

# Owner-Occupied Housing Costs

One important aspect of the Administration's tax reform proposal is how it may substantially boost the costs of owning a home, thus damping housing demand. The proposal would lower marginal tax rates for individuals, thereby raising the after-tax level of interest costs. And, it would eliminate deductions for state and local taxes, consequently pushing up the after-tax level of property taxes. In this capsule, we quantify these boosts to the carrying costs of the primary residence of a typical homebuyer.

To begin, we calculate the marginal tax rate faced by the average homeowner under existing and proposed law. We estimate that the proposed law would lower the average homeowner's present marginal rate from about 25 percent to just over 18 percent. These estimates are roughly in line with the tax expenditure data reported in the *Special Analyses* of the Federal budget.

From these numbers we can estimate the changes in costs to a new homeowner. Based on the median new home price and the mortgage rate early in 1985, we calculate that after-tax interest costs would climb by about \$670 per year, about 7 percent of the total current carrying costs (table). Moreover, the annual after-tax property tax, now about \$950, would average around \$230 more per year, a 2.3 percent addition to carrying costs. Together, these tax changes would raise the average annual cost of homeownership by over 9 percent.\* To put this increase into perspective, mortgage rates would have to rise by about one and one-half percentage points, without these tax changes, for there to be a comparable increase in carrying costs.

These estimates are for typical homebuyers, i.e., those whose marginal tax rate and property taxes are about average. Individuals who would face larger declines in their marginal rates under the Administration's proposal would be affected more sharply, as would homeowners in communities with relatively high property taxes. On average, though, a sharp rise in the cost of homeownership would be one direct effect of the tax reform proposal, possibly reducing the demand for houses.

\*The "rental rate", another widely used measure of the cost of homeownership, by definition is lower than the carrying costs of a home by the expected capital gain. On the basis of the actual annual percent change in the median house price over the past two years, we estimate that the expected annual capital gain on a typical house is now 4 percent. Using this estimate, we calculate that the higher after-tax interest and property tax costs would raise the rental rate by 12.3 percent.

## Estimated Impact of the Administration's Tax Proposal on the Carrying Costs of Owner-Occupied Housing

	Level	Percent change from current level
Average carrying cost*	\$9850	
<b>Increase From:</b>		
Elimination of property tax deduction	230	2.3
Lower marginal tax rates	670	6.8
Projected average carrying cost	\$10,750	9.1†

$$\begin{aligned} \text{*Carrying cost} &= \text{After-tax Interest} + \text{After-tax Property Taxes} + \text{Economic Depreciation} \\ &= (1 - t_F - t_S)iP + (1 - t_P)T + dP \end{aligned}$$

where  $t_F$ ,  $t_S$ ,  $i$ ,  $P$ ,  $T$ , and  $d$  are defined as follows

Variable	Source	Period	Current value	Proposed value
$t_F$ Average marginal Federal tax rate for homeowners	the author†	†	24.7 percent	18.4 percent for interest 0 percent for property taxes
$t_S$ Average marginal state and local tax rate for individuals	MPS model	1984	8.0 percent	
$i$ Mortgage interest rate	FHLMC	1985-II	12.8 percent	
$P$ Median price of new homes sold	Bureau of the Census	Jan -May 1985	\$83,200	
$T$ Average state and local property tax paid per homeowner	the author†	†	\$950	
$d$ Average yearly economic depreciation of a house	MPS model	‡	2.4 percent	

†Equivalent to a 1.6 percentage point increase in the mortgage rate

‡Estimated using 1981 and 1983 IRS Statistics of Income data and the tax expenditure data reported in *Special Analyses, Budget of the United States Government* (Fiscal year 1986)

§Not applicable

Sources: Internal Revenue Service, *Statistics of Income* (1981) and *SOI Bulletin* for 1983, Federal Home Loan Mortgage Corporation, National Association of Realtors; *Special Analyses, op cit*, Flint Brayton and Eileen Mauskopf, *The MPS Model of the United States Economy* (1985)

Carl J. Palash and Robert B. Stoddard