

Who pays the Income Tax

PRESIDENT'S ADVISORY
PANEL
ON FEDERAL TAX REFORM

Congress is presently discussing reforms of the Internal Revenue Code. It may be helpful if we understood how the income tax is currently collected. The heard testimony is just plain wrong. It takes this short read to understand the current payment posture. If we continue to misunderstand the current code we will only create a new construct based on a faulty premise. A concept based on a faulty premise will produce conclusions that are uniformly false!

The empirical method as championed by Aristotle teaches for a statement to be valid it must describe reality. The following rather simple observation describes the reality of who pays the income tax assessment.

The Observation

If the Congress doubled the tax assessment on the owners and managers of your neighborhood super market, what would happen to its price for groceries? Obviously, the prices for groceries would increase.

If the Congress doubled the tax assessment on physicians, what would happen to the price for medical procedures and office visits? Again the prices for these medical services would increase.

This nexus between the taxes assessed and consumer prices can be observed as it permeates the entire economy. You can offer hundreds of additional examples.

The Reality

In a free market economy, a graduated income tax is converted into a disguised consumption tax manifest through increased consumer prices by free market forces. This disguised consumption tax is frequently referred to as the imbedded tax. To understand how the conversion takes place one needs to focus on the process of how income taxes are extracted from the economy.

How it Happens

The taxing system allows the congress to levy a tax assessment on the tax filers with the amount of the assessment determined by the amount of taxable income reported on the filer's tax return. Any individual or entity which is required to file a return is referred to as a, "tax filer".

You have been invited by the Feds to conclude that the assessed tax filers are also the persons or business entities who pay the income tax assessment. Unfortunately the simple answer is so incomplete that it must be labeled incorrect.

The Tax Code has appointed each assessed tax filer as a, "tax collector" and each employer an unpaid, "tax administrator". When the employer sells its goods or services at the tax driven higher prices, occasioned by the employee assessment, it creates an imbedded tax. The employer then captures the imbedded tax and uses it to pay the employees tax assessment. The employee acts as a taxpayer when he makes purchases at the tax driven higher prices.

Consider

The question: Where do the tax filers obtain the money to satisfy the tax obligation assessed on their tax return?

The answer: Through higher prices. Business tax filers increase the prices of the goods and services produced or provided to recoup the tax cost. This includes the tax driven cost increase for labor; for an individual tax filer, he or she is paid the, "take home pay" after the negotiated salary or wages is reduced by the amount of the assessment. The assessment plus the take home pay is factored into the product or service cost, which is paid by the consumer. The self-employed increases the price of the services produced to cover the assessment cost.

Question: Who actually pays these increased costs?

Answer: You - the consumers of the goods and services produced pay the increased cost through tax driven higher prices, regardless of the income quintile upon which the taxes are assessed and at any rate assessed. The increased cost of goods and services is determined by the total assessment on all assessed tax filers (in 2002 it was 23%).

Question: How do we know that the Federal Income Tax is added to the price consumers must pay?

Answer: The cost of raw materials, labor, capital, energy and the cost of government must all be recouped through the price of the goods or services sold to the consumers. If these costs, including the cost of tax assessments, cannot be recouped, production ceases. No one is in business to lose money. Consumers are only supplied with products and services for which the federal income tax and other cost have been factored into the sales price. The free market does not allow for production and sale of goods and services at prices that fail to cover the cost of production.

Reality Distorted, The Prevailing Wisdom

The prevailing wisdom claims that a free market employee who agrees to produce \$100.00 worth of consumer productivity has an economic value of \$100.00 even though the employee understands that implicit in this agreement is the fact that his take home pay will be \$77.00 after his employer withholds \$23.00 (on the average) to satisfy his assessment. In an F. I. T. free environment, the same unit of consumer productivity could be purchased for \$77.00 instead of the tax driven \$100.00. Thereafter, the employee pays \$23.00 per hundred in tax driven price increases when he makes consumer purchases which are reported on the tax return of the vendors he has chosen for his consumer purchases. The \$23.00 number is used because in 2002 the Federal income tax was 23% of gross domestic product. You may be assessed at 0, or 10% or 36%. It doesn't matter. It is the aggregate tax assessment that sets the imbedded tax cost you and every other consumer must pay. The employer's accountants figure all the assessments together to determine the size of the tax account. Prices are increased to cover this aggregate cost.

