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

For at least three decades, housing analysts and advocates alike have been concerned about the favoritism that the Internal Revenue Code has shown toward homeownership. The privilege that the tax code confers on homeowners, permitting them not to report imputed income on the equity in their homes, while allowing them to deduct mortgage interest and real estate tax payments from their gross income, is felt to have deleterious effects with respect to both allocative efficiency and equity. Too much investment is drawn into housing and away from more productive sectors of the economy; homeowners unfairly benefit at the expense of renters; and upper income owners in higher marginal tax brackets benefit at the expense of lower income owners who cannot itemize deductions on their tax returns—or so it is argued. Moreover, while homeownership remains the principal or only capital investment of many U.S. households, their gains on sale remain effectively untaxed.[1]

Although other countries also favor homeownership in their tax codes, none is as generous as the United States. The Tax Reform Act of 1986 (TRA86) limited the tax benefits of homeownership, but the loss of revenue to the Treasury occasioned by this special treatment remains large. Follain, Ling, and McGill estimate that the tax expenditure on homeownership was $109 billion for 1989, if the loss of imputed income on housing is included. Over the years, there have been many proposals either to eliminate the tax favoritism to homeownership entirely or to modify the rules

[1] Homeowners are permitted to roll over their capital gains if they purchase another home of equal or greater value; those aged 55 or over are allowed a one-time exclusion of their capital gain if they purchase a home of lesser value. It should be noted that other forms of tax preferences for homeownership are targeted to specific groups; for example, tax subsidies are extended indirectly to first-time home buyers through state and local mortgage-revenue bonds, the interest on which is exempt from federal income taxation.

to produce greater equity across income and tenure groups. Most recently, 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 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 (Vickrey 1993, 4).

Congress has ignored these recommendations, except for setting $1 million as the maximum amount of mortgage interest that a taxpayer can claim as a deduction. Removing the favoritism without imposing unfair losses on current homeowners is perceived as almost impossible. Even owners who do not itemize their deductions express alarm over what might happen to their home values if the deductions are eliminated.

Amid the array of possible arguments and counterarguments, one thing has become clear: The sacred-cow status of tax provisions for homeowners is evaporating. The frontal attack on the federal debt has forced Congress to consider every possibility for potential revenue relief. Although tax provisions for homeowners are not yet on the table, they are definitely an option, and it is no longer considered political lunacy to mention them. Over the next few years, the electorate is likely to become more aware and perhaps more informed about the arguments. Proposals for major revision are inevitable.

The appearance of this third summary article in the series by Follain, Ling, and McGill (Follain and Ling 1991; Ling and McGill 1992) is therefore timely, particularly because of the challenge the authors raise and the evidence they offer to contradict much of conventional wisdom. By explicitly incorporating a measure of net implicit income into estimates of the tax expenditure arising from the treatment of homeownership and by comparing the current system with a more neutral system that taxes implicit income on home equity, Follain, Ling, and McGill demonstrate that (1) the aggregate tax expenditure associated with tax preferences for homeowners greatly exceeds previous estimates; (2) given the increase in the standard deduction and the reduction in itemizable nonhousing expenses dictated in TRA86, the tax savings available to many low- and moderate-income households through the deductions for mortgage interest and property tax have been reduced or eliminated, thus introducing an "anti-mortgage bias" into the tax code and a commensurate incentive

toward equity investment; and (3) lower income households are shown to receive *more* and higher income households *less* than their proportional share of tax savings in relation to what they pay in taxes. Therefore, the distributional effects of changes made in the tax code to reduce or eliminate the tax expenditure are a key consideration.

The effects of TRA86

It is ironic that as serious attention is finally being focused on tax provisions for homeowners, some of the aims of reforming these provisions have already been achieved, partly because of TRA86. The efficiency costs of the tax treatment of owner-occupied housing have decreased dramatically, even for households still able to itemize (Poterba 1992). In addition, by increasing the standard deduction and lowering marginal tax rates, TFW36 greatly reduced the revenues that might be gained by eliminating the mortgage interest deduction. Lowered marginal tax rates also reduced the value of revenues that might be realized as part of future tax reform by taxing net imputed income.

