
FRBSF WEEKLY LETTER

January 25, 1985

The Flat Tax And Housing

The United States Treasury recently presented suggestions for reforming the Federal individual and corporate income tax systems. Its proposal, identified as a "modified flat tax," was the latest in a number of proposals generically referred to as "flat tax" systems. Many of these flat tax systems alter the tax treatment of housing significantly. The purpose of this *Letter* is to discuss briefly the rationale behind a flat tax system and the implications of such a system for the housing market.

In its most general sense, a flat tax system is simply one that imposes a tax on income, profits, wages or some other base at a rate that is independent of that base. Thus, most of the sales, property and excise taxes levied in the United States today are flat taxes. A sales tax, for example, applies a flat rate to the volume of retail sales. The present flat tax reform movement applies the flat rate principle to the Federal income tax system in which individual income tax rates rise progressively with income.

Rationale

The rationale for replacing a progressive tax system with a flat tax system lies in the effects of taxation in distorting economic behavior. Taxation of wage income, for example, is believed to reduce labor supply and, hence, to depress national income. Under a progressive rate scheme, the highest marginal tax rates — and, hence, the greatest disincentives to additional work — are imposed on those who earn the highest wage, who usually are considered the most productive workers. Thus, although a progressive tax rate system may have desirable consequences for equity, namely, by placing most of the tax burden on those best able to pay, it may have a more than offsetting deleterious effect on the performance of the economy.

The economist Edgar Browning, for example, has demonstrated that when the tax burden is shifted from the lowest income taxpayers to the highest income taxpayers by progressive taxation, the loss to the economy as a whole far exceeds the benefits to the low income taxpayers. Converting a progressive rate system to a flat rate system generating equivalent tax revenue, therefore, could be ex-

pected to increase national income. Economist Jerry Hausman estimates that converting our present income tax system to a 20 percent flat tax system would result in an 8 percent increase in income because it would encourage individuals to work harder.

In a similar way, the progressive taxation of income earned from invested savings is believed to result in lower aggregate saving and, hence, less rapid accumulation of productive capital in the economy. Households in the top 1 percent of the income distribution are responsible for approximately 25 percent of all saving that occurs in the U.S. economy. Although it has proved difficult to document empirically the effect of economic conditions on saving behavior, a flat rate tax system can be expected to reduce the tendency to substitute consumption for saving. Economists Auerbach, Kotlikoff, and Skinner estimate that a flat rate income tax generating the same total revenue would increase national wealth 6 percent more than a progressive system.

Marginal vs. average rates

Critics believe that the present Federal income tax system is flawed not only because of the progressivity of the current rate structure but also because of the *level* of tax rates. In an attempt to correct the disincentive effects of high marginal tax rates on productive economic activity, a tremendously complex system of deductions and exemptions has been employed. The result is a system with a very high marginal tax rate (estimated by economist Robert Barro to average about 33 percent) and a wasteful use of resources to avoid paying taxes.

Because of such considerations, most current "flat tax" proposals call not only for "flattening" the rate schedule but also for reducing the average marginal tax rate applied to taxable income. However, for the reform to generate the same amount of revenues in total, allowable deductions and exemptions must be reduced or eliminated. Although the various tax reform proposals differ significantly in their details, there are four major changes in deductions or exemp-

FRBSF

tions that conceivably might have an effect on the housing market.

Mortgage interest deduction

First, virtually all of the major "flat tax" proposals impose some limitations on the deductibility of mortgage interest. The Treasury plan, for example, disallows deductions of mortgage interest on second homes. The Bradley-Gebhardt "FAIR" plan implicitly reduces mortgage interest deductibility as taxpayer income rises. And the DeConcini "FLAT" plan eliminates mortgage interest deductibility altogether. All of the major tax reform proposals continue to allow mortgage interest on rental property to be deductible. By itself, limiting the deductibility of mortgage interest on owner-occupied residences would encourage the use of equity financing (also known as "self-financing") in home purchases and renting rather than home-ownership. The overall effect would be to reduce the demand for housing capital and to depress the price of housing. It is not clear how big the effect on housing prices would be, however. Many western economies, including Australia and Canada, limit or disallow the deduction of mortgage interest, yet the relationship between their housing costs and income is similar to that observed in the United States.

Property taxes

A second feature of many "flat tax" reform proposals that would influence the housing market is the elimination or restriction of the deductibility of property taxes against income. The property tax is a component of the cost of consuming housing services. Limiting the deductibility of property taxes, therefore, will increase the implicit after-tax cost of obtaining housing services. This, too, would tend to depress the demand for and, hence, the price of housing.

This price effect will be smaller in states such as California that rely more on tax revenues from income or retail sales rather than property to support public services. If the deductibility of property taxes were eliminated by law, one could expect a further shifting of the tax burden for financing public services away from property to other bases. This shift would, in turn, ameliorate the depressing effect of this aspect of tax reform on housing prices.

