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BALANCED BUDGET TALKING POINTS #7: WHAT CONGRESS'S BALANCED BUDGET WITH TAX CUTS WOULD MEAN FOR HOUSING

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Congress's plan to balance the budget over seven years with tax cuts, vetoed on December 6 by President Clinton, would significantly improve the housing of many renters and homeowners while lowering their housing costs. According to an econometric analysis by The Heritage Foundation, adopting the spending and tax policy changes contained in the Balanced Budget Act of 1995 would likely lead to:

- ✓ 104,000 additional housing starts worth $11 billion over the period 1996 through 2002;
- ✓ New or improved housing for 1.8 million Americans;
- ✓ A drop in mortgage interest rates, with total payments on a $100,000 mortgage about $10,000 less in today's dollars over 30 years than a mortgage purchased under current budget and tax law; and
- ✓ A 4 percent drop in the cost of housing by 2002 (principally through decreases in the cost of capital and lower interest rates), with the value of existing housing maintained at or near current levels by the growing demand for new homes.

This good news on housing reflects the stronger economy that economists at The Heritage Foundation predict would result from the vetoed Balanced Budget Act of 1995.[1] Incomes and output would rise, inflation and interest rates would fall, and the spending and tax cuts proposed by Congress would lead to significant growth in productivity and investment. Each has a positive effect on housing. Specifically, the boost in new home construction would produce widespread benefits, and the tax policy provisions of the Act would lead simultaneously to lower housing costs.

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1 See William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

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The Heritage Foundation conducted this analysis of the congressional budget plan using an economic model of the U.S. economy developed by Laurence H. Meyer & Associates, a nationally recognized economics consulting firm whose model is used routinely by major private firms and by such public agencies as the President's Council of Economic Advisers, the White House Office of Management and Budget, the Board of Governors of the Federal Reserve System, and the Congressional Budget Office.

Growth in New Home Construction

The healthier economy that flows from Congress's tax and spending cuts produces two important effects on family housing.

First, the tax reductions, particularly the cuts in capital gains taxes, would jump start a boom in new investments by households and businesses.[2] The Meyer model indicates that investors would pour an additional $11 billion (adjusted for inflation) into the housing sector as a result of the congressional budget plan. Without the tax and spending cuts, these new investments in family housing likely would not be made.

- ✓ Home builders would use these new funds to construct an estimated 51,200 new single-family homes and 52,800 new multi-family dwellings over the seven-year period from 1996 through 2002.
- ✓ This construction activity would mean employment and income growth in the housing industry, in the banking and real estate sectors, and in thousands of other companies that sell new homeowners everything from telephones to tabletops.

Second, these new investment dollars would provide improved housing for nearly 700,000 families. The model projects 7,200 starts of 2-to-4-unit dwellings and 45,600 starts of 5-or-more-unit dwellings. Assuming that all dwellings in the 2-to-4 category are actually 2-unit dwellings and all in the 5-or-more category are only 5-unit buildings, then the Balanced Budget Act of 1995 could provide new apartments for 288,000 families. Add to this number the 51,200 families who would be moving into single-family housing, and it becomes apparent that Congress's budget plan will significantly improve the housing of many Americans. Specifically:

- ✓ An additional 339,200 families could move into new housing over the next seven years as a result of the Balanced Budget Act of 1995. Assuming a national average family size of 2.63, this means 892,100 people could enjoy new housing over this period.[3]
- ✓ Assuming that the 339,200 dwellings vacated by these families who are moving up in housing are purchased or rented by another 339,200 families looking to improve their own housing, the total number of people affected by these new housing starts could be 1,784,200.

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2 For an overview of the benefits that flow from a reduction in capital gains tax rates, see William W. Beach, "Who Will Benefit from Cuts in Capital Gains Taxes," Heritage Foundation *F.Y.I.* No. 76, December 4, 1995.

3 U.S. Department of Commerce, *Statistical Abstract of the United States, 1994* (Washington, D.C.: U.S. Government Printing Office, 1994), p. 59, Table 67. This national average household size is for 1993.

Reduced Housing Costs

While the Balanced Budget Act of 1995 would contribute significantly to the welfare of Americans through its salutary influence on housing, the legislation's benefits for homeowners and renters would not end there. The Act's role in stimulating the growth of investment and reducing the after-tax cost of capital (largely through reductions in the effective tax rate on capital gains) reduces the cost of housing. The Meyer model projects that the cost of housing will be 4 percent lower by 2002 than it otherwise would be under current law. Two factors explain this drop in the relative price of housing.

First, Congress's budget plan would reduce the costs of capital directly by reducing the effective tax rate on capital gains. For example, if Jones is thinking about cashing out an appreciated asset (say, a company stock) and loaning the proceeds to Smith, who is building an apartment building, Jones will consider the taxes he or she must pay on the capital gain as an important part of making the loan. If Jones paid a high capital gain tax, then he or she will demand a higher rate of return on the investment. Thus, dropping the effective tax rate on capital gains works to lower the cost of capital for those who borrow. The Meyer model predicts that the after-tax cost of capital by 2002 would be a full percentage point lower than it would be under current law.

- ✓ Because capital costs are an important part of the costs landlords must cover by the rents they receive, one highly possible outcome of tax cuts is lower than expected rental payments by families in apartments or single-family rental property.
- ✓ Similarly, the prices of new single-family homes will rise less rapidly in a world with tax cuts than in a world without them for the very same reason: Homebuilders will be paying less for the capital they need for home construction.

Second, the relative price of housing would drop under the vetoed plan because mortgages would be less costly. The Balanced Budget Act of 1995 not only would cut the effective rate on capital gains, but also would permit middle and lower income families with children to keep $23 billion more of their income each year through the child tax credit. The Meyer model indicates that families would use a portion of this money to buy stocks and bonds and to increase their personal savings accounts. These actions would increase the supply of funds available for investment. Thus, the mortgage interest rate (like all of the major interest rates in the Meyer model) would fall because the after-tax cost of capital would decline and the supply of investment dollars rise.

- ✓ The 0.4 percent drop in the mortgage interest rate from what it otherwise would be means that a $100,000 home loan would cost about $10,000 less in today's dollars over a typical 30-year loan repayment period.
- ✓ Lower borrowing costs would allow more families to enter the housing market, which would contribute to price stability in housing and the preservation of household net wealth.

This important role of lower interest rates—preserving the value of all homes through the competitive price bidding of home buyers—explains in part the impressive growth in household net worth by 2002: The Meyer model projects that, at the end of the seven-year balancing period, households will be worth nearly $200 billion more than they otherwise would have been under current law.

It is benefits of this magnitude that President Clinton has foregone through his veto. Not only does the Balanced Budget Act of 1995 inadvertently create a "housing program" of significant proportions; it also contributes to a general improvement in family financial well-being.