“Reconsidering and Improving Existing Tax Subsidies for Housing”

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Committee on Housing and Community Development
Committee on Revenue and Taxation

Thank you for the opportunity to participate in this discussion on California’s investment in housing and, in particular, on the role of tax policy in that investment.

What I want to do today is provide a framework that I hope will assist your Committees in thinking about the advantages and disadvantages of using the tax system to subsidize aspects of housing policy in California.

In using taxation to encourage or discourage certain kinds of behavior, we should evaluate (and then **re**-evaluate) at least four factors: **See SLIDE 2**

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 on the books are working as planned or desired; and
4. Whether we should preserve, repeal, or redesign existing subsidies.

I’d like to consider these factors one by one. But first, before determining whether we need a subsidy to influence some desired behavior we have to identify the desired behavior.

As I see it, there are two primary goals WRT our investment in housing. First, promoting homeownership, which as we know enjoys broad political support and which currently receives considerable financial support through the tax system—indeed, to the tune of over $200 billion in foregone tax revenues at the federal level and at least $8 billion in foregone tax revenues for California. The second goal is promoting affordable housing, which enjoys far less political support and receives a fraction of financial support through the tax system—in fact, we spend a comparatively paltry few hundred million dollars in tax subsidies on such policies.

I will spend the remainder of my time on the first goal, while leaving discussion of the second goal to the next panel.

(1) Do we need a subsidy to influence the desired behavior?

The evidence here is ambiguous. People buy homes for all kinds of perceived benefits: better schools, safer neighborhoods, achieving a sense of place, attaining status in their community, and possible financial security.

But it is unclear whether government subsidies have any effect on the rate at which people buy homes. With respect to the mortgage interest deduction, for example, substantial empirical research over the last thirty years has concluded that the subsidy has almost no effect on the rate of homeownership.

Cross-country comparisons reinforce this conclusion. Consider that Switzerland permits taxpayers to deduct mortgage interest and property taxes but its homeownership rate is less than 40 percent, while Australia does not allow such deductions and its homeownership rate is higher than that in the United States.

So this question in our policymaking analysis does not allow a clear answer. Nonetheless, let's assume that despite the ambiguity we still want to promote homeownership, if only for reasons of political economy.

But what does it mean to promote homeownership? At the very least, it means influencing the decision to own versus rent without creating unnecessary economic distortions.

With these parameters in mind, let's examine our second question:

(2) Should housing subsidies be located inside or outside the tax system?

The key to influencing the purchase decision is to make the purchase price less expensive. If we use the tax system to accomplish this goal, our chosen policy needs to lower the after-tax cost of housing, particularly for those taxpayers who need the subsidy to move from renting to owning.

Our current policies express a preference for using tax deductions, namely the deductions for mortgage interest and property taxes (which, together, cost the state over $6 billion a year). We can analyze how effectively these policies target the right taxpayers: again, those taxpayers choosing between owning and renting.

It turns out these deductions do a terrible job of influencing the purchase decision for our target population. In fact, they represent the classic upside-down subsidy, delivering benefits to precisely the wrong people. They are available to taxpayers who itemize, but only one-third of taxpayers itemize. Moreover, high-income taxpayers itemize at considerably higher rates than low- and middle-income taxpayers. Even among itemizers, the net benefit of housing subsidies can be negligible.

Consider the mortgage interest deduction. In 2010, taxpayers reporting adjusted gross income (AGI) above $200,000 (or just 2.5% of all tax filers) received 35% of the tax savings from the subsidy, while taxpayers with AGI over $100,000 (or 12.5% of all filers) took home nearly 80% of the subsidy's benefits.

That leaves very little for everyone else. Taxpayers with income below AGI of $75,000—or 80% of all filers—received just 11% of the subsidy.

Thus, this very expensive tax expenditure (costing $4.5 billion in fiscal year 2012-13) misses our target population; that is, those on the margin between owning and renting. And it fails in this regard, because it takes the form of a deduction.

