The FAIRtax- Expected Effect on U.S. Tax Evasion
September 15, 2020
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Executive Summary
The FAIRtax will significantly reduce U.S. income tax evasion by 95% relative to the current gross tax gap. In 2019, the $780 billion gross tax gap would have been reduced to $41 billion under the FAIRtax. For 2020, the estimated $827 billion gross tax gap would be reduced to $43 billion, and by 2026, the estimated $1.2 trillion gross tax gap would be reduced to $55 billion.

This analysis summarizes the primary aspects of the current U.S. income and payroll tax system, relative to the FAIRtax, that create a fertile environment for income tax evasion that the country currently experiences. Next, the gross tax gap under our current U.S. income and payroll tax system is compared to an estimated tax gap that would persist if the FAIRtax were the primary mechanism in which the U.S. funded its treasury coffers, as opposed to the current income and payroll tax system.

The FAIRtax offers multiple aesthetically pleasing aspects of a tax collection system which contrast greatly with the current U.S. income and payroll tax system. David R. Burton’s January 2020 article, “The FairTax Will Materia tally Reduce Tax Evasion,” (the “Burton Study”) highlights that lower marginal tax rates, fewer collection points, increased likelihood of evasion being discovered, reduced complexity, increasing the clarity of penalties, sales tax gaps being lower, and an increase in perceived fairness are all aspects of the FAIRtax that make it much more efficient with significantly less tax evasion expected relative to our current income and payroll tax system.

Several of the aforementioned traits of the FAIRtax system may individually be difficult to quantify as it relates to a measurable reduction in tax evasion relative to the current income and payroll tax system. However, using available data, including the current gross tax gap outlined above as well as existing consumption tax system empirical evasion analysis and study, we can reasonably infer, extrapolate and calculate the effect on gross tax evasion upon adoption of the FAIRtax, while simultaneously eliminating the IRS, all income taxes, and the payroll tax.

Tax Evasion Quantified- Current U.S. Income and Payroll Tax System
For purposes of this analysis, it is important to define what is commonly referred to as the “income tax gap,” which is calculated by multiplying the average federal income tax rate by underreported income. This income tax gap figure is a useful measure to be sure but excludes other important and quantitatively meaningful aspects of tax evasion, such as non-filing, overreported deductions, credits, exclusions, exemptions and preferences. This different and more fulsome measure, the “IRS Tax Gap” also referred to as “gross tax evasion,” the “total tax gap,” or the “gross tax gap,” is distinguishable from the income tax gap because it not only measures underreported income via the income tax gap, but overreported deductions outlined

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above, yielding a total of taxes owed but not timely paid to the IRS, including all federal taxes—individual and business income taxes, payroll taxes, capital gains taxes, estate taxes and gift taxes.

The table below outlines the gross tax gap relative to U.S. GDP.

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<thead>
<tr>
<th></th>
<th>Gross Tax Gap (in billions US$)</th>
<th>U.S. GDP</th>
<th>Gross Tax Gap as a % of U.S. GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$458 ($13,815)</td>
<td>3.3%</td>
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<tr>
<td>2016</td>
<td>$653 ($18,715)</td>
<td>3.5%</td>
<td></td>
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<tr>
<td>2019</td>
<td>$780 ($21,429)</td>
<td>3.6%</td>
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<tr>
<td>2020</td>
<td>$827 ($22,111)</td>
<td>3.7%</td>
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<td>2026</td>
<td>$1,179 ($27,615)</td>
<td>4.3%</td>
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According to Dr. Richard J. Cebula and Dr. Fiorentina Angjellari-Dajci’s 2017 tax evasion study, the gross tax gap will reach approximately $9 trillion, over the 2017-2026 time period, and, will be 23.6% of projected gross tax receipts by 2026. As indicated in the table above, the annual gross tax gap grows from $827 billion in 2020 to $1.2 trillion in 2026, representing a 43% increase in annual gross tax evasion in just six years. At this rapid pace of tax evasion increase, the current income and payroll tax system is at risk of collapsing in its entirety at some point in the not too distant future.

Most Americans are aware that during the past the past 12 years, in the 2008-2019 time period, the U.S. national debt increased on average $1.1 trillion per year. When we compare the average annual increase to our national debt during the more recent 2016-2019 period, $1.2 trillion per year, to the average gross tax gap during the same period, we find that approximately 60 percent of the annual increase to our national debt could be avoided if all taxes owed and due were collected by the U.S. Treasury. This is a staggering figure which does not incorporate other aspects of the FAIRtax that would separately work to reduce spending, including but not limited to eliminating the current annual $12 billion IRS budget and replacing it with the FAIRtax Act’s miniscule budget needed to fund the newly created Sales Tax Bureau within the Department of the Treasury to administer the national sales tax. The reason this $12 billion would be reduced to a de minimis amount under the FAIRtax is due to the individual state’s administering, collecting and remitting the FAIRtax receipts to the U.S. Treasury, with the Sales Tax Bureau only having to administer the national sales tax in the few states that do not currently utilize a sales tax and to discharge other relatively minor federal duties and powers relating to the FAIRtax.

