The FairTax Bill: A Better Way to Fund the Federal Government

A Paper by

Aaron Lucas Finch

Presented to:

Prof. Kim P. Germany

In partial fulfillment of the requirements of

English Comp. II

Nazarene Bible College

Colorado Springs, CO

October 23, 2007

THE FAIRTAX BILL: A BETTER WAY TO FUND THE FEDERAL GOVERNMENT

Thesis: The current federal tax code is broken, and the best way to fix it is by replacing all federal taxes with the national sales tax plan that has been proposed in the FairTax Bill.

I. The History of American Taxation
   A. There was no taxation under the Articles of Confederation.
   B. The first taxes under the U.S. Constitution were excise taxes on consumer goods.
   C. The first income tax was passed to fund the American Civil War, and it was removed in 1872.
   D. The income tax was reestablished in 1894.
      1. President Cleveland did not sign this bill into law.
      2. The U.S. Supreme Court found the income tax to be unconstitutional.
   E. The Sixteenth Amendment to the U.S. Constitution was ratified in 1913, thus allowing congress to impose a federal income tax.
   F. Today the federal system of taxation is broken, and several proposals have been made to fix it.

II. The Broken Tax Code
   A. The current tax code is too complex for most people to understand.
   B. Income taxes are an inefficient way for individuals to pay their taxes.
      1. Taxes withheld from paychecks keep individuals from being informed about how much they pay to the federal government.

2. Income is an inefficient way to determine how much tax liability a person should have.
3. Income taxes are easily evaded, thus leading to a large dollar amount going uncollected.

C. Corporate taxes are an unneeded burden to corporations and consumers.

1. A large amount of money is spent by corporations in attempts to comply with the federal tax code.
2. Corporate taxes result in consumers paying more for goods and services.

III. The FairTax Solution

A. The FairTax is significantly simpler than the current tax code.

B. Consumption taxes are a much more efficient way for individuals to pay their taxes.

C. The elimination of corporate taxes will significantly reduce the ticket price of goods and services.

IV. Concerns about the FairTax

A. Those in poverty will not be overburdened by the FairTax Bill.

B. Corporations will, in fact, pass on their savings from eliminated corporate taxes to consumers.

C. The federal government will be adequately funded through the FairTax.

THE FAIRTAX BILL: A BETTER WAY TO FUND THE FEDERAL GOVERNMENT

"Taxation without representation is tyranny" was a cry that was used to rally volunteers to the cause of liberty during the American Revolutionary War. This war cry illustrates the frustration that the founding fathers of the United States of America felt towards their English overlords. In order to fund its war against France, the English Parliament enacted the Stamp Act on the American colonies in 1765. Not long after, this was followed by a tax on tea. The American colonies had no representation in Parliament; thus, they had no say on whether these taxes were imposed upon the American people or not ("Fact Sheets: Taxes" par. 3).

Since those days, the process of funding the federal government has gone through many transformations. Under the Articles of Confederation, no system for funding the national government was established; instead, it relied upon donations from the States ("Fact Sheets: Taxes" par. 4). The U.S. Constitution, adopted in 1789, gave congress the power to enact certain ways to fund the federal government. Specifically, it states, "The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States . . ." (US Const., art. 1, sec. 8). The first taxes imposed by the federal government were excise taxes on various consumer products, such as spirits, tobacco, and sugar ("Fact Sheets: Taxes" par. 6). The first tax on personal income came through the Revenue Act of 1861 during the American Civil War. This income tax was set at three percent of all annual incomes above $800. This initial attempt at an income tax was abolished in 1872 ("Fact Sheets: Taxes" pars. 12, 15).

In 1894, congress reestablished the personal income tax. This time, it was a two percent tax on annual incomes at or above $4,000. President Grover Cleveland did not think that this income tax was constitutional, though, so it went into law without his signature. This called for a review by the U.S. Supreme Court, and they ruled that the income tax was a violation of the Constitution (Boortz 12-13), which states, “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or enumeration herein before directed to be taken” (US Const., art. 1, sec. 9).

