

# Policy Analysis

## **THE HIDDEN BURDEN OF TAXATION** *How the Government Reduces Take-Home Pay*

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### **Executive Summary**

One of the most confounding economic trends in the United States during the past 20 years has been the relative stagnation of workers' real wages. One of the primary reasons for flat wages is that taxes and other government mandates on employers have been expanding steadily, crowding out worker take-home pay.

Today an average manufacturing worker costs his employer \$14.89 an hour (not including fringe benefits). But the employee's take-home pay is only \$10.79 an hour. The government takes \$4.10 per hour in taxes--federal and state income taxes, payroll taxes, unemployment insurance taxes, and workers' compensation--thus reducing the worker's take-home pay by 28 percent. Or to put it another way, abolishing income and employment taxes would raise the manufacturing worker's take-home pay by about \$4.00 an hour. For a worker earning \$60,000 a year and living in a state with average taxes, the government's share rises to 36 percent. That counts only the employment-related taxes that come directly out of the worker's paycheck or are paid by the employer on the worker's behalf. Workers still must pay a host of other taxes with their remaining take-home pay. The overall federal, state, and local tax burden is now at an all-time high.

Nearly half the amount taken from workers' paychecks is hidden. Three ways to bring those costs out of hiding are to replace federal income and payroll taxes with a national sales tax, to repeal withholding, and to encourage employers to adopt the Right to Know Payroll Form, first proposed by the Mackinac Center for Public Policy. That payroll form itemizes on workers' pay stubs each and every one of the costs that the employer must bear on behalf of the worker as a result of government tax and regulatory policies.

## **Introduction**

Today the tax burden on middle-income workers in America is at an all-time high. According to the Tax Foundation, a median-income two-earner family pays nearly \$23,000, or roughly 38 percent of its income, each year in federal, state, and local taxes.<sup>1</sup> That is more than the typical family pays for food, clothing, housing, and transportation combined. However, Americans are not required to write out a check to the tax collector for \$23,000 every year, or for \$1,900 every month, as they do when they make their mortgage, utilities, and car payments. Instead, much of that tax burden is hidden, collected from them indirectly through a mind-numbing assortment of taxes, fees, and levies.

One indication of such hidden taxation is the growing "tax wedge" between how much employers pay and how much their employees receive. As Table 1 indicates, a full-time worker earning the average manufacturing wage makes \$27,200 but costs the employer a total of nearly \$31,000 when unemployment insurance, workers' compensation, and the employer's share of the payroll tax are included. That figure does not include the cost of fringe benefits and tax and regulatory compliance, which the employer pays, or union dues and the host of other taxes--property taxes, sales taxes, gas taxes, cigarette taxes, and so on--that workers must pay out of their take-home pay. As Figure 1 shows, after income and payroll taxes are withheld, the worker gets in take-home pay only about 72 percent (or \$22,400) of the \$31,000 he costs his employer. The percentage ranges from a high of 75 percent in South Dakota to a low of 67 percent in Hawaii. That means that more than one-quarter of every dollar employers pay to keep an average manufacturing wage worker on their payrolls goes to the government rather than to the worker. The government takes an even higher share from higher-income workers. For a worker earning \$60,000 a year in an average-tax state, the government's share is 36 percent (Figure 2).

Furthermore, nearly half of that tax burden is hidden from workers. It cannot be found anywhere on their pay stubs. That hidden burden of taxation masks the true cost of government, leading Americans to believe that publicly provided services cost them less than they really do. Those hidden costs thereby distort the political process and create a bias in favor of expanding government. A sound tax system should make all taxes visible to the electorate, so they can make rational decisions about whether they are getting their money's worth.

One way to address that problem would be to replace the federal income and payroll taxes with a national sales tax, so that Americans would get a clearer picture of the cost of government every time they made a purchase. Americans for Fair Taxation--a Texas-based research and advocacy organization--has developed a plan for imposing a 23 percent national sales tax. Eliminating federal income and payroll taxes would increase an average manufacturing wage earner's take-home pay by 28 percent.

As an alternative, within the confines of the current tax system, the deceptive practice of tax withholding could be eliminated. Taxpayers would write checks for the full amount of their tax liability either monthly, quarterly, or annually, just as they do for other expenses such as mortgage payments and utilities. At the very least, employers could be

encouraged to adopt the Right to Know Payroll Form, as first proposed by the Mackinac Center for Public Policy, a state-based think tank located in Midland, Michigan. That payroll form itemizes each and every cost borne by the employer for the employee and thereby makes the tax burden more visible to workers.