Of course, FAIRtax enactment would not on its face prevent Washington, D.C. from increasing spending to even higher levels to continue the blistering and explosive pace of national debt

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4 "Estimated Future Tax Evasion under the Income Tax System and Prospects for Tax Evasion under the FairTax: New Perspectives," Figure 5, Cebula and Angjellari-Dajci, March 1, 2017


engorgement. However, the simplicity and reduced complexity of the FAIRtax will reduce virtually all of the confusion around how our U.S. Treasury’s receipts are spent. For example, many U.S. expenditures are not delineated within the U.S. budget each year, in that tax deductions, exemptions, credits, exclusions, etc. lead to the equivalent of spending, because less income taxes are collected due to these deductions. The home mortgage interest deduction (“HMID”) is an example many can relate to; however, few realize that approximately the richest 20% of Americans receive an estimated 80% of the HMID deduction each year. The U.S. Treasury Department estimates that the HMID will reduce federal revenue by $600 billion from 2019-2028. Under the FAIRtax, there will no longer be this other type of Washington, D.C. spending that gets shrouded within the tax code.

The FAIRtax taxes consumption on new goods and retail services with no exclusions or exemptions, meaning the eyes of each constituent can squarely focus on how much the U.S. government spends and how much it receives in FAIRtax receipts based on the statutory 23 percent inclusive rate. Qualitative benefits of this FAIRtax construct include a drastic reduction in tax code lobbying expenditures, currently third-most in Washington, D.C. behind only the federal budget and pharmaceutical lobbying. More important however, the ability for either political party to criticize the opposing party is significantly diminished. Currently, U.S. political parties campaign on the weary and fatigued platform of needing to either raise taxes on certain classes of citizens to ensure their fair share is remitted to the treasury, or to spend less and lower taxes to stimulate economic growth. Every two and four years, the same arguments are recycled year after year, and decade after decade by both political parties, which lead to significant cultural and psychological divisions within the country. Under the FAIRtax, the only real questions each political cycle are a) how much should the U.S. spend and on what? and b) what should the national FAIRtax rate be in the U.S.?

A Fertile Environment for U.S. Income Tax Evasion

The Burton Study highlights that higher tax rates cause more tax evasion because people respond to incentives. Both on its surface and upon research of various margin rate tax systems, this phenomenon holds true. The Burton Study cites numerous studies linking increased tax evasion with higher marginal tax rates. A basic understanding of human behavior and motivations would seem to corroborate the Burton Study’s findings. The FAIRtax rate is 23 percent, while the average marginal income tax rate, including payroll taxes, under present law is 36.6 percent, which is 59 percent higher than the FAIRtax rate.

However, let’s take a moment and double-click on this positive aspect of the FAIRtax system relative to the current income and payroll tax system. It is important to highlight the source of taxation and qualitatively analyze the effects of such source as it relates to tax evasion. The income and payroll tax are calculated and assessed on an individual’s income. Many euphemisms exist relating to one’s earned income, such as sweat equity, a hard day’s work, industrious, diligent, indefatigable, busy, assiduous, and the sweat off my brow. Why do so many references to working hard resonate with the human experience so deeply? Adam Smith, author of “The Wealth of Nations” (1776), explained that:

“The property which every man has in his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable. The patrimony of a poor man lies in the strength and dexterity of his hands; and to hinder him from employing this strength and dexterity in what manner he thinks proper without injury to his neighbor is a plain violation of this most sacred property. It is a manifest encroachment upon the just liberty both of the workman and of those who might be disposed to employ him.”

In modern terms, Adam Smith articulated that our human psyche is pre-programmed to consider our own labor and its rewards as sacred, hallowed and venerated. Our labor is our toil, our sweat, our life’s work, our commitment, craft and expertise. Our current income and payroll tax system strikes at the heart of, with an extremely sharp tip, one’s labor and its rewards, because the product of our labor in today’s vernacular is one’s income. Our current system is configured to tax our income with both the income and payroll tax, which are both levied on our income at various rates and levels.

Given Adam Smith’s aforementioned philosophy and insight into human psychology, what does modern research tell us about defalcation, evasion and fraud? In 1951, Donald R. Cressey and Edwin Sutherland published an article questioning why people committed fraud. Then, in 1953, Donald R. Cressey wrote a book which outlined and developed what would later become known as the fraud triangle, which is one of the most used and useful tools that auditors and investigators of white collar crime employ today.

The fraud triangle highlights three concepts or areas that, when present, will inevitably lead to fraud of some kind. For purposes of this analysis, illegal tax evasion is a fraudulent activity. Fraud is defined within the Public Company Accounting Oversight Board (“PCAOB”), AS 2401.5 as “an intentionnal act that results in a material misstatement in financial statements...” When we contemplate an income tax return, it is in a sense, our personal income statement for the year, where we describe our earnings and income, and then subtract expenses, credits and deductions, to arrive at a net taxable income figure upon which applicable income tax rate(s) are applied. It is useful to utilize the PCAOB’s definition of fraud when we consider income tax evasion, with the key elements being intentionality and material misstatement. Although some de minimis amount of the U.S. gross tax gap is likely attributable to unintentional error, miscalculation or other fallacy, it is reasonable to approach this assessment from the perspective of individual psychological and human motivations when analyzing the attributes of the current income and payroll tax system relative to a consumption tax system.

