

Comment on James R. Follain, David C. Ling, and Gary A. McGill’s “The Preferential Income Tax Treatment of Owner-Occupied Housing: Who Really Benefits?”

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Introduction

Tax preferences afforded homeowners are acknowledged incentives toward homeownership, but judgments about their actual, as well as their appropriate, size vary widely. The distribution of these tax benefits, although also investigated intensely, is seldom examined carefully and thoroughly. Follain, Ling, and McGill’s treatment makes a valuable contribution by developing unique data and comparing the distribution of tax burdens in a theoretical system to the current one. However, the inclusion of net imputed rent in their estimates of tax benefits, while intellectually satisfying, is not likely to be of practical use to those who make policy. Further, equity issues related to intergenerational and interregional distributions of tax benefits should also be included in any consideration of changes to the current tax treatment of homeownership.

Highlights

Follain, Ling, and McGill draw three conclusions from their analysis: First, they find that including net imputed rent in a calculation of tax expenditures doubles the perceived tax benefits received by homeowners. Second, they conclude that the benefit of the generally accepted tax incentives to homeownership—the mortgage interest and real estate deductions—are “wasted” advantages for low- and moderate-income households because they either do not itemize at all or must use some of the housing deductions to exceed the standard deduction. Third, the authors find that the distribution of the full tax benefits of homeownership would be less progressive than the present tax system.

The authors draw three policy implications from these conclusions. First, removing the mortgage interest deduction would increase the bias against mortgage debt that is already built into present tax policy. Second, some consideration should be given to

increasing the value of the mortgage interest deduction at lower incomes. Third, taxing imputed rent would be relatively more burdensome to lower income households than to upper income ones, thereby making the tax code less progressive. This implication is especially interesting because it suggests that if maintaining the progressivity of the current tax system is a goal, then the policy rationale for including net imputed rent is weak.

The authors are commended for developing in this and two earlier articles an innovative expansion of American Housing Survey (AHS) by adding data from the Internal Revenue Service. This expansion enhances AHS data by adding nonhousing deductible expenses so that the authors can construct a tax return for each household.

This approach is characteristic of a tenure choice analysis of housing tax issues. The authors posit that a neutral system taxes all production of goods and services, whether realized or not. Hence by inference, according to the authors, the housing services provided to a homeowner should be taxed as they are received. Although this approach fits into the economist's framework of a theoretically calculable amount, it is an impractical source of revenue that will probably never be taxed.

Net implicit income

The inclusion of net imputed rent is often used to describe the differential tax benefits to owner-occupied housing, usually in the context of tenure choice. It is argued that homeowners act as their own landlords and that the unrealized net rental income from supplying themselves with housing should be taxed. However, imposing a tax on imputed rent has significant operational barriers, implies that similar applications to other durables are required, and has been dropped from federal assessments of tax sources.

Taxing implicit income or rent presents some overwhelming operational difficulties. Because the amount of implicit income is based on the value of the home, some universal, fair method of assessing every home would be required to avoid having taxpayers undervalue their homes. A homeowner would be required to keep detailed records, like a business operation, to justify expenses incurred in the "production" of housing income. For instance, would a trip to the grocery store be a deductible business expense if the homeowner purchased a repair item while shopping for food?

If the implicit rental income from owner-occupied housing is taxed, then arguably other forms of income from owning durables should also be taxed. Taxpayers “avoid” taxation of the return on equity in most durables. By purchasing rather than renting automobiles, appliances, or works of art, for instance, the owner pays no tax on the returns these purchases generate. Aside from economists’ perverse preoccupation with the tax treatment of housing, housing appears to be a prime target because it receives other tax benefits, usually appreciates in value, and represents a large portion of owners’ expenditures. These distinctions imply a difference in magnitude but not a difference in principle between returns on homeownership and returns on other commodities.

A reduction in the tax benefits received by homeowners will continue to be a potential source of added revenue as Congress and the administration seek new sources. Taxing implicit income is by far the least likely of the alternatives discussed. As the authors point out, the Office of Tax Analysis stopped calculating imputed net rent. The implication that should be drawn is that the government stopped because such a tax is not a politically viable or practically feasible source of additional revenue, not because it was too difficult to calculate.

Congressionally recognized tax expenditures resulting from current explicit tax preferences afforded housing, however, have real potential as tax sources. The Joint Committee on Taxation (1992) estimates that the tax expenditure for the mortgage interest deduction in fiscal year 1993 will be \$44.2 billion. The other recognized tax expenditures (the deduction for real estate taxes, the deferral of capital gains, and the one-time exemption of the first \$125,000 in capital gains for those over 55) will total \$31.1 billion for 1993. The size of these homeowner tax benefits make them prime candidates for added taxes.