Are We Double Taxed?

The problem with the prevailing wisdom is that it can only be rationalized by double taxation. Both of these taxations can't happen. First, either the employee pays \$23.00 per \$100.00 of the income he has earned, or: Second; he pays 23% higher consumer prices when he makes consumer purchases, but not both. We are not double taxed. The Feds assess and collect a little over 23% of Gross Domestic Product in F. I. T., not over 46%, which a double taxation would produce.

Despite the irrefutable numbers set out above some insist that assessed taxpayers are indeed double taxed, they will argue:

First; The assessed taxpayer, acting as a consumer, is taxed when he makes consumer purchases at prices 23% higher than he would pay if there were no income tax assessment

Second; The assessed taxpayer points out that \$23.00 for each \$100.00 of their "earnings" is withheld by the employer which is represented by a W2 Form or the self employed may produce a cancelled check for payment to the I.R.S. This is convincing evidence, not of a tax payment by the assessed tax filer but evidence that the assessed tax filer had fulfilled his obligation as a, "tax collector". The employee or his employer captures that portion of the imbedded tax necessary to satisfy the employee's assessment obligation and forwards it to the Feds to satisfy the employee's assessment.

The argument continues. Doesn't that mean the employer collects the assessment twice, once when it withholds 23% of the employees, "earnings", and once when they capture the 23% imbedded tax? The answer is NO. It is a legal fiction that the employee "earned" 23% more than his take home pay. The \$23.00 deducted from the employees, "earning" has nothing to do with compensating the employee. It is the measure of the amount of the imbedded tax an employer must capture to satisfy the employee's assessment.

The employee's final argument. "I thought I was earning \$100.00 for my work, instead I earned \$77.00. I thought my employer had paid my taxes, now I discover that another \$23.00 will be extracted from my \$77.00 due to the price increase created by my assessment. This leaves me with only \$54.00 of purchasing power from my \$100.00 contract rate. That is Double Taxation, is it not?" A powerful argument but not quite right. It is true that your purchasing power will erode by \$23.00 as you spend your \$77.00. It is not true that you ever earned \$100.00. Moreover, the assessment is captured from the purchase price on the sale of your productivity.

The fact that you contracted for \$100.00 and only, "earned" \$77.00 is a difficult argument to make on two levels

Emotionally, we don't like to be told that we only, "earned" \$77.00. Even I don't like to think it is true, but accurate reporting requires that the axiomatic be reported as observed, not as one might wish. You can charge 23% more for your productivity because buyers have no choice. Your competitors also must charge 23% more.

Practically, a more interesting argument; Employee must still produce items deemed to be worth 23% more or he will be unable to sell his productivity. This is a tougher argument wrapped in a facade of supposed logic. However, the argument is largely metaphysical. Employee's productivity need only match the productivity of his competitors who are also charging 23% more. There is an unintended consequence Foreign producers can escape much of the income tax assessed on domestic workers!

You the employee paid your income taxes only once. Not when you made your I.R.S. 1040 filing but when you made consumer purchases

Who is assessed - Who pays?

There are 130 million tax filers who the congress has appointed by the tax code as the "tax collectors". The filers think they are taxpayers but you may decide that a more accurate characterization is "tax collectors", even though it is counter intuitive, contrary to the prevailing wisdom, and not immediately obvious. We call the assessed, "tax collector" because their function is to capture a sufficient amount of the imbedded tax to satisfy their assessment. How do they capture the imbedded tax? By increasing the price of their goods or services they sell by an amount necessary to compensate for the assessment. There is a difference between who is assessed and who pays the Federal Income Tax. The income tax is assessed against all economic participants who achieve a certain minimum income level but is paid by those who consume.

