

8. Solving the Low Savings Problem

As described in Genesis, Joseph came up with a plan for the Egyptian pharaoh to save grain during seven years of plenty so that Egypt would have grain during the following seven years of famine. As Prime Minister of Egypt, Joseph implemented the plan beautifully. During the famine, all of the nations of the world came to buy grain from Egypt.

In the last chapter, we argued that the corporate income tax amounts to a double tax on savings invested in the corporate sector and should be replaced by a consumption tax, either a Value-Added Tax or a national sales tax. This alone would go far to stimulate saving and investment. But in this chapter we consider a more sweeping reform, replacing both the corporate and personal income taxes with a single consumption tax in order to stimulate savings even more.

During the last few decades, there has been a minor revolution underway in the economics literature on income taxation. The trend has been steadily away from the income tax and towards some form of consumption tax. The chief problem with income taxes, as currently structured, is that they give incentives to consume income, and they penalize income that is saved and invested. Most economists, though not all, agree that a shift towards a consumption tax would increase long-run economic output and welfare by encouraging savings and investment.

Different formulations of the consumption tax have somewhat different economic effects, but all would increase long-term economic performance. This is because consumption taxes encourage savings which in-turn encourage fixed investments. The extent to which economic growth would be stimulated depends upon the extent to which fixed investment increases. The existence of investment opportunities is a *sine qua non*. But if trade is brought toward balance there will indeed be investment opportunities due to increased exports and diminished imports.

The idea of excluding savings from taxation goes as far back as Thomas Hobbes' *Leviathan*, published in 1651. John Stuart Mill in

his *Principles of Political Economy* in 1848 argued that savings should be exempt from income tax, but he believed it impractical to measure an individual's consumption and instead recommended taxing savings at a lower rate.

Many economists today would agree with Mill. They recognize that savings are borrowed by investors and that new technology is developed as a by-product of investment. Investment and the new technology it creates have been the drivers of economic growth ever since the industrial revolution. The more investment, the more growth.

But not all tax experts would agree that the long-term growth effects make consumption taxes superior. In a 1984 paper, Bob McIntyre of Citizens for Tax Justice critiqued proposals for consumption taxes to replace the income tax. He argued that income taxes are more clearly based upon ability to pay. Specifically:

Under income tax theory ... you the spender, and your neighbor, the saver, should be treated equally on your equal incomes because you each have the same ability to pay taxes and enjoy similar control over economic resources. A year later, when your neighbor's income is higher than yours due to the interest he earns on his savings, an income tax would ask him to pay more in taxes than you, since his control over economic resources has increased and his ability to pay taxes has become higher than yours. Whether your neighbor is paying a "single tax" or a "double tax," this result seems to square best with what assistant secretary Chapoton concedes to be "most people's conception of equity."¹

He also correctly noted that at some times in our economic history, we have needed more consumption, not more savings. For example, in the midst of a recession or depression the economy needs more spending (either by government or consumers) to get it moving. President George W. Bush's tax cuts, for example, clearly helped get the US economy out of the 2001-2002 recession. But, temporary tax cuts work to get an economy out of a recession whether the tax involved is an income or a consumption tax.

Moreover, in the near future, we will clearly need more domestic savings if the trade deficit is to be brought under control. Economists recognize that savings lead to fixed investments and that fixed invest-

Table 3. Consumption Taxes Report Card

Tax	Encourages Savings	Border Adjustable	Progressive	Eliminates Paperwork
VAT	A	A	D	A
Flat Tax	D	F	C	C
GIT	F	C	B	D
FairTax	A	A+	A	A
USA Tax	A	F	A+	D

Grade: A=Excellent, B=Good, C=Fair, D=Poor, F=Fail

ments lead to economic growth. Thus, consumption taxes tend to produce higher rates of economic growth in the long run than income taxes.

At least five different taxes have been proposed in recent years as ways to move our tax system in the direction of a consumption tax: (1) the Value-Added Tax, (2) the Flat Tax, (3) the Growth and Investment Tax, (4) the FairTax, and (5) the USA Tax. These five taxes differ in the attributes shown in Table 5. We will discuss each of these tax proposals, in turn, and explain the reasons for the grades we gave each tax in that table.

THE VALUE-ADDED TAX

The Value-Added Tax, commonly known as the VAT, is a very widely used tax throughout the world, outside of the United States. It is such a successful tax that, once tried, it has never been withdrawn. Under a VAT, each business pays a flat percentage tax on the difference between the value of the products that it sells and the cost of the products that it buys from other businesses. The sum of the value-added by every productive unit in the country adds up to a total equal to Gross Domestic Product (GDP). The VAT doesn't tax savings, so

it is a tax on the consumption of what is produced. (For more detail about the basis of a border-adjustable consumption tax, see the appendix at the end of this chapter.)

The fact that it is hidden from consumers – it is included in the price of goods with the consumers unaware of how much they are being taxed – makes this tax a very easy tax for governments to increase without consumers becoming aware of the increased burden that they are bearing. Partly as a result of imposing VATs, European nations have been able to raise their tax revenues significantly in recent decades in order to build extensive social-safety nets without much taxpayer protest. Although being hidden is considered an advantage by those who wish to increase tax revenue, it is considered a disadvantage by those who wish to keep tax rates low. Many conservatives have opposed it because they believe it encourages big government.

In 2005, the President’s Advisory Panel on Federal Tax Reform calculated that a 15% VAT, made progressive at low income levels through work and family credits, would collect 65% of the revenue now collected by the personal and corporate income taxes combined. This particular version of the VAT would also exempt “non-commercial government services, primary and secondary education, existing residential housing, and charitable and religious services. Special rules would apply to financial services and other goods that are difficult to tax.”² But the VAT would still not be progressive at higher income rates, so they suggested that if the VAT were adopted, which they didn’t recommend, it be combined with a simplified version of the current corporate and income taxes, except with vastly lower tax rates.

Since a 15% VAT would replace 65% of the revenue now collected by the personal and corporate income taxes, it is possible to extrapolate that a 23% VAT would fully replace both income taxes. Such a tax rate would not be particularly high for a VAT. Four of the countries in the OECD database (Iceland, Sweden, Norway, and Denmark), as shown in Figure 20, already have VATs above 23%.

Encourage Savings = “A”

The VAT would eliminate the corporate income tax. Thus it would

encourage corporate savings by leaving corporate profits with the corporation where they would likely be invested (see Table 2 of Chapter 7). This would likely result in an increase in corporate savings just because the corporations would have more money to save.

Eliminating the corporate income tax would also greatly reduce the opportunity cost of capital, which would, in turn, increase corporate investment. If the tax rate on corporate income were 50% and the going rate of interest were 6%, corporations would require a 12% return just to earn the opportunity cost of capital, but under the VAT, the corporation would just require a 6% return in order to earn the opportunity cost. The result would likely be greatly increased corporate investment.

Unlike corporations, individuals would not have more money to save, but they would have greater incentive to save because only the money that they would spend on consumption would be subject to the tax. Any savings would be tax free to be taxed only when consumed in the future.