### **The Hidden Costs Government Imposes on Employers**

To better understand how the burden of taxation is hidden from us, try the following thought experiment. Imagine that you are an average manufacturing wage worker. You receive a paycheck twice a month. Your gross earnings cost your employer \$1,133.33 per pay period, but after unemployment insurance, workers' compensation, and the employer's share of the payroll tax are included, your employer must spend \$1,289.76. After income and payroll taxes, your take-home pay is \$934.73. Now, assume that our current system of withholding and employer-paid taxes does not exist. In your bimonthly paycheck, your employer gives you the entire \$1,289.76 that he must pay to keep you on the payroll, rather than your previous take-home pay of \$934.73. That is 38 percent more than you were receiving. However, individual employees now must pay each and every one of the various government-imposed costs themselves. Imagine that every time you receive a paycheck you have to go to a series of windows and pay the cashiers behind each.

- At the first window you pay \$86.70 for the "employer share" of the Social Security/Medicare payroll tax.
- At the second window you pay \$58.12 for the workers' compensation contribution.
- At the third window you pay \$9.28 for the state unemployment insurance tax.
- At the fourth window you pay \$2.33 for the federal unemployment insurance tax.
- At the fifth window you pay another \$86.70 for the employee's share of the Social Security/Medicare payroll tax.
- At the sixth window you pay \$85.31 for the federal income tax.
- Finally, at the seventh window you pay \$26.59 for the state income tax.

You have now paid the government its \$355.03 share, only \$198.60 of which (the amount from windows 5, 6, and 7) would have appeared on a standard pay stub. As a result, your new paycheck of \$1,289.76 has shrunk by roughly 28 percent to \$934.73. Of course, you will then have to pay additional taxes--property taxes, sales taxes, gasoline taxes, cigarette taxes, alcohol taxes, and the like--out of your remaining take-home pay.

In contrast, under our current system, you would have received a bimonthly paycheck of \$934.73. If you took the time to examine your pay stub, you could have learned that your gross earnings were \$1,133.33. However, the additional \$156.43 that your employer remits to the government on your behalf would have been completely hidden from you. Over the period of a year, that amounts to \$3,754.32 that your em-

ployer pays to keep you on the payroll and you never see. The government takes it all without even giving you notice that it has done so. That is the essence of our hidden burden of taxation.

### **Methodology**

This study examines hidden taxes from the perspective of employment costs. Taxes and other government mandates increase the total cost that employers must pay for each of their employees. To estimate that cost, the profile of a full-time worker earning the average manufacturing wage is used.<sup>2</sup> That worker has annual earnings of roughly \$27,200. The following factors were taken into account in deriving an estimate of the total employment costs in all 50 states and the District of Columbia: federal income tax, state income tax, Social Security and Medicare payroll tax, unemployment insurance, and workers' compensation. Unless otherwise noted, estimates refer to tax year 1996.

The estimates do not include all taxes, nor all employer expenditures for employee compensation. The following costs are not included in the estimates.

- Fringe benefits. On average, fringe benefits such as employer contributions to private health insurance plans increase the employer's total cost of compensation for an average manufacturing wage worker by an additional 22 percent, from \$31,000 to \$37,800.<sup>3</sup>
- Complying with the tax code. In 1996 complying with the federal tax system was estimated to cost roughly \$225 billion, \$157 billion of which was for the income tax alone.<sup>4</sup>
- Complying with government regulations. Complying with just the federal government's regulations has been estimated to cost roughly \$688 billion, or about \$6,800 per family.<sup>5</sup> Another estimate is that the burden of federal regulations is from \$3,000 to \$4,000 per employee, or about \$1.40 to \$2.00 per hour for a full-time worker.<sup>6</sup>
- Other taxes paid by workers. In addition to the employment-related tax burden, Americans must use a significant portion of their take-home pay to pay a host of other taxes--property taxes, sales taxes, gas taxes, cigarette taxes, and so on. While this study finds that the government's share of employer costs for an average manufacturing wage worker is 28 percent, that is by no means an estimate of the total tax burden. According to the Tax Foundation, when all taxes are included, a median-income two-earner family pays 38 percent of its income in taxes.<sup>7</sup> In addition to those government extractions, many workers, particularly those in manufacturing, are required to pay substantial union dues.

Each of the five factors that are included in the estimates is explained below.

