The Viability of The Fair Tax

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Abstract

This thesis begins by investigating the current system of federal taxation in the United States and examining the flaws within the system. It will then deal with a proposal put forth to reform the current tax system, namely the Fair Tax. The Fair Tax will be examined in great depth and all aspects of it will be explained. The objective of this paper is to determine if the Fair Tax is a viable solution for fundamental tax reform in America. Both advantages and disadvantages of the Fair Tax will objectively be pointed out and an educated opinion will be given regarding its feasibility.
The Viability of the Fair Tax

In 1986 the United States federal tax code was changed dramatically in hopes of simplifying the previous tax code. Since that time the code has undergone various changes that now leave Americans with over 60,000 pages of tax code, rules, and rulings that even the most adept tax professionals do not understand. As a result of the complexity inherent in the current tax code, many ideas for federal tax reform have been discussed in recent years. One such idea is the Fair Tax. This Honors thesis deals with examining the Fair Tax and its various components. The goal of this paper is to determine if the Fair Tax is a viable solution for fundamental tax reform in America. This paper will be written from an objective standpoint, and it will examine both the advantages and the disadvantages of the Fair Tax as proposed in the Fair Tax Act of 2007 before the Congress of the United States. After exploring both sides of the issue, an educated opinion will be made regarding whether or not the Fair Tax is a feasible alternative to current income taxation as it appears in the United States.

Goals of Tax Reform

Before the Fair Tax is discussed, a proper foundation for tax reform must be laid. There are three main goals of tax reform this thesis will identify: simplification, efficiency, and limitation of government (Policy Analysis Options for Tax Reform, 2005). As previously mentioned, the current federal income tax code is anything but simple. Its complexity imposes high administrative and compliance costs, impedes efficient decision making by individuals and businesses, causes frequent and costly errors by individuals and the IRS, promotes invasion of personal privacy by the government, and leads to greater noncompliance with the tax system. Simplification is one goal of a
well-designed tax system. It will lead to reduced time and lower expenses for administration, planning, and enforcement; better economic decision making; fewer taxpayer and government errors; and less tax avoidance and evasion. The second goal of a well-designed tax system is efficiency. In his Policy Analysis on Options for Tax Reform, Chris Edwards (2005) states, “the current income tax system is very inefficient because it alters wage, price, and profit signals and diverts resources into low productivity uses” (p. 5). A good tax system is efficient and leads to lower marginal tax rates; less taxation of savings and investment; equal treatment of industries, assets, and investments; and greater economic growth and higher incomes. The final goal of tax reform to be identified is limited government. The federal tax code in place today is a large source of government power and abuse: “Large omnibus spending bills typically include many items that would not gain legislative support under a more visible standalone vote. Legislators have a bias toward dishing out government largesse to visible and important constituencies, while hiding the resulting costs from current taxpayers in the form of deficits” (p. 9). A well-designed tax system should strongly encourage limited government. It should allow greater transparency so taxpayers can measure the cost of government; have fewer and slower growing tax bases so the overall tax burden can be better controlled; treat all citizens equally and bring an end to the “social engineering” in the current code; and maximize privacy and civil liberties (p. 3). The Fair Tax will be measured with these three goals of tax reform in mind. How well these goals are met will help to determine the viability of the Fair Tax.
Now that a proper foundation for tax reform has been laid, an explanation of the Fair Tax is warranted. The Fair Tax is relatively easy to understand and transparent. As a result, an explanation of the Fair Tax is quite simple. The idea for such a plan began to grow some roots when Representative John Linder and Senator Saxby Chambliss filed legislation in the form of H.R. 25 in the House of Representatives, and S.25 in the Senate. This legislation was introduced in the 109th Congress as the Fair Tax Act of 2005. H.R. 25 was reintroduced in the 110th Congress and is now known as the Fair Tax Act of 2007. This legislation, if passed, would repeal the individual income tax, the alternative minimum tax (AMT), corporate and business income taxes, capital gains taxes, Social Security taxes, Medicare taxes, all other payroll taxes, the self-employment tax, estate taxes, and gift taxes (The FairTax Book, 2005). To replace all of these taxes, a personal consumption tax would be imposed on all consumer purchases of new goods and services at a “tax inclusive” rate of 23% (Tax administration and collection costs, 2007). This tax would be an embedded tax, meaning it would be included in the price of the goods or services purchased, rather than added on top of the price of the goods or services (FairTax: The Truth, 2008). New goods and services include all items purchased at the retail level as well as doctor’s fees, accountant’s fees, lawyer’s fees, and all other service fees. The Fair Tax would only tax new items at the retail level, meaning the sale of used or previously owned items would not be taxed (The FairTax Book, 2005). Business-to-business purchases would not be taxed, because the tax would be collected once the ultimate user purchases the good or service (A Macroeconomic analysis of the Fair Tax Proposal, 2006). Items taxed by the Fair Tax would also include internet and catalog
sales of new goods. The Fair Tax is a neutral tax that has no favorites. As a result, state, local, and federal governments would pay the Fair Tax on all new purchases (The FairTax Book, 2005). It is important to note several things at this point. First, the Fair Tax is a replacement of the current federal tax system, not an additional tax imposed on top of all other taxes in place today. Secondly, the Fair Tax is revenue neutral. The idea of revenue neutrality essentially means to replace the current system of taxation with an alternative system, the Fair Tax, and still raise the same amount of revenue. In other words, the amount of revenue currently derived from the system of federal taxation would remain constant as the method of taxation changed to the Fair Tax. The entire goal of the Fair Tax is to use a new method of taxation to raise the same amount of revenue the current system raises. The key to revenue neutrality is setting the sales tax rate at the appropriate level to ensure that the federal government receives the same amount of revenue.

