

RESPONSE TO CRITICS OF THE FAIRTAX PLAN

Synopsis

Below are detailed responses to FairTax criticisms but a short response to these attacks is: A frequent critic of the FairTax, who's employment has been centered around working with today's complicated tax code, seems to have intense motivation to disparage the FairTax which is the best hope for transformational tax reform. Instead of ending the IRS' reign of terror as the FairTax would, he wants to enable them to enforce an unproven tax code of his own creation. Why someone would dedicate so much time to keeping the IRS in our lives only raises questions as to his motivations.

An overview

The FairTax enjoys by far the largest groundswell of national grassroots support of any tax reform plan of the last 15 years or currently before Congress. As with any proposal of this magnitude, there are a few critics who consistently relay flawed and outright wrong information while attempting to make their case. One frequent commentator proudly states that he is a retired CPA/tax lawyer specializing in the taxation of insurance companies. What this individual fails to also tell readers is the magnitude of spending the insurance industry allocates to lobbying Congress for preferential tax treatments.

For example, in the 112th congress, the insurance industry alone spent in excess of \$45 million on exclusive tax preferences¹. These exemptions are paid for by hard working citizens who can't afford a stable of high priced lobbyists to plead their case for taxpayer relief, because every time a special interest obtains a tax preference the rest of us have to make up the difference.

To date, we have been unable to determine if this individual has any other demonstrable credentials in public policy or economics. It is our experience that those who spend a majority of their professional career in service to special interests intentionally fail to acknowledge the positive impact of the FairTax; perceiving it to be in conflict with their personal self interest (as well as that of their co-workers and clients) as it eliminates the trade in tax favors.

The purpose of this document is to provide a thoughtful response for readers seeking rational, research-based information on which to evaluate the FairTax and its critics. We fully expect these critics will continue with their opposition campaign and support their right to do so under the first Amendment of the Constitution. We would, however, encourage all readers to use sound research vs. opinion and conjecture when evaluating which tax plan best serves the American people as a whole. In fact, we recommend this process when deliberating any matter of public policy.

It is our hope that this document provides the reader with a basic foundation of factual information from which to begin that process.

The purpose of this document is to address the critics' most common misstatements/attacks so readers can make an informed decision on a subject as important to our nation's future as is federal taxation.

One Critic's Alternatives to the FairTax

One of the FairTax's most vociferous and frequent critics claims that he recognizes that our current tax system badly needs reform, just not the FairTax. He has advocated two different

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alternatives at different points in time. The first proposal was being advocated in 2010 while the second one receives the majority of his energy today. It isn't clear whether he has abandoned his first one or sees the second one as an interim step to get to it, so we will describe both of them here and point out the problems inherent in each one.

1. Head Tax - The national budget, after being reduced from 2013's \$3,454 billion to around \$800 billion per year, would be divided by the national population to arrive at an annual tax bill of approximately \$3K to \$4K for every man, woman and child in America. This would mean that a six week old infant would have the same tax liability as Bill Gates. To put this \$800B number in further perspective, in FY 2012 the federal government spent \$682 billion² on the military, and approximately \$360 billion in interest on the national debt³. In other words, this proposed reduced budget would not even cover the military and our minimum required debt service at 2012 levels, even if we totally eliminated the Justice Department and the federal court system, both houses of congress, the White House and all cabinet agencies, the State Department and all overseas embassies, the CIA and every other department of the federal government.

During a debate in 2010, the head tax author was asked if defaulting on the national debt was a component of his proposal and how the subsequent economic repercussions of that decision factored into his plan. He responded that default was not assumed in his plan; his head tax proposal would not be implemented until the national debt was paid off. At the time of this question, the national debt was somewhat above \$14 trillion (as compared to somewhat over \$17 trillion now). When asked how he thought that we could pay off \$14+ trillion in accumulated debt when we could not even get a balanced budget amendment through congress and continue with a tax system that hid the true cost of government from those who have to pay it, he responded with silence.

2. The Plan Z flat tax (we assigned this name to differentiate his proposal from the myriad of other flat tax proposals) - The author went to the internet and found a flat tax proposal which was specified in the form of a bill in congress - HR 1040. HR 1040 is a flat tax bill which was originally championed by House Majority Leader Dick Armey and has been reintroduced into every subsequent session of congress by his successor in TX CD #26, Rep. Michael Burgess, since Mr. Armey's retirement. HR 1040 has never recorded more than about 10 co-sponsors (as opposed to HR 25, which has had more than 70 at various times) and it is not even supported by a majority of those who call themselves flat taxers. Because it is not revenue neutral, it will never be taken seriously in congress.

