

# The Flat Income Tax and the FairTax Consumption Tax A Comparison of Federal Taxation Proposals



## Flat Tax vs. Fair Tax

	Fair Tax	Flat Tax
Is still an income tax	No	Yes
Eliminates \$250 mil. Income tax industry	Yes	No
Simplifies business accounting and reporting	Yes	No
Stimulates exports	Yes	No
Encourages capital repatriation from tax havens	Yes	No
Encourages investment	Yes	No
Eliminates product tax build up in product cycle	Yes	No
Result in lower interest rates	Yes	No
Eliminates double taxation of business profits	Yes	No
Facilitates home ownership	Yes	No
Taxes inherited and gifted wealth more fairly	Yes	No

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## A Comparison of the FairTax<sup>SM</sup>, the Income Tax, and the Flat Tax August 2001

	FairTax, H.R. 25 Linder-AFFT	Federal Income Tax Pre-2001 Law	Flat Tax, H.R. 1040 Armedy
<b>16th Amendment</b>	Proposes repeal.	No change.	No change.
<b>Complexity</b>	Individuals do not file. Businesses need only to deal with sales tax returns.	Very complex; 20,000 pages of regulations; I.R.S. incorrect over half of the time.	Withholding continues. Individuals and businesses must still track income and file income tax forms.
<b>Congressional Action</b>	23% Linder/Peterson FairTax Act of 2001 (H.R. 2525). Employees receive 100% of pay. Social Security and Medicare funded from consumption tax revenue, not your paycheck. (H.J.Res45) - Will repeal the 16th Amendment.	Used by lobbyists and the wealthy for tax-breaks and loopholes. Used by bureaucrats for social engineering.	Rep. Armedy's H.R. 1040 has some problems, but is far superior to current law. It would impose a 17% Flat Tax on income.
<b>Cost of Filing</b>	No personal forms are filed. Significant cost savings.	\$225 billion in annual compliance costs	Significant simplification costs are somewhat reduced.
<b>Economy</b>	Un-taxes wages, savings, and investment. Increases productivity. Produces significant economic growth.	Taxes savings, labor, investment, and productivity multiple times.	Imposes a tax burden some of which is still hidden in the price of goods and services.

<b>Equality</b>	Taxpayers pay the same rate and control their liability. Tax paid depends on life style. All taxes are rebated on spending up to the poverty level.	The current tax code violates the principle of equality. Special rates for special circumstances violate the original Constitution and are unfair.	The flat tax is an improvement over the current income tax, but it is still open to manipulation by special interests.
<b>Foreign Companies</b>	Foreign companies are forced to compete on even terms with U.S. companies for the first time in over 80 years.	Current tax code places unfair tax burden on U.S. exports and fails to neutralize tax advantages for imports.	A flat tax taxes exported goods and does not tax foreign imports to the U.S., creating unfair competition for U.S. manufacturers and businesses.
<b>Government Intrusion</b>	As the Founding Fathers intended, the FairTax does not directly tax individuals.	Current tax code requires massive files, dossiers, audits, and collection activities.	A flat tax still requires personal files, dossiers, audits, and collection activities.
<b>History</b>	45 states now use a retail sales tax.	The 1913 income tax has evolved into an antiquated, unenforceable morass, with annual tax returns long enough to circle Earth 28 times.	A flat tax just won't <i>stay flat</i> . Starting out nearly flat in 1913, the income tax grew out of control with top rates over 90% until the Kennedy administration.
<b>Interest Rates</b>	Reduces rates by an estimated 25-35 percent. Savings and investment increase.	Pushes rates up. Biased against savings and investment.	Reduces rates 25-35 percent. Neutral toward savings and investment.
<b>Investment</b>	Increases investment by U.S. citizens, attracts foreign investment.	Biased against savings and investment.	Neutral toward savings and investment.
<b>IRS</b>	Abolished.	Retained.	Retained with reduced role.
<b>Jobs</b>	Makes U.S. manufacturers more competitive against overseas companies. Escalates creation of jobs by attracting foreign investment and reducing tax bias against savings and investment.	Hurts U.S. companies and decreases available jobs. Payroll tax a direct tax on labor.	Positive impact on jobs. Does not repeal payroll tax on jobs.
<b>Man-hours required for compliance</b>	Zero hours for individuals. Greatly reduced hours for businesses.	Over 5.4 billion hours per year.	Reduced.
<b>Non-filers</b>	Reduced tax rates and fewer filers will increase compliance.	High tax rates, unfairness and high complexity harm compliance	Reduced tax rates and improved simplicity will improve compliance.
<b>Personal and Corporate Income Taxes &amp; FICA Social Security Taxes</b>	Both are abolished. FICA Social Security payroll withholding eliminated also, and funded within the sales tax revenues at today levels.	Retained. Both employee and employer will still pay 7.65% each into Social Security	Retained in a different form. Both employee and employer will still pay 7.65% each into Social Security.
<b>Productivity</b>	Increases.	Inhibits productivity.	Increases.
<b>Savings</b>	Increases savings.	Decreases savings.	Increases savings.
<b>Visibility</b>	The FairTax is highly visible and easy to understand. No tax is withheld from paychecks.	The current tax code is hidden, embedded in prices, complex, and incomprehensible. Taxes are withheld from paychecks.	The business component of the flat tax and payroll taxes are hidden and would be embedded in prices. Taxes are withheld from paychecks.

