JOHN LINDER
SEVENTH DISTRICT, GEORGIA

COMMITTEE ON
WAYS AND MEANS

COMMITTEE ON
HOMELAND SECURITY

Congress of the United States
House of Representatives
Washington, DC 20515–1007

WASHINGTON, DC, OFFICE:
TEL: (202) 225–4272
FAX: (202) 225–4696

DISTRICT OFFICES:
TEL: (770) 232–3005
FAX: (770) 232–2909

ONLINE OFFICE:
HTTP://LINDER.HOUSE.GOV

June 8, 2005

Senator Connie Mack
Senator John Breaux,
Chairman and Vice-Chairman
The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW
Suite 2100
Washington, DC 20220

Mr. Chairman, Mr. Vice-Chairman, and members of the Panel,

I want to thank the panel for the many long hours that it has grappled with how to fundamentally transform our tax code. I know that many more hours are still to come.

In your May 11th hearing, you used several of those hours to explore consumption tax proposals generally and specifically a national retail sales tax proposal known as the FairTax. As the Congressional sponsor of the FairTax, I appreciated the many questions that panel members asked about the proposal at the hearing, and while you received very good answers at that time, I wanted to take an opportunity to add to them.

The FairTax is somewhat unique among the proposals that the panel is considering. It is unique not only because it confronts the payroll tax and the funding for Social Security and Medicare—respectively the largest tax that most Americans pay and the largest fiscal crises that America is facing—but also because the FairTax is not simply an idea. It is actual legislation, introduced in the House as H.R. 25 and in the Senate as S.25. This is important because the answers that I provide to your questions are not based on what could be or should be, but rather on what actually is in the legislation.

Why go to a retail sales tax rather than a VAT (Value Added Tax)?

Two reasons: simplicity and visibility. Simplicity comes because 45 of our 50 states already have an infrastructure in place to collect sales taxes. Certainly, as the FairTax base is larger than any state base, an expansion of that infrastructure might be necessary, but the core experience and know-how is available today to make a national sales tax possible tomorrow. A VAT, on the other hand, would need to be implemented from scratch with no experience or infrastructure in place to aid that process.

Visibility, however, is the even more compelling reason to prefer a sales tax over a VAT. The VAT, once in place, is an extremely easy, extremely efficient tax to collect—too easy and too efficient, in fact. Buried in the cost of goods and hidden from voter consumers, the VAT cannot be easily controlled by our democracy. We need only look at our Europeans neighbors to see how the implementation of a VAT and the increase in government spending go hand in hand.

A sales tax, though, is seen and felt in every purchase. It is printed on every receipt. And if that tax is raised even one penny, it impacts every voter and thus the merit of that increase is tested in every election. When we see today that most Americans have no idea how much they pay in payroll taxes and many Americans view April 15th as "refund day", the need for transparency in our tax code and visibility of our taxes is vital for ensuring informed voters in our democracy.

Why a national sales tax instead of simplifying the current system?

The most simple of economic principles is to tax that of which you want less. So why do we tax what people contribute to society (measured in income) rather than what they take out of it (measured in consumption)? This simple notion is the fatal flaw of the income tax and cannot be corrected with simplification.

Aggressive simplification, going far beyond what occurred in 1986, could address the transparency and complexity failings of the income tax. Treating all income sources alike, having a simple rate structure, and allowing full expensing of capital purchases could all help to bring transparency and simplicity. But, the steps toward simplicity that we took in 1986 have all been undone in less than 20 years. If we nibble around the edges again, we will surely require this discussion before another 20 more years have passed.

Federal Reserve Chairman Greenspan testified that predictability is the most important economic component of the tax code. A code that must be replaced every 20 years and is amended 10,000 times in the interim is predictable only in the worst sense of the word.

How would a national retail sales tax affect the health care industry? How would catastrophic events be handled?

The second question is easiest, so I will answer that first. The sales tax would be charged on insurance premiums rather than on the business-to-business transaction of the insurance company paying the doctor and hospital, so there would be no giant tax bite in the case of a catastrophic injury.

How the sales tax affects health care in general is a trickier question. Just today, the President and CEO of General Motors, as he was announcing plans to eliminate 25,000 American jobs, observed that GM health care adds $1,500 to the price of every automobile. *USA Today* reported yesterday that the average GM car sells for about $20,600, meaning that health care costs for GM workers represent more than 7% of the cost of the car. GM must export those costs when it sells these cars in the global market. With that sort of competitive drag, it is no wonder that 25,000 more American jobs are disappearing.

GM provides these health benefits today because the American tax code encourages it to do so. The tax code punishes individuals who want to buy their own health insurance—insurance that could be carried with them from job-to-job for life—and it encourages companies to purchase one-size-fits-all solutions that must be left behind when an employee changes jobs. A national retail sales tax would remove this perverse incentive—along with thousands more—and return health care decisions to patients and doctors.

Will businesses pay the sales tax?

