Memorandum

To:	Laura Dale, Ph.D., Vice President, Director of Research Americans for Fair Taxation
From:	David Burton & Dan Mastromarco The Argus Group
Date:	March 16, 1998
Re:	Comments on William Gale's paper entitled "An Evaluation of a National Sales Tax", February 17, 1998 and "Don't Buy the Sales Tax" (Policy Brief no. 31)

This memorandum responds to the paper entitled "An Evaluation of a National Sales Tax" written by William Gale of the Brookings Institution.[1] Gale also recently posted a shorter policy brief "Don't Buy the Sales Tax" (no. 31) on the Brookings Institution web site.[2]

In many respects, Gale's paper is a personal bill of particulars, a lengthy opinion, on why he believes a sales tax could not be enacted. The paper does not represent an impartial, critical analysis of either the FairTax proposed by Americans for Fair Taxation, or the Schaefer-Tauzin proposal, and therefore fails to contribute in a meaningful way to the tax reform debate.

[1] This paper is marked "Very Preliminary Draft, Not for Quotation" although the shorter version of it has nevertheless been posted to the Brookings web site.
[2] The E-mail from Brookings announcing the posting was received March 10, 1998.

I. Primary Points

Dr. Gale's paper attempts to make at least the following eleven primary points:

- a national sales tax would have to be imposed at rates of 60 to 67 percent (Policy Paper, 2/17/98, page 29-30, 52 and table 8, Policy Brief 31, page 2);
- the sales tax is regressive and would raise the tax burden on all Americans with incomes under $75,000 per year (Policy Paper, 2/17/98, page 52, see also page 44);
- economic growth would not increase under a national retail sales tax;
- taxation of services is highly problematic under a national retail sales tax(Policy Paper, 2/17/98, page 11);
- transition is unmanageable and expensive under a sales tax proposal (Policy Paper, 2/17/98, page 8, 36);
- the sales tax would cascade imposing a tax on a tax (Policy Paper, 2/17/98, page12);
- tax evasion would increase dramatically under a national retail sales tax (Policy Paper, 2/17/98, page 16, 23, 24, 25, 26, 28, 47);
- taxing government output, as it is taxed today, would require spending cuts (page 20);
- charities would be disadvantaged under a sales tax regime (page 50);
- homeowners would be disadvantaged under the national retail sales tax (page 50-51); and here "is little dispute that monetary policy would determine the price level" but that income taxes are "clearly incorporated in the price of goods that are bought and sold" except that "it is not at all obvious that removing the income tax would reduce the price level." Moreover, although "it seems plausible on theoretical grounds that an added sales tax would eventually get passed forward to consumers via higher prices" (Policy Paper, 2/17/98, page 33) assets prices would fall because returns fall (i.e. the tax was pushed back because prices fell) (Policy Paper, 2/17/98, page 36).

A. Gale Perspective: The Sales Tax Would Have to be Imposed at Rates as High as 67 percent

Gale: However, adjusting those proposals for the possible non-taxation of some government purchases, sales and investments, the possible non-taxation of some private consumption, plausible rates of tax evasion, the need to convert state income and sales taxes to conform with a NRST, and transition costs suggests that the required rates would exceed 50 percent and quite possibly 60 percent on a tax-exclusive basis (*Policy Paper 2/17/98*, *page 52). Cutting the base like this would raise the required rate to 67 percent.* (*Policy Brief 31*, page 2).

This assertion is erroneous. The FairTax base is all consumption. Using 1995 figures (as Gale does), according the Department of Commerce National Income Product Accounts (NIPA) consumption is 84 percent of the Gross Domestic Product (GDP). Investment accounts for the remaining 16 percent. Consumption ($6,061) plus investment ($1,193) equals GDP ($7,254), using 1995 figures.

In 1995, the FairTax would replace $1,274 of income, payroll and estate and gift taxes equal to 17.56 percent of GDP. 17.56 percent divided by 0.836 (the share of GDP that is consumption) is 21.0 percent. Similarly, $1,274 in replaced taxes divided by consumption of $6,061 is 21.0 percent.[3]

It is patently absurd to assert, as does Gale that a sales tax that (1) raises revenue equal to 17.6 percent of GDP and (2) because it taxes all consumption, has a tax base equal to 84 percent of GDP, must be set at rates anywhere near the 50 or 60 percent that he claims.

It is, of course, true that NIPA consumption expenditures and the FairTax sales tax base are not identical. Some adjustments increase the FairTax base relative to NIPA consumption and some adjustments reduce the FairTax base relative to consumption. Using 1995 data, the FairTax sales tax base was 95.3 percent of NIPA consumption. Ergo, the FairTax revenue neutral tax rate (before the rebate) would be 21 percent (tax exclusive) NOT 50 or 60 percent. If the rate were converted to an income tax or flat tax equivalent rate (i.e. a tax-inclusive rate) then it drops to 17.4. The cost of the rebate increases it back toward the 23 percent that is incorporated into the FairTax bill.

Gale's estimate is wildly inconsistent with those of many respected researchers. For example, Dale Jorgenson (Harvard) has found that the FairTax plan is revenue neutral at 22.9 percent.[4] Jim Poterba (MIT) has found that the FairTax plan is revenue neutral at 23.1 percent.[5] Laurence Kotlikoff (Boston University) found that the revenue neutral tax rate was 24 percent.[6] Researchers at Stanford, the Heritage Foundation, Fiscal Associates and the Cato Institute have reached similar conclusions (22.3 percent to 24 percent).

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[3] All data is from the February, 1998, Economic Report of the President or from the August, 1996, *Survey of Current Business*.
[4] See, *The Economic Impact of the National Retail Sales Tax*, Dale W. Jorgenson.
[5] Letter to Americans for Fair Taxation, April 4, 1997.
[6] See *Replacing the U.S. Federal Tax System with a Retail Sales Tax – Macroeconomic and Distributional Impacts*.

B. Gale Perspective: The Sales Tax is Regressive and Would Raise the Tax Burden on All Americans with Incomes under $75,000 per year

Gale: Under the FairTax proposal, taxes would rise for households in the bottom 90 percent of the income distribution, while households in the top 1 percent would receive an average tax cut of over $75,000. (Policy Brief 31, page 2; Policy Paper 2/17/98, page 52).

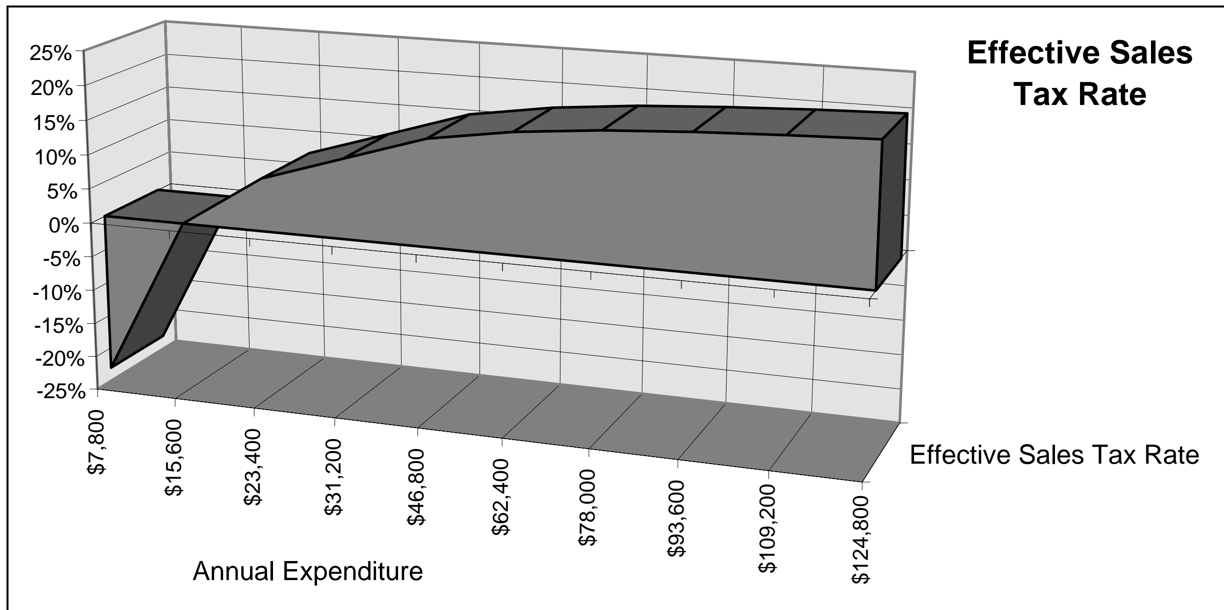
This statement is inaccurate. By its very structure, the poor would pay no tax at all under the FairTax plan. Period. Because of the payroll tax, some poor people do pay tax today, and therefore, some poor will see an improvement under the FairTax. In fact, those with expenditures below the poverty line will actually have a negative effective tax rate under the FairTax plan.

The FairTax provides a tax rebate to every household equal to the sales tax rate (23 percent) times the HHS poverty level ($16,050 for a family of four). Thus, households that live at or below the poverty level will not pay any sales tax at all, and no household in America will pay sales tax on the cost of the basic essentials of life as estimated by HHS. Because of the rebate, the effective FairTax sales tax rate for a family spending $32,100 is only 11.5 percent. Most families earning spending $32,100 have combined payroll tax and income liabilities of over 11.5 percent today. If you take into consideration only the entire payroll tax of 15.3 percent today that family will pay 30 percent more tax today than they would under the FairTax. And this does not include income taxes or the hidden component of tax in goods and services they purchase.

Most middle income Americans will pay less tax under the FairTax plan. For example a family of four earning and spending the median household income in 1996 ($34,475) would pay $4,238 under the FairTax plan and pay $5,184 in income and employee payroll taxes today. Thus, this very typical family would pay 18 percent less tax under the FairTax than under current law. Any household of four earning and spending $24,049 or less will pay *less* than just the 7.65 percent payroll tax alone (one-half the tax actually imposed on payroll.)

Based on an objective analysis, it is simply impossible to conclude that under the FairTax plan, poor or lower middle income families will pay more tax than under current law. In fact, the **FairTax**, is the only proposal, including current law, that completely "untaxes" the poor. As annual spending levels increase and the use of tax planning devices (tax loopholes and exemptions) increase, it becomes easier to find taxpayers who may pay more under the FAIR FairTax proposal.

