



Alabama Economic Freedom Act
Why the AEFA Taxes Final Government Consumption
An AEFA White Paper

Government consumption is included in the AEFA base to put personal and government consumption expenditures on an equal footing. Government consumption expenditures include payroll taxes paid by governments and income taxes and payroll taxes paid by government employees. They also reflect payroll and income taxes paid in the course of producing consumption goods bought by government from private-sector firms. The intent of the FairTax is to substitute a sales tax for all of those taxes. Failing to tax government consumption, while taxing only private consumption, would make government consumption expenditures artificially cheap in comparison with private consumption expenditures and could cause the provision of some goods and services to migrate from the private sector to the government sector. Activities such as trash collection and transportation services are taxed under the FairTax, whether provided by government or the private sector.

The philosophy of the AEFA 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/sales tax as the source of revenue to cover the cost of providing a government service, such activity is hidden from the final consumer. The AEFA 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 AEFA.

To explain how the AEFA 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 state 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 as private sector employees. As with the private sector, government employers have to accumulate and report 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 taxes and also has to pay its employees higher wages than it would otherwise have to pay if there were no individual state income taxes.

So the state government is already paying taxes today, albeit, indirectly through higher wages



paid to government employees and higher payments to contractors because of the state income tax system. In effect, taking money out of one pocket and putting it in the other. This is true for local governments as well.

The AEFA changes the state tax system from one based on income/sales taxes to one based on consumption. The primary benefit of this switch is that taxing consumption removes the distortions in the economy caused by the existing state tax system. Savings and investment are not taxed. This is what creates the much higher increase in economic growth under the AEFA.

Thus, 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 AEFA 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 its workers' wages and then withholds income taxes and sends them to the state 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 its workers' wages and then withholds income taxes and sends them to the state 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 system built into their costs.

Under the AEFA. "Jobs Are Us" sells services to its customers and charges the AEFA on each sale. Each month it adds up the gross payments it receives for its services (including the AEFA), and remits 8.03% of this amount as a consumption tax to the tax collection authority. This is the AEFA burden on consumption through the private sector.

What about the "State Job Services Center?" This government agency provides free services to its "Customers." It does not charge its customers a fee for the job counseling services it provides. Therefore there is no "retail sale" to impose the AEFA 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 AEFA 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 AEFA burden on the services provided by the "State Job Services Center." This gives the "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 AEFA 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 AEFA should be?



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

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

Therefore, to tax (1), The AEFA requires each governmental unit to pay the tax on the total compensation paid to all its employees. To tax (2), AEFA imposes the consumption tax on government purchases of all goods and services from businesses. Under the AEFA, each month the State Job Services Center adds up the total wages it pays to its employees and multiplies that total by 8.03% to compute the tax amount to send to the state government. The State Jobs Center also pays the AEFA when it purchases goods and services from private sector vendors who collect the tax and then remit it to the state 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 charge consumers for their services.

Government enterprises that operate as quasi-businesses and charge consumers for their services are treated the same as the private sector. Examples are the DMV, Secretary of State Business licensing and solid waste pick up. All of these enterprises charge fees for their services (e.g., driver licenses/ad valorem taxes, business licenses and periodic waste disposal). These government entities add the AEFA to the price they charge their customers for their services and remit the AEFA that they collect on a monthly basis just like the private sector. Because they charge sales tax on what they sell, government enterprises will not have to pay the AEFA on the wages paid to their employees; and, like private sector businesses, they do not have to pay the AEFA on what they purchase.

The AEFA 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.

Language from the AEFA making government consumption taxable

The definitions of **taxable employer** and **taxable service (appearing below)** operate together to require that wages paid by a government agency (as a taxable employer) are taxable and the tax must be remitted by the government agency to the state sales tax authority. The section on the imposition of the tax says that the tax shall be remitted by government employers. [Sections from the AEFA that apply are presented below.] Compensation paid to employees who are employed by a government enterprise (an entity that charges for its services), and government educational institutions directly providing education and training are not taxable.

