A CBO Study

The Tax Treatment of Homeownership: Issues and Options

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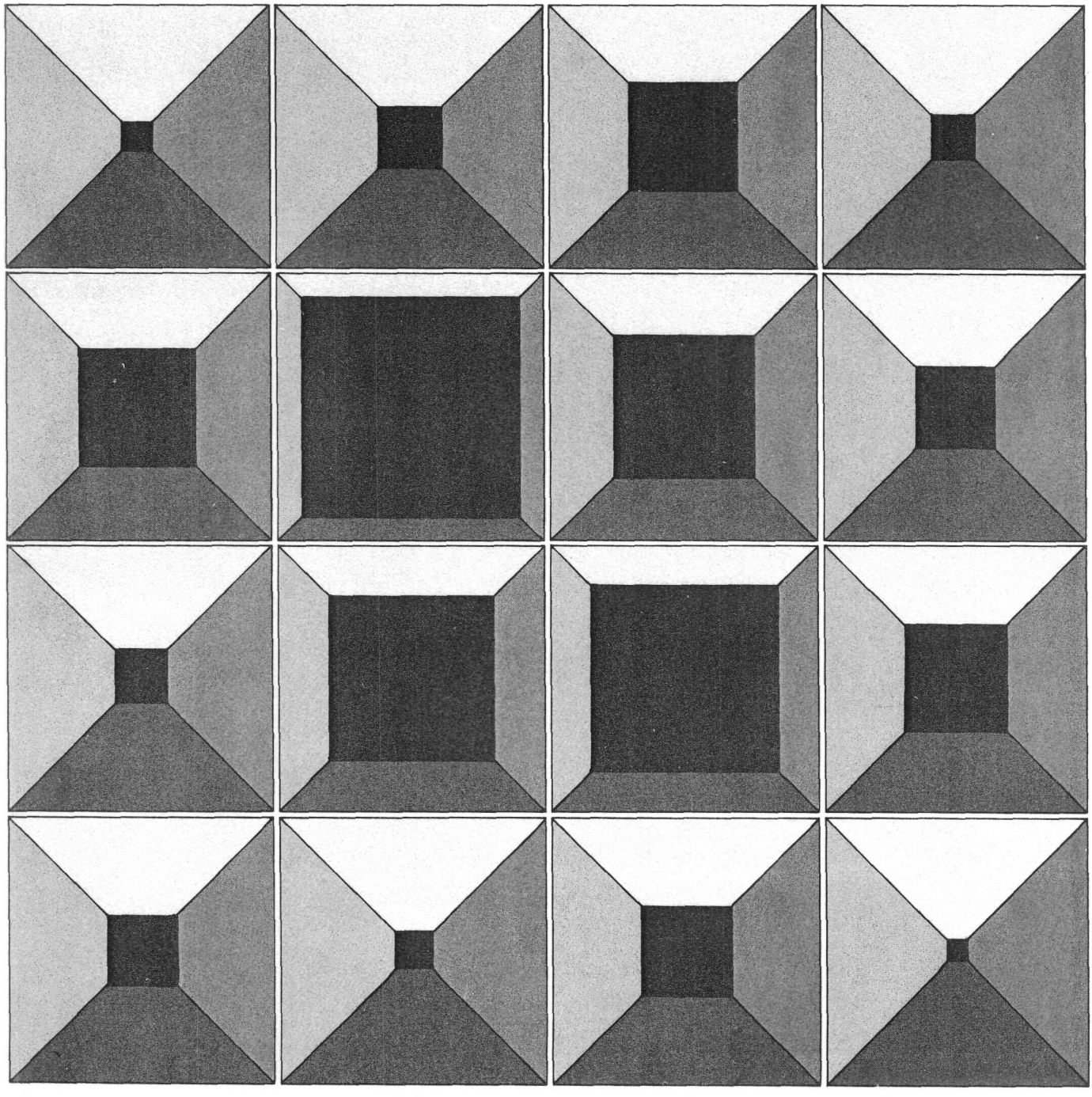
Congress of the United States
Congressional Budget Office



THE TAX TREATMENT OF HOMEOWNERSHIP: ISSUES AND OPTIONS

The Congress of the United States
Congressional Budget Office

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PREFACE

This report, requested by Chairman Henry S. Reuss of the Joint Economic Committee, examines the current federal income tax provisions benefiting homeownership and their effect on nonresidential investment, the housing market, and the tax system. Alternatives to the current provisions are also considered, although in accordance with CBO's mandate to provide objective and impartial analysis no recommendations are made.

The Tax Treatment of Homeownership: Issues and Options was written by Joshua E. Greene of CBO's Tax Analysis Division, under the supervision of James M. Verdier. Martin D. Levine, Brent Shipp, and the staff of CBO's Tax Division provided valuable comments in preparing the report, while Ben Steffen was responsible for important portions of the computer analysis.

Many persons outside CBO also provided technical assistance and valuable comments during the preparation of this report, including Van-Xe Nguyen and Ned Newland of the Joint Committee on Taxation; Michael Lea, Duane McGough, Jay Howenstine, Emanuel Savas, John Simonson, and Kevin Villani of the Department of Housing and Urban Development; and Henry Aaron, Joseph Donohue, Anthony Downs, Rolfe Goetze, Richard Goode, Jane Gravelle, Patric Hendershott, Paul Manchester, Richard Marcis, Barbara Miles, Nonna Noto, Stephen Oliner, Thomas Parliment, Joseph Pechman, James Poterba, Harvey Rosen, Wilbur Steiger, George Sternlieb, Emil Sunley, Craig Swan, Louis Talley, John Tuccillo, and James Wetzler. Francis Pierce edited the paper, and Martha Campbell provided fact-checking assistance. Special thanks are due Linda Brockman and Shirley Hornbuckle for their work in typing the many drafts.

Alice M. Rivlin
Director

September 1981

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SUMMARY

Homeowners receive considerable assistance from the federal government in the form of income tax benefits. These benefits are the result of general provisions in the tax laws that enable homeowners to deduct mortgage interest and property taxes from their taxable income, and that also reduce their capital gains tax liabilities. In fiscal year 1982 these tax benefits will amount to more than $39 billion. By way of comparison, in the same year the federal government will spend about $16 billion for the entire budget of the Department of Housing and Urban Development.

Over two-thirds of the recognized tax benefits to homeowners in fiscal year 1982--about $25.3 billion--will come from the deductibility of home mortgage interest payments. Another $10.7 billion will result from the deductibility of property tax payments for owner-occupied homes. Homeowners will receive an additional $1.2 billion in subsidies from the deferral of income tax on capital gains from selling their homes. About $650 million more in subsidies will result from excluding $125,000 in capital gains income from the sale of homes by persons aged 55 and older. Further tax benefits result from the use of tax-exempt bonds to finance private home mortgages, and, to a lesser extent, from the provision of excess bad debt deductions to financial institutions. In addition, many economists contend that homeowners benefit from the nontaxation of net imputed rental income--the difference between the income they could receive from renting their homes and the total costs of homeownership (mortgage interest, taxes, insurance, maintenance, and depreciation).

RATIONALE AND CONSEQUENCES OF THE CURRENT SUBSIDIES

The current tax provisions affecting homeownership came about for a variety of reasons. The mortgage interest and property tax deductions, for example, are part of the more general itemized deductions allowed many taxpayers for interest payments and nonfederal taxes, while the exclusion of state and local housing bond interest is part of the general provision authorizing tax-exempt state and local bonds. The deferral of capital gains on home

sales, added to the tax code in 1951, was adopted to shield homeowners from tax liability when unforeseen circumstances such as job changes required them to sell one house and buy another. The exclusion of $125,000 in capital gains on home sales for persons 55 and older, which replaced a much smaller exclusion adopted in 1964, was instituted largely to reduce tax liabilities for older persons who decide to become renters or to purchase smaller homes.

Effects on Homeownership Costs

These tax provisions reduce the after-tax costs of acquiring, owning, and selling a home. The mortgage interest and property tax deductions, for example, can lower the first-year costs of homeownership by 35 percent or more for some households in high marginal tax brackets. The deferral and exclusion of capital gains from home sales enable many families to use the entire gains realized from the sale of their previous residence in buying another home.

By lowering the after-tax cost of homeownership, the tax provisions tend to shift resources into housing at the expense of other capital assets, and into the production of owner-occupied housing rather than rental housing. They provide particularly large tax savings to upper-income taxpayers, with the consequence that marginal tax rates for all taxpayers must be significantly higher than would otherwise be necessary to raise the same amount of revenue. They also help to raise housing prices.

Recent research indicates that these effects of the homeownership provisions have been substantial. One study suggests that as much as one-third of the owner-occupied housing in the United States as of 1976-1977 would not have been built if tax benefits had not lowered the after-tax cost of buying a house far below the cost of other investment assets. Other research suggests that the fraction of homes that are owned by their occupants would be 4 to 5 percentage points less without the mortgage interest and property tax deductions, and without the exclusion of net imputed rental income. Studies also indicate that households would buy less expensive houses in the absence of tax subsidies, and that housing prices might be lower. Finally, recent estimates by the Congressional Budget Office (CBO) suggest that marginal tax rates could be at least 10 percent lower at fiscal year 1982 income levels if the deductions for mortgage interest and property taxes, the deferral and exclusion of capital gains for home sales, and the use of tax-exempt bonds for owner-occupied housing were eliminated.

Developments During the 1970s

During the last decade, the tax treatment of homeownership has gained special importance because of dramatic changes in housing markets and in the economy as a whole. Between the years 1965-1973 and 1973-1978, the average annual growth rate of net business investment fell nearly 50 percent, a development many analysts view as a major reason for the nation's declining productivity growth. During this same period, rental housing construction decreased, while a growing number of existing rental units--135,000 alone in 1979--were converted to owner-occupied housing. At the same time, house prices rose at an unprecedented rate from 1969 to 1979--roughly 150 percent, about one and one-half times as fast as the rise in household incomes or the general rate of inflation. These price increases made it harder to purchase a first home, while those who already owned homes have received sizable capital gains. The rapid price increases also contributed to rising wage and pension costs through their effect on the Consumer Price Index (CPI), which is used to adjust many federal benefit payments and private-industry wage agreements.

Underlying these developments was the interaction of inflation with the individual income tax. Inflation and a tax rate structure basically unchanged since 1964 pushed taxpayers into steadily higher marginal tax brackets, significantly increasing the tax benefits for homeownership. This greatly augmented the rate of return to homeownership as an investment, and in turn contributed to the more-than-proportionate rise in house prices and the two-percentage-point rise in homeownership between 1970 and 1980. Higher benefits have also contributed to the decline in rental housing construction, the growth of condominium conversions, and the further shift of consumer savings toward homeownership. Between 1975-1976 and 1977-1979, for example, the percentage of disposable personal income devoted to net financial investment fell by more than 75 percent, while the share allocated to homeownership rose more than 50 percent. This shift in savings may have reduced net corporate investment, although other factors such as heavy government borrowing, economic recessions, and slow economic growth also contributed significantly to the decline.

Current Tendencies

The sharp increase in mortgage interest rates since 1979 may have reduced the impact of the tax provisions described above. Over the last year and a half, house prices have risen less rapidly

while home sales and the construction of new homes have both fallen to near-record lows. The spread of variable-rate mortgages will eliminate much of the windfall investment gains that homeowners have received in the past, while the recently enacted increases in depreciation allowances should make business investment more attractive. Thus, homeownership tax benefits may have smaller effects in the coming decade. Nevertheless, the underlying demand for homeownership should remain strong for the next two decades, because households of the primary homebuying age (those in the 25- to 34-year-old age group) will remain about one and one-half times as large as the main group of net home sellers, households with heads aged 55 to 64, through the year 2000.

If the demand for homeownership remains strong, savings may continue to flow into housing despite the new demand for business investment generated by the 1981 tax law changes. This competition for investment funds could, in turn, place upward pressure on interest rates. Some analysts also believe that the present tax benefits for homeownership could exacerbate what is likely to become an excess of single-family homes by the time the current members of the post-World War II "baby boom" generation retire. Demographic projections indicate that this generation will far exceed the group of new homebuyers early in the next century. Thus, there may then be a significant oversupply of single-family houses and a shortage of the smaller, less expensive units that the elderly have traditionally preferred.

POLICY OPTIONS

If the Congress wishes to review the current tax provisions affecting homeownership, a number of policy options are available. Some would amend the tax law to moderate its effects on capital investment and on the housing market. Others would redirect tax benefits toward low- and moderate-income families and toward first-time housebuyers. The Congress could also decide to maintain current law.

Maintaining Current Law

One option available to the Congress is to make no change in the current law. This might seem preferable considering the current depressed state of the construction industry and the housing market. Annual housing starts have recently fallen to

their lowest level since World War II--just over one million units a year--largely as a result of high interest rates.

Maintaining current law would preserve the existing tax benefits for homeowners but allow time for the market to adjust to the effects of high interest rates, more generous business depreciation deductions, and the recent innovations in mortgage finance. This approach would also leave intact forces that may lead to a long-run excess of single-family homes, however, because the need for such housing will decline as the unusually large generation of newly-formed households approaches retirement.

Options to Moderate the Investment and Housing Market Consequences of the Current Tax Provisions

If the Congress wishes to reduce the investment and housing market effects of the current tax provisions affecting homeownership, a number of policy options are available.