Nevertheless, it was used as the starting point for still another flat tax proposal. Please understand that there is currently no shortage of flat tax proposals that have been floated by various groups. In addition to HR 1040, there is Hall-Rabushka, Governor Rick Perry's, Heritage Foundation's, Senator Richard Shelby (R/AL) has one and there are several others out there. Dr. Arthur Laffer even a version on The Glenn Beck Show a couple of years ago which replaced payroll taxes. This is in spite of the fact that most flat taxers criticize the FairTax for replacing payroll taxes. All of these are apparently lacking since new versions continually pop up like dandelions in a spring

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lawn. Flat taxers might be better served by spending their time and energy coalescing around a single flat tax proposal, rather than continuing to proliferate new versions. After all, if the minority who call themselves flat taxers cannot agree on a single proposal, how is the rest of the nation supposed to join them?

HR 1040 includes the following features:

- (a) It has a 17% single rate with a basic standard deduction plus additional standard deductions for dependents,
- (b) It is an option, meaning that taxpayers can make a one-time non-reversible election to file under the flat calculation method. This means that it retains the current dysfunctional tax system, since some taxpayers will not elect the new option. It actually adds to the current 70,000 page mess that no one understands, rather than reducing it to a more manageable number.

The author of this “new and improved” flat tax proposal changed both of these features with a mere wave of his hand. The process of modifying HR 1040 to meet the author’s personal preferences must have taken all of 15 or 20 minutes, since HR 1040 is a one page document. It is fairly easy to develop a tax reform proposal when you aren’t constrained by congressional rules and you aren’t really serious about seeing your proposal enacted.

This Plan Z flat tax proposal has a 10% flat rate with no deductions. It does not replace Social Security or Medicare taxes, so the combined stated tax rate on wages would exceed 25% inclusive, somewhat higher than the FairTax.

However, the *effective* rate (which is a far more relevant comparative measure) would be much higher than the FairTax. Although the nominal rate of the FairTax on a tax inclusive basis is 23%, the rebate mechanism reduces the effective rate for all consumers, significantly in most cases. Those spending at twice the poverty level, for example, pay an effective rate of half of the nominal rate, or 11.5%. This flat tax proposal has no deductions, so the nominal rate would be the same as the effective rate. That means that the flat tax proposal would represent an enormous tax increase for middle class Americans. See the last section of this paper which addresses the tax burden differential between three alternatives: flat tax vs. current system vs. FairTax.

Neither the head tax nor the Plan Z flat tax are documented as to their specifics, nor is there any written explanation of their benefits (that we know of). Neither of them have a grassroots organization mobilizing support for them, there is no website where an interested citizen can go to obtain more information nor are there any economic studies. There is no bill in congress for either of them, which also means, of course, that there are no co-sponsors. However, the author of these two unserious and deeply flawed proposals claims they are the result of “thorough professional analysis”.

SPECIFIC CRITICISMS

Charge #1

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The Head Tax and Plan Z Flat Tax proposals referenced above are the products of “thorough professional analysis”, the implication being that the FairTax is not.

Response

Some of our nation’s premier economists and marketing professionals were commissioned during the mid 1990s by Americans For Fair Taxation (AFFT) to conduct a series of economic and marketing studies to determine (1) what the American people wanted in a tax system and (2) what system would provide the least economic “drag”. This process required more than two years of development time. The marketing professionals were “loaned” by some of the nation’s most successful and respected Fortune 500 companies and the economists were employed by some of the nation’s leading academic institutions (Rice University, Harvard University, MIT) and “think tanks”. The marketing team was tasked with finding out what the American people, as a whole, wanted in a tax system and the economic team was tasked with making sure that “the numbers work”. The marketing techniques included telephone polling, targeted advertising, focus groups and measurement of website hits. Even the name “FairTax” was a by-product of this sophisticated process.

This was the most thorough and rigorous methodology ever employed to develop a federal tax reform proposal, and at over \$22 million, the most expensive. This research has been documented on fairtax.org and is referenced in a multitude of white papers published over the past 15 years. The proposal itself has been subject to periodic reevaluation by economists, Congressional researchers and the media.