### **Federal Income Tax**

For income tax purposes, the profile worker is assumed to take the standard deduction (for head of household filing status) and to have two children. A worker with two children who earns \$27,200 and files as a head of household would have been eligible for a standard deduction of \$5,900, a personal exemption of \$2,550, and two dependent exemptions of \$2,550 each. With taxable income of \$13,650, all of this worker's income is taxed at the 15 percent rate, yielding a federal tax liability of \$2,048. That is 7.5 percent of his gross earnings.

No assumption has been made about whether the profile worker is married or, if so, whether the spouse earns additional income. Many families do have two earners. However, since the purpose is to estimate how much an individual worker costs his employer, not how much that worker's household pays in taxes overall, additional income earned by the profile worker's spouse is not included. If a median-income spouse's earnings had been included, the profile worker would have faced an even higher effective income tax rate.<sup>8</sup> In addition, the federal earned income tax credit (EITC) was not included in this analysis.<sup>9</sup>

### **State Income Tax**

The same procedure was followed for state personal income taxes. Nine states (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming) do not levy a state income tax on wages and salaries. Two of those states (New Hampshire and Tennessee) do impose a limited income tax on interest and dividend income. For the remaining 41 states and the District of Columbia, deductions, exemptions, bracket levels, and rates varied widely.<sup>10</sup> The average state personal income tax burden for an average manufacturing wage worker was \$638.

As is the case with the federal income tax, if a median-income spouse's earnings had been included, the profile worker would have faced an even higher effective state income tax rate. Several states have their own additional earned income tax credits. Those were not included in the analysis. Local income taxes were also not included.

### **Social Security and Medicare Payroll Tax**

The profile worker is subject to the 7.65 percent Social Security payroll tax on his entire earnings of \$27,200, which amounts to \$2,081. The employer is responsible for paying an additional 7.65 percent payroll tax on the worker's earnings.

Although it is remitted by the employer, that employer share is actually borne by the worker. That is, the worker's gross compensation is \$2,081 lower than it would otherwise have been. The price that employers are willing to pay for a worker's services is not just the wage they are willing to pay but the total cost--including taxes, benefits, and all the rest--that they are willing to bear to employ that worker. All else being equal,

employers should be indifferent to whether the employer share of the payroll tax is remitted to the government or to the worker. Thus, if the payroll tax were eliminated, the gross earnings of our profile worker should rise by the \$2,081 currently spent on the employer share of that tax.

It should be noted, as Figure 3 illustrates, that the payroll tax has risen substantially since its enactment in 1937, from a combined employee-employer share of 2 percent to 15.3 percent. In 1955 a median-income two-earner family spent about 3.1 percent of its income on the payroll tax. Today that figure has risen to 13.7 percent of income.<sup>11</sup>

### **Unemployment Insurance**

Unemployment insurance is a joint federal-state program financed through employer payroll taxes. The federal unemployment tax rate is 6.2 percent on the first \$7,000 of each employee's earnings. However, employers are allowed an offset credit of 5.4 percent against their state unemployment tax; therefore, the net federal tax rate is 0.8 percent, for a maximum of \$56 per full-time employee per year. State rates and taxable wage bases vary widely. The average state unemployment tax burden paid by the employer of an average manufacturing wage worker was \$223.<sup>12</sup>

It should be noted that many states have recently reduced their unemployment insurance taxes. However, many of those reductions are not reflected in the most recent data available, which were used in these estimates. The estimates herein are for 1996.

As is the employer share of the payroll tax, the unemployment tax burden is borne by the worker in the form of lower gross earnings.

### **Workers' Compensation**

Most employers are required to purchase insurance to cover the cost of workers' compensation benefits, medical care, and cash benefits paid out to workers injured on the job. Workers' compensation laws vary widely from state to state, and within states the costs can vary from industry to industry. In most states employers can choose from a variety of competing insurers, but in six states--Nevada, North Dakota, Ohio, Washington, West Virginia, and Wyoming--and the District of Columbia employers must pay into a monopolistic state government fund. Comparable estimates for those seven jurisdictions were not available, so a value of zero was used and those states were not included in figuring the national average for workers' compensation. Therefore, the total employer cost estimates for those states are not comparable to those for the other 44 states. For manufacturers, the average workers' compensation premium per \$100 of payroll is \$5.13.<sup>13</sup> So for the profile worker earning \$27,200, the average workers' compensation cost is about \$1,395.

Like that of the previous two items, the cost of workers' compensation is ultimately borne by the worker in the form of lower wages.

