Congress of the United States
House of Representatives

# Transform America Transaction Fee Proposal

Comprehensive Reform Proposal

Submitted by

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**Comprehensive Transform America Transaction Fee Act**

This submission describes the economic aspects of a broad-based transaction fee as set forth in H.R. 1601 (hereinafter "Fattah Transaction Fee" Proposal). The Fattah Transaction Fee designates the new revenue-generating mechanism as a "fee," therefore, the terms fee and "transaction fee payors" are used throughout this document.

The transaction fee would be triggered by a transaction that uses any kind of a payment instrument: check, cash, credit card, or anything else. The fee would be collected on retail and wholesale sales, business to business purchases of goods, and financial or other intangibles' transactions. Transaction fee payors would become liable for the fee at the moment they are able to exercise control over a piece of property, goods or services regardless of the payment method.

The transaction fee may appear similar to the sales and use tax — one of the major revenue sources for state and local governments — but there is a major distinction: sales tax is charged only on sales to the final consumer of the product, while the transaction fee would apply to intermediate users as well. It also differs from a value added tax (VAT), commonly used by European countries, since the VAT is imposed on only a portion of a transactions' value, roughly the difference between an item's selling price and its cost, thus avoiding multiple layers of taxation.[1] Transaction fees may be assessed as a percentage of the value of the transaction (ad valorem) or as a flat or tiered fee per transaction. For example, when a person makes a $1000 purchase of a piece of electronic equipment under the fixed rate transaction fee, the tax due would amount to $10, using a 1% rate for illustration. By the same token, a firm buying $1 million dollars worth of equipment would incur a $10,000 liability. An example of a fixed fee would be a $1 fee for any transaction,

[1] For further information, see CRS Issue Brief 95060, *Flat Tax Proposals and Fundamental Tax Reform: An Overview,* by James M. Bickley.

whether valued at $100 or $1 million. A tiered fee system could also be instituted. For example, tiers could be established for transactions valued at less than $1,000, transactions valued between $1,000 and $10,000, and so on. To avoid computation of the transaction fee becoming cumbersome, as in the case of a complex multi-party transaction involving a real estate purchase financed through a bank where several transactions may be required to complete the sale, the fees could be collected by the seller or financial institution servicing the transaction, transferred to the U.S. Treasury or collected directly by the Federal Reserve.

## I. Fattah Transaction Fee Components

### 1. *Tax base*

It is an uncontradicted maxim in tax policy that the broader the base the lower the rate. There is no broader base for revenue generation than transactions. Consequently, the Fattah Transaction Fee proposal is different from other proposals in that it provides the broadest revenue base at the lowest possible rate. As set forth in depth below, the Federal Reserve estimates the value of the daily volume of transactions to be more than $3 trillion dollars, which puts the annual estimated value at over $750 trillion.[2] Given the federal government's annual budget of roughly $2.6 trillion, the adjusted fee rate based on Federal Reserve payments alone would only amount to a transaction fee of less that 0.4%.

Under the Fattah Transaction Fee proposal two previously untapped sources of revenues will be subject to revenue generation. As recently stated by Chairman Bill Thomas of the House Ways and Means Committee, "the transaction fee concept could potentially simplify tax collections while capturing underground economic activity that

[2] The Federal Reserve Board, "Payment Systems," visited on April 27, 2005, at [http://www.federalreserve.gov/paymentsys.htm].

currently evades taxation."[3] In addition, transactions made by foreign investors and corporations will also be captured for the first time.

**2. *Exemptions, deductions, credits and exclusions***

The proposal calls for several potential exclusions. For example, the fee would not apply to cash transactions of less than $500; salaries and wages by employers to employees; and transactions involving individual savings instruments through financial institutions. Additionally, an analysis will be done to maintain specific exemptions including the mortgage interest deduction. HR 1601 provides a framework for the promotion of home ownership, charitable giving, and incentives for those who currently benefit from the earned income tax credit. Societal goals, like these and others, presently being promoted through the use of tax expenditures (deductions and or credits) may be continued by adjusting the fee, or where appropriate, by direct and more transparent government appropriations.

3. ***Tax rate(s)***

At the request of Ways and Means Chairman Bill Thomas, and Ranking Member Charles Rangel, the Joint Committee on Taxation is presently undertaking a detailed analysis of the effect various rates would have on the economy.[4]

With $750 trillion dollars in transactions annually going, through the Federal Reserve, a rate of 0.4% will accomplish revenue neutrality at $2.6 trillion. Moreover, there are innumerable considerations in any major tax policy decision for example, choosing between a flat or tiered fee, the question of progressivity in fee structure, protection of various economic sectors or industries (i.e., financial markets), and collection approaches

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[3] Rep. Bill Thomas, April 8, 2005, letter to Rep. Chaka Fattah concerning the "Transform America Transaction Fee."

