Criticism of the

Sales Tax for Residential Real Estate Isn't Built on a Solid Foundation

Dan R. Mastromarco and David R. Burton respond to a recent viewpoint claiming that a national retail sales tax would be detrimental to the real estate industry.

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[1] In the June 8 issue, *Tax Notes* contained a commentary/viewpoint by Gary M. Fleischman, assistant professor of accounting at the University of Tennessee. (*Tax Notes*, June 8, 1998, p. 1359.) In his article, "National Sales Tax & Residential Real Estate: Worse Than You Think," Professor Fleischman criticized the national sales tax in application to residential real estate:

"Proposals for comprehensive tax reform need to be studied in detail to determine whether or not the proposal would be a suitable replacement for our current income tax system. The NRST proposal treats homebuyers much more harshly than the current income tax system or the Armey flat tax proposal....Needless to say, the NRST proposal...with respect to its treatment of principal residences, is especially bad. Real estate lobbyists, where are you?"

Professor Fleischman's observations further the debate only as examples of popular misconceptions about how a national retail sales tax would affect real estate.

[2] Tax reform proponents should welcome intense examination of their plans. Certainly, the proponents of the Americans for Fair Taxation (AFT) national sales tax plan, the Fair Tax, welcome such examinations. Only in this manner can we hope to reach a consensus among the affected communities -- including the real estate industry -- over what constitutes the best plan. Unfortunately, Professor Fleischman's observations further the debate only as examples of popular misconceptions about how a national retail sales tax would affect real estate.

[3] Although such myths gain currency by repetition, they don't get any more veracious. In rebuttal to Professor Fleischman's viewpoint, we would like to briefly describe the Fair Tax sales tax plan, suggest some criteria by which tax reform alternatives should be judged relative to real estate, and then analyze the Fair Tax using those criteria.

What is the FairTax?

[4] The truth is that the Fair Tax plan is much more favorable to homebuyers and realtors than current law, and much simpler. To understand how, let us begin by discussing the basic elements of the Fair Tax plan. In a nutshell, the Fair Tax taxes only consumption. This is the amount we spend on goods and services, rather than the amount we earn. It would replace virtually all federal taxes, including personal income taxes, corporate income taxes, capital gains taxes, and transfer taxes (death taxes). Unlike the Schaefer- Tauzin bill, it would also repeal the payroll taxes (both FICA and SECA). It would apply to all consumption of new goods and services. Business-to-business transactions, however, would not be taxed. Economists would note that the main difference between a consumption tax and an income tax is that the latter taxes savings and investment and the return to savings and investment -- often several times. The Fair Tax would not tax savings and investment.

[5] In 1996, consumption was about 82.5 percent of the gross domestic product (GDP). Investment, including both private and government investment, accounted for the remaining 17.5 percent. In 1996, the GDP was $7,636 billion, investment was $1,341 billion, and consumption was $6,295 billion. The Fair Tax replaces taxes equal to about 18 percent of GDP.

[6] Apart from its broad base, the Fair Tax rate accommodates a rebate mechanism that gives each individual or family unit a rebate of all the taxes they will pay in the next month on an amount determined to fund essentials. The rebate is paid monthly in an amount equal to 23 percent times the HHS poverty level divided by 12. The rebate is a "refund" in advance of the taxes that an individual or family unit will pay in the succeeding month on the necessities of life. The rebate is a way of nonpaternalistically providing that each person or family unit can consume tax-free up to the poverty level. Part of these costs are living accommodations.

[7] The rate also funds two modest incentives. It rewards retailers for being tax collectors under the system by allowing them to keep one-quarter of 1 percent of the taxes collected. Since in many respects the Fair Tax is not that different from what they are already doing in 45 states (and would hopefully lead to harmonization of the current balkanized sales tax rules), and because retailers, like all businesses, would gain from the repeal of the income tax that does not compensate them for their compliance costs, this rebate is generous. Second, it entices states to be collecting apparatuses, by allowing them to keep one-quarter of 1 percent of the revenue collected if they choose to conform the state tax base to the federal base and administer the federal tax.

The 'Supposedly Important' Benefits of the Fair Tax.

[8] What are some of the "supposedly important" benefits of the Fair Tax, to use the words of Professor Fleischman?

[9] First, the Fair Tax is the only plan that untaxes the poor. More than just a pleasant thought, this reflects AFT's view that a tax system should not burden Americans with other's needs before they have met their own. /1/

[10] It provides individuals with maximum choice over what to do with their income: they can consume or save. If one chooses to consume for one's own benefit beyond the necessities of life,

one will pay a tax. If one does not, but chooses instead to save and invest (in real estate, for example), one will pay no tax. The Fair Tax in effect provides universal IRAs to the American people.