Decelerated depreciation

A third, specific, feature of many flat tax reform proposals relevant for housing is the elimination of accelerated deductions for depreciation of capital assets. The Treasury proposal, for example, recommends lengthening the depreciable life of capital assets such as rental housing. For the existing stock of housing to be held voluntarily by investors after such a change, the price of housing must fall. In addition, the change would give rise to a greater desire for owner-occupancy.

Marginal tax rates and capital gains treatment

Finally, the changes in marginal tax rates could themselves disturb housing markets. Finance theory provides a guide to the potential effects. It stresses that the demand for capital — such as housing — depends upon the "user cost" of that capital. The user cost of housing capital can be approximately represented by the foregone interest earnings on equity in the house (that is, foregone from an alternative investment of the same funds) plus the cost of debt service minus any anticipated capital gains — all on an after-tax basis. Even when mortgage interest remains deductible, the reduction in marginal tax rates increases the after-tax return on non-housing investments and thereby the opportunity cost of equity in housing. It also increases the after-tax cost of debt service, everything else being equal.

In addition, most of the tax reform proposals reduce or eliminate the current preferential treatment of capital gains. The consequent reduction in after-tax capital gains also increases the user cost of housing capital as defined above. Thus, the reduction in marginal tax rates and the changes in the preferential treatment of capital gains tend to increase the user cost of capital and thereby reduce the demand for housing capital.

The current Treasury proposal adds some other considerations to this analysis. By indexing both interest income and capital gains receipts to the inflation rate, it would tax only the real (and not nominal) income from these two sources. Moreover, it retains a \$125,000 capital gains exclusion on private residences that, in effect, continues the current, favored capital gains treatment of owner-occupied housing. Nevertheless, in an environment of low inflation, the Treasury's pro-

posed change in capital gains treatment would still increase the user cost of capital to investors on the margin.

Overall effects

It should be apparent from this discussion that a careful inventory of the myriad features of tax reform proposals is needed to determine their effect on housing. Eliminating the mortgage deduction, for example, would introduce a bias toward rental housing, but eliminating accelerated depreciation would encourage owner-occupancy.

Similarly, although all of the reform features discussed above would, by themselves have a tendency to depress housing prices, the *comparative* treatment of housing versus other assets could have an offsetting effect. The Treasury has stated, for example, that its reform proposal represents a shift of the Federal tax burden away from households to corporations. If this were indeed the case, the proposal may make owning housing more attractive than owning corporate equity. This would tend to offset, at least partially, the downward pressure on housing prices exerted by the features discussed above.

In addition, one must distinguish between the short-term and long-term effects of such reform

proposals. If the economy is, in fact, responsive to reductions in marginal tax rates in the directions assumed by the architects of these plans, interest rates would fall and national income would rise. Both of these effects would tend to increase the demand for housing and further offset the effects caused by less favorable tax treatment of housing alone.

It is also important to point out that none of the major tax reform proposals eliminates a major tax feature that favors housing in general (and owner-occupancy in particular) over other capital — the failure of the tax system to tax “imputed income” enjoyed by owner-occupants of housing. An owner of a home enjoys a continuous flow of services, such as shelter, security, and various aesthetic amenities. These services have value in the marketplace and thus represent income to the household. However, because this income is received in the form of services that are consumed directly by the household, it escapes taxation as income. Regardless of the ultimate direction of tax reform, therefore, housing will retain most of its favored treatment in our economy.

Randall J. Pozdena

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

San Francisco
Bank of
Federal Reserve
Research Department

PRESORTED
FIRST CLASS MAIL
U.S. POSTAGE PAID
PERMIT NO. 752
San Francisco, Calif.

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from 01/11/84	
	Outstanding 01/09/85	from 01/02/85	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	188,371	-1,186	13,449	7.7
Loans and Leases ^{1 6}	170,043	-1,178	15,743	10.2
Commercial and Industrial	52,364	- 724	6,189	13.4
Real estate	61,841	- 133	2,599	4.4
Loans to Individuals	32,363	104	5,649	21.1
Leases	5,282	69	227	4.5
U.S. Treasury and Agency Securities ²	11,183	- 10	- 1,331	- 10.6
Other Securities ²	7,145	3	- 961	- 11.8
Total Deposits	195,073	-5,372	8,192	4.4
Demand Deposits	45,141	-5,871	- 27	- 0.1
Demand Deposits Adjusted ³	30,925	-2,252	- 465	- 1.5
Other Transaction Balances ⁴	13,275	- 41	853	6.9
Total Non-Transaction Balances ⁶	136,657	541	7,367	5.7
Money Market Deposit				
Accounts—Total	45,593	542	2,825	6.6
Time Deposits in Amounts of				
\$100,000 or more	40,487	134	2,153	5.6
Other Liabilities for Borrowed Money ⁵	21,090	- 504	2,600	14.1
Two Week Averages	Period ended	Period ended		
of Daily Figures	12/31/84	12/17/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	75	40		
Borrowings	30	44		
Net free reserves (+)/Net borrowed(-)	45	- 3		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change