The VAT would also encourage savings by allowing them to grow more rapidly since they would no longer have their growth slowed by

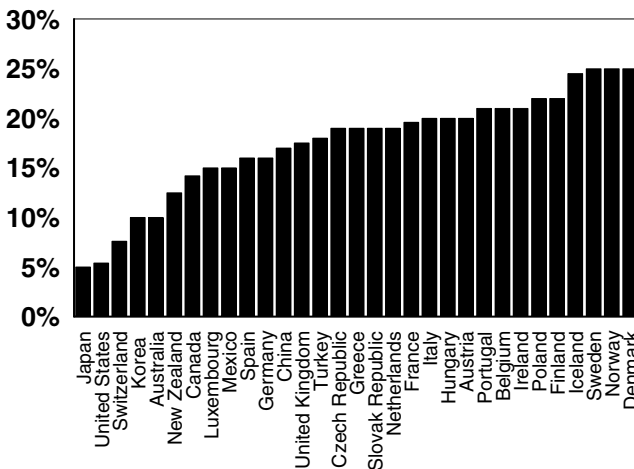


Figure 20. Border-Adjustable Consumption Taxes by Country.

In 2006, The United States had the second lowest border-adjustable tax rate (VAT+Sales Tax) with an average sales tax rate of 5.4% (tax inclusive).

(Source: mostly OECD Tax Database, Table 12.³)

taxation upon that growth. The current tax code slows the growth of savings by taxing corporate profits each year. Interest on savings are also taxed, unless those savings are in a retirement account.

Border-Adjustability = “A”

The international rules of trade of the World Trade Organization favor those countries that impose VATs. Their governments are permitted to rebate those taxes as an export subsidy to their exporters and to impose those taxes as an import duty upon imports.

The average sales tax in the United States is only 5.4% (calculated on a tax-inclusive basis). In contrast, almost all of our trading partners have much higher VATs which they use to subsidize their exports and tax their imports, as shown in Figure 20. Imposing a 23% VAT would turn the uphill playing field faced by the American producer in the international marketplace into a downhill playing field.

Take for example the situation where an American automobile company is competing with a Korean automobile company. Under the current income tax, the American company cannot pass on its taxes to the consumer or it would lose sales since the Korean company does not have to pay the US corporate income tax. On the other hand, with the VAT both the US company and the Korean company would have to pay the VAT when they sell a car in the United States. The American company would likely increase its profits and market share. It would also tend to invest some of its new profits in more efficient factories and to expand its research in order to improve its product line.

At the same time that the American company was investing, the American consumer would be saving tax-free and lending increased savings to the investor. These increased personal savings and the reinvested corporation profits could replace the savings that formerly came from abroad while producing the trade deficits.

The VAT should be made fully border adjustable by charging it to any nonresidents earning income from the United States. In other words, it should be withheld from dividend, interest and other income payments made by American businesses to nonresident foreigners. It should even be withheld from interest and dividends paid to foreign

government dollar reserves, which are currently tax free. By the end of 2006, foreign governments already had \$3,200 billion in dollar reserves earning interest directly or indirectly from the United States, and that amount was growing rapidly. All US tax treaties should be terminated or renegotiated to allow withholding of the VAT in these income payments.

Similarly, the VAT should be charged to returning tourists on products that they had purchased abroad and should be rebated to exiting foreign tourists on products purchased in the United States. It should also be rebated up to the VAT percentage to US residents who had paid tax to foreign governments on income, interest, or dividends received from abroad.

Progressivity = “D”

VATs are flat taxes in that the poor and rich pay the same flat percentage rate on consumption. The federal personal income tax with all its defects has the important virtue of being progressive in that richer people tend to pay higher percentage rates than poorer people. And those workers whose incomes fall below the poverty threshold receive a tax credit whether or not they pay any tax at all.

The VAT has been adopted by every country that is in the OECD database except for the United States. It has been made a bit progressive by applying lower rates to those products consumed most heavily by low income groups, such as foods, rents, and health expenditures. Henry Aaron of the Brookings Institution, while noting that the regressivity of the VAT can be reduced by multiple rates, wrote that most of the participants in a conference on the VAT in Europe agreed that it would be preferable to use other taxes and transfer payments to alleviate the VAT’s undesirable distributional consequences.⁴ Moreover, the 2005 President’s Advisory Panel on Federal Tax Reform reported that when differential tax rates for different products are employed, European businesses tend to evade taxation by incorrectly claiming that their products belong in the lower-taxed category.⁵

Instead, the President’s Advisory Panel on Federal Tax Reform put together a VAT proposal that was made progressive through

supplemental family and work credits paid out directly to families. Some of the credits would be given to all families, others would be given only to those earning low wages. According to the President's Advisory Panel, these changes would make the VAT just about as progressive for the lowest 40% percentile of families in income as the taxes it replaces. However, above the 40% percentile level of income, the VAT would still be less progressive than the taxes that it would replace.⁶

A progressive tax is one in which the rich pay a higher percentage rate than the poor. The degree of progressivity is usually measured by calculating the burden of the tax as a proportion of the taxpayer's income. That taxes should be progressive relative to income is a value held almost universally. Both among the public⁷ and in Congress, there is strong support for maintaining or increasing the progressivity of the income tax.

Because there is a trade-off in income taxes between progressivity and incentives to work and invest, there is disagreement over how progressive the tax system should be. A progressive tax on consumption would not necessarily have the same trade-off because an increased incentive to save at higher levels of taxation could stimulate growth even with a tax that is more progressive than the current US income tax.

Many economists make the case for progressivity on the ground that the utility of additional income decreases as income increases. Economic textbooks illustrate this concept by demonstrating that the first orange or apple is worth more to the consumer than a second, the second more than the third, and so on. Money like all other goods is subject to the law of diminishing utility. The first few thousand dollars are essential to keeping body and soul together while the last few thousand dollars of a multimillionaire are spent with little or no regard to cost. Some behavioral economists use the fact that happiness is little correlated with income to suggest that progressive taxes do little to diminish the welfare of anyone, and may increase overall happiness.⁸ That said, interpersonal utility is difficult to measure – misers (if they still exist!) place a very high utility on money no matter how wealthy

they are.

The real case for progressive taxation, as Henry Simons points out in his book *Personal Income Taxation*, is that it reduces inequality after taxes by imposing heavier rates of tax on those with high incomes. He enunciated the then-dominant economic view that society values greater equality or at least reduced inequality in the distribution of income, and therefore the tax system should be as progressive as possible, given awareness of the trade-off between progressivity and growth. At the margin, in his view, the marginal social value of the redistributive effects should equal the marginal social costs of retarded growth.⁹ The problem is, how do we know when we have reached this optimum point? For a recent attempt to find it mathematically, see a recent paper by Juan Carlos Conesa and Dirk Krueger.¹⁰

While progressive taxation makes income after tax less unequal, raising incomes is also important. The growth of society's capital stock increases demand for workers, increases labor productivity, and raises wages. Indeed, the single best explanation given for different levels of income in different countries is the amount of capital per worker. Progressive taxes have the problem that their marginal rates of taxation are much higher, especially for the rich, than would be the marginal rates of proportional taxes. As a result, they can be expected to result in slower rates of growth.