Our tax laws should be comprehensible to all - not just those who can afford lawyers and accountants who read *Tax Notes*.

[11] It exempts education, recognizing that education and job training are investments in our nation's human capital and every bit as important as investment in physical capital. It respects privacy rights. It is border-adjusted because foreign- and U.S.-produced goods sold in the U.S. would pay the same tax and exports would be untaxed.

[12] Moreover, it would make the U.S. a global tax haven by imposing a zero rate of taxation on income and investment within our borders. Foreign investment is taxed today at disfavorable rates, sometimes as high as 30 percent of the gross on fixed determinable, annual and periodic income. And foreign entity investment within the U.S. is subject to numerous rules, including the branch profits tax. With a tax rate of zero, under the Fair Tax U.S. investment lost to other countries will be repatriated and foreign investment will flow to our shores for the purchase of plants, facilities, and, yes, real estate.

[13] Although the magnitude of the economic growth generated by a neutral flat rate tax system generates lively debate among economists, virtually all agree that the large marginal tax rate reductions in the AFT tax plan, combined with neutral taxation of savings and investment, will have powerful positive effects on the economy. Investment would rise, the capital stock would grow, productivity would increase, and the output of goods and services would expand. The economy would create more and better paying jobs for American workers and take-home pay would increase considerably. If we had enacted a Fair Tax 10 years ago, according to Harvard's Dale Jorgenson, we would each be 10 percent better off today.

[14] Finally, the Fair Tax will simplify our ridiculously complex tax system. Our tax laws should be comprehensible to all -- not just those who can afford lawyers and accountants who read *Tax Notes*. We are doubtful that even the esteemed readers of this fine publication really understand the tax system any more.

Effects on Housing: Mythology and Some Salient Factors.

[15] Before we rush to conclude that the Fair Tax or any tax reform alternative is good or bad for real estate, a responsible starting point might be to ask ourselves just what it is that we are looking for in any tax system with respect to real estate. In other words, before we evaluate plans, we must answer one fundamental question: by what criteria should we judge whether the current system or the tax alternatives are better for real estate?

[16] In his article, Professor Fleischman does not set forth those criteria. Rather, he asks how the Fair Tax would deal with certain tax expenditures now in the code. He then concludes that the sales tax is worse than either the Armey flat tax (a/k/a subtraction method VAT) or the income tax for real estate because the sales tax: (1) taxes the sale of a home, (2) eliminates the exclusion for capital gains on home sales, (3) eliminates the mortgage interest deduction (MID), and (4) includes a complicated used property credit.

[17] It is relatively simple to refute each of his observations *in seriatim*. (1) All tax systems tax home purchases. Today and under the flat tax, a person must earn much, much more than $100,000 to buy a $100,000 house because principal payments are not deductible. In fact, a middle-class taxpayer in the 28 percent tax bracket and earning wages must earn $154,400 to buy that $100,000 house (making the favorable assumption that the employer share of the payroll tax is actually paid by the employer, although most economists think employees actually bear its burden), much more than under the 23 percent AFT sales tax. (2) The sales tax doesn't just exclude from tax $500,000 of capital gain from the sale of a home sales, it excludes all income from tax, period. (3) The sales tax doesn't tax interest, which is better than merely allowing a deduction against income for some interest (also, when the tax premium is removed, interest rates will fall toward the current tax exempt rate). /2/ And (4), in contrast to the Schaefer-Tauzin bill, the Fair Tax doesn't tax used property at all. The Fair Tax then has the simplest possible rule, much simpler than the current system. In short, each of the objections identified by Professor Fleischman are either incorrect or without merit.

[18] However, we believe the question of whether or not a plan is beneficial -- especially when we are comparing an income tax system with a consumption tax system -- should be examined in the context of a larger framework. *This analytical framework should begin by delineating a series of goals that we seek to reach with the tax system*. Then, it should compare how well each of the system's provisions -- be they the MID, the exclusion, the like-kind exchange provisions, or other provisions -- achieve those goals. We suggest that the following criteria should help us evaluate the effect of the Fair Tax or any other tax reform proposal, including the income tax, on real estate.

- What effect will the tax reform alternative have on the ability of taxpayers to save for the purchase of their first home, a larger home, or a second home?
- What effect will the tax reform alternative have on the velocity of sales?
- What effect will the tax reform alternative have on housing values?
- What effect will the tax reform alternative have on the affordability of loans (i.e. interest)?
- What effect will the tax reform alternative have on after-tax capital gain from the sale of homes?
- What effect will new marginal rates have on the cost of making principal payments (in other words, what is the after-tax cost of buying a home)?