The FairTax is not regressive. The effective tax rate climbs with consumption as illustrated in the chart below. It is a highly progressive tax proposal.



C. Gale Perspective: Economic Growth Would Not Increase

Gale: Estimates suggest that a well-functioning, broad-based consumption tax, with limited personal exemptions and limited transition relief could raise income per person by up to 2 percent over ten years. But more generous transition relief or erosion of the tax base would drive the growth effects to zero fairly quickly. (Policy Brief 31, page 4, Policy Paper 2/17/98, page 40).

The FairTax plan would move to a broad-based consumption tax with a low, flat tax rate. Virtually all economic analysts agree that replacing the income tax with a consumption would promote economic growth. Virtually all economic analysts agree that replacing a graduated tax rate system with a flat marginal tax rate system will promote economic growth. Virtually all economic analysts agree that lower marginal tax rates and a broader tax base will promote economic growth. Most analysts believe that moving to a FairTax type plan would have dramatic, positive effects on the economy. Gale's remarks are out of the mainstream and reject commonly held views among most economists.

Although the magnitude of the economic growth generated by a flat rate consumption tax generates lively debate among economists, virtually all agree that the large marginal tax rate reductions in the FairTax plan combined with neutral taxation of savings and investment, will have powerful, positive effects on the economy.

Work by Harvard economist Dale Jorgenson shows a quick 9 to 13 percent increase in the GDP.[7] Similarly, Boston University economist Laurence Kotlikoff predicts a 7 to 14 percent increase.[8] Much of this increase is predicted to come in the first several years. Work by Gary Robbins shows that replacing the current tax system with a flat rate system that taxed capital and labor income equally – such as the FairTax – would increase the GDP 36.3 percent and increase private output by 48.4 percent over the long run.[9] Even work by Nathan Associates, commissioned by steadfast opponents of a national sales tax and which should be viewed as the worse case scenario, shows that the economy would be one to five percent larger under a sales tax than in the absence of reform.[10] In short, the economic gains to the American people from replacing the income tax with a national sales tax would be very large indeed. The tax base would grow correspondingly and the revenue neutral rate would fall over time.

Gale mentions only two of the many papers on this subject, one of which is a 1993 Cato Institute paper by Kotlikoff. He asserts that Kotlikoff has changed his opinion since the Cato paper was presented, giving the results of a model called the Altig, Auerbach, Kotlikoff, Smetters and Walliser model. However, Kotlikoff has recently authored a paper for the National Tax Research Committee that confirms the work he did for Cato in 1993.

Gale for many years has argued that savings rates are not responsive to changes in the tax law. His work stands in contrast to work by Stanford economist, and former Chairman of the Council of Economic Advisors, Michael Boskin and recent updates of the Boskin work by Gary Robbins. He does not quarrel, evidently, with the proposition that business investment is highly responsive to tax policy changes, which would be difficult given the apparent robustness in the relationship between investment levels and changes in the real after-tax return. This is important because it is not necessary to posit large savings rate gains (and consumption declines) to see large investment increases if one acknowledges that foreign capital can flow here to meet the demand for U.S. investment capital.

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[7] Jorgenson, National Tax Research Committee study, "The Economic Impact of the National Retail Sales Tax." See also, "The Economic Impact of Fundamental Taxing Consumption", Dale W. Jorgenson, Testimony before the House Ways and Means Committee, March 27, 1996 and "The Economic Impact of Fundamental Tax Reform", Dale W. Jorgenson, Testimony before the House Ways and Means Committee, June 6, 1995.

[8] Kotlikoff, National Tax Research Committee study, "Replacing the U.S. Federal Tax System with a Retail Sales Tax – Macroeconomic and Distributional Impacts." See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute Policy Analysis.

[9] Robbins, currently a principal in Fiscal Associates, is former Chief of Applied Econometrics at the U.S. Treasury Department, "Looking Back to Move Forward: What Tax Policy Costs Americans and the Economy," Gary Robbins and Aldona Robbins, Policy Report No. 127, September 1994, published by the Institute for Policy Innovation, p. 31, p. 47.

[10] "Replacing the Federal Income Tax with a Consumption-Based Tax System", prepared by Nathan Associates for the National Retail Institute (1996), p. 29. To achieve results as modest as they did, Nathan Associates made virtually every judgment call in a way that would show lower gains from implementing a sales tax. They assumed away international capital flows (p. 30) so all increased investment in their model must be financed by lower domestic consumption rather than partially by foreign investment, assumed low elasticities, seemingly made no acknowledgment of the reduction in the tax bias against work and the concomitant increase in employment and hours worked and so on. The study shows, even with all of these adverse assumptions, that consumption will return to levels that would be achieved in the absence of reform by the fourth year and will be higher every year thereafter (after having fallen a maximum of less than one percent (p. 32)).

Gale’s proposition that the national sales tax would have minimal or no positive impact on the economy contradicts most economists' view on this issue. It is inconsistent with his statement that taxpayers “avoid” taxes by working less, and fly’s in the face of common sense. A plan that dramatically reduces the tax bias against work, saving and investment will increase work, saving and investment and the economy and living standards will improve.

D. Gail Perspective: The Taxation of Services is Highly Problematic

Gale: The taxation of services is even more problematic. ... Enforcement of sales taxes on services has proven difficult. These taxes are hard to administer and easy to evade since there are even fewer records to audit. (Policy Paper 2/17/98, page 11).

The FairTax plan taxes services as does the income tax and the payroll tax. To exempt services would be to exempt roughly one half of the consumption in the economy and to therefore double the tax burden on goods. It would also introduce huge distortions in the choice between services or goods.

Today, a service provider pays a high income tax rate and a 15.3 percent payroll tax (very explicitly if the service provider is self-employed). Effective income tax rates are very high for service providers since deductions and tax planning devices are quite limited in the service businesses. Thus, a service provider in the 28 percent income tax bracket will pay a combined 43.3 percent tax inclusive rate and can very nearly double his after-tax income by failing to report the income. Under the FairTax plan, this service provider would bear a 23 percent tax inclusive rate. As more fully discussed elsewhere in this memorandum, the lower marginal rate reduces rather than increases the incentive to evade tax and the dramatically smaller number of filers increases the risk of being detected. Since the benefit of evasion goes down and the risk of evasion goes up, evasion will decline. Of course, there will continue to be evasion but perhaps less than under current law.

There is no reason to believe that auditing or collecting a sales tax on services will be any more difficult than it is under an income tax system. The issue regarding sales tax audits is the same as the first line on an income tax return, what were the gross revenues (i.e. how much was sold)? A sales tax audit will be simpler, however, because a host of subsidiary issues will no longer be relevant to the determination of tax liability. Gale fails to provide a reasonable and objective explanation as to why this dramatic simplification should make a tax on service “problematic” under a sales tax.

E. Gail Perspective: The Transition is Unmanageable and Expensive

Gale: Despite the potentially sizable magnitude of these costs, neither plan appears to incorporate transition costs into its revenue figures. (Policy Paper 2/17/98, page 8, 36);

While more detailed analysis should be undertake with regard to transition issues, the transition from current law to a sales tax would be easier than the transition from current law to a flat tax, and would be much easier than claims made in the Gale papers. A sales tax would not tax the income flow generated by old or new assets and does not "expense" new capital investment as the flat tax does since there is no income or cash flow tax base from which to deduct the capital cost. Stated somewhat differently, the flat tax and the income tax explicitly tax the rents generated by capital while the sales tax does not.[11] The flat tax effectively limits this taxation to rents used to fund consumption by expensing capital investment while the income tax interposes the tax wedge on all rents. A national sales tax, instead of imposing a tax wedge between gross and net of tax rents, imposes a wedge between gross and net prices in the consumption goods and services market.

A flat tax taxes rents of both existing (i.e. "old") capital and new capital. A flat tax, however, would provide more generous capital cost recovery allowances to new capital. There is, therefore, an asymmetry in the tax treatment of existing capital and new investment. Under a sales tax, the rents of both existing and new capital are not taxed. The sales tax wedge between the sales tax-inclusive price that a consumer pays and what a producer receives affects goods and services produced by "old" and new capital equally. New capital investment does not receive a more favorable capital cost recovery allowance since neither old nor new capital investment is afforded any deduction. Thus, unlike the flat tax, there is no asymmetry in the tax treatment of "old" and new capital

If, as is commonly done, the assumption were made that a sales tax is incident on consumers and, therefore, the after-tax return to the factors of production (including capital and labor) increases, it would seem that old capital fares well. In this scenario, the after-tax return that old assets earn is increased by the amount of the repealed income tax so that the pre-tax and after-tax return is the same. The capitalized value of the future income stream will increase since the after-tax income stream has increased.[12] Although, the tax-inclusive price of consumption goods will have gone up, so will have the return that factors earn. New capital investment would similarly see its pre-tax and after-tax return be the same. Since new capital investment is not expensed in a sales tax, it therefore would not seem to have the competitive advantage of new capital over old capital that drives the decline in old asset prices in the consensus view. In both cases the relative price of money returns (or rents) to higher (by assumption) tax-inclusive prices is the same. It is not clear, then, why capital losses would occur, and Gale does not provide and explanation for this assertion.

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[11] Rents here are used in the sense of rental price or returns to the owner of a form of capital and not in the sense of super-normal returns or quasi rents.

[12] Since the future income stream should be discounted by the after-tax discount rate which represents the opportunity cost of funds, this analysis implicitly assumes that pre-tax interest rates will fall under a consumption tax since the tax wedge or tax premium is removed. This is a widely held but not universally held view. If, however, the discount rate were to rise from its current after-tax level to the current pre-tax level, then the assets value would be constant.

