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# Income Tax Concessions for Owner-Occupied Housing

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## *Abstract*

This article considers arguments for and against the major tax concessions for owner-occupied housing in the Internal Revenue Code—concessions that have a significant effect on the federal budget. It recommends retaining two of the concessions—nontaxation of net imputed income and exemption of capital gains—and abolishing two others—the mortgage interest and real estate tax deductions.

After a review of the market impact of removing each deduction, the article concludes that an appropriate phase-out period of 15 to 20 years would virtually eliminate adverse effects on house prices and homeowners.

**Keywords:** Homeownership; Tax policy

## Introduction

For more than a decade, Congress and three successive administrations have tried to balance the budget, simplify the Internal Revenue Code, reduce marginal tax rates, and flatten the rate schedule. Throughout this series of exercises, the favoritism that has been accorded the housing sector through various tax concessions has been left largely untouched. The principal concessions all apply to owner-occupied housing, which currently accounts for about two-thirds of the housing stock.[1]

[1] There are six quantitatively less important housing tax concessions, only one of which applies to owner-occupied housing: exclusion of interest on owner-occupied mortgage subsidy bonds, exclusion of interest on state and local debt for rental housing, deferral of income from post-1987 installment sales, exemption from passive loss rules for $25,000 of rental loss, credit for low-income housing investments, and accelerated depreciation on rental housing. The estimated total tax concession for these privileges for fiscal 1998 is about $13 billion (Office of Management and Budget [OMB] 1997). We reject the argument that certain normally deductible business expenses should be considered tax concessions to landlords and, indirectly, to tenants. Such an argument has been advanced, for example, by Litzenberger and Sosin (1978) and Woodward and Weicher (1989).

The concessions are

1. Nontaxation of net imputed income from owner-occupied homes[2]

2. Nontaxation of the first $250,000 ($500,000 for a married couple) of capital gains on the sale of an owner-occupied home[3]

3. Deductibility of mortgage interest on owner-occupied homes

4. Deductibility of local property taxes on owner-occupied homes

These concessions have a significant impact on the federal budget. It has been estimated that in 1989, nontaxation of imputed income cost the U.S. Treasury $109 billion, or about one-fourth of federal revenues from individual income taxes in that year (Follain, Ling, and McGill 1993; Ling and McGill 1992).[4] Although more recent estimates of this concession have not been published, if this cost rose roughly in proportion to the growth in individual income tax receipts, then it would have been about $145 billion in 1998. For the same year (but prior to the recent tax reform legislation that changed the tax treatment of capital gains), it was estimated that nontaxation and deferral of capital gains on owner-occupied housing deprived the federal Treasury of another $22 billion (Office of Management and Budget [OMB] 1997). Mortgage interest and real estate tax deductions were expected to cost the Treasury $52 billion and $17 billion, respectively.[5] The actual cost of the mortgage interest deduction is likely to be considerably less than OMB's estimate, because eliminating the deduction would increase the cost of and reduce the demand for mortgage debt (see, for example, Follain and Dunsky 1997). Follain and Melamed (1998) estimate that the increase in revenue would be only about one-fourth of the amount

[2] Because the federal government does not tax any type of imputed income, OMB does not treat nontaxation of owner-occupants' imputed rent as a tax expenditure. To avoid confusion, we have chosen to use the term "tax concession" in this article since OMB does not regard nontaxation of imputed income as a tax expenditure and also since the tax expenditure concept itself is a bit fuzzy around the edges. Although not part of the tax base, income from owner-occupied housing is imputed by the U.S. Department of Commerce in estimating gross domestic product.

[3] These provisions were changed in 1997. Previously, the capital gains tax could be deferred indefinitely if the proceeds were used to buy another principal residence. Also, taxpayers over 55 were eligible for a one-time exclusion of up to $125,000.

[4] Follain, Ling, and McGill (1993) point out that the actual savings from taxing net imputed rent would have been less than this estimate because of the general equilibrium effects of the tax change, such as reductions in the quantity of housing consumed by owner-occupants.

[5] The Joint Committee on Taxation (JCT) (1998a) estimated the revenue loss from the mortgage interest deduction to be $43 billion for the same year. Inquiries to OMB and JCT staffs failed to uncover the reason for the difference between these two estimates.

calculated by OMB. Households would likely shift taxable investments into nontaxed housing equity to reduce the use of more costly debt.[6]

Moreover, the concessions are not additive for at least two reasons. First, imposing a tax on net imputed rent logically entails eliminating the concessions for mortgage interest and property taxes. Although both would remain deductible expenses, they would no longer be tax concessions. This means, in effect, that the cost of not taxing imputed income under current tax law also includes the cost of the two deductions. Second, due to the standard deduction, the mortgage interest and property tax deductions are not additive. Taken together, the two deductions make it advantageous for about 45 percent of homeowners to itemize, but if either were to be removed, the value of the remaining one would be reduced or eliminated for many of these homeowners.

Although the concessions are not additive, they are nevertheless equivalent to substantial proportions of expected individual income tax receipts (about $700 billion for 1998). The mortgage interest deduction alone is exceeded by only two of the tax concessions calculated by OMB: exclusion of employer contributions for medical insurance and care at $77 billion and exclusion of employer pension plan contributions and earnings at $56 billion (1997).

The four major concessions are not only quite large, they are extraordinarily generous to individual homeowners. If net imputed income were taxed, then mortgage interest payments and local real estate taxes on the homeowner's income tax return would be deducted when calculating net imputed income. However, since the federal government does not tax imputed income (on owner-occupied housing or any other asset), the deductibility of mortgage interest and real estate taxes simply adds another layer of tax concessions to the nontaxation of imputed income.

For a number of years, various people have argued that eliminating these tax concessions should be done on grounds of simple equity and allocative efficiency.[7] According to this argument, these concessions favor the well-to-do and also cause resources to be allocated to the housing sector that could be used more productively elsewhere in the economy. It has also been argued that, by encouraging families to purchase more housing than they would otherwise, these concessions contribute to urban sprawl (Voith 1999). Perhaps most important, it is argued that they do little to increase the rate of owner-occupancy among the income groups Congress wishes to assist.

