



A FairTax® Whitepaper
How the FairTax affects wages

Under the FairTax (H25 / S155), 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:

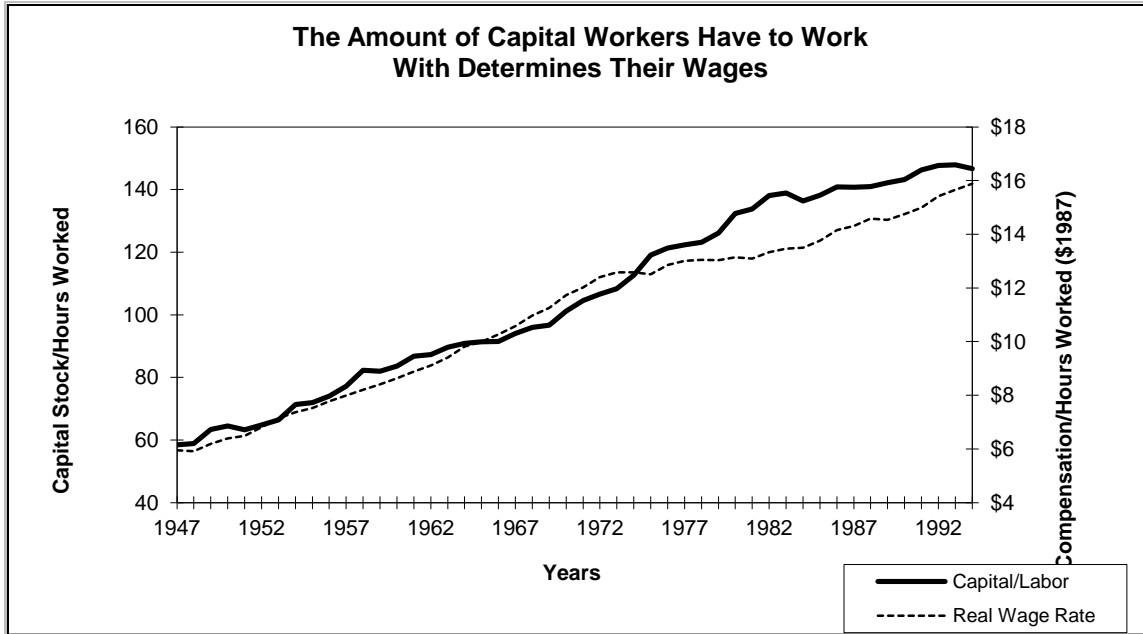
- Higher investment levels increase the productivity of employees.
- The economy grows more rapidly, increasing the demand for workers and improving job opportunities.
- The economy becomes more productive because we waste fewer resources on needless paperwork related to complying with an overly complex 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 the chart below.¹ The chart 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.