Production pays the Tax

Regardless of the type of tax assessed, whether a graduated or flat Income tax assessed on labor and profit or a Value Added tax assessed on product enhancement or a gross receipts tax, the tax is factored into the consumption price. A free market economy accommodates the assessment, which is paid by those who consume the goods or services produced. A Consumption tax or a Retail Sales Tax is not included in the price of the product but is added to the transaction on final sale to the consumer. A consumption tax is levied on the entire product price, not just the labor component or an enhancement.

All of these methods of taxation, whether an Income Tax, a Value Added Tax, or Gross Receipts Tax, a Consumption Tax or a Retail Sales Tax, have one characteristic in common. The Tax is Paid by The Consumer.

The Tax Man Cometh

Employers capture the imbedded tax generated through higher consumer prices and apportion it among the various employees to satisfy the employee assessments. Employees are then paid the remainder, sometimes called the, "take home pay". The employee now thinks his employer has paid his income tax for him. Unfortunately the employer only satisfied the employee's assessment as a, "tax collector". Actually the employee will then pay \$23.00 of his \$77.00 take home pay through higher prices when he converts his take home pay into purchases for living expenses. The vendors chosen by a consumer for purchases then capture this imbedded tax as a portion of the sales price and forwards the imbedded tax portion to the Feds on the vendor's or vendor's employees tax returns. The process is repeated over and over as it permeates the entire economy. This is the payment function. It is through higher consumer prices that employees and all consumers are separated from their money by the taxman.

How the Payment is Disguised

(1) In a free market economy, the graduated income tax, regardless of whether assessed on business, the affluent or other tax filers, at whatever rate assessed is converted into a price increase on consumption items.

(2) It is the total tax assessed on all tax filers that set the tax driven price increase for the goods and services consumed. Reduction of the total tax assessed benefits all consumers through lower prices. Increasing the assessment whether on the top two percent or any other group adversely impacts the 23% of G.D.P., which is born by all consumers.

(3) It is a flat tax in the sense that each consumer, be they more affluent or less affluent, pays the same \$23.00 per hundred on consumption expenditures to satisfy the graduated income tax assessed on business, the wealthy, and all other tax filers. It is the same \$23.00 for each \$100.00 spent by the affluent who spends \$200,000, \$46,000 of which is a tax payment and the less affluent who spends \$20,000, \$4,600, which is his tax payment.

(4) Contrary to what you have been told, the income tax is assessed on productivity, not on wealth. The income tax is assessed on what you earn, not on what you own. In fact, in a free market economy you can't tax wealth through an income tax because an income tax is levied on labor and productivity, not on wealth. When you assess a tax on the productivity of the affluent they simply add it to the cost of production, as do all other assessed participants, whether a one person economic unit working for wages or a mammoth corporation.

You, the consumer, pay the assessed tax

Assessed sellers of goods and services bear the inconvenience of pricing their products and services, including labor, at a price sufficient to collect their portion of the total embedded tax necessary to satisfy their assessment. However, they are excused from the disastrous task of actually paying the income tax except to the extent they make consumer purchases. Conversely, dismissal from the assessment system does not exempt the payment obligation. All consumers of goods and services pay this imbedded tax driven price increase. Don't blame me; it was the Congress who made the Code so convoluted! Now is the time to scrap the Code as we know it!

It is your Money

Americans have been misled into believing the fairy tale that some, "rich" person somewhere is paying their income taxes for them. Intuitively, they know this is not true but no one has explained why

Regardless of how high or low a consumer ranks on the income scale, all goods and services purchased carry the same 23% tax driven price increase. It really is your money. Remember late Senator Russell Long's famous dictum, "Don't tax you, don't tax me, tax that fellow behind the tree". The fellow behind the tree is the defenseless consumer who doesn't even realize he pays his income tax at the Supermarket and Drug Store. Today we have consumers paying the income tax through disguised price enhancements, employees who believe the employer is paying their income tax for them and employers who know they are not at a competitive disadvantage because their competitors face the same assessments. It is this useful ignorance that allows the current system to survive.

The Value of Dismissal From The Assessment System

A large percentage of the work force is dismissed from the assessment system because their income is insufficient to attract a tax currently. However, they are still taxed by paying prices that are increased to accommodate the assessment made on those who produce and supply goods and services. Dismissal from the assessment system allows the less affluent to escape the duty to act as a "tax collector". This is a comparative advantage in favor of the unassessed as opposed to the assessed. Because they pay the assessment-adjusted rate for good and services it adds up to a net wash. The unassessed by paying for goods and services at assessment adjusted prices do contribute to the assessed vendors tax account and that is a net loss for poor people!