If one adopts the alternative incidence assumption that a sales tax is borne by the factors of production in proportion to their output, then the pre-tax return under the income tax and the sales tax return to labor and capital will not be the same.[13] The return to the factors will decline by the sales tax rate such that the factor return under a sales tax, r, will be equal to (1-v)r, where r is the gross pre-tax rental price under the income tax and v is the sales tax rate. Note, however, that in this scenario the tax-inclusive price of consumption goods will not be higher than the price under the income tax. Thus, although the factor return is lower than the pre-tax return under the income tax, the after-tax return to factors (including new and old capital) will be comparable to the after-tax return those factors received under the income tax, except for differences in the after-tax return caused by changes in marginal tax rates.[14]

Inventory existing on the changeover date does pose a problem and the FairTax plan contains a rule to address it. This inventory will have been taxed under the income tax since inventory is not deductible under the income tax as a cost of goods sold until it is sold and yet it must be acquired with after-income-tax dollars. It would, therefore, constitute double taxation to subject this inventory to a sales tax. Accordingly, the FairTax plan provides a credit to firms holding inventory on the changeover date equal to the sales tax rate times the value of the inventory on the last tax return. This credit is taken when the inventory is sold.

To the extent that other transition rules are deemed appropriate, transition should not be "expensive" at all. If it is fair to hold people harmless against adverse changes in the tax law, then it is equally fair to tax people on windfall gains accruing because taxes they planned to pay when they made an investment have been repealed. These gains in some cases will be of large magnitude and they can be subject to tax to fund any addition transition relief that Congress, in its wisdom, deems appropriate. Transition can raise revenue as well as reduce revenue.

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[13] Factor rental prices are a function of the return they will provide to the owners or, in the case of actual rental, renters of those factors. Since the sales tax imposes a tax wedge between the price of the good to the consumer and the price received by the producer, producers will not be receiving the full value of the products sold to consumers and the rent they can pay for factors and remain profitable will decline. This, however, assumes that the consumer demand function is held constant. Given repeal of the income tax (and in the FairTax plan the payroll tax as well), consumers will have more money income and the demand function in terms of money prices will presumably shift to the right to some very considerable degree.

[14] The marginal tax rate on capital (and average tax rate for that matter) will almost certainly be much lower under a sales tax or a flat tax than it is under current law.

F. Gail Perspective: The Sales Tax Would Cascade Imposing Tax on a Tax

Gale: Including business sales has political appeal for two reasons. First, by broadening the tax base, it reduces the required tax rate. Second, it avoids the appearance that businesses are not paying "their fair share." The perceived unfairness of not taxing business is apparently an important political influence. ... Cascading may not prove to be much of a problem at rates between 3 and 7 percent but at the higher rates required by a national sales tax, the effect could be quite significant. (Policy Paper 2/17/98, page 12)

The only problem with this analysis is that neither the FairTax proposal nor the Schaefer-Tauzin proposal, the two national sales tax plans supposedly analyzed in the Gale papers, cascades. Both plans fully exempt intermediate business to business transaction because of the inappropriateness of doing so. We would note that this is, of course, *not true* with respect to the current system, which cascades both tax and compliance costs, a significant omission by Gale.

G: Gale Perspective: A Pure Sales Tax Will Give Way to Numerous Exceptions

Gale: [E]xtensive product exemptions in state sales tax has troubling implications for a national sales tax. At the very least, the product exemptions show that political pressures and appearance of progressivity influence the political determination of sales tax bases and rates. There is nothing inherently "clean" about a sales tax from a political economy perspective. (Policy Paper 2/17/98, page 10). ... The state experience in taxing services raises several red flags for a national retail sales tax. (Policy Paper 2/17/98, page 11).

In this and other areas, Gale seeks to imply that the sales tax base would erode. As a consequence, he posits the rate would climb. Ignoring for the moment his contra point that there would be widespread evasion and that the tax would be unenforceable, the likelihood of the Congress granting exemptions is far less under the sales tax at the Federal level. At the Federal level today, there are significant micro distortions, given separate and often unjustified subsidies to industries and even to specific firms within industries. These distortions take the form of credits, deferrals, exclusions, exemptions, accelerated deductions or other devices, and they result in increased taxes on other firms. However, narrowing the base under the FairTax would necessarily result in a rate increase in order to accommodate, and all taxpayers would face these higher rates together, visibly and appreciably. The typical hid and disguise accounting tactics at the Federal level would be visible in the rate increase. Increasing rates on all taxpayers would, one should conclude, be a more difficult under the FairTax plan.

Gale fails to point out that the political pressure has not been to narrow the base, but to expand the base. State sales tax bases have moved in the opposition direction claimed in his paper, including expansion of the base to the taxation of services. Moreover, the current balkanization in the state taxing systems is an argument for uniformity at the Federal level in order to

accelerate the harmonization of variegated state taxing laws and the compliance costs they engender.

H. Gale Perspective: The Sales Tax is Very Complex

Gale: …Henry Simons noted that the supposed simplicity of the sales tax "turns out to be a mirage," and that a sales tax is a simple tax only in the sense that most people have no part in its technical operation." (Position Paper 2/17/98, page 22).

In this and other areas, Gale seeks to characterize the sales tax as a complex tax. However, for anyone who has dealt with the extreme complexity of the current Federal tax system, this logic is surprising and difficult to follow, particularly if what is meant by the statement is that the sales tax complexity would approximate that of the income tax.

First, the elimination of the vast majority of taxpayers from the "technical operation" of the FairTax is a primary achievement of the proposal. There were over 115 million individual 1040 series returns filed in 1997. The elimination of individual tax filers from the tax equation is clearly a significant relief in complexity for them.

In comparing the sales tax to the income tax, estate taxes and the payroll taxes it replaces, it is so obviously a vast an improvement in simplicity that a footnote discussion is surely unnecessary. The income tax is now at a state where it is so complicated, few understand it. Its complexity supports an army of professionals who specialize in one or another of its 7000 sections. The 10,000 pages of code are beyond the comprehension of single individual. As an annual, albeit unscientific survey, Money Magazine presented professionals with a single family scenario. This year, as last year, no one got the correct answer, and the tax liability was off by as much as $30,000. The survey was given to 34 C.P.A.'s. Even the IRS does not stand behind its own advice unless in the form of a PLR. Very few tax professionals would characterize the tax code today as remotely simple, but rather as a trap for the unwary and wary alike.

To see how much simpler a sales tax would be, we need only delve into the mysteries of the Code as it applies to one aspect of income taxation that would be replaced with the sales tax. If we take, for example, international taxation, we have an entire semester of study, and that is true only for out-bound transactions. We must know, for example, how income is sourced, how expenses are sourced, whether we have a controlled foreign corporation, whether there is Subpart F income, foreign base company income, or foreign personal holding company income. We must know whether we have an entity classified by the U.S. as a corporation, whether the tax was an "income tax," or if there was a substantial economic benefit. We must know what were the baskets of income and how they interacted. We must know all this just to determine the foreign tax credit limitation. As Professor Doernburg has pointed out concerning the baskets of income under the international system, "it is enough to turn anyone into a basket case." The sales tax eliminates this entire area of complexity.

The sales tax will not eliminate all decisional junctures, however, and there has been no claim that it will. As Gale pointed out, and as sponsors of the FairTax point out, problems arise in the treatment of financial intermediation services or in mixed use property. However, these problems pale in comparison to the income tax. For many retailers, the question will simply be: How much was sold to consumers? For consumers that are individuals, the entire field of taxation is irrelevant at the Federal level. For business consumers, the equation becomes, is this a business input? That same question must be asked each day when business consumers buy goods and services that must either be capitalized, sold as inventory, amortized or expensed.

I. Gale Perspective: Taxing Government Output, as it is Taxed Today, Would Require Spending Cuts

Gale: At the very least it is not obvious that the correct treatment is to tax all government purchases of consumption and investment goods and tax government sales of goods or services to the public. ... This would reduce real spending on other items, but the proposals do not indicate where the spending cuts would occur. (Policy Paper 2/17/98, page 18-20)

Gale is right when he states that the correct treatment of government under a sales tax is not obvious, however, he goes on to reaches the wrong conclusion. Government output is taxed today. Failure to tax it in a sales tax would constitute a massive increase in the relative size and scope of government. The goal of the FairTax plan is to be spending and revenue neutral.

The GDP includes, of course, both government value added and private value added. Government value added is included at "cost", which is *primarily* the wages paid to its employees. The income tax taxes income whether the source is government or the private sector, and by doing so, taxes government output. The government pays its employees a gross amount and then withholds income tax and payroll tax from their paychecks. No money changes hands – an accounting entry is made debiting the expense side and crediting the tax revenue side of the government budget. We could, of course, just pay government workers a lower tax-free wage and reduce federal spending considerably. Similarly, we could reduce government spending by making businesses' income from the sale of product tax-exempt. GM would certainly sell cars to the government cheaper if they didn't have to pay income tax on the revenue. However, we choose not to do this: with the result that we have higher spending (from paying pre-tax wages and higher product prices) and higher tax revenue (from the income tax on those wages).

And it is important to note that the flat tax does tax government (and non-profit) output because government (and non-profit) wages are included in the tax base. The FairTax does so as well.

A pure subtraction method VAT (a.k.a. a business transfer tax) would not typically tax government value added. The Hall-Rabushka flat tax variant is an exception, however. Unlike a normal subtraction method VAT, the flat tax allows a deduction for wages and then taxes wages at the individual level. In doing so, it also provides the mechanism for taxing government wages (while a normal BTT only taxes business wages by taxing receipts and denying the deduction for

wages). Thus, the flat tax base is much larger than the base of a normal BTT (i.e. larger by the size of the government (and non-profit) wages).[15]

So today, both the income tax and the flat tax tax government output.

However, a sales tax, in the absence of a special rule, would, like a pure BTT, not tax government value added by employee wages. In the absence of a tax on government payroll, therefore, the tax base would be much smaller than under either the income tax or the flat tax schemes. Assuming spending were held constant, this would effectively increase the relative size of government. The FairTax taxes government value added in order to maintain the relative size of the government to the private sector, rather than increasing the size of the government.

Another way of looking at this problem is to examine it using two different incidence assumptions.

