

**Statement by
Bruce Bartlett
Before the
Committee on Ways and Means
U.S. House of Representatives
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Thank you for the opportunity to testify this morning on tax reform and consumption-based tax systems.

First, I would like to say that I have always supported a consumption-based tax system in principle.¹ Income taxes, by their nature, double tax saving and investment, which imposes a large deadweight or efficiency cost on the economy. This is the economic burden over and above the tax itself. A 2005 Government Accountability Office study estimated the total efficiency cost of the federal tax system at between 2 percent and 5 percent of GDP.²

Second, I think it matters a lot how a consumption tax or consumption-based system is imposed. Many economists gloss over the administrative problems inherent in different forms of consumption taxes; from a purely economic point of view, they reason, it makes no difference whether you have a retail sales tax, a value-added tax, or some kind of consumed income tax. All that really matters is that saving and investment are excluded from the tax base because that is what raises economic growth.

Unfortunately, as this committee knows better than I do, technical details and administrability are important considerations in developing tax policy. Over the years, your hearing record has been filled with proposals that sounded good on paper but were just utterly impractical. Sometimes these good-on-paper ideas were enacted into law and had to be delayed and repealed before they could even take effect.

A good example is carryover basis, which was enacted as part of the Tax Reform Act of 1976. Although it is a perfectly good idea in principle, it was just not workable.³ This is still a problem for the estates of those who died last year.⁴

This brings me to my core disagreement with the FairTax. I just don't think it will work. It is the most pie-in-the-sky major tax reform I have ever heard of. Even by tax policy standards, it is grossly complex, a virtual Rube Goldberg contraption of pieces that are unworkable individually and become exponentially more unworkable as they are layered on top of each other. The idea that this is a simple form of taxation is nonsense.

¹ Bruce Bartlett, "Tax Spending, Not Savings," *New York Times* (July 6, 1997).

² GAO, *Summary Estimates of the Costs of the Federal Tax System*, GAO-05-878 (Aug. 2005).

³ Bruce Bartlett, "Carryover Basis: A Cure Worse Than the Disease?" *Tax Notes* (Oct. 18, 2010).

⁴ "Carryover Basis Rules Top Estate Tax Guidance Needs," *Tax Notes* (Jan. 10, 2011); "IRS Delays Filing Deadline for Basis Allocation," *Tax Notes* (April 11, 2011).

The FairTax would abolish virtually all federal taxes, including the payroll tax and the income tax, and replace them with a 23 percent retail sales tax like those levied by the states. Indeed, the states would actually be required to collect the tax for the federal government, thus allowing for abolition of the Internal Revenue Service. To relieve the burden on the poor, everyone would receive a monthly rebate on the tax equal to the tax rate on a poverty level income.

FairTax supporters are well financed. They have no difficulty buying the services of academics like Prof. Kotlikoff to produce studies on their behalf. FairTax supporters are also evangelical in the belief that their plan will be an enormous blessing for Americans not to have to file income tax returns or keep all the associated financial records. As Gov. Huckabee has said, “When the FairTax becomes law, it will be like waving a magic wand releasing us from pain and unfairness.”⁵

There are, however, a number of problems with the FairTax that its supporters tend to dismiss or downplay. Here are a few.⁶

The true rate is not really 23 percent. Thought of the way people think of state retail sales taxes, the rate is actually 30 percent. The 23 percent figure is derived this way. On a \$1 purchase, the tax would be 30 cents for a total price of \$1.30. Since the 30 cent tax is 23 percent of \$1.30, FairTax supporters argue that the true tax rate is 23 percent. Non-supporters are more inclined to think that this is just a trick to make the tax rate appear lower than it really is in order to increase support for the FairTax.