[19] When considering each of these factors, the Fair Tax compares favorably to current law and to the flat tax.

Point 1: Individuals Will Be Able to Save for the Purchase of a Home Much Faster, Which Will Increase and Accelerate the Volume of Home Sales.

[20] Professor Fleischman asserts that the sales tax would make it more difficult than either the income tax or the flat tax to buy a home. In this assertion, he advanced the most common mythology, that a national sales tax plan would be bad for real estate because the purchase of a home would be taxed:

"Here is why the NRST proposal is so bad regarding residential real estate transactions. At least our current income tax system provides forthe "ability to pay concept," whereby persons aregenerally taxed only when they have cash to pay the tax, such as after a home sale. . . . I suppose homebuyers will not be able to put as much money down as they otherwise would, to have money to pay the tax. This new provision will negatively affect homebuyers."

[21] However, the Fair Tax plan is far more beneficial to homebuyers than is the income tax because Professor Fleischman has forgotten that the ability to save will assist in home purchases. Since the Fair Tax does not tax savings and investment, it will enable new homebuyers, second homebuyers, or buyers stepping up to more expensive homes to save for their purchase faster than under the income tax. Buyers will be able to qualify for a mortgage faster and existing owners will be able to sell their homes faster.

[22] Why can individuals save so much faster? First, the Fair Tax removes the enormous disadvantage to savings and investment that exists under our income tax system. Today, savings and investment income is greatly disadvantaged. Wage and salary income is included in the income tax base. If that income is consumed, the benefits of consumption go untaxed. However, if what is left of the wages and salaries is saved (for example, for a new home), the earnings are generally taxed as the income from that investment is generated. Then, if the income-producing asset, such as a stock or bond, equipment, or real property interest is sold for more than it cost, the capital gain is taxed a third time. Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Inter-corporate dividends are also subject to tax, creating yet another level of taxation.

[23] A principal advantage the Fair Tax has over an income tax, therefore, is that the down payment can be saved without fighting against cascading taxes on savings.

[24] To illustrate the effects of the current taxes on savings and investment, let's construct a typical fact pattern and then analyze the effects. Let's take a married couple who want to purchase a home of $150,200, which is the 1996 average previously owned home price. /3/ Let us further assume that that couple will need to save $15,020, or 10 percent, for the down payment. Since the median family income of a married couple in 1995 was $47,129 according to the Bureau of the Census, Current Population Reports (April 1997), let's further assume that that is the amount our couple earns. Today, the personal savings rate nationwide, as a percentage of disposable income, is about 4.3 percent. /4/

[25] Our income tax system's attack on our couple's ability to save begins at the very beginning, when they earn their income. Our family will be taxed on their earnings. To save $15,020 after tax that family must earn, at the margin, an additional $23,341 (looking only at the employee share of payroll taxes and income taxes).

[26] If the $47,129 of our family's income was all wage income, then that couple would have paid $3,605 in employee payroll taxes on those wages. Note also that their wages were also about $3,605 lower because of the employer payroll tax. As noted earlier, economists generally believe that the employer share of the payroll tax is borne by the employee in the form of lower wages. After the standard deduction, the couple would pay income taxes of $6,433, most of which would be in the 15 percent rate bracket, but some of which would be in the 28 percent rate bracket. /5/ Hence, using a standard deduction, the couple would have paid $10,038 of taxes on

$47,129, leaving our family $37,091 after taxes. Of that disposable income, 4.3 percent is $1,595.

[27] Today, assuming our couple earn 8 percent on their savings, are in the 28 percent bracket, and save $1,595 each year at the beginning of the year, they would be able to save their down payment by early in the eighth year.

[28] Under the AFT Fair Tax plan, their disposable income will increase to $50,734 because of the repeal of all payroll and income taxes. Assuming they continue to save 4.3 percent of this amount, they would save $2,131 each year. Assuming they would continue to earn 8 percent on this amount, they would be able to save a $15,020 down payment by the fifth year. Even if we add 23 percent to this amount, they would be able to save $18,475 by the sixth year.

[29] What does this mean in national aggregates? It means that we would accelerate the purchase of homes, increasing the velocity of those sales for some significant period. It means that realtors would make more money faster since there would be many more home sales crunched into a smaller period of time. More sales mean more commissions. And since there will be more demand for homes, property values and commissions can be expected to increase, at least initially.

Point 2: The Cost of Buying a Home Will Decrease, Since Home Purchases Will Be Much More Tax-Advantaged.

1. Mortgage Interest Will be Paid for Out of Pre-Income and Prepayroll Tax Dollars, Which Is Much More Advantageous Than Today.

