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Before the Joint Committee on Economics

on

How U.S. Tax Policy Affects Business Investment and Job Creation

November 17, 2011

Dear Mr. Chairman and Members of the Committee:
Let me begin with an observation leading to a compliment. My observation? The debate over America's tax system is not about one problem. It is about a bundle of competing problems searching out competing solutions. Although all Americans share a fervent disdain for the tax system, they do so for many reasons. Before policymakers can make true progress in discussing the effectiveness of various alternatives in achieving reform goals, therefore, they must first agree upon the common issues reform is meant to address. Stated another way, they must decide "what are the central problems with our current system?" before they can intelligently ask "how well the ideas for reform address those problems?"

My compliment? The Committee insightfully titled this hearing "*How* American Tax Policy Affects U.S. Businesses." Shrift was doubtless given to titling it "*Whether* U.S. Tax Policy Affects Business." U.S. Tax policy affects, and unfortunately disaffects business, in ways well beyond the tax expenditures purposely designed to effect that result.[1] In short, our tax regime influences business from the cradle to the grave: whether or not to start a business, what business to start, how to organize it, where to locate it (here or abroad), how to fund and run the business, when and how to expand it, when to hire, when to terminate it and how to unwind it.

Over the course of the last 25 years, I have seen how tax policy affects business from many angles: as a practitioner, an advocate, a federal prosecutor, an adjunct professor, an author of treatises and a book on the policy process, and as a Congressional counsel. And from these differing perspectives, I cannot help but see the discouragement of many economists whose voices of reason are ignored, not because they are discordant, but because they are drowned out by the deafening din of lobbyists. Our tax system has in a nutshell devolved into an unholy trinity of lobbyists, industry seeking relative advantage and Members who seek campaign contributions, all of whom would sacrifice at the altar of a public auction our national prosperity for personal advantage.

The good news is that Tax reform is coming. It is a tide that if resisted by this Congress will be passed by their replacements. But the bad news is that the direction of tax reform remains to this day uncertain. What will reform look like? What are the criteria by which reform will be adjudged? Will reform be accomplished in name only, to leave to another generation the ultimate fix when the economy has worsened?

[1] 1974 Congressional Budget and Impoundment Control Act (PL 93-344).

Understanding how we have gone astray is as easy as hearing the central chorus of economists, as discordant as they sometimes sound. You will hear that the critical maladies of our current system are three-fold:

- its complexity, prolixity and crushing compliance costs;
- its high marginal rates which trample productive income, stifle growth, job creation and wages;
- an anachronistic international tax system that is self-flagellating.

And many will tell you, as I will today, that the solution to this crisis is a consumption tax that makes the taxes we pay visible, ensures all Americans are stakeholders, is neutral as to savings and investment, lowers marginal rates, reduces compliance costs and removes the anti-competitive nature of our non-border adjustable extraterritorial tax system. The best of these is the FairTax, which stands in such stark contrast to the *causus male* of our current system that it illuminates the path this Nation must take to regain the trajectory of our prosperity.

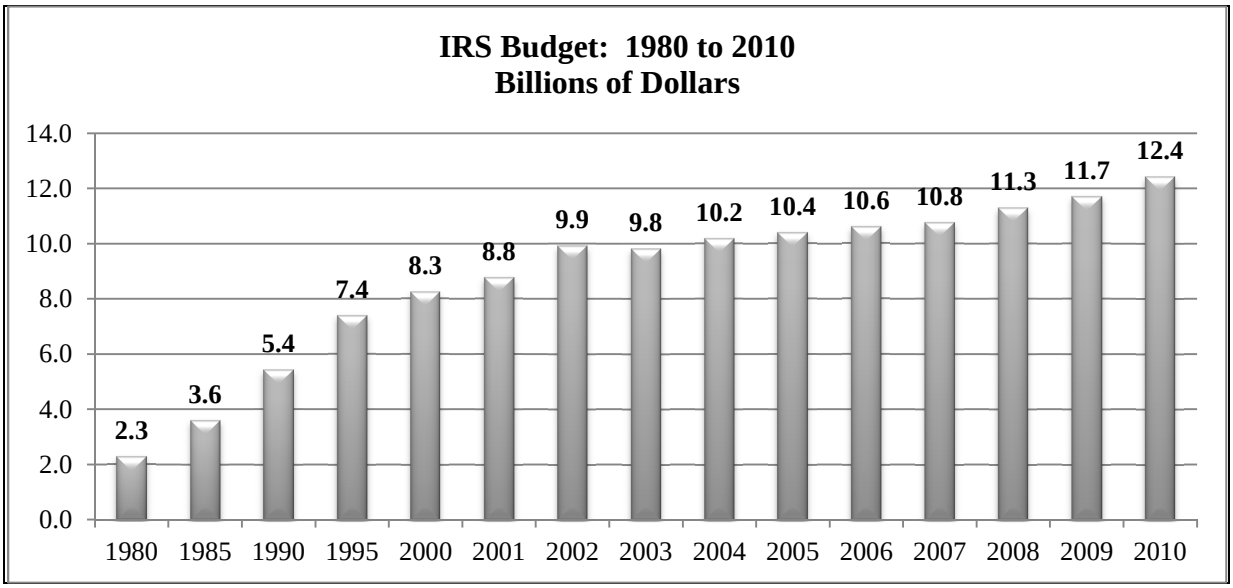
I. The Maladies: Three Ways Our Tax System Hurts Business

A. Compliance Costs Impose a Crushing Weight on Business.-- As we think about the ways (and degree to which) the U.S. tax regime adversely affects business, it is helpful to see the issue as a cluster of *antibiosis maladies*. In case one missed that, *antibiosis* is the opposite of *symbiosis*. What it means is that each factor combines to *worsen* the negative contribution of the other; and that is a perfect description. Complexity begets costs, begets loopholes, begets evasion, begets high rates, begets more lobbying for loopholes, which begets more evasion, which begets a perception of unfairness, which begets even higher rates, more evasion, more economic inefficiency, and so on.

Understanding the tax regimes harmful effects begins with the compliance costs it imposes. To begin to understand how ludicrous these costs are, visualize the 1967 movie, Cool Hand Luke. Then imagine the taxpayer personified by Paul Newman as he complains about breaking rocks and moving them back and forth from one pile to another, for no apparent reason in the prison yard. When Newman approaches expiration, the response of the guard is "What we've got here is... failure to communicate." The gravity of the problem has been heard by this very Committee several times.[2]

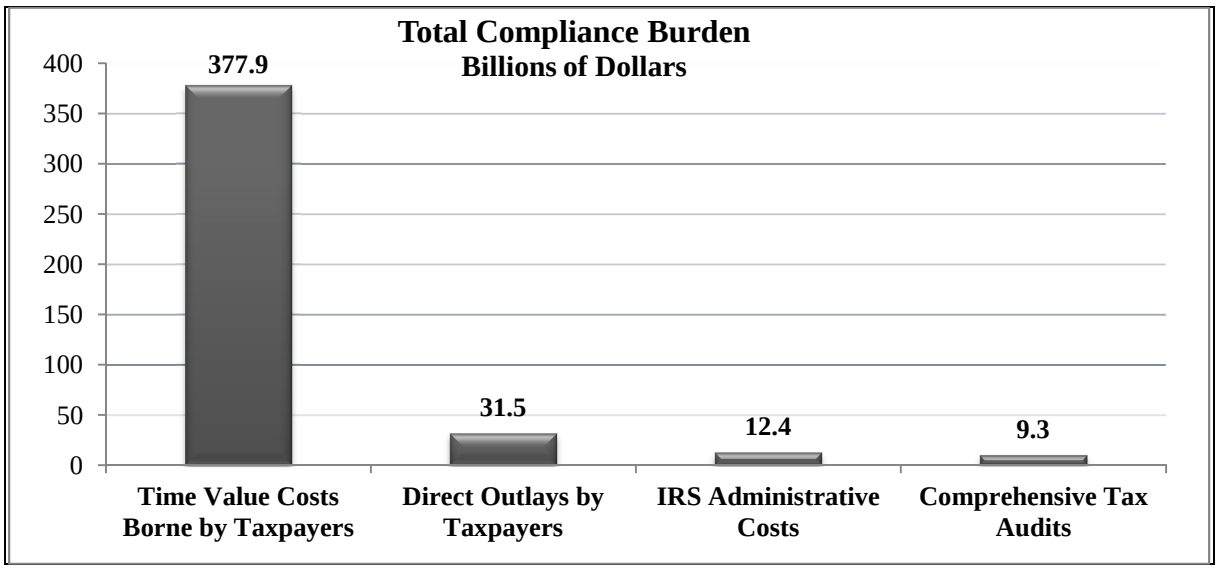
One aspect of compliance costs are administrative costs. The IRS directly employs about one hundred thousand employees. The IRS budget is about $12.4 billion[3], which has grown by 323% since the Tax Reform Act of 1986 in order to, among other things, handle 1.7 billion pieces of paper annually. All told, Americans spend more on IRS enforcement than they do to administer the nation's environmental, labor or other laws combined.

[2] Joint Economic Committee, Report #109-353, Report on the 2005 Economic Report of the President, Nov., 2005.
[3] The Internal Revenue Service Data Book, 2010, Table 28.



Source: IRS Data Books and Budget of the Unites States, various years.

But these *administrative* costs are themselves negligible when compared to the broader federal mandate thrusts upon the IRS's "customers." These are the *compliance* costs, borne by businesses and individuals in their efforts to calculate, substantiate and pay the taxes owed.

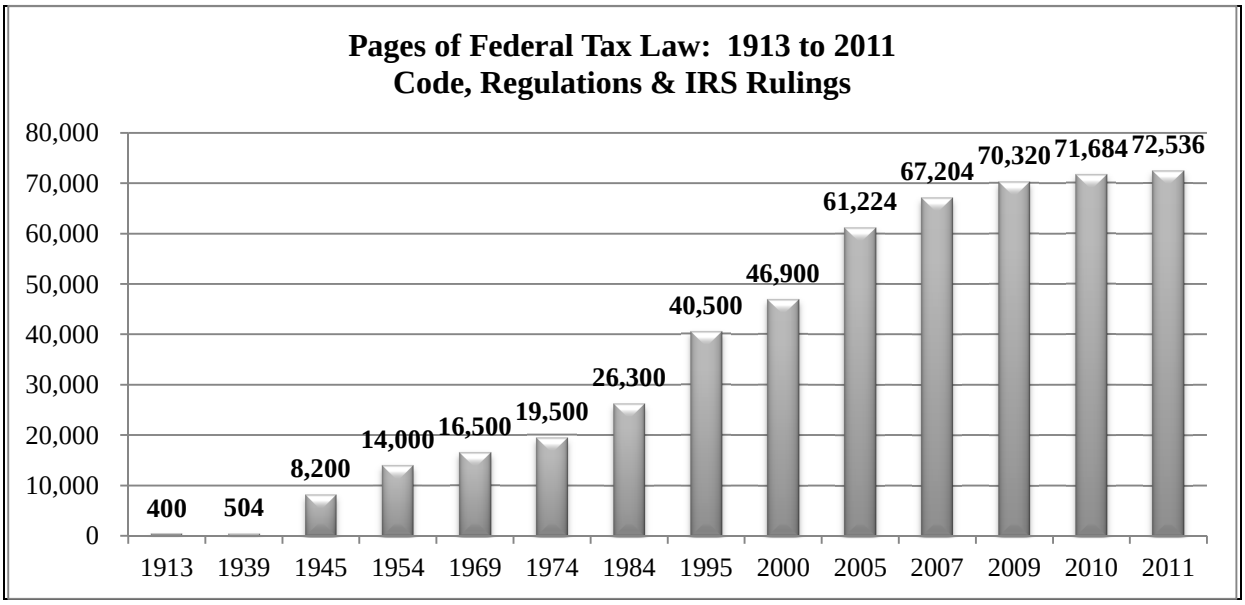


Source: Laffer, Winegarden and Childs, "The Economic Burden Caused by Tax Code Complexity, April 2011.