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The fraud triangle alluded to and depicted above highlights the elements that, when present, indicate fraud will occur. There are entire fields of study that investigate and attempt to uncover the intricacies of the human elements of fraud. One of a multitude of postulates that researchers have put forth is the 10-80-10 rule, which, as described by the National Association of State Auditors, Comptrollers and Treasurers (NASACT), is a theory based on the assumption that 10 percent of people are ethical all of the time, 80 percent could behave unethically depending on the situation or the pressure(s) being applied, and 10 percent have no or a severely broken moral compass and will pounce on opportunities to commit fraud.

Knowing that humanity can be swayed into unspeakable darkness and depravity, despite the ability for redemption and recovery, the fraud triangle amply identifies the situational state when fraud is most likely to occur.

**Opportunity**

The most obvious characteristic of fraud is that a perpetrator, an individual or business when we contemplate income tax evasion, must have ample opportunity to abscond with whatever resource they covet. For example, in a business, if there is not adequate segregation of duties, an opportunity exists for fraud. Segregation of duties refers to different people being responsible for varying activities within a business, owing to the fact that when more than one person is needed to commit a fraud, it is less likely to occur. This aspect of fraud, where more than one person is involved, is commonly referred to as collusion, and although it is exponentially more difficult to detect, is less common given the need for more than one person's involvement. An example is where a business has a clerk who opens the mail and tallies customer remittances, applies the payments to the customer's accounts receivable sub-ledger balance, and is also responsible for bank deposits and reconciling the monthly bank statement. The clerk in this instance would have the opportunity to misappropriate the company's funds much more easily, for example in a lapping scheme, relative to if different personnel were responsible for these different activities. A more straightforward example is whether a store's cash register drawer remains locked when not
in use. If the drawer is locked, apart from unlikely forced entry via a crowbar, the opportunity for stealing the cash register’s currency is much less likely relative to if the drawer remains locked.

As the examples above illustrate, it is intuitive to most that for fraud to occur, an opportunity must exist for the perpetrator to deploy their plot to defraud. The current U.S. income tax is mostly an on-your-honor system. Based on 2016 IRS data, there were 244 million tax returns filed for fiscal year 2016, along with approximately 33 million business tax returns and 3 billion informational returns. This data reveals that 211 million of these 2016 income tax returns relate to individuals who are uninhibited from fraudulently misstating various aspects of their tax returns (e.g., overreporting certain deductions, underreporting certain types of non-W-2 income, etc.).

Although a spouse, in the case of a joint return, might protest if a fraudulent return is filed, the level of complexity and ambiguousness of the current income tax system yields these scenarios de minimis at best. These millions of individual income tax returns were subject to an overall audit rate of 0.45 percent for fiscal year 2019, despite the IRS employing approximately 78,000 people. Given these statistics, the current U.S. population does not expect or fear an IRS audit relative to prior generations when, for example in 1963, 5.6 percent of all Americans were audited and everyone knew a family member, friend or colleague who had experienced an IRS audit.

The premise that opportunity exists within the current income tax system for fraudulent reporting of tax liability has been established (e.g., the cash register is unlocked and no one is monitoring it (low IRS audit rate) and the individual is tasked with applying approximately 77,000 pages with literally millions of words of the Internal Revenue Code, regulations, rulings and court interpretations and findings, calculating their tax liability defined by these thousands of pages, as well as acting as the tax collector and remittance handler for the tax liability due to the U.S. Treasury (no segregation of duties)).

The FAIRtax results in a 94 percent reduction in tax return filers relative to the current income tax system\textsuperscript{11}, from 244 million filers to 14.2 million retail business filers. This dramatic decrease in tax filers under the FAIRtax on its own indicates a substantial decrease in the opportunity for illegal tax evasion. However, the Dr. Richard J. Cebula and Dr. Fiorentina Angjellari-Dajci’s 2017 tax evasion study\textsuperscript{12} highlights that of the 959,749 active U.S. wholesale and retail corporations, 6.1 percent of these U.S. businesses make up 88 percent of the $7.8 trillion in gross receipts collected in 2012. This 6.1 percent equates to 58,998 businesses comprising 88 percent of gross retail business receipts collected. A staggering 1.3 percent of all U.S. retail businesses make up 75 percent of gross receipts, which is a miniscule 13,019 retail businesses. The vast majority of U.S. retail receipts and current state sales taxes would be collected by an infinitesimally small number of retail businesses, such as Sam’s, Walmart, Amazon, Home Depot, and Chick-fil-A, which are significantly dissuaded from either not collecting required sales taxes or not remitting collected sales taxes to the state, given reputational risk, risk of sales tax license revocation, etc.

Further, tax withholding has been shown to increase tax collection substantially\textsuperscript{13}. Currently, the least evaded portion of the U.S. income and payroll tax system is the payroll tax, where social security and Medicare taxes are automatically withheld from employee paychecks up-front throughout the year. The FAIRtax is inherently a withholding tax, given that as one purchases a new good or service, they remit the FAIRtax to the retailer at the time of purchase through

\begin{thebibliography}{9}
\bibitem{11} “The FairTax Will Materially Reduce Tax Evasion,” David R. Burton, January, 2020, p. 15
\bibitem{13} “The FairTax Will Materially Reduce Tax Evasion,” David R. Burton, January, 2020, p. 8
\end{thebibliography}
automated point of sale software. There is no ongoing or further obligation for the purchaser to calculate, interpret, administer or remit owed taxes to the U.S. Treasury like there is with the current annual filing requirements with the income tax. The longer one has to calculate what is owed the U.S. Treasury, the more likely that individuals will begin rationalizing why they should perhaps pay less and may ultimately remit less than owed to the treasury. The FAIRtax eliminates this current temptation given its withholding up-front at the retail level.