[30] The second common myth concerns the mortgage interest deduction. Professor Fleischman also states that "since the NRST would abolish the income tax and tax only retail sales, a deduction for mortgage interest expense, or for any expense for that matter, would be rendered obsolete."

[31] Yes, the sales tax eliminates the mortgage interest deduction, but these deductions would not "disappear" in a negative sense. Rather, they could not exist in the world where there would be no taxable income against which the deduction could be taken.

[32] More importantly, the intended result of the mortgage interest deduction reappears in a different and stronger form: the nontaxation of mortgage interest. Under an income tax, the mortgage interest deduction serves the purpose of ensuring interest payments are made from pre*income* tax dollars. This not only benefits those seeking to purchase a home, but those who are fortunate enough to have equity in a home and who use the monies loaned against that equity to convert nondeductible interest into deductible interest. Unless one does not have the income to offset or does not itemize, the mortgage interest deduction accomplishes the purpose of offsetting income taxes paid on the mortgage interest. In fact, in 1995, 28.3 million taxpayers took the mortgage interest deduction, for a total itemized deduction amount of $203.1 billion. /6/ The tax expenditure associated with this deduction was $49 billion last year and is estimated to be $51 billion this year. /7/

[33] It is important to note that as large as it is, the deduction is seriously limited today because it serves only to negate the income tax. Today, mortgage interest payments must be made from after payroll tax dollars, which constitutes a major segment of the taxes Americans -- particularly the poor and middle-income taxpayers -- pay. As a national aggregate, in 1997 individual income taxes were $737.5 billion, and payroll taxes were $539.4 billion, or 42 percent of the combined total. Many taxpayers, especially lower- and middle- income individuals who are purchasing their first home, simply pay a greater portion of their tax liability in payroll taxes as opposed to income taxes.

[34] Let us again see the world through the eyes of our fairly average homebuyer. Recall the median family income of a married couple in 1995 was $47,129. Recall further that if that income were all wage income, then that couple would have paid $7,210 in combined payroll taxes on those wages (employer and employee share). Even if that couple did not itemize, the income taxes that they would pay if they filed married filing jointly would be $6,433, or 10 percent less than the payroll taxes. /8/ In other words, the couple would have paid more payroll taxes than income taxes (assuming here, with most economists, that the employer share is borne by employees). When the couple takes a mortgage interest deduction, the couple cannot take that deduction against the most significant form of taxes that apply to them -- payroll taxes.

[35] Now let us consider what happens under the Fair Tax. Under the Fair Tax plan, mortgage interest is simply not taxed -- ***not at all***. Therefore, like current law, homebuyers would pay mortgage interest out of pre-income-tax dollars. But because the Fair Tax repeals both payroll taxes and the income taxes, the interest payments would be made ***with both preincome and pre-payroll tax dollars***. This would significantly advantage homebuyers relative to current law by reducing the cost of servicing their loans. Since the interest must be paid with after-payroll tax dollars, a taxpayer today must earn $108.28 to pay $100 in mortgage interest if only the "employee" share of the payroll taxes are considered. If the employer payroll taxes are considered /9/ (or if the taxpayer had a sole proprietorship), he or she must earn $118.06. Under the Fair Tax, that taxpayer would need to earn only $100 to pay $100 in mortgage interest.

[36] The relative advantage of not taxing interest payments in a sales tax vs. the mortgage interest deduction in the income tax is depicted in Figure 1 above. In this graph, we seek to take representative information from the U.S. Federal Housing Finance Board, /10/ again using the average purchase price of a previously occupied home, $150,200. /11/ But we add the fact that the interest rate on all loans was an average of 7.6 percent last year and that the median term of all loans was about 27 years.