While the economic burden occasioned by compliance has been estimated many ways by many researchers, with a correspondingly large range of values, the most recent credible study shows that U.S. taxpayers waste as much as $431.1 billion annually on tax compliance. If this figure is near correct, it means that we pay about 30 percent of total income taxes collected, just to … well … pay those taxes.[4] Of the 431.1 billion, 88% is the time value costs borne by taxpayers: $161.7 billion by businesses and $216.2 billion by individuals.

[4] Laffer, Winegarden, and Childs, "The Economic Burden Caused by Tax Code Complexity, April, 2011.

How much is $431.1 billion? It is more than the dollar value of *all* the finished goods and services produced in the states of Virginia ($427.7 billion), North Carolina ($407.4 billion), and Georgia ($404.6 billion); in fact, more than the GDP of 42 of the 50 states. It is more than the GDP of 171 other nations.[5] It represents more workers than employed by Wal-Mart Stores, United Parcel Service, McDonald's, International Business Machines, and Citigroup combined.



Source: Commerce Clearinghouse, www.cch.com. Nov. 11, 2011

The drivers of these costs are several-fold. Costs are increased by the complexity of the law, by the numbers of taxpayers, and by the taxable events they incur.

The legendary complexity of our tax system is part of a protean trend that has accelerated over a century with the nearly perennial enactment of new tax legislation (4,428 changes to the tax code in just the last decade). In 2010 alone there were 579 changes, more than one per day.[6] The continuous tinkering with the tax code has resulted in tripling the length of the tax code, now a mind-boggling 3.8 million words.[7] As shown graphically above, the combined federal income tax code, regulations, and IRS rulings have exploded from 14,000 pages in 1954 to 72,536 pages by 2011 – an increase of 518 percent. Consider as well the sheer volume of returns: 236.5 million in 2010 (excludes informational returns).

Who pays these costs? Not surprisingly, small firms disproportionately absorb the lion's share of the $161.7 billion in fixed costs that stem from paperwork and record keeping, tracking wages, and interpreting the law – costs they cannot passed along. In 2007, researchers at the IRS estimated the total

[5] "List of Countries by GDP (nominal)." 2010 estimates. Wikimedia Foundation, Inc. Nov. 11, 2011. http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal).

[6] Taxpayer Advocate Service, 2010 Annual Report to Congress, "The Time for Tax Reform is Now," Dec. 31, 2010, p. 4. The IRS's own centers established to help people prepare their tax returns show the complexity. According to the Taxpayer Advocate Service, the IRS received 110 million calls in each of the last two fiscal years; 25 percent of which the IRS was unable to answer. In addition to the telephone calls, the IRS must process more than 11 million pieces of taxpayer correspondence annually.

[7] *Ibid*.

costs of complying with the income tax for businesses of varying sizes.[8] They found that the cost of compliance consumed from 15 to 18 percent of revenues for very small businesses—those with receipts of $50,000 to $100,000. For businesses with receipts between $100,000 and $500,000, that ratio fell to about 5 percent. For businesses with receipts between $500,000 and $1 million, it was about 2 percent. And for businesses with receipts greater than $1 million, it was only 0.5 percent.

What effect do these costs have on business? Dollars wasted on compliance are directed away from hiring, reinvestment, plant or equipment, R&D and other productive activity; all to fund an industry of tax attorneys, accountants and financial planners that produce nothing that adds to our economic well-being. The estimate of $431.1 billion in tax compliance costs does not include any of the behavioral changes that misallocate resources from their most economically efficient uses toward their most tax-efficient uses. Nor do these compliance costs measure the lost economic opportunities due to the uncertainty created by our complex tax code.[9] Indeed, increases in business uncertainty are associated with prolonged declines in economic activity.[10]

There is also collateral damage not always measurable in currency. Our system is so complex the IRS does not understand it[11] (and tax-writers don't try to). One survey found that only 58% of the public agree that the IRS and its staff are experienced and knowledgeable, while 37% do not. The findings are the same for perceived trustworthiness (59% versus 38%, respectively).[12] Even Warren Buffet, with the most sophisticated tax advisers money can buy is in a years'-long dispute over its federal tax bills.[13] But that fact does not prevent the income tax to be collected with a heavy hand. In 2010, our government embroiled its citizens in more than 71,696 litigation actions, with 7 of 10 involving small firms. Taxpayers sustained more than 3.6 million levies. That same year, the IRS assessed 37,055,841 Americans $28.1 billion in civil penalties (27.1 million penalties for the individual income tax alone). The corporate income tax required the issuance of 1,145,931 penalties and the employment tax had 7,838,423 penalties issued to businesses with employees. The IRS data on civil penalties also shows that13% of these penalties (representing 36% of the penalty amounts) were ultimately abated.

And at a deeper level of analysis, when compliance costs and complexity are seen as a function of the rate of compliance itself; we can see just how broken our system is. To understand the relationship between compliance costs and compliance, consider how we may be able to achieve an acceptable compliance rate, even with a tax system – such as a poll tax – if we were only willing to impose enough penalties at a high rate, take away civil liberties, require enough substantiation, or provide enough

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[8] Donald B Marron, "Tax Policy and Small Business,' Testimony before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 3, 2011 citing research by DeLuca, et.al., "Estimates of U.S. Federal Income Tax Compliance for Small Businesses." Paper presented at the 2007 National Tax Association meetings, Columbus, OH.

[9] Adbiweli M. Ali, "Political Instability, Policy Uncertainty and Economic Growth: An Empirical Investigation," Atlantic Economic Journal, March, 2001.

[10] Bachmann, *et al.*, Uncertainty and Economic Activity: Evidence from Business Survey Data, NBER Working Paper No. 16143, June 2010.

[11] In 1989, one out of three callers got incorrect answers. GAO accepts IRS testing that says in 1992 the IRS gave the right answer to taxpayer questions 88 percent of the time. The IRS's own centers labor hard to help people prepare their tax returns; however, even the IRS gave incorrect answers – or no answer at all – to 43 percent of the questions asked by Treasury Department investigators posing as taxpayers. The investigators concluded that half a million taxpayers may have been given wrong information between July and December 2002.

[12] Benno Torgler, *Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis*. Massachusetts: Edward Elgar Publishing, Inc., 2007.

[13] According to Berkshire Hathaway's own annual report — see Note 15 on pp. 54-56.

resources for detection. Reducing the interrelationship between compliance and enforcement to a very simple balancing act, we might, therefore express this interrelationship as a goal: our goal would be to minimize one function (compliance costs) at the same time we maximize another (the voluntary compliance rate).

But today, despite these onerous compliance costs, as much as one-fifth of all income taxes owed are not actually paid. The U.S. tax gap is a major, continuing and growing problem, notwithstanding a much larger IRS, more burdensome information reporting requirements, increasingly stiff and numerous penalties. In 2001, the IRS estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $345 billion. Adjusting the 2001 "tax gap" estimate to tax revenues for 2006 yields a gross tax gap estimate of $432 billion.[14] Further escalation of compliance costs may actually spawn further noncompliance [15] An estimated 18 million wage-earning Americans have dropped out of the income tax system entirely as "non-filers." Non-filers alone accounted for $30 billion of the tax gap in 2001, up nearly 300 percent since 1992.

The *antibiosis* continues because complexity breeds complexity as a target rich area for lobbyists to mine the Code. In this year's State of the Union address,[16] President Obama said:

> *Over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change. . . . So tonight, I'm asking Democrats and Republicans to simplify the system. Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit.*

But that was just before he proposed small firms be given a tax credit for hiring veterans, which of course they already do. Who could possibly be against small business and veterans?

In summary, for business, compliance costs, complexity and the tax gap conspire as the *antibiotic maladies*. Compliance costs impose dead weight. Complexity introduces unfairness. Both contribute to the tax gap. And as the tax gap increases, because taxpayers are not paying what the law requires, further compliance costs are imposed. Honest businesses pay in several ways: they pay higher taxes because non-compliers evade or avoid them, they pay higher compliance costs to ensure the low level of compliance that currently occurs, and they pay again when the complexity stimulates more lobbying, more loopholes that result in higher rates that weight down investment and our national prosperity. And the beat goes on . . . .

B. The Anti-Growth Effects of Punishing Productive Enterprise

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[14] John O'Hare, Managing Principal, Quantria Strategies, LLC, an economic and tax policy consulting firm, September, 2007.

[15] Willis, Lynda D., "Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap," U.S. General Accounting Office, Testimony Before the National Commission on Restructuring the Internal Revenue Service, GAO/T-GGD-97-35, January 9, 1997. Higher compliance costs can reduce voluntary compliance at a certain level. As the GAO has stated, "…some of the 'tax gap' may not be collectible at an acceptable cost. Such collection might require either more intrusive record keeping or reporting than the public is willing to accept or more resources than IRS can commit."

[16] Speech given to Congress on January 25, 2011.

High Marginal Rates and Triple Taxation of Savings and Investment Stifle Job Creation, Reduce Real Wages and National Prosperity.-- To cite a general economic proposition and its corollary: no form of taxes have a benign effect on the economy; but not all forms of tax regimes inflict the same degree of harm. There is a consensus in the economics profession that given a certain level of taxation, the two most important factors affecting investment, savings, output and real incomes are (1) the level of marginal tax rates and (2) the degree to which the tax base penalizes savings, investment and productive activity.

What is emblematic of a good tax system? An optimal tax regime imposes the lowest marginal tax rates that can be devised in order to raise a given level of taxes (which themselves should be low), in conjunction with a tax base that is neutral towards savings and investment (*i.e.,* does not favor consumption), is neutral across industries and international borders. Although there is spirited disagreement about how large the positive effects are of a system that lowers marginal rates or achieves such neutrality, no serious analyst would disagree with the salient effects. And more importantly, no serious analysis would find that the U.S. is going in the right direction.

