

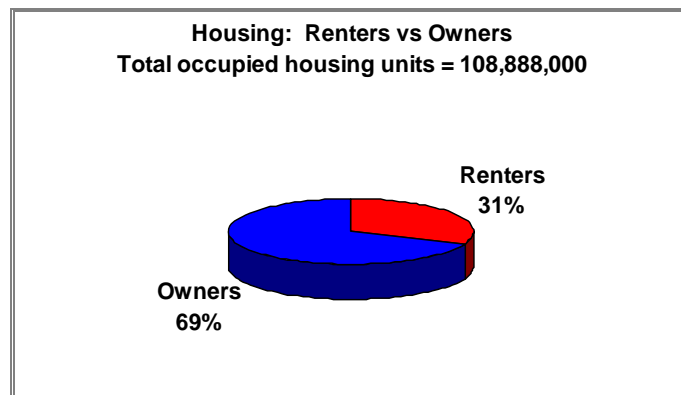


A FairTax<sup>SM</sup> White Paper

**Promoting home ownership:  
How the FairTax's benefits for homeowners  
exceed the mortgage interest deduction**

**Under the FairTax home purchases are *more* tax advantaged than they are today. For working Americans, the “true cost” of buying a home goes down. In a nutshell, homes are more affordable because the majority of homes are used and are not taxed, the interest paid on new homes at a lower rate is untaxed, new home prices do not bear taxes imposed upstream, and the saving and investment needed to buy homes is not taxed multiple times.**

Recent U.S. Census figures<sup>1</sup> show that 69 percent of Americans own homes rather than rent. This high percentage of home ownership is often attributed to the tax-favored status of home purchases as opposed to other forms of consumption.



In particular, the mortgage interest deduction (MID) is often believed to favor homeowners. Interest paid on a home mortgage is often deductible, whereas the interest paid on other consumer debt (e.g., annual expenditures on food, transportation, medical care, vacations) is not deductible.

Under the FairTax, the purchase of a home, just like the purchase of a car, food, or any good or service for personal use is seen for what it is: An item of consumption. Since the FairTax taxes all consumption without exception (except previously taxed goods and services), the FairTax imposes a 23 percent (tax-inclusive rate) tax on the purchase price of new homes. Given that the FairTax taxes new homes at 23 percent and repeals the income tax along with the

<sup>1</sup> U.S. Census Bureau, press release, January 31, 2006.



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MID, some pose the following question: How could a home be as affordable to a homebuyer after the FairTax as under our income tax system? The answer may surprise you.

The fact is that even though the FairTax makes the MID irrelevant, housing is not only more affordable but homebuyers will have more money with which to purchase their home. There are several reasons for this:

- Most home sales are for used homes, and unlike today, taxpayers can use pretax earnings to buy used homes.
- Unlike the current tax regime, the FairTax does not tax the earnings used to pay mortgage interest. Even if the MID offset all income taxes, interest would still be paid with what one has left over after payroll taxes.
- Mortgage debt will be paid at a lower interest rate since the FairTax lowers the interest rate of such debt.
- While a new home is taxed, the FairTax imposes a lower marginal rate of tax on the earnings used to buy the home.
- Unlike the current tax regime, the FairTax fully untaxes capital gains from the sales of used or new property.
- The FairTax removes all embedded tax costs of current construction by untaxing the businesses involved in home construction and producing building supplies.
- The FairTax enables homeowners to save for a home faster by not taxing savings, unlike today.
- The FairTax improves the economy and increases national income by removing the drag the current system imposes on economic growth.

Let's explore more closely how the FairTax makes home ownership more affordable than today.

## **I. How the FairTax Beats the Current System Hands Down**

### **The FairTax completely untaxes preexisting homes.**

Perhaps most important is that preexisting homes are not taxed under the FairTax. These are the most common properties bought by first time home buyers. The seasonally adjusted statistics for 2005 show that about three-quarters of all home sales are projected to be existing homes and existing home sales most often provide the resources for the purchase of new homes. To place these statistics into perspective consider that privately-owned housing starts are at an approximate seasonally adjusted annual rate of between 1.5 and 1.9 million units. By comparison, there were 109 million existing occupied housing units in 2005.<sup>2</sup> What this means is that, unlike today, taxpayers can pay for used homes with pretax dollars. Today, taxpayers pay for homes (that already bear embedded taxes imposed upstream on the timber producers, the lumber mills, the construction material supplies, and so on) with what remains of their salaries and earnings after the imposition of payroll and income taxes. The FairTax does not tax used homes because it assumes that previously owned homes were taxed upon their construction, and

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<sup>2</sup> U.S. Census Bureau, press release, January 31, 2006.



