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Joseph R. Santoro* and Caleb S. Fuller**

ABSTRACT

In the United States, debates over the optimal tax base have raged since the implementation of the income tax in 1913. Recently, the controversy has centered around the Fair Tax. Advocates of the Fair Tax contend that it will achieve two goals. First, they claim it will maintain revenue neutrality. Second, they claim it will tax only consumption rather than impinging on income and savings. We use insights from the Austrian tradition of economics to question the desirability of the first claim and to question the feasibility of the second claim. We conclude that debates over taxation in general would be more fruitful if they returned to more fundamental issues—namely, the quantity of resources over which the state possesses ultimate ownership.

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INTRODUCTION

Tax reform is a perennial issue in American politics. This is unsurprising given that taxes affect all aspects of modern life. As Justice Holmes stated, “[t]axes are what we pay for civilized society.”¹ While there may be widespread agreement as to the inevitability of taxation, there is no such agreement regarding the most desirable means or quantity of tax collection. In 1986, the United States Internal Revenue Code underwent significant changes in order to simplify the collection of tax revenue.² Since that time, Congress has amended and repealed many components of its 1986 reforms, resulting in a complex and unwieldy tax code.³ Because of the complexity and perverse incentives of the current tax system, there is a never-ending cry for a simpler tax system.⁴

One such proposal for reform is the oft-debated Fair Tax, which originated in Houston, Texas, with the organization Americans for Fair Taxation (“AFT”).⁵ The AFT seeks to “develop a [tax] system that would raise the same amount of revenue for the government as our [current] income tax system, but which would be less intrusive, abusive, coercive, and corrosive.”⁶ The AFT believes the Fair Tax best embodies these ideals. In the minds of Fair Tax advocates, the Fair Tax would maintain revenue neutrality, but would tax consumption rather than income. As such, it would allegedly not penalize saving and investment decisions, unlike the current system of progressive income taxation.

This Note does not seek to investigate potential benefits of the Fair Tax relative to the current federal income tax code nor to debate the specific details of the Fair Tax. Instead, it examines two primary objectives offered by Fair Tax advocates. First, we question the desirability of any tax reform—in this case, by way of the Fair Tax—that maintains revenue neutrality. Second, we question the ability of the Fair Tax—or any proposed consumption tax—to tax consumption

¹ *Compañía Gen. de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

² Michael J. Graetz, *The Tax Reform Road Not Taken—Yet*, 67 NAT’L TAX J. 419, 419–20 (2014).

³ *Id.* at 420.

⁴ *See id.* at 419–20.

⁵ *See generally* AMERICANS FOR FAIR TAX’N, <http://fairtax.org/> (last visited Oct. 6, 2015).

⁶ NEAL BOORTZ & JOHN LINDER, *THE FAIR TAX BOOK: SAYING GOODBYE TO THE INCOME TAX AND THE IRS* 70 (2005).

rather than income. We construct both critiques by applying insights from the Austrian tradition of economics to the Fair Tax proposal.

We first detail a brief history of the debate on income versus consumption-based taxation. We then give a brief overview of the mechanics of the proposed Fair Tax. Next, we briefly sketch a framework of economics rooted in the Austrian tradition and then use that framework to analyze the Fair Tax. Finally, we conclude with a few brief policy implications.

I. THE CONSUMPTION TAX DEBATE: A HISTORICAL OVERVIEW⁷

From the birth of the United States through the Civil War, customs receipts or tariffs provided sufficient revenues to fund the federal government.⁸ During the Civil War, in order to fund the war effort, both the United States and the Confederacy enacted income taxes.⁹ When the war ended, the government repealed these taxes, but the push for federal income taxes remained.¹⁰ However, the Constitution did not grant the federal government power to levy direct taxes on income.¹¹ Not until 1913 and the passage of the Sixteenth Amendment did the Constitution grant the federal government power to levy direct income taxes. Since 1913, the federal income tax has comprised the primary source of revenue for the United States federal government.¹²

Dating to the introduction of the federal income tax, one of the central questions in tax policy has been whether income or consumption constitutes a superior tax base.¹³ The last several decades have seen a renewed call to tax

⁷ For a history of previous attempts to replace the income tax with a consumption tax, see Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238 (2003).

⁸ RICHARD J. JOSEPH, *THE ORIGINS OF THE AMERICAN INCOME TAX* 39 (2004).

⁹ JEROLD L. WALTMAN, *POLITICAL ORIGINS OF THE U.S. INCOME TAX* 3 (1985).

¹⁰ See generally STEVEN R. WEISMAN, *THE GREAT TAX WARS* (2002).

¹¹ See *Pollack v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895).

¹² See Robertson Williams, *The Numbers: What are the federal government's sources of revenue?*, TAX POL'Y CENTER, <http://www.taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm> (last updated Sept. 13, 2011).

¹³ See NIALL FERGUSON, *THE CASH NEXUS: MONEY AND POWER IN THE MODERN WORLD, 1700–2000*, at 51–76 (2001) (providing a historical analysis of consumption versus income taxation and arguing that, from a political standpoint, it is better to raise direct taxes on income, because taxes on consumption have historically been regressive causing political unrest amongst the poor).

consumption rather than income.¹⁴ One proposal that continues to garner significant attention is the Fair Tax,¹⁵ a transaction-based consumption tax proposal that would replace the current system of federal income, corporate, Social Security, Medicare, capital gains, and estate taxes with a consumption tax. This tax would take the form of a 23% national sales tax on all new goods and services.¹⁶

On January 6, 2015, the Fair Tax Act of 2015 was introduced to Congress with the most support a Fair Tax bill has ever received upon introduction.¹⁷ While this particular piece of legislation is likely to fail, it should not be ignored. At least one 2016 presidential candidate has voiced support for the Fair Tax,¹⁸ and there is growing political and popular backing for the idea.¹⁹ To better understand the Fair Tax plan and other reform proposals like it, it is important for lawyers, as advocates and policy makers, to investigate the economic implications of the Fair Tax.

Though the Fair Tax was only introduced in 1999, resistance to income taxation has a distinguished, centuries-long intellectual tradition. Frank Chodorov goes so far as to call the income tax the “Root of All Evil.”²⁰ Through the years, many other notable economists and political scientists have argued for the superiority of consumption rather than income-based taxation.²¹ The notable English political philosopher, Thomas Hobbes, wrote in *Leviathan*:

[T]he equality of imposition consisteth rather in the equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there that he which laboureth much and, sparing the fruits of his labor, consumeth little should be more charged than he that, living idly, getteth little,

¹⁴ See Reuven S. Avi-Yonah, *The Rise and Fall of the Consumption Tax*, 146 TAX NOTES 247 (2015).