Testimony by the Arthur Hall, Tax Foundation and before the House Ways and Means Committee, 1998

# The Flat Income Tax and the FairTax (HR 25) Consumption Tax

## A Comparison of Federal Taxation Proposals

### Tax Rate Comparison – An Income tax is an Inclusive Tax – a Sales Tax is an Exclusive Tax

Flat Tax System - 24.65% (inclusive including FICA social security tax) = 32.5% (exclusive rate )  
= 17% (inclusive withholding income tax rate) + 7.65% separate inclusive FICA Social Security tax rate  
= 24.65% total inclusive tax rate (converts to 32.5% exclusive rate) under the current Flat Tax proposal

ALL personal income and business profits are taxed first, which translate to a tax on ALL consumption and savings (made with after tax dollars), thus translating to a tax on all new goods, used goods, services, savings, investment, education, charity, estate and gift giving, business to business purchases and tax on some State tax payments (tax on tax). Mortgage interest only and charity giving over a certain level is not taxed through a refund deduction, and there is a standard deduction (tax free income) for dependents. Additionally employers will also pay 7.65% in FICA for each worker, reducing the salaries for everyone by a comparable amount. Self Emp. FICA is 15.3% inclusive. Filing of multiple forms is done at the end of the year to receive overpayment or return of taxes paid on dependents, mortgage interest and charity donations above certain levels.

FairTax System - 23% (inclusive rate includes FICA) = 30% sales tax (exclusive sales rate includes FICA)  
on consumption of NEW Goods & Services ONLY at the point of end use retail only.

No tax on initial spending up to the HHS poverty level for ALL households determined by number of dependents only. Paid for with before tax dollars, there is no tax on any used items, no tax on any and all savings or investment, no tax on any business profits, no tax on any education expenses, no tax on any existing mortgage or other loan payments both interest and principal, no tax on any charitable giving, no tax on any estate and gift giving, No tax on ALL State and Local taxes paid. No tax on business to business transactions. No filing of any kind is necessary at the end of the year to receive a tax refund on any of the tax exempt items, as no tax was actually paid initially on these items when the purchase or saving, or giving took place. FICA social security is paid through the sales tax receipts funding social security benefits for you at today's levels. You pay the appropriate tax exactly, when you spend, and in your time, based on your personal choices.

### Inclusive and Exclusive Tax Rate Comparisons – Apples to Apples

All tax systems should be quoted in the same form of tax rate structure and include both General Fund & FICA.

Inclusive tax rate = tax rate as a percentage of the total dollar paid out or earned = the way current Income Tax , FICA payroll tax and Flat Tax rates are quoted.

