

Fair Tax Problems

Ramesh Ponnuru, “A Misleading Sales Pitch,” *National Review*, March 22, 2010, 42–43.

Here’s the pitch: The FairTax — a plan to replace the federal income tax and payroll tax with a national sales tax — will get rid of the IRS forever. It will let workers keep their entire pensions. It will raise just as much money as the current tax code. It will promote economic growth. It won’t hurt the middle class, and it won’t cause prices to rise. It will even end our illegal-immigration problem.

These claims are drawn from the leading proponents of the plan: a group called Americans for Fair Taxation, former Republican presidential candidate Mike Huckabee, and the trio behind the book *FairTax: The Truth*. By painting an attractive picture of a prosperous America without an IRS, they have gotten many conservatives to become enthusiasts for their cause. Rising conservative star Marco Rubio, a Senate candidate in Florida [and eventually winner], has endorsed the Fair Tax in the past (although more recently he has hedged on it). Republican congressman John Linder of Georgia, a *FairTax* co-author who just announced that he will not run for reelection, has made promoting it his principal mission in Congress. The Iowa Republican party has endorsed it. It seems to be gaining support among tea partiers.

The FairTax sounds too good to be true. It is. The campaign for the FairTax is deeply misleading, and much more likely to set back the cause of tax reform than to advance it.

The FairTaxers give a misleading answer to the first question everyone asks about their idea: How big will the tax be? The FairTaxers say they want a 23 percent sales tax. Most people will assume that a product that costs \$100 before the tax is added would cost \$123 with the tax. Actually, the tax would be \$30 and the total price \$130. They call it a “23 percent” rate because \$30 is 23 percent of \$130. Those FairTaxers who understand the numbers defend this way of calculating the tax rate because it makes it comparable to the income-tax rates they’re trying to replace. But it’s not the way any of the 45 states that have sales taxes calculate their rates. Whether or not the FairTaxers intend to mislead people by using the 23 percent figure, confusion is the effect.

It is not at all clear that this 30 percent sales tax would raise enough revenue to eliminate income and payroll taxes. Brookings Institution economist William Gale has estimated that to replace current federal tax revenues, the tax rate would have to be 44 percent (or 31 percent the way the FairTaxers calculate rates: A \$100 product would cost \$144 after tax). Gale’s calculation assumed that nobody would evade the sales tax and that Congress would not narrow the tax base by, for example, exempting medical services from the tax. Relaxing those assumptions increases the rate required even further.

Several groups of people would be adversely affected by the tax. Retirees, for example, have paid taxes on their wages during their working lives. After a FairTax was implemented, they would find themselves also having to pay higher taxes on everything they used their accumulated savings to buy. The value of non-retirees’ accumulated savings would drop, too.

The middle class would also pay higher taxes. Under the FairTax plan, the federal government would give all legal residents of the U.S. a “prebate” to cover sales taxes on all purchases up to the poverty line. That would protect the poor (except for illegal immigrants; higher prices are supposed to induce immigrants to come legally so they can get their prebate). And the rich would pay less than they do now, since returns to investment typically are a large share of their income, and these would go untaxed. So if revenues are to stay the same, the middle class will have to pay more. If the change in tax policy increases economic growth, this effect will be mitigated — but it will take a very long time for it to disappear under any plausible assumptions. Governor Huckabee’s claim that voters in all income groups would come out ahead while the federal government would raise the same amount of revenue as before is of course unsupportable.

FairTax proponents generally respond to these criticisms with what we would have to call flimflammy if we thought they understood the issues. Existing taxes are embedded in today’s consumer prices, they say, so getting rid of them would cause prices to drop. Adding sales taxes would be “a wash,” says

Huckabee. So prices don't go up, and workers get to keep their "entire paycheck." Again, it sounds too good to be true.

And again, it is. If prices stay flat after a sales tax, workers can't keep their "entire paychecks": Wages have to fall. The paycheck you're keeping would be smaller. (Think about it this way: If existing taxes are embedded in the cost of every product, they're embedded in the cost of labor, too.) If wages don't adjust downward, then unemployment has to rise. If the Federal Reserve increases the money supply to prevent this combination of falling wages and rising unemployment, then consumer prices will increase.