Limiting the Deductibility of Mortgage Interest Payments. One option would be to limit the deductibility of home mortgage interest payments. Under this approach, a ceiling would be imposed on the amount of deductible mortgage interest payments. Such a ceiling would be particularly effective if made part of a general limit on nonbusiness interest deductions, since this would reduce the ability of homeowners to circumvent a mortgage deductibility limit by shifting loans to other assets. CBO estimates that a simple $5,000 ceiling on the deduction effective January 1, 1982, would affect about 4.6 percent of all taxpayers (based on 1981 income levels), raising federal revenues by $3.0 billion in fiscal year 1982 and $5.4 billion in fiscal year 1983. A $10,000 ceiling, which would avoid tax increases for many recent purchasers of homes costing up to $100,000, would increase federal revenues by $600 million in fiscal year 1982 and $1.0 billion in fiscal year 1983.

Limiting the amount of deductible mortgage interest payments would decrease the tax advantages in owning a home rather than renting one, and reduce the incentive to devote private savings to homeownership. But it could also mean that fewer people could afford to own homes. Moreover, it would change the structure of house prices, decreasing them for more expensive homes and increasing them for those with interest payments below the ceiling. These price shifts could impose losses on many present

owners, even if they were exempted from the new ceiling, because new homeowners would still face higher after-tax housing costs.

Limiting Property Tax Deductions. Another way to limit the investment and housing market effects of current policy would be to limit the deductibility of property tax payments on owner-occupied homes. This could be done by allowing only a certain portion of property tax payments, such as 50 or 75 percent, to be deducted. A 75 percent limitation effective January 1, 1982, would reduce revenue losses by about $2.0 billion in fiscal year 1982 and $3.5 billion in fiscal year 1983.

Limiting property tax deductions might be more effective than a ceiling on mortgage interest deductions in reducing tax benefits for homeownership, because homeowners could not evade this type of restriction by borrowing against other assets. The major drawback of this approach is that it could seriously weaken the ability of state and local governments to use the property tax as a source of revenue, thereby reducing their fiscal resources.

Reducing the Exclusion of Capital Gains Income from Home Sales. A third option would be to reduce the exclusion of capital gains from home sales for those 55 and older. This would prevent many homeowners from escaping tax on the accumulated gains from the sale of their homes and would treat homeownership more like other capital investments. CBO estimates that reducing the excludable gains to $50,000 in calendar year 1982 would increase revenues by more than $100 million in fiscal year 1983 and between $200 and $300 million a year during subsequent years.

Reducing the exclusion could, however, impose significant cash burdens on taxpayers who become renters or purchase smaller homes, since a lifetime of accumulated gains (less any exclusion) would become subject to tax. Such a change could discourage older homeowners from selling their homes, thereby preventing the flow of accumulated savings in private homes into other capital assets. The cash flow problem could be alleviated by allowing the tax to be deferred until death, although in that case older homeowners might be even more inclined to keep their homes until their death (since current law provides a step-up in basis for property at the time of a decedent's death, thereby eliminating any tax liability on capital gains during the decedent's lifetime).

Taxing Gains at the Time of Sale. Another more far-reaching option would be to replace both the deferral and the exclusion of gains with a small tax at the time of sale. Under this approach, 10 or 20 percent of the gains from selling a house might be included in taxable income in the year of sale. This would make the tax treatment of gains from home sales more like that of other assets, where all short-term gains and 40 percent of long-term gains are subject to tax.

Abolishing the deferral of gains would eliminate the present incentive for homeowners to keep reinvesting their gains in owner-occupied housing and thus free some personal savings for nonresidential investment. Without some indexing of capital gains, however, this option could impose significant tax liabilities on movers during periods of house price inflation. It could also discourage homeowners from accepting job transfers or new positions in another locality.

Creating New Tax Subsidies for Renters. Still another way to reduce the effects of current law on the housing market would be to create a new tax credit or deduction for renters. This option would decrease the tax advantages of homeownership and possibly encourage some households to remain renters. It would also enable many renters to afford higher rents--a move that could encourage better apartment maintenance and discourage condominium conversions if local laws do not prohibit rent increases.

The chief problem in establishing new tax credits or deductions for renters is that even measures with significant revenue costs might not be large enough to offset the effects of homeownership subsidies on the rental housing market. A 7 percent refundable tax credit for rent payments, for example, would provide more than $5.1 billion in new subsidies for rental housing. This type of subsidy would benefit existing landlords and tenants, but it might not be sufficient to encourage more middle-income households to choose renting.

Options to Retarget Benefits and to Reduce Alleged Inequities in the Tax Treatment of Housing

If the Congress wishes to redirect tax benefits toward low- and moderate-income families or first-time homebuyers and to reduce alleged inequities in the tax treatment of housing, still other policy options are available.

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Converting the Deduction for Home Mortgage Interest Payments to a Tax Credit. One way to concentrate tax benefits for homeownership more heavily on low- and moderate-income households would be to convert the deduction for home mortgage interest payments to a flat-rate tax credit. This approach would provide taxpayers at different income levels with the same rate of subsidy for mortgage interest payments, replacing a subsidy that now increases with taxable income. It would also provide explicit interest subsidies to the more than 37 percent of homeowners with mortgages who do not itemize their deductions. Both of these features would benefit less affluent homeowners, who tend on average to have lower marginal tax rates and to itemize less frequently than do taxpayers with higher incomes.

Converting the home mortgage interest deduction to a tax credit could either increase or decrease federal revenues, depending on the rate of credit chosen. CBO estimates, for example, that moving to a 25 percent tax credit, effective January 1, 1982, would increase revenues by about $2.4 billion in fiscal year 1982 and $4.3 billion in fiscal year 1983, while a credit of 30 percent or more would decrease revenues. A tax credit would also affect house prices, raising them somewhat for less expensive homes and lowering them for higher-priced units. Some upper-income homeowners might thus experience a decrease in the value of their homes as well as an increase in their tax payments. Allowing current owners the choice of a deduction or credit would limit these capital losses, but the revenue losses from doing so could be substantial.

Eliminating the Deductibility of Mortgage Interest or Property Tax Payments for Second Homes. Another way to retarget savings on low- and moderate-income families would be to eliminate the deductibility of mortgage interest or property tax payments for second homes held for personal use. Taxpayers could then deduct only the payments on their principal residence and on rental properties for these items.

These changes would affect mostly higher-income families--those with vacation homes and multiple residences. Limiting property tax deductions would probably be more effective than limiting mortgage interest deductions, since many owners of second homes own other assets against which they could borrow to circumvent limits on the interest deduction. The overall revenue gain from these changes would probably be less than $900 million at fiscal year 1982 income levels if the deductibility of both payments was eliminated.

Concentrating More Benefits on First-Time Homebuyers. A third option would be to concentrate more of the tax benefits for homeownership on first-time homebuyers. This might be appealing as a way of moderating the past effects of the existing tax benefits and inflation on first-time buyers, or if the Congress believes that first-time buyers deserve special treatment in any move to reduce the current tax benefits.

In addition to providing separate deductibility limits for first-time buyers, a number of more extensive policy options are also available. Special tax-subsidized savings accounts, for example, would enable households to acquire a down payment more quickly, as would tax credits for a limited percentage of the purchase price of a first home. Alternatively, the federal government could encourage the use of mortgage instruments that reduce housing costs during the early years of homeownership, although lenders might require large subsidies to provide these loans in substantial quantities.

Each of these options would help first-time buyers, but each would also have important drawbacks. The establishment of special savings accounts, for example, would provide substantial benefits for those who do not need such assistance, and would also entail heavy revenue cost--about $5.7 billion in fiscal year 1983 and $7.8 billion the following fiscal year, if effective January 1, 1982. A 5 percent tax credit limited to the first $50,000 of house price would be somewhat less expensive and would direct more savings at households with difficulty amassing a down payment, but even this approach could provide significant windfalls to would-be buyers unless limited to households with incomes below a specified amount.

Besides these specific problems, both options might also raise prices for so-called "starter" homes. In addition, these and other moves to assist first-time buyers could worsen the side-effects of the existing provisions unless they were introduced as part of a package designed to reduce the overall magnitude of tax benefits for homeownership.

CHAPTER I. INTRODUCTION

The federal income tax law has encouraged homeownership since its inception. Nevertheless, recent developments in the housing and capital markets have led some analysts to question the desirability of large tax benefits for homeowners. During the last five years, the rate of productivity growth and net investment in business capital have slowed considerably, while many taxpayers have devoted increasing shares of their incomes to homeownership rather than to savings that could be invested in industry. Rental housing construction has also diminished, while many apartments in metropolitan areas have been converted to cooperatives and individually-owned condominiums. Another important trend has been the rapid appreciation of housing prices, which has made it far harder for families to acquire a first home while significantly benefiting those who are already homeowners. Each of these developments can be attributed in part to the tax provisions favoring homeownership, although other factors such as inflation and demographic trends have played a part.

Current federal law provides homeowners with large tax benefits through the deductibility of home mortgage interest and property tax payments and through the preferential tax treatment given capital gains from the sale of owner-occupied homes. These tax benefits are largely the unintended by-products of more general tax provisions affecting interest payments, state and local government taxes, and the tax treatment of unrealized income. Nevertheless, they have a substantial effect on the federal budget. In fiscal year 1982, the arithmetic sum of the five major tax expenditures benefiting homeowners will exceed $39 billion, based on the most recently available estimates.[1] By

1. A tax expenditure is the estimated direct revenue loss created by a particular tax provision. Because tax provisions are interrelated and frequently affect individual behavior, eliminating a tax expenditure could bring about smaller or larger revenue gains than the tax expenditure estimate associated with the provision. See Congressional Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1981-1985 (April 1980).

fiscal year 1986, this sum could exceed $82 billion, again based on the most recently available estimates.[2]

PLAN OF THE PAPER

This paper analyzes the current tax treatment of homeownership, examining its effects and analyzing alternative policies the Congress may wish to consider. It focuses on five major tax expenditures that benefit homeowners: the deductibility of home mortgage interest payments and property taxes for owner-occupied homes; the deferral of capital gains from home sales; the exclusion from taxable income of $125,000 in capital gains from home sales for persons aged 55 and older; and the use of tax-exempt bonds to finance owner-occupied housing. The paper also discusses the exclusion from taxable income of net imputed rental income--the income homeowners implicitly earn from owning and occupying (rather than renting out) their homes. The revenue loss from this exclusion is not considered a tax expenditure because of the problems of valuing and taxing noncash income. Nevertheless, many analysts contend that a theoretically correct income tax system would tax net imputed rental income.

Chapter II analyzes these tax provisions and one other tax expenditure that affects homeownership: the use of tax-exempt bonds to finance owner-occupied housing. For each of these items, a history of the provision, its estimated revenue loss, and, where possible, a distribution of tax savings by income group are provided.

Chapter III explores the major effects of the tax treatment of homeownership on economic activity. Included here is a discussion both of the "direct" effect of these subsidies on after-tax housing costs and of the "side effects" they have for the rest of

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2. These tax expenditure estimates, and the revenue estimates for other tax proposals, are all based on the schedule of marginal tax rates effective before passage of the Economic Recovery Tax Act of 1981. The reductions in tax rates brought about by the law will decrease both the tax expenditure estimates and the revenue effects of the various proposals discussed in this paper by a small but as yet undetermined amount.

the economy. Special attention is paid to four particular "by-products": the effects of the tax provisions on business capital formation, on rental housing, on house prices, and on the structure of the income tax.

Chapter IV analyzes several policy options. One would maintain current law. Other options would reduce existing tax subsidies, such as limiting the amount of deductible mortgage interest or property tax payments, or altering the capital gains exclusion for home sales. Another would provide renters with tax credits or deductions, still another would convert the mortgage interest deduction to a tax credit. In addition, several policy options would aim at helping first-time homebuyers through such measures as the establishment of tax accounts for the purchase of a first home, and the provision of tax credits for first-time homebuyers.

The report ends with two appendixes on related issues. The first is a brief overview of other federal programs and federally-sponsored organizations to assist homeownership. Included here is a brief account of the mortgage assistance programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA) and the activities of the Federal Home Loan Bank System (FHLBS), the now-privately-owned Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC). The second appendix contains a brief account of new mortgage instruments that have begun to displace fixed-interest-rate loans as the standard home mortgage. Among those discussed are the variable rate (VRM), renegotiable rate (RRM), shared appreciation (SAM), and graduated payment (GPM) mortgages.

CHAPTER II. CURRENT TAX PROVISIONS AFFECTING HOMEOWNERSHIP

The federal individual income tax has two sets of provisions that explicitly affect homeownership. The first allows taxpayers to claim two of the major expenses of homeownership--mortgage interest and property tax payments--as itemized deductions. The second set largely exempts from tax any capital gains income from home sales. Under current law, capital gains realized from the sale of one's principal residence can be deferred if the taxpayer purchases another residence of equal or greater value within a prescribed time period. In addition, taxpayers aged 55 or older may claim a one-time exclusion of up to $125,000 in capital gains from the sale of their principal residence, whether or not they buy another home.

