Reconsidering and Improving Existing Tax Subsidies for Housing

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Policymaking Framework for Thinking About Tax Subsidies

1. Whether we need a subsidy of any kind to influence the desired behavior.
2. Whether the subsidies should be located inside or outside the tax system.
3. Whether the subsidies already on the books are working as planned or desired.
4. Whether we should preserve, repeal, or redesign existing subsidies.

The Perceived and Real Value of Tax Deductions

- Consider a married household with AGI of $100,000 in the 25% tax bracket.
- This household currently rents.
- Possible itemized deductions:
  - $4,000 in state income taxes
  - $1,000 in charitable contributions
  - Total itemized deductions well below the standard deduction of $12,000. So this household cannot itemize, and instead takes the standard deduction.

The Perceived and Real Value of Tax Deductions

- The same household buys a house. Hurray!
- Possible itemized deductions:
  - $10,000 in mortgage interest paid
  - $5,000 in state/local property taxes
  - $4,000 in state income taxes
  - $1,000 in charitable contributions =
  - **$20,000,** which exceeds the standard deduction, so we itemize. But what is the subsidy worth?

Perceived

- What is the after-tax value of the $15,000 in new housing costs?
  - The full $15,000?
  - $15,000 multiplied by the marginal tax rate of 25%?
  - Correct answer: The excess of itemized deductions over the standard deduction multiplied by 25%.
  - $20,000 - $12,000 = $8,000 x .25 = $2,000.
- What if the household were in the 39.6% bracket and had itemized deductions exceeding the standard deduction *before* the home purchase?
  - $15,000 x 39.6% = $5,940 (or almost 3x the benefit).

Current Tax Subsidies Distort Housing and Mortgage Markets

- Distort the cost of owner-occupied housing relative to other investments, contributing to overinvestment in housing stock and misallocations of capital stock.
- Distort not only where to invest but also how to invest by encouraging taxpayers to take on massive debt and precariously high LTV ratios.
- Artificial demand from subsidized mortgage debt encourages buyers to consume larger and more expensive homes.
- Distortions raise the cost of housing between 3-10 percent and thereby prevent millions of potential buyers from entering the market.

CA Tax Expenditures for Housing

• Home mortgage interest deduction	$4.5 billion
• Exclusion for capital gains on home sales	$1.8
• Deduction for state/local property taxes	$1.6
• **TOTAL**	**$7.9 billion**

- **PLUS**:
  - Basis step-up on inherited property — $3.4 billion
    - A large percentage of which = housing stock.

Recommendations

1. Reclaim lost revenue by abandoning federal AGI as the starting point for determining state income tax liability.
2. As a general rule, avoid using deductions as a delivery mechanism for housing benefits run through the tax system.
3. Restrict basis step-up on inherited property to cases of hardship.
4. Limit the exclusion on capital gains on home sales by accounting for built-in gains due to inflation and taxing only real gains and not nominal gains.
5. Most importantly, consider adopting a "Homeownership Tax Credit" in lieu of both the mortgage interest deduction and the property tax deduction.
   a. A credit that provides a fixed dollar amount rather than a fixed percentage of mortgage interest and property taxes would boost rates of homeownership by providing larger relative benefits to households on the margin between owning and renting.