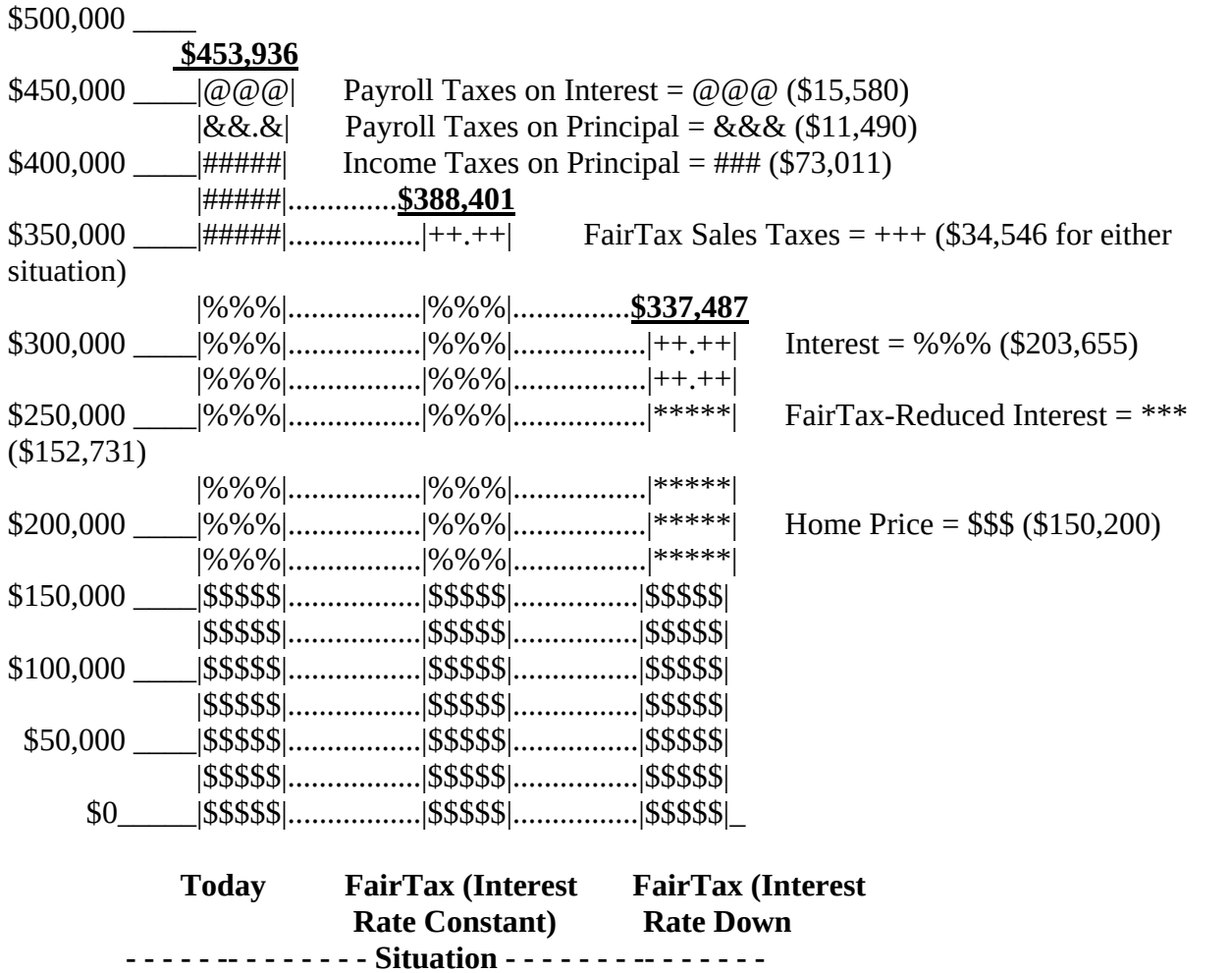
[37] If we were to model our typical married couple above, with a typical home purchase, with a typical interest rate, with a typical term of years in a simple graph, we could compare how much today's mortgage interest deduction benefits the homebuyer relative to the full nontaxation of interest on mortgages under the Fair Tax. Over the course of the 27-year term, an interest rate of 7.6 percent would add $203,655 to the required payoff of the loan. To completely pay off their loan, our couple will have to earn $453,936 once employee payroll taxes and income taxes are taken into account. (Considering the impact of employer payroll taxes would make the figure higher.) Under the Fair Tax, in contrast, the couple would need to earn only $388,400, or fully 14.4 percent less.

Figure 1

Cost of Purchasing $150,000 House

(Wages That Must Be Earned For Purchase)

As described in text of article



[38] This is not the end of the advantages, however. Our family's disposable income would probably go up by the 7.65 percent employer payroll tax and, since interest is no longer taxable, interest rates would come down by about one-quarter as they settle toward the municipal bond rates. /12/ These two factors would save our couple over $148,000, which consists of $97,335 in additional wages and $50,913 in reduced interest costs. If we were just to consider the interest rate reduction, the cost of homeownership would be $337,487, or 25.7 percent less than under current law. Our homebuyers would also have $97,335 more in income over those 27 years with which to purchase the home. /13/

[39] In short, homeownership under the Fair Tax is vastly more affordable.