Besides these two sets of provisions, the income tax contains one provision that gives more indirect subsidies to owner-occupied housing: the exclusion from tax of interest on state and local government bonds.[1] This benefits a limited number of homeowners through the use of tax-exempt bonds that provide subsidized home mortgage loans.[2] In addition, the income tax law does not count as taxable the income homeowners implicitly receive from owning and occupying (rather than renting) their homes, although they are taxed on the income received from other investments (including rental property). This chapter analyzes each of these tax provisions, summarizing the history and rationale of each and, where possible, indicating the size and distribution of the tax benefits it provides.

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1. In addition to this provision, the provision of excess bad debt reserves to financial institutions benefits homeowners to the extent that the tax savings are passed on in the form of lower mortgage interest rates.

2. The Congress limited the volume of tax-exempt mortgage revenue bonds in the Budget Reconciliation Act of 1980. For a detailed analysis of the mortgage bond issue, see Congressional Budget Office, Tax-Exempt Bonds for Single-Family Housing, study prepared for the Subcommittee on the City, House Committee on Banking, Finance, and Urban Affairs, 96:1 (April 1979), Committee Print 96-2.

THE DEDUCTIBILITY OF HOME MORTGAGE INTEREST PAYMENTS

Section 163 of the Internal Revenue Code allows taxpayers to deduct the full value of all interest paid or due--including home mortgage interest payments--with certain limitations for interest on property held for investment income. The deductibility of mortgage interest payments on owner-occupied homes constitutes a subsidy because the income associated with homeownership (net imputed rental income) is not taxed. In fiscal year 1982, CBO estimates that this provision will generate a tax expenditure of nearly $25.3 billion (see Table 1). Current estimates indicate that this figure could reach $56.5 billion by fiscal year 1986. The actual revenue loss could be higher if interest rates or the level of household formation exceed current projections.[3]

Rationale. The deductibility of interest from taxable income in the federal income tax dates from 1913. No explicit rationale for this provision was advanced at the time of its enactment, but committee reports and floor debates suggest that interest payments were viewed as reductions in income that should be taken into account in determining a person's ability to pay income tax.[4] No distinction was made between interest payments for business and nonbusiness purposes. At that time most interest was a business expense and a cost of earning income; home mortgage and consumer borrowing were far less prevalent than today.

Currently, a major justification for the deductibility of home mortgage interest payments is the desire to encourage homeownership. Homeownership can encourage neighborhood stability, promote civic responsibility, and improve the maintenance of residential buildings. Evidence for this last point has come from several studies, and one economist (James Sweeney) has even developed a

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3. See Nonna A. Noto, "Tax and Financial Policies for Owner-Occupied Housing in the 1980's," in Dale R. Marshall and Roger Montgomery, eds., Housing Policy in the 1980s (D.C. Heath and Co., 1981).

4. See U.S. Senate, Committee on the Budget, Tax Expenditures, 95:2 (September 1978), p. 72.

TABLE 1. MAJOR TAX EXPENDITURES FOR HOMEOWNERSHIP, FISCAL YEARS 1981-1986 (In millions of dollars)

Provision	1981	1982	1983	1984	1985	1986
Deductibility of Mortgage Interest on Owner-Occupied Homes[a]	19,805	25,295	31,115	37,960	46,310	56,500
Deductibility of Property Taxes on Owner-Occupied Homes	8,915	10,705	12,740	15,160	18,040	21,465
Deferral of Capital Gains on Sales of Owner-Occupied Homes	1,110	1,220	1,345	1,480	1,630	1,790
Exclusion of Capital Gains on Sales of Owner-Occupied Homes for Persons Aged 55 and Older	590	650	715	785	860	950
Exclusion of Interest on State and Local Bonds for Owner-Occupied Housing	840	1,220	1,600	1,855	1,890	1,810
Arithmetic Sum	31,260	39,090	47,515	57,240	68,730	82,515

SOURCE: Joint Committee on Taxation and Congressional Budget Office.

a. Does not include the deductibility of interest payments for home improvement loans or loans on investment property.

complex model explaining this phenomenon.[5] The deduction may also help to stimulate residential construction and contribute to the goal of providing a "decent home" and a "suitable living environment" for all Americans.[6]

Extent and Distribution of Tax Savings. A major part of the tax savings from the mortgage interest deduction goes to middle- and upper-income taxpayers. Estimates from the Treasury Department's Tax Calculator[7] indicate that at 1981 income levels, about 62 percent of all tax savings goes to taxpayers with expanded incomes[8] of $20,000 to $50,000. About 30 percent goes to taxpayers with expanded incomes over $50,000, a group representing less than 5 percent of all taxpayer units (see Table 2). In part,

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5. See, for example, William G. Grigsby, Housing Markets and Public Policy (University of Pennsylvania Press, 1963); and James L. Sweeney, "Housing Unit Maintenance and the Mode of Tenure," Journal of Economic Theory, vol. 8 (June 1974), pp. 111-38.

6. See William F. Hellmuth, "Homeowner Preferences," in Joseph A. Pechman, ed., Comprehensive Income Taxation (Brookings, 1977), p. 193; and Housing Act of 1949, P.L. 87-171, sec. 2.

7. The Treasury Department's Tax Calculator is a model using a randomly chosen sample of individual tax returns designed to represent the universe of individual income taxpaying units during any given year. The Calculator is constructed to allow easy simulation of the effects on individual income tax liabilities of changing various tax provisions, although no estimates of "feedback effects" (the effect on tax revenues of taxpayers' response to changes in tax provisions) are included. For further discussion of the Tax Calculator, see Roy A. Wyscarver, "The Treasury Personal Individual Income Tax Simulation Model," U.S. Department of the Treasury, Office of Tax Analysis (Fall 1980).

8. Expanded income is a special concept designed to measure actual taxpayer income more closely than the readily available income definitions in the federal tax code can. In addition to adjusted gross income, it includes the untaxed part of capital gains, percentage cost depletion, and other tax preferences subject to the minimum tax. It also limits the deduction of investment interest to the amount of investment income.

TABLE 2. DISTRIBUTION OF TAX SAVINGS FROM MORTGAGE INTEREST DEDUCTION

Expanded Income Class (in thousands of dollars)	Total Tax Returns[a]	Number of Returns with the Deduction (thousands)	Total Tax Savings to Taxpayers (in millions of dollars)	Average Tax Savings to Taxpayers (in dollars)	Percent of Tax Savings from the Deduction Received by Taxpayers	Percentage Share of Total Tax Payments	Percentage Share of Total Returns[a]
Less than 5	18,282	383	23	60	0.1	b	19.7
5 - 10	16,324	1,494	216	145	1.0	2.4	17.6
10 - 15	13,302	1,574	408	259	1.9	5.8	14.3
15 - 20	10,932	2,307	995	431	4.6	8.3	11.8
20 - 30	16,756	5,842	4,035	691	18.8	20.8	18.0
30 - 50	13,211	7,639	9,328	1,221	43.4	29.7	14.2
50 - 100	3,417	2,260	4,998	2,212	23.3	17.4	3.7
100 - 200	614	336	1,159	3,447	5.4	8.2	0.7
200 and above	161	70	313	4,487	1.5	7.5	0.2
Total	92,999	21,905	21,476	980	100.0	100.0	100.0

SOURCE: Treasury Department Tax Calculator, for 1981 law at 1981 income levels.

NOTE: Details may not add to totals because of rounding.

a. Includes nontaxable returns.

b. Net recipients of federal funds because of the earned income credit.

TABLE 3. NUMBER AND PERCENT OF HOMEOWNERS RECEIVING MORTGAGE INTEREST DEDUCTION, BY ADJUSTED GROSS INCOME, 1978[a]

Adjusted Gross Income (in thousands of dollars)	Number of Homeowners in Class (millions)	Number of Homeowners with Outstanding Mortgages (millions)		Total Homeowners Without Mortgages (millions)	Percent of Homeowners in Class Claiming the Deduction	Percent of Homeowners with Mortgage Claiming the Deduction
		Claiming the Deduction	Not Claiming the Deduction			
Less than 5	5.3	0.1	1.3	3.9	2.1	8.0
5 - 10	7.6	0.9	2.1	4.6	12.3	31.3
10 - 15	8.8	2.0	3.3	3.6	22.2	37.2
15 - 20	7.9	3.6	2.1	2.3	45.3	63.4
20 - 30	12.2	7.5	2.1	2.6	61.5	78.5
30 and above	8.6	5.7	1.1	1.8	66.2	83.5
Total	50.5	19.8	11.9	18.8	39.2	62.5

SOURCE: CBO Imputations from U.S. Department of Housing and Urban Development, Annual Housing Survey, 1978, and U.S. Internal Revenue Service, Statistics of Income, 1978.

a. Details may not add to totals because of rounding.

this concentration of tax savings reflects the nature of the subsidy as a deduction from taxable income. Deductions reduce tax payments by the taxpayer's marginal tax rate for each dollar of deductible expenses, and higher incomes are taxed at progressively higher marginal rates. In addition, higher-income taxpayers are more likely to own homes--in particular, more expensive homes with larger mortgages and correspondingly larger interest payments. Higher-income taxpayers also receive a disproportionate share of the tax savings because many lower-income homeowners do not itemize deductions. For these taxpayers, the only subsidies for homeownership are the capital gains provisions affecting home sales, the exclusion of net imputed rental income, and the savings implicitly built into the zero bracket amount (formerly called the "standard deduction").

The most recent figures available to CBO indicate that, as of 1978, less than 40 percent of all homeowners in the United States were claiming the home mortgage interest deduction (see Table 3). Of those with mortgages, only 62 percent took the deduction. Among taxpayers with mortgages and $30,000 or more of adjusted gross income in 1978, 83.5 percent claimed the deduction, as compared with fewer than 31 percent of those below $15,000. On the other hand, the deduction particularly benefits younger families, whose consumer expenditures are especially great and who have the most mortgage debt. In 1978, for example, more than 90 percent of all homeowners with heads of household aged 44 or less had mortgages, and 72 percent of those with heads aged 45 to 54 (see Table 4).

TABLE 4. PERCENT OF HOUSING UNITS WITH AND WITHOUT MORTGAGES, 1978, BY AGE OF HOUSEHOLD HEAD

	Total	Under 30	30-44	45-54	55-64	65+
Unit with Mortgage	62.8	91.7	90.0	71.8	49.0	18.8
Unit Owned Free and Clear	37.2	9.3	10.0	18.2	51.0	81.2

SOURCE: U.S. Department of Housing and Urban Development, Annual Housing Survey, 1978.

THE DEDUCTIBILITY OF PROPERTY TAX PAYMENTS

Section 164 of the Internal Revenue Code allows homeowners to deduct all state, local, and foreign taxes paid on real property. This provision, like the deductibility of home mortgage interest, applies to all owner-occupied housing units. In fiscal year 1981, CBO estimates this provision will result in a tax expenditure of almost $9 billion. By fiscal year 1986, annual revenue losses are projected to reach $21.5 billion (see Table 1).

History and Rationale. The deductibility of real property taxes dates from the beginning of the federal income tax. A major rationale for the deduction was that nonfederal tax payments reduce disposable income and thus should be deducted when determining a taxpayer's ability to pay the federal income tax. The deduction has also been viewed as an important way of promoting fiscal federalism, since the resulting decrease in federal tax liabilities helps equalize effective tax burdens among states and localities and leaves a source of revenue for state and local governments.[9] The value of this can be seen in cities such as Newark, N.J., where high local government expenditures and a generally limited income tax base have led to heavy property tax burdens.

Some analysts object to the property tax deduction on the grounds that property taxes are largely paid for services provided by the taxpayer's community and thus resemble user fees, which are normally not deductible. Others object that the deduction discriminates against renters, who cannot claim it even though their rental payments include at least some portion of the property tax.[10] Renters may benefit from the landlord's deduction, however, if some of the tax saving is passed on in the form of lower rents.

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9. See Richard Goode, The Individual Income Tax, rev. ed. (Brookings, 1976), p. 170; and George F. Break, "Tax Principles in a Federal System," in Henry J. Aaron and Michael J. Boskin, eds., The Economics of Taxation (Brookings, 1980), pp. 317-26.

10. The extent to which property taxes are shifted onto renters is a highly controversial issue. The current view among economists is that renters probably incur at least a portion of any differential in property tax rates across jurisdictions (continued)

Extent and Distribution of Tax Savings. Tax savings from the deduction for property taxes, like those for the mortgage interest deduction, are concentrated heavily among middle- and upper-middle-income taxpayers (see Table 5). In 1981, for example, about 53 percent of the total tax savings went to taxpayers with expanded incomes of $20,000 to $50,000. Another 25.5 percent went to taxpayers with $50,000 to $100,000 of expanded income. Less than 10 percent was realized by the 63 percent of taxpayers with incomes of $20,000 or less, while at the other extreme 13.5 percent went to the 0.8 percent of taxpayers with incomes of $100,000 or more.

DEFERRAL OF CAPITAL GAINS ON HOME SALES

Section 1034 of the Internal Revenue Code excludes from taxable income any capital gains from the sale of a principal residence when another residence costing at least as much is purchased within two years of the sale of the former one.[11] In figuring the sale price, taxpayers may deduct the cost of any expenses incurred "to assist in its sale." In addition, if the new residence costs less than the old, adjusted as indicated above, only the lesser of the amount by which it falls short of the selling price of the old unit and the capital gain is taxed. The deferral is limited to one such sale during any one two-year period, except for taxpayers whose move is "in connection with the commencement of work . . . at a new principal place of work." CBO estimates that the capital gains deferral will mean a revenue loss of about $1.1 billion in fiscal year 1981. By fiscal year 1986, this is projected to reach almost $1.8 billion annually.

