Impact of the FairTax on Investment

The FairTax will dramatically increase investment levels, compared to levels that will be achieved under the current income tax system.

Investment is important to all wage earners because of the relationship that exists between real wage rates and the level of capital investment per worker. In fact, the most significant contributing factor to achieving higher, real wages is the level of capital investment per worker. A worker or farmer, for example, is more productive if he has more machinery and equipment to work with, particularly new equipment that incorporates the latest technological innovations. Higher productivity leads to higher real wages. Employers cannot pay workers higher wages than their productivity justifies without jeopardizing their businesses. 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]

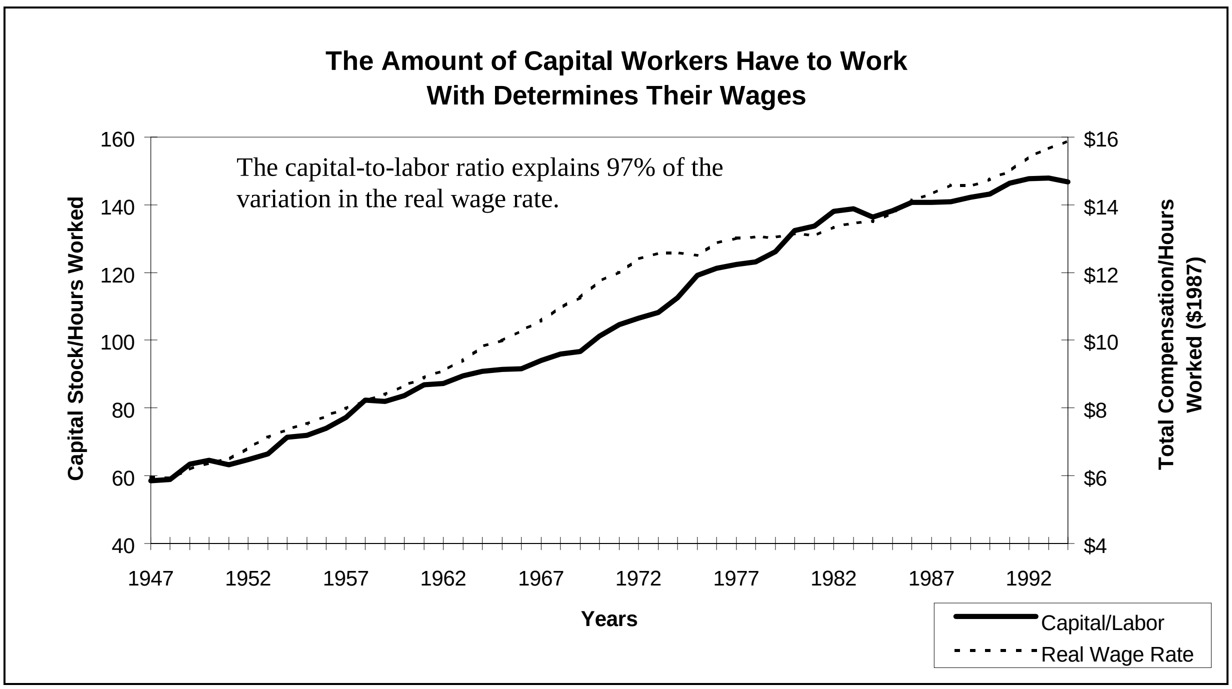

Figure 1: This figure shows the positive correlation between real wage rates and capital investment per hours worked, from 1947 to 1992. During this time period, the amount of capital per hour worked increased steadily, and this increase led to increases in real wage rates over the same time period.

The income tax retards economic performance by creating a significant bias against saving and investment through double, triple and even quadruple taxation. Initially, wage and salary income are taxed when they are earned. Then, if wages and salaries are saved or invested, the resulting benefits are taxed again and again and sometimes again still. All income derived from

[1] "The Truth About Falling Wages," Gary and Aldona Robbins, p. 5, Institute for Policy Innovation, 3rd Quarter, 1995.

investment is taxed. If an income-producing asset, such as a stock or bond, equipment or real estate, is sold for more than it was purchased, the increase in the value of the capital investment — the capital gain — is taxed. Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Intercorporate dividends are also often subject to tax, creating yet another level of taxation. When the taxpayer dies, the estate and gift tax may tax his or her investments one final time.

Replacing the current tax system with the FairTax would eliminate the tax bias against investment. Harvard economist Dale Jorgenson estimates that, after implementation of the sales tax, yearly real investment would initially increase by 80 percent relative to the investment that would be made under present law. Jorgenson's research shows that this increase would gradually decline over the period of a decade to 20 percent.[2] Boston University economist Laurence Kotlikoff also predicts an investment boom. Measuring the change in the size of the overall capital invested (rather than annual investment), he predicts that, within 10 years, total invested capital will be 17 percent larger than it would be under the present tax system.[3] The higher productivity caused by more investment per worker is one of the few ways to make U.S. goods more competitive while maintaining high living standards. The U.S. has lower rates of capital formation and a lower savings rate than most of its major trading partners, including Japan, Germany, France, the Netherlands, Italy and Canada.[4]

Although domestic capital investment is a leading factor influencing wage rates, it is not the only factor. Foreign capital investment will also positively impact domestic wage rates and our economy. After repeal of the income tax, the U.S. will be perhaps the most attractive place on earth to invest. The U.S. will attract investment capital from around the world that will finance new plants and create jobs here in America. U.S. workers will build these plants, much of the equipment installed in the plants will be American made, and American workers will be employed in these plants to produce goods for both domestic and foreign markets. Additionally, expatriated U.S. investment dollars can also be expected to find their way home. In all, during the 1980s when marginal tax rates were reduced in the U.S. from a top rate of 70 percent down to 28 percent, the U.S. attracted a net capital inflow of roughly one-half trillion dollars.[5] Given the proposed tax treatment, strong infrastructure, political stability, relatively sound legal institutions, large domestic market and educated workforce in the U.S., investment in the U.S. will be singularly attractive -- to the benefit of U.S. industry, U.S. workers and U.S. consumers.

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[2] Dale W. Jorgenson, Harvard University, "The Impact of Taxing Consumption," Testimony before the Committee on Ways and Means, U.S. House of Representatives, March 27, 1996.

[3] Laurence J. Kotlikoff, Boston University, Testimony before the Committee on Ways and Means, U.S. House of Representatives, June 6, 1995. See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Laurence J. Kotlikoff, April 15, 1993, Cato Institute.

[4] Statistical Abstract of the United States, 1999, Table 1365, p. 843.

[5] See, "The ABCs of the Capital Gains Tax," Stephen Moore and John Silvia, October 4, 1995, the Cato Institute, pp. 16-17.