

The Case for the FairTax

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Chairman Camp, Ranking Member Levin, and Members of the Committee, we are honored by your invitation to testify about tax reform at this critical juncture in our fiscal policy debate. Our testimony focuses on the need for consumption taxation and the manner in which the FairTax, as proposed in H.R. 25, can implement consumption taxation. We strongly support the FairTax, but recognize that there are many ways to tax consumption. In this regard, one of us, Professor Kotlikoff, has proposed a variant of the FairTax, called the Purple Tax (see www.thepurpletaxplan.org), which is also worth your consideration.

In the interest of full disclosure, we need to indicate that we have both done research on the FairTax under contract with Americans for Fair Taxation.¹ Several of our studies have been published in *Tax Notes* and other outlets. We are not currently under contract with Americans for Fair Taxation or any other organization or individual to do research on the FairTax. Nor are we being compensated for our time in testifying today.

The FairTax would replace the federal personal income tax (including the capital gains and the alternative minimum tax), the corporate income tax, the FICA employee and self-employment tax, and the estate and gift tax with a retail sales tax levied on consumption goods and services. H.R. 25 specifies an effective (tax-inclusive) rate of 23 percent – a rate set to maintain revenue neutrality. To ensure that those living at or below the poverty line pay no sales tax, on net, the FairTax provides all families with a monthly demogrant, also called a prebate, whose size depends on the family's composition. This feature transforms the FairTax from a proportional tax to a progressive tax.

¹ The Beacon Hill Institute's work can be accessed at <http://www.beaconhill.org/FairTaxPapers.htm>.

The most important criteria for judging tax systems are efficiency, equity, growth, simplicity, transparency, political sustainability, and compliance. Compared with income taxation, consumption taxation has a number of advantages along each of these dimensions. And among alternative ways to tax consumption, the FairTax ranks particularly high with respect to transparency and political sustainability, of which we say more below.

What Does Consumption Taxation Tax?

In thinking about taxing consumption and how it meets each of these criteria, it's important to realize that taxing current and future consumption is equivalent to taxing what's used to pay for consumption, namely one's current and future wages and one's current wealth. In fact, a consumption tax is mathematically equivalent to a one-time tax on current wealth, the proceeds of which are used to reduce the ongoing tax on labor income.

In contrast, the income tax taxes, on an ongoing basis, labor income as well as the income earned on one's wealth. So if you earn money, you pay taxes on that income immediately, and then if you save that money, the income earned on that additional savings will also be subject to the income tax. This is the sense in which an income tax represents a double tax on the use of one's labor income and why it embodies, in part, a tax on new saving.

A consumption tax, in contrast, does not include a tax on new saving. If you earn money under a consumption tax and save it, you hand the government no tax payments until you spend that money. (We're assuming here that the consumption tax is implemented as a retail sales tax.) Hence, your labor income is taxed only once regardless of when you spend that labor income.

Under a consumption tax, if you have existing wealth, you hand the government taxes on that wealth whenever you spend it. That's why the consumption tax also embodies a tax on existing or current wealth.

Delaying One's Spending Does Not Lower the Present Value of the Consumption Tax

An income tax provides an incentive to consume right away because doing so avoids the second tax hit. In contrast, a consumption tax provides no such incentive. If you have \$X in wages you just earned or in wealth that you accumulated in the past, you hand the government taxes just once – when you spend these funds.

But does that mean that one can reduce the consumption tax hit by delaying one's spending? The answer is no. If you delay spending your current wages and wealth and save it and spend it plus the asset income you've earned, say, next year, you'll pay consumption taxes not just on the original money, but also on the additional asset income. In present-value terms, your tax payment will be the same. I.e., the additional consumption taxes paid on the asset's income makes you indifferent, in terms of taxes, between spending now and spending tomorrow.

To summarize, a consumption tax is neutral with respect to when you spend your money. Whether that money is newly earned or was earned in the past and saved, you hand the government tax payments just once. An income tax is not neutral with respect to when you spend your money. The sooner you spend it, the more you avoid having it taxed again.

A Consumption Tax Is Effectively Levied Immediately

If the government hands you a bill and says you need to pay it either now or in the future, but that if you pay it in the future, you have to pay interest as well, you've been hurt right away. Whether you pay the bill now or pay it in ten years with interest, you're in the same boat in terms of the present-value impact.