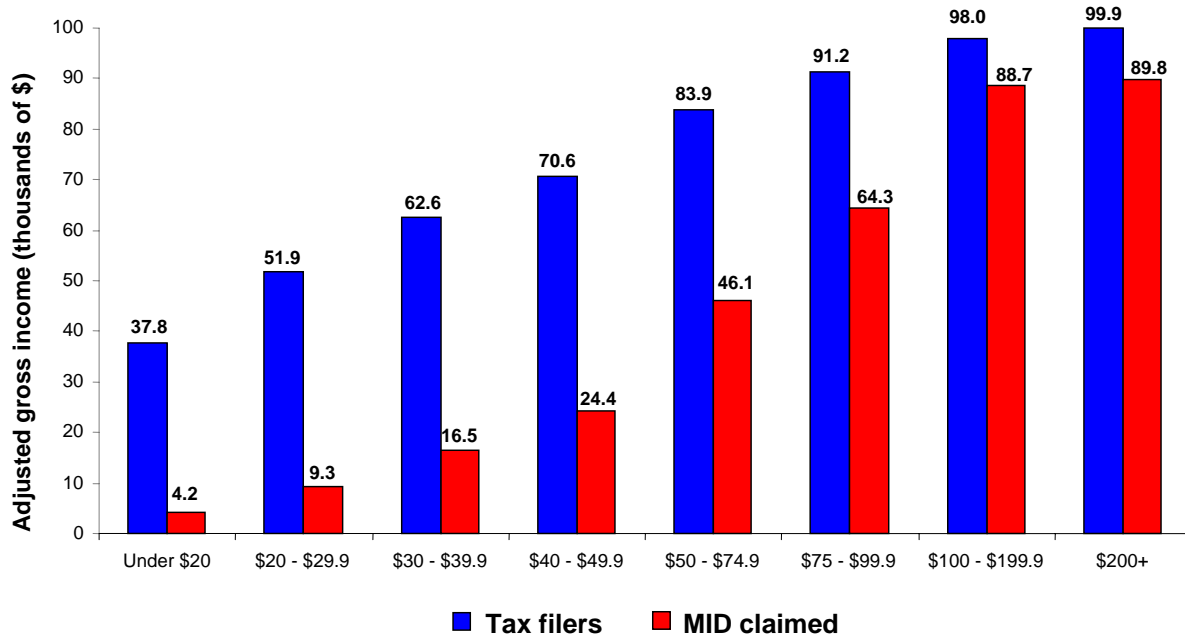
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the price of those homes already includes the taxes that were imposed upstream. This alone exceeds the benefit of the MID.

**The replacement of the MID by a system that helps first time buyers more, lowers interest rates, and allows interest to be paid with before-income and payroll tax dollars**

The MID, a tax expenditure worth an estimated \$69.4 billion,<sup>3</sup> is touted as one of the greatest tax advantages of home ownership. However, a closer look reveals some very key flaws that call into question its impact in stimulating home ownership. First, little of the MID’s benefit goes to low- and middle-income families. While 52 percent of taxpayers report adjusted gross income of less than \$30,000, less than 10 percent of the MID was claimed by this group. The 71 percent of filers with adjusted gross income of less than \$50,000 received only 24 percent of the total MID.<sup>4</sup>

**Mortgage Interest Deduction**  
Percent of tax filers vs percent of MID claimed by income



Indeed, in 2005, the MID was taken by only 28 percent of all taxpayers.<sup>5</sup> Hence, it is of little value to those seeking to transition to home ownership, it is not relied upon by at least half of the current homeowners, and its benefits are distributed to high income taxpayers.

<sup>3</sup> Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010,” prepared for the House Committee on Ways and Means and the Senate Committee on Finance, April 25, 2006, p. 33.

<sup>4</sup> Chart using data from Prante, Gerald, “Who Benefits from the Home Mortgage Interest Deduction?” Tax Foundation, Fiscal Fact No. 49, February 6, 2006, based on Internal Revenue Service data.

<sup>5</sup> Joint Committee on Taxation, op. cit., pp. 43-44.



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And even for those who can and do take the deduction, the intended result of the MID is diluted because the MID ensures at best only the non-*income* taxation of funds used to pay mortgage interest. This presents a problem for the vast majority of Americans for whom payroll taxes represent a greater share of the taxes paid than income taxes. Specifically, payroll taxes (FICA, FUTA, and self-employment taxes) account for 46 percent of combined income and payroll taxes<sup>6</sup> and at least three-quarters of Americans taxpayers pay more payroll taxes than income taxes. The majority of taxpayers, therefore, cannot take the MID against one of the most significant forms of taxes that apply to them – payroll taxes. And these costs are significant when one considers that households spend 30 percent of their disposable income on housing-related expenses. The taxpayers who are burdened most by the fact that the deduction applies only to income taxes and not payroll taxes are first time homebuyers.

