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Comment on Steven C. Bourassa and William G. Grigsby's "Income Tax Concessions for Owner-Occupied Housing"

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Abstract

Federal income tax deductions for mortgage interest and property taxes are defensible on grounds of both economic efficiency and the social benefits of homeownership. Homeowners should be treated as landlords renting to themselves; as such, they benefit because they do not pay a tax on the imputed rental income they receive, while rental property owners do. Both receive deductions for mortgage interest and property taxes, and both should.

The mortgage interest deduction generates symmetry between debt and equity financing of a home; if interest were not deductible, those whose income derives largely from property would have an advantage over those whose income comes from labor. Because workers would be disadvantaged, repeal is unlikely to generate the revenues Bourassa and Grigsby expect or modify the distribution of the tax burden in the way they favor. Finally, the deductions promote homeownership, which is socially desirable.

Keywords: Homeownership; Tax policy

Federal income tax deductions for mortgage interest and property taxes have been widely criticized by economists and other analysts for many years. Bourassa and Grigsby's argument is part of this literature. My own judgment is that they are "goring the wrong ox," to borrow the title of a paper on this subject I coauthored with Susan E. Woodward (Woodward and Weicher 1989).[1] The deductions are defensible partly on grounds of economic efficiency and partly on the basis of the social benefits of homeownership.

For some time, economists have recognized that homeowners should be treated as landlords renting to themselves, and this is the best place to start. The tax treatments of mortgage interest and property taxes need to be considered within such a framework. There are numerous differences in the tax treatment of homeowners and rental property owners, the most important being the treatment of rental income, real or imputed. Mortgage interest and property taxes are treated similarly; they are perhaps the only items that are. This analysis suggests the desirability of a tax on the imputed rental income of homeowners, but

[1] Because this comment draws in part on Woodward and Weicher (1989), it is important to make it clear that I am speaking here only for myself, even though I occasionally quote from the coauthored article.

there are problems with such a tax on the grounds of economic efficiency, in addition to the widely recognized administrative difficulties.

Both deductions raise other issues of efficiency and equity. The local property tax can be analyzed as a tax on the imputed net rental income of owner-occupied housing; in that context, its treatment at both the state and federal levels is relevant. The mortgage interest deduction generates symmetry between debt and equity financing of a home purchase, which is not a "small gain in efficiency" (535), as Bourassa and Grigsby term it. In my judgment, the deductions do promote homeownership, which is socially desirable.

I ignore the transitional problems that would arise if the deductions were repealed. Bourassa and Grigsby devote quite a bit of attention to the issue, as have some defenders of the deductions (e.g., Slitor 1976).

Homeownership versus renting: The analytical framework

By and large, rental property owners are treated like other business owners. They are taxed on their rental income, net of business expenses. Deductible expenses include utilities, repairs, and maintenance, as well as mortgage interest and property taxes.[2] Rental property owners cannot deduct improvements but instead add them to the basis of the property. They can also deduct depreciation but are then taxed on the depreciation when the property is sold, to the extent that the value is higher than its depreciated basis. They benefit in a present value sense, taking depreciation earlier and being taxed on it later. In addition, depreciation is taxed as a capital gain when the property is sold, so that owners receive a larger tax deduction when depreciation is claimed and pay less when it is recaptured.[3] Rental owners are subject to capital gains tax when they sell their property, unless they buy another rental property meeting specific, rather complicated conditions with respect to value and use within six months.

Homeowners are not taxed on rental income and cannot depreciate utilities, repairs, or maintenance. Nor can they deduct depreciation. As is the case with rental property, improvements can be added to the basis, but few homeowners are now subject to capital gains when they sell a home, and not many were before the most recent change in the tax law in 1997.

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[2] This discussion ignores the passive loss rule, which limits the tax benefits of rental losses.

[3] This statement applies to rental real estate purchased after passage of the 1986 Tax Reform Act, the relevant situation if the deductions were repealed. The capital gain is taxed partly at 25 percent and partly at 20 percent.

