Viewpoint

‘Fair Tax’ Ignores Economic, Mathematical, and Legal Realities to Buy Votes

BY ALLEN BUCKLEY

Once upon a time, there was a great country that had an evil tax system. The tax system was evil because it was very complex, and it extracted a lot of tax from the citizens and companies of the country. Worst of all, an evil dragon called the Internal Revenue Service collected the taxes.

Then one day a white knight named John Linder, a Republican congressman from Georgia, used his courage and wit and produced a means of eliminating the evil tax system. He sponsored the "Fair Tax" bill. This bill, it was said, would reduce the price of goods and services by the exact amount of a retail sales tax while eliminating withholding of taxes from wages, thus resulting in tremendous gains to all workers. People would receive their gross paychecks. Corporations would no longer have to pay taxes. The economy would flourish. With the exception of some average retirees, under a simple system, everyone would pay less tax. Best of all, the evil dragon would be eliminated!

Former Arkansas Governor Michael Huckabee is now a front-runner among the Republican presidential candidates, and one major piece of his campaign platform is the "Fair Tax" bill (H.R. 25) that is co-sponsored by Rep. John Linder (R) of Georgia.

Huckabee was quoted in the Dec. 16, 2007, issue of *The Atlanta Journal-Constitution* as follows with respect to the Fair Tax proposal and Social Security: "Instead of basing our national budget off payroll tax for Social Security . . . it means the base of funding is much broader." In 2005, Linder and radio talk show host Neal Boortz co-authored the best-selling *The Fair Tax Book*.

This article discusses flaws in the proposed Fair Tax proposal, and lists winners and losers under a realistic replacement national retail sales tax.

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Overview

The main objective of the Fair Tax proposal is to change the system of taxation from one that primarily taxes income to one that taxes consumption. The Fair Tax would replace the individual income tax, corporate income tax, estate and gift tax, and Federal Insurance Contribution Act tax (i.e., Social Security and Medicare taxes) with a single retail sales tax at a rate of 29.9 percent of the price of a good or service.

Sales Pitch

Proponents of the Fair Tax insist that:

- the cost of goods and services would go down by the amount of the tax, thus meaning that goods and services would cost the same to consumers, but people would no longer have to pay income, FICA (Social Security and Medicare) or estate and gift taxes;
- employees would receive the gross amount of their current paychecks;
- the economy would flourish; and
- the Internal Revenue Service would be eliminated.

Popularity

Aside from Huckabee and Linder, the following excerpt was posted on "Tulsa World" in early 2007:

> **Tulsa World: A Fair Chance**
>
> - **January 12, 2007 -**
> - http://www.tulsaworld.com/NewsStory.asp?ID=070112_Op_a12_let3 - The Fair Tax Act of 2007 was re-introduced into the House by Rep. John Linder, R-Ga. The bill was first introduced by Linder in 1998 and has become increasingly popular since then. At the close of the 109th Congress the Fair Tax Act was the most popular tax reform bill with 59 supporters in the House. . . .
>
> . . . Call your legislators and ask them to support the Fair Tax. For more information check out www.fairtax.org or www.okfairtax.org to find the local Fair Tax representative.
>
> Billy D. Harrington, Collinsville

On Thanksgiving night 2007, a TV news show in Greenville, S.C., reported that the total number of members of Congress supporting the Fair Tax bill was up to 68.

Tax Specifics

Under the Fair Tax, with a few exceptions, virtually all retail sales of goods and services are subject to tax. The seller charges, collects, and remits the tax.

Notable exemptions from the Fair Tax are:

- property or services purchased for a business purpose in a trade or business;

- any property or service that is exported, provided the buyer supplies a registration certificate and the seller is a wholesaler;
- property or a service purchased for an investment purpose; and
- education and training, excluding room and board.

A business purpose is broadly defined by the bill as follows:

> (b) BUSINESS PURPOSES. — For purposes of this section, the term ''purchased for a business purpose in a trade or business'' means purchased by a person engaged in a trade or business and used in that trade or business—
>
> (1) for resale,
>
> (2) to produce, provide, render, or sell taxable property or services, or
>
> (3) in furtherance of other bona fide business purposes.

Thus, companies and businesses would cease paying taxes. For the fiscal year ended Sept. 30, 2006, companies paid 25 percent of all federal income taxes and a substantial portion of FICA taxes.

''Investment Purposes'' are defined in a general manner, as follows:

> (c) INVESTMENT PURPOSES. — For purposes of this section, the term ''purchased for an investment purpose'' means property purchased exclusively for purposes of appreciation or the production of income but not entailing more than minor personal efforts.

Certainly, some sort of significant regulatory guidance would be necessary to prevent the investment exception from being exploited.

Excluding purchases for education purposes, purchases by state and local governments, and by the federal government, would be subject to tax. With the exception of education salaries and wages, salaries and wages paid to government employees would be subject to the tax.

Oddly enough, one of the main causes of controversy with respect to the Fair Tax is the actual tax rate itself. Many Fair Tax advocates say that the rate is 23 percent. When an ordinary person hears that a sales tax rate is 23 percent, he assumes that a good that costs $1 would result in a tax of 23 cents. However, under the Fair Tax, a sale of a good for a dollar would produce a tax of 30 cents.

In pertinent part, the Fair Tax bill provides:

> SEC. 101. IMPOSITION OF SALES TAX.
>
> (a) IN GENERAL. — There is hereby imposed a tax on the use or consumption in the United States of taxable property or services.
>
> (b) RATE. —
>
> (1) FOR 2007. — In the calendar year 2007, the rate of tax is 23 percent of the gross payments for the taxable property or service. . . .
>
> (5) GROSS PAYMENTS. — The term ''gross payments'' means payments for taxable property or services, including Federal taxes imposed by this title.

In the preceding example, 30 cents is 23 percent of $1.30. This methodology of defining a tax is called ''tax-inclusive.'' This methodology is ordinarily used for income taxes, but it is not ordinarily used for a sales tax. Rather, for a sales tax, the tax is usually computed as a percent of the retail price of the good—a ''tax-exclusive'' rate. However, when you are talking tax rates, 23 sounds better than 30.

The Fair Tax includes a rebate, or ''prebate,'' system that provides a refundable tax credit based on the annual poverty amount determined by the U.S. Department of Health and Human Services (HHS). The 2007 HHS Poverty Guidelines are provided in the following chart.

2007 HHS POVERTY GUIDELINES

PERSONS IN FAMILY OR HOUSEHOLD	48 CONTIGUOUS STATES AND D.C.	ALASKA	HAWAII
1	$10,210	$12,770	$11,750
2	13,690	17,120	15,750
3	17,170	21,470	19,750
4	20,650	25,820	23,750
5	24,130	30,170	27,750
6	27,610	34,520	31,750
7	31,090	38,870	35,750
8	34,570	43,220	39,750
For each additional person, add	3,480	4,350	4,000

SOURCE: Federal Register, Vol. 72, No. 15, Janury 24, 2007, pp 3147 - 3148

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The Fair Tax system does not use this table as written. Instead, married couples receive double the individual poverty amount of $10,210—$20,420. For each additional household member, an additional $3,480 is added to the total. (So, for 2007, for a family of four residing in one of the 48 contiguous states, the poverty exemption was $27,380.)

The exemption amount is multiplied by 0.23 to produce the annual prebate. The total is split into 12 equal amounts that are paid to lawful residents of the U.S.

An interesting thing to note about the Fair Tax prebate is that if a single person made purchases equal to the poverty exemption amount, he would pay tax. This is so because goods are subject to tax at a rate of 29.9 percent, but the prebate is calculated at a 23 percent rate. Thus, $10,210 of purchases made by a single person would result in a tax liability of $3,053, while the rebate received from the federal government would be $2,348 ($10,210 x 0.23).

Oddly, while the Fair Tax basically converts the entire tax system to a consumption tax system, nonresident aliens, foreign partnerships, and foreign corporations remain subject to an income tax at a rate of 23 percent of gross (not net) income from sources within the United States. This is true of any foreign partnership or foreign corporation, even those with regular U.S. operations. Currently, such income of a foreign person or entity that is passive in nature (interest, dividends, and royalties, etc.) ordinarily is subject to withholding and taxation at a rate of 30 percent, unless a tax treaty reduces the rate. However, with respect to income from business operations, only the net taxable income (revenues less expenses) is currently subject to taxation, under the graduated rate system.

A 23 percent tax on the gross income might not only be unconstitutional, but it would also violate the terms of many existing tax treaties. (Reworking numerous tax treaties would be necessary if a conversion to the Fair Tax system was undertaken.)

Lotteries and casinos are subject to a 23 percent tax on the excess of gaming receipts over prizes and federal, state, and local taxes on gambling activities.

Returning to Huckabee's statement about Social Security funding, the revenue produced by the Fair Tax is allocated to all government spending needs. In contrast, under current law, Social Security is paid by employers and employees (at a rate of 6.2 percent of wages, each). Surpluses have existed since 1983 and are expected to continue to exist through 2017. Annually, the surpluses are ''loaned'' to the General Fund of the federal government.

Revenue Neutrality

The authors of the 2005 *The Fair Tax Book* claim that the current tax system could be replaced by the Fair Tax system without any loss of revenue to the federal government. Thus, proponents claim that a change to the Fair Tax would be ''revenue-neutral.''

The revenue from the Fair Tax would need to pay for virtually all federal government expenses, including Medicare and Social Security. At page 76 (as well as numerous other places), the 2005 best-selling *The Fair Tax Book* specifically states that all government expenditures, including Medicare and Social Security, would be covered by the Fair Tax:

> The Fair Tax is revenue-neutral. In other words, the sales tax rate will be set to ensure that the federal government—and all the programs within it, including Social Security and Medicare—will receive from the national retail sales tax exactly what they have been receiving under the current tax system. This isn't about cutting spending or changing government benefits.

According to an April 7, 2000, memorandum of Lindy Paull, then chief of staff of the Joint Committee on Taxation (JCT), the tax-exclusive rate under the Fair Tax would need to be 59.5 percent for the first five years of application, and 57 percent thereafter, in order for the bill to be revenue-neutral relative to 1999 revenue. The JCT is a nonpartisan arm of Congress. The rate was calculated in connection with H.R. 2525, the predecessor to H.R. 25. There is virtually no difference between the two bills.

In 2005, I spoke to Paull about her memo. She told me that, basically, a group of lawyers and economists were put into a room and told to come up with the revenue-neutral rate. Also in 2005, Paull informed me that, although Fair Tax advocates were informed that their economic study that produced a 23 percent tax rate (29.9 percent, tax-exclusive) was flawed, they refused to seek a correct rate.

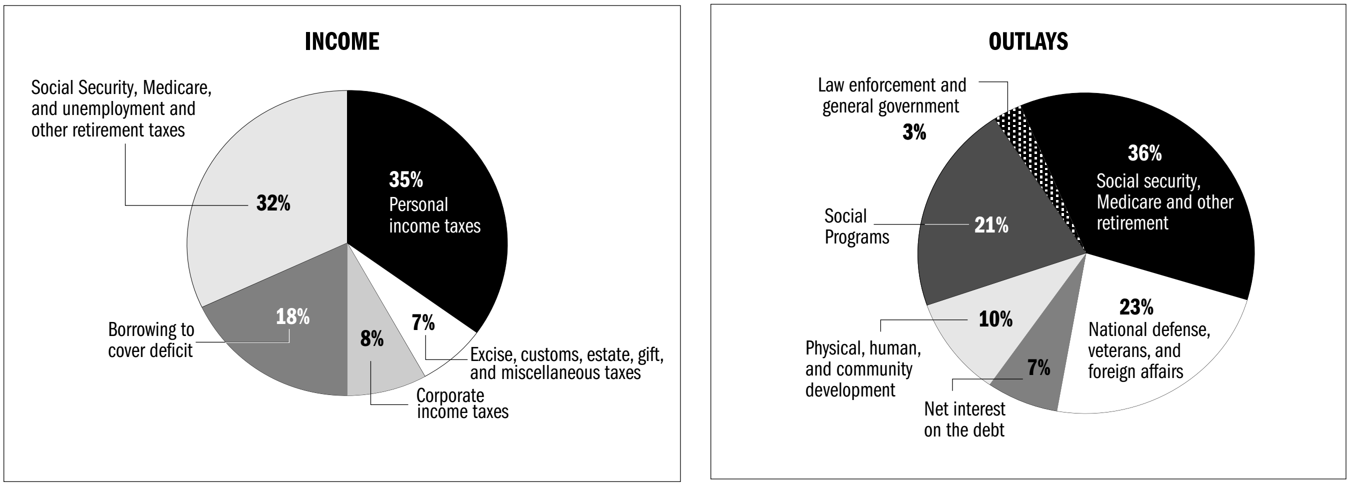
The President's Advisory Panel on Federal Tax Reform published its report in November 2005. A quote from page 217 of the 2005 Report of the President's Advisory Panel on Federal Tax Reform is as follows:

> In their submission to the Panel, proponents of the Fair Tax claimed that a 30 percent tax-exclusive sales tax rate would be sufficient not only to replace the federal income tax, but also to replace all payroll taxes and estate and gift taxes and fund a universal cash grant. In contrast, the Treasury Department concluded that using the retail sales tax to replace only the income tax and provide a cash grant would require at least a 34 percent tax-exclusive rate.