This is true of the consumption tax. Even though the government gives us the option of when we want to hand over the tax on our current wages and existing wealth, it effectively charges interest if we wait to hand over the tax. Hence, we're hurt immediately when the tax is imposed.

An example will help. Suppose Joe has \$1 billion and the government implements a 30 percent nominal sales tax. Let's assume, for simplicity (the point doesn't hinge on this) that the Fed accommodates this tax and lets consumer prices rise by 30 percent. If Joe spends his \$1 billion today, he'll wind up with only \$770 million in goods and services since 23 percent of each dollar he spends goes to pay the sales tax. This is why we say that a 30 percent nominal tax entails an effective tax of 23 percent.²

Clearly, if Joe spends now, he's hurt. But suppose Joe waits and spends his \$1 billion in a year. Does this lower Joe's tax liability? No. Joe knows that the tax will still be in place in a year, so even though he still has his \$1 billion sitting in his pocket, he realizes its purchasing power has already been reduced by 23 percent.

² Alternatively, we can say that a 30% "tax-exclusive" rate entails a 23% "tax-inclusive" rate.

Joe's not happy, and waiting to spend won't change his demeanor. Whenever he spends his wealth plus the income earned from saving it, he'll need to pay taxes on the total expenditure, which is the original principal of his wealth plus the income earned on his wealth. So he can spend today and hand over less in taxes or spend tomorrow and hand over more in taxes. Either way, he's out the same 23 percent of his current wealth. And if he gives his kids his wealth, either before or at his death, he's giving them less real wealth because the dollars he hands them entail less purchasing power.

In the Weimar Republic, even billionaires were poor. Our real wealth is not just a matter of the number of pieces of currency in our pocket. Our real wealth depends on what that currency can buy. And if the wealthy can buy less today than yesterday because of a switch to consumption taxation, then they are poorer in real terms. With this background on consumption taxation, we now evaluate the consumption tax in light of each of the aforementioned criterion.

Tax Efficiency

To economists, tax efficiency means limiting the degree to which the tax system distorts economic decisions, particularly decisions to work, save, and invest. Unlike income taxation, which distorts both the decisions to work and save, consumption taxation affects only the incentive to work. I.e., as just discussed, the income tax biases you to spend your wages and wealth immediately.

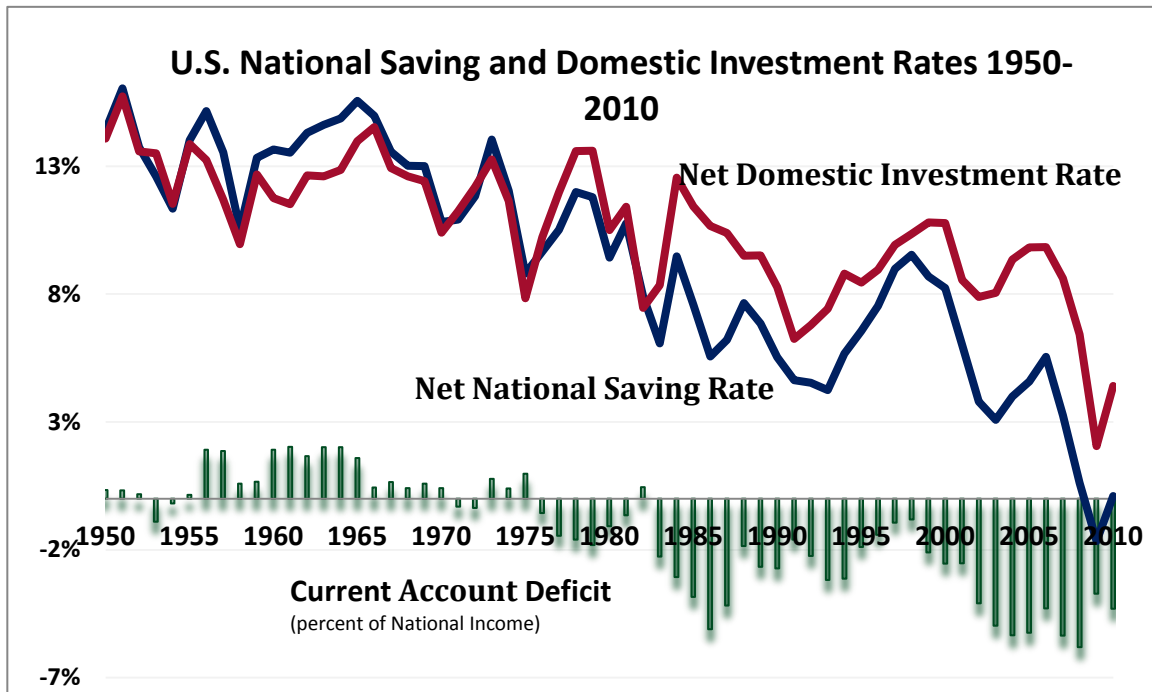
Take Judy, who earns \$100,000 this year and wants to spend it all in ten years. Under a 23 percent wage tax, Judy hands Uncle Sam \$23,000 this year and also hands Uncle Sam, *each year for the next ten years*, 23 percent in taxes of each dollar of asset income she earns by saving her remaining \$77,000.