¹⁵ See Ryan Lovelace, *The FairTax Makes a Comeback*, NAT'L REV. (Jan. 22, 2015, 4:00 AM), <http://www.nationalreview.com/article/396921/fairtax-makes-comeback-ryan-lovelace>.

¹⁶ BOORTZ & LINDER, *supra* note 6, at 75–76.

¹⁷ The Fair Tax Act has been introduced at the beginning of every new Congress since 1999. *Id.* at XII.

¹⁸ See Tami Luhby, *What the Republicans are saying about taxes*, CNN MONEY (Sept. 15, 2015), <http://money.cnn.com/2015/09/15/pf/taxes/republican-candidates-taxes/>.

¹⁹ See MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS 45 (2008).

²⁰ FRANK CHODOROV, THE INCOME TAX: ROOT OF ALL EVIL (1954).

²¹ To avoid confusion, it is important to note that none of the scholars discussed in this section advocated for the Fair Tax *per se*. They simply argued for taxing consumption rather than income, primarily to avoid the perverse consequences of double taxation.

and spendeth all he gets; . . . [b]ut when the impositions, are layed upon those things which men consume, every man payeth equally for what he useth.²²

Classical economist John Stuart Mill sided with Hobbes' preference for a consumption tax, arguing that "the proper mode of assessing an income tax would be to tax only the part of income devoted to expenditure, exempting that which is saved."²³ Prominent early nineteenth-century economists Irving Fisher and Nicholas Kaldor concurred with their classical forebears such as Mill. Fisher's primary objection to the income tax was the double taxation²⁴ levied on savings.²⁵ He wrote that, "by taxing the increase in capital, they kill the most important geese which lay the most important golden eggs."²⁶

Fisher's solution was that "the proposed tax base is income spent, that is, income used for consumption purposes, excluding all income saved."²⁷ His model, employed today, calculates taxable income by subtracting the amount of money not spent in a year—savings and investment—from the total amount of income received in a year.²⁸ While Fisher's idea was not synonymous with the modern-day Fair Tax, both proposals would, in the minds of advocates, be more equitable than a progressive income tax. In either case, taxation would be dependent on spending rather than earnings.

²² THOMAS HOBBS, LEVIATHAN 212–13 (Rod Hay ed., McMaster Univ. Archive of Econ. Thought 1999) (1651), available at <http://socserv2.socsci.mcmaster.ca/econ/ugcm/3ll3/hobbes/Leviathan.pdf>.

²³ JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 628 (Project Gutenberg 2009), <http://ect.pixelonline.org/files/etranslation/original/Mill,%20Principles%20of%20Political%20Economy.pdf>.

²⁴ As referred to throughout this Note, double taxation means the result of the income tax regime including capital accumulation in the definition of income. The double taxation that results from including capital accumulation in the definition of income is distinguished from the more familiar forms of double taxation: (1) different levels of domestic government taxing the same income; (2) more than one country taxing the same income; and (3) the taxation of both corporate profits and the distribution of the profits to shareholders.

²⁵ IRVING FISHER & HERBERT W. FISHER, CONSTRUCTIVE INCOME TAXATION 3 (1942).

²⁶ *Id.*

²⁷ *Id.* at 4.

²⁸ For a full explanation of Fisher's formulation of a consumption tax, see *id.* at 3–17.

Kaldor rejected the income tax due largely to the fact that he believed it impossible, or at least very difficult, to measure taxable capacity.²⁹ He wrote, “[a]ccruals from the various sources cannot be reduced to a common unit of spending power on any objective criteria.”³⁰ He goes on to say that “each individual performs this operation for himself when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses.”³¹ Kaldor concludes, “thus a tax based on actual spending rates each individual’s spending capacity according to the yardstick which he applies to himself[, . . . and] they are all brought into equivalence in the measure in which they support the actual standards of living.”³²

Sophisticated techniques, such as computable general equilibrium models (“CGE”),³³ augment the classical reasoning supportive of consumption-based taxation. One such example is a study conducted by the Beacon Hill Institute (“BHI”) on the Fair Tax.³⁴ This simulation purports to show the potential for increased economic growth under the Fair Tax system. The study used a CGE model to forecast the effects of the Fair Tax on major economic variables, such as real gross domestic product (“GDP”), domestic investment, capital stock, employment, real wages, and consumption.³⁵

According to the simulations run by the BHI, real GDP would increase 10.3% in the first twenty-five years after enacting the Fair Tax.³⁶ Likewise, investment

²⁹ When Kaldor refers to taxable capacity, he means the ability to pay or bear the burden of taxation. For Kaldor’s full argument for the expenditure tax, see NICHOLAS KALDOR, AN EXPENDITURE TAX 25–53 (1955).

³⁰ *Id.* at 47.

³¹ *Id.*

³² *Id.*

³³ Understanding the technical construction of the model is beyond the scope of this Note. For an explanation of CGE models in general, see Ian Sue Wing, *Computable General Equilibrium Models and Their Use in Economy-Wide Policy Analysis: Everything You Ever Wanted to Know (But Were Afraid to Ask)* (MIT Joint Program on the Sci. & Policy of Global Change, Technical Note No. 6, 2004), available at http://web.mit.edu/globalchange/www/MITJPSPGC_TechNote6.pdf.

³⁴ For the formal specifications of the Beacon Hill Institute model cited in this Note, see DAVID G. TUERCK ET AL., THE ECONOMIC EFFECTS OF THE FAIRTAX: RESULTS FROM THE BEACON HILL INSTITUTE CGE MODEL 7–21 (2007), available at <http://www.beaconhill.org/FairTax2007/EconomicEffectsFTBHCModel4-30-07.pdf>.

³⁵ *Id.* at 1–2.

³⁶ *Id.* at 1.

would increase, causing the capital stock to rise 17.3% within the first twenty-five years after Fair Tax implementation.³⁷ Employment levels would increase 4.7% in the same time frame.³⁸ “In particular, the household would find that, with the replacement of the existing income tax by a national sales tax, the reward for increased work and saving would rise, motivating economic ‘agents’ (i.e., households and firms) to expand both”³⁹ soon after implementing the Fair Tax. Critics of the current income tax system often cite its disincentivizing effects on the decisions to work and save.⁴⁰ Fair Tax proponents argue that the consumption tax system they propose reduces the disincentives to work and save income.

The BHI simulation also finds that in the early years of the Fair Tax, consumption would decrease compared to current levels because households would increase their savings in response to the higher net return on capital.⁴¹ However, within twenty-five years, consumption would eclipse the benchmark figure by 6%.⁴² According to this study, these increases are attributable to the elimination of double taxation.⁴³ Thus, the authors conclude that replacing the current federal tax code with the Fair Tax would confer substantial long-run macroeconomic benefits.⁴⁴

In the legal academy, Professor William Andrews of Harvard Law School ignited the consumption versus income tax debate when he published his revolutionary article calling for a consumption tax to replace the income tax.⁴⁵ This

³⁷ *Id.* at 24.

