Why the FairTax Won't Work

By Bruce Bartlett

Bruce Bartlett was formerly Treasury deputy assistant secretary for economic policy and executive director of the congressional Joint Economic Committee.

In this article, he criticizes the FairTax, a tax reform proposal supported by former Arkansas Gov. Mike Huckabee, a candidate for the Republican presidential nomination. The proposal alleges that a 23 percent national retail sales tax collected by the states would be sufficient to replace all federal taxes. That would allow for abolition of the IRS and other benefits, supporters claim.

Bartlett argues that the FairTax is deeply flawed and has been systematically misrepresented by its supporters. Quite apart from the fact that there is zero chance that Congress would ever enact it, it is clear, writes Bartlett, that the FairTax simply would not work at all if it were tried, which is why no country has ever attempted to collect all its revenue from a retail sales tax.

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One solution to the nation's long-term fiscal problems that has gained support in recent years is the idea of replacing all federal taxes with a 23 percent national retail sales tax called the FairTax. The idea is that this proposal would unleash so much economic growth that the cost of an aging society could be borne with relative ease.[1] Unfortunately, the administrative problems inherent in this proposal make it impossible to take seriously.

People know how the current tax system operates. They receive gross wages from their employers and automatically have income and payroll taxes withheld from their paychecks. A worker may see that his employer pays him $1,000 per week, but he has only $800 to spend because of all the taxes.

FairTax advocates repeatedly claim that their proposal would allow all workers to keep 100 percent of their paychecks. The clear implication is that withholding would simply disappear. The worker now netting $800 per week would immediately get a $200 raise and start taking home the full $1,000 gross wage that he is paid. Instead of paying income and payroll taxes, workers would pay their taxes when they buy things. The FairTax would impose a 23 percent tax on all goods and services. This is not really correct, but for now we'll accept it at face value for analytical purposes.

So on the day the FairTax is imposed, a worker's disposable income would rise, but he would have to pay more for everything he buys. Whether he is better off or not depends on what his effective tax rate is. Assuming he spends all his income and no more than that, he will be no worse off if he now pays 23 percent of his income in taxes. That is, his effective tax rate (taxes divided by income) is 23 percent. He has 23 percent more income, but pays 23 percent more for everything he buys.

In this case, the FairTax is a wash. The worker is no better off or worse off in terms of taxes than he is now. He may still prefer the FairTax because he doesn't like filing tax returns, because he thinks it is fairer to pay taxes on consumption rather than on income, or because he thinks that exempting all saving and investment from taxation will increase economic growth. These are perfectly valid reasons to favor the FairTax or any other consumption-based tax system.

But what if the worker is now paying less than 23 percent of his income in federal taxes? In this case, he is clearly worse off. The prices of the things he buys will rise by more than his income rises from the elimination of income and payroll taxes. Conversely, if one is wealthy and in a tax bracket above 23 percent, that person would be much better off. His income and payroll taxes would fall by much more than the prices of goods and services he consumes would rise.

Table 1 illustrates this problem by showing that the vast majority of people pay much less than 23 percent of their income in combined federal taxes.

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[1]Sabine Jokisch and Laurence J. Kotlikoff, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007, p. 225.

Table 1. Effective Federal Tax Rates, 2004

Income Quintile[a]	Pretax Income	After-tax Income	Tax Rate[b]
Lowest	$15,400	$14,700	4.5%
Second	$36,300	$32,700	10.0%
Middle	$56,200	$48,400	13.9%
Fourth	$81,700	$67,600	17.2%
Highest	$207,200	$155,200	25.1%
Top 10 percent	$297,800	$217,500	26.9%
Top 5 percent	$443,400	$317,000	28.5%
Top 1 percent	$1,259,700	$867,800	31.1%
All	$78,700	$62,900	20.0%

[a]20 percent of households.
[b]Includes federal personal income taxes, payroll taxes, corporate taxes, and excise taxes.
Source: Congressional Budget Office, *available at* http://www.cbo.gov/ftpdocs/77xx/doc7718/EffectiveTaxRates.pdf.

FairTax Rebate: Additional Income or Tax Cut?

FairTax supporters are well aware of this problem and propose to deal with it by sending monthly government checks to every person in America. This would theoretically constitute a rebate of some of the taxes paid at the cash register on goods and services. The rebate is based on the Census Bureau's calculation of poverty-level income, adjusted for family size. Since the poverty-level income in 2007 is $10,210 for a single person, the FairTax would rebate 23 percent of this amount, divided by 12 and paid monthly. That would come to $196 per month. The idea is that everyone should have some minimum income that is free of tax to pay for the necessities of life. That was the original rationale for the personal exemption.[2]

There is no income or consumption test for the rebate. It would go equally to those with zero income and those who buy nothing in the course of a month, as well as to billionaires like Warren Buffett and Bill Gates. In effect, it would constitute a national welfare program with a flat payment for every American regardless of need.[3]

All persons and families would be required to register with the federal government annually and disclose their residence, the number of family members, and their ages. Rebates would be cut off immediately for those who fail to do so. Every qualifying family member would have to have a Social Security number. Rebates would go directly to those over age 18 and to the designated head of family in the case of children under 18.

The FairTax would treat married couples as two persons for rebate purposes.[4] Thus, in principle, they would have $20,420 of their income effectively exempted from tax and receive a monthly rebate of $391, or $4,697 per year. This is equivalent to the annual return on an investment in U.S. Treasury securities of more than $120,000.[5]

But children are not treated so generously. Each child would raise the exempt amount by $3,480 and generate a monthly rebate of just $66. A single parent with one child would therefore receive a total rebate of $262 per month — $129 per month less than a childless couple; a single parent with two children would also receive less ($329 per month), and a single parent with three children would get only about the same rebate as a childless couple ($396 per month).

Perhaps one rationale for this disparate treatment is that the FairTax considers having children as just another form of consumption to be taxed. As the great tax theorist Henry Simons once explained, "As regards minor dependents, it would be hard to maintain that the raising of children is not a form of consumption on the part of parents."[6]

In any case, there is essentially no relationship between the rebate and the cost of living or raising children. It's absurd to think that a single parent with three children needs to spend no more than a childless couple to achieve the same level of poverty — which is what the rebate is based on. It should be remembered that poverty-level income is not based on an annual analysis of what such an income is. Rather, it is based on a back-of-the-envelope calculation done in the 1960s that has simply been increased by the inflation rate ever since. In other words, the figure is essentially arbitrary.[7]

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[2]Lawrence H. Seltzer, *The Personal Exemptions in the Income Tax* (New York: Columbia University Press, 1968), p. 96.

[3]Such forms of universal welfare are common in European countries. *See* Joseph A. Pechman and Gary V. Engelhardt, "The Income Tax Treatment of the Family: An International Perspective," *National Tax Journal*, Mar. 1990, p. 1.

[4]Of course, it is not twice as expensive for a married couple to live as for two single adults because of economies of scale. After all, one rationale for marriage has always been that "two can live as cheaply as one." *See* Boris I. Bittker, "Federal Income Taxation and the Family," *Stanford Law Review*, July 1975, p. 1422. However, there is no guarantee that a married couple will share and share alike. Few marriages are absolutely equal partnerships. *See* Jill Elaine Hasday, "Intimacy and Economic Exchange," *Harvard Law Review*, Dec. 2005, p. 499.

[5]As this is written, the yield on two-year notes is 3.9 percent.

[6]Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), p. 140. *See also* Lawrence Zelenak, "Children and the Income Tax," *Tax Law Review*, Spring 1994, p. 359.

[7]On the history of the poverty rate calculation, see Gordon M. Fisher, "The Development and History of the Poverty Thresholds," *Social Security Bulletin*, Winter 1992, p. 3. On the

(Footnote continued on next page.)

Table 2. Effective Tax Rates: FairTax Presentation

Income	Gross Tax[a]	Rebate	Net Tax	Effective Rate[b]
$13,690	$3,149	$6,297	$-3,148	-23%
$27,380	$6,297	$6,297	$0	0%
$54,760	$12,595	$6,297	$6,298	11.5%
$109,520	$25,190	$6,297	$18,893	17.3%
$219,040	$50,379	$6,297	$44,082	20.1%
$438,080	$100,758	$6,297	$94,461	21.6%
$876,160	$201,517	$6,297	$195,220	22.3%

[a]23 percent of income.
[b]Net tax divided by income.
Source: "Thumbnail Sketch of the FairTax," p. 6., *available at* http://www.fairtax.org/PDF/FairTaxThumbnailSketch.pdf.