The result, the FairTax Act, is now an active bill in both houses of congress (HR 25 / S 122) and its co-sponsors number almost a quarter of the members of the U.S. House of Representatives, approximately 10 times more than any other tax reform plan currently under consideration. It is publicly available for all to read and critique; unlike some critics’ proposals, which are not published, have not been reduced to legislative language, are not subject to media or public scrutiny, and typically do not have any supporting research studies or data available for review.

As explained in the section above entitled **One Critic’s Alternatives to the FairTax**, the methodology utilized to develop these two alternatives would be described as amateurish at best. It is also important to point a major difference relative to the fundamental assumptions underlying the critic’s approach to tax reform as opposed to what formed the foundation of the FairTax:

1. We don’t know what the best way to tax the American people is; we just know there has to be a better way than the one we have now and the quality of the work product is a direct reflection of the quality of the process. We trust the collective judgment of the American people.
2. The author is the sole authority for all matters having to do with taxation and it is neither necessary nor desirable to expend considerable time and energy finding out what the American public as a whole wants.

We will let the reader decide which tax plan has utilized the most “thorough professional analysis”.

Charge #2

The FairTax relies heavily on deceptive and dishonest promotional efforts.

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Response

FairTax volunteers are among the most selfless and sincere citizens in this nation today. Time and again, we hear our volunteers state that they do not expect much in the way of personal benefits from the FairTax. After all, many are toward the end of, if not already through, their earning years and the economic boost and job creation of the FairTax will primarily benefit today's younger generation, as well as future generations. They also state that, contrary to the unfounded charges of many of our critics, they would be willing to pay slightly more in taxes in order to leave behind a society which would have greater freedom, enhanced financial privacy, much greater economic opportunity and one that has addressed our current unsustainable trends such as the federal budget deficit, our enormous trade deficit, the looming insolvency of Social Security & Medicare, our chronically low savings rate, and our anemically slow rate of growth and job creation.

Unless our nation changes its trajectory with respect to these enumerated unsustainable economic trends, today's older generation will be the first in U. S. history which will pass along to the next generation a society with less opportunity than the one they inherited from their parents' generation. FairTaxers are, on the whole, extremely concerned about that prospect and it is that concern that animates and motivates us more than anything else.

Having said that, there are cases in which well-intentioned supporters have exaggerated or passed along opinion, rather than benefits for which we have solid economic support. We make every effort to "self-police" and correct our peers when these occurrences appear.

Of course, when you have a proposal which is only advocated by a single American, and you do not have any complex economic studies to explain to the average layman, you don't have these problems. We would also point out that demonizing the opposition under the circumstances described above is a highly deceptive and dishonest way to promote your alternative proposal. That is especially true when a critic spends 90% or more of his/her time and energy attacking the FairTax and its supporters and very little time actually explaining the benefits of his/her alternative.

The author of the Plan Z Flat Tax has even told audiences that his proposal will eliminate the I. R.S. As a self proclaimed "tax expert", he should know that an I. R. S. will be necessary for any type of income tax, whether the rate schedule is flat or graduated. A consumption tax (such as the FairTax) would eliminate the I. R. S. So who is guilty of utilizing "deceptive and dishonest promotional efforts"?

Charge #3

The actual FairTax rate would be in the range of 40 - 70%.

Response

The only reason the FairTax rate would exceed 23% would be to ensure that it is revenue neutral when subject to a static scoring methodology. Static scoring is the methodology required by congress for all tax reform proposals. Neither the Plan Z Flat Tax, nor HR 1040 (a flat income tax proposal that was the starting point for Plan Z) make any pretense of being revenue neutral on a static basis, which means neither proposal will ever be seriously considered by Congress. However, there is a blatant hypocrisy when the critics maintain that it is neither necessary nor desirable for their alternatives to the FairTax to be revenue

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neutral, but then to use artificially and dishonestly use inflated rates for the FairTax in order to achieve revenue neutrality.

Second, in arriving at a FairTax range of 40 to 70%, one critic of the FairTax uses the tax exclusive rate of 30% as his starting point rather than the 23% inclusive rate, refusing to acknowledge that this is a biased calculation approach favoring income taxes in any comparison. This is like comparing apples with oranges; they are both fruits but distinctly different. To compare the FairTax with an income tax, both tax systems must be reviewed on either an inclusive or exclusive basis.

Third, the critic asserts that state income taxes should be added to the FairTax rate in order to reach a “true rate”, adding that state sales taxes average 10%. We are not sure how this individual comes up with the 10% figure, given that states typically have a sales tax rate below 8%. Even if you add in county and local taxes, there are relatively few legal jurisdictions (and no entire states) with a rate that high. In addition, according to ITEP, the *effective* rate for sales taxes in the 50 states is less than 2%⁴.

