those at the bottom of the income distribution (probability of 98%).

Table 6: Income Mobility and Utility Change Compared to Benchmark Models

Income class	Sample	Mean	Median	Min.	Max.	Probability of being better off
Less than \$10,000	10,000	2.0%	1.9%	-0.6%	11.1%	98%
\$10,000 - \$24,999	10,000	1.7%	1.5%	-0.9%	13.4%	94%
\$25,000 - \$49,999	10,000	1.5%	1.3%	-1.0%	10.2%	90%
\$50,000 - \$74,999	10,000	1.4%	1.2%	-1.2%	11.1%	87%
\$75,000 - \$99,999	10,000	1.7%	1.4%	-1.0%	11.0%	89%
\$100,000 - \$149,999	10,000	1.9%	1.6%	-1.2%	12.4%	90%
More than \$150,000	10,000	3.0%	2.7%	-0.3%	13.9%	100%*
Population (all classes)	10,000	1.7%	1.5%	-1.1%	11.8%	91%

Note: * 99.7%, which rounds to 100%.

So the choice of how to present the distributional effects matters a lot. The main problems with comparing tax payments to current income are (i) current income is more volatile than spending, and so is a poorer guide to "lifetime" income, (ii) welfare comes from consumption and leisure rather than income and (iii) measures of current income are particularly unreliable at the bottom of the distribution. For these reasons, we find the breakdown of tax incidence by expenditure per capita to be more compelling.

Question (4):

Dr. Kotlikoff and Dr. Tuerck: Mr. Bartlett has asserted that the actual rate of the FairTax is 30%, not 23% as proponents say. Many commentators also argue the required rate in order to be revenue neutral would need to be much higher than 23%. Can you explain the tax-inclusive structure and justify the 23% rate as revenue neutral?

Answer:

The answer to Mr. Bartlett lies in the distinction between a "tax-inclusive" and a "tax-exclusive" sales tax rate. Suppose that a good, say a pizza, reaches the counter of a retailer and that the retailer needs to collect \$10 in order to cover his costs (including profit). If there is no sales tax, the retailer charges his customer \$10, and that is the end of it. But now suppose the government wants to impose a sales tax high enough to collect \$3.00 from this transaction (given that production cost remains unchanged, at \$10.00). The retailer must now charge

\$13.00 for the same pizza. The \$3.00 that goes to the government is 23% of the \$13.00 that the retailer must now charge but 30% of the \$10.00 that he charged before the tax was imposed. If the government wanted to impose a uniform tax on all retail sales, it would write a law that requires retailers to pay 23% of the price they charge their customers, *inclusive* of the sales tax, or 30% of the price they charge *exclusive* of the sales tax.

The designers of the FairTax wrote the law in terms of the *tax-inclusive* rate. Had they wanted to, they could just as well have written it in terms of the *tax-exclusive* rate. The two rates are the opposite sides of the same coin.

Mr. Bartlett and others have criticized the law as written deliberately to understate the true FairTax rate. Whatever motives might have been at work here, there is an argument for using the tax-inclusive rate. The taxes to be replaced by the FairTax are all expressed in tax-inclusive terms. If the pizza retailer has \$100,000 in gross income and if his tax liability on that income under current law is \$23,000, then we would say his effective income tax rate is 23%. Congress could have written the current law as requiring this taxpayer to pay 30% of his after-tax income of \$77,000, but it did not; instead, they wrote it in terms of the tax-inclusive rate. The designers of the FairTax wanted to frame their proposal in terms of the tax-inclusive rate in order to facilitate an apples-to-apples comparison with the way current law is written.

The designers of the FairTax determined that the required tax-inclusive rate would be 23%. This is intended to be a revenue-neutral rate in the sense that it would fund all current federal expenditures funded by taxes to be replaced by the FairTax, plus the “prebate.” Once the law was put in place, there would be periods in which the FairTax would yield somewhat more than this amount of revenue and periods in which it would yield somewhat less, depending on the state of the economy and on how much Congress wanted to spend. To the extent that personal consumption, which makes up 82% of the FairTax base, is more stable than personal and corporate income over the business cycle, the legislated rate would raise more than is raised under current law during periods of contraction and less under periods of expansion.

In 2006, we and our co-authors estimated the revenue-neutral rate for 2007 to be 23.82%.⁵ We estimate that the rate that would have been required for 2010 was 20.13%. These calculations underestimate the required rate insofar as we ignored non-compliance and overestimated the required rate insofar as we ignored the “dynamic,” expansive effects that the new law would have (after a few years) on personal consumption.

It is important to keep in mind that the correct FairTax rate, whatever it is, does not depend on how the introduction of the FairTax affects producer costs or retail prices. In the foregoing example, the retailer raised his price by 30%, from \$10.00 to \$13.00. If we consider retailers in the aggregate, however, we have to keep in mind that the general price level is not something that an individual retailer controls; rather it is the monetary authorities, particularly the governors of the Federal Reserve System (the Fed), who determines the general price level. If

⁵ Paul Bachman, Jonathan Haughton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver and David G. Tuerck, “Taxing Sales under the FairTax: What Rate Works?” *Tax Notes*, November 13, 2006, p. 672.

we adopt the simplifying assumption that a 30% rise in the general price level requires a 30% rise in the money supply, then the general price level will rise by 30%, as in that example, only if the Fed “accommodates” by increasing the money supply accordingly.