If we assume that consumption taxes are fully incident on the factors of production, then the return to capital and the return to labor will decline by the amount of the tax. As noted earlier, under this incidence assumption, tax-inclusive prices would not be higher but the return to workers and capital would decline. Thus, in the absence of a special rule, government workers would experience a windfall. Their consumption prices would not go up and their wages would go up by the amount of the repealed income and payroll taxes. Since government value added is not taxed, their wages would not appear to be subject to downward pressure.[16]

Taking the alternate incidence assumption, namely that the FairTax would be fully passed forward and borne by consumers, government employees would pay the tax just like private sector workers, since tax-inclusive prices would be higher by the amount of the FairTax. Government workers would, of course, have higher pre-tax wages, but the costs of purchasing goods and services would be higher by the amount of the FairTax. However, the inequity in our alternative incidence assumption redounds to the beneficiaries of government who would now be consuming a level of government services that is enlarged by the removal of the wage taxes formally imposed. Beneficiaries of government spending (whether the Armed Forces, the Consumer Product Safety Commission, National Public Radio, or the Joint Committee on Taxation) would receive those benefits free of tax. Those who disproportionately benefit from government would disproportionately benefit from this effective increase in government spending. Moreover, the relative price of government consumption would decline, encouraging consumption through the medium of government. The price of government consumption would no longer reflect its true opportunity cost.

Another way of addressing this problem is to simply take the National Income Product Accounts and start calculating the tax base under the various consumption taxes. If one goes through this

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[15] Even a normal BTT, however, taxes government purchases of goods and services from the private sector since the private revenues from those sales are includible in the taxable base.

[16] Eventually, with free market forces, private sector workers and perhaps political pressure would bid the government salaries down. However, given the rigidity of government pay scales this may take many years (i.e. government wages are unusually "sticky"). In the interim, the relative size of government will have increased.

exercise to demonstrate the oft-repeated equivalence of the various consumption tax plans, it becomes clear that in the absence of a special FairTax rule regarding government, the flat tax has a broader base because it taxes government wages. Similarly, a pure income tax is broader not only by the amount of unconsumed capital income but also by the government wages amount.[17]

In the context of a sales tax, then, an employer payroll tax on government wages simply achieves parity with the income tax and the flat tax. Failure to impose this tax would exempt government value added from tax for the first time and constitute a dramatic incentive to consume through the medium of government. The Joint Committee on Taxation seemingly recognized this in their pamphlet "*Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax*," p. 57-58, May 1, 1996, where they state, a sales tax should also be imposed on government purchases from the private sector to fully reflect the opportunity cost of that purchase.

Government enterprises (e.g. Amtrak, the Post Office) are a separate case, and they can easily be put on equal footing by taxing their sales and exempting their inputs as if they were a private enterprise. If government (and non-profit) enterprises are not subject to tax, they will have a huge relative price advantage over private companies through cross-subsidization.

J. Gail Perspective: Consumer Pricing: Up, Down and Sideways Simultaneously

Gale: There "is little dispute that monetary policy would determine the price level" but income taxes are "clearly incorporated in the price of goods that are bought and sold" except that "it is not at all obvious that removing the income tax would reduce the price level." Moreover, although "it seems plausible on theoretical grounds that an added sales tax would eventually get passed forward to consumers via higher prices" (Policy Paper 2/17/98, Page 33) asset prices would fall because returns fall (i.e. the tax was pushed back because prices fell) (Policy Paper, 2/17/98, page 36).

Gale's analysis of the impact on prices and assets levels is contradictory and confused. He is right, however, that the analysis of the impact on prices, nominal wages, and asset prices should be divided into two questions: (1) the impact of the repeal of the income and payroll tax and (2) the impacts of the replacement sales tax.

Throughout his analysis Gale asserts inconsistent opinions on the impact of both repealing the existing tax system and of replacing it with a sales tax. He states that income taxes are "*clearly incorporated in the price of goods that are bought and sold.*" This means that when they are repealed, producer prices will come down as research conducted by Harvard's Dale Jorgenson suggests. Jorgenson finds that repealing the income and payroll tax would reduce producer

[17] Since the sales tax does not tax the "return" to government investment (i.e. later government consumption scored as government capital consumption in NIPA), using a tax prepayment approach that is equivalent in present value terms to taxing the returns is appropriate.

prices by 20-35 percent depending on the industry. Gale, however, then rejects the view that income taxes are in the price of goods we buy and assumes that removing them will not reduce prices. He can not hold both points of view simultaneously. Federal income and payroll taxes either are or are not incorporated into the prices of goods and services. If they are embedded in prices, their removal will reduce prices. If they are not, then their removal will not reduce prices but instead returns to labor and capital will go up. If returns to labor go up, people will see their after-tax wages increase and asset values will increase since the present discounted value of the new, higher returns will be higher.

The replacement sales tax could be incident on the factors of production or it could be incident on consumers through higher prices. It cannot be both. If it is incident on the factors of production, then wages and the return to capital will fall but sales tax inclusive prices will not be any higher, on average, than they are today. If the sales tax is fully incident on consumers, then prices will increase by the amount of the sales tax but returns to labor and capital will be higher.

Monetary policy, of course, will affect prices. Other things being held constant, an increase in the money supply will, after distortions caused by it introduction into the economy, increase prices since "more money is chasing the same amount of goods." Of course, all other things are not equal. Gale fails to express his opinion about whether the change from an income tax to a sales tax warrants a monetary expansion (accommodation) or not and why.

K. Gale's Perspective: The Sale Tax Will Have a Negative Effect on Charities, Housing, and Education

Gale: [T]he income tax contains a series of deductions, exemptions, and tax credits. These exist for reasons of social policy, tax administration, and politics; they support a variety of sectors and groups including medical care, housing, non-profits institutions, retirement savings ... and others. (Policy Paper 2/17/98, page 9). <u>Education</u>. Both proposals would exempt education.... An exemption for education would likely have emerged for political reasons, even if not for stated economic ones. No state taxes education heavily and it is hard to imagine imposing a 30 percent .... sales tax on college payments or tuition at private elementary or secondary schools. (Policy Paper, 2/17/98, page14). There is no reason to expect that an implemented sales tax would be as free of loopholes as the proposed sales tax. Indeed, the case for subsidies to education, ... housing, charities, etc. is just as strong in a consumption tax as it is in an income tax. (Policy Paper 2/17/98, page43)... Tax reform would affect the treatment of many social policies and special provisions.... (Policy Paper, 2/17/98, page .49). These sectors represent the three largest tax expenditures in the current system ... subsidies ... are more or less permanent features of the income tax. The nontaxation of imputed rental income from owner-occupied housing and deductions for mortgage interest were part of the original income tax in 1913. Deductions for charity ... were established in 1918. The sales tax could hurt each of these sectors. This is, in short, a large part of how the tax reform medicine is supposed to work...(Policy Paper, 2/17/98, page 49). Under current law, owner-occupied housing enjoys major advantages ... [h]omeowners may deduct mortgage interest ... but they are not required to report imputed rental income.... (Policy Paper, 2/17/98, page 50). These provisions increase demand for owner-occupied housing and boost the pie of housing.... Under the sales tax, the

deductions for mortgage interest and property taxes would disappear. This would reduce the value of newly constructed houses as well as of existing houses. …. It is worth noting that even declines of housing prices in the 5-15 percent range would hurt homeowners and cause significant declines in family net worth. Housing wealth is often of crucial importance in retirements ... declines in ... prices could also increase ... defaults and ... jeopardize ... viability of lending institutions…. Confronted with these possibilities, Congress might choose to offer special treatment – either reduced rates or an exemption – to newly constructed housing. (Policy Paper, 2/17/98, page 50). Charles Clotfelter and Richard Schmalveck (1996) estimate that enactment of the Armey-Shelby flat tax would reduce charitable giving in at least three ways. The end of the personal income tax deduction for individuals will reduce their giving by 10 percent to 22 percent…. A NRST would have the same impact on corporate and estate giving as the flat tax…. Under a NRST, however, the taxpayer would only give up ($w(1-t) of consumption, just like under the income tax (here t is the tax-inclusive sales tax rate). Thus, in this sense the "effective deductibility of charitable contributions under the sales tax would not change. (Policy Paper, 2/17/98, page 50-51).

In many respects, Gale's paper is a personal bill of particulars, a lengthy opinion, on why he believes a sales tax could not be enacted. However, the paper is misleading in that it fails to accurately recount the facts and overemphasizes the distinctions between the sales and income taxes in an effort to bolster this opinion. While the paper contains many examples of a willingness to engage in less than objective analysis, three examples deserve special attention: the paper's analysis of the FairTax treatment of charities, housing and education. As indicated above, it appears to be Gale's objective to show that the sales tax is bad because housing, education and charities will be hurt (with disastrous results), and that the Congress will not be able to resist the desire to benefit these industries, which will raise the rate. However, these industries are actually helped, not hurt by the FairTax and perhaps Gale would have himself arrived at this conclusion had he engaged in a more objective analysis of the subject matter.

<u>Housing</u>. Let us take housing as the first example. Yes, the sales tax eliminates the mortgage interest deduction, but these deductions would not "disappear", as Gale asserts, in a negative sense. They could not exist in the sales tax world since there would be no income against which the deduction could be applied. They would simply not be needed.

Rather than disappearing, they reappear in a different form: the non-taxation of mortgage interest. In an income tax, the mortgage interest deduction is provided only to ensure interest payments are made against pre-<u>income</u> tax dollars. This not only benefits those seeking to purchase a home, but those who are fortunate enough to have equity in a home and to use the monies loaned against that equity to personal debt – a benefit not available to those who do not have homes and cannot afford them. In many cases, unless one does not have the income to offset, the mortgage interest deduction accomplishes the purpose of offsetting income taxes paid on the mortgage interest. But these payments are also made from after payroll tax dollars, which often comprises a greater portion of the tax liability of the individual, especially lower income individuals.

Under the FairTax plan mortgage interest is simply not taxed at all. Therefore, in the FairTax plan, like current law, mortgage interest is paid out of pre-income-tax dollars; but more to the point, since the FairTax repeals both the payroll taxes and the income taxes – the effect of not taxing interest payments is to ensure that the payments are made with both pre-income and pre-payroll tax dollars. This will significantly advantage home buyers relative to current law by reducing the costs of their loan, often more than 50 percent (since the payroll tax often taxes individuals more than the income tax). In short, under a sales tax, the mortgage interest "deduction" is achieved by neither taxing the income earned nor the mortgage interest at all. Of course, one other point deserves mention. Since personal interest is also not subject to the sales tax, lower income individuals without home equity can effectively make student loans or other debt consolidation costs "deductible" as well. This adds greater equity.

Despite this glaring oversight, what Gale also fails to tell us is that housing today is not completely out of the tax base. Like other firms, homebuilders pay corporate taxes and payroll taxes, not only on their own accord, but in the form of upstream producer price increases to the extent those are pushed forward. These upstream costs would disappear.