After having the tax on personal income rejected by the Supreme Court, politicians began an effort to amend the constitution. Eventually, their efforts paid off, and the Sixteenth Amendment was ratified on February 12, 1913 (Boortz 14-15). The Sixteenth Amendment says, “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration” (US Const., amend. 16). This amendment paved the way for the tax code that we have today.

Today, the system of federal taxation is broken. The tax code is so complicated that even professional tax preparers cannot reach a consensus when preparing individuals’ tax returns. Income taxes are an extremely inefficient way for individuals to pay their taxes and provide an avenue for tax evasion. Corporate taxes add a huge unneeded expense to corporations and hide taxes that are paid by consumers in the prices they pay for goods and services. These are just a few examples of the problems that exist with the federal tax code.

Different proposals have been made on how to best reform the tax code. In his book *If Americans Really Understood The Income Tax*, attorney John O. Fox, who specializes in tax and business matters, proposes a system that retains the income tax but presents “a simpler [tax system] that raises the same amount of revenue for the government while taxing people more consistently on their income at much lower rates” (17-18). Steve Forbes, Editor-in-Chief of *Forbes Magazine*, prefers a system of flat taxation where all tax payers pay the same percentage of income tax ("The Case for a Flat Tax" par. 2). In 1992, Senators Peter Domenici and Sam Nunn began developing a plan to replace the taxing of personal income with the taxing of consumed income (Seidman par. 1).

Following the pattern of a consumption tax, where all taxes are paid when goods and services are purchased, Congressman John Linder developed the FairTax Bill. He first introduced the FairTax Bill in 1999, and he has been introducing it in each Congress since then (Boortz XII). The FairTax Bill, if passed, would eliminate individual income taxes, alternative minimum taxes, corporate taxes, capital gains taxes, Social Security taxes, Medicare taxes, self-employment taxes, estate taxes, and gift taxes. These would all be replaced by a 23 percent national sales tax "on all goods and services sold at the retail level" (Boortz 74-76). After eliminating the hidden corporate taxes that individuals pay on goods and services, this 23 percent sales tax would result in consumers paying about the same amount as they do now for goods and services. According to the presidential and congressional scorecards at fairtax.org, this is a proposal that is supported by seven presidential candidates and 88 senators and congressmen. All of these politicians, and many individuals in the grassroots level, have become aware of the fact that the current federal tax code is broken, and the best way to fix it is by replacing all federal taxes with the national sales tax plan that has been proposed in the FairTax Bill.

The current tax code is far too complex for most people to comprehend. Currently, there are over 50,000 pages of tax laws and regulations in effect ("The FairTax", par. 2). The majority of individuals who file form 1040 hire a professional to prepare their tax returns for them. The professionals can't even reach a consensus on how to interpret the massive tax code, however. In 1997, *Money* magazine enlisted the assistance of 45 professional tax preparers. Their job was to figure out the taxes for an imaginary taxpayer. The result of this experiment was that 45 different answers were computed (Fox 53).

Not only is the tax code excessively complex, but it provides a very inefficient way for individuals to pay their taxes. Currently, most individual taxes are paid through payroll withholdings. At the end of the year, either the individual taxpayer or a hired professional computes his tax liability. If additional taxes are owed, he pays them; if additional taxes are not owed, then he receives a refund from the federal government.

Unfortunately, income taxes withheld from paychecks keep taxpayers ignorant about how much they are actually paying in taxes to the federal government. Although the original income tax bill allowed for taxes to be withheld from paychecks, after a considerable number of complaints, lawmakers made withholding taxes illegal in 1917. From then up through World War II, taxpayers would write one check to the Internal Revenue Service each year to pay the previous year's taxes (Boortz 22-23). Taxpayers were much more aware of what they were paying in taxes when they paid one lump sum than they are today by having a percentage deducted from their paycheck that they never actually see. For example, an individual who owes $10,000 in federal income taxes is more conscious of exactly how much she is paying than if she just has $416.66 that she never actually sees deducted from her paycheck every two weeks. Additionally, withheld taxes contribute to the myth that it is a good thing to get a tax refund. Taxpayers don't typically perceive that in overpaying their taxes, they have essentially loaned the federal government those funds interest free when they could be putting the money to work for themselves.

