December 2002

tax and financial ISSUES

The Big Budgetary Squeeze

A brief history of credit and tax policy affecting the residential housing market, or How we morphed houses into credit cards

Our year-end newsletter usually focuses on the current year's tax legislation, but because of unusual action in the financial markets, this year's subject deals with the effect of government policies on the pricing of residential housing. In the face of an economic slowdown, the need to fund additional costs for security has put stress on budgets at all levels of government. Owners and purchasers should consider the effect of these increased costs on the economics of real estate ownership.

Markets Diverge

Anyone who hasn't been asleep has noticed that the financial and real estate markets have been moving in opposite directions for the past three years. Starting in April 2000 the stock markets retreated with the NASDAQ going from 5000 to 1,200, and the Dow Jones Industrial Average going from 12,700 to a low of 7,400. The current levels are 1,400 for the NASDAQ and 8,500 for the Dow. In the same period housing prices have advanced steadily.

The run-up in stock prices was led by a variety of factors, some of which turned out to be non-recurring:

- A massive retooling of software used by industry
- Technology expenditures incurred in connection with preventing Y2K problems
- The emergence of the Internet
- Technology related reductions in fixed overhead by large corporations
- Corporate misbehavior in financial reporting (inflating reported earnings)

The decline in stock prices was led by a reduction in business spending. When cost savings could not make up for the reduction in revenue growth, earnings momentum was lost and stock prices collapsed. The high level of business activity led investors to underestimate risk and make overly optimistic assumptions about business prospects.

The election cycle drives economic stimulus

We now have a two year election cycle in this country, with the party in power doing everything possible to avoid recessions and unemployment that will result in loss of the Executive Branch or Congress. The recent force behind this was the 1992 election loss of George Bush Sr., who lost to Bill "I feel your pain" Clinton despite high approval ratings at the end of the Gulf War. The 1991-1992 recession was a mild one, but that election loss has convinced politicians that economic stimulus has to be put in place to avoid being tagged as indifferent to the plight of working Americans. The resignations in the Bush Jr. economic team last week are a reflection of this change in attitude.

Changes in residential housing credit from 1950 to present

In the post World War II period, the main source of residential mortgage financing was the savings and loan industry. These banks borrowed short (via passbook accounts), and loaned long, issuing 30-year mortgages to

Peter M. Rub, CPA

33 N. Dearborn St./Suite 504 • Chicago, Illinois 60602
312/372-2268 • FAX: 312/372-6179 • *Pete.Rub@RubCPA.com*

home buyers. During this period, government management of the business cycle was to apply reverse stimulus by limiting the supply of credit. If the economy appeared to be overheating, interest rates could be raised. This limited the supply of funds to the S&L industry, and temporarily choked off mortgage financing, reducing activity in the housing industry. The underlying philosophy was to keep the economy on an even keel, and apply restraint where appropriate.

This practice ended in 1979 when ceilings on interest rates were repealed during the post Vietnam War inflation cycle. Thirty year mortgages that had been issued in the 1960's and 1970's were now under water. The short term cost of funds to the banks was higher than the yield on their mortgages. This set the table for the failure of the entire industry in the 1980's.

The structural replacement for the S&L industry was the creation of the market in mortgage backed securities, led by quasi governmental agencies Fannie Mae and Freddie Mac. Banks would originate the loans, and the mortgages would immediately be pooled and sold to investors. The banks eliminated their interest rate risk and became mortgage brokers rather than financial intermediaries. It also ensured that mortgage money would flow to homeowners regardless of the nominal level of interest rates. This marked the end of government policy in applying restraint focused strictly on the housing activity to smooth the business cycle.

The most recent changes to housing credit were in legislation designed to widen the availability to credit. The best example of this is the Community Reinvestment Act (CRA). This legislation restricted the ability of banks in having credit policies that might be considered discriminatory. A more cynical view of this legislation is that it was designed to socialize the cost of making credit available to marginal borrowers. The point where sound lending policies stop and where discrimination starts is very murky.

Profitable lending centers on estimating default levels, and charging appropriate interest rates to compensate for these losses. Recent litigation in lending has focused on the rates charged in the sub prime market. Both Citibank and Household International have settled suits challenging the charging of excessive interest rates to these borrowers.

The Great Real Estate Tax Shelter Episode

In the early 1980's when mortgage rates were over 10%, the real estate industry was in dire straits. The government responded in 1982 by lowering the depreciation period for real estate to 15 years. Top-end individual tax rates were over 50% at that time, and the intent was that tax subsidies would overcome the effect of high interest rates, and promote a recovery in construction.

Individual real estate projects looked attractive, but developers and investors didn't factor in the effect that a huge increase in the supply of commercial properties would have on pricing. Rents crashed, leading to a wave of bankruptcies. The final nails in the coffin that closed this episode were the enactment of the passive loss rules in 1986, and a lengthening of depreciation periods to 27.5 years for residential property, and 39 years for commercial property.