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[6] This is consistent with the fact that countries such as Australia, which do not allow the mortgage interest deduction, have much lower average loan-to-value ratios than the United States (Bourassa, Greig, and Troy 1994).

[7] Examples are cited in the detailed discussions of each tax concession.

Despite these arguments, Congress has only nibbled at these concessions.[8] Mortgage interest cannot be deducted on home loan balances in excess of $1 million, a restriction that affects very few taxpayers. Also, to prevent the diversion of the proceeds from mortgage loans into the financing of consumer durables, there is a cap on the amount of interest that can be deducted in connection with mortgage refinancing. This gesture, however, is not aimed at housing but rather at the attempt by some homeowners to circumvent the prohibition of interest deduction on consumer loans. Indicative of the extreme reluctance of Congress and the administration to touch owner-occupied housing itself has been their refusal to eliminate even the tax concessions enjoyed by owners of second homes that are not rented out.

The federal income tax code appears to treat owner-occupied housing as a sacred cow for four reasons: First, it is widely felt that the tax concessions encourage owner-occupancy, a highly valued national priority that has been promoted not only through the tax code, but also through direct subsidies to lower-income households. Second, removing these tax concessions without causing a significant reduction in the market value of owner-occupied homes is thought to be difficult and problematic. Third, some analysts argue that eliminating the concessions would increase rather than reduce distortions in the tax code (e.g., Woodward and Weicher 1989). Finally, several influential housing trade associations are against eliminating the concessions because of concern that such action would adversely affect their members. Whether members of Congress themselves seriously subscribe to these arguments is unclear. They may feel only that an old tax concession is a good tax concession, unless the arguments for eliminating it are especially compelling.

Without endorsing or rejecting the various arguments that have been put forward over the years about the benefits of homeownership, this article explores the question of whether the four major tax concessions for owner-occupied housing are indeed good ones.[9] The article examines difficulties involved in eliminating each of them, as well as some of the

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[8] Indirectly, the value of the tax concessions has been reduced for higher-income taxpayers. Cuts in marginal tax rates in 1981 and 1986 reduced the value of nontaxation of imputed rents and deductible expenses. More recently, however, effective marginal tax rates have increased for higher-income households, but limitations on deductions have made the concessions less valuable for households with incomes above $124,500. In addition, the Alternative Minimum Tax, which has been in effect in its current general form since 1978, removes the deductibility of real estate taxes for higher-income households (JCT 1998c). It does not affect the mortgage interest deduction itself, however, provided the mortgage was used to buy, build, or substantially improve the taxpayer's principal or second home.

[9] Our evaluations of the concessions would, in any case, be unaffected even if we did endorse such arguments.

consequences of their removal on the housing market, the tax system, and the economy. It then suggests ways in which certain of the concessions that are recommended for removal can be eliminated without hurting existing homeowners.

The analysis is divided into eight parts. The next section briefly puts the tax concessions into a historical and international context. The following four sections discuss each of the concessions separately and conclude that both the mortgage interest and real estate tax deductions should be removed. The sixth section discusses the potential adverse impact of their removal on existing homeowners. The seventh section deals with the critical question of how to phase in the removal painlessly for these owners. The final section summarizes our conclusions. The pros and cons of retaining current tax concessions are summarized in table 1.

## Historical and international context

The most important fact about these tax concessions is that their creation was largely accidental (Baer 1975). The mortgage interest and real estate tax deductions became embedded in the first Internal Revenue Code in 1913 without any thought to their effect on housing purchases, and for nearly 30 years they had little effect because tax rates were very low and the proportion of households who paid no tax at all was fairly high.[10] Only with the advent of high tax rates during World War II did their impact on home purchases become significant. They came to be defended as a revered part of the code only after the fact. Also, nontaxation of imputed income from owner-occupied dwellings and taxation of capital gains on home sales were not issues until after the war.[11]

Like the United States, most developed countries give favored status to owner-occupied housing. However, 10 Organisation for Economic Cooperation and Development (OECD) countries—Belgium, Denmark, France, Greece, Italy, Luxembourg, The Netherlands, Norway, Spain, and Switzerland—currently tax at least some imputed income. Five other countries—Austria, Finland, Germany, Sweden, and the United Kingdom—have imposed such a tax in recent decades (Ministry of Housing, Physical Planning, and the Environment, The Netherlands

[10] The deductions first appeared as part of the income tax legislation passed to finance the Civil War (Baer 1975).

[11] The exclusion of owner-occupants' imputed income from taxation was, however, mentioned explicitly in the legislation to finance the Civil War (Baer 1975).

*Table 1.* **Pros and Cons of Retaining Current Tax Concessions**

| Concession | Pros | Cons | Overall Assessment |
| --- | --- | --- | --- |
| Nontaxation of imputed net income | A tax on wealth would effectively be created<br>Problems would arise with setting a single tax rate due to variations in rates of return across space and time<br>Assessment standards vary across jurisdictions<br>Additional complexity of the tax system would be onerous | Inefficiencies in allocation of capital investments result | Pros outweigh cons: Administrative infeasibility of accurately taxing net imputed income makes it undesirable |
| Nontaxation of capital gains | Much of the nominal gain is due to general inflation<br>If gains are taxed, then losses should be deductible, thus reducing revenues<br>Additional complexity of the tax system would be onerous | Inefficiencies in allocation of capital investments may result | Pros outweigh cons: Efficiency gains do not appear to justify high administrative costs and small revenue gains |
| Mortgage interest deduction | The homeownership rate rises<br>The amount of housing constructed increases, thus preventing a housing shortage<br>The capital value of existing homes is maintained | At best, it has only a marginal impact on the rate of homeownership (and may benefit only those who would become homeowners anyway, but at a later date)<br>It is unlikely to have a big impact on the number of new starts<br>Capital values could be protected by phasing in tax reform<br>Higher-income households receive undue benefits<br>Renters are treated inequitably<br>It complicates the tax system unnecessarily<br>It encourages urban sprawl | Cons outweigh pros: Benefits of the deduction are negligible |
| Real estate tax deduction | The real estate tax is analogous to a very high sales tax, which calls for offsetting treatment in the federal tax code<br>It is often unrelated to ability to pay<br>It is imperfectly assessed<br>It is regressive with respect to household income | Housing deductions are themselves regressive, meaning that they do not offset the regressivity of the real estate tax<br>The real estate tax deduction would become more regressive after the mortgage interest deduction is eliminated | Cons outweigh pros: Benefits of the deduction appear to be the opposite of what is intended |