Although the income an individual receives gives an indicator as to how much money he has available, a system of taxation based solely on income is an inefficient way to determine an individual's tax liability. There are a number of factors that contribute to how much a person can afford to pay in taxes. These include, but are not limited to, caring for dependants, paying for education, paying for housing and transportation needs, and various additional expenses that are determined by the geographic location of the individual's residency. Many of these things can be deducted when figuring out the tax liability, but this is a complicated process to take on.

Because tax liability is computed by individual tax payers or a professional whom they hire, it is easy for individuals to avoid paying their taxes, and a large amount of owed taxes goes uncollected each year. The philosopher Plato wrote in *The Republic* over 2000 years ago that "when there is an income-tax, the just man will pay more and the unjust less on the same amount of income." The IRS estimates that $312 to $353 billion goes uncollected each year as a result of taxpayers not being in compliance with the tax code, either intentionally or unintentionally ("IRS Estimates Tax Gap Estimates" par. 2). According to Martin Crutsinger, an economics writer for the Associated Press, in January 2007 the Bush Administration predicted an annual budget deficit of $339.2 billion for Fiscal Year 2007 (Crutsinger par. 8). Based upon these numbers, if all American taxpayers were in compliance with the tax code, then there would be no, or an extremely small, budget deficit. However, since tax evasion is so easy under the current system, there is an outrageous national deficit, and the national debt continues to skyrocket.

In addition to the inefficient personal income taxes, the tax code imposes corporate taxes that are an unneeded burden to corporations and consumers. In *The FairTax Book*, radio talk show host Neal Boortz and U.S. Congressman John Linder report that "according to the Tax Foundation, just the time and effort of complying with our massively complex tax code costs the average small business about $724 for every $100 it pays in income taxes to the government"

(35-36). This means that the cost for businesses to comply with the tax code is 724% of what they are actually paying in taxes. Annually, according to the director of the Congressional Budget Office, businesses in the United States pay between $400 and $500 billion in attempts to accurately pay their taxes (Boortz 36). This is, in effect, $400 to $500 billion that is being passed on to consumers in the price of products and services they receive.

Not only does the cost of compliance get passed on to consumers, but the very corporate taxes themselves get passed on to consumers as well. It is time to correct a common myth. Corporations don't pay taxes; consumers do. It is common for Americans to hear of record corporate earnings in a given industry, such as oil, and for them to think that we need to raise taxes on that industry. What is misunderstood, though, is the fact that the corporations affected just increase the price of their product when their taxes are raised, thus resulting in consumers paying the price of the increased taxes (Boortz 32). Corporate taxes, then, result in embedded taxes that consumers aren't aware they are paying.

Each industry that a product, or the components of the product, goes through prior to reaching the consumer pays corporate taxes, and at each level, these taxes are embedded in the price of the product at the next level. To illustrate how this works, take a look at a very simple product, such as a piece of fruit. The fruit is grown on a farm. The farm pays taxes but embeds these in the price the company purchasing the fruit pays. The company transporting the fruit from the farm to the distribution center pays taxes, but again these are passed on. The distribution center once again passes on the taxes it pays to the retailer. Finally, the retailer passes on its own corporate taxes, along with all of the embedded taxes it has already paid. The end result is that the consumer pays, on average, 22% more than she would pay if there were no corporate taxes embedded in the price of the product (Boortz 55).

The solution to the problems that have been raised because of the broken tax code is for congress to pass the FairTax Bill. All of the problems that exist as a result of the complexity of the tax code will be eliminated. As has already been pointed out, the current tax code is over 50,000 pages. Tax professionals can't even agree on how to interpret it, and companies pay $400 to $500 billion annually trying to comply with it. The FairTax Bill is only 132 pages ("The FairTax", par. 2). This should make it much easier for individuals, professionals, and corporations to be able to understand it.

