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| Austrian Students Scholars Conference |
| Flat, Fair, or Fuzzy? |
| A Praxeological Look at Presidential Candidates’ Tax Plans |

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Introduction

The current election cycle is notable for both the large number of candidates vying to be elected President of the United States, and for the variety of proposals to reform the current federal tax code they are producing, especially on the Republican side. In this paper, I will demonstrate that both ‘normal’ income taxes and sales/value-added taxes are taxes on someone’s income and that no tax plan can be structured to eliminate the natural inefficiencies arising from government consumption. I will attempt to demonstrate that of all the tax schemes currently proposed, the flat tax on personal income will have the least pernicious effects.

Basics of Austrian Tax Analysis

When the state removes a portion of its citizens’ income from the free market economy, the effects are diffused in a way that makes the true cost hard to measure. Murray Rothbard demonstrated that no tax can be structured in a way that results in neutral effects, neutrality being defined as organizations (either for-profit or not-for-profit) engaging in behavior that efficiently satisfies the ends of consumers (1997, pp. 56-63). In the event of taxation, the portion of money removed from the market will not be utilized in a way that matches how those taxed would have spent that portion of their income (pp. 66-69). Therefore, all taxation must necessarily distort the workings of the free market. Given that praxeology holds as a basic principle that the free market is the most efficient way of providing goods and services to persons, and the more efficient it is the better off humanity will be, government (and thus taxation) is evidently at best a necessary evil (Mises, 1962, p. 98) and may in fact be an unnecessary evil (for Rothbardians).

For the purpose of this paper, I will assume both the Rothbardian disbelief in neutral taxation while also accepting the Misesian tolerance of the state, and attempt to determine which of the current tax proposals will likely create the least distortion from the purely free market outcome if enacted. The basis of my analysis will be to consider the incentives and disincentives to various actions contained in each proposal, and whether or not they contain hidden double taxation. As noted by Hans Sennholz, taxation presents economists with many complexities in analysis (1982, p. 18), and I will attempt to trace the incidence of these taxes, especially regarding income taxes on business enterprises, which must necessarily be transferred to the individual owners of the firm at some point, as the firm is being operated to produce profits for the owners. Also worth mentioning is a suspicion by Israel Kirzner that economics lacks the “conceptual and analytical tools” needed to create a reconstruction of tax theory (Kirzner, p. 93).

While no tax can be neutral, it seems a logical conclusion that a tax system where all forms of income are taxed at the same rate will create fewer imbalances in the economy than one with different rates for different types of income and exemptions for special interests. Taxes play an incentive role in the economy, albeit having more of a stick than carrot function. Those with capital look at these different incentives built into the tax code and logically allow those imbalances to affect what lines of investment to pursue. For example, in the event of a tax system where income from investment in government bonds is taxed at a lower rate than investment in privately issued securities, the government will be able to pay out less interest on its bonds than private firms. This may raise the cost of capital for private firms, and will cause investors to act contrary to how they would in a free market (where they would choose the bond that paid the most, and bonds of similar risk would pay similar interest.) When many different exemptions are piled on top of each other, this creates a huge imbalance and causes malinvestment in both business enterprises and in the creation of an industry around tax compliance and avoidance.

Kirzner argued that a necessary component of tax analysis was consideration, not only of purely financial incentives and disincentives, but also of how tax rates draw attention to certain opportunities (pp.96-98). In this argument, special tax carve-outs or lower rates function to incentivize investment in the favored areas, not only because they now have a higher profit level, but also because attention is drawn to them. In effect, tax breaks can serve a misdirection function, causing investment in certain areas because they are perceived to be more profitable, and possibly blinding entrepreneurs to more truly profitable areas of production and investment.