1992; Robinson 1988; Scholten 1999; Werczberger 1997).[12] Most of these countries—plus Japan, Portugal, Turkey, and the United States—allow deduction of mortgage interest payments. Only two OECD members—The Netherlands and Sweden—tax capital gains. Australia, Canada, and New Zealand do not allow mortgage interest or real estate tax deductions. Nor, however, do they tax capital gains or imputed rent.

## Nontaxation of net imputed income from owner-occupied housing

As already noted, nontaxation of net imputed income is the single largest tax concession for owner-occupants. Using time series data, Rosen and Rosen (1980) concluded that about one-quarter (four percentage points) of the post–World War II growth in the homeownership rate was due to this tax concession combined with the concessions for mortgage interest and property taxes. Using cross-sectional data for 1970, Rosen (1979) reports a similar percentage. Subsequent estimates of the impact of the tax deductions by Rosen (1989) suggest that nontaxation of net imputed rent probably accounts for at least two percentage points of the homeownership rate.

The nontaxation of imputed income on owner-occupied homes was originally criticized on grounds of simple fairness (e.g., Goode 1960; White and White 1965). A family that invests $10,000 in a savings bond, for example, is taxed on the interest earned. An identical family that invests the same amount in a home is not taxed, even though the home also yields a return, albeit one that cannot be precisely measured.

The nontaxation of net imputed rent is usually criticized on the grounds of allocative inefficiency. Nontaxation lowers the cost of investing in owner-occupied housing below the cost of investing in other forms of physical capital, causing the economy to invest too much in housing and not enough in other productive sectors, such as plant and machinery (Aaron 1970; Hendershott 1987; Ott and Ott 1973). One solution to this problem would be to liberalize the tax treatment of income from investment in nonhousing capital (Hendershott and Hu 1980). Another more often recommended solution, and one that would also increase equity and allocative efficiency across income and tenure groups, is to tax investment returns on owner-occupied housing. For

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[12] Wisconsin taxed imputed rental income from owner-occupied housing between 1911 and 1917 (Goode 1960). Australia may have been the first country to tax net imputed rent. The tax was created in 1915 when the federal income tax was introduced, but it was abolished eight years later, in part because it appeared to discourage homeownership (Reece 1975).

example, Nobel laureate economist William Vickrey, in his 1993 presidential address to the American Economic Association, argued for

> the inclusion in taxable income of the rental value of owner-occupied residences. This would not only improve the equity and progressivity of the income tax but also go a substantial way toward making more units available for rental and, to a modest extent, promoting the construction of additional affordable rental housing and abating the problem of homelessness. (4)[13]

Congress has consistently ignored these recommendations, and perhaps for good reason. Proposals to bring the taxation of owner-occupied housing into line with the taxation of other forms of capital investment run into four major difficulties. The first is inherent in the concept of imputed income. Because there is no measurable money income stream to serve as the tax base, rental income must be calculated from an estimated market value and an assumed gross rental rate of return for each property.[14] The tax, therefore, is really a levy on wealth, even though gross rent is adjusted downward to reflect occupancy costs, financing expenses, and depreciation. Indeed, any tax on imputed income could be considered a tax on wealth, and vice versa. Except in the case of estate taxes, the federal government does not tax wealth, because that is a state and local prerogative in the present federal system.

The second difficulty is that the tax bears little relationship to capacity to pay, weighing most heavily on lower-income, elderly homeowners, the group for which most state governments now provide some form of property tax relief for this very reason.[15] Substantial exclusions would be required to protect retired homeowners from being taxed out of their own homes.[16] Such exclusions would blunt the efficiency gains and reduce tax revenues.

[13] For other examples, see Goode (1960), Laidler (1969), and Simons (1938).

[14] This exercise is made more difficult by the fact that there is no active single-family rental market in the middle and upper price ranges that could provide comparative data on prices and rents.

[15] This also appears to be the primary reason that Follain, Ling, and McGill (1993) found that taxation of net imputed rent, accompanied by elimination of mortgage interest and property tax concessions, would have a disproportionately adverse impact on lower-income households (Crowe 1993).

[16] In a study of the impact of a hypothetical tax on net imputed rent proposed for Australia, Bourassa and Hendershott (1994) recommended exempting retired households or taxing them at a reduced rate. For working-age households, the proposed tax was found to be progressive when net imputed rent was included in household income. Because net imputed rent is not cash income, the finding of progressivity did not imply anything about ability to pay.

A third set of difficulties relates to the fact that both current and long-term net rates of real return vary substantially from one property to another, depending on location and time of purchase. This variation makes it grossly inaccurate to apply a single imputed rate of return across all properties. For example, properties in a depressed inner-city neighborhood may experience declining values and high rental returns relative to values, while properties in a more prosperous neighborhood or city may have rapidly appreciating values and low rental returns relative to values. To assume a constant rate of net rental return across properties would ignore the wide disparity in rates of appreciation or depreciation.