It should be noted that most states administer sales tax licenses, commonly referred to as resale permits that allow businesses to purchase items tax-free for use in producing their new products and retail services. This sales tax licensing practice, which is currently subject to abuse, will undoubtedly continue under the FAIRtax. For example, a small business may utilize their state sales tax license to purchase various end-use retail items tax free that are intended for personal use (e.g., clothes, food, landscaping, repair services, etc.), and will not be used in their business. As it relates to sales, states currently have in place detection algorithms that analyze, for example, average sales for a small retailer by comparing each retailer’s sales to models of similar sized retail stores in similar demographic zones, to determine if they are remitting an expected amount of sales tax.

To mitigate this risk of abuse and state sales tax evasion on purchases while using a sales tax license, many states have already developed extensive computer modelling to identify outliers, anomalies, and potential purchase abuse, similar to the detection software utilized to detect sales anomalies. Wholesale or business to business sellers who do not have to collect tax must still register as sellers under the FAIRtax. Thus, the state sales tax authorities have the ability to audit and monitor wholesale company sales to other businesses. State sales tax authorities presently rely on these controls to determine whether sales taxes that retailers report are within projected norms. States then have the ability to audit any business including examining their tax-free purchases to determine whether or not they were in fact utilized within their business. Under the FAIRtax, these potential abuses and related evasion detection will persist, however the amount of evasion is expected to be minimal given the aforementioned state sales tax controls in place, as highlighted within the sales tax evasion studies discussed further below.

The FAIRtax therefore reduces the opportunity for illegal tax evasion in two significant but distinct ways. First, the number of tax filers is drastically reduced by 94 percent as outlined above. Second, a minute number of these drastically reduced number of retail business filers (6.1% of approximately one million total U.S. retail businesses), comprise the overwhelming majority of retail sales (75 percent of gross receipts) and resulting sales tax collections, which reduces to an exponentially low level, the number of filers that FAIRtax collection and audit efforts can concentrate efforts on.

**Rationalization**

Many choices humans make that are detrimental to themselves, their family, company, community or country usually involve some level of rationalization in their mind. Many if not most of us can think of times when poor decisions were made by ourselves, family, or others where the person rationalized their behavior in one way or another. When a sole proprietor reports vehicle deductions in excess of the proportion used for bona fide business purposes because they believe “everyone else is doing it,” or when an employee steals from their company because “I am not paid nearly what I’m worth”, are just a few examples of this justification we sell to ourselves.
Often, rationalization can include good intentions that justify the fraud, such as an intention to reimburse the person they are defrauding. Upon the discovery of many defalcations, fraudsters have been reported to have said, “I was going to pay it back,” or a similar sentiment and intention to reimburse. Other justifications can include ill-intent, anger or resentment such as the mental gymnastics that include sentiments such as “Nobody will miss the money” or “if they don’t realize I’m doing it, they deserve to lose the money.”

Adam Smith’s aforementioned quote indicates that our most treasured, sacred and revered property is our own income we earn. The core tenet of the U.S. income and payroll tax system is that one’s earnings and income, their most sacred property, are being taxed, and taxed at a progressively higher rate should they be blessed to live the American dream and blessed enough to see their earnings and income increase over time. The current income and payroll tax system targets and confiscates a portion of what humanity generally believes is our most sacred property, creating fertile soil for rationalization.

The FAIRtax, by comparison, does not necessitate the calculation, monitoring or reporting of one’s earnings, capital gains, interest, dividends, investment appreciation or any type of individual or business income whatsoever. Further, the FAIRtax does not tax our consumption on the basic necessities of life up to the poverty level as annually determined by the U.S. Department of Health and Human Services (“DHHS”), thanks to the family consumption allowance commonly referred to as the prebate. If consumption on the basic necessities of life was taxed, this could arguably lead to resentment by many, especially the working poor. If Americans cannot afford to consume at levels in excess of the DHHS poverty level, they will not pay any tax, or potentially pay (i.e., receive) a negative tax rate when considering the receipt of the prebate and purchasing some pre-owned items (e.g., vehicle, clothes, etc.) as a portion of one’s consumption. However, as America’s end-use retail consumers choose to consume goods and services at levels above their basic life necessities, they will pay the FAIRtax at the retail level for new goods and services. The FAIRtax single-handedly eliminates taxation on one of the most susceptible areas for rationalizing illegal tax evasion, income. If one chooses to purchase a new Lamborghini, Gulfstream G650, or Benetti superyacht, the FAIRtax collected will be substantial, but every individual has the element of choice as it relates to what they purchase. Increased spending, after consideration of the prebate, yields the FAIRtax as more progressive in nature relative to the income and payroll tax, which increases perceived fairness of the tax.

In 2020, the U.S. DHHS poverty level for a family of four is $34,480, and the FAIRtax prebate is $7,930, or 23% of the entire $34,480 in expenditures for the basic necessities of life, up to the DHHS-determined annual poverty level. The data below incorporates the prebate that each legal U.S. household would receive with the FAIRtax, and assumes all consumption is of new goods that are subjected to the inclusive FAIRtax, and no purchases of pre-owned goods occurs (e.g., a used car, etc.).