Thus, the difference in the tax treatment of homeownership and investment in rental property is that homeowners pay no tax on imputed rental income and cannot deduct many operating expenses, while rental property owners are taxed on imputed rental income but can deduct all operating expenses and claim depreciation. In addition, homeowners rarely pay any capital gains tax; many property owners do. (In the remainder of this article, I will put aside capital gains issues.) Homeownership is indeed favored in tax policy, but the favoritism comes from the treatment of imputed net rental income and capital gains, not the deductibility of mortgage interest and property taxes.[4] The common tax preference reporting procedure is asymmetric and misleading. Mortgage interest and property taxes are treated as tax preferences for homeowners but not for rental property owners. They are not preferences for either, but rather are business expenses for both.[5]

Viewed in terms of consumption rather than production, it is quite true that these deductions benefit homeowners directly. It is less often recognized that they benefit renters indirectly as well because the tax system and the rental market affect the relative cost of housing consumption by tenure. Landlords typically have higher marginal tax rates than tenants, because of the progressivity of the federal personal income tax (and most state income taxes). Competitive rental markets force landlords to pass their tax savings on to their tenants. Households facing zero or low marginal tax rates are therefore likely to find lower relative costs in renting as opposed to owning. This point was first made explicitly by Litzenberger and Sosin (1978) vis-à-vis the appropriate tax treatment of homeowners.

On the taxation of imputed rental income

If the major difference in the tax treatment of homeownership and rental property is indeed the exclusion of imputed rental income from homeowners' income, why not tax that income? Bourassa and Grigsby

[4] For a similar argument, see Follain, Ling, and McGill (1993): "Under current law, owners do receive substantial tax savings relative to renters and other investors, but not because of the mortgage interest deduction" (4).

[5] Bourassa and Grigsby reject the contention that mortgage interest (and, apparently, property taxes and operating expenses) should be treated as "tax concessions to landlords and, indirectly, to tenants," rather than as "normally deductible business expenses" (521), a view they attribute to Woodward and Weicher. They appear to be referring to our statement: "For landlords as well as homeowners, interest on a mortgage is deductible. If deductibility is a tax preference for the latter, it should also be one for the former; but it is not reported as such" (Woodward and Weicher, 306). This does not say that mortgage interest should be treated as a tax concession to landlords, but rather that it is a business expense for both landlords and homeowners. The same point applies to the property tax (not discussed by Woodward and Weicher).

mention some important considerations: the administrative burden on the Internal Revenue Service (IRS) and the widely inconsistent valuation procedures across local property-taxing jurisdictions. In addition, homeowners would face a heavy recordkeeping burden for maintenance and repair expenses.

There are other issues as well. The actual income tax paid by rental property owners is likely to be small or nonexistent. Net rental income from rental property is not large as a share of gross rental income. Net rental income can be expressed as

$$Y = R - P - X - D - M \tag{1}$$

where Y is net rental income, R is gross rent, P is the property tax, X is other operating expenses, D is depreciation as permitted by the tax code, and M is mortgage interest. Operating expenses (including property taxes but not mortgage payments) are about 40 to 45 percent of rent, leaving 55 to 60 percent as net operating income. The market rate of return for rental property owners—the capitalization rate, net operating income relative to property value—appears to be in the range of 8 to 11 percent.[6] Depreciation is calculated as a share of property book value excluding land. In a typical year, it is about 3.6 percent of structure costs or 3.3 percent of book value.[7] The relationship between book and market value depends on appreciation since the property was purchased. The 1995 Census Property Owners and Managers Survey indicates that the typical multifamily rental property was purchased about 10 years before the survey; the National Council of Real Estate Investment Fiduciaries apartment value index shows an increase of about 2.4 percent over the past 10 years, so book value and market value would be close for a typical property over that period (but quite different for shorter periods).[8] Using the midpoints of the ranges for operating expenses and market rate of return, depreciation is about 20 percent of the rent:

