Impact of the FairTax on Manufacturing

U.S. manufacturing is comprised of approximately 326,000 enterprises, 278,000 of which have assets under $1 million per year. In 1996 (currently available data), the industry reported $286 billion in net income, with $4.9 trillion in gross receipts. The industry paid $88 billion in income taxes in 1999. It is a capital-intensive industry, with $2.2 trillion of capital investment in depreciable property.

Item	Manufacturing
Gross Receipts	$4,902.7
Net Income	$286.1
Income Tax	$88.0[1]
Effective Tax Rate (on net income)	30.8%
Net Income as Percentage of Gross Receipts	5.8%

Source: 1996, Statistics of Income, Returns of Active Corporations, Tables 4 and 6. All dollar figures are in billions.

Present Law

Manufacturing is disadvantaged under current law by slow capital cost-recovery allowances that raise the cost of capital investment. Moreover, adverse alternative minimum tax rules further raise the cost of capital for many manufacturers.[2] Finally, firms pay very high effective tax rates on their export income and on their operations abroad.

Firms conducting research and experimentation are eligible for a credit to the extent they increase their research expenditures over a moving, four-year base.[3] Manufacturers are generally subject to taxation on their worldwide income.[4] They receive, however, a credit for foreign income taxes paid, subject to limitation.[5] Manufacturers are eligible for a modest export incentive under the Foreign Sales Corporation (FSC) provisions. The legal status of the FSC provisions is unclear, however, given a recent ruling by the World Trade Organization (WTO). In general, FSC effectively exempts 15 percent of export income.[6] In addition, the so-called export source rule allows firms to characterize some export income as foreign source income, increasing the effective foreign tax credit.[7] Under current law exports are taxed; however, imported goods bear no income tax at all.[8]

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[1] Of which $29.2 billion were foreign income taxes.

[2] Internal Revenue Code §§55-59. The alternative minimum tax (AMT) is imposed at a 20 percent rate. Generally, AMT capital cost recovery allowances have longer recovery periods and lower declining balance percentages.

[3] This credit applies to qualified scientific research and experimentation but not development costs. There are actually two alternative methods and sub-credits. Moreover, this credit has expired and has then been re-enacted many times. Internal Revenue Code §41.

[4] Subchapter N of the Internal Revenue Code.

[5] Internal Revenue Code §§901-908.

[6] Internal Revenue Code §§921-927. For a firm paying an effective tax rate of 35 percent, this would imply an effective tax reduction to 29.75 percent.

[7] §861(a)(6) and §865(b). This rule applies only to purchased inventory property, not to produced inventory. Since the §904 foreign tax credit limitation is effectively the U.S. tax rate multiplied by foreign source income (divided

The Impact of the FairTax on Manufacturing

Under the FairTax, the United States will become the most attractive industrialized country in which to manufacture. American manufacturers will neither collect nor pay income tax. The FairTax Bill will repeal not only the corporate income tax, but also the payroll tax, the individual income tax, including capital gains taxes, the estate tax and gift tax, and the self-employment tax.

The cost of capital will decline dramatically. American manufacturers will be more competitive in the global marketplace. American firms will be much more likely to build plants in the U.S. Foreign firms are likely to find the U.S. a highly attractive place to build their plants to serve U.S. and foreign markets, given the stable political environment, an educated workforce, the large domestic market and the lack of an income tax. The construction and operation of these new plants would generate relatively high-paying jobs. Exports would no longer bear the burden of embedded income and payroll taxes and imports would bear the same sales tax burden as domestically produced goods. For the first time, exported and imported goods will have the same tax treatment. Imported goods will no longer be advantaged over domestically produced goods.

The overall U.S. economy will grow dramatically under the FairTax. All known economic projections predict a much healthier economy. Real wages will increase. People will be able to purchase more and better homes in a healthy economy. Typical estimates are that the economy will be 10 to 14 percent larger than it would have been under the income tax within 10 years, and both production and consumption will grow substantially. Some studies show the potential gains to be much higher. Manufacturers will make more money in a prosperous, growing economy.

Compliance costs will be much lower. According to the Tax Foundation, these expenditures will drop by as much as 90 percent under the FairTax. Instead of having to comply with the complexities of the income tax and the payroll tax, there will be one sales tax on the final purchase for consumption of all goods and services. Business to business transactions will not

into separate baskets), an increase in foreign source income will increase the limitation amount. This provision is only helpful for firms that are in an excess foreign tax credit position.

[8] The income earned wholesaling or retailing foreign produced goods is taxed but the value of the imported goods escapes any income tax burden. The income earned either by firms or workers at each stage of production of U.S. produced goods is subject to income tax. Wage income is also subject to payroll tax.