Because of these considerations, it is frequently assumed that the best tax scheme is one that taxes only one form of economic exchange (income or consumption) in order to avoid double taxation, and if income is taxed, the rate should be equal and apply to all forms of income. According to this theory, by taxing all income equally, entrepreneurs will not be drawn into expending resources on finding the tax-minimizing investment opportunities, and will instead remain focused on the profit-maximizing opportunities. Double taxation and graduated rates should be avoided, as they allow the state to conceal the immediate effects of taxation from the majority of voters, allowing taxes to consume more of the people’s productive energy without setting off a backlash. Recall Rothbard’s argument that all government spending is consumption, contrary to the argument that some government expenditure is actually investment.

The Deduction Question: Rothbard’s Intriguing Argument

Mitt Romney set off a firestorm during the 2012 elections when he suggested that part of the problem with the current tax system was that 47% of American households didn’t pay federal income taxes. While some people suggested this proved he wanted to tax poorer people more and give out more tax cuts to the rich, others argued that all people should pay some tax. For the economist, the question becomes a matter of which is more important: a broad tax base or the least tax necessary collected. A common notion among tax reformers is a desire to eliminate deductions and make taxes broad-based. It is assumed that tax breaks on certain forms of economic activity are more inefficient, because they can cause redirection of resources, as explained in Kirzner’s theory of taxes as incentive. For instance, suppose there is a tax credit for investment in energy production. The proponent of flat taxation contends that this will result in more investment in energy production than would occur on the free market, thus, this tax credit should be eliminated.

Rothbard differed strongly on this issue in his essay: “The Myth of Tax Reform”. He contended that a tax system with deductions was in fact preferable to one without for the following reason: In a hampered market economy with taxation, the alternative to investment in energy is not just all other (possibly more profitable) investments, but there are actually three options facing the capitalist: energy production, other investment, and taxation. Rothbard concludes, quite logically given the setup, that even if investment in energy production is less efficient than other forms of investment, it is still more efficient than government consumption, so the tax credit at least allows the entrepreneur to keep more money. (Rothbard, 1997, pp. 117-118) The existence of tax deductions also necessarily means the nominal tax rate will be higher than the actual tax rate someone pays, so the tax burden the government places on the economy would actually be perceived as being higher than it actually is, limiting the government to consuming even fewer resources than the people would normally accept.

This is an interesting theory, and while it flies in the face of many tax reform arguments, I believe it is a well-reasoned argument in support of keeping deductions and loopholes. It seems to be a general rule with government consumption that the government will consume all it can get, so reducing the amount of money the government can consume without backlash may indeed the most effective way to reduce the waste of the state. However, from a purely economic rather than political viewpoint, I believe that eliminating loopholes and deductions are more economically efficient for the reasons Kirzner and others outlined. And, to specifically address Rothbard’s point of keeping the tax system addle-brained in order to build opposition, I suspect that educating the populace about the inefficacies endemic in any tax scheme would be at least as effective at building public disfavor for high taxation as maintaining a system that deliberately builds extra inefficiencies in. I would also note one consideration regarding his argument that deductions keep the effective rate under the nominal rate. Deductions are usually (always?) sought by groups with lobbying power over the tax bureaucrats, and by eliminating deductions, these groups would turn to lobbying for across-the-board tax cuts, since they could no longer procure a carve-out for their own specific interest. Causing these groups to ally against taxes in the general sense could also result in further tax cutting.

Tax Revenues, History and Source Comparison

When first introduced following the ratification of the Sixteenth Amendment in 1913, the income tax was markedly low compared to what it soon would grow into. From 1913-1915, the lowest rate was 1%, applied to the first $20,000 of household income, equal to roughly $480,000 in 2015 dollars, according to the BLS consumer price index calculator. The top tax bracket was 7%, and only applied to income greater than $500,000 (over $12 million today). The tax system exempted the first $3,000 of income, meaning only about 2% of US households paid income tax (Brownlee, pp. 56-57). With the coming of the First World War, taxes began to climb, and by 1918, while only about 15% of citizens paid taxes, the top 1% of income earners paid 80% of the tax collected, at effective rates around 15% (p. 63). After the war, with the election of Warren Harding as president and selection of Andrew Mellon as Treasury Secretary, the new government began cutting marginal rates back down. Mellon correctly believed high tax rates resulted in a reduction in economic productivity and misdirection of resources into less profitable (but tax sheltered) investments, but his Republican party violated sound economic principles by carving out exemptions for special interest groups (pp. 73-74).