### Major Findings

When all of the government-imposed employer costs described above are taken into account, an average manufacturing wage worker costs his employer \$30,954. That's 14 percent more than the worker's earnings of \$27,200, and 38 percent more than the employee's take-home pay of \$22,434. As Figure 4 shows, while the average manufacturing wage is \$13.08 per hour, after allowing for taxes the employer pays, the hourly cost of that worker to the employer is \$14.89.

Again, that figure does not include other costs such as fringe benefits and tax and regulatory compliance. After the government takes its share, the employee is left with only \$10.79 per hour in take-home pay. So government reduces the worker's take home pay by about \$4.10 an hour, or 28 percent. And workers must pay a host of other taxes out of their remaining take-home pay. In addition to those government extractions, many workers, particularly those in manufacturing, are required to pay substantial union dues.

The government's share is even larger for higher-income workers. For instance, in an average-tax state like Kansas, an employee who earns \$60,000 per year costs his employer \$67,700 but takes home only 64 percent of that amount. The other 36 percent goes to the government.

Tables 2 and 3 show the employer costs and take-home pay for an average manufacturing wage worker for all 50 states and the District of Columbia. The difference among the states is a result of the variation in state income and unemployment taxes and workers' compensation costs.

- The U.S. average for employer costs was \$30,954. The three states with the highest costs were Hawaii (\$32,327), Rhode Island (\$32,246), and Maine (\$31,834). The three states with the lowest costs were Virginia (\$30,045), Indiana (\$30,113), and South Carolina (\$30,260).
- The U.S. average for take-home pay was \$22,434. The states with the highest pay were the nine states with no broad-based state income tax--Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming--where take-home pay was \$23,072. The three states with the lowest pay were Hawaii (\$21,534), Oregon (\$21,543), and Wisconsin (\$21,664).
- The U.S. average share of employer costs that goes to employees in take-home pay, rather than to the government, was 72.5 percent. The three states where the employee's share was the highest were South Dakota (75.4 percent), Tennessee (75.2 percent), and Arizona (74.5 percent). The states with the lowest employee's share were Hawaii (66.6 percent), Rhode Island (69.8 percent), Kentucky (70.1 percent), and Oregon (70.1 percent).

The difference between what employers pay and what their employees receive in take-home pay is sometimes referred to as the "tax wedge." On average, 56 percent of that tax wedge is paid directly by workers through their income and payroll taxes. However, even the visibility of those direct taxes is diminished by withholding. The rest is paid by the employer, although the burden is ultimately borne by the worker in the form of lower wages. The taxes paid by the employer are even less visible since they do not appear anywhere on workers' pay stubs. Thus, the larger the share of the tax wedge paid by the employer, the less visible the overall tax burden. Tables 4 and 5 show the total size of the tax wedge and the share of that amount that is paid by the employer.

- The average tax wedge was \$8,521. The three states with the highest tax wedges were Hawaii (\$10,793), Rhode Island (\$9,737), and Maine (\$9,348). The three states with the lowest tax wedges were South Dakota (\$7,524), Tennessee (\$7,612), and Arizona (\$7,767).
- The U.S. average for the tax wedge as a percentage of employer costs was 27.5 percent. The three states with the highest percentages were Hawaii (33.4 percent), Rhode Island (30.2 percent), and Kentucky (29.9 percent). The three states with the lowest percentages were South Dakota (24.6 percent), Tennessee (24.8 percent), and Arizona (25.5 percent).
- The U.S. average for the share of the tax wedge paid by employers was 44.1 percent. The three states with the highest employer share, and thus the least visible tax burden, were Rhode Island (51.8 percent), Maine (49.6 percent), and Texas (49.1 percent). The three states with the lowest employer share, and thus the least hidden tax burden, were Virginia (35.7 percent), Indiana (37.0 percent), and Wisconsin (37.5 percent).

Table 6 shows the state personal income tax burden for the profile worker. The U.S. average for the state personal income tax burden on an average manufacturing wage worker was \$638. The three states with the highest income taxes were Hawaii (\$1,538), Oregon (\$1,528), and Wisconsin (\$1,408). The three states with the lowest income taxes--excluding the nine states with no broad-based state income tax--were California (\$144), Connecticut (\$190), and North Dakota (\$287).

Because they punish productive activity (work, saving, and investment), as opposed to consumption or ownership of property, income taxes are widely considered the taxes most harmful to economic growth.<sup>14</sup> That is especially true of state income taxes because businesses and residents have a choice as to where to locate. Therefore differences in state personal income tax burdens can have a substantial effect on the health of a state's economy.<sup>15</sup>

Tables 7 and 8 show the state unemployment insurance tax burden and the workers' compensation contribution for an average manufacturing wage worker.

