



A FairTax® White Paper

## **Why the FairTax is collected on goods & services provided by Government**

The philosophy of the FairTax is to tax final consumption, without exception or exclusion. Therefore, the tax must include a tax on final consumption even when the cost or service is paid for by a proxy (i.e. government). If one does not tax this consumption, it would encourage more government activity thereby crowding out private sector activity. For example, if the government, at any level, built cars and then gave them to the consumer free, before long all cars would be made by the government. The private sector could not compete. When the proxy can pass the cost on to others by using the income/payroll tax as the source of revenue to cover the cost of providing a government service, such activity is hidden from the final consumer. The FairTax taxes all proxy buying whether it occurs in the public sector or the private sector. For example, if a business buys a car for an employee to use (consume), it is final consumption that is taxed under the FairTax.

It is important to note that the FairTax prohibits the taxation of State government functions that do not constitute the final consumption of taxable goods and services.

To explain how the FairTax taxes government, it is necessary to understand how government output/consumption is taxed today. Just like private sector goods and services, the cost of the existing federal tax system is embedded in the cost of providing government services. This happens in two ways:

- 1) Government employees are subject to the same income tax withholding and employee payroll taxes (Social Security & Medicare) as private sector employees. Likewise, government employers have to pay the employer share of these taxes. And just like the private sector, governments pay their workers higher wages than they would otherwise have to pay if these taxes did not exist.
- 2) Governments also purchase substantial amounts of goods and services from government contractors. A road contractor, for example, must pay corporate income and employer payroll taxes, and also has to pay its employees higher wages than it would otherwise have to pay if there were no individual federal income and payroll taxes.

So the federal government is already paying taxes today, albeit, indirectly through higher wages paid to government employees and higher payments to contractors because of the federal income/payroll tax system. In effect, taking money out of one pocket and putting it in the other.

This is true for state and local government as well.

The FairTax replaces the federal tax system based on an income/payroll with a tax system based



on consumption. The primary benefit of this switch is that taxing consumption removes the distortions in the economy caused by the existing federal tax system. Savings and investment, important drivers of economic growth, are not taxed. This is why economic growth is much higher under the FairTax.

When replacing one tax system for another, it is important to make sure that the relative tax burden on the government sector of the economy and the private sector remain approximately the same. Therefore, the FairTax does not exempt government output or government consumption from taxation. Doing so would create a strong incentive to consume through the medium of government rather than the private sector.

Let's look at a real world example: the provision of employment agency services, i.e. services to help an individual get a job or to help an employer find a person to fill a position.

**Under the current system.** Take a private sector employment agency, "Jobs Are Us". Today, the private employment agency pays it workers wages and then withholds income taxes and payroll taxes and sends them to the federal government. Therefore, these taxes are currently built into its costs of doing business. The same holds true for the government employment agency, "State Job Center". It pays it workers wages and then withholds income taxes and payroll taxes and sends them to the federal government. Therefore, these taxes are also currently built into the government employment agency's cost of doing business. Thus "Jobs Are Us" and "State Job Services Center" are on a level playing field, each having the income tax and payroll tax system built into their costs.

**Under the FairTax.** "Jobs Are Us" sells services to its customers and charges the FairTax on each sale. Each month it adds up the gross payments it receives for its services (including the FairTax), and remits 23% of this amount as national sales taxes to the tax collection authority. This is the FairTax burden on consumption through the private sector.

What about the "State Job Services Center?" This government agency provides services to its "customers" for free. It does not charge its customers a fee for the job counseling services it provides. Therefore there is no "retail sale" to impose the FairTax on. [The government could figure out what it costs to provide one hour of job counseling, and require the person to pay it and charge the FairTax on that amount. However, for many reasons, only one of which would be the lack of cost accounting procedures necessary to correctly price the service, government does not do this.] So at this point, there is no FairTax burden on the services provided by "State Job Services Center". This gives "State Job Services Center" a cost advantage over "Jobs Are Us". This is the case for any government service that does not directly charge the customer for its services.

Thus, to level the playing field, the FairTax must continue to tax government as the current system does. Since there is no market price on the provision of services by the "State Job Services Center" government employment agency, how do we figure out what the FairTax should be?



