A FairTax® whitepaper

The impact of the FairTax on American manufacturing, agriculture, trade, and international competitiveness

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll taxes with an integrated approach including a progressive national retail sales tax, a rebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar revenue neutrality, and through companion legislation, the repeal of the 16th Amendment.

The FairTax plan reduces the cost of American manufacturing and agriculture considerably. Under the FairTax, American manufactured or grown goods and services no longer enter the marketplace burdened with hidden corporate taxes, the cost of compliance with such taxes, and Social Security employee matching. This amounts to an average cost reduction from 12 percent to in some cases more than 25 percent. Said another way, American goods become 12 to 25 percent more competitive.

This nonpartisan legislation (HR 25 / S122) abolishes all federal personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes and replaces them all with one simple, visible, federal retail sales tax – collected by existing state sales tax authorities. The FairTax taxes us only on what we choose to spend, not on what we earn. It is a tax on wealth, not wages. It does not raise any more or less revenue; it is designed to be revenue neutral.

How do U.S. goods incur federal taxes today, while imported goods do not?
Let's buy a bottle of California wine. Or a Boeing 787. Or some Kansas wheat. Or a Caterpillar D11T dozer. Or some consulting services from PricewaterhouseCoopers. While your invoice will not show it, included in the cost you'll pay is your share of each provider's corporate income taxes. And you'll pay for the tax department, accounting firms, and law firms that figure those taxes and defend the audits or lobby tax-law loopholes. While the taxes themselves can go below zero in a bad year, those compliance costs just keep on toting up. And then there is the matching of each employee's Social Security contribution.

In the price you pay are all three costs (taxes/compliance/matching) for the company that provides the glass bottles containing the wine. And the cork provider. And the label printer. And the label ink supplier. And the label glue manufacturer. And the tires on the 737. And the fertilizer for the wheat. And the paint on the dozer. And the Iphones and Ipads carried by your PricewaterhouseCoopers consultants.

Whether these products and services are provided here in the U.S. or exported, the purchaser is going to pay all of these costs, along with the actual cost of the product, its marketing, and delivery.

Why do American companies move offshore? Antipatriotism or to meet shareholder demand for competitive returns in an ever-less-forgiving world?

Further exacerbating this crippling tax burden on American producers is the fact that U.S. corporate taxes are the highest in the industrialized world, with a top corporate rate about nine percentage points higher than the OECD[1] average.[2] These taxes also rank among the most complex and least stable or predictable, thanks to the incessant work of an army of lobbyists. This drives huge and ever-increasing compliance costs. To the extent that these corporate and payroll taxes and compliance costs imposed on producers and workers have forward incidence (econospeak for "the consumer pays") and remain embedded in producer prices, relative prices of goods and services go up in the global marketplace. The only alternative left to producers is to make dispassionate decisions about where to produce or invest. That all too often means moving offshore.

Now let's buy some French champagne.

Or an Airbus A300. Or some Argentinean wheat. Or a Komatsu D21A-7 dozer. Or some consulting from France's SOFRECO. While your invoice as a U.S. purchaser will not show it, these providers incurred value-added taxation (VAT) all along the way, *which was rebated upon export*. Local users pay these hidden taxes; as a U.S. recipient, you do not. When such products arrive here in the U.S., their prices *do not include any country-of-origin taxes*. There are compliance costs. Sitting side by side, the hidden hand of Uncle Sam raises the price of American goods worldwide, while goods imported into our country bear no such burden from their governments.

It is estimated that border-adjustable tax regimes – virtually the entire world outside of the U.S. – effectively grant their producers an 18-percent price advantage over U.S. produced goods, whether competing here or abroad.[3] Since effectively all of our trading partners have such border-adjusting systems, our failure to follow suit results in the equivalent of a self-imposed handicap, stimulating international outsourcing, encouraging plant relocations offshore, and lowering the wages of remaining American workers. A recent report by MIT Professor of Economics Jerry Hausman states that the U.S.'s failure to recognize and confront this problem costs us more than $100 billion in exports annually.[4]

Border-adjustable taxes are consumption taxes that are removed/rebated upon the export of goods from producing nations. Such nations reciprocate when importing, assessing incoming goods

[1] Organisation for Economic Co-operation and Development (www.oecd.org)

[2] Sullivan, Martin A., "On Corporate Tax Reform, Europe Surpasses the U.S.," *Tax Notes*, May 29, 2006. If you compute the EU average for each year, you will find that it has declined from 35 percent in 1996 to 26 percent in 2005.

[3] Hartman, David A., "The Urgency of Border-Adjusted Federal Taxation," *Tax Notes*, September 6, 2004. Conversely, in U.S. markets foreign goods bear no U.S. tax and the foreign VAT is forgiven. Thus, among the most manifest violations of neutrality in the U.S. tax system is that it places U.S. producers – including businesses and workers in manufacturing, agriculture, mining, and forestry – at a large competitive disadvantage relative to their foreign competitors both in U.S. markets and in foreign markets. If Professor James R. Hines, Jr. were to add one more neutrality dynamic to the CEN, CIN, NN, CON, and NON, he might add the notion of Export Import Neutrality, which would integrate not only marginal rates of production but whether or not a consumption tax system treats exports and imports alike in the marketplace. Only a destination-based system can achieve such neutrality.

