

**The Fair Tax
A COSE Issue Paper
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Executive Summary

The Fair Tax

- Replaces all forms of federal taxes with a simple 23%¹ national retail sales tax (consumption tax).
- Makes goods produced in America more competitive abroad and therefore retains American jobs.
- Repeals the 16th amendment to the U.S. Constitution.
- Replaces the IRS with a significantly smaller, less costly *Excise Tax Bureau*.
- Spurs economic growth that outperforms any recent growth.
- Encourages saving and both direct (capital) and portfolio (financial) investing.

Small businesses across the nation stand to gain from the implementation of the “Fair Tax Act” and should support it wholeheartedly.

As presented in H.R. 25 the “Fair Tax” imposes a 23% tax on all final retail sales. Intermediate transactions (i.e. business-to-business transactions) are no longer taxed at the federal level. Also, the Fair Tax repeals all other forms of federal taxes such as the income tax, capital gains tax and social security taxes. The Fair Tax is *revenue neutral* meaning that it will raise the same amount of tax dollars as the current Internal Revenue Code (IRC), but from one source. Collection of the Fair Tax would take place at the point of sale, meaning that the merchant charges the consumer the tax (23% in the case of the Fair Tax) when a purchase is made.

Some of the most-cited arguments in favor of adopting the Fair Tax are the fact that it will save about \$256 billion in annual compliance costs, the fact that the Fair Tax will create trade benefits for goods produced in the U.S. and the fact that it will foster economic growth, by encouraging savings. The majority of savings will be for individuals and small businesses, while all businesses that export will see increased sales due to their products being more competitively priced.

¹ The proposed rate is 23 percent or 30 percent, depending on how one calculates the rate. The **inclusive** calculation is to figure the tax as a percent of total purchase price. Thus, if an item cost \$100.00 the tax would be \$30.00: $100 + 30 = 130$; $30/130 = 23.076\%$. The **exclusive** calculation is to figure the tax as a percent of the pretax purchase price, which is probably how most people would do it. Using the above example $30/100 = 30.0\%$.

Americans spend about a quarter of a trillion dollars (roughly 2% of U.S. Gross Domestic Product (GDP), a prime indicator of the size of the U.S. economy) per year on expenses directly related to compliance with the Internal Revenue Code (IRC), which currently spans about 54,000 pages describing various credits and reductions for particular groups, ranging from low-income individuals to specific industries. By adopting the Fair Tax the IRC would be reduced to a fraction of its current size. Thus, enabling easier compliance and freeing up significant resources for other purposes.

To ensure that low-income individuals are not disproportionately burdened by the Fair Tax, it has a 'prebate' built in that reimburses households for all taxes spent on consumption up to the household's poverty level, as determined by the guidelines set by the U.S. Department of Health and Human Services. 'Prebate' checks are mailed at the beginning of each month.

After a steady decline over recent years, the U.S. savings rate went into the red in the second quarter of 2005. A major cause of the decline is the fact that the current IRC penalizes savings. Most economists agree that if society wants to encourage a particular economic activity, that activity should be subsidized. In the same vein, if society wants to discourage some economic activity, that activity should be taxed. Thus, taxing income which mirrors the market value of productivity discourages productivity. Similarly, property and other investment taxes discourage or at least distort investment decisions. The Fair Tax is a tax on consumption which discourages spending and therefore encourages savings.

The expected surge in savings will help keep interest rates lower because the funds available for investment will increase dramatically. This combined with the \$256 billion previously lost to compliance in turn will boost Gross Domestic Product by relatively large amounts for some time to come. An additional boost to U.S. GDP comes from American exports not being subject to Federal taxes, hence making those exports more competitively priced abroad.

Another benefit the IRC brings with it is a reduction in the potential for tax evasion. Since individuals no longer file taxes, the number of audits that have to be performed by the IRS or its successor agency will be reduced accordingly. The reduction in the number of audits required along with the comparative ease of auditing retail sales will provide the base for an effective auditing system that can detect wrongdoers better than the current system. The reduction in code volume will ensure that law abiding taxpayers are less likely to be the subject of erroneous prosecution by the Government's tax agency.

Some may say that no tax can ever be fair, but if there is such a thing as a fairer tax, then the "Fair Tax" definitely takes that status in comparison to the current IRC. The potential economic impact of the "Fair Tax" appears to be positive and the ease of compliance it creates for taxpayers is overdue. The COSE advocacy committee reviewed and endorsed the Fair Tax in September 2005. COSE

believes that small businesses in particular stand to gain a lot from the adoption of this bill since they are often hit the hardest in terms of compliance cost per revenue dollar.