ECONOMIC BRIEF NO. 35

Fiscal Changes & Asset Prices

Suppose a person is considering buying one of two identical houses in neighboring communities with much the same amenities and public services. While the buyer is meditating, the city council in City A approves a mill rate increase that adds $500 a year to the tax bill without any appreciable increase in services. What will the buyer do? Buy the house in City B, of course. And so would anyone else. The housing market in City B will be booming, while houses in City A will languish for months in the real estate ads.

But that's not the end of the story. Market forces are at work. Over time, housing prices will decline in City A as desperate sellers cut their selling prices and savvy buyers offer lower bids. This price decline reflects the fact that each house in City A now comes with a bigger tax burden than before, and a bigger tax burden relative to houses in other nearby cities. That tax burden is incorporated in the price of the house, a process called capitalization.

Capitalization is not unique to houses. It can apply to any asset, such as a piece of land, a business, or an airplane. And it is not unique to taxes. Changes in labor costs, gasoline costs, zoning, utility rates, road access, or dozens of other things change the stream of future income or amenities or costs associated with owning and using any asset.

So how much will the value of a house fall in this particular case? The answer lies in the concept of present value. The cost of owning the house has risen $500 a year for the indefinite future. That's $500 this year. It's not quite $500 next year, because $500 a year from now is less than $500 today. You could put less than $500 in the bank, earn interest, and have $500 a year from now. If the interest rate was 6 percent, for example, only $472 is needed today to have $500 in a year and only $445 to have $500 in two years. So the amount that one would need right now to make tax payments of $500 a year for 20 years is not $500 x 20 or $10,000. It's only $6,079.

If the $500 goes on forever, the formula for the present value of all those future tax payments becomes very simple. It's just the annual $500 tax payment divided by the interest rate, that is, $500/.06 or $8,333. So this tax increase will, other things being equal, reduce the value of the house in City A by $8,333.

The burden of any change, such as a tax increase, affects the owner of the asset when the change is made, not future owners. Future owners will get to purchase the house at a lower price that reflects the obligation for future tax payments. Those who buy the house have little ground for complaint about high property taxes, because the burden of those taxes was absorbed by the previous owner whose house declined in market value.

Of course, if the tax increase were accompanied by better services, the fall in the house's value would be less. And if taxes were increased in City B at the same time, a buyer would have fewer alternatives, so the house's value would fall less. If a buyer deducts property tax on his income tax, the net payment in each future year will be smaller, and the impact on the price of the house will be less. But capitalization offers a rough guide to how much a particular change that will continue into the indefinite future can be expected to affect the value of an asset such as a house.