Under a retail sales tax imposed at a 23 percent effective rate, Judy hands over nothing to Uncle Sam for 10 years, at which point she is taxed on the principal plus interest. In present-value terms this is equivalent to Judy's simply handing over \$23,000 to the government now and not paying any taxes in the future.

By letting her defer taxes on the original \$100,000 of labor income earned as well as on the asset income earned along the way, the consumption tax effectively taxes her once to the tune of \$23,000, when measured in present-value terms. To summarize, an income tax biases people to spend now, whereas a consumption tax does not. This means that an income tax penalizes saving, whereas a consumption tax does not.

As the chart below shows, our country has a terrible saving problem. We are currently saving literally nothing and, as a consequence investing next to nothing, and, as a

further consequence, inducing foreigners to invest in our stead. Foreign net investment references our current account deficit.



Effective Marginal Tax Rates

Economists measure the disincentive to work in terms of people’s marginal tax rates (marginal tax brackets). Table 1 below shows the dramatic impact of switching to the FairTax on federal marginal taxes on working.

The impact of The FairTax on the incentives to save, at the margin, would also be substantial. Under The FairTax, the federal government’s taxation of saving at the margin is zero.

Under the current federal tax, the size of the marginal tax a household faces on saving depends on whether it is using retirement accounts to shelter its saving. If so, it will face a low marginal tax from the federal personal income tax, but a potentially quite hefty marginal tax from the corporate income tax. If the household is saving outside of a 401(k), IRA, or similar tax-favored saving vehicle, the current federal marginal tax can be substantial depending on the household’s tax bracket and whether it is receiving its asset income as tax-preferred capital gains and dividends or in non-tax preferred dividends.

Table 1. Marginal Effective Federal Tax Rates on Working, FairTax Vs. the Current System

Single Households						
Total Annual Household Earnings	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$10,000	-23.1%	23.0%	-23.2%	23.0%	29.8%	23.0%
\$15,000	33.3%	23.0%	33.8%	23.0%	22.4%	23.0%
\$25,000	34.2%	23.0%	47.7%	23.0%	26.2%	23.0%
\$35,000	50.2%	23.0%	28.3%	23.0%	29.0%	23.0%
\$50,000	28.2%	23.0%	22.4%	23.0%	36.5%	23.0%
\$100,000	27.6%	23.0%	27.5%	23.0%	28.6%	23.0%
\$250,000	41.5%	23.0%	37.2%	23.0%	35.5%	23.0%
Married Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$20,000	33.8%	23.0%	41.4%	23.0%	23.5%	23.0%
\$30,000	33.7%	23.0%	47.6%	23.0%	28.2%	23.0%
\$50,000	28.0%	23.0%	28.2%	23.0%	28.2%	23.0%
\$70,000	28.3%	23.0%	28.2%	23.0%	32.7%	23.0%
\$100,000	33.5%	23.0%	33.7%	23.0%	34.3%	23.0%
\$200,000	35.3%	23.0%	31.2%	23.0%	37.5%	23.0%
\$500,000	38.4%	23.0%	38.4%	23.0%	37.2%	23.0%

Source: Laurence J. Kotlikoff and David Rapson, “Comparing Average and Marginal Tax Rates Under the FairTax and the Current System of Federal Income Taxation,” 2006.

Equity – The Consumption Tax is Not Regressive

Many people view moving to consumption taxation as regressive. These same people would view switching from our current system to a tax on existing wealth, whose proceeds are used to lower the taxation of labor income, as highly progressive. But it is not possible to hold both beliefs since a consumption tax is identical to a tax on existing wealth and current and future wages, and a tax on existing wealth and current and future wages is identical to a tax on consumption.