The two main reasons for the difference were supplied:

> First, it appears that Fair Tax proponents include federal government spending in the tax base when computing revenues, and assume that the price consumers pay would rise by the full amount of the tax when calculating the amount of revenue the government would obtain from a retail sales tax. However, they neglect to take this assumption into account in computing the amount of revenue required to maintain the government's current level of spending. For example, if a retail sales tax imposed a 30 percent tax on a good required for national defense (for example, transport vehicles) either (1) the government would be required to pay that tax, thereby increasing the cost of maintaining current levels of national defense under the retail sales tax, or (2) if the government was exempt from retail sales tax, the estimate for the amount of revenue raised by the retail sales tax could not include tax on the government's purchases. Failure to properly account for this effect is the most significant factor contributing to the Fair Tax proponents' relatively low revenue-neutral tax rate.
>
> Second, Fair Tax proponents' rate estimates also appear to assume that there would be absolutely no tax evasion in a retail sales tax. The Panel found the assumption that all taxpayers would be fully compliant with a full replacement retail sales tax to be unreasonable. The Panel instead made assumptions about evasion that it believes to be conservative and analyzed the tax rate using these evasion assumptions.

Government Revenue Sources



Source: 2005 Form 1040 instructions

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Page 81 of the 2005 Form 1040 instructions provides pie charts, as shown, of government revenue sources. The following percentages are provided: personal income tax—35 percent; corporate income tax—8 percent; payroll taxes—32 percent; borrowing—18 percent; and excise, customs, estate and gift taxes, and miscellaneous taxes—7 percent.

Again, the President's Advisory Panel said that a 34 percent tax-exclusive rate would be necessary to cover foregone revenue due to elimination of the income tax. The estate and gift taxes produce approximately 1 percent of federal revenue. The sum of the individual income tax revenue of 35 percent and the corporate income tax revenue of 8 percent is 43 percent. The FICA tax revenue percentage is 32 percent. Assuming the estate and gift tax provides 1 percent of total revenue, the following calculation produces a 60.2 percent rate:

- (32 + 35 + 8 + 1) = 76;
- 76/43 = 1.77; and
- 1.77 x 34 = 60.2 percent.

Where did Fair Tax creators and advocates get the tremendously important revenue-neutral rate? According to the 2005 *The Fair Tax Book* (page 148), the Houston businessmen who wanted to install a consumption tax to replace the current system ". . . sought expert opinions on how much that tax must be in order to duplicate the revenue the federal government would have received from the various taxes eliminated by the Fair Tax. The researchers and analysts concluded that we would need an inclusive sales tax rate of 23 percent."

The book then points out that studies are under way that could result in a final tax-inclusive rate that is a percentage point or two less. (Note: As discussed below, for pay, several professors produced a study for the Fair Tax people in September 2006 that concluded that a 31.2 percent tax-exclusive rate would be revenue-neutral.)

If the revenue-neutral rate is 60 percent, at a rate of 30 percent the Fair Tax would produce roughly one-half of the tax revenue of the current system. Thus, assuming such a feat was financially possible, the annual net funding deficit of the federal government would explode. This result would be disastrous to the country on a long-term basis.

Fair Tax Opinions: Rate Revenue-Neutral? The following opinions on the revenue-neutral tax-exclusive rate are known to exist:

Pro Fair Tax—Sufficient

- Original compensated study of the Fair Tax bill (29.9 percent).
- Bachman, Haughton, Kotlikoff, Sanchez-Penalver and Tuerck 2006 compensated study that concluded that a 31.2 percent rate would work (discussed below).
- Laurence Kotlikoff and Sabine Jokisch recently jointly authored study that produced a 35.1 percent rate, or 29.9 percent with an 18 percent reduction in federal spending

Anti Fair Tax—Insufficient

- None known to the author.[1]

Neutral—Insufficient

- Memo to the Joint Committee on Taxation.
- President's Advisory Panel on Federal Tax Reform.

The 31.2 Percent Opinion. In 2006, for compensation, a study of the revenue-neutral rate was undertaken by Paul Bachman, Jonathon Haughton, Laurence Kotlikoff, Alfonso Sanchez-Penalver, and David Tuerck. The study was titled *Taxing Sales Under the Fair Tax—*

[1] In a May 16, 2005, *Tax Notes* article titled "The National Retail Sales Tax: What Would the Rate Have to Be?," William Gale wrote:

> I show that even under the strong assumptions made in H.R. 25—no avoidance, no legislative erosion of the private consumption or the state and local government consumption and investment purchase tax base—the NRST would still require a 31 percent tax-inclusive rate (44 percent tax-exclusive) to be revenue-neutral and hold government programs constant relative to current law over the next 10 years.

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What Rate Works? The study concluded that a 31.2 percent tax-exclusive rate would be revenue-neutral. Hereafter, the study is called the ''31.2 Percent Opinion.''

The 31.2 Percent Opinion provides:

> Moreover, Gale (2005) and the Tax Panel (2005) arrived at a higher tax rate because they did not estimate the FairTax rate, but instead estimated a sales tax of their own design which had a substantially narrower base.

This point very likely is accurate. However, the justification therefor is noted below. (Gale is William Gale of the Brookings Institution, and he has stated on many occasions that the revenue-neutral tax-exclusive rate is substantially higher than 29.9 percent. The Tax Panel is the President's Advisory Panel on Federal Tax Reform.)

Obviously, there is a huge discrepancy between the revenue-neutral rate figure of the two government studies (both approximately 60 percent), and the Fair Tax bill's 29.9 percent rate or the 31.2 Percent Opinion rate. The government studies do not explain how their figures were reached. However, the 31.2 Percent Opinion does show and explain how it reached its conclusion.

The 31.2 Percent Opinion utilized projected gross domestic product (GDP) figures for 2007 to calculate its revenue-neutral rate. GDP is comprised of personal consumption expenditures (C), investments (I), and government spending (G), plus net exports or minus net imports. The 31.2 Percent Opinion starts with the personal consumption expenditures portion of GDP, as published by the Congressional Budget Office (CBO), and then makes adjustments thereto. Pertinent excerpts from the 31.2 Percent Opinion, with bold emphasis added, follow:

> We find the 2007 FairTax base to be $11,244 billion. Starting with personal consumption expenditures of **$9,772 billion**, we make adjustments for housing by adding the purchase of new homes and the improvement of existing homes. The imputed rent for owner-occupied housing and farm dwellings is removed since the tax due on the imputed rent will become prepaid when the property is sold as a new dwelling.[11]
>
> We also adjust for education tuition (excluded under the FairTax), taxable interest and financial intermediation, foreign travel, and other items.[12] The net effect of these adjustments is to reduce the private consumption base to **$9,235 billion**, as Table 2 shows.
>
> Next, we add government consumption at the state, local and federal levels to the base. We subtract wages paid to government employees who provide education and training, and we subtract capital consumption allowances (since it is impractical to tax the consumption of capital).[13] We add spending for new buildings and equipment to the base. **State and local government consumption, thus adjusted, equals $1,093 billion; federal government consumption equals $916 billion**. These amounts sum to $11,244 billion dollars, represent 81% of 2007 U.S. GDP as projected by the Congressional Budget Office.[14]

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[11]Table 2, line 2 according to March 2005 report by the National Association of Realtors, 23% of homes purchased in 2004 were for investment purposes. Also, 79% of homes purchased for investment purposes are single-family homes. These numbers provide a basis for this estimate.

[12]Table 2, line 8 includes ''Other,'' (see NIPA 2.5.5, line 110) which consists of (1) fees paid to business schools and computer management training, technical and trades schools, etc., and (2) current expenditures (including consumption of fixed capital) by nonprofit research organizations and by grant-making foundations for education and research. Gale (1999) includes it while Burton and Mastromarco (1997) exclude it. We have chosen to include half of its value.

[13]According to BEA, government consumption expenditures include the consumption of fixed capital; given the impracticality of collecting tax on the consumption of capital, we have removed it from the base in the form of the capital consumption allowance.

[14]U.S. Congress, Congressional Budget Office, ''Budget and Economic Outlook for Fiscal Years 2007 to 2016,'' Washington D.C., Government Printing Office, January 2006, 26.

Included in personal consumption expenditures (C) are, among other things, motor vehicles and parts, gasoline, transportation, and other energy goods. As noted below, some of these expenditures would qualify as business purchases under the Fair Tax bill, and thus would be fully or partially exempt from tax. However, no reduction or adjustment is made for this consideration in the 31.2 Percent Opinion.

The 31.2 Percent Opinion next considers the CBO's anticipated tax revenues for 2007 from the taxes that would be eliminated due to adoption of the Fair tax system. These amounts are:

Individual income taxes	$1,101 Billion
Corporate income taxes	290 Billion
Social insurance and retirement receipts	871 Billion
Estate and gift taxes	26 Billion
Total	**$2,288 Billion**

The 31.2 Percent Opinion then estimates the total prebate base, by using the HHS Poverty Level Guidelines for 2006 and U.S. Census Bureau estimates for the number and size of households in the United States. The following resulting chart was produced.:

TABLE 4. COMPUTING THE FAIR TAX BASE REDUCTION DUE TO THE PREBATE FOR 2007

SINGLE HOUSEHOLDS			
HOUSEHOLD SIZE	FAMILY CONSUMPTION ALLOWANCE	NUMBER OF HOUSEHOLDS	BASE REDUCTION
1	$10,016	29,858	$299,049,690
2	$13,490	12,719	$171,584,833
3	$16,965	6,645	$112,727,257
4	$20,440	3,233	$66,092,706
5	$23,915	1,441	$34,464,747
6	$27,390	489	$13,406,258
7 or more	$30,864	395	$12,179,087
SUBTOTAL, SINGLE HOUSEHOLDS		**54,781**	**$709,504,577**
MARRIED HOUSEHOLDS			
HOUSEHOLD SIZE	FAMILY CONSUMPTION ALLOWANCE	NUMBER OF HOUSEHOLDS	BASE REDUCTION
2	$20,031	24,991	$500,599,437
3	$23,506	11,489	$270,055,951
4	$26,981	12,980	$350,222,029
5	$30,456	5,775	$175,871,370
6	$33,930	2,009	$68,177,390
7 or more	$37,405	1,006	$37,636,330
SUBTOTAL, MARRIED HOUSEHOLDS		**58,250**	**$1,402,562,508**
TOTAL PREBATE BASE REDUCTION			**$2,112,067,084**
PREBATE AS % OF GDP			**18.8%**

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The calculation of the revenue-neutral rate by the 31.2 Percent Opinion is as follows:

TABLE 5. COMPUTATION OF THE 2007 FAIR TAX RATE

In Billions of Dollars

REVENUES TO BE REPLACED	
Gross Revenue to be Replaced	$2,228
Less: EITC and Child Tax Credit	-52
TOTAL REVENUE TO BE REPLACED $(R1_{07})$	**2,236**
IRS Savings (IRSS)	-8
ADJUSTED REVENUES TO BE RAISED $(R1_{07} - IRSS)$	**2,228**
ADJUSTED TAX BASE (INCLUSIVE OF TAX) COMPONONENTS	
Personal Consumption adjusted for Administrative Fee $(0.9950C_{07})$	9,189
State and Local Government Consupmtion adjusted for Administrative Fee $(0.9960GS_{07})$	1,089
Federal Government Consumption adjusted for Administrative Fee $(0.9966G_{07})$	913
Taxed Federal Government Transfers $(1.0132GN_{07})$	276
Less: IRS Savings Adjustment $(0.0016IRSS)$	-0.01
Less Prebate Base (B)	-2,112
ADJUSTED TAX BASE	**$9,355**
THEREFORE TAX RATE (t_i) **IS 2,228/9,355, WHICH EQUALS**	**23.82%**
TAX-EXCLUSIVE RATE (t_e) **IS 2,228/(9,355-2,228), WHICH EQUALS**	**31.27%**

Note: Totals may not add due to rounding.

A BNA Graphic/dt814g10

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Dividing 9,189 by 0.995 produces the $9,235 billion private consumption base previously mentioned.

Concerning the 31.2 Percent Opinion, five points need to be made. First, no evasion is assumed whatsoever. Second, the federal government's taxable purchases produce a circular equation, but no adjustment is made therefor. (These two points were noted by the President's advisory panel as being the two greatest reasons for insufficiency in the Fair Tax rate.) Third, as noted above, some of the personal consumption expenditures (C) would not be taxable under the Fair Tax bill. Fourth, it is very possible that application of the tax to purchases by state and local governments is partially or wholly unconstitutional. Fifth, the prebate credit is calculated incorrectly. The prebate is 23 percent of the poverty level exemption amount.

Making adjustments for these factors would necessitate decreasing the adjusted tax base for the first four factors, and increasing both the adjusted tax base and adjusted revenues to be raised for the fifth factor. Each of these points is considered below.