³⁸ *Id.* at 25.

³⁹ *Id.* at 1–2.

⁴⁰ *See id.* at 3.

⁴¹ *Id.* at 25.

⁴² *Id.*

⁴³ *Id.* at 2 (“To understand this feature, consider a wage earner who wants to save part of his income. That wage earner pays a tax once when he receives his wage and pays a tax a second time when he receives a return (interest, dividends, capital gains) on his saving. Because the Fair Tax would fall on consumption, not ‘income’ conventionally defined, wage earners would pay a tax only when they consume. Eliminating the double tax on saving would encourage saving, investment and capital formation, leading to an increase in production, as our results show.”).

⁴⁴ *Id.* at 1–2.

⁴⁵ William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

debate has continued for over forty years and has taken various forms.⁴⁶ Some scholars believe that the debate is over—that the income tax is here to stay.⁴⁷ However, so long as tax reform proposals like the Fair Tax continue to be introduced to Congress, it is important for lawyers to rigorously analyze these proposals so they might become better equipped as policy analysts and advocates.

The historical debate over whether consumption serves as a better tax base than income highlights the long history of dissatisfaction with the income tax and provides valuable insight into the motivation of those who advocate to abolish the income tax. As such, it provides important historical context for understanding the modern-day Fair Tax proposal.

II. UNDERSTANDING THE FAIR TAX

A. Mechanics

The simplicity of the Fair Tax probably contributes to its political appeal. Notably, the plan abolishes the Internal Revenue Service (“IRS”) and replaces all current federal taxes with a national retail sales tax. Abolished taxes would include individual income, alternative minimum, corporate and business, capital gains, Social Security, Medicare, payroll, self-employment, estate, and gift taxes.⁴⁸

In order to achieve revenue neutrality, the Fair Tax imposes a personal transaction-based consumption tax on all consumer purchases of new goods and services at a “tax-inclusive” rate of 23%.⁴⁹ To ensure that income taxes could not be reinstated in the future, the Fair Tax also calls for the repeal of the Sixteenth Amendment to the Constitution—the amendment granting the federal government the power to tax income.⁵⁰

As explained by its advocates, the Fair Tax is an “embedded tax,” implying that it is included in the price of the goods or services purchased rather than added to the price of the goods or services.⁵¹ This argument is intended to support the

⁴⁶ See Avi-Yonah, *supra* note 14.

⁴⁷ *Id.*

⁴⁸ BOORTZ & LINDER, *supra* note 6, at 74–75.

⁴⁹ *Id.* at 150–51.

⁵⁰ AMERICANS FOR FAIR TAXATION, *Which Comes First? The Implementation of the Fair Tax or the Repeal of the 16th Amendment?*, FAIRTAX.ORG (2007), available at <http://fairtax-psyclone.netdna-ssl.com/media/attachments/54988cc62017a86464000132.pdf?1419283654>.

⁵¹ BOORTZ & LINDER, *supra* note 6, at 151.

proposition that the general price level will not increase through the imposition of the Fair Tax. New goods and services include all items purchased at the retail level as well as from service providers, such as doctors, accountants, or lawyers.⁵² The Fair Tax only taxes new items at the retail level so that the sale of used or previously owned items is exempt from taxation.⁵³ Business-to-business purchases are likewise exempt since the tax is levied only once the ultimate user purchases the good or service.⁵⁴ Other alleged benefits of the Fair Tax include closing loopholes, since everyone pays the tax and all industries are taxed the same. To achieve the goal of equality, all state, local, and federal governments pay the Fair Tax on all applicable purchases.⁵⁵

The Fair Tax replaces the current federal tax system and does not impose additional taxation. The plan aims to be revenue neutral—that is, to keep the current level of tax revenue constant—while changing only the method of collection. The key to achieving revenue neutrality is setting the sales tax rate at that level which ensures that the federal government receives the same amount of tax receipts.

Collection of revenues under the Fair Tax is alleged to be simpler because retail stores and service providers would collect the tax. These retailers would then remit their collections to the state sales tax authority after the retailers deducted a 0.25% administrative credit for collecting the tax. Finally, the state would remit this amount to the federal government after deducting another 0.25% administrative credit for collecting the tax.⁵⁶

B. The Prebate

To combat the inherent regressivity⁵⁷ of the national sales tax, the Fair Tax aims to eliminate the tax burden on low-to-middle income households through a tax

⁵² *Id.* at 163.

⁵³ *Id.* at 76.

⁵⁴ *Id.* at 153–54.

⁵⁵ *Id.* at 78.

⁵⁶ DAVID G. TUERCK ET AL., TAX ADMINISTRATION AND COLLECTION COSTS: THE FAIRTAX VS. THE EXISTING FEDERAL TAX SYSTEM 12 (2007), available at <http://www.beaconhill.org/FairTax2007/TaxAdminCollectionCosts071025%20.pdf>.

⁵⁷ Like other sales taxes, the Fair Tax is inherently regressive. While sales taxes are flat, the poor, on average, spend a higher percentage of their income on consumer goods. Consequently, sales taxes are regressive because they disproportionately impact the incomes of the poor as compared to their wealthier counterparts.

“prebate.”⁵⁸ The Fair Tax plan includes a prebate to each United States household to cover taxes on the basic necessities of life.⁵⁹ The prebate would be paid in advance to every household in the amount of the sales tax that a taxpayer spending at the poverty level would be expected to have paid.⁶⁰ Every household in the United States—low, middle, or high income—would receive this prebate on a monthly basis to reimburse them for the sales tax the household would pay on all spending up to the poverty level.⁶¹

The quantity of monthly prebate payments would be based upon the federal government’s published poverty levels for various sized households.⁶² For example, suppose a married couple with two children had an annual consumption allowance of \$30,000. This family would be reimbursed a total of \$6,900 for the amount of tax on this level of annual consumption spending ($\$30,000 \times 23\%$) by receiving monthly prebates from the federal government of \$575 ($\$6,900 \div 12$). Lastly, because the poverty level for a family of two is not twice the poverty level of one individual, the prebate includes an additional sum for married couples in order to prevent a marriage penalty.⁶³ Thus, the prebate is the attempt of the Fair Tax to mitigate the regressivity of a national sales tax by ensuring that lower income Americans pay no tax on all spending up to the poverty level.

