A FairTax® Whitepaper

The FairTax lowers the true cost of a new U.S. produced automobile

Background

Because the FairTax is a single-stage consumption tax, supporters of a double and treble tax on savings, investment, and exports (our current income tax) would assert that the cost of an automobile would go up by the amount of the FairTax rate. This is not only wrong, it is dead wrong. Automobiles are the second most expensive purchase a family can make beyond a home, yet today we penalize the purchase of U.S. made automobiles. We impose taxes on labor and on capital that literally bury tax costs upstream in the production costs of the vehicle. We subsidize foreign competition by allowing foreign produced automobiles to enter our shores without imposing any U.S. tax, while the foreign governments rebate their taxes (at about 18 cents per dollar on the average) at their border. At the same time, we punish exports with U.S. labor content by imposing heavy taxes which are not, and cannot be, rebated at the border. And to claim that the price of an automobile would rise under the FairTax also fails to understand how the FairTax actually lowers the costs to a consumer of buying a U.S./UAW made automobile by reducing the carrying costs of the debt. The FairTax greatly benefits the industry, and U.S. producers and workers in particular.

What the FairTax does not do – raise the price of the automobile to the consumer

Even if the automakers are not making a profit and therefore do not pay taxes at their entity level, the subcontractors, labor, and the many component parts industries do pay taxes. And they do bear considerable compliance costs. Indeed, the current system alone imposes compliance costs of an estimated $265 billion, which is a dead-weight inefficiency buried in the price of each good and service Americans buy.

And to the extent the prices of goods and services reflect these tax costs, sellers push these costs forward in the product and service prices. In other words, the prices we pay today at the retail level – for instance, the price at a car dealership – reflect the hidden content of taxes and compliance costs imposed upstream. With the FairTax, these costs disappear, and with it, the prices will decline.

Those who support the income tax – and in fact want to continue to impose unnecessary costs on the economy by complicating it further – make the claim that the FairTax would increase the costs of consumer purchases, such as automobiles. This logic, however, assumes that the price of automobiles would not decline by the repeal of corporate taxes, payroll taxes, and capital gains taxes and administrative costs that automobile manufacturers bear today. They believe the forgiveness of tax at the business level would simply be turned into additional profit when those taxes are repealed, rather than passed along in the lower price of vehicles. However, U.S. automakers know firsthand how competitive is the marketplace. Competition will drive prices downward simply because of the taxes the automobile manufacturers no longer face.

What the FairTax does – make automobiles more affordable

Interest carrying costs decline.

While economists can dicker over how much producer prices – and therefore the costs of the vehicle – will fall, one factor is indisputable: The purchasing costs to U.S. consumers will decline about 10 percent because of the effect on interest. The key question to ask is this: How much would an American wage earner have to earn to buy an automobile under the FairTax versus the income tax? The answer is: A whole lot less than today.

Consider the following math (shown in the table below). Using a down payment of 10 percent (which is a conservative assumption), and assuming that the owner paid 7.65 percent payroll taxes and was in the 28 percent marginal tax rate bracket, let us see how purchasing a new car becomes more affordable under the FairTax.

Actual cost of purchasing a new car
(Wages that must be earned to buy new car)

Components of new car cost	**Current tax system**	**FairTax system (25% Interest rate drop)**
NADA average vehicle price*	$30,659	$30,659
Down payment of 10%	$3,066	$3,066
Auto loan amount	$27,593	$27,593
Interest rate**	4.04%	3.03%
Interest paid at above rate for 48 months	$2,336	$1,741
FairTax on new car purchase	—	$9,198
Income tax on interest	$654	
Payroll tax on interest	$179	
Payroll tax on principal	$2,345	
Income tax on principal***	$8,585	
Total taxes	$11,763	$9,198
Total new car cost including taxes	$44,758	$41,597
Percent difference		**-7.06%**

**NADA DATA 2012*, new vehicle average selling price for 2011.
**National new auto loan rates for April 4, 2013, www.bankrate.com.
Interest rates will drop by 25% under FairTax.
***Assumes purchaser is in the 28% income tax bracket.

First, look at the current system. Today, a worker must earn $44,578 to be able to pay for the average new vehicle sold in 2011 (according to NADA) because in order to do so, he first had to give the federal government $11,763 in payroll taxes and income taxes. This leaves $2,336 to pay the interest on the loan and $30,659 for the price of the car. Under the FairTax, our buyer only has to earn $100 to spend $100 – no income taxes or payroll taxes are deducted from his or her wages. The total cost of purchasing the car is $41,597 which includes the price of the car at $30,659 plus total interest of $1,741 and the FairTax of $9,198. This is 7.06% percent less than today, even after the sales tax is added on! The cost savings increase to 12.02% percent if the car buyer is self-employed and pays 15.3 percent payroll taxes (both the employer and employee share) instead of 7.65 percent.