Before analyzing these five factors, it is important to note that the 31.2 Percent Opinion assumes no price reduction whatsoever in the prices of goods and services. To the extent a price reduction was experienced, in order to account for the lower taxable base, the rate would need to be higher for revenue neutrality to exist. Of course, to the extent government spending would be reduced, the rate would not need to be revenue-neutral.

Prebate. The total exemption amount of $2,112 billion would produce a prebate of $486 billion (2,112 x 0.23). Adding this figure to the $2,228 billion of taxes produces $2,714 billion. Adding $2,112 billion to the adjusted tax base of $9,355 billion produces $11,467 billion. Dividing $2,714 by $11,467 produces a tax-inclusive rate of 23.67 percent, and a tax-exclusive rate of 31.01 percent. Thus, this adjustment reduces the revenue-neutral rate.

Taxation of the Federal Government. Concerning taxation of the federal government, inclusion of such purchases in the adjusted tax base produces a ''circular equation.'' Substantively, the federal government cannot get tax revenues for itself from itself. Removing federal government consumption of $913 billion and taxed federal government transfers of $276 billion from the adjusted tax base, as recomputed immediately above, results in a revised adjusted tax base of $10,278 billion (11,467 - (913 + 276)). The tax-inclusive revenue-neutral rate would increase to 26.41 percent (2,714/10,278), and the tax-exclusive revenue-neutral rate would increase to 35.89 percent.

Business Personal Consumption Expenditures. The next potential adjustment relates to personal consumption expenditures (C). It is important to note the composition of personal consumption expenditures. Below is a listing of the components. A portion of these components are business-related. Since purchases by businesses in furtherance of bona fide business purposes are exempt from the Fair Tax, an adjustment should be made to the adjusted tax base to account for business use.

A 1988 book by James Flink titled *The Automobile Age* provided that U.S. Highway Administration data for 1977 revealed that 9.6 percent of domestic automobile use was for business purposes. Also, 44.7 percent of use was for travel to and from work. Assuming that the 9.6 percentage still applies, then 9.6 percent of the automobile spending should be eliminated from the taxable base. (For partial business use property, technically, the Fair Tax system uses a credit system whereby the tax is initially paid, but later refunded over a period of years to the extent of business use. However, for these calculation purposes, the manner of exemption is insignificant.)

Personal Consumption Expenditures

Durable goods:
- Motor vehicles and parts.
- Furniture and household equipment.
- Other.

Nondurable goods:
- Food.
- Clothing and shoes.
- Gasoline, fuel oil, and other energy goods.
- Other.

Services:
- Housing.
- Household operation, including electricity and gas.
- Transportation.
- Medical Care.
- Recreation.
- Other.

Motor vehicles and parts typically comprise approximately 5 percent of consumption (C). Gasoline, fuel oil, and other energy goods typically comprise approximately 4 percent of consumption. Applying a 9.6 percent reduction, a net 0.81 percent reduction would apply to the 9 percent sum.

While food, clothing, and shoes should be subject to the Fair Tax in virtually all cases, some of the costs in many (or perhaps all) of the above categories will be business purchases. For example, entertaining customers by taking them to dinner should qualify as an expenditure ''in furtherance of other bona fide business purposes.'' Certainly, a portion of ''other energy goods'' and transportation costs (for example, business travel) would qualify as expenditures made in furtherance of other bona fide business purposes.

It would be very difficult to accurately assess the percentage of personal consumption expenditures that are business purchases. This author believes that an estimate of 5 percent would be reasonable and conservative. Applying that rate to the gross (unadjusted) personal consumption figure of $9,189 billion results in a reduction of $459 billion (9,189 x 0.05). Applying this reduction to the revised adjusted tax base of $10,278 (which resulted from steps 1 and 2) produces a revised adjusted tax base of $9,819. The tax-inclusive revenue-neutral rate would be increased to 27.64 percent (2,714/9,819) and the tax-exclusive revenue-neutral rate would be increased to 38.20 percent.

Constitutionality of Taxation of State and Local Governments. Taxation of purchases by state and local governments may be unconstitutional. Constitutional law is, basically, whatever the U.S. Supreme Court says it is. Unlike many statutes that are very specific and objective (for example, the maximum speed limit is 55 mph), constitutional law is based on the very broad language of the U.S. Constitution. Accordingly, the judges have broad latitude when interpreting. Thus, as times change and the court changes, constitutional law changes.

An old U.S. Supreme Court case, *McCulloch v. Maryland* (1819), held that the state of Maryland could not impose a tax on the Bank of the United States because the bank was an instrumentality of the federal government used to carry out the federal government's delegated powers. Hence, the doctrine of ''intergovernmental tax immunity'' exists.

In *Ohio v. Helvering* (1934), the Supreme Court ruled that the federal government's tax on alcoholic beverages could lawfully be applied by the federal government. The court's reasoning rested, in large part, on the fact that the state of Ohio was engaging in a commercial activity (selling alcoholic beverages). The court stated that ''the immunity of the states from federal taxation is limited to those agencies which are of a governmental character.''[2]

According to a 1939 U.S. Supreme Court decision, *Graves v. New York ex rel. O'Keefe*,[3] the issue that must be resolved is whether the imposition of a tax by one governmental unit on another unit results in ''interference by one government with the other in the performance of its functions.''

In *New York v. United States* (1946),[4] the Supreme Court ruled that the federal government could tax mineral waters sold by the state of New York. The court saw little distinction between the sale of mineral waters and the sale of alcoholic beverages. In unspecific terms, the court suggested a reduction in scope of the intergovernmental immunity doctrine. The court said:

> So we decide enough when we reject limitations upon the taxing power of Congress derived from such untenable criteria as ''proprietary'' against ''governmental'' activities of the States, or historically sanctioned activities of government, or activities conducted merely for profit, and find no restriction upon Congress to include States in levying a tax exacted equally from private persons upon the same subject matter.

Clearly, based on this language, Fair Tax advocates could make a strong argument for constitutionality. It is noteworthy that this case was decided shortly after World War II, when a large and dominant federal government was almost universally accepted. (During World War II, the highest income tax bracket rate was 94 percent.)

The *New York v. United States* decision also provides:

> But so long as Congress generally taps a source of revenue by whomsoever earned and not uniquely capable of being earned only by a state, the Constitution of the United States does not forbid it merely because the incidence also falls on a state.

The most recent U.S. Supreme Court case to consider taxation of state and local governments by the federal government is *Massachusetts v. United States* (1978).[5] In the *Massachusetts* case, a use tax on civil aircraft was considered with respect to a helicopter used by the state of Massachusetts exclusively for police work.

[2] *Ohio v. Helvering*, 292 U.S. 360, at 368.
[3] 306 U.S. 466, 481.
[4] 326 U.S. 572.
[5] 435 U.S. 444.

In *Massachusetts*, the Supreme Court held that the tax was not unconstitutional. The basis for finding the use tax to be constitutional was three-fold. First, the tax did not discriminate against state governments. Second, the tax was based on a fair approximation of the state's use of the facilities relative to total use. Third, the tax was not excessive in relation to the cost of benefits supplied by the federal government.

Since the Fair Tax is not a user fee type of tax, but rather a broad tax on virtually all purchases by state and local governments, as well as a tax on government employees' wages and salaries and on revenues received from government services, it does not fit squarely in the *Massachusetts* rationale. The revenues received from the Fair Tax would be used for all federal government spending. For example, money would be sent to New Orleans to aid with the Hurricane Katrina clean-up, as well as directly to individuals to provide entitlements. So, there would be no tie-in between the tax and benefits received.

Salaries and wages of states and local employees (and federal employees) are generally subject to the Fair Tax, while salaries and wages of private employees would not be subject to the tax. It appears to be very likely that application of the Fair Tax to salaries and wages of state and local employees would be found to be discriminatory and, thus, unconstitutional. In contrast, it appears very likely that it would be found that taxation of funds generated by commercial-type activities, such as fees received by a local government for water and sewer services, would not violate the U.S. Constitution.

Concerning purchases by state and local governments, the Supreme Court could rule that the state and local governments can be taxed because the tax applies to them in the same manner as it applies to individuals. However, the Fair Tax would levy a very heavy financial burden on state and local government purchases. The state and local governments would have to make very substantial changes to their tax systems to pay for the tax. Most important, the tax does not relate to a specific program or programs from which state and local governments benefit. Rather, the tax is a general tax that is used to pay all expenditures of the federal government. Thus, this author believes that the U.S. Supreme Court would rule that the Fair Tax is unconstitutional as it relates to purchases by state and local governments.

Although unclear, it appears that the 31.2 Percent Opinion excludes wages and salaries of government employees (except education salaries and wages) from the adjusted tax base. Thus, an adjustment does not appear to be necessary therefor. It is unclear if funds received by state and local governments attributable to services (water, sewer, etc.) are included in the adjusted tax base. If not, a small increase would be necessary to account for amounts paid for such services.

Assuming unconstitutionality as to all state and local government purchases, the adjusted tax base (as recomputed above) would be reduced by $1,089, from $9,819 to $8,730. The tax-inclusive revenue-neutral rate would be 31.09 percent (2,714/8,730) and the tax-exclusive revenue-neutral rate would be 45.12 percent. If the Fair Tax is constitutional as to state and local government consumption, then the tax-exclusive revenue-neutral rate would remain 38.20 percent.

If the Fair Tax is not unconstitutional with respect to state and local taxes, then state and local taxes would

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increase to pay the new taxes. Practically, state and local governments would simply pass the tax on to their residents and businesses. Thus, substantively, the higher rate is more accurate. Obviously, the states would immediately sue if the Fair Tax was enacted.

Evasion. As noted above, no evasion is assumed. Near its end, the 31.2 Percent Opinion provides the following reasoning for failing to make any evasion assumption:

> Our analysis has made no direct mention of tax evasion, an issue of considerable concern to FairTax critics notwithstanding (a) the fact that the overwhelming majority of purchases of goods and services occur in major retail outlets that will surely comply with the FairTax and (b) *the fact that the federal government would be able to concentrate its entire tax enforcement efforts on a single tax —the FairTax.*
>
> But the fact that we have not explicitly considered tax evasion does not mean that we have ignored it. On the contrary, we have implicitly incorporated a significant degree of tax evasion in our calculations simply by using National Income and Product Account-based projections of household consumption expenditures in forming the FairTax tax base (Easton, 2001).
>
> The National Accounts already understate total household consumption because they make no adjustment for either underground income or the underground consumption it supports. For example, the National Accounts do not impute the income earned by drug dealers and include it as part of national income. But the income earned by drug dealers comes by way of an unrecorded retail commodity sale, which is omitted from the National Accounts measure of household consumption.
>
> To state this point differently, if our FairTax rate calculations are biased downward due to failure to incorporate tax evasion, it is not because we are leaving out retail sales that are now unreported or that we are leaving out other sales that would go unreported, but rather because the National Accounts recorded sales we assume will be reported will, in fact, not be reported. This seems highly unlikely given that large retailers would most surely continue to account for the vast majority of retail sales.
>
> The extent of potential tax evasion under the FairTax and its implications of the FairTax tax certainly deserve careful study . . . .

(Emphasis supplied via italics.) Note that the italicized language is inconsistent with the notion that the IRS would be eliminated.

The $2,228 of federal government revenue estimated by CBO (and used in the 31.2 Percent Opinion) was actual revenue, not revenue assuming no evasion. It is difficult to find logic in the above quote.

According to *A Comprehensive Strategy for Reducing the Tax Gap*, a Sept. 26, 2006, U.S. Department of the Treasury Office of Tax Policy study, as a percentage of correct tax liability, the "gross tax gap" for 2001 was 16.3 percent. The gross tax gap is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay on time. For 2001, it was $345 billion. The "net tax gap" is the difference between the amount of tax actually collected, including late payments and payments made via IRS collection efforts, and the correct tax liability. For 2001, it was $290 billion. In percentage terms, it was 13.7 percent.

Assuming there would be no IRS, the tax gap under the Fair Tax would very likely be greatly in excess of 13.7 percent or even 16.3 percent. However, conservatively applying a 13.7 percent rate, the adjusted tax base, as recomputed above assuming that the Fair Tax does not apply to state and local purchases, is reduced by 13.7 percent from $8,730 to $7,534. The tax-inclusive revenue-neutral rate would be increased to 36.02 percent (2,714/7,534) and the tax-exclusive revenue-neutral rate is increased to 56.30 percent.

Assuming the same evasion rate while assuming that the Fair Tax is not unconstitutional with respect to any state or local government purchases results in a tax-inclusive revenue-neutral rate of 32.03 percent, based on a reduced adjusted tax base of $8,474 (9,819 x 0.863). The tax-exclusive revenue-neutral rate would be 47.12 percent.

In reality, the 23 percent rate is a "teaser." Fair Tax proponents who understand the above issues presumably know that the rate does not work. The apparent hope is to get people who are fed up with the current system hooked on the Fair Tax concept, and then hold onto them when the real rate is disclosed.

The Price of Goods and Services And Wages Reduction

Advocates of the Fair Tax allege that, via elimination of embedded taxes,[6] replacement of the current federal tax system with the Fair Tax system would cause the price of goods to go down by approximately 20 percent to 25 percent, thus covering the tax and allowing for elimination of income, FICA, and estate and gift taxes. Neal Boortz, co-author of the 2005 best-selling *The Fair Tax Book*, has said that the cost of goods would decrease by 30 percent. These allegations are without merit, unless wages and salaries would be cut by, on average, 20 percent to 30 percent.