How High Are the U.S. Tax Rates?-- When the media, pundits and politicians use the term "tax rate," they neglect to explain what they mean by that term. When economists refer to the *national statutory rate* they always mean the government's tax rate imposed by law and assessed on income/profits, and they typically mean the top statutory marginal rate. This is very different from the effective tax rate, which is the total tax paid as a percentage of total income earned, and which accounts for all brackets, deductions, credits, depreciation, and preferences in the tax code and is a function of what the entity actually pays in taxes.

In the U.S., corporations that earn profits of more than $18,333,333 are taxed at an outstanding top statutory marginal rate of 35 percent.[17] The statutory combined rate adds to this state and local tax rates (on average 4.2 percent), yielding a 39.2 percent statutory combined rate. Owners of S corporations, partnerships and sole-proprietorships based on the current budget proposal pay a *national statutory rate* of 39.6 percent (not including payroll taxes) on income over $383,350. But that same taxpayer pays 10 percent on income up to $8,600, and 15 percent on income up to $34,900, etc. Depending on deductions, a taxpayer might pay a relatively modest average tax on total earnings, yet nonetheless face a 39.6 percent marginal tax on any activities that could push income higher—such as extra effort, education, entrepreneurship, or investment. The chart below shows where the U.S. ranks among developed countries when considering corporate rates.

2010 Corporate Tax Rates, U.S. vs. OECD Countries

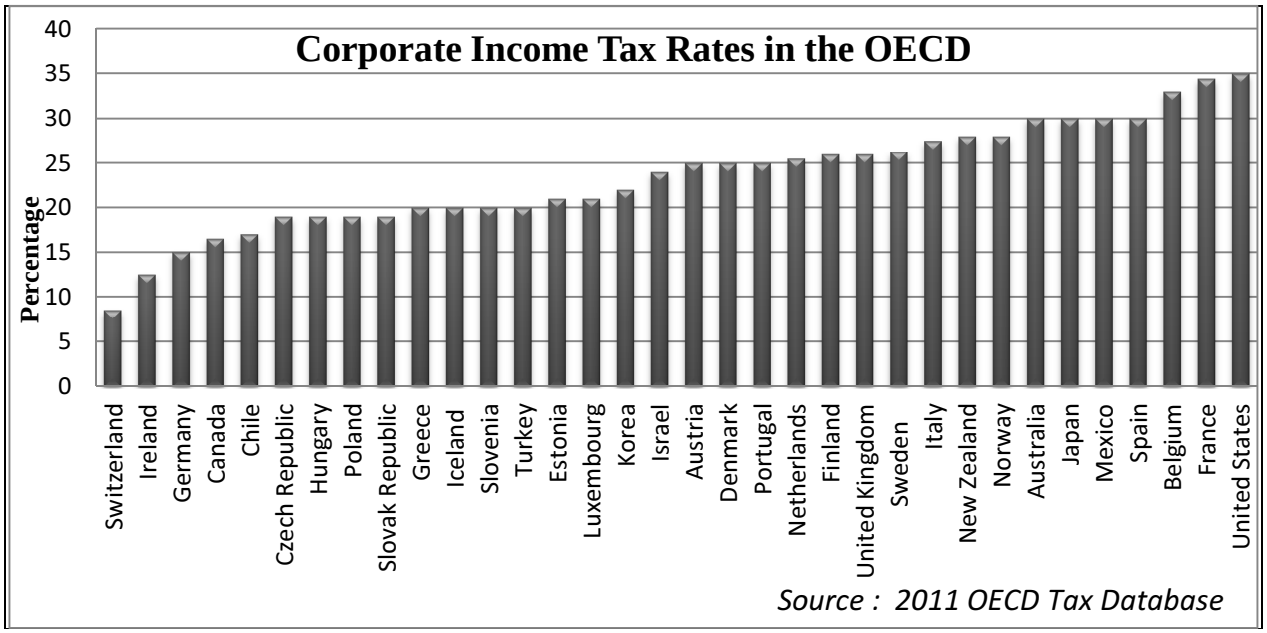
	U.S.	***OECD Average***	***U.S. Rank***
National Statutory Rate	35.0%	23.4%	34th out of 34
Statutory Combined Rate	39.2%	25.1%	33rd out of 34
Effective Rate	29.0%	20.5%	33rd out of 34

In short, the U.S. has the dubious distinction of sporting a national statutory rate of 35 percent and a statutory combined rate of 39.2 percent, compared with average OECD rates of 23.4 percent and 25.1

[17] According to the 2008 SOI, there were 1.8 million C Corporations for that year, 4.05M S Corporations, 3.14M Partnerships (LLCs, LLPs, LP's, et cet), and 22M sole-proprietorships.

percent, respectively. For tax policy considerations, marginal decisions (such as extra effort or investment) depend mainly on marginal incentives (extra income, after taxes). For this reason, it is the marginal rate that has the greatest negative effect on the economy.

Mercatus Center Senior Research Fellow Veronique de Rugy has done excellent work in charting corporate income tax rates. According to her findings, the U.S. has the highest national



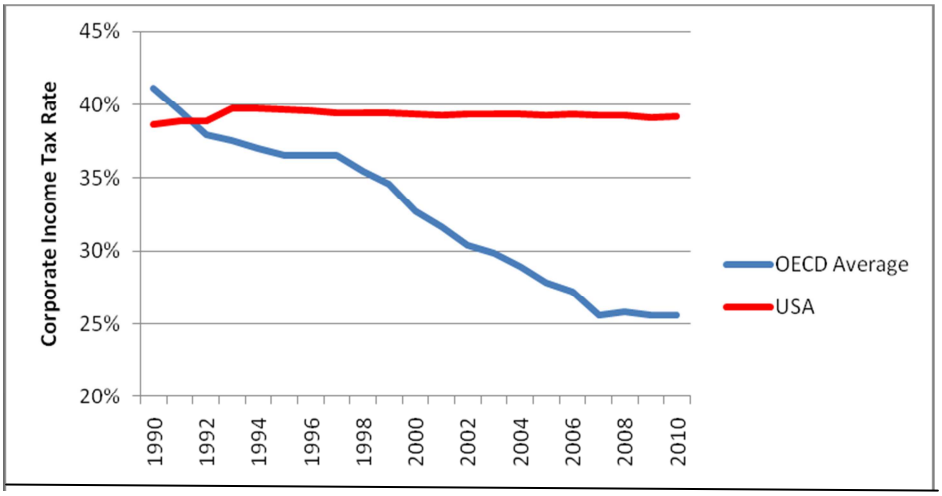
statutory corporate tax rate in the OECD. In 2011, national statutory corporate tax rates among the thirty-four members of the OECD will range from 8.5 percent in Switzerland to 35 percent in the U.S. The chart below is derived from the OECD database. When sub-national taxes are added, the U.S. has the second-highest statutory combined corporate tax rate – 39.2 percent – after Japan's rate of 39.5 percent. Marginal tax rates became the central theme of a revolution in economic policy that swept the globe during the last two decades of the twentieth century, with more than fifty nations significantly reducing their highest marginal tax rates.

According to World Bank rankings, the U.S.' relative ranking on the "total tax cost" imposed on businesses has gone from bad to worse, falling from 118th in 2010 to 124th in 2011. The total tax cost expressed a as a percent of before-tax profits is 46.8%.[18] The U.S. effective corporate tax rate on new investment was 34.6 percent in 2010, which was the highest rate in the OECD and the fifth-highest rate among 83 countries. The average OECD rate was 18.6 percent, and the average rate for 83 countries was 17.7 percent.[19]

[18] The World Bank, Paying Taxes in 2011: The Global Picture, Table 4.

[19] Chen, D. and Mintz, J. "New Estimates of Effective Corporate Tax Rates on Business Investment." Tax and Budget Bulletin, No. 64, February 2011.

How did we arrive at this point? We arrived here because Congress would rather trade influence in doling out special interests tax breaks that reduce the tax base and raise marginal rates than hear the chorus of economists. In 1990, the Organization for Economic Co-operation and Development (OECD) average statutory combined corporate tax rate was 41.1 percent, higher than the U.S.' rate of 38.7 percent. But while other nations have been racing over the past few decades to slash corporate tax rates to welcome multinational corporations, the U.S. has stagnated. Japan is the only country with a higher combined corporate tax rate than the U.S., and it plans to reduce its statutory combined rate by roughly 5 percent in the near future.



Lowering marginal tax rates became the central theme of a revolution in economic policy that swept the globe during the last two decades of the twentieth century. More than fifty nations significantly reduced their highest marginal tax rates on individual income. The U.S. was not among them.

And the U.S. income tax remains a model for *what not to do* in more ways than just high marginal rates. By double, triple, and even quadruple taxation, our system inhibits economic performance and wage growth by creating a significant bias against saving and investment, in favor of leisure and consumption. Initially, wage and salary income are taxed when earned. Then, if wages and salaries are saved or invested, the resulting earnings are taxed again and again and sometimes again still. All income derived from investment is taxed. If an income-producing asset, such as a stock or bond, equipment or real estate, is sold for more than it was purchased, the increase in the value of the capital investment – the capital gain – is taxed.[20] Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Intercorporate dividends are also often subject to tax, creating yet another level of taxation. When the taxpayer dies, the estate and gift tax may tax his or her investments one final time. If what we tax we get less of, then we have sought to punish savings, investment, and entrepreneurial activity.

Why We Must Care: The Economic Effect.-- As bad as compliance costs are, estimates of efficiency losses of the federal tax system can dwarf compliance costs. Efficiency costs, deadweight loss, reduced output, excess burden (all terms for the same thing) occur when tax rules distort the decisions of individuals and businesses regarding work or leisure, savings and investment or consumption. By changing the relative value of highly taxed and lightly taxed activities, taxes alter decisions such as what

[20] Thus, both the future income stream *and* its capitalization are taxed, constituting still another layer of multiple taxation.

to consume and how to invest. When taxpayers alter their behavior in response to tax rules, they often end up with a combination of savings, investment, or consumption and work, risk taking and leisure that they value less than the combination they would have preferred to make if decisions were freed of any tax influences. According to a GAO study, efficiency costs imposed on the economy on the order of magnitude of two to five percent of Gross Domestic Product (GDP).[21] Based on GDP of $14.551 trillion in 2010, efficiency costs can top $728 billion. In fact, the economic loss increases with the square of the tax rate.[22] Similarly, the economic gain from reducing marginal tax rates increases at a more rapid rate than the reduction in the tax rate.

What are some of the ways in which high marginal rates and triplicative taxation of savings and investment create such distortions? As noted, they create an incentive to consume now rather than save for the future. Although market interest rates effectively pay people to defer consumption into the future (i.e., to save), because the tax wedge reduces those payments, people inevitably will choose less future consumption (saving) and more current consumption. This harms the economy because less saving results in less investment, less innovation, slower growth, and lower future living standards than would be enjoyed without a tax on saving. Future consumption is reduced by both the extra current consumption and the forgone returns that greater saving would otherwise have produced. Some of this loss is a deadweight loss to society; that is, a loss to some that benefits no one. Eliminating taxes on capital income would eliminate the tax wedge on saving, and total saving would be much closer to the optimal amount. The tax system would be "temporally" neutral in the sense that it would not affect the choice between current consumption and future consumption (saving).

