



**A FairTaxSM rebuttal
to remarks made by Professor Michael Graetz during the *Debate on the Fair
Tax* broadcast on April 15 and 16, 2006 on C-SPAN2's Book TV.**

Neal Boortz, co-author of *The FairTax Book*, and Professor Graetz appeared on C-SPAN2's Book TV to debate the FairTax. During the course of that debate Professor Graetz consistently and erroneously attributed features to the FairTax that can best be described as material misstatements about the FairTax. While this paper is not a transcript of the debate, it identifies those statements and provides additional information to correct the record with regard to the FairTax. It also clarifies a few remarks made by Neal Boortz.

Graetz misstatement: "Revenue-neutral tax reform is difficult politically because there are both winners and losers." He also agreed with Neal Boortz that tax reform is essential.

FairTax rebuttal: This statement that there has to be winners and losers assumes a static analysis, i.e., it ignores the fact that once the income tax system is repealed and replaced with a consumption tax such as the FairTax, the rate of economic growth will more than double what it would otherwise be under the current system. Furthermore, out of 42 representative income/age/marital status household types, all 42 experienced lower remaining lifetime tax rates under the FairTax compared to what they would have under the current federal tax system. Source: Laurence Kotlikoff, Ph.D., "Would the FairTax Raise or Lower Marginal and Average Tax Rates?" NBER Working Paper 11831, December 2005.

Graetz misstatement: "Tax reform should not reduce taxes on the very well off." He contends "that it is hard to do that [tax the wealthy] without keeping some tax on income."

FairTax rebuttal: Graetz does not acknowledge that a tax on consumption taxes not only current income when it is spent but also accumulated wealth when it is spent. The FairTax, as a consumption tax, is the only tax reform plan that taxes accumulated wealth.

According to Dr. Kotlikoff, "Taxing consumption is effectively the same as taxing wages plus taxing wealth. The logic is simple if you consider the most straightforward way of taxing consumption, namely via a retail sales tax. In this case, when people spend their wages or their assets on goods and services, they pay sales taxes, meaning they end up with less to consume. This is no different from having the wages and wealth directly taxed, but facing no sales tax. But what about saving one's wages and wealth and spending these funds plus accumulated interest in the future? Doesn't this avoid the consumption tax? No. You end up paying consumption taxes not just on the original sums, but also on the accumulated interest. The same holds if you save your wages and wealth and give it to your kids. When they spend it, they pay consumption taxes



on both P&I [principal and interest].” Source: “The Case for the ‘FairTax,’” by Laurence J. Kotlikoff, Ph.D., *The Wall Street Journal*, March 7, 2005.

Graetz misstatement: “The FairTax doesn’t tell you about the shift in tax burden from high-income people to middle-income people.”

FairTax rebuttal: If you are measuring the tax burden appropriately you do not get this result. Since consumption varies throughout a household’s life cycle it is important to measure the lifetime tax burden. According to Dr. Kotlikoff, “The FairTax would also relieve the tax burden on middle-class workers. Since the FairTax generates a goodly portion of its revenues by effectively taxing wealth, it can afford to have a lower effective tax on wages.” Source: “The Case for the ‘FairTax,’” by Laurence J. Kotlikoff, Ph.D., *The Wall Street Journal*, March 7, 2005.

Graetz misstatement: “A 15 percent sales tax would eliminate the income tax for over 150 million Americans, and an income tax of 25 percent with an exemption of \$100,000 per family, and that reduces payroll taxes.” [His proposal is more clearly stated in the FairTax rebuttal below.] Graetz says that his proposal is a realistic proposal, and that the government has agreed upon the numbers regarding his proposal. He further states that his sales tax differs from the FairTax in that it has some withholding, and not just retailers would be required to collect the tax.

FairTax rebuttal: Graetz's proposal would have a 25 percent income tax, a 25 percent corporate income tax, a 14 percent value-added tax (VAT), and a 15.3 percent tax on wages accompanied by a payroll tax offset for low-income workers similar to the Earned Income Tax Credit. Thus, his proposal would give the United States a tax system very similar to Europe. Like the original income tax, the Graetz income tax only taxes the affluent (in his proposal those with incomes over \$100,000). It is virtually certain that the same thing will happen to the Graetz income tax that happened to the original income tax. It will be modified by reducing the exemption amount so that lower and lower income individuals pay it (or the income floor will not be adjusted for inflation like the current AMT which is hitting more and more of the middle class every year). We would then end up with a very substantial income tax and a very substantial VAT.