In all likelihood, politicians would take this into account in calculating rebate amounts and enlarge those for children, greatly increasing the cost of the rebate program from what FairTax supporters assume. Nor is Congress going to send rebate checks to billionaires. There is no chance whatsoever that the rebate mechanism would be equal for everyone. At a minimum, this is going to greatly increase the complexity of the rebate mechanism, because income as well as the number of family members will have to be taken into account. That also undercuts one of the key selling points of the FairTax — that people will not have to disclose their income to the federal government.

Nor is there any possibility that the rebate would be free of future political manipulation, as politicians decide that some groups deserve something extra and others deserve punishment — just as is the case with the tax code today. There is also the high probability that Congress would exempt some goods and services from the FairTax, either to improve fairness or just because business lobbyists persuade them to do so. As economist Martin A. Sullivan points out, "There is nothing in the history of the federal tax legislative process to suggest that a federal consumption tax would be untainted by special interest provisions."[8] In short, many of the problems that FairTax supporters see with the current tax system would simply shift to endless changes in the rebate of the FairTax to fix some real or perceived problem in the distribution of income — or just to buy votes.

If one treats the rebate as a reduction of taxes paid, many families would pay less than they do now. If we assume that those in the middle quintile are typical, on average they pay $7,800 in federal taxes now, or 13.9 percent of income. Assuming they spend all their income, they would pay $12,926 (23 percent of $56,200) under the FairTax, but the rebate would offset part of that. Subtracting the rebate amount, the effective tax rate would be 18.8 percent for a single person, 14.6 percent for a childless couple, 13.2 percent for a couple with one child, and 11.8 percent for a couple with two children.

Table 2 shows how the rebate affects effective tax rates using data from the FairTax organization. The income levels and the effective tax rates are exactly the same ones on its Web site (columns one and five). They apply to a married couple with two children. I have added the three middle columns to show how the tax calculation was made. Note that the figures assume that no matter how large a family's income, 100 percent of it is consumed every year.

The assumption that everybody spends all of his income every year makes the tax rates on the wealthy appear much higher than they actually would be. In the real world, consumption falls as income rises. That is to say, more of a family's income is saved the more money it makes. However, those with low incomes tend to spend much more than their annual income. This happens for several reasons. One is that many people with low incomes are retired and are drawing down their savings to supplement their income. Another is that some of those with low incomes may believe that their situation is temporary, so they either draw down savings or borrow to maintain their consumption at what economists call their permanent income level. Those facts are illustrated in Table 3, which is drawn from the Consumer Expenditure Survey.

One consequence of the FairTax is to penalize those who are young who may need to borrow and consume heavily to establish themselves by buying their first cars, first homes and all the furnishings that go with them, and possibly to pay for the costs of child rearing as well. (The FairTax applies to new homes and autos, as well as food, clothing, and other consumption items.) It also penalizes those who are older who have saved for their retirement during an era when saving was heavily penalized by the income tax. But rather than being able to spend their savings tax free, as they anticipated, they will now have to pay sales taxes on everything they buy, including healthcare. It will be hard for them to avoid seeing this as

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lack of any meaningful relationship between current official methods of measuring poverty and the actual incidence of poverty, see National Research Council, *Measuring Poverty: A New Approach* (Washington: National Academy Press, 1995); Patricia Ruggles, *Drawing the Line: Alternative Poverty Measures and Their Implications for Public Policy* (Washington: Urban Institute, 1990); U.S. General Accounting Office, "Poverty Measurement: Issues in Revising and Updating the Official Definition," Report GAO/HEHS-97-38 (Apr. 1997).

[8]Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: American Institute of Certified Public Accountants, 1995), p. 13.

Table 3. Income and Spending, 2005

Income Quintile	Average Income Before Tax	Average Spending	Spending as a Share of Income
Lowest	$9,676	$19,120	198%
Second	$25,546	$28,921	113%
Middle	$42,622	$39,098	92%
Fourth	$67,813	$54,354	80%
Highest	$147,737	$90,469	61%
All	$58,712	$46,409	79%

Note: These data are compiled on a different basis than those in Table 1.
Source: Bureau of Labor Statistics, *available at* http://www.bls.gov/cex/csxann05.pdf.

Table 4. Effective Tax Rates: Alternate View

Income	Income Plus Rebate	Effective Rate (1)[a]	Effective Rate (2)[b]
$13,690	$19,987	15.7%	23%
$27,380	$33,677	18.7%	23%
$54,760	$61,057	20.6%	23%
$109,520	$115,817	21.7%	23%
$219,040	$225,337	22.4%	23%
$438,080	$444,377	22.7%	23%
$876,160	$882,457	22.8%	23%

[a]Assumes that the rebate is saved and all other income is spent.
[b]Assumes that all income including the rebate is spent.

a double tax. Meanwhile, those with high incomes who save a large portion of it will pay far less of the FairTax than Table 2 implies.

Table 4 presents an alternative way of looking at effective tax rates under the FairTax. Instead of thinking of the rebate as a reduction of one's tax liability, suppose that people think of it as simply an increase in their income. Then the calculation is quite different. Remember that it doesn't matter that the rebate is tax free, because all income is tax free under the FairTax. Using the same figures in Table 2, increasing each income by the rebate and dividing by taxes paid on purchases yields much higher effective tax rates.

At this point, FairTax advocates are undoubtedly thinking that I have distorted their proposal. They intend for the rebate to be counted against the sales tax you pay on spending, not as additional income. But people don't typically think of monthly government checks as offsetting their taxes. When someone today receives a Social Security check or a payment for unemployment compensation, they don't think of it the same way they do the check they get from the Treasury Department as a refund when their withholding exceeds their income tax liability. They are two completely different things in most people's minds. The rebate offsets their tax withholding, the other is just income. If the government suddenly decided to start calling Social Security a ''rebate'' on past Social Security taxes paid — which it is to a large extent — it is doubtful that people would change their perception of Social Security as ordinary income. This is one reason why government agencies that calculate the distributional effects of taxes always ignore government spending changes even when they accompany a tax change.[9]

A key reason for this distinction is that no one today knows in advance what their tax refund will be. If they did, they could adjust their withholding so that it exactly matches their tax liability. Also, refunds today arrive only once a year and people usually don't know when they will get it. Thus, tax refunds now are essentially windfalls or ''found money,'' like winning a small lottery. But a regular monthly check from the government isn't a windfall; effectively it's income just like pensions, wages, rent, interest, or dividends, because people will know how much they will get and exactly when they will get it. Its certainty and regularity ensure that people will necessarily think of the FairTax rebate as ordinary income and not as a reduction in their taxes.[10] Studies have shown that people tend to think of income purely in cash terms, with any regular cash receipt viewed as income even if it doesn't correspond to the economist's definition

[9]Michael Graetz, ''Paint-by-Numbers Tax Lawmaking,'' *Columbia Law Review*, Apr. 1995, p. 657; Joint Committee on Taxation, U.S. Congress, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, Joint Committee Print (Washington: U.S. Government Printing Office, 1993), p. 2.

[10]Richard Goode, ''The Economic Definition of Income,'' in Joseph A. Pechman, ed., *Comprehensive Income Taxation* (Washington: Brookings Institution, 1977), p. 1; Carl C. Plehn, ''The Concept of Income, as Recurrent, Consumable Receipts,'' *American Economic Review*, Mar. 1924, p. 1; Victor Thuronyi, ''The Concept of Income,'' *Tax Law Review*, Fall 1990, p. 45.

Table 5. Distribution of the Federal Tax Burden Under the FairTax

Income Quintile	Share of Income Tax Burden, 2006	Share of FairTax Burden With Rebate	Change (percent)	Change (billions of dollars)*
Lowest	-0.5%	0.9%	+1.4	+19.6
Second	-0.9%	4.4%	+5.3	+74.1
Middle	3.8%	10.5%	+6.7	+93.7
Fourth	13.4%	19.5%	+6.1	+85.3
Highest	84.2%	65.1%	-19.1	-267.0
Total	100%	100%	0	0

*Total corporate and individual income tax revenues in 2006 were $1,398 billion.
Note: Totals may not add due to rounding.
Source: Office of Tax Analysis, Cited in President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005), p. 212, *available at* http://www.taxreformpanel.gov.

of income.[11] Therefore, the second method of calculating effective tax rates is a much more realistic depiction of how the FairTax rebate system will be viewed should it come into being.

Even with the rebate counted the way FairTax supporters want it calculated — as a reduction in tax liability rather than an increase in income — there would be an enormous shift in the tax burden from the wealthy to those with lower and middle incomes. Table 5 shows Treasury's estimate based only on replacement of income taxes.