Paperwork Reduction = "A"

The VAT is very inexpensive to administer; only businesses are taxed. Individual taxpayers do not pay it, and thus do not have to spend any time filling out tax returns. Businesses pay the tax on the value of the products they have sold after subtracting the value of the products that they have purchased from other business. Customs officials charge the tax to incoming products and give a rebate of the tax to exporters. The current tax code involves compliance costs of 12% to 15% of the tax collected, but the European experience with the VAT suggests that the compliance costs would just be 3% to 5% of the tax collected.¹¹

THE FLAT TAX

The novel idea of the Flat Tax, which *Forbes Magazine* pub-

lisher Steve Forbes popularized in his unsuccessful run for President in 1996, was to tax businesses on their cashflows, not their profits. The cashflow is the amount that a business takes in after expensing investment and subtracting all of its expenses except interest costs. The tax was called “flat” because businesses would not pay tax on what they paid to labor, but individuals would file income tax forms and be taxed on their labor income at the same flat rate that businesses were taxed.

In 2007, Robert E. Hall and Alvin Rabushka published the second edition of *The Flat Tax*. The authors reported that a number of countries have adopted the Flat Tax beginning with Estonia in 1994 and followed by more than nine other countries since then, including Russia by the end of 2006.¹²

Hall and Rabushka and many other economists consider the Flat Tax to be a consumption tax, but they are wrong. The Flat Tax does not exclude savings from taxation. It taxes the value-added that is produced (which is income) while the VAT taxes the value-added that is consumed (which is consumption). As a result, the Flat Tax does not encourage savings as much as would a consumption tax.

The key aspect of the Flat Tax is the expensing of investment. The same effect could be obtained by having businesses take 100% depreciation the year that an investment is made. The other key aspect of the Flat Tax is charging businesses tax on the interest paid on any money that they borrow, a provision designed to encourage equity financing (see Chapter 7).

Encourage Savings = “D”

The Flat Tax would not encourage savings or investment in any of the four ways that a true consumption tax, like the VAT, would encourage them: (1) it would not eliminate the corporate profits tax which subtracts from corporate savings; (2) it would not greatly reduce the opportunity cost of capital, and thus would not much increase corporate investment; (3) it would not give individuals a direct incentive to save, and (4) it would not encourage savings by allowing savings to grow tax free. We’ll discuss each of these in turn:

1. *No increased corporate savings.* The Flat Tax only gives cor-

porations more money to spend on savings during the first year of the tax, when they would be able to expense that year's depreciation. After that, they would still have to be paying tax on the profits produced by capital that had been expensed the first year, but would no longer be reducing their taxes by depreciation on their previously invested capital. They would thus have less and less profits to spend on investment during succeeding years of the tax. The Flat Tax frontloads corporate savings, but doesn't increase their savings in the long run.

2. *Little reduction in the opportunity cost of capital.* The opportunity cost of capital is the amount that a business would need to earn in order to break even from an investment. Under the Flat Tax, the opportunity cost of capital would not change very much. It would be reduced by the reduction in the corporate tax rate, but it would be increased because the Flat Tax would be applied to interest payments for borrowed money.
3. *No direct incentive to save.* Individuals, under the Flat Tax, would pay the same tax rate on income allocated to savings as on income allocated to consumption.
4. *Savings not allowed to grow tax free.* Profits and interest would be taxed each year as part of the cashflow tax paid by business. As a result, the growth of savings would be slowed by taxation.

The biggest mistake of the Flat Tax proponents, as far as savings is concerned, is their plan to completely eliminate any taxation on capital gains from the sale of shares of stock. As we demonstrated in Chapter 5, giving a reduced rate of taxation to capital gains actually encourages the consumption of capital stock, and thus discourages savings. A much better treatment would be the one we advocated in Chapter 5 in which capital gains are taxed at the same tax rate as other income when the capital producing the gain is consumed, but are not taxed at all if the capital producing the gain is reinvested.

Border-Adjustability = "F"

The Flat Tax is collected as an income tax and as such is charged only to US residents. Unlike the VAT, the international rules of trade would not allow it to be applied to imports but rebated to exports.

Unlike a sales tax it would not naturally be applied to imports but excluded from exports.

Progressivity = “C”

Critics of the Flat Tax argue that it is not as progressive as the taxes it would replace, even though the advocates of the Flat Tax have tried to make it more progressive through generous personal allowances. Figure 21 compares the 1996 personal and corporate income taxes with one of the most progressive Flat Tax options ever advocated (a \$34,700 exemption in 1996 dollars for a family of four and retention of the Earned Income Tax Credit). The two curves were actually quite comparable except that the middle class would be taxed more heavily under the Flat Tax and the upper class would be taxed more heavily under the 1996 income tax system. The current version of the Flat Tax, as advocated by Hall and Rabushka, has a slightly less generous exemption (\$27,500 in 2007 dollars for a family of four) and thus would be less progressive than the version shown.

Paperwork Reduction = “C”

One argument for the Flat Tax is its simplicity, but what complicates the income tax is not its progressive rate schedule. Once you have determined your taxable income, it takes little time to read your tax

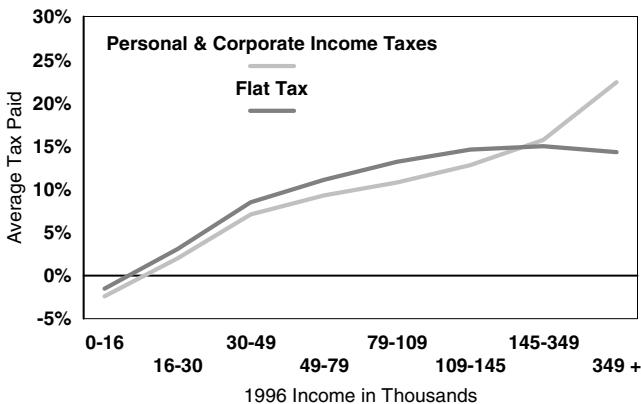


Figure 21. Tax Rates for 1996 Tax Code and the Flat Tax

In 1996, the personal and corporate income taxes combined taxed the rich at a higher rate than the middle class. Not so with the Flat Tax, given a 22.9% flat tax, a \$34,700 exemption for a family of four, and retention of the EITC. (Source: U.S. Treasury, Office of TaxAnalysis, 1995a and 1996.)

from the tax tables. It is the countless rules for determining taxable income that make the income tax complicated.

The Flat Tax eliminates taxation of interest, dividend income, and capital gains from the sale of shares of stock from the personal tax form. However, for many taxpayers filling out tax returns would still be quite time consuming. Capital gains on rental property, plants, and equipment would still be subject to the tax. Those with royalties from copyrights and patents or with rental income would have to pay tax using the cashflow tax methods that apply to all businesses. And that is just the beginning. Congress, given time, would surely come up with many new complications. Although the Flat Tax would clearly reduce personal income tax paperwork, the only way to fully reduce it would be to eliminate personal income taxation altogether.

THE GROWTH AND INVESTMENT TAX

It is possible to modify the personal income part of the “Flat Tax” with graduated tax rates so that the rich would pay more. In fact just such a proposal was one of the two tax alternatives developed and recommended in 2005 by the President’s Advisory Panel on Federal Tax Reform, The Growth and Investment Tax Plan (GIT). Essentially this graduated version of the Flat Tax combines a cashflow tax paid by businesses with a graduated income tax paid by personal taxpayers.¹³

Although the GIT, like the Flat Tax, is a cashflow tax for business, its rate of business taxation (30%) is much higher. As with the Flat Tax, labor, rather than business, pays the tax on labor income. Although capital gains are untaxed under the Flat Tax, they are taxed at a 15% rate under the GIT. Although dividends and interest are untaxed at the personal level under the Flat Tax, they are taxed twice under the GIT, first at a 30% rate by the business, second at a 15% rate by the individual. The GIT however would expand the availability of Roth IRAs so that taxpayers could shelter much of their income from the 15% personal tax.