### **A supercharged MID**

How does the FairTax rectify this problem? It does so in two ways. First, the FairTax plan provides the equivalent of a “supercharged MID.” By repealing both income taxes and payroll taxes and not taxing interest, interest payments to service the debt on a home are made with both pre-income and pre-payroll tax dollars; in other words, with totally pre-tax earnings! For the income tax to treat mortgage interest as favorably as the FairTax does, the income tax would have to allow mortgage interest paid by homebuyers to be deductible against payroll taxes as well as income taxes for both itemizers and non-itemizers alike. That is hardly likely to ever occur even if the National Association of Realtors were to triple its already substantial lobbying budget.

### **Lower interest rates**

On top of the advantage homebuyers directly receive from not being taxed on the amount of their wages used to pay mortgage interest, they will be further advantaged because interest rates are driven downward under the FairTax, making home ownership more affordable. Consider this truism: Banks and other financial institutions (or even private parties) that lend money are taxed today on the interest income received. As a result, these lenders have to charge as much as 2.5 percentage points more to cover the cost of the tax wedge imposed upon them. Mortgage debt is no different. Homeowners pay the taxes imposed on interest charged to them to the extent those taxes are “pushed forward.” One can see the price of this tax wedge pushed forward on debtors every day in the persistent difference observed between for-profit corporate bonds (which are taxed) and municipal bonds (which are not taxed).<sup>7</sup> The FairTax eliminates taxation of the interest received, as it eliminates all income taxes. As a result of the non-taxation of the lender, mortgage interest rates will fall as the lender has to concern itself with only the risk-adjusted rate of return, not a combination of the tax and risk-adjusted rates of return.

### **Lowering the tax on earnings used to pay principal**

What proponents of the current income tax fail to mention is that the earnings used to pay down the principal on either a used or new home (the true cost of the home in present value) must be subjected to income and payroll tax before they can be applied to the principal. Hence, taxpayers

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<sup>6</sup> Congressional Budget Office, “The Budget and Economic Outlook, Fiscal Years 2007 to 2016.”

<sup>7</sup> *The Wall Street Journal* is a good source for this information.



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pay down the principal only with what they have left over after the imposition of payroll and income taxes on those earnings. The principal is not deductible. The counterpart to this current taxation of principal is the taxation of the home purchase price under the FairTax on new homes only. The marginal rate on the purchase of used homes under the FairTax is zero. The marginal rate imposed on the purchase price of new homes is less than under current law because the average marginal rates under the FairTax are lower than those imposed under the income and payroll tax. And to the extent used homes today bear taxes imposed upstream, the taxation of earnings used to buy used homes is actually a double tax today.

**The FairTax removes all embedded tax costs.**

As noted, when a new home is constructed the businesses building the house and making the building supplies bear tax costs that they must recover in their sales price. Hence, the housing stock bears embedded costs, and the price of the new home reflects those costs that are “pushed forward” on the purchaser. The FairTax removes those costs, making homes more affordable.

**The FairTax enables homeowners to save faster.**

Of course, one of the main advantages of a consumption tax, apart from the economic growth (discussed below), is that it does not punish savings now at Depression Era levels. By not taxing savings, the FairTax enables first time homebuyers and buyers stepping up to more expensive homes to accumulate the funds needed to qualify for home mortgages at a faster rate. Hence, more people can qualify faster for homes that will be more affordable, and whose debt service will decrease.

**The FairTax improves the economy.**

But perhaps one of the most forgotten points is that the FairTax increases national prosperity, which is the key to home ownership. Under the FairTax, a decade from now the economy will be about 15 percent larger and real wages will increase far more than under current law. In fact, recent simulations under the present system show capital per unit of human capital declining 5.0 percent over the course of the century for an 18.0 percent decline over the long run in after-tax take-home pay.<sup>8</sup> A switch to the FairTax causes real wages to rise by 13.0 percent for an 18.0 percent difference in remuneration; by 2030 real wages under the FairTax are 9.3 percent higher than they otherwise would be. The shift to the FairTax raises marginal labor productivity and real wages over the course of the century by 18.9 percent and long-run output by 10.6 percent. Conversely, the income tax reduces the resources Americans have to buy homes.<sup>9</sup>

**II. Demonstration of These Benefits**

**The FairTax makes homes more affordable.**

One way to properly measure the “true” cost of purchasing a home is using the wages that a family has to earn to be able to purchase that home. Let’s compare this for a family who buys a new \$230,000 home today under the current income/payroll tax system and under the FairTax.