The Fair Tax would be collected by retail stores and service providers. It would then be remitted to the state sales tax authority after the retailers deducted a 0.25% administrative credit for collecting the tax. The state would then remit this amount to the federal government after deducting another administrative credit (0.25%) for collecting the tax (Tax administration and collection costs, 2007). The federal government would receive no administrative credit for collecting any Fair Tax revenue: “To ensure that income taxes would not be reinstated in the future, the Fair Tax plan calls for the repeal of the 16th amendment to the U.S. Constitution – the amendment granting the federal government the power to tax income” (A Macroeconomic analysis of the Fair Tax Proposal, 2006, p. 4).
The Prebate

The last major concept of the Fair Tax relates to its plan to avoid being a regressive tax by virtually eliminating the total tax burden on middle and lower income Americans. To eliminate the burden of the Fair Tax on low-to-middle income earners, the Fair Tax would send a prebate to each head of household in America to cover taxes on the basic necessities of life. This may be thought of as a rebate, paid in advance to every household, of the amount of Fair Tax that a taxpayer spending at the poverty level would normally be expected to have paid. Every head of household in America, rich or poor, would receive this prebate on a monthly basis to reimburse them for the sales tax the family would pay on all spending up to the poverty level. The amount of the monthly prebate payments would be based upon the government’s published poverty levels for various sized households (The FairTax Book, 2005). For example: In 2006, a married couple with two children would have had an annual consumption allowance of $26,400, the amount the government estimated this family would spend during that one year on the basic necessities of life for the family. This family would be reimbursed for the amount of tax on this amount ($26,400 x 23% = $6,072) by receiving monthly prebate payments from the government of $506 ($6,072 ÷ 12) (The FairTax Book). Lastly, because the poverty level for a family of two is not twice the poverty level of one individual, the prebate includes an additional amount of money for married couples to prevent a marriage penalty (A comparison of the fair tax base and rate, 2007). The prebate allows the Fair Tax to avoid being a regressive tax by ensuring that lower income Americans, young and old, pay no tax on all spending up to the poverty level.
Another point worth explaining is the “tax inclusive” 23% rate that the Fair Tax would impose on all purchases of new goods and services. It is important to distinguish between “tax inclusive” and “tax exclusive” rates for purposes of a proper comparison between the Fair Tax and the current system of income taxation in America. The easiest way to ascertain this difference is seen through an example. Suppose an individual earned $200 and spent the entire amount. Also, suppose this individual paid a tax of $40 on these earnings. If this person were subject to an income tax, he or she would earn $200 before tax, $160 after tax and spend $160 at the store. In order to spend $160 while being subject to a tax on income, this individual would need to earn $200. On the other hand, if there were no income tax but a sales tax instead, this person would earn $200 and pay $200 at the store for $160 worth of goods. Of the $200 paid at the store, the store would remit $40 in sales tax. Using this example, the tax rate could be seen on a “tax exclusive” basis as $40/$160=25 percent or on a “tax inclusive” basis as $40/$200=20 percent. The Fair Tax rate proposed in H.R. 25 is a tax inclusive rate, just like the current personal income tax. Contrary to this, most state sales taxes are tax exclusive (A comparison of the fair tax base and rate, 2007). Because the Fair Tax is designed to replace the existing federal income tax and payroll tax system, the rate should be quoted on the same basis as the taxes it is designed to replace are quoted (FairTax: The Truth, 2008). In order for an accurate comparison between the Fair Tax and the current income tax system, the tax rate must be stated on a tax inclusive basis.

Economic Effects of the Fair Tax

Now that the basic workings of the Fair Tax have been explained, it is important to determine the economic effects that would transpire as a result of the enactment of the
The Fair Tax. To begin, a proper goal of tax policy from an economic efficiency perspective must be established. It is a well-known fact that individuals do not work simply to pay taxes; they work in order to receive after-tax income. It is also a well-known fact that as government increases its share of income earned by its citizens, the incentive for the individuals to engage in such activities falls: “The higher the tax on the next dollar earned (the marginal tax rate) the larger the disincentive” (A Macroeconomic Analysis of the Fair Tax Proposal, 2006, p. 2). Of course, without taxes the government cannot operate. These points lead Arduin, Laffer, and Moore to conclude that the appropriate goal of tax policy from an economic efficiency perspective is “to establish a tax system that minimizes the tax disincentives on economic activities, given the revenue needs of the government” (p. 2) (Arduin, Laffer, and Moore is an economic consulting firm). Given this goal, this paper will measure the Fair Tax in terms of how effectively it would lead to increased economic efficiency, while meeting the revenue needs of the government.

One of the main objectives of the Fair Tax is economic growth. Arduin, Laffer, and Moore Econometrics point out the significant impact the Joint Committee on Taxation (JCT) 1997 Tax Modeling Project and 1997 Tax Symposium have played in many of the analyses done on consumption taxation: “The JCT held a series of meetings to examine the methodologies and feasibility of incorporating a dynamic macroeconomic model into the revenue estimating procedures for alternative tax reforms – including consumption-based taxes” (A Macroeconomic analysis of the Fair Tax Proposal, 2006, p. 21). During these meetings, participating academics presented the results of their individual models: “All of the models projected that a switch to a consumption tax would ultimately lead to higher economic growth” (p. 22).
Several studies have been done by economists in an attempt to identify the economic effects of the Fair Tax. One such study, done by David Tuerck, Jonathan Haughton, Keshab Bhattarai, Phuong Viet Ngo, and Alfonso Sanchez-Penalver, members of the Beacon Hill Institute, (Beacon Hill Institute is the research arm of the Department of Economics at Suffolk University in Boston) uses a dynamic Computable General Equilibrium (CGE) model to determine the effect the Fair Tax would have on major economic indicators, such as real GDP, domestic investment, capital stock, employment, real wages, and consumption. According to this study, real GDP would rise 7.9% the year after the Fair Tax was implemented and would increase 10.3% twenty-five years later (The economic effects of the Fair Tax, 2007). The level of investment in the U.S. would increase dramatically causing the country’s capital stock to rise 17.3% twenty-five years after the Fair Tax was implemented (p. 24). Employment levels would increase by 11.9% in the first year under the Fair Tax and would settle 4.7% higher after twenty-five years: “In particular, the household would find that, with the replacement of the existing income tax by a national sales tax, the reward for increased work and saving would rise, motivating economic “agents” (i.e., households and firms) to expand both” soon after the Fair Tax was implemented (The economic effects of the Fair Tax, 2007, p. 3-4). Of the other major economic indicators looked at in this study, only consumption would not increase in the first year after the Fair Tax was implemented. In the early years of the Fair Tax consumption would decrease compared to current levels because households would increase the savings amount due to the opportunity for a higher net return on capital. However, twenty-five years down the road, consumption would be 6.0% higher than the benchmark number (p. 25). The reason for the increase in all these factors is
largely driven by the elimination of the double taxation feature of the current system in place today. Tuerck et al, give an excellent example to prove this point:

To understand this feature, consider a wage earner who wants to save part of his income. That wage earner pays a tax once when he receives his wage and pays a tax a second time when he receives a return (interest, dividends, capital gains) on his saving. Because the FairTax would fall on consumption, not “income” conventionally defined, wage earners would pay a tax only when they consume. Eliminating the double tax on saving would encourage saving, investment and capital formation, leading to an increase in production, as our results show. (The economic effects of the Fair Tax, 2007, p. 4)

Tuerk et al, conclude that while not everyone would be better off under the Fair Tax system, the number of individuals better off would outnumber those worse off by a factor of more than ten to one. According to this study, households in all income groups, on average, would experience greater increased welfare under the Fair Tax (The economic effects of the Fair Tax, 2007). This study shows that the Fair Tax would minimize tax disincentives and effectively lead to greater economic efficiency.

Another analysis done by Arduin, Laffer, and Moore Econometrics concluded that many benefits would arise as a result of the Fair Tax. This study echoes many of the same findings that Tuerk et al, derived from their analysis of the Fair Tax on economic indicators. According to this study, total economic output would be 11.3% higher than it would be without the implementation of the Fair Tax as a result of a neutral tax base and lower tax rate. Arduin et al, also point out the potential for even higher growth if higher productivity growth is linked to higher capital accumulation, which they say is a likely
scenario. If increased capital accumulation induced a ½% increase productivity growth, total economic output after ten years would be 19.4% greater, as opposed to 11.3% greater. In addition to this, the study also found that compliance costs would be lower under the Fair Tax. All of these factors combined could lead to increased economic growth of 24.4% after ten years under the Fair Tax (A macroeconomic analysis of the Fair Tax Proposal, 2006). Arduin, Laffer, and Moore also claim that investment would increase dramatically under the Fair Tax. According to their study, total investment would increase 33% in the first year after the Fair Tax was implemented and is estimated to be 41% higher than the baseline scenario after ten years.

The macroeconomic analysis of the Fair Tax projects that employment would grow 3.5% in year one of the Fair Tax and would be 9.0% higher than the baseline number after ten years. The reason for this increase is directly tied to the increased incentive for people to work as a result of higher take home wages. As a result of higher employment, total labor income would rise 27.4% in the first year following the implementation of the Fair Tax. After ten years, this number is estimated to jump 41% above the baseline scenario under the current system of federal taxation. Unlike the study done by Tuerck et al, the study done by Arduin, Laffer, and Moore concluded that consumption would increase right away if the Fair Tax was implemented. According to their study, consumption would increase by 2.4% in the first year and by 11.7% after ten years under the Fair Tax. As a result of these increases to various economic factors, Arduin, Laffer, and Moore determine that government revenues would increase by 0.5% after one year and by 6.2% after ten years if the Fair Tax was implemented. The macroeconomic analysis of the Fair Tax concludes that the Fair Tax would lead to
increased economic efficiency while meeting the revenue needs of the government, hence achieving the tax policy goal from an economic efficiency perspective.

**Simplicity of the Fair Tax**

While the Fair Tax would have a profound impact on the economy, it would also affect several other areas in positive ways. One such way is the simplicity that the Fair Tax would bring in comparison to the current tax code. In 1954 the combined federal income tax code, regulations, and IRS rulings were about 14,000 pages long. By 2006, this number had grown to over 67,000 pages, an increase of 380% (The FairTax reduces complexity, compliance costs, and noncompliance, 2007). As the size of the code has grown immensely, so have the complexities and misunderstandings. This is seen through the centers the IRS has established all over the country to help people prepare their tax returns:

In a study conducted by Treasury Department investigators posing as taxpayers, the investigators found these centers gave incorrect answers – or no answer at all – to 43 percent of the questions. The investigators concluded that half a million taxpayers may have been given wrong information between July and December 2002. Auditors were given correct answers to 57 percent of their tax law questions during the course of the study. Less than half, or 45 percent, of the questions were answered correctly and completely. In 12 percent of the cases, the answer was correct but incomplete. (The Fair Tax reduces complexity, compliance costs, and noncompliance, 2007, p. 3-4)

As this example shows, the current tax code in place is so complex that even IRS employees do not understand all of its intricacies. Another example of the complexities
inherent in the current code is the sheer volume of returns filed with the IRS each year. According to the IRS (2003), the total number of U.S. returns is expected to reach 249.7 million by 2010 (not including information returns). The Fair Tax would take away the complexity of the current code and replace it with a simple, transparent tax that everyone could easily understand. Under the Fair Tax there would be no need to track income and expenses and a high probability that the tax would remain simple because it could not revert back to an income tax.