Most experts in tax administration also say that enforcing sales taxes gets hard quickly once the rates hit double digits. That's one reason that many countries with broad-based consumption taxes levy value-added taxes, which are collected in smaller amounts at each step along the production and distribution chain, instead of sales taxes, which are collected in one big lump at the end. The fact that no country relies on sales taxes to the extent the FairTaxers advocate does not, however, faze them. Americans for Fair Taxation's website discusses the issue thus: "Two of the largest economies in the world rely almost solely on sales taxes: Florida and Texas. Many civilizations in history have relied solely on transaction-based consumption taxes: a percentage of a grain shipment in exchange for a safe harbor." Sales taxes in Florida and Texas are under 10 percent. Might imposing a 30 percent tax rate on the sales of a non-grain-based economy pose different issues? AFT doesn't say.

Even some of the real advantages of the FairTax are overstated. Households would not have to prepare returns, and would thus enjoy more privacy. On the other hand, the federal government would still have to know people's wages in order to determine how much they have earned in Social Security benefits. (Which leads to another problem, albeit a surmountable one. Those benefits are now linked to payroll taxes paid, which would of course end with the FairTax. As a result, people would have an incentive, for the first time, to make the federal government think they earned more than they actually did: They would accrue higher Social Security benefits while paying no extra taxes. Waitresses would start over-reporting their tips. The FairTax proposal has to take steps to combat this misreporting.)

And we haven't even gotten to the politics of it. How likely is it that Congress and the president — any Congress, any president — will agree to create a new tax system that punishes the middle class and senior citizens? One that taxes people when they buy a home in which to live, but not when they buy a house as an investment? (This example comes from *The FairTax Fantasy*, a fairly comprehensive attack on the idea by Hank Adler and Hugh Hewitt.) That requires state and local governments to pay taxes to the federal government whenever they buy something — and thus, in all likelihood, to raise their own taxes? Let's even stipulate that these are good ideas, and that the protests of the homebuilders and the charities at the loss of their popular deductions should be ignored. What are the odds that they will be?

AFT also advocates the repeal of the Sixteenth Amendment, which permits a federal income tax. Doing so would require the approval of 38 states' legislatures. Good luck with that.

In their book *FairTax*, talk-show host Neal Boortz, Congressman Linder, and Linder aide Rob Woodall dismiss the notion that their campaign is quixotic by arguing that the American Revolution seemed that way too. Abandoning the FairTax as politically impractical, they say, would betray "the American spirit." They add: "How sad it would be if the FairTax came so very close to reality, then failed legislatively because just a few people — people who could really have helped, people who could have made such a positive difference — just shrugged their shoulders and said, 'Hey, it's a good idea, but I don't see it happening.'"

They need not worry about that scenario. The FairTax is not going to come close to reality. It is true that some things once considered unlikely have come to pass, but working to enact the FairTax is still a waste of time. The American spirit has historically included a fair amount of calculating of odds. And the vast majority of times that people have said, "That will never happen," they were right.

But even if, *per impossibile*, the FairTax were enacted, its vulnerability to public sentiment would not end. One of the FairTaxers' arguments against reform of the income tax is that no reform will stick. The income tax, they say, started as a simple flat tax, and look where we are now. Leaving aside the fact that it has proven quite possible to improve the income tax for long periods of time — most people don't want

to see a restoration of the pre-Reagan code — the same objection applies to the FairTax. Over time, wouldn't it become just as riddled with exemptions and loopholes as the income tax is? Or as existing state sales taxes are? Or more so: How hard is it to imagine Congress adopting different tax rates for recyclable and non-recyclable products? And wouldn't the FairTax be at least as easy for politicians to raise as the income tax?

AFT says no. "The FairTax is highly visible. And because there is only one tax rate, it will be very hard for Congress to adopt the typical divide-and-conquer, hide-and-disguise strategy employed today to ratchet up the burden gradually, by manipulating the income tax code." But how visible would the FairTax really be? Each receipt would show how much the tax had raised the cost of a purchase, but most people would have no sense of how much they had given the federal government over the course of a year. Ask yourself whether you are better at estimating how much income and payroll tax you paid last year, or how much sales tax you paid.

The sound insight behind the FairTax is that the income tax pushes down the return on savings and thus creates a bias toward consumption today instead of consumption tomorrow. So taxing consumption instead of income, as the FairTax aims to do, makes a lot of sense. But there are many other ways to tax consumption. You could, for example, tax income but exempt savings. Other methods of taxing consumption pose far fewer economic, administrative, and political problems.

We do need to reform taxes — to make them simpler, more conducive to growth, and lighter on families. But if conservative politicians campaign for the FairTax, they will lose elections. If tax reformers define reform as the FairTax, there will be no tax reform. The nice thing to say would be that the people who came up with the FairTax and its marketing campaign need to go back to the drawing board. The truth is that they shouldn't be allowed near drawing boards.