Let me explain with a quick example. **SLIDE 3** Consider a married household with $100,000 in AGI that currently rents and is in the 25% tax bracket. This household pays $4,000 in state income taxes and makes $1,000 in charitable contributions, for a total of $5,000 in potential itemized deductions, well below the standard deduction of $12,000. This household takes the standard deduction.

SLIDE 4 Now consider the same household the next year after purchasing a house. The new owners are excited for many reasons, including the promised tax benefits that their real estate agent described: the deductions for mortgage interest ($10,000 for this household) and property taxes ($5,000). Assuming no change in state income taxes and charitable contributions, this household now has $20,000 worth of itemized deductions, which exceeds the standard deduction, so they itemize.

SLIDE 5 But what are the tax subsidies worth to this household? In other words, what is the after-tax value of their $15,000 in new housing costs?

Is it the full $15,000? No.

Is it the $15,000 multiplied by their marginal tax rate? No.

Rather, it is the amount by which total itemized deductions exceed the standard deduction multiplied by their marginal tax rate. In determining the after-tax benefit of a tax subsidy, we need to know the marginal benefit. Here, the marginal benefit is only $2,000: $20,000 (total itemized deductions) less $12,000 (otherwise available standard deduction) = $8,000 x .25 = $2,000.

Not bad. But consider a household with exactly the same housing costs of $15,000 in the top tax bracket of 39.6%. This household is already itemizing deductions due to higher state income taxes paid, so any additional deductions associated with housing are simply multiplied by the household's marginal tax rate to determine their value. As a result, the marginal benefit of the tax subsidies increases dramatically for this higher-income household from $2,000 to $5,940, or nearly three times the benefit enjoyed by the household the 25% tax bracket: $15,000 (the full amount of housing costs) x 39.6% = $5,940.

The lesson here is that if we want to use the tax system to promote homeownership, we should <u>**not**</u> be using deductions. I will describe a better alternative later. But first, let's tackle our third question:

<u>**(3) Are the subsidies on the books working as planned?**</u>

As we've seen, with respect to <u>*effectiveness*</u>, <u>*equity*</u>, and <u>*targeting*</u>, the existing tax subsidies are failing to promote homeownership. And they're failing just as badly with respect to one final criterion, <u>*efficiency*</u>.

<u>**SLIDE 6**</u> Economists have long indicted the current housing tax subsidies for distorting the housing and mortgage markets.

First, they distort the cost of owner-occupied housing relative to other investments, which contributes to significant overinvestment in housing stock and economy-wide misallocations of capital stock. And no wonder: the economy-wide tax rate on housing investment is close to zero, while the tax rate on corporate investment exceeds 30 percent.

Second, current tax subsidies for housing distort not only where to invest but also how to invest. Specifically, they encourage taxpayers to take on massive debt and precariously high loan-to-value ratios. Largely due to this incentive, mortgage indebtedness soared in the decade preceding the most recent housing collapse, with debt as a percentage of GDP rising from 47% in 1995 to 81% by 2007.

Third, by creating artificial demand for owner-occupied housing through subsidized mortgage debt, these subsidies simply encourage homebuyers to consume larger and more expensive homes than they would otherwise purchase.

Finally, all of this artificial demand raises aggregate housing prices between 3-10 percent such that the subsidies prevent millions of potential homebuyers from entering the market. And while current homeowners may prefer inflated prices for maximizing gain upon sale, any perceived benefit is illusory as sellers become buyers in the same overheated market.

At the end of the day, our current tax policies for homeownership are ineffective, inequitable, and inefficient. Plus, they cost a lot of money: over $8 billion a year in foregone tax revenues to the state of California. **<u>SLIDE 7</u>** And yet, these expensive policies are not putting people into homes.