Embedded Taxes

One problem with analyzing the distributional consequences of the FairTax is that its supporters sometimes argue that after-tax incomes will rise by enough to pay the higher prices for goods and services once the 23 percent is added to the prices people pay today. At other times, they argue that prices will fall once income taxes currently embedded in prices are removed, implying a free lunch in which everyone is better off and no one is worse off. Actually, it's a double free lunch because not only do you get to keep all the taxes currently withheld and pay no more for goods and services now, but you get the rebate as well. As FairTax advocates Neal Boortz and John Linder put it:

> Once the FairTax takes effect, you'll be receiving 100 percent of every paycheck, with no withholding of federal income taxes, Social Security taxes, or Medicare taxes — and you'll be paying just about the same price for T-shirts and other consumer goods and services that you were paying before the FairTax. But there's something more. Under the FairTax Plan, you'll also be receiving a check every month from the federal government equal to the amount of sales tax you would spend on the basic necessities of life for that month.[12]

The problem is that people cannot both get an increase in their after-tax income and at the same time have prices fall once embedded taxes are removed. It is unclear whether FairTax supporters are genuinely ignorant of this fact or dishonestly implying that both will happen so they can build support for their plan.

For those who live in a state with a sales tax, we know that it raises the cost of what we buy.[13] But FairTax supporters say this won't happen when they add a 23 percent sales tax to everything. The reason is that income taxes also raise prices, they say. Citing research by Harvard economist Dale Jorgenson, Boortz and Linder say that existing taxes raise the price of everything by 22 percent on average. "That means that for every dollar you spend on a loaf of bread, twenty-two cents ends up being passed on to the government somewhere along the line in the form of taxes."[14]

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[11]Gordon B. Dahl and Michael R. Ransom, "The 10% Flat Tax: Tithing and the Definition of Income," *Economic Inquiry*, Jan. 2002, p. 120.

[12]Neal Boortz and John Linder, *The FairTax Book* (New York: HarperCollins/Regan Books, 2005), p. 59.

[13]James M. Poterba, "Retail Price Reactions to Changes in State and Local Sales Taxes," *National Tax Journal*, June 1996, p. 165. Indeed, sales and excise tax increases often cause prices to rise by more than the tax because businesses use the opportunity to increase producer prices. *See* Paul G. Barnett, Theodore E. Keeler, and Teh-wei Hu, "Oligopoly Structure and the Incidence of Cigarette Excise Taxes," *Journal of Public Economics*, July 1995, p. 457; Timothy J. Besley and Harvey S. Rosen, "Sales Taxes and Prices: An Empirical Analysis," *National Tax Journal*, June 1999, p. 157; Maura P. Doyle, "The Effects of Interest Rates and Taxes on New Car Prices," Federal Reserve Board, Finance and Economics Discussion Series 1997-38 (July 1997); Douglas J. Young and Agnieszka Bieliska-Kwapisz, "Alcohol Taxes and Beverage Prices," *National Tax Journal*, Mar. 2002, p. 57.

[14]Boortz and Linder, *supra* note 12, p. 54. The cited source for Jorgenson's estimate is a paper commissioned by Americans for Fair Taxation, the principal pro-FairTax organization, titled "The Economic Impact of the National Retail Sales Tax" (May 18, 1997). As far as I can determine, this paper appears nowhere at http://www.fairtax.org or anywhere else in published form or on the Internet, so it cannot be checked for accuracy. Of Jorgenson's public writings, those that seem most closely to represent the views attributed to him by Boortz and Linder in his secret study are the following: Dale W. Jorgenson, Statement in Committee on Ways and Means, U.S. House of Representatives, *Replacing the Federal Income Tax*, Vol. II, 104th Congress, 2d Session, Serial 104-146 (Washington: U.S. Government Printing Office, 1996), p. 102; Dale W. Jorgenson and Peter J. Wilcoxen, "The Effects of Fundamental Tax Reform and the

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That's certainly a plausible argument. Workers work for after-tax wages, not gross wages. So employers have to pay them more to compensate for the taxes that workers must pay. Similarly, the supplies they buy and the other business expenses they incur are more costly because of embedded taxes. If the existing federal tax system were just to disappear and federal revenues fell to zero, it's reasonable to think that prices would eventually fall by 22 percent as Jorgenson estimates.

If the FairTax imposes a new 23 percent tax on goods and services, it looks as if it is largely a wash. Their prices will fall by 22 percent once all income taxes are abolished and the FairTax will add about the same, so the final consumer cost will be no higher than it is now, at least on average.[15] If this is true, however, it is hard to understand why there needs to be a tax rebate to compensate for the burden of the tax, since it appears as if there is no burden.

Of course, there is also the question of transition that FairTax supporters gloss over. They assume that prices will fall by 22 percent the day the FairTax takes effect.[16] However, economists know that in practice, wages and prices are fairly rigid.[17] If they weren't, we would never have recessions, which occur mainly when the Federal Reserve tightens monetary policy to control inflation. A recession emerges precisely because wages and prices don't adjust downward either quickly or easily.[18]

Consider the Great Depression. Most economists now believe that its fundamental cause was that the Federal Reserve allowed the money supply to shrink by about one-third between 1929 and 1933.[19] This was a problem because the general price level is fundamentally determined by the money supply times its rate of turnover (which economists call velocity). This will equal the quantity of goods and services times their prices (which is the GDP).

If the money supply suddenly shrinks like that, there will necessarily be a glut of goods that people will have insufficient money to buy in the aggregate. If prices adjusted as easily as FairTax supporters assume, producers and sellers would have just cut their prices by one-third. Then prices would have been in equilibrium relative to the money supply.

This didn't happen during the Great Depression, because the only way producers could cut their prices by one-third and stay in business was for their costs to also fall by one-third. In particular, workers needed to accept a one-third cut in their nominal wage rates. In theory, if all prices and wages fell equally, nobody would be worse off. Workers would have one-third less income, but everything they bought would cost one-third less, leaving them with the same standard of living.

But workers strenuously resisted any reduction in their wages, which often led to long and bitter strikes. Since wages didn't fall, producers' costs didn't fall. But monetary forces still pushed down market prices. With fixed costs and falling prices, the inevitable result was that a vast number of businesses lost money and went bankrupt. As workers were laid off, they were unable to find new jobs, so their incomes fell, reducing what they could afford to pay for goods and services.

The result was gridlock that went on for almost a decade. It ended only when World War II came along and the federal government needed to spend much more money than it had. The resulting budget deficits forced the Federal Reserve to finally increase the money supply to the point at which wages were no longer too high.

Thus, we see that even in the face of massive unemployment, workers were very strongly disinclined to accept reductions in their nominal wages. Had they done so, the depression would have ended as soon as they did. Instead, workers were determined to maintain their nominal wages, and that's what caused the depression to drag on for years and years, inflicting enormous pain on millions of people.[20]

In hindsight, it would have been far better if the Federal Reserve had recognized its error and increased the money supply enough to restore balance sooner. One reason it didn't do so is because a number of economists thought it would be relatively easy to get workers to accept large pay cuts — as FairTax advocates today assume.[21]

The point of this digression is to emphasize that the Federal Reserve essentially establishes the price level through monetary policy. The price level cannot rise significantly unless the Fed increases the money supply. If it holds firm on the quantity of money, and business costs increase for some reason — say, because OPEC sharply raises the price of oil — those costs cannot cause the price level to rise more than temporarily. Relative prices will have to adjust, with some of them falling to accommodate the higher price of oil, leaving the overall price level unchanged.[22]

Feasibility of Dynamic Revenue Estimation," in Joint Committee on Taxation, U.S. Congress, *Joint Committee on Taxation Tax Modeling Project and 1997 Tax Symposium Papers*, Joint Committee Print (Washington: U.S. Government Printing Office, 1997), p. 130. Unfortunately, those publications provide insufficient detail to determine what assumptions were made regarding Federal Reserve policy.

[15]Jorgenson's figures show that some prices will fall by only 15 percent while others may fall by more than 25 percent. Boortz and Linder, *supra* note 12, p. 54.

[16]*Id.* at 58-59.

[17]Dennis Carlton, "The Rigidity of Prices," *American Economic Review*, Sept. 1986, p. 637.

[18]David Romer, "The New Keynesian Synthesis," *Journal of Economic Perspectives*, Winter 1993, p. 5.

[19]Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963), p. 299.

[20]Michael D. Bordo, Christopher J. Erceg, and Charles L. Evans, "Money, Sticky Wages, and the Great Depression," *American Economic Review*, Dec. 2000, p. 1447.

[21]Hugh Bancroft, "Fighting Economic Law," *Barron's*, Jan. 25, 1932; Robert Lekachman, *The Age of Keynes* (New York: Random House, 1966), p. 59; John Oakwood, "How High Wages Destroy Buying Power," *Barron's*, Feb. 29, 1932; Lionel Robbins, *The Great Depression* (London: Macmillan, 1934), p. 185.