C. *The Rate Debate*

The Fair Tax proposes a 23% tax on all purchases of new goods and services. The 23% rate is computed on a tax-inclusive basis, which includes the amount of the tax in the base of the tax.⁶⁴ Opponents of the Fair Tax argue that expressing the tax rate on a tax-inclusive basis misrepresents the actual rate that a taxpayer will pay at the cash register.⁶⁵ Those who oppose the Fair Tax argue that the actual rate

⁵⁸ BOORTZ & LINDER, *supra* note 6, at 80.

⁵⁹ *Id.* at 85–86.

⁶⁰ *Id.* at 85.

⁶¹ *Id.*

⁶² *Id.*

⁶³ DAVID G. TUERCK ET AL., A COMPARISON OF THE FAIR TAX BASE AND RATE WITH OTHER NATIONAL TAX REFORM PROPOSALS 17 (2007), available at <http://www.beaconhill.org/FairTax2007/FairTaxBaseandRate3-15-07FINAL.pdf>.

⁶⁴ GRAETZ, *supra* note 19, at 229 n.6.

⁶⁵ *Id.* at 44.

of the tax would be closer to 30%, based on a tax-exclusive basis, which does not include the amount of the tax in the base.⁶⁶

The clearest way to illustrate the significance of this debate is through an example.⁶⁷ Suppose a gallon of milk costs a total of one dollar (\$1). Under the Fair Tax, seventy-seven cents (\$0.77) will go to the retailer, and twenty-three cents (\$0.23) will go to the federal government. On a tax-inclusive basis, the tax is 23% ($0.23 \div 1$). On a tax-exclusive basis, the tax is 30% ($0.23 \div 0.77$).

Sales taxes are typically expressed on a tax-exclusive basis. Those who oppose the Fair Tax argue that the Fair Tax should be expressed on a tax-exclusive basis as well. Proponents of the Fair Tax argue that, because the Fair Tax is designed to replace the existing federal income tax and payroll tax system, the rate should be quoted on the same basis as the taxes it is designed to replace.⁶⁸

III. THE AUSTRIAN TRADITION: A BRIEF INTRODUCTION

A. *Historical Origins and Contributions*

The general equilibrium simulation conducted by the BHI is one attempt by Fair Tax advocates to convince others of its significant macroeconomic benefits. Nonetheless, this Note offers analysis drawn from the Austrian school of economics⁶⁹ because we believe it yields a fuller, richer, and sometimes neglected framework by which to analyze potential impacts of taxation policy. Of particular importance to this Note, we wish to use the insights of the Austrian school to

⁶⁶ *Id.* at 229 n.6.

⁶⁷ A similar example can be found at *id.*

⁶⁸ NEAL BOORTZ ET AL., FAIRTAX: THE TRUTH 117 (2008).

⁶⁹ The name “Austrian School” can be somewhat misleading. The name was coined pejoratively by Gustav Schmoller as he referred to early authors in this tradition who were based in Vienna, Austria. *See* Peter J. Boettke, *Austrian School of Economics*, in CONCISE ENCYCLOPEDIA OF ECONOMICS 23, 23–24 (David R. Henderson ed., 2008) (introducing the origins and key ideas of the Austrian tradition). Due to the spread of “Austrian” ideas in the twentieth and twenty-first centuries, adherents have proposed other names, such as “market process economics,” for the tradition’s focus on change rather than static equilibrium states; “causal-realist economics,” for its focus on universal economic laws which derive from individual human action; and “mundane economics,” for its important insights into the “everyday” phenomena of value, price, money, exchange, and regulation. Israel Kirzner is the most consistent proponent of the term “market-process.” *See, e.g.*, ISRAEL M. KIRZNER, COMPETITION AND ENTREPRENEURSHIP (1973). For a discussion of the term “causal-realist economics,” see Joseph T. Salerno, *What is a Causal-Realist Approach?*, MISES INSTITUTE (Oct. 8, 2007), <https://mises.org/library/what-causal-realist-approach>. For a discussion of the term “mundane economics,” see Peter G. Klein, *The Mundane Economics of the Austrian School*, 11 Q. J. AUSTRIAN ECON. 165 (2008).

answer two primary claims made by Fair Tax advocates. First, is the goal of revenue neutrality a socially desirable objective of tax reform? Second, is it possible for the Fair Tax to tax consumption exclusively, as it purports to do, or does the Fair Tax effectively tax income? In order to answer these questions, we first offer a framework rooted in the Austrian tradition.

The Austrian tradition has a rich history, including many contributions which form the corpus of contemporary economic theorizing. Among these seminal contributions are Carl Menger's 1871 "Principles of Economics,"⁷⁰ in which he outlines his marginal utility theory of value, thereby contributing to the Marginal Revolution,⁷¹ the most significant paradigm shift in the history of economic thought. Other important insights come from Friedrich Wieser's 1889 "Natural Value,"⁷² where he formulates his theory of "alternative cost," which later came to be termed "opportunity cost," and Ludwig von Mises' 1922 critique of centralizing the means of production in his work "Socialism."⁷³

In 1974, another key contributor, F.A. Hayek, received the Nobel Prize in economics for his "pioneering work in the theory of money and economic fluctuations and for [his] penetrating analysis of the interdependence of economic, social[,] and institutional phenomena."⁷⁴ Other important thinkers in the tradition include Eugene Böhm-Bawerk, Murray N. Rothbard, Ludwig Lachmann, and Israel Kirzner, the last of whom is notable for expounding an economic theory of entrepreneurship.

B. *Economic Calculation*

One key contribution of Austrian economics is "praxeology," the general study of human action, based on the fundamental axiom that individual human

⁷⁰ CARL MENGER, PRINCIPLES OF ECONOMICS 114–65 (1981).

⁷¹ The Marginal Revolution introduced the idea that individuals do not value "classes" of goods, but evaluate goods at the margin. They do not compare "water" with "diamonds"; instead, they compare the next unit of water with the next unit of diamonds. *See generally* ROBERT B. EKELUND, JR. & ROBERT F. HEBERT, A HISTORY OF ECONOMIC THOUGHT 292–318 (2007).

⁷² *Fredrich von Wieser*, ENCYCLOPEDIA BRITANNICA ONLINE, <http://www.britannica.com/biography/Friedrich-von-Wieser> (last updated Feb. 3, 2015).

⁷³ LUDWIG VON MISES, SOCIALISM: AN ECONOMIC AND SOCIOLOGICAL ANALYSIS (1951).