In addition to being easier to understand, the consumption tax proposed in the FairTax Bill is a much more efficient way for individuals to pay their taxes. Instead of having to sit down once a year with complicated tax forms trying to interpret what they owe and what they don't owe, taxpayers will pay a 23% national sales tax every time they purchase goods or services, and that is it. No more W4s, W2s, 1040s, or any other tedious paperwork to fill out. No more April 15th deadline to reach. No more income taxes or FICA taxes withheld from their paychecks, which, on average, result in 20.1% of a worker's paycheck being withheld ("Fiscal Facts" par. 10, "Social Security & Medicare Tax Rates" tax rates table). No more calculating tax liability of capital gains taxes, self-employment taxes, estate taxes, and gift taxes (Boortz 74-75). Instead, consumers will keep all of their paychecks and determine when and where they will pay taxes when they purchase goods and services. Tax evasion also disappears as people no longer have the option of not accurately reporting their tax liability.

Not only will taxpayers benefit by the simplification of the tax paying process and the increased amounts of their paychecks, they will also benefit by reduced prices of goods and services. Since under the FairTax there will be no more corporate taxes, the ticket price of goods and services will be reduced by an average of 22%. Then, when the 23% sales tax is added on, the average amount paid will only be 1% greater than it currently is, and taxpayers are still keeping all of the other taxes that are currently being withheld from paychecks and paid directly to the IRS (Boortz 56).

One of the concerns that has been raised about the proposal in the FairTax Bill is that it will hurt the poor. Currently, those in poverty have little or no income tax liability. If they are required to pay 23% more for goods and services, then that is money being taken away from them that they are currently not paying. In response to this concern: first of all, as has already been explained, everybody is currently paying an average of 22% more for goods and services in embedded corporate taxes, rich and poor alike. If you take these corporate taxes away, those in poverty are only paying 1% more under the FairTax than they are currently paying, plus they are keeping any taxes withheld from their paychecks.

Also, the FairTax Bill has written into it a plan for prebate checks. Under this plan, each month every household will receive a check from the government designed to offset the taxes paid for essential goods and services. The amount of the check is based upon the government's current poverty income and spending estimates. As of 2005, this is how the prebate checks would look. A single person would receive a monthly check for $183.43, a married couple would receive a monthly check for $366.85, and each dependent would result in an additional $62.48 being added onto the prebate check (Boortz 85-86). Such a check would offset the additional 23% tax paid for essentials, such as food and medical expenses; thus, the poor would not be hurt by the FairTax.

Another concern that has been raised is in regards to the removing of the embedded corporate taxes. What is to stop corporations from leaving the prices as they are and then making a significantly larger profit than they currently make? The answer is this: a competitive capitalistic market. As long as there is a company out there that is willing to sell a product for a price cheaper than what other companies sell the same product for, then the vast majority of consumers will support that company. Retailers, and the corporations they receive their products from, understand that in our competitive capitalistic market it is in their best interest to offer the best product they can for the cheapest price they can. If they don’t, another retailer or company will come in and offer the product at cheaper prices, thus stealing business from the original company. As long as we maintain a competitive capitalistic market, there is no concern about corporations not passing the savings from their removed taxes on to the consumers (Boortz 56-59).

One final concern is whether the FairTax Bill can adequately fund the federal government. Those who wrote the FairTax Bill wrote it in such a way as to be “revenue neutral for the first year of operation. It raises the same amount of revenue as is raised by current law. After the first year, revenue is expected to rise because of the growth generated by this plan” (“About the FairTax” par. 78). Essentially, this is how it works: Taxpayers will retain all of their paychecks and will not owe any additional taxes to the federal government. This gives them more money to consume, or spend, than they currently have. Because we live in a consumer society, this is, indeed, what will happen with the majority of the extra funds. Thus, when this money is spent, the government will bring in extra funds through the sales tax. The 23% tax level wasn’t set arbitrarily. In response to a question regarding how the tax percentage was derived, the Frequently Asked Questions at FairTax.org states the following: “The proper tax rate has been carefully worked out; 23 percent does the job of: (1) raising the same amount of federal funds as are raised by the current system, (2) paying the universal rebate, and (3) paying the collection fees to retailers and state governments" ("About the FairTax" par. 8). Therefore, there should be no problems providing adequate funds to our government through the FairTax.