We might imagine an opposite scenario in which the Fed doesn’t raise the money supply at all, which is to say it does not accommodate the imposition of the FairTax. What then happens to our pizza retailer? The answer is that the costs he incurs in form of wages and other costs would have to fall by 23%, so that if production cost was \$10.00 before the imposition of the FairTax, it would have to fall to \$7.70 under the FairTax and “non-accommodation.” Because the market price would then remain constant at \$10.00, a tax rate of 23% would yield \$2.30 in revenue.

Interestingly, the “real” effects of both scenarios – accommodation and non-accommodation – are identical. To see why, consider what happens to after-tax incomes and to tax revenues in the two scenarios. Suppose that the government taxed income at 23% before the FairTax was imposed. Workers and other factor suppliers who produced the pizza paid \$2.30 in income taxes for every pizza produced, leaving them with \$7.70 in after-tax income. Thus 23% (= $\$2.30/\10.00) of production went to government and the remaining 77% (= $\$7.70/\10.00) to the factor suppliers.

Next suppose that the FairTax is imposed and that the Fed accommodates. As before, 23% of production (= $\$3.00/\13.00) goes to government and 77% ($\$10.00/\13.00) to factor suppliers. Now, finally, imagine that the FairTax is imposed and the government does not accommodate. Again, 23% of production (= $\$2.30/\10.00) goes to government and 77% ($\$7.70/\10.00) to factor suppliers. The required rate and the share of income going to government and to the private sector do not depend on what happens to prices or production costs.

Question (5):

Dr. Kotlikoff and Dr. Tuerck: Critics suggest that because the FairTax taxes government purchases, it would impose a new burden on government, particularly on state and local government. Would you please address that concern?

Answer:

The FairTax imposes no new burden on the federal government, insofar as it merely replaces taxes implicitly paid by the federal government to itself under current law with a new tax that it also pays to itself. Suppose that it costs the federal government \$100,000 a year to employ a government worker or purchase materials, and suppose that the government taxes the income received by the worker or the producers of those materials at 23%. These taxes come out of the money that government pays in order to secure the services of the government worker or of the materials it buys. The government, in effect, charges itself and pays itself \$23,000 in taxes on this transaction.

Now suppose the government eliminates the income tax and replaces it with the FairTax. If the Fed accommodates, the cost of the worker or materials will rise to \$130,000, and, at 23%, the government will charge itself and pay itself \$30,000 in taxes. If the Fed does not accommodate, the cost will remain constant, and the government will charge itself and pay itself \$23,000 in taxes. In all three instances – current law, the FairTax with accommodation and the FairTax without accommodation – the government charges itself and pays itself taxes at the rate of 23%. Hence, adoption of the FairTax does not raise the cost of government.

The answer is somewhat more complicated, but essentially the same, for state and local governments. Just as with the federal government, state and local governments already, in effect, pay taxes to the federal government on their purchases of labor and materials. The FairTax just changes the way that the federal government collects those taxes, from taxing the income of persons who supply labor services or materials, to taxing state and local government purchases of the same services or materials. Either way, state and local government has to pay the federal taxes – indirectly through the taxed incomes of persons who supply services or materials, or directly on the purchases of those services or materials.

The difference lies in the way that state and local governments collect their own taxes. Suppose that a state imposes a 5% sales tax on the pizza in our earlier example. Under current law, and given that the cost of producing the pizza is \$10.00, the state collects 50¢ on each pizza sold. Now suppose that the FairTax is imposed and that the Fed accommodates, so that market prices rise by 30%. The price of a pizza rises from \$10.00 to \$13.00. If the state continues to tax the sale of the pizza on the price, exclusive of the FairTax, i.e., on the \$10.00 price, the state will still collect 50¢ on each pizza sold. But because prices are now 30% higher than before, that same 50¢ is worth 23% less than it was before. State revenues have not kept up with prices. The solution, however, is simple: the state should impose the sales tax on the tax-inclusive price of \$13.00. It will then collect 65¢ in tax revenue, which is exactly 30% more (in nominal terms) than it collected before. The answer, then, is that the FairTax imposes no new burden on state and local governments provided they adjust their tax laws in order to prevent the real value of their tax base from eroding under the FairTax.

Question (6):

Dr. Kotlikoff and Dr. Tuerck: To what extent does the current system hurt American exporters? What affect would the FairTax have on American trade more broadly?

Answer:

The current tax system is not particularly harmful to exporters; sales taxes are not levied on exports, but of course the cost of exports reflects the costs of taxes on capital and labor.

The FairTax would have a minimal impact on American trade. Taking a microeconomic view, we can make either of the following assumptions.

