



A FairTaxSM White Paper

How the FairTax affects wages

Under the FairTax, what you make is what you keep. Income and payroll taxes are no longer withheld from employees' paychecks. The self-employed are no longer subject to income and self-employment taxes.

The FairTax has a pronounced positive impact on the after-tax real wages of the American people. Real wages increase because:

- Higher investment levels increase the productivity of employees.
- The economy grows more rapidly, increasing the demand for workers and improving job opportunities.
- The economy becomes more productive because we waste fewer resources on needless paperwork related to complying with an overly complex tax system.
- American-based businesses are more competitive in the international marketplace because of the improved tax climate and lower compliance costs.
- Foreign and domestically produced goods are taxed equally, instead of foreign-produced goods enjoying a tax advantage as under current law.

The income of some people increases because they find working more attractive in the absence of income and payroll taxes, and they may choose to work more or at a second job. Others may choose to work less because they are making more money per hour worked, and it is easier for them to meet their personal financial goals. In either case, people are better off.

The most important cause of higher real wages is a higher level of capital investment per worker. A worker or farmer is more productive if he or she has more machinery and equipment to work with, particularly new equipment that incorporates the latest technological innovations. Higher productivity leads to higher real wages. It is impossible, on a sustained basis, for an employer to pay workers higher wages than their productivity justifies because employers that do so would go out of business. Higher investment levels per hour worked explain as much as 97 percent of the increase in inflation-adjusted wages since 1948, as can be seen in Figure 1.¹

¹ Robbins, Gary and Aldona, "The Truth About Falling Wages," Institute for Policy Innovation, Tax Action Analysis, Economic Scorecard, Third Quarter, 1995, p. 5.

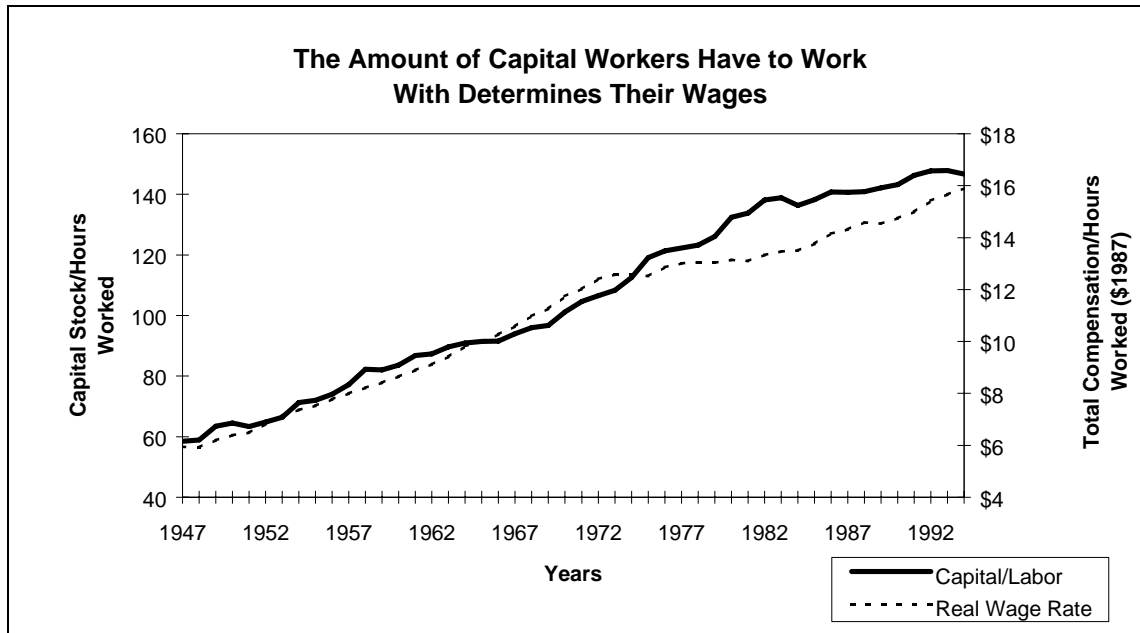


Figure 1: This figure shows the positive correlation between real wage rates and capital investment per hours worked, from 1947 to 1992. During this time period, the amount of capital per hour worked increased steadily and these increases led to increases in real wage rates over the same time period.

Virtually all economic models project a much healthier economy with the FairTax replacing the current tax system. These models typically project that the economy will be 10 to 14 percent larger in 10 years.² A dynamic, growing economy provides more and better paying jobs. Laurence Kotlikoff’s study of the FairTax predicted significant macroeconomic and welfare improvements from implementing a national retail sales tax to replace the federal income/payroll tax system.³ These improvements include increasing the economy’s capital stock by 42 percent, its labor supply by 4 percent, its output by 12 percent, and *real wages by 8 percent*.⁴ Furthermore, with such economic growth employers will need more and better trained workers.