The proposals distinguished:

The Flat Tax

Currently the income tax is paid at a flat rate for all consumers whether assessed or not. The graduated income tax was Item No. 2 in the Communist Manifesto. It may have produced the desired result in an economy where prices were controlled. However, in a free market, the graduated income tax is added to the cost of production converting the assessment into a flat tax paid at a rate equal to the assessment percent of the Gross Domestic Product. In 2002 that rate was 23%. A flat tax would provide the same income to the Fed with a great simplification of the current code. The great negative of this tax approach is that it retains the status quo with its much-maligned I.R.S. More disastrous, it fails to remove the penalty the Code inflicts on our exports. Additionally, it does not ameliorate the competitive advantage enjoyed by imports provided under the current Code!

The Consumption Tax compared to the Retail Sales Tax

Both of these approaches assess the tax on the final transfer to the end user or consumer of the productivity. Conceptually, the Consumption Tax would assess a tax on a larger universe of taxable transactions thereby lowering the tax cost percentage on each transaction. It would of course include the retail transactions and would be somewhat more complex. However, either would be preferable to the current system.

The Retail Sales Tax or the Consumption Tax would offer several advantages. Regardless of what name you put on it or the way you define it. Here are some advantages of the retail or consumption tax.

1. Tax filers would decrease from 130 million to fewer than 5 million. What a saving. Over 80% of retail sales are transacted by fewer than 10,000 retail organizations.

2. It is estimated that over 250 billion is expended annually in compliance cost for income tax filers. This would be reduced to a fraction of the current cost.

3. People who are concerned about outsourcing and our chronic balance of payment deficit would find great comfort in an R.S.I. Under the international trading rules there would be no sales tax on exports but imports would be subject to the Retail Sales Tax. This would level the playing field, in manufactured products such as automobiles, aircraft, industrial equipment, farm products, textiles, shoes and all other

domestic exports. Currently, outsourcing is very appealing because the imported goods and services escape much of the income tax assessment.

Imagine, the increased sales of automobiles or bulldozers to foreign buyers if they could be set on the shipping dock at prices up to 20% lower than currently. Additionally, the importers will face Sales Tax for items imported into our market. This leveling of the playing field would create a sizeable balance of payments shift in our favor. Additionally, it would provide enhanced employment opportunities for our domestic workers.

Most people seem to suggest that an RSI tax would be 15% to 20%. True, but elimination of the income tax would then reduce cost of goods and services by the amount of the current assessment. The Feds also would capture those unassessed taxes from Drug Dealers and other non-compliers. The total retail price including the sales tax would be the same as or less than the tax cost which currently exist.

When the reduced assessments of 2003 and 2004 have permeated the entire economy the \$23 00 per hundred numbers will decrease. This decrease benefits all consumers. We anticipate that a sales tax rate between 15% and 20% would be sufficient to replace the current revenue to the Feds.

The Future is Now

The current Code primarily places the assessment on wages and salaries. It is projected by a large academic institution that another 10% of our domestic jobs will be outsourced during the next ten years. We must take the assessment off of wages and salaries. Tax the total product, not just the labor component. We must stop penalizing our domestic workers and our exports while favoring imports as we do through the current Tax Code. A consumption or retail sales tax would solve these problems!

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For a short outline of a creative hybrid plan see the attached page.

D. S. C.

"COX HYBRID PLAN"

Here is a broad outline of a possible Tax Plan. The rates can be adjusted to meet the revenue projections.

President Bush ask that you be creative and review all options. Chairman Thomas of the House Ways and Means Committee is looking for funds to defray the cost of long-term care for seniors.

I offer for your consideration the, Cox "plan". This hybrid would tax three sources. A gross receipts tax, a value added tax and a consumption tax. The objective is to ameliorate sizable changes occasioned by any individual tax and still collect the necessary revenue through a greatly simplified plan, all without the discredited current Internal Revenue Code.