NOI = $0.095\,V$, where NOI is net operating income and V is property value

NOI = $0.575\,R$

[6] These data are provided by John L. Goodman Jr. of the National Multi Housing Council. The Institute for Real Estate Management (1999, 154–55) reports a median operating expense of 45 to 47 percent, depending on the type of apartment project. Property taxes are about 7 percent of rent. Kang (1999) reports that between 1985 and 1997, capitalization rates on apartments fluctuated between about 8.5 and 9.7 percent. Using the midpoints of these ranges—or the extreme values—would not change the conclusions in the text.

[7] The annual depreciation rate is 3.64 percent on the structure after the first year. Structure is assumed to be 90 percent of property value.

[8] I am indebted to Goodman for these data also.

$$R/V = 0.165$$
$$D = 0.033/0.165\,V = 0.20\,R$$

If there is a mortgage on the property, net rental income for tax purposes will be small or negative.[9]

Essentially the same calculations are relevant for determining net imputed rental income for homeowners. Equation (1) can be rewritten as

$$Y = i(R - M) - pV - X - D \qquad (2)$$

where i is the opportunity cost of capital invested in a home (assumed to be the interest rate on mortgage debt), and p is the property tax rate. Data from the 1998 Survey of Consumer Finances indicate that aggregate homeowners' equity is about \$6.2 trillion, the difference between \$9.7 trillion in total home value and \$3.5 trillion of mortgage debt (Kennickell, Starr-McCluer, and Surrette 2000).[10] The 1997 American Housing Survey (AHS) reports a median mortgage rate of 8.1 percent (U.S. Bureau of the Census and U.S. Department of Housing and Urban Development 1999).[11] At this rate, the annual imputed return on homeowners' equity is about \$500 billion. The AHS reports a mean property tax rate of 1.1 percent on total home value, amounting to about \$120 billion in taxes. Homeowners would also be entitled to deduct depreciation and maintenance. The depreciation deduction would be about \$150 billion.[12] Maintenance expenditures would be about \$30 billion.[13]

[9] Cruciano (1998, table 1) reports net rental income on 1996 federal income tax returns of \$11 billion. This includes commercial property as well as the 34 million residential rental housing units. The 1995 Census Property Owners and Managers Survey reports that about half of apartment owners say they make a profit, but half say they break even or lose money.

[10] The value of principal residences is reported by the owners. Goodman and Ittner (1992) calculate that owners' estimates of their home values are about 6 percent too high. Applying this correction factor would lower total house value by about \$550 billion and annual imputed rent by \$44 billion.

[11] Coincidentally, this is exactly the same rate calculated by Follain, Ling, and McGill (1993) as the after-tax opportunity cost of invested equity for homeowners. Their calculation is for 1989, when rates on new mortgages were some 250 basis points higher than in 1997. The figure in the text may thus overstate both current opportunity cost and imputed net rental income.

[12] This is derived from the 3.6 percent annual depreciation allowed for rental property, assuming that the value of the structure is 75 percent of total property book value. The 1997 AHS reports the mean home purchase price at about 58 percent of the mean estimated value (U.S. Bureau of the Census and U.S. Department of Housing and Urban Development 1999).

[13] Maintenance expenditures have been calculated from the 1997 AHS at about \$33 billion. The U.S. Bureau of the Census estimates expenditures of \$27 billion for all residential properties in 1997 (2000).

Net imputed rental income would be something like $200 billion, about 2 percent of total home value or 25 percent of annual gross imputed rent. Federal tax revenue would be about $40 billion. The calculated revenue is the tax on the *net* imputed rental income, after deducting mortgage interest and property taxes; tax revenues would also be higher by the amount of these deductions (reported by Bourassa and Grigsby as $69 billion in 1997).

Obviously, these numbers are very rough approximations. An alternative calculation, derived from the house value and mortgage data in the 1997 AHS, suggests that imputed net rental income might be about 7 percent of the home value, or 45 percent of the rental value.