Be taxed. There will be no more uniform inventory capitalization requirements, no more complex rules governing employee benefits and retirement plans, no more tax depreciation schedules, no more alternative minimum tax, no more capital gains tax and depreciation recapture and no more tax rules governing mergers and acquisitions.

Capital investment is the life-blood of manufacturing. The income tax retards economic performance by creating a significant bias against saving and investment by double, triple or even quadruple taxing. First, wage and salary income is included in the income tax base when it is earned originally. If wages and salaries are saved or invested, the benefits of that deferred consumption are taxed again and again and sometimes again still. The income of any investment is taxed. If an income-producing asset, such as a stock or bond, equipment or real estate, is sold for more than it was purchased, the increase in the value of the capital investment — the capital gain — is taxed a third time. The income of depreciable property is overstated by very slow capital cost recovery allowances. Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Intercorporate dividends are also often subject to tax, creating yet another level of taxation. When the taxpayer dies, the estate and gift tax may tax his or her investments yet again.

Replacing the current tax system with the FairTax would eliminate this tax bias against investment.[9] Harvard economist Dale Jorgenson estimates that yearly real investment would initially increase 80 percent relative to the investment that would be made under present law. This relative increase would gradually decline over the period of a decade to 20 percent.[10] Boston University economist Laurence Kotlikoff also predicts an investment boom. Measuring the change in the size of the overall capital stock (rather than annual investment), he predicts that the capital stock will be 17 percent larger than it would be under the present tax system within 10 years.[11]

The higher productivity caused by more investment per worker is one of the few ways to make U.S. goods more competitive, while maintaining high living standards. The U.S. currently has lower rates of capital formation than most of our major trading partners, including Japan, Germany, France, the Netherlands, Italy and Canada.[12]

Interest income would not be taxed under the FairTax, unless the income is spent on consumption of goods or services. Interest will not be "deductible" since there will be no income tax. A deduction in an income tax system allows taxpayers to make interest payments from pre-tax dollars. Similarly, under a sales tax, people will make interest payments from pre-tax dollars.

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[9] Sales tax treatment of investment is equivalent to expensing capital investment in an income tax.

[10] Dale W. Jorgenson, Harvard University, "The Impact of Taxing Consumption," Testimony before the Committee on Ways and Means, U.S. House of Representatives, March 27, 1996.

[11] Laurence J. Kotlikoff, Boston University, Testimony before the Committee on Ways and Means, U.S. House of Representatives, June 6, 1995. See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute.

[12] Statistical Abstract of the United States, 1999, Table 1365, p. 843.

Interest rates will fall 25-30 percent under the FairTax.[13] Interest rates will fall immediately and quickly toward the current tax-exempt rate. Investors will choose to save and invest more of their money rather than use it to consume, because the after-tax return on their investment makes deferring consumption worthwhile. Investors will no longer need to charge a tax premium to achieve a particular after-tax rate of return. The impact of elimination of the 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. A borrower will not be able to deduct interest but will pay a much lower interest rate. A lender will receive a lower interest rate but will not pay taxes on his interest income.[14] Manufacturers' after-tax borrowing costs will be comparable to those of today. Their net income, however, will not be taxed.

Because a sales tax is neutral toward savings and an income tax is not, the attractiveness of savings relative to consumption will increase.[15] The income tax double-, triple- and often quadruple-taxes savings, while the FairTax will tax it only once. Economic studies show that savings are responsive to changes in tax treatment and that savings rates are closely correlated to the return on savings.[16] After having fallen steadily for almost two decades, U.S. savings rates – the U.S. supply of capital – will improve under the FairTax because the return to savings will increase. This greater availability of capital will help the manufacturing community grow as the economy expands.

[13] For a more detailed discussion of the impact on a national sales tax on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?" Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27).
[14] For a more detailed discussion, see "Impact of The FairTax[SM] on Interest Rates," Americans for Fair Taxation.
[15] Ibid.
[16] See, Gary Robbins and Aldona Robbins, "Eating Out Our Substance: How Taxation Affects Savings," Institute for Policy Innovation, Policy Report No. 131, September, 1995. Mr. Robbins is the former Chief of the Applied Econometrics Staff at the U.S. Treasury Department. This paper updates the work of Stanford University economist and former Council of Economic Advisors Chairman Michael J. Boskin, "Taxation, Saving and the Rate of Interest," *Journal of Political Economy*, Vol. 86, No. 2, Part 2, April 1978, pp. S3-S28.