Resale prices suffered because buyers didn't have comparable tax subsidies, the supply of capital was reduced because leveraged tax shelter investing had been restricted by the passive loss rules, and the economics of property ownership wasn't good because of oversupply. The boom period lasted for about 5 years, but the hangover from overbuilding lasted through the mid 1990's. The lesson learned from this episode is that not all tax subsidies are permanent.

Tax and Financial ISSUES

Residential housing stimulus via tax policy

Housing subsidies via deductions for mortgage interest and real estate taxes have always been around. Recent changes in tax policy have focused on making gains on sale of residences exempt from the income tax, and in restricting the deductibility of mortgage interest.

In 1997, the rules for avoiding gain on sale of a principal residence were changed. Previously, reinvestment in a more expensive home would result in the gain not being recognized, and there was a $125,000 once in a lifetime allowance for individuals who were 55 or older and did not reinvest. The 1997 change allowed for a $500,000 exemption for married couples ($250,000 for single filers) that could be taken every two years. The driving force behind this change was the need by senior citizens to use the equity in their home for living expenses. This produced a wave of downsizing without tax consequences. Much of the untaxed appreciation from the post Vietnam War inflation was unleashed on the economy.

What we now have is housing as the most tax subsidized industry in the country. Owners can deduct most of the carrying costs as incurred, and gains on sale will generally exempt from tax.

Consumers skirt limitations on interest deductions: real estate is monetized

In 1986 the government eliminated the deduction for consumer interest (credit cards, auto loans, etc.), and restricted the deductibility of mortgage interest to the original acquisition indebtedness on the property. Acquisition indebtedness is eliminated as mortgages are paid down, and mortgage interest is only deductible on additional debt up to $100,000.

Financial institutions and home owners responded loading consumer debt onto home mortgages. This takes the form of individuals mortgaging homes to the maximum when purchased, and frequently refinancing to convert property appreciation into cash for living expenses. Home equity debt is now the preferred way of engineering tax-deductible consumer debt. *What the mortgage origination industry in this country has done is to turn the nation's residences into credit cards*.

These factors lead to Rub's first law of housing prices:

> **The pricing of real estate is adjusted to reflect tax subsidies.**

This is illustrated most clearly by California real estate values, which reflect not only the federal income tax subsides, but also the real estate tax freeze enacted with Proposition 13 back in the early 1980's. It's no wonder that California real estate values were the first to shoot to the moon. You can have tax-free appreciation, and your principal operating expense is frozen.

Economic stimulus via interest rate policy

A noted above, the original government policy towards real estate was negative. Interest rates were raised to avoid an overheating of economic activity. With the mountain of mortgage debt outstanding, we now have something quite different. To keep the level of economic activity high in the face of a decline in business activity, the Federal Reserve has forced short-term interest rates lower, leading to a wave of refinancings. Borrowers get an immediate cash flow increase. Real estate developers get lower costs of carrying inventory.

The real impact is on selling prices, as explained by Rub's second law of housing prices:

> **The price of residential housing is directly related to the amount of income available to service mortgage debt.**

Tax and Financial ISSUES

One of the national sports of America is buying as much house as you can afford. This means that when the government is able to engineer lower interest rates for borrowers, it results in higher prices for sellers of existing housing and for developers. Everyone feels good because they own appreciating assets. The size of the real estate credit card gets bigger every time lower interest rates produce an increase in prices.

This behavior leads to counter-intuitive result with respect to inflation statistics. Low inflation and a decline in business activity should lead to low inflation expectations, including changes in real estate values. However, following behavior reinforced by 35 years of inflation aided increases in values, buyers have built the benefit of lower interest rates straight into property values.

Debt Service Requirements: % to Disposable Personal Income						
Year	Mortgage Debt	Consumer Debt	Total	30-Year Mortgage Rate	Consumer Price Index Inflation	Mortgage Rate Less Inflation
1980	4.5%	8.4%	12.9%	13.8%	13.5%	0.3%
1985	5.5%	8.1%	13.6%	12.4%	3.6%	8.9%
1990	6.2%	7.2%	13.4%	10.1%	5.4%	4.7%
1995	5.8%	6.8%	12.7%	8.0%	2.8%	5.1%
2000	6.0%	7.7%	13.7%	8.1%	3.4%	4.7%
2001	6.2%	7.9%	14.1%	7.0%	2.8%	4.1%
Source: Federal Reserve Board						

This stimulus is immediate, but the hangover related to debt repayment has a delayed impact. Because of the decline in interest rates, interest payments on 30 year mortgages may be manageable, but the eventual retirement of principal is starts to look like Mount Everest. There is also the hidden impact on investors. Imagine being a saver and seeing your interest income evaporate in tandem with the decline in interest rates.