H = \$120,400, where H is mean home value for owner-occupants
R = $0.165\,H$ = \$19,900, assuming the same rent/value relationship as for rental housing
D = \$2,300, calculated as above for owner-occupied homes
X' = \$8,600, where X' is the median total housing expense including mortgage payment, property taxes, and other operating expenses—unlike equations (1) and (2).

Several factors contribute to the calculations describing imputed net rental income for homeowners as probably larger than realized net rental income for rental property owners. About 40 percent of homeowners do not have a mortgage; among those who do, on the basis of the AHS data in the preceding paragraph, imputed net rental income might be about 4 percent of home value and 30 percent of the rental value. Also, owners' reported monthly housing expenses, excluding mortgage interest, are about 20 percent of imputed rent rather than 40 percent or more. If imputed rental income were taxed, however, it is quite likely that homeowners would then find it in their interest to keep careful track of maintenance expenditures, reducing net imputed rental income and adding very substantially to the administrative burden on both themselves and the IRS in the process.[14]

It is worth noting that we already have a kind of tax on imputed rental income: the property tax. The property tax is of course a levy on wealth, but insofar as wealth is the capitalized value of future imputed rental income streams, it is also a tax on imputed income.[15]

[14] For example: "Would a trip to the grocery store be a deductible business expense if the homeowner purchased a repair item while shopping for food?" (Crowe 1993, 26).

[15] Bourassa and Grigsby note that a tax on imputed rental income is really a tax on wealth because there is no measurable money income to serve as the tax base. The same issue arises with the property tax. A tax on any asset can be considered as a tax on the imputed income from that asset—for example, the personal property taxes of some states.

Viewed as a tax on imputed rental income, the property tax is high, relative to other nonfederal taxes on income. The disparities in tax assessment and administration make comparisons difficult, but national averages can be calculated from various data sources. For example, the 1997 AHS reports a mean effective property tax rate of 1.24 percent for homeowners (U.S. Bureau of the Census and U.S. Department of Housing and Urban Development 1999). Assuming that the market rate of return for homeowners would be similar to the return for rental property owners, the property tax translates into a tax on imputed net rental income of 13 percent.[16] This is higher than the highest state income tax rate (Holt 1999).[17]

Although the issue is not central to this comment, these calculations support the deductibility of local property taxes against state income taxes. Otherwise, the combined state/local tax rate on the imputed rental income of homeowners would be higher than the tax rate on other types of income.

This line of analysis does not modify the conclusion of the preceding section that the exclusion of net imputed rental income for homeowners is the relevant difference in the tax treatment by tenure (again setting aside capital gains issues). Both homeowners and rental property owners pay property tax, and thus both can be considered as paying a tax on the rental income of the property; in addition, of course, landlords pay an income tax on that income.

An economic justification for the mortgage interest deduction

The estimates of imputed net rental income in the preceding section can be used to develop a rationale for eliminating the mortgage interest and property tax deductions. If homeowners have a net imputed rental income near zero or slightly positive, then in the aggregate their tax burden would be the same if they were treated like rental property owners, with net imputed rental income taxed and all business deductions allowed or, alternatively, if net rental income were not taxed and all deductions (including those for mortgage interest and property taxes) were disallowed. Thus, repealing the allowed deductions would have a revenue effect roughly the same as the economically preferable system of treating homeowners as property owners renting to themselves. It could be argued that repealing the deductions would

[16] This tax is calculated as follows: $P/V = 0.0124$; $NOI/V = 0.095$; $P/NOI = 0.131$.

[17] Massachusetts has a tax rate of 12.0 percent on unearned income. Montana had the highest state tax rate on earned income, at 11.0 percent for income above $69,000 in 1998. These comparisons omit any local income taxes.

be a step toward economic neutrality, a kind of second-best reform. In my judgment, this argument is flawed, certainly with respect to the mortgage interest deduction; it overlooks the economic significance of the deduction and the social benefits of homeownership.