The larger issue is that state sales taxes which are paid now would still be paid under either the FairTax or the Plan Z Flat Tax. Why, then, is the sales tax rate (irrespective of what you think that rate is) only added to the FairTax to get a “true” rate and not to Plan Z?

Fourth, some critics have calculated a higher (revenue neutral) rate for the FairTax Plan. None of these critics scored the FairTax legislation as written and submitted to Congress; choosing instead to score a modified version of the bill while dishonestly attributing their own elevated rate to HR 25, the FairTax. Neither the critics nor the supporters of the FairTax support these modified versions of the FairTax proposal. This raises the question of why anyone is wasting limited time and resources scoring a tax reform proposal which has absolutely no known support on the planet, rather than the tax reform proposal which has by far the most support of any tax reform legislation in congress. The answer seems obvious.

Fifth, critics ignore the removal of the embedded costs of the current tax system when projecting enormous increases in after-tax prices. Dr. Karen Walby, Americans For Fair Taxation Chief Economist, estimates those costs at approximately 12.5% for U. S. produced goods.

Sixth, some of the nation’s premier economists have validated the FairTax rate on multiple occasions. This is a fact that critics choose not to acknowledge in their opposition commentary.

Finally, the critics’ inflated rate is ostensibly necessary to compensate for a 30% evasion rate of the new tax. We address the compliance issue in the next charge.

Charge #4

Tax evasion (non-compliance) will skyrocket under the FairTax.

Response

This is another area where some critics have failed to provide supporting documentation for their assertions.

Here are the facts which have a bearing on why evasion under the FairTax is expected to be lower than it currently is with the present income tax system.

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- 1) 85% of retail sales occur in the largest 10% of retailers e.g. Walmart, Kroger, Home Depot, Target, etc. It is a generally accepted conclusion that major national retailers do not and will not conspire to evade federal taxes. The risk of detection is too high and the payoff is too small.
- 2) There are currently approximately 154 million tax returns (individual and corporate combined) filed annually. The FairTax would require approximately 20 million retailers to file annually

(an 87% reduction). It is much easier to enforce the tax laws when there are fewer points of collection/enforcement.
- 3) The current tax system exceeds 73,000 pages (according to Commerce Clearing House) and is expected to swell to over 100,000 pages with the addition of the Affordable Care Act regulations. As written, HR 25 contains less than 150 pages. Even if Treasury issues 500 additional pages of amplifying instructions, the FairTax would represent a simplification of approximately 99.1% if one accepts the number of pages as a reasonable approximation of complexity.
- 4) It is relatively simple for a sales tax auditor to reconcile sales reported on various sales tax returns to those on audited financial statements covering the same period of time. This is especially true with the broad base and no exceptions that are the hallmarks of the FairTax proposal.
- 5) With the income tax you can cheat the system by understating your income or overstating your expenses all by yourself. With the FairTax it takes two to cheat - the buyer and the seller. Even when dealing in just cash, all your customers will know if you are not collecting the FairTax - hundreds of potential witnesses including competitors willing to report you. If you are collecting and not remitting, a relatively simple audit will quickly detect (see #4 above). Because the FairTax is vastly simpler and has 90% fewer points of collection/remittance to the government (see #2 & 3 above), comparable resources allocated to sales tax enforcement will always result in higher compliance rates than would be the case with an income tax regimen.

Charge #5

The FairTax rate assumes 100% compliance - in spite of Charge #3.

Response

According to economist Dr. Lawrence Kotlikoff⁶ of Boston University, evasion was considered in the FairTax calculations. The FairTax base starts with personal consumption expenditures (PCE). PCE is part of the National Income Product Accounts (NIPA) and is kept by the Bureau of Economic Analysis at bea.gov. Kotlikoff explains NIPA underreported income is very closely related to NIPA unreported consumption. For example, a waitress that doesn't collect the FairTax on tips probably isn't reporting the tips under the current system. So this revenue doesn't show up under either system. The evasion is already reflected in the base used to calculate the FairTax. In essence, the FairTax rate calculation assumes that evasion will be just as high under the FairTax as it is under the current system - which we view as an extremely conservative assumption. The assertion that there will be more evasion under the FairTax is nothing more than a critic's (or multiple critics') uneducated opinion. As previously

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indicated, compliance is expected to be considerably greater under the FairTax than under the income tax, for all the reasons listed in the response to charge #3.