- 1) The Fed increases the money supply to accommodate the FairTax. Then:
 - a. In the United States, there will be no change in the price of U.S. imports from foreign countries relative to the price of domestically produced goods.
 - b. In foreign countries, there will be no change in the price of imports from the United States relative to the price of domestically produced goods.
 - c. Thus there will be no change in the U.S. trade balance and no change in the exchange rate.
- 2) The Fed does not increase the money supply to accommodate the FairTax. Then:
 - a. In the United States, the switch to the FairTax would make imports less attractive (because imports would now cost more than domestically produced goods). In foreign countries, it would also make imports from the United States more attractive (because imports from the United States would now cost less than domestically produced goods). The immediate result would be fewer U.S. imports and more U.S. exports, which is to say, an improvement in the U.S. trade balance.
 - b. However, the exchange rate is a market price, which equilibrates the demand for and supply of foreign exchange. A rise in exports, coupled with a fall in imports, would lead to an excess demand for dollars, which in due course would lead to an appreciation of the dollar in order to re-establish market equilibrium over time, thus eliminating the temporary improvement in the U.S. trade balance.

There may be macroeconomic consequences too, but these are somewhat harder to pin down. Among the effects:

- 1) In the short-run, U.S. households would save more under a FairTax. Some of this money may seek opportunities overseas, in which case the dollar would depreciate (in real terms) in the short-run. We may think of this as the U.S. needing to earn more foreign exchange in order to be able to pay for investments overseas. Over a longer horizon the dollar would appreciate as the proceeds of these investments are repatriated.
- 2) If the abolition of the corporation income tax (and other direct taxes) makes the U.S. a more attractive place to do business, foreign direct investment may flow into the country, causing the dollar to appreciate.
- 3) Over the very long run, the FairTax, by encouraging investment, should make U.S. workers more productive. Higher labor productivity is associated with currency appreciation, without any change in the balance of trade.

A Technical Explanation of the Microeconomic Impact of the FairTax on American Trade

The supply price of an *import* is given by the international supply price times the exchange rate

$$P_I^s = eP_I^*,$$

where e is expressed in terms of dollars per foreign currency (e.g., \$1.40/€), and P_i^* is measured in foreign currency (e.g., in euros). If there is no tax on the import, then the demand (i.e., consumer) price will be the same as the supply price, so

$$P_i^s = P_i^d.$$

The supply price of a *domestic good* is based on the wage divided by the marginal product of labor

$$S_i^s = \frac{w}{MP_{Li}}.$$

Again, if there is no indirect tax, the supply price will equal the demand price for the local good, so

$$S_i^s = S_i^d.$$

At a first approximation, competition forces the prices to be close, so

$$P_i^d \sim S_i^d.$$

With some algebraic manipulation we then have

$$e \sim \frac{w}{P_i^* MP_{Li}}.$$

Case 1: Price Accommodation

Wage rates remain unchanged in nominal dollar terms (because, although workers do not need to be compensated enough to pay income tax, they do need to be compensated enough to pay FairTax when they purchase goods and services). Imports will now pay FairTax (t), so

$$P_i^d = P_i^s(1+t) = eP_i^*(1+t)$$

and domestic goods will now pay FairTax, so

$$S_i^d = S_i^s(1+t) = \frac{w}{MP_{Li}} (1+t).$$

There is no reason to change the quantity of imports relative to domestic goods, so the exchange rate will be unchanged. This can also be seen mechanically, so we still have:

$$e \sim \frac{w}{P_i^* MP_{Li}}.$$

Likewise, the price of our exports would not change, and so their relative attractiveness on international markets would not change either.

Case 2: No Price Accommodation

In this case, wage rates fall in nominal dollar terms by the reduction in the personal income tax (t_p , which we assume for simplicity equals t), so $w_{new} = w/(1+t)$, and the domestic producer price will be lower. As before, consumers will now have to pay, for imports:

$$P_i^d = P_i^s(1+t) = eP_i^*(1+t).$$

But now domestic goods sell at the same price as before, given by:

$$S_i^d = S_{i,new}^s (1+t) = \frac{w_{new}}{MP_{Li}} (1+t) = \frac{\frac{w}{1+t}}{MP_{Li}} (1+t).$$

This would make U.S. imports less attractive to Americans, and it would also make U.S. exports more attractive to foreigners (because now the exports are put out onto the world market at a lower dollar price). The immediate result would be fewer imports and more exports. However, the exchange rate is a market price, which equilibrates the demand for and supply of foreign exchange; a rise in exports, coupled with a fall in imports, would lead to an excess demand for dollars, which in due course would lead to an appreciation of the dollar in order to re-establish market equilibrium. Mechanically, setting $P_i \sim S_i$ we get a new exchange rate:

$$e \sim \frac{w}{P_i^*(1+t)MP_{Li}}.$$

This represents fewer dollars per euro – i.e., the dollar appreciates – and this in turn will eliminate the temporary improvement in the current account.