- If this family of four spent $34,480, they would pay $0 in tax and have $34,480 to use, and a 0% tax rate. The tax rate might actually be negative, if the family purchased used goods of any kind.

- If the same family spent $40,000, they would pay $1,270 in tax and have $38,730 to use, which is a 3% tax rate.
• If the same family spent $50,000, they would pay $3,570 in tax and have $46,430 to use, which is a 7% tax rate.

• If the same family spent $100,000, they would pay $15,070 in tax and have $84,930 to use, which is a 15% tax rate.

• If the same family spent $1 million, they would pay $222,070 in tax and have $777,930 to use, which is a 22.2% tax rate.

• If the same family spent $10 million, they would pay $2,292,070 in tax and have $7,707,930 to use, which is a 22.9% tax rate.

Thus, the more one spends under the FAIRtax, the higher and more progressive the tax rate they pay, gradually and asymptotically approaches 23%. The above depicted progressivity is greater than the current U.S. income and payroll tax system, despite a flat 23% inclusive tax on consumption, due in large part to both the prebate and the extreme regressivity of the current payroll taxes collected from working Americans, which currently represent nearly 40% of all U.S. Treasury receipts. The FAIRtax actually taxes existing wealth as it is spent, and all wealth does eventually get spent. The current income and payroll tax has no practical mechanism to tax the wealthiest Americans, many of which pay no social security and Medicare payroll tax since they are not a W-2 employee and only pay taxes on capital gains, which are usually taxed at lower rates than income. “The sense of unfairness is often a function of deliberate policy choices that are perceived as “loopholes” in an income tax system. The FAIRtax contains no ‘loopholes.’ A public opinion poll conducted by Rasmussen Reports found that sales taxes are perceived as the most fair means of taxation.”14 15

The result is a discernable increase in perceived fairness for the FAIRtax, relative to the current income and payroll tax system. One’s income is inevitable, however one’s purchases above the level necessary to subsist are a matter of choice, as it relates to amount, brand, timing, and magnitude. This element of choice that accompanies one’s consumption, which is a key tenet, if not one of the most foundational aspects, of freedom, substantially reduces the human tendency to rationalize how tax evasion is a viable and justified option.

Pressure / Motivation

When fraud occurs, there exists a pressure, motivation, or incentive to commit a fraud, such as illegal tax evasion. Most who have lived past a certain age will attest to the fact that life on earth brings with it a cadre of pressures, stress and expectations for success. For example, when one finds their indebtedness at levels that are out of control, unmanageable and inescapable. Lifestyle needs, especially in the U.S., are a very real aspect of many citizens’ lives and may include a perceived need to keep up with the Jones’. One may find themselves entangled in illicit activities or vices such as drugs, gambling, affairs, among other trappings. Often, unrealistic performance targets at a company motivate or incentivize fraudulent behavior. Lastly, some of life’s pressures

15 “Americans Say Sales Tax Fairest of Taxes,” Rasmussen Reports, September 13, 2017
are self-inflicted, such as internal pressure to perform, showcase success or talent, or may result from unfortunate events such as financial needs arising from a family sickness, job loss, etc.

Pressure and motivation to defraud the U.S. Treasury exists under the current income and payroll tax system but would also persist under a FAIRtax system. The inexorable fact is that humans are imperfect and in fact, are susceptible to multiple failings. However, because the FAIRtax rate is 37% lower relative to the current income and payroll tax system’s marginal tax rate, it is at least reasonably possible to conclude that the pressures and motivation to evade the FAIRtax are lower by at least a like percentage. In fact, a $52 billion annual tax evasion reduction under the FAIRtax was estimated, due to this significant reduction in marginal tax rates. As the average American’s tax burden grows larger, the pressure and motivation to illegally evade such tax dramatically increases, because the amount of stress that such an increasing tax obligation brings with it grows and becomes more prominent relative to the individual life circumstances such as those mentioned above.

The FAIRtax is a more efficient system of taxation relative to the income and payroll tax partly because it has a much broader consumption tax base ($14.8 trillion in 2019 according to the Tax Foundation), relative to income ($7.9 trillion taxable income according to 2017 IRS data). While income originates solely from income, consumption can be derived from several sources that include income, savings, borrowing, and even theft, hence the much larger taxation base. Additionally, multiple studies corroborate the fact that personal consumption expenditures not only represent a broader tax base, but are a much more consistent and a less volatile basis of taxation, relative to income, especially during times of high economic stress (e.g., the Great Recession and the current COVID-19 pandemic-induced economic crisis). The political realities that persist are that it is not typically considered a winning campaign position to begin to have approximately half of U.S. citizens who currently do not pay any income tax, to begin paying income tax or pay at a higher rate. Likewise, with marginal income tax and payroll rates combined for the most wealthy Americans reaching approximately 50 percent, the reality is that the wealthy will not be able to fund a significantly greater proportion of the U.S. tax burden, without an offsetting behavioral effect that diminishes output, business growth and economic expansion.