Encourage Savings = “F”

Like the Flat Tax, the GIT does not encourage savings in any of the four ways that a VAT or other true consumption tax would en-

courage savings. Perhaps the worst effect of the GIT is that it introduces double-taxation of interest. This would particularly discourage savings that were kept in interest-bearing accounts. The GIT would increase the rate of taxation on interest income from the current rate which is set by the individual's marginal rate of taxation to a double-taxation rate of 40.5% (30% by the borrowing business, 15% by the lending individual). To ameliorate this problem, the GIT would expand the use of Roth-style retirement accounts.

Border-Adjustability = "C"

The truly innovative idea of the GIT is that the cashflow tax would be rebated to business on exports, but imports would not be deducted from cashflow. Any business or any subsidiary of a business operating in the United States would be subject to this taxation.

Although the tax panel argued in their report that border adjustability is not important since exchange rates adjust to balance trade (sigh!), they did try to make this tax proposal border adjustable. There must have been someone on the panel who had an inkling that US trade may actually be out of kilter.¹⁴

If the other nations of the world would agree to change the rules of international trade, then the GIT would be quite border-adjustable. Any business importing foreign goods or services would not be able to deduct the expense from taxation, but any business exporting goods or services would be rebated the entire 30% cashflow tax from their exports. If all exports and imports were to go through taxable companies, then the GIT would indeed provide substantial border-adjustability.

Unfortunately, the problem here is that the rules of International Trade are not made by the United States. As currently written, the GATT and WTO rules do not allow the proposed tax treatment, though they do allow a similar tax treatment for the VAT.

It is likely that our trading partners would object to treating the GIT as a VAT, especially with the high tax rate of the GIT (30%). The President's Advisory Tax Panel agreed that this aspect might not fly, but noted that if it did fly, it would result in an estimated \$775 billion additional revenue over 10 years:

Multilateral trade rules originally developed as part of the General Agreement on Tariffs and Trade (GATT), and now incorporated into the rules of the World Trade Organization (WTO), affect the use of border adjustments. GATT/WTO rules treat border tax adjusting “direct taxes” as a prohibited export subsidy.... (G)iven the uncertainty over whether border adjustments would be allowable under current trade rules, and the possibility of challenge from our trading partners, the Panel chose not to include any revenue that would be raised through border adjustments in making the Growth and Investment Tax Plan revenue neutral. If border adjustments are allowed, then the plan would generate about \$775 billion more revenue over the ten-year budget window than is currently estimated in the scoring of this plan.¹⁵

Unlike the GIT, a VAT or national sales tax would produce the huge boost of additional government revenue that accrues to a trade-deficit nation from a border-adjustable tax.

Progressivity = “B”

Unlike the Flat Tax, the tax rate for labor in the GIT is graduated with three tax brackets, 15% on incomes up to \$80,000, 25% to \$140,000, and 30% on incomes over \$140,000. As a result, the GIT would be just as progressive as the corporate and personal income taxes that it would replace.

On the other hand, income from investments is not taxed progressively under the GIT. The capital gains tax is 15% for all taxpayers. As a result, those with incomes up to \$80,000 would not get to take advantage of the huge (but foolish) tax-loophole available to rich taxpayers who consume their capital gains (see Chapter 5). The combined double-taxation rate for interest and dividends would be a flat 40.5%, with 15% paid by the personal taxpayer and the rest paid by the business that borrows the money or distributes the dividends. This increased tax burden would be somewhat alleviated through the promulgation of Roth-style retirement accounts in which interest and dividends would only be subject to the flat 30% rate of business taxation.

Paperwork Reduction = “D”

Although the intention of the President’s Advisory Panel on Tax Reform was to make the GIT less complex than the current code, they did not succeed very well. For many taxpayers the burden of

filling out tax returns under the GIT would be quite time consuming. Unlike the Flat Tax, the personal income tax part of the GIT taxes interest, dividend income, and capital gains from the shares of stock. With good intentions (to encourage charitable giving, to get people to buy their own homes, and to get people to buy their own health insurance) the President's Advisory Tax Panel also introduced several new deductions.¹⁶ Given time, Congress would likely find ways to make the GIT just about as complicated as the current personal income tax code.

THE FAIR TAX

Congressman John Linder's FairTax proposal, as described in *The FairTax Book* by Neal Boortz and John Linder,¹⁷ is the most comprehensive national sales tax proposal ever to be put forth. It would replace not only the personal income tax, but also the corporate income tax, the Social Security tax, the Medicare tax, the alternative minimum tax, and the estate and gift tax with a single 23% tax-inclusive sales tax. A 23% tax-inclusive rate is actually computed as a 30% sales tax since if you buy a \$1 item and pay 30¢ in sales tax, you have paid 23% of the \$1.30 in taxes. (Tax-inclusive terminology allows us to compare the FairTax with other taxes.) Proponents of the FairTax claim that a 23% tax-inclusive rate would raise about the same amount of government revenue as the taxes that it would replace.

Nothing sold new at retail would be exempt from the FairTax except educational tuition and items that were already in a business's inventory when the tax was instituted. Even governments buying automobiles, sick people paying medical expenses, and those buying a new home would pay the tax. Items sold used, though, would be exempt.

Encourage Savings = "A"

The FairTax would encourage savings in all of the ways that a VAT would encourage savings: (1) it would eliminate the corporate profits tax which subtracts from corporate savings; (2) it would greatly reduce the opportunity cost of capital, and thus would increase corporate investment; (3) it would give individuals a direct incentive to

save because only the money that they would spend on consumption would be subject to the tax; and (4) it would encourage savings by allowing savings to grow tax free.

Border-Adjustability = “A+”

The FairTax is even more border-adjustable than the VAT since it replaces the non-border-adjustable Social Security and Medicare taxes as well as the non-border-adjustable income taxes. Like the VAT, it would not be charged on American products exported abroad, but it would be charged on foreign products imported into the United States. As we noted in our discussion of the VAT, the FairTax should be withheld from interest, dividend, and other income paid to nonresidents and should be rebated to US residents who had paid tax to foreign governments on income received from abroad.

Progressivity = “A”

Because the FairTax would replace the progressive personal income tax as well as the regressive Social Security and Medicare Taxes, it is actually more progressive for two-adult families than the taxes replaced as shown in Figure 22. The FairTax is especially progressive for the poor because all taxpayers, rich and poor alike, get a sizable “prebate” check or debit card payment at the beginning of each month equivalent to the amount that they would pay when buying necessities.

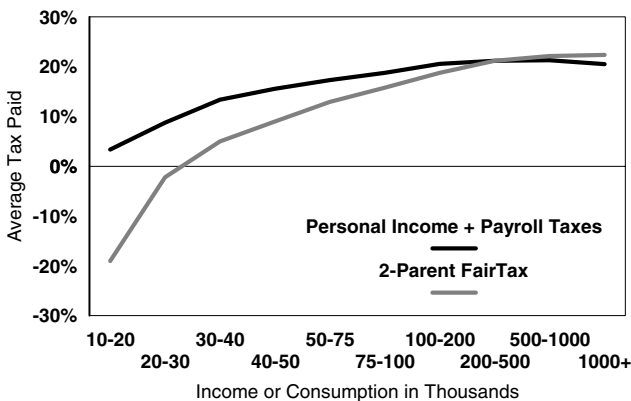


Figure 22. Tax Rates for Current Tax Code and the 2-Parent FairTax

Although the current personal income tax combined with payroll taxes as a share of cash income is progressive, it is less progressive for two-parent, 2-child families than the FairTax.