- The U.S. average for the state unemployment insurance tax burden was \$223. The three states with the highest burdens were Rhode Island (\$651), Alaska

(\$532), and Hawaii (\$520). The three states with the lowest burdens were South Dakota (\$35), North Carolina (\$36), and Nebraska (\$56). The good news is that because of low unemployment, many states have been reducing their unemployment insurance taxes recently. However, many of those reductions are not reflected in the most recent data available that were used in these estimates.

- The U.S. average for the workers' compensation contribution in the manufacturing industry, excluding the seven monopolistic-fund states, was \$1,395. The three states with the highest costs were Hawaii (\$2,470), Rhode Island (\$2,258), and Maine (\$2,239). The three states with the lowest costs were Virginia (\$612), Indiana (\$685), and South Carolina (\$783).

These figures do not measure the total tax burden, just taxes snatched from workers' paychecks. Other taxes such as business taxes, sales taxes, and property taxes were not included. When all taxes are factored in, a median-income two-earner family pays roughly 38 percent of its income in federal, state, and local taxes.<sup>16</sup> Furthermore, taxes also increase the true price of the goods and services purchased by consumers. In an average-tax state, for instance, in order to earn enough to purchase a \$1,500 computer, workers must make \$2,550 in pre-tax income. That is 70 percent more than the sticker price. In high-tax states, a worker must make nearly double the sticker price.<sup>17</sup>

### **The Problem with Hidden Costs**

Good decisionmaking requires accurate information about costs and benefits. For example, assume that the true price of a hamburger is \$1.50 and that consumers would want to buy four hamburgers a month at that price. However, the sticker price is only listed as \$1.00. (The rest is collected from consumers through some other means.) With that extra 50 cents hidden from them, consumers' demand for hamburgers would likely be closer to six a month at \$1.00 each. The hidden cost reduces the perceived price, leading to greater than optimal consumption of hamburgers.

This concept is as applicable in the political arena as it is in business. If citizens are to rationally determine whether they support or oppose specific government policies, they must be able to weigh the costs and benefits of those policies. If some of the costs of government programs are hidden from them, the perceived price of those programs will be reduced. As a result, citizens are likely to support more government spending than they would if they knew the full tax-price of that spending. Hidden taxes are the essence of bad government. They distort the political decisionmaking process and create a bias in favor of expanding the size and scope of government.

The results shown in the previous sections of this study document that the hidden employment costs associated with federal and state tax policies can be quite substantial. More than one-quarter of every dollar employers pay for average manufacturing wage workers goes to the government, rather than to employees in take-home pay. That is \$4.10 an hour for the typical worker. For higher-income workers, the government's share is even larger. While much of that amount is itemized on the employee's pay stub, almost

half of it is not. The employer contributions for unemployment insurance and workers' compensation and the employer share of the Social Security and Medicare payroll tax are real costs that the employer must pay in order to keep a worker on the payroll. However, they are nowhere to be found on employees' pay stubs. If those three employer taxes did not exist, those dollars could be passed on to workers in the form of higher take-home pay, 17 percent higher for an average manufacturing wage worker. Furthermore, by deceiving citizens about the true cost of government, those hidden taxes help perpetuate the myth that taxes and mandates can be placed on businesses without affecting workers.

The history of our federal income tax withholding system is instructive. The federal income tax was increased substantially during World War II as a temporary, emergency measure to fund the war effort. Between 1939 and 1944, the top rate was raised from 79 percent on income over \$5 million to 94 percent on income over \$200,000. The lowest rate was increased from 4 percent on incomes as low as \$4,000 to 23 percent on incomes as low as \$2,000. The latter measure served to accelerate the broadening of the income tax from one previously paid only by the rich to one paid by virtually everyone. The number of income tax returns filed grew from 7.6 million in 1939 to 47.1 million in 1944.<sup>18</sup>

To make that income tax increase more palatable, Congress passed the Current Tax Payment Act of 1943. That act ended the practice of paying federal income tax liability in one annual lump sum and instituted the practice of withholding money from employees' paychecks throughout the year. The goal of reducing opposition to the tax increase, by reducing the visibility of the tax burden, was made clear in congressional debates. For example, the following exchange between Sen. Bennett Champ Clark (D-Mo.) and Randolph Paul of the Treasury Department took place in a 1942 congressional hearing on withholding.

Senator Clark: Psychology almost certainly ought to be considered in the tax year. Some British Chancellor of the Exchequer once said: "Taxation consists of getting the greatest amount of money with the least amount of squawks."