Overall, the fraud triangle represents a three-legged fraud stool, which includes opportunity, rationalization, and pressures or motivation. If any leg of the three-legged stool is eliminated, then the fraud stool falls down and fraud cannot generally occur. Two legs of the fraud stool are virtually always present, those being rationalization and pressures or motivation. As long as we endeavor to contemplate a taxation system that will be administered by and for human beings, there will exist the tendency for those subject to such system to rationalize why they should not have to adhere to such system, and there will exist humanity’s inevitable conundrums, challenges, enigmas and complications that lead to a multitude of pressures, motivations and incentives to defraud the existing system of taxation. The aforementioned 10-80-10 rule provides insights into these inherent challenges we all face as part of humanity. Therefore, we can generally presume that two-thirds of the fraud triangle are always present and are unavoidable.

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U.S. companies and many businesses around the world realize the inevitability of the first two aspects of fraud being extremely difficult to mitigate and curtail. Thus, most companies look to the third leg of the fraud stool, which is opportunity. If opportunity is removed from the equation, the three-legged fraud stool becomes a two-legged stool and can no longer stand upright. At a high-level, companies incorporate controls at the strategic places where fraud or error could occur within a process. As companies accumulate data from various places within their organization, for example in connection with the preparation of their year-end financial statements or their monthly or quarterly close, a process exists whereby relevant financial and operational data is initiated, authorized, processed, recorded and ultimately reported within the company’s financial statements. These processes can have multiple touch points, hand-offs, transfers of data between accounting systems, sub-ledgers and spreadsheets. Generally, the longer, more complicated and cumbersome the process is, the more susceptible the process is to fraud or error. To combat this possibility, controls (e.g., segregation of duties, account reconciliations, secondary reviews for large cash disbursements, new vendor review and approval, and multiple reviews for requested changes to vendor bank account or wire information, to name only a few), are strategically placed at the precise locations within the aforementioned process where fraud or error could or most likely would normally occur, with the aim of mitigating and lowering the risk of such fraud or error to an acceptably low level, understanding that no system of controls can ever be absolutely infallible or foolproof.

As it relates to a taxation system, the analysis above highlighted how the practical ability (opportunity) to illegally evade a sales tax is dramatically reduced under the FAIRtax relative to the income and payroll tax. Given there would be 94% fewer filers under the FAIRtax, along with the vast preponderance of U.S. retail business receipts, and accordingly tax collectors, being derived from a remarkably small number of larger retailers, the FAIRtax simply incorporates a much more concise, direct, up-front, and efficient process where tax collection occurs. Other than the small number of retail businesses that collect the FAIRtax, the typical U.S. consumer has no further obligation, record keeping, compliance costs, tax software, or tax preparation assistance to be concerned with after they make their retail purchase. The FAIRtax is simply quantified on the purchase receipt, and that is the end of the process for the consumer. The tax administration and collection process, when analogized to a typical business as described above, is simply shorter and presents significantly less opportunity for defalcation to occur.

For retailers, 45 states and the District of Columbia have state sales taxes and virtually all U.S. sales already incorporate a sales tax collection mechanism at the state level, meaning point of sale software and related programming is a decades-old technology that is not complicated or cumbersome. Under the FAIRtax, retailers would not experience a significant change in their existing retail and tax remittance process, given the FAIRtax collected would be remitted by retailers to their respective states, with the states remitting the FAIRtax collections onward to the U.S. Treasury. Since retailers do incur time and expense to collect and remit tax collections to the state, the FAIRtax compensates for these tax collection services in the form of a 0.25% of taxes collected fee for each retailer. For example, if Walmart sold $10 million of goods on Tuesday, collecting $2.3 million of FAIRtax, they would only remit $229,425 to the state, keeping $5,750, or 0.25% of FAIRtax collected, as their reimbursement for their tax collection efforts. Currently, when the over 200 million U.S. income tax filers interpret and apply existing income and self-employment tax law, complete the necessary tax return forms, and collect and remit their taxes due to the IRS, they receive no recompense for their efforts. These efforts are currently immense, with the Tax Foundation estimating in 2016 that 8.9 billion hours and $409 billion in costs to
comply with existing U.S. tax law was incurred, with this figure increasing each year. These enormous compliance costs, along with the income and payroll taxes administered, are all aspects of U.S. business’ cost make-up, which ultimately lead to increased retail prices for U.S. consumers, which on average represent 22% of the end-use retail cost of every product or service we consume. Dr. Dale Jorgenson, former head of Harvard’s Economic Department, performed an extensive tax cost study\textsuperscript{19} where it was determined that over time, prices will drop by as much as 29 percent under a national consumption tax, but was conservatively estimated at a 22 percent drop in retail prices as it relates to the long-term embedded costs of federal taxes alone.

Given human nature and what we generally hold most sacred in the form of income, the FAIRtax elegantly and systematically eliminates the opportunity for illegal tax evasion to a significant extent. Additionally, while rationalization can never be eliminated from the human psyche and is a ubiquitous aspect of our shared human existence, the FAIRtax allows consumers the choice of when, where, why, and how much FAIRtax they pay for goods and services they consume beyond the basic necessities of life. Income, which is generally revered as most sacred to humanity, is no longer taxed, thereby gracefully curtailing a primary motivating factor that leads to rationalization for illegally evading taxation.

The three-legged fraud stool, otherwise known as the fraud triangle, can no longer stand under the FAIRtax because the opportunity leg is removed. Additionally, the fraud stool is even further degraded because the rationalization leg, while it can never be completely removed, is significantly diminished, given the FAIRtax consumption source of taxation, relative to income.