[22]Contrary to popular belief, the inflation of the 1970s resulted not from an upward oil-push effect on prices, but because central banks tried to minimize the pain of higher oil

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As in the case of the Great Depression, if wages and prices don't adjust quickly to something like a large increase in oil prices, the whole economic structure becomes unbalanced, leading to a recession like the one from 1973 to 1975. If the Fed decides to increase the money supply to accommodate an oil price increase, the result will be inflation.

Wages Must Fall

This being the case, let us examine further the FairTax argument that prices will automatically and instantaneously fall by 22 percent if all federal income taxes are abolished. The only way this can happen is if workers agree to immediately cut their nominal wages by 22 percent. It makes no sense to assume that prices will fall if costs don't also fall. As former Federal Reserve Board Governor Lawrence Lindsey explains:

> For the consumer price to stay constant, the producer price must fall by the amount of the tax. And because a drop in the producer price means that the business revenue produced by hiring another worker drops, the before-tax wage must drop by a corresponding amount.[23]

Theoretically, workers would be just as well off. If their nominal wages fall by the amount of income and payroll taxes they are now paying, their net wage will be unchanged and they will still get the rebate on top. If before-tax prices fall by 22 percent and the FairTax adds 23 percent, the basic cost of consumption is unchanged. It's all a wash.

But as we saw in the 1930s, workers have historically resisted nominal wage cuts, even when the prices of things they buy have already fallen. Consequently, it's very hard to believe that wages will fall much or quickly even if all income taxes disappear. However, if wages don't fall, there is no way to get a reduction in prices. Therefore, the 22 percent price cut promised by FairTax supporters cannot realistically be contemplated.

More likely, the Federal Reserve will increase the money supply enough to allow the price level to rise by 23 percent so workers won't have to cut their nominal wages. The FairTax will just be passed on to consumers in the form of higher prices. Historically, every nation that has imposed a national sales tax such as a value added tax has accommodated the new tax through monetary policy and seen a one-time rise in the price level of about the amount of the tax.[24] When Treasury considered adopting a national retail sales tax in 1984, it concluded that such a tax would raise the price level by about the amount of the tax even if it replaced some or all of the income tax. As it explained:

> Assuming an accommodating monetary policy, a sales tax would almost certainly increase the price level by roughly the percentage it represents of consumption spending. . . . To the extent the sales tax replaced part of the income tax, there would be little offsetting reduction in prices or wages.[25]

However, if prices rise by 23 percent to allow workers to avoid cutting their wages, they aren't really better off. They have more disposable income because of the abolition of withholding, but everything costs more because of the inflation necessitated by imposition of the FairTax. As noted earlier, the result will be a wash that people may still prefer over the current system. But there's no free lunch.

The problem is that at different times, FairTax supporters assume a fixed price level and at other times they assume that prices will rise by the amount of the FairTax. Obviously, both cannot be true.

In short, there are two mutually exclusive options for determining the ultimate impact of the FairTax. First, we can assume an accommodative Federal Reserve policy. The money supply would be increased enough so that nominal wages would not have to fall and prices would rise by the amount of the tax, meaning a cut in real wages. Prices would be higher by the amount of the FairTax, but net incomes would be higher by the same amount so people would have the money to pay the higher prices and their standard of living would be unchanged.

The second option is to assume the Federal Reserve will not accommodate the FairTax. Before-tax prices would fall by 22 percent so that the FairTax would not raise the cost of goods and services to consumers in the long run. But in this case, nominal wages must also be cut by 22 percent or else prices cannot fall. We would be in a situation not dissimilar to that which led to the Great Depression.

In 1993, Congress's Joint Committee on Taxation studied the economic impact of imposing a national retail sales tax. This was its conclusion:

> A consumption tax can lead to increases in the general price level in the economy or to reductions in nominal wages and profit rates . . . Whether a consumption tax leads to nominal wage and profit declines or to price increases will depend on the monetary policy of the Federal Reserve, and cannot be predicted on the basis of economic theory.[26]

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prices by printing more money. *See* Robert B. Barsky and Lutz Kilian, "Do We Really Know That Oil Caused the Great Stagflation? A Monetary Alternative," *NBER Macroeconomics Annual, 2001*, p. 137; Dallas S. Batten, "Inflation: The Cost-Push Myth," *Federal Reserve Bank of St. Louis Review*, June/July 1981, p. 20; Michael Parkin, "Oil Push Inflation?" *Banca Nazionale del Lavoro Quarterly Review*, June 1980, p. 163.

[23]Nicholas Bull and Lawrence B. Lindsey, "Monetary Implications of Tax Reforms," *National Tax Journal*, Sept. 1996, p. 362.

[24]Henry J. Aaron, *The Value-Added Tax: Lessons from Europe* (Washington: Brookings Institution, 1981), p. 12; George N. Carlson, *Value-Added Tax: European Experience and Lessons for the United States* (Washington: Office of Tax Analysis, U.S. Treasury Department, 1980), p. 65; U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 3 (Washington: U.S. Government Printing Office 1984), p. 20.

(Footnote continued in next column.)

[25]Treasury Department, *Tax Reform* (1984), p. 221.

[26]Joint Committee on Taxation (1993), *Distribution of Tax Burdens*, p. 51. *See also* Harry Gunnison Brown, "The Incidence of a General Output or a General Sales Tax," *Journal of Political Economy*, Apr. 1939, p. 254; Edgar K. Browning, "Tax Incidence

(Footnote continued on next page.)

Given those two choices, it is reasonable to assume that the Federal Reserve will not allow the second option to occur. This means that prices are not going to fall as FairTax supporters claim. That can happen only if nominal wages fall, something that is highly unlikely. But if we assume the price level rises, real wages will fall because the price of everything will rise by 23 percent. Either way, workers are going to lose whatever they think they might gain from the elimination of income taxation.

The True FairTax Rate

FairTax supporters place a great deal of emphasis on their claim that a tax rate of 23 percent would be sufficient to match current federal revenues. Any implication that a higher rate would be necessary is strenuously resisted. The reason, I believe, is that polls have long shown that support for all flat rate tax schemes is highly sensitive to the proposed rate, with support falling sharply at a rate higher than about 23 percent.

A Roper/*Reader's Digest* poll in 1995 asked what should be the highest tax rate on a family of four with a ''high income.'' The average response was 23 percent. Perhaps not coincidentally, that was the year when Americans for Tax Reform, the principal FairTax advocacy group, was established. Subsequent polls have tended to show that most people would prefer an even lower rate. Fox News/Opinion Dynamics polls in 2001 and 2003 found that the maximum rate that anyone should pay in total taxes was just 17 percent. And annual polls by the Tax Foundation and Harris Interactive show that the vast bulk of people think that 19 percent is the most that people should pay; just 9 percent of respondents said that a rate above 29 percent was acceptable.[27] It is reasonable to conclude that any tax reform proposing a rate of 30 percent or more would have virtually no support whatsoever. After all, as Table 1 shows, only the ultrawealthy pay that much now.

Unfortunately, the FairTax rate is not really 23 percent. It's actually 30 percent when thought about the same way we think of state sales taxes. The 23 percent figure is what is known as the tax-inclusive rate; the 30 percent rate is called the tax-exclusive rate. Think of the difference this way: You go to the store now and buy something for $1. The FairTax adds 30 percent for a total price of $1.30. Since the 30-cent tax is 23 percent of $1.30, this is where the 23 percent figure comes from.

FairTax supporters don't make a secret of this fact, but they don't exactly advertise it, either.[28] Virtually everything one reads about the plan asserts that the rate is 23 percent. There is no question that the vast majority of those who hear this figure equate it to the state sales taxes that they are familiar with. Rather than pay an additional 30 percent on their purchases, as would be the case under the FairTax, they naturally assume that they will only pay 23 percent. Instead of paying $1.30 on a $1 purchase, they think they will pay $1.23.

Personally, I believe that this is subterfuge and is done for one reason only: to make the FairTax rate seem much lower than it actually is. As noted earlier, political support for flat tax reforms is extremely sensitive to the proposed rate, and support for the FairTax plan would collapse if people thought the rate was going to be 30 percent instead of 23 percent.

In response, FairTax supporters assert that their purpose is not deception; rather, their goal is to put their plan on an equal footing with the taxes that it would replace. After all, we don't typically calculate income tax rates by assuming that they come on top of our net income. We calculate income tax rates, such as those in Table 1, as a share of gross income including the tax. Therefore, a commonly understood 23 percent income tax rate would indeed be comparable to a 23 percent FairTax rate on a tax-inclusive basis.