24.65% inclusive Flat Tax plan including FICA payroll tax (17% Flat Tax + 7.65% FICA)  
of every \$100 of earned income from all sources - \$24.65 goes to the tax man and \$75.35 you can keep  
23% inclusive FairTax Plan including Social Security funding within the sales tax rate itself  
of every \$100 spent in the market place on new goods and services - \$23 goes to the tax man and \$77 is your buying power

Exclusive tax rate = the tax payment as a percentage of income left or price of the item being purchased

32.7% exclusive Flat Tax including FICA = (24.4% exclusive Flat tax + 8.3% exclusive FICA tax)  
means if you have \$75.35 left in your pocket after taxes, you actually had to earn 32.5% more (\$24.65) or \$100 total in income to begin with

30% exclusive FairTax sales tax rate at the register (which includes paying for Social Security)  
means if you want to purchase an item for \$77 you will have to pay an additional 30% (\$23) in sales tax or \$100 total at the register for that item.

Notice in both inclusive and exclusive terms, the dollars paid in tax, and the dollars left to spend for Flat Tax are the same (\$24.65 in tax and \$75.35 left to spend) and for FairTax are the same (\$23.00 in tax and \$77.00 left to spend). Inclusive and exclusive while they appear to be different percentage rates, actual produce the same results. It's a matter of 12 inches = 1 foot....you can't just look at the number to compare you have to look at the label too.

### Social Security Funding

Flat Tax – Social Security FICA payroll taxes remain in place designated as a 7.65% inclusive tax on wages for each worker up to first \$92,000 earned. Employers will continue to match this with 7.65% on wages paid, making the total tax burden for FICA under Flat Tax = 15.3% (inclusive) per wage earner - Self employed workers will pay 15.3% on their own earnings for FICA.

FairTax – Social Security is fully funded within the 30% (exclusive) Sales tax collected at consumption on new goods and services at end use retail. The current 7.65% FICA payroll withholding for each employee and the 7.65% employer matching payment will be eliminated completely for all wage earners and their employers. Self-employed business owners will also have their 15.3% FICA tax payment eliminated. 1/3 of every dollar collected

through the sales tax is designated within HR 25 to be used as social security revenues, and will fund the Social Security system at today's levels, without a change to any benefits, while all savings and investment will be done at any level totally tax free. This is the ultimate in Social Security privatization.

### Tax Payer Base

**Flat Tax** – While there will be a small increase in the number of working citizens that will pay into the Flat income tax system, due to the elimination of many deductions and loopholes, there will still be those that receive Government benefits of all types, that will escape paying into the Federal Flat Tax system. Examples are those working within the underground economy; those 20 million that are not here legally and are not reporting wage income; those who visit the U.S.A. as tourists, using our benefits of roads and protection, but not paying anything toward those benefits.

**FairTax** – Everybody pays into the system at point of consumption of new goods and services. Illegal citizens, tourists, those spending dollars earned "under the table" or through illegal means, currently not paying income tax, will all pay the sales tax when they consume, thus broadening the base of those paying into the system. This broader base of taxpayers will also be paying into the Social Security system, as it is also funded by the sales tax. A broader base, means a lower tax rate for all. The tax free spending exemption up to the poverty level that will be given to everyone in the form of a rebate monthly, will make the poor and lower income tax free. However, they will still be part of the sales tax system, and will pay their fair share of consumption taxes on new goods and services as their income goes up beyond the poverty level, like everyone else.

### Both the Flat Tax and the Consumption Tax Reduce Marginal Tax Rates Dramatically, Although a Consumption Tax Will Reduce Marginal Tax Rates More Than a Flat Tax

Flat tax supporters often emphasize, correctly, that marginal tax rates, rather than average or effective, are the most economically relevant tax rates. It is marginal tax rates that affects an individual's decision about what to do. A consumption tax can be viewed as imposing a zero marginal tax rate on labor and capital income, if the economic incidence of the tax is on consumers. Alternatively, one can view the incidence of the consumption tax on the factors of production (labor and capital). The comparison below is based on the view that the consumption tax is incident on the factors of production.

The flat tax bill would reduce the top marginal income tax rate to 17%. This rate, however, is not revenue neutral. The flat tax is revenue neutral at about a 21-22% rate, not taking into account the impact of the plan on economic growth. In the real world, the flat tax would cause economic growth that would increase the tax base, perhaps reducing the revenue neutral tax rate to 20% (within a few years). The flat tax would not affect the employer or employee Social Security or Medicare payroll tax. Those that have earnings below the Social Security wage base (\$72,600 per worker in 1999) would, therefore, face a marginal tax rate of 32.3%. Taxpayers over the Social Security wage base would face a marginal tax rate of 19.9% on wage income and 17% on capital income. These figures are about 3-5% points higher in a revenue neutral flat tax.