Another oddity is that the FairTax would apply to all government spending, including federal spending, as well as private spending. This will undoubtedly force state and local governments to raise their taxes. And it serves no logical purpose for the federal government to tax itself.⁷

The FairTax would apply to new home sales as well as rent. And of course, mortgage interest and local property taxes would not be deductible because there would be nothing to deduct them from. However, sales of used homes would be exempt, as would sales of homes to businesses. Prof. George Yin, who is well known to this committee, described the tax treatment of housing under the FairTax this way:

If a person buys a new house from Barry Rutenberg Homes to be used as a family residence, the buyer would owe sales tax on the purchase because it is a sale by a business to a household. If, instead, the person purchases the same new house from Rutenberg Homes to be used for a new law practice, that transaction would not be taxed because it is a business-to-business

⁵ Mike Huckabee for President, Issues: Taxes/Economy, www.mikehuckabee.com, accessed Dec. 10, 2007.

⁶ I discuss these and other problems at more length in Bruce Bartlett, “Why the FairTax Won’t Work,” *Tax Notes* (Dec. 24, 2007): 1241-54.

⁷ William G. Gale et al., “Taxing Government in a National Retail Sales Tax,” *Tax Notes* (October 5, 1998); Evan F. Koenig, “Achieving ‘Program Neutrality’ Under a National Retail Sales Tax,” *National Tax Journal* (Dec. 1999).

transaction. Rather, the cost of the person's legal services, which should presumably incorporate the cost of the building in which the practice is located, will be taxed when the services are consumed by a household. Finally, if a person purchases a used house from another family, the transaction again would not be taxed because it would be one between households.⁸

FairTax supporters argue that the prices of all goods and services will fall by about as much as the 23 percent tax that would be imposed because of the elimination of existing federal taxes. It is all a wash, they say. As prominent FairTax advocates talk show host Neal Boortz and former Rep. John Linder explain:

Once the FairTax takes effect, you'll be receiving 100 percent of every paycheck, with no withholding of federal income, Social Security taxes, or Medicare taxes – and you'll be paying just about the same price for T-shirts and other consumer goods and services that you were paying before the FairTax.⁹

The principal documentation for this assertion appears to be a paper commissioned by Americans for Fair Taxation by Harvard economist Dale Jorgenson that is unavailable on its web site or anywhere else as far as I can tell. Although it is often implied by FairTax supporters that Prof. Jorgenson supports their proposal, this is not the case. He has his own tax reform plan that bears no resemblance to the FairTax.¹⁰ Jorgenson has also been publicly critical of the FairTax. In 2007, he called it “reform by focus group.”¹¹ In 2008, Jorgenson said, “The main weakness of the FairTax is its comprehensiveness. It tries to roll everything into one tax, which simply can't carry all that weight.”¹² He has also testified before this committee that a national retail sales tax would need a rate of 40 percent to equal all federal revenues.¹³ And in a 2005 academic article, Jorgenson said, “The very high tax rate of the national retail sales tax provides powerful incentives for tax evasion and renders effective tax administration difficult.”¹⁴

While Jorgenson's published work does indeed show that prices would decline if all existing federal taxes suddenly vanished, a key reason is that all workers would have to

⁸ George K. Yin, “Is the Tax System Beyond Reform?” *Florida Law Review* (Dec. 2006): 983.

⁹ Neal Boortz and John Linder, *The FairTax Book* (Regan Books, 2005): 59.

¹⁰ Dale Jorgenson, “Efficient Taxation of Income,” *Harvard Magazine* (March-April 2003); “A Smarter Type of Tax,” *Financial Times* (June 19, 2002).

¹¹ Quoted in Jonathan Weisman, “Criticism Aside, ‘FairTax’ Boosts Huckabee Campaign,” *Washington Post* (Dec. 28, 2007).

¹² Quoted in Tom Redburn, “Huckabee Sales Tax Plan Appeals, but Is It Fair?” *New York Times* (Jan. 6, 2008).

¹³ Subcommittee on Select Revenue Measures, *Second in Series on the Extraterritorial Income Regime*, 107th Cong., 2nd sess. (May 9, 2002): 73.