2. Why Mortgage Interest Rates Will Fall.

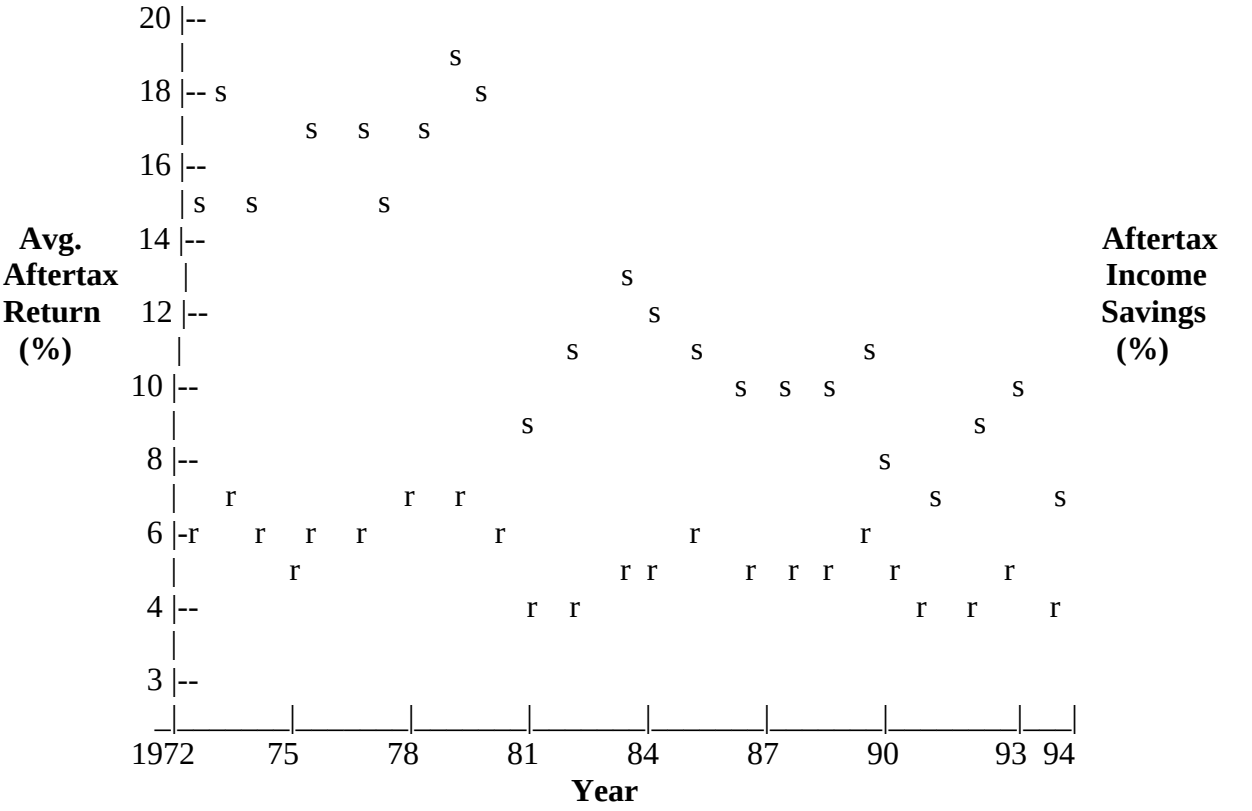
[40] Most of the studies indicate that home mortgage interest rates will fall by 25 to 30 percent (i.e., about two points on a 30- year conventional mortgage). A legitimate question is "why?"

[41] The answer is that current mortgage interest rates include a tax premium, which is the amount lenders pay in taxes on the income received. The magnitude of the wedge can be seen by comparing the interest rates on taxable bonds to tax-exempt municipal bonds of comparable risk and term. The impact of eliminating the tax wedge or tax premium on interest is evidenced each day in *The Wall Street Journal*. Tax-exempt municipal bonds tend to yield about 30 percent less than taxable corporate bonds of similar term and risk. The decline in interest rates will occur entirely because of the elimination of the tax wedge or premium on interest and will happen independently of the impact of the sales tax on savings and investment. /14/ Investors will simply no longer need to charge a tax premium to achieve a particular after-tax rate of return.

[42] A national sales tax is neutral toward savings. Because the attractiveness of savings relative to consumption will increase, investors will choose to save and invest more of their money rather than use it to consume immediately. The after-tax return on their investment makes deferring consumption worthwhile. In contrast, the current income tax is biased against savings and investment. The income tax double, triple, and often quadruple taxes savings.

Figure 2

% Returns vs. Savings %



[43] Economic studies show that savings are responsive to changes in tax treatment and that savings rates are closely correlated to the return on savings. /15/ The chart (Figure 2 above) illustrates the close connection between savings rates and the return to savings. After having fallen steadily for almost two decades, U.S. savings rates -- the U.S. supply of capital -- will improve under a national sales tax because the return to savings will increase.

[44] On the other hand, the demand for that savings (investment) will increase as well. Therefore, the direction of the change in interest rates caused by the improvement in the climate for savings and investment is ambiguous. In any event, international capital flows will dampen the magnitude of any change. The change in interest rates due to the removal of the tax premium will nevertheless be large and immediate.

