The Fair Tax of 2023: A Great Idea with a Major Flaw

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Twenty-five Republican members of the House of Representatives co-sponsored a bill to radically overhaul the U.S. tax system. The Fair Tax Act of 2023 (H.R.25) proposes to eliminate all federal income taxes, replacing the revenue with a national sales tax of 23–30 percent.

The bill is well-thought out and extremely thorough. It effectively would repeal the Sixteenth Amendment, thereby prohibiting the federal government from levying income taxes.

US Tax Policy: A Brief History

Major overhauls in the financing of government are rare. Article 1, Section 9, of the U.S. Constitution prohibited Congress placing a tax on incomes. Except for a few brief departures, prior to 1913 the federal government did not tax either individual or corporate incomes.

The prohibition on taxing incomes limited the size of the federal government to such an extent that in 1913 federal spending amounted to less than 2 percent of the total economy (GDP). With a severely limited federal government, the economy soared and U.S. workers rapidly became the most prosperous in the world.

In 1819, Chief Justice John Marshall rendered an opinion in *McCulloch v. Maryland* regarding taxation and states' rights. Marshall's ruling contained a famous statement: "The power to tax involves the power to destroy."

In 1913, the Sixteenth Amendment to the constitution removed the federal prohibition to tax income. Congress immediately passed the Revenue Act of 1913, which imposed income taxes on individuals and corporations at rates ranging from 1–7 percent. What followed showed the prescience of Marshall's statement insight. During the eight years following the passage of Revenue Act of 1913, there were major additional increases in income tax rates and federal spending. America's miraculous growth in living standards came to an abrupt halt amid soaring inflation. This was the first of six cycles of alternating periods of rising and falling taxes that would mark the next century.

My book *Rich Nation, Poor Nation* documents all but the most recent cycle. Each cycle shows a pattern of economic problems associated with rising tax rates and increases in federal spending. Once the problems become too severe, policies change with lower tax rates and limits on federal spending producing a recovery. However, each complete cycle ends with higher tax rates and more federal spending than before.

Armed with the ability to tax incomes, the size and scope of the federal government soared. In 2022, federal spending amounted to 25 percent of all spending. In addition, government regulations are estimated to control at least another 8–10 percent of earned income. State and local governments also have expanded, controlling another 15 percent of earned income. As a result of this seemingly relentless growth, government currently controls about half of American's income and spending. The effect has been a serious erosion in the freedom Americans traditionally enjoyed.

The Fair Tax Act of 2023

The sponsors of H.R.25 present a plan to enhance individual freedom by eliminating the root cause of the federal government's ability to enhance its power. The bill effectively replaces all income taxes with a national sales tax on final goods and services, including imports. It abolishes the Internal Revenue Service, thereby significantly increasing individual freedom. The overall effect is to increase incentives for production while limiting the incentives for consumption.

One argument against the Fair Tax is that its promoters attempted to deceive voters by claiming it was a 23 percent tax when consumers realistically see a 30 percent increase in prices. There is no deception. Both the act and the key website (fairtax.org) mention the tax will produce a 30 percent increase in prices of consumer goods. The sales tax rate is clearly 30 percent.

Another objection to the plan is that the 30 percent rate is insufficient to replace revenues generated by the current system. This may be true, but only because the 30 percent rate is far too high and could do serious damage the economy.

A quick, and admittedly superficial, estimate of the revenue from a comprehensive 22 percent national sales tax in 2022 would have generated 94 percent of all federal revenues.

This calculation does not include a key benefit from a national sales tax. Taxing consumption captures revenues and income in the illegal or shadow economy. An analysis from the Federal Reserve Bank of St. Louis estimates the illegal or shadow

U.S. economy at 13 percent of GDP. Shining a light on illegal activity has the potential to add $2.8 trillion in consumer spending and imports. In 2022, a 22 percent sales tax the *additional* spending would have increased federal revenues to $5.3 trillion, about $300 billion more than under the current tax system.

There are powerful feedback effects to capturing taxes from illegal activities which raise estimates of total output or GDP. The compounding effects of this increase grow over time, dramatically increasing measures of economic activity and federal revenues.

The Congressional Budget Office (CBO) has yet to review the revenue impact of H.R.25. I can almost guarantee the CBO will miss much of the benefits from this law. CBO is particularly inept at capturing either positive or negative interactions from major economic changes. Prior to the passage of the Affordable Care Act (ACA), Congress asked the CBO to estimate the act's impact on health insurance premiums. The CBO estimated premiums would increase by no more than 10 percent. The actual increase was a 100 percent. With an accurate estimate, the ACA would never have passed.

Most criticism of H.R.25 centers on the burden of individuals paying an extra 20 percent or 30 percent for most items. Lost in this estimate is the increase in purchasing power from the removal of income taxes, particularly the payroll tax on companies and the working poor. Also ignored is the substantial fall in prices from removing the tax burden to doing business.

Those opposed to H.R.25 don't have to worry. It has no chance of becoming law anytime soon. The public is often opposed to radical policy changes, regardless of how beneficial they may be.

Overall, the idea of a consumption tax replacing income taxes would be one of the greatest positive changes imaginable for unleashing the economy's growth potential and individual freedom. The bill's sponsors should be commended for proposing a major innovative change in government financing. It will work, but only if the tax rate is not so high as to undermine its effectiveness.

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