The tax system should be neutral with respect to the form of financing a home purchase—whether debt or equity financing is used. Under current law, interest earned is taxable, and mortgage interest paid is deductible, so the cost of buying a home is independent of the financing decision. If interest paid were not deductible, debt would be more expensive than equity financing. Those who can afford to pay cash, that is, people with large enough holdings of financial assets that they can convert some of their assets into real estate, would not be affected. Some of them will be the neostereotypical young millionaires of Silicon Valley; others will have received their assets through inheritance. They can buy their home with pretax dollars, substituting untaxed imputed rental income for taxed dividends and interest. A home buyer who borrows to finance a home should have the same ability to buy with pretax dollars; otherwise, the tax system is discriminating in favor of those whose wealth takes the form of financial assets and against those whose wealth takes the form of human capital. Moreover, given the fact that interest accounts for almost all of the mortgage payment when the home is purchased and a gradually declining share thereafter, eliminating the deduction would raise taxes on home buyers at a particularly inconvenient time, when many have stretched their financial resources to the limit to make the purchase.[18]

Most home buyers choose to finance partly with debt and partly with equity. The same point applies to the decision about the appropriate division between mortgage and down payment. The deduction facilitates homeownership by those who rely more on labor income; eliminating it would favor those who rely more on property income.

Empirical evidence to this effect has been provided recently by Follain and Melamed (1998), who find that the beneficiaries from the mortgage interest deduction are families with not much in the way of assets and a substantial mortgage debt. They conclude that within the age distribution, young families (those whose head is less than 35) benefit the most, and the benefits decline sharply with age. They also conclude that upper-middle-income families benefit more than other income groups, though middle-income and lower-middle-income families also benefit

[18] A more detailed presentation of this analysis appears in Woodward and Weicher (1989, 304–05, 308–09). A second argument there—that the deduction helps correct the “tilt” in the real mortgage payment and other distortions caused by inflation—is fortunately not very important in the present economic situation, and I ignore it here; but it certainly has been relevant in the not so distant past, and it remains valid as an analytical proposition.

significantly (a point they do not stress). Higher-income and older households are generally able to pay cash for a home if they choose. Empirically as well as theoretically, it is clear that the deduction benefits those who have not inherited or accumulated assets—those who rely on labor income—and that it enables families to become homeowners sooner.

This analysis does not contradict the evidence that accumulating the down payment is a bigger problem for first-time home buyers, on average, than making the monthly mortgage payments (Linneman and Wachter 1989). Both matter.

The benefits of the deductions by income class

Bourassa and Grigsby join other critics of the deductions in objecting to their distributional effects by income. They point out that the standard deduction reduces and may eliminate the benefits of the deductions, particularly for low- and moderate-income homeowners. Homeowners reap the full benefit only if their nonhousing deductions are more than the standard deduction. This is not necessarily an argument for eliminating the deduction; it can be adduced in support of proposals to extend the tax benefits to lower-income home buyers in other ways. Follain, Ling, and McGill (1993), for example, suggest converting the deduction to an adjustment to income or, alternatively, a credit.

Most first-time home buyers probably do not enjoy the full benefit of the deductions, but most do obtain substantial tax relief. AHS data indicate that the median first-time home buyer in 1996–97 had an income of about $40,000 and bought a house worth about $80,000.[19] Assuming that this household consisted of three persons and bought the house with 10 percent down and an 8 percent, 30-year fixed-rate mortgage, and took the average deductions for charitable contributions that households with similar incomes did, the household would reduce its taxes by about two-thirds of the possible benefit from the deductions—at least in my jurisdiction, the District of Columbia. A similar household at the first quartile of the first-time buyer distribution, with an income of about $25,000 and buying a $50,000 house, would receive smaller savings, amounting to about one-fourth of the maximum, all of them on the state tax.