Through this distortion and through confiscation of net profits from which investments are made, marginal tax rates and a biased tax base reduce capital formation and the savings and investment necessary to finance the higher levels of capital per worker that increase productivity, output, competitiveness, and material well-being. Investment is important to all wage earners because of the relationship that exists between real wage rates and the level of capital investment per worker which is the most significant contributing factor to achieving higher real wages. A worker or farmer, for example, is more productive if he or she has more machinery and equipment to work with, particularly new equipment that incorporates the latest technological innovations. Higher productivity leads to higher real wages. Employers cannot pay workers higher wages than their productivity justifies without jeopardizing their businesses. Higher investment levels per hour worked explain as much as 97 percent of the increase in inflation-adjusted wages since 1948, as can be seen in the chart below.[23]

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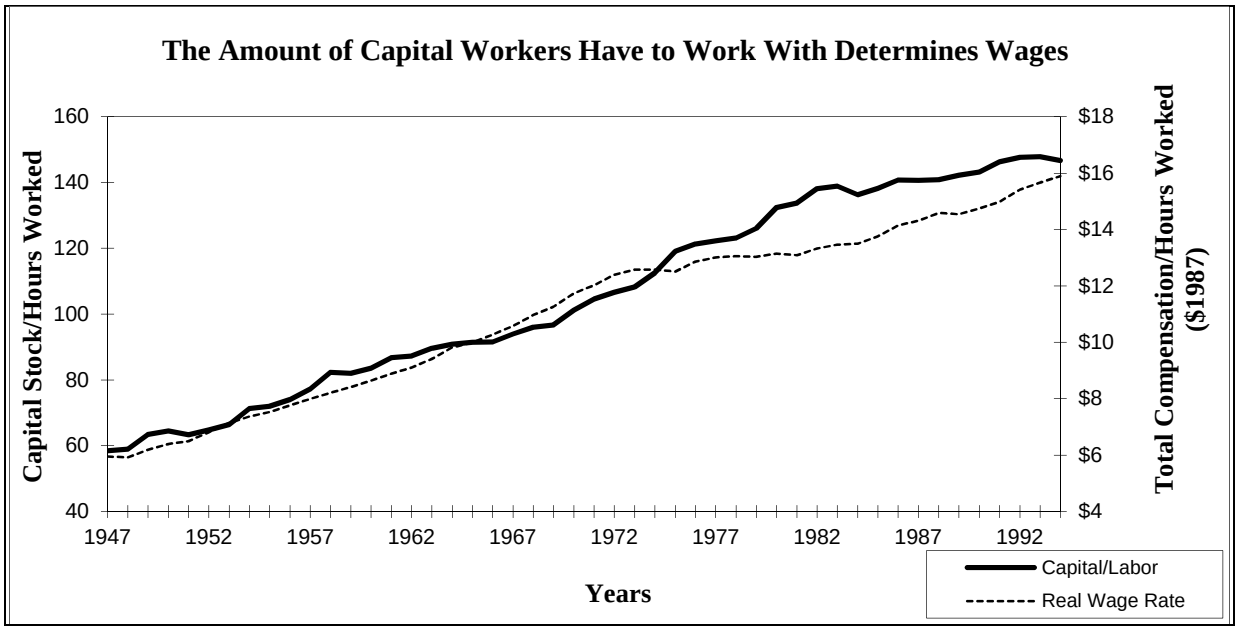
[21] "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System," U.S. Government Accountability Office Report No. GAO-05-878, August, 2005, p. 20.

[22] More formally, the increases with the square of the tax rate. See almost any Price Theory textbook for a discussion of why. For a detailed and mathematically sophisticated discussion, see Auerbach, Alan J., and James R. Hines, "Taxation and Economic Efficiency," *Handbook of Public Economics*, Vol. 3, Chapter 21, sections 1-3. For a short summary, see Economic Report of the President, February 2005, Chapter 3, p. 71.

[23] Robbins, Gary and Aldona, *The Truth About Falling Wages*, Institute for Policy Innovation, Tax Action Analysis, Economic Scorecard, Third Quarter, 1995, p. 5.



Source: Gary and Aldona Robbins, Institute for Policy Innovation.

As consumption is to savings, theory suggests that an increase in the marginal income-tax rate makes leisure relatively less expensive. This tends to increase leisure relative to consumption and work. As this happens, GDP falls. The evidence from economic research indicates that high and increasing marginal tax rates have serious negative consequences on labor supply, as well as economic growth, and capital formation.[24] A decrease in marginal income-tax rates on labor income makes leisure relatively more expensive. Thus, leisure decreases and consumption increases, which increases labor input and GDP.[25]

Numerous studies have found that high marginal tax rates not only reduce people's willingness to work up to their potential, but to take entrepreneurial risks, and to create and expand a new business (ably surveyed by Karabegovic *et al.*[26](2004)). Personal income tax rates have a direct effect on small business profits, hiring, investment, and growth. Recent research by Carroll, *et al.*, measured the impact of marginal tax rate cuts under TRA86 on sole proprietor revenue growth.[27] They found that tax rate reductions had a "significant influence" on firm growth rates and concluded that a tax cut that raised taxpayers' after-tax share on marginal income (i.e. one minus the tax rate) by 10 percent would cause them to increase business revenues by 8.4 percent. Another paper by Carroll, *et al.*, examined changes in sole proprietor capital investment before and after TRA86. The authors found that "changes in marginal tax rates have a substantial impact on entrepreneurs' investment spending." For example, they found that a five-percentage point change in marginal tax rates would cause a 10-percent change in capital investment expenditures.

[24] Federal Reserve Bank of Minneapolis senior adviser EDWARD PRESCOTT, corecipient of the 2004 Nobel Prize in economics, found that the "low labor supplies in Germany, France, and Italy are due to high [marginal] tax rates" (Prescott 2004, p. 7).

[25] Prescott attributes lower labor-force participation in some European countries almost entirely to higher marginal tax rates. Lower marginal income-tax rates, he suggests, would increase the labor supply and therefore total output in the process.

[26] Karabegović, Amelia, Economic Freedom of North America**,** Fraser Institute (Vancouver, B.C.), National Center for Policy Analysis (U.S.), 2004.

[27] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," Tax Policy and the Economy, Vol. 15. 2001.

A third paper by the same authors examined the effect of personal income tax rates on sole proprietor hiring decisions.[28] They found that a tax cut that boosts after-tax income by 10 percent would raise a small business's likelihood of hiring by 12 percent. In summary, reductions in marginal income tax rates can be expected to have an expansionary impact on America's small business sector.[29]

Lifetime family work effort and entrepreneurship are not the only things affected. Nobel laureate Robert Lucas emphasized the deleterious effect on economic growth of high tax rates on capital. Philip Trostel focused on the impact on Human Capital, finding that high marginal tax rates on labor income reduce the lifetime reward from investing time and money in education. There are evidently many channels through which high marginal tax rates may discourage additions to personal income, and thus also discourage marginal additions to national output (*i.e.*, economic growth). Countries in which the combined marginal impact of taxes and benefits is to punish success and reward indolence often face "capital flight" and a "brain drain." And finally, the U.S. tax code — high rates with a bounty of subsidies, shelters and special breaks — has made American multinationals world leaders in tax avoidance. Loopholes (the result of lobbying themselves) severely distort market behavior, influencing behavior based on tax preferences rather than economic choice.[30]

The bottom line is simply this. People react to tax incentives or tax increases for the same reason they react to price incentives or increases. Supply (of effort and investment) and demand (for government transfer payments) respond to marginal incentives. To increase income, people may have to study more, accept added risks and responsibilities, relocate, work late or take work home, tackle the dangers of starting a new business or investing in one, and so on. People earn more by producing more. Because it is easier to earn less than to earn more, marginal incentives matter. To the extent to which a country's tax system punishes added income with high marginal tax rates, it also punishes added output—that is, economic growth.

C. Our International System is Anachronistic.

The U.S. international tax system is today an embarrassing anachronism. When it was shiny and new in 1918 – the year President Woodrow Wilson donned his top hat to become the first president to leave North America -- we led the way in enacting a system where income taxes duly paid to a foreign country could be credited against U.S. income taxes. Ten years after that, in 1928, the League of Nations introduced draft model income tax treaties, based on this formulation.

Time has passed us by. As our tax code remains anchored in the past, developed at a time when the U.S. was more insular in trade and a dominant capital exporter, before the age of consumption taxes, the world economy and our role within it has transformed. Throughout the 1920s, the U.S. was running budget surpluses. Today, of course, the U.S. is a net debtor nation running huge budget deficits, and trade deficits with nearly every major partner is nearly every traded good. In the 1920s, we were a net

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[28] Carroll, et.al., "Taxes and Entrepreneurs' Use of Labor," Journal of Labor Economics, Vol. 18, No. 2, pp. 324-351, 1999.

[29] This is important because small businesses fill a unique role in the economic growth process. While many small businesses stay small, some will grow to become leaders in whole new industries. New firms often challenge existing firms with untried ideas and thereby generate greater competition and efficiency. Evidence suggests that small firms perform a disproportionately large share of radical innovations in the economy.

[30] Donald Marron, Urban-Brookings Tax Policy Center, "Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction," Testimony before the Senate Committee on the Budget, February 2011.

creditor nation. While in 1961, the U.S. exported just under $21 billion ($159 billion real terms today) and imported approximately $14.5 billion in merchandise ($110 billion today), we exported $1.4 trillion of goods and services and imported $1.8 trillion from January to August of this year alone.[31] During the 1920s, federal revenues averaged about 4 percent of GDP. In recent history, from 1971 to 2010, revenues have averaged 18 percent of GDP. Technological improvements in communications and transportation, and the opening of formerly closed markets have created permanent interdependencies among nations that will exponentially increase this volume of trade and with it the need to get our international tax regime right with the times.

Our failure to evolve with the international economy has been succeeded only by our failure to keep pace with evolutions in its tax laws. Today, the U.S. is:

- in the minority in trying to tax its multinational corporations on their foreign earnings.
- virtually alone in imposing some of the highest tax rates in the world
- and virtually alone in failing to adopt a border-adjustable destination based consumption tax.

High Rates Diminish Foreign Investment and Discourage Repatriation.— How do these anachronisms perversely influence corporate decisionmaking and impede competitiveness? At the core of our international tax system, as most tax policy gurus know, is the principal of extraterritoriality. What this principal means in the context of outbound transactions is that the U.S. system will tax its individual residents and citizens, and corporations on their worldwide income under the rates specified in IRC section 1 and 11 (the individual and corporate rates), regardless of where that income is derived. U.S. taxpayers engaged in activities abroad generally compute taxable income in the same manner as U.S. taxpayer producing solely with the U.S. Because the norm of international juridical taxation, with the U.S. generally follows, cedes the primary taxing authority to the country or territorial connection (i.e., where the income is earned) and the residual taxing authority to the county of residence, the U.S. seeks to avoid double taxation by crediting any income taxes paid to the foreign country, against the income tax otherwise due in the U.S.[32] One of the largest exceptions to deferral is, of course, Subpart F, which was introduced in the Kennedy Administration in exchange for lowering rates, and is intended to discourage U.S. corporations from redirecting income outside the U.S. in order to avoid immediate U.S. taxation.