There are embedded taxes of the current system in many goods and services. However, the reduction in the average cost of goods and services due to elimination of the current system's taxes would be insignificant absent substantial cuts in wages and salaries.

On pages 53-55, *The Fair Tax Book* cites a study by Dale Jorgenson, who reportedly concluded, while serving as the chairman of the Harvard Economics Department, that: "On average, . . . 22 percent of the price paid for a consumer product represents embedded taxes." *The Fair Tax Book* then provides a chart reportedly created by Jorgenson. What did Jorgenson say about this matter?

An article in CNNMoney.com dated Sept. 7, 2005, by Pat Regnier provides the following regarding a 20 percent price decline:

> What *The Fair Tax Book* fails to mention is that prices can only fall this sharply if companies cut wages. I asked Jorgenson about this, and he agreed. Say your salary is $100,000 today, but you take home $80,000 after taxes . . . . In other words, your take-home pay is the same as before . . . . That's kind of a big thing to leave out.

Very importantly, the only way for a substantial reduction in the price of goods and services to be experienced is through a substantial reduction of salaries and

[6] "Embedded taxes" are tax costs that manufacturers, wholesalers, and retailers incur and then recoup by increasing their prices. Thus, the taxes are embedded in the cost of a good or service.

wages. That means that employees would receive only the net amount of their current paychecks (net of taxes currently withheld, not their gross wages).

So, assuming no imports, if wages of employees were reduced by federal taxes currently withheld, and companies have been passing all of their taxes on to consumers, the price of goods could go down by 20 percent to 25 percent. (If states eliminated their income taxes, the figure could be higher.) But, recall that the 31.2 Percent Opinion assumed no reduction in prices in reaching its 31.2 percent rate. A drop in prices would result in a reduction in the taxable base.

In many cases, corporate taxes can be and are passed on to consumers. In a large part, the corporate savings from eliminating the current tax system would doubtlessly be passed on to consumers. However, there are circumstances when corporate taxes are not passed on to consumers.

Obviously, there is a significant difference between keeping the gross amount of one's pay, versus keeping the net (after-tax) amount of one's pay. Would Fair Tax advocates try to deceive the public about such an important issue? What about the drafters of the 2005 best-selling *The Fair Tax Book*?

Pages 116-117 of the 2005 *The Fair Tax Book* supply language that cannot be disputed. In a discussion about houses and the impact of the Fair Tax plan thereon, *The Fair Tax Book* provides (the language was italicized in the book):

> *Shall we go through that exercise again? Houses will cost slightly less because the embedded tax cost of 23 percent is slightly less than the current embedded cost of the IRS on new construction. If you're making $60,000 per year, you're currently taking home $3,800 per month to pay your mortgage and other bills. Under the Fair Tax, you'll take home $5,000—and you'll pay less in interest because rates will decline by about 30 percent.*

This $3,800/$5,000 deception is repeated on page 160.

Many products are subject to excise taxes that would not be reduced if the Fair Tax was implemented. Gasoline carries federal excise taxes of 18.4 cents per gallon. States as well assess excise taxes on gasoline. Many other goods are subject to excise taxes that would not be reduced if the Fair Tax system was enacted. Consider the massive trade deficit and imported goods, including oil. There are no embedded U.S. taxes, or virtually no embedded U.S. taxes, in these goods.

While it is logical that, due to competition, employers would in large part reduce the prices that they charge due to elimination of the corporate income tax and the FICA tax, those reductions would not lead to substantial reductions in the prices of goods and services. (The reductions would be only in the 5 percent to 6 percent range.) In order for substantial price cuts to be experienced, workers would have to receive the net after-tax pay that they currently receive. Would that happen?

Actually getting many workers (for example, union workers employed under a collective bargaining agreement) to take a substantial pay cut could be unrealistic. In any event, if and when employers attempted to cut wages and salaries to the net after-tax amounts, a conflict would certainly occur.

The extent to which such a change would actually occur is a major unknown about the Fair Tax proposal. The 31.2 Percent Opinion assumed no reduction. The government rate studies probably made the same assumption. Regardless of the amount of a price reduction (if any), as noted immediately below, the tax burden on the middle class and retirees increases very significantly, and the tax burden on wealthy and high-income earners decreases very significantly, under the Fair Tax system. For this purpose, ''middle class'' roughly means a family with income of less than $100,000.

Effect on Individuals and Families

As the Fair Tax Bill is presently drafted, if it is financially feasible to convert to the Fair Tax (discussed below), the Fair Tax would significantly reduce the taxes of virtually all wealthy persons. Corporations would pay no income tax or FICA tax.

Compared to the current system, lower-income working people would pay the same, slightly more, or slightly less tax under the Fair Tax. The poor without earned income would receive more money from the federal government than they currently receive.

As currently drafted, many elderly persons would pay more tax under the Fair Tax. Virtually everyone else would pay less tax than they currently pay.

Individual Analysis for 2005. Consider a single person who makes $50,000, saves $3,000 through his employer's 401(k) plan, and spends the balance, with $3,000 of the amount spent not being subject to the Fair Tax or state and local sales tax. The following chart and related assumptions apply to produce personal financial implications.

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	Wages are net-of-tax amount; prices cut 20%		Wages remain constant and no price reduction	
	29.9% RATE	59.5% RATE	29.9% RATE	59.5% RATE
Current Salary (2005)	$50,000	$50,000	$50,000	$50,000
Less: 2005 Federal Income Taxes*	(6,371)	(6,371)	0	0
Less: State Income Tax (6%)*	(2,328)	(2,328)	0	0
Less FICA Tax	(3,825)	(3,825)	0	0
Remainder	37,476	37,476	50,000	50,000
Less 401(k) Plan Savings	(3000)	(3000)	3000	3000
Net	34,476	34,476		
Less Assumed Tax-Free Payments	(3,000)	(3,000)	3,000	3,000
Amount to be used for Purchases	31,476	31,476	31,476	31,476
Divided by 1.06 (State /local sales tax)	/1.06	/1.06	/1.06	/1.06
Equals: H.R. 25 taxable purchases	29,694	29,694	29,694	29,694
H.R. 25 cost	x.80	x.80	x1.00	x1.00
H.R. 25 Price of Goods/Services	23,755	23,755	29,694	29,694
Multiplied by: Pre-Prebate Tax Rate	x.299	x.595	x.299	x.595
Equals: Pre-Prebate Fair Tax	7,103	14,134	8,879	17,668
Less: 2005 Prebate (9,570 x .23)	(2,201)	(2,201)	(2,201)	(2,201)
Equals: Fair Tax	4,902	11,933	6,678	15,467
TOTAL FAIR TAX LIVING CHANGE:				
H.R. 25 Salary (See above)	37,476	37,476	50,000	50,000
State Taxes**	(4,110)	(4,110)	(4,110)	(4,110)
Fair Tax	(4,902)	(11,933)	(6,678)	(15,467)
Purchases	(23,755)	(23,755)	(29,694)	(29,694)
Tax-Free Paments (3,000 x .80 with price reduction)	(2,400)	(2,400)	(3,000)	(3,000)
401 (k) savings	(3,000)	(3,000)	(3,000)	(3,000)
NET GAIN/(LOSS) TO LIFESTYLE	**(691)**	**(7,722)**	**3,518**	**(5,271)**

*Taxable income is $38,800.
**Assumed to be the same as current system.
(The income tax is $2,328 and the state/local sales tax is 1,782 (31,476 - 29,394).)
In the wages are net-of-tax amount; prices cut 20% column, the state taxes would likely be greater that $4,110 under the 29.9% rate and less than $4,110 under the 59.5 rate.

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Other 2005 examples are provided below. Keep in mind that the only taxes of the current system considered here are the individual income tax and the employees' portion of the FICA tax. Corporate taxes, and estate and gift taxes, which would be eliminated under the Fair Tax, are not considered. By reviewing the numbers and recalling the pie chart from the instructions to Form 1040 for 2005 that showed the sources of revenue of the federal government, one can easily see that if the Fair Tax is revenue-neutral, as its proponents claim, something is amiss.

2005 SAMPLE FEDERAL TAX CALCULATIONS*

	Note: H.R. 25 (i.e. Fair Tax) Proposals assume (1) a 20 % Price Reduction on Goods and Services and a 20% Pay or Self-Employment Income Reduction and (2) No Price Reduction and No Pay or Self-Employment Income Reduction		**(1)20% Price and Wage Reduction**	**(2)No Price or Wage Decrease**
1	Middle-age married couple; 2 kids; employee income of $50,000($40,000 under H.R. 25); no significant itemized deductions [1]	Current System (2005): H.R. 25 (29.9% rate) H.R. 25--59.5% rate	$7,071 3,417 12,643	$7,071 5,747 17,279
2	Retired single person; $15,000 of Social Security income; $12,000 of pension income [2]	Current System (2005): H.R. 25 H.R. 25--59.5% rate	254 3,800 9,741	254 5,300 12,726
3	Retired married couple; $15,000 of Social Security income; $12,000 of pension income [2]	Current System (2005): H.R. 25 H.R. 25--59.5% rate	0 1,691 7,723	0 3,214 10,754
4	Middle-age couple; 2 kids; $100,000 of employee income from one spouse; $25,000 of itemized deductions[2,3]	Current System (2005): H.R. 25 H.R. 25--59.5% rate	13,645 2,791 11,397	13,645 4,964 15,721
5	Married couple with employee income of $1,000,000 ($800,000 under H.R 25 in column 1); $80,000 of itemized deductions; $50,000 of qualifying dividends; $20,000 of nonqualifying dividends[4] and interest income; purchases of $200,000 of taxable goods and services	Current System (2005): H.R. 25 H.R. 25--59.5% rate	296,308 41,938 89,298	296,308 53,898 113,098
6	Single employed person with employee income of $16,000 ($12,800 under H.R. 25) and no deductions [5,6]	Current System (2005): H.R. 25 rate H.R. 25--59.5% rate	2,033 951	2,033 1,739
7	Single person with no compensation but $5,000,000 of tax-exempt interest, $5,000,000 of taxable interest, $5,000,000 of “qualifying” dividends (taxable at 15%) and $5,000,000 of nonqualifying dividends; $200,000 of itemized deductions (lives in Florida) and spends $500,000 on taxable purchases	Current System (2005): H.R. 25 H.R. 25--59.5% rate	4,216,470 117,399 235,799	4,216,470 147,299 295,299

***Notes:** All examples above assume no new home purchases.
In Column 1, because wages and salaries are 20 percent less, the fair Tax cost is magnified with respect to workers.

[1] Assumes that all disposable income (as calculated under present system) Is spent on purchases taxable under HR25; HR25 assumptions presume the same purchase at a 20% discount in the first column (but no reduction in second column), and assume a 20% reduction in pay in the first column (but no reduction in the second column).

[2] Assumes that all disposable income (as calculated under present system) is spent, but no more; HR25 assumptions presume the same purchases at a 20% discount in the first column (but no reduction in the second column), and assume a 20% reduction in pay in the first column (but no reduction in the second column) (if applicable). In example 4, $20,000 of the itemized deductions is mortgage interest and $25,000 is mortgage payments on an existing home (so, $5,000 of principal payments exist). Mortgage payments are not considered in the Fair Tax base. A 6% state and local sales tax and a state income tax are assumed.

[3] Assumes $15,000 of gross income is saved via 401(k) plan. An additional $5,000 of exempt payments are assumed to exist.

[4] Assumes $15,000 of gross income is saved via a 401(k) plan.

[5] Assumes that all disposable income (as calculated under present system) is spent, but no more; HR25 assumptions presume the same purchases, and assume a 20% reduction in pay (if applicable) in column 1. Mortgage payments are not considered in the Fair Tax base. A 6% state and local sales tax and a 6% state income tax are assumed.

[6] In example 6, with a 59.5% rate, spending must be reduced to cover tax. Thus no calculation exists.

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From the above examples and numerous other examples not shown above, the following summary can be drawn with respect to the Fair Tax system relative to the current system in terms of the tax benefits and burdens:

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TYPE PERSON/FAMILY	H.R. 25-29.9% RATE	H.R. 25-59.9% RATE
Poor with no earned income	Better than current system	Worse than current system
Lower income working people (as a group)	About the same as or better than the current system	Much worse than the current system
Upper middle income working people (as a group)	Better than the current system	About the same as or better than the current system
Wealthy working people	Much better than the current system	Much better than the current system
Wealthy investers who do not work	Much better than the current system	Much better than the current system
Average retiree	Worse than the current system	Much worse than the current system

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The President's Advisory Panel On Federal Tax Reform

The President's Advisory Panel on Federal Tax Reform issued its long-awaited report in November 2005. The panel rejected a national retail sales tax proposal.