Charge #6

The FairTax would increase “welfare” and is more progressive than the current system.

Response

The FairTax “may” be more progressive than the current system, but if so, primarily because it replaces payroll taxes. The payroll tax is the most regressive of all taxes today. The poor pay it from the first dollar and higher earners are capped at a little over \$100,000. That makes it regressive. The FairTax applies to everyone equally as does the Prebate.

Under the current system, the U.S. incurs over \$900 billion a year in “tax expenditures” - also known as loopholes, exemptions and deductions. Many of these tax expenditures are regressive, only used by those who itemize and not available generally to the middle or lower income classes. The FairTax replaces that regressive \$900 billion in lost revenue allocated in a highly political manner with a \$440 billion a year Prebate that goes to every family equally. The Prebate is designed to untax everyone up to the poverty level without attracting lobbyists to the halls of Congress to exempt their goods or services from taxation.

The reason the word “may” was used in the first sentence of this rebuttal to Charge #6 is that under the current system, one needs to distinguish between theoretical progressivity and actual progressivity. The term “progressive” in relation to a tax system refers to a structure in which those at higher levels on the tax base (whether that base be income or consumption based) pay not only proportionately higher amounts, but also higher rates. The current system has a “progressive” rate schedule, which means that higher income individuals pay higher marginal and effective rates - in theory. However, because of “tax expenditures”, actual progressivity may be quite different. For example, when Ted Turner and Jane Fonda were divorcing in the ‘90s, *The Atlanta Constitution* reported that for the previous tax year, Mr. Turner reported taxable income of approximately \$125 million and paid taxes of approximately \$5 million. That is an effective rate of 4%. There are many taxpayers with incomes that are only a tiny fraction of Mr. Turner’s who would love to have an effective tax rate of 4%. This is the difference between a theoretical and an actually progressive tax system.

The FairTax (as described in the Summary above) was designed using a methodology that sought to determine what all Americans wanted in a tax system. One of the findings was that Americans, across all political and economic spectrums, did not want a tax system that was punitive to those at the lower end or that makes it extremely difficult for lower income individuals to be able to afford the necessities of life. With the Prebate, the FairTax is truly and consistently progressive, and especially advantageous to those on lower end of the economic ladder. The FairTax would return the concept of equal treatment under the law to our tax system for the first time in 100 years. This is not a Democratic, Libertarian or Republican ideal - it is an American ideal.

Another issue with respect to the alleged welfare increase is that some recipients of monthly rebates/prebates may spend less on consumption than the poverty level for their family size. They would therefore pay less at the cash register in sales taxes than they are receiving in monthly rebates. Although we are unaware of any independent data on this subject, it is

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unlikely that there are many American families who consistently spend below the poverty level, at least not by material amounts. All Americans presumably buy food and clothing and most lower income families pay rent. Energy and transportation are other necessities of life for almost all Americans. If a small minority of a small minority spends 10 to 20% less than the poverty level for their family and therefore receives a “windfall” of \$40 or \$50 per month, is that really a valid reason to deny the enormous economic benefits of the FairTax?

Charge #7

The FairTax is equivalent to “Marxism on steroids”.

Response

In plank #2 of *A Communist Manifesto*, by Karl Marx and Friedrich Engels, the authors propose “A heavy progressive or graduated income tax.”

Obviously, America’s current federal tax system is a graduated income tax. And, the Plan Z Flat Tax is also an income tax. The FairTax is not. It is a national consumption tax, which is what our Founding Fathers advocated when creating America’s Constitution.

Two of the more prominent framers, Hamilton and Madison, wrote:

“It is a singular 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 purposed - that is, an extension of the revenue.”

-Alexander Hamilton in Federalist Paper #21.

“It will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow.”

-James Madison in Federalist Paper # 62

The Constitution makes only one distinction relative to the type of taxes that the federal government can levy - direct vs. indirect. The Constitution’s Framers believed that direct taxes (such as income taxes) were the tools of despots and tyrants whereas indirect taxes (such as sales taxes) were more compatible with their concepts of freedom and liberty. They incorporated two different requirements for taxes in the Constitution: apportionment for direct taxes and uniformity for indirect taxes. Apportionment is a much higher hurdle; so much so that there has never been a direct apportioned federal tax in the 235+ year history of our republic.