Nevertheless, the distributional effects of recent changes in the tax code are of particular concern, because any reform effort will be tied not only to the need to raise revenues and promote a more efficient, neutral tax system, but also to housing policy objectives and related political pressures. The consensus about the effect of TRA86 on equity is that the after-tax costs of homeownership have increased for all owner-occupants, but especially for lower income households. Further, the benefits of the deductions for both mortgage interest and property tax are now distributed more heavily toward high-income homeowners. In 1991, the absolute number of itemizing households dropped, from roughly 28 million in 1985 to an estimated 24 million, or only 40 percent of owner-occupied households. At the same time, the number of households owning homes increased by several million. The incidence, and full benefits, of itemization have decreased for all except the highest income groups (i.e., those with an adjusted gross income in excess of $80,000).[2]

The articles by Follain, Ling, and McGill demonstrate that if the interest earned on financial assets is taxable, but mortgage

[2] Figures taken from estimates presented by Poterba (1992).

interest does not remain fully deductible, debt financing is more expensive than equity financing, and the amount of tax savings depends on the homeowner's loan-to-value ratio.[3] The value of tax savings available to homeowners is independent of the method of financing only if the before-tax costs of debt and equity are equal and if the homeowner can deduct all mortgage interest paid, as was the case before TRA86.

Desirability and feasibility of a neutral tax system

Within the context of the current tax code, Follain, Ling, and McGill show that simply eliminating the mortgage interest deduction will not move the tax code toward greater neutrality. (Recent buyers, households with high loan-to-value ratios, and those who do not or cannot replace debt with equity would be losers in this case.) At the same time, the feasibility and desirability of a truly neutral system with respect to housing remain problematic. Follain, Ling, and McGill provide a simple, clear starting point for debate on adopting a neutral system by emphasizing that the effects on the progressivity of the tax system would depend critically on how increased tax revenues were distributed to taxpayers. If redistribution were implemented through proportional reductions in marginal tax rates, the tax code would become even less progressive than under TRA86, as the tax liabilities of low- and moderate-income households (particularly those with adjusted gross incomes less than $36,000) would increase. Therefore, if enhanced progressivity is an explicit objective, tax revenues should be redistributed by other means—namely, tax credits to lower income groups or direct assistance.

Although many other countries retain some form of favoritism toward homeownership, several have attempted to move toward neutrality by taxing some measure of implicit rental income as well as allowing deductions for homeowner expenses and sometimes taxing capital gains (see table 1). Other countries that tax imputed rental income, while allowing deductions for mortgage interest, include Finland, Sweden, and Norway (Organization for Economic Cooperation and Development 1988). Australia, Canada, and New Zealand do not tax imputed income or allow mortgage interest deductions. Experience elsewhere has shown that even when the imputed income on home equity is taxed, the formulas used to calculate this income are such that the amount

[3] The derivation of this result is detailed clearly by Ling and McGill (1992, 280–83).

Table 1. **The Tax Treatment of Owner-Occupied Housing, 1992**

	Country Tax on Imputed Rental Value	Interest Relief	Relief of Maintenance Costs	Capital Gains
Belgium	x	x[a]	–	x
Denmark	x	x	–	–[b]
France	x	x[a]	x[a]	–
Germany	–	x	–	–[b]
Greece	x	x	x[a]	x[c]
Ireland	–	x[a]	–	–
Italy	–	x[a]	x	x
Luxembourg	x	x[a]	–	x
Netherlands	x	x	–	–
Portugal	x[a]	x[a]	x[a]	–
Spain	x	x[a]	–	x
United Kingdom	–	x[a]	–	–

Source: Netherlands Ministry of Housing (1992).
[a] Limited.
[b] Only when sold within two years.
[c] Established in 1991.

of income subject to taxation is quite low, a fact which leads to lower taxes on owner-occupied housing than on other forms of investment. Generally, the implicit income on housing is figured as a flat percentage of the capital value of the property (between 1 percent and 4 percent). Hence, the tax really functions as a disguised ad valorem tax, carrying with it all of the administrative problems associated with such a tax. In addition, when expenses exceed imputed rental income and the losses may be taken against other sources of household income, the tax revenues may actually decline. This fact explains in part why the United Kingdom abandoned taxing imputed income and why other countries have limited deductions of expenses.[4]

[4] For example, imputed income reportedly was taxed in West Germany in the early 1980s (McGuire 1981). The house value was estimated as for property taxation (i.e., at a fraction of current market value). This value was then multiplied by 1 percent. Deductions, including ones for maintenance and depreciation, were allowed so that imputed rent could be negative. (Germany did not allow losses to be taken, but Sweden and Denmark did and still do.)