Two important considerations to the panel's decision were:

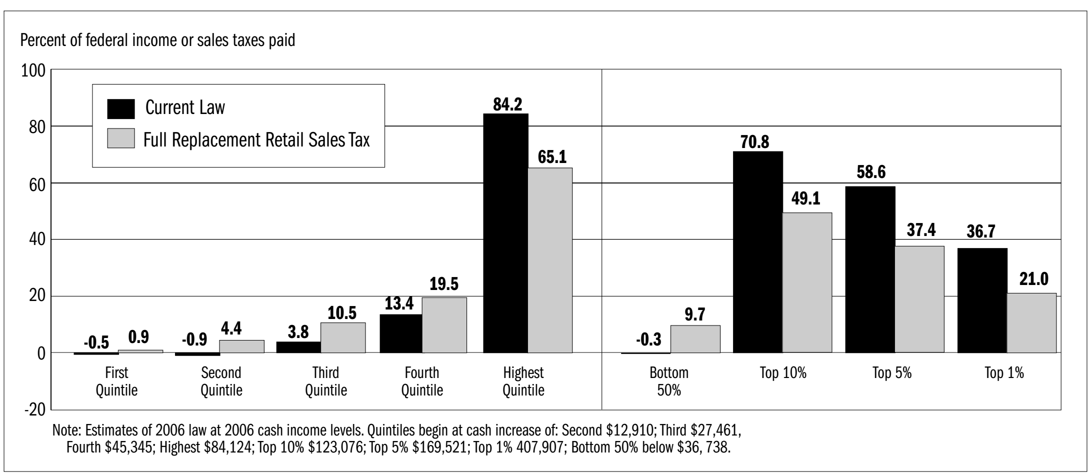
> Replacing the income tax with a retail sales tax, absent a way to ease the burden of the retail sales tax on lower and middle-income Americans, would not meet the requirement in the Executive Order that the Panel's options be appropriately progressive.
>
> Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program—by far the largest in American history. Adjusting the distribution of the burden of the retail sales tax through a cash grant program would cost approximately $600 billion to $780 billion per year and make most American families dependent on monthly checks from the federal government for a substantial portion of their incomes. The Panel concluded that such a cash grant program would inappropriately increase the size and scope of government.

The Panel specifically considered the ''prebate'' program advanced by Fair Tax advocates. Here is what the Panel said:

> This cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required tax rate, assuming evasion rates somewhat lower than those under the income tax, would be 34 percent. Using a higher evasion rate assumption, discussed further below, the tax rate would be 49 percent. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher.

Regarding the financial impact on individuals and families, the following charts from the panel's report (pages 212 and 213) lay out the detail.

Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Percentile (2006 Law)



Source: Department of the Treasury, Office of Tax Analysis

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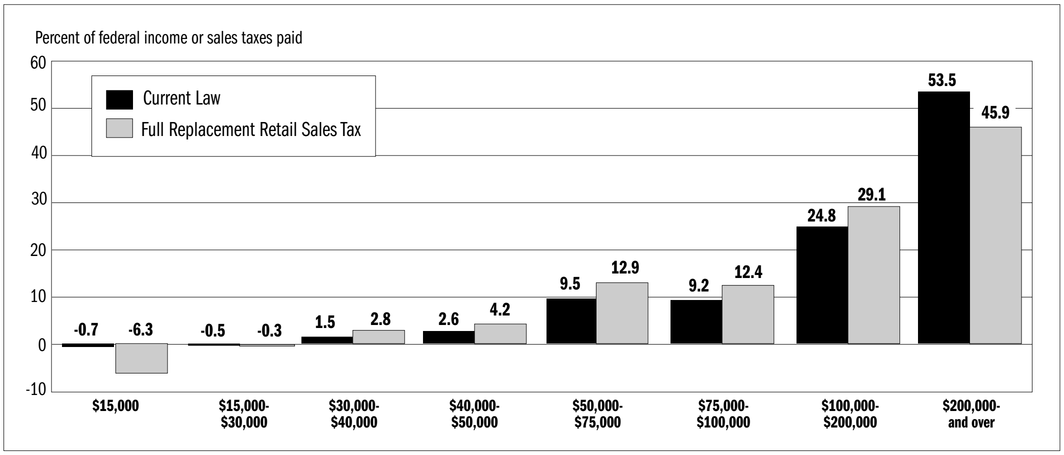
Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels

Source: Department of the Treasury, Office of Tax Analysis

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On page 213, the panel's report says ''Figures 9.3 and 9.4 show that low-income and high-income Americans would benefit from a retail sales tax with a Prebate, while middle-income Americans would pay a larger share of the federal tax burden.'' A direct quote from page 79 of the 2005 *The Fair Tax Book* is as follows: ''If there's one thing to remember about the Fair Tax, though, it's that the plan all but eliminates the total tax burden on middle- and lower-income Americans, allowing them to save . . . .''

The panel's report also provided:

> Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department's analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married taxpayers would see substantial tax increases under a full replacement retail sales tax. A typical married couple at the bottom 25th percentile of the income distribution earns $39,300 per year and would pay $5,625 dollars in federal taxes in 2006. Under the retail sales tax with a Prebate, the same family would pay $7,997 in net federal taxes after subtracting the Prebate of $6,694, resulting in a tax increase of $2,372, or 42 percent. A typical married couple at the 50th percentile of the income distribution making $66,200 would pay an additional $4,791, a tax increase of 36 percent, and a typical married couple in the 75th percentile, making $99,600 would pay an additional $6,789, a 29 percent tax increase. A typical single mother at the bottom 25th percentile of the income distribution for head of household taxpayers has $23,100 of income per year and, compared to current law, would pay $5,866 more under the retail sales tax with a Prebate.

Negative economic consequences would exist if the middle class bears a significantly higher percentage of the federal tax burden.

The Economy

Application of the Fair Tax would have positive and negative effects on the economy. Giving people more take-home pay gives them more money to spend. But, in order to produce the 20 percent to 30 percent price reduction promised, employees would not get more take-home pay. Applying a 60 percent tax (or even a 30 percent tax) to the sale of virtually every good would discourage spending on (consumption of) new goods. The heavy hit on the middle class produced by a 60 percent tax rate would hurt economic growth.

In 1997, the Joint Committee on Taxation produced a study of the economic effects of conversion from the current (1997) tax system to two different systems. Eleven different groups (teams) of economists participated. Nine of them issued reports on various economic factors.

The first system considered was a unified income tax under which:

- individual and corporate tax rates were integrated,
- the tax base was broadened (deductions reduced), and
- the individual income tax rate schedules were flattened.

The tax on dividends was eliminated and the tax on capital gains of individuals was reduced. Personal itemized deductions and tax credits were eliminated and replaced with a credit. Employee benefits of all sorts were taxable.

The second system considered was a consumption tax. Importantly, it was designed to replace only individual and corporate income taxes. The payroll (FICA) tax was not eliminated.

Two consumption tax alternatives could be considered by the teams. One was a value-added tax (VAT) on the excess of the value of goods and services over certain business expenses for domestic business enterprises.

The second consumption tax alternative was a consumption-based flat tax. On page 7, the study provides the following regarding this alternative:

> The second consumption tax alternative, the consumption-based flat tax, in theory, falls on the same base as the VAT. The only difference between the two forms is that under the flat tax, wages paid are deductible by the employer and taxable to the wage earner at the flat rate.

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In other words, the first alternative was a VAT and the second alternative was similar to a VAT. Neither alternative was a retail sales tax such as the Fair Tax proposal.

A summary table from the study, showing the estimated medium-run and long-run impacts of changes from the current system to either of the two proposed systems on GDP, follows, along with the estimated short-term impacts of changes to the two proposed systems on GDP.

TABLE 1. SIMULATION RESULTS: MEDIUM-RUN AND LONG-RUN
(Percent differences from current tax code baseline)

SUMMARY VARIABLES	NET CHANGE INTERNATIONAL CAPITAL FLOWS	CONSUMPTION TAX[1]			UNIFIED INCOME TAX[2]		
		2005	2010	LONG RUN	2005	2010	LONG RUN
REAL GDP:							
Fullerton-Rogers—low[3]	No	—	—	1.7	—	—	1.8
Fullterton-Rogers—high[4]	No	—	—	5.8	—	—	3.8
Auerbach, Kotlikoff, Smetters & Walliser	No	4.0	5.0	7.5	-1.7	-2.1	-3.0
Engen-Gale	No	1.8	2.1	2.4	-0.2	-0.3	-0.5
Jorgenson-Wilcoxen	No	3.6	3.3	3.3	1.6	1.4	1.3
Macroeconomic Advisers (transition relief[5])	Yes	1.4	1.3	5.4	—	—	—
Robbins	Yes	16.4	16.9	—	14.6	15.4	—
DRI Inc./McGraw-Hill	Yes	4.7	—	—	-1.1	—	—
DRI Inc./McGraw-Hill—("VAT")	Yes	-4.2	—	—	—	—	—
Gravelle	No	0.7	1.0	3.7	0.6	0.7	1.8
Coopers & Lybrand	Yes	1.2	—	—	1.1	—	—

TABLE 2. SIMULATION RESULTS: SHORT-TERM EFFECTS
(Percent differences from current tax code baseline)

SUMMARY VARIABLES	NET CHANGE INTERNATIONAL CAPITAL FLOWS	CONSUMPTION TAX[1]					UNIFIED INCOME TAX[2]				
		1997	1998	1999	2000	2005	1997	1998	1999	2000	2005
REAL GDP:											
Fullerton-Rogers—low[3]	No	1.2	—	—	—	—	1.3	—	—	—	—
Fullterton-Rogers—high[4]	No	5.8	—	—	—	—	3.6	—	—	—	—
Auerbach, Kotlikoff, Smetters & Walliser	No	1.2	1.7	2.1	2.4	4.0	-0.9	-1.0	-1.1	-1.2	-1.7
Engen-Gale	No	0.8	1.1	1.3	1.4	1.8	0.0	0.0	0.0	-0.1	-0.3
Jorgenson-Wilcoxen	No	3.4	3.8	3.6	3.7	3.6	1.1	1.3-	1.5	1.6	1.6
Macroeconomic Advisers (transition relief[5])	Yes	1.8	-2.0	1.1	4.3	1.4	—	—	—	—	—
Robbins	Yes	7.9	12.4	14.7	14.0	16.4	5.9	9.9	12.1	11.9	14.6
DRI Inc./McGraw-Hill	Yes	-0.3	-1.2	-1.2	-0.8	4.7	-1.5	-4.1	-5.1	-5.3	-1.1
DRI Inc./McGraw-Hill—("VAT")	Yes	-2.3	-7.7	-11.2	-12.5	-4.2	—	—	—	—	—
Gravelle	No	0.1	0.2	0.3	0.3	0.7	0.5	0.5	0.5	0.6	0.5
Coopers & Lybrand	Yes	0.2	0.3	0.3	0.7	1.2	-0.2	0.2	0.4	0.5	1.1

1 Consumption tax with income tax credit—bifurcated, "flat" consumption tax unless noted as a subtraction method value added tax ("VAT").
2 Unified income tax with income tax credit.
3 Assumes leisure-consumption (intratemporal) and intertemporal elasticities both are 0.15.
4 Assumes leisure-consumption (intratemporal) and intertemporal elasticities both are 0.50.
5 Transition relief allows retention of present law depreciation for existing investments, and of interest deductions and continued deduction of pre-tax change NOL carry-forwards.
6 Generally represents hours worked or employment.
7 Percentage point change in the net domestic savings rate.

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The medium- and long-term chart of the study, showing estimated impacts on labor and saving, appears on the following page.

Would implementation of the Fair Tax produce the results supplied by the preceding tables (or very similar results)? It seems that a consumption VAT would produce results somewhat close to a national retail sales tax. However, a few points need to be considered.