History and Rationale. The deferral of capital gains from home sales was first introduced in 1951. Committee reports and floor debates at the time indicate that the Congress believed that

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(differentials may be shifted in part to other economic agents as well), but that the basic or minimum property tax rate across communities is probably absorbed by landowners in the form of lower land prices. See Charles E. McClure, Jr., "The New View of the Property Tax: A Caveat," National Tax Journal, vol. 30 (March 1977), pp. 69-75.

11. Formerly 18 months, with a two-year time period for newly-constructed homes.

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TABLE 5. DISTRIBUTION OF TAX SAVINGS FROM THE DEDUCTION FOR PROPERTY TAXES, BY EXPANDED INCOME CLASS

Expanded Income Class (in thousands of dollars)	Total Tax Returns[a]	Number of Returns with the Deduction (thousands)	Total Tax Savings to Taxpayers (in millions of dollars)	Average Tax Savings to Taxpayers (dollars)	Percent of Tax Savings from the Deduction Received by Taxpayers	Percentage Share of Total Tax Payments	Percentage Share of Total Returns[a]
0 - 5	18,282	319	11	36	0.1	b	19.7
5 - 10	16,234	1,502	109	73	1.1	2.4	17.6
10 - 15	13,302	1,878	222	118	2.3	5.8	14.3
15 - 20	10,932	2,716	411	151	4.3	8.3	11.8
20 - 30	16,756	6,743	1,489	221	15.6	20.8	18.0
30 - 50	13,211	8,668	3,575	412	37.5	29.7	14.2
50 - 100	3,417	2,823	2,435	862	25.5	17.4	3.7
100 - 200	614	527	851	1,615	8.9	8.2	0.7
200 and above	161	143	440	3,065	4.6	7.5	0.2
Total	92,999	25,319	9,544	377	100.0	100.0	100.0

SOURCE: Treasury Department Tax Calculator, for 1981 law at 1981 income levels.

NOTE: Details may not add to totals because of rounding.

a. Includes nontaxable returns.

b. Net recipients of federal funds because of the earned income credit.

taxing these capital gains imposed a "hardship," because capital gains may reflect only a general rise in housing prices--in which case the tax on the gain for homeowners who moved would reduce their ability to replace the home they had sold.[12] The inequity was considered particularly great when such events as an increase in family size or a change in employment required the move. In that case, the sale of a house was said to have the character of an "involuntary conversion." Although the taxation of gains from other assets also made it impossible to acquire property having the same price as the asset sold without other sources of financing, the Congress singled out home sales for special treatment because they were considered to result mostly from personal reasons or uncontrollable circumstances, rather than the desire to make a profit.[13]

This may still be valid if homeownership is viewed as primarily a consumption decision. With the tremendous appreciation of home prices in the last decade, however, a growing number of households have come to view their homes as investments as well. To the extent that this is so, homeowners receive a significant tax benefit, since capital gains from investments in other assets are taxed when realized.

ONE-TIME EXCLUSION OF $125,000 OF CAPITAL GAINS ON HOME SALES FOR TAXPAYERS 55 AND OLDER

Section 121 of the Internal Revenue Code allows taxpayers 55 and older a one-time exclusion from taxable income of $125,000 in capital gains on the sale of any property used as a principal residence during three of the previous five years. This provision, together with the deferral of gains on previous home sales, allows older taxpayers to avoid some or all of the tax liability that would otherwise accrue from price increases in the value of their homes. CBO estimates that the exclusion will mean a revenue loss of about $590 million in fiscal year 1981, and of $950 million in 1986.

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12. See, for example, The Revenue Act of 1951, Report of the Senate Finance Committee to Accompany H.R. 4473, Rept. No. 781, 82:1 (September 18, 1951), pp. 35-6.

13. See, for example, remarks of Representative Forand in Congressional Record, House, vol. 97, pp. 6960-62 (1951).

History and Rationale. The $125,000 exclusion is among the more recent homeownership provisions in the tax code. First introduced in 1964, it applied only to taxpayers 65 and older and then only under special circumstances. Full exclusion was available only when the sale price of the home did not exceed $20,000. For more expensive homes, only a portion of the gain could be excluded. The Revenue Act of 1976 subsequently increased the basic sale price figure to $35,000.

The Revenue Act of 1978 significantly liberalized the exclusion, increasing the amount of excluded gains to $100,000 and allowing all taxpayers 55 and older to claim it. It also reduced the required period of time that a unit had to serve as a taxpayer's principal residence from five of the last eight years to three of the last five. The 1978 act also allowed taxpayers whose previous residence had been "involuntarily converted" (that is, condemned or destroyed) to count toward the three-year requirement the period spent in a replacement home or apartment. The Economic Recovery Tax Act of 1981 then raised the $100,000 amount to $125,000 ($62,500 in the case of married persons filing separately).[14]

The one-time exclusion is designed to shield older taxpayers from heavy tax burdens when they decide to become renters or move to a less costly residence. Without this provision, many taxpayers who become renters would be required to pay tax on approximately the difference between the sale price of their final home and the purchase price of their first (less the accumulated costs of real estate commissions, transfer taxes, and the like). Since home prices have appreciated significantly in the last decade, the resulting tax liabilities could reduce the after-tax proceeds sufficiently to make it difficult to afford another home several years hence at current inflated prices, even though the actual tax rate on the gains would be 20 percent or less (only 40 percent of the gains would be included in taxable income). Thus, the deferral provision, without the one-time exclusion, could discourage some older taxpayers from selling their homes. On the other hand, the exclusion converts the continuing, interest-free loan on tax liabilities that the deferral provides into a permanent forgiveness

14. See Economic Recovery Tax Act of 1981, §123, affecting IRC §121(b).

of tax liabilities. It thus compounds the favorable tax treatment created by the deferral of capital gains on home sales. It also augments the special treatment given housing relative to other types of investment assets, an issue to be discussed further in the next chapter.

Distribution of Benefits. Estimates of the distribution of tax savings from the exclusion are unreliable because only a small fraction of home sales are reported to the IRS. Analysis is further complicated by the absence of age-specific information on this type of income. Data on home sales during 1978, the most recent year for which information was available to CBO, indicates that 85 percent of those aged 55 and older selling homes had incomes of $30,000 or less. These data do not allow any clear-cut assessment of the distribution of tax benefits from the exclusion. They do suggest, however, that middle-income taxpayers (those with 1978 incomes of $30,000 or less) may be receiving a significant portion of the savings from the exclusion, because many older persons with expensive homes do not have very high incomes.

EXCLUSION OF INCOME FROM TAX-EXEMPT MORTGAGE BONDS

The newest tax benefit for homeownership is the use of tax-exempt bonds to finance private housing. States and localities began to sell tax-exempt bonds in 1978 to provide mortgage funds for homes and rental units at below-market interest rates. Since interest earnings from the bonds are tax-exempt, funds can be raised at rates that historically have averaged 30 percent below those for taxable corporate issues. The proceeds from the bond sale are then transferred to a mortgage servicer, who actually originates the mortgages to household applicants, generally for a percentage fee.

Between January 1978 and April 1979, more than $1.6 billion worth of tax-exempt mortgage bonds were sold. Before the enactment of legislation in 1980 restricting their issuance, CBO projected that total new issues could equal $20 billion to $35 billion a year by 1984.[15] But the Budget Reconciliation Act of 1980 imposed significant limits on the issuance of new tax-exempt mortgage

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15. See Tax-Exempt Bonds for Single-Family Housing, Note 1.

bonds, banning new single-family issues after 1983. Nevertheless, CBO estimates that revenue losses from new and existing mortgage revenue bonds will exceed $1.2 billion in fiscal year 1982 and reach $1.8 billion by fiscal year 1986.

Because the benefits of tax-exempt mortgage bonds accrue not only to homebuyers but also to bond purchasers, the precise distribution of tax and interest-rate savings from the bonds is hard to estimate. Treasury studies indicate that on average the federal government loses $1.33 for each $1 of interest-rate savings provided to bondholders. Such bonds are thus an expensive way of reducing borrowing costs for homebuyers. In addition, they raise interest rates for state and local public bond issues that compete with mortgage bonds in the tax-exempt market.

THE EXCLUSION OF NET IMPUTED RENTAL INCOME FROM TAX

Federal law does not require that taxpayers include as taxable income the net value (after expenses) of the services they receive from their homes. Such income would be taxed as ordinary income if the units were rented out, with a full deduction allowed for taxes, interest, insurance, maintenance, and depreciation; most economists contend that the appropriate tax treatment of owner-occupied homes should be the same. Thus, under a comprehensive income tax, the net imputed rental income from owning a home--what a homeowner would receive by renting it out, less the costs of ownership, taxes, depreciation, and maintenance--would be taxed as ordinary income.[16]

Non-economists have difficulty recognizing that net imputed rental income is, in fact, income, because it comes in the form of services rather than cash. In principle, homeowners could convert the value of these services to cash either by renting out their homes or by selling them and investing the proceeds in cash-yielding assets such as bonds or common stock.[17] But these activities

16. See William F. Hellmuth, "Homeowner Preferences," in Joseph A. Pechman, ed., Comprehensive Income Taxation (Brookings, 1977), pp. 163-64.

17. See Richard Goode, The Individual Income Tax, rev. ed. (Brookings, 1980), p. 117.

would only make the income from homeownership more tangible; they would not actually create new income.

Net imputed rental income from homeownership has never been included as taxable income in the federal income tax, in part because few non-economists have accepted the idea that owning a home (or other consumer durables) provides owners with implicit income that should be taxed, and in part because of the administrative difficulty of taxing such income.[18] Further, many economists doubt that imputed rent could be accurately taxed in the United States as a practical matter. Little is known, for example, about the probable rental value of owner-occupied homes; only rough estimates could be made from available data on assessed house values. Furthermore, in periods of rising house prices, the taxation of net implicit rental income would probably lead to increasing income tax liabilities, since implicit rental income is typically figured as a percentage of overall house value.[19] This last point may explain why the United Kingdom, which had taxed net imputed rental income for many years, stopped doing so in 1963. British house values had not been reassessed since roughly the end of World War II, and the rise in assessed values would have imposed substantially higher tax burdens on many low- and moderate-income homeowners.[20]

The exclusion of net imputed rental income is not classified by the federal government as a tax expenditure largely because of these practical considerations.[21] Thus, neither CBO, the Joint

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18. Imputed rental income was taxed, however, until 1963 by the United Kingdom and from 1911 to 1917 by the State of Wisconsin in its income tax. Ibid., p. 118; and Goode, "Imputed Rent of Owner-Occupied Dwellings Under the Income Tax," Journal of Finance, vol. 15 (December 1960), p. 504. Imputed net rental income still is taxed in a number of other countries including Belgium, Denmark, Luxembourg, the Netherlands, Portugal, Spain, and West Germany.

19. See, for example, Hellmuth, "Homeowner Preferences," pp. 166-67.

20. See Goode, The Individual Income Tax, p. 118.

21. See, for example, Budget for Fiscal Year 1982, "Special Analysis G," p. 206.

Committee on Taxation, nor the Treasury Department have reliable estimates of the subsidy it provides to homeowners. A recent HUD study estimated it at $14 billion to $17 billion in fiscal year 1979.[22]

22. See John C. Simonson, "Existing Tax Expenditures for Homeowners," U.S. Department of Housing and Urban Development (July 1981), Tables IV and VII.

CHAPTER III. EFFECTS OF THE CURRENT TAX PROVISIONS

The current tax treatment of homeownership reduces the after-tax cost of owning a home, enabling more families to buy homes and allowing homes to be of better quality. But the same tax provisions that make homeowning more affordable also increase the rate of return on homeownership as an investment. They divert personal savings from business investment into home building, reduce the demand for and production of rental housing, and raise house prices (thereby offsetting some of the effects of tax savings on homeownership costs). The tax benefits provided to homeowners also increase with taxable income and cause homeowners and renters to be taxed differently. These effects became especially pronounced during the inflationary period of the 1970s, in part because taxpayers were pushed into higher marginal tax brackets--thereby increasing the rate of subsidy provided by the tax provisions.

Over the next decade, a number of factors ranging from the recently-enacted Economic Recovery Tax Act of 1981 to changes in mortgage financing may moderate these effects. Nonetheless, the strong demand for housing that can be expected for the remainder of the decade will make the consequences of these tax provisions a continuing concern.

EFFECTS ON THE COST AND EXTENT OF HOMEOWNERSHIP

Effects on Homeownership Costs

Tax subsidies reduce the apparent cost of owning a home. They also increase the rate of return on homeownership as an investment.