With the stock market collapse and the election of Franklin Roosevelt came a new job for revenue: fund a large and exponentially expanding state apparatus, along with raising taxes on the superrich, bringing the effective rate for the top 1% up to 16.4% in 1936, and 20% by 1940. In addition, FDR created the Social Security system, with its flat and capped payroll tax, indicating a willingness to accept the regressive (to income) nature of contributions in order to make it less susceptible to repeal (pp. 92-93). While the 1930s New Deal policies were not considered to be effective at wealth redistribution, they did boost the revenue the government was capable of raising: from $2.9 billion in 1929 to $7.4 billion in 1941 (p.100). When compared to GDP for those years, we see the government went from consuming 2.7% of the nation’s measured output to 5.8%. When the United States entered into the Second World War in late 1941, taxes on all citizens skyrocketed. In Brownlee’s words: “Mass taxation had become more important than class taxation” (p. 115). By the end of the war, an average household with income of $1,500 would be subject to a 23% marginal rate thanks to surtaxes (Tax Foundation data).

After the war, the federal tax regime became entrenched in its current form, with three components: a progressive tax on personal income, a flat tax on corporate income, and a regressive payroll tax to finance social insurance. Interestingly, while the top tax rate has fluctuated from a high of 92% (early 1950s) to a low of 28% (1988-1990) since the end of WW2, the total income tax (excluding social insurance withholdings) consumed by the government has averaged 7.8% of GDP since 1950, and has been as high as 9.9% (2000) and as low as 5.6% (1950), the periods of highest revenue do not seem correlated with the periods of highest tax rates, but rather with periods of economic growth. When the economy is doing well, people seem to pay more tax, and when it is doing poorly, tax revenues fall. Social Security and Medicare taxes add an additional source of revenue for government consumption. These two taxes make up the lion’s share of federal revenue, and evaluating revenue at all levels (federal, state and local), we find that individual income and social insurance taxes combined made up nearly 60% of all government revenues in the 2011 fiscal year (Tax Foundation). Income taxes provided 37.1% of revenue, social insurance taxes 22.8%, consumption taxes (mostly at state level) accounted for 18.3%, property taxes 12.4%, and corporate taxes 9.4%.

Comparing this figure for all levels of US government revenue with other countries in the Organization for Economic Cooperation and Development (OECD) leads to a notable contrast. When the sources of revenue for all other 33 member nations of the OECD are averaged, income taxes make up a significantly lower 24.1% of their revenues, and property taxes account for only 5.4%. Corporate taxes contribute 8.7%. While social insurance taxes do account for a few percent more of revenue (26% instead of 22.8%) than they do in the United States, the majority of the difference is covered by consumption taxes, with 32% of non-US OECD tax revenue coming from that source. This heavy use of consumption taxes by other developed economies has resulted in many proposals for the US to adopt a federal consumption tax, and it is these proposals we will now turn our attention to.

Current Proposals

In the current race, former Florida governor Jeb Bush, Florida senator Marco Rubio and businessman Donald Trump have indicated support for a simplification and rate reduction of the current scheme. Gov. Bush’s plan features 3 personal income tax brackets and a flat 20% corporate rate, Sen. Rubio proposes 2 brackets with a 25% corporate rate, and Mr. Trump is suggesting 4 brackets (one of which is 0%) with a 15% corporate rate. In contrast, Texas senator Ted Cruz and Kentucky senator Rand Paul are proposing flat income taxes combined with ‘business transfer taxes’ (subtraction method value-added taxes). Sen. Cruz’s proposal appears to be calculated to appear more populistic, as it features a 10% flat income tax and a 16% ‘business’ tax. Sen. Paul’s proposal is apparently designed to appear ‘flatter’ as it includes a 14.5% income and 14.5% ‘business’ tax. Both Cruz and Paul remove the payroll taxes for Social Security and Medicare. Neurosurgeon Ben Carson’s plan has not been released, but the devout Carson has spoken about modeling taxes on the Biblical principle of tithing. The general inference from his speeches is that he supports a flat tax, somewhere between 10 and 15%, and it’s not clear what his stance is on corporate taxes. Former Arkansas governor Mike Huckabee is taking a different tack, backing the FairTax® (fairtax.org) which would eliminate all income taxes, including payroll taxes, and implement a 23% national sales tax. To date, none of the other leading candidates, conspicuously including former Secretary of State Hillary Clinton and Vermont senator Bernie Sanders have released comprehensive plans.