A factor cited in the JCT study as impeding economic growth was the double tax on dividends and taxes on capital. When the study was done (1997), dividends were not tax-deductible to companies, and they were

TABLE 1. SIMULATION RESULTS: MEDIUM-RUN AND LONG-RUN—CONTINUED
(Percent differences from current tax code baseline)

SUMMARY VARIABLES	NET CHANGE INTERNATIONAL CAPITAL FLOWS	CONSUMPTION TAX[1]			UNIFIED INCOME TAX[2]		
		2005	2010	LONG RUN	2005	2010	LONG RUN
LABOR EFFORT:							
Fullerton-Rogers—low[3]	No	– – –	– – –	-0.1	– – –	– – –	-0.1
Fullterton-Rogers—high[4]	No	– – –	– – –	0.0	– – –	– – –	0.3
Auerbach, Kotlikoff, Smetters & Walliser	No	0.1	0.1	0.0	-0.9	-0.8	-0.4
Engen-Gale	No	0.1	0.1	0.1	0.1	0.1	0.1
Jorgenson-Wilcoxen	No	6.8	6.6	6.8	5.1	5.0	5.2
Macroeconomic Advisers (transition relief[5])	Yes	-0.3	-0.5	1.7	– – –	– – –	– – –
Robbins	Yes	4.2	4.3	– – –	4.2.	4.3	– – –
DRI Inc./McGraw-Hill	Yes	1.2	– – –	– – –	-1.2	– – –	– – –
DRI Inc./McGraw-Hill—("VAT")	Yes	-4.3	– – –	– – –	– – –	– – –	– – –
Gravelle	No	0.2	0.2	0.3	0.7	0.7	0.7
Coopers & Lybrand	Yes	1.0	– – –	– – –	1.0	– – –	– – –
SAVING RATE							
Fullerton-Rogers—low[3]	No	– – –	– – –	0.1	– – –	– – –	0.1
Fullterton-Rogers—high[4]	No	– – –	– – –	0.6	– – –	– – –	0.3
Auerbach, Kotlikoff, Smetters & Walliser	No	3.9	3.3	1.4	-1.2	-1.0	-0.4
Engen-Gale	No	1.0	0.9	0.7	-0.1	-0.1	0.1
Jorgenson-Wilcoxen	No	-1.0	-1.0	-1.0	-1.4	-1.4	-1.3
Macroeconomic Advisers (transition relief[5])	Yes	-0.2	-0.6	1.1	– – –	– – –	– – –
Robbins	Yes	-3.7	-4.9	– – –	-2.6	-2.8	– – –
DRI Inc./McGraw-Hill	Yes	-1.4	– – –	– – –	0.9	– – –	– – –
DRI Inc./McGraw-Hill—("VAT")	Yes	0.9	– – –	– – –	– – –	– – –	– – –
Gravelle	No	0.8	0.7	0.5	0.2	0.2	0.3
Coopers & Lybrand	Yes	-0.1	– – –	– – –	-0.1	– – –	– – –

1 Consumption tax with income tax credit—bifurcated, "flat" consumption tax unless noted as a subtraction method value added tax ("VAT").
2 Unified income tax with income tax credit.
3 Assumes leisure-consumption (intratemporal) and intertemporal elasticities both are 0.15.
4 Assumes leisure-consumption (intratemporal) and intertemporal elasticities both are 0.50.
5 Transition relief allows retention of present law depreciation for existing investments, and of interest deductions and continued deduction of pre-tax change NOL carry-forwards.
6 Generally represents hours worked or employment.
7 Percentage point change in the net domestic savings rate.

A BNA Graphic/dt814g16

subject to tax at ordinary income tax rates at the individual level. The long-term capital gains tax rate was 20 percent. The highest individual income tax rate was 39.6 percent in 1997. Thus, a tremendous amount of dividend income was taxed at a 39.6 percent rate.

Today, ''qualifying dividends'' (paid by any domestic corporation and by many foreign corporations) are subject to a maximum tax rate of 15 percent. Also, long-term capital gains are taxed at a maximum rate of 15 percent. So, these impediments to growth have been significantly diminished.

The Fair Tax Book says that conversion to the Fair Tax would cause substantial repatriation of earnings of foreign subsidiaries of U.S. companies, thus resulting in substantial economic growth. However, a 2004 tax law change has already induced substantial repatriation of earnings to U.S. companies. Generally, for 2004 or 2005 (as elected by the company), 85 percent of any extraordinary dividends received from a controlled foreign corporation (CFC) could be deducted from gross income. A tremendous amount of wealth was repatriated under this law change in 2004 and 2005. Accordingly, much of the economic growth that would supposedly be experienced from conversion to the Fair Tax has already been experienced.

At page 138, the 2005 *The Fair Tax Book* provides: ''If, as many predict, we double the size of our economy in the first fifteen years after passage of the Fair Tax Act, ...'' Under the income tax system, the economy has doubled in size over 15 years several times. Below are real GDP figures in billions of 2000 dollars.

GDP in 2000 Dollars
In Billions of Dollars

YEAR	GDP
1929	$865.2
1934	704.2
1939	950.7
1944	1,806.5
1949	1,634.6
1654	2,065.4
1959	2,441.3
1964	2,998.6
1969	3,765.4
1974	4,319.6
1979	5,173.4
1984	5,813.6
1989	6,981.4
1994	7,835.5
1999	9,470.3
2004	10,755.7

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(The FICA tax did not exist for all years above.)

As previously noted, Dale Jorgenson is quoted in *The Fair Tax Book* regarding embedded taxes in the price of goods. Jorgenson and Peter Wilcoxen formed one of the

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teams that participated in the 1997 JCT study. On page 135 of the study, the Jorgenson/Wilcoxen team wrote:

> Although GDP increases, the consumption tax does not increase overall welfare: the equivalent variation corresponding to it is essentially zero. The increase in GDP is brought about by higher labor supply and increased investment. This requires lower consumption of goods and leisure, particularly in the early years of the simulation, and tends to lower welfare and offset the effect on GDP.

In their conclusion (on page 136 of the JCT study), the Jorgenson/Wilcoxen team wrote:

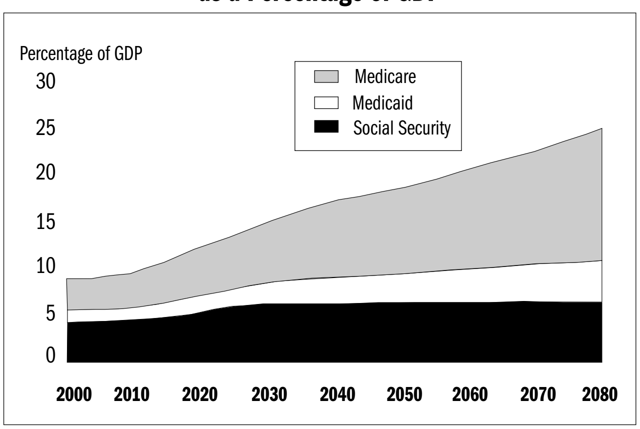
> Substitution of flat rate consumption or income taxes for existing taxes would be the most drastic change in federal tax policy since the introduction of the income tax in 1913. Therefore, it is somewhat surprising that the economic impacts we have summarized would be so modest. In fact, in the case of the consumption tax it appears that the major gain from tax reform would be a reduction in the substantial compliance costs associated with the existing tax system, estimated to range from $100 to $500 billion per year. These benefits are large and are not captured by our model.

(Simplicity is discussed below.)

Many Fair Tax advocates like the fact that the elderly will pay more tax, because their baby boom entitlements will hit the economy of the United States very hard in the near future. There is no doubt that the entitlement wave is a disaster waiting to happen.

The entitlement expectation chart for the United States, as produced by the U.S. Government Accountability Office (GAO), is provided below.

Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



Source: GAO analysis based on data from the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, Congressional Budget Office

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Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2005 trustees' reports. Medicaid projections are based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under midrange assumptions.

In 2007, the GAO reported that the present value of the federal government's retirement-type benefits (Social Security, Medicare, and other federal pensions and retirement-type benefits) is $50.5 trillion, while the total net worth of all Americans combined is $53.3 trillion. Seventy-five years of unfunded liabilities were discounted to present value using a 5.7 percent interest rate to produce the $50.5 trillion figure. For 2006, these entitlements represented approximately half of federal expenditures.

The penultimate paragraph of the 31.2 Percent Opinion provides:

> The scale of federal expenditures is, of course, projected to rise sharply over time as the baby boomers retire and as government-provided healthcare benefits continue to soar. Permitting federal expenditures to grow at their projected rates spells much higher tax rates regardless of the tax system in place. But, as documented in Kotlikoff (2005) and many others, it will surely also spell fiscal insolvency and economic collapse.

Ultimately, absent very substantial immigration, fiscal insolvency and an economic collapse are, unfortunately, realistic possibilities under current fiscal policy or anything like it. However, because the baby boomers will gradually grow the entitlement pool, the decline will be gradual. The Fair Tax, which provides no means of reducing spending other than the practicality that deficits can grow only so large, does not solve the problems.

Homes. The Fair Tax applies to the sale of new homes but not to sales of existing homes. Thus, much of the new homes industry would be significantly hurt. With it would go industries that flow into the new homes industry, such as bricks, lumber, glass, and roofing materials.

New car sales would be hurt as well. Similar to homes, new cars would be subject to the Fair Tax but used cars would not be subject to the tax. Consider all of the industries that flow into the automotive industry. The same is true of all other products—new products would be subject to the tax but used products would not be subject to the tax.

Since existing homes are not subject to tax, the advantage that they would hold over new homes would be significant. Transition rules aside (discussed below), there simply are not enough embedded costs in homes to make up the difference. Again, a price reduction assumes that wages and salaries are cut by the amount of the eliminated taxes. (The 31.2 Percent Opinion assumed no price reduction.)

Under the Fair Tax system, mortgage interest payments and state and local property taxes would no longer produce a tax benefit. Also, a portion of the interest on the amount borrowed from a home mortgage lender would ordinarily be subject to the Fair Tax. It is doubtful that the new homes industry, that is now significantly slowing down, would welcome such a change with open arms.

In addition, interest income received from a bank is subject to the Fair Tax. The tax applies to the excess of the federal short-term rate over the interest rate paid by the bank. So, if the federal short-term rate is 4 percent and the bank pays 2 percent interest, the 2 percent difference would be subject to tax. If the tax rate was 60 percent, the tax would be 1.2 percent, netting the account holder a return of 0.8 percent.

Aside from the loss of the mortgage interest deduction and taxation of part of the interest on the amount borrowed, the Jorgenson/Wilcoxen team said the following in the 1997 JCT study about the consumption tax considered:

> Figure 3 shows that the reform would have only a small positive effect on the capital stock but this masks a very substantial shift of capital out of housing and consumer durables and into business capital. The shift comes about be-

> cause the consumption tax would eliminate the mortgage interest deduction while providing more favorable tax treatment of business investment than exists under current law. This would cause a large reallocation of capital . . . . Household capital would decline by about 10 percent and business capital would increase by about 12 percent. The reallocation happens immediately (that is, beginning in the first period after the change in tax systems) because we allow free mobility of capital between uses. This probably overstates the short run movement of capital out of housing.

Another participant in the 1997 JCT study was DRI/McGraw-Hill. Its report by Roger Brinner provides, similar to the Jorgensen/Wilcoxen team's report:

> *The prices of key assets would change substantially, creating major windfall gains and losses.* As a key example, elimination of interest and property tax deductibility for owner-occupied homes would remove a valuable subsidy that is reflected in the price of land and, by extension, residences today. This subsidy raises the market price and quantity consumed, thus its sudden removal would generate huge windfall losses to current homeowners and would depress new construction activity. Market interest rates would not decline by a sufficient margin to buffer this shock.

Brinner's estimated loss in value of homes:

> *Housing:* Real home prices can be expected to drop by the capitalized value of lost mortgage interest and property tax deductions: a 15% decline . . . .

A more long-lasting effect is the wealth effect from lower home prices. Owner-occupied homes make up a large share of personal wealth, so the 15 percent drop in prices reduces consumer wealth, and thus consumer purchases. Higher equity prices are not enough to offset this impact.

Interest Rates. Contrary to the 30 percent reduction in interest rate alleged on page 160 of the 2005 *The Fair Tax Book*, Brinner anticipated a small increase in the 10-year Treasury bond yield for the first two years after a change to a consumption tax. Thereafter, small decreases were anticipated.

Another participant in the 1997 JCT study was Coopers & Lybrand LLP. Its report was written by John Wilkins. Regarding future interest rates, Wilkins's report provides:

> Interest rates in 2006 would be below the baseline. Real short-term rates would be down about 50 basis points and real long-term rates would be down about 20 basis points under all three alternative tax systems.

''Fifty basis points'' means one-half of 1 percent; 20 basis points means two-tenths of 1 percent.

At this point, it should be apparent that the real winners under a revenue-neutral Fair Tax would be wealthy persons who own a lot of corporate stock, and the real losers would be middle-class and elderly homeowners.

Tax Evasion and the IRS

As noted above, most advocates of the Fair Tax use elimination of the IRS as a selling point.

As correctly noted in the 2005 *The Fair Tax Book*, substantial evasion exists under the present tax system. Much of that evasion relates to cash ''under the table'' transactions. It is difficult to police those transactions.

However, very little evasion exists with respect to wage withholding and reporting because there is little incentive for an employer to report fraudulent (insufficient) compensation figures to help an employee, when the employer gains nothing by doing so and the employer receives a tax deduction for the amount of the compensation. Even in a family company setting, absent fraud, reduced wages means higher taxable profits. In other words, a for-profit employer can benefit by maximizing compensation reported to IRS.

Contrast the current employer-reporting incentive with the incentive of a small retailer to charge and then pocket the Fair Tax. Without a policing agency (such as IRS), a tremendous amount of tax would be pocketed by small and mid-sized retailers. Under the Fair Tax system, there simply is not a natural divergence of interests present.

If the Fair Tax was enacted, a significant black market would evolve to evade the tax. Consider the number of people who go to Canada to purchase prescription drugs at lower prices. In anticipation of evasion, the Fair Tax bill includes an ''800 number'' provision whereby people can report cheaters. (If there is no IRS, whom would one call?)

Consider the mom-and-pop retailers of the United States. Many of them are getting clobbered by chains such as Wal-Mart. They cannot buy in bulk, so they cannot compete. But they could charge lower prices than the chains, keep two sets of books, and pocket some of the sales tax to compete.

As a practical matter, the major retail chains, which are evaluated in a large part based on sales growth (thus creating a desire to maximize sales that are reported to the public and the SEC), would demand audits of private retail businesses with which they compete.