[4] Hausman, Jerry, "Hausman Study Shows Distortions in International Trading System Hurting U.S. Manufacturers: An Economic Analysis of WTO Rules on Border Adjustability of Taxes," May 2006.

with *ad valorem*[5] taxes. Today, 29 of 30 OECD nations have border-adjustable tax regimes; only the U.S does not. By failing to respond, the net effect is the export of both jobs and entire industries.

The FairTax levels the playing field.
Under the FairTax, imported goods and domestically produced goods incur the same U.S. tax. This stands in stark contrast to the present system, where U.S. companies and workers must pay income tax and payroll taxes, but foreign goods enter the U.S. entirely free of any tax, other than whatever modest customs duties are levied.

The FairTax is inherently border adjusted.[6] U.S. exports are not taxed since they are not sold at retail in the U.S., but imports are taxed when sold at retail in the U.S. or when brought into the U.S. by a consumer.[7]

The FairTax is GATT compliant.
Under the General Agreement for Tariffs and Trade (GATT), indirect taxes, such as VATs or the FairTax, may be border adjusted, while a direct tax, such as the U.S. income tax, may not. Since the FairTax is indisputably an indirect tax, this border-adjustment feature poses no difficulty in implementation or legal compliance.

Many observers – and unemployed or underemployed American manufacturing workers – take the position that this border adjustment gives foreign firms a large advantage. Since their goods do not include the full burden of their domestic governments in their prices, while U.S. goods and services do, some consider this unfair, or at least uncompetitive. Most business leaders would agree. Professional economists are divided. Some agree. Some argue that foreign exchange rates change in response to border tax adjustment, and little competitive advantage is provided to imports.[8] The flight of U.S. jobs would appear to provide all-too-real disagreement with this theoretical viewpoint. Others argue that in the short term, imports (i.e., the traded goods sector) gain an advantage that evaporates over time.[9] None argue that failure to reciprocate with a border tax adjustment has an adverse impact on the U.S. manufacturers, farmers, or service providers.

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[5] *ad valorem* - A tax, duty, or fee that varies based on the value of the products, services, or property on which it is levied; a sales tax.

[6] Border adjustment is commonly used to describe a feature of most value-added tax (VAT) systems in use today. Such VATs, unlike retail sales taxes, impose a tax at every stage of production, with each new stage reimbursing the prior for taxes it paid. If retailed within a domestic economy, the full tax buck stops with the end user paying the entire tax burden. However, if exported, such taxes are often rebated to achieve a zero tax rate on exports. This is called border adjustment. Because the FairTax does not impose any tax on goods (or services) not sold at retail, including exported goods, there is no need for a border tax adjustment, though the net effect on prices is similarly positive.

[7] As with domestically produced goods, imported capital goods and other business purchases are not taxed immediately. But the output of goods produced by capital goods is ultimately taxed when consumption goods are produced and sold at retail.

[8] See Feldstein, Martin and Paul Krugman, "International Trade Effects of Value Added Taxation," in *Taxation in the Global Economy*, Assaf Razin and Joel Slemrod, eds., Cambridge, Massachusetts: National Bureau of Economic Research, 1990, pp. 263-282.

[9] Hufbauer, Gary Clyde and Joanna M. Van Rooij, *U.S. Taxation of International Income: Blueprint for Reform*, Washington, D.C.: Institute for International Economics, 1992; Hufbauer, Gary Clyde and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, Washington, D.C.: Institute for International Economics, Policy Analyses in International Economics 43, 1996; Raboy, David G., "International Implications of Value Added Taxes," in *Value Added Tax: Orthodoxy and New Thinking*, Murray Weidenbaum, David G. Raboy, Ernest S. Christian, Jr., eds., St. Louis, Missouri: Center for Study of American Business/Kluwer, 1989, pp. 131-162.

Interest rates and currency trading are the significant factors in exchange rates; increased demand for American goods and services is not.

There are many things that affect foreign exchange rates. Expectations about interest rates and inflation rates in the two countries are the most important. The magnitude of currency traded by banks, other financial institutions, governments, and private currency traders dwarfs the amount of currency bought and sold because of international trade. The magnitude of currency trading is vast compared to the small amount of excess demand caused by the U.S. trade deficit and changes in that deficit. It is, therefore, far from clear that the changes in exchange rates generated by an increased demand for U.S. goods would cancel out the improvement in the competitiveness of U.S. produced goods caused by the "border-adjustment" feature built into the FairTax.

A recent study by Professor Hausman found that:

- Existing disparities in treatment of corporate income taxes and VATs for purposes of border adjustment lead to extremely large economic distortions.
- U.S. exporters suffer both domestic income taxes and foreign VATs when selling abroad.
- Foreign exporters in countries relying largely on VATs typically receive a full rebate of such taxes upon export to the U.S., and are not subject to U.S. corporate taxes when sold here.
- This situation creates a very significant tax and cost disadvantage for U.S. producers in international trade with significant impact on investment decisions – leading to the location of major manufacturing and other production facilities in countries that benefit from current rules on the border adjustment of taxes.
- The adverse economic implications for the U.S. are very large. Ask someone from Michigan.
- Elimination of the current disparity in WTO rules (by eliminating border adjustment for either direct or indirect taxes) would increase U.S. exports by 14 to 15 percent, or approximately $100 billion based upon 2004 import levels.
- Eliminating such economic distortions should be a high priority.