¹⁴ Dale Jorgenson and Kun-Young Yun, “Efficient Taxation of Income,” in Timothy J. Kehoe, T.N. Srinivasan, and John Whalley, eds., *Frontiers in Applied General Equilibrium Modeling* (Cambridge University Press, 2005): 193.

cut their wages by the amount of the tax for this to happen.¹⁵ This fact is conceded by Prof. Kotlikoff, who has said, if the Federal Reserve does not accommodate the FairTax by increasing the money supply to create a one-time inflation rate of 23 percent, “producer prices, wage rates, and rental rates would all fall.”¹⁶ Of course, 23 percent inflation would cause real wages to fall if they are fixed in nominal terms. How else would businesses be able to reduce their prices unless all their costs fell, and labor is the largest cost any business has. But there is nothing in the FairTax proposal to compel workers to take a pay cut and no reason to think that they won’t resist doing so strenuously.

FairTax supporters have always glossed over the huge incentive for evasion once the existing machinery of tax compliance is abolished and all federal revenues are collected at exactly one point: retail sales. This is a key reason why the Reagan administration rejected the idea. In its 1984 tax reform report it said, “A federal retail sales tax, when combined with the retail sales taxes levied by most states, would provide irresistible inducement to tax evasion at the retail level.”¹⁷

Furthermore, the idea of replacing existing taxes with a retail sales tax has been studied by foreign countries and international organizations. An Organization for Economic Cooperation and Development report had this to say, “Governments have gone on record as saying a RST of more than 10 percent to 12 percent is too fragile to tax evasion possibilities.”¹⁸

Finally, FairTax supporters have always maintained that their plan would neither raise nor lower aggregate federal revenues. Yet revenues have fluctuated between 14.8 percent of GDP and 20.6 percent of GDP over the time the FairTax has been under consideration without any change in the proposed 23 percent rate. In any case, every serious effort to score the FairTax by the Treasury Department, Joint Committee on Taxation, and the Brookings Institution has concluded that a rate significantly higher than 23 percent would be necessary for it to be fiscally neutral.¹⁹

There are many other technical problems with the FairTax as well such as the interaction between a national retail sales tax and state and local sales taxes that are collected on different goods and services; the problem of exempting sales between businesses so that taxes aren’t levied on top of taxes, a problem economists call cascading; how the states will be compelled to collect federal sales taxes, especially in states that have no sales tax; and the fact that state income taxes will require people to still file returns and keep the

¹⁵ Dale W. Jorgenson and Kun-Young Yun, *Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (MIT Press, 2001): 317-407.

¹⁶ Laurence J. Kotlikoff, “Why the FairTax Will Work: A Response to Bartlett,” *Tax Notes* (Feb. 4, 2008): 647.

¹⁷ *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 1 (USGPO, 1984): 34.

¹⁸ *Taxation in OECD Countries* (OECD, 1993): 78. See also, *Taxing Consumption* (OECD, 1988): 103.

¹⁹ William G. Gale, “The National Retail Sales Tax: What Would the Rate Have to Be?” *Tax Notes* (May 16, 2005); Lindy Paull to John Buckley, “Budget Neutral Tax Rate for H.R. 2525,” (April 7, 2000); *Simple, Fair, & Pro-Growth: Report of the President’s Advisory Panel on Federal Tax Reform* (November 2005): 207-57.

necessary records.²⁰ There is nothing in the FairTax legislation requiring the states to abandon their income taxes. Nor is there any requirement that the federal government permanently abandon the taxation of income; that would require not just repeal of the 16th Amendment, but passage of a new amendment explicitly banning the taxation of income in a way that will be enforced by the courts.