Of course, the biggest fallacy in his assertions is the apparent oversight that today home equity payments are taxed. Like current law, under the FairTax, equity payments would be taxed. Principal payments are not deductible today and they would be subject to the FairTax tomorrow. Moreover, lower income taxpayers often are taxed more today on these equity payments. A taxpayer who is in a 28 percent bracket, and pays a 15.3 percent payroll tax, under the tax-exclusive measurement Gale would like to apply to the FairTax (43.3/56.7), would have to earn $177,000 to purchase a home of $100,000 devoid of the interest. Under the sales tax, at a marginal rate of 23 percent, the same home would cost $130,000 after tax. So, the cost of making equity payments decreases as well under the FairTax.

If we were to provide an "exemption" to newly constructed housing, as Gale suggested politicians would want to do, we would be enacting the equivalent of a deduction today for all equity payments, as if a home were a business expense.

Gale's paper fail to acknowledge two other factors that give the housing industry preferential treatment under the FairTax. First, new buyers can save for a new home faster, since savings are untaxed. This means that new buyers will be able to qualify for a mortgage faster. If they own an existing home, like 70 percent of buyers of new homes, they will enjoy an increase in their net asset value. This is easily contrasted with current law. First, wage and salary income is included in the income tax base when it is earned originally. If that income is consumed, the benefits of consumption go untaxed. However, if wages and salaries are saved or invested, the benefits — the earnings — are taxed again and again and sometimes again still. Then, if an income-producing asset, such as a stock or bond, equipment or real estate is sold for more than it was purchased, the benefit of the capital investment — the capital gain — is taxed a third time. Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Inter-corporate dividends are also subject to tax, creating yet another level of taxation. Another difference between a sales tax and an income tax, therefore, is that the downpayment can be saved without fighting against the double or triple tax on savings.

Second, most of the studies indicate that home mortgage interest rates will fall by 25 to 30 percent (i.e., about two points on a 30 year conventional mortgage). Current mortgage interest rates include a tax premium. This can be seen by comparing the interest rates on taxable bonds to tax-exempt municipal bonds of comparable risk and term. The difference is about 30 percent. This decline will occur entirely because of the elimination of the tax wedge or premium on interest and will happen independently of the impact of the sales tax on savings and investment.

Research by Harvard economist Dale Jorgenson shows that producer prices will fall 20 to 35 percent under the FairTax plan since the income tax and payroll tax is embedded in the price of everything we buy. In this case, new housing prices will be approximately the same price including the sales tax as they are today and the relative price of new and used housing will remain roughly comparable to what they are today. If Jorgenson is wrong and the sales tax causes prices to rise, then existing home prices will rise immediately to reflect the fact that they are not subject to tax. Although this would result in a one-time, quick windfall gain to owners of existing houses, the relative price of new and old homes will be comparable.

<u>Charities</u>: Gale is somewhat duplicitous in his reasoning about charities, and concludes, "the net impact … is unclear." Gale nonetheless leaves one with the distinct impression that if he can't provide the evidence, he will still provide the assertion that charities will still be hurt. But studies that show charitable giving will be hurt (funded by the largest non-profit that have existing donors) fail to explain two factors. First, many of these studies assume that the higher the tax on income or testamentary transfers, the higher the level of giving. Following this logic, charities would do very well under death taxes at 90% or income taxes at that level. But there are two problems with this analysis.

First, empirical evidence shows that charitable giving is motivated more by resources available to the donor than to the level of tax savings. After the 1986 TRA, charitable giving increased rather than decreased, despite lowering of marginal income and transfer tax rates. Sine the FairTax would not interpose a tax before the decision to give has been made, all business and individuals would have more resources to contribute.

Second, if charitable giving is truly motivated by the charitable deduction, then to the extent it is, it is not motivated by benevolence, but cross-subsidization by all other, typically middle income taxpayers.

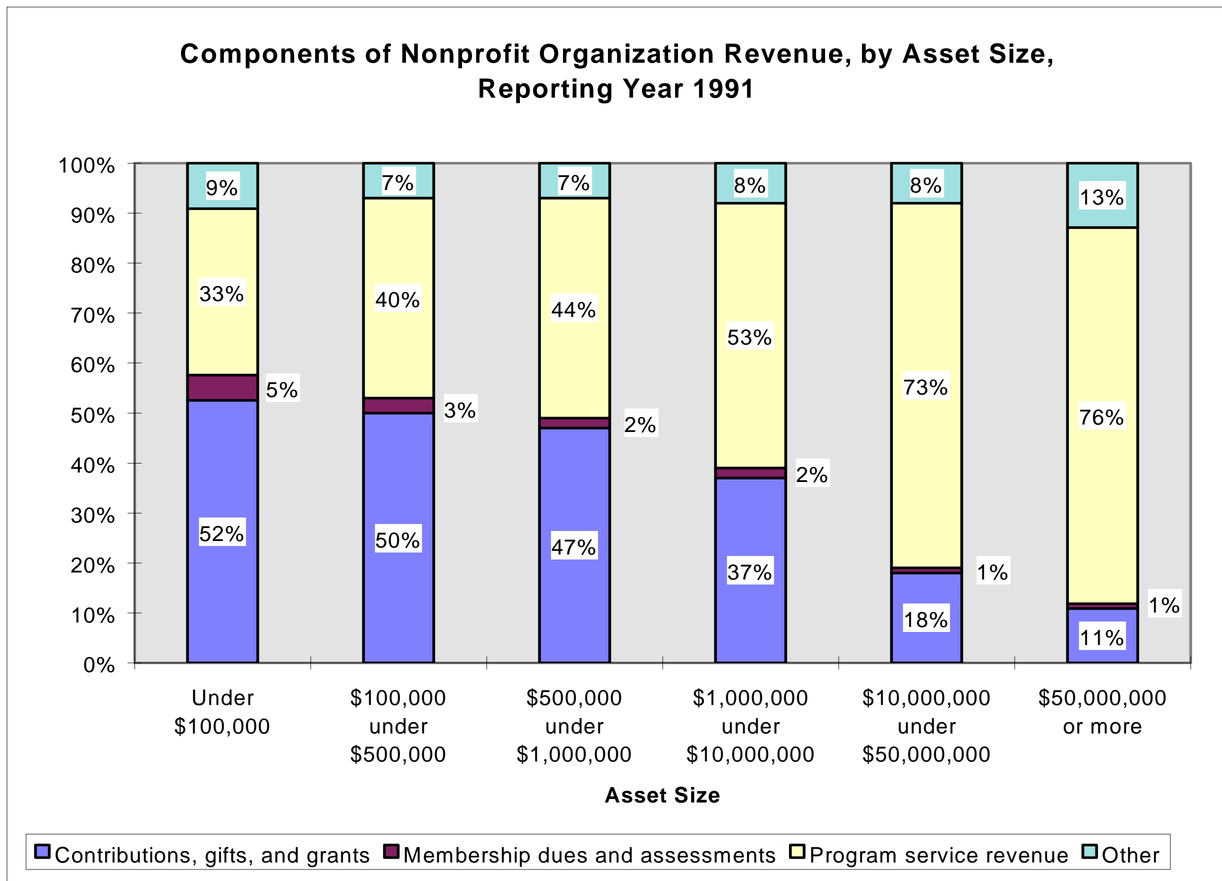
Third, Gale again overlooks the fact the charitable giving deduction is maintained under the FairTax in the same effective way that the mortgage interest deduction is effectively maintained under the FairTax. Like the mortgage interest deduction, the charitable contribution deduction is designed to make contributions pre-income tax. However, such contributions are likewise not taxed by the sales tax. Consequently, they are made effectively with pre-income and pre-payroll tax dollars. That they are made with pre-payroll tax dollars under the FairTax, is an added benefit to the charities; in fact, a far greater benefit than would result from income tax relief alone. This relative advantage is further enhanced because charitable deductions are made deductible today only for itemizers. According to the 1994 SOI, only 33 million taxpayers

itemized and 81 million did not itemize. And, one more point along this vein deserves mention. The charitable deduction is limited for itemizers as well under current law – no such limitations apply under the FairTax.

Finally, it is important to point out that the effect on charities of the itemized deduction is itself somewhat suspect. While churches rely on charitable donations, they are somewhat impervious to the tax motivation. Other charities, universities and museums, for example, rely little on traditional donative sources of giving today.

While there are about 1.3 million non-profit, only a relatively small proportion account for the vast assets holdings and income activity. For example, organizations with assets of $50 million or more accounted for < 2 percent of all the 501(c)(3) returns filed, but represented more than 70 percent of the total asset holdings. Moreover, contributions, gifts and grants as a percentage of total revenue decrease with organization size.

For example, organizations with assets of $50 million and above relied on contributions, gifts and grants for only 11 percent or their income in 1991. This can be contrasted with organizations with under $100,000 in assets, which relied on gifts grants and other contributions for 52 percent of their revenue. The $50 million asset group derived 76 percent of their income from "program service revenue" as opposed to 33 percent of the $100,000 asset class organizations. There is a steady increase in reliance on "program service revenue" as the size of the nonprofit, measured by asset holding or gross income, increases. Alternatively stated, the Nation's largest non-profit disproportionately rely on commercial as opposed to donative sources of revenue. The charitable contribution is therefore of limited effect on funding sources today.



<u>Education</u>: While volunteering that education will be hurt, Gale does not offer any reason as to why. On the contrary, education is not taxed under the FairTax and is treated far more favorably than under current law. That is because the FairTax, as a philosophical point, recognizes that education is an investment in the future of our Nation's intellectual capital stock. It permits an effective "deduction" for all education expenditures.

Let us compare. Today, education and training are paid for, in most part, with after income and payroll tax dollars, as is the interest on debt obligations to fund that education; and the savings are also taxed. For instance, a student saving for college with a summer job, who is lucky enough to make $20,000 will be taxed at a combined payroll and income tax marginal rate of 30.3% tax inclusive, or about a 43% tax exclusive rate (again, the uncommon measurement by which Gale prefers to measure the FairTax). In order for that student to save enough to afford $5,000 tuition costs, that student will need to earn and save $7,150. Under certain limited circumstances, such as the student's parents are wealthy enough, there is a temporary tuition credit.