⁷⁴ Press Release, Nobel Prize, Econ. Prize for Works in Econ. Theory & Interdisciplinary Research (Oct. 9, 1974), *available at* http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/press.html.

beings act and that collectives, as such, do not engage in action.⁷⁵ From the axiomatic fact of individual human action, the praxeological method uses verbal and logical deduction to reach necessarily true conclusions.⁷⁶ The necessity of a logically valid conclusion flows from the true and valid premise that individual humans act. So long as the logical deductions made in the praxeological analysis are correct, the conclusion must follow.⁷⁷

Human action is purposive behavior;⁷⁸ put another way, it is the application of means according to values or ideas to achieve ends.⁷⁹ It is rational in the sense that it aims at certain goals—goals based on the subjective valuations of the acting individuals.⁸⁰ Individuals apply means in the present, according to ideas, in order to achieve an end in the immediate or distant future.⁸¹ Deducible from the fact of action is that individuals seek to increase their satisfaction through action.⁸² As Ludwig von Mises explains, “[t]he incentive that impels a man to act is always

⁷⁵ See LUDWIG VON MISES, HUMAN ACTION 41–43 (scholar’s ed. 1998).

⁷⁶ MURRAY N. ROTHBARD, MAN, ECONOMY, AND STATE WITH POWER AND MARKET 72 (2d scholar’s ed. 2009).

⁷⁷ Note that the use of deductive logic as the starting point for many in the Austrian tradition does not mean that these thinkers are averse to all empirical techniques. They simply reject the use of such techniques to verify or falsify the fundamental axioms of human action and the basic economic laws which are derivative of them.

⁷⁸ MISES, *supra* note 75, at 11.

⁷⁹ ROTHBARD, *supra* note 76, at 72.

⁸⁰ The term “rational” conveys the concept of purposive action. It is not a normative value judgment concerning the desired end. Rationality can be contrasted with merely reflexive behavior (removing your hand from a hot stove or breathing). See MISES, *supra* note 75, at 18–23.

⁸¹ ROTHBARD, *supra* note 76, at 4–6.

⁸² MISES, *supra* note 75, at 13–14. Mises explains this concept as follows:

Action is always directed toward the future; it is essentially and necessarily always a planning and acting for a better future. Its aim is always to render future conditions more satisfactory than they would be without the interference of action. The uneasiness that impels a man to act is caused by a dissatisfaction with expected future conditions as they would probably develop if nothing were done to alter them. In any case action can influence only the future, never the present that with every infinitesimal fraction of a second sinks down into the past. Man becomes conscious of time when he plans to convert a less satisfactory present state into a more satisfactory future state.

Id. at 100.

some uneasiness.”⁸³ As Rothbard puts it, “[a]ll action is an attempt to exchange a less satisfactory state of affairs for a more satisfactory one.”⁸⁴ The determination of whether an individual perceives his situation to be satisfactory or unsatisfactory is based exclusively on the subjective⁸⁵ preferences of that individual.⁸⁶ Thus, not all individuals are motivated to act under the same circumstances.

This human action never occurs in an institutional vacuum. That is, the purposive, ends-oriented action of human beings will have different manifestations depending on the institutional arrangement, which constrains how individuals act and interact. Specifically, the consequences of action will be markedly different under the institution of private property than they will be under a regime of public resource ownership. This fact is crucial for the tax policy analysis that follows, so we must first understand its underlying reasoning.

As Mises explains,⁸⁷ private ownership allows for rational economic calculation by entrepreneurs and thus allocation of scarce societal resources in accord with the preferences of individuals. Under a private property regime, individuals are free to exchange their property with other market participants. This exchange is motivated by a desire to trade a less desired state of affairs for one that is more desired. For example, if Jack and Jill engage in voluntary exchange, it must be because Jack valued Jill’s goods or money more than his own, and the reverse is true for Jill.

The consequence of such voluntary exchange of private property is the emergence of “exchange ratios.”⁸⁸ If money is one part of all exchanges, the common term for these emergent “exchange ratios” is “prices.” Exchange against money permits the expression of all exchange ratios in a single, common denominator—the monetary unit. When these prices are the consequence of voluntary exchange, they reflect the value that market participants place on every good in the economy. In a regime of market prices, participants, to exchange, can

⁸³ *Id.* at 13.

⁸⁴ ROTHBARD, *supra* note 76, at 19 (emphasis omitted).

⁸⁵ By “subjective,” we simply mean that each individual can judge for himself how much he values any action compared to alternative courses of action.

⁸⁶ ROTHBARD, *supra* note 76, at 59–60.

⁸⁷ MISES, *supra* note 75, at 213–25.

⁸⁸ *Id.* at 213. If Jack trades ten dollars for one of Jill’s hats, the exchange ratio may be expressed as “ten dollars for one hat” or alternatively (and less commonly) “one hat for ten dollars.”

engage in quick and direct comparison of the relative opportunity cost of purchasing any good by directly comparing the goods' prices.⁸⁹

Such market-based prices allow for profit and loss accounting by entrepreneurs and thus the efficient stewardship of valuable social resources. When entrepreneurs purchase productive inputs, they incur present costs in the anticipation of reaping future profits because they hope that the selling prices of their products will more than compensate them for waiting for future output. If they anticipate the future better than their rivals, entrepreneurs earn profits, which signal the desirability of entry to would-be entrepreneurs, who then begin shifting resources into the profitable line of production. When revenues voluntarily acquired from consumers exceed an entrepreneur's costs of production, it is an indication that he has transformed resources from lower to higher valued usages.

Conversely, losses de-capitalize entrepreneurs who have poorly forecasted future market conditions, thus ensuring the release of resources to alternative, more valuable lines of enterprise.⁹⁰ Thus, Mises describes this property-based system as being characterized by "consumer sovereignty," since entrepreneurs "are bound to obey unconditionally the captain's orders" and "the captain is the consumer."⁹¹ Obeying these "orders" of the consumers is necessary for any entrepreneur who hopes to earn a profit.⁹² Consequently, Mises calls "monetary calculation" the "guiding star of action under the social system of division of labor."⁹³

In various places, Israel Kirzner describes this activity of entrepreneurs as a "market process" of "dynamic" and "rivalrous" activity.⁹⁴ He employs this terminology to emphasize the fluid process of change, which characterizes the marketplace.⁹⁵ Kirzner describes the entrepreneur as the economic agent who is

⁸⁹ Peter J. Boettke, *Economic Calculation: The Austrian Contribution to Political Economy*, in 5 *ADVANCES IN AUSTRIAN ECONOMICS* 131, 131–58 (1998).

⁹⁰ MISES, *supra* note 75, at 286–97.

⁹¹ *Id.* at 270.

⁹² *Id.*

⁹³ *Id.* at 230.

⁹⁴ For more on his discussions of entrepreneurship, see ISRAEL M. KIRZNER, *MARKET THEORY AND THE PRICE SYSTEM* (John R. Beishline ed., 1963) [hereinafter *MARKET THEORY*] and KIRZNER, *supra* note 69.