Mr. Paul: Do you think if we cut down the squawking under this method we could raise the individual tax rates?

Senator Clark: That is what I am trying to find out: How we can raise the greatest amount of money with the least amount of hardship on the taxpayer.<sup>19</sup>

Our system of federal income tax withholding was instituted during a period of crisis, to help fund the war effort. Nevertheless, when the war ended, withholding did not. It is still with us today, and it has been adopted at the state level as well.<sup>20</sup> By making the tax burden less visible, withholding has made it easier for our elected officials to expand the reaches of government well beyond what was once considered its proper role. After the adoption of income tax withholding, the federal income tax burden rose quickly from only 0.9 percent of gross domestic product in 1940 to 5.8 percent by 1950. Today it

stands at 9.3 percent of GDP.<sup>21</sup> It seems unlikely that the tax burden would have expanded so dramatically if Americans had continued to pay their federal and state income tax bills in one lump sum every year.

### **Bringing Employment Costs Out of Hiding**

To solve the problem of hidden employment taxes, those costs must be made more visible to workers. There are a variety of ways for Congress and state policymakers to do that. This study discusses three specific reforms that would help remove the veil of secrecy and expose the true cost of government employment and tax policies.

### **Replace Income and Payroll Taxes with a National Sales Tax**

One of the most effective ways to address the problem of hidden taxation is to eliminate the federal income and payroll taxes. As Table 9 illustrates, that would increase the average manufacturing wage earner's take-home pay by 28 percent. Of course, unless government spending was reduced proportionately, those revenues would have to be replaced by another tax. However, the visibility of our tax system could be increased by replacing income and payroll taxes with a national sales tax. That would give Americans a much clearer picture of the cost of government every time they made a purchase.<sup>22</sup> A national sales tax would be more visible because

- hidden taxes would be eliminated;
- taxes would be paid at the cash register every time a purchase was made; and
- your tax burden would be more easily calculated, since it would be a percentage of your purchases (with a 25 percent rate, your national sales tax would be \$500 on a \$2,000 computer, \$100 on a \$400 roundtrip plane ticket, \$3 on a \$12 compact disc, and \$1 on a \$4 super value meal at your local fast-food restaurant).

In addition to making the tax burden more visible, replacing the income and payroll taxes with a national sales tax has numerous other advantages. It eliminates the anti-growth features of our current income tax system, such as the double taxation on savings and investment and the progressive rate structure, each of which punishes productive behavior. As a result, it has been estimated that after just five years the national savings rate would be 2.5 times its current level, the capital stock would have grown by 8 percent above the level attained under the current tax system, output would be 5 percent higher than otherwise for almost a \$500 billion per year increase in output and incomes, and the interest rate would have fallen by 0.3 percentage points.<sup>23</sup>

Since the tax code would be much simpler, replacing income and payroll taxes with a national sales tax would also reduce the amount of resources currently spent on complying with our hopelessly complex income tax code. In 1996, complying with the federal tax system was estimated to cost roughly \$225 billion, \$157 billion of which was for the

income tax alone.<sup>24</sup> That compliance cost could be reduced to about \$8.2 billion under a national sales tax.<sup>25</sup>

Since individuals would pay at the point of purchase, instead of having to fill out numerous forms every year, they would no longer need to keep detailed records of their financial transactions. Furthermore, individuals would no longer be subject to the Internal Revenue Service's heavy-handed tactics, which sometimes include searches without a warrant and seizures of property without a trial.<sup>26</sup>

A Houston-based research and advocacy group called Americans for Fair Taxation recently released a plan that details how replacing the federal income and payroll taxes with a national sales tax would work.<sup>27</sup> AFT estimates that raising the same amount of revenue as the current system raises would require a rate of 23 percent (tax inclusive). However, the effective rate would be much lower because all consumption up to the poverty level--\$16,276 for a family of four in 1997--would be exempted from the tax.<sup>28</sup> That means that purchases of the basic necessities of life would essentially be tax-free for everyone.

