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## National Sales Tax

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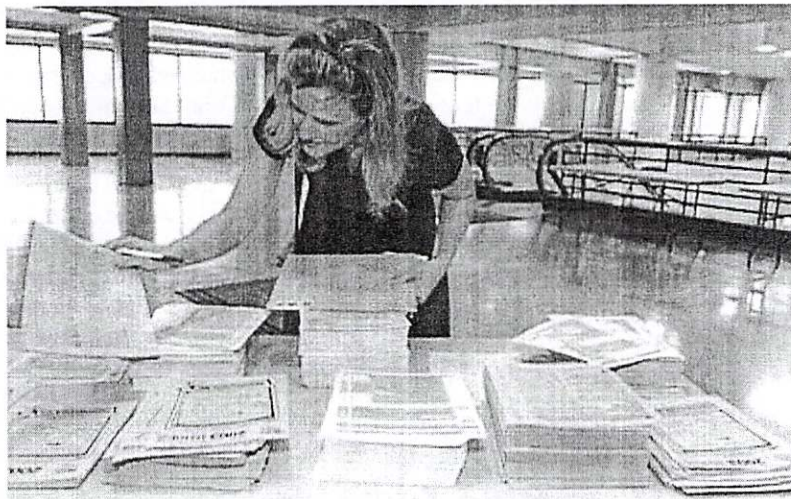
**The issue: Should the federal government replace the current income tax system with a national sales tax? Or should the government retain a system that taxes at the national level on the basis of income?**

- *Proponents of a national sales tax say:* The current income tax system and the code governing it is far too cumbersome on taxpayers. A national sales tax would eliminate the bureaucracy of the Internal Revenue Service and make it much easier for taxpayers to comply with the tax code. Businesses who have taken their assets to off-shore accounts because of the federal income tax would return to the U.S., bolstering the economy.
- *Opponents of a national sales tax say:* A tax system based on sales is regressive, in that it taxes all individuals equally, forcing lower-income individuals to spend a much greater percentage of their income on tax than higher-income earners, who would be able to place much of their earnings in untaxed investments and savings. The national sales tax would not get rid of the IRS; collecting the sales tax and administering a proposed rebate to taxpayers would require a bureaucratic entity.

*The hardest thing in the world to understand is income tax.*

—Albert Einstein

Get in the middle of any discussion about taxes, and nearly everyone will have something negative to say. But much as they are disliked, taxes are a vital means of keeping a government running. Taxes build roads, pay teachers at public schools, and provide cities and towns with police and fire departments. Moreover, the federal government requires taxes to maintain programs such as Social Security, Medicare and a defense system. However, while it is difficult to argue that taxes should not exist at all, how, and how much, to tax is the subject of constant and fervent debate.



Tim Boyle/Getty Images

**A taxpayer looks over a few of the tens of thousands of documents that make up the U.S. federal tax code. A proposal to replace the income tax with a national sales tax would eliminate the need for taxpayers to file tax returns.**

Today, the argument that the federal taxation system is too complicated is often voiced by politicians, and is universally agreed upon by economists and taxpayers alike. Taxation did not exist in any permanent fashion at the federal level until 1913, after the ratification of the 16th Amendment to the U.S. Constitution. Since that time, however, the tax system, and the code that defines it, has created a huge governmental bureaucracy, in the form of the Internal Revenue Service (IRS), and a corresponding cottage industry of tax lawyers, accountants, tax preparation firms and mom-and-pop tax advisers. In fact, the IRS estimates that taxpayers in the U.S. spend somewhere between \$180 billion and \$250 billion and approximately six billion hours each year on learning tax rules, planning tax strategies, sheltering funds against taxes and preparing tax returns.

In the 1930s, the federal tax system included about 500 pages of laws and regulations, but only 16 of those pages dealt with the federal income tax. In the 21st century, the tax code has grown to nearly 55,000 pages long, with 9,722 subsections and 1.4 million words. Since the 1970s, the tax code has more than doubled in length. Furthermore, the IRS estimates that the federal government loses anywhere from \$257 billion to \$298 billion of tax revenue annually due to noncompliance. Overall noncompliance is estimated at 15% to 16.6% of the actual total amount of taxes owed, which is largely attributed not to purposeful criminal activity but to the sheer difficulty of complying with an increasingly complex tax code.