If FairTax supporters were consistent in their arguments, one might be inclined to say they have a point. As noted above, much of the FairTax case involves the notion that income taxes are currently embedded in the cost of goods and services. Elimination of those taxes could theoretically cause prices to drop by 22 percent. Talking about both income taxes and the FairTax on a tax-inclusive basis helps make this point. The problem is that FairTax supporters never point out that a logical consequence of this argument is that nominal wages must also fall by 22 percent for this comparison to be valid. Instead, they imply that people can have a free lunch — more income to spend and no increase in the net price of goods and services.

Given this deception, I think it is reasonable to conclude that the FairTax's emphasis on the 23 percent tax-inclusive rate rather than the 30 percent tax-exclusive rate is a ruse designed solely to increase support for the proposal above what would be the case if it were generally known that the more appropriate rate assumption is 30 percent. This conclusion is reinforced by other deceptions inherent in the FairTax proposal.

Taxing Governments

The most important of those deceptions is that the FairTax would apply to government purchases as well as those made by individuals and families, including those by the federal government and state and local governments. This requirement is buried in a very brief section of the 133-page FairTax bill. It states, ''Purchases by the

Analysis for Policy Makers,'' in David F. Bradford, ed., *Distributional Analysis of Tax Policy* (Washington: American Enterprise Institute, 1995), p. 169; Don Fullerton and Gilbert E. Metcalf, ''Tax Incidence,'' in Alan J. Auerbach and Martin Feldstein, eds., *Handbook of Public Economics*, vol. 4 (New York: Elsevier, 2002), p. 1863.

[27]American Enterprise Institute, ''Public Opinion on Taxes'' (Apr. 6, 2007), p. 27, *available at* http://www.aei.org/publicopinion6; Andrew Chamberlain, ''What Does America Think About Taxes?'' Tax Foundation Special Report 154 (Apr. 2007), *available at* http://www.taxfoundation.org/files/sr154.pdf.

[28]''The FairTax Rate: A 23% Tomato or a 30% Tomato'' (May 31, 2007), *available at* http://www.fairtax.org/site/PageServer?pagename=news_feature_053107_ tomato.

Federal Government of taxable property and services shall be subject to the tax imposed by section 101.'' It further states, ''Purchases by State governments and their political subdivisions of taxable property and services shall be subject to the tax imposed by section 101.''[29]

FairTax supporters claim that this provision is necessary to keep governments from competing with private businesses.[30] However, all countries that have national consumption taxes exempt government purchases because it makes no sense except when government businesses are in fact competing directly with private businesses. For example, the European Union's official directive on the VAT says:

> States, regional and local government authorities and other bodies governed by public law shall not be considered taxable persons in respect of the activities or transactions which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with these activities or transactions. However, when they engage in such activities or transactions, they shall be considered taxable persons in respect of these activities or transactions where treatment as non-taxable persons would lead to significant distortions of competition.[31]

While it is true that governments, especially at the state and local level, sometimes engage in businesslike operations that could be handled by the private sector — trash collection is a good example — the vast bulk of what the federal government does are things that only the federal government can do, national security being the most important. That being the case, it cannot possibly make any sense for the Department of Defense to pay 23 percent more for a weapons system because the FairTax has been added. The revenue just goes to Treasury, another branch of the federal government. Spending and revenues are higher to exactly the same extent; it's a wash, which is why foreign countries don't do it.

The truth is that the only reason the FairTax is added to government purchases is because it artificially broadens the tax base and helps maintain the fiction that a 23 percent tax rate will be sufficient to equal all current federal taxes. Also, because the FairTax is designed only to be revenue neutral, not spending neutral, the higher spending is effectively not counted in the calculation. In other words, the higher costs for the Defense Department are not taken into account, rather than being raised by the FairTax, to maintain the same level of real spending.[32] Inclusion of this higher spending would require either a higher rate or a massive cut in spending, which is why FairTax supporters ignore this critical element of their proposal.

The problem for state and local governments is worse. The FairTax simply raises their spending without simultaneously raising their revenue. Realistically, their only choice is to increase their taxes to pay the FairTax on their spending, including that for police protection and other essential services that only government can provide. Thus, to the extent the FairTax forces state and local governments to raise their tax rates, it becomes a backdoor means of financing it at a deceptively low rate.

The importance of paying taxes on government purchases is shown on the FairTax Web site in its study ''A Macroeconomic Analysis of the FairTax Proposal.''[33] Using 2004 numbers, the study estimates a tax base of $10.04 trillion for the FairTax. Of this amount, $2.2 trillion comes from taxing all government purchases and investment spending. This increases federal revenue by $510 billion. Without it, the tax-inclusive rate would rise to 29.5 percent and the tax-exclusive rate would rise to 36.5 percent.[34]

A more recent study on the FairTax Web site updates those figures.[35] According to the new study, the tax base is not quite as large as the previous study estimated. The earlier study estimated that the FairTax would apply to 85.5 percent of GDP; this one estimates that only 81 percent could be taxed. Partly for this reason, it says that a tax-inclusive rate of 23.82 percent (31.27 percent on a tax-exclusive basis) would actually be necessary, requiring a cut in federal spending of $77 billion in 2007 to get the rate down to 23 percent. The authors dismiss this as virtually nothing — just 2.73 percent of non-Social Security spending, they say. But non-Social Security spending includes things like Medicare, national defense, and interest on the debt, which would never be cut. Limiting the spending reduction to nondefense discretionary spending ($490 billion in 2007) would require a much more substantial cut of 15.6 percent.

However, the new study also maintains the fiction that the federal government would pay taxes to itself on its own purchases and that the tax on those purchases would not increase spending by the amount of the tax.[36] As noted above, this would not happen, because the price

[29]Section 703, H.R. 25, 110th Congress, 1st Session.

[30]Boortz and Linder, *supra* note 12, p. 78.

[31]EU, Sixth Council Directive (May 17, 1977), Article 4(5), *available at* http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1977/L/01977L0388-20060101-en.pdf.

[32]William G. Gale, Evan F. Koenig, Diane Lim Rogers, and John Sabelhaus, ''Taxing Government in a National Retail Sales Tax,'' *Tax Notes*, Oct. 5, 1998, p. 97, *Doc 98-29707, 98 TNT 192-84*; Evan Koenig, ''Achieving 'Program Neutrality' Under a National Retail Sales Tax,'' *National Tax Journal*, Dec. 1999, p. 683.

[33]*See* http://www.fairtax.org/PDF/MacroeconomicAnalysisofFairTax.pdf.

[34]This study is somewhat deceptive because it uses 2004 as a base year — a year when federal revenues as a share of GDP were at a historically low level of about 2 percentage points below the postwar average. Incidentally, it is worth noting that since 1995, when the FairTax was first proposed, it has always maintained that the same 23 percent rate would be sufficient to equal federal revenues. But over that period, actual revenues have varied from a high of 20.9 percent of GDP in 2000 to a low of 16.3 percent of GDP in 2004. If FairTax supporters were honest, their proposed rate would have risen and fallen with federal revenues over the years.

[35]''Taxing Sales Under the FairTax: What Rate Works?'' *available at* http://www.fairtax.org/PDF/Tax%20Notes%20article%20on%20FT%20rate.pdf.

[36]The study points out, ''H.R. 25 calls for revenue, rather than spending, neutrality.''

level would rise by the amount of the tax.[37] Inclusion of federal consumption and investment spending, including outlays for national security, lifts the tax base by $916 billion in 2007. That raises $211 billion in additional revenue. But spending is not increased by this amount. That is because the analysts have defined spending in real terms — that is, excluding the effects of price changes. Thus, they have effectively assumed away one of the major problems with the FairTax — that it will raise prices by the amount of the tax.[38]

Forcing state and local governments to pay the FairTax expands the tax base by $1,093 billion, which increases federal revenue by $251 billion. According to the latest Census Bureau data, state and local governments collected $263 billion in general sales taxes in 2005. If they were to pay for their increased costs due to the FairTax by raising sales tax rates, I estimate that the average state and local sales tax rate would have to rise from about 6.5 percent to about 11 percent. Insofar as this 4.5 percent rate increase results solely from institution of the FairTax, this should be added to the true FairTax rate.

The cost of the tax rebate that would have to be paid is also cleverly dealt with in the new study so as to minimize its budgetary impact. As explained earlier, the rebate will take the form of government checks sent to every household, meaning that it is government spending in every sense of the term. However, the study does not show spending rising by the amount of the rebate, which it estimates to be $486 billion. Rather, the cost of the rebate is accounted for by reducing the tax base by $2.112 trillion — the poverty-level income times the relevant population. The only purpose of doing it that way is to maintain the fiction that the rebate is a reduction in taxes rather than an increase in federal spending. It would be more honest to do this accounting by adding the rebate cost to the spending side of the budget.