⁹⁵ Though this may seem like a commonsensical insight, many economists adhere to the neoclassical conception of perfect competition, which effectually treats the "perfect" market in a static fashion.

constantly alert to the possibility of resources, which are underpriced in the present relative to the revenues they can generate in the future.⁹⁶ The entrepreneur is constantly arranging and rearranging assets in search of profit.

In Kirzner's conception, the entrepreneur is driving the market towards an equilibrium, but the market never reaches that equilibrium because market conditions are themselves ever-shifting.⁹⁷ The point of this discussion is to show that when individuals allocate resources via the price mechanism, they do so in a way that accords with social preferences. This follows from the idea that prices, which act as guides to entrepreneurs, are reflections of the value consumers place on various goods and services.

The only alternative to the economic calculation described above is bureaucratic decision-making concerning resource allocation.⁹⁸ Such bureaucratic decision-making takes place in the context of public ownership of goods, or what we might call the "mixed economy." In this scenario, government officials decide on the particulars of production for any given project—what, where, how much, by whom, for whom, what quality, and any other decision that enters into the production process. The state extracts its revenue through involuntary taxation, while it makes expenditures regardless of the demands demonstrated in the market.

As such, taxation necessarily breaks the link between market-based price emergence and the eventual satisfaction of individual preferences as entrepreneurs work to earn profits by satisfying those preferences. The state official might make his production and expenditure decisions based on noble sentiments, such as providing for the poor, enriching civic life, or bolstering national defense. Regardless of the public official's motives or aims, his decision is not constrained by the discipline of potentially earning losses by forecasting consumer preferences incorrectly; consequently, there is no objective way to analyze whether the new configuration of resources adds to or subtracts from social wealth. Unlike the entrepreneur who is regulated by the preferences of market participants, the public actor has no similar overseer.⁹⁹

⁹⁶ See KIRZNER, *supra* note 69, at 222–25.

⁹⁷ MARKET THEORY, *supra* note 94, at 28–30.

⁹⁸ MISES, *supra* note 75, at 307.

⁹⁹ See Mises' seminal work on public resource allocation, LUDWIG VON MISES, BUREAUCRACY (1944).

As we discuss next, this understanding of economic calculation within the institutional context of a private property regime is critical to analyzing the desirability of the revenue neutrality objective.

IV. AN AUSTRIAN ANALYSIS OF THE FAIR TAX

A. *Is Revenue Neutrality a Desirable Objective?*

Mises and Kirzner's explanation of how entrepreneurs allocate scarce resources, guided by market prices, lays the backdrop by which to analyze intervention into the market economy. In the modern nation-state, taxation is a ubiquitous form of intervention. Understanding the general nature of taxation and its relationship to the market¹⁰⁰ process outlined above is necessary to evaluate tax policy alternatives. Many economists hold that government is a voluntary social institution, which provides important "public goods" through the means of taxation.¹⁰¹ Murray Rothbard explains this understanding of taxation: "Government is considered akin to a business firm, supplying its services to the consumer-voters, while the voters in turn pay voluntarily for these services."¹⁰²

However, the etymology of the word "tax" hints at the fundamentally involuntary nature underlying all taxation. The English word "tax" derives from the Latin "*taxare*," translated "to touch sharply."¹⁰³ Unlike market exchanges, which are voluntary, a tax levy is a forced or coercive exchange between the state and the citizenry. This proposition is true regardless of whether individuals possess cheery attitudes towards fulfilling their tax obligations. The obligation must be met if the individual wishes to avoid prosecution by the state.

¹⁰⁰ Mises defines the market as the following:

[A] process, actuated by the interplay of the actions of the various individuals cooperating under the division of labor. The forces determining the—continually changing—state of the market are the value judgments of these individuals and their actions as directed by these value judgments. . . . There is nothing inhuman or mystical with regard to the market. The market process is entirely a resultant of human actions. Every market phenomenon can be traced back to the definite choices of the members of the market society.

MISES, *supra* note 75, at 258–59.

¹⁰¹ Murray N. Rothbard, *The Myth of Neutral Taxation*, 1 CATO J. 519, 528 (1981).

¹⁰² *Id.*

¹⁰³ NOAH WEBSTER, WEBSTER'S ACADEMIC DICTIONARY: A DICTIONARY OF THE ENGLISH LANGUAGE 569 (1895).

Because taxation is a coercive interaction, it provides the government with revenue, but such cash flows are no longer linked to the voluntary preferences of consumers as they are in the market economy. Therefore, any tax, regardless of its form, inevitably transfers resources from the realm of economic calculation to a realm of bureaucratic decision-making. When a business firm acquires revenue voluntarily, it can compare that revenue to its costs to determine whether it has reaped a profit or made a loss. The former indicates the firm has added to social wealth because consumers value the final product more than they value the use of the inputs for some other endeavor. By contrast, the latter indicates that the entrepreneur has decreased social wealth.

Bureaucratic decision-makers do not have access to profit and loss feedback because neither their revenues nor their costs are derivative of the voluntary choices of market participants. Consequently, they may make allocative decisions with public-spirited intentions, but because their actions earn neither a profit nor a loss, it is impossible to say whether they have enabled the most wants-satisfying configuration of scarce resources.

It follows from this reasoning that the *form* of a tax is not as consequential as is the *level*. Thus, Rothbard argues, “by far the most important impact of taxation results not so much from the *type* of tax as from its amount. It is the *total level* of taxation . . . that is the most important consideration. Far too much significance has been attached . . . to the *type of tax*”¹⁰⁴ Because taxation necessarily removes resources from the realm of economic calculation, Rothbard identifies the quantity of taxation as the most important question, though he does not deny that the form of the tax can be consequential.¹⁰⁵

Thorough analysis of public finance never stops with taxation; raising revenues is only half of the picture. The purpose of the government raising revenue is to spend the revenue in order to acquire resources produced by the private sector. Because government tax receipts are eventually spent, taxation involves some group of people benefiting at the expense of some other group of people.¹⁰⁶ By its

¹⁰⁴ ROTHBARD, *supra* note 76, at 1155 (first emphasis added).

¹⁰⁵ *Id.* As one example of Rothbard arguing for the importance of the *form* of the tax, he notes that the progressive income tax structure acts as a penalty on service to the consumer. *Id.* at 1191–92. This derives from his argument that high incomes are earned by successfully allocating resources in accord with consumer preferences. *See id.* at 741. By punishing those who most successfully satisfy consumer preferences, the general standard of living will fall in the long-run. *Id.* at 1191–96.