Now let us contrast this with the FairTax that Gale says disadvantages education. Under the FairTax, that same student would need to earn and save only $5,000 to afford $5,000 in tuition

costs. And if the student needs to pay interest, that interest will not be taxed to the student (he will not make payments with after tax dollars). Like charitable contributions and mortgage interest these payments will be effectively made with both pre-income and pre-payroll tax dollars today. The student will not only pay less for education, but will be able to save the necessary funds much faster than under current law. Of course, if someone wanted to give the student a gift, there would be no gift tax that would apply.

L. Gail Perspective: The Sales Tax Advocates Incorrectly Tout Their Plan As Capturing the Underground Economy

Gale: One of the major claims of sales tax advocates is that the NRST would … raise revenue from the underground economy. The classic example … frequently offered is that of a drug dealer who currently does not pay income tax…, but would be forced to pay sales taxes … if he took the funds and bought.. a Mercedes. The problem with this argument is laid out by Armey (1995). 'If there is an income tax in place, he … won't report his income. If there is a sales tax in place, he won't collect taxes from his customers and send the taxes to government. In the end, neither system taxes the drug trade. …' {then an example by Gale which merely tries to make the point} [M]ost analysts agree with Murray (1996)(that shifting t an NRST would generate little change in the revenues collected from taxing the undergone economy. (Policy Paper 2/17/98, page. 25-26)."

This statement is obviously intended to build up a straw man, and knock him down; however, there are three problems with the statement. First, most sales tax advocates do not make this claim. The FairTax certainly does not. Second, if they do make this claim, it is not a "major claim." And last, both claims – that the sales tax utterly fails and that the sales tax fully captures the underground economy – are hyperbole.

No, the FairTax won't tax drug sales any more than the income tax causes drug dealers to pay income taxes on the sales. But neither does this mean the sales and income taxes are a wash in taxing criminal activity, for example, on the $57 billion cocaine and heroin trade.

First, some, and by some data much, of the income used to buy illicit drugs was never taxed to begin with since theft was involved. An unemployed person is twice as likely to be a drug user as a person employed, under the HHS data. Under an income tax situation, let's assume that 'x' buys heroin from 'y.' The chances are high that 'y' won't file returns and therefore will avoid reporting even legitimate income as he launders the proceeds. Drug dealers typically fail to file tax returns in order to avoid the commission of a felony (evasion, section 7601) as opposed to a misdemeanor (failure to file). By dropping out of the system, they report no income, not even legitimate income that year or in the future; even though they are profligate consumers of fancy clothing, food, jewelry and cars on which they would pay the sales tax. 'x' also paid no income taxes on his stolen items. At best, in a sales tax, 'y' is captured when he buys the Mercedes. The FairTax at least captures the income once.

And if he seeks to go down this road, the paper should also point out that the drug dealer is likely in a higher tax bracket than the drug purchaser. Therefore, the income tax would in fact result in a higher loss of revenues under the income vs. the sales tax.

But perhaps more importantly, the same logic outlined above applies to the vast array of other activities in the underground economy, particularly, simple theft. A thief is hardly likely to declare income on the fruits of his "labor," stolen items; but he is also unlikely to declare income again when sold. There were then two separate income tax defalcations. Under the FairTax, he is taxed when he uses the proceeds to buy legal goods and services from the economy. He is at least captured once. And there is certainly another area that would be captured – non-filers of the income tax.

M. Gail Perspective: The Sales Tax Was Tried in Europe and Failed Because it Could not be Complied With

Gale: Many other countries have attempted to implement a retail sales tax, or variants of sales taxes…. Almost all these countries have ended up with value-added taxes. The general lesson … is fairly clear. In 1967, 19 OECD countries had some form of … retail … tax. By 1995, all 19 of these countries had converted to value-added taxes. … Only Iceland, Norway, South Africa, Sweden and Zimbabwe have operated retail sales taxes at rates over 10 percent. All of those countries except Zimbabwe have replaced those RSTs with a VAT. The OECD has stated that Governments have gone on record as saying that a RST of more than 10 to 12 percent is too fragile to tax evasion possibilities, and it is probably not entirely accidental that in OECD countries VAT rate are nearly always above 12 percent, and that except in Canada and Iceland RST rates have always been well below 12 percent. … The general view ... is that 10 percent may well be the maximum rate feasible under an RST… There are good reasons for why RSTs get replaced with VATs; namely cascading and evasion. Cascading occurs when taxed inputs are used to produce taxed outputs. …(Policy Paper, 2/17/98, page 26-27).

A common misconception, and one adopted here by Gale, is that retail sales taxes, let alone anything that resembles the FairTax, were tried in Europe and failed. This was asserted by Bruce Bartlett as well in an effort to discredit the FairTax. However, it is simply received wisdom and a historical inaccuracy.

To be gracious, the genesis of this misperception must lie in the fact that European VATs and cascading turnover taxes that preceded them were commonly referred to, under European colloquialism, as "sales taxes." In truth, however, most European states have never had a sales tax like we know them in the U.S. And none have had sales taxes like the FairTax. The FairTax plan, as Gale knows, does not tax business inputs and therefore avoids cascading.

Why did the European cascading turnover taxes (misnamed "sales" taxes by Gale) become VATs? A VAT of the additive type was first advocated in Germany in 1919. In 1948, France transformed its production tax into a VAT. France then persuaded the 5 other EC member states to adopt the VAT in order to harmonize their system of indirect taxation. The EC unanimously adopted a VAT under the Treaty of Rome as a condition of acceptance into the Community. The

6th Directive of the EC made it a mandatory requirement for admission. And in the two decades that followed, through this persuasive force, 17 of 24 OECD countries adopted a destination-based consumption tax (VAT). These VATs have also been promiscuously but misleadingly, referred to as "sales taxes." Interestingly, even staunch advocates of the flat tax, which is a VAT, argue that sales taxes are bad because they have reverted to VATs (Bruce Bartlett). One would think, if this were true, flat tax supporters would like the prospect.

The reasons why the EU directed that Members and prospective members to adopt a VAT, was the influence of Germany and France to end the excessive compliance costs by a lack of uniformity across borders (and a beggar thy neighbor policy of tax incentives). It was also directed by the EU to avoid Europe's punitively cascading turnover taxes, levied on virtually every transaction on every stage of production and distribution with no allowance for tax collected at an earlier stage. The VAT was enacted in order to avoid this cascading in the same manner that the FairTax plan exempts all business inputs from the tax and taxes only final consumption.

In only two instances can EC states really be said to have moved from a "retail" sales tax to a VAT: Sweden and Norway. However, neither country imposed pure retail sales taxes, since they also improperly taxed producer goods rather than final consumption. Their evolution into VATs was also not caused by compliance concerns. In fact, Norway's Federation of Labor and Association of Civil Servants argued that the enforceability of a RST would be far superior to the VAT, and had it not been for the requirement that European states adopt a VAT as a condition of entry into the EU, Norway might still have a retail sales tax. Vito Tanzi's observation was merely a passing reference in an OECD working paper and was not based on empirical evidence to our knowledge. Of course, it could not have been, given the historical fact that the European Nations did not have a RST to replace.

N. Gale's Perspective: The Sales Tax Will Not Be Adminstrable Because Evasion Will Skyrocket

Evasion is higher in an RST than a VAT for several reasons. First, retailing is the weakest enforcement link in the entire production chain. Second, if a retailer evades the tax, the full tax liability on the sale is lost under an RST, but on the tax on value added at the retail level is lost under a VAT. Third, there is no paper trail in a sales tax.... (Policy Paper, 2/17/98, page 26-27). Such high rates raise serious questions about the overall administrability and enforcement of a NRST. ... Consequently, the NRST does not appear to be plausible [or] workable.... Joel Slemrod of the University of Michigan concludes that the tax is "not adminstrable at usual standards of equity and intrusiveness." ...[A] NRST could present plenty of opportunities for avoidance and evasion. To take a few examples, a wealthy household would have more of an opportunity to avoid the tax by traveling abroad, or by doing business as a cover for making individual consumption purchases tax-free, or by combining business and individual consumption. (Policy Paper, 2/17/98, page 43)... Note that the sales tax would feature no withholding and no cross-reporting, so the possibility of high rates of evasion needs to be taken quite seriously. Moreover at rates of 30 percent or more in an NRST, the high rate would make

> *it very attractive to evade. Those with certificates would have considerable incentive and opportunity to use them for nonexempt purchase. So the tax system would need high audit rates and more information collected on the identity of the buyer of exempt goods. …. Sales tax advocates claim that "Under a retail sales tax, only retailers would be in a position to cheat." The problem is that the advocates do not seem to understand incentives for evasion under the sales tax. … [E]xemption certificates could be a huge area of tax evasion. (Position Papers, 2/17/98, page 25).*

In addition, to improperly claiming that the FairTax proposal does not provide room for evasion in its rebate, this discussion is a seriously deficient treatment of an issue well beyond the scope of Gale's paper. First, he fails to account for the fact that much of the failure of taxpayers to comply today is due to confusion over the right answer or to game playing – both of which would be effectively eliminated under the FairTax, where the decisions are simply removed on all non-business taxpayers. For instance, the last TCMP audit showed that forty percent of Americans are not in compliance with the income tax, and it also gave the reasons. A principal reason: taxpayers lacked the requisite knowledge of the tax law.

This discussion is also deficient because it fails to take into account that virtually every factor that academicians believe influences evasion, is lessened under the FairTax. If Gale is going to conclude that compliance will be worse he must explain why the magnitude of all the known factors that influence evasion are reduced under the FairTax.

For example, one of these factors is, quite simply, the number of taxpayers. The number of business taxpayers is about 25 million today and the number of retailers, significantly less. Today, there are about 211 million total returns filed. Even if every business sold at retail, the focal points for enforcement activity would be about 80 percent of what they are today. Moreover, according to the IRS, individuals account for $94 billion of the $127 billion tax gap and corporations for $33 billion. Individuals will be taken entirely out of the tax system, except for those who falsely claim they are operating a business. However, the same problem exists today.