Evaluations of Various Tax Types: Flat

The flat income tax’s perceived advantages are simplicity and its proportionality to income, as everyone pays the same rate on all income. Senator Cruz’s plan would exempt the first $36,000 of income for a family of four, taxing income above that amount at 10%. Senator Paul would exempt more income ($50,000 for a family of four) and institute a 14.5% tax “applied equally all personal income, including wages, salaries, dividends, capital gains, rents and interest” (<https://www.randpaul.com/issue/taxes>). Both senators would maintain the Earned Income Tax Credit (EITC) and child tax credit along with deductions for charitable contributions and mortgage interest payments.

Roger W. Garrison raised some interesting points regarding the flat tax in a 1996 article for *The Freeman*. In it, he contended that perhaps economists should take as an acronym TANSTAABST or ‘There Ain’t No Such Thing As A Big Simple Tax’. In his own words: “Head taxes, the only truly simple taxes, are never big; income taxes, the primary source of revenue for the welfare state, are never simple.” (Garrison, 1996). While the proposed gains in simplicity come from the elimination of deductions, Garrison is concerned that by guaranteeing a certain amount of income would be extracted, there would be a new surge of tax avoidance strategies, these based around minimizing reportable income. While income tax filing would be simple for those who are paid wages reported on a W-2 form, other forms of income might become harder to identify, and thus tax. Given the current plans being proposed promise to tax all forms of income equally, this is no longer a concern, correct?

Actually, it still is. When wages and salaries are taxed, the taxpayer may choose to save and invest their remaining money. If they are then taxed on the dividends and interest from the securities they bought, the capital gains from the stocks they traded and the rents from the properties they invested in, is this not double-taxation? By taxing wages/salaries, the government has reduced the money available to individuals to invest, so it should be clear that to extract taxes again on the investor, who already had his or her investment potential (and therefore potential income from investment) reduced by the first round of taxation is a double-hit, and has a strong bias against capital formation. But to exclude certain forms of income would result in more tax avoidance, as people worked to put their money into the tax exempt income streams. Garrison visualized a world where employees, instead of being paid cash reported on W-2s, would become independent contractors paid with the tax exempt cash flow from bonds, for example. Excluding some income would also eliminate some people from the tax pool. The extreme example is the trust-fund socialite who gets her entire living from great-great-grandpa’s massive stash of stocks and bonds, but a more common example might be the successful entrepreneur or CEO. They may receive very little actual salary, but are compensated with significant amounts of dividend and interest paying securities. In these cases, the primary source of income is tax exempt. A class-warfare tax plan might solve the problem by exempting wages and salaries, only taxing investment income. Such a plan would be quite efficient… at creating an extreme disincentive to invest, torpedoing the availability of capital and the structure of production. Alternatively, one could imagine a tax plan that, like the ‘only-capital income’ tax, enshrined in law a division between two categories of income, wage income and investment income, and would require the taxpayer to pay the tax on whichever category of income produced more. So, a taxpayer who earned a $100,000 salary for his year’s work and also earned $10,000 on stock investments would only be taxed on his salary, while one who earned the same salary, but had much more investment income, say $120,000 and would be taxed on the $120,000 investment income only. This seems rather equitable, except for the matter of investment being intertemporal in nature. The taxpayer with the large amount of investment income had to acquire the investments first, and perhaps he was taxed on the income he used to make the investments in the first place. We have no guarantee that this will even out over time, and if it does, it will be by chance. It seems that not only is it theoretically impossible to make a tax fair, it may also be technically impossible to make the unfair tax apply equally.