Under a federal consumption tax, the poor would experience negative effective tax rates because of the universal rebate. They would pay no tax up to the poverty level. Middle-income and affluent taxpayers would pay 23% at the margin. It should be noted that since taxes have crept up over the past several years, the revenue neutral tax rate, without taking into account economic growth, is approaching 25%. Once the FairTax-induced economic growth is taken into account, 23% would probably raise as much revenue as the current system.

Thus, middle-income taxpayers would pay a much lower marginal tax rate under the consumption tax than under the flat tax. This is because the FairTax replaces payroll taxes as well as the income tax. Affluent taxpayers would pay comparable marginal tax rates under the consumption tax and the flat tax. These differences are summarized in the table below.

### Comparative Marginal Tax Rates

Type of Person	Armey-Shelby	Revenue Neutral Flat Tax (+3)	FairTax (Consumption Tax)	Difference
Poor	15.3	15.3	0	-15.3
Middle Class	32.3	35.3	23	-12.3
Affluent (capital)	17	20	23	+ 3.0
Affluent (salary)	19.9	22.9	23	+ 0.1

The FairTax generally has a more positive impact on marginal tax rates than does the flat tax.

## **Both the Flat Tax and the Federal Consumption Tax Are Neutral Toward Savings and Investment**

The flat tax and the consumption tax both remove the income tax bias against savings and investment. The flat tax accomplishes this result by expensing capital costs and exempting the return on savings. The consumption tax accomplishes this same result by only taxing final consumption sales. Each would result in higher levels of savings and investment, higher rates of capital formation, higher productivity, and higher real incomes.

## **Both the Flat Tax and the Federal Consumption Tax Promote Economic Growth, but the Consumption Tax Will Be More Pro-Growth**

Since it will have a better impact on marginal tax rates and the arguably equivalent tax on capital investment, the consumption tax will have a more positive impact on economic growth. Moreover, because U.S. and foreign producers for overseas markets can produce goods and services tax free under a consumption tax, but not under a flat tax, the consumption tax will have a relatively more positive impact on economic activity in the U.S.

## **The Consumption Tax Does a Better Job of Eliminating Work Disincentives for the Poor**

Since the Consumption Tax plan removes the payroll tax while the flat tax keeps the payroll tax (and repeals the earned income tax credit), the FairTax will make it easier for the working poor to climb out of the dependency trap. In contrast, the working poor will continue to pay the 15.3% payroll tax on their first dollar earned under the flat tax. Under the FairTax, payroll taxes are repealed and a rebate of the consumption tax on expenditures up to the poverty level is provided. Thus, the marginal tax rate the poor will face is zero, and therefore, lower under the consumption tax than under the flat tax.

The flat tax is biased against workers because only those earning wages pay the tax. Those that earn income from capital gains (such as those with personal wealth) can avoid paying their fair share of taxes. This makes it less palatable to the American public.

## **A Flat Tax is Easy to Convert Back Into an Income Tax**

Under the flat tax, the I.R.S. continues to exist. They will administer a system that is not structurally different from the income tax. All individuals and businesses will file tax returns.

With five simple changes, the flat tax can be converted into a graduated income tax. Step one is to depreciate rather than expense capital costs. Step two is to make interest expenses deductible and interest income taxable. Step three is to tax capital income (such as dividends and rent) and capital gains. Step four is not to allow inventory purchases to be deducted until the inventory is sold. A fifth step is to impose graduated rates, which would complete the transition back to a graduated income tax.

After a consumption tax is enacted, it will be virtually impossible to go back to an income tax. The I.R.S. will no longer exist because the states will, for the most part, be administering the tax system. The entire income tax apparatus will have disappeared, and the expertise in administering this present Byzantine system will be dispersed. People will have gotten used to not filing returns and will not want to go back to the old system. People will have gotten used to keeping what they earn and will not want to go back to withholding.