The misperception that homeowners’ tax deductions primarily benefit upper-income households adds to the political pressure to limit these deductions. Presidential candidate Ross Perot suggested lowering the current symbolic cap on mortgage interest from the interest on \$1,000,000 to an actual binding level of \$250,000. Press coverage before President Clinton’s State of the Union Address suggested that part of a proposed tax increase would probably come from the mortgage interest deduction. While the Clinton proposal did not contain such a provision, the sheer size of the deduction, the presence of the symbolic cap, and the general public belief that most of the benefit goes to the

wealthy make the mortgage interest deduction a potential source for added tax revenue.

Therefore, evaluating distributional impacts is extremely important in understanding potential tax policy changes and their effects across different classes of taxpayers. An investigation of the distribution of tax benefits should consider the current version of the mortgage interest deduction as well as potential changes to it. The Congressional Budget Office (1993) evaluated several options but did not focus on distributional issues.

Equity

The most significant policy conclusion about equity in the article is in the last paragraph, in which the authors conclude that tax benefits to homeowners do not necessarily favor the wealthy. The validity of this conclusion rests on the inclusion of net implicit income as a tax expenditure, which in turn depends largely on the variation in the house value-to-income ratio across incomes. Because the authors treat home debt and equity equally, the theoretical tax expenditure for not taxing net imputed rent is based on the value of the home, not the value of the mortgage. Column 4 of table 3 of the article shows that the value-to-income ratio declines with income. Taxing imputed rent falls disproportionately on lower incomes because their housing values are high in relation to their incomes. Therefore, taxing net imputed rent, if feasible, would be regressive relative to the present system because lower income households devote a greater portion of their income to housing than higher income households do. The inverse relationship between the ratio of value-to-income and income is a life-cycle phenomenon.

Generational distribution

Vertical equity and, to a lesser extent, horizontal equity of homeowner tax expenditures are affected by intergenerational distribution. Hence, evaluating distributional impacts must also consider benefits calculated over the course of a life. The fact that lower income households tend to have high-value homes relative to their income is largely due to older homeowners who bought their homes while they were working but who have since retired and have lower incomes. According to the 1989 AHS data, nearly two-thirds of the homeowners with incomes under \$20,000 were 60 or older, and more than half of the homeowners with incomes

under \$30,000 were 60 or older. Conversely, low value-to-income ratios are concentrated among higher incomes. More than half of the households with incomes over \$40,000 had value-to-income ratios under 2.0 and more than half of the households with value-to-income ratios under 2.0 are headed by someone between the ages of 30 and 50.

Older households have lower mortgage balances and fewer years left on the mortgage term. According to the 1989 AHS, homeowners 55 or older and with incomes between \$30,000 and \$40,000 had median remaining mortgage terms of 10 to 12 years and median mortgage balances of about \$12,000. Given the reported mortgage rate of 9.5 percent, these median values imply an interest deduction of \$1,100. Interest payments for low- and moderate-income older homeowners are at the point where itemization does not exceed the standard deduction, especially for those over 65 who receive an additional standard deduction.

Conversely, younger households have higher balances and are in the early years of a mortgage. According to the 1989 AHS, median remaining mortgage terms for homeowners aged 30 to 39 years with incomes between \$30,000 and \$40,000 were between 20 and 25 years, and outstanding balances were about \$40,000, thereby suggesting interest deductions of \$4,000 per year. Balances are higher not only because younger households must purchase a home in the current market, but they also have higher loan-to-value ratios that increase the share of their income going to interest. Because interest is therefore a large part of their mortgage payment, itemization is usually beneficial.

A typical household purchases its first home when current income is less than permanent income. The household purchases a home that may be more than it can comfortably afford because the high transaction costs make it more efficient to “overshoot” the equilibrium level of housing consumption until incomes increase with training, experience, and advancement. Because first-time home buyers have only human capital as an asset, the purchase is highly leveraged. Standard mortgage amortization compounds the front-end payment burden for first-time buyers. The mortgage interest deduction provides a payment offset to a large portion of first-time buyers because home value is a large multiple of income and a mortgage is a large share of the value.

Consequently, a substantial number of first-time home buyers derive a significant benefit from tax preferences. According to the 1989 AHS, 87 percent of all first-time home buyers bought their

home with a mortgage, and two-thirds of them were between the ages of 25 and 39 and had incomes between \$15,000 and \$75,000. This core group of first-time buyers had a mortgage balance of \$62,300 with a median term of 30 years at 10 percent. These parameters imply first-year interest payments of \$6,214, enough to exceed the standard deduction.

The authors' construct of a tax return for each household provides the necessary basis for analyzing the intergenerational impact of changes to the mortgage interest deduction. As Follain, Ling, and McGill point out, the level of total deductions determines whether the household benefits from the mortgage interest deduction, but the benefit to taxpayers who take the standard deduction should not be overlooked as if it were unrelated to housing.

Although the standard deduction is not new, several changes mandated by the 1986 Tax Reform Act make the standard deduction more widely used. The concept, however, remains the same—a minimum deduction that every taxpayer is allowed regardless of total deductions. Therefore, a “standard” or average amount of mortgage interest is embedded in the standard deduction.