¹⁰⁶ *Id.* at 1062.

very nature, taxation extracts assets from one party and bestows them on another party. The primary distorting component of taxation is the fact that the government spends the tax dollars it collects.¹⁰⁷ Tax analysis would not be nearly as significant if the state simply burned the dollars that it received through taxation.¹⁰⁸ To illustrate this point, consider an example provided by Rothbard and drawn from the income tax:

[T]he government taxes the codfish industry and uses the proceeds of this tax to spend money on armaments. The first receiver of the money is the armament manufacturer, who pays it out to his suppliers and owners of original factors,¹⁰⁹ etc. In the meantime, the codfish industry, stripped of capital, reduces its demand for factors. In both cases, the burdens and benefits diffuse themselves throughout the economy. “Consumer” demand, by virtue of [s]tate coercion, has been shifted from codfish to armaments.¹¹⁰

In the short-run, the codfish industry likely incurs losses, or, at a minimum, reduced revenues, while the armaments industry may experience profits. These gains and losses, representative of the new supplies and demands governing the respective industries, do not stop with the industries immediately involved. Both codfish and armaments producers have suppliers who themselves have suppliers. While the codfish industry *reduces* the quantities it purchases from its suppliers, the armaments industry *increases* the quantities that it buys from its suppliers. In turn, these suppliers respond accordingly with respect to their own suppliers. This process continues until the effects of the taxation impact the owners of original factors of production, such as land owners. Responding to a new market configuration, though not one which is a consequence of consumer preferences, entrepreneurs begin to shift resources away from the codfish industry and towards the armaments industry.¹¹¹

¹⁰⁷ *Id.* at 1151–55.

¹⁰⁸ Government expenditure shifts patterns of demand throughout an economy and changes patterns of production from what they would be on the unhampered market because the government becomes a consumer with the funds it collects through taxation. *Id.* at 1153.

¹⁰⁹ The original factors of production are land, labor, and capital goods. *Id.* at 10.

¹¹⁰ *Id.* at 1152.

¹¹¹ *See id.* at 1152–54.

This example highlights how taxation alters the market process, that is, the arrays of supplies and demands that would emerge in a system of private-property-based economic calculation discussed in Section III.¹¹² Through taxation and subsequent expenditure, the government has altered both market demands and supplies. Though Rothbard's example deals with the case of an income tax, the analysis yields insights for the case of a general sales levy, such as the Fair Tax. In the case of the Fair Tax, the state collects tax monies from all sellers of final goods, yet the impact of subsequent governmental expenditures would be identical to the case described above. Inevitably, certain firms or industries would be the recipient of government largesse via the new configuration of supplies and demands, which the government spending actualized.

Because taxation, regardless of its form, results in government spending, it impedes the ability of the market economy to adjust to demands that are truly reflective of consumers' preferences. Entrepreneurs continue to allocate resources on the basis of price signals, but increased levels of government spending imply that these prices are not necessarily reflective of market participants' voluntary exchanges. For this reason, tax reform that aims to maintain revenue neutrality will do little to improve the functioning of the economic system. Our analysis of economic calculation in Section III, coupled with our analysis of how taxation and spending interacts with the market process, indicates that tax reform should focus on reducing the total level of government spending.¹¹³

B. *Is It Possible to Tax Consumption?*

Proponents of the Fair Tax argue that the income tax is particularly harmful to saving and investing due to the effect of double taxation,¹¹⁴ and they argue that the

¹¹² See MISES, *supra* note 75, at 201–32 (explaining the idea of economic calculation and its importance to the market economy). Mises describes economic calculation in the following manner: “It is the compass of the man embarking upon production. He calculates in order to distinguish the remunerative lines of production from the unprofitable ones, those of which the sovereign consumers are likely to approve from those of which they are likely to disapprove.” *Id.* at 230. As the analysis by Mises demonstrates, taxation introduces “noise” into the otherwise smooth functioning of the marketplace, which ordinarily responds to what consumer preference dictates.

¹¹³ This Note does not discuss the myriad issues necessarily involved with decreasing government spending. Because government spending necessarily benefits certain parties, these same parties stand to lose when government spending falls. Any reduction in government spending must overcome the fact that it confers concentrated benefits, while diffusing the associated costs. Since the benefits of spending are concentrated on a few parties, these parties may find it easier to organize resistance to planned spending cuts, often taking the form of political action, such as lobbying.

¹¹⁴ See ROTHBARD, *supra* note 76, at 1168–69.

Fair Tax eliminates this vice by taxing consumption rather than income.¹¹⁵ This argument follows from the traditional understanding of tax incidence. The incidence of taxation concerns the question of who shoulders the real burden of a tax. Put alternatively, tax incidence analysis examines which party experiences a fall in real income because of the tax. The textbook view of tax incidence contends that sellers can shift the general sales tax to consumers, dependent on the relative elasticity of demand.¹¹⁶ If demand for a product is highly inelastic, then producers will find it profitable to “pass the tax forward” to consumers. By the same reasoning, if demand is highly elastic, producers will find it less profitable to raise prices in order to recoup the revenue lost to the tax.

Rothbard offers an alternative to this analysis. He argues that no tax can be shifted forward; this implies that it is impossible to tax consumption.¹¹⁷ As he contends, entrepreneurs set prices at the point of maximum net revenue.¹¹⁸ Since neither the supply nor the demand for the good being taxed has changed, entrepreneurs will not find it profitable to increase the price of the good in response to a new tax. To do so would actually reduce the revenue the entrepreneur receives because the quantity purchased would fall proportionately more than the increase in price.

In the case of a general sales tax, such as the Fair Tax, he maintains that only a change in the demand for or supply of money could cause a rise in the general level of prices.¹¹⁹ He closes his case by making a commonsensical insight: If businesses found it profitable to pass on tax increases to the consumer by raising prices, why would they wait for the tax in order to raise prices? They could simply raise prices in the absence of the tax. As he argues, “[i]f the state of demand had permitted higher prices, firms would have taken advantage of this fact long before.”¹²⁰

¹¹⁵ It is true that the income tax does levy a more severe burden on savings-investment than it does on consumption. *See id.* at 1164–71.

¹¹⁶ For a standard textbook view of tax incidence, see HARVEY S. ROSEN, PUBLIC FINANCE 254–74 (Paul Shensa & Sandy Teixeira eds., 6th ed. 2001).

¹¹⁷ ROTHBARD, *supra* note 76, at 1156.

¹¹⁸ *Id.* at 1157.

¹¹⁹ *Id.*

¹²⁰ *Id.* at 1158.