A final difficulty in trying to tax imputed income is administrative. The Internal Revenue Service (IRS) does not have the resources to treat homeowners as landlords and process 65 million Schedule C income and expense statements. To tax imputed income, some sort of simplification would be necessary. In the OECD countries that tax imputed income, the taxable rent is set at a specified fraction of the dwelling's assessed value minus mortgage interest payments and (in two of the countries) imputed maintenance (Scholten 1999). For all practical purposes, even this streamlined approach is too cumbersome to adopt here. The large number of local property-taxing jurisdictions in the United States, with their wide range of valuation standards and methods, makes it extremely difficult and expensive to develop a common basis for assessment across jurisdictions. The federal government would have to create a large tax equalization facility or rely on taxpayers to accurately report the market value of their homes. Neither approach seems feasible.

## Nontaxation of capital gains

If the investment returns that homeowners earn on the equity in their homes cannot feasibly be taxed, then surely, one might argue, the capital gains these owners receive should be taxed. The taxation of capital gains, however, also raises difficult policy and administrative issues. Three are especially important. First, a large part of the capital gain on a particular home sale, or for that matter any asset, may be due to general inflation and hence be fictitious.

Second, contrary to what is popularly believed, in the absence of modernization, a large proportion of the owner-occupied stock depreciates over time. If capital gains from home sales are taxed, capital losses should also be deductible. If that were the case, the net revenue that would accrue to the Treasury from taxing capital gains from home sales would be considerably less than the figure the OMB currently estimates would be received.

Third, an accurate accounting of capital gains and losses requires accurate records of improvement expenditures by owner-occupants and careful auditing by the IRS. If all of the 4 to 5 million homeowners who sell their homes each year reported their capital gains and losses, the burden on them and on the IRS would be unacceptably large.

In exempting all but very large capital gains from taxation, Congress has probably resolved these issues as satisfactorily as possible.

## Deductibility of mortgage interest

Since the Internal Revenue Code does not treat homeowners as their own landlords and require them to report imputed rental income, logic would seem to dictate that the code also should not allow homeowners to take deductions from this unreported income (Goode 1960). Yet, despite a continuous stream of analyses calling for its elimination, the mortgage interest deduction survives. Defenders argue that (1) it increases the rate of homeownership, helping families achieve an essential element of the American dream (e.g., Tretzger 1998); (2) it increases the volume of housing constructed, enabling the home building industry to accommodate an expanding population without recourse to direct subsidies;[17] and (3) eliminating it would seriously depress house values, causing unfair capital losses to homeowners whose purchase decisions were based in part on the availability of the deduction (e.g., Capozza, Green, and Hendershott 1997). Opponents dispute these arguments and argue further that the deduction (1) provides undue benefits to higher-income households at the expense of lower-income households (e.g., Baer 1975; Dreier 1997; Pierce 1989), (2) unfairly favors homeowners over renters (e.g., Goode 1960; White and White 1977), and (3) causes excessive consumption of housing because it increases housing expenditures among higher-income groups that do not need any subsidy to acquire adequate accommodation (e.g., Baer 1975; Hendershott and Hu 1981). We will examine five of these points of contention in this section, saving the question of potential capital losses for the section on market impact of tax reform.

### *Impact on the rate of homeownership*

The primary purpose of the mortgage interest deduction is allegedly to increase the homeownership rate. Through owner-occupancy, families are presumably able to acquire better housing, increased finan-

[17] For example, the National Association of Home Builders has lobbied Congress to preserve the mortgage interest deduction, evidently because of its perceived impact on housing starts (see Downey 1989).

cial security, higher social status, a greater stake in society, and more control over and satisfaction with their living environments. The deduction does not appear, however, to have had a significant impact on the country's overall rate of homeownership.

A weak measure of possible impact is provided by a comparison with Canada and Australia, two countries that are strikingly similar to the United States except for their much smaller populations. Although both of these countries provide less favorable tax treatment for homeownership than the United States, they have similar rates of owner-occupancy.[18] Rosen (1989) has provided a more rigorously derived estimate. According to his calculations, without the mortgage interest deduction, the homeownership rate in the United States in 1988 would have been about 62 percent instead of the 63.7 percent actually obtained in that year. One cannot, unfortunately, tell from such a comparison whether eliminating the deduction would have locked most of the affected families permanently in the rental market or only postponed their purchase for a few years. Accelerated purchases raise the rate of homeownership without reducing the proportion of households that will never become owner-occupants.[19] Also, we simply do not know enough about the characteristics and tenure considerations of potential itemizers at the margins between owning and renting to determine who is influenced by the mortgage interest deduction. We suspect, however, that only a tiny fraction of potential home buyers get to the point of making a pro forma tax calculation on Form 1040 to decide whether to buy or not.

Even more troubling than the questionable impact of the mortgage interest deduction on the overall rate of owner-occupancy is the fact that low- and moderate-income families, which Congress wants to help become homeowners, benefit least from the deduction. Fully 90 percent of the benefit goes to homeowners with incomes over $50,000 a year (table 2, line 4b) because most low- and moderate-income homeowners find that taking the standard deduction is more advantageous than itemizing expenses. Whereas over 85 percent of homeowners earning more than $75,000 a year itemize, less than one-sixth of those earning under $30,000 do so (table 2, line 3). If the standard deduction were raised, as is often suggested, even fewer low- and moderate-income

[18] The ownership rates for 1996 were 69.8 percent in Australia, 64.0 percent in Canada, and 65.4 percent in the United States (Australian Bureau of Statistics 1999; Statistics Canada 1999; U.S. Bureau of the Census 1998).

[19] Bourassa et al. (1994) concluded that removing Australia's substantial subsidies to first-time home buyers in 1990 merely delayed the time to first ownership by two years. Heavy subsidies to households that would soon become homeowners in any case are not justified by the resulting small gains in aggregate homeownership rates.