The FairTax determines the taxable value of governmental consumption to be the sum of:

- (1) the dollar value of the labor services used to provide government services, and
- (2) the dollar value of what the government purchases in order to provide services.

Therefore, to tax (1), The FairTax Act of 2021 (HR25) requires each governmental unit to pay the FairTax on the total value of compensation paid to all its employees. To tax (2), HR25 imposes the FairTax on the value of all goods and services purchased by each governmental unit.

So, each month the State Job Services Center adds up the total wages it pays to its employees and multiplies that total by 23% to compute the tax amount to send to the federal government. The State Jobs Center also pays the FairTax when it purchases goods and services from private sector vendors who collect the tax and then remit it to the federal government. This method essentially equalizes the tax burden of the private sector employment agency and the government employment agency. This is the method used to tax government consumption for governmental entities that do not directly sell their services to consumers.

**Government enterprises** that operate as quasi-businesses and directly sell services to consumers are treated the same as the private sector. Take the US Post Office and Amtrak, for example. Consumers pay for stamps and express mail and for train tickets directly. These governmental entities add the FairTax to the price they charge their customers for their services and remit the FairTax that they collect on a monthly basis just like the private sector. Because they charge sales tax on what they sell, government enterprises do not pay the FairTax on the wages paid to employees; and, like private sector businesses, they do not have to pay the FairTax on goods and services they purchase from vendors.

The FairTax expressly states that **no State government functions that do not constitute the final consumption of taxable goods and services shall be taxed**. For example, any State pass-through funds to local governments are not considered final consumption and not taxable.

**Why does the FairTax impose a tax on government as a solution to the government's lack of retail sales?** The absence of retail sales, for the most part, in government does not allow the FairTax to tax government consumption in the same manner as private sector consumption so another method was necessary. We could have taxed the government's output/consumption by taxing the consumer. Or, we could try and determine what it costs to provide one hour of the government's time, and then charge the FairTax against the person receiving that unit of service; much like Coast Guard charges the equivalent of a "use tax" for certain rescues. We believe, however, that these alternatives are flawed due to a lack of cost accounting procedures to correctly price the service(s). The FairTax considers the value of the government services to be the wages paid to its employees plus the purchase of goods and services from the private sector. These items are already accounted for and can be considered a good proxy for the value of government services consumed.

**Impact of FairTax on State Budgets.** Won't the tax on government cause a budget shortfall for the state? No. Let's look at a hypothetical State Department of Transportation (SDOT) which



hires 200 workers and pays each employee \$100,000 per annum. The agency's budget is \$20 million. If the state relies entirely on a 5% sales tax to fund SDOT, it would take \$400 million in retail sales to generate enough revenue to fund its budget.

Under the FairTax plan, the SDOT will have to pay the FairTax on the total compensation paid to its employees. This cost will increase its budget from \$20 million to \$25,974,000.<sup>1</sup> Does the agency have to increase taxes to offset the increased budget? No, and here is why. The state can impose its state sales tax after the FairTax is captured on goods and services (on the tax-inclusive price), just like the state sales tax is imposed on the federal tax-inclusive price of goods and services today.

Recall that, before the FairTax, in order for the state sales tax rate of 5% to generate enough revenues to cover SDOT's \$20 million budget, the state had to tax \$400 million in retail sales. Under the FairTax, all the state has to do now is impose its 5% sales tax on top of the FairTax tax-inclusive price of the goods and services. The original \$400 million in retail sales would now sell for \$519,480,000 including the FairTax. (= \$400 million \* 1.2987). Applying the 5% state sales tax to this amount of retail sales yields the required \$25,974,000 in revenue to fund SDOT's budget. So state revenues would rise by just enough to offset the increase in costs as a result of the FairTax. Thus, the state is not harmed by the imposition of the FairTax on government consumption. Nor are its taxpayers.

For example, one of the SDOT's workers buys a \$1.00 pack of gum, which costs him \$1.05 with the state's 5% sales tax. He or she earns \$100,000 and has 23% of his pay withheld for federal taxes. This leaves him or her with \$77,000 with which to purchase that \$1.05 pack of gum. The SDOT worker really likes gum and decides to buy 73,333 (= \$77,000/1.05) packs.