The revenue necessary to fund the Government will be provided by:

First, A Consumption or Sales Tax. The sales tax rate could be 10% or less.

A 10% sales tax on the sale to the final user of a product or service seems quite palatable. It should remain low because other governments also use the Sales Tax.

Second, A Gross Receipts Tax. All, "for profit", businesses and individuals would be taxed at a rate less than one percent of gross receipts. I suggest one half of one percent or \$500.00 for each million of gross receipts. The first \$400,000 or so of gross receipts would be exempt from the tax. This would eliminate over 90% of individuals plus many small business from the gross receipts tax. This tax should be set at a rate, which would provide the remaining fraction of the total revenue necessary to finance all Fed expenditures after subtracting the payroll tax and the 10% consumption tax.

Some claim that a gross receipts tax is unfair because low margin, capital-intensive businesses would bear a disproportionate tax burden. This perceived unfairness is more apparent than real. The tax will remain at a fraction of 1%. Moreover, the legislation could provide added decreases where the net income is a smaller percent of gross receipts. For example, if the income for a specific industry is less than 2% of gross receipts the rate could be set at 2/10th of 1.0% etc. Of course, a larger fraction for industries with a 20% net. Increased perceived fairness results in greater complexity. The gross receipts tax is immediately converted into a price enhancement on the cost of goods or services sold. The consumer pays this tax as it does all other taxes

Third; Value Added Tax of a sufficient amount to defray all payroll taxes for Social Security, Medicare etc. This should be a dedicated tax for the payment of Social Security, Medicare, long term nursing care and other payroll taxes only. Consider exempting individuals and entities who employ 3 or fewer people.

The two advantages that any reform must produce.

First; Elimination of the 1040 and a revised mission of the I.R.S. as we know it.

Second; We must address outsourcing and our balance of payment problems as aggravated by the current code.

Exports; There will be no sales tax on exports, the gross receipts tax and the value added tax will be refundable on items exported. This gives us a level playing field for exports.

Imports; We can add the 10% sales tax to imports upon sale to the consumer. I am not sure whether we can add the V.A.I. or the Gross Receipts Tax to imports. If it can be done under the international trading rules, it should be done. At worst, we tax part of the proportionate cost of government from imports. If we can add the V.A.I. and the Gross Receipts Tax to the import price we would level the playing field and stop penalizing domestic workers as we do through the current I.R.S. Code.

President Bush mentions other objectives of the tax proposal he is seeking

Real estate; Exempt the sales tax on land and building cost. Additionally, the homebuilders would also be exempt from the gross receipts tax but would be taxed on value added (The payroll tax) because massive amounts of labor are involved

New construction and rehabs of \$5,000.00 or more would be available for a refund of the consumption tax paid for materials on any project.

Charities; Exempt from some or all taxes as the commission may determine.

Savings; Banks and financial institutions exempt from the consumption sales tax and the gross receipts tax but pay the value added tax (payroll tax!). No tax on interest, dividend or rental income.

Chairman Thomas additional concern:

Long Term Care For Seniors. Why not make the program voluntary. Qualified oldsters can sign up at any time, but when they do they restrict their estate assets and the Government gets reimbursed from the estate except for \$50,000.00 or so. This would be enforced by the State Probate Court. The Government could recoup some of its cost. Obviously, the less affluent would sign up. The more affluent would sign up after expending much of their savings on long term care. This would be funded by the V.A.I.

Here is an idea of how the tax collections could appear.

Because of tax reduction and increased G.D.P. Secretary Snow says the Government portion of G.D.P. in 2003 was down to 19%. These same forces could reduce the 2004 Government portion to an estimated 18% of G.D.P. distributed as follows:

The Consumption Tax	10 points	(10% sales tax)
The Gross Receipts Tax	4 points	(1/2 of 1% of Gross Sales)
The Value Added Tax	4 points	(Fully pay S.S. and Medicare etc.)

The advantages of this hybrid become more apparent as you review both the possibilities and limitations of other plans. If you would like to take a closer look at this hybrid just let me know and I will be more definitive.

Thanks,
DSC