As a matter of semantics, taxpayers with nonhousing deductions that do not exceed the standard deduction do not “waste” some of their housing deductions. If all eligible deductions do not exceed the standard deduction, the tax system does not influence tenure, but the household can be considered to be receiving some housing tax expenditure embedded in the minimum deduction.

Geographical distribution

Also, changes to the mortgage interest deduction might have a differential impact depending on geography. States with high housing costs would bear the bulk of the tax increase if the mortgage interest deduction were capped at a lower level. In 1991, half of the purchase mortgages for more than \$300,000 were for homes in California. Four of every five home sales with a mortgage exceeding \$300,000 were concentrated in eight states.¹ Over time, the outstanding mortgages over the threshold would reflect the one-year flow of mortgages originated.

¹ Based on housing transfer data collected by Dataman, Inc., and compiled by the National Association of Home Builders. The eight states are California, Florida, Connecticut, New Jersey, Massachusetts, Texas, Illinois, and Virginia.

Dynamics

The most difficult part of evaluating changes to homeowner tax expenditures is estimating the behavior of home buyers. However, just as the authors characterize the lack of an estimate of imputed net rent as no reason to assume that it is zero, so the lack of a solid estimate of dynamic change is no reason to believe that no change would occur. The clear demonstration that the debt-to-equity ratio does not change the value of the imputed net rent tax expenditure also shows that, for households with sufficient nonhousing wealth, avoiding mortgage debt is both possible and economically beneficial.

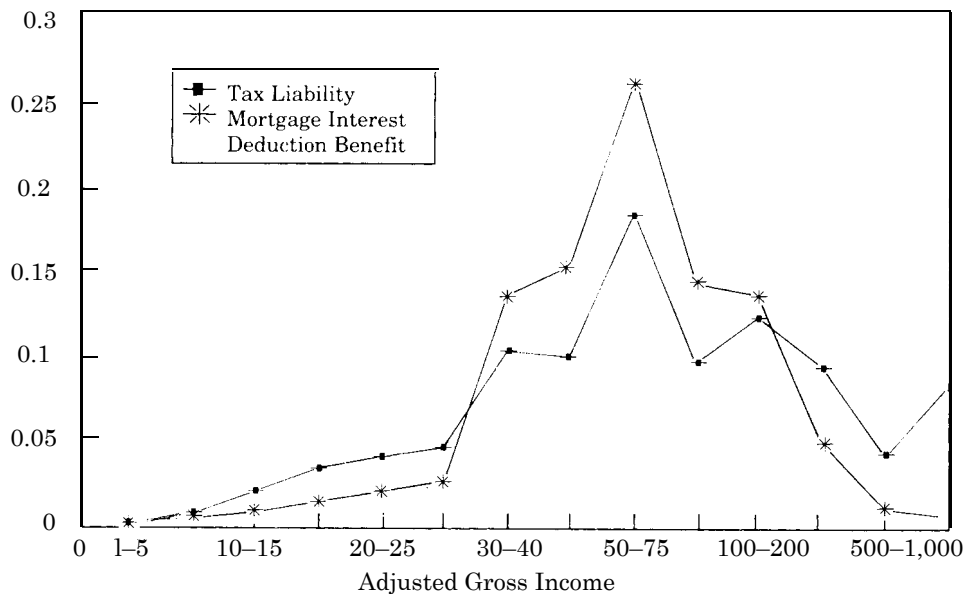
Woodward and Weicher (1989) make the case that those with sufficient assets to pay down their mortgage below the level of allowable deduction would do so and therefore avoid any of the increased taxes from a limit. Moreover, congressional expectations for tax revenue overestimate what would actually happen because the Joint Committee on Taxation does not recognize the potential for change.

The most recent complete data on individual tax returns available are for 1989 (Internal Revenue Service 1992). The distribution of benefits from the mortgage interest deduction, along with the distribution of tax liability, is shown in figure 1. This static evidence suggests that the mortgage interest deduction, by itself, benefits households with incomes between \$30,000 and \$200,000 in which the share of benefits is larger than the share of total tax liability. However, missing from this comparison are (1) the effective benefit from the standard deduction for lower incomes, (2) behavioral changes of upper income taxpayers as they shift assets, and (3) all taxpayers' behavior as housing consumption and home prices change in reaction to a change in the deduction. The approach used by Follain, Ling, and McGill could address these omissions.

Conclusion

The distribution of tax benefits to homeowners reflects a number of taxpayer characteristics. The authors compare vertical and horizontal equity across income, but because housing decisions are based on permanent incomes, comparisons over a lifetime or across ages of heads of household reveal a different, more appropriate comparison of benefits to taxpayers.

Figure 1. Distribution of Tax Liability and Benefit of Mortgage Interest Deduction



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