What's Ahead for Housing Prices?

By Anthony M. Rufolo*

Everyone knows that housing prices are high—but are they really all that high in relation to past experience? And is it likely that housing prices will continue to rise more rapidly than prices in general *ad infinitum*?

ESCALATING PRICES DID NOT DAMPEN HOUSING SALES

It doesn't take much arguing to convince people that housing prices have been going up even faster than most other prices lately and faster than incomes as well. Housing prices exploded during the 1970s: while prices overall were doubling, the median housing price approximately trebled. Many observers consider this price rise socially undesirable because they believe that it places homeownership beyond the reach of many families. But a more careful analysis doesn't seem to support this position.

Housing prices certainly have risen much faster than income since 1970, but much of this relative increase merely offsets a large relative decline in 1969 and 1970—a decline attributable in part to Federal subsidies for new low-income housing in the late 1960s and early 1970s. One author estimates that Federal programs reduced the median cost of

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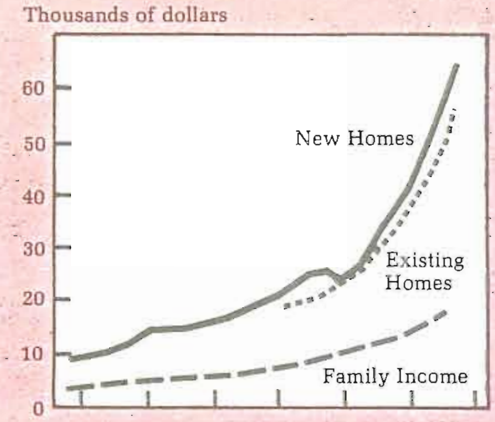
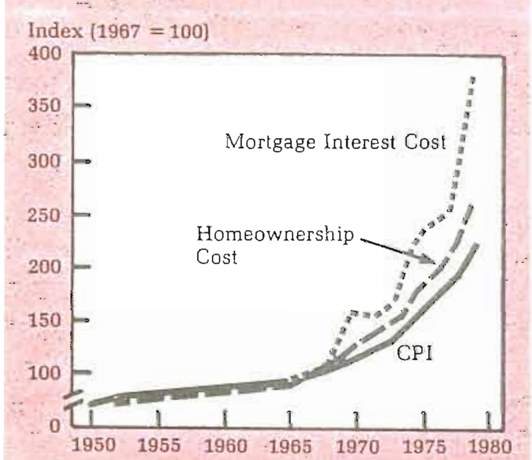
HOUSING PRICES HAVE BEEN RISING FASTER THAN FAMILY INCOME



AND OWNERSHIP COSTS ARE RISING RELATIVE TO THE CPI



SOURCES: New homes data (median sale price) calculated from various sources at the Federal Reserve Bank of Philadelphia. Existing homes data (median sale price for existing single-family homes) provided by the National Association of Real Estate Boards. Family income data (median family income) and CPI derived from *Economic Report of the President 1980*. Homeownership data 1952-77 compiled from U.S. Department of Housing and Urban Development, *1977 Statistical Yearbook* and previous issues. Remaining data provided by U.S. Department of Labor, Bureau of Labor Statistics.

new housing by $2,000 in 1970. But this reduction reflects the construction of many small, low-grade units, not an actual decline in housing costs. As Federal subsidies were phased out, the observed median price jumped back up. Current housing-price-to-family-income ratios clearly are above normal, but the difference is not nearly as great as one would believe from looking only at the last ten years.

The jump in housing prices appears even less troublesome when looked at in relation to per capita income rather than family income. The number of households has been increasing faster than the population as more individuals have chosen to live alone. The increase in the number of single-person households may have reduced median family income without affecting the ability of traditional home buyers to afford a house. Housing prices were rising relative to per capita income throughout the 1970s, but only now are they reaching the average level relative to income which they maintained through the late 1950s and most of the 1960s.