In sum, Professor Hausman agrees that exchange rates are not likely to counteract the relative price advantage of foreign produced goods.

To be fair, there *are* three ways to pay the extortion of our corporate income tax and Social Security systems.

Increasing prices is only the first and most obvious way to pay the piper. But sometimes competition limits the raising of prices. This causes providers to seek lower labor costs. Efficiency takes some jobs, and it should. But then jobs move overseas. Finally, with prices as high as possible and labor costs as low as possible, reducing profits to owners/shareholders is the final means to remain competitive.

Domestically, higher prices are a huge burden to the least affluent Americans, including retirees on fixed incomes. Lower labor costs hit our least affluent sector hardest as well. But when it comes to export/import tax imbalances perpetrated by current federal tax policy, the job losses have a corrosive effect throughout every sector of our labor market. Then, when it comes to reducing profits to shareholders, the losers are extended to union, public employee, and corporate pension funds as well as the cliché wealthy widows. Clearly, being directly competitive benefits all levels of our society. These are real problems, not esoteric discussions by economists.

The FairTax brings more and better jobs to the U.S.

Perhaps a more fundamental issue is the overall impact that the FairTax has on the competitiveness of U.S. industry. U.S. businesses are much less likely to locate their plants or corporate headquarters overseas, and foreign companies come to the United States in droves. Americans are employed building these new plants; Americans are employed in the new plants.[10]

Compliance costs evaporate under the FairTax.

American firms no longer face crushing income tax compliance costs, costs that exacerbate years with no profits. Costs that have no exchange value in the international economy, or any economy for that matter. Costs that amount to make-work to the tune of at least $430.1 billion each year, as much as three percent of the American gross domestic product *annually*. Costs that disproportionately burden small business, the biggest job producer. Under the FairTax, this much sand is removed from the gearbox of the American economy. This much friction evaporates.

Under the FairTax, the U.S. becomes a manufacturing haven improving on the Irish model[11] and a tax haven improving on the Cayman Islands model.

The cost of capital is much lower. Banks' costs are reduced by about 25 percent. And the huge pool of U.S. firms' profits currently trapped offshore comes home, putting substantial downward pressure on interest rates simply due to the availability of capital. Firms producing here do not pay taxes on their profits, unless an American owner's profits are used to fund consumption, or a foreign income tax imposes taxes on a foreigner's income earned here. The United States is the most attractive place to build plants in the world. Our sound political and economic system, educated workforce, unparalleled infrastructure, large domestic market, and – once the FairTax tax is passed – extremely attractive tax system draws capital to, and keeps capital in, the United States. The giant sucking sound is job-producing and productivity-enhancing capital flowing to the United States from throughout the world.

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[10] The U.S. capital surplus cannot increase while the current account deficit simultaneously falls. These two quantities must be equal (but of opposite signs). The current account balance is equal to merchandise exports, minus merchandise imports, plus net military transactions, plus net travel and transportation receipts, plus receipts on U.S. assets abroad, minus payments on foreign assets in the U.S., minus foreign aid and other gifts. The difference between merchandise exports and imports is the widely reported merchandise trade deficit (surplus). The capital account balance is the net change in U.S. assets abroad (minus equals outflow), plus the net change in foreign assets into the U.S. (plus equals inflow). Private assets dominate the figures, but government reserve assets and other government assets are included. A capital surplus requires an equal current account deficit. A capital deficit requires a current account surplus. A capital surplus is when foreigners are investing more here than we are investing abroad. Foreign investment may be loans to the U.S. Imports in the merchandise trade accounts may be capital equipment. It is likely that the FairTax causes a capital surplus that consists more of direct investment than lending funds. It is also probable that the FairTax increases the proportion of capital goods as a share of total imports.

[11] The Effective Tax Rate for U.S. Companies among the Highest in the World, Tax Foundation, Sept. 13, 2011. http://taxfoundation.org/article/effective-tax-rate-us-companies-among-highest-world

The FairTax has broad impact.
In conclusion, the income and Social Security tax systems have a broad and universally negative affect on the American society as a whole. The power to tax is the power to destroy. The FairTax has an equally broad impact, though positive. This is a tax through which the individual has the ultimate power to be taxed – or not. To control the amount of taxation with each purchase. And to avoid taxation altogether, should they chose to live very modestly – at or near the federally mandated poverty level. Besides the multitudinous jobs this returns to American workers, it also reestablishes civil liberties with equal, if not greater, quantity. And this freedom, if perhaps esoteric, may be more important than the tangible result of a good job.

What is the FairTax Plan?
The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR25/S155) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans for Fair Taxation® (FairTax.org)?
FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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(AFFT Documents\Papers on a specific subject\explanation of prebate)