Compliance Problems

As noted earlier, both of the FairTax studies assume that more than 80 percent of GDP would be taxed. It would not be readily apparent to nonexperts that this is an extraordinarily high figure. The International Monetary Fund has looked at what percentage of GDP is covered in nations with VATs. Even though the VAT is a much more efficient form of consumption tax than a national retail sales tax like the FairTax, at most, 48 percent of GDP is covered by VATs, and only in some small island nations where opportunities for evasion are severely limited by geography. In the European Union, the VAT covers only 38 percent of GDP, and coverage is less in most other countries.[39] In other words, if the FairTax is able to tax only as much of GDP as countries that have decades of experience with national consumption taxes, the rate would have to be more than twice as high as estimated.

The extremely broad coverage of the FairTax means that it contemplates full taxation of all services, including medical care, insurance premiums, transportation, auto repair, telephone and Internet access, cable and satellite television access, lawyers' and accountants' fees, cleaning, recreation, brokers' fees, funeral services, and anything else one can imagine except education, which is explicitly exempted.[40] According to the Federation of Tax Administrators, no state comes anywhere close to taxing services as broadly as the FairTax would. The only two states that have ever tried to tax more than a handful of services — Florida in 1987 and Massachusetts in 1990 — quickly encountered such heavy resistance that the legislation was almost immediately repealed.[41]

Much consumption takes the form of services and there is no justification in principle for excluding them from taxation. The problems are political and administrative. Experience shows that it is very hard to tax intangible services because people resist paying taxes on them in a way that they don't with tangible goods. Also, it's easier to evade taxation of services because there is no record of purchases from wholesalers for resale. Under the FairTax, every time you purchase a service, you would probably get two prices — one you can pay with a check or credit card that includes the FairTax and one you can pay in cash and save 23 percent. Because there would no longer be any audits of income, since the IRS would have been abolished, tracing such tax evasion would be extremely difficult.[42]

Another problem area is housing. Not only would rent be taxed by the FairTax, but so would new home purchases. However, previously purchased homes would be free of tax in perpetuity, no matter how many times they changed hands. Given the large stock of existing homes, it could be many years before a new home is built in America if the FairTax takes effect. This would benefit existing homeowners, but they would also lose from loss

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[37]The study admits, "For the purpose of this analysis, we assume that under the FairTax, V and Y would remain unchanged. Therefore, a rise in the price level would be possible only if accommodated by an increase in the money supply."

[38]The study explains, "We are interested in the FairTax rate and not the actual values of G, GN and TR."

[39]Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (Washington: International Monetary Fund, 2001), p. 41.

[40]The exemption applies only to tuition. Room, board, and textbooks would be taxed.

[41]*See* http://www.taxadmin.org/fta/pub/services/tan0505_services.pdf. On repeal of the Florida tax on services, see Walter Hellerstein, "Florida's Sales Tax on Services," *National Tax Journal*, Mar. 1988, p. 1. On Massachusetts, see Samuel B. Bruskin and Kathleen K. Parker, "State Sales Taxes on Services: Massachusetts as a Case Study," *Tax Lawyer*, Fall 1991, p. 49.

[42]The people who originally came up with the idea of a national retail sales tax collected by the states to replace the federal income tax did so for the sole reason that they wanted to get rid of the IRS. They were affiliated with the Church of Scientology, which has long opposed the IRS and tax audits for both religious and political reasons. Although FairTax supporters strenuously deny any relationship between their plan and the one originated by the Scientologists, there is a direct connection between them that is well documented. *See* Bruce Bartlett, "Dianetics, the Tax Plan," *New Republic*, Sept. 10, 2007, p. 13; Joel Sappell, "The Scientology Story, Part One," *Los Angeles Times*, June 24, 1990, Paul Starobin, "No Returns," *National Journal*, Mar. 18, 1995, p. 666.

of the mortgage interest deduction and the deduction for local property taxes, since there would no longer be an income tax against which to use them. To equalize the tax treatment between new and existing homes, it would be necessary to tax imputed rent — the rent that homeowners pay to themselves when they live in their own homes because they are in effect both landlord and tenant to themselves. But the FairTax excludes this particular service from taxation.[43]

Massive evasion is inevitable with the FairTax because all revenue would be collected at just one point in the entire economic system. We now have separate corporate and individual income taxes. There are well-developed reporting requirements for income that have been in place for many years and withholding of taxes on individuals to ensure compliance. The FairTax would scrap all that with the expectation that the states would collect the federal government's revenue for it and that all of this revenue would be collected from one source: final sales.

Other countries have considered imposing national retail sales taxes. However, none has ever contemplated raising all of the central government's revenue this way, but instead have used the tax only as a supplement to other revenue sources. Even so, all of those countries rejected a national retail sales tax in large part because the opportunities for evasion are too great. Instead, they instituted VATs. The VAT is also a consumption tax, but one that is much less prone to evasion because part of the tax is collected at each step in the production/distribution process.[44]

The way a 10 percent VAT works is that a farmer grows wheat and then assesses a 10 percent tax on the sale when it is sold to the miller. The miller assesses 10 percent when his flour is sold to the baker, deducting the tax he paid to the farmer. The baker assesses 10 percent when he sells bread to the food store, deducting the tax he paid to the miller. Thus, when the retailer buys bread from the baker, he automatically pays much of the total tax because it was already paid by the farmer, the miller, and the baker. If the retailer fails to collect his share of the tax, therefore, the government loses only 10 percent of the final markup between what he paid the baker and what he sells the bread for. And the system is largely self-enforcing because sellers need to show that they paid the VAT to claim the credits on the VAT embedded in the prices of inputs or products that they purchased for processing or resale.[45]

But under the FairTax, the retailer is the sole point of tax collection. If he fails to collect the tax, the government loses everything. There is no backup, no withholding, no previous tax collection at earlier stages of production and distribution as is the case with the VAT. That makes the tax collection process very fragile. And the problem would be worse under the FairTax because it contemplates having the states collect the federal government's revenue for it. But it is hard to imagine that they would be especially vigilant in doing so. After all, if they look the other way when retailers fail to collect the federal tax, the states haven't lost anything as long as the retailer pays the state's tax. In fact, lax collection by the states would be a way of giving their own citizens a tax cut at the federal government's expense.[46]

Yet despite the VAT's vastly superior ability to counter tax evasion, it also suffers from this problem to an increasing extent.[47] And the greatest evasion is at the last point in the chain — at the retail level.[48] The reason is that as VAT rates have crept up, the return on evasion has become so great that it is worth taking the risk of being caught and of setting up elaborate evasion operations that are difficult for the authorities to detect.[49] Analysts now think there is a limit of about 20 percent on how high the VAT can go before it starts to have diminishing returns in terms of revenue.[50]

If the economic limit for the VAT is about 20 percent, it is certain that the economic limit for a retail sales tax is much lower. Studies done by the OECD, IMF, and academic economists have long shown that the upper limit for such a tax is about 10 percent before the incentive for

[43]Gary M. Fleischman, ''National Sales Tax & Residential Real Estate: Worse Than You Think,'' *Tax Notes*, June 8, 1998, p. 1359, *Doc 98-18082, 98 TNT 109- 90*; Richard Goode, ''Imputed Rent of Owner-Occupied Dwellings Under the Income Tax,'' *Journal of Finance*, Dec. 1960, p. 504.

[44]*Taxing Consumption* (Paris: OECD, 1988), p. 103; Sijbren Cnossen, ''Evaluating the National Retail Sales Tax From a VAT Perspective,'' in George Zodrow and Peter Mieszkowski, eds., *United States Tax Reform in the 21st Century* (New York: Cambridge University Press, 2002), p. 215.

[45]President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, p. 205.

[46]Even if one assumes that the states won't intentionally avoid collecting the federal FairTax, they are not likely to be equally vigorous in their collection efforts. Moreover, there are bound to be legitimate differences of opinion about how the tax applies that will vary from state to state with implications for the tax burden. *See* JCT, U.S. Congress, *Description and Analysis of Proposals to Replace the Federal Income Tax*, Joint Committee Print (Washington: U.S. Government Printing Office, 1995), p. 49.