Under the FairTax, which repeals the income tax and payroll taxes, the SDOT worker earns \$100,000 in tax-free income. Including the FairTax and the state sales tax, each pack of gum now sells for \$1.3636 (= \$1.00 X 1.2987 X 1.05). Thus, the worker can still buy 73,333 (= \$100,000/1.3636) packs of gum. His or her purchasing power remains the same.

The fraction of after-tax income taken by State government remains constant at 6.5%: before the FairTax it was .05/.77 and after the FairTax it is .065/1.00. (.065/1.00 = .05/.77 = 6.5%). Thus the ability of state government to make purchases is held harmless, as is the purchasing power of state taxpayers.

## Appendix

---

<sup>1</sup> The FairTax is computed by multiplying the tax-exclusive tax rate of 29.87% times \$20 million, or \$5,974,000.



**Language from HR25 which imposes a tax on government consumption**

The definitions of **taxable employer** and **taxable service (appearing below)** operate together to require that wages and salary paid by a government agency (as a taxable employer) are taxable. Additional language about the imposition of the tax requires that the government agency as a taxable employer must remit the tax.

Compensation paid to employees employed by a government enterprise (an entity that charges for its services) is not taxable. Likewise, compensation paid by a governmental educational institution to employees directly involved in providing education and training is not taxable.

**Taxable employer** – In general, the term taxable employer includes (1) any household employing domestic services (nannies, housekeepers, gardeners, etc.), and (2) any government. The term taxable employer does not include any employer which is: (1) engaged in a trade or business, (2) a not-for-profit organization, or (3) a government enterprise (a *quasi* business entity that charges a fee for their services, such as the U.S. Post Office and Amtrak, solid waste pickup, etc.).

**Taxable service** – any service, including service performed by an employee for whom the employee is paid **wages or salary** by a taxable employer (as defined above).

**Wages and salary** mean all compensation paid for employment service including cash compensation, employee benefits, disability insurance, or wage replacement insurance payments, unemployment compensation insurance, workers’ compensation insurance, and the fair market value of any other consideration paid by an employer to an employee in consideration for employment services rendered.

The FairTax is a tax on final consumption so HR25 prohibits the tax being imposed on State government functions that do not constitute the final consumption of property or services.

**Applicable Sections from the FairTax Act of 2021, HR25.**

**SEC. 2. DEFINITIONS.**

(a) In General- For purposes of this subtitle--

(12) **TAXABLE EMPLOYER-**

(A) IN GENERAL- The term 'taxable employer' includes--

(i) any household employing domestic servants, and

**(ii) any government except for government enterprises (as defined in section 704).**

(B) EXCEPTIONS- The term 'taxable employer' does not include any employer that is--

- (i) engaged in a trade or business,
- (ii) a not-for-profit organization (as defined in section 706), or
- (iii) a government enterprise (as defined in section 704).**

(C) CROSS REFERENCE- **For rules relating to collection and remittance of tax on wages by taxable employers, see section 103(b) (2).**

(14) TAXABLE PROPERTY OR SERVICE-

(B) SERVICE- For purposes of subparagraph (A), the term `service'--

**(i) shall include any service performed by an employee for which the employee is paid wages or a salary by a taxable employer, and**

**(ii) shall not include** any service performed by an employee for which the employee is paid wages or a salary--

(I) by an employer in the regular course of the employer's trade or business,

(II) by an employer that is a not-for-profit organization (as defined in section 706),

**(III) by an employer that is a government enterprise (as defined in section 704), and**

**(IV) by taxable employers to employees directly providing education and training.**

SEC. 102. INTERMEDIATE AND EXPORT SALES.

**(3) STATE GOVERNMENT FUNCTIONS-** No tax shall be imposed under section 101 on State government functions that do not constitute the final consumption of property or services.

SEC. 103. RULES RELATING TO COLLECTION AND REMITTANCE OF TAX.

(b) Tax To Be Remitted by Purchaser in Certain Circumstances-

**(2) CERTAIN WAGES OR SALARY-** In the case of wages or salary paid by a taxable employer that are taxable services, the employer shall remit the tax.



**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 16<sup>th</sup> Amendment. This nonpartisan legislation (HR 25) 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](http://www.FairTax.org) or call 1-800-FAIRTAX.

*Author: Karen Walby, Ph.D., Director of Research, Americans For Fair Taxation, January 30, 2021.*