The actual decrease in homeownership costs is hard to estimate, for two reasons. First, the reduction in tax liabilities, together with other tax provisions, has increased the demand for owner-occupied housing, thereby raising house prices and interest rates. Second, the provisions have enabled people to afford larger homes, giving a further boost to the price of the average house. On the basis of present housing prices and mortgage interest rates, however, the pre-tax cost of homeownership has been reduced by 35 percent or more in some cases--the amount depending on house

prices, interest rates, and the taxpayer's marginal tax rate. A couple with two children and $30,000 of income, who purchase a $60,000 house with 20 percent down and the balance financed by a 30-year mortgage at 13 percent interest, might experience a 24 to 25 percent reduction in before-tax housing expenses in the first year, depending on their property taxes and their utility, insurance, and maintenance costs (see Figure 1). Higher-income households can receive relatively larger savings because their marginal tax rates are higher. Thus, a two-earner, childless couple with $50,000 of income who purchase a $100,000 house for 20 percent down and a 13 percent, 30-year mortgage could receive almost a 38 percent reduction in their pre-tax housing payments, depending again on property tax rates and their costs for utilities, maintenance, and insurance (see Figure 2).

A similar example will show how the current tax provisions increase the rate of return to homeownership as an investment. If only the deductions for mortgage interest and property taxes are considered, the present tax treatment of homeownership increases the rate of return on a $30,000 house purchased in 1970 (with a 20 percent down payment, other closing costs of 3 percent, and a 30-year, 8 percent mortgage) by amounts varying from 11 percentage points during the first three years of ownership to almost 16 percentage points by the tenth year of ownership (see Figure 3).[1] The increases would be larger still during the last several years of ownership if the nontaxation of net imputed rental income is considered, since the rise in house prices makes net imputed rental income turn positive in this example by the eighth year of ownership. Furthermore, the effective nontaxation of capital gains on the home increases the after-tax capital gain in this example by 16.3 percent--from $32,440 on the initial $6,900 investment to $37,721 (see Figure 4).

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1. These calculations are based on those developed by deLeeuw and Ozanne for a typical new home purchased during the mid-1960s, but they assume that the house price stays abreast of the "average price of a constant-quality house" reported in Table 8 of this chapter and that operating costs increase by the rise in the Consumer Price Index for "Homeownership Maintenance and Repair." See Frank deLeeuw and Larry Ozanne, "Housing," in Henry A. Aaron and Joseph A. Pechman, eds., How Taxes Affect Economic Behavior (Brookings, 1981), pp. 283-319, esp. Tables 1 and 2, pp. 286-88.

FIGURE 1. EFFECT OF MORTGAGE INTEREST AND PROPERTY TAX DEDUCTIONS ON FIRST-YEAR HOUSING COSTS FOR A MIDDLE-INCOME FAMILY BUYING A HOME WITH A 20 PERCENT DOWN PAYMENT, 1981

ASSUMPTIONS: Married couple with $30,000 in income and 2 children

House price:	$60,000.00	
Down payment:	12,000.00	(20 percent)
Mortgage:	48,000.00	for 30 years at 13 percent
Annual property taxes:	1,200.00	($2.00 per $100 of market value)
Monthly maintenance, utility, and insurance costs:	125.00	per month

First-year costs before taxes[a]

Mortgage:	$6,374.40	($13.28 yearly per $100 of original mortgage balance[b])
Property taxes:	1,200.00	
Utilities, maintenance, and insurance:	$1,500.00	($125 per month)
	$9,074.40	

Tax deductions and savings

Deductible amounts:		
Mortgage interest	$6,231.84	($12.983 per $100 of mortgage balance)[b]
Property taxes	$1,200.00	
	$7,431.84	
Tax savings, at 30 percent average marginal rate:	$2,229.55	
Tax savings as a percent of total pre-tax costs:	$2,229.55 / $9,074.40	= 24.6 percent

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a. Excludes closing costs and forgone earnings on down payment.

b. Based on mortgage amortization schedules.

FIGURE 2. EFFECT OF MORTGAGE INTEREST AND PROPERTY TAX DEDUCTIONS ON FIRST-YEAR HOUSING COSTS FOR A FIRST-TIME HOMEBUYING COUPLE WITH $50,000 OF INCOME, 1981

ASSUMPTIONS: Married couple with $50,000 in income and no children

House price:	$100,000.00	
Down payment:	20,000.00	(20 percent)
Mortgage:	80,000.00	for 30 years at 13 percent
Annual property taxes:	2,000.00	($2.00 per $100 of market value)
Monthly maintenance, utility, and insurance costs:	175.00	per month

First-year costs before taxes[a]

Mortgage:	$10,624.00	($13.28 yearly per $100 of original mortgage balance[b])
Property taxes:	2,000.00	
Utilities, maintenance, and insurance:	$ 2,100.00	($175 per month)
	$14,724.00	

Tax deductions and savings

Deductible amounts:		
Mortgage interest	$10,386.40	($12.983 per $100 of mortgage balance)[b]
Property taxes	$ 2,000.00	
	$12,386.40	
Tax savings, at 45 percent average marginal rate:	$5,573.88	
Tax savings as a percent of total pre-tax costs:	= $ 5,573.88 / $14,724.00	= 37.9 percent

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a. Excludes closing costs and forgone earnings on down payment.

b. Based on mortgage amortization schedules.

FIGURE 3. EFFECT OF MORTGAGE INTEREST AND PROPERTY TAX DEDUCTIONS ON THE RATE OF RETURN FROM BUYING AND HOLDING A $30,000 HOME IN 1970 FOR 10 YEARS[a] (In Dollars)

Year of Residence	House Value	Imputed Rent	Outlays				Net Imputed Rent (After Outlays)	Tax Savings		Net Imputed Rent Plus Tax Savings	Before-Tax Rate of Return (in percent)	After-Tax Rate of Return (in percent)
			Operating Costs	Property Taxes	Mortgage Interest	Amortization		Property Tax	Mortgage Interest			
1	30,000	2,700	780	600	1,913	200	-793	180	574	-39	-11.5	-0.6
2	31,600	2,844	841	632	1,896	217	-742	190	569	17	-10.8	+0.2
3	33,600	3,024	885	672	1,878	235	-646	202	563	119	-9.4	+1.7
4	36,600	3,294	950	732	1,859	255	-502	234	595	327	-7.3	+4.7
5	40,000	3,600	1,079	800	1,837	276	-392	256	588	452	-5.7	+6.6
6	44,300	3,987	1,180	886	1,815	299	-193	284	581	672	-2.8	+9.7
7	48,100	4,329	1,256	962	1,790	323	-2	337	627	961	-0.0	+13.9
8	54,200	4,878	1,351	1,084	1,763	350	+331	379	617	1,327	+4.8	+19.2
9	62,100	5,589	1,466	1,242	1,734	379	+768	435	607	1,810	+11.1	+26.2
10	70,900	6,381	1,613	1,418	1,702	411	+1,237	497	596	2,330	+17.9	+33.8

SOURCE: Congressional Budget Office, based on calculations by deLeeuw and Ozanne (see citation in text).

NOTE: All figures have been rounded to the nearest $1.

a. Assumes house price equals the average price of a constant-quality home, as measured by the Bureau of the Census in 1970 and subsequent years. Example also assumes that imputed rent = 9 percent of current house value; that the home is purchased with a 20 percent down payment, closing costs of 3 percent, and an 8 percent, fixed-rate, 30-year mortgage; and that operating costs in first year equal 2.6 percent of purchase price and rise with the "Homeownership-Maintenance and Repair" component of the Consumer Price Index; that property tax equals 2 percent of house value; and that the taxpayer's marginal tax rate equals 30 percent in years 1-3, 32 percent in years 4-6, and 35 percent in years 7-10. Rates of return are calculated in comparison with an initial investment of $6,900: $6,000 in down payment and $900 for other closing costs.

FIGURE 4. EFFECT OF CAPITAL GAINS DEFERRAL ON RATE OF RETURN FROM SELLING A HYPOTHETICAL HOUSE BOUGHT IN 1970 AND SOLD IN 1980

ASSUMPTIONS:[a]	Sale price:	$71,000[b]	
	Selling costs:	5,325	(7 1/2% of sale price)
	Mortgage balance:	21,054	(balance on 30-year, 8 percent mortgage after 10 years)
Returns			
	Net cash flow:	$44,621	
	Less initial investment:	-6,900	(20 percent down payment of $6,000 plus closing costs of $900)[a]
	Capital gain:	$37,721	
	Tax avoided because of deferral:	$5,281	(0.35 x 0.40 x $37,721)[c]
	Resulting increase in after-tax capital gain:	16.3%	($\frac{37,721}{37,721-5,281}$ = 116.3 percent)

SOURCE: Same as Figure 3.

a. See Figure 3 for basis of figures in this example.

b. Assumed price of the average constant-quality house at the beginning of 1980 (see Table 8).

c. Taxpayer's marginal tax rate is 35 percent; 40 percent of capital gain would normally be taxed.

Effects on the Extent of Homeownership

The current tax provisions also appear to increase the extent of homeownership. Most of the studies analyzing this issue have found that the provisions raise the incidence of homeownership by about 3 to 5 percentage points--meaning a 5 to 8 percent rise in the fraction of households owning a house or apartment, or about one-fourth of the total increase in homeownership observed since World War II. For example, Harvey Rosen estimates in a study based on a cross-section of households surveyed during 1970 that the proportion owning their own homes would have been 2.5 to 5.5 percentage points lower (depending on income level) if deductions for mortgage interest and property taxes had been disallowed and net imputed rental income had been taxed.[2] In addition, those owning homes would have held units costing an average of 10 to 20 percent less than the homes they actually held. Another study based on data for households over the years 1949-1974, by Harvey Rosen and Kenneth Rosen, found that about 4 percentage points of the approximately 64 percent of housing units that were owner-occupied in 1974--roughly one quarter of the rise in the percentage of homes that were owned over that period--could be traced to the current set of tax subsidies.[3] A third study, by Patric Hendershott and James Shilling, which uses data through 1978, found a slightly larger effect on homeownership. Their results suggest that the homeownership rate would have been about 4 to 5 percentage points lower than observed in 1978 if property taxes and mortgage interest payments had not been deductible.[4] This larger impact may reflect the particular circumstances that developed during the last half of the 1970s, when inflation made homeownership particularly attractive by greatly increasing the magnitude of tax savings from these deductions.

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2. Harvey S. Rosen, "Housing Decisions and the U.S. Income Tax," Journal of Public Economics, vol. 11 (February 1978), pp. 1-23.

3. Harvey S. Rosen and Kenneth T. Rosen, "Federal Taxes and Homeownership: Evidence from Time Series," Journal of Political Economy, vol. 88 (February 1980), pp. 59-75.

4. Patric H. Hendershott and James D. Shilling, "The Economics of Tenure Choice, 1955-1979," in C. F. Sirman, ed., Research in Real Estate, vol. 1 (JAI Press, Inc., 1980).

OTHER CONSEQUENCES

Besides their effect on the extent and after-tax cost of homeownership, the tax subsidies also have other economic consequences. First, they decrease business investment by increasing the attractiveness of homeownership as a use of personal savings. Second, they weaken the market for rental housing by enhancing the attractiveness of homeowning as an investment and by lowering its cost. Third, the tax subsidies help to raise the price of housing, particularly during periods of inflation when the interaction of inflation with the income tax increases the tax benefits for homeownership and decreases those for other types of assets (particularly depreciable business plant and equipment). Fourth, the tax subsidies alter the structure of the individual income tax and require significantly higher marginal tax rates to obtain any specified level of federal revenues. None of these consequences, though they flow naturally from the effects of the current tax code on the demand for homeownership as against renting and other types of investments, was a matter of much concern when the various tax provisions were adopted. Each one, though, has attracted growing attention during the last several years as declining productivity growth, a dwindling supply of rental housing, and rapidly escalating house prices have become major concerns.

Effects on Business Capital Formation and Productivity

Tax subsidies for homeownership tend to reduce business investment because they raise the rate of return on homeownership as an investment, thereby attracting more personal savings. This effect can be measured by examining the impact of homeownership subsidies on the after-tax cost of capital for homeownership and other types of investment projects, since projects with lower after-tax costs of capital tend to obtain more funds than do those with higher costs.

A recent study by Patric Hendershott and Sheng-Cheng Hu suggests that the average, risk-adjusted net cost of capital for owner-occupied housing in 1964-1965 was 5.3 percent, compared with 9.5 to 10 percent for investments in corporate plant and equipment and 7 to 7.4 percent for investments in noncorporate structures and equipment, and in rental housing. For the years 1976-1977, the figures were 5.3 percent for owner-occupied housing, 11.5 percent for corporate equipment, 12.8 percent for corporate structures, and

8 to 8.8 percent for noncorporate investment and rental housing.[5] These large differences in the cost of funds imply a substantial diversion of funds from other investment assets, particularly from corporate plant and equipment into owner-occupied housing. They also imply a corresponding loss in economic output, because the lower costs of funds for homeownership allow funds to be bid away from higher-cost projects whose true (before-tax) rate of return is higher. Hendershott and Hu's figures suggest that as much as 23 percent of the owner-occupied housing in 1964-1965 and 33 percent of that in 1976-1977 represented construction that was induced by the effects of the tax provisions in lowering the cost of capital for homeownership as against business investment. At 1976-1977 levels, these investment shifts implied an annual economic loss of about $6 billion in 1972 dollars, or 0.4 percent of GNP, if based on the standard assumption that the marginal rate of return from investments equals the marginal cost, meaning that these induced increases in the stock of owner-occupied housing represented less productive uses of funds than the business investments from which they were diverted.[6]

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5. See Patric H. Hendershott and Sheng-Cheng Hu, "Government-Induced Biases in the Allocation of the Stock of Fixed Capital in the United States," in George M. Von Furstenberg, ed., Capital, Efficiency, and Growth (Ballinger, 1980), Table 4-5, p. 343.