In 2007, that amount would have been based upon \$10,210 spending per adult and \$3,480 spending per child.

Figure 22 is not a perfect comparison. Ideally we would compare the two-adult two-child families of four shown for the FairTax with families of four under the current system, but we don't have statistics that isolate families of four under the current system, nor do we have statistics that break up all the taxes replaced by the FairTax by income level. In Figure 22, the black line shows the overall level of taxation under the current system for just the personal income tax and the payroll taxes according to 2006 tax year Brookings Institution statistics.¹⁸

As shown in Figure 22, two-parent families in the middle class would benefit greatly from a switchover to the FairTax. Families in the \$30-40,000 category would only pay an average of 5%, not 13% (2.6% income tax; 10.8% payroll tax). Families in the \$40-\$50,000 category would pay an average of 9%, not 16% (4.8% income; 10.8% payroll). Families in the \$50-75,000 category would pay an average of 13%, not 17% (6.6% income; 10.7% payroll).

If a family were to save money, buy anything used, or pay any educational tuition, they would reduce their tax rate further since saving, buying used items, or paying educational tuition would all be exempt under the FairTax. Conversely, if they were to spend more than their income, they would increase their tax burden.

Not all taxpayers would fare as well under the FairTax as the two-parent two-child family shown in Figure 22. A single parent with one child would receive half the prebate. Figure 23 compares how they would fare, as compared to the average taxpayer under the current tax system.

The one-adult, one-child family shown in Figure 23 could still reduce its taxation by saving money, paying tuition, or by buying used items. Some taxpayers might even find a partner to put their family into the two-parent bracket. But if they do not do any of these, they would pay approximately the same amount under the FairTax, as shown as shown in Figure 23, as the average taxpayer pays under the current tax code.

It is commonly believed among economists that wealthy people save a much higher percentage of their income than the middle class. This was once true, but may not be true any longer. As the trade deficits have been growing, wealthy Americans have been selling off their stocks and bonds to foreigners. Although some wealthy people are accumulating wealth that would be exempt from the FairTax until consumed, others are living off of their wealth. Those who are accumulating wealth would pay lower taxes under the FairTax; those who are consuming their wealth would pay higher taxes.

The current tax system shown in Figures 22 and 23 might appear as more progressive if it were possible to determine who really pays the corporate income tax. In the long run (as we discussed in Chapter 7) that burden is distributed among all of those who suffer because of the investment that the corporate income tax stifles, but principally it is paid by the owners, the shareholders.

In 2005, the President's Advisory Panel on Federal Income Tax Reform criticized the FairTax's prebate as being a new entitlement. The report stated that the money distributed to all families would "make most American families dependent on monthly checks from the federal government for a substantial component of their incomes."¹⁹ In-

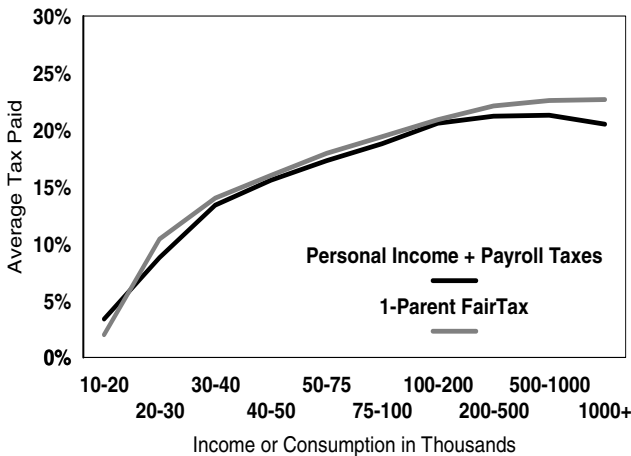


Figure 23. Tax Rates for Current Tax Code and the 1-Parent FairTax

A one-parent, one-child family would get half the prebate of a two-parent, 2-child family. They would pay a similar tax rate under the FairTax as under the current tax system.

deed, the poorest of the poor might rely upon the prebate for subsistence.

This particular entitlement, however, has a tremendous advantage over most of the other entitlements already in place in that it doesn't create a poverty trap consisting of disincentives against work. When poor people work, under the present system, their income rises and they lose eligibility for the various poverty programs. The effect is the same as a very high level of marginal taxation. Not only that, but the current system provides substantial incentives for mothers to remain single because an additional income would make the family ineligible for benefits. The resulting incentive system produces a poverty trap that prevents some of the poor from working their way out of poverty.

On the other hand, under a 23% FairTax, every taxpayer, rich or poor, gets to keep 77% of the additional dollar earned (even more if they save some of that additional dollar). This particular form of entitlement is similar to the negative-income tax recommended by libertarian-economists Milton & Rose Friedman in their book *Free to Choose* as a replacement for all of the current poverty programs.²⁰

The Problem of Social Security

Although Boortz and Linder envision that social security payments would not be affected by a switchover to the FairTax, ending social security taxes would require developing a new formula for determining social security benefits. At first that formula would largely be based upon the payments by the recipient into the Social Security tax system before the institution of the FairTax, but as time went on, there would no longer be reliable income measures on which to base such a formula. Little by little, social security payments would move toward a flat rate that would be received by all retirees.

The poor would come to benefit from higher retirement incomes, but the middle class would end up receiving less than they would have received under the current system. Social Security would come to be seen as a welfare program instead of a system in which people are paying for their own retirement. Boortz and Linder point out that, to a certain extent, this new perception would be valid. They write:

Social Security is an income redistribution and welfare program. Low-

income Americans receive a check that replaces 90 percent of their pre-retirement income. Workers paying taxes on a \$50,000 income will receive a check for only 32 percent of their pre-retirement income, and those workers paying taxes on \$90,000 will receive a check covering just 15 percent of their retirement income.²¹

Since all taxpayers plan to be elderly some day, the gradual movement toward flat payments for every recipient may not cause a reduction in the overall level of Social Security payments. Those who want more than the eventual flat payments to retirees would have plenty of years to save additional money for their own retirements, and the society would be richer as a result. Furthermore, given the fact that Social Security, as currently constituted, will eventually require either a cash infusion or a reduction of benefits, something will have to change regardless of whether the FairTax is enacted. Boortz and Linder point out that transferring Social Security to the broad based FairTax would actually preserve Social Security benefits.

The FairTax achieves greater progressivity than the current tax system largely by eliminating the regressive Social Security tax. While eliminating or modifying this regressive tax makes economic sense, the proposal is likely to make the FairTax a hard sell. The Social Security system is defended by powerful interest groups, and is justly characterized as the “third rail” of American politics.

But the current entitlement system is not sustainable. Perhaps the only way to reform it would be to do so as part of a sweeping overhaul, such as the institution of the FairTax. The prebate of the FairTax would provide a substantial new benefit for the poor and retired, while the elimination of the regressive Social Security tax and of income tax paperwork would provide a substantial increased benefit for those still working.