If people who oppose a consumption tax understood that it embeds a significant wealth tax, they would likely support it. In this regard, it is paradoxical that Democrats appear to oppose consumption taxation, whereas Republicans appear to support it.

Economists measure tax progressivity in terms of lifetime net tax rates, specifically as the ratio of the present value of lifetime net tax payments divided by the present value of lifetime resources (initial wealth plus the present value of future labor earnings).

Politicians like to measure tax progressivity in terms of current taxes divided by current income. But current income is not a useful measure of a person or household's economic resources. Warren Buffett may have zero current income this year if his capital losses are large enough to offset his capital gains, but his personal resources are immense. By measuring tax progressivity incorrectly, politicians conclude that a consumption tax is regressive, whereas economists view it as proportional. This makes sense. Since a consumption tax is, in essence a tax on existing wealth and the present value of wages, taxing consumption at a fixed rate is taxing economic resources (existing wealth and the present value of wages) in proportion to the level of those resources.

By adding its demogrant/prebate, the FairTax transforms a proportional consumption tax into a progressive one. Table 2 below shows that the FairTax reduces lifetime net tax rates substantially (thanks to its base broadening), while enhancing tax progressivity.³

Growth

In the course of its work on the FairTax, the Beacon Hill Institute built a computer model aimed at determining the effects of the FairTax on economic growth. The model was constructed in 2006 for a hypothetical implementation date of January 1, 2007.⁴ The findings for 2007 through 2031 are summarized in Table 3. The table shows the percentage difference in each indicator resulting from implementation of the FairTax for selected years 2007 to 2031. For example, real GDP would have been 7.9 percent higher in 2007 under the FairTax than under the "baseline" current law and 10.3 percent higher by 2031.

³ See also David G. Tuerck, Jonathan Haughton, Paul Bachman, Alfonso Sanchez-Penalver, Phuong Viet Ngo, *A Distributional Analysis of Adopting the FairTax: A Comparison of the Current Tax System and the FairTax Plan* (February 2007):4, <http://www.beaconhill.org/FairTax2007/DistributionalAnalysisFairTaxBHI4-25-07.pdf>.

⁴ See David G. Tuerck, Jonathan Haughton, Keshab Bhattarai, Phuong Viet Ngo, Alfonso Sanchez-Penalver, *The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model* (February 2007):1, <http://www.beaconhill.org/FairTax2007/EconomicEffectsFTBHCModel4-30-07.pdf>.

**Table 2. Average Remaining Federal Lifetime Tax Rates –
Current System vs. the FairTax**

Single Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$10,000	-12.3%	-17.6%	6.2%	-13.5%	6.5%	-27.1%
\$15,000	-4.0%	-5.0%	11.3%	-10.0%	9.8%	-28.0%
\$25,000	10.2%	5.6%	17.7%	4.7%	14.1%	-6.2%
\$35,000	18.5%	10.1%	20.7%	5.4%	16.7%	-5.9%
\$50,000	21.1%	13.5%	23.5%	11.4%	21.5%	3.9%
\$100,000	27.5%	17.8%	30.3%	14.7%	32.1%	9.2%
\$250,000	27.9%	20.8%	33.6%	19.7%	40.8%	18.2%
Married Households						
Total Household Income	Young Adult (Age 30)		Middle Aged (Age 45)		Senior (Age 60)	
	Current System	FairTax	Current System	FairTax	Current System	FairTax
\$20,000	3.1%	1.3%	11.0%	1.5%	7.2%	-11.0%
\$30,000	12.5%	7.8%	15.3%	3.4%	10.1%	-10.5%
\$50,000	19.1%	13.4%	19.6%	11.1%	14.2%	1.4%
\$70,000	21.1%	15.6%	21.3%	11.6%	17.0%	2.2%
\$100,000	23.2%	17.4%	24.0%	14.7%	22.4%	7.9%
\$200,000	27.2%	19.7%	29.0%	17.0%	32.2%	12.3%
\$500,000	30.6%	21.6%	35.6%	20.5%	41.5%	19.3%

The capital stock would remain unchanged in the first year because incremental investment in that year would add only to the usable capital stock in the following year. However, the capital stock would begin to increase in the second year and eventually rise to 17.3 percent above baseline 24 years out. Consumption would fall slightly at first, as agents found it in their interest to take full advantage of the FairTax and substantially increase their saving. Investment would rise to 88.4 percent above baseline in the second year. Consumption would rise steadily to 6.0 percent above baseline for the last year, as households took advantage of the increased income made possible by the increased capital formation.