While the extraterritorial credit system is at least in theory straightforward -- by crediting the foreign taxes paid on the foreign income up to the rate of tax imposed on that income we seek to avoid taxing the same income twice -- it is ridiculously complex in application. That is because before one can determine what credit can apply, the U.S. resident, citizen or corporation must first determine where the income and deductions are sourced under an elaborate set of rules, modified further by treaty and the intercompany transfer pricing rules. One must determine whether and to what extent the foreign taxes are even creditable. One must then compute the direct and indirect credit (on dividends) by distributing the income within more than nine separate "baskets" for which the foreign tax credit is individually limited – enough baskets to turn any sane individual into a "basket" case. And neither least nor last, before determining the credit to which one is entitled, one must determine if deferral from a subsidiary

[31] http://www.census.gov/foreign-trade/Press-Release/current_press_release/ft900.pdf

[32] A U.S. parent of a foreign subsidiary is generally not taxed on the earnings of the subsidiary until distributed at which time the credit is imputed. (IRC section 951-960.

must yield to any one of the separate rules under Subpart F pertaining to Controlled Foreign Corporations.

Because the U.S. is virtually alone in trying to tax its multinational corporations on their foreign earnings, it incentivizes companies to avoid those taxes indefinitely by keeping profits overseas. That in turn encourages companies to use accounting maneuvers to shift profits to low-tax countries and to invest profits offshore. However badly U.S. multinational corporations who earn money overseas want to bring that money back home to the U.S., our international tax system discourages, and some would say "penalizes" repatriation of foreign earnings by imposing a 35 percent residual U.S. tax at the time of repatriation. As a result, several high-profile U.S. multinational corporations are sitting on large piles of cash earned from foreign operations. Yet these same corporations are actually borrowing money rather than repatriating their offshore cash.

How much money is trapped offshore? U.S. multinational companies MNCs currently hold an estimated $1.4 trillion in foreign earnings overseas. About $581 billion in after-tax dividends will be distributed to U.S. shareholders, according to one recent study.[33] And that same study stated that spending could increase gross domestic product by $178 billion to $336 billion and will add 1.3 million to 2.5 million jobs if we were to offer a temporary reprieve from the repatriation tax, as well as boost U.S. tax revenues. About half of OECD nations do not have this problem because they have "territorial" tax systems.

Our extraterritorial income tax system affects U.S. entities and corporations in more ways than by frustrating their effort to repatriate earnings like their competitors based in lower taxed jurisdictions can do. That is, in a manner of speaking, just a symptom. The greater infirmity is that rate of the tax we impose makes the U.S. one of the least favorable locations to base international operations.

Again an understanding of the U.S. international tax system is critical. Broadly stated, nonresident alien individuals, unincorporated entities even corporations are taxed like U.S. taxpayers on most U.S. Business income. An individual is taxed when it is engaged in a trade or business on income effectively connected to that trade or business (IRC section 871(b). A foreign corporation is likely taxed under IRS section 11 on its taxable income effectively connected with the conduct of a U.S. trade or business (IRC section 882). But nonresident individuals are also subject to U.S. taxation on some types of recurring investment income. And a corporation who is conducting a trade or business may be also subject to the Branch Profits Tax.[34]

Paradoxically, despite having the highest national statutory rate, the U.S. raises less revenue from its corporate tax than do the other members of the OECD on average. In fact, federal corporate income taxes raise little revenue compared with other federal taxes; roughly comprising 11.6% of total federal tax revenues. At $191 billion, they were equal to 1.3 percent of the nation's gross domestic product.

The combination of high rates, worldwide taxation and a competitive global marketplace makes our corporate tax system extremely punishing. But it is the marginal tax rate -- the rate on the last dollar of

[33] "The Benefits for the U.S. Economy of a Temporary Tax Reduction on the Repatriation of Foreign Subsidiary Earnings," by Laura D'Andrea Tyson, Ph.D.; Kenneth Serwin, Ph.D.; Eric Drabkin, Ph.D. (October 13, 2011).

[34] The branch profits tax is an extra income tax imposed by the U.S. on foreign corporations which earn profit from their U.S. investments or U.S. business operations.

income earned (which is very different from the average tax rate, which is the total tax paid as a percentage of total income earned) – that matters the most. The rate at which we tax decisions at the margin matters in at least three regards: it discourages foreign corporations from locating their corporate offices or subsidiaries in the U.S. and in locating plants, facilities here for production purposes (i.e., it influences the location where capital is deployed), and (2) it encourages outsourcing of plants, facilities and production facilities of domestic multinationals to jurisdictions where the taxes imposed are less.[35]

Border Adjustable Taxes Act as Unanswered Trade Subsidies.-- Add to this the fact most of our trading partners effectively rebate their taxes at the border and provide for themselves a powerful export trade subsidy and benefit for consumption of domestic goods that is unanswered by the U.S. It is a widely understood proposition that the U.S. should not target a particular trade deficit level, subsidize its exporters or impose tariffs on imports. The reason, established clearly in economic theory, is that doing so interferes with mutually beneficial transnational economic exchanges, to the disadvantage, in the aggregate, of both countries' economies. However, the U.S. government should not, as a matter of policy, accord a huge advantage to foreign companies competing in the U.S. market or impose a huge disadvantage on American producers and workers selling their goods and services in the U.S. and foreign markets. That has been the effect, however, of border adjustable VATs.

Consider this. The U.S. tax system imposes heavy income and payroll taxes on U.S. workers and businesses producing goods in the U.S. whether those goods are sold in the U.S. market or abroad. Recall U.S. corporate taxes are the about nine percentage points higher than the OECD average.[36] The U.S., however, imposes no corresponding tax burden on foreign goods sold in the U.S. market. Moreover, foreign VATs -- a major component of the revenue raised in most developed countries -- are rebated if foreign goods are exported to the U.S. market. This creates a large and artificial relative price advantage for foreign goods, in both the U.S. market and abroad.

The table below illustrates this point. American producers pay two sets of taxes when selling into foreign markets. Conversely, in U.S. markets, foreign goods bear no U.S. tax and the foreign value added tax is forgiven. Thus, a most manifest unfairness in the U.S. tax system is that it places U.S. producers – including businesses and workers in manufacturing, agriculture, mining, and forestry – at a large competitive disadvantage relative to their foreign competitors here and abroad. Our failure to counteract these border adjusted taxes explicitly encourages consumption of foreign, goods. And it converts many of our nation's retailers into tax free trade zones for foreign produced goods.

Advantage for Foreign Producers

	Sold in U.S. market	Sold in foreign markets
U.S. production	Pays U.S. income and payroll taxes.	Pays U.S. income and payroll tax & foreign VATs.
Foreign production	Pays no U.S. income or payroll tax and no foreign VAT.	Pays foreign value-added tax.

[35] Salvador Barrios (European Commission), Harry Huizinga* (Tilburg University and CEPR) Luc Laeven (International Monetary Fund and CEPR) and Gaëtan Nicodème (European Commission, CEB, CESifo and ECARES), International Taxation and Multinational Firm Location Decisions (April 2009). See also Claudio A. Agostini, "The Impact of State Corporate Taxes on FDI Location," *Public Finance Review 2007*; 35; 335.

[36] Edwards, Chris, "The U.S. Corporate Tax and the Global Economy," Cato Institute, September 2003.

The U.S. has adopted this self-destructive policy, in part, because of our entirely laudable commitment to free enterprise and our rejection of mercantilism. At least since WWII, American business and political leaders have viewed free trade as the basis for international peace and prosperity. As the dominant economic and military power, the U.S. led the movement to dismantle trade barriers, both by setting the example and by supporting a New World Order of international trade regulation (GATT and WTO), economic cooperation (OECD), and customs unions (such as the European Union and NAFTA). According to the OECD, its members have reduced their average tariff rates from 40 percent at the end of World War II to 4 percent today. The average import duty on goods in the U.S. is currently 1.7 percent.

Today, the 29 of 30 OECD countries have enacted border-adjustable tax regimes. America stands nearly alone as the sole developed economy which refuses to adopt a border-adjustable tax system. The European Union 15 has an average standard VAT of 19 percent, and the average OECD standard VAT is 18.5 percent. During the 1990s, Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent, respectively, and China adopted a 17-percent VAT in 1994. As foreign governments have increased the VAT, they have also reduced effective corporate income taxes. Meanwhile, high U.S. corporate tax rates today coupled with our custom of taxing the foreign income of corporations based in the states causes the flight of corporations' headquarters to countries that exempt taxation of overseas income. In effect, the U.S. tax system is distorting the international marketplace and literally driving plants and good jobs out of this country at a devastating and unsustainable pace. There are, after all, only so many assets we can sell to foreigners before the entire financial system enters into a severe crisis.

Some economists mistakenly argue that if America adopted a border-adjusted tax system, *any* relative price change would be eliminated by an offsetting appreciation in the dollar. If the FairTax were implemented, for example, they hypothesize that the price change would be offset by a 23 percent immediate appreciation in the dollar. The appreciation in this case, they contend, would be caused by a reduction in U.S. demand for foreign currency to acquire (the now more expensive) foreign goods and an increase in foreign demand for U.S. currency to acquire (the now less expensive) U.S. goods. However, the arguments are dubious. The problem with that logic is that the demand for U.S. dollars is not limited to the traded-goods market. Nearly $90 trillion in U.S. assets owned by households and non-financial businesses are denominated in dollars. Financial institutions trade trillions of dollars in securities and currency each day based on expectations and guesses. Furthermore, the non-traded goods and services sector is also denominated in dollars and exceeds the traded-goods sector in size.[37] A study by Professor Jim Hausman of the Massachusetts Institute of Technology is helpful to understanding this problem.[38]

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[37] If, however, these economists are right and there is no increase in the competitiveness of U.S. goods because of a 23-percent increase in the price of the dollar (more or less precisely) relative to foreign currency, then that means the FairTax will have succeeded in increasing the wealth of the American people by something on the order of $20 trillion (23 percent of $90 trillion) relative to the rest of the world, an instantaneous increase nearly equal to the value of all the goods and services produced in the U.S. over two years. That would be reason enough to enact the FairTax. Unfortunately for American asset owners, it is impossible for the traded-goods sector to dominate the currency movements, since the dollar-asset markets are perhaps 100 times as large as the annual traded-goods market (net basis). See B. 100 and B. 102, Flow of Funds Accounts, U.S. of America, Fourth Quarter 2004, Federal Reserve System, for statistical information on asset markets.