Finally, looking straightforwardly at price changes for new housing can be misleading because of quality changes. Over time, new houses tend to get bigger and to have more amenities. Additional bathrooms, central air-conditioning, and more insulation all add to the cost of a house. And if costs are rising simply because of improved quality, then buyers have little to complain of. It might seem that looking at the median price of *existing* housing would hold quality constant, but it doesn't. Some of the worst housing simply goes off the market each year, and some recently built housing goes onto the resale market. The number of homes lacking indoor plumbing has declined over time, for example, and most other measures of quality show steady increases over time.

Although housing prices may not be a very large deterrent to homeownership, the monthly outlays associated with owning a house have been skyrocketing. Monthly ownership costs have been rising faster than other prices, with higher interest rates contributing heavily to cost growth; but it wasn't until the most recent round of mortgage rate rises that new housing construction started to suffer. In fact, housing sales were booming during much of this rapid runup in costs.

In short, housing prices have been rising rapidly. But the current relation of housing prices to income does not seem to be terribly out of line with historical trends. Monthly housing costs appear to have risen faster than the CPI, at least partly because of mortgage interest costs. Yet this rise apparently did not affect the demand for housing until mortage rates hit record levels in 1978. What does the future hold?

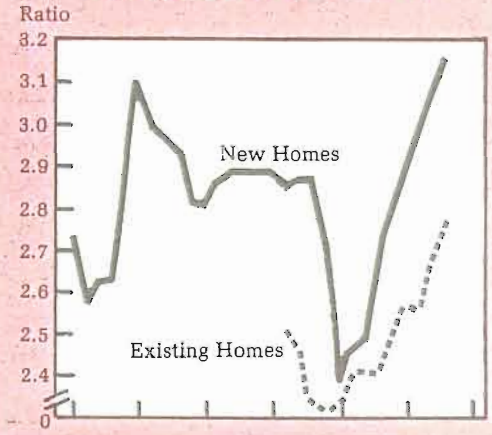
It is quite possible that the conditions underlying the surge in housing prices could weaken and that the sharp upward trend in prices could be reversed, especially if inflation slows dramatically. With predictions of lower housing prices becoming more widespread in the financial press, economists are looking closely at the influences that may shape the housing picture in the years ahead.

THE SINGLE-FAMILY HOME AS AN INVESTMENT

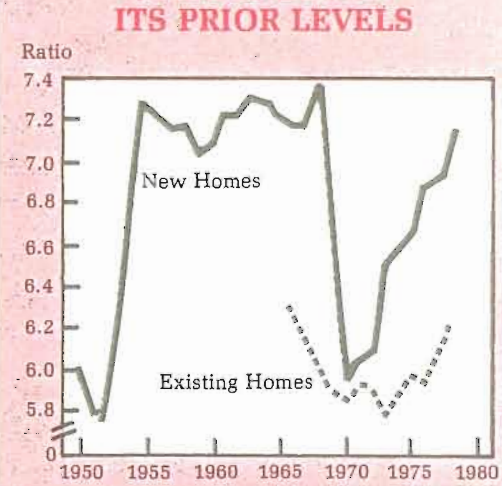
Unlike certain other consumer goods, housing has value as an investment item. Indeed, for many homeowners, a house offers the chief avenue toward increasing wealth over time. If inflation unwinds, however, housing could lose its investment appeal and housing prices could rise much more slowly—or perhaps even fall.

Housing's Dual Role: Consumption and Investment. A family buying a house is interested primarily in how much enjoyment living in that house would provide. But whenever consumers buy something that is going to last for a while, they are also making an investment decision. Separating out the consumption and investment components of housing may help explain why high housing prices did not seem to deter buyers very

BUT THE RATIO OF HOUSING PRICES TO FAMILY INCOME IS NOT MUCH ABOVE THE PREVIOUS PEAK



AND THE RATIO OF OWNERSHIP COSTS TO PER CAPITA INCOME STILL IS BELOW ITS PRIOR LEVELS



SOURCES: New homes ratio equals new homes data divided by family income data or personal income data; existing homes ratio equals existing homes data divided by family income data or personal income data. Personal (per capita) income data 1950-70 compiled from *Historical Statistics of the United States: Colonial Times to 1970*, Part 2 (Washington: U.S. Bureau of the Census, 1975); subsequent personal income data compiled from *Survey of Current Business*.

much during most of the 1970s.