In a February 2007 article titled *Taxing Sales Under the Fair Tax: What Rate Works?*, William Gale made the following astute observation:

> The tax rate will need to be increased due to legal erosion of the tax base. For example, it will be politically impossible to apply sales tax to a portion of mortgage and credit-card interest payments, as the FairTax plan proposes. As these and other items are exempted from the tax, a vicious cycle will ensue; the erosion of the base will require higher tax rates, which will intensify the pressure for still more erosion.[7]

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[7] In his May 16, 2005, *Tax Notes* article titled ''The National Retail Sales Tax: What Would the Rate Have to Be?,'' William Gale wrote:

I also examine the required rate under more realistic assumptions, allowing for some avoidance, some evasion, and some legislative adjustments to the tax base. Modest adjustments in this direction significantly raise the required tax rate and raise the revenue loss from imposing a 23 percent (tax-inclusive) tax rate. For example, if evasion occurred at the same rate in the sales tax as in the income tax and if the sales tax did not cover interest payments such as mortgages and credit card payments, 20 percent of the consumption base would be lost. In that case, even with no avoidance and with all other consumption (including health, housing, and food) fully taxed, the required 10-year rate would rise to 39 percent tax-inclusive (65 percent tax-exclusive). If, in addition, state and local purchases were omitted from the federal sales tax, the 10-year revenue-neutral federal sales tax rate would rise to 45 percent tax-inclusive (82 percent tax-exclusive).

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Exemptions from the Fair Tax include purchases by businesses that are in furtherance of ''bona fide business purposes.'' If the Fair Tax was enacted, an overnight shrinking of hobbies and birth of ''businesses'' would be experienced. In other words, to avoid the tax, many persons would claim that undertakings that they had previously considered to be hobbies officially are businesses that can buy their supplies tax-free. While the Fair Tax Bill has a ''safe harbor'' for enterprises with significant sales, the bill otherwise provides no certain answers. Therefore, a strong policing force would be necessary.

On pages 118 and 119, the 2005 *The Fair Tax Book* says that in order to cheat under the Fair Tax system, ''two people must conspire to cheat: The provider or seller, and the consumer or buyer.'' That statement is incorrect. An example: Home Depot sells plywood for $3 per board. Slick Joe's Hardware, located down the street, sells it for $2.70, and so advertises: ''We are 10% cheaper than Home Depot on plywood.'' Slick Joe sells to Sam Honest, consumer, charges the tax, and then pockets the tax. One person cheated.

There would be evasion cases involving both seller and buyer. For example, a home addition by a contractor might go untaxed. Canada has experienced such evasion with respect to its 7 percent goods and services tax (GST).

Concerning the monthly refunds relating to the poverty exemption, the April 7, 2000, JCT memorandum of Lindy Paull notes that the consumption allowance would require ''substantial monitoring to avoid widespread abuse.'' That monitoring would need to be performed by IRS (or some other agency with a different name that serves the current function of IRS) and/or state collections agencies that would be expanded considerably to handle all of these functions.

Under the Fair Tax, a purchaser of goods outside the United States for use in the United States would be required to report and pay tax on the imported goods. Revenue agents would be necessary at borders and at airports to collect the tax. A tax return is also required to be filed by a consumer for any month for which a taxable good or service is purchased, if the seller does not withhold and pay the tax and issue a receipt to the consumer.

The bottom line is that with any tax system there will be evasion. The Fair Tax system would present a different system of evasion than the current system. To assume that there would not need to be a centralized federal agency charged with preventing evasion is unrealistic.

State and Local Taxes Impact

As previously discussed, there is a good chance that the U.S. Supreme Court would conclude that the Fair Tax, as applied to purchases by state and local governments, violates the intergovernmental tax immunity doctrine and is unconstitutional as applied to such purchases.

An obvious fix to this problem would be to amend the Fair Tax bill to exempt purchases by state and local governments. However, as previously discussed, such a change would necessitate an increase in the rate in order to hold revenue constant. The remainder of this section generally assumes that application would not be unconstitutional.

The Fair Tax would apply to many purchases by state and local governments (for example, a police car purchase). Because the revenue-neutral tax rate would exceed the cost reduction (if any), in order to cover the increased cost, state and local taxes and fees would increase.

Currently, interest income on bonds issued by state and local governments is tax-free for federal income tax purposes. Because of this attribute, state and local governments can issue bonds that pay less interest than bonds issued by corporations. Under the Fair Tax system, interest paid by state and local governments would no longer produce a tax benefit to taxpayers, and state and local governments would need to increase the interest rates that they offer in order to attract investors.

Existing state and local bonds would take a major value hit upon enactment. Accordingly, the cost of state and local borrowing would increase, thus resulting in increases in state and local taxes and fees across the board. (Note that these impacts would result regardless of whether state and local purchases were or were not subject to the Fair Tax.)

Generally, with the exception of wages and salaries relating to education, wages and salaries paid to any governmental employee are subject to the tax. Again, state and local taxes and fees would need to increase to cover this cost increase.

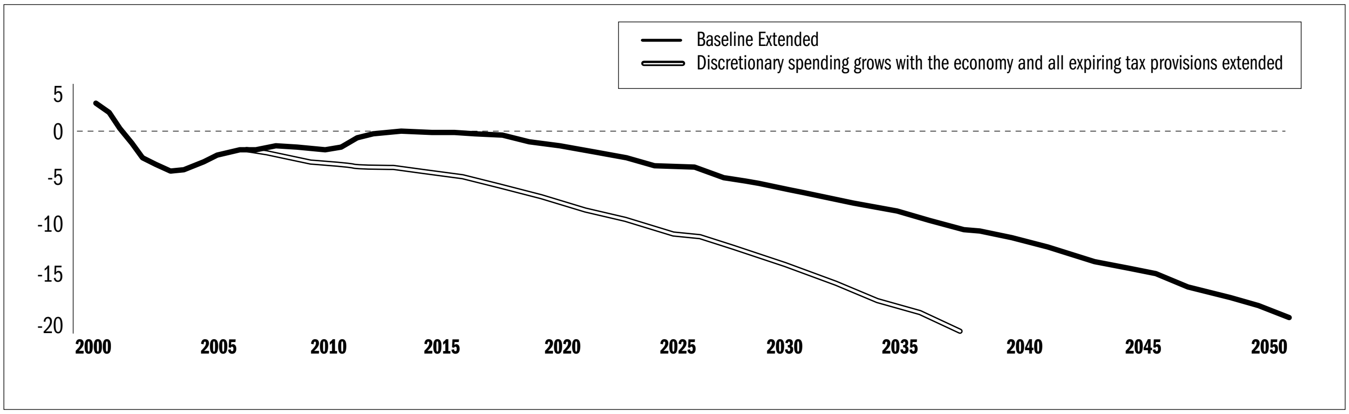
State and local governments currently do not tax services. However, under the Fair Tax, they would begin taxing services to cover their increased costs. Although the bill does not require the states to tax services, the bill is drafted so that states can and will collect the Fair Tax for a fee. It is only logical that the states would use the same tax base as the federal government, particularly given their increased costs. On page 158, the 2005 *The Fair Tax Book* provides: ''. . . we expect that the state governments will start feeling tremendous pressure to conform their own tax systems to the National Fair Tax System.''

Financial Practicality

A question that must be considered is whether, from a financial perspective, the proposed Fair Tax could work. An understanding of the current financial problems of the United States is necessary to answer the question.

Unfortunately, on its current fiscal path, the long-term economic outlook for the United States is bleak. While the current debt is approximately $9 trillion, the total debts and the present value of the unfunded entitlement liabilities now total between $34 trillion and $61 trillion, which breaks down to $270,000 to $485,000 per full-time worker.

Unified Surpluses and Deficits as a Share of GDP under Alternative Fiscal Policy Simulations



Source: GAO's August 2006 analysis A BNA Graphic/dt815g5

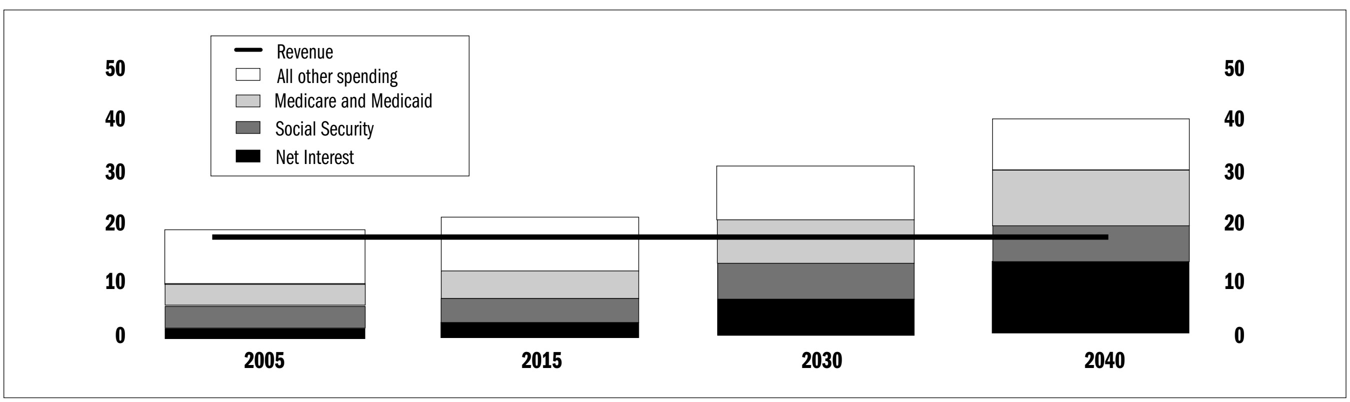
In September 2006, the GAO issued *The Nation's Long-Term Fiscal Outlook, September 2006 Update*. The subheading of the outlook is *The Bottom Line: Today's Fiscal Policy Remains Unsustainable*. The chart above and the following quote are from the first page thereof:

> GAO's current long-term simulations continue to show ever-larger deficits resulting in a federal debt burden that ultimately spirals out of control. The timing of deficits and the resulting debt build up varies depending on the assumptions used, but under either optimistic (''Baseline extended'') or more realistic assumptions, current fiscal policy is unsustainable.

Thus, with baby boomer entitlements coming due soon, our economic system as we know it is in deep trouble.

The GAO also produced the following analysis:

Composition of Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's Annual 2006 analysis A BNA Graphic/dt815g6

David Walker, comptroller general of the United States and head of the GAO, recently said the following about the financial problems:

> As Washington embarks on the budget cycle for fiscal year 2007, the facts are clear and compelling that the federal government is on an imprudent and unsustainable fiscal path that, if not effectively addressed, could serve to swamp our ship of state. Our current course doesn't just threaten our future economy and quality of life, but also our long-term national security . . . .

Before the Senate Budget Committee Jan. 11, 2007, Walker also said:

> We are on an imprudent and unsustainable long-term fiscal path, and while the short-term deficits have improved in recent years, the long term is getting worse every second of every minute of every day and the time for action is now.

Some studies have shown that seniors outvote younger persons by a ratio of 4-to-1. The large group of seniors heading into retirement (the baby boomers), and the two major political parties' pandering for their votes, is not a good combination for the United States.

In a sense, the Fair Tax system would tax retired persons twice. Under the income tax and FICA tax system, working people and wealthy people ordinarily pay

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taxes and fund the lion's share of individual taxes, while an average retiree pays little or no tax. Changing the system now would cause retirees to pick up a substantial portion of the federal tax bill.

A rate of 30 percent is approximately one-half of the 60 percent rate produced by both the President's advisory panel and the chief counsel of the Joint Committee on Taxation. If the revenue-neutral tax-exclusive rate is 60 percent, due to the following reasoning, the U.S. government could not function in its present manner if the proposed Fair Tax (with a 30 percent tax-exclusive rate) replaced the current system.

Budget figures produced by CBO are as follows:

BUDGET FIGURES BY CBO

	ACTUAL 2005	2006
REVENUES		
Individual income taxes	927	1,003
Corporate income taxes	278	302
Social insurance taxes	794	838
Other	154	169
TOTAL	**2,154**	**2,313**
On-budget	1,576	1,704
Off-budget	577	608
OUTLAYS		
Mandatory spending	1,320	1,429
Discretionary spending	968	1,002
Net interest	184	218
TOTAL	**2,472**	**2,648**
On-budget	2,070	2,220
Off-budget	402	428
DEFICIT(-) OR SURPLUS	**-318**	**-336**
On-budget	-493	-516
Off-budget	175	180
Debt Held by the Public	4,592	4,931
MEMORANDUM:		
Gross Domestic Product	12,293	13,082

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If the revenue of $2,313 billion for 2006 were cut in half to $1,157 billion (2,313/2 = 1,157), the annual deficit for the 2006 fiscal year would have been $1,491 billion (1,157 - 2,648).

Even if the economy and tax revenues both grew by 5 percent to 10 percent, the deficit figure would substantially exceed $1 trillion. No reasonable person would lend the United States $1 trillion at any reasonable rate of interest if the anticipated annual cash outflow of the United States was expected to be almost double its anticipated annual cash inflow for an indefinite period of time. So, financially, the Fair Tax proposal would not work.