One movement to simplify the tax system that has been gaining momentum is a proposal that the income tax be abolished altogether and replaced with a national sales tax, a type of consumption tax in which sales of goods and services are taxed at a given, uniform rate. Referred to by the chief nonprofit organization behind the movement as the "Fair Tax," a national sales tax system would repeal the 16th Amendment, which authorizes the federal government to levy an income tax, and replace it with a national sales tax. The national sales tax, according to Americans for Fair Taxation, would be a "single-rate, federal retail sales tax collected only once, at the final point of purchase of new goods and services for personal consumption." Used items also would never be taxed, items sold by one business to another would not be taxed, and a rebate would be provided to every valid Social Security cardholder who is a U.S. resident (either a citizen or a green card holder).

The idea of taxation based on levels of consumption is not a novel idea. Alexander Hamilton, one of the founding fathers of the U.S. and one of the authors of the seminal Federalist Papers, wrote in the Federalist No. 21:

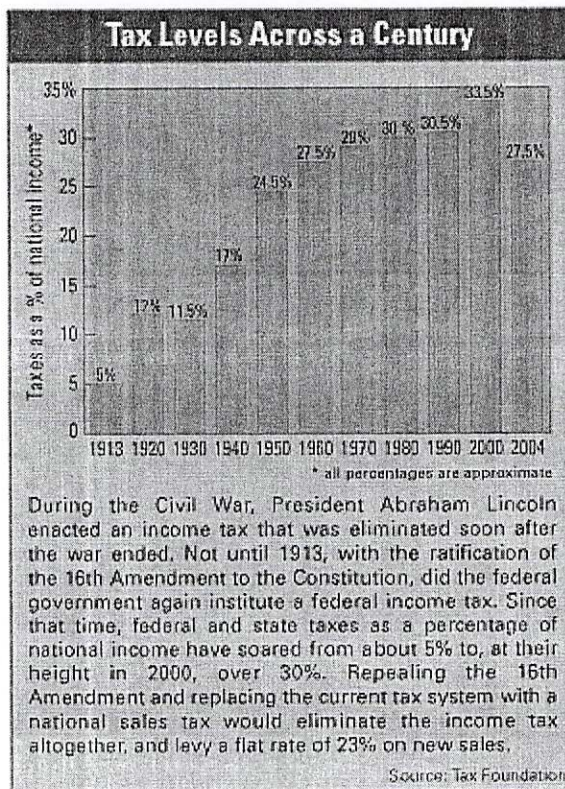
*Imposts, excises, and, in general, all duties upon articles of consumption, may be compared to a fluid, which will, in time, find its level with the means of paying them. The amount to be contributed by each citizen will in a degree be at his own option, and can be regulated by an attention to his resources. The rich may be extravagant, the poor can be frugal; and private oppression may always be avoided by a judicious selection of objects proper for such impositions...*

As of 2005, 45 of the 50 states impose a state sales tax, though the level of taxation varies from state to state. What items and services are taxed also greatly varies. The Fair Tax proposal is by no means the only active tax reform movement. During the 2000 presidential election campaign, independent candidate Steve Forbes campaigned on the basis of reforming the tax system by replacing the current, graduated tax rate with a flat tax. The flat tax, which was also espoused by then-House Majority Leader Dick Armey (R, Texas), would still base federal tax on individual and corporate income, but all would be taxed at the same rate.

Others propose various sweeping changes to the current tax code, including the abolition of the estate tax and the lowering of tax rates for higher income levels. And still others propose the introduction of a value added tax, which would tax a product at each stage of its production, with final costs reflecting the taxes imposed along the production route. But with the 600,000-member Americans for Fair Taxation, the largest taxpayer organization in the nation, gaining momentum, and recent, albeit tepid, support of a consumption tax by Federal Reserve Chairman Alan Greenspan, the national sales tax has been making headlines. Proponents of a national sales tax system argue that the current system is far too complicated, and that billions of dollars are wasted in trying to comply with tax codes and pay income tax. In addition, proponents claim that the current system discourages spending and investment in equipment and inventory, which hurts the economy by discouraging business growth. Replacing the income tax system with a national sales tax, they argue, would encourage businesses to increase capitalization and inventory, which would not fall under the sales tax. That would lead to growth in the business sector and thus general growth in the economy, they contend.

