HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

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The Sales Tax And the Myth of Falling Prices

Dear Democratic Colleague:

Extensive analysis by non-partisan economic scholars has shown conclusively that replacing existing federal taxes with a national sales tax, beyond being administratively infeasible, would be patently unfair. Working families would pay much more in tax, while the very wealthiest Americans would have their tax burdens cut by more than half. In the name of increasing the incentive for working people to save more, Republicans would increase their share of the tax load so much that they would not be able to save at all.

However, whenever others refer to the troubling news in the body of economic analysis about the sales tax, advocates respond that all will be well, because prices of all goods and services miraculously will fall. Working people will accordingly be newly more prosperous. The only problem with this theory is that very few serious economists would buy it.

The advocates' argument is that all of the taxes that they would repeal — the individual income tax, the corporate income tax, the payroll tax, and the estate and gift tax — are "embedded" in the cost of all goods and services in the economy. Repeal those taxes, and prices naturally will fall, because of the pressure of competition. Lower prices will make workers better off — and for that matter, will cut the government's revenue needs.

But there are two major flaws in this argument. First of all, ***it is highly unlikely that prices would fall*** if we changed over to a sales tax. And second, ***even if prices did fall, it would not make anyone better off — because when sellers cut prices, they also, by that very step, cut their own before-tax incomes as well.***

Consider a simple example to illustrate both points. Imagine that you are an individual customer, walking up to a one-person manufacturer and retailer to buy his or her product; and note that most of the revenue from the taxes that are being repealed comes from the individual income tax. Your individual income tax liability has just been repealed. The seller's individual income tax liability has been repealed as well; but you and he also know that there is a new sales tax to pay on any of his profit, or your income, that is spent. And because the sales tax is supposed to replace fully any lost income tax revenue, then this average seller is going to have to pay as much sales tax as the amount of his reduction in income taxes.

Would that seller rush to cut his prices, because he no longer must pay income taxes on his profit? Most likely not, because he knows that he will need to pay an equal amount of sales tax when he goes out to buy what he needs. ***If he cuts his price to you, he also cuts his income,*** and when he spends his profit on his household needs, he will wind up behind, not ahead.

But just ***assume*** that this seller does cut the price he charges you, because he observes that ***every*** seller is cutting prices. ***Even if every seller cuts his prices, he also, by that very step, cuts his own cash income.*** If every other seller cut his prices, then our example seller would be better off with respect to his purchases; but he would be worse off with respect to his own pre-tax cash income, and the two would cancel out, and he would be no better off. He also would gain in that he would not have to pay income tax, but he would be worse off in that he still would have to pay the sales tax on what he buys for his own personal use, and those two changes would cancel out. At the end of the day, he would be ***no better off***. This micro picture would generalize to all transactions in the economy. All sellers and all consumers (whose own incomes would have to be cut when their employers cut their prices) would, on average, be back where they started, not better off. There is no free-lunch reduction in prices in the conversion to a national sales tax — even if such a blanket price cut were to occur, which is far from certain.

Shifting your gaze from individual transactions to the very big picture confirms this interpretation. Although sales tax advocates would have the federal government shift its revenue collections from one type of tax to another, the government would still pay for national security, for homeland security, for Social Security and Medicare, for health care, for education, and all of the rest. ***Merely shifting the same revenue collection from one type of tax to another, with the same spending going on, cannot make the entire society instantaneously better off.*** It ***cannot,*** all by itself and with all else the same, allow a massive reduction in prices that people pay — that is, a massive increase in real incomes.

Sales tax advocates see one more advantage in a possible drop in prices, in that they believe that it would make our products more competitive internationally. But economists would not buy that story, either. The value of the dollar would rise in the free market, and fully offset that shift.

So if prices fall and wages fall in equal amount, then everything ends up exactly where it started. Only the price of our money in the international currency markets would change. You can analyze the sales tax as if prices and wages do not change, or as if prices and wages both decline; but you get the same result either way. You cannot ignore that if prices are cut, pre-tax incomes are cut, too.

So you can be confident that the only effect of the shift to a consumption tax is the distributional shift in who pays the taxes. And as we have seen from numerous economic analyses, that is good news only for those who already have accumulated considerable wealth, and bad news for the vast majority of Americans who work for a living.

Sincerely,
/s
John M. Spratt, Jr.
Ranking Democratic Member