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The Flat Tax And Housing Values

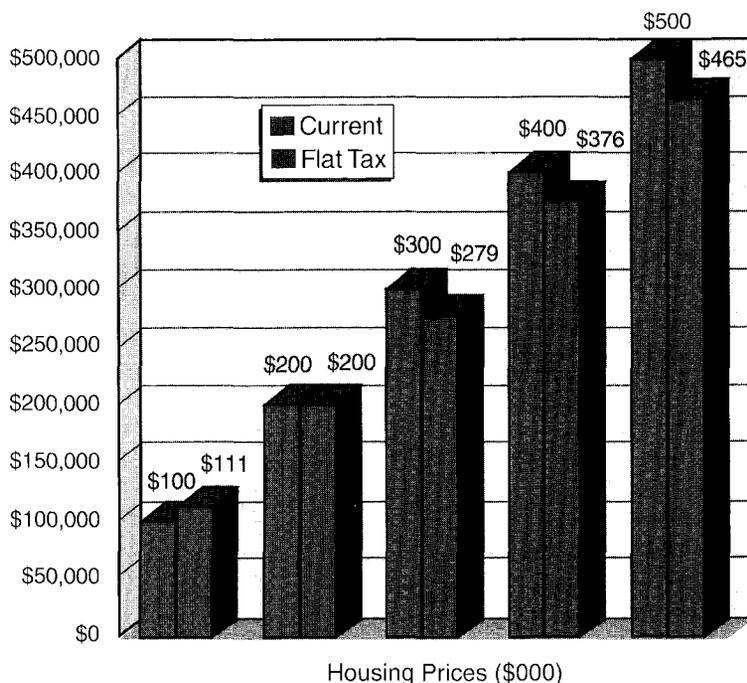
By J.D. Foster, Ph.D.
Executive Director and
Chief Economist
Tax Foundation

As tax reform develops, millions of homeowners will be concerned about the effect the new tax system will have on housing values. For many taxpayers, the equity built up in their home represents a large share of their total net worth. If tax reform appeared likely to reduce home values significantly, as some have suggested would occur, it would create a significant political obstacle to enacting tax reform. On the other hand, if it can be shown that tax reform would cause housing prices to

rise, this would obviously improve the prospects for tax reform.

The flat tax designed by Professors Hall and Rabushka of the Hoover Institute and introduced as legislation in the U.S. Congress by Representative Richard Arney (R-TX) and Senator Richard Shelby (R-AL) includes a number of changes that would clearly affect the value of the nation's housing stock. These changes include a change in tax rates and the elimination of: the capital gains tax, the home mortgage and property tax deductions, the tax on interest income, and the gift and estate tax. Each of these changes would affect housing prices, some offering the hope of greater appreciation, others clearly threatening to reduce housing values. This report summarizes work done at the Tax Foundation ["The Flat Tax and Housing Prices, by J.D. Foster," Tax Foundation *Background Paper 15*] to net out the various tax changes' effects.

Figure 1
Comparison of Housing Values Under Current Tax System
and a Pure Flat Tax System



Source: Tax Foundation.

Housing Values Under a Pure Flat Tax

A change in housing prices following enactment of a flat tax would reflect a number of factors including how closely the enacted flat tax adheres to a pure flat tax. *Table 1* and *Figure 1* present the estimated dollar change in housing prices under a flat tax for houses currently worth from \$100,000 to \$500,000.

As the results presented in *Table 1* indicate, the expected percentage change varies significantly for different priced houses. For homes valued around \$100,000, a flat tax is likely to cause a significant increase in value, which is due entirely to an expected decline in mortgage interest rates.

Other changes in taxation from adopting a flat tax would likely not affect prospective

Table 1
Estimated Net Change in Housing Prices
Under a Pure Flat Tax

Current Value of Home	Value of Home Under Pure Flat Tax	Change in Value	Percent Change in Value
\$100,000	\$111,000	\$11,000	11%
200,000	200,000	0	0
300,000	279,000	-21,000	-7
400,000	376,000	-34,000	-6
500,000	465,000	-35,000	-7

Source: Tax Foundation.

buyers of homes in this price range. For example, homeowners carrying a \$100,000 mortgage are unlikely to have enough itemizable deductions, even with mortgage interest to benefit much, if at all, from itemizing their deductions under current law. Therefore, the loss of these deductions has no effect on the after-tax cost of the home. Similarly, the one-time exclusion of residential capital gains is sufficient under current law to prevent an owner of a lesser priced home from paying much capital gains tax under normal rates of appreciation. Therefore, the elimination of the capital gains tax under the flat tax offers no relief in this case.