Lower Compliance Costs

The Fair Tax would lead to lower compliance costs for individuals in America and the IRS budget would decrease dramatically. There are two general types of economic costs created by the complexity of the current tax code: overhead and opportunity costs. Overhead costs can be divided into three categories: tax planning, compliance, and litigation costs. A study done by the Tax Foundation, a non-profit, non-partisan research institution that receives no federal funds, estimated the cost of compliance for individuals and businesses to be $140 billion in 2001. It is worth noting that this was a very conservative estimate of the compliance burden on taxpayers because tax planning, litigation, and opportunity costs were not included in the estimate (The Cost of Tax Compliance, 2001). Another report done by the Tax Foundation in 2005, estimated the dollar amount of compliance costs for the tax year of 2008 to be $325 billion. The compliance costs for individuals, businesses, and non-profits are projected to rise to $482.7 billion by 2015 (The rising cost of complying with the federal income tax, 2005). Compliance cost is also highly regressive when measured by income level. According to the 2005 report by the Tax Foundation, taxpayers with AGI under $20,000
incur a compliance cost equal to 5.9% of their income, while taxpayers with AGI exceeding $200,000 incur a compliance cost equal to only 0.5% of their income (p. 1). These statistics prove that rising complexity of the tax code has led to much higher compliance costs for everyone in America. The Fair Tax would eliminate these compliance costs by taking away all of the complexities inherent in the current code and replacing them with a simple, transparent system that the average American can easily understand.

A Larger Tax Base

The Fair Tax would lead to a much broader tax base and would greatly diminish the amount of lost revenues reported by the government each year. According to the IRS website, the budget for IRS operations in 2005 was slightly over ten billion dollars (Internal Revenue Service collections, costs, personnel, and U.S. population, fiscal years 1971-2005). However, even with such a large amount of money being spent on enforcement, the tax gap has continued to grow in recent years. The tax gap “is the difference between what taxpayers should pay and what they actually pay on a timely basis” (New IRS study provides preliminary tax gap estimate, 2005, p. 1). This tax gap is made up of three components: underreporting of income, underpayment of taxes and non-filing of returns. A study done by the IRS in March 2005, estimated the tax gap to be between $312 billion and $353 billion for tax year 2001. It is important to note that the burden created by the tax gap is placed squarely on other taxpayers. “According to the IRS, of the nation’s 130 million individual taxpayers, each one is paying, on average, a “surtax” of at least $2,680 a year to subsidize noncompliance” (The FairTax reduces complexity, compliance cost, and noncompliance, 2007, p. 6). It is also important to note
that the tax gap estimated by the IRS does not include any estimate of the underground economy. The underground economy is made up of individuals dealing in illegal or illicit behavior. This is accompanied by the shadow economy: unreported but legal cash-based transactions. The authors of the Fair Tax book estimate the underground economy to be between $1.5 trillion and $3 trillion per year (FairTax: The Truth, 2008). The IRS estimates that lost revenues from the underground and shadow economies were approximately $350 billion in 2001. This number will only increase in the future as the tax code becomes more and more complex and it becomes easier to go underground and harder to get caught. The Fair Tax would greatly reduce the amount of lost revenues the current system has from the tax gap and the underground economy because tax would be obtained when the funds were ultimately spent on new goods or services (How Fair is the Fair Tax, 2007). While many people avoid paying taxes under the current system, they still spend money in the legitimate marketplace when they purchase new goods or services. Under the Fair Tax, these transactions would be taxed, eliminating the loss of revenues to the government. It is important to understand that the underground economy will not just evaporate if the Fair Tax is enacted. Proponents of the Fair Tax understand that there will always be individuals who cheat and find their way around the system; however, the Fair Tax would dramatically reduce the amount of tax evasion taking place today by making it much more difficult to cheat and much easier to get caught.

While the underground economy creates a tremendous amount of lost revenue to the government, another, perfectly legal method places an even larger tax avoidance drag on the U.S. economy. This legal method of avoiding taxes is known as offshore financial centers. As a result of the punishing tax system in place today, more than one third of the
world’s high net worth individuals hold their wealth in offshore accounts (The FairTax Book, 2005). In 2000, the amount of wealth held offshore was estimated to be $11 trillion. This wealth was removed from the U.S. economy and was protected from the tax obligations it would have experienced in America. The Fair Tax would encourage an immense capital infusion into the American economy because it would make the U.S. the largest tax haven in the world. Much of the capital held in offshore accounts as well as money from foreign nations would flow into the U.S. as a result of the Fair Tax. Corporations that have left America in search for countries with less punishing tax structures would return if the Fair Tax were enacted. The infusion of capital into the U.S. helps explain why the tax base would increase so much. Under the Fair Tax, every American citizen would be included in tax base because everyone will consume goods and services, thus paying the Fair Tax. The underground economy, untaxed under the current system, would be part of the tax base because consumption would be taxed. Foreign tourists and illegal immigrants, neither of which pays any taxes under the current system, would be included in the tax base because they too would consume goods and services. All of these examples are evidence that a larger tax base would be present under the Fair Tax. The larger tax base is important because it allows tax rates to be lower.

The enactment of the Fair Tax would make U.S. products more competitive internationally by removing the federal tax component on capital and labor. According to Dr. Dale Jorgenson’s study cited in the The Fair Tax Book, 22% of the price paid for a consumer product in the United States represents embedded taxes (p. 53). Under the Fair Tax, the embedded taxes would be removed from the price giving U.S. businesses an
advantage in a global marketplace: “Goods produced in the United States but sold internationally would be free of U.S. tax” leading to more competitive U.S. products in the global marketplace (How Fair is the Fair Tax, 2007, p. 3).