The current federal tax code is broken, and the best way to fix it is by replacing all federal taxes with the national sales tax plan that has been proposed in the FairTax Bill. This will simplify the tax collecting process, enable workers to keep all of their hard-earned income, remove the problem of tax evasion, allow corporations to eliminate large amounts of wasted funds in compliance, and eliminate hidden embedded taxes that are paid by consumers without their knowledge. The federal government will be fully funded through the FairTax, and those in poverty do not receive an extra tax burden.

The founding fathers of this great nation gave their lives fighting against an unfair system of taxation, yet citizens today are willing to allow their hard earned income to be taken from them without giving it a second thought. It is time for Americans to set aside ignorance and apathy towards their government. It is time for Americans to stand up and demand a fair system of taxation. It is time for Americans to support politicians who support the FairTax. It is time for Americans to call their elected representatives and demand that the FairTax Bill be passed.

WORKS CITED

"About the Fair Tax: Frequently Asked Questions". *FairTax.org*. 2007. Americans For Fair Taxation. 23 Oct. 2007 <http://www.fairtax.org/site/PageServer?pagename=about_faq_answers#41>.

Boortz, Neal and John Linder. *The FairTax Book: Saying Goodbye to the Income Tax and the IRS*. New York: HarperCollins Publishers, 2005.

"Congressional Scorecard". *FairTax.org*. 2007. Americans For Fair Taxation. 14 Oct. 2007 <http://www.fairtax.org/site/PageServer?pagename=news_scorecard>.

"Constitution of the United States". *The National Archives Experience*. The U.S. National Archives and Records Administration. 18 Oct. 2007 <http://www.archives.gov/national-archives-experience/charters/constitution_transcript.html>.

Crutsinger, Martin. "Deficit Falls to Lowest Level in 4 Years". *The Associated Press*. Jan. 12, 2007. Breitbart.com. 21 Oct 2007 <http://www.breitbart.com/article.php?id=D8MJU5901&show_article=1>.

"Fact Sheets: Taxes." *United States Department of the Treasury*. 18 Oct. 2007 <http://www.treas.gov/education/fact-sheets/taxes/ustax.shtml>.

"Fiscal Facts: Summary of Latest Federal Individual Income Tax Data". *Tax Foundation*. Oct. 5, 2007. Tax Foundation. 21 Oct 2007 <http://www.taxfoundation.org/publications/show/250.html>.

Fox, John O. *If Americans Really Understood the Income Tax*. Boulder, CO: Westview Press, 2001.

“IRS Updates Tax Gap Estimates”. *Internal Revenue Service*. Feb 14, 2006. United States Department of the Treasury. 21 Oct 2007 <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

Plato. *The Republic*. The Republic by Plato. The Internet Wiretap. 1901. 18 Oct. 2007 <http://www.fordham.edu/halsall/ancient/plato-republic.txt>.

“Presidential Scorecard”. *FairTax.org*. 2007. Americans For Fair Taxation. 14 Oct. 2007 <http://www.fairtax.org/site/PageServer?pagename=news_presScorecard>.

Seidman, Laurence S. "A Better Way to Tax." *Public Interest* 114 (1994): 65+. 07 Oct. 2007 <http://find.galegroup.com.proxy.lib.wy.us>.

“Social Security & Medicare Tax Rates”. *Social Security Online*. Oct. 18, 2007. U.S. Social Security Administration. 21 Oct 2007 <http://www.ssa.gov/OACT/ProgData/taxRates.html>.

“The Case for a Flat Tax”. *Forbes.com*. 18 Oct. 2007 <http://www.forbes.com/taxes/>.

“The FairTax” *United States Representative John Linder*. 18 Oct. 2007 <http://linder.house.gov>.