[4] See footnote 3 above.

beyond the Federal Reserve system itself. Should the scope of any federal tax policy expand beyond revenue neutrality to achieve such important social objectives as eliminating deficits and the national debt, providing for national security and educational opportunity—all of which the transaction fee rate in H.R. 1601 could potentially be structured to achieve—the fee could be twice as much or more. It should be noted that even if the fee were doubled to achieve the stated goals, the revenue base in such a system would remain broad enough to maintain an extremely low fee rate.

**4. *Distribution of the tax burden***

Should the transaction fee replace other federal receipts, the aggregate burden on the U.S. economy as a whole will remain constant. The economic activity sharing the burden of federal revenue generation will be broadened because every transaction fee payor making transactions, i.e. purchases, investments, transfers, throughout the American economy would be subject to a fee, and for the first time foreign citizens and businesses would also be included. The Congressional Research Service ("CRS") in analyzing all international treaties, and laws, has concluded that there are no legal impediments for the implementation of the transaction fee proposed by HR 1601.

The current tax system is inherently unfair. The Joint Committee on Taxation reported that last year, over 2,000 of those individuals earning more than $1 million paid no federal taxes. The General Accounting Office (GAO) found last year that 62% of all American businesses paid no federal taxes over a five year period. In the seminal work, "Perfectly Legal," by Pulitzer Prize Winning author David Cay Johnston, it asserts that Americans earning $500,000 and above are legally avoiding paying taxes and that those earning between $50,000 and $500,000 are carrying nearly the entire current tax burden.

The Fattah Transaction Fee proposal provides the purest, fairest, system for revenue collection. The movement or transfer of any money in an attempt to evade the revenue collection system would still be subject to the transaction fee and it would capture revenues that heretofore were hidden in the current tax system. This would have the effect of broadening the tax base, and in doing so, would subject many more people making transactions in the U.S. economy to the transaction fee.

The Fattah Transaction Fee proposal makes specific recommendations for an analysis or feasibility study to be undertaken to consider options to make the transaction fee progressive in its distribution of the tax burden among individuals and economic sectors. For example, the proposal requests analysis on retaining certain goals of our current tax system such as the earned income tax credit, the alternative minimum tax, the child tax credit, and the deduction for mortgage interest.

**5. *Treatment of charitable giving***

The Transaction Fee could be adjusted to reduce or eliminate fees for public policy purposes so that charities could be exempted from having the fee applied to transactions that they make and/or on contributions made to them. Adjusting, rebating and/or eliminating the fee for donors and/or recipients, of appropriate charitable and/or religious institutions may continue charitable giving currently encouraged through tax expenditures.

***6. Treatment of homeownership***

Adjusting, rebating, or eliminating the fee for first time homebuyers, for example, will continue home ownership goals promoted through currently existing home mortgage deductions. In addition, the nation could provide more direct and targeted support to other Americans in need of assistance for home ownership.

***7. Collection method(s)***

The transaction fee would be triggered by a transaction that uses any kind of a payment instrument: check, cash, credit card, or anything else. The fee would be collected on retail and wholesale sales, purchases of intermediate goods, and financial or other intangibles' transactions. The fee could be collected by the seller or financial institution servicing the transaction and transferred to the U.S. Treasury just as sales and use taxes are transferred to state treasuries today, collected directly by the Federal Reserve or handled in some other manner prescribed by law. Transaction fee payors would become liable for the fee at the moment they are able to exercise control over a piece of property or a service regardless of the payment method.

As stated previously, the transaction fee may appear similar to the sales and use tax — one of the major revenue sources for state and local governments — but there is a major distinction: sales tax is charged only on sales to the final consumer of the product, while the transaction fee would apply to intermediate users as well. It also differs from a value added tax (VAT), commonly used by European countries, since the VAT is imposed on only a portion of a transaction's value, roughly the difference between an item's selling price and its cost, thus avoiding multiple layers of taxation. Transaction fees may be assessed as a percentage of the value of the transaction (ad valorem) or as a flat or tiered fee per transaction.

Levying the fee on transactions going through the Federal Reserve Bank system (Fed) would be one of the most technically feasible implementation options for a broad-based transaction tax described in H.R. 1601. The Fed estimates the daily value of the volume of payments at more than $3 trillion, which puts the annual total at over $750 trillion. Given the federal government's annual budget of roughly $2.6 trillion, the adjusted fee rate based on Fed payments alone would only amount to a transaction fee of less that 0.4%.