The economic stimulus from lower interest rates is also transmitted disproportionately throughout the economy. The prime beneficiaries are existing property owners with higher rate mortgages. These property owner either benefit through increased cash flow or though higher sales prices. The benefit to new (and presumably younger) buyers has been muted by increases in property prices. Despite decreases in nominal interest rates, household debt service payments expressed as a percentage of disposable income are higher than in 1980's. Rates are lower, but mortgage balances are higher.

The big squeeze on disposable income

We now have advance warning of problems on the horizon. State and local governments are reporting budget deficits that can't be debt financed. California is currently running a $23 billion budget deficit on total spending of $73 billion. New York State and New York City are struggling to deal with a cyclical decline in the securities industry. Unlike the federal government which has the ability to run deficits for protracted periods of time, states and local governments have legal requirements to keep their budgets in balance.

At the same time that revenues are declining because of the downturn in business activity, unfunded service mandates continue to be passed down from the federal government in the form of Medicaid and homeland security support. This is something that Republicans used to complain about when the Democrats controlled Congress, but the same problems continue now. (Perhaps the op ed articles from the *Wall Street Journal* that framed this issue during the 1990's should be reprinted now, with name changes only.)

These state budget problems have to be dealt with quickly, and the obvious solutions, spending cuts and tax increases, do nothing to stimulate consumer confidence and the economy. A key source of tax revenue may be from real estate taxes, and this could cause problems in property values. The most dramatic example of this is in California, where valuations that determine taxes are frozen at the amount paid to purchase the property. These valuations can only change when the property is sold. The usual approach is to base assessed valuation on the current fair market value of the property.

The Casualty Insurance Factor

The casualty insurance industry has been busy raising premiums to rebuild capital after the 9-11 attacks. Premium increases have not been limited to policies covering commercial properties. Stiff increases are also being seen on residential policies, both on rental and owner occupied single-family housing

The cost of the war on terror is percolating down to property owners, putting a squeeze on rental cash flow in a soft economy, and increasing carrying costs of single-family housing.

Questions to ponder moving forward

- What will happen to housing valuations if tax subsidies or interest rate stimulus are withdrawn?
- What should property owners do to avoid incurring losses if interest rates increase?
- Is the government creating a housing bubble by artificially stimulating the housing industry?
- Are the economics of property ownership less favorable because of higher operating costs (real estate taxes and casualty insurance)?

For an individual to purchase a property at a high valuation because of low interest rates, the implicit assumption is that the property will be held for a long period of time. Even if interest rates would rise, the value created by locking in a long term interest rates would offset any decline in the value of the home. It's akin to having a hedged financial position. If it is likely that the home will be sold after several years, buyers would likely be required to finance the purchase at higher rates, and would require lower prices to have the same debt service burden.

Investors in the 1970's and 1980's paid higher interest rates, but had the momentum of inflation behind them that increased property values. As interest rates declined, they got the double benefit of a higher price level, and lower debt service. Property owners now have low inflation momentum, and little prospect of further declines in interest rates. The economics of property ownership are decidedly less favorable.

With respect to government stimulus, one should consider the state of the farm economy. For decades the government has supported farmers through crop subsidies and loan programs. Farm values still collapsed in the early 1980's in tandem with a decline in farm income. In real terms prices have never recovered. The problem with subsidies is that they get put in place in poor economic times, but are never removed during boom periods. Investors then make assumptions that the stimulus will be in place permanently.

Property owners in New York City were recently treated to an 18% increase in property taxes that was needed to make up for a decline in income tax revenues in the financial industry. This can only have a depressing effect on property values. California currently has one of the highest state income tax rates in the country, and it is unlikely that their budget deficit can be cured by income tax increases. A likely source of revenue is from property taxes. Californians have been willing to pay stratospheric amounts for housing knowing that their real estate taxes would not float up with the general inflation in the economy. They would be less likely to do so if increased real estate taxes could squeeze their disposable income.

Tax and Financial ISSUES

The long-term implications of this trend are ominous. By some measures, the ratio of owner equity as a percentage of fair market value is some 20% below the level of the 1970's. The state of the economy and real estate valuations are increasingly dependent on the willingness of individuals to borrow. Will this continue if property owners are concerned about rising taxes and interest rates, and flat personal income?

Action for property owners

What action should property owners and purchasers take to minimize the damage from potential increases in interest rates and real estate tax increases?

- Don't invest in political jurisdictions where there is obvious budgetary stress.
- Lock in low interest rates with long term fixed rate mortgages.
- Don't overpay for properties. (There is less of a margin of error in a low inflation environment.)
- If you intend to sell property in the next several years, consider accelerating the sale to take advantage of the current low interest rates.
- Exercise caution in buying vacation properties. (Ownership is discretionary, and demand can disappear quickly.)
- If you are an empty nester, review the economics of downsizing your primary residence.

This is definitely a new environment. Both purchasers and existing owners should anticipate future trends rather than looking at the economics of property ownership through a rear view mirror.