Graetz misstatement: “The amount of money for prebate checks will be huge, \$600 billion.”

FairTax rebuttal: Like the standard deduction and personal exemptions in the current tax code, the purpose of the prebate is to ensure that a minimum level of consumption is not taxed. It should be viewed as a rebate of taxes rather than as a transfer payment; that is, with the exception of those few who spend less than the poverty level, the prebate is returning the taxpayer’s money.

Graetz correctly quoted the Treasury Department’s estimate of the prebate as being \$600 billion; however, their figure overestimates the cost of the prebate. The amount of the prebate is a function of the FairTax rate times the family consumption allowance (total exempt spending).



The higher the FairTax rate, the higher the prebate. Since the Treasury Department's estimate of the FairTax rate is too high (as explained on the following page), their prebate estimate is too high. The actual estimate is about \$429 billion, which can be contrasted with the \$725 billion currently being spent on loopholes and tax incentives under the income tax system.

Graetz misstatement: "People would become dependent on it, want it increased, and Congress would have difficulty resisting this."

FairTax rebuttal: First, as the economy grows, the family consumption allowance on which the prebate is based rises with increases in the cost of living, ensuring that over time households will not pay taxes on spending up to the poverty level. Second, with a single uniform national sales tax rate, Congress will not be able to increase the prebate without increasing the tax rate on everyone at the cash register. This is unlike the current system, where no one has any idea how the various tax preferences passed by Congress increase their income taxes.

Graetz misstatement: "My proposal will encourage savings and investment, eliminates marriage penalties, and it is realistic, whereas the sales tax rate required just to eliminate just the income tax is 34 percent (according to the tax panel). With a sales tax base that is the average used throughout the states, the Treasury Department estimated the national sales tax rate at 64 percent."

FairTax rebuttal: The tax rates Graetz quotes were produced by the Treasury Department for the President's Advisory Panel on Federal Tax Reform. Their estimates have several flaws. Most notably, despite the fact that the FairTax has several features that tend toward reducing evasion (simplicity, lower marginal rates, drastic reduction in collection points, and greater likelihood of getting caught), the Treasury Department analysts *assumed* that the rate of evasion would be *twice* what it is for the income tax, i.e., the current system rate is 15 percent so they used a 30 percent rate for the FairTax. Second, they did not compute the FairTax base as defined in the legislation. They left out government consumption altogether (about 18 percent of the base), and then said that the FairTax base would be the average tax base of the states. The average tax base for the states is no model for what would happen under the FairTax. The FairTax taxes only final consumption of goods and services and state taxes do not. State tax bases, for the most part, do not tax services, which are over 60 percent of personal consumption expenditures.

Graetz misstatement: "Sec. 801.83 of HR 25 taxes imputed income from checking accounts; if your checking account is paying you less than the federal government rate, the difference is taxed. If your home mortgage interest rate is higher than the federal rate, the difference is taxed because it is called a financial service."

FairTax rebuttal: Often financial institutions, rather than directly charging you for the services they provide when servicing your loan, mortgage or checking account, charge you higher interest rates on loans or pay you lower interest rates on checking accounts. The difference between the market rate and the interest rate that they are charging/paying is really a charge for servicing your account. Yes, this is taxable under the FairTax. However, what will most likely happen is



that banks will go back to simply stating service charges outright and adjust the interest rates they charge/pay accordingly. Then you will pay tax on the service fees rather than on the portion of interest that is imputed to be service fees.

Graetz misstatement: “The [FairTax] base is highly unrealistic – 84 percent of GDP, 120 percent of personal consumption expenditures. Where does the extra come from?” His answer is by taxing state and local government employees whose wages are taxed. He further states that, “If you are in the military working for the U.S. military government you don’t get the payroll tax cut, there is a 23 percent tax on your payroll, and there is a sales tax of 30 percent on everything you buy. Your payroll taxes don’t go down.” He says that there are 20 million people who are going to pay double taxes.