Furthermore, the flat tax, as proposed, is not flat. With the built in exemption for income under a certain point, there will be automatic progressivity in the tax. For Senator Cruz’s plan, a family of four with household income under $36,000 has an effective rate of 0%. At $50,000, their effective rate is 2.8%, at $75,000 it is 5.2%, at $100,000 it is 6.4%, and so forth. The double taxation effects of the system may even raise some households’ effective rate above the 10% rate. While the rates are lower, flat taxes with exemptions for lower income and double taxation of investment will still has a broad spread of rates, not a flat deduction from everyone’s income.

The absolute best chance at making the flat tax flat would be as follows: All wages/salaries would be taxed, with no exemption for income under a certain level. When filing taxes, the taxpayer could then decide if he wanted to deduct the money he put into investments, and pay taxes on the income from those investments later or if he wished to pay tax on all his income, and then if he invested in anything, the profits from those investments would be tax-free. This would require both a complex tax form, and a complex system of government record keeping to determine what investment income was tax free. Such a system would be complex, increasing tax compliance costs and the amount of money the government would expend on collecting revenue.

Graduated (Progressive)

The graduated tax is the current and familiar regime in the United States, and most reform proposals from more ‘moderate’ candidates focus on maintaining the graduated tax, while simplifying it. The dominant criticism of this system is the blunt fact that if higher earners are taxed at a greater rate, the incentives to produce a level of output beyond that needed for basic sustenance is reduced. For supply-side popular economic theorists, the notion of taxing those who are most productive more than the least is highly questionable. For these economists, the highly productive individual has already contributed more to society through their actions of production, and to tax away a greater percentage of their earnings is wrong, and Rothbard agreed with this analysis in Power and Market (p. 161 ). But, as the evaluation of the flat tax has just demonstrated, maybe a plan with graduated rates and different treatment of different income isn’t quite so glaringly unfair after all.

Evaluating the progressive income tax in contrast with the flat income tax, we notice that while the progressive tax does indeed have flaws, some of the criticisms leveled at it are not valid. For example, some would complain that the progressive income tax reduces saving, on the assumption that higher earners save more and therefore, taxing the high earners at a higher rate creates a reduction in savings even greater than the reduction from a proportional tax. However, while it is quite correct to criticize taxation (and any other form of government intervention) for creating actions that deviate from those that would occur in a free market, Rothbard questioned how strong the criticism of progressivity causing less saving was, predicated as it is on the notion that saving is better than consumption. That notion is a bit of a simplification. It is more correct to say that all tax schemes will cause either saving or consumption to be reduced, both of which can be negative outcomes. The primary concern of the supply-sider seems to be a fear of too much consumption causing a reduction in the capital stock, but too much investment in capital is also a negative outcome, leading to an over-extension of the capital structure and an eventual collapse and liquidation of assets. Just because the progressive income tax reduces saving does not make it any worse than other systems. It is, after all, conceivable that if high taxes are allowing the government to wastefully consume a large proportion of the peoples’ wealth, there would be a corresponding reduction in the resources available to rational actors to consume with. Given this reduction, the imagined higher level of saving that would occur with a flat tax might actually lead to an unsupportable extension of capital compared to what the economy was able to consume.

Rothbard noted that even progressivity as progressivity is not necessarily worse. The classic example that he used to illustrate this compared two societies. In one, all people were taxed at a 50% rate, while in the second society, rates were steeply progressive: a man making $1,000 would be taxed at ½ %, while a man making $20,000 would be taxed at 20%. In the ‘fair’ society, Mr. Smith would make $1,000 and lose $500 to taxes, while Mr. Jones would make $20,000 and see $10,000 taken by the state. In the ‘progressive’ society, Smith’s taxes would be only $5, while Jones would pay $4,000. Even though Jones is being taxed at a higher rate than Smith in Society 2, he would still very much prefer to only be taxed at 20%, even if it meant his neighbor would only pay ½ %. (Rothbard, 2006, pp. 148-149). What matters in a practical sense is not having a fair tax system, but having low taxes.