The consumption part of owning a house is the value that the family gets from living there. It is essentially equivalent to the rent they would have to pay if someone else owned the house. In a sense, the family is renting the house to itself, and this so-called imputed rent can be viewed as the income return on the investment. A family that owns a $50,000 house which could be rented for $5,000 per year, for example, is in a sense getting a $5,000 per year dividend on its $50,000 investment.

Like most other investments, housing can go up or down in value. Today's $50,000 house may be worth $40,000 or $60,000 one year hence. These changes in capital value, which can be realized if the house is sold, are also part of the return on investment in housing. In fact, because housing has been mostly going up in value, homeowners have been getting large returns on their housing investment. And these high returns offset some of the cost of owning a house. Thus the net cost of homeownership has actually been much lower than the cash payments (see THE ROLE OF MORTGAGE RATES).

Although recent experience seems to indicate that housing can only go up, it is dangerous to make such an assumption. Even in times of generally rising housing prices, homes in certain neighborhoods and towns have declined in value. And the sudden appearance of a slowdown in housing prices could create a feedback effect which might cause a more broad-based decline in housing prices.

When housing stops increasing in value, other things being equal, the net cost of homeownership will increase. (There will not be as much capital gain to offset the interest, maintenance, and other expenses.) Such a turnaround could cause many people to try to switch back to renting. And reduced demand for homes should create more downward pressure on prices. The possibility of such a scenario depends crucially on what causes housing prices to rise in the first place. Clearly, some of the recent housing demand is attributable to the baby-boom generation's moving into the home buying age group. But some is attributable to the effects of taxes and inflation on the demand for housing as an investment, and the influence of these factors might be reversed in a fairly short time.

Housing's Tax Status Makes It Especially Attractive. Housing is different from other investment items not only because it has a consumption component but also because it enjoys very favorable tax treatment. And the tax advantages of home ownership become even greater in an inflationary environment.[1]

Virtually everyone is aware that the U.S. tax code provides tax breaks to homeowners. But many people are mistaken about the source of these tax benefits. In their view the tax benefit comes primarily from being able to deduct interest payments for a mortgage from income in computing Federal income taxes; but, in fact, *the tax benefit is available even to those who own their home outright.* The reason, simply put, is that the imputed rent from owning a home isn't taxed.

Consider two families—the Owners and the Renters. The Owners own their own home worth $50,000. Mr. Owner earns $20,000 per year as does Mr. Renter. But Mr. Renter owns $50,000 worth of stocks which pay him $5,000 per year. And he pays $5,000 rent for a house identical to the Owners'. These two families enjoy the same dollar income and the same housing. Yet the Renters will pay

[1]Ownership does not get all of the tax advantages. For example, a landlord can depreciate the property for tax purposes and deduct maintenance expenditures while the owner-occupier can do neither. It is generally agreed, however, that the tax laws on net favor the owner-occupier over the landlord-renter by a fairly large margin. In addition, the tax benefits to landlords, such as depreciation deductions, tend to be reduced in inflationary periods while the tax benefits to owners tend to increase in value.