As a result of the rebate feature and because the regressive payroll tax would be eliminated, replacing the federal income and payroll taxes with a national sales tax would reduce the tax burden on middle-income workers.<sup>29</sup> For instance, under the AFT plan, workers earning from \$20,000 to \$30,000 annually would face an effective tax rate of 10.9 percent, compared to a rate of 18.9 percent under the current system. Those earning from \$10,000 to \$15,000 annually would face a negative effective tax rate of 1.2 percent, compared to a rate of 13.5 percent under the current system. That means they would pay no federal taxes. Instead they would get a net refund from the government worth 1.2 percent of their income.<sup>30</sup>

### **Repeal All Withholding of Taxes**

As an alternative, within the confines of the current income tax system, eliminating withholding would substantially enhance the visibility of the tax system. Currently, it is common for taxpayers to view their income tax refund as a windfall, when in fact it is just the opposite. By withholding too much from their paychecks, the government has essentially taken out an interest-free loan from the taxpayers. Instead, that money could have been earning interest for the taxpayers, if the government had not been holding it all year. Taxes should be paid like all other bills--by writing a monthly, quarterly, or annual check to the government. Last year Rep. Cliff Stearns (R-Fla.) introduced legislation in Congress that would repeal withholding of federal income taxes and require taxpayers to pay estimated taxes monthly.

Eliminating withholding would make our tax system more visible and honest. It would make it easier for taxpayers to comprehend the total cost of government. That would improve the functioning of our democracy by increasing the likelihood that voters would accurately communicate their preferences for the desired size and scope of government.

## **Right to Know Payroll Form**

Another way to address the problem of the hidden burden of taxation--which does not require action by Congress--would be for employers to adopt the Right to Know Payroll Form (RTKPF). Created by the Mackinac Center for Public Policy (a state-based think tank in Midland, Michigan), the RTKPF itemizes each and every one of the costs of government that are borne by the employer for each employee. It is designed to be included with each employee's paycheck. Figure 5 shows an example of what that form would look like for our profile worker's bimonthly paycheck.

In addition to the employee's state and federal income tax and Social Security and Medicare payroll tax payments that are already included on most pay stubs, the RTKPF includes the employer-paid tax costs that drive a wedge between how much employers pay and how much employees receive. Those include the employer's share of the Social Security and Medicare payroll tax and the employer's costs for unemployment insurance and workers' compensation.

Figure 5  
Sample Right to Know Payroll Form

According to the Mackinac Center, dozens of employers, including the state of Michigan, have begun voluntarily implementing the RTKPF concept in new pay stubs for over 60,000 workers in several states.<sup>31</sup> In addition, Rep. Pete Hoekstra (R-Mich.) is working on legislation that would require employers to include the employer share of the Social Security and Medicare payroll tax on workers annual W-2 statements.

The RTKPF would make workers more aware of the numerous hidden costs their employers must bear in order to keep them on the payroll. Workers would have more complete information about the true cost of government tax and regulatory policy and thus be able to make better informed decisions as citizens in a democracy.

## **Conclusion**

Stagnant wages are a major economic concern in this country. One of the primary causes of stagnant take-home pay is that taxes and government mandates have been expanding, making it more and more expensive to keep employees on the payroll. Thus, while total employee compensation costs have been rising, take-home pay has not. It has been crowded out by the growth of taxes and employer mandates, many of which are hidden. They cannot be found anywhere on workers' pay stubs. Those hidden taxes distort the political process, making it easier for politicians to expand the size and scope of government. Replacing the federal income and payroll taxes with a national sales tax would help bring those costs out of hiding. Short of such fundamental tax reform, repealing withholding and encouraging employers to adopt the Right to Know Payroll Form would make the tax burden more visible.

**Notes**

1. Tax Foundation, "Tax Burden on American Families Rises Again," Special Report no. 74, November 1997.
2. The Bureau of Labor Statistics' April 1997 estimate of \$13.08 for the average manufacturing wage was used.
3. Based on the Bureau of Labor Statistics' "Employer Costs for Employee Compensation" series.
4. Arthur Hall, "Compliance Costs of Alternative Tax Systems II," Tax Foundation, Special Brief, March 1996.
5. Clyde Wayne Crews, "Ten Thousand Commandments: An Annual Policymaker's Snapshot of the Federal Regulatory State," Competitive Enterprise Institute, February 5, 1998.
6. Thomas D. Hopkins, "Profiles of Regulatory Costs," Report to the Small Business Administration, November 1995, Tables A-6 and B-6.
7. Tax Foundation.
8. Median weekly earnings for females was \$418 in 1996. If the profile worker's spouse was at that median, she would have contributed roughly \$21,700 in annual income. The combined gross earnings of the worker and his spouse would have been \$48,900, and they would have been eligible for a standard deduction of \$6,700 (for married filing jointly), two personal exemptions of \$2,550 each, and two dependent exemptions of \$2,550 each. With taxable income of \$32,000, all of their income would have been taxed at the 15 percent rate, yielding a federal tax liability of \$4,800. That is 9.8 percent of their total gross earnings.
9. The federal EITC is a refundable tax credit available to lower-income working families and individuals. For taxpayers with more than one child, in 1996 the EITC was phased in at annual incomes below \$8,850, where the credit reached its highest level of \$3,556, and phased out at incomes above \$11,650. Those with income in excess of \$28,495 did not qualify for the EITC. If it had been assumed that the profile worker was unmarried or was married to a spouse who did not earn additional income, that worker would have qualified for a modest EITC of \$267, lowering his federal income tax burden to \$1,781. That assumption was not made because many families now have two earners, and the purpose

