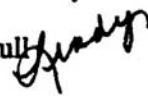


**Congress of the United States**  
JOINT COMMITTEE ON TAXATION  
Washington, DC 20515-6453

**APR 07 2000**

**MEMORANDUM**

**TO:** John Buckley  
**FROM:** Lindy L. Paul   
**SUBJECT:** Budget Neutral Tax Rate for H.R. 2525

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This memorandum is in response to your request for an estimate of the budget neutral tax rate for H.R. 2525, the "Fair Tax Act of 1999," a bill to replace the current U.S. corporate and individual income, estate and gift, and Federal Income Contributions Act ("FICA") payroll taxes with a flat tax on retail sales of all goods and services.

Under H.R. 2525, the Federal individual and corporate income tax, the Federal estate and gift tax, and payroll taxes under the Federal Insurance Contributions Act ("FICA") would be repealed. In general, a single flat tax would be imposed on retail sales of goods and services by all persons and governments (expenditures on education would be exempt). In addition, a tax at the same rate would be imposed on government compensation of employees. Although the tax would be imposed on imports, exports would be exempt from taxation. Each family would receive a family consumption allowance in the amount equal to the poverty level for a family of that size multiplied by the statutory tax rate.

H.R. 2525 would provide some transition relief for inventories that had been acquired prior to the effective date of the bill, which is assumed to be January 1, 2001. Taxpayers may claim a nonrefundable transitional inventory credit equal to the cost of the qualified inventory multiplied by the statutory tax rate. The credit would be allowed in the month in which the inventory is sold. The taxpayer entitled to the transitional inventory credit may sell the right to receive the credit. No transitional inventory credits may be taken after December 31, 2004.

H.R. 2525 would provide that a State or other collecting agent that enters into an agreement with the U.S. government to collect the tax may retain an administration fee equal to one percent of the amounts otherwise required to be remitted to the United States. Taxpayers

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who file timely monthly reports would be permitted to retain an administration fee equal to 0.25 percent of the amounts otherwise required to be remitted to the United States.

A retail sales tax is levied exclusive of the tax itself, or "on top of" the listed retail prices; the tax rate associated with this type of taxation is referred to as a "tax-exclusive rate." The present-law income tax is paid out of the proceeds of the sale, as would be the case with many other types of tax reform proposals, such as a business cash flow tax. The rate associated with this type of tax is referred to as a "tax-inclusive rate." The statutory rate in the legislative language would be comparable to a tax-inclusive rate. However, this language also provides that both the price of the item exclusive of the tax and the tax amount be provided to the purchaser for each taxable sale. The apparent tax rate that would be derived by dividing these two figures would be comparable to the tax-exclusive rate.

In order to facilitate comparisons between a budget neutral rate for a retail sales tax and budget neutral rates for other "tax-inclusive" taxes, we are providing below our estimates for both a tax-exclusive and a tax-inclusive rate for H.R. 2525. Because the transitional inventory credit would reduce potential revenues from this tax during the first several years after H.R. 2525 takes effect, we are providing you with estimates of budget neutral rates assuming neutrality on average over a five- or a 10-year period:

|                           | <b>Neutral over<br/>Five Years</b> | <b>Neutral over<br/>Ten Years</b> |
|---------------------------|------------------------------------|-----------------------------------|
| "Tax-inclusive" rate..... | 37.5%                              | 36%                               |
| "Tax-exclusive" rate....  | 59.5%                              | 57%                               |

The "budget neutral" rates presented above were calculated without respect to certain short-run and long-run effects that tax restructuring may be expected to have on the economy.

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That is, although we assume no transition relief is provided for persons or businesses with undepreciated assets, accumulated net operating losses, or long-term, fixed-interest rate debt obligations, we do not assume any disruption in the economy during the transition period. Similarly, the rate presented above does not take into account probable short-run decreases in the taxable base due to individuals increasing savings (hence decreasing consumption) in response to the increased rate of return on savings; nor do they include probable long-run increases in the taxable base due to the increase in economic growth that would eventually result from the increased savings.

The above rates have been calculated assuming that rates of tax compliance and tax avoidance would be roughly the same under the proposal as they have been under the administration of the present-law income, estate and gift and payroll taxes. However, studies of compliance with sales taxes in other jurisdictions suggest that tax evasion increases rapidly with sales tax rates above ten percent. In addition, H.R. 2525 makes the sellers of goods and services at the retail level the parties responsible for the actual filing of tax returns and remission of tax payments. Present-law tax compliance is weakest among small businesses, which are represented disproportionately in the retail sector. However, as a gross receipts tax, H.R. 2525 should be much less difficult to administer than the present-law system of taxes. Finally, experience with compliance problems with refundable tax credits under present law would suggest that the family consumption allowance in H.R. 2525 would require substantial monitoring to avoid widespread abuse.

For the purposes of the estimate provided above, we are assuming that the Federal compliance resources freed by elimination of individual taxes would be reallocated as necessary to bring about a present-law level of compliance plus the additional compliance necessary to pay the tax administration fees provided for in H.R. 2525. In addition, we are assuming that retail sales through the internet would be subject to the same Federal tax as other retail sales, notwithstanding the current moratorium that has been placed on taxation of internet sales by State and local governments, which is scheduled to expire on October 1, 2001.

You also requested a distributional analysis for H.R. 2525, as well as a distributional analysis for H.R. 1040. We are not able to provide a distributional analysis of either bill at this

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time. We need to do significantly more data refinement and modeling work before we can produce an analysis that would provide a reasonably accurate picture of the probable distributional consequences of comprehensive tax reform. We have done some preliminary analyses of hypothetical approaches to comprehensive tax reform for discussion purposes within our staff and our Revenue Estimating Advisory Board. These analyses represent works in process and not final distributional analyses. Any copy that you may have received from the press would be a working draft for internal discussion purposes only.