Eliminating the Social Security and Medicare payroll taxes would also reduce the unemployment rate for two reasons. First, the extensive paperwork of payroll taxes discourages small businesses from hiring employees. Second, according to the structuralist theory of unemployment developed by 2006 Nobel Prize winning economist Edmund S. Phelps, payroll taxes, unlike consumption taxes, increase structural employment, a particularly persistent form of unemploy-

ment. In a summary of his theory Phelps wrote:

Another central theme is the thesis that assorted interventions in the labor market operate to raise the natural unemployment rate, not just to lower the wage. The taxation of employment is the leading example. (Barriers to firing a worker once hired are another.) More generally, the burden of taxation on wages relative to that on nonwage incomes (returns from existing bonds and equities, services of consumer durables, and entitlements) matters for employment. The theory says that a value-added tax is fairly benign for the natural rate, since it is a tax falling more or less proportionally on wage and nonwage income alike; the payroll tax (and the personal income tax too if nonwage incomes tend to escape or evade it) bears disproportionately on the reward to not quitting and not shirking, with the result that the natural unemployment rate is pushed up (as any fall of the wage curve is less than the fall of the demand curve).²²

Is the 23% Tax Rate Reasonable?

Those looking at Figure 22 might wonder how it is possible for tax rates to decline for almost all two-parent families, but yet for the FairTax to generate enough money to replace not only the taxes shown in the figure, but also to replace the corporate income, gift, and estate taxes which in 2006 together generated \$382 billion.²³ There are several reasons why the 23% rate may be possible:

1. *Lower compliance costs.* The FairTax would eliminate unproductive work. It would eliminate most of the approximately \$140 billion annually spent by individuals and businesses to comply with the current tax system.²⁴ It would also save the federal government some of the Internal Revenue Service's \$11 billion budget.²⁵ At the same time the elimination of the corporate income tax could cause many multinational corporations to move their headquarters to the United States. Some of the white collar workers now working in tax code compliance and collection might find new jobs in these corporate offices.
2. *Less Tax cheating.* Tax cheating on the current income taxes is increasing. In 2001, the IRS estimated that between \$281 and \$322 billion went unreported on individual and business tax returns.²⁶ In general, the fewer the tax payers, the easier it is to catch tax cheating. With the FairTax only businesses, not indi-

- vidual taxpayers, would pay the tax. Furthermore, there could easily be many safeguards against cheating by businesses. For example, the FairTax could be collected from all businesses exactly the same way as the VAT is collected, with the only difference being that it would show up on all sales receipts. When paying the FairTax to the government, each business would subtract the tax that it had paid to other businesses. As a result, retailers would keep their suppliers honest; if a supplier had not collected tax because of an under-the-table transaction, the retailer would have to pay it. The government could easily investigate whether retailers were being honest. They could send an undercover agent to a retailer, make a cash purchase, and then investigate the next month whether the transaction appeared correctly on the retailer's records.
3. *Higher Basis for Taxation.* Due to the low rate of US savings and the high US trade deficit, the FairTax has a higher basis for taxation than an income tax. Specifically, in 2006 the basis for the FairTax would have been \$515 billion higher than the basis of the current corporate and personal income taxes, even though the FairTax would exclude undistributed corporate profits and other savings from taxation! (See the appendix to this chapter for the calculations behind this estimate.) The main reason is that the FairTax is border adjustable. In 2006, US imports exceeded exports by \$760 billion. The foreigners who produced those imports were not taxed by the United States income taxes. The higher tax basis of a 23% FairTax would yield \$118 billion of additional revenue.
 4. *Economic growth.* As we pointed out in Chapter 7, a tax on corporate income is a tax on the nation's future growth. In contrast, the FairTax would leave more profits with corporations and would reduce the opportunity cost of capital. As a result, businesses would have more money to invest and more incentive to make investments. In February 2007, five economists from the Beacon Hill Institute at Suffolk University used their model of the economy to predict the effects of the FairTax. They concluded

that in just one year GDP would go up by 7.9% more than it otherwise would, largely due to the end of double-taxation upon the revenue produced by investment. In the first two years, consumers would consume less, but due to the growth of the American economy, by the third year they would already be consuming more than they would be consuming without the switchover.²⁷

Dan R. Mastromarco, a principal in the Argus Group economics consulting firm, summarized the predictions of several of the studies that have been conducted:

The FairTax increases the income of U.S. residents and the purchasing power of U.S. residents' income. Recent studies show that under the FairTax, a decade from now the economy would be about 20 percent larger, and real wages would increase far more than the current law.... A switch to the FairTax would cause real wages to rise by 13 percent for an 18 percent difference in remuneration; by 2030 real wages under the FairTax would be 9.3 percent higher than they otherwise would be. The shift to the FairTax would raise marginal labor productivity and real wages over the course of the century by 18.9 percent and long-run output by 10.6 percent. In the long run, low-income households would experience a 26.7 percent welfare gain, middle-income households a 10.9 percent welfare gain, and high-income households a 4.7 percent welfare gain.²⁸

Several economists who have put together their analyses agree that the FairTax could indeed replace all of the taxes that it replaces with a tax-inclusive tax rate of about 23%.²⁹ But critics of the FairTax cite the 2005 President's Advisory Panel on Federal Tax Reform's claim that the FairTax rate would have to be between 25% and 41% (which they described in tax-exclusive terms as between 34% and 49%) just to replace the income taxes. In order to arrive at this exceptionally high estimate of the FairTax's replacement tax rate, they made two claims: (1) that FairTax advocates assume in their calculations that there will be absolutely no tax evasion, and (2) that governments would have to raise their taxes to pay the FairTax bills on their consumption and investment purchases.³⁰

The first of these assumptions can be quickly dismissed. FairTax advocates begin their calculations using GDP statistics which already

leave out the underground cash transactions that don't get reported on income taxes. The panel's second claim does have some validity, but not as much as the panel supposed. They were correct that governments would indeed pay the FairTax on their purchases, but they ignored the fact that governments would also have several of their own expenses reduced.

Take, for example, the statistics for government spending in 2004. That year, according to an analysis put together by Arthur, Laffer & Moore Econometrics, a 23% FairTax would have taken in \$1,863 billion in revenue, which is \$106 billion more than the \$1,717 yielded that year by the combination of all the taxes that it would replace. Included in that amount was \$335 billion collected from government spending on consumption and investment.³¹ But governments, in 2004, would also have had cuts in their spending that could total about \$203 billion:

1. *\$65 billion*, their share of the Social Security and Medicare payroll taxes for their employees. Federal, state, and local governments are huge employers and would gain an immediate 7.65% windfall just from the payroll taxes that they would no longer have to pay.³²
2. *\$110 billion* or more because the businesses that they would be buying from would be facing lower costs and thus would be forced to charge at least 10% less due to competitive bidding.
3. *\$28 billion* more by applying the FairTax to interest earned by foreign government dollar reserves in 2004 (assuming a 5% average interest rate). If foreign governments reciprocate by taxing US government currency reserves, the effect would be negligible, given the paucity of US reserves. Essentially, this would be tax collected upon dollar mercantilism. In 2004 the US foreign debt was \$2,361 billion while foreign governments had about \$2,424 billion in dollar reserves.³³

Thus, the additional government spending due to the FairTax could just be \$132 billion, an amount that could be accommodated given the Arthur, Laffer & Moore Econometrics calculation that the FairTax would have taken in \$106 billion more revenue than that yielded by

the taxes that it would replace.