Progressive taxation can also be seen as ‘Robin Hood’ economics, where the poor rob the rich via high taxes that fund welfare programs. This overlooks the many wealthy people that receive government subsidies for their businesses or favored charities. Continuing with the Rothbardian view, we note that taxation is not so much a Robin Hood game as a legalized Mafia. The government takes from less favored individuals and consumes the money for itself, using some of the funds to provide goods and services to its friends, to ensure it has supporters to keep it in power. The less favored groups may be rich, but they may also be poor or middle class (especially if they are working and are having part of their paychecks siphoned by Social Security and Medicare withholding). The favored groups may also be from any economic level, and may be receiving the pay-offs because they have voting power to keep politicians in office (poor and middle class community blocs) or because they can finance those politicians pursuit for more power (the wealthy). It is here we see that the single greatest fault of the progressive income tax is how it legitimizes this gaming of the public’s money and the public trust through differencing rates, exemptions and carve-outs.

Fair

Some groups, most prominently Americans for Fair Taxation, have proposed replacing the entire revenue structure of the federal government with a national sales tax (NST). It is believed such a measure would allow for a significant reduction in collection and compliance costs, as the tax would be added onto the price of goods at the time of retail sale, similar to state sales taxes. The merchant would than remit the collected tax to the federal government. There would be no paperwork for the consumer to deal with, virtually eliminating all costs except that of the tax itself to consumers. The primary criticism of such a system lies in its regressivity relative to income. Whereas a progressive income tax increases the percentage of money taken as income rises and a flat one holds the percentage steady, those with higher incomes tend to direct less of their income to consumption, and more to saving. Because only consumption is taxed, the frugal will pay less tax. Suppose there are three people: Mr. Jones, Mr. Buffet and Mr. Brady. Suppose further that Mr. Jones earns $80,000 per year and spends it all, Mr. Buffet earns $10 million but only spends $80,000 (being rather frugal), and Mr. Brady earns $10 million and spends it all. Under an income tax regime, Mr. Jones will pay significantly less than Mr. Buffet and Mr. Brady (who would pay the same amount), while under the sales tax regime, Mr. Buffet will pay the same tax as Mr. Jones, who earns 1/20 of Mr. Buffet’s income.

Now, it should be instantly apparent that the NST would face an uphill battle in the court of public opinion to be enacted on this feature alone, but is allowing such a simple way to reduce one’s tax burden necessarily a bad idea? Proponents would note that for someone to avoid the tax, they must be possessed of a remarkably frugal nature. In general, people save in order to consume, but they do intend at some point to consume goods. It is the rare person who wishes to accumulate money without eventually spending it. Therefore, it is likely that even if someone saved money for a long time, accumulating capital as they went along, at some point they would choose to treat themselves to a large house or yacht, and then pay a significant amount of tax.

In effect, proponents say, while consumption taxes provide a simple method for avoiding the paying of tax, in order to do so, one must live as a miserly hermit. Most of those who have wealth will not choose to do this. The tax rate is also effectively limited by international competition. Should the tax rate become too high, residents of that country will begin traveling abroad to do their shopping, allowing them to avoid the tax. This provides a much needed restriction on the government’s ability to confiscate private wealth, and ensures that the tax rate cannot be raised beyond a certain level.