The necessary corollary of the tax collection point being concentrated on retail establishments and purchasers (mostly small firms that have the opportunity to falsely characterize personal expenses as business) rather than with individuals and all businesses is that there are far fewer points where revenue agents must concentrate their enforcement efforts. The collection points in a national sales tax system would be perhaps 10 percent of those under the current income tax system or other alternative tax systems. Because the number of collection points is so much lower, if enforcement funding is held equal then the audit rate for potential evaders would increase considerably and the likelihood of apprehension and the perception of risk are correspondingly higher. In other words, the risk of detection would increase and risk adjusted cost of evasion would increase.

Small businesses are viewed as more likely to evade taxes since the owner, and beneficiary of tax evasion, is more likely to also be responsible for keeping the books and filing the tax returns.

There is, of course, some truth to this proposition. A number of factors, however, reduce the importance of this consideration. First, those small business persons that are inclined to cheat on their sales tax are probably already cheating on their income tax and would be inclined to do so under any tax system. Under any system we adopt, firms, both large and small, must determine if the item is business input or not. Second, the economic importance of small firms in the retail sector is usually grossly overstated. According to the Joint Committee on Taxation (JCT), small firms only account for 14.9 percent of gross receipts by all retailers, wholesalers and service providers.[18] Since the gross receipts of wholesalers would not typically be subject to tax, the true scope of the small "problem" companies is smaller still.

Share of Total Gross Receipt by Firms with less than $1 million of Gross Receipts[19]
($ Millions, 1993)

Industry	Entity Type	Firm Sales Under $1 mil.	Firm Sales All Firms	Small Share Percent
Retail and Wholesales Trade	C Corp.	116,929	2,663,541	4.4%
Services	C Corp.	91,383	610,438	15.0
Retail and Wholesales Trade	S Corp.	358,566	959,501	37.4
Services	S Corp.	98,721	283,680	34.8
Retail and Wholesales Trade	Partnership	22,938	112,112	20.5
Services	Partnership	30,783	187,588	16.4
Total	Combined	719,319	4,816,860	14.9

Second, the number of opportunities for these fewer taxpayers greatly diminishes under the sales tax. What are the opportunities today? Today, our tax code is riddled with a badlands of 7,000 Code sections, each with a way to overstate deductions or perhaps understate income, to falsely claim a credit or a refund, or to defer taxes, or to shift tax burdens. Most can be done with a plausible denial that the law was broken intentionally. Most of this inordinate complexity is reduced to a present day analysis under one code section -- section 162. Was it an "ordinary and necessary" business expense? As noted, any tax system that does not seek to tax business inputs to avoid cascading must make this essential distinction. But the FairTax need not make the tens of thousands of other distinctions in the Code.

Marginal rates are also important as a factor of evasion, since this sets the reward for cheating. All other things being equal, the motto that "every man has his price" applies to encourage more attempted evasions as the reward increases. Research has confirmed the intuitive relationship between higher marginal tax rates and higher rates of evasion. Lower rates, all other things being

[18] 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.
[19] Ibid.

equal, imply lower evasion because the benefit from evasion declines while the costs of evasion remain comparable. However, because of lower marginal tax rates, the benefit from lawful tax avoidance or illegal tax evasion under the FairTax will be much less at the margin relative to either the present system or competing alternative tax systems, such as the USA Tax[20], that have higher marginal tax rates. And this analysis does not take into consideration avoidance of the costs of compliance, which today falls disproportionately on small firms.

The severity of the penalty is also a factor: but this would be expected to increase. This is not to say that the FairTax would need the array of penalties now in the Code, but rather, that it will become quite transparent that someone is cheating, as opposed to gaming the system. When a retailer fails to pay over trust funds, he does so at great peril and with the knowledge that he is violating the law (i.e. committing evasion). Few excuses apply.

And there is one other important factor influencing evasion that is not mentioned by Gale, the perception of the fairness in a tax system. However, today, cheating is exacerbated by the perception that one's neighbor is not paying his or her fair share. Under the FairTax, as the costs of compliance shrink and the perceived fairness of the tax system increases, some of the hostility to the tax system will decline. People who are in non-compliance because they perceive the present system as unfair or illegitimate may choose to comply with a sales tax.

In sum, Gale's paper should seek to explain how a system with far fewer taxpayers, far fewer opportunities to cheat, far smaller incentives to do so, and a greater chance of getting caught, will be less complied with.

Furthermore, to correctly evaluate evasion potential, Gale should not merely mention Slemrod's observation that compliance is relative to intrusiveness and equity or asserts that the sales tax could simply not be complied with under normal standards of intrusiveness and equity. He should instead elucidate two factors: (1) what is compliance standard today and (2) what is the normal standard of intrusiveness and equity. True enough, evasion is relative to intrusiveness and equity as it is relative to many other factors, such as those mentioned above. However, the paper should not have neglected to point out, for example, that under the income tax, tax evasion is a major, continuing and perhaps terminal problem. Moreover, our Nation could not have developed a system that is more intrusive into the lives of its citizens than the income tax. Today, compliance and intrusiveness are at a nadir.

[20] The USA Tax has a top marginal tax rate of 40 percent (actually an effective rate of 32.35 once the payroll tax credit is considered) that takes effect at relatively low taxable income levels ($24,000 for joint returns and $14,400 for single persons). The marginal tax rate under the flat tax (payroll tax inclusive) is higher than under either the FairTax plan or the Schaefer-Tauzin plan (payroll tax inclusive) because of the higher standard deduction and personal exemptions. For example, even assuming a flat tax rate of 17 percent (which most do not regard as revenue neutral in the short or intermediate term) 17 percent plus the 15.3 percent payroll tax yields a marginal tax rate of 32.3 percent until the Social Security wage base is reached and 19.9 percent thereafter (including the 2.9 percent Medicare tax). At a 20 percent flat tax rate (the beginning rate under the Armey plan), the *lowest* marginal tax rate is 22.9 percent which is the same as the FairTax rate of 23 percent and 35.3 percent for most middle class wage-earners.

Notwithstanding a much larger Internal Revenue Service (IRS), more burdensome information reporting requirements (1 billion information returns), increasing stiff and numerous penalties and a host of legislative initiatives, compliance is getting worse. Based on IRS figures, tax evasion has increased by 67 percent during the past 11 years. As a percentage of Gross Domestic Product (GDP), tax evasion has reached 2.0 percent compared to 1.6 percent in 1991, a 67 percent increase. Taxes evaded continue to be in the range of 22 to 23 percent of income taxes collected. These IRS figures do not include taxes lost on illegal sources of income.

The income tax is collected with a heavy hand. In 1995, the IRS assessed over 34 million civil penalties on American taxpayers in an effort to force compliance with the tax system. Of these, about 4.1 million were forgiven. 22.1 millions penalties involved the income tax and 10.6 million involved the payroll tax, taxes which the FairTax would replace.

In its most recent report on the tax gap, the General Accounting Office stated:

> *Almost every year since 1981 has witnessed legislation to address tax gap issues. These legislative actions generally required information returns reporting on income and deductions, imposed penalties for tax noncompliance, or reduced the opportunity for noncompliance by eliminating certain tax write-offs. IRS estimated that some of these provisions resulted in additional 1990 tax revenue of $3.4 billion. Even so, the IRS' estimated tax gap increased $50.7 billion in current dollars from tax years 1981 to 1992. However, the growth of the gap could have been higher without these legislative actions.*

Relative Magnitude of Tax Evasion Under the Income Tax 1981-1992[21]
Using Internal Revenue Service Estimates

	1981	1992
Total tax gap (Real 1992 $ millions)	$75,966	$127,129
As Percentage of Income Taxes Collected	23.3%[22]	22.0%
As Percentage of Gross Domestic Product	1.6%	2.0%
Annual Growth Rate (1981-1992)		6.1[23]

Tax evasion will undoubtedly be a problem under any tax system. It is a major *and growing* problem under the current tax system, despite very substantial efforts and increasingly harsh treatment of the taxpaying public. The Brookings Institute could best add to this debate by helping to develop the needed safeguards to ensure compliance with minimal compliance cost under the FairTax.

II. Lesser Points

[21] GAO, Supra.
[22] Calculating real taxes using the GDP deflator.
[23] 4.68 percent using a continuously compounding grow rate.

Gale states that "State sales taxes only tax about half of all consumption. That finding, combined with the fact that 20 to 40 percent of the revenues they do raise come from business purchases, makes it difficult to characterize state sales taxes as consumption taxes." (Policy Paper, 2/17/98, page 12). Since the adjusted gross income under the current income tax is only 67 percent of personal income and taxable income much less still, then presumably it would also be "difficult to characterize" the income tax as an income tax.

Referring to a burden to retailers, Gale says, "several problems arise." One is the need to verify that taxes were remitted appropriately by retailers. This would require record-keeping by, and auditing of, all business." (Policy Paper, 2/17/98, page 22). Gale's concern for businesses compliance costs under the sales tax is curious in that he seems utterly unaware of the huge burden that the present system imposes on business. The sales tax would require little more record keeping than any business has to keep in the ordinary course of business, *to wit*, its gross receipts. It would require vastly less record keeping than the present tax system. Businesses would have to fill out a simple monthly form reporting their sales and remitting their taxes. There would be no more uniform inventory capitalization requirements, no more complex rules governing employee benefits and retirement plans, no more tax depreciation schedules, no more capital gains tax and depreciation recapture, no more alternative minimum tax, no more payroll and income tax withholding requirements, no more 1099s, W-2s and the like, and no more tax rules governing mergers and acquisitions, no more complex international tax provisions. Firm's accounting, tax and personnel (human resources) departments will shrink dramatically. The Tax Foundation has estimated that compliance costs would drop more than 90 percent.

Gale expresses concern that businesses will conspire to reduce the prices at which they report business to business transactions (Policy Paper, 2/17/98, page 23). This is difficult to understand since business to business transactions are not relevant to the tax due under a sales tax regime. To express such a concern Gale must simply not understand the proposal or is confusing it with current law, where immense problems exist in intercompany transfer pricing rules under Section 482.

Gale expresses concern that consumer to consumer sales will not be reported (Policy Paper, 2/17/98, page 23.) Under the FairTax, consumer to consumer sales are exempt since used property (e.g. cars, homes) is not subject to tax. Only newly produced property is subject to tax. Only when a business first sells a good or service to consumers, would the good would be taxed. He further states that compliance will decline since "third party" withholding will no longer occur. (Policy Paper, 2/17/98, page 24). Gale is referring primarily to an employer withholding taxes from an employee. It is not, therefore, truly third party withholding in the sense of withholding by a party not a party to the transaction but simply withholding by payors such as employers or financial institutions. The *entire* sales tax is such a withholding system. When a consumer goes to WalMart or McDonalds or Sears, the sales tax will be "withheld" at the cash register.