No. As everyone who has owned a business will confirm, businesses never pay taxes. They merely raise their prices and collect the tax from the consumer. The central theme of the FairTax is that everything should be taxed…but taxed once and only once. Therefore, since the tax is levied on the final purchase of the product, it is essential that businesses not bury any taxes in the price of goods.

I have just described in the question above the international competitive impact of burying health care costs in the price of car. Taxes create that same drag. Research suggests that more than 20% of the price of an automobile represents the drag of the American tax system. With the drag estimated to be 22% on average across all product categories, it is no wonder that that American products are struggling to compete overseas. The wonder is that we have remained as competitive as we have…and the even bigger wonder is how amazingly competitive we could be if we eliminated this drag forever by enacting a national retail sales tax and abolishing business taxes.

How will the transition take place?

The transition will occur overnight, but the announcement of the transition will come long before so that businesses and individuals can prepare. As we continue to pay "temporary" telecommunications taxes dating back to the 1800's and the Spanish-American War, we can see that the American experience with abolishing taxes is abysmal. Therefore, we cannot transition slowly by reducing the income tax while raising the sales tax. If we begin with a little of each we will surely end with a lot of both.

By announcing the transition early, however, the marketplace will itself implement the tax gradually as individuals and businesses make decisions based on what they expect to happen. The only transition rule is that businesses receive a tax credit for all existing inventory at the moment of the transition. As the FairTax aims to tax everything once and only once, it must have a mechanism for eliminating the tax burden hidden in the price of goods produced under the income tax.

How will the tax be enforced?

As I mentioned earlier, 45 of the 50 states already have a great deal of experience with the sales tax and its enforcement. The federal government will contract with the states to collect the tax, even providing 25 basis points of the tax to the states as a collection fee.

Not only do the states already have expertise in this area, but eliminating the income tax and payroll tax will allow enforcement authorities to focus even more on sales tax enforcement. (Though states are certainly not required to end their income taxes or payroll taxes, the expectation certainly is that they will model a new state revenue system on the new federal system, much like they have done with the current federal system.) Simply looking at current IRS statistics shows the magnitude of this enforcement change. In 2003, for example, the IRS received nearly 6 million corporate returns, but the nearly 30 million payroll tax returns and the 130 million individual returns dwarf this figure.

Enforcement will certainly be easier across 6 million, or 12 million, or 30 million collection points than it is today across 170 million.

How will we tax financial services?

Financial services are not economically distinct from any other service, though the industry has developed in a way that does make taxation slightly more difficult. As anyone who has applied for a mortgage knows, there are two ways to pay for financial services. One way is with a direct fee (points, in the case of a mortgage), and these fees—like those of dentists, lawyers, and accountants—are easy to identify and tax.

The second way to pay for financial services is to agree to a "different than market" interest rate. In the case of a "free" checking account, consumers agree to be paid less than market rate interest on their money. In the case of "no fee" mortgages, consumers agree to pay higher than market rate interest for their loan. In both cases, it is easy to see that the "fee" is reflected (though hidden) in the non-market interest rate, and the interest spread is the taxable service.

These same principles of taxing fees and the spread on non-market interest rates would apply across the financial services sector. The Bureau of Economic Analysis has long calculated the value of these "free" services in its calculation of GDP, so finding them and taxing them is not as new as some might imagine.

Why do you use a 23% rate in the FairTax?

This question can mean three things, and I will address all three. Some people are asking why the rate is so high, others are asking why the rate is so low, and others are asking why it is 23% in particular.

The rate is 23% in particular because the FairTax is designed to be revenue neutral, and economists who have scored the FairTax find that is will take a 23% tax to replace the revenue currently generated by the taxes that the FairTax eliminates: personal income, corporate income, payroll, death, gift, capital gains, and self-employment.

Many think that the rate is too high because they believe that government spending is too high. I agree that spending is too high, but that is a different fight for a different day. Today is the day for tax reform. Others who think that rate is too high generally do not know that the FairTax replaces the payroll tax. As the payroll tax makes up about a third of revenues to be replaced, we could reduce the 23% tax by a third is we left payroll taxes in place. However, as the payroll tax is the most regressive tax in America and funds two of the most important programs in America, any successful fundamental tax reform program must confront these issues. To my knowledge, the FairTax is the only one that does, and that explains the 23% rate.

Those who think that the rate is too low fall into two categories, and often both categories. One category contains those who believe that the economists who have scored the FairTax are just wrong and that in order to be revenue neutral a much higher rate must be applied. The other contains those who simply take issue with the way that the rate is stated. I will confront this issue first.

State sales taxes are universally stated in terms of the tax added to the price of the product at check-out. If you buy a soda for a 75 cents and the clerk asks you for a dollar, you have been charged a 33% sales tax: the soda cost three quarters and the tax was one more. Again, you gave the clerk a dollar, you got a soda, the government got 25 cents, and you have been charged a 33% tax.