There are two features of this scheme that need careful attention, the inclusion of a subsidy to make the tax progressive, and the question of whether or not this is truly a tax on consumption. The subsidy (called a ‘prebate’ in the FairTax plan) is crafted to cover the tax costs for people with low incomes. The plan calls for a subsidy equal to the amount of sales tax that would be paid by someone at the poverty line to be given to all households. If the poverty line for a family of 4 is $20,000, and the sales tax rate is 20%, each household with 4 people would receive $4,000 per year to cover their tax. Americans for Tax Reform notes that this makes their plan progressive, because a family spending at the poverty level would have a 0% effective rate, a family spending $40,000 would have a 10% effective rate, and so on. However, this feature seems to have similarities to guaranteed minimum income schemes, such as those proposed by Milton Friedman and criticized by Murray Rothbard. To decide whether or not it is an income transfer payment or a justifiable rebate of taxpayers’ money to themselves, we must determine the incidence of the tax, is it really a sales tax, or is it a tax on income?

Assuming the government taxes sales, what must happen to the effective price of goods and services as paid by the consumer? Well, the theory is that they must go up. But, according to economic principles, competitive firms must find a price where they can maximize revenue. If they raise their prices, revenue will fall, therefore, the firms must reduce other costs to cover the cost of the tax, rather than passing it forward to the consumer (Rothbard, 2006, pp. 110-112). We see from this that rather than the general sales tax being a tax on the consumption of goods and services, it is a tax on the income of producers of goods and services. In order to cover the cost of the tax, those who sell to consumers will bid the price of their inputs down and reduce their own profits. A home electronics retailer will be willing to pay less for flat-screen TVs, and in turn, the makers of TVs will pay less for glass and circuit boards, the makers of glass and circuit boards will pay less for their inputs, and so on, all the way up the production line. At each stop, the supply of these goods at the new lower prices will decline, resulting in the use of less labor, and reducing producer income. As a result, the general sales tax may be more pernicious than the income tax, because its perceived effects are different from its actual effects. We also see, now that the true incidence of the tax has been revealed, that the ‘prebate’ is not a tax break at all, but a transfer payment from producer income to consumers. This plainly invalidates any argument of fairness. Creating a tax plan where the incidence of the tax is concealed, the burden falls on producers and consumption is subsidized violates all principles of good economics. Even if supporters of this plan were correct in assuming that the tax would fall on consumption, this would still be a poor plan, as it runs the risk of causing over-investment in capital, extending the capital structure beyond its natural level. Overall, the FairTax is poorly thought out and should not be considered as a reasonable method for raising revenue.

Hybrid (Flat + VAT)

As proposed by Sens. Cruz and Paul, these hybrid plans would include both a flat income tax and a value added tax on business. Having already addressed the flat tax, let us turn to the VAT, which is intended to replace the FICA payroll taxes for Medicare and Social Security, as well as the corporate income tax. Proponents point to the flat rate that all firms would pay, and the efficiency of collection. A value added tax is levied at each step in the production structure, and takes a share of the value added by each firm. For instance, in the production of a loaf of bread, a farmer would grow a bushel of grain and sell it for $1. Supposing the VAT is 10%, the government would tax the farmer 10 cents. The miller buys the grain, grinds it into flour and sells the flour for $2. There was $1 of value added to the grain by the act of turning it into flour, so the miller is now taxed 10 cents. The baker buys the flour and turns it into bread, selling the resulting output for $3. Again, the baker added $1 of value, so he is taxed 10 cents. The total VAT paid at all levels of the production structure is 30 cents, equal to 10% of the price of the finished good, but the tax was paid in increments by everyone involved.

There are two different methods of calculating a VAT: the subtraction method and the credit-invoice (C-I) method. Almost all major economies with a VAT use the C-I method, with only Japan using a form of the subtraction method. (Grinberg, 2010, p. 309) It is then somewhat curious that both the Cruz and Paul plans use the subtraction method. The credit-invoice method works by calculating the tax due on sales, and then subtracts the amount of tax that has already been paid on inputs. The subtraction method does the subtraction first by deducting the cost of inputs, and then multiplies the value added by the tax rate. Both methods are mathematically equal, but the subtraction method seems to be simpler for a firm to calculate. This then begs the question, why does the C-I see such greater use?