### *8. Treatment of businesses*

The effective rate of the fee, in any and all sectors of economic activity, can vary to avoid economic distortions that would otherwise occur, i.e., the financial markets, or to promote important national economic goals, i.e., manufacturing, minority business development, etc. The financial sectors may be extraordinarily sensitive to a fee set too high. To maintain or capture additional economic activity in that sector, in a global economy, special attention to the fee rate may have to be paid, or common agreement sought to fees set in financial markets in which American publicly traded companies are active.

By eliminating existing federal taxes, the transaction fee will cut efficiency losses and economic distortions associated with them, most importantly those arising from higher marginal tax rates. For example, firms would be willing to undertake projects that were not profitable in the past and workers would be more willing to supply labor than before. The fee can be structured to relieve any potential distortions among specific economic sectors created by implementation of the fee. At every stage the fee becomes a cost ultimately incorporated in the output prices. Therefore, even though the nominal fee rate can be set at a relatively low level, the effective rate may end up being a multiple of that rate. These multiple layers of taxation would affect different sectors of the economy in different ways. Thus the effective fee would differ across goods, and generally such variation would be likely to create more distortions than a fee imposed at a uniform effective rate.

## II. Impact of Proposal Relative to Current System

The transaction fee, by complete elimination of income, payroll, corporate profits, and capital gains taxes, creates an opportunity to address a major concern with the existing law: its complexity, reflected in high compliance, administration, and other costs. The Internal Revenue Service (IRS) net cost of operations in 2002 was over $10 billion, and this is just a part of the total economy-wide cost.[5] The estimates of the total societal compliance costs range from $200 billion to $300 billion or 10 to 20 times larger than the IRS budget.[6]

Replacing federal individual and corporate taxes with a transaction fee will eliminate portions of this burden to society. For example, individual taxpayers will no longer need to file an annual federal tax return. The magnitude of this cost reduction would depend on the fee's exact design and on other factors, such as whether states follow suit and repeal their income taxes or whether any tax preferences remain under the new system.

A transaction fee would discourage short-term speculative trading in financial markets in favor of long-term investments. In any time period short-term traders execute more trades than long-term investors, and therefore would pay proportionately more in transaction fees.

A transaction fee will capture some of the revenues from an underground economic activity that currently evades taxation. Since illicit income remains undeclared, the federal government does not collect any taxes on it. However, proceeds from illegal operations

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5 U.S. General Accounting Office, *Financial Audit. IRS's Fiscal Years 2002 and 2001 Financial Statements,* GAO Report to the Secretary of the Treasury, GAO-03-243 (Washington: Nov. 2002), p. 74.

6 See for example, Chris Edwards, "Simplifying Federal Taxes: the Advantages of Consumption-Based Taxation," *Policy Analysis,* No. 416, Oct. 17, 2001, visited on April 27, 2005, at [http://www.cato.org/pubs/pas/pa416.pdf]; The Office of Tax Policy Research, "Hot Topics n Taxation, Compliance Costs," visited on Feb. 20, 2004 at [http://www.otpr.org] or [http://www.otpr.org/compliance_costs.html]; Tax Foundation, "Cost of Complying with Federal Income Tax Will Reach $140 Billion in 2001," July 17, 2001, press release, visited on April 27, 2005, at [http://www.taxfoundation.org/pr-compliancetestimony.html].

eventually are used to buy goods and services, partially achieving the goal of revenue collection.

## III. Transition, Tradeoffs and Special Issues

The transition to a transaction fee would be easily accomplished and accountable in our economy, which is more transparent than any other in the world, and in which transactions are the basic building blocks and are documented trillions of times over every single day.

There are no negative tradeoffs that significantly outweigh the benefits of having our nation's economy transformed by HR 1601.

The bill requires Treasury to do a comprehensive detailed analysis. The Joint Committee on Taxation will provide a recommended fee rate. CRS has already provided economic, legal, detailed looks at distortion issues and provided analysis of potential cascading effects of the transaction fee. The choice is clear, the present system with its known alternatives that have been suggested (flat, national sales, and value added tax) or the Fattah Transaction Fee Proposal which provides the country with an opportunity to reform its current tax system and transform our nation and our economy.

For more information on the Transform America Transaction Fee, or on the history and background of the transaction fee, please contact CRS or contact your Member of Congress.[7]

[7] For further information, see U.S. Congressman Chaka Fattah's official website at [http://www.house.gov/Fattah]; also see CRS Report RL 32266, *Transaction Tax: General Overview,* by Maxim Shvedov.