Proponents also claim that oppressive corporate tax rules cause multinational corporations to transfer their funds to offshore accounts, thus decreasing the inflow of capital to the U.S. Eliminating corporate taxation, they argue, would cause a great





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influx of capital from those companies and from other companies based in more tax-oppressive countries, further stimulating economic growth. And finally, they counter any arguments that a universal sales tax is a regressive tax--a tax in which the lower the income, the greater the tax burden relative to earnings--by pointing out that sales tax proposals include a rebate to all taxpayers in an amount equal to what the federal government determines are the annual expenditures for families living at the poverty level. That would essentially exempt the poorest Americans from paying taxes. Opponents of a national sales tax system, however, argue that simplifying the current system is a much better option, and that retaining a taxation system based on increasingly higher tax rates as income increases keeps the system progressive. The wealthy would disproportionately benefit from a national sales tax, they claim, as they are able to make, save and invest more money, none of which would be subject to taxes.

Furthermore, opponents assert that the process of administering the universal rebate would require a large bureaucracy, and that the claim that a national sales tax would lead to the abolition of the IRS is disingenuous, as another bureaucracy would have to be created to take its place. Finally, opponents argue that the installation of a sales tax system would disproportionately harm the elderly, who tend to spend all of their income and thus not benefit from any theoretical untaxed savings resulting from the elimination of the income tax. Moreover, they claim, the elderly, having paid taxes on the savings they accumulated under the income tax

system, would be paying a double tax on every new item or service they purchased under a sales tax system.

### Government Debates Tax Reform

In every congressional session since the mid-1990s, there have been dozens of pieces of legislation introduced that offer substantive changes to the current national tax system. The proposals take the form of one of three types of tax: income tax, flat tax or a national sales tax. The calls for reform stem largely from the fact that the current tax system is seen as an unnecessarily intricate and involved system that benefits innumerable special interest groups and costs taxpayers billions of dollars and countless time to comply with.

Over the past decade, there has been an increasing emphasis on the debate between those who favor a flat tax and those who favor a national sales tax. Armev and Forbes have both proposed a flat tax system as a replacement for the current system. However, as critics note, it does not eliminate the IRS, and would still be based upon individuals and corporate income. In addition, workers and businesses would still be required to fill out annual tax forms. Thus, while simplifying the current system, it would not entirely replace it. [See 1996 [Flat Tax](#)]

Other proponents of tax reform call for sweeping changes to the tax code, but do not go so far as to call for its replacement. They argue that the system is greatly flawed, but does not require replacement; rather it only needs changes to simplify it and create a more level playing field for taxpayers. What constitutes a level playing field is a hotly debated among liberal and conservative politicians and economists.

Gaining much media attention since 2003 have been proposals to replace the income tax system with a national sales tax. A national retail sales tax would tax a flat percentage of the price of all new goods and services. A recent study by tax expert David Burton of the Cato Institute, a conservative think tank, outlines the features of a national sales tax plan. It would repeal the 16th Amendment authorizing a national income tax, abolish the IRS, eliminate federal income tax on individuals and corporations, and allow some kind of universal rebate to all taxpayers to assist lower-income households that would not have been subject to tax under the income tax system.

In January 2003, Rep. John Linder (R, Ga.) and Sen. Saxby Chambliss (R, Ga.) introduced the "Fair Tax Act of 2003." The

act's subtitle stated that its purpose was "to promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States."

The legislation sought to impose a tax on the use or consumption in the U.S. of taxable property or services, and set the sales tax rate at 23% for the calendar year 2005. For the years after 2005, the legislation provided a calculation of the sales tax rate taking into account several factors, including general revenue rate, old-age survivors' and disability rate, and hospital insurance rate. The Fair Tax was proposed as a flat-rate federal sales tax to be collected only upon the purchase of new goods and services for personal consumption.