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<sup>8</sup> Kotlikoff, Laurence J., and Sabine Jokisch, “Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax,” National Bureau of Economic Research, Working Paper 11858, December, 2005, Section III.

<sup>9</sup> Ibid., Section IV.



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In the chart below we compare how much today’s MID benefits the homebuyer relative to the full nontaxation of interest and principal payments on mortgages under the FairTax by drawing only the most conservative assumptions. To purchase the \$230,000 home mentioned above (assuming a 30-year term and mortgage rate of 6.6 percent), the prospective homebuyer would have to pay \$298,806 in interest in addition to the price of the home. Since the current system taxes income and payroll, these taxes must be taken into account when figuring out how much the family would have to earn over the lifetime of the loan to pay the loan off. Taking these taxes into account, our homebuyer would have to earn \$633,660 to completely pay off the loan.

**Actual cost of purchasing a \$230,000 new home<sup>10</sup>  
(wages that must be earned to buy the home)**

Component of housing cost	Current law	FairTax
Difference in total housing costs		-19.4%
Total housing cost including taxes	\$633,660	\$510,962
Federal taxes	\$104,854	\$69,000
Income taxes on principal	\$64,400	\$0
Payroll taxes on principal	\$17,595	\$0
Income taxes on interest	\$0	\$0
Payroll taxes on interest	\$22,859	\$0
FairTax on home purchase price	\$0	\$69,000
Interest @ 6.6 for 30 years	\$298,806	\$211,962
Mortgage interest rate <sup>11</sup>	6.6%	4.95%
Home purchase price	\$230,000	\$230,000

In contrast, the FairTax does not tax earnings, and instead taxes consumption – in this case the purchase of the new home. Thus, our homebuyer only has to earn \$510,962 to completely pay off the loan – an amount over 19 percent less than he/she does today. This results from two factors: First, the entire mortgage payment is made with untaxed dollars; and second, mortgage interest rates are projected to drop by 25 percent.

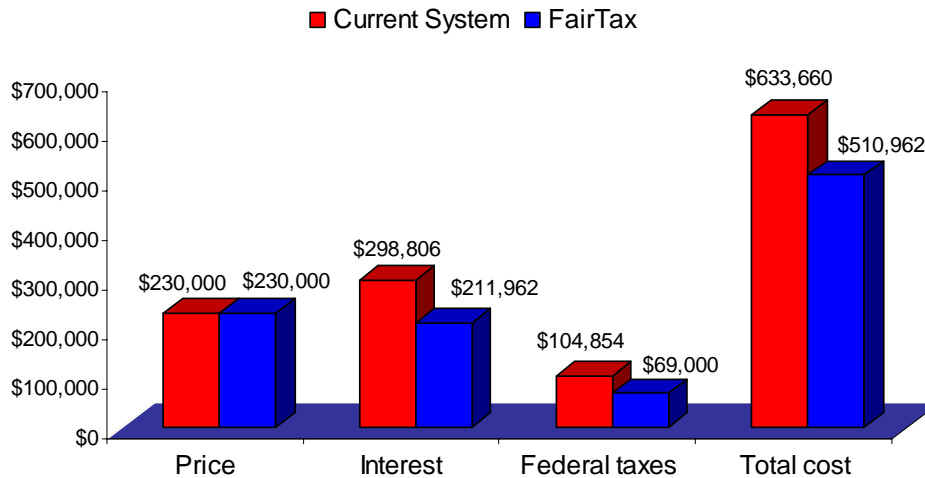
<sup>10</sup> According to the National Association of Realtors, the median price of existing homes in May, 2006 was \$230,000.

<sup>11</sup> Several economic studies have estimated that switching from an income tax system to a consumption tax system such as the FairTax would result in an interest rate drop of approximately 25 percent. See, e.g., Golob, John E., “How Would Tax Reform Affect Financial Markets?” *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter, 1995.



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### "True cost" of housing



In this example, we have not considered the economic growth and higher real wages that would occur by removing the drag on the economy from the income tax, even though few economists dispute the pro-growth impact of the FairTax.

#### Conclusion

In order to match the power of the FairTax for encouraging home ownership, the current tax system would have to at the very least: (1) allow all taxpayers to fully deduct the purchase of used property against income and payroll taxes, (2) expand the mortgage interest deduction so that it permits a deduction against payroll taxes, (3) fully untax interest income to lenders and institutions, and (4) fully untax returns on savings. It would also have to stimulate economic growth and promote higher real wages. For policymakers who profess to support home ownership, the FairTax is far superior to current law.

#### 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 16<sup>th</sup> 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](http://www.FairTax.org) or call 1-800-FAIRTAX.

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(AFFT Documents\Papers on a specific subject\Promoting home ownership)