FairTax rebuttal: The above statement by Graetz is not accurate. The *truth* is that under the FairTax Social Security and Medicare taxes are repealed for *all* workers including those working for all governmental entities, including the military. Just like all workers, military personnel no longer have income tax withholding or payroll tax deductions taken out of their paychecks. It is also true that the FairTax taxes government consumption which includes the wages it pays to its employees. There is a 23 percent tax on the wages (total compensation) paid by government to its employees. The tax on wages is imposed on the *government* as a taxable employer. The tax is *not* imposed on the worker (military personnel). Later on in the debate Graetz makes it clear that he knows the tax is on the government rather than on the worker, for he states that the 23 percent tax would be an extra burden “on government.”

Under the FairTax, the sale of goods at military exchanges and commissaries is taxable because the FairTax is a *federal* sales tax. However, the FairTax repeals the entire income tax/payroll tax system so military personnel no longer pay tax on benefits of any kind and they get their whole paycheck (an average 28 percent raise).

Today, there are no sales taxes on goods sold at military exchanges and commissaries because only states levy sales taxes and the *states* do not have the authority to levy taxes on military installations under *federal* jurisdiction. Legally, the installation is not part of the state within which it is geographically located so that the state has no power to levy state sales taxes there. That does not mean to say that you have been purchasing goods at military exchanges tax free. Economic studies show that approximately 20 percent of the cost of goods and services is due to embedded income/payroll taxes. They are part of the cost of doing business so the business has to build them into its pricing structure in order to cover costs and stay in business.

Although the Fair Tax Act does not have an exemption for sales at military exchanges and commissaries, the FairTax prebate ensures that no military personnel pay taxes on the necessities of life. Each military household receives a monthly prebate check based on family size which pays the federal sales taxes on spending up to the poverty level. For example, a family of four will receive a monthly rebate check of \$506 or \$6,072 per year which pays the FairTax on annual spending of \$26,400. Providing tax relief by means of the prebate makes tax enforcement much easier and it keeps the tax rate as low as possible; whereas exempting various categories of items or persons would raise the tax rate for everybody. Go to the Frequently



Asked Questions (FAQ) section of our Web site, http://www.fairtax.org/site/PageServer?pagename=about_faq, then click on question number 3 which tells how the rebate works and how much spending is tax free for each household size.

Graetz misstatement: “For people to get their before-tax wage, either prices will rise or wages will go down.” He further stated that, “[Dr. Dale] Jorgenson said that he agreed with me.” He stated that, “Larry Kotlikoff said that wages won’t go down but prices will go up 30 percent” and “Jorgenson assumes that wages will go down and therefore prices won’t go up. One of these is true but not both of them.”

FairTax rebuttal: Economists have opposing theories on what will happen with the cost savings resulting from the repeal of the current federal tax system. Jorgenson assumed that all cost savings will be used to reduce prices, whereas Kotlikoff, for example, assumes that all cost savings will go to increasing wages. Of course, both of these can’t happen. What does happen, however, is that relative wages and prices will have basically the same relationship to each other as they do today. Remember, the FairTax takes the same amount of taxes out of the economy as the current system, however, it does so in a way that gets rid of tax related distortions in the economy, promotes economic growth, and reduces compliance costs, so over time wages relative to prices will rise and the standard of living will improve. Dr. Kotlikoff states that the FairTax “would reduce the excess burden of our tax system by roughly two-thirds! A very conservative estimate of this annual saving is 2% of GDP or about \$250 billion for the coming year. Add in the aforementioned \$250 billion in wasteful tax compliance, and we’re talking big bucks. But this is still small potatoes compared with the gains in economic growth associated with adopting the FairTax. Over the next few decades, the FairTax would likely raise U.S. GDP by 15% relative to its alternative value.” Source: “The Case for the ‘FairTax,’” by Laurence J. Kotlikoff, Ph.D., *The Wall Street Journal*, March 7, 2005.

Graetz misstatement: “If you are now making \$10 per hour and \$3 per hour is taxes, the FairTax people are saying that your after-tax pay will be \$7 per hour.”