The Fair Tax would also bring more business to America because one incentive for American corporations to move offshore would be eliminated. Currently, an American corporation doing business in a foreign country will pay income taxes in the United States for earnings realized in the foreign country. If the corporation incurs income tax liability in the foreign country, U.S. tax laws allow a credit for those taxes to be applied to the taxes due in the United States. However, many countries encourage corporations to deal in an international market by not taxing earnings realized overseas. This gives foreign corporations a competitive advantage over U.S. corporations because of the more favorable tax treatments (The Fair Tax Book, 2005). The enactment of the Fair Tax would give a major incentive for corporations to move to the United States because corporate income taxes would be eliminated.

Criticisms of the Fair Tax

Thus far, this thesis has focused on an explanation of the Fair Tax and what benefits would arise from its enactment. Now, this thesis will discuss some of the criticisms leveled at the Fair Tax and look at what Fair Tax supporters have said in response to the criticisms. One of the major concerns by critics relates to the Fair Tax’s ability to remain revenue neutral while maintaining a 23% tax rate. In November 2005, President Bush created the President’s Advisory Panel on Federal Tax Reform to identify the major problems in America’s tax code and to recommend options to make the code simpler, fairer, and more conducive to economic growth. This panel examined several
alternatives for federal tax reform including a national retail sales tax. After studying the national retail sales tax, the panel concluded that such a system would not be in America’s best interests. There were several reasons given by the panel that pointed them to their conclusion, one of which claimed that the tax rate under such a system would have to be at least 34% (Stated on an “exclusive” basis) and even higher if evasion increased (Report of President’s Advisory Panel on Federal Tax Reform, 2005). Another study done by William Gale in 2005 claims the required tax rate for the Fair Tax proposal over the next ten years would have to be 31% on a tax inclusive basis and 44 percent on a tax exclusive basis in order for the government to remain revenue neutral (The National Retail Sales Tax: What would the rate have to be?, 2005, p. 890). Gale claims the enactment of H.R. 25 at a 23% tax inclusive rate would create a $7 trillion revenue loss over the next decade. According to Gale (2005), the difference in tax rates is caused by a mathematical or logical mistake made by the advocates of the Fair Tax:

When they estimated government revenues under the sales tax, they (implicitly) assumed that consumer prices (what consumers pay, including the sales tax) would rise by the full amount of the sales tax and that producer prices (what producers receive, net of the sales tax) would stay constant. But when they estimated government spending needs, they (implicitly) assumed that consumer prices would stay constant and producer prices would fall by the full amount of the tax. Both sets of assumptions cannot be valid at the same time; either the first assumption overstates nominal revenues, or the second assumption understates nominal required spending, or both. (p. 890)
In response to the two reports claiming the Fair Tax rate would be well above 23%, several economists supporting the Fair Tax performed a study building on Gale’s analysis and claimed that a 23% rate is “eminently feasible and suggest why Gale and the panel reached the opposite conclusion” (Taxing sales under the Fair Tax: What rate works?, 2006, p. 663). In response to why Gale (2005) and the panel reached a different conclusion for the proper Fair Tax rate, the Fair Tax economists gave this explanation:

The different findings stem, in part, from the mistaken assumption by Gale and, we presume, by the president’s tax reform panel (which has not disclosed its method) that state and local governments should be compensated for having to pay the FairTax, in part from our use of updated data, in part from the focus on different years, in part from other methodological refinements and choices, and, in part, from our decision in this study to ignore (other than some passing remarks) issues of tax evasion, expansion of the tax base due to general equilibrium effects, and capital gains on outstanding government debt. (p. 664)

This study began by calculating the tax base, which after various adjustments would have been $11.244 trillion in 2007. Next, the study discussed the Fair Tax rate and began by computing two items: the amount of 2007 revenue to be replaced (the amount raised by the current system) and the amount of revenue needed to pay for the prebate. The first computation revealed that the current system was expected to raise $2.288 trillion in 2007 from income, payroll, estate and gift taxes. In order to pay for the prebate, the Fair Tax base had to be reduced by $2.112 trillion in 2007. Thus after several more adjustments, the tax base would have been $9.355 trillion. In order to raise $2.288 trillion in revenue from this base, a 23.82% tax inclusive rate would have to be
imposed. This study points out that while this is a small difference from what is proposed in H.R. 25, the difference would have to be made up one way or another. One way mentioned in the study suggests a reduction in real spending by the federal government would be necessary to make up the difference. In order to implement the Fair Tax at a 23% rate and remain revenue neutral, a 2.73% reduction in real non-social security spending would be necessary (p. 673). An alternative to this would be for the Fair Tax to “enhance economic growth enough to increase the Fair Tax base by 3 percent, in which case 23 percent would be sufficient to avoid any spending reduction” (p. 673). The economists also point out that the 23.82% tax rate “ignores the expansive effect that the Fair Tax could be expected to exert on economic activity as it eliminates the existing bias against saving” (p. 673). Therefore, the study concludes it would be highly probable to remain revenue neutral while implementing a 23% rate without reducing federal spending.

The Cost of the Prebate

Another criticism cited by many critics of the Fair Tax is the effect the prebate would have on American families. The inventors of the Fair Tax proposed the prebate to eliminate the regressive nature of the Fair Tax. However, Bradley and McKee point out that it would be another government entitlement because every family in America would receive it regardless of whether anyone is gainfully employed (How Fair is the Fair Tax, 2007). The President’s Advisory Panel estimated the cost of the prebate to be $600 billion in 2006:

This amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending,

As this statement shows, the prebate proposed by H.R. 25 would become the largest entitlement program paid for by the U.S. government. Bradley and McKee believe this would dramatically increase the size and scope of the government. The President’s Advisory Panel concluded that the prebate would benefit lower income families (those in the bottom 20% of cash incomes) and higher income families (those in the top 10% of cash incomes) while adversely affecting middle class families. To alleviate the burden on the middle class, the President’s Advisory Panel developed a more targeted cash grant program that would have cost $780 billion in 2006. The Panel concluded the government would need to collect 34% more revenue to pay for this targeted cash back program. Another concern raised by the Panel related to the complexity of administering a cash back program such as the prebate proposed by the Fair Tax:

The proposed cash grant programs would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals’ marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant. (p. 214)
As a result of the enormous cost, the potential for growth in the size and scope of the government, and the complex nature of administering the prebate; the President’s Advisory Panel concluded that it would be inappropriate to recommend such a proposal.