*Table 2.* **Benefits from the Mortgage Interest Deduction by Income Category, 1998**[a]

| | Under $20,000 | $20,000–$29,999 | $30,000–$39,999 | $40,000–$49,999 | $50,000–$74,999 | $75,000–$99,999 | $100,000–$199,999 | $200,000+ |
|---|---|---|---|---|---|---|---|---|
| 1. a. Taxable returns, owners and renters (thousands) | 9,915 | 12,446 | 12,860 | 11,269 | 19,167 | 9,976 | 8,367 | 2,125 |
| b. Percentage of total returns | 12 | 14 | 15 | 13 | 22 | 12 | 10 | 2 |
| 2. a. Mortgage interest itemizers (thousands) | 359 | 1,134 | 2,375 | 3,080 | 8,201 | 6,358 | 6,306 | 1,554 |
| b. Percentage of returns within income group (line 2a divided by line 1a) | 4 | 9 | 18 | 27 | 43 | 64 | 75 | 73 |
| 3. Percentage of owner-occupants who itemize | 3 | 16 | 34 | 45 | 67 | 86[b] | 86[b] | 86[b] |
| 4. a. Mortgage interest tax concessions (millions of $) | 131 | 466 | 1,238 | 2,270 | 7,667 | 10,029 | 15,739 | 9,438 |
| b. Percentage of total mortgage interest tax concessions | 0.3 | 1.0 | 2.6 | 4.8 | 16.3 | 21.4 | 33.5 | 20.1 |
| 5. a. Tax liability, all taxable returns (millions of $) | −11,587 | 14,101 | 29,025 | 38,022 | 99,413 | 94,567 | 164,726 | 272,265 |
| b. Percentage of total taxes paid | −1.6 | 2.0 | 4.1 | 5.4 | 14.2 | 13.5 | 23.5 | 38.9 |
| 6. Average tax liability for all taxable returns (line 5a divided by line 1a, $) | −1,169 | 1,133 | 2,257 | 3,374 | 5,187 | 9,480 | 19,688 | 128,125 |
| 7. Average tax liability if mortgage interest tax concession is abolished ($) | −1,155 | 1,170 | 1,965 | 3,573 | 5,587 | 10,485 | 21,570 | 132,567 |
| 8. a. Average mortgage interest tax concession for itemizers (line 4a divided by line 2a, $) | 365 | 410 | 521 | 737 | 935 | 1,577 | 2,496 | 6,073 |
| b. As a percentage of average tax liability[c] | — | 35.0 | 26.5 | 20.6 | 16.7 | 14.6 | 11.6 | 4.6 |

*Source:* JCT (1998a) and authors' calculations.

[a] The JCT defines income categories according to adjusted gross income plus tax-favored income excluded from the adjusted gross income.

[b] The average across the highest three categories is listed.

[c] This figure is based on the assumption that within income groups, average tax liability for itemizers and nonitemizers would have been the same in the absence of the mortgage deduction.

taxpayers would itemize, and the mortgage interest deduction would become even more a benefit targeted at upper-income families.[20]

The small proportion of lower-income owner-occupants who itemize receive substantial tax benefits from the mortgage interest deduction. For owners with annual incomes under $30,000, the deduction lowers their federal income tax liability by 35 percent (table 2, line 8b). The conjunction of a relatively small proportion of itemizers in this income group and relatively large tax benefits for those who itemize may seem incongruous. One would think that the large benefits to the few would be sought after by the many. No doubt, however, most of these itemizers have either temporarily low incomes or temporarily large medical deductions in combination with other deductions.

Regardless of how these data are interpreted, it does seem likely that because homeownership has become so much a part of the American dream, the mortgage interest deduction has had only a marginal impact on tenure choice overall. The deduction is too poorly targeted to achieve its objective.

### *Impact on the volume of new housing construction*

For the past half-century, federal policy toward the residential construction industry has been influenced by the belief that because the price of new housing is beyond the reach of such a large segment of the population, home builders are unable to sell enough unsubsidized dwelling units each year to accommodate household growth (Grigsby and Baratz 1986). Many housing subsidies over the years, including the mortgage interest deduction, have been justified in part on this assumption. In this connection, it is worth noting that over the past three decades, there has been a substantial increase in vacancies in the low-rent sector of the market in most metropolitan areas, suggesting that while the subsidies may have improved housing quality, all of them may not have been needed. Also, a portion of the assisted housing starts simply substituted for homes that would have been built anyway had the subsidies not been in place.

With respect to the question of whether the mortgage interest deduction acts as a stimulus to home building, it is clear that to the extent that the deduction is not capitalized into home values—a possibility to be discussed later in the article—it enables itemizers to buy more expensive housing than would otherwise be possible. The deduction

[20] Follain and Ling (1991) point out that the Tax Reform Act of 1986 reduced the value of the mortgage interest deduction for many low- and moderate-income households by increasing the standard deduction and by making certain formerly deductible expenses nondeductible.

has the potential, therefore, of moving a certain number of buyers upward from the market for inexpensive used homes into the market for slightly more expensive, but still modestly priced, new units.

The size of this group, hence the potential impact of the deduction on the volume of new construction, varies across market areas, depending on the affordability of the least expensive newly constructed homes in these markets. If the minimum-price new home in a particular market is already affordable to moderate-income families taking the standard deduction, then eliminating the mortgage deduction would have little, if any, effect on the amount of new construction. There would be modest price and cost adjustments on the supply side of the market and, perhaps, spending adjustments among a few families on the demand side without affecting the number of units built. This is likely to happen in market areas where home builders are able to reach far enough down the income scale to include families normally taking the standard deduction or those whose itemized deductions exceed the standard deduction by only a small amount. In a few market areas, however, where housing is quite expensive and new housing is apparently out of reach for a large majority of households, eliminating the deduction might have an adverse effect on the volume of housing starts. Whether the number of starts would drop enough to create a housing shortage, however defined, is a question that requires more study.