Could the Fair Tax system work if spending was cut by 40 percent to 50 percent? This author believes that, with a strong central collection agency, the Fair Tax system could work with such spending cuts.

Retirement Savings, Charities And the Unemployed

The current tax system encourages retirement savings in 401(k) plans and similar plans. Contributions to 401(k) plans, pension plans and profit-sharing plans are tax-deductible for income tax purposes. Assets of these plans grow on a tax-free basis.

Withdrawals generally cannot be taken until termination of employment. Distributions that are not "rolled over" to an individual retirement account (IRA) or to another employer's "qualified" plan are subject to income tax. Also, if the payee is under age 59½, a 10 percent penalty ordinarily applies to any distribution. Thus, incentive exists to roll over any distribution to an IRA or another employer's plan to continue tax-free growth until retirement.

In contrast, under the Fair Tax system, other than the tax on spending on services and new goods, there is no tax-saving incentive to save.

It is uncertain what effect conversion to the Fair Tax system would have on pension plans and profit-sharing plans. It seems likely that 401(k) plans would either disappear or be changed substantially. On a positive note, "nonqualified" deferred compensation plans for executives would be freed from the need to subject plan assets to potential loss to creditors in order to defer taxation.

As noted above in the Tables I and II of the JCT study concerning the economy, one of the economist teams in the 1997 JCT study was the Engen-Gale team. "Engen" is Eric Engen, and "Gale" is William Gale. Their summary in the 1997 JCT study concerning savings provides the following:

> Aside from saving in tax-sheltered accounts, U.S. net personal saving is negligible . . . . Over the last twenty years, while the personal saving rate has declined, the rate of tax-preferred retirement saving has risen but other net personal saving has vanished. In the 1970s, tax-preferred retirement and life-insurance saving comprised less than 60 percent of total personal saving. Since the mid-1980s, they have made up more than 100 percent of personal saving.

Currently, income tax deductions and estate and gift tax deductions are available for the value of gifts to charities. For an individual in the highest federal income tax bracket (35 percent), a $100 contribution costs the donor only $65. If there is an effective state income tax rate of 5 percent, the after-tax cost is $60.

For a very wealthy individual, the highest tax rate under the estate and gift tax is 45 percent. So, making a $100 bequest to a charity really costs the estate of the donor $55.

Tax-qualified plan benefits and IRA benefits are subject to both the income tax and the estate and gift tax, except that an income tax deduction is available for the amount of the estate tax attributable to the benefits. Accordingly, for the very wealthy, the effective tax rate on these benefits ordinarily is in excess of 60 percent. Not surprisingly, retirement and IRA benefits are often the first item targeted for charitable giving by wealthy individuals.

In contrast to the current system, the Fair Tax system provides no incentive whatsoever to give to charities. It is very unlikely that charities would politely accept such a change.

One of the good things about the current system is that it "goes easy" on the unemployed. A person with no income pays no tax.

Goods and services would cost more, on an after-tax basis, under a revenue-neutral Fair Tax. Accordingly, included on the losers list would be the unemployed persons ordinarily in the middle- and upper middle-income ranks. With no money coming in, a net increase in the price of goods and services would be painful.

Transition

Assuming that all of the previously considered defects with respect to the Fair Tax could be fixed—the rate is raised to a revenue-neutral rate and IRS is reassigned to cover small and mid-sized businesses, sales tax administration, and border transactions—the question becomes whether an effective transition could be made from the current system to the Fair Tax system.

It is not realistic to think that a transition could be undertaken overnight. If the current system had been ''shut off'' on Dec. 31, 2007, and replaced by the Fair Tax system on Jan. 1, 2008, absent an effective transition rule, there would have been a tremendous amount of purchases in December 2007, and a virtual shutdown of the economy beginning Jan. 1, 2008. How long would it take to recover from that point in time? Not long for grocery stores, but a very long time for builders and automobile manufacturers and dealers.

The possibility of such a problem with respect to a new VAT is discussed in the DRI/McGraw-Hill report of the 1997 JCT study. Its report by Roger Brinner provides with respect to a replacement of the current system with a value-added tax:

> *The economy will likely be subject to major waves of sectoral buying and selling pressure.* A new value-added tax, in the absence of extraordinary wage concessions, will bring higher prices that are easily predictable in advance by the buying public. If the price of any durable good, from an expensive car to a simple box of frozen food, is expected to rise by 10 or 15% in the near future to cover a new tax, then a buy-in-advance mania will be followed by shopping-withdrawal after the tax becomes effective. The American public consistently behaves this way, waiting for bargains at Christmas, for department store clothing markdowns, and for special auto deals. The effect will be more pronounced with a new tax whose price effect and timing are easier to anticipate than current retail promotions. Few if any of the models quantify this shock because there are few historical parallels of the magnitudes under consideration here.

The Fair Tax bill includes a transition rule for inventory in existence on the date of the transition. Such inventory produces a tax credit, if sold within two years and sold in a taxable sale (under the Fair Tax). The tax credit equals the full cost of the property multiplied by the applicable tax rate—23 percent. The credit is available for finished goods and work-in-process. The Fair Tax bill does not specify a source of cash to provide this substantial credit.

The apparent intent of the Fair Tax transition credit is that the retailer will pass on the 23 percent savings to the buyer, so that the price reduction will allow the cost of the product, after application of the Fair Tax, to be in line with the cost of existing products that are not subject to the Fair Tax. This relief would help reduce the disparity in after-tax costs of new versus existing homes, cars, and other products. However, as previously mentioned, this benefit provides less than full relief because the tax-inclusive revenue-neutral Fair Tax rate exceeds any price reduction that would be experienced due to elimination of the current system's taxes.

For example, assume a home builder has built a home at a total cost of $300,000, and desires to sell it for $350,000. The Fair Tax transition credit would be $69,000 (300,000 x 0.23). To produce the same $50,000 profit, the seller would need to sell the house for $281,000 (300,000 – 69,000 + 50,000). At a rate of 60 percent, the house would cost $449,600 (281,000 x 1.60). (At a 29.9 percent rate, the house would cost $365,019 (281,000 x 1.299). Keep in mind that existing homes would be losing value at this time due to the lost tax subsidies for homes at the same time.

Many businesses have made business decisions based on cash flow projections that take tax benefits into account. Realistically, some tax breaks would need to be given to compensate for lost unused tax credits, etc., due to transition.

In reality, if the Fair Tax was implemented to replace the current system in revenue-neutral form, it would likely be installed over several years, while the current system was phased out over the same period. From an income tax perspective, people would try to defer income recognition as long as possible, while accelerating deductions, given the gradual reduction in the income tax rates.

While a gradual transition could be undertaken, the fact that new goods are subject to the tax, but not used goods, must be kept in mind. Economic expansion, followed by contraction, could be anticipated for each incremental spike in the Fair Tax rate. Also, as noted previously, homes and state and local bonds would immediately lose value.

Given the anticipated retirement of the ''baby boomers'' beginning in full in December 2011, a more realistic scenario would be phase-out of the current system with a permanent freeze on the phase-out at some point prior to completion, coupled with full implementation of the Fair Tax, or vice versa—retention of the Fair Tax at its partially phased-in status along with a return of the income system to the present system. In other words, more tax would be charged to pay for the massive entitlements coming due. Such a change would make the U.S. tax system similar to the tax systems of Canada and other industrialized countries.

Simplicity

A partner with the Ernst & Whinney accounting firm once explained the federal tax system as follows:

> A rule is created by Congress. Then, people find a way around the rule, and Congress steps in and patches the leak. Then, people find a way around the patching, and Congress steps in again and re-patches. The cycle continues . . . .

He was right. Because people simply do not want to pay taxes, any system will need to be amended to patch loopholes, and thus will gradually become more complicated.

Probably the main pro of the Fair Tax system compared to the current tax system is that it is relatively simple. The current system's complexity results in higher costs for businesses and individuals. Higher costs for businesses translate into higher prices for consumers.

Virtually no effort has been made whatsoever by Congress to simplify the federal tax system. Logic would suggest that it is worth losing some revenue if doing so will greatly enhance simplicity. But that has not happened—at all.

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Government filings would continue to be necessary under the Fair Tax system. Individuals would have to file information returns at least annually. Social Security numbers would have to be listed thereon. In addition to preparing and submitting sales and services tax returns to IRS or a state tax agency, companies would have to report Social Security and Medicare wages, so that benefits could be calculated.

As noted above, the Fair Tax provides a poverty level exemption through a ''consumption allowance'' that is recovered through a tax prebate. All of these administrative features of the Fair Tax system would necessitate a tax collection agency or agencies.

Significant patching (and regulations) absolutely would be necessary if the Fair Tax system was enacted. But, in its final patched form, the Fair Tax system would not be close to the current system, in terms of complexity. And the disputes would primarily exist between retailers and the tax collection agency. This attribute is the best attribute of the Fair Tax proposal.

Alternatives

The current system is a complex mess. To retain progressivity, an alternative would be to install the Fair Tax with a greater exemption. Such an alternative would eliminate more people from the tax rolls and reduce the effective burden on the middle class and retirees. However, then people who earn more than very low income levels would not pay any tax and the rate would need to be increased to be revenue-neutral.

A better possibility that would substantially prevent the shift of tax burden from wealthy persons to the middle class and average retirees, would be to install the Fair Tax with changes to exclude governments from taxation (and to include an IRS to prevent evasion) with a flexible rate (x), while keeping an individual income tax for income in excess of a substantial amount. For example, a 20 percent income tax could apply to income in excess of $200,000. If desired, deductions from income could be available for cash/marketable securities charitable contributions and primary residence mortgage interest. The Fair Tax rate could be ''X,'' a floating rate that is tied to spending, to annually balance the budget.

However, a problem with this approach is that when the income tax was originally enacted, it applied only to wealthy persons. It did not take long for the system to be expanded to cover virtually everyone. With the baby boomer entitlements coming due soon, a similar expansion would almost certainly be experienced.

An alternative that would maintain the current progressivity while providing simplicity and reigning in spending would be to keep the Social Security and Medicare taxes, and change the individual income tax as follows (or in a similar manner):

- Have a basic survival exemption that is the HHS poverty amount for family size—generally, for 2007, $10,210 for a single person, $13,690 for a two-person family, and $20,650 for a family of four.
- Apply a 20 percent tax rate up to $25,000 of taxable income in excess of the poverty exemption amount, and apply one tax rate to all taxable income in excess of $25,000 that is tied to spending (the rate is X) to annually balance the budget, while excluding Social Security and its surplus from the equation (a reasonable deficit could be run in an emergency situation or when a significant recession exists).
- Allow four deductions—primary residence home mortgage interest; retirement savings contributions to a qualified plan or IRA (with a limit—for, example $15,000); health care premiums up to the average high deductible health plan (HDHP) premium amount for the coverage type (single or family), along with health savings account (HSA) contributions and flexible spending account (FSA) contributions; and cash/marketable securities charitable contributions.
- Eliminate the alternate minimum tax (AMT), personal exemptions, the earned income credit (EIC), and itemized deductions
- Allow inflation indexing of investments held more than one year (cost increases) for gain or loss calculations and utilize a lower tax rate (for example, 20 percent) for net long-term capital gains (on investments held more than one year).

One of the most complex aspects of completing an individual income tax return is the calculation of taxes on dividends. A significant percentage of the population owns some stock. Often, the tax savings from applying the long-term capital gains rate is very small. A simpler approach to providing relief from double taxation would be to entitle domestic C corporations to a deduction equal to the product of their dividends paid multiplied by the average percentage of stocks held by taxpaying persons and entities (as determined by a government agency), and then require dividend income to be reported on income tax returns of individuals, trusts and estates, and taxable corporate shareholders as ordinary income.

Thus, for example, if the national average of stocks held by individuals, taxable trusts and estates, and taxable corporations was 75 percent for a year, each C corporation could deduct 75 percent of its dividends. In lieu of the national average, a company that knew the breakdown of its shareholders between taxable and tax-exempt could apply its actual percentage. The other areas of the income tax system—corporate tax, partnership tax, and qualified retirement plans—need to and should undergo similar simplifications.

Conclusion

In the 2008 election, the Fair Tax proposal amounts to a vote buy. Presumably, the politicians pressing for it know that the numbers do not work. But they will get credit for offering a huge tax cut to their constituents who have ''run their numbers'' via an online calculator or otherwise.

There is no doubt that the economic problems of the United States are real and very substantial. Legitimate solutions are needed. The Fair Tax is not a legitimate solution.

Finally, how long would it take people to hate a tax of 47 percent to 70 percent (and higher in the future than it would be initially) on virtually everything purchased?

As it turned out, the Fair Tax bill was not all that it was cracked up to be. If it was changed so that it worked, it would result in a major shift of tax burden away from wealthy individuals to middle class persons and average retirees—almost a Robin Hood-in-reverse.

Of course, most of the politicians that backed the bill realized that all along. None of them could fathom pro-

posing any spending cuts, let alone the incredible cuts that would be necessary under the Fair Tax Bill as proposed. But, because the citizenry generally only understood the benefits that they would receive, the politicians received credit for having been brave mavericks who stood up for the citizens and did all that they could to reduce taxes and kill that evil dragon!

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