While the President’s Advisory Panel and many others target the prebate as a major problem with the Fair Tax proposal, Fair Tax supporters are quick to respond to the criticisms leveled against the prebate. In FairTax: The Truth, Neal Boortz and John Linder (2008) tactically take apart the argument given by opponents of the prebate. They begin by assuming every household will spend what it needs to provide for the basic necessities every month: “We believe that the government should acknowledge and honor the need of every household, rich or poor, to cover the cost of its basic needs before it starts funding government” (p. 151). Next, the authors make the argument that the Fair Tax prebate would no more be a welfare program than are the standard deduction and personal exemptions given under the current federal income tax system: “To disagree with this approach is to believe that the government should have the first claim on household income—a claim superior to that household’s need to provide for its own sustenance” (p. 152). Boortz and Linder support this claim by citing a report done by the Congressional Research Service on the cost of tax subsidies. This study estimated that special deductions, exclusions, and exemptions under the current system would amount to $945 billion in fiscal year 2006 (Tax Expenditures: Trends and Critiques, 2006). In comparison to this number, a study done by the Beacon Hill Institute of Suffolk University estimated the cumulative cost of the prebate to be $486 billion (A comparison of the Fair Tax base and rate, 2007). After comparing these two studies, Boortz and
Linder believe a prebate that cost almost half as much as the current system’s tax subsidies would clearly be the most feasible way to ensure the Fair Tax is not regressive.

As the idea of a prebate has shown, some federal administrative agency would still be needed to ensure accurate collections of the Fair Tax and to maintain the records for the refund of the prebate to every household. This was another concern cited by the President’s Advisory Panel in their report on the national retail sales tax. The Panel concluded that two administrative agencies would be needed; one to collect the tax and one to keep track of the personal information necessary to determine the size of the taxpayers prebate (Simple, fair and pro-growth: Proposals to fix America’s tax system, 2005). While Boortz and Linder claim the IRS would be abolished with the enactment of the Fair Tax, some federal agency would still be needed under the new system. However, this agency would be much smaller in size and scope than the IRS and would function with greatly reduced cost in comparison with the IRS.

The Fair Tax’s Effect on the Middle Class

Many critics of the Fair Tax argue that the middle class will end up footing the bill under such a system because wealthy individuals will no longer have high income tax rates and the poor will essentially be exempted from paying tax due to the prebate. In fact this is one of the main reasons the President’s Advisory Panel on Federal Tax Reform rejected the Fair Tax proposal:

Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department’s analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married
taxpayers would see substantial tax increases under a full replacement retail sales tax. (p. 213)

In response to this criticism, proponents of the Fair Tax give a definitive answer. In *FairTax: The Truth*, Neal Boortz and John Linder (2008) begin by saying middle-class Americans living beyond their means will pay more under the Fair Tax. The author’s say today’s income tax system encourages living beyond one’s means because it subsidizes debt and penalizes savings. Secondly, Boortz and Linder say the critics are correct about middle-class bearing more of the tax burden if only the income tax system were repealed. However, the Fair Tax also would repeal the payroll tax, the largest tax most working Americans pay. This is important because most wealthy individuals in America pay no payroll taxes. Many of the top income earners in America do not earn any wages; they receive large capital gains and dividends which are taxed at a 15% rate. Because these individuals have no wages, they pay no payroll taxes. As a result, the major burden from payroll taxes rests on the shoulders of those earning a wage, the middle-class. This would disappear under the Fair Tax because spending, not wages, would be taxed; therefore, everyone would pay the Fair Tax.

This point becomes even more important when the impending collapse of Social Security and Medicare are brought into the picture. According to the Medicare Board of Trustees, Medicare will be insolvent in 2020. The Social Security Board of Trustees predict the Social Security trust fund will be bankrupt by 2041 (The FairTax Book, 2005). To combat this imminent crisis, many politicians simply suggest raising taxes. However, at what point would the tax increases stop? The authors of *The FairTax Book* cite a study done by Dr. Larry Kotlikoff, chairman of the Economics Department at
Boston University, that showed a permanent fix for Social Security and Medicare would cost $74 trillion in today’s dollars. A figure this large shows the system as it exists today is simply unsustainable. Raising taxes to cover this gap would dramatically hurt the middle class. The Fair Tax offers an alternative solution which would help fund both Social Security and Medicare while not punishing the middle class. Dr. Kotlikoff’s analysis showed how the Fair Tax would broaden the effective tax base, thereby lowering the tax rate:

The sales tax will effectively tax wealth as well as wages: When the rich spend their wealth and when workers spend their wages, they will both pay sales taxes. By broadening the effective tax base to include the corpus of wealth, not just the income earned on it (much of which is currently exempted or taxed at a low rate), one can lower the required sales tax rate and, thereby, reduce the tax burden on workers. (Averting America’s Bankruptcy with a New, New Deal, 2007, p. 2-3)

As this statement shows, the Fair Tax will reduce the tax burden on the middle class because everyone will be included in the effective tax base. It is also worth mentioning that the repeal of the payroll tax and its effects are not mentioned in the President’s Advisory Panel report. As a result it would seem that the Panel did not give an accurate representation of the Fair Tax proposal.