### *Undue benefits to higher-income households*

The mortgage interest deduction is widely criticized because it reduces the progressivity of the federal income tax. For example, a family with a taxable income of $40,000 and a marginal tax rate of 15 percent would receive only $1,500 in tax benefits from mortgage interest payments of $10,000 (assuming for the purpose of simplicity, no standard deduction), while a family with a taxable income of $60,000 and a marginal tax rate of 28 percent would gain $2,800 in benefits from the same deduction. The regressivity is made more pronounced by the standard deduction, which, as discussed earlier, makes it disadvantageous for most low- and moderate-income homeowners to itemize their interest expenses (table 2, line 3).

It is interesting to note that the $200,000+ income group contributes proportionately much more in taxes than it receives in concessions.[21]

[21] This is undoubtedly due to the limitations on deductions applicable to higher-income households. The JCT (1998b) estimated that 4.5 million households would be affected by the limitation in 1998, including 95 percent of households with incomes above $200,000 (defined by the JCT to include adjusted gross income plus tax-favored income excluded from adjusted gross income). Only about a third of households with incomes between $100,000 and $200,000 and a negligible number of households with lower incomes would be affected.

Households in the highest income group receive only about 20 percent of the mortgage interest tax concessions, even though they account for almost 40 percent of taxes paid.

Contrary to popular opinion, then, the mortgage interest deduction is almost entirely a tax concession from the wealthy ($200,000+) to the well-to-do ($50,000 to $200,000) and from well-to-do nonitemizers to well-to-do itemizers. Low- and moderate-income homeowners (below $50,000) are, on average, only slightly worse off because of the deductions, and it is likely that many of the nonitemizing homeowners in this income group benefited from the deductions when their mortgage loans were larger.

On balance, the very modest regressivity of the mortgage interest deduction does not by itself warrant eliminating it, especially given the fact that, even with this tax concession in place, the overall tax structure remains progressive. Since, however, the deduction contributes only marginally, at best, to achieving its primary alleged objective—an increase in the rate of homeownership among households that could not otherwise afford to become homeowners—its regressivity adds still another reason for eliminating it.

Some researchers have emphasized the fact that mortgage interest deductibility achieves neutrality between debt and equity financing of owner-occupied housing (Bourassa and Hendershott 1992; Ling and McGill 1992; Woodward and Weicher 1989). Even so, providing well-to-do homeowners with large tax concessions is a clumsy way to achieve this small gain in efficiency.

### *Inequity to renters*

Since renters cannot take the mortgage interest deduction at all, they appear to be even more disadvantaged by the Internal Revenue Code than lower-income owner-occupants. However, comparisons across tenure involve a different set of considerations, and we must look at the treatment of renters separately. The question is perhaps most appropriately phrased as follows: To the extent that tax deductions confer benefits on the owner-occupancy market, are the beneficiary homeowners favored over renters, or are there circumstances that might make renters either more or less disadvantaged?

The short answer to this question is that inequities do exist but not nearly to the degree assumed. If households are unrestricted in their tenure choice, they are obviously not penalized, in the strict sense of the word, if they choose to rent. For a variety of reasons, however, some households are confined, as it were, to the rental sector. For example, they may require only two or three rooms, and nothing that small is

available in the owner-occupancy market in their community. Or they must live in a location where few or no single-family homes are available in their price range. Or they change residence so frequently that the annualized costs associated with purchase and sale are excessive. Or they are barred from owner-occupancy by unnecessarily conservative mortgage lending practices. In all of these situations, renters cannot compete for housing of as high quality as would be within their reach if the benefits of tax concessions in the rental and owner-occupancy markets were more or less equal.

To the degree that tax concessions increase housing starts, renters may benefit indirectly, but the horizontal inequity relative to owner-occupants remains. Still, for several reasons, the extent of the inequity may be less than it seems. As explained later, some of the concessions to owner-occupants are capitalized into house prices, meaning that landowners and developers receive part of the benefit.[22] Also, a large percentage of current renters have been or will be owners at some point during their lifetime, so any tax inequity they now suffer as renters will be partially or fully offset by their favored position later when they are owners. In addition, many renters do not pay income taxes, so they cannot be said to be treated inequitably in the Internal Revenue Code with respect to households that do pay taxes. Moreover, most renters (as is already true of a majority of homeowners) would not itemize deductions on their tax returns, even if they did become owner-occupants. Further, the rise of condominiums has made small dwellings more broadly available for owner-occupancy. And as already suggested, some renters have incomes high enough to suggest that they have ample freedom to choose the tenure status they wish. Finally, the tax treatment of investment in rental housing mitigates some of the apparent disadvantage to renters.[23]

### *Excessive consumption of housing*

As noted earlier, analysts have argued that failure to tax imputed income from owner-occupied housing results in overinvestment in and overconsumption of housing, particularly for upper-income households. Because owner-occupied housing is favored by the Internal Revenue Code, it is argued that owners invest too much in housing and not enough in other assets that would be more productive for the U.S. economy. If imputed income were taxed, then mortgage interest would, of course, be deductible. However, given that imputed income is not now

[22] However, White and White (1977) conclude that to the extent that capitalization of benefits occurs in the owner-occupied sector, rents would increase in the rental sector, so that renters are themselves disadvantaged by higher house prices.

[23] See the list of tax concessions in footnote 1.

part of the federal government's tax base and is not likely to become so, the mortgage interest deduction itself is subject to the criticism that it encourages overconsumption of housing, particularly among higher-income households. This is a problem only to the extent that the spending diverted to housing would have contributed to the efficiency and productivity of the U.S. economy. If, instead, the spending would have been mainly on other luxuries, such as imported cars or international vacations, then the misallocation of resources to housing consumption and investment may not matter or may even be desirable.[24]

Recent empirical research by Capozza, Green, and Hendershott (1997) concludes that the basic premise of the overconsumption argument is incorrect. According to their research findings, housing tax concessions do not affect housing consumption and investment at all, because they are fully capitalized into residential land prices. If Capozza and colleagues are correct, then it is also true that housing tax incentives do not produce any of the other benefits or problems attributed to them: that is, increased owner-occupancy, larger volumes of new construction, favoritism to owners over renters, or undue benefits to higher-income households.