6. Ibid., Table 4-9, p. 353. Hendershott and Hu, in a more recent paper, have developed a more elaborate model designed to simulate the effects of inflation and changes in the risk premium required for assets on house prices, user costs of capital for residential and nonresidential capital, and tax, income, and individual asset levels. The results of this model suggest that higher inflation, if combined with a rise in risk premiums, increases interest rates and the differential between user costs of capital for residential and nonresidential investment, but not necessarily the shift in assets from corporate capital to housing. For example, a rise in the inflation rate from 1 to 8 percent, combined with a roughly 50 percent increase in the risk premium on corporate stock, widens the difference in user cost of capital between housing and corporate equity to 4

continued

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During the last decade of persistent inflation and sluggish economic growth, the effects of homeownership tax provisions on business investment have received particular attention because of the relationship between business investment and productivity growth. Recent studies suggest that the virtual halving in the growth rate of nonresidential investment between the years 1965-1973 and 1974-1979 may have contributed to the simultaneous dramatic decline in productivity growth during the late 1970s.[7]

Although many factors other than the homeownership tax provisions were responsible for the slowdown in net business investment, including a stagnant economy and large federal deficits that absorbed much of the expanding credit in the economy, shifts of personal saving into homeownership may also have played a role. Between 1970 and 1979, for example, the percentage of personal savings devoted to net investments in owner-occupied housing more than doubled, from 13.6 to 28.0 percent.[8] Perhaps more striking, between 1975-1976 and 1977-1979 the fraction of disposable income used for net purchases of owner-occupied housing rose by more than half, from 2.4 percent to 3.8 percent, while the share devoted to net financial investments fell from 4.3 percent to 1.0 percent.[9] These figures do not necessarily "prove" that homeownership was attracting funds from business investment, because shifts in this direction could have resulted from the rapid growth in the number

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percentage points (versus 3 points before) but creates no further shift of corporate assets into housing if real house prices are allowed to increase about 30 percent and if lenders limit home mortgages so that the percentage of after-tax income used for housing costs (minus utilities) does not exceed 17 percent. See Hendershott and Hu, "The Allocation of Capital between Residential and Nonresidential Uses," unpub. paper, Purdue University (July 1981).

7. See Congressional Budget Office, The Productivity Problem: Alternatives for Action (January 1981), Tables 11 and 13, pp. 30 and 34.

8. Ibid., Table 9, p. 14.

9. See Carol Corrado and Charles Steindel, "Perspectives on Personal Saving," Federal Reserve Bulletin, vol. 66 (August 1980), Table 2, p. 615.

of younger households, which traditionally devote more of their resources to acquiring homes and other consumer durables than do the older households that were more prevalent at the end of the 1960s. Nevertheless, they are consistent with research indicating that, between 1972 and 1979, homeowners earned rates of return on their homes averaging 10 percentage points higher (7.6 percentage points in real terms) than were available from other financial assets.[10]

Whether these extraordinary returns on homeownership, and the corresponding effects on the allocation of savings, will continue over the next decade is uncertain. The development in the last several years of new mortgage instruments whose interest rates fluctuate with market conditions will probably decrease the attractiveness of homeownership as an investment, as will the continuation of high interest rates, which raise the cost of capital for owner-occupied housing.[11] Similarly, the growth of money market funds and the gradual lifting of interest ceilings on savings accounts are providing alternative ways for homeowners to earn a high return on their savings. Passage of the Economic Recovery Tax Act of 1981, with its faster depreciation writeoffs for business investment, may also stem the flow of savings out of financial assets by offsetting the decline in depreciation allowances caused by inflation, thus increasing the returns from nonresidential investment. On the other hand, the number of households with a head aged 25-34--the demographic group that includes most first-time homebuyers--will outnumber those with heads of age 55 to 64 by at least 50 percent through the year 2000.[12] This rough index of housing demand pressure suggests that the underlying demand for homeownership will remain strong over the next two decades so long as income levels, interest rates, and mortgage instruments make homeownership accessible to a large share of these households.

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10. Patric H. Hendershott and Sheng Cheng Hu, "Inflation and Extraordinary Returns on Owner-Occupied Housing: Some Implications for Capital Allocation and Productivity Growth," Journal of Macroeconomics, vol. 3 (Spring 1981), Tables 1 and 2, pp. 188 and 191.

11. For a further discussion of recent developments in mortgage finance, see Appendix B.

12. See Nonna A. Noto, "Tax and Financial Policies for the Housing Market of th 1980s," Policy Studies Journal, vol. 8 (October 1979), pp. 211-19, esp. pp. 212-16.

If the demand for homeownership remains strong, savings could continue to be diverted into housing at a time when capital markets will already be under heavy pressure to finance the increased business investment resulting from the 1981 tax law changes. This, in turn, could generate strong upward pressure on interest rates. In addition, continuation of the present tax incentives for homeownership during the coming period of high demographic pressures for homeownership could exacerbate what is likely to be an excess of single-family homes by the time the current members of the postwar "baby boom" generation enter retirement. Census Bureau data project a sharp rise in the percentage of the population aged 65 and older beginning about the year 2015. From then through at least the year 2030 these persons will represent between 14 and 18 percent of the population, as against 11.2 percent in 1980 and 11.7 percent in 1985. The percentage of the population aged 25 to 34, by comparison, will fall by 2025 to about 13 percent, compared with about 17 percent in 1985.[13] Because younger families traditionally favor larger homes while the elderly prefer smaller, less expensive units, these trends suggest there would already be an excess of single-family homes and a shortage of smaller units by that time. Current tax law, by creating incentives to purchase homes, could well increase that imbalance of housing units.[14]

Effects on Rental Housing

Tax subsidies reduce the demand for rental housing by decreasing the relative cost of homeownership as a consumption good and increasing its attractiveness as an investment. This lower demand, in turn, leads to the construction of less rental housing. To some extent, these effects are offset by the provision of other tax subsidies for rental housing. Under current law, owners of rental housing may claim accelerated depreciation on their buildings[15]

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13. See U.S. Bureau of the Census, Current Population Reports, Series P-25, No. 704, "Projections of the Population of the United States: 1977 to 2050" (USGPO:1977), Tables C and H (Series II projections).

14. Noto, "Tax and Financial Policies."

15. Owners of rental housing and other investment realty can depreciate their holdings over a 15-year life using the 175 percent declining balance method. Owners of low-income property are allowed to use the 200 percent declining balance method in claiming deductions.

and amortize construction-period interest and real estate taxes over a ten-year period, rather than over the full economic life of the project.[16] Other subsidies result from the use of tax-exempt bonds to finance private rental housing. The net tax subsidies provided by these three items, though, are smaller than those for homeownership.[17] Including the accelerated amortization of construction-period interest and taxes for all commercial buildings (including nonresidential real estate), the estimated tax expenditures for rental housing will sum to $1.9 billion in fiscal year 1982 (see Table 6). This compares with a total of almost $39.1 billion for the five major tax expenditures for homeownership listed in Table 1.

Over the last several years, the role of tax subsidies for rental housing has gained particular attention because of the shrinking rental housing market in the United States. Rental housing construction since the 1974-1975 recession has averaged about 10 percent less than that during the last economically stable period, the late 1960s, based on figures for multifamily housing construction (see Table 7).[18] Moreover, during the last five years, an important new trend--the conversion of rental units into owner-occupied condominiums and cooperatives--has developed. Overall, this trend has caused only a small percentage of the nation's rental units--about 366,000 during the 1970s, including 135,000 in 1979--to be converted. Conversions have been concentrated, though, in a small number of metropolitan areas. In these areas, particularly Chicago and Washington, D.C., the effects have been more pronounced.[19]

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16. This ten-year period, specified by IRC §189, reflects a change from previous tax policy, which allowed these expenses to be claimed in the year incurred ("expensing"). The new policy is being phased in over a seven-year period that began in 1977 (1982 for government-subsidized, low-income housing).

17. For further development of this point, see deLeeuw and Ozanne, "Housing," especially pp. 308-15.

18. Data on new housing starts intended for rental use are available only for years after 1973.

19. See U.S. Department of Housing and Urban Development, The Conversion of Rental Housing to Condominiums and Cooperatives (June 1980).

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TABLE 6. TAX EXPENDITURES FOR RENTAL HOUSING, FISCAL YEARS 1981-1986 (In millions of dollars)

	1981	1982	1983	1984	1985	1986
Accelerated Depreciation of Rental Housing	400	425	455	495	535	580
Expensing of Construction Period Interest and Taxes[a]	760	875	915	990	1,065	1,140
Exclusion of Interest on State and Local Bonds for Rental Housing	430	555	680	800	940	1,095
Arithmetic Sum	1,590	1,855	2,050	2,285	2,540	2,815

a. Includes nonresidential commercial construction.

The decline in rental housing construction and the conversion of rental units to ownership status can be traced to many causes. Rising costs of housing maintenance and construction, for example, are a factor in both developments, as is the spread of rent control, which has made it hard for landlords to keep rents in line with costs and with the rate of return available on other investments. Another factor that has encouraged both condominium conversion and the shifting of multiunit construction toward condominiums has been the rise in the number of small, higher-income families that prefer smaller homes in urban centers--a change attributable largely to the maturation of the postwar "baby boom" generation and, to some extent, the rise in divorce rates.

A major impetus both for conversions and for decreased rental construction, however, has been a further drop in the demand for rental housing among middle- and high-income households,. thus leaving landlords to meet higher expenses with an increasingly poorer clientele. Between 1970 and 1977, for example, the median

TABLE 7. TRENDS IN RENTAL HOUSING CONSTRUCTION, 1965-1980

Year	New Privately-Owned Units Started (in thousands)			
	Units Intended for Rental Use[a]	Multiunit Housing Starts		
		Total	For Sale	For Rent
1965	NA	509	NA	NA
1966	NA	386	NA	NA
1967	NA	448	NA	NA
1968	NA	608	NA	NA
1969	NA	656	NA	NA
1970	NA	621	NA	NA
1971	NA	901	NA	NA
1972	NA	1,047	NA	NA
1973	NA	913	NA	NA
1974	327	450	131	319
1975	230	268	45	223
1976	320	375	63	312
1977	455	536	90	446
1978	470	587	131	456
1979	395	551	173	378
1980	289	440	163	277

SOURCE: U.S. Bureau of the Census, Construction Reports: Housing Starts, Series C20-81-2 (April 1981), Table 8, p. 10.

NA = not available.

a. Excludes units originally intended for sale and later rented.

income of renter households fell by 10 percent in real terms. In 1979, the median rental household income was only $10,000.[20] The

20. See Larry Ozanne, "Divergent Views of Rental Market," paper presented at the HUD Conference on the Rental Housing Crisis, Washington, November 13, 1980, p. 2; U.S. Department of Housing and Urban Development, Annual Housing Survey, 1979, Part C, Table A-1, p. 4.

declining economic position of renter households, together with rent control, helps to explain why rent levels increased only 67 percent between 1970 and 1979 as against a 200 percent rise in operating costs for rental housing.[21]

Much of the "disappearance" of higher-income households from the rental market can be traced to the combined effects of tax subsidies for homeownership and inflation-induced "bracket creep," although the prospect of investment gains from house price inflation has also played a role. Inflation, which pushed middle- and upper-income households into steadily higher tax brackets, greatly increased the value of the various tax benefits for homeownership, thereby increasing the appeal of homeowning. The tax benefits also enabled these households to pay substantially more for housing if they owned rather than rented. Thus, it became attractive for some landlords to convert rental units and for builders to shift some rental construction to condominiums and cooperatives.

Effect on House Prices, the Inflation Rate, and Inflation-Indexed Benefits

Tax benefits for homeownership, by increasing the demand for homeowning, tend to raise the price of homes. In the long run, house prices can be expected to reach a point where, on average, the rate of return to homeownership as an investment should equal that for other investments. During periods of economic stability, when the age structure of the population and the magnitudes of tax benefits are relatively constant, house prices should also be stable. House prices can increase rapidly, however, during periods of inflation or when changing demographics increase the rate of household formation and, thus, the demand for housing units.

In the past decade, and particularly the past five years, the price of homes has increased dramatically in the United States. Between 1969 and 1979, the median sales prices for new and existing homes and the "average" price of a new, constant-quality house all rose by 140 to 160 percent--roughly one and one-half times as fast as the Consumer Price Index (CPI) or GNP deflator,

21. Ozanne, "Divergent Views of Rental Market," p. 1.

two general measures of inflation (see Table 8).[22] These price increases have given existing homeowners substantial investment gains but made it far harder for nonhomeowners to enter the market, since incomes over this period increased only about as fast as the general inflation rate.[23] Housing price increases have also increased benefit levels and expenditures for many federal programs and raised wage levels for many private employees, because house prices enter directly into the Consumer Price Index, and the CPI is used to adjust benefit levels for Social Security and Food Stamp payments, in addition to setting wage rates under many private labor contracts.[24]

The increase in the relative price of homes during this period can be traced to many factors. The rapid rate of household formation during this period, discussed earlier, was clearly one influence, since new households have a heavy demand for consumer durables and for housing in particular. Another factor was the highly cyclical nature of the homebuilding industry, which experienced unusually rapid cost increases because of more stringent government regulations and the need to recruit workers and reassemble capital after the housing downturn of 1969-1970 and the much greater recession of 1974-1975. But the interaction of inflation with the existing tax provisions for homeownership,

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22. Average prices of new single-family homes actually sold over this period rose by about 157 percent--from $27,000 to $76,300. See U.S. Department of Commerce, Bureau of the Census, Construction Reports, Series C27: Price Index of New One-Family Houses Sold, First Quarter 1981, No. C27-81-Q1 (June 1981), Table 2.

