

Homebuilders and the FairTaxSM

Homebuilders Will Reduce Costs and Increase Profits

- Like other firms, homebuilders will enjoy a zero corporate tax rate under the FairTax. Also, shareholders will not be taxed on dividends received from homebuilders or on capital gains from their investments. Partnerships, limited liability companies, and sole proprietorships will also not be taxed on profits because of the repeal of the individual income tax.
- Overall compliance costs of the current income tax system will be reduced. These costs, which are estimated conservatively to be \$225 billion,¹ are partly borne by homebuilders (discussed below).
- All purchases by homebuilders of building materials will be free of consumption tax. Business-to-business sales are not taxed under the FairTax. Moreover, since all producers of these materials will be operating free from income tax and with dramatically lower compliance costs, material (wood, sheet rock, nails, etc.), prices that now contain these costs will fall significantly. This will allow homebuilders to sell their products at lower prices while maintaining their current profit margins.
- Research by Dr. Dale Jorgenson, Chairman of the Department of Economics at Harvard University, and one of the country's leading economists, shows that producer costs in the construction industry will decrease in the first year by as much as 25 percent. Economic output in the construction industry during the first year of implementation of the FairTax is expected to increase by more than 50 percent. The huge boom in this industry will be due largely to a significant rise in the demand for all investment goods. Dr. Jorgenson's research shows that these increases will continue well into the next quarter century with the 25-year outlook still showing a 13 percent increase in output.²
- As an immediate compliance savings, there will no longer be any need for homebuilders and other employers to maintain the distinction between employees and contract labor for tax purposes. This will also result in a substantial labor cost savings, because homebuilders and other employers will no longer need to collect payroll taxes. Payroll taxes (including the employer portion and FUTA) will be repealed. The repeal of this tax will also fuel the economy. Consumers will have more money in their pockets and, therefore, more money to spend, save, or invest.

¹ "Compliance Costs of Alternative Tax Systems II," Arthur P. Hall, Ph.D., Senior Economist, The Tax Foundation, Special Brief, House Ways & Means Committee Testimony, March 1996.

² "The Economic Impact of Taxing Consumption," Dale W. Jorgenson, Ph.D., Harvard University, Testimony before the Ways and Means Committee, March 27, 1996.

The Demand For New Homes Will Increase

- Demand for new homes will increase, due to at least two factors. First, most economic projections predict a much healthier economy under a consumption tax. People are willing and able to purchase more and better homes in a healthy economy. Typical estimates are that the economy will be 10 to 14 percent larger than it would have been under the current income tax system within 10 years, and consumption will grow very substantially.³ Some studies show the potential gains to be much higher.⁴ These studies typically do not account for the productivity gains that will be achieved due to lower compliance costs.
- Second, discretionary income will increase. Consumers will see their paychecks increase by over \$1.6 trillion because income and payroll taxes are eliminated (estimated for 2001). This increase in disposable income will help to generate both consumption and savings.

Interest Rates Will Drop

- Under the FairTax, conservative estimates predict that mortgage interest rates will fall by 25 to 30 percent or about two points on a 30-year conventional mortgage.⁵ For example, for a \$150,000 thirty-year home mortgage at an interest rate of 8 percent the monthly mortgage payment would be \$1,112.64. On that same mortgage at a 6 percent interest rate the monthly payment would be \$907.64. The two-point decrease in interest rates in this instance would result in a \$73,800 cost savings to the consumer.
- To illustrate the source of the reduction in interest rates, it is useful to examine the bond market. Current taxable interest rates include a tax premium. The cost of this premium can be determined by comparing the interest rates on taxable bonds to the interest rates on tax-exempt municipal bonds of comparable risk and term. The difference between the return on investment of a taxable bond and that of a tax-free bond of comparable risk is about 30 percent. Interest rates will decline due to the elimination of this tax premium because interest earnings will no longer be taxed.
- With lower interest rates, more consumers will qualify for new home purchases, and will refinance to obtain equity from older homes.

³ *Ibid.* "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Laurence J. Kotlikoff, April 15, 1993, Cato Institute Policy Analysis.

⁴ "Looking Back to Move Forward: What Tax Policy Costs Americans and the Economy" Robbins, Aldona Robbins, Policy Report No. 127, September 1994, *Taxation Analysis*, The Institute for Policy Innovation.

⁵ "Effect of a Consumption Tax on the Rate of Interest," Dr. Martin Feldstein, Ph.D., Working Paper 5397, December 1995. See also, *The Flat Tax*, 2nd Edition 1995, Robert E. Hall and Alvin Rabushka, The Hoover Institution Press.

Homeownership Under the FairTax Will Be More Affordable

- Under the current income tax system, a home must be purchased from after-income-tax and after-payroll-tax dollars. Under the FairTax, a home is purchased from income dollars that have not been taxed, since taxation occurs at the time of purchase. A consumer may choose to roll the consumption tax into a mortgage payment, just as state sales taxes on most purchases are today. The home mortgage interest deduction available under the current income tax system *only* has value when an income tax liability exists. Under the FairTax, there is no need to mitigate income tax liabilities, since none exist.

Homebuilders' Compliance Costs Will Be Lower

- Instead of having to comply with the complexities of the income tax and the payroll tax, there will be one consumption tax on all new goods and services. A firm will simply need to calculate, on a monthly basis, its total retail sales of new homes.
- The homebuilder will receive an administration fee of $\frac{1}{4}$ of one percent for complying with the consumption tax.
- The firm's accounting, tax, and personnel (human resources) departments will shrink dramatically.
- There will be –
 - o No more uniform inventory capitalization requirements.
 - o No more complex rules governing employee benefits and retirement plans.
 - o No more tax depreciation schedules.
 - o No more capital gains tax and depreciation recapture.
 - o No more tax rules governing mergers and acquisitions.