For homes currently priced around \$200,000, a flat tax would have little or no net effect because the negative effect from the loss of the property tax and mortgage interest deductions is about equal to the positive effects of the decline in mortgage rates and the elimination of anticipated future capital gains tax paid on appreciation.

For homes priced around \$300,000 and above, however, the net effect is likely to be about a 7 percent decline. As homes become more expensive, prospective buyers are likely to have greater amounts of taxable income and therefore face ever higher marginal tax rates. At higher current-law marginal tax rates, the loss of the home mortgage and property tax deductions becomes more costly and so will have a greater negative effect on housing prices. These effects are partially offset by the greater amount of capital gains tax relief provided to owners of more expensive homes in moving to a flat tax.

Estimated Effect of the Flat Tax on the Value of the National Housing Stock

Aside from the net effect a flat tax would have on housing values, policy makers also

need some sense of the effect on the value of the overall national housing stock if a flat tax were to be enacted. Based on the results presented above and using the distribution of the national private housing stock by price as described in the American Housing Survey for the United States in 1993 produced by the Department of Housing and Urban Development, it is possible to derive a weighted-average change in the price of the national housing stock. Using these weights, one would anticipate anywhere between a 3 percent increase, on average, to a 2 percent drop in the value of the national housing stock if a flat tax were adopted, with a point estimate of about a 1 percent increase. Overall, however, the safest conclusion to draw from these results is that, once all effects are defined, assessed, and netted out, on average the value of the nation's housing stock would be unaffected by the adoption of a flat tax.

The Flat Tax and Housing Values

The model developed to produce these estimates treats a home as an asset and prices it accordingly. Unlike a machine in a plant which produces a stream of income, a home produces a stream of housing services that are valued by the home owner, but which are difficult to quantify objectively. A home also carries various maintenance, mortgage interest, and tax costs that must be covered. And a home offers the possibility of economic gain in the form of price appreciation. Therefore,

Home Price = Total Present Value of Housing Services

plus the

After-Tax Present Value of Expected Appreciation

less the

Total Present Value of all Related Expenses

There is no reason to believe that a flat tax replacing an income tax would affect a prospective buyer's valuation of the home's housing services. Therefore we can focus our attention on the effects of a flat tax on the possibility of after-tax appreciation and on the home's costs.

Four main changes that would occur in moving from an income tax to a flat tax dominate the cost side of the calculation of housing prices and are included in the model:

- 1) The elimination of the home mortgage interest deduction;
- 2) The decline in the interest rate on mortgages issued after the flat tax is introduced;
- 3) Tax rates and the interaction of the standard deduction and the mortgage interest deduction under the income tax; and,
- 4) The elimination of the deduction for state and local property taxes.

Every careful prospective home buyer considers the potential for the appreciation of his or her home when making an offer. The greater the potential for appreciation, the more the buyer is willing to offer. The home buyer must also consider the capital gains treatment he or she will face. The tax imposed on capital gains from the sale of residential housing is subject to a number of complications, all of which can affect the effective capital gains tax rate. For example, taxpayers are able to defer tax upon the sale of a residence so long as they purchase another home of equal or greater value within two years.

Mortgage Interest Rates

As nearly every home buyer knows, mortgage interest rates play an important role in determining how much home one can afford. Therefore, changes in interest rates following the enactment of a flat tax would have an important effect on housing prices.

*Table 2
Estimated Effect on a \$200,000 Home of Adopting a Flat Tax Under Varying Assumptions Regarding Change in Mortgage Interest Rates*

Assumed Mortgage Interest Rates	Value of Home Under Flat Tax	Change in Value	Percent Change in Value
6.4%	\$190,000	\$-10,000	-5%
6.2	192,000	-8,000	-4
6.0	196,000	-4,000	-2
5.8	198,000	-2,000	-1
5.6	200,000	0	0
5.4	204,000	4,000	2
5.2	208,000	8,000	4
5.0	210,000	10,000	5
4.8	214,000	14,000	7
4.6	218,000	18,000	9

Source: Tax Foundation.

Every day, both taxable and income tax-exempt bonds, primarily municipal bonds, trade in the United States bond market. While the risk characteristics of these bonds vary, there is a clearly observable "tax wedge" between the bonds that pay taxable interest and those that pay tax-exempt interest. For example, on March 28, 30-year Treasury bonds paid 6.68%; on that same day, the yield on 30-year municipal bonds was 5.3%. Since the Treasury bonds are generally regarded as risk-free while municipal bonds bear some risk, the tax wedge for Treasury bonds was at least 1.38 percentage points on that date. In other words, if all interest income were tax free, then all currently taxable interest rates would have been at least 1.38 percentage points lower.