3. Lower Marginal Rates Will Reduce the Costs of Principal Payments to Home Buyers.

[45] Sometimes the rhetoric surrounding tax reform loses sight of the fact that today home equity payments are still taxed. Professor Fleischman, for example, cites a third myth:

"The Armey plan exempts from tax proceeds of any principal residence sale. The income tax system now permits married persons to exclude up to $500,000 of the gain on sale of their principal residence, but the NRST is worse, much worse! The NRST would tax home purchases as well. Forget the current glory days provided by the income tax gain exclusion of up to $500,000. Forget the Armey proposal's exclusion of all home sale gains."/16/

[46] More in taxes? Subject to tax the purchase of a home? God forbid! However, what many opponents of the Fair Tax may also fail to tell us is that housing today is already taxed. Taxpayers today already pay for the principal in homes with after- income and after- payroll tax dollars. The interest is deductible against taxable income but the principal is not. As under current law, the Fair Tax would tax principal payments. Under the Fair Tax, income used to make those payments would be tax-free but the housing payment would be subject to sales tax. Under the current tax system, income used to make the payments is subjected to income and payroll taxes but the actual payment for the house is not a taxable event. Moreover, since the Fair Tax lowers marginal rates for virtually all homebuyers, they would face lower after-tax costs for homeownership.

[47] In truth, as John Makin points out:

"Both systems tax consumption once; therefore, the distinction between them rests not upon the taxation of consumption but upon whether non-consumption (saving) is taxed once or twice." /17/

When we take each of these factors into consideration, the benefits are overwhelming and it is inconceivable that realtors or homeowners who seriously examine the issue would not support the FairTax.

[48] Given the fact that a consumption tax taxes purchases, but the income tax takes the money before we purchase, how can we compare the two as they affect the homebuyer? The only proper comparison is to ask ourselves this question: how much money would a purchaser have to make to pay for the principal in the home? As noted, today, a purchaser of a home must make principal payments with after-tax dollars. A taxpayer who is in a 28 percent bracket, and pays a 15.3 percent payroll tax, would have to earn $177,000 to purchase a home of $100,000 devoid of the interest charge. If we were to stick with our example of the archtypical homeowners, they would have to make $269,000 to pay cash for a new home of $150,200. Under the sales tax, at a marginal rate of 23 percent, the $100,000 home would cost $130,000 after tax and the home of our archtypical family, $195,100. So, the cost of making equity payments decreases as well under the Fair Tax.

[49] One other point also deserves mention. Yes, the Fair Tax would eliminate the $500,000 home capital gains exclusion for married individuals ($250,000 for single filers), but in its place would be a complete forgiveness of any tax on the capital gains from the sales of a home or any other capital asset. Because the sales tax is neutral as to savings and investment, unlike our current system, it would not tax the gain from the sale of a home twice: once when bought and again when sold.

4. The Fair Tax Makes Housing More Affordable by Repealing Upstream Taxes.

[50] Furthermore, before we get nostalgic about "glory days" of the income tax or the flat tax, we would also note that under both plans housing is still in the tax base in one other respect. Like other firms, homebuilders pay corporate taxes and payroll taxes, not only on their own accord, but in the form of upstream producer price increases to the extent these taxes are pushed forward. Many economists believe that the repeal of the income tax and payroll tax will dramatically reduce producer prices. These upstream costs would disappear under the Fair Tax. They would remain in the flat and income tax.

[51] Research by Harvard economist Dale Jorgenson shows that producer prices will fall 20 to 35 percent under the Fair Tax plan since the income tax and payroll tax is embedded in the price of everything we buy. In this case, new housing prices will be approximately the same, even including the sales taxes, as they are today, and the relative prices of new and used housing will remain roughly comparable to what they are today. If Jorgenson is wrong and the sales tax causes prices to rise, then existing home prices will rise immediately to reflect the fact that they are not subject to tax. Although this would result in a one-time, quick windfall gain to owners of existing houses, the relative price of new and old homes will be comparable.

Conclusion

[52] The combination of these factors means that the Fair Tax would be highly beneficial to real estate. The Fair Tax would:

- significantly quicken the pace of saving for a down payment and concomitantly the pace of home sales;
- reduce substantially the tax burden on those paying mortgage interest;
- lower interest rates and make homes more affordable;

- lessen the pretax earnings a buyer must earn to pay for a home; and
- make homes more affordable by eliminating the upstream producer prices.