[38] Professor Hausman found:

(1) That the existing disparity in treatment of corporate income taxes and VATs for purposes of border adjustment leads

Border-adjustable taxes are, quite simply, the most powerful weapons foreign producers have against U.S. producers and workers. Our failure to adopt a destination-based consumption tax sends a clear message to American producers: Please, move your plants and facilities overseas, hire foreign workers, and then market your products back to the American consumers who are punished for saving and rewarded for overspending. It sends a clear signal to retailers: stock foreign inventory. It sends a clear signal to consumers: buy foreign products. The problem is that American industry and consumers are taking the Congress' tax policy advice. Market forces do work. And the burgeoning trade deficit is one of the consequences of our failure to confront this reality. The decimation of our domestic producer base results in job losses for America's middle class, lost opportunities for the young, suffering for the poor and a widening wealth gap.

II. The Medicine: Three Ways the FairTax Helps Businesses

As we lament the maladies of the current system, Congress has clear options. The best example of a tax regime that would permanently save compliance costs is the FairTax. The FairTax has been introduced in the House by Representative Rob Woodall as H.R. 25 and in the Senate as S. 13 by Senator Saxby Chambliss. The House bill now has 66 cosponsors, more than any other tax replacement plan in a century. The Senate bill has 8 cosponsors. Some are on this Committee.

The FairTax is an integrated tax replacement system that repeals all current taxes imposed by the Internal Revenue Code on income and wages, including personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes. In place of these taxes, the FairTax imposes a single-rate tax on the final retail sale of new goods and services used or consumed in the U.S. at the revenue-neutral rate of about 23 cents from every dollar spent.[39] The FairTax plan also amends the U.S. Constitution so that the income tax chapter of American taxation is closed forever.

To ensure the FairTax does not cascade, business-to-business transactions are not taxed under the FairTax. Intermediate goods and services are properly treated as inputs into goods and services sold at retail. Unlike the current system that taxes income multiple times and on an inconsistent basis, the FairTax taxes income only once, upon consumption.

A. The FairTax Would Reduce Compliance Costs More than Any Other Tax Replacement/Reform Proposal.

Compliance Costs Are Reduced an Estimated 90 Percent Under the FairTax.— The Tax Foundation, the oldest national tax research organization, has estimated that compliance costs would drop more than

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to extremely large economic distortions.

(2) That U.S. exporters typically bear both domestic income taxes and foreign VATs in selling abroad.

(3) That foreign exporters in countries relying largely on VATs typically receive a full rebate of such taxes upon export to the U.S., and are not subject to U.S. corporate income taxes.

(4) That this situation creates a very significant tax and cost disadvantage for U.S. producers in international trade with significant impact on investment decisions – leading to the location of major manufacturing and other production facilities in countries that benefit from current rules on the border adjustment of taxes.

(5) That elimination of the current disparity in WTO rules (by eliminating border adjustment for either direct or indirect taxes) would increase U.S. exports by 14 to 15 percent, or approximately $100 billion based upon 2004 import levels.

[39] This is *a tax-inclusive* rate, the same means by which the income, payroll and capital gains taxes it replaces are measured.

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90 percent under the FairTax.[40] No other plan that has been developed or could be developed would eliminate wasteful compliance costs quite like the FairTax. Consider that by imposing taxes at the cash register, the FairTax wholly exempts individuals from ever having to file a return. Since business-to-business transactions are fully exempt, businesses that serve other businesses will neither collect nor pay taxes. Retailers, most of which already collect state sales taxes (in the 45 states that have them) are provided an administrative credit compensating them for the costs of sales tax compliance. It reduces the more than 700 incomprehensible sections of the Internal Revenue Code to one simple question asked of retailers: How much did you sell to consumers?

Examples of provisions in the tax law that cause great complexity but no longer exist under the FairTax include the uniform capitalization rules for inventory; the qualified plan rules that establish various top-heavy, non-discrimination, participation, vesting, and other rules for approximately a dozen different types of retirement savings accounts; the passive loss limitation rules; the alternative minimum tax; the qualified dividend rules (for determining whether the 15- percent rate applies to dividends); the different depreciation rules applicable for regular tax, AMT, and earnings and profits purposes; the complex rules governing whether mergers, acquisitions, and liquidations are tax free; and, in the international area, the separate basket limitations; income sourcing and expense allocation rules; controlled foreign corporation; branch profits tax, and passive foreign investment company rules.

The FairTax would be a much more efficient taxation system from the point of view of the administration, collection, and filing costs that it would bring about when compared to the administration, collection, and filing costs of the current tax system it replaces. Researchers have found the administrative costs of state sales tax vary as a percent of revenue received from between 0.4 and 1.0 percent, and average 0.7 percent of revenues received.[41] The compliance costs imposed on businesses from state sales taxes have been estimated to fall between 2.0 and 3.8 percent of revenues.[42] Based on similar methodology, researchers have estimated that the costs to comply with a national sales tax would be as low as 1.0 percent of collections, compared with the flat tax at 1.2 percent of collections and a consumed-income tax at 4.6 percent of collections.[43]

According to the IRS, historically about 12 percent of all C and S Corporation returns were filed by retail firms.[44] Retail trade accounts for about 12.9 percent of all business establishments in the U.S., according to the industry statistics as well. There are approximately 25 million business establishments in the U.S. FairTax.org estimates that, including retailers and service providers likely to sell to consumers, the number of businesses remitting the FairTax is, therefore, approximately 13 million firms. A study by Beacon Hill Institute, found that the FairTax saves $346.5 billion in administrative costs in 2005 when compared to the administrative costs of the current federal tax system it replaces. This implies a saving of $14.70 per $100 of the gross revenue the FairTax would collect.

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[40] Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation, Testimony before the House Ways and Means Committee, June 6, 1995.

[41] Due, John F., and John L. Mikesell, *Sales Taxation, State and Local Structure and Administration*, Second edition, Washington, D.C.: Urban Institute Press, 1994.

[42] Research summarized by Cnossen. Cnossen, Sijbren, "Administrative and Compliance Costs of the VAT: A Review of the Evidence." *Tax Notes International*, Vol. 8, No. 25, June 20, 1994, pp. 1649-68.

[43] Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation Special Brief before the House Ways & Means Committee, June 1995.

[44] IRS Statistics of Income, Table 1.--2001, Corporation Income Tax Returns: Selected Balance Sheet, Income Statement, and Tax Items, by North American Industry Classification System (NAICS) Sector and by Asset Size.

Under the Fair Tax, certain transactional areas still require special rules. For example, the treatment of financial intermediation services, the treatment of mixed-use property, and transitional considerations will add some complexity. However, when fully operational, the main decisional juncture is reduced to the analysis under one current code section – section 162. Was a purchase an "ordinary and necessary" business expense? Any tax system that does not seek to tax business inputs (meaning any well-considered tax system) must make this essential distinction.

In summary, the savings from the reduction in taxpayers, the reduction in decisional points by simplicity, and the reduction in the events of taxation, are robust enough to ensure that even if any additional spending were needed under the FairTax to hold avoidance and evasion to their current levels; this increased spending would never overcome the savings the FairTax brings when compared to the current taxation system. [45] The Laffer study on tax code complexity previously mentioned finds that over 10 years, an increase in our annual economic growth rate between 0.45 percent (the low-end estimate from a 50 percent reduction in tax complexity) and 0.9 percent (the high-end estimate from a 90 percent reduction in tax complexity) becomes significant. By the 10th year, per capita incomes would be $2,800 to $6,000 higher. So enacting the FairTax plan, which reduces compliance costs by 90 percent would create an increase in income growth and tax revenues more than double what would be expected with other tax reform plans that only bring about a 50 percent reduction in compliance costs. And this of course would inure to the advantage of business, particularly small business which again bears the lion's share of these costs.

Of course, higher economic growth by itself would raise tax revenues as well. The benefit from reduced tax complexity could significantly reduce our national debt. Due to enhanced economic growth, over the entire 10-year period, increased tax revenues at current tax rates are between $650 billion and $1.4 trillion in net present value terms[46].

The Ratio of Cost to Actual Compliance Would Greatly Improve.-- The twin advantages of simplicity and visibility produce another benefit: Greater enforceability with less intrusiveness. Recall that compliance costs are only the price to achieve compliance.

It is true that some people will evade taxes no matter what the governing tax system. The difficulty of enforcing the income tax (a tax based on a complicated legal concept of income, deductions, credits, exclusions, deferrals, exemptions, and allocations) will only worsen in the digital age without much more stringent and onerous regulation.

Analytics and empirical evidence suggests that the FairTax would increase voluntary compliance at the same time compliance costs are reduced. For example, much of the tax gap today is attributable to mistakes caused by the complexity of the law. Mistakes and confusion would be all but eliminated under a system that creates no exemptions, and dispenses with the complex issues present today. And the FairTax improves all the known factors that bear upon noncompliance, including reducing the rate and the number of focal points. The more than 60 years of practical experience in administering sales

[45] Tuerck, David, Paul Bachman, and Alfonso Sanchez-Penalver, Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System, The Beacon Hill Institute at Suffolk University, Sept. 2007.
[46] Laffer, Winegarden, and Childs, "The Economic Burden Caused by Tax Code Complexity, April, 2011.

taxes at the state level supports the assertion that the FairTax would be administrable at higher compliance rates relative to administrative and compliance costs

Not only are the administrative and compliance costs of a sales tax much lower than an income tax per dollar of revenue received, the compliance rate is higher. A Minnesota study in the year 2000 compared input-output data to taxable sales and estimated how much tax should have been collected. The difference between estimated and actual collections was 9.9 percent. The sales tax gap was therefore an estimated 9.9 percent in Minnesota. This compares favorably to a federal tax compliance gap (and therefore a state income tax compliance gap) nearly double that amount, despite the imposition of much higher administrative and compliance costs. Overall, the noncompliance rate is from 15 percent to 16.6 percent of the true tax liability, according to the IRS, and that same rate of noncompliance can be expected to apply to the state tax system that relies on the Federal enforcement apparatus. In the broadest aggregate, assuming the gap of $353 billion, gross noncompliance is about 18 percent of revenues.[47] The evidence at the state level suggests sales taxes – even those at the state level that are largely very complicated and which cascade – have twice the compliance rate of the income tax at a fraction of the cost.

To understand how a simple plan reduces the tax gap, policymakers must distinguish between two components of the tax gap: Fraud and non-fraud contributions. The tax gap is certainly comprised of taxes not voluntarily paid because the taxpayer violated a known legal duty (evasion), but it is also comprised of failures to pay that are unintentional, such as those caused by mathematical errors or confusion. The tax gap is at the same time a measure of the burden and frustration of taxpayers who want to comply but are tripped by tax code complexity and of willful tax cheating by a minority who want the benefits of government services without paying their fair share.[48]

The portion of the tax gap attributable to mistake and confusion is high, as high as 80 percent. Almost 40 percent of the public, according to the IRS, is out of compliance with the current tax system, some unintentionally due to its enormous complexity. The reasons for noncompliance are instructive as to the benefits of simplicity: (1) taxpayers lack the requisite knowledge of the tax law; (2) taxpayers interpret the law differently than the IRS –; (3) taxpayers lack record keeping sufficient to satisfy the IRS; and (4) taxpayers do their math wrong or they rely on professional return preparers who get it.[49] The largest percentage increase in the tax gap from 1981 to 1992 was attributable to math errors, a 212.3 percent increase.