But now look at the income tax today in America. The tax bracket that captures the most Americans is 25%, which means—of course—that the government takes 25 percent of every dollar that you earn. You earn one dollar, and the government gets 25 cents.

Now look at the sales tax again: you earn a dollar, you spend it, the government gets 25 cents, and you get a 75 cent soda. Now look at the income tax: you earn a dollar, the government gets 25 cents, and you have enough money left to buy a 75 cent soda. In both cases, you earn a dollar; in both cases the government gets 25 cents; and in both cases you have just enough money to buy a 75 cent soda. The tax—though stated differently as 25% on income and 33% on sales—is exactly the same tax. But imagine the question on a state referendum: would you rather pay a 25 percent income tax or 33 percent sales tax? I imagine that "25 percent" wins even though the tax is exactly the same and even though the sales tax scenario even lets you keep your money until you spend it while the income tax scenario grabs the money as soon as you earn it.

If we are going to have a serious discussion about tax reform, we must be able to compare apples to apples, and framing the FairTax as a 23% personal consumption tax does that. It tells us that the government will get 23 cents out of every dollar that we spend, and it allows us to compare that possibility with the lifetime of experience that most of us have had with the income tax. For those who want to call it a 30% tax, that is fair too, but only if we can agree that the 25 cents on the dollar income tax and the 15 cents on the dollar payroll tax that most Americans pay today is a 66% tax (when the government gets 40 cents and the consumer gets 60 cents).

For the other category of naysayers—those who believe our economists are just wrong—the numbers are what the numbers are. We have enlisted professors from Harvard, Boston University, and Stanford—as well as a host of minds from the private sector—in search of the truth about the numbers. These academics have all reported that the required rate of the FairTax would be 22 to 24 percent.

To require a higher rate, detractors must either narrow the base on which the FairTax is applied or increase government spending so that more revenue is required.

Will the FairTax be progressive?

Absolutely, though "progressive enough" for detractors is a more difficult question. For too long, some in this country have defined a progressive tax in exclusively income terms. It will always be true that those who earn more can consume less as a percentage of their income—the very definition of wealth accumulation. In fact, if we believe that taxes discourage behavior, a central idea behind the FairTax is to stop discouraging work and saving and start discouraging consumption, thus encouraging—promoting, even—wealth accumulation at even the lowest income rungs of our economy. So, yes, the FairTax is progressive, but, no, it can never be as progressive as a strict tax on income could be.

Nevertheless, the FairTax is progressive. The FairTax provides for tax-free spending up to the poverty level—meaning that those who spend at the poverty level pay nothing in federal taxes while those who spend twice the poverty level will pay an effective rate of 12% and those who spend four times the poverty level (more than $100,000 for a family of four) will pay 18%. The uber-wealthy who are uber-spenders will have an effective rate close to 23%. No taxes on the poor, 12% on the middle class, 18% on higher income earners and 23% on the uber-wealthy is very progressive

But our inquiry cannot stop there, because most Americans pay more in payroll taxes than income taxes. In fact, a CBO report this year found that only those in the highest quintile of income had a lower federal payroll tax burden than federal income tax burden. The FairTax repeals this regressive tax and replaces it with the progressive tax schedule mentioned above. So the answer to the progressivity question is, "Yes, the FairTax is progressive in its own right, but compares even more favorably to today's system because it repeals the largest and most regressive tax that most Americans pay: the payroll tax."

Why haven't other countries tried this?

Actually, other countries are way ahead of America in terms of consumption taxes generally. The U.S. is the only OECD country, in fact, that does not have a national consumption tax.

Most of these countries have opted for a VAT, which sales tax advocates will readily admit is a more efficient method of collecting taxes. But America is unique in two respects. First, the U.S. already has in place an incredibly efficient sales tax collection system. Not only are 45 of 50 U.S. states already collecting sales taxes, but they are collecting them for multiple layers of government: states sales taxes along with county sales taxes along with municipal sales taxes. Adding a Federal layer, then, is a much smaller endeavor for us than it would be for most other nations.

Second, the U.S. has a unique view of freedom. The very efficiency that sales tax proponents credit to the VAT is the very thing that makes it the most dangerous to freedom. While economists disagree about whether the dramatic rise in European government spending, for example, is related to the implementation of the VAT, all economists agree that a VAT is hidden from consumers and can be easily raised.

Coming back to the original question, most countries do use consumption taxes and use them successfully. Most countries, however, do not have the infrastructure and experience with sales taxes that America does nor do their citizens have the natural suspicion of big government that Americans do. Thus, while the VAT may be a better choice for these foreign nations, a sales tax is the better choice here at home.

Mr. Chairman, Mr. Vice-Chairman, and members of the Panel, thank you again for all of the work that you and your panel are doing. Please do not hesitate to contact me if I can provide any more information on the FairTax to any of your members.

Sincerely,

John

John Linder
Member of Congress