[53] When we take each of these factors into consideration, the benefits are overwhelming and it is inconceivable that realtors or homeowners who seriously examine the issue would not support the Fair Tax. In fact, our taxpayer would have to pay $337,487 for the final purchase price of the home as opposed to $453,000 today. If we properly consider the buyer to pay the "employer share" of the payroll tax, or the buyer is a small business person, we will reduce further by $97,335 the amount our family has to earn to make just the interest payments over the course of the loan. Finally, our couple can buy a home after five years of saving, instead of eight.

[54] Professor Fleischman asked of the residential realty industry one question:

"Needless to say, the NRST proposal . . . with respect to its treatment of principal residences, is especially bad. Real estate lobbyists, where are you?"

[55] Hopefully, they are in the process of studying the proposal. Or perhaps they have already reached the conclusion that the Fair Tax makes sense for real estate.

FOOTNOTES

/1/ It achieves this result with a rebate mechanism as discussed above. Today, notwithstanding the EITC, many poor pay the income tax and payroll taxes. Payroll taxes regressively and insidiously apply to wages -- the only source of income for those who don't have wealth.

/2/ More critically, all the mortgage interest deduction allows the taxpayer to do is to pay the mortgage interest expense from pre- income-tax dollars but after-payroll tax dollars. Under the Fair Tax, homeowners will be able to pay mortgage interest from pretax dollars since both the income and payroll tax are repealed.

/3/ According to that data, the average purchase price of a new home was $182,000 in 1996, and the average purchase price of a previously occupied home was $150,200.

/4/ U.S. Bureau of Economic Analysis, National Income and Product Accounts of the United States. (May 1997), Table 2.1.

/5/ The 28 percent bracket for a married couple applies after $36,900 of taxable income.

/6/ SOI Bulletin, Fall 1997.

/7/ U.S. Budget for Fiscal Year 1999.

/8/ $47,129 - $7,100 (standard deduction for married filing jointly) = $40,109. The income tax on taxable income of $40,109 is $6,433.

/9/ Most economists believe that the employer-employee split is really a fiction; that employees really do bear the full 15.3 percent. However, we make this adverse assumption to arrive at a conservative estimate of the advantages of the Fair Tax.

/10/ Rates and Terms of Conventional Home Mortgages, Annual Survey.

/11/ The Fair Tax, in contrast to the Schaefer-Tauzin plan, taxes only new homes, since it taxes goods and services only when they are first consumed.

/12/ See, e.g., Golob, John E., "How Would Tax Reform Affect Financial Markets?" Economic Review, Federal Reserve Bank of Kansas City, Fourth Quarter, 1995.

/13/ The degree to which after-tax wages will increase is a function of the incidence of both the sales tax and the repealed taxes. If the income tax and payroll taxes are incident on income recipients and the sales tax is incident on consumers, then after-tax wages and returns will go up quite considerably as will tax inclusive prices. If the sales tax is incident on the factors of production, then after-tax wages and the after-tax return to capital will not go up to any considerable degree (at first) but producer prices will fall and retail prices, even including the sales tax, will remain roughly comparable. The real purchasing power of wages will undoubtedly increase considerably over time because of a larger capital stock (increasing productivity), microeconomic efficiencies caused by a more efficient allocation of scarce resources, and higher productivity from lower compliance costs.

/14/ For a more detailed discussion of the impact on a national sales tax on interest rates, see Golob, note 13 supra.

/15/ See Gary Robbins and Aldona Robbins, "Eating Out Our Substance: How Taxation Affects Savings," Institute for Policy Innovation, Policy Report No. 131, September, 1995. Dr. Gary Robbins is the former chief of the Applied Econometrics Staff at the U.S. Treasury Department. This paper updates the work of Stanford University economist and former Council of Economic Advisors Chairman Michael J. Boskin, "Taxation, Saving and the Rate of Interest," Journal of Political Economy, Vol. 86, No. 2, Part 2, April 1978, pp. S3-S28.

/16/ His argument is not much different from that contained in the Chicago Tribune of March 15, 1997, which stated:

"To help you follow the debate, here's how a [national retail sales tax] would apply to housing: . . . If enacted, homebuyers would not only have to pay an extra 15 percent. . . . In other words, if you bought a $150,000 house, you'd have to pay $22,500 more in taxes. . . . That of course sounds totally outrageous, especially at a time when there is a major federal push to boost homeownership. . . ."

If the Tribune views it as outrageous to impose a sales tax on homes, then it should consider it equally outrageous that principal payments on homes (and rent for that matter) are not tax deductible.

/17/ See John H. Makin, "Income Tax Reform and the Consumption Tax," in The Consumption Tax, Charles E. Walker and Mark A. Bloomfield, eds., The American Council for Capital

Formation Center for Policy Research, Ballinger Publishing Company, Cambridge, Massachusetts, 1987, pp. 87-115.

END OF FOOTNOTES

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