Again, the GAO as well as others have indicated that the simpler the rules, the better. According to the GAO, "[t]his reflects the basic principle that the simpler the tax code, the more certain the results in applying it and the fewer the opportunities for disagreements over the 'fine points' of tax law."[50] The increased transparency of the FairTax system induces more compliance because it increases the likelihood that tax evasion is uncovered.

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[47] The income tax gap of $353 billion/$1,952 trillion in collections for FY 2004.

[48] The IRS defines the tax gap as "the difference between the tax that taxpayers should pay and what they actually pay on a timely basis." The gap is broken down into three components by the IRS: Non-filing (failure to file a tax return), underreporting (understating income, overstating deductions) and underpayment (failure to fully pay reported taxes owed).

[49] The annual *Money* magazine survey in which 50 accountants prepare a hypothetical middle class couple's tax return and come up with at least 45 different answers each year is a major indication that our tax system is simply not administrable.

[50] Willis, supra.

Even if we are looking at the portion of the tax gap attributable to fraud, the FairTax reduces the tax gap. To understand how it does so, policymakers need to look at the several factors that bear upon compliance: both fraud and non-fraud. An objective analysis of the FairTax demonstrates that it would have a much higher compliance rate than current law (i.e., substantially reducing the large current $312 to 353 billion "tax gap"[51]) – even with respect to those taxpayers who seek to intentionally violate a known legal duty – because it improves upon all known factors that improve compliance. For example, the FairTax reduces the number of tax filers by as much as 80 percent, as individuals are removed entirely from the tax system and because small firms account for only 14.9 percent of gross receipts by all retailers, wholesalers, and service providers.[52] More than 85 percent of the sales tax is collected by less than 15 percent of the retailers. Because compliance is inversely proportional to the marginal rate or the reward for being noncompliant,[53] and marginal tax rates are the lowest they can be under any sound tax system, cheaters profit less from cheating. In short, tax collectors focus enforcement resources on far fewer taxpayers, using consistent and vastly simpler forms, with far fewer opportunities to cheat, diminished incentives to do so, and a far greater chance of getting caught if they do.

B. The FairTax Would Unleash Economic Growth, Increase GDP, Real Wages, the Number of Jobs, Tax Revenue and Our National Prosperity

How does the FairTax address the problem of high marginal rates and double taxation of savings and investment? The short answer is that the FairTax has more positive impact than any other tax reform proposal because it has the lowest marginal tax rates of any plan, a tax base that is neutral toward savings and investment, reduces compliance costs and eliminates the bias against U.S. producers. It is difficult, therefore, to conceive of a plan that would have a more positive impact on the economy and the material well-being of the American people than the FairTax.[54]

In the final analysis, the FairTax has the broadest overall base and the lowest marginal tax rates of any tax reform proposal being considered today and dramatically lower than the marginal tax rates under current law.

Kotlikoff's research finds that the current total effective federal marginal tax rates on labor supply appear to be either higher or much higher for almost all American households than they would be under the FairTax. The current system's marginal wage tax rate exceeded the FairTax's 23 percent marginal rate for all of the 42 single and married stylized households he considered.[55]

For some low- and middle-income households, the marginal tax on working under our current tax system is more than twice the 23 percent FairTax rate! Take, as an example, a middle-aged married couple earning $30,000 per year with two children. Given the level of their federal marginal tax bracket, their loss, at the margin, of the Earned Income Tax Credit from earning extra income, and their exposure to marginal FICA taxation, their current total marginal effective tax on earning an extra dollar is 47.6

[51] The difference between what taxpayers should pay and what they actually pay on a timely basis.

[52] IRS Statistics of Income, reported in "Impact on Small Business of Replacing the Federal Income Tax", Joint Committee on Taxation, April 23, 1996, JCS-3-96, pp. 109-127.

[53] Clotfelter, Charles T., "Tax Evasion and Tax Rates: An Analysis of Individual Returns," *The Review of Economics and Statistics*, Vol. 65, No. 3, 1983, pp. 363-373.

[54] In fact, only a head tax or per capita tax that requires each person to pay a set amount annually is more pro-growth because the marginal tax rate would be zero. Such a tax, however, would generally be regarded as unfair and is politically impossible to enact. Thus, no serious analyst has proposed it.

[55] Kotlikoff, Laurence J. and David Rapson, "Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation," NBER Working Paper No. 12533, revised October 2006.

percent!

Since the FairTax taxes consumption at the same rate no matter when it occurs, it imparts no incentive to consume now as opposed to later and, thus, no disincentive to save. In economic terms, the FairTax's marginal effective tax rate on saving is zero. In contrast, the existing federal tax system imposes very high marginal effective tax rates on saving. For the 42 households considered here, marginal effective tax rates on saving range from 22.6 percent to 54.2 percent.

In addition to imposing, in almost all cases, much lower marginal taxes on working and, in all cases, dramatically lower marginal taxes on saving, the FairTax imposes much lower average taxes on working-age households than does the current system. The FairTax broadens the tax base from what is now primarily a system of labor income taxation to a system that taxes, albeit indirectly, both labor income and existing wealth. By including existing wealth in the effective tax base, much of which is owned by rich and middle-class elderly households, the FairTax is able to tax labor income at a lower effective rate and, thereby, lower the average lifetime tax rates facing working-age Americans.

Below is a summary of three independent research studies on the economic impact of the FairTax plan by three different groups of economists utilizing three distinct modeling approaches. While the results vary, all three studies show that GDP growth is significantly higher than it would otherwise be if the current federal tax system remained in place. The FairTax plan would also improve wages and the economic well-being of all Americans.

First, Arduin, Laffer and Moore Econometrics found that the economy fares much better under the FairTax (see table below). The economy as measured by GDP is 2.4 percent higher in the first year and 11.3 percent higher by the tenth year than it would otherwise be. Consumption increases by 2.4 percent more in the first year than it would be if the current system were to remain in place. The increase in consumption is fueled by the 1.7 percent increase in disposable (after tax) personal income that accompanies the rise in incomes from capital and labor once the FairTax is enacted. By the tenth year consumption increases by 11.7 percent over what it would be if the current tax system remained in place, and disposable income will be up by 11.8 percent.[56]

FairTax simulation model results						
Cumulative growth over current system	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 10**
Gross domestic product	2.4%	5.2%	7.0%	8.2%	9.0%	11.3%
Employment	3.5%	5.7%	7.0%	7.7%	8.2%	9.0%
Domestic investment	33.0%	35.4%	36.9%	38.0%	38.8%	41.2%
Income from employment (wages)	27.4%	31.8%	34.5%	36.4%	37.7%	41.2%
Consumption	2.4%	4.1%	5.8%	7.1%	8.1%	11.7%
Disposable personal income (adjusted for changes in the price level)	1.7%	4.5%	6.4%	7.7%	8.7%	11.8%

Units scaled 2004 GDP = 1.00. Capital and labor set to equal constant shares of 0.3 and 0.7, respectively.

[56] Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal," Americans for Fair Taxation Research Monograph, July 2006.

Following the implementation of the FairTax plan, the higher take-home wage provides an immediate incentive for people to work more. During the first year, this will lead to total employment growth of 3.5 percent in excess of the baseline scenario, which continues to grow through year ten such that total employment is 9.0 percent above what it would have been under the baseline scenario. The impact on total labor income is even more pronounced, increasing due to both an increase in after-tax wages and an increase in the number of people working. Total labor income will rise 27.4 percent in the first year. By year ten, labor income will be over 41 percent higher than what it would have been under the baseline scenario.

In the second study, Laurence Kotlikoff found that switching to the FairTax (replaces all federal taxes on income with a single rate tax on final consumption) improves capital stock, which is dramatically higher in the long run under the FairTax than under the current tax system. Indeed, the capital stock in 2100 is 96.2 percent higher. While the expansion of the capital stock proceeds relatively slowly, it is noticeable even by 2010. In that year, the capital stock is 12.8 percent higher. By 2030, the capital stock is 43.7 percent higher than would otherwise have been the case.

The increased capital formation also leads to a rise in the real wage per unit of human capital. Rather than declining by 8.0 percent by the end of the century, the real wage now rises by 17.0 percent. This is a 25.0-percent difference in real worker remuneration. Again, the pace of the change is slow, but by 2030 real wages under the FairTax are 11.5 percent higher than they would otherwise have been. In transforming the economy's prospect from one of a capital shortage to one of capital deepening, the FairTax also reduces real interest rates, with the 2100 real interest rate ending up 160 basis points lower than under the current system.[57]

And the third study, by The Beacon Hill Institute, uses a dynamic computable general equilibrium (CGE) model to estimate the impact of the FairTax plan on the economy. Their main findings are:

- GDP is estimated to be 7.9 percent higher in the first year, 10.9% higher in year 10 and 10.3% higher in year 25 after enactment of the FairTax than what would otherwise be the case if the current system remained in place.
- Domestic investment is 74.5% higher, 75.9% higher and 65.2% higher in years 1, 10, and 25, respectively.
- The capital stock is 9.3% higher in year 5, 14.1% higher in year 10, and 17.3% higher in year 25.
- Real wages are 10.3%, 9.5%, and 9.2% higher in years 1, 10, and 25, respectively than would otherwise be the case.
- Consumption drops slightly in the first two years (0.6% and 0.8%), and then becomes 1.8% higher in year 5, 4.3% higher in year 10, and 6.0% higher in year 25.

The findings for 2007 through 2031 are summarized in Table 1 below. The table shows the percentage difference in each indicator resulting from implementation of the FairTax for selected years 2007 to 2031. For example, real GDP would be 7.9 percent higher in 2007 under the FairTax than under the "benchmark" current law and 10.3 percent higher by 2031.[58]

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[57] Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007.

[58] David G. Tuerck, et.al., "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model," The Beacon Hill Institute at Suffolk University, February 2007.

The economic studies discussed above examine only the effects caused by the reduction in the user cost of capital and labor responsiveness to changes in marginal tax rates and do not examine microeconomic efficiencies gained from a more efficient allocation of scarce capital/labor resources, productivity gains from lower private tax compliance costs, or gains in competitiveness from moving to a destination-principle tax. They also generally make limiting assumptions about attracting investment from abroad.

