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GOP Tax Law Could Starve Cities of Revenue.

Housing experts predict that the tax overhaul will spur home values and property tax revenues to drop, forcing cities to find new ways to raise money — or to cut spending.

The recent, sweeping overhaul of the federal tax code holds the potential to shake the foundation of municipal finance and could lead cities to look elsewhere to raise revenues in the coming years, according to housing analysts.

Under the new tax plan, passed by Congress in December and signed by President Donald Trump just days before Christmas, the mortgage interest deduction will now be capped at $750,000, down from the previous cap of $1 million, and homeowners will no longer be able to deduct state and local taxes from their federal tax liability. Under the new plan, homeowners with existing mortgages above $750,000 can continue to deduct the interest, but new homeowners cannot.

The new plan also caps the deduction for state and local taxes at $10,000 and doubles the standard deduction. According to a study by the real estate website Zillow, 44 percent of U.S. homes were valuable enough to incentivize their owners to itemize and take the mortgage interest deduction. The new cap on mortgage interest deduction and state and local tax means only 14.4 percent of homes are valuable enough to incentivize their owners to itemize instead of taking the standard deduction.

In other words, the vast majority of homeowners will take the standard deduction, which analysts expect to drive down property values. And that means significantly less revenue for cities.

“Only 6 percent of homeowners have mortgages exceeding $750,000, and only 5 percent pay more than $10,000 in property taxes, but most homeowners won’t itemize under the new regime,” said Elizabeth Mendenhall, president of the National Association of Realtors, in a statement released after passage of the new tax code.

The mortgage interest deduction and the ability to deduct state and local tax has long been seen by real estate groups as a strong incentive for families to purchase homes. Capping the deductions could negatively impact a sector that economist largely agree has not fully recovered from the 2008 housing crisis.

“The new tax regime will fundamentally alter the benefits of homeownership by nullifying incentives for individuals and families,” Mendenhall added in her statement after Congress passed the bill.

The results could be chilling on housing markets nationwide, with estimates ranging from a 4 percent drop in home prices (according to Moody’s) to a 10 percent drop (according to the National Association of Realtors). Hotter markets in states and municipalities with higher property tax burdens — such as New York, California and the Washington, D.C. metro area — could experience more precipitous drops in home prices, according to Moody’s.

The blow to the housing market could ripple throughout municipal finance structures, since cities rely on property tax for nearly half of their revenue. According to the Tax Policy Center, local governments collected $442 billion in property tax in 2013, the most recent year data for which data was collected — 47 percent of the general revenue collected by those municipalities. In Northeast states, including Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, and Rhode Island, property taxes accounted for three quarters of local tax revenues.

The passage and signing of the bill prompted Washington, D.C., Mayor Muriel Bowser to make a late-December plea to homeowners in her city to pre-pay their taxes before the New Year (and prior to the implementation of the new tax code) in order to take advantage of the old tax deductions.

“Because of how hastily this tax reform legislation was created and passed, even its authors cannot fully explain all of the many ways it will hurt millions of hardworking Americans. … One way Washingtonians can get the highest deduction possible is to pre-pay property taxes before the year ends,” Bowser said in a statement Dec. 20.

Homeowners from the affluent northern Virginia suburbs to New York made haste to file taxes prior to the Jan. 1 deadline.

Capping of the mortgage interest deduction has traditionally been a policy position supported by progressives. Economists and progressive tax policy groups have long called for reforms to the mortgage interest deduction, which they say amounts to welfare for the wealthy and economists say inflates the value of homes and does little to incentivize broad homeownership.

In fact, several countries that do not utilize mortgage interest deductions have higher rates of homeownership than the United States.

“The evidence is pretty strong that in its prior form it was clearly a very expensive subsidy that mainly benefited high income homeowners who did not need the help,” says Stockton Williams, executive director of the Urban Land Institute’s Terwilliger Center for Housing. “And it doesn’t seem to a be a significant driver of homeownership.”

The effectiveness of the mortgage interest deduction in inducing homeownership is a mixed bag.

Of the top 20 countries in terms of homeownership rate, 11 don’t offer the benefit to homeowners, according to a recent study. Canada, Great Britain and Australia have higher rates of homeownership without offering the benefits of a mortgage interest deduction.

Homeownership rates are already at a 50-year low, according to the National Association of Realtors. Credit remains tight, limiting access to mortgage loans for new homeowners. In addition, the housing market recovery has been largely limited to luxury condominiums, high-priced homes and high-priced rentals. A dearth of affordable housing, and smaller starter homes has driven up prices for the available housing stock.

The provision protecting the interest deduction for existing mortgages might keep homeowners in their houses longer, but the inability to deduct local and state taxes could trigger a sell-off, says Williams.

“There could be further tightening in some of these high value housing markets.”

What is clear is that cities will have to think of new ways to raise more revenue — or make tough choices to cut spending.

Local property taxes pay for wide range of services, from public safety to parks to schools. Raising fees could help cities make up for lost tax revenue. But those fees are often seen as regressive taxes which land heavier on households on the lower end of the income spectrum.

“The cap on local and state taxes is going to force those communities to make some tough choices,” Williams says.“There’s reason for concern. Localities will have to get more creative in bringing in revenue.”

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