A major cost component of an automobile for a consumer is interest. The FairTax results in interest cost savings on the purchase of a new car in two ways. First, under the FairTax interest rates will decline from their level under an income tax. Interest rates will fall 25 to 35 percent under a consumption tax like the FairTax.[1] Rates will drop immediately and quickly toward the current tax-exempt rate. Investors will no longer need to receive a tax premium to achieve a particular after-tax rate of return. The impact of eliminating this "tax wedge" or tax premium on interest can be seen every day in *The Wall Street Journal.* Tax-exempt municipal bonds tend to yield about 30 percent less than taxable corporate bonds of similar term and risk.

Second, the taxpayer can use his or her complete earnings to pay for the interest. Using pre-tax earnings to pay for the interest on a new vehicle is analogous to the home mortgage deduction where home purchasers can deduct interest paid. Deducting interest paid on home purchases is the tax code's attempt to allow interest to be paid with pre-income tax dollars. Since interest payments are not taxed first under the FairTax, the FairTax extends what is essentially the treatment of home mortgage interest to car buying. But it takes it one step further, granting what would be the equivalent today of a sort of supercharged interest deduction. That is because the mortgage interest deduction does not allow a deduction of such interest against payroll taxes (which three-quarters of Americans pay more of than income taxes). The FairTax allows interest for a new car to be paid before any tax, either payroll or income taxes, further reducing the actual costs of buying a car.

Removes the subsidy on foreign vehicles

Today, we have a tax system that remarkably subsidizes foreign content vehicles, assisting Japan, Germany, and others in competing against the American worker. How do we do so? By doing nothing to counter the fact that foreign countries rebate their taxes on exported items before they enter our shores and impose an ad valorem tax on U.S. goods.

The U.S. should not grant an advantage to foreign companies competing in the U.S. market or impose a disadvantage on American producers and workers selling their goods and services in the U.S. and foreign markets as we now do as a matter of policy. Foreign VATs, which are a major component of the total revenue raised elsewhere, are rebated when foreign

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

goods are exported to the U.S. market. Conversely, the U.S. tax system imposes no corresponding tax burden on foreign goods sold in the U.S. market. The U.S.'s failure to answer with an ad valorem tax or to remove the tax on exports creates a large and artificial relative price advantage for foreign goods, in both the U.S. market and abroad. The table below illustrates the penalty U.S. producers pay in taxes.

Advantage for foreign producers

Origin	Sold in U.S. market	Sold in foreign markets
U.S. production	Pays U.S. income and payroll taxes	Pays U.S. income and payroll taxes and foreign VAT
Foreign production	Pays no U.S. income or payroll tax and no foreign VAT	Pays foreign VAT

Indeed, it has been estimated that border-adjusted regimes effectively grant foreign producers an approximately 18 percent price advantage over U.S. produced goods, whether competing here or abroad.[2] Since virtually all our trading partners have such border-adjusted regimes, our failure to follow suit results in the equivalent of a self-imposed handicap, stimulating outsourcing, encouraging plant relocations, and lowering the wages of American workers. A recent report by Jerry Hausman, Massachusetts Institute of Technology Professor of Economics, states that the U.S. failure to recognize and confront this problem costs us more than $100 billion in exports annually.[3]

Our failure to counteract these border-adjusted taxes explicitly encourages consumption of foreign, rather than American, automobiles. And it converts many of our nation's retailers into what are effectively tax-free trade zones for foreign produced cars.

In effect, the U.S. tax system is distorting the international marketplace and literally driving plants and good jobs out of this country at a devastating and unsustainable pace.

With each passing year, manufacturing has become an ever-decreasing part of the overall economy. Consider that the value of all goods manufactured in the U.S. was roughly 30 percent of the value of all goods and services in the economy in 1953, 25 percent in 1970, 20 percent in 1982, and it fell to 11.5 percent in 2008. The share of the U.S. labor force working in the manufacturing sector fell over the same period from 30 percent to about 9 percent in 2009.

[2] 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.

[3] 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.

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Thus, today manufacturing represents less than half of what its share of Gross Domestic Product (GDP) was in the 1950s. Real wages in manufacturing have fallen because the demand for labor has gone overseas.

Makes the U.S. the haven for manufacturing

Finally, the FairTax will help the autoworkers in one other significant way. The FairTax will make the U.S. the manufacturing capital of the world by being the only industrialized nation with a zero rate of tax on manufacturing and hiring U.S. workers. It will stimulate greater investment, which is the lifeblood of manufacturing; it will exempt all taxes from exported domestically manufactured goods, but tax imports placing them on a level playing field with domestically produced goods; and it will reduce the price of automobiles to the American consumer. A better system would be impossible to design for U.S. autoworkers.

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 (HR 25 / S 155) 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.

Authored by Karen Walby, Ph.D., Chief Economist, Americans For Fair Taxation, 2007. Updated February 2015.