Paperwork Reduction = “A”

The income tax and payroll taxes that the FairTax replaces are very difficult for individuals and businesses to comply with. Sales taxes like the FairTax, on the other hand, are very easy to comply with since individual taxpayers would not have to complete any paperwork whatsoever. All of the tax paying would be done by businesses.

The states with income taxes would likely change their own tax codes in order to make their taxes similar to the FairTax. Taxpayers would not stand for having to continue to file income tax returns with their states once they no longer have to file returns with the Federal government.

As we have already noted, the current tax code involves compliance costs of 12% to 15% of the tax collected. The FairTax could be collected exactly the same way as a VAT (except that the tax would be visible on all sales receipts). As we already noted when discussing the VAT, compliance costs in Europe are just 3% to 5% of the tax collected. Thus the FairTax could reduce compliance costs from the current 12% to 15% of tax collections to a much lower 3% to 5%.

The FairTax stands up well to the criticisms leveled against it. Just as its advocates state, it would eliminate the high cost of complying with the income tax code and it would lead to increased investment and long-term economic growth. At the same time, it would provide a substantial tax reduction to two-adult poor and middle class families.

THE USA TAX

For a long time the literature presented a false dichotomy between progressive taxation and taxing consumption. The old saw about why the United States does not use the VAT was that Republicans opposed it because it was too efficient and opaque when it came to collecting revenue, and Democrats opposed it because it was regressive. Although the FairTax is more progressive than the taxes it would replace, there is an even more progressive option, the USA Tax.

Progressivity = “A+”

Unlike the FairTax which must replace the regressive Social Security tax in order to be more progressive than the current system, the

USA Tax could achieve progressivity in the overall system without eliminating the Social Security tax. In fact, the USA Tax could be made more progressive than the current system with the highest bracket rate reaching 90% or more for the high-spenders, because the base of the tax is not income but consumption.

A progressive tax on consumption is not a new idea. One of its leading advocates was Irving Fisher who, with his brother Herbert, wrote a 1942 book about the progressive consumption tax.³⁴ In a recent journal article, John B. Shoven and John Whalley extol that book as a remarkable and pioneering contribution to the study of income taxation.³⁵

In 1955, Cambridge economist Nicholas Kaldor published *An Expenditure Tax*.³⁶ Kaldor served as an advisor to the governments of India and Sri Lanka, which each briefly adopted the expenditures tax but had to abandon it as a failure. Unlike the tax we recommend here, it complemented but did not substitute for the income tax. It was intended to tax the rich who avoided income taxation, but neither of these countries had long experience with income taxation.

In 1977, the US Treasury issued its *Blueprints for Basic Tax Reform* which called for a cashflow tax (a kind of progressive consumption tax), to replace the income tax and also called for integration of the corporate and personal income taxes.³⁷ In 1995, Senators Sam Nunn and Pete Domenici proposed the Unlimited Savings Allowance Tax (USA Tax), a progressive consumption tax proposal that built upon the popularity of tax free Individual Retirement Accounts.

Progressive consumption taxes have their critics as well as their admirers. In 1978, most of the leading experts on income and consumption taxes attended a conference at the Brookings Institution. The proceedings were reported in a 1980 book entitled *What Should Be Taxed: Income or Expenditure?*³⁸ At that conference, the leading opponent of substituting a progressive consumption tax for the income tax was Richard Goode, a mentor of the chief author of this book. Goode's criticism of the progressive consumption tax, while cogent, has been overtaken by an event this book is concerned about,

the decline in the rate of personal savings to less than 1% of personal income after taxes in both 2005 and 2006.

Goode argued that the income tax is superior, especially if its “existing remedial effects” are corrected. One of those defects, in our view, is its treatment of capital gains, as we discussed in Chapter 5. He also argued that failure to include savings and capital appreciation makes the progressive consumption tax more regressive. But progressivity depends on the rates of taxation. In theory, a progressive consumption tax could be graduated more severely than the current system without causing much, if any, reduction in savings or investment.

He noted that the US Treasury’s *Blueprints* proposed to exclude gifts and bequests in the taxable consumption of the recipients. We agree that that is anomalous. There is no reason that gifts and inheritances that are consumed should be excluded from a progressive consumption tax.

Goode argued that both the income tax and the progressive consumption tax favor leisure and household production. But leisure is not free, especially the preferred ways of spending one’s leisure time. Spending for leisure activities is taxed under both tax systems, even more under a consumption tax. In a section dealing with resource allocation, he noted that “The expenditure tax might be less biased in favor of leisure (or under demanding jobs), because some work is motivated by a desire to accumulate wealth rather than to consume.” However, he argued, the higher rates of tax needed by the progressive consumption tax to obtain equal revenue would tend to counteract that incentive.

Goode was writing at a time when US savings were still high. Given the extremely low rate of personal savings in 2006, a consumption tax with comparable rates can raise just about as much, or even more revenue than an income tax with the same rates. (See the appendix to this chapter for the mathematics behind this assertion.)

In his 1984 paper, Bob McIntyre of Citizens for Tax Justice noted several specific shortcomings of progressive consumption tax proposals. Specifically, he wrote:

Particularly hard hit would be those who spend more than their incomes. Who might we expect to find in this last group? Some examples that come to mind include students borrowing to fund their educational expenses; elderly people drawing down their savings to pay their living costs; unemployed individuals forced to deplete their bank accounts or borrow in order to put food on the table, and families taking out loans for major purchases.³⁹

Here McIntyre made it sound like poor people would be especially hard hit by a consumption tax. He did not mention the fact that one of the hardest-hit groups would be rich people living off their inheritances! He also ignored the fact that a progressive consumption tax (the USA Tax or the FairTax) would likely leave poor people with more money, not less, and that those working to pay off their debts would be among the greatest beneficiaries.

We would modify the USA Tax to address one of McIntyre's concerns. We would count education as an investment in human capital. Those borrowing to pay their educational expenses would have those educational expenses deducted from their income. The extra income produced by their education can be taxed later.

Seidman, in his analysis of the USA Tax, provides a detailed explanation of how a progressive consumption tax would work.⁴⁰ We like his proposal, but also agree with the criticisms pointed out by Steven Pressman in his 1998 review of Seidman's book.⁴¹ We would modify the USA Tax to meet these concerns:

1. *Revenue Shortfall.* Seidman's proposal results in a revenue shortfall in the early years because all capital transferred into IRAs could be deducted from the base income for taxation. We would modify the USA Tax by having all savings – stocks, bonds, business capital, savings accounts, real estate, cash, and so on – treated as capital assets as if they were all in an IRA. Under our proposal an IRA would simply be an accounting convenience. The owner of an IRA would not have to total any change in the value of the IRA but would just consider as income the difference between the amount removed from the IRA and the amount placed into the IRA.
2. *Role of Depreciation.* One of the weaknesses of Seidman's pro-

posal was its treatment of durable goods. We would modify his proposal so that when a person purchases a durable good, such as a car, with a standard life of a certain number of years (five, perhaps), he ends up paying taxes on only one-fifth of its purchase price each year. When the durable good is something that does not depreciate, a rule-of-thumb could be devised. For example, although the purchase of the home or art work could be counted against income, as a rule-of-thumb 1/30 of the purchase price could be considered to be its rental value and could be taxed as consumption each year.