Today we spend \$265 billion per year – nearly \$900 for every American – complying with the present tax system.⁵ The Government Accountability Office (GAO) recently conducted a review of the research on the compliance costs of the existing federal tax system. The study

² See Jorgenson, Dale W., “The Economic Impact of Fundamental Tax Reform,” testimony before the House Ways and Means Committee, June 6, 1995; Robbins, Gary and Aldona, “Looking Back to Move Forward: What Tax Policy Costs Americans and the Economy,” Institute for Policy Innovation, Policy Report Number 127, September, 1994. Also see Burton, David R., and Dan R. Mastromarco, “The National Sales Tax: Moving Beyond the Idea,” *Tax Notes* 71 No. 9, May 27, 1996, pp. 1237-47.

³ Kotlikoff, Laurence J., “Replacing the U.S. Federal Tax System with a Retail Sales Tax: Macroeconomic and Distributional Impacts,” December 1996.

⁴ Real wages are wages that have the effect of inflation removed, so an 8 percent increase in real wages means an 8 percent increase in purchasing power.

⁵ Moody, J. Scott, Wendy P. Warcholik, and Scott A. Hodge, “The Rising Cost of Complying with the Federal Income Tax,” Tax Foundation, Special Report No. 138, December 2005.



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found that compliance costs are about one percent of GDP.⁶ We spend much more money complying with the tax system than we do building every automobile and airplane built in the country.⁷ Under the FairTax, well over three-quarters of these resources can be redirected toward more useful pursuits,⁸ and the productivity and competitiveness of our industries increases.

Compliance costs, though large, are dwarfed by the efficiency costs of the federal tax system. Efficiency costs occur when tax rules distort the decisions of individuals and businesses regarding work, savings, and consumption and investment. By changing the relative attractiveness of highly taxed and lightly taxed activities, taxes alter decisions such as what to consume and how to invest. When taxpayers alter their behavior in response to tax rules, they often end up with a combination of consumption and leisure that they value less than the combination they could have achieved if they made decisions free of any tax influences. This reduction in value is a welfare loss or efficiency cost. The same GAO study estimated that efficiency costs run in the range of two to five percent of GDP.⁹

Under the FairTax, businesses are able to compete much more effectively in the international marketplace than under our present tax system. If U.S. firms are more competitive, they will need to employ more workers. As the demand for U.S. workers rises, employment and wages will increase. Because compliance costs and the overall tax burden are lower, firms manufacturing in the United States are better able to compete than today. Firms can sell their products at lower prices and still achieve the same rate of return for their investors.

Under the FairTax, manufacturers of foreign-produced goods pay the same tax as manufacturers of U.S.-produced goods. Under the current tax system, imported goods bear no income or payroll tax on the value added abroad. Similarly, U.S. goods exported abroad contain embedded income and payroll taxes that must be included in the price of the goods, reducing the competitiveness of U.S. firms.

⁶ "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System," U.S. Government Accountability Office Report No. GAO-05-878, August, 2005, p. 6.

⁷ An IRS commissioned study "Development of Methodology for Estimating Taxpayer Paperwork Burden," by Arthur D. Little, Inc. (June, 1988) estimated total compliance hours in 1983 at 5.4 billion hours per year. Since then, the economy and the population have gotten larger and the tax law much more complex. Accordingly, the number of hours lost to our tax system is undoubtedly larger today. James L. Payne, author of *Costly Returns: The Burdens of the U.S. Tax System*, (ICS Press, 1993) in testimony before the House Committee on Ways and Means, "Replacing the Federal Income Tax," Hearings of June 6 - 8, 1995, Serial No. 104-28, p. 183-187, estimated that we spent 10.2 billion hours in 1995. Assuming a 40-hour work week and further assuming a burden equal to that of 1983, 5.4 billion hours translates into 2.7 million man-years (Payne's work implies 5.1 million man-years in 1995) for tax compliance compared to 850 thousand persons employed in automobile manufacturing and 550 thousand employed in aircraft manufacturing. See also, U.S. Census Bureau, Statistical Abstract of the United States, 1995, Table 1246, p. 753, manufacturing value added, automobiles \$80.5 billion (1992) and aircraft \$49.3 billion (1992) compared to estimated compliance costs of \$225 billion.

⁸ Hall, op. cit.

⁹ "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System," op. cit., p. 20.



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What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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