Although it is also quite possible to apply graduated rates under a flat tax, it is not possible to impose graduated tax rates on individuals or businesses under the FairTax because the consumption tax is an indirect tax imposed on goods and services.

## **A Consumption Tax Actually Gets Rid of the I.R.S.**

In general, states would administer the federal consumption tax because they already have the expertise. States would not be required to administer the tax; however, in most cases, they would choose to do so. F.I.R.S.t, they will be provided with a generous administration fee to administer the federal tax. Since 45 states already administer sales tax systems, the incremental costs of implementation of the FairTax will be low (particularly if the state conforms its tax base to the federal tax base). Second, for the f.I.R.S.t time, states will be able to tax direct mail sales originating in their respective states under this integrated system. This will broaden the state's tax base and put all retailers on an equal footing. Third, states will know that if they do not administer the tax, the federal government will do so. Given that choice, they will want to do it themselves for reasons of control and professional pride.

## **Compliance Costs Will Be Lower Under a Consumption Tax Than Under a Flat Tax**

A flat tax would simplify the tax code considerably. However many of the complexities of current tax law would remain. For example, tremendous pressure, would be placed on intercompany pricing rules since offshore income is exempt from tax. Manipulating the prices at which goods change hands between a U.S. company and its foreign affiliate could zero out the U.S. source income under a flat tax. Under a flat tax, the cost of employee benefits, interest, insurance, and other costs must be segregated since they are not deductible. The current complex pension system stays largely intact. Under a consumption tax, the question is simply how much did a firm sell to consumers.

## **The Flat Tax May Require Only a Postcard for Wage Earners, but the Consumption Tax Requires No Tax Return At All**

Flat tax proponents are proud that their individual tax form will fit on a postcard. So, of course, could today's 1040 EZ. Under a consumption tax, individuals who are not in business for themselves will file no return. No return is preferable to a postcard.

## **A Federal Consumption Tax Is Much Easier for the Public to Understand Than the Flat Tax**

A federal consumption tax is something that is easily explained and understood by the public. Flat tax proponents have had difficulty explaining it to the American people, notwithstanding large budgets, Mr. Forbes's Presidential campaign, the efforts of Majority Leader Arme, the Heritage Foundation, Citizens for a Sound Economy, and others.

Perhaps the most obvious problem with explaining the flat tax is the issue of capital income. Again and again, it has been argued that the flat tax does not tax "coupon clippers." This argument is made in response to the allegation that rich people can live well and tax free on interest and dividends and pay no tax while the *working stiff* has to pay tax. Although this allegation is false because the tax on that income is effectively withheld at the business level, flat tax proponents have failed in their efforts to get their message across.

## **The Consumption Tax Is More Visible**

Under the flat tax, much of the tax burden is hidden in the business tax. Will recipients of dividend and interest payments actually understand that a withholding tax has been imposed by denying a deduction to the business making the payment? Will recipients of employer-provided fringe benefits understand that a withholding tax has been imposed by denying the employer a deduction for the benefits? Will the non-deductibility of employer taxes be understood as tax increases? In all cases, it is highly doubtful. Thus, hundreds of billions of dollars in taxes are hidden under a flat tax.

There are those who believe that hiding taxes from the American people is a good thing, because if the people actually understood the true level of the tax burden, they wouldn't stand for it. The consumption tax, however, works on the principle that taxes should be visible and fairly convey the true cost of government. The consumption tax will by law be shown on every retail purchase sales receipt, and this provision will be mandatory.

## **The Consumption Tax Is Not a VAT and Will Not Turn Into One; the Flat Tax Is a VAT**

Flat tax supporters who are also consumption tax opponents often argue that a consumption tax would turn into a value-added tax (VAT). VAT's are usually hidden taxes, collected at each stage of production. The consumption tax is not a VAT since the consumption tax is collected at the retail level, and no tax is imposed on intermediate sales.

The flat tax is a VAT. None other than the father of the flat tax, Robert Hall of Stanford University (along with Alvin Rabushka), in his 1995 Ways and Means Committee testimony said, "The Hall-Rabushka flat tax is a value-added tax." Thus the flat taxers are effectively attacking their own proposal when they attack a VAT. Most, however, do not understand their own proposal well enough to understand this.