23. Between 1969 and 1979, median household income in the United States rose by 97.3 percent, as against 98.0 percent for the Consumer Price Index. Median household income for households with heads of age 25-34, the most common age group for first-time homebuyers, rose by 95.6 percent over this period. See U.S. Department of Commerce, Bureau of the Census, Current Population Reports, Series P-60: Consumer Income, various nos.

24. For a more detailed explanation of how housing prices enter the Consumer Price Index, see Phillip Cagan and Geoffrey H. Moore, The Consumer Price Index: Issues and Alternatives (American Enterprise Institute, 1981).

TABLE 8. MEDIAN SALES PRICES OF EXISTING HOMES AND AVERAGE PRICES OF CONSTANT-QUALITY NEW HOMES SOLD IN THE UNITED STATES, COMPARED WITH MEASURES OF INFLATION: ANNUAL AVERAGES, 1965 - 1980

	Median Sales Price of Existing Homes		Average Price of Constant-Quality New Homes[a]		General Inflation Indexes	
	Price in Dollars	Percent Change From Previous Year	Price in Dollars	Percent Change From Previous Year[b]	Percent Change in Consumer Price Index	Percent Change in GNP Deflator
1965	20,000	+5.8	24,000	+2.1	+1.7	+2.2
1966	21,400	+7.0	25,100	+4.1	+2.9	+3.3
1967	22,700	+6.1	25,800	+2.8	+2.9	+2.9
1968	24,700	+8.8	27,100	+5.3	+4.2	+4.5
1969	25,600	+3.6	29,200	+7.6	+5.4	+5.0
1970	23,400	-8.6*	30,000	+2.8	+5.9	+5.4
1971	25,200	+7.7	31,600	+5.4	+4.3	+5.1
1972	27,600	+9.5	33,600	+6.5	+3.3	+4.1
1973	32,500	+17.8	36,600	+8.7	+6.2	+5.8
1974	35,900	+10.5	40,000	+9.3	+11.0	+9.7
1975	39,300	+9.5	44,300	+10.7	+9.1	+9.6
1976	44,200	+12.5	48,100	+8.6	+5.8	+5.2
1977	48,800	+10.4	54,200	+12.7	+6.5	+6.0
1978	55,700	+14.1	62,100	+14.5	+7.7	+7.3
1979	62,900	+14.1	70,900	+14.2	+11.3	+8.8
1980	64,600	+2.7	78,700	+11.0	+13.5	+9.0
Change						
1969-79	+37,300	+145.7	+41,700	+142.8	+98.0	+90.8
1976-79	+18,700	+42.3	+22,800	+47.4	+27.5	+23.8

SOURCE: U.S. Bureau of the Census, National Association of Realtors, and Economic Report of the President.

* Median price decreased because of extensive construction of low-cost, federally-subsidized housing.

a. Average price of the type of new house sold in 1977, based on Census Bureau estimates.

b. Based on unrounded yearly averages.

coupled with, until recently, fairly low real rates of interest, also had an important influence. The rise in the value of tax subsidies attributable to inflation greatly increased the investment returns for homeownership, thereby encouraging households to pay steadily higher prices for new and existing homes. This trend was encouraged by tax policies that limited business earnings by requiring firms to use historical rather than current values for equipment in claiming depreciation allowances.[25] The sharp rise in mortgage interest rates since 1979 has reduced the rate of house price appreciation, but a return on interest rates return to more normal levels could accelerate it again because of the strong, underlying demand for housing. On the other hand, future appreciation rates could be lower than during the 1970s if greater use of variable-rate mortgages makes homebuying a riskier financial proposition, thereby decreasing the investment demand for housing.

Effect on the Federal Tax System

The present tax treatment for homeownership has three major effects on the federal income tax. First, by narrowing the tax base, it requires higher marginal tax rates to collect any desired amount of revenue. These higher tax rates, in turn, can create disincentives for savings, investment, and labor supply if they are at all sizable. Second, the provision of tax benefits for homeowners causes homeowners and renters in otherwise equal circumstances to be taxed differently. Third, these benefits reduce the progressivity of the income tax, partly because higher-income households own, on average, more expensive homes that have greater tax-subsidized expenses and partly because the form in which the benefits are provided gives taxpayers a higher rate of subsidy the higher is their taxable income. Thus, the current tax provisions benefit most those least likely to need help in buying a home. All six of the key tax provisions described in this paper provide benefits in the form of deductions or exclusions from taxable income; such deductions or exclusions provide a rate of subsidy roughly equal to the taxpayer's marginal tax rate, rising with

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25. To varying degrees, the disadvantages of historical cost depreciation were offset by the availability of accelerated write-offs for investments (based on historical costs) and by the investment tax credit. Nevertheless, historical cost rules limited after-tax business earnings, thereby reducing the attractiveness of investments in corporate equity.

taxable income. This "upward tilt" of the tax benefits is especially great for the home mortgage interest and property tax deductions, since these are limited to taxpayers who itemize--a group consisting disproportionately of taxpayers with expanded incomes of $30,000 or more.[26] Progressivity is further reduced because wealthy taxpayers with multiple homes receive the exclusion of net imputed rental income and the deductions for mortgage interest and property taxes on each one--not just on their principal residence. It is doubtful that a deliberate subsidy for homeownership would be designed in this way.

The indirect rate-increasing effects of the current tax provisions for homeownership have become quite substantial with the recent increases in house prices and interest rates. Using the arithmetic sum of the five key tax expenditures for homeownership listed in Table 1 as a basis, CBO estimates that, eliminating these provisions would allow marginal tax rates to be more than 10 percent lower with no change in aggregate tax revenues.[27] The actual erosion of the tax base because of these five provisions and the exclusion of imputed net rental income may be less than estimated, since if they were not available taxpayers might shift some of their income and savings into other tax-favored forms. Nevertheless, these figures suggest that the current tax provisions for homeownership have had a substantial impact on the tax base.

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26. Estimates using the Treasury Department's Tax Calculator indicate that less than half of all taxpayers with incomes below $30,000 now itemize deductions, compared with more than 75 percent of those with incomes above that level.

27. Recent CBO estimates suggest that, at fiscal year 1982 levels, each 1 percent across-the-board change in marginal tax rates for the individual income tax is associated with a revenue change of about $3.56 billion. Dividing the sum of the five tax expenditures in Table 1 by this figure implies that these five provisions require an 11 percent rise in marginal rates to offset their effect on the tax base if the sum fairly indicates the aggregate revenue effect of these provisions ($39.1 billion ÷ $3.56 billion per 1 percent change in rates = 11.0 percent increase in marginal tax rates).

CHAPTER IV. POLICY OPTIONS FOR THE TAX TREATMENT OF HOMEOWNERSHIP

The previous chapter described the effects of the current income tax treatment of homeownership on the housing market, on the tax system, and on the general economy. If the Congress wishes to revise current policy, a variety of options is available. Some of these would moderate tax benefits that now encourage investment in homeownership over other assets. Some would also reduce the preponderance of tax benefits favoring owner-occupied over rental housing. Still other options would retarget the existing tax benefits toward low- and moderate-income homeowners or first-time homebuyers and away from those with multiple homes. The Congress could also simply maintain current law if it believes that the costs of changing current law would exceed the benefits. This chapter examines a variety of approaches under each of these headings.

MAINTAIN CURRENT LAW

Clearly one option available to the Congress is to maintain current law. Under this approach, mortgage interest and property tax payments would remain fully deductible without limit, while capital gains on home sales would not be taxed so long as homeowners bought a replacement residence of greater or equal value within the prescribed time limit. This approach would also preserve the $125,000 exclusion for capital gains on home sales by persons over 55, current limits on the sale of tax-exempt mortgage bonds, and the exclusion of net imputed rental income from tax.[1]

Maintaining current law would avoid imposing new constraints on homeownership at a time when rising home prices and mortgage interest rates have greatly weakened the demand for housing. When this paper was written, total housing starts were running at an annual rate of barely 1 million units, one of the lowest levels since World War II, while sales of existing single-family homes

1. The $100,000 capital gains exclusion became $125,000 and the 18 month period in the deferral of capital gains became 24 months on July 20, 1981, under the recently-enacted Economic Recovery Tax Act of 1981.

were averaging slightly over 2.5 million at an annual rate--again, far less than in recent years. Both housing construction and home sales could weaken further if the existing tax benefits for homeownership were reduced.

Maintaining current law would perpetuate the undesirable incentive effects of current policy on investment decisions, the housing market, and the structure of the income tax. These consequences are now obscured by the current slump in homebuilding and real estate sales, but they may become more visible if interest rates decline significantly. The impact of tax benefits might be less in the future than during the 1970s, because the introduction of variable rate mortgages will make homeowners more vulnerable to future interest rate increases, while the recently-passed increases in business depreciation allowances and the removal of limits on interest rates that can be paid by financial institutions will enhance the attractiveness of business equipment and financial assets as investment alternatives to homeowning.

Nevertheless, maintaining the current level of tax incentives for homeownership could continue to divert funds to housing at a time when capital markets will already be under heavy pressure to finance the increased business investment likely to result from the Economic Recovery Tax Act of 1981. In addition, if the tax incentive to purchase larger-than-necessary homes for investment purposes continues through the 1980s and 1990s, the excess of single-family homes that is likely to result from demographic trends could be exacerbated. As noted in the last chapter, the growth rate of household formation will begin to decline in the last half of this decade, while the need for smaller units to accommodate the elderly will increase as the current "baby boom" generation reaches retirement age. Thus, maintaining current law could pose significant problems as a long-term strategy, even though it may be an attractive option while further developments in housing, financial, and investment markets remain as uncertain as they are now.

OPTIONS TO REDUCE THE INCENTIVES FAVORING HOMEOWNERSHIP AS AN INVESTMENT AND DISCOURAGING RENTAL HOUSING

If the Congress wants to reduce the impact of current policy on investment choices and on the decision between rental and owner-occupied housing, a number of options are available. Five specific proposals are considered in this section. One is to limit the amount of deductible home mortgage interest payments. The second

is to limit the deductibility of property tax payments on owner-occupied homes. The third is to decrease the exclusion of capital gains on home sales for persons aged 55 and older. The fourth option is to reinstate some tax liability on gains from home sales at the time of sale, a greater revision than merely decreasing the current exclusion. The fifth is to provide renters with new tax credits or deductions equal to a portion of their rent payments.

Limit the Amount of Deductible Home Mortgage Interest Payments

One way to moderate the effects of current policy on the investment demand for homes, on the choice between owned and rented housing, and on federal revenues would be to limit the amount of home mortgage interest taxpayers could deduct. Under this approach taxpayers could deduct only home mortgage interest payments up to a stated dollar ceiling; payments above this level would not be deductible. This limitation would apply only to owner-occupied housing, so that expenses could still be deducted for investment property (including vacation homes rented out). It would also not apply to other interest payments a household incurred--something that could lead taxpayers to secure mortgage loans to other assets unless an effective limitation against all nonbusiness interest could be implemented.[2]

In principle, any ceiling on the mortgage interest deduction, including full elimination, is possible. Lower ceilings would provide greater revenue increases and affect relatively larger numbers of homeowners, while higher ceilings would generate smaller revenue gains and insulate more homeowners from tax increases. A $5,000 ceiling effective January 1, 1982, for example, would increase federal revenues by about $3.0 billion in fiscal year 1982. About 4.6 percent of all taxpayers would experience tax increases, based on data for 1981 income levels--19.5 percent of all those claiming the deduction. Thus, taxpayers with a mortgage balance above $41,650 at 12 percent interest, for example, or

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2. The House of Representatives approved a $12,000 limit on all nonbusiness borrowing in 1975, but it is unclear how effective this proposal would have been in practice in prohibiting taxpayers from increasing their business loans to finance nonbusiness activities through debt. See U.S. Congress, House Committee on Ways and Means, Tax Reform Act of 1975--Report of the Committee on Ways and Means, H. Rept. 94-658 (November 12, 1975), pp. 102-106 (proposed §206 to H.R. 10612).

$71,750 at 7 percent interest, would pay higher taxes. A $10,000 ceiling would increase federal revenues by about $0.6 billion in fiscal year 1982 and affect about 0.5 percent of all taxpayers based on 1981 income levels--2.3 percent of all those claiming the deduction. This ceiling would allow a full deduction for interest payments on a mortgage of roughly $83,000 at 12 percent interest. Thus, many recent purchasers of homes costing as much as $100,000 could be shielded from tax increases. Full elimination of the deduction would increase federal revenues by about $17.6 billion in fiscal year 1982 and, using 1981 income levels, affect nearly 22 million taxpayers--over 23.5 percent of all projected returns (see Table 9) and about 70 percent of all itemizers.