The definitions of “taxable employer” and “taxable service” have the effect of taxing government consumption. Since governments generally provide services free to the public, the value of the consumption is the value of the services used to provide services to the public, i.e. the services of labor or wages paid.



Taxable employer – Generally, the term taxable employer includes (1) any household employing domestic services (nannies, housekeepers, gardeners, etc.), and (2) any government. Excluded from the definition of taxable employers are the employees paid wages or a salary for services performed for: (1) any employer engaged in a trade or business, (2) an employer that is a not-for-profit organization, or (3) a government enterprise (a *quasi*-business entity that charges a fee for their services, such as the DMV, state business licensing, solid waste pickup, etc.).

Taxable service – any service (including financial intermediation services). It also includes any 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.

Applicable Excerpts from the AEFA, 200313-1 : n : 04/30/2019 : LFO-KF** / jmb

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17 §40-23A-2 Definitions
18 (a) The following terms shall have the following
19 meanings for purposes of this chapter:

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12 (11) TAXABLE EMPLOYER.
13 a. The term taxable employer includes:
14 1. any household employing domestic servants, and
15 2. any government except for government enterprises
16 as defined in §40-23A-64).
17 b. The term taxable employer does not include any
18 employer which is:
19 1. engaged in a trade or business,
20 2. a not-for-profit organization (as defined in
21 section 40-23A-66), or
22 c. a government enterprise (as defined in section
23 40-23A-64).
24 {12} CROSS REFERENCE. For rules relating to
25 collection and remittance of tax on wages by taxable
26 employers, see section 40-23A-5(b) (2).



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4 (14) TAXABLE PROPERTY OR SERVICE.

5 a. GENERAL RULE. The term taxable property or
6 service means:

7 1. any property (including leaseholds of any term or
8 rents with respect to such property) but excluding

9 2. intangible property, and

10 3. used property, and

11 4. any service (including any financial.
12 intermediation services as determined by section 40-23A-71).

13 b. SERVICE. For purposes of subparagraph (A), the
14 term service:

15 1. shall include any service performed by an
16 employee for which the employee is paid wages or a salary by a
17 taxable employer, and

18 2. shall not include any service performed by an
19 employee for which the employee is paid wages or a salary-

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

22 (ii) by an employer that is a not-for-profit
23 organization (as defined in section 40-23A-66),

24 (iii) by an employer that is a government enterprise
25 (as defined in section 40-23A-64), and

26 (iv) by taxable employers to employees directly
27 providing education and training.

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1 §40-23A-5 Rules relating to collection and
2 remittance of tax.

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8 (b) Tax To Be Remitted by Purchaser in Certain
4 Circumstances.

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15 (2) CERTAIN WAGES OR SALARY. In the case of wages or
16 salary paid by a taxable employer which are taxable services,
17 the employer shall remit the tax imposed by section 40-23A-3.

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1 §40-23A-23 Intermediate and out-of-state sales
2 credit.

3 For purposes of section 40-23A-21, a person's
4 intermediate and out-of-state sales credit is the amount of
5 consumption tax paid on the purchase of any taxable property



6 or service purchased for
7 (1) a business purpose in a trade or business (as
8 defined in section 40-23A-4), or
9 (2) for use or consumption outside the State of
10 Alabama.

What is the AEFA Plan?

The AEFA Plan is a comprehensive proposal that replaces all state income and sales taxes with an integrated approach including a progressive state retail sales tax, a rebate to ensure no Alabamian pays state taxes on spending up to the poverty level, dollar-for-dollar state revenue replacement, and, through companion legislation, repeal of the all current income and sales taxes. This nonpartisan legislation abolishes all state corporate and personal income taxes, general sales taxes, and replaces them with one simple, visible, state retail sales tax – collected by the existing state sales tax authority. The AEFA taxes us only on what we choose to spend, not on what we earn. It does not raise any more or less revenue; it is designed to be revenue neutral. The AEFA is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current income/sales tax system.

Adapted from:

Why the FAIRtax Taxes Final Government Consumption

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