In reality, of course, it does seem that consumers bear the burden of the tax by paying higher prices. How do we reconcile this commonly observed fact with the analysis we have provided? As Rothbard argues, the imposition of the sales tax on any particular industry, also known as an excise tax, will tend to decrease the supply of the good being sold.¹²¹ Since businesses cannot simply raise their prices to pass the tax forward, the tax “squeezes” the profitability of the least efficient producers in the industry, thus forcing some to exit the industry. As the supply of the good falls, consumers eventually pay higher prices. Thus, the excise tax may increase the prices consumers pay, but it does through a general decrease in the number of suppliers—suppliers who can no longer remain profitable in the face of a tax which reduces their real revenue stream.¹²²

This explains why, in the case of a partial sales tax, consumers usually pay higher prices. However, note that in the case of a general sales tax such as the Fair Tax, the tax will simply be shifted backward since it is applied to all sellers of final goods. The Fair Tax could not cause a general increase in the price level because neither the supply and demand for money nor the supply and demand for goods has changed.¹²³ In order to affect a general increase in the price level, one of these factors would need to change, and the Fair Tax does not impact any of them.

Our analysis has important implications for the question of whether the Fair Tax can successfully tax consumption, thereby avoiding a penalty to savings and investment. Because the market economy is comprised of highly interrelated producers and consumers, the imposition of any tax has far-reaching consequences. French economist Frederic Bastiat famously argued that an “act, a habit, an institution, a law produces not only one effect, but a series of effects.”¹²⁴ He continues to argue that of these multi-layered effects, only the first is immediately visible.¹²⁵ The following effects require foresight and careful economic reasoning.¹²⁶

¹²¹ *Id.* at 1162.

¹²² *Id.* at 1156–57.

¹²³ *Id.* at 1157.

¹²⁴ FREDERIC BASTIAT, SELECTED ESSAYS ON POLITICAL ECONOMY 1 (George B. de Huszar ed., Seymour Cain trans., 1848).

¹²⁵ *Id.* at 1–4.

¹²⁶ *Id.* at 1–2.

Such is the case for a general sales tax like the Fair Tax. We argued in our previous analysis that entrepreneurs cannot shift a general sales tax forward. Neither can business-owners avoid the tax by shifting to alternative lines of enterprise since the tax is general and uniform. Thus, they must shift the tax backwards. As business firms comply with the tax and their revenue streams fall, they reduce their demands for their productive inputs.

An example helps illustrate this case. Suppose all final goods sellers find their real revenues are lower by the amount of the general sales tax, so they reduce their demands for the productive inputs produced by intermediate sellers. Intermediate suppliers find their revenues have fallen and respond by reducing their demands for the original factors of production, such as land and labor. Thus, land-owners and wage-earners will eventually experience a fall in their incomes because of the general sales tax. As Rothbard concludes, “an alleged tax on *consumption*, has been transmuted by the processes of the market into a tax on *incomes*.”¹²⁷ Since the owners of original factors of production see their incomes fall, they reduce their own spending patterns, and this behavior eventually reduces the incomes of all sellers in the economy.

Our analysis, rooted in the dynamic approach to market adjustments that we described in Section III, implies that it is impossible to tax consumption, while leaving income unaffected. Those who support the Fair Tax are correct in saying that the income tax is more destructive to saving and investment than it is to consumption, but they are wrong to think that the Fair Tax is the panacea. As Bastiat urges us, sound economic reasoning should consider the long-run effects of any economic activity, including policy prescriptions. For that reason, we contend that all taxation is ultimately a tax on income. The Fair Tax simply obscures the long-run economic impact of taxation, which is to reduce income.

V. POLICY CONCLUSIONS

This Note has shown that analysis rooted in the Austrian tradition can aid lawyers in their endeavor to understand the likely consequences of a tax proposal to better equip them as policy analysts and advocates. Henry Hazlitt, echoing Bastiat, argued that policy analysis should aim to foresee the long-run consequences of any policy: “The art of economics consists in looking not merely at the immediate but

¹²⁷ Murray N. Rothbard, *The Consumption Tax: A Critique*, REV. AUSTRIAN ECON., Sept. 1994, at 75, 87.

at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups.”¹²⁸

In light of that advice, this Note has two primary implications for policy. First, our analysis shows that revenue neutrality should not be a primary objective of tax reform as it is in the Fair Tax proposal. Reasoning by way of economic calculation demonstrates that tax reform should aim to reduce the total quantity of goods over which the state possesses ultimate control rights. This recommendation does not stem from a pre-commitment to fiscally conservative or libertarian ideals. Instead, it flows from the logic of market prices, which enable the dynamic process of economic calculation to guide the allocation of resources in such a way that satisfies the wants of consumers. Non-price resource allocation, as necessarily practiced by governments, may succeed at satisfying the preferences of consumers, but this outcome seems unlikely. In order to achieve this outcome, governments would have to produce the correct quantities with the correct inputs at the correct time and distribute the output to the correct recipients, all without the aid of market prices serving as a guide to profitability.

Second, the Fair Tax fails in its objective to tax consumption while leaving income and, by extension, saving and investing unchanged. This conclusion follows from the logic of the dynamic market outlined above. In the presence of a general uniform sales tax, entrepreneurs throughout the economy experience a decline in wealth. They respond to this decline by reducing their demands for inputs. These reduced demands work their way through the economy until owners of original inputs notice their incomes are lower. In turn, these individuals have lower incomes from which to engage in spending.

Under a general sales tax that applies to all finished goods, a large majority of wage-earners will find that the tax reduces their income. With less income to save and invest in capital goods, the economy will experience slower long-term growth as compared to a case of minimal taxation, such as a head or poll-tax, which was designed to lower total tax receipts by the government. This does not imply that the Fair Tax may not have benefits over directly taxing income. For example, direct taxation of income reduces the incentive to increase one’s income by satisfying consumer preferences; the system of progressive taxation that prevails in the modern-day nation-state only exacerbates this disincentive. Nonetheless, our analysis indicates that only a naïve interpretation of general sales taxation would conclude that the result will be no reduction in saving and investing.

¹²⁸ HENRY HAZLITT, *ECONOMICS IN ONE LESSON* 5 (spec. ed. 1952).

We contend that far too much time and energy is focused on the form of taxation. A better solution to tax reform is not to tinker with the method of taxation, but to simply focus on reducing the overall amount of resources that are diverted away from productive uses. The history of taxation in the United States is a history filled with debate over the optimal method of tax collection. The opportunity cost of such debates is an analysis such as the one we have provided in this Note. Debates over the form of tax collection should occur, but they should not replace analysis of the effects of taxation more broadly. These controversies have directed attention away from critical questions, such as the optimal quantity of resources that the state should remove from the arena of economic calculation.

In part, the failure of these debates to tackle what we consider the more important questions stems from a failure to follow the advice of Frederic Bastiat. His admonition reminds analysts to pursue the consequences of any policy beyond the immediate effects. In this Note, we have done just that. Our hope is that this Note will inspire readers to take a break from the endless debates surrounding the method of tax collection to once again consider the broader nature of taxation and its relationship to the market economy.