TABLE 9. COMPARATIVE EFFECTS OF SELECTED LIMITATIONS ON THE HOME MORTGAGE INTEREST DEDUCTION, FISCAL YEARS 1982-1986

	Estimated Revenue Increase[a] (in billions of dollars)		
	Full Elimination	$5,000 Cap	$10,000 Cap
1982	17.6	3.0	0.6
1983	31.1	5.4	1.0
1984	38.0	6.5	1.2
1985	46.3	8.0	1.5
1986	56.5	9.7	1.8
Total, 1982-86	189.5	32.6	6.0
Percent of All Taxpayers Affected, 1981 Income Levels	23.5	4.6	0.5
Percent of Taxpayers Claiming the Deduction Affected, 1981 Income Levels	100.0	19.5	2.3

SOURCE: Joint Committee on Taxation and Congressional Budget Office.

a. All proposals assume effective date of January 1, 1982.

Effect on Savings Flows, Federal Revenues, and Housing Markets. Limiting the deductibility of home mortgage interest would reduce federal revenue losses and decrease the attractiveness of homeownership both as an investment and as an alternative to renting. Thus, it could free some consumer savings for investment in business capital. Although some homeowners would find themselves initially with less income to save because their after-tax housing costs had increased, this effect could be partially offset if the revenues gained by limiting interest deductions were returned through an across-the-board tax cut.[3] Nevertheless, recent homebuyers and owners of more expensive units could experience significantly higher housing costs, possibly inducing some current owners either to rent or to acquire less expensive homes. The demand for homes among prospective owners would also probably decrease, implying a corresponding increase in rental demand unless households "doubled up" to a significant extent. Rent levels could thus rise, at least in the short run, while the quantity of rental housing would probably increase in the long run, through the reallocation of some housing units from the sale to the rental market. The construction of new homes, by contrast, would probably fall.

In addition to these effects, capping the deductibiity of home mortgage interest payments would alter home prices, because demand would shift toward units whose interest payments fell below the ceiling. In general, prices for more expensive homes would decrease relative to less expensive units, while the prices of less costly units would rise relatively. Owners of more expensive homes, thus, could experience capital losses, while owners of less expensive homes might have corresponding gains. Excluding current homeowners from a deductibility ceiling would not eliminate these capital losses, because future homeowners would incur greater costs than current owners and would therefore be unwilling to pay as high a price for their homes.

Distributional Impact. Limiting the deductibility of home mortgage interest payments would impose significant tax increases primarily on taxpayers with incomes of $30,000 or more, although many taxpayers with lower incomes would also be affected. At 1981 income levels, over 55 percent of the tax increase resulting from a

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3. A rate cut of equal revenue cost could not fully compensate those directly affected by the limitation, because some of it would go to nonitemizers.

$5,000 ceiling, for example, would fall on taxpayers earning $50,000 or more (see Table 10). Only 1.5 percent of those with incomes of $30,000 or less, as compared with 25 percent of those with incomes of $50,000 or more, would experience a tax increase. Among those affected, taxpayers with incomes of $30,000 or less would face an average tax increase of $310 or less, while those with incomes of $50,000 or more would experience average increases of more than $1,500. A $10,000 ceiling, by contrast, would affect very few taxpayers with incomes under $50,000. Almost 45 percent of the increase would fall on households with incomes of $100,000 and above.

Limiting the deductibility of home mortgage interest payments would also introduce a further distinction between the tax treatment of homeowners with similar homes but different amounts of debt. With a deductibility ceiling, homeowners with larger mortgages would be at a disadvantage relative to otherwise similar homeowners. The differences among their tax liabilities would decrease, even though homeowners with larger mortgages might arguably have less ability to pay taxes. The deductibility ceiling, however, would reduce the discrepancy between homeowners and renters in otherwise equal circumstances, because the tax benefits for homeownership would be smaller relative to those for rental housing.

Variants. Because almost any dollar ceiling on the deduction could subject some taxpayers to financial hardship, the Congress might want to tie a deductibility ceiling to the size of the mortgage or to phase in a dollar interest limit over several years. Following are various ways this could be done, including exempting current homeowners ("grandfathering").

--Cap based on mortgage amount. One alternative to a simple cap on mortgage interest deductions would be a cap based on the size of the mortgage. Under this option, only those interest payments corresponding to a mortgage balance below a certain amount, such as $50,000, would be deductible. Alternatively, a sliding scale of deductibility could be established. Under this approach, a homeowner might be able to deduct all interest payments corresponding to the first $50,000 worth of mortgage balance and half of those reflecting the next $50,000, for example.

A deductibility limit keyed to the mortgage balance would remedy some of the drawbacks in a cap based on total interest payments. This alternative, for example, would shield many recent

TABLE 10. DISTRIBUTIONAL EFFECT OF SELECTED MORTGAGE INTEREST DEDUCTIBILITY CEILINGS AT 1981 INCOME LEVELS

Expanded Income Class (in thousands of dollars)	Percent of All Returns in Income Class[a]	$5,000 Ceiling			$10,000 Ceiling		
		Percent of Taxpayers in Class Affected	Average Increase for Affected Taxpayers (in dollars)	Percent of Tax Increase Experienced by Taxpayers in Income Class	Percent of Taxpayers in Class Affected	Average Increase for Affected Taxpayers (in dollars)	Percent of Tax Increase Experienced by Taxpayers in Income Class
Less than 5	19.7	b	0	b	0.0	0	b
5-10	17.6	b	225	b	0.0	0	b
10-15	14.3	0.3	146	0.2	0.0	0	b
15-20	11.8	1.3	208	0.8	0.0	30	b
20-30	18.0	5.4	310	7.7	0.2	271	1.4
30-50	14.2	15.6	625	34.9	1.1	498	10.3
50-100	3.7	26.7	1,546	38.3	6.6	1,324	44.1
100-200	0.7	27.2	2,959	13.4	11.2	2,920	29.5
200 and above	0.2	23.0	4,598	4.7	13.0	4,833	14.7
Total	100.0	4.6	862	100.0	0.5	1,372	100.0

SOURCE: Joint Committee on Taxation.

a. Includes nontaxable returns.

b. Less than 0.05.

first-time homebuyers with high-interest-rate mortgages from a tax increase. Some purchasers of more expensive homes with lower-rate mortgages would pay higher taxes than under a simple dollar limit on deductible payments, however. A deductibility limit keyed to the size of the mortgage would also target tax subsidies more on less expensive homes and reduce the incentives to use debt financing so heavily in purchasing a home. Both these changes would help moderate the rise in prices for expensive units even more than a dollar limit on deductible interest payments. At the same time, owners of expensive units could experience greater capital losses under this variant. In addition, this option would be more complicated for taxpayers to use, since homeowners with second and third mortgages would have to determine how to apportion deductible mortgage payments among mortgages with different balances and interest rates. This problem could also arise for homeowners with graduated payment mortgages (GPMs), in which the mortgage balance increases during the early years of the loan, although GPMs now represent only a small part of the entire mortgage market (see Appendix B).

--Artifically high ceiling. One way to phase in a dollar interest limit for deductibility would be to impose an artificially high ceiling, such as $20,000, on the amount of deductible home mortgage interest. A ceiling this high would affect relatively few taxpayers at current income levels. In future years, however, the ceiling would become more significant, as inflation increased the price of housing and thus the size of future mortgage balances and the interest paid on them. Taxpayers would be on notice from the start that the ceiling was there, and could make orderly plans to accommodate themselves to it. At 1981 income levels, a $20,000 ceiling would affect only about 32,000 taxpayers, mostly those with incomes of $100,000 or more. For those affected, tax increases would average about $3,250. By 1984, however, many more taxpayers might be affected if housing prices continue to escalate. This could create pressure to raise the limit on deductible payments, although if kept in place it could also help moderate the rise in house prices.

--Gradually falling cap. Another option that would impose an even tighter, phased-in ceiling would be to establish an artificially high cap initially and then lower the amount in subsequent years. Under this approach, the Congress could impose a $20,000 ceiling effective calendar year 1982, for example, and then lower the ceiling by $2,000 each subsequent year until it reached $10,000 in 1987. This option would provide a greater long-term federal

revenue gain than the previous one, because a lower ceiling would be effective in later years. At the same time, it would give taxpayers some time to adjust their financial assets if they wished. One problem with this option is that the Congress might be pressured to override the scheduled imposition of lower ceilings as the new amounts took effect.

--Grandfathering current owners. Another way to phase in a ceiling would be to apply it only to new homeowners or to new principal residences. Either approach would shield current homeowners from tax increases. Neither, though, would fully protect homeowners from capital losses, since future homebuyers would be subject to the ceilings. In addition, each option would have other drawbacks.

Exempting all current owners and applying a ceiling only to first-time homeowners could destabilize housing markets unless the ceiling was very high or the effective date was made retroactive to before the time of serious consideration. Without retroactive application, a low ceiling could drive many prospective homebuyers to purchase now and avail themselves of an unlimited interest deduction. This could cause a temporary spurt in home sales and house prices followed by a sharp decline. Restricting a ceiling to new homebuyers could also create resentment among those covered by the new rule and ultimately bring pressure for liberalization or repeal, reducing both the revenue gains and the housing market effects a ceiling would bring.

Exempting interest payments on current residences could create serious lock-in problems for present homeowners, especially if the ceiling was relatively low, because moving would subject many homeowners to higher income taxes. Thus, housing sales would probably fall, as would house prices over the long run. In the short run, house prices could increase if the quantity of homes offered for sale fell substantially. In addition, employment markets could be affected because more persons would be reluctant to accept job offers involving relocation. These effects could all generate pressure for the Congress to rescind the ceiling or to raise the cap above the initially-legislated level.

Limiting the Deductibility of Property Tax Payments for Owner-Occupied Homes

Another way to moderate the adverse effects of the current tax provisions would be to limit the deductibility of home property tax

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payments. The Congress could, for example, restrict homeowners to deducting only 75 percent of their property taxes. One argument for such a limit is that, because homeowners have some choice over the level of property taxes they will pay--by, for example, moving to a lower-tax jurisdiction or voting for property tax reductions--some portion of the property tax comes close to being an optional user charge, which is not deductible. CBO estimates that a 75 percent ceiling of this sort could reduce tax expenditures by roughly $2.5 billion at 1981 income levels. If effective January 1, 1982, it could increase revenues by about $2.0 billion in fiscal year 1982 and $3.5 billion in fiscal year 1983.

Like a cap on mortgage interest deductions, limiting property tax deductions would increase the cost of homeownership and reduce the rate of return from homeowning as an investment. Unlike the mortgage interest limitation, it would be difficult to circumvent because property tax payments are tied to the property in question and cannot be altered by borrowing against other assets. The major drawback with limiting property tax deductions is that it could impose fiscal hardships on state and local governments. State and particularly local governments rely heavily on the property tax as a revenue source, and restricting the deductibility of property taxes could make it harder for these governments to maintain or increase property tax rates. Limiting deductibility, thus, could compound the cut in state and local government services beyond that resulting from the recently-enacted federal program cuts, if these units of government cannot offset property tax reductions with increases in sales or income taxes.

Reducing the Exclusion of Gains for Persons 55 and Older

A third option that would particularly reduce the tax advantages of homeownership as an investment would be to decrease the amount of gains that persons aged 55 or older can exclude from taxable income.[4] Under this option, taxpayers 55 and older who sold their homes would no longer be able to exclude as much capital gains from taxable income if they sold their homes without buying another of equal or greater value. CBO estimates that reducing the excludable amount to $50,000, effective January 1, 1982, would increase revenues by somewhat more than $100 million during fiscal

4. The Congress moved in the opposite direction in the recently-passed Economic Recovery Tax Act of 1981, increasing the $100,000 exclusion to $125,000.

year 1983 and between $200 and $300 million a year during subsequent years.

Reducing the amount of excludable capital gains income from home sales might not have much aggregate impact on housing markets, but it could discourage some older taxpayers from selling their homes. Because in many cases a lifetime of accumulated gains (less selling expenses) would be subject to tax, some older homeowners could face substantial cash flow problems if the exclusion was significantly reduced, particularly if they later tried to buy a home after having rented for more than two years, even though the tax rate on nonexcluded gains would be fairly small (20 percent or less).[5] These cash flow problems could be alleviated by allowing the tax to be deferred until death, although in that case older homeowners might consider more heavily the tax advantages of retaining their homes until their death.[6]

Although a smaller exclusion could adversely affect older homeowners, it would also have some positive effects. It would, for example, reduce the incentives for persons just under 55 to invest more funds in housing so as to obtain a large, tax-free return. If so, it could help to moderate price increases for more expensive homes, although this effect could be offset if many older taxpayers decided not to sell their homes. On the other hand, a smaller exclusion could reduce the flow of savings from older homeowners back into nonresidential investments if it discouraged older homeowners from selling their residences.

Replacing the Current Tax Treatment of Gains from Home Sales with a Small Tax at the Time of Sale

A fourth option, representing a more far-reaching modification of the current tax treatment of gains from home sales, would be to tax all gains on home sales at a very low rate, eliminating both the deferral