[47]''A Tax Net Full of Holes,'' *The Economist*, Dec. 12, 2005, p. 87; Bertrand Benoit, ''Germany and Austria Take Steps to Combat VAT Fraud,'' *Financial Times*, Dec. 12, 2005; Guillaume Delacroix and Martin Arnold, ''France Discovers €12bn Annual Shortfall in VAT,'' *Financial Times*, Feb. 20, 2007; Vanessa Houlder, ''Surge in VAT Fraud Costs States up to €100bn,'' *Financial Times*, Mar. 26, 2007; Chang Woon Nam, Rüdiger Parsche, and Barbara Schaden, ''Measurement of Value Added Tax Evasion in Selected EU Countries on the Basis of National Accounts Data,'' Center for Economic Studies & Ifo Institute for Economic Research Working Paper 431 (Mar. 2001).

[48]Silvia Fedeli and Francesco Forte, ''Joint Income-Tax and VAT-Chain Evasion,'' *European Journal of Political Economy*, Sept. 1999, p. 391.

[49]Michael Keen and Stephen Smith, ''VAT Fraud and Evasion: What Do We Know and What Can Be Done?'' *National Tax Journal*, Dec. 2006, p. 861.

[50]Ali Agha and Jonathan Haughton, ''Designing VAT Systems: Some Efficiency Considerations,'' *Review of Economics and Statistics*, May 1996, p. 303; Kent Matthews, ''VAT Evasion and VAT Avoidance: Is There a European Laffer Curve for the VAT?'' *International Review of Applied Economics*, Jan. 2003, p. 105; Kent Matthews and Jean Lloyd-Williams, ''Have VAT Rates Reached Their Limit: An Empirical Note,'' *Applied Economics Letters*, Feb. 2000, p. 111.

evasion becomes too great to control.[51] FairTax supporters dismiss those studies by pointing to the relative lack of evasion of state sales taxes in the United States. But the highest state rate is only 7 percent (in Mississippi) and state sales taxes do not attempt to tax many things such as services that are especially easy to evade.[52]

Evasion possibilities under the FairTax are not limited to nonpayment of taxes. The rebate mechanism also has tremendous fraud potential. Already there is a major problem with illegal immigrants using fake Social Security numbers, with an estimated 10 million now in use.[53] The possibility of getting a fairly substantial monthly check from the federal government for everyone in one's household with a Social Security number will undoubtedly lead to a vast increase in the proliferation of fake Social Security numbers. The FairTax requirement that all children have a Social Security number before parents receive their rebate check ensures that many such numbers would be issued to nonexistent children, which is already a problem.[54]

The likelihood of increased evasion under the FairTax is one reason why independent estimates of the true FairTax rate have always been substantially higher than 23 percent. Independent analyses also take account of the increased spending mandated by the FairTax.

- Bill Gale of the Brookings Institution has estimated that a tax-inclusive rate of 31 percent (44 percent on a tax-exclusive basis) would be needed even if there were no evasion or avoidance whatsoever. Making allowances for evasion and removal of state and local government consumption from the tax base would boost the tax-inclusive rate to 39 percent and the tax-exclusive rate to 65 percent.[55]
- The JCT, which is the official revenue estimator for all tax bills coming before Congress, estimated that the tax-inclusive rate would have to be 36 percent (57 percent on a tax-exclusive basis).[56]
- Treasury estimated that a tax-inclusive rate of 25 percent (34 percent on a tax-exclusive basis) would be needed just to replace the corporate and individual income taxes, leaving the payroll tax and estate and gift taxes in place. But if the FairTax were unable to tax as much of GDP as it hopes and if evasion were extensive, the tax-inclusive rate could rise as high as 47 percent on a tax-inclusive basis and 89 percent on a tax-exclusive basis.[57] Inclusion of the payroll tax and estate and gift taxes would raise these percentages by two-thirds.[58]

State Collection

It should be noted that there are many other problems with having the states collect the federal government's revenue, as the FairTax proposes. For one thing, five states don't have state sales taxes. In those states, the federal government would have to collect the FairTax itself. Another problem is that no two states have exactly the same sales tax, and no state has a sales tax that is even close to the FairTax.[59] Either the states would be forced to adopt a state version of the FairTax or there would be massive confusion and complication as to what is taxed by the state and what is taxed by the federal government.

FairTax supporters just assume that the states will quickly and eagerly adopt the FairTax for themselves. The broadening of the tax base over the limited sales tax base that the states have would allow them to collect the revenue necessary to pay the FairTax on their own purchases without having to raise state tax rates. But as explained earlier, their citizens are still going to be paying a lot more taxes to the states than they do now because the FairTax applies to most state and local government consumption.

Not surprisingly, state tax officials have voiced strenuous opposition to anything like the FairTax. When surveyed by the Government Accountability Office, 80 percent opposed a national retail sales tax as an intrusion on a tax base that has traditionally belonged to them. Most state tax officials also expressed great concern about confusion from having two separate sales tax systems in operation and about a loss of state sovereignty if they are pressured into piggybacking on a federal tax.[60] It's worth remembering that only a handful of states piggyback on the federal income tax now, even though it would greatly simplify tax collections for all states.

When the Tax Reform Commission asked state tax officials about a national retail sales tax, they expressed the view that if the federal government were to give up the taxation of incomes, as the FairTax proposes, the states would view this as a tax base now available to them to tax more fully. Since all but seven states have income taxes of their own now, it could be better for them to just get rid of their sales taxes altogether and let the

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[51] *Taxation in OECD Countries* (Paris: OECD, 1993), p. 78; Joel Slemrod, "Which Is the Simplest Tax System of Them All?" in Henry J. Aaron and William G. Gale, eds., *Economics Effects of Fundamental Tax Reform* (Washington: Brookings Institution, 1996), p. 370; Alan A. Tait, *Value Added Taxes: International Practice and Problems* (Washington: IMF, 1988), p. 18; Vito Tanzi, *Taxation in an Integrating World* (Washington: Brookings Institution, 1995), p. 50.

[52] Matthew Murray, "Would Tax Evasion and Avoidance Undermine a National Retail Sales Tax?" *National Tax Journal*, Mar. 1997, p. 176.

[53] Tony Freemantle, "Fake IDs Critical and Easy to Get," *Houston Chronicle*, Feb. 21, 2006.

[54] *See* U.S. Government Accountability Office, "Social Security Administration: Actions Needed to Strengthen Processes for Issuing Social Security Numbers to Children," Report GAO-05-115 (Jan. 2005).

[55] William G. Gale, "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Notes*, May 16, 2005, p. 889.

[56] JCT, "Budget Neutral Tax Rate for H.R. 2525," Memorandum from Lindy Paull to John Buckley (Apr. 7, 2000), *reprinted in Tax Notes*, Nov. 15, 2004, p. 917.

[57] President's Advisory Panel, *supra* note 45, p. 216.

[58] George K. Yin, "Is the Tax System Beyond Reform?" *Florida Law Review*, Dec. 2006, p. 993.

[59] John Mikesell, "A National Sales Tax? Taxing Consumption the American Way," *Tax Notes*, July 22, 1996, p. 524, *Doc 96-20557*, *96 TNT 142-76*.

[60] U.S. General Accounting Office, "Tax Policy: State Tax Officials Have Concerns About a Federal Consumption Tax," Report GAO/GGD-90-50 (Mar. 1990).

federal government collect its own revenue.[61] Taxpayers would no longer be paying federal income taxes, so they probably wouldn't object too much if state income taxes were raised slightly in return for no longer having to pay state sales taxes, especially if a federal sales tax were raising the price of everything by 23 percent. Under those circumstances, abolishing state sales taxes would undoubtedly be very popular.

Unless the states go in the other direction and abolish their income taxes in favor of raising all their revenue through a sales tax, the FairTax promise that no one will have to file income tax returns, keep records, or be audited is hollow indeed. More than likely, people would still have to file income tax returns to their states, keep all the same records they do now, and risk being audited.[62] The only way this could be avoided would be for the federal government to mandate the abolition of all state income taxes when the FairTax is implemented. It would probably also have to mandate that the states conform their sales taxes to the FairTax, which would make them little more than administrative districts for federal tax collection. Quite apart from the unlikelihood that such legislation would ever be enacted, it undoubtedly would be considered an unconstitutional violation of federalism.

VAT Preferred

FairTax supporters often talk as if they are the first to discover the benefits of a consumption-based tax system. In fact, people have written about the benefits of a consumption tax for hundreds of years.[63] And many nations have had VATs for decades. Yet FairTax supporters appear to be almost entirely unaware of the VAT experience or the reasons why this form of consumption tax evolved in preference to a national retail sales tax.