Gale mentions a Florida study which estimated that about 5 percent of business purchases involved abuse or misuse (Policy Paper, 2/17/98, page 25). What he fails to mention is that the

Florida sales tax wrongfully taxes a huge proportion of business inputs, including capital equipment.

Gale asserts that there is no paper trail in a sales tax for an audit (Policy Paper, 2/17/98, page 26). Most sales tax audits are followed on a paper trail today. It is your sales and accounts receivable records (for the sales side) and your accounts payable and expense records (for the business inputs that are subject to tax in many state sales taxes). These are records kept in the ordinary course of any business and must be maintained under the FairTax plan.

Gale questions whether states could administer the national sales tax (Policy Paper, 2/17/98, page 27). First, it is much more likely that states would do a better job than the IRS since states have experience with sales taxes and federal civil servants do not. In his paper presented at the Annual State and Local Taxation Conference, New York University[24] Ernest J. Dronenburg, Jr. states that, "State governments…have had as much as sixty (60) years of experience in the administration of a state sales taxes.

Dronenburg goes on to state that "The state governments do have experience administering a federal tax program. Currently, both the state and federal governments administer the unemployment tax system in this nation. Under the Federal Unemployment Tax Act (FUTA), the federal government has mandated that each state shall administer an unemployment program for the federal government. The federal government has contracted and paid each state to administer the unemployment program for over sixty (60) years. The states administer the program by processing state unemployment tax returns completed by businesses, collecting the unemployment tax revenue, auditing the tax returns, and conducting unemployment tax appeals. The unemployment tax collected by the states is deposited into a federal trust fund from which unemployment benefits are paid.

Other authors on the issue have stated that state governments have existing structures already set up for the administration of consumption taxes on which a Federal consumption tax could piggyback. In addition, many of the states administer and collect local, county, and state excise taxes.[25] If we look to foreign examples regarding this issue, we find that in Canada, Quebec administers the federal GST successfully and in Germany the Lander successfully administer the federal VAT.

Gale states that "Sales tax advocates claim they could eliminate the IRS and Tauzin has written that there would be no more IRS audits under an NRST (Policy Paper, 2/17/98, page 28). He

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[24] ASFCT: State Administered Federal Consumption Tax: The Case For State Administration Of A Federal Tax, Ernest J. Dronenburg, Jr., New York University Annual State and Local Taxation Conference, November 30, 1995.Ernest J. Dronenburg, Jr. the Vice Chairman of the California State Board of Equalization, was first elected in 1978, and now is serving his firth term as a Member of the Board. The Third district, which he represents, includes over 8 million people and most of southern California. He is now the senior elected constitutional officer in the entire state. Considered as expert in the areas of state and local taxation, Dronenburg has written, testified, and lectured extensively on matters of tax policy and theory, nationally and internationally.

[25] John F. Due, "The Case For The Use of The Retail Form of Sales Tax in Preference to The Value-Added Tax" (Baltimore and London: The Johns Hopkins University Press, 1983), p206-207.

then asserts that "These claims are sufficiently ludicrous not to merit a response…" The only problem with his opinion is that Tauzin is right with respect to the vast majority of Americans who are not in business for themselves. Individuals would never again have to face the prospect of an IRS audit. Businesses would face simplified audits. In addition, the IRS would be eliminated. Most states, given the strong incentives in the FairTax plan, would choose to administer the federal sales tax rather than forgo the benefits of being part of a national system, collecting for the first time tax on mail order sales into their state, collecting a fee and achieving the benefit for their local business community of a coordinated federal and state sales tax. Moreover, if the state didn't choose to administer the tax, then the federal sales tax authority would administer the tax directly.

Gale claims that supporters of the FairTax, Americans for Fair Taxation, have claimed its rate estimate had been "audited by several different institutions" and terms that claim ridiculous. We have never used the term "audited" with rate determination, but it is a fact that the FairTax rate has been corroborated or confirmed or agreed with by many leading economists at the finest universities and institutions. For example, Dale Jorgenson (Harvard), Jim Poterba (MIT), Laurence Kotlikoff (Boston University), Joe Kahn (Stanford) as well as the Heritage Foundation, Fiscal Associates and the Cato Institute. Yet Gale has based his claim of the need for a sales tax rate based on the FairTax proposal of as high as 67 percent on absolutely no authority whatsoever.

Gale states that it is ironic that FairTax supporters view the sales tax base as (slightly) more stable than the income tax base (Policy Paper, 2/17/98, page 40). Indeed, it is an advantage for the government to have a stable revenue source. Gale seems to be entranced by the auto stabilizing aspect of the income tax. This is undoubtedly a function of the Keynsian view that deficit spending is the way to fine tune the economy. It would be easy to inject Keynsian-style stimulus into the economy under a sales tax by either increasing government spending or cutting the sales tax rate to run a deficit.

Gale states that it is "Misleading to compare an NRST that exists only on paper to a tax system – like the current one – that has survived the political process (Policy Paper, 2/17/98, page 43). In other words, according to Gale, the very integrity of the FairTax proposal and other tax reform proponents is in doubt by the very act of proposing tax reform. Is Gale arguing that we should propose bad tax reform so that it will be a "fair" comparison with the present bad tax system?

Gale claims that the sales tax would "boost the price of existing homes relative to new homes" and then two paragraphs later, he is talking as if housing prices will fall 5-15 percent (Policy Paper, 2/17/98, page 50). Which is it?

III. Other Inaccuracies

There are many inaccuracies in Gale's paper, many more than can be examined here, but in the interest of setting the record straight so that Gale may attempt a more accurate analysis, a few are corrected below.

Gale states that the sales tax taxes "all single-family homes as if they were owner-occupied." (Policy Paper, 2/17/98, page 13). This is not the case. A home that was purchased as an investment and rented out would not be taxed but the rent would be.

Gale says that the Schaefer-Tauzin bill would repeal all excise taxes (Policy Paper, 2/17/98, page 6). That bill would repeal only non-trust fund excise taxes so, notably, the fuels taxes would remain.

Gale expresses doubt about what aspect of educational expenses are treated as exempt human capital investments (Policy Paper, 2/17/98, page 14). Both the FairTax plan and Schaefer-Tauzin are clear: tuition and job training courses only are exempt.

Gale expresses concern about incentives for financial institutions to take risks (Policy Paper, 2/17/98, page 15). The FairTax plan and H.R. 2001 provide a credit for bad debts actually experienced. An interest rate may be viewed as having three components. First, the normal, risk-free return to capital.[26] The normal return can, in turn, be divided into the real return and the inflation premium which combined are the nominal return.[27] Second, the interest rate includes a risk premium to compensate the lender for the risk of default...[28] Third, the interest rate includes a payment to the financial institution for the financial intermediation services it provides. It is only this last component that should be taxed and only when sold to consumers.

A bank is compensated for holding itself out in the banking business, taking deposits, conducting credit reviews, doing the required paperwork and the like. They act as "intermediaries" between depositors (and other capital providers[29]) and borrowers. Providing these services is costly and the services are valuable to both depositors and borrowers.

Typically, banks do not charge explicitly for the financial intermediation services they provide. Instead, they implicitly charge depositors (especially checking account depositors) by paying a lower rate of interest and charge borrowers an interest rate that is higher than the sum of the normal return to capital and the risk premium.

To be neutral between types of consumption, a sales tax should tax all goods and services purchased for final consumption, including financial intermediation services.[30] It should not

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[26] This may be viewed as the pure time value of money.

[27] In practice, U.S. Treasury securities are a reasonable proxy for the risk free return to capital. Since the recent advent of indexed Treasury bonds, it has been possible to reliably differentiate the nominal and real returns.

[28] In a competitive capital market, the risk premium on a loan or similar class of loans will equal the present discounted value of expected costs of default expressed as a ratio of the expected costs to the outstanding loan balances.

[29] Including preferred and common stockholders and lenders to the bank.

[30] The National Income Product Accounts (NIPA) puts financial intermediation services purchased by consumers at $293 billion which corresponds to a tax inclusive (pre-tax) base of $380 billion. This figure includes investment counseling, brokerage fees, bank service charges, trust services, imputed bank service charges and the expenses of handling life insurance. See Table 2.4 of National Income and Product Accounts, Survey of Current Business, August 1996, p. 30. The total sales tax base is about $5.98 trillion. Thus, financial intermediation services account for about 6.4 percent of the total base. According to NIPA, financial services industries account for about 20

matter whether the financial intermediation services were explicitly charged or implicitly charged to the customer. For example, a bank could charge a customer a monthly fee (or fees per transaction) for his checking account and provide a market rate of interest on the deposits, or the bank can pay a lower rate of interest and charge no explicit fee. The service provided is the same in either case and the tax imposed on the service should not, in principle, be different depending on the mechanism employed by the bank to charge for the service. The challenge in a sales tax is to accurately measure the implicit charge for the financial intermediation service without taxing either the normal return to capital or the risk premium components of the interest rate.

The FairTax plan accurately taxes only financial intermediation by reducing the taxable payment by the risk free return to capital and by providing a credit for bad debts actually incurred. Thus, a financial institution must incur actual losses to get the credit. They will never profit from taking a loss. If the loan is subsequently repaid, the proceeds are taxable.

Gale has made an erroneous analysis of how not-for-profit institutions are treated under the sales tax (Policy Paper, 2/17/98, page 15). Sales by not-for-profit institutions are taxed as if they were a business, period. Dues and contributions to not-for-profits are not taxed. For example, a contribution to a church is not treated as the purchase of religious services. As under current law, contributions for which you receive a product or service in return are taxable at the fair market value of the product or service provided in return for the contributions. These are really disguised sales.

Gale has misunderstood the treatment of foreign travel (Policy Paper 2/17/98, page 15). Under the FairTax proposal, half of the cost of foreign travel originating or terminating in the United States is taxed.

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percent of corporate profits (excluding the federal reserve). A large proportion of the profits of the financial services industries comes from business to business transactions.