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



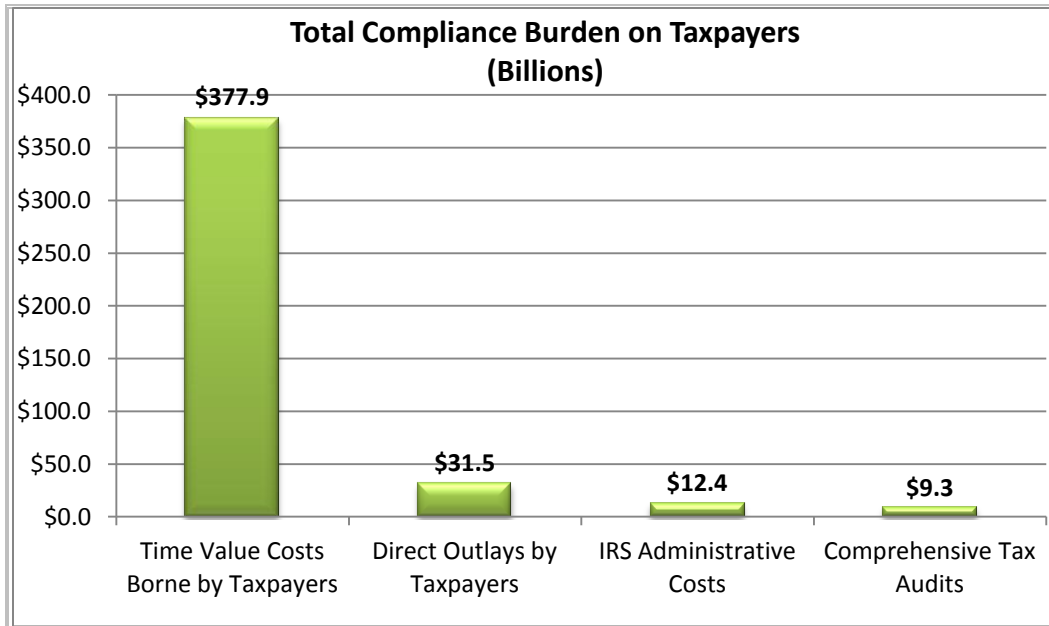
Virtually all economic models project a much healthier economy with the FairTax replacing the current tax system. These models typically project that the economy will be 10 to 14 percent larger in 10 years.² A dynamic, growing economy provides more and better paying jobs. Kotlikoff found that switching to the FairTax (replaces all federal taxes on income with a single rate tax on final consumption) improves capital stock, which is dramatically higher in the long run under the FairTax than under the current tax system. Indeed, the capital stock in 2100 is 96.2 percent higher. While the expansion of the capital stock proceeds relatively slowly, it is noticeable even in the third year. In that year, the capital stock is 12.8 percent higher. By 2030, the capital stock is 43.7 percent higher than would otherwise have been the case.

The increased capital formation also leads to a rise in the real wage per unit of human capital. Rather than declining by 8.0 percent by the end of the century, the real wage now rises by 17.0 percent. This is a 25.0-percent difference in real worker remuneration. Again, the pace of the change is slow, but by 2030 real wages under the FairTax are 11.5 percent higher than they would otherwise have been. In transforming the economy’s prospect from one of a capital shortage to one of capital deepening, the FairTax also reduces real interest rates, with the 2100 real interest rate ending up 160 basis points lower than under the current system.

While the economic burden occasioned by compliance has been estimated many ways by many researchers, with a correspondingly large range of values (to be glib, depending upon how much the research tends to like the income tax), the most recent credible study shows that U.S. taxpayers waste an astounding \$431.1 billion annually on tax compliance. If this figure is near

² Arduin, Laffer & Moore Econometrics, “A Macroeconomic Analysis of the FairTax Proposal,” Americans for Fair Taxation Research Monograph, July 2006. Kotlikoff, Laurence J. and Sabine Jokisch, “Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax,” *National Tax Journal*, June 2007. David G. Tuerck, et.al., “The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model,” The Beacon Hill Institute at Suffolk University, February 2007.

correct, it means that we pay about 30 percent of total income taxes collected, just to ... well ... pay those taxes.³ Of the \$431.1 billion, 88% is the time value costs borne by taxpayers: \$161.7 billion by businesses and \$216.2 billion by individuals.



Source: Laffer, Winegarden and Childs, “The Economic Burden Caused by Tax Code Complexity,” April 2011. Estimates based on 2008 IRS tax data.

We spend much more money complying with the tax system than we do building every automobile and airplane built in the country.⁴ Under the FairTax, well over three-quarters of these resources can be redirected toward more useful pursuits,⁵ 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

³ Laffer, Winegarden, and Childs, “The Economic Burden Caused by Tax Code Complexity, April, 2011. Paperwork is the most visible compliance cost, but it is clearly not the only cost, and perhaps not the largest cost. Return processing, determining liability, record keeping, and other burdens are an estimated 13 to 22 percent of the total revenue raised by the income tax system.

⁴ See 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.

⁵ Hall, Arthur P., “Compliance Costs of Alternative Tax Systems,” Tax Foundation Special Brief before the House Ways and Means Committee, June, 1995.



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.⁶

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.

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 / S155) 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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(AFFT Documents\Papers on a specific subject\How the FairTax affects wages)

⁶ “Tax Policy: Summary of Estimates of the Costs of the Federal Tax System,” op. cit., p. 20.