The answer seems to be fraud protection. Under the C-I system, the producer must verify that the inputs he is using have had the tax paid on them up to that point, otherwise, he will be on the hook for the whole amount of VAT, not just the VAT on the value his firm added. With the addition method, the producer need not concern himself with this, and would have an incentive to cheat by buying inputs from firms that had not paid the VAT, allowing for lower costs, and therefore a more competitive price in the market. In effect, the C-I method leads to firms policing each other, while the addition method leads to competitive disadvantage for firms that obey the law, which is certainly not a just system. The C-I would apparently require all inputs to be tracked by the firms, with some sort of verifier that the tax had been paid. This adds a tax compliance cost to every business-to-business transaction, increasing market friction. It was because of this that Murray Rothbard argued in the 1970s the VAT tends to lead to vertical mergers and the reduction of competition. By vertically integrating, firms can reduce the costs of record keeping, and as is typical with adding administrative costs to businesses, large firms benefit at the expense of small ones, because they are more able to cope. Rothbard’s polemical flourish was a prediction that the government would then commence on a new round of anti-trust acts to compensate for firms growing larger and consolidating in response to the tax. (1972)

The implementation of both plans is decidedly fuzzy. While this is supposed to be a tax on business transfers, all that Sen. Cruz’s website says is that: “The tax will be based on revenues minus expenses such as equipment, computers, and other business investments.” (tedcruz.org) This sounds more like a replacement of the current corporate income tax with one that has fewer write-offs available. I cannot determine whether the tax would be paid on each item when purchased, or would be calculated at the end of the year similar to the current system. Perhaps Senator Cruz doesn’t know either. If it does function like a standard VAT, with tax collected at transfer, there are possible points of confusion about what constitutes a business. If the tax only applies to corporations, how would other forms of business be taxed?

To evaluate these specific plans with the hybridization of income with VAT taxes, they seem likely to have negative effects on the economy, and also serve to obscure the true tax rate. By reducing the personal income tax rate, these plans may be initially popular, but they compensate by increasing the share of tax paid by businesses, the costs of which are of course transferred to employees and shareholders. Employees will see lower wages when input prices rise, and lower profits for firms mean lower incomes for shareholders. This is the essential problem with double taxation. The tax that a person knows he pays may be less, but his total income is less because of taxation upstream of where he received his wages or dividend check. I would expect to see the degree of double taxation to be worse under this system than the current one, as there are fewer ways to get around the tax, unlike the current corporate tax code where tax can be avoided by transferring all profits to shareholders as deductible expenses.

Adding the value-added tax, in any form, to the revenue system of the federal government is a bad idea. The frictions it places on exchange and its hidden nature allow it to add almost invisible costs to the economy.

Conclusion

I believe I have effectively demonstrated that all tax schemes are fundamentally unfair, but if a praxeologist is asked by a policy maker to recommend a tax plan, I contend sound economic theory would suggest a flat tax on personal income, without a corporate tax or exemptions for low incomes. While this does result in double taxation of most investment income, it at least avoids triple-taxation on dividends (investor’s income used to buy stock, corporate income, investor’s income from dividends.) Because people at all income levels will be subject to the same tax, policy makers will have to keep the tax rate low, and the lower the rate is, the less the disincentive to investment caused by the double taxation of investment income will be. By making the stated incidence the same as the effective incidence, the degree to which people in the economy can act to adjust to the tax will be maximized, and it it to be hoped this will reduce malinvestment. The tax will naturally be unable to raise as much money as the current system, due to the low rate, but this is a net positive, as it reduces the amount that the government can consume, and so the burden that government could place on the economy would be greatly reduced. I would make a final point: the greatest fault of all these plans is their claim to keep taxes revenue-neutral. What is needed is not a tax plan that allows for the federal government to consume some 15-20% of the economy’s productive capacity every year, but a budget that drastically reduces the wealth transfers and consumption of the government. Huge levels of government consumption are destructive to the economy, and trying to create a ‘fair’ tax system that consumes private productive capacity is like trying to build a ‘clean’ nuclear bomb.

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