However, Sinai (1997), in research critical of the Capozza et al. analysis, concludes that there is a much lower rate of capitalization, on the order of 14 percent. This conclusion seems more plausible. Full capitalization of the housing deductions implies an inelastic long-run supply curve for urban residential land, an argument that both economic theory and urban sprawl call into question. Whether the added consumption that the housing deductions encourage is in some sense excessive is, of course, a value judgment. Since the deductions benefit the income groups least in need of assistance, we find that it is excessive.

On balance, our analysis leads us to the conclusion that the arguments for eliminating the mortgage interest deduction considerably outweigh those in favor of retaining it. Although encouraging homeownership may be desirable, the deduction does little to achieve that goal. Rather, it primarily provides large and unnecessary tax relief to upper-income households. Equally, it does little to increase the number of housing starts, except possibly in a few high-cost market areas. Members of Congress may realize that the mortgage interest deduction is, indeed, a clumsy policy tool, but they may also share the widespread fear that removing it would hurt their home-owning constituents by causing capital losses. To address this concern, we will show later how the deduction can be painlessly removed.

[24] There is also the difficult question, which we will not attempt to address here, of whether conspicuous consumption by the wealthy has a negative impact on those who are less wealthy.

## Deductibility of local real estate taxes

From the perspective of federal tax policy, the deductibility of local real estate taxes, like the deductibility of mortgage interest, should be eliminated. From the perspective of the federal-state-local tax system, however, there are several arguments for retaining the property tax concession as an offset to a not very efficient or equitable local tax system. The first argument has to do with the size of the real estate tax. Although the tax is a small percentage of the value of the home on which it is levied, averaging slightly more than 1 percent across U.S. cities (Ling and McGill 1992), it is quite a large proportion of annual housing expenditures. The real estate tax typically accounts for about 15 percent of a homeowner's annual cash costs for housing.[25] Excluding financing costs, property taxes rise to as much as 40 percent of out-of-pocket expenditures. The property tax is analogous to a very high sales tax and, as such, is thought to repress both housing consumption and housing investment.[26] Because the property tax is so high, most states have enacted various types of tax relief, such as homestead exemptions and tax caps, to lessen its impact on either selected groups of owners or owners as a whole. Deductibility of the tax on income tax returns provides similar relief, but to a more well-to-do group of households.

The second problem with the local real estate tax is that it is imperfectly related to income and, therefore, often does not reflect ability to pay. This is an especially serious problem for elderly homeowners and is one of the reasons for the tax caps just mentioned.

A third problem relates to tax administration. In many communities, real estate assessment practices are so poor that the taxes homeowners pay do not accurately reflect the value of their properties. Although improvements in local assessment procedures have begun to ameliorate this problem, it is still widespread.

The final problem has to do with the regressivity of the local real estate tax. Data reported by Ling and McGill (1992), based on the 1989 American Housing Survey, indicate that property taxes averaged across the United States are regressive (table 3).[27] Deductibility of property taxes

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[25] This is based on median housing costs from the 1989 American Housing Survey (U.S. Department of Commerce and U.S. Department of Housing and Urban Development 1991, table 3–13). Netzer (1966, table 2–8) reported a figure of 17 percent, based on the 1960 Census of Housing.

[26] Some analysts see the tax simply as a payment for local public services, but more than 50 percent of the tax in a large proportion of communities funds public education, although most households do not have school-age children. The cost of housing is expensive in part because public education is expensive.

[27] As table 3 shows, however, the taxes are progressive with respect to owners' equity.

*Table 3.* **Regressivity of the Real Estate Tax, 1989**

| Adjusted Gross Income Range ($) | Average Adjusted Gross Income ($) | House Value ($) | Average Equity ($) | Average Tax ($) | Tax as a Percent of Adjusted Gross Income | Tax as a Percent of Equity |
|---|---|---|---|---|---|---|
| 0–5,000 | 1,575 | 60,876 | 51,927 | 593 | 37.7 | 1.1 |
| 5,000–10,000 | 7,598 | 66,839 | 56,679 | 682 | 9.0 | 1.2 |
| 10,000–15,000 | 12,826 | 66,790 | 52,029 | 711 | 5.5 | 1.4 |
| 15,000–20,000 | 18,235 | 74,435 | 57,538 | 820 | 4.5 | 1.4 |
| 20,000–25,000 | 23,163 | 72,261 | 48,054 | 802 | 3.5 | 1.7 |
| 25,000–30,000 | 27,788 | 76,244 | 43,688 | 842 | 3.0 | 1.9 |
| 30,000–35,000 | 32,927 | 78,089 | 45,760 | 868 | 2.6 | 1.9 |
| 35,000–40,000 | 38,023 | 90,650 | 53,846 | 967 | 2.5 | 1.8 |
| 40,000–45,000 | 42,822 | 99,175 | 55,736 | 1,112 | 2.6 | 2.0 |
| 45,000–50,000 | 48,017 | 107,776 | 61,648 | 1,156 | 2.4 | 1.9 |
| 50,000–60,000 | 55,283 | 115,110 | 64,116 | 1,260 | 2.3 | 2.0 |
| 60,000–75,000 | 67,130 | 128,633 | 76,923 | 1,414 | 2.1 | 1.8 |
| 75,000–100,000 | 87,398 | 170,067 | 101,020 | 1,991 | 2.3 | 2.0 |
| 100,000–120,000 | 108,486 | 196,363 | 109,178 | 2,435 | 2.2 | 2.2 |
| 120,000+ | 152,856 | 260,522 | 131,824 | 3,081 | 2.0 | 2.3 |
| All | 35,855 | 94,675 | 63,622 | 1,042 | 2.9 | 1.6 |

*Source:* Derived from Ling and McGill (1992), table 1.

could, in theory, help offset this regressivity, but as discussed earlier, the regressivity of the housing deductions themselves means that this does not happen in practice.