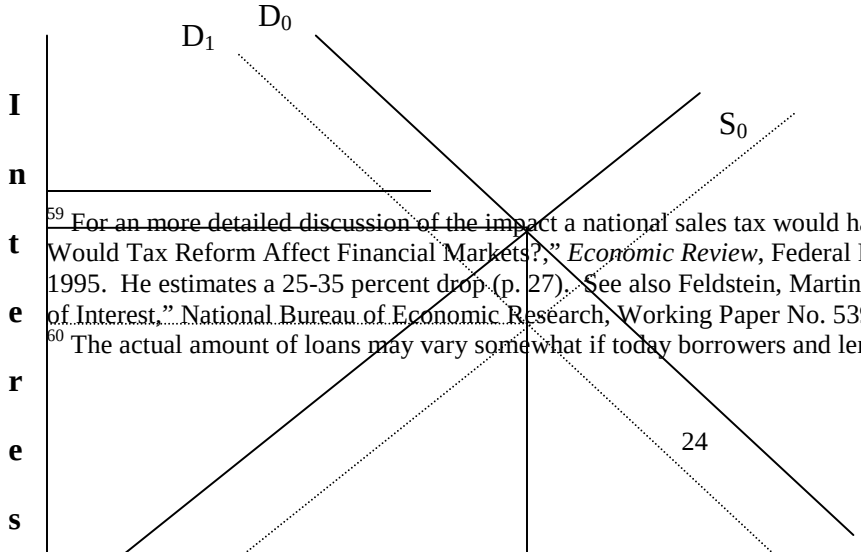
Replacing federal income, payroll, and estate and gift taxes with the FairTax has a positive impact on the stock and bond markets as well. The value of corporate stock or a corporate bond is the present discounted value of the expected future income stream (net of tax) of the stock or bond. Thus, a stock's value or a bond's value is a function of two things: The expected future income from owning the asset and the interest rate. If a firm's expected future income stream increases, then the stock will increase in value. If a firm's expected future income stream goes down, then the stock price will fall. If the expected future income stream from a bond declines due, for example, to a heightened risk of default, then the price of the bond will fall. Changes in interest rates also dramatically affect the price of stocks and bonds.

Similarly, lower interest rates mean that the present value of the future income that a corporation is expected to earn will increase. Thus, lower interest rates cause stock prices to rise. When interest rates rise, the present value of the corporation's future income declines and stock prices decline.

The FairTax causes nominal interest rates to fall. Interest rates will fall 25-35 percent under a consumption tax like the FairTax.[59] Rates will drop immediately and quickly toward the current tax-exempt rate. Investors will no longer need to receive a tax premium to achieve a particular after-tax rate of return. The impact of eliminating this "tax wedge" or tax premium on interest can be seen every day in the *Wall Street Journal*. Tax-exempt municipal bonds tend to yield about 30 percent less than taxable corporate bonds of similar term and risk.

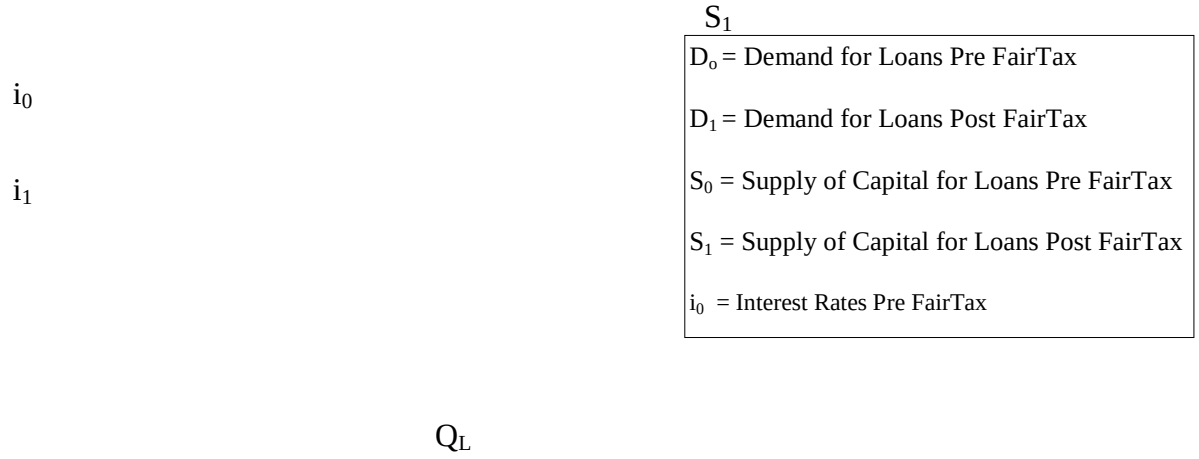
As shown in the graph below, the demand for loans at any given interest rate will decrease. This effect would be brought about by the increase in cost due to the elimination of interest deductibility. In other words, for any particular interest rate, fewer loans will be demanded since the cost of paying a particular interest rate will have risen. Conversely, since interest is no longer taxable, the availability, or supply of loans at any given interest rate will increase. Market equilibrium will be achieved at a lower interest rate (i_1) and, in the short run, the same amount of capital will be supplied.[60]

Short-run impact of the FairTax on interest rates



[59] For an more detailed discussion of the impact a national sales tax would have on interest rates, see Golob, John E., "How Would Tax Reform Affect Financial Markets?," *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27). See also Feldstein, Martin, "The Effect of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research, Working Paper No. 5397, December, 1995.

[60] The actual amount of loans may vary somewhat if today borrowers and lenders have different income tax rates.



C. The FairTax Would Introduce to the World the Most Internally Sound and Competitive Tax System

Effect on Direct Investment, Locational Decisions, and Repatriation.— Consider what would happen to the current international tax problems posed above if the FairTax were adopted beginning with the consequences of the U.S. being the world's largest national market with a zero marginal rate of tax on productive activity, investment and capital returns. Such a change would have profound relevance for both foreign direct investment and domestic locational choices.

The U.S. would become the most attractive jurisdiction in the world from which to export, attracting both foreign direct investment and domestic investment to base operations here. This, of course, satisfies the fundamental policy goal of those who are considering a territorial taxing regime for the U.S., as many countries have adopted: that goal is to ensure that a choice between headquartering a company in the U.S. or overseas would not be influenced through the application of high U.S. marginal tax rates to global income with no connection to the U.S. save the fact that the location of the headquarters of the company. The FairTax provides the equivalent of a territorial taxing regime because it does not tax foreign sourced income at all, and therefore cedes taxing jurisdiction to the country of income source.

But it improves upon this choice dramatically. The FairTax would not also encourage investment overseas as the territorial tax movement, by its own rationale, admits would occur. In fact, a zero rate of U.S. tax would give foreign jurisdictions two choices: Reduce their tax rate on savings and investment (which will stimulate global economic reform and growth) or lose investment to America. Companies now American in name only would repatriate investment and jobs back to our shores.

Adoption of the FairTax would also end the problem posed by deferral – which imposes a penalty for repatriating income earned overseas. Companies here now in name only would repatriate investment and jobs back to our shores without penalty, since the earnings of subsidiaries would not be taxed to the parent at all and the taxes paid to foreign nations would not be limited by the complex foreign tax credit rules. And since the U.S. would not tax foreign returns to capital (as it would not tax U.S. returns) the

U.S. market for investment in stocks, in business, in real estate and otherwise would effectively become the world's largest tax haven for investment capital.

Answering the Problem Posed by Border-Adjustable Tax Subsidies.-- There are two ways tax-writers could confront the reality of global border-adjustable taxes: (1) encourage our trade representatives and trading partners to allow income taxes to be border-adjusted, or (2) adopt our own destination-based consumption tax. The first will never happen.

To get some sense of the Herculean task involved with the former tack, consider convincing the WTO's Member countries to eliminate the admittedly artificial distinction now drawn by the WTO between direct taxes (income taxes) and indirect taxes (consumption taxes) on which their trade subsidies depend. These are the same nations willing to sue in international courts to get the U.S. to abandon its relatively minor export incentive worth about $4 billion annually (the Foreign Sales Corporations) so as to preserve for themselves this unilateral advantage.

Even if such diplomacy were to miraculously prevail, eliminating the indirect/direct distinction would only countervail a sliver of the trade subsidy, and then only for exporters. If the direct/indirect distinction were fully eliminated, an export subsidy would only allow exporters to defer or exempt a portion of their *income tax,* when payroll taxes constitute about 36 percent of the gross collections by type of tax. And lest we forget, since America has record trade deficits, this does nothing to level the playing field on imports which continue to compete against domestic producers unfairly on our own soil.

The best alternative is to enact what the rest of the world has enacted – a destination-principle tax system (also known as a border-adjusted tax system) – that incorporates our entire tax burden. We need to move to a tax system that taxes all goods consumed in the U.S. alike, whether the goods are produced in the U.S. or abroad. We need to eliminate those aspects of the U.S. tax system that artificially place U.S. production at a competitive disadvantage compared to foreign production.

How would the FairTax accomplish this full-scale border adjustability? As an indirect tax, fully WTO-compliant, the FairTax would:

- repeal *all* upstream federal taxes now embedded in the product price of U.S. goods and eliminates any business-to-business taxes, including payroll taxes,
- completely exempt foreign consumption from taxation. Only goods and services for final retail sale in the U.S. are taxed, and
- impose the FairTax on foreign goods entering our shores for final consumption.

Recall the table above which showed the unfair application of foreign and U.S. taxes on exports and imports restively. In essence, under current law, foreign and U.S. taxes are doubly imposed on goods produced in the U.S., while imports which compete against U.S. produced goods are exempted from taxation. Now consider how under the FairTax, the table would look entirely neutral as to whether foreign or U.S. goods were consumed here or abroad.

The U.S. tax system under the FairTax

	Sold in U.S. market	**Sold in foreign markets**
U.S. production	Pays the FairTax.	Pays foreign value-added tax

	Sold in U.S. market	**Sold in foreign markets**
Foreign production	Is exempted from the source country VAT, but pays *the FairTax*	Pays foreign value-added tax

Only the FairTax can claim that under its regime, foreign manufactured goods and U.S. manufactured goods will pay the same tax when the goods are sold at retail. Only the FairTax can make the claim that U.S. businesses selling goods or services in foreign markets will be fully relieved of federal tax (including payroll taxes).

Conclusion

I conclude with an observation about tenor of discussion for fundamental tax reform. Many who lack an in-depth knowledge of the tax laws, their practical effect cling to an unfounded assumption that the Income Tax System is somewhat of an American inheritance – devolved from a celestial body as highest social engineering achievement of mankind. Perhaps this theory is bolstered by the ecosystem made dependent upon it, where lobbyists, Members and industry seeking relative advantage combine in that unholy trinity to conspire unwittingly against national prosperity. But to mainstream economists nothing could be farther from the truth.

Enabled by a political system that has literally sold each word, each deduction, each credit and each exemption to the highest bidder at a private auction, our tax system has been cobbled together by the finest lobbyists America can produce, not our nation's finest economists. The result has been predictable: our tax code has enshrined politics over sound policy, special interests over the interests of our national prosperity. And what is most troublesome, in this season of politics, it is justified by political advisers who see the merits in advancing trite distributional tests without defining fairness– even as the devastating effects of slower economic growth impact our national well-being. Must we be reminded, lower income Americans are the first to be fired when bad times come, and the last to be rehired when good times return.

The beneficiaries of this broken discourse are the new industry of American political divisiveness: the losers are the American people, whose prosperity is diminished. It is as if political leaders who would rather sow the seeds of divisiveness than accede true reform is essential to our national prosperity. To the extent your hearing examines what we are doing wrong, how a tax system can be least destructive, it is a breath of fresh air. To the extent you are able to move the monolith, to effectuate these recommendations, to define reform in a manner repeated by the chorus of economists, we applaud you. You will be living up the trust that the American people have given to you.