The main reason why the VAT was developed was to prevent a problem called cascading, which is when taxes are levied on taxes. That was particularly a problem in the area of international trade. Unless there was some way of rebating taxes at the border on exports, the same goods would be taxed differently depending on how many countries they passed through on their way from producer to consumer. The VAT produced a paper trail showing exactly how much tax was embedded in a product. That was also important because international trade rules permit the rebating of consumption taxes on exports, because they are assumed to raise their prices on a one-for-one basis. By contrast, income taxes cannot be rebated because there is no way of calculating the extent to which they are embedded in any particular product.[64] That's especially a problem for the corporate income tax because economists have long been divided on its incidence.[65]

Because the VAT is rebated on exports and applied at the border on imports, consumers pay the VAT rate only in their own country. This allows different countries to have different VAT rates without this having a distorting effect on international trade. Although at first glance the VAT's rebate mechanism looks like a way of subsidizing exports, it is in fact necessary for neutrality.[66]

Another important benefit of the VAT, especially as compared with a retail sales tax, is its superiority in terms of exempting business-to-business purchases. Unless these are exempted from tax, cascading and economic distortions will result.[67] However, studies of state sales taxes show that 40 percent or more of total sales tax revenue comes from taxing business inputs that should not have been taxed.[68] Historically, states have tried to deal with this problem by just exempting from sales tax products that appear to have only business uses.[69] But over time it has become harder and harder to make such distinctions when so many products, such as computers, have business and personal uses. Also the proliferation of warehouse stores has made the old distinction between wholesale and retail trade increasingly obsolete. And of course the Internet and interstate sales compound this problem.

FairTax supporters are aware of the necessity for exempting business purchases from tax. Retailers would

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[61]President's Advisory Panel, *supra* note 45, p. 220-221.

[62]State and local tax enforcement is just as oppressive as that of the IRS. *See* William P. Barrett, "Tax Torture, Local Style," *Forbes*, July 6, 1998, p. 80.

[63]As long ago as 1651, philosopher Thomas Hobbes wrote about the superiority of taxing consumption in his book *Leviathan* (Part II, Chapter 30). *See* Dudley Jackson, "Thomas Hobbes' Theory of Taxation," *Political Studies*, June 1973, p. 175.

[64]Kenneth Messere, "Border Tax Adjustments," *OECD Observer*, Oct. 1967, p. 5.

[65]Some economists believe that the corporate tax is largely paid by shareholders; others believe that a major portion is shifted to consumers in the form of higher prices, while others think that workers pay a big chunk of the tax in the form of lower wages. *See* Congressional Budget Office, "The Incidence of the Corporate Income Tax" (Mar. 1996); Alan J. Auerbach, "Who Bears the Corporate Tax? A Review of What We Know," *Tax Policy and the Economy*, vol. 20 (2006), p. 1; Richard Goode, "The Corporate Income Tax and the Price Level," *American Economic Review*, Mar. 1945, p. 40; Arnold Harberger, "The Incidence of the Corporate Income Tax," *Journal of Political Economy*, June 1962, p. 215.

[66]Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990), p. 263.

[67]Charles E. McLure Jr., "Economic, Administrative, and Political Factors in Choosing a General Consumption Tax," *National Tax Journal*, Sept. 1993, p. 345. One such distortion would be to force businesses to vertically integrate, combining production, distribution, and final sales to the greatest extent possible. The fact that very few companies do so currently shows that this is usually an uneconomic form of business organization.

[68]Robert Cline et al., *Sales Taxation of Business Inputs* (Washington: Council On State Taxation, 2005); Raymond J. Ring, "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," *National Tax Journal*, June 1989, p. 167; Raymond J. Ring, "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, Mar. 1999, p. 79; Robert P. Strauss, "Federal Tax Mechanisms to Enable State Taxation of Final Consumption," *Tax Notes*, June 19, 2000, p. 1657.

[69]John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, 2d ed. (Washington: Urban Institute, 1994), p. 61.

have to keep track of all the sales taxes they pay and get a credit against the sales taxes they owe. But producers and middlemen would not collect any taxes against which to get a credit. They would have to produce exemption certificates and the seller would be required to keep a copy of the certificate on every tax-exempt sale. In effect, the burden is on the seller to ensure that a tax-exempt sale is being made to a legitimate reseller.

States also use such a system, but it is very cumbersome. If you have ever had to stand in the checkout line behind someone making a tax-exempt purchase, you know what I mean. It is obvious from any visit to a large hardware store that many of the purchases are being made by contractors who seldom, if ever, make any effort to have the tax taken off their purchases. They just add the tax to their cost and the consumer ends up paying taxes on taxes.

Under a VAT, this problem is handled much more easily. All sales include VAT regardless of whether they are made to a reseller or consumer. The VAT also makes no distinction among producers, resellers, and retailers. All pay and collect the tax, which means they all have paid taxes to take credits against. This is a problem for the FairTax because only the retailer collects taxes. Therefore, under a VAT, sellers do not need to worry about whether a purchase is being made for business purposes or final consumption and whether no exemption mechanism is necessary. The burden is on the person or business claiming credits to justify them in the event of an audit.

The VAT also facilitates exports. Exporters are allowed to claim a credit for all the VAT embedded in their foreign sales. If they have no taxable sales against which to use their credits, they can get a direct refund from the government. Tourists are able to claim a refund as well by filling out a form at the airport since their purchases are in effect exports. The FairTax would also exempt exports, but it's hard to see why this wouldn't become a major opportunity for evasion since foreign purchasers won't have exemption certificates.[70]

Tourist sales are another problem area. The Internet exacerbates those problems by allowing people to transship purchases through foreign countries. Although the FairTax would apply to imports, governments would have to examine virtually every package entering the country to plug this loophole. There is also no way of taxing foreign consumption of services; there's nothing tangible to bring across the border for customs inspectors to tax.

FairTax supporters essentially assume away those problems by falling back on the idea that consumer prices will fall by the amount of the tax. ''It is unlikely that 'shopping across the border' in Canada or Mexico will result in any cost savings to the consumer,'' the FairTax Web site says. ''Remember, the FairTax is revenue neutral and therefore price neutral. This means the relative cost of retail goods and services after the FairTax remains very close to the same levels found in the marketplace today.''[71]

But as noted earlier, the assumption that prices will fall by the amount of the FairTax is based on a fixed money supply and a sharp cut in wages, neither of which is plausible. In any case, it is irrelevant to the issue of exports because the FairTax is rebatable on exports. So exports would be 23 percent cheaper than goods sold domestically regardless of what would happen to producer prices. Indeed, FairTax supporters tout this as an advantage of their plan and how it would boost exports. So they are effectively arguing simultaneously that there is no price advantage on exports and also that there is.

Basically, the VAT solves all of the administrative and compliance problems that FairTax supporters are either ignorant of or just assume away. Virtually all reputable economists who have looked at this issue have concluded that if the United States wishes to adopt a national consumption tax, either as a supplementary tax or a replacement for all or part of the existing tax system, the VAT makes far more sense than something like the FairTax. This has also been the conclusion of every foreign country that examined the issue.[72]

Perhaps if we could shrink the size of the federal government down to less than 10 percent of GDP, a national retail sales tax might be a workable option, because the rate would be low enough that many of the problems discussed above would not be insurmountable. After all, we funded the federal government largely with tariffs on imports — a kind of consumption tax — until 1913.

But economists know that bad taxes that can be borne relatively easily at low rates present serious problems at higher rates. That's why it was impossible to continue funding the federal government with tariffs and why the income tax was developed. In short, at a 10 percent rate, the FairTax might be viable; at a 23 percent rate — and certainly higher — it just won't work.

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[70]How this would work is very confusing. Section 102 of H.R. 25 says only that no tax is imposed on ''export from the United States for use or consumption outside the United States, if, the purchaser provided the seller with a registration certificate, and the seller was a wholesale seller.'' It looks as if only wholesalers are allowed to make tax-free export sales and only to foreigners with exemption certificates. It's hard to see how this cumbersome process would facilitate exports.

[71]*See* http://www.fairtax.org/PDF/FairTaxThumbnailSketch.pdf.

[72]Charles E. McLure Jr., *The Value-Added Tax: Key to Deficit Reduction?* (Washington: American Enterprise Institute, 1987), p. 107; Ken Messere, Flip de Kam, and Christopher Heady, *Tax Policy: Theory and Practice in OECD Countries* (New York: Oxford University Press, 2003), p. 152; Carl S. Shoup, ''Factors Bearing on an Assumed Choice Between a Federal Retail Sales Tax and a Federal Value-Added Tax,'' *in Broad-Based Taxes: New Options and Sources* (Baltimore: Johns Hopkins Press, 1973), p. 226; Treasury Department, *Tax Reform* (1984), p. 225; George Zodrow, ''The Sales Tax, the VAT, and Taxes in Between — or, Is the Only Good NRST a 'VAT in Drag'?'' *National Tax Journal*, Sept. 1999, p. 429.