FairTax rebuttal: That could be the case, but only if one is also assuming that all tax cost savings to businesses from repealing the federal tax system are used to lower prices (Jorgenson makes this assumption in his study) rather than increase wages. It could just as well be that employers will pay the above employee \$10 and reduce prices by a lesser amount. It is important to note that the Jorgenson study did *not* take into account the reduction in compliance costs, which is also a substantial source of business tax cost savings that would be available for price decreases.

Boortz statement: “The FairTax is not state tax reform. It is strictly federal; states that index to the federal income tax will have to change their taxes and many of these states will change their exclusive tax to inclusive taxes.”

FairTax clarification: What Boortz is alluding to is that states will probably conform their state sales tax bases to the FairTax base and be able to replace their state income taxes with the extra revenues generated by having a much broader state sales tax base.



A FairTax rebuttal to Prof. Graetz remarks

Graetz misstatement: “The FairTax also taxes the state and local governments on every purchase they make . . . and on the wages they pay to their employees. They are getting no relief from the payroll tax because it is 23 percent under this bill and they are having to pay tax on all of their purchases.”

FairTax rebuttal: We explain elsewhere in this rebuttal about how the FairTax just maintains the current level of taxes on government. Preserving the current tax burden on government is necessary to keep government from having a cost advantage over the private sector.

Graetz misstatement: “The president’s panel said that in our federalist system it is inappropriate for the federal government to tax the state and local governments. And I say not just inappropriate – constitutionally questionable.”

FairTax rebuttal: The current federal tax system has been requiring state and local governments to pay the employer share of Social Security taxes and Medicare taxes on their employee’s wages since the mid-1980s. This legal requirement has been upheld by the U.S. Supreme Court.

Boortz statement: “Everybody gets treated equally. Everybody pays the tax. You give the state and local governments an exemption from paying the tax and all of a sudden they have a great incentive to enter into more and more and more competition with private industry and private businesses in their states. We’re not supposed to be in the business of having government compete with private industry. The FairTax applied across the board would be a disincentive for that.”

Graetz misstatement: “It’s an additional tax that other organizations other than the federal government don’t pay of 23 percent of their payroll. And this means if you are a state and local government and you are deciding whether to hire an employee to build this road or whether to contract it out to a private business, you can contract it out to a private business and avoid this tax or you can have your employees and pay this tax. So it’s a double tax and it’s in the bill and it’s in the base and you remove it from the base and the rate has to go up.”

Boortz statement: “Since this is a federal tax he is absolutely right. I concede the point. The federal government will pay the tax at the retail level like everybody else. But then what happens? It goes right back to the federal government. So instead of creating exclusions and the paperwork and bureaucracy that has to go with that, the federal government just plays the game with everybody else and in that sense it is truly a revenue-neutral event.”

Graetz misstatement: “Government is not paying a tax burden today.”

FairTax rebuttal: Government currently pays taxes in the following ways: It has to pay Social Security and Medicare taxes on its employees’ wages. Government also has to pay employees higher wages because the employees have to pay income tax and payroll taxes. The same thing goes for government purchases. Government contractors have to pay payroll taxes and pay their employees higher wages because their employees have to pay income and payroll taxes. So, just



like the private sector, government is paying significant taxes under the current system. This is not a new burden imposed by the FairTax.

On the subject of government taxation under a consumption tax, Dr. Jorgenson remarks that, “Here again there is competition between private and public supplies. The government can hire people to provide the services it requires; alternatively, it can purchase these services from the private sector on contract. In the interest of efficiency the two alternative forms for obtaining the services should be taxed in the same way. Accordingly, government payrolls should be included in the tax base.” Source: Dale Jorgenson, Ph.D., Memorandum to Americans for Fair Taxation, April 1996.

Graetz misstatement: “The states are not very good at collecting taxes on things that are brought in from out of state or purchased through the internet with two exceptions, boats and cars. ... They collect them on things that you have to go to some other state employee and register. So that’s the only way they are collected.”