Fair Tax Act proponents make it clear that the tax replaces the current tax system, rather than reforms it. It eliminates federal income taxes, including personal, estate, gift, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes. However, the funds raised from the sales tax would still be used to pay for Social Security and Medicare, at levels commensurate with the amounts paid under the income tax system.

Furthermore, in an effort to ensure that lower-income families and individuals who would not have been taxed under the current system of graduated income taxes are not taxed under the new system, all valid Social Security cardholders who are U.S. residents would receive a monthly rebate. The rebate would be the equivalent of the tax that would have been paid on what the U.S. Health and Human Services Department calculates to be the sum total of poverty-level expenditures.

The Fair Tax Act was sent to committee in both the Senate and the House but never reached the floor for debate or a vote. However, in that same year, Congress created a tax reform committee to reconsider the current tax system and to open the floor to new suggestions for tax reform. In addition, in 2004, citing a need to revamp the current, overly complicated system, President Bush (R) created the President's Advisory Panel on Federal Tax Reform. The committee, headed by former Sens. Connie Mack (R, Fla.) and John Breaux (D, La.), would travel throughout the U.S. in 2004 and 2005 to hold hearings to gather ideas for tax reform. The group will offer proposals for tax reform to the president by July 31, 2005.

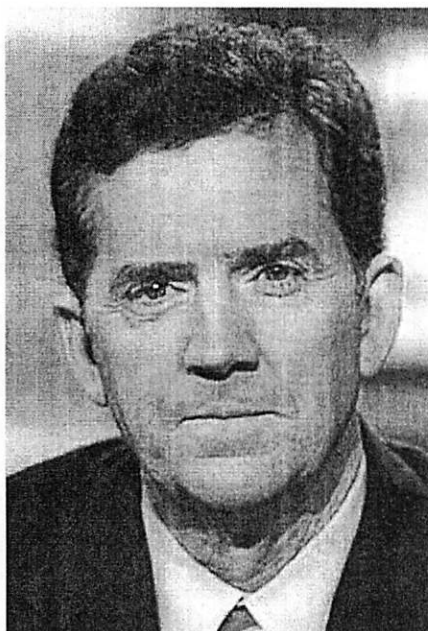
Bush instructed the panel to preserve the "progressive" nature of the current system, meaning that individuals with higher incomes are taxed at a higher rate. Bush also specifically asked the panel to "recognize the importance of homeownership and charity in American society," referring to tax breaks for interest paid on home mortgages and for donations to nonprofit groups. The president asked the panel to create at least one tax proposal based on the current system, but did not specify whether it need be based on income or income-neutral, meaning a flat-tax rate.

The Americans for Fair Taxation organization, along with a bevy of congressmen endorsing a national sales tax, have been lobbying across the U.S. since the 1990s for the replacement of the current system. With the proposed legislation and Bush's mention of a consumption tax as a possible means of simplifying the system, the idea seems to be gaining momentum.

#### Federal Reserve Chairman Addresses Consumption Tax

In March 2005, Greenspan testified before the president's tax-reform panel. As the long-standing head of the Federal Reserve, which controls interest rates in the U.S. and also monitors the economy in general, Greenspan is very influential and his statements hold strong sway. He noted first that since the tax system was altered in 1986, it had made great strides toward simplification, but he argued that the code had since "drifted back to be overly complicated." He asserted that the most effective tax reforms in the past had been based on broadening the tax base--bringing in more taxpayers--and lowering tax rates in general. In addition, he said that one of the most important characteristics of a healthy tax code is its predictability, which he claimed the current system entirely lacked.