The flat tax is not an income tax because its tax base is not income. At the business level, value added by capital is taxed by the flat tax. At the personal level, labor value added is taxed. The business tax burden under the flat tax is much higher than under current law. Interest expense, most insurance expenses, taxes (including payroll taxes), rent, and other expenses are not deductible under the flat tax. The aim of the flat tax is not to measure net income, but value added.

The flat tax is identical to the USA Tax business tax, an acknowledged subtraction method VAT, except in two respects. First, the flat tax taxes exports and exempts imports from tax. This makes it an origination principle VAT instead of the usual destination principle VAT. The other difference is that business can deduct wages in the flat tax, but not in normal VAT's. The flat tax individual tax, however, is a wage tax. Thus, the flat tax taxes wages just like a normal VAT. However, because it taxes wages at the individual level, the flat tax taxes most government value-added, while normal VAT's do not.

## **Tax Evasion Under Both Systems Will Be Comparable**

Under a consumption tax, the number of persons that the tax administration authorities must focus on is reduced by 80% or more. Only businesses are in the tax system. Dramatically lower marginal tax rates — lower for most than the flat tax — will reduce the marginal benefit to cheat. If enforcement and associated penalties remain comparable, and the marginal benefit to cheating falls, evasion should decline. The overall legitimacy of the system will improve, and non-compliance generated by frustration or hostility will decline. Individuals who are not in business, and non-retail businesses will be unable to cheat on their taxes, since they will not be in the system. Retailers would benefit equally from cheating under the flat tax and the consumption tax (assuming the rate were the same). Let's take a bar owner that pockets \$1,000 per week and fails to report his sales either to the income

tax, flat tax, or consumption tax authorities. In the world of either the income tax or the flat tax, that pocketed \$1,000 will reduce the owner's gross revenues, and therefore, his profits by \$1,000 per week. He will, of course, continue to report all of his expenses. He will retain the documentation for the wages he paid and the liquor he bought. The government will lose revenue equal to the tax rate times the \$1,000 per week. In a consumption tax world, the government will lose revenue equal to the consumption tax rate times the \$1,000 per week. In both cases, the loss to the government is the same.

### **The Transition Is Easier Under a Consumption Tax Than Under a Flat Tax**

Under the flat tax, the tax liability of the business community increases dramatically, by hundreds of billions of dollars per year. All capital value added is taxed at the business level. Only wages are taxed at the individual level. About \$5 trillion worth of future deductions (remaining basis), relating to inventory acquisitions, depreciation on capital investment made under the income tax, and so on, exist under the income tax. Since the return on these assets would be in the flat tax taxable base, failure to allow these deductions would amount to a confiscation of nearly one-fifth of existing wealth. The business community, large and small, will not let the flat tax pass without transition rules.

For example, under the Armev-Shelby flat tax if you bought a building for \$1 million dollars the day before the bill went into effect and sold it for \$1 million the day after the bill went into effect, you would have taxable income of \$1 million (even though you have no profit) since the bill assumes that you have expensed the building. In the real world, the taxpayer's income tax basis in that building is going to have to be deductible. The revenue from this kind of expropriation is presently counted in flat tax revenue estimates.

Allowing these deductions, however, would increase the revenue neutral tax rate in the flat tax considerably. Alternatively, the transition could be funded by a complex series of taxes on various windfall gains accruing to certain businesses or taxpayers.

Under the consumption tax, corporations and other businesses and investors pay no tax on their income. Accordingly, it is doubtful that any transition "relief" is appropriate. The future income of their assets will be tax free. Transition rules are only appropriate with respect to inventory held on the date of the changeover, since those inventory costs would not have been deducted in the income tax and the sale of the inventory will be taxed. Rules need to be provided to ensure that the CPI used to index benefit payments includes the consumption tax to protect against any consumption tax induced price increases (although it is not clear there will be any, since repealed income and payroll taxes account for 20-25% of the price of goods and services, according to Harvard economics department Chairman Dale Jorgenson). That's about it. The transition is a much simpler problem under a consumption tax.