FairTax rebuttal: Under current law and Supreme Court decisions, states do not have the power to force out of state vendors to collect their state sales tax on sales made to state residents. In other words, Ohio can not force vendors located in the other 49 states who sell to Ohio residents to collect the Ohio sales tax on sales and remit it to the State of Ohio. Since the FairTax is a national law of uniform application, this problem goes away. Vendors will be required to keep track of sales by states and collect the national FairTax on all of their sales. It will be an easy step to collect state sales taxes as well. As a carrot, the bill allows states that conform their state sales tax base to the national FairTax base to be able to require vendors to collect their state sales taxes. Under the auspices of the Streamlined Sales Tax Project (SSTP), the accounting software to perform this function has already been developed and in use by multi-state online retailers selling in states participating in the SSTP. Source: “Avalara, Certified for Streamlined Sales Tax Project, Releases SST-Certified Editions of Sage Software's ERP Packages,” Business Wire, May 8, 2006. For more information about the SSTP, see www.streamlinedsalestax.org.

Graetz misstatement: “People are going to behave differently in taking out home mortgages when you start taxing them the way these people want to tax home mortgages. They’re not going to be able to borrow as much because every month they are going to have to pay a tax on the difference between their mortgage rate and whatever the federal government can borrow at.”

FairTax rebuttal: The prebate will count in the calculation of how much money a person will be able to borrow; reduced interest rates will also increase the monthly mortgage payment they can afford. Yes, Graetz is correct about the tax on financial intermediation services; however, he ignores any change in the behavior of banking institutions. Once they can no longer hide the cost of fees in interest rates, because the FairTax imputes these costs, they will go back to explicitly stating them, and charge the FairTax on these amounts. If the FairTax did not tax these “implicitly priced” financial intermediation services, then banks could just roll all service charges into interest rates to avoid collecting the FairTax on their services.



Boortz statement: “The embedded taxes on the price of a new home in this country are approximately 26 percent, if my memory serves me. About 26 percent. The total cost of all the taxes paid by everybody involved in manufacturing every component of that house – taking it to the site, erecting it, building it, painting it, hanging sheet rock. All of that. Those embedded taxes go away. They don’t exist anymore. And they’re replaced again by an inclusive 23 percent tax on the price of that home. I’ve seen so many critics talk about the FairTax, ‘A \$300,000 home would cost \$380,000 or \$390,000.’ No it wouldn’t. It would cost \$300,000...or maybe even less if the embedded taxes are higher than the FairTax rate. Our houses are all appreciating so it would come up to probably the same price.”

FairTax clarification: Boortz’s statement is based on the findings of a 1997 study by Dale Jorgenson, Ph.D. His study assumed that all of the tax cost savings (*not* including the reduction in compliance costs, however) would be passed on in lower prices and that workers would be getting their current net pay once the FairTax goes into effect. Other economists’ models assume that all of the tax cost savings end up in higher wages and/or dividends. Either way, the relationship between wages and prices remains approximately what it is today.

Graetz misstatement: Referring to his support of the estate tax, Graetz said he doesn’t believe that you should be able to work hard and pass on the fruits of that effort to your heirs. “But if you have a big exemption and a little lower rate you still collect about \$70 billion dollars per year from the people who are inheriting wealth without working for it as opposed to taking that \$70 billion and saying that we are going to add it to the sales tax rate and everybody else is going to pay another one or two percent.”

FairTax rebuttal: Neal Boortz’s reply is apt, “Somebody worked for it and that somebody already paid taxes on it when they earned it.” According to The Budget For Fiscal Year 2007, estate and gift tax receipts in 2005 totaled \$24.8 billion, or about 1.1 percent of total federal revenues. Although the revenues are relatively small, a number of studies have found that it actually brings in a lot less revenue, or even could be a net revenue loser once all the costs of the tax are taken into account. Those costs include the disincentives it provides for investment and entrepreneurial activity. It siphons capital away from businesses, causes the dissolution of some businesses, imposes formidable compliance costs, and generates extensive tax avoidance measures. All of these are distinct negatives for the economy. Those costs indicate that the estate and gift tax’s economic impact reaches well beyond what might be indicated by its 0.2 percent share of GDP. As noted above, the FairTax effectively taxes accumulated wealth when it is spent. It does not tax wealth that is invested in the economy, thus fueling economic growth.



A FairTax rebuttal to Prof. Graetz remarks

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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(AFFT Documents\Articles & Articles w Rebuttals\A FairTax rebuttal to Prof. Graetz remarks)