We will leave it to the reader to determine which of today’s current and proposed tax plans meets Marx’s criteria and which plan meets the criteria set forth by the Founding Fathers. The historical record speaks for itself.

Charge #8

Sales tax audits are inevitable for individual consumers under the FairTax when revenues come up short.

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Response

As previously addressed, under the FairTax plan, sales tax audits would be limited to retailers and those audits would be far less intrusive and burdensome than the income tax audits the FairTax eliminates. Under the FairTax, there is little reason for a federal tax agency to make contact with a consumer, and a very small possibility an individual would need to be contacted by the state tax authority.

Of the 45 states that currently have sales taxes, none of them have the kind of invasive and/or abusive audit processes that some have charged would be inevitable under the FairTax. The FairTax legislation, as written, does not require that any individual retain sales tax receipts or be subject to an audit. Unfortunately, some detractors mistakenly assert that under the FairTax, receipt retention and audit are a requirement of the legislation or that such a requirement could be initiated by the STAA. To support their assertion, they cite this section of the FairTax bill:

Sec. 101. Imposition of the Sales Tax

(d) Liability for Tax-

(1) IN GENERAL- The person using or consuming taxable property or services in the United States is liable for the tax imposed by this section, except as provided in paragraph (2) of this subsection.

(2) EXCEPTION WHERE TAX PAID TO SELLER- A person using or consuming a taxable property or service in the United States is not liable for the tax imposed by this section if the person pays the tax to a person selling the taxable property or service and receives from such person a purchaser's receipt within the meaning of section 509.

This section ensures that Congress cannot issue waivers from the sales tax to itself and friends. In other words, the FairTax permanently ends trading campaign cash for tax favors; a practice that has greatly diminished our representative form of government under the current tax system. While auditing a retailer, the state or STAA could theoretically ask a retail customer for receipts to verify their information, but no one can cite any case where this has ever happened in any state.

Critics of the FairTax have ready access to the FairTax bill. If there are areas where the wording of the bill needs to be "tightened up" so that it conforms to the intent of its authors, then that is certainly possible. It seems to be the height of hypocrisy for FairTax critics to maintain, on the one hand, that they do not even need to have a proposal in writing or a bill in congress to be taken seriously, but the FairTax written proposal, on the other hand, can be placed under a microscope and any defect (real or imagined) can be cited as a show-stopper.

Charge #9

Sales tax audits are more intrusive and administratively burdensome than income tax audits and the new Sales Tax Administration Authority (STAA) would be worse than the current Internal Revenue Service (IRS).

Response

Each state will have a choice whether to collect the tax from retailers, pay another state for collection or let the STAA collect. The expectation is most states will collect it themselves. Currently, forty-five states already collect a sales tax so collecting the FairTax would be easy, and if they harmonize their state sales tax with the FairTax they can simplify their own base. In addition, states will be paid a small percentage of the taxes collected as an administrative fee for their collection efforts. Unlike the IRS, the STAA will generally be collecting the tax from state tax authorities, not from retail businesses and never from any individual consumers.

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For those experienced in small business accounting, the claim that sales tax audits are more onerous than income tax audits is, at best, laughable. One FairTax supporter is a former financial officer for several entrepreneurial level high-tech companies. While he was with one company the state conducted a sales tax audit. For those unfamiliar with the process, he described it as follows:

“An auditor came to the company a little after 9 am one morning, presented his credentials and announced that he was there to perform a sales tax audit. The controller provided the conference room and the requested financial records. The auditor’s task required that he compare the sales reported on the company’s quarterly sales tax reports against the audited financial statements, and reconcile any differences. That auditor completed his work by lunch (approximately 3 hours), giving the company a clean report with no adjustments needed.”

Compare this to a federal income tax audit where there would have been multiple auditors over a week or more on-site; plus the inevitable debates over differing interpretations of income tax law - including those necessitating legal representation. Just ask anyone who has experienced a federal income tax audit.

Charge #10

The FairTax is equivalent to “a Bernie Madoff financial scam”.

Response

This charge by one critic is so absurd it does not merit a response. For the record, it is highly unlikely that some of the nation’s premier economists developed Madoff’s Ponzi scheme.

Charge #11

Home lenders will not finance the new sales tax and initial down payments for new home purchases will increase substantially e.g., the down payment on a \$700K home will be \$350K, thereby killing the housing market.

Response

As a nation we need to rethink our assumptions about how America’s economy would function in a consumption tax vs. an income tax paradigm.