\textbf{Quantification- Tax Evasion Under the FAIRtax vs. the Income and Payroll Tax}

While the lower marginal tax rates the FAIRtax incorporates relative to the income tax resulted in a quantified $52 billion annual reduction in illegal tax evasion\textsuperscript{20}, a question remains as to how to reasonably estimate a quantified difference in illegal tax evasion under the FAIRtax relative to the current income and payroll tax system as a whole rather than only quantifying one aspect. The aforementioned study indicated that, “There are a number of other factors, as discussed above, that ideally should be considered and almost all of these factors would improve under the FAIRtax. Thus, the estimates below [$52 billion annual reduction in the annual tax gap] are very conservative and likely underestimate the actual decrease in tax evasion that adoption of the FAIRtax would cause.”\textsuperscript{21}

Using information from tax evasion studies and the current gross tax gap, a reasonable approximation of the total expected reduction in the gross tax gap under the FAIRtax can be calculated.

The Burton Study\textsuperscript{22} references that the State of Washington Department of Revenue estimates its sales tax gap at 1.0% percent, based on its most recent study of 2006 data. This figure excludes use tax evasion, which is rampant and would not be relevant to a national consumption tax system, since use taxes are designed to collect tax in a state when an item is purchased from another state without sales tax being collected. The U.S. Supreme Court’s 2018 South Dakota v.

\textsuperscript{21} “The FairTax Will Materially Reduce Tax Evasion,” David R. Burton, January, 2020, p. 21
\textsuperscript{22} “The FairTax Will Materially Reduce Tax Evasion,” David R. Burton, January, 2020, p. 5 & p. 18
Wayfair, Inc. decision will significantly reduce the relevance of state use tax prospectively, and for purposes of a national system of taxation, is moot. Further, a Fox and Murray study confirms a general consensus that sales tax evasion would be extremely modest relative to the current income and payroll tax system. The California Board of Equalization estimated that its sales tax gap, excluding use tax, was approximately 2.0%. The state of Washington’s documented sales tax gap may well be the best approximation of what a national FAIRtax system might experience. Washington has a large city, Seattle, with sprawling suburbs, like many U.S. states do at varying degrees of density, while also its fair share of rural and sparsely populated areas. California, on the other hand, may well represent one of the most diverse and multi-faceted economies relative to any other U.S. state, bringing along with it a multitude of variables, including criminal underground economies and a significantly higher rate of sales tax evasion relative to other states. For simplicity, given California’s estimated 2020 population of 39.8 million, relative to the 2020 U.S. population of 331.0 million, approximately 12.0 percent of the U.S. population currently resides in California. If we apply Washington state’s 1.0% sales tax gap to 88% of the U.S., with California representing the other 12%, a weighted-average U.S. sales tax evasion rate would be 1.1 percent. Utilizing the known and estimated gross U.S. tax revenues from Dr. Cebula’s and Dr. Angjellari-Dajci’s study, and applying the aforementioned 1.1 percent sales tax evasion rate, estimated annual FAIRtax evasion figures are calculated as outlined below.

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26 (Washington) 1.0% x 88% = 0.88% plus (California) 2.0% x 12% = 0.24%, summing to 1.12%.
In billions US$

<table>
<thead>
<tr>
<th>Gross FAIRtax Tax Gap, at 1.1%</th>
<th>Gross Tax Revenues</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016 $ 36</td>
<td>$3,233</td>
<td>1.1%</td>
</tr>
<tr>
<td>2019 $ 41</td>
<td>$3,750</td>
<td>1.1%</td>
</tr>
<tr>
<td>2020 $ 43</td>
<td>$3,901</td>
<td>1.1%</td>
</tr>
<tr>
<td>2026 $ 55</td>
<td>$4,996</td>
<td>1.1%</td>
</tr>
</tbody>
</table>

For comparison, in 2019, the gross tax gap of $780 million equaled 20.8 percent of gross tax revenues. Under the FAIRtax, the 2019 gross tax gap would have been only $41 billion, or 1.1 percent of the same $3.8 billion in gross U.S. tax revenues. The difference in illegal tax evasion under these different taxation systems is remarkable, at $739 billion for the single year of 2019, representing a **95 percent annual reduction in illegal U.S. tax evasion under the FAIRtax**. The rapidly increasing rate of illegal tax evasion under the current income and payroll tax system will exacerbate this difference prospectively, given the relatively minor amount of sales tax evasion expected to be experienced. For 2019, this $739 billion in additional collections represents a substantial majority of the annual $1.2 trillion U.S. budget deficit prior to 2020. For 2020, the reduction in gross tax gap would be $784 billion and based on these estimates, the FAIRtax would reduce the gross tax gap by over $1.1 trillion in 2026. A 95% reduction in the gross tax gap would transform the level of efficiency by which our U.S. Treasury collects lawful taxes it is owed and have numerous positive effects on the future financial stability of our U.S. economy, including a prolonged viability for social security benefits beyond the Social Security Administration’s current estimates that by 2034, the combined Social Security trust funds that pay retirement and disability benefits will run out of cash reserves.

