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The Case for the 'FairTax'

by

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Our tax code is a mess for a reason. Special interests pay for special favors. And with 17,000 pages and counting, there's plenty of places for our politicians to hide the kickbacks. Meanwhile, all the exemptions, deductions, exceptions and special provisions reduce the tax base, which means higher tax rates and smaller incentives for individuals and companies to produce income. And whether the tax breaks are set in fine print or spelled out in bold type, they generally favor the rich, making our tax system less progressive than is generally believed.

No tax system is perfect, but ours is so awful that fundamental reform is the only option. Fundamental reform is not just a necessity; it's also an opportunity to stop taxing income and start taxing consumption. My colleagues and I have been studying income and consumption taxation via computer simulations for some time now. We've found that switching from taxing wage and capital income to taxing consumption can significantly improve economic efficiency and growth. What's more, it can make our tax system much more progressive and generationally equitable.

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Efficiency means different things to different people. To economists it means equating the extra output workers and savers generate for society with the extra compensation they receive for their sacrifice. Government taxation throws a wrench into this equation, setting the private return from working and saving below the social return and leaving the public supplying too little labor and capital.

When tax rates get really high, people stop working and saving altogether. At that point, everyone can see the system's nuts. But even moderate tax rates can cause major economic distortions. Unfortunately, our tax rates, particularly on labor earnings, aren't moderate. They're high. This is true despite recent federal tax cuts. Add together all the federal and state personal income, payroll, excise and sales taxes, and you quickly reach effective wage tax rates of 50% -- and not just for the rich and middle class. For the poor, the rates reach this level thanks to their loss of welfare and health-care benefits as well as tax credits from earning more money.

The bottom line is that our tax rates remain far too high and continue to generate a very large efficiency loss from taxation. The introduction of a consumption tax would broaden the tax base, significantly reduce tax rates, and improve economic efficiency. The efficiency gain comes not just from lowering rates; it also comes from effectively taxing something whose supply can't be distorted. That something is the existing stock of wealth.

Democrats need to listen up here. Their view that taxing sales is regressive is just plain wrong. Taxing consumption is effectively the same as taxing wages plus taxing wealth. The logic is simple if you consider the most straightforward way of taxing consumption, namely via a retail sales tax. In this case, when people spend their wages or their assets on goods and services, they pay sales taxes, meaning they end up with less to consume. This is no different from having the wages and wealth directly taxed, but facing no sales tax.

But what about saving one's wages and wealth and spending these funds plus accumulated interest in the future? Doesn't this avoid the consumption tax? No. You end up paying consumption taxes not just on the original sums, but also on the accumulated interest. The same holds if you save your wages and wealth and give it to your kids. When they spend it, they pay consumption taxes on both P&I. In present value it's the same as taxing the wages and wealth immediately. Thus a retail sales tax, with its effective wealth tax component, is highly progressive compared, for example, to taxing just wages.

Over the years, we've moved pretty darn close to just taxing wages by reducing capital gains and dividend taxes and expanding tax advantaged retirement accounts. In the process, we've not only reduced overall progressivity. We've also shifted the tax burden from the elderly, who receive most of the capital income, to the young, who earn most of the labor income.

The FairTax proposal, which awaits Congressional passage as H.R. Bill 25, would greatly rectify this intra- and inter-generational inequity and do marvelous things for our economy. The FairTax (details at www.FairTax.org) replaces not just the federal and corporate income taxes, but also the federal estate and gift taxes, and the highly regressive FICA payroll tax with one simple and fully transparent federal retail sales tax. In addition, the FairTax provides a highly progressive rebate to each household of their sales tax payments on consumption expenditures up to the poverty line.

Assume H.R. 25 becomes law. Overnight, people would move from paying, to the feds and states, roughly 50 cents per dollar earned on their supplies of labor and capital to roughly 30 cents. Because the relationship between tax rates and economic distortions is non-linear, this would reduce the excess burden of our tax system by roughly two-thirds! A very conservative estimate of this annual saving is 2% of GDP or about $250 billion for the coming year. Add in the aforementioned $250 billion in wasteful tax compliance, and we're talking big bucks.

But this is still small potatoes compared with the gains in economic growth associated with adopting the FairTax. Over the next few decades, the FairTax would likely raise U.S. GDP by 15% relative to its alternative value. Here's why. The FairTax generates much bigger incentives to work and save. It also redistributes from rich older spenders to younger savers. While it's not widely known, America's biggest spenders are actually the elderly, and for good reason. They know they have fewer years left to spend their resources and, consequently, are consuming their resources at more than twice the rate of the young.

What about the poor, both young and old? Wouldn't they be worse off under the FairTax? No. The FairTax's rebate would leave poor young households paying a zero net sales tax. And it would leave poor elderly households better off thanks to both the rebate and Social Security's automatic adjustment of benefits to any increase in prices.

The FairTax would also relieve the tax burden on middle-class workers. Since the FairTax generates a goodly portion of its revenues by effectively taxing wealth, it can afford to have a lower effective tax on wages.

Is a sales tax the best way to tax consumption? Notwithstanding some enforcement concerns, my answer is yes. The flat tax, propounded by some, purports to tax consumption. But read its fine print or talk to its sponsors. You'll find special transition rules that eliminate any effective taxation of existing wealth, leaving the rich, particularly the rich elderly, completely off the hook. The same simulations showing efficiency gains and enhanced economic growth from consumption taxation, show the reverse from moving to wage taxation. Thus, the flat tax, as it would likely be implemented, is a loser on both economic and moral grounds.

Fundamental tax reform is long overdue. Consumption taxation is the way to go. The FairTax is a reform every Democrat who cares about equity should love. And it's a reform every Republican who cares about efficiency, transparency and growth should champion.

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