For example, home mortgage lenders are largely collateral lenders; their risk is a function of their loan amount relative to the value of the collateral pledged on the loan. This is how that market has always operated and there is no rational basis for expecting it to change under the FairTax.

Suppose you purchase a new \$200K home and six months later the FairTax becomes law. Because of the removal of embedded taxes, your builder can sell the same home for a pre-tax price of \$175,000 due to the elimination of 12.5% in costs, which the builder no longer has to recapture through his sales price. When you add the sales tax, you get an after-tax price of \$227,500.

Now you have a home, which you paid \$200K for in a subdivision selling new homes for a full (after-tax) price of \$227,500. A year later, your employer transfers you out of state and you put your house on the market. Your house is identical to new homes the builder is selling for \$227,500 - except yours has been lived in for a year. Homes do not depreciate with age like

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automobiles and other assets. Given that, you must now determine what the sales price will be for your home. Your two immediate options are the \$200,000 you paid for it, or a \$227,500 “comparable” currently being sold by the builder.

Buyers are first and foremost interested in how much house they can buy for what amount of money - irrespective of how much (if any) of their cost to acquire goes to the federal government. As a result, they will be looking at the benefits and features of your home in comparison to the builder's homes and the price of each. If they decide on the new home, they do not care that part of their \$227,500 is going to pay the sales tax, while if they buy your (slightly used) unit, the entire amount goes to you, the seller.

Now, what will the appraised value be for your one-year-old home? Professional appraisers use current “comparables” in determining appraised values. The real question is, will mortgage lenders fail to adjust to the new tax paradigm or refuse to accept the shift in home values that will occur as a result of the FairTax? There may be a few, but it is unlikely that any lenders will see their competitors making good loans and accepting no more risk than they previously eagerly accepted without seriously revising their view of their industry.

Suppose a worst case occurs and existing lenders won't accept current appraisals. That would open up a tremendous market opportunity for an aggressive entrepreneur to raise a few billion in investment capital for a new reality based mortgage-lending company. Sophisticated and flexible lenders will flourish while inflexible companies who refuse to change will go out of business, just as many buggy-whip makers went out of business when the automobile came of age.

Finally, there is one additional and very important factor that must be considered. It is widely accepted that the biggest barrier to homeownership (first home or moving up) is the down payment. Although down payments will be slightly larger under the FairTax because of the appreciation in prices and values, Americans taking home their entire paychecks will easily offset that small increase.

Using the previous example, assume that lenders require a 20% down payment before enactment of the FairTax. Again, it is assumed that down payment ratio will continue after enactment of the FairTax. This means the pre-FairTax down payment of \$40,000 would be \$45,500 under the FairTax. If you assume the buyer has a yearly income of \$150K per year, and an average effective rate (income and payroll taxes combined) of 20%, that equates to an annual savings from the taxes eliminated by the FairTax of \$30K. Although consumption prices (after-tax) will be slightly higher under the FairTax, that additional \$5,500 is now quite manageable. In addition, under the FairTax interest rates will fall 25% to the level of tax-exempt interest today because interest income will not be taxed⁷. This drop in interest rates will dramatically decrease the total cost of purchasing homes (for example, 1.5% over 30 years on a \$200,000 home loan would be ~\$45,000).

If you have additional questions about the FairTax plan please visit FairTax.org website and begin with the “Frequently Asked Questions” section, and to view the actual proposed legislation and the professional studies presented by top economic experts.

Footnotes:

1. Note that this \$45 million figure is for lobbying fees only. Knowing how the current corrupt system of influence peddling works in Washington, it is a fairly safe assumption

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that these industry special interests tallied that much or more in campaign contributions.

2. http://en.wikipedia.org/wiki/List_of_countries_by_military_expenditures
3. http://en.wikipedia.org/wiki/National_debt_of_the_United_States
4. http://www.ask.com/wiki/Sales_taxes_in_the_United_States
5. Lawrence J. Kotlikoff, PhD, is a William Fairfield Warren Professor of Economics at Boston University, Fellow of the American Academy of Arts and Sciences, Research Associate of the National Bureau of Economic Research, Fellow of the Econometric Society and former Senior Economist, President's Council of Economic Advisors. Coauthor of *The Coming Generational Storm* and *Spend 'Til the End*, and author of *The Healthcare Fix* and *Jimmy Stewart is Dead*, Kotlikoff has been published extensively in the nation's leading newspapers, magazines and financial web sites on financial reform, taxes, saving, growth, deficits, Social Security, healthcare, pensions and personal finance. He is only one of many top economists that have conducted FairTax related studies.
6. There are other factors which would tend to reduce market interest rates that are beyond the scope of this paper.