Greenspan did not take a position on what is the best tax system for the U.S. to Congress and the president, but laid out the



Alex Wong/Getty Images

**Rep. Jim DeMint (R, S.C.) has proposed legislation to initiate reform of the current tax code. He favors replacing the national income tax system with a national sales tax and abolishing the Internal Revenue Service.**



possibilities: income tax, consumption tax or some combination of the two. And, vital to the sales-tax proponents, he then noted:

*As you know, many economists believe that a consumption tax would be best from the perspective of promoting economic growth--particularly if one were designing a tax system from scratch--because a consumption tax is likely to encourage saving and capital formation.*

Greenspan recognized that while a tax based on consumption, like the national sales tax, had high merit, bringing it into existence faced many hurdles. "Getting from the current tax system to a consumption tax raises a challenging set of transition issues," he stated.

#### Proponents Back National Sales Tax

Bush, in creating the President's Advisory Panel on Federal Tax Reform, recognized the general perception in the U.S. that the federal income tax system is too complicated, and opened the way to sweeping changes in the system. He has also indicated that he is interested in the possibility of a consumption tax. Furthermore, while Bush has not overtly endorsed a national sales tax system, his advisers have spoken favorably of the economic benefits that could be achieved by moving from a system that taxes income to one that taxes consumption.



Brendan Smialowski/AFP/Getty Images

**President Bush sits with former Sens. John Breaux (D, La.), right, and Connie Mack (R, Fl.), co-chairmen of the bipartisan President's Advisory Panel on Federal Tax Reform. The panel is holding hearings on tax reform and will propose various tax reform schemes.**

The Economic Report of the President published in February 2005 argued that personal savings could increase as much as 43% in the first year that a consumption tax is used in place of the income tax. "By removing the tax on the return to savings and investment, a consumption tax would increase savings and investment," the report asserted. And the report also stated that, in the long run, a consumption tax system could result in higher production rates and higher wages. "With a larger stock of capital" as a result of the elimination of federal taxation on individual and corporate incomes, the report claimed, "workers would be more productive and output and wages would rise."

In addition, Bush's advisers note that the current tax system is actually a combination of a system that taxes income and one that taxes consumption. Therefore, they argue, moving to a system based wholly on a consumption tax--like a national sales tax--would not be such a radical departure from the status quo.

Proponents of a national sales tax argue that such a tax would eliminate what they claim are distortions of the current income tax system. For instance, they say, it would get rid of the differential tax treatment of corporate and noncorporate businesses, since under the current system, corporate earnings are taxed twice--once when the corporation is taxed on income, and again when dividends are provided to shareholders. That inequity, proponents claim, distorts business decisions and discourages the provision of dividends to shareholders (who would presumably spend the dividends under a consumption tax system) and

investment in equipment and inventories.

Sen. Jim DeMint (R, S.C.) strongly favors creating a national sales tax in lieu of the current tax scheme, as well as abolishing the IRS. In addition to campaigning for a national sales tax, DeMint was instrumental in the creation of the congressional committee investigating possibilities for tax reform. He argues that the current income tax system discourages investment and creates a trade disadvantage for the U.S. "We're not going to be able to compete with our trading partners if we ignore this problem," he argues.

In addition, he claims that the overburdensome tax system, with its high rates and complex rules, is stunting the U.S. economy. "Our current tax code is the biggest job killer in America," DeMint argues. "If we want to create more jobs and grow our economy, the best thing we can do is to scrap the IRS and the current tax code and replace it with a simple, fair system."

Proponents further argue that a national sales tax system would provide an incentive for multinational companies to bring their businesses back to the U.S. Under the current scheme, because corporations are taxed, they tend to create offshore accounts; as much as \$6 trillion would be returned to the U.S. by getting rid of the income tax system, they assert.

Rep. Linder has introduced a 133-page document that would completely replace the nearly 55,000-page tax code. His bill would abolish the IRS and would replace income tax, including payroll tax and self-employment tax, estate tax, tax on capital gains, the alternative minimum tax, and earned-income tax credits--with a 23% national sales tax on personal consumption for new goods and services. Linder argues that the bill treats all taxpayers, including as many as 50 million foreign visitors per year who pay no federal tax on goods or services, equally, and allows them to pay "as much as they choose, when they choose, by how they choose to spend."

In a Washington Post opinion piece, conservative commentator George Will argued for Linder's proposal, noting that consumers would benefit not only from not paying individual income tax, but from paying lower prices on goods and services once such prices stop reflecting corporate income tax costs. "Corporations do not pay payroll and income taxes and compliance costs," he argues. "They collect them from consumers through prices."