THE ROLE OF MORTGAGE RATES

In determining whether to own or rent housing, the mortgage rate becomes a crucial factor. At a rate of 14 percent, for example, a prospective buyer has to pay one-seventh of the mortgage in interest alone each year. But until recently, record rates were not deterring buyers, because many felt that the house they were buying would go up in value at a higher rate than the interest they were paying. A $35,000 house with a 100-percent mortgage at 14 percent, for example, would cost almost $5,000 in interest in the first year alone. But suppose the house increases in value at the same 14-percent rate. Then at the end of the first year, the house is worth $40,000. Thus, the buyer could save the $5,000 and buy the $40,000 house at the end of the year and still get a $35,000 mortgage. But this isn't the whole story. That $5,000 interest payment can be deducted from income for Federal tax purposes. So the net (after-tax) cost of the mortgage interest can be much less than $5,000.

High mortgage rates do tend to discourage homeownership, but high mortgage rates usually are associated with high rates of inflation, and high rates of inflation tend to encourage homeownership. It is really the relation of mortgage rates to inflation that determines the effect on housing demand. Only when mortgage rates are substantially above the expected rates of inflation do they provide a strong incentive not to buy.

When mortgage rates and inflation rates both are high, buyers are likely to have cash-flow difficulties because of their large monthly payments even if housing remains a good investment. The mortgage lending industry commonly figures that a buyer can carry a home priced in the range of two to three times his annual income. Thus the buyer of a $35,000 home might have an annual income of roughly $12,000 to $18,000. An individual who saved $5,000 would be saving from about a quarter to about 40 percent of his income—a savings rate far above the national average. And paying $5,000 a year in interest for housing could strain the household budget, leaving too little for other forms of consumption. But lower down payments, second mortgages, and other forms of consumer credit can be used to offset this unintended saving.

Another advantage that homeowners can have with respect to a conventional mortgage is the fixed interest rate. If interest rates rise, the debtor gains by being allowed to pay off the mortgage at the lower rate. But if interest rates fall, many homeowners can renegotiate the mortgage. Thus even if someone expects both interest rates and inflation rates to come down in a few years, it may make sense to borrow now and incur the renegotiation costs if current interest rates are below current inflation rates.

tax on $25,000 of income while the Owners pay tax on only $20,000. Implicitly the Owners are receiving $5,000 income on their housing investment which they then pay to themselves as rent. But this imputed rent is not subject to taxation. Clearly, the Renters have a strong incentive to become owners. And as inflation pushes actual rents higher and higher, the incentive gets still stronger. In other words, inflation makes the imputed-rent tax shelter more valuable and hence creates additional demand for homeownership. The consequence: a more rapid rise in the price of housing relative to other goods.[2]

Gains Not Taxed at Turnover. For most investments, if you sell something with a

[2]Interest rate deductions are indeed a benefit to many people because they make it possible to borrow money in order to buy a house and take advantage of the imputed-rent tax shelter. Without the interest deductibility, only people with enough wealth to buy a house outright would reap the full benefit of the imputed-rent tax break.

The property tax writeoff is an additional tax benefit to homeowners. In computing their Federal tax liability, homeowners who itemize can deduct this tax from their capital gain and then invest the proceeds again, you pay the capital gains tax. But if you sell your house and buy another, you can defer the capital gains tax. And if you are over fifty-five, you can now receive up to $100,000 in capital gains tax free.

The tax treatment of capital gains on housing can be an important consideration for investment purposes. Going back to Owner and Renter, suppose that both Owner's home and Renter's stocks doubled in value and each sold his investment to purchase a $100,000 house. The Owners would have $100,000 to purchase this new home, but the Renters would pay a portion of their $50,000 capital gain in the form of income taxes. They could easily have $10,000 diverted to paying additional taxes and end up with only $90,000 to reinvest.

Inflation typically means higher capital gains on most kinds of investments. But the capital gains from owning a house receive more favorable tax treatment than others. Therefore, when inflation accelerates, housing becomes more attractive with respect to other forms of investment. If housing and stock prices both double, for example, the Owners gain relative to the Renters. Why? Because the Renters incur a tax liability associated with the capital gain. Since accelerating inflation means bigger capital gains, the tax advantage of owning a house increases during periods when inflation is on the rise. More people are induced to try to become homeowners, and current homeowners are encouraged to buy bigger houses. The increase in demand for homes is likely to bid up their price relative to other investment goods.