herein is to estimate how much an individual worker costs his employer, not how much that worker's household pays in taxes overall.

10. To take those variations into account, a separate calculation was done for each state. Those state-by-state calculations are available from the author upon request. They also will be posted, along with the text of the study, at the Cato Institute's Web site: [www.cato.org](http://www.cato.org).

11. Tax Foundation.

12. Information on state unemployment tax rates and wage bases comes from the U.S. Department of Labor, Employment and Training Administration, Unemployment Insurance Service. Facsimile transmission.

13. "Workers Compensation State Rankings: Manufacturing Industry Rates and Statewide Benefit Provisions, 1996 edition," Actuarial & Technical Solutions, Ronkonkoma, N.Y., 1997. Note that this average does not include estimates for the seven monopolistic fund jurisdictions. Comparable estimates for those jurisdictions were not available.

14. See, for instance, Dale Jorgenson, "The Impact of Taxing Consumption," Testimony before the House Committee on Ways and Means, March 27, 1996; and Laurence Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Cato Institute Policy Analysis no. 193, April 15, 1993.

15. See for instance, Stephen Moore, "Taxing Lessons from the States: Why Much of America Is Still in a Recession," Joint Economic Committee of the U.S. Congress, October 1993; Richard Vedder, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee of the U.S. Congress, December 1995; Zsolt Becsi, "Do State and Local Taxes Affect Relative State Growth?" Federal Reserve Bank of Atlanta Economic Review, March-April 1996, pp. 18-36; and Stephen Moore and Dean Stansel, "Tax Cuts and Balanced Budgets: Lessons from the States," Cato Institute Fact Sheet, September 17, 1996.

16. Tax Foundation.

17. George Nastas and Stephen Moore, "A Consumer's Guide to Taxes: How Much Do You Really Pay in Taxes?" Cato Institute Briefing Paper no. 15, April 15, 1992.

18. U.S. Department of Commerce, Bureau of the Census, Historical Statistics of the United States, Colonial Times to 1970, Part 2 (Washington: Government Printing Office, 1975), pp. 1095, 1110.

19. Quoted in Charlotte Twight, "Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change," Cato Journal 14, no. 3 (Winter 1995): 372.

20. For a more detailed discussion of the history of the withholding tax, see Twight, pp. 359-96; Milton Friedman and Rose Friedman, Two Lucky People: Memoirs (Chicago: University of Chicago Press, 1998); and Robert Higgs, Crisis and Leviathan: Critical Episodes in the Growth of American Government (New York: Oxford University Press, 1987).

21. Office of Management and Budget, Historical Tables, Budget of the U.S. Government, Fiscal Year 1999 (Washington: Government Printing Office, 1998), pp. 31-32.

22. For a more detailed discussion of how a national sales tax would work, see David Burton and Dan Mastromarco, "Emanicipating America from the Income Tax: How a National Sales Tax Would Work," Cato Institute Policy Analysis no. 272, April 15, 1997.

23. Laurence Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Cato Institute Policy Analysis no. 193, April 15, 1993.

24. Hall.

25. Ibid.

26. See David Burnham, A Law unto Itself: Power, Politics and the IRS (New York: Random House, 1989); and Dan Pilla, "Why You Can't Trust the IRS," Cato Institute Policy Analysis no. 222, April 15, 1995.

27. Americans for Fair Taxation, "Position Papers," 1997.

28. Poverty level from "Poverty Thresholds by Size of Family and Number of Children--Preliminary Thresholds for 1997," U.S. Department of Commerce, Census Bureau, Current Population Survey, January 29, 1998.

29. For a more detailed analysis of the incidence of a national sales tax, see Gilbert Metcalf, "The National Sales

Tax: Who Bears the Burden?" Cato Institute Policy Analysis  
no. 289, December 8, 1997.

30. Americans for Fair Taxation.

31. Mackinac Center for Public Policy, "The Right to Know  
Payroll Form," undated.