Working toward reform

Follain, Ling, and McGill offer their results as evidence that conventional wisdom regarding the tax treatment of owner-occupied housing is flawed. They conclude that the recent focus on eliminating the mortgage interest deduction to reduce the estimated level of tax expenditure and to alleviate current inequities is not likely to produce the desired results. Instead, efforts to reduce the tax expenditure to homeownership by eliminating the mortgage interest deduction or by taxing net implicit income on equity can be expected to (1) reduce the rate of homeownership; (2) lower home values over the short run; (3) decrease the amount of housing consumed by owner-occupants; and (4) as a result, yield tax revenues significantly less than the estimated annual tax expenditure. To the extent that any reform increases the costs of owning, and homeowners are particularly sensitive to their carrying costs (e.g., Rosen, Rosen, and Holtz-Eakin 1983), revenue estimates will be even lower. Moreover, the net effect of these reforms would be to decrease the progressivity of the tax code, although as Follain, Ling, and McGill emphasize, the way anticipated new revenues are distributed and housing costs are expensed against income can mitigate much of this concern.

The propensity for policy makers to abandon reform efforts is likely to be strong in the face of these and other results—for example, Woodward and Weicher (1989) with respect to the mortgage interest deduction. Yet with more than $100 billion in estimated tax expenditures at stake—tax expenditures that average over $1,000 per U.S. household and whose contribution to better housing is mixed—it is especially worthwhile to explore options that attempt to integrate tax and housing policy into a system that not only moves closer to neutrality but also targets housing objectives more efficiently and equitably. In the following paragraphs, we outline a proposal for moving toward a more neutral tax system with respect to housing, a system that alleviates some of the distributional and antidebt aspects of the current one but maintains a modest bias toward homeownership. The proposal focuses on the politically more tractable and administratively more feasible notion of recapturing imputed income upon sale, rather than collecting it annually. In addition, it explicitly incorporates a tax on capital gains.

An example of how this system might work is the tax treatment of the owner of a $100,000 home purchased with a $90,000 loan amortized in nine equal installments and sold at the end of 15 years (see table 2). During this holding period, net imputed

Table 2. **Hypothetical Income Tax Treatment of Homeowner Who Purchases $100,000 Home with a $90,000 Loan and Amortizes the Debt in Nine Equal Installments**

Year	Book Equity	Imputed Income*	Book Depreciation*	Taxable Net Imputed Income
1	10,000	300	300	0
2	20,000	600	600	0
3	30,000	900	900	0
4	40,000	1,200	1,200	0
5	50,000	1,500	1,500	0
6	60,000	1,800	1,800	0
7	70,000	2,100	2,100	0
8	80,000	2,400	2,400	0
9	90,000	2,700	2,700	0
10	100,000	3,000	3,000	0
11	100,000	3,000	3,000	0
12	100,000	3,000	3,000	0
13	100,000	3,000	3,000	0
14	100,000	3,000	3,000	0
15	100,000	3,000	3,000	0
Total		31,500	31,500	0

* For purposes of simplicity, both the before-tax return on equity and the book depreciation are assumed equal to 3 percent.
(1) If, at the time of sale, real depreciation turns out to equal book depreciation, there is no capital gains and no imputed income to recapture.
(2) If the home sells for its original purchase price, there would be either a recapture of tax on $31,500 of imputed income or a tax on a capital gain of $31,500, but not both.
(3) If the home appreciates an average of 1 percent per year, reaching a total appreciation of 15 percent, imputed income would rise to $35,100. Both imputed income and the capital gains of $15,000 would be taxed. Assuming a marginal rate of 20 percent on both, the total tax on recapture and sale would be $10,000.

income on equity, calculated at 3 percent of book equity, rises from $300 initially to $3,000 in the year of sale. The 3 percent rate of return is set deliberately low, because real imputed income varies with each homeowner's opportunity cost and many homeowners would not confine the estimate of their opportunity cost to the income that could be earned on alternative investments of similar risk.