3. *Income paid by a third party is taxed as income.* Another weakness of Seidman's proposal was that it might encourage corporate consumption. Whenever a business pays for something personal for the employee, it would report the benefit as employee income. Such expenses should include medical insurance and any consumption paid for by the business.

Encourage Savings = "A"

The USA Tax, like the VAT and FairTax would encourage savings in the same four ways: (1) it would eliminate the corporate profits tax which subtracts from corporate savings; (2) it would greatly reduce the opportunity cost of capital, and thus would increase corporate investment; (3) it would give individuals a direct incentive to save because only the money that they would spend on consumption would be subject to the tax; and (4) it would encourage savings by allowing them to grow tax free and by only subjecting them to single taxation, at a graduated rate, when they are consumed.

Border Adjustable = "F"

The USA Tax is not border-adjustable. Unlike the VAT, the international rules of trade would not allow it to be rebated to our exporters. Unlike the FairTax it would not naturally be excluded from exports but applied to imports.

Paperwork Reduction = "D"

Under the USA Tax with the modifications that we propose, all sources of income would receive equal treatment. The incentives of

the current law to avoid taxes by converting income from one form to another would disappear. Taxpayers who roll over their assets into other assets would pay no tax. Income taxes would be postponed until the taxpayer consumed those wages, salaries, dividends, interest, rents, and capital gains. Thus, savings would not be taxed, but consumption would be taxed.

In order to calculate your taxable income, you would simply calculate your income and then subtract your educational expenses and the net additions to your assets. Specifically, your taxable income would consist of wages, rents, dividends, profits, plus the proceeds from the sale, depreciation or depletion of capital assets. Then you subtract all purchases of capital assets, including deposits in savings accounts and purchases of financial assets. Educational expenses would also be subtracted, as an investment in human capital. Society can postpone taxation until the education produces additional future income.

Adding to your wealth by saving part of your current income lowers your taxes. Any money that you saved during the year gets subtracted from your basis for taxation. Any money that you borrowed for consumption gets added to your basis for taxation. Any money that you used to pay back loans gets subtracted from your basis for taxation.

COMPARISON OF THE CONSUMPTION TAX PROPOSALS

While the tax system is not the only way to increase incentives for savings and investment, it is a feasible way to do so. Replacing the income taxes, both corporate and personal, with a true consumption tax would do so.

We examined five different proposals that were thought to be consumption taxes or to have strong consumption tax components. Two of them, the Flat Tax and the Growth and Investment Tax (GIT), are actually not consumption taxes and would not increase savings and investment much, if at all. Both of these proposals tax corporate cashflow instead of profits, and thus are more-or-less equivalent to a corporate income tax that expenses depreciation. The effect would be to increase business savings the first year after the switchover, but reduce business savings in succeeding years because there would no

longer be a deduction for depreciation from earlier investments that were still producing income. Furthermore, both of these cashflow taxes charge businesses tax on interest paid when money is borrowed, which would tend to discourage borrowing for fixed investment.

At least the Flat Tax would significantly reduce the tax rate on business income and end double-taxation on dividends and interest. The GIT would not. Its only advantages over the Flat Tax are that it would be more progressive and could be border adjustable should the rules of international trade be interpreted in a way that would be favorable to it. The President's Advisory Panel on Federal Tax Reform, with much input from the President's Council of Economic Advisors, recommended the GIT as a way to increase growth and investment even though it would do neither!

The other three (the VAT, the FairTax and the USA Tax) are true consumption taxes that would greatly increase savings and investment and likely produce rapid economic growth. Any personal savings by individuals would be encouraged through exemption from taxation. Corporations would also be completely untaxed, which would not only increase their savings, but would also greatly reduce their opportunity cost of capital, encouraging them to increase their fixed investment.

Two of these (the FairTax and the USA Tax) are more progressive than the taxes that they replace and thus would fall more heavily on the rich and less heavily on the poor. The FairTax achieves its progressivity partly by replacing the regressive Social Security and Medicare taxes, not just the personal and corporate income taxes. The USA Tax does not need to replace the Social Security and Medicare taxes in order to be more progressive than the taxes it replaces.

Two of these (the FairTax and the VAT) would eliminate the personal income tax, thus greatly reducing taxpayer paperwork. Both of these are also border adjustable. These two taxes would provide a double-benefit as far as balancing trade is concerned. First, by making American producers more profitable and investment less expensive, they would result in greater business investment. Second, by removing the taxation upon savings, they would generate the increased

personal and corporate savings needed to replace foreign savings.

However, it should be kept in mind that the expected reduction in the trade deficit would not occur unless dollar mercantilism is addressed at the same time. As we pointed out in Chapter 2, when President Clinton and the Republican congress moved the US budget into surplus in the late 1990s, they expected the increased American savings to cause the trade deficit to go down. But the inflow of foreign savings, mostly foreign government reserves, prevented those benefits from occurring and instead caused American interest rates to plummet and US markets to experience unsustainable bubbles.

As the United States brings trade toward balance, growing domestic savings will be needed to replace diminishing foreign savings. The point of this chapter, like the previous three, is that we should shift the US tax code toward policies that encourage savings. In this chapter we proposed the most sweeping reform of all, replacing both the personal and corporate income taxes with a single true consumption tax (the VAT, the FairTax, or the USA Tax). Doing so would encourage savings, fixed investment and long-term growth.

TECHNICAL APPENDIX: TAX BASIS OF VARIOUS TAXES

Each kind of tax has a different overall tax basis:

1. *Flat Tax and Current Income Taxes.* These are both non-border-adjustable income taxes. Their basis is National Income which equals GDP after subtracting Depreciation (Capital Consumption Allowances):

$$\text{Income Tax Basis} = \text{GDP} - \text{Depreciation} \quad (1)$$

where GDP is equivalent to the total aggregate demand for the products produced domestically. In 2006, GDP was \$13,194 billion and Depreciation was \$1,589 billion. So their basis was \$11,605 billion.

2. *USA Tax.* The USA Tax is a non-border adjustable consumption tax. It does not deduct depreciation but it does exclude savings, including business savings, from taxation. The tax basis for the USA tax is thus GDP after subtracting Gross Savings:

$$\text{USA Tax Basis} = \text{GDP} - \text{Gross Savings} \quad (2)$$

In 2006, Gross Savings was \$1,834 billion, so the basis of the USA tax was \$11,360 billion.

3. *VAT and FairTax.* The VAT and FairTax are border-adjustable consumption taxes. Like the USA Tax, they do not deduct depreciation, but they do exclude savings, including corporate savings. Being border-adjustable, they tax Imports but exclude Exports from taxation. The tax basis for the VAT and FairTax is thus the same as the basis for the USA tax except that the trade deficit (Net Imports) is added:

$$\text{VAT or FairTax Basis} = \text{GDP} - \text{Gross Savings} + \text{Net Imports} \quad (3)$$

In 2006, Net Imports were \$760 billion, so the basis of these taxes was \$12,120 billion. Thus the FairTax and the VAT, even without taxing corporate savings (undistributed corporate profits) had a tax basis that was \$515 billion higher in 2006 than the combination of the personal and corporate income taxes. If the percentage rate of the VAT or FairTax were 23%, this additional basis would generate \$118 billion in additional revenue.

Note: The statistics for depreciation and savings cited in this appendix were calculated from Table 2 of Chapter 7. The calculations on this page are for the overall basis. Targeted tax exemptions tend to reduce this basis.