Finally, proponents of a national sales tax system argue that a system based on consumption is not regressive, as opponents claim. By providing every individual holding a valid U.S. Social Security card with a universal rebate equal to the amount the government determines that a family living at the poverty level spends annually, proponents argue, a national sales tax system would be as progressive as the current system. Furthermore, proponents assert, if every individual received a rebate, the stigma associated with the welfare system could also be eliminated.

### **Opponents Say National Sales Tax Hurts Lower Classes**

Opponents of a national sales tax contend that a national sales tax would create a regressive tax system, in that low- and middle-income families and individuals would pay out a much higher percentage of their earnings than would those in higher-income brackets. That is because most Americans must spend most or all of their yearly incomes just to make ends meet, opponents claim, whereas wealthier people need spend only part of their incomes, and can save the rest. Under the national sales tax system, savings would never be taxed. Backing up this claim, a 2002 report by the Treasury Department concluded that nearly any form of a national consumption tax would result in the shift of some taxes from higher- to middle-income households.

A September 2004 report from the Institute on Taxation and Economic Policy (IETP), a liberal-leaning think tank, addresses the economic effects of the Americans for Fair Taxation's national sales tax proposal. The report argues that replacing most federal taxes with a national sales tax would cause large tax increases for most Americans while allowing huge tax cuts for the wealthiest. It claims that the lower 80% of taxpayers in almost every state would face average tax increases of \$3,200 per year.

In other words, the report says, on average, 80% of Americans in the middle- and lower-income ranges would pay as much as 51% more in sales tax than they currently pay under the income tax system. The report then points out that at the same time, those in the top 1% income bracket in the U.S. would each receive an average tax reduction of approximately \$225,000 per year. More conservative estimates allow that, under the Fair Tax proposal, tax cuts for the top 1% would be closer to \$75,000 annually.

Opponents also point out an alleged discrepancy between the 23% sales tax rate that national sales tax proponents quote and the effective rate at which the government would actually tax sales. The Fair Tax proposal, in particular, quotes the rate of 23% for the sales tax, but that rate, opponents point out, is arrived at by dividing the sales tax by the cost of an item plus the tax. Thus, sales-tax proponents claim that taxing a \$100 purchase \$30 is the equivalent of a 23% tax rate. Opponents argue that most people would say they were being taxed at a 30% rate, but that sales-tax proponents take the \$100, add the \$30 in

taxes, and then divide the \$30 in taxes by \$130, yielding a 23% rate. "No ordinary person would think of computing a sales tax that way," economists at ITEP argue.

Furthermore, many economists contend that the sales tax rate would have to be far higher than 30%. Economist William Gale of the Brookings Institution, an independent think tank, has argued that a 60% tax rate would be required to replace all of the federal taxes that national sales-tax advocates claim the sales tax will replace.

Another weakness in the sales tax proposal, opponents argue, lies in its call for the abolition of the IRS. It is disingenuous to argue, as sales-tax proponents do, that the IRS would be eliminated altogether, opponents claim. They wonder how the rebate system would be administered without a centralized system, and claim that at some point, the federal government would have to set up an expensive bureaucracy to administer the collection of the sales tax from the states and the delivery of the rebates to every taxpayer in the U.S. Failure to take the costs of such a bureaucracy into account leads to gross underestimates of the costs of a national sales tax system, opponents argue.

Additionally, critics point to the fact that under the national sales tax system, individuals who own property would pay no tax on their mortgage, while those who rent would pay sales tax on rent every single month. The disparity between homeowners and renters is also hugely regressive, opponents claim.

Furthermore, opponents of a national sales tax argue that an immediate switch from the existing tax system to a national sales tax would shift a large proportion of the tax burden to older people who have already paid income taxes on their earnings. Under the new system, older people would essentially have to pay a second, large tax on their earnings by being taxed on all goods and services purchased during their retirement. And, critics argue, the national sales tax would also shift the tax burden away from wealthier states and onto poorer states and states with a high percentage of elderly taxpayers. According to Americans for Fair Taxation, under the national sales tax system all states would receive one half of 1% of the aggregate sales tax that is collected in the state. Larger states such as California and New York would receive a much larger share of sales tax income than would smaller states, opponents assert, and those states with a larger proportion of elderly taxpayers--who on average spend far less than younger individuals--would also suffer under the system.