In a flat tax system, all interest income is tax-exempt, which means that interest rates on new debt instruments that would be taxable under current law would decline by the amount of the current tax wedge if no other influences came to bear. Therefore, this study assumes a decline in mortgage rates of 1.4 percentage points in its base estimates. Because of the importance of this assumption, however, and the possibility that other influences would follow enacting a flat tax that would affect the net change in mortgage interest rates, additional estimates were generated based on alternate assumptions regarding these rates. *Table 2* presents the estimated effect of the adoption of a flat tax on a \$200,000 home assuming a pre-reform mortgage rate of 7% and a range of post-tax reform mortgage rates.

A Flat Tax Home Mortgage Deduction

It is possible to enact a flat tax that allows for a mortgage interest deduction, even though this is not the normal formulation of a flat tax

*Table 3
Estimated Change in Housing Prices Under a Flat Tax Allowing a Mortgage Interest Deduction*

Current Value of Home	Value of Home Under Modified Flat Tax	Change in Value	Percent Change in Value
\$100,000	\$124,000	\$24,000	-5%
200,000	224,000	24,000	12
300,000	316,000	16,000	5
400,000	426,000	26,000	6
500,000	525,000	25,000	5

Source: Tax Foundation.

and such proposals have already been advanced. It is worth exploring, therefore, the consequences for housing values of a flat tax that includes such a deduction under two different scenarios. The first scenario, presented in *Table 3*, allows a mortgage interest deduction in the flat tax and suggests no other changes to the tax system insofar as it affects housing values (such as to offset the loss in federal receipts, for example).

As the figures in *Table 3* indicate, a flat tax that allows a mortgage interest deduction would actually cause a significant increase in housing values for homes up to about \$200,000, with the greatest increase occurring for those homes valued around \$100,000 and less. The increase is moderated for homes in the \$300,000 to \$500,000 range.

A Revenue Neutral Mortgage Interest Deduction

Allowing a home mortgage deduction in a flat tax system creates two serious problems. Under a flat tax, interest income is not generally taxable to the recipient. This, of course, means that the home mortgage deduction would create a significant tax subsidy to home ownership. The second problem is that the deduction would significantly erode the tax base, thereby requiring some kind of offsetting change to maintain revenue neutrality.

Fortunately, the correct solution to the first problem also generally solves the second.

If the flat tax is to have a mortgage interest deduction, then mortgage interest income should be taxed to the recipient. Also, the reduction in the tax base created by allowing the deduction is offset by the increase in the base caused by taxing the interest income. *Table 4* presents the estimated decline in housing prices under a flat tax that allows a mortgage interest deduction and taxes mortgage interest income to the recipient as under current law.

The figures in *Table 4* indicate that if mortgage interest was both taxable and deductible, then homes currently valued at around \$100,000 would see a significant increase in price. There would be a slight increase in the price of homes currently valued around \$200,000 and a slight decrease for homes currently valued around \$300,000 or more under this assumption.

Conclusion

Fundamental tax reform will affect virtually every sector and every aspect of the economy. To the many millions of homeowners, the effect of tax reform on housing values is of crucial importance as the equity built up in their home often represents a very large share of their net worth. Because of the popularization of the flat tax, and the absence of a home mortgage deduction in the major flat tax proposals, this issue has been thrust to the forefront of the tax reform debate.

The results presented here indicate that owners of homes currently priced at around \$100,000 or below should look forward to the enactment of a flat tax as they should expect a significant increase in the price of their asset. Owners of homes in the \$200,000 range similarly have little to fear even with a pure flat tax as the net effect of the various changes seems to leave them with little hope of a windfall, but little fear of a significant loss. Owners of homes that cost in excess of about \$300,000, however, may see a modest decline in the value of their homes following the enactment of a flat tax. On average, the value of the nation's housing stock is unlikely to be affected significantly by the flat tax currently under debate.

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Editor and Communications
Director
Stephen Gold

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005
(202) 783-2760

taxfnd@intr.net
<http://www.taxfoundation.org/>

Table 4
Estimated Change in Housing Prices Under a Modified Flat Tax Allowing a Mortgage Interest Deduction

Current Value of Home	Value of Home Under Pure Flat Tax	Change in Value	Change in Value
\$100,000	\$112,000	\$12,000	12%
200,000	206,000	6,000	3
300,000	293,000	-7,000	-2
400,000	396,000	-4,000	-1
500,000	498,000	-2,000	-1

Source: Tax Foundation.