In this scenario, the household theoretically accounts for implicit income in each year the home is held. However, the Internal Revenue Service permits the owner to assume that the home is depreciating annually in amounts that would exactly offset

implicit income, leaving the homeowner's adjusted gross income the same as under the current tax system. This adjustment effectively postpones the entire tax burden until the time of sale and also removes the need for annual calculations. Upon sale, the owner is taxed on accumulated imputed income (without interest penalties) and on any capital gain. The capital gain would be adjusted both for book depreciation, as in the rental sector, and for inflation.

From this simple example, it is apparent that the amount of income tax that will be recaptured varies with the amount by which the home appreciates or depreciates. If, at the time of sale, it turns out that actual depreciation in constant dollars equals book depreciation, there is no imputed income to recover and no capital gain. However, if the home sells for its inflation-adjusted original purchase price, there would be either a recapture of tax on $31,500 of imputed income or a tax on a capital gain of $31,500, reflecting the difference between assumed and actual depreciation. If the home appreciates, for example, at an average of 1 percent per year, reaching a total appreciation of 15 percent, imputed income would rise to $35,100. Both imputed income and the capital gain of $15,000 would be subject to taxation, reflecting the fact that as the home rises in value, so does imputed income. Assuming a marginal rate of 20 percent on both, the total tax bill on recapture and sale would be $10,000.

In the example shown in table 2, the overall burden on the taxpayer is by no means severe. While residential capital accumulation is reduced by this tax, the federal government can at last share in some of the upside of the homeowner investment that it supports. Under the current tax code, the federal government limits its downside risk by disallowing capital losses on owner-occupied housing, but effectively leaves real appreciation untaxed. Further, in most cases, tax administration is not difficult, requiring only modest changes to existing reporting procedures and avoiding annual collection of implicit income from roughly 60 million homeowning households. Crude calculations suggest that this approach to reducing the tax expenditure to owner-occupied housing might produce revenues in the neighborhood of $30 billion to $40 billion annually, excluding gains that would be achieved if adjustments were made to the tax treatment of mortgage interest and property taxes.

The system illustrated here is deceptively simple, however. Its implementation depends on the ability of taxpayers to make an easy calculation of average book equity for their entire holding

period at the time of sale. In most cases, this computation would be relatively straightforward, but it would be quite difficult for owners who had refinanced or used home-equity or second-mortgage loans. Among the alternative approaches that might solve this problem would be taxation of imputed rental income on the asset itself. The mechanics of this approach would be the same as in the taxation of imputed income on equity. Collection of the tax would be deferred until the home was sold. The assumed depreciation rate—hence the assumed imputed income flowing from the home—would be set lower in the earlier years and rise over time (see table 2). This feature would protect owners who sold their homes after only a few years from leaving the settlement table with little or no cash.

This change should affect homeownership only slightly, both because of the strong preference among Americans for owner-occupancy and because financial assets would still be taxed at a higher rate than owner-occupied housing.[5] Nor would there be a significantly adverse effect on home values if the changes were phased in over a period of years (Grigsby and Baratz 1986). The equity implications of such a change, however, are less clear, depending as they do on the variation in rates of appreciation or depreciation across the owner-occupied stock. Because houses of lower income owners generally appreciate more slowly than those of upper income owners, the recapture or capital gain tax might actually be slightly progressive. It is important to note that the annual tax burden on lower income households would be avoided completely.

The treatment of mortgage interest and property taxes under such a system would still need to be decided. If the two deductions are to be continued, there are compelling arguments for allowing them even for taxpayers who do not itemize deductions. Such a change would shift the bulk of the benefits from those who now receive them to those who do not. Follain, Ling, and McGill rightly emphasize this point.

More broadly, the authors open the door to consideration of a wider array of options for reforming the tax treatment of owner-occupancy. Any such consideration should focus more on those two aspects of reform that are usually rejected at the outset:

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[5] The full effect of such treatment, of course, would depend on other factors as well: the treatment of deductions for mortgage interest and property tax, the costs of renting, and demographic characteristics.

implicit income and capital gains. In this vein, evaluation of how proposed changes would affect house prices and markets, determination of appropriate rates of return on equity and of depreciation, and estimates of real capital gains on owner-occupied housing would be in order. Above all, any revisions of homeowner tax provisions should improve both allocative efficiency and equity, not just raise additional revenues.

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