Another problem area is the cash grant that would be sent to every household to offset the regressivity of the FairTax. These grants would be based on Social Security numbers and this committee well knows that we already have a serious problem in this country with illegal aliens obtaining such numbers improperly.²¹ Imagine the abuse when every American has an incentive to get multiple numbers to obtain multiple rebates. Or the enormous incentive Congress will have to use the rebates to deal with various problems particular groups might be having, to give them a little bit more – maybe around election day.

No wonder the tax reform report issued by the George W. Bush administration called the FairTax rebate the largest new entitlement program in history. It estimated the cost of the program at between \$600 and \$800 billion per year in 2005 dollars and would make most American families “dependent on monthly checks from the federal government for a substantial portion of their incomes.” Prof. Michael Graetz has also commented on the effects of the FairTax rebate program:

It is ironic that the self-described advocates of a smaller government, who have invented the FairTax proposal, have put forth a program involving a massive new check-writing scheme from the federal treasury to all Americans. One can readily imagine the possibilities for fraud and abuse, much as conservatives have long complained about such problems in our now shrunken welfare system.²²

Every serious study of imposing some sort of national consumption tax in the U.S. has concluded that a value-added tax would work much better. That is because it was designed to overcome the administrative problems inherent in the nature of the FairTax. In other words, if the FairTax is a good idea, the VAT is a far better idea.²³ As the Reagan administration concluded, “On balance the administrative advantages of the

²⁰ William F. Fox and Matthew N. Perry, “A National Retail Sales Tax: Consequences for the States,” *State Tax Notes* (July 25, 2005); Robert Cline et al., *Sales Taxation of Business Inputs* (Council of State Taxation, 2005).

²¹ GAO, *Individual Taxpayer Identification Numbers Can Be Improperly Obtained and Used*, GAO-04-529 (March 10, 2004).

²² Michael J. Graetz, *100 Million Unnecessary Returns* (Yale University Press, 2008): 170.

²³ Sijbren Cnossen, “Evaluating the National Retail Sales Tax from a VAT Perspective,” in George R. Zodrow and Peter Mieszkowski, eds., *United States Tax Reform in the 21st Century* (Cambridge University Press, 2002); James M. Bickley, “A Value-Added Tax Contrasted With a National Sales Tax,” CRS Issue Brief for Congress No. IB92069 (Sept. 30, 2004); George Zodrow, “The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a ‘VAT in Drag’?” *National Tax Journal* (Sept. 1999); John L. Mikesell, “Changing the Federal Tax Philosophy: A National Value-Added Tax or Retail Sales Tax?” *Public Budgeting and Finance* (Summer 1998).

value-added tax appear to outweigh the primary administrative advantage of the retail sales tax.”²⁴

Finally, I think it is revealing that a former chairman of this committee, Bill Archer, was a very strong supporter of the FairTax during a time when his party held both houses of Congress and the White House, yet he never even introduced a bill to implement it. He held many, many days of hearings on the subject, but never attempted to get legislation through committee and onto the House floor for debate. I don’t know why, but I suspect that the more he thought about it, the more unworkable the FairTax seemed to him.

Another lesson from Mr. Archer’s experience is that excessive attention to a tax reform proposal that has not the remotest chance of enactment drains time and resources that are better spent on achievable reforms. This point was recently made eloquently by prominent conservative talk show host Hugh Hewitt. “The FairTax movement hurts the tax reform movement in the way that quack medicine hurts the real thing,” he said. “All the effort and debate (and money) that goes into promoting this ultimately fruitless effort is wasted, and worse than wasted, is damaging to the real deal – genuine tax reform and simplification.”²⁵

In conclusion, I would strongly urge the committee to reject the FairTax and concentrate its attention on real world reforms that will actually work and have at least a fighting chance of enactment by Congress.

²⁴ *Tax Reform for Fairness, Simplicity, and Economic Growth*, p. 225.

²⁵ Hank Adler and Hugh Hewitt, *The FairTax Fantasy: An Honest Look at a Very, Very Bad Idea* (Townhall Press, 2009): 150.