#### Future of Federal Tax System Remains in Debate

No one argues that the current tax code is ideal. Indeed, most everyone agrees that the current system allows too many loopholes, taxes the wrong individuals and is far too complicated.

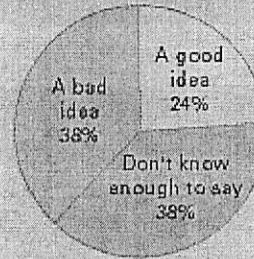
But what is the optimal tax system? One that creates an involuntary tax, such as a sales tax system, where the act of purchasing an item or a service requires payment of a tax? Or a voluntary service, whereby individuals fill out forms and send them into the government with accounts of their annual income? Simplifying the system as much as possible seems to be the optimal way of assuring maximum compliance, but how to best simplify remains open to debate.

From the government's perspective, creating a simplified system for taxation would benefit both itself and taxpayers. With a less-complicated system, taxpayers will be better able to predict what their taxes will be, and presumably will be in a better position to manage their earnings and become more productive. And with a simpler system, the government should be able to spend less time and money in trying to enforce the system. In theory, everybody wins.

In practice, simplification is a far more complex task. While it is generally agreed that the expenditure of time, money and resources involved in complying with tax codes and paying taxes is overly burdensome, as a 2002 internal study by the

### Americans Divided on Implementation of A National Sales Tax

Would the replacement of the current federal income tax with a national sales tax be a good idea?



Do you think a tax system based on everyone paying a tax on what they buy instead of what they earn would be more fair or less fair than the current graduated income tax system?\*



\* Numbers do not add up to 100% due to rounding

A nationwide poll taken in April 2003 asked Americans whether they would prefer to replace the current federal income tax system, including all taxation on income from work savings or investments, with a consumption tax, also called a national sales tax. Those polled indicated ambivalence as to whether a national sales tax would be a good idea. However, when asked whether a national sales tax system would be more fair than the current graduated income tax system, the number who responded positively increased by 6%. In response to both questions, a hefty percentage of respondents indicated that they did not know enough about the topic to answer.

Source: National Public Radio/Kaiser Family Foundation/Kennedy School of Government, "National Survey of Americans' Views on Taxes"

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Treasury Department noted, any simplification of the nation's tax system will "produce windfall winners and losers." And while national sales tax proponents argue that the sales tax would greatly simplify the tax code and its implementation, there are plenty of legislators, economists and taxpayers arguing that under that system, the losers would far outweigh the winners.

### Discussion Questions & Activities

- 1) Would you rather pay a tax on what you earn or a tax on everything that you purchase? Explain your reasons.
- 2) Would a national sales tax have any effect on your spending decisions?
- 3) Is simplifying the tax code a sufficient reason to replace the existing tax system with a national income tax?
- 4) Why do some people claim that a national sales tax would hurt lower-income people?
- 5) Of the three main systems of taxation--income tax, flat tax and national sales tax--which do you think is the fairest way to tax people?

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### Contact Information

*Information on how to contact organizations that are either mentioned in the discussion of national sales tax or can provide additional information on the subject is listed below:*

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**Internal Revenue Service**  
1600 20th Street, N.W.  
Washington, D.C. 20009  
Telephone: (202) 588-1000  
Internet: [www.irs.gov](http://www.irs.gov)

**Institute on Taxation and Economic Policy**



1311 L Street, N.W. Suite 400  
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Internet: [www.cfi.org/itep](http://www.cfi.org/itep)

### Key Words and Points

For further information about the ongoing debate over national sales tax, search for the following words and terms in electronic databases and other publications:

Fair Tax  
Rep. Jim DeMint  
Regressive tax  
Consumption tax  
President's Advisory Panel on Federal Tax Reform

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