Bourassa and Grigsby are also concerned that “[f]ully 90 percent of the benefit goes to homeowners with incomes over $50,000 a year” (531). This may seem inequitable, but it is also true that 90 percent of the

[19] These income data were provided by David A. Crowe of the National Association of Home Builders.

taxes are paid by households with incomes over $50,000. Any deduction is probably going to benefit higher-income households, because they pay most of the taxes. Within this group, the mortgage interest deduction is less a benefit to the rich than to the middle class; as Bourassa and Grigsby note, families with incomes between $50,000 and $200,000 benefit much more than those whose incomes are over $200,000.

Ultimately these distributional issues are aspects of a basic question: How much progressivity do we as citizens want in our tax structure? This question has been answered differently in the various tax law changes of the past two decades, and it has been raised and debated vigorously in recent years. It is, of course, an issue in the current presidential election campaign. Changing the tax treatment of mortgage interest and property taxes, for distributional reasons, is best addressed as part of a broader debate.

The social benefits of homeownership

It is widely believed that homeownership is good public policy; promoting it has been a bipartisan objective of public policy since the 1930s. Social scientists, particularly economists, have tended to be rather skeptical of this popular view. It is beyond the scope of this comment to review the large literature on the subject but worthwhile nevertheless to note some relevant recent research.

The simplest argument for homeownership, and the one that social scientists have found the least persuasive, is that homeowners are better citizens. In their extensive review of literature and data, Rossi and Weber (1996) found some differences between owners and renters that support the conventional wisdom about the benefits of homeownership, but also other differences that do not. Homeowners are more engaged in local politics and community improvement organizations. They are more likely to vote and more knowledgeable about elected officials. This pattern extends to lower-income owners: According to Rohe and Stegman (1994), low-income families that became homeowners were more involved in neighborhood organizations than similar renters. Overall, Rossi and Weber (1996) conclude that homeownership has “some beneficial effects, but the effects are not large or consistent” (32).[20]

It may be, however, that it is the *children* of homeowners, rather than the owners themselves, who are better citizens. Green and White (1997) found, rather to their surprise, that the children of homeowners be-

[20] More recently, DiPasquale and Glaeser (1999) found evidence that homeowners are more willing to invest in social capital in both the United States and Germany.

haved in more socially desirable ways than the children of renters. They are less likely to drop out of school and less likely to be arrested, and their teenage pregnancy rate is lower. These results are quantitatively important, particularly for low-income families. This is the first study focusing on the children of homeowners. If further research confirms these findings, they will provide strong evidence in support of the deductions, all the more so because policy makers have found it quite difficult to address these issues successfully.

There is another respect in which homeownership contributes to a better society, and in this instance its contribution is large. It is a major factor in economic well-being. Until very recently, equity in owner-occupied housing was the largest component of household wealth; only since 1995 has it been passed by stock holdings (Kennickell, Starr-McCluer, and Surrette 2000), and it still accounts for 20 percent of total household wealth. Even more important, homeownership is the most important force for a more equal distribution of wealth. Excluding equity in owner-occupied housing, the Gini coefficient of the wealth distribution is about 0.9, and the richest 1 percent of Americans own over 40 percent of total household wealth. Including homeowners' equity, the Gini coefficient is about 0.8 and the richest 1 percent own about 35 percent of all wealth (Weicher 1995, 1997). Accumulation of wealth is also a reason for encouraging homeownership sooner rather than later. Wealth rises with age, and it is heavily concentrated among older households; the sooner families are able to become homeowners, the more equal the distribution of wealth is likely to be.

Conclusion

In my judgment, homeownership generates valuable benefits to American families and to society as a whole. It is reasonable for public policy to encourage it. The mortgage interest deduction in particular significantly promotes homeownership, and repealing it would place working families at an economic disadvantage: "The American dream of homeownership is indeed intertwined with the deductibility of mortgage interest" (Woodward and Weicher 1989, 312). The deductions are not perfect instruments of public policy, but that is true of virtually every provision in the tax code, and every expenditure program as well.

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