If Inflation Unwinds, Housing Prices Could Fall. If accelerating inflation makes housing prices rise more rapidly than the price of other investments, shouldn't decelerating inflation do the opposite—reduce the rate of housing price increases relative to that of other assets? In the extreme, might housing prices actually fall? There are several reasons to suspect that housing prices will not fall sharply in absolute dollar value. The first is that inflation is unlikely to go away overnight; and the relative attractiveness of housing as an investment will only come down with the rate of inflation. Second, the current tax treatment of capital gains on houses makes it difficult for most homeowners to shift back to renting. Those under fifty-five or with more than $100,000 in capital gains would have to pay the taxes on their capital gains. They would have a tax-based incentive not to shift out of housing. Finally, the relative price increase for housing really does not appear to have been extremely large.

Of course, people don't make calculations in quite this fashion when they decide to buy housing. They look at the expected increase in housing prices and the tax breaks, as well as the mortgage payments and other costs of ownership. When housing prices look as if they are going to rise rapidly, prospective buyers rush to buy; but they may be buying because they feel that if they wait they won't be able to buy as nice a house. Yet this has the same outcome as calculating the increase in housing value, treating it as a return on an investment, subtracting this return from the costs of homeownership, and buying on the basis of this lower cost. And the tax benefits make it easier to finance a house. The imputed-rent benefit makes the monthly payments easier to take by lowering income

income. Renters cannot deduct the property tax, however, because they do not pay it directly.

It might seem that there is no real difference between owning and renting because landlords can deduct property taxes as an expense on their tax returns. But there is a difference. Suppose that property taxes go up for the owner and landlord by $100 per year and that the landlord then raises rents by this amount. The owner gets a $100 deduction on his Federal tax return as does the landlord; but the landlord's income has gone up by $100 also. Hence the landlord gets no net writeoff and the renter is paying the increased property tax through his rent.

subject to Federal tax, and the sheltering of capital gains makes it possible for people moving from one house to another to finance a more expensive house.

When people no longer believe that housing prices will rise rapidly, many of these incentives to buy will be reduced. First-time home buyers will be more inclined to wait and save for a bigger down payment; and people will not be as inclined to spend so much on housing relative to other investments because the reduced tax shelter on housing will make other investments more attractive.

Thus a slackening off of inflation, which many observers are predicting will occur by the end of 1980, could make housing less attractive than other forms of investment. And a shift out of housing by investors would lower its relative price. If inflation subsides rapidly enough, the absolute dollar price of housing could even fall. But the price of housing does not seem to be greatly out of line with other prices, and accrued capital gains make it advantageous for most homeowners to remain homeowners. So it seems unlikely that there would be much of a long-term fall in housing prices. The short-term outlook is, of course, more dominated by current mortgage rates and worries about the recession, so it is not possible to rule out fairly large fluctuations in housing prices. But even these effects are likely to be tempered by the long-run considerations.

IN SUMMARY

The above-trend increases in housing prices have several explanations, including the rise in the quality of housing and the advantages that inflation and a favorable tax treatment bestow on homeowners. Some factors, such as improved housing or increased demand from the baby-boom generation, are not likely to be reversed in the near future. But the tax advantages which make housing an especially attractive investment during inflationary periods would be greatly reduced if the rate of inflation came down rapidly. This lower investment return would reduce the demand for homeownership somewhat and should lead to slower rates of increase in housing prices than in other prices. If inflation were expected to come down rapidly, housing would start to look like a poor investment; and as people tried to shift into other forms of investment, the price could actually decline. But many people would have to pay fairly stiff capital gains taxes if they decided to stop being homeowners. Thus even a rapid fall in the rate of inflation is not likely to cause much of a shift away from homeownership, and any fall in housing prices is likely to be fairly shallow.

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