With that in mind, let's turn to our last question:

<u>(4) Should we preserve, repeal, or redesign existing tax subsidies?</u>

The most important thing to remember in considering this last question is that the California legislature never had the benefit of independently analyzing the current tax subsidies for housing that affect our state. Rather, those subsidies were enacted by the U.S. Congress as national policy over the course of the last 100 years. And we are currently stuck with them, because we use <u>federal</u> AGI as the starting point for determining for <u>state</u> income tax liability.

<u>We need not be so fiscally confined</u>. There is no requirement for the state of California to accept every tax deduction, exclusion, exemption, and credit that comprises the federal tax expenditure budget. Indeed, to the extent those tax expenditure items ineffectively promote homeownership in California, or distribute benefits inequitably, or create wealth-destroying inefficiencies, or siphon off billions of dollars in state revenue, policymakers have a responsibility to critically reconsider their endorsement of them.

If we wanted to reclaim $4.5 billion in annual revenue from the mortgage interest deduction, for instance, we could easily require California taxpayers to add back any amount reflected on line 10 from the federal tax return form, Schedule A, "Itemized Deductions." Furthermore, if we wanted to reclaim the $1.6 billion in annual revenue lost to the property tax deduction, we could have taxpayers add back the figure reflected on line 6 of Schedule A.

SLIDE 8 Therefore, in answering this last question—Should we preserve, repeal, or redesign existing tax subsidies?—I urge your Committees to pare back and redesign all tax subsidies purporting to promote homeownership. That means deviating from federal AGI in several ways. In particular, I would eliminate usage of tax deductions as a deliver mechanism for any housing tax benefits. I would restrict basis step-up on inherited property to cases of hardship. I would limit the exclusion for capital gains on home sales by accounting for built-in gains due to inflation (thus taxing only real gains and not nominal gains).

And most importantly, if you really want to promote homeownership using the tax system, I recommend a "**Homeownership Tax Credit**" in lieu of both the mortgage interest deduction and the property tax deduction. A credit that provided 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.

In addition, a tax credit would offer the same dollar-for-dollar benefit to all qualifying taxpayers, to high incomes as well as low incomes, to itemizers as well as non-itemizers, and to owners of big and small homes as well as big and small loans.

Studies over the last fifteen years have shown that a tax credit could increase owner-occupied housing between 3-5 percentage points in the aggregate and 8 percentage points for the lowest income taxpayers. Other studies indicate that a credit replacing both the mortgage interest deduction and the property tax deduction could provide a 5-percentage point boost to homeownership.

Millions of new homeowners translate into millions of new homes, a happy occurrence for homebuyers, the housing industry, and policymakers.

One final subject deserves attention. The housing industry would have us believe that disturbing existing tax subsidies for housing will result in a precipitous drop in housing prices. That is false. Dire predictions of a collapse in the housing market in the event policymakers reconsidered tax subsidies are dramatically overstated. In fact, researchers have shown that repealing the mortgage interest deduction (and not even replacing it with an alternative policy such as a tax credit) could raise rates of homeownership, particularly in high-priced areas like California. The idea is that positive effects on homeownership rates from lower home prices would more than offset any negative effects on homeownership from loss of the deduction. This is particularly true of younger, urban buyers living in high-priced, space-constricted markets such as San Francisco where the price effect would provide an opportunity for them to enter the market. Over time, the natural increase in demand would raise home prices—but not in an artificial or distortionary way—as demand began to outpace supply.

Other studies have found that to the extent prices dipped in the event policymakers reformed or replaced existing tax subsidies, the downturn would be temporary and would almost exclusively affect bigger, more expensive homes. If policymakers were still concerned about preserving artificially inflated values for sellers of bloated homes, any policy changes could be phased in over several years.

Either way, repealing or redesigning our existing tax subsidies for housing would encourage the buildup of home equity; that is, real ownership rather than leveraged ownership. It would increase the saving rate of California homeowners, help households absorb future income shocks, and create less risk of financial catastrophe when the next downturn in housing occurs.

Thank you for your attention.

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