Table 3. Summary of Effects of the FairTax Relative to Current Law (% change), 2007-2031

	2007	2008	2009	2010	2011	2016	2021	2026	2031
Year	1	2	3	4	5	10	15	20	25
Real GDP	7.9	9.3	9.9	10.3	10.7	10.9	10.7	10.5	10.3
Domestic investment	74.5	88.4	88.0	87.1	86.3	75.9	69.0	65.7	65.2
Capital stock	0.0	2.8	5.3	7.5	9.3	14.1	16.0	16.9	17.3
Employment	11.9	12.0	11.2	10.5	9.9	7.6	6.1	5.3	4.7
Real wages	10.3	10.6	10.4	10.3	10.2	9.5	9.1	9.0	9.2
Consumption	-0.6	-0.8	0.2	1.1	1.8	4.3	5.5	5.9	6.0

Laurence J. Kotlikoff and Sabine Jokisch, using an overlapping-generations open-economy simulation model, estimate that in 25 years the introduction of a FairTax would raise the capital stock by 43.8 percent, the real pre-tax wage by 11.5 percent, and national income by 9.4 percent.⁵ Arduin, Laffer & Moore Econometrics find that the FairTax would raise total economic output by 11.3 percent ten years out. Investment would be 41 percent higher and employment 9 percent higher.⁶

Simplicity

Under The FairTax, American households and businesses file no tax returns. Taxes on final purchases of goods and services are collected at the store and transmitted to the government. There would be no need for tax accountants or tax lawyers. These hundreds of thousand highly skilled professionals would be freed up to lead socially productive work lives.

Transparency

Under the FairTax, the tax system is very simple and, therefore, very clear. There is a single 23 percent effective sales tax, which everyone pays.

Compliance

The Beacon Hill Institute estimated that the cost to all parties of collecting the FairTax in 2005 would have come to \$60.6 billion and that the saving in compliance costs for federal tax filers would have been \$407.11 billion, for a net saving of \$346.51 billion.⁷

⁵ Laurence J. Kotlikoff and Sabine Jokisch. "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax." *NBER Working Paper Series* 11858 (2005). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=872721.

⁶ Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal," (June 2006):28, <http://www.fairtax.org/PDF/MacroeconomicAnalysisofFairTax.pdf>

⁷ David G. Tuerck, Paul Bachman, Alfonso Sanchez-Penalver, "Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System (September 2007) <http://www.beaconhill.org/FairTax2007/TaxAdminCollectionCosts071025%20.pdf>.

Sustainability

Because The FairTax has one tax rate, everyone will know that spending more on anyone or anything will entail raising that single tax rate. Everyone will also know that tinkering with the tax rate schedule will damage this tight link between what's spent and what people have to pay. That will make it harder to hide new taxes or to hand out tax breaks to special pleaders. The FairTax is more likely than other taxes, including other consumption taxes, to sustain itself in the face of political pressure to undo what it sets out to accomplish.

The FairTax Rate

In 2006, we showed that the FairTax rate would have to be 23.82% in 2007 in order to raise the revenue needed to replace the revenue lost by eliminating existing taxes and to fund the demogrant.⁸ More recent calculations show that the 23% rate called for in the statute would have raised more revenue than needed in 2009 and 2010.

Opponents claim that evasion would require the rate to be much higher. By our estimate, however, the evasion to be expected under the FairTax would trim the base by only about two percent. And this effect would eventually be offset by the rise in consumption that implementation of the FairTax would bring about. The Beacon Hill Institute predicts that consumption would rise by 2 percent four years out and by 6 percent beyond that. Moreover, the entire tax enforcement apparatus of the federal government would be available to enforce this single tax with its many fewer tax filers.

Conclusion

Compared with the existing federal tax system, The FairTax is a sure winner. It's more efficient, equitable, transparent, sustainable, and growth-and-jobs oriented. It will help revitalize investment, and with it, expand our economy, create jobs and bring in new revenues.

⁸ Paul Bachman, Jonathan Houghton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck, "Taxing Sales Under the FairTax: What Rate Works?" *State Tax Notes* (November 13, 2006):672 <http://www.beaconhill.org/FairTax2006/TaxingSalesundertheFairTaxWhatRateWorks061005.pdf>.