These estimated differences in tax evasion are conservative, in that multiple aspects of increased FAIRtax collections relative to the income and payroll tax system do not lend themselves to immediate quantification. For example, the FAIRtax will tax all consumption at the retail level, meaning as illegal underground economies inevitably spend on food, shelter, automobiles and jewelry, they will pay their full federal tax burden, relative to the current state when most illegal activities are not adequately or accurately captured when measuring illegal tax evasion. Further, individuals who reside in the U.S. illegally, estimated conservatively at 20 million, the preponderance of which do not file or pay U.S. federal income taxes, will finally pay their full federal tax burden, as they consume products and services in the U.S. Further, only legal U.S. residents are entitled to the monthly FAIRtax prebate meaning that there is an implicit penalty in

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28 Gross tax revenues multiplied by the 1.1% expected national sales tax evasion percentage of gross tax revenues, under the FAIRtax
the form of no reimbursement on purchases up to the poverty level for individuals who dwell in the U.S. illegally. This aspect will incentivize legal U.S. immigration and naturally disincentivize illegal immigration.

Additionally, it is estimated that up to one-third of the wealth of the highest net worth individuals is held offshore, with estimates from $7 trillion to over $20 trillion, with billions in lost tax revenues each year. The FAIRtax will permanently eliminate income tax on unremitted foreign earnings and single-handedly eliminate one of the largest barriers to U.S. economic expansion and growth. While difficult to quantify, as offshore funds move back home, given no penalty to do so, more money will inevitably be deposited, invested and ultimately spent in the U.S., which will result in more revenues to the U.S. Treasury and reduced tax evasion related to these offshore funds. The fact that the FAIRtax will not be collected on sales of U.S. goods abroad will also significantly improve the U.S.’s competitive position internationally. For example, as noted previously, the embedded costs of the U.S. income and payroll tax system conservatively represents approximately 22 percent of every end-use retail good or service purchased. After FAIRtax enactment, these embedded income and payroll tax costs will quickly fall out of the cost buildup of U.S.-produced goods and services given at least semi-efficient U.S. capital markets and competition, meaning when U.S. goods are sold abroad, they will be markedly cheaper, on average 22 percent cheaper, and as such, much more competitive. Currently, many European countries refund the value added tax (“VAT”) tax accumulated within the cost of European produced goods when those goods are sold internationally, which has historically been a significant advantage for these countries relative to the U.S., and a significant reason the U.S. trade deficit has been so large in recent decades.

It is important to address a possible objection to the above quantified analysis. Given the aforementioned discussion of the positive effect that lower marginal tax rates have on tax evasion, one could postulate that because the U.S. is not accustomed to a sales tax rate as high as 23 percent, that such a high rate might work to increase sales tax evasion under the FAIRtax. This contradictory perspective is examined further here. In Europe, sales taxes in the form of a VAT are imposed at rates of 18-27 percent, in addition to relatively high income and payroll taxes. Currently in the U.S., retail state sales taxes of 9-10 percent are routinely collected. When we consider all aspects of the FAIRTax in concert, including the 23 percent inclusive rate, the possible objection diminishes significantly. This is due to the fact that the FAIRTax eliminates both federal income tax as well as social security and Medicare payroll tax withholdings from Americans’ paychecks, meaning that apart from voluntary deductions (e.g., 401-K savings contributions), the American worker will keep their entire paycheck under the FAIRtax as opposed to the “take home pay” workers currently procure. Additionally, the prebate will be deposited into legal residents’ bank accounts each month, defraying the tax on life’s necessities, increasing one’s purchasing power even further (See the actual tax rates paid on page 8 of this study, which for the vast majority of Americans, are significantly lower than 23 percent). The reality is that an overall increase in purchasing power that accompanies FAIRtax enactment works to significantly if not entirely counteract any potential increase in sales tax evasion given the 23 percent inclusive rate. Additionally, the aforementioned opportunity, or lack thereof previously outlined for consumption tax evasion, offsets the potential tax evasion consequence of the perceived magnitude of the 23 percent inclusive FAIRtax rate. A brief summary of the effect of enacting the FAIRtax is included below:

Disposable personal income, after adjusting for changes in price level, is expected to increase by the following amounts in years one through five, and year 10, after FAIRtax enactment, relative to the current income and payroll tax system. Although studies indicate that GDP, employment, domestic investment, income from wages (real wages), consumption, and capital stock will all significantly increase under the FAIRtax, the net measure of what is left for an individual after all consumption and all taxes paid is disposable personal income. The FAIRtax results in a significant increase in disposable personal income, relative to the income and payroll tax.\textsuperscript{32} This increase in disposable personal income works to counteract and offset any potential increase in tax evasion that the 23 percent inclusive FAIRtax rate might otherwise incentivize.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.7%</td>
<td>4.5%</td>
<td>6.4%</td>
<td>7.7%</td>
<td>8.7%</td>
<td>11.8%</td>
</tr>
</tbody>
</table>

Overall, an extremely conservative approximation of the decrease in the gross tax gap that the FAIRtax would yield, is an \textbf{annual 95\% illegal tax evasion reduction}, in the form of a lower gross tax gap which in 2020, approximates \$784 billion per year with an expected increase to a \$1.1 trillion reduction in gross tax gap by the year 2026.

\textsuperscript{32} “A Macroeconomic Analysis of the FairTax Proposal,” Arduin, Laffer & Moore Econometrics, June 2006, p. 30