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## Why Democrats should love the FairTax

By Laurence Kotlikoff | February 24, 2008

SUPPOSE A presidential candidate proposed taxing wealth and using the proceeds to reduce taxes on workers and provide a rebate large enough to cover taxes paid by poor workers. Such a candidate would be hailed by the left and reviled by the right.

Thus, it's remarkable that so many Democrats, with the exception of presidential candidate Mike Gravel, oppose the FairTax and so many Republicans, particularly presidential candidate Mike Huckabee, support it. In fact, the FairTax, which replaces all federal taxes with a federal retail sales tax and provides a rebate, represents a way to tax wealth, reduce taxes on wages, and disproportionately redistribute money to the poor.

A sales tax effectively taxes wealth?

It does. When we buy goods and services in a sales tax world, part of the payment goes to sales taxes. So we end up with fewer real goods and services.

Take Mr. Megabucks, who is sitting on \$65 million and wants to buy a jet like Oprah Winfrey's - a 10-passenger, \$50 million Global Express XRS. Under the FairTax, the jet costs him an extra \$15 million because of the 30 percent sales tax. Mr. Megabucks gets the jet, but the extra \$15 million, which he had budgeted for Beluga caviar, Dom Pérignon, and other flight snacks, goes to Uncle Sam.

Now \$15 million is 23 percent of \$65 million - so the FairTax cost Mr. Megabucks 23 percent of his wealth. Precisely the same outcome would arise were Uncle Sam to directly tax Mr. Megabuck's \$65 million in wealth at a 23 percent rate, leaving him with \$50 million to buy the jet at the original price.

What if Mr. Megabucks sits and counts his money? With a direct wealth tax Mr. Megabucks pays \$15 million immediately and is left with \$50 million in purchasing power. Under the FairTax, Mr. Megabuck is in the same boat. Retail prices rise by 30 percent and Mr. Megabucks finds that his \$65 million can only buy \$50 million in real goods and services; Mr. Megabucks has the same number of dollars, but 23 percent less purchasing power.

This equivalence is no coincidence; taxing consumption is mathematically identical to taxing the resources used to buy consumption - current wealth holdings plus wages as they are earned. The beauty of the FairTax is that taxing wealth at a 23 percent rate generates enough revenue to reduce workers' marginal tax brackets to 23 percent. This is dramatically lower than the 30 percent to 45 percent marginal tax bracket confronting most workers under our combined income and payroll taxes.

The FairTax sales tax rate isn't graduated; everyone's resources get taxed at the same 23 percent effective rate. What makes the FairTax progressive is its rebate. The rebate is a trivial share of the resources of the rich, but 23 percent of the resources of the poor. Since our current tax system is regressive, adopting the FairTax would achieve progressivity.

Our tax system is regressive because none of the corpus - the principal - of the wealth of the rich, including our more than 400 billionaires, is subjected to taxation. Instead they pay taxes only on the income earned on their wealth. But this income comes primarily as capital gains, which are taxed at only 15 percent. Furthermore, capital gains taxes are levied only when wealth holders realize their gains - when they sell their appreciated assets.

But the superrich don't need to sell their gains. If they need cash they can borrow using their appreciated assets as collateral. When they die, they can hand their heirs their appreciated assets with a step-up in basis,

which wipes out prior capital gains. With the right estate planning, they can also avoid most estate and gift taxes. Unlike most of us, what the superwealthy and just plain wealthy pay in taxes is a matter of choice - their choice. When Warren Buffet says his tax rate is much lower than his secretary's, he's got it right.

So why do so many Democrats think the FairTax is regressive? Because they consider taxes relative to annual income rather than resources, and the former is a terrible proxy for the later. Bill Gates's income this year may be zero given what's happening to stocks. If so, a man with over \$47 billion in resources will be classified, based on income, as no better off than the homeless. And since Gates's consumption is based on his resources, not his current income, the ratio of this "poor" person's FairTax payments to his income would be sky high. Measuring taxes relative to income will thus suggest regressivity with respect to consumption taxation where none exists.

Our economy needs a simple, transparent, and progressive tax system. The FairTax is the answer. Democrats should give it another look and a fair chance.

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