Although, collectively, the reasons for leaving the deductibility of local real estate taxes intact seem compelling, they are not. The deductions do nothing to offset the inequities just described. Moreover, if the deductibility of mortgage interest is eliminated, then the number of households finding it to their advantage to itemize deductions would drop dramatically to a very low level, and the few households that continued to deduct real estate taxes would be those with high nonhousing deductions and high incomes. An already regressive real estate tax deduction would become more regressive.

## Market impact of removing mortgage interest and real estate tax deductions

If Congress removed the mortgage interest and real estate tax deductions for owner-occupied housing, existing owner-occupants with outstanding mortgage loans could and, in our view, should be held harmless with respect to these deductions. Even with this protection, however, many homeowners would be adversely affected if the deductions were eliminated overnight rather than phased out gradually.

Buyers could no longer afford homes as expensive as those they had previously been able to purchase and would move down-market, leaving an overhang of used housing in the upper reaches of the market. Even if home building in the higher price ranges stopped immediately, the overhang would persist, as homeowners had to move for one reason or another in the normal course of events. While the price declines would encourage some buyers to spend more for housing than they would have otherwise, the net effect in the short run would still be a drop in home values.

Various analysts have estimated that these capital losses might range from 10 to 20 percent or more, depending on market conditions and other factors (Brimer, Lasky, and Wyss 1995; Buchanan 1996; Capozza, Green, and Hendershott 1996, 1997; Cecchetti and Rupert 1996). The estimated reductions are greatest in high-price cities, with losses of more than 15 percent in Boston due to elimination of the property tax deduction and of over 20 percent in Honolulu, San Francisco, and San Jose (CA) due to elimination of the mortgage interest deduction (Capozza, Green, and Hendershott 1997). Even though, as argued earlier, it seems unlikely that the deductions would be fully capitalized into home values over the long term, these percentages may be reasonable estimates of the probable average impact on house prices in various metropolitan areas in the short run. Follain and Melamed (1998) suggest, however, that "a substantial portion of the impact will be absorbed by the mortgage market because of portfolio reshuffling on the part of households, especially higher-income households" (197).

The amount of these price declines would be different in different segments of local housing markets, depending on the proportion of buyers in a particular submarket who had previously been able to take advantage of the deductions. Prices at the top end would drop the most, because despite portfolio reshuffling, most households in this price range would opt for less housing, resulting in a general shift in demand from higher-price to somewhat lower-price homes. Demand for homes in the middle price ranges would stay approximately the same, as buyers who were forced to shift downward and into these markets replace other buyers who had to shift into less expensive sectors. Prices at the bottom of the value spectrum would increase, as households already in this market would be joined by those moving downward from the more expensive sectors.

Perhaps the most important point to emphasize is the fact that the potential adverse impacts under any scenario could be avoided by an appropriate phase-out procedure. We describe such a procedure in the next section.

## Phasing out the income tax deductions

Proposals to abolish or limit the mortgage interest and real estate tax deductions are always met with strong opposition on the grounds that existing homeowners would suffer the huge capital losses just described. Phasing in the tax reform over a period of 15 to 20 years should, however, make this transition almost painless. All that is necessary is fixing a date after which no more deductions are allowed. If the cutoff date were, say, January 1, 2021, for all buyers who purchase after December 31, 2000, then buyers in 2001 would get 20 years of deductions, buyers in 2002 would get 19 years of deductions, and so on. Households buying before January 1, 2001, would be allowed to deduct mortgage interest and real estate taxes until their original mortgage loans were paid off. If the deductions were phased out slowly in this fashion, there would be virtually no adverse effect on demand for, or capital values of, expensive homes in the existing stock. On the supply side, as home builders reduced the amount of expensive construction during the phase-out period, home sellers in this price bracket would face less competition from the new construction market. On the demand side, the gradual reduction in demand for expensive homes caused by phasing out the deductions would be offset by a corresponding gradual increase in demand due to income and population growth.

At the lower end of the market, home builders would gradually increase construction of less expensive housing in response to the shift in demand. If, however, it seemed necessary at some point to stimulate demand in this sector of the market, various subsidy methods could be used to do so.

## Conclusions

In this article, we have reviewed the four main tax concessions for owner-occupied housing: nontaxation of net imputed income, exemption of most capital gains, deductibility of mortgage interest, and deductibility of real estate taxes. We conclude that the first two concessions should remain and that the last two should be abolished. As a package, these four recommendations are precisely the opposite of what good tax policy would seem to demand: that imputed rental income and real capital gains should be taxed and that mortgage interest and property taxes should be allowable deductions. But both conceptual and administrative problems argue against taxing imputed income and capital gains, and if the IRS leaves these two concessions untouched, the justification for retaining the mortgage interest and property tax deductions largely evaporates. A major source of resistance to eliminating these deductions is the belief that doing so would bring about significant declines in the market value of most existing

owner-occupied homes. Phasing out the deductions over a period of 15 to 20 years, however, would prevent capital losses from occurring.

Some analysts have proposed that the savings from eliminating the two deductions be reallocated to promote homeownership programs for low- and moderate-income households. For example, in a recent review of U.S. housing policy, Dreier (1997) recommended replacing the mortgage interest deduction with a $50 billion progressive homeownership tax credit. Even more recently, Green and Vandell (1999) recommended a revenue-neutral replacement of the mortgage interest and property tax deductions with a fixed tax credit available to all homeowners.[28] They estimated that the homeownership rate would increase by three to five percentage points and even more in lower-income categories. Because the tax credits would be unaffected by the standard deduction (and, in Dreier's proposal, they would be progressive), this approach would be much better targeted than the mortgage interest deduction. While we agree with this conclusion, the question of whether redirecting the mortgage interest deduction in this fashion would be the most appropriate way of providing homeownership assistance for the groups Congress wishes to help goes well beyond the scope of this article, particularly since our proposed phase-out period, if adopted, would leave the present structure of deductions relatively unchanged for a considerable length of time.

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[28] Follain, Ling, and McGill (1993) also recommend a tax credit.

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