Tax Compliance Under the Fair Tax

The issue of compliance is another common criticism aimed at the Fair Tax. Most analysts agree that some amount of evasion is inevitable in any tax system; however, some believe it would be even higher under a consumption tax such as the Fair Tax. The President’s Advisory Panel on Federal Tax Reform believes having a federal
sales tax on top of state sales taxes would provide substantial incentives for evasion at the retail level (Simple, fair and pro-growth: Proposals to fix America’s tax system, 2005). The Panel cites several examples of potential evasion such as unregistered cash sales, misapplied exemption criteria by retailers, failure to tax goods that should be taxed, and retailers collecting the tax from consumers but keeping the money rather than remitting it to the government. Several other examples provided in the Panel’s report are worth mentioning. First, individuals may attempt to create “paper businesses” in order to obtain business exemption certificates (the Fair Tax does not tax business-to-business purchases) and avoid paying taxes on purchases for personal use. Even individuals with legitimate business exemption certificates could use their business exemption to purchase goods for personal use. Secondly, there would be no third party reporting under the Fair Tax: “Retailers would add their retail sales tax to the pre-tax price for their goods and would remit that amount to the government, but shoppers would not separately report what they bought, and at what price, to the government” (p. 218). This means the government would be completely dependent upon the retailers to report their own taxable and non-taxable sales. The Panel estimates a 50% evasion rate for income taxes that are not withheld and have no third party reporting. Because there would be no third party reporting under the Fair Tax, the Panel believes a high evasion rate would ensue. All of the above reasons support the Panel’s claim that evasion under the Fair Tax would significantly cripple the U.S. economy. Bradley and McKee sight another concern relating to compliance: cross border shopping. Because the Fair Tax only applies to goods and services sold in the United States, how would purchases made by U.S. citizens in foreign countries be treated? (How Fair is the Fair Tax, 2007). It is conceivable that
some U.S. citizens, particularly wealthy individuals, would purchase high ticket items from another country and leave them offshore to avoid paying the Fair Tax. How would this be dealt with?

In response to criticism stemming from potentially high evasion rates, Neal Boortz and John Linder combat the critics with several points. They begin by discussing the tax gap resulting from the current system and mention that this figure does not include any estimate of lost revenue from the underground economy. They suggest the combined loss of revenue from the tax gap and underground economy would dwarf any realistic estimate of tax evasion under the Fair Tax (FairTax: The Truth, 2008). Boortz and Linder go on to say that cheating under the Fair Tax would be more difficult than cheating under the current system of income taxation because it would take two parties to cheat. They point out that it would take a seller and a purchaser conspiring to cheat in order to evade taxes under the Fair Tax. The President’s Advisory Panel also mentioned the advantage the Fair Tax would have from an enforcement perspective. Because the Fair Tax would rely on retail businesses to collect the tax and remit it to the government, the number of federal tax return filers would decrease substantially. This fact coupled with the reduced complexity inherent in the system give the Fair Tax a significant advantage from an enforcement perspective (Report of The President’s Advisory Panel on Federal Tax Reform, 2005). Boortz and Linder agree with this analysis and cite some statistics in support of their conclusion. In America, 688 companies, 0.03%, sell 48.5% of all of the merchandise. According to the Census Bureau’s Economic Census from 2002, 3.6% of America’s companies, a total of 92,334 firms, make 85.7% of all sales (FairTax: The Truth, 2008). In the services sector, 1.2% of all businesses make 80% of
all the sales. These statistics lead Boortz and Linder (2008) to conclude that the numbers for compliance and avoidance dramatically favor the Fair Tax because “Most of the FairTax money will be collected by big companies that have no interest in cheating” (p. 150). While Boortz and Linder give a persuasive argument about low evasion rates under the Fair Tax, the fact remains that some level of evasion will inevitably take place under the Fair Tax. Higher evasion levels would diminish the size of the tax base and lead to a higher tax rate in order for the government to remain revenue neutral.

The Fair Tax’s Effect on Prices

Many opponents of the Fair Tax claim its enactment will drive the prices of goods and services to higher levels than seen currently. If prices did not adjust downward, inflation would set in causing a dramatic slowdown in the U.S. economy (How Fair is the FairTax, 2007). While many people believe prices would escalate under the Fair Tax, Neal Boortz and John Linder give a straightforward explanation claiming such a thing would never happen. They begin by saying the Fair Tax cannot possibly keep prices static while increasing each taxpayer’s amount of take home pay. (Higher take home pay does not mean higher wages; rather, it means employees will receive their “gross wages” under today’s system). Employers could not reduce the cost of their products and increase their employees take home pay at the same time. However, Boortz and Linder believe some combination of a reduction in the cost of products and an increase in take home pay would take place as a result of the Fair Tax being enacted (FairTax: The truth, 2008). A study done by Arduin, Laffer & Moore Econometrics found Boortz and Linder’s conclusion to be accurate. The macroeconomic analysis of the Fair Tax found that prices would rise but wages would also rise, more than compensating for the increase
in prices. The implementation of the Fair Tax would have a significant, one-time effect on the price level, causing prices to rise 24.8% following the enactment of the Fair Tax (A Macroeconomic analysis of the Fair Tax proposal, 2006). However, “total labor income will rise 27.4 percent in the first year following the implementation of the FairTax” (A Macroeconomic analysis of the Fair Tax proposal, 2006, p. 29). These statistics show that an increase in prices would be offset by higher labor income, meaning American workers would have more purchasing power in the domestic marketplace than they do today (FairTax: The Truth, 2008). While this response deals with Americans who are currently working it fails to mention what would happen to those who are not working. If prices indeed did rise by 24.8%, but an individual did not have any labor income, how would they compensate for the increase in price? The answer lies in the prebate proposed by H.R. 25. The prebate compensates everyone, but those who are not working will benefit more from its enactment. This will allow the elderly and others to avoid the majority of the price increases as a result of the Fair Tax enactment.

Transition Costs

A final major criticism of the Fair Tax relates to the transition costs involved in moving to a consumption tax from an income tax. One of the major concerns from critics relates to something known as generational equity. All individuals who have accumulated any amount of capital during their lifetime will have to pay the Fair Tax when they spend any of that money. Because these individuals have already paid taxes when they earned the income, paying the Fair Tax would amount to double taxation (How Fair is the FairTax, 2007). Bradley and McKee advocate some kind of generational equity provision so younger workers do not have an unfair advantage when
purchasing items without having to pay taxes on earned income. Daniel Goldberg, from the University of Maryland School of Law, also believes there would be some sort of class and intergenerational warfare as a result of the enactment of a consumption tax. He believes retired people and those living off of investment income would view a consumption tax with hostility. “They would be more likely to sense the unfairness of double taxing savings amounts on which income tax has already been paid, unless extensive transition relief for existing wealth accompanied the change” (The aches and pains of transition to a consumption tax: Can we get there from here, 2007, p. 480). In response to this criticism, Boortz and Linder counter with the fact that individuals who spend money accumulated over a period of time would have to pay embedded taxes in every product or service consumed under the current system. Under the new system they would have to pay the Fair Tax, but they would also receive the prebate to help offset the price increase in the goods and services. Essentially, this would amount to the same thing according to Boortz and Linder (FairTax: The Truth, 2008). However, it should be noted that dollars spent above the poverty spending level would indeed be taxed twice.

Transition from the current income tax system to the Fair Tax would have a serious effect on tax-advantaged activities. Two of the most commonly cited advantages that would be removed under the Fair Tax are charitable contributions and the mortgage interest deduction. The Fair Tax is a major source of apprehension among the non-profit sector because it would eliminate the current income tax and the associated tax deduction for charitable giving. Charitable organizations fear the erosion of their base of financial support as a result of the Fair Tax being implemented. Many taxpayers and charitable organizations believe the Fair Tax would cause a severe decline in charitable
contributions and would threaten the viability of many non-profit organizations. To address the concerns from taxpayers and charitable organizations, five economists from the Beacon Hill Institute performed an analysis to determine what impact the Fair Tax would have on charitable contributions. The economists concluded the fears by taxpayers and charitable organizations were unfounded:

The Fair Tax would cause charitable giving by those in the very highest marginal tax brackets to decrease as the tax incentives for this income group became less valuable and as the price of giving increased. However, this shortfall in charitable giving by the wealthy would be more than offset by an increase in charitable giving by other taxpayers. Under the Fair Tax, the majority of taxpayers (who currently do not itemize or fall into the lower tax brackets) would see the price of giving decrease. The decrease in the price of giving would provide an attractive incentive for the majority of taxpayers to increase their charitable giving under the Fair Tax. (The Fair Tax and Charitable Giving, 2007, p. 25)

This analysis concluded that charitable giving would decrease by 5.24% in the first year under the Fair Tax, but would increase substantially in the following years as GDP experienced sustained growth as a result of the Fair Tax.

The other major tax-advantaged activity that would disappear if H.R. 25 were passed is the mortgage interest deduction. Many opponents of the Fair Tax believe its enactment would cripple the housing industry because the home mortgage interest deduction would be eliminated and new home purchases would be taxed. Daniel Goldberg notes a transition from an income tax to a consumption tax could reduce the value of home prices due to effective elimination of the tax subsidy of deductible home
mortgage interest (The aches and pains of transition to a consumption tax: Can we get there from here, 2007). However, supporters of the Fair Tax claim housing would not only be more affordable, but homebuyers would have more money with which to purchase a home:

For working Americans, the “true cost” of buying a home goes down. In a nutshell, homes are more affordable because the majority of homes are used and are not taxed, the interest paid on new homes at a lower rate is untaxed, new home prices do not bear taxes imposed upstream, and the saving and investment needed to buy homes is not taxed multiple times. (Promoting Home Ownership, 2007, p. 1)

All of the above reasons demonstrate how the Fair Tax would benefit the housing industry rather than cripple it. Homebuyers would be better off under the Fair Tax than under the current system of income taxation and the economy would benefit significantly as a result.

Citizens Responsibility

The Fair Tax is a tax reform measure, not a government reform measure. Enactment of the Fair Tax would greatly reduce the power given to the federal government. Yet, it is crucial to understand that vigilance on behalf of the citizens would remain. Under the Fair Tax, Senators and Congressmen would still have the ability to impose higher taxes upon the people by simply raising the Fair Tax rate. While politicians would lose the ability to raise taxes upon one segment of the population and give a tax break to another segment, citizens would still need to remain informed and involved to ensure taxes were not raised.
Conclusion

After looking at the potential advantages and disadvantages of switching from an income tax to the Fair Tax, the question regarding its viability remains. While the Fair Tax has the potential to set off a high level of expansion and growth in the U.S. economy, is it the most practical source of tax reform in this country? The Fair Tax is not a cure-all for every financial problem in America. It is not a tax cut; it does not attempt to reduce government spending; and it does not guarantee that more jobs will not be shipped overseas. There would be transition costs involved that would lead to dislocations and inconveniences. IRS employees and tax attorneys would lose their jobs. Some form of evasion would still ensue under the Fair Tax. Many other issues and problems could result from a switch to a consumption tax. However, as this paper detailed, many benefits would come as a result of the Fair Tax. It could lead to a tremendous amount of growth in the U.S. economy; would be much more simple and transparent than the current code; and would greatly reduce the size and power given to the government in comparison with the current code. Simply stated, the Fair Tax meets the three goals of tax reform quite well. It would lead to much more simplification, greater economic efficiency and limited government. As a result, this thesis concludes that the Fair Tax is indeed a viable option for fundamental tax reform in the United States of America.
References