Tax Burden: Plan Z vs. Income Tax vs. The FairTax

As previously noted the Plan Z author and FairTax critic has yet to provide many details of his proposed tax plan except to indicate it is a 10% flat rate on all income while leaving in place Social Security and Medicare taxes. This is enough information to allow the calculation of the tax burden this proposal would impose on taxpayers.

What follows are the results of tax calculations for a 4-member family with an income of \$50,000. The calculations are performed for the current tax system, a flat tax of 10% and the FairTax. This comparison has been made to assist in refuting claims made by those in opposition to the FairTax and who favor a 10%, no deduction, no exemption flat tax with payroll taxes. Note: the opposition proposes the continuation of the payroll tax adjustment to omit income taxes on that portion of the tax applicable to the employer share of the self-employment tax. This makes the self-employment payroll tax rate to be 14.13% and not 15.3% (as is often erroneously stated - even by the IRS).

Findings:

1. A 10% flat tax imposes a 95% increase in income taxes over that paid today by a 4-member family with an income of \$50,000 and 77% more than under the FairTax with respect to the general fund percentage.
 - a) Current system income tax: \$2,569 = 5.1%
 - b) 10% flat tax: \$5,000 = 10%
 - c) FairTax specific to general fund (64.83%): \$2,830 = 5.7%
2. The payroll tax is regressive under both forms of income taxing due to the cap on Social Security, but under the FairTax it's progressive. Some of the regressive effect of the FICA tax

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is slightly offset by the Medicare tax increase on high wage earners and high-earned income added under the Patient Protection and Affordable Care Act (\$200,000 single and \$250,000 joint).

- a) Current system payroll tax on \$50,000: either 7.65% (employee) or 14.13% (self-employed)
- b) 10% flat tax payroll tax on \$50,000: either 7.65% (employee) or 14.13% (self-employed)
- c) FairTax equivalent payroll tax on \$50,000: 3.1% (no employee and self-employed differentiation)

3. The total tax consequence under a 10% flat tax is greater than under either the current system or the FairTax. (Note: The income tax effective tax rates cannot be appropriately compared to the FairTax effective tax rates as follows because of the difference in purchasing power; i.e. \$1 now vs. \$1.30 under the FairTax. Item 4 below makes the appropriate comparisons for purchasing power.)

- a) Current system total tax: \$6,394 (employee) and \$9,634 (self-employed) = 12.8% and 19.3% effective tax rate
- b) 10% flat tax total tax: \$8,825 (employee) and \$12,065 (self-employed) = 17.65% and 24.13% effective tax rate
- c) FairTax total tax: \$4,365 = 8.7% effective tax rate

Note: Single parent with one child and earning \$24,000 has a -0.94% effective tax rate (employee) under the current system; a 17.65% or 24.13% effective tax rate under the 10% flat tax; and an 8.2% tax rate under the FairTax. The rebate is not as generous in appearance for single parents as it is for two adults in the household due to the significant difference between a 1 and 2 adult allowance. However, this may, in some cases, provide an incentive for couples to stay together or, in divorce and paternity cases, the States may consider the adult rebate as dividable property and payable in part or whole to the primary custodian which will help offset the higher effective tax rate for a single parent. Just one of the many ways governments 'could' impact the rebate amount to be paid to any one payee as a means of offsetting potential costs to the government resulting from welfare or Medicaid expenses among other possibilities.

4. The FairTax has a purchasing power advantage over the current tax system of 0.7% and over the 10% flat tax of 5.6% (employee) and 12.0% (self-employed). The 10% flat tax will likely cause a commensurate increase in product and service prices making the widgets used in this example to actually exceed \$1.

- a) Total \$1 widgets that can be purchased under current system: 43,606 (employee) or 40,366 (selfemployed) = 12.8% and 19.3% effective tax rate
- b) Total \$1 widgets that can be purchased under 10% flat tax: 41,175 (employee) and 37,935 (selfemployed) = 17.65% and 24.13% effective tax rate
- c) Total \$1.30 widgets that can be purchased under the FairTax whether by an employee or the self-employed: 43,950 = 12.1% effective tax rate

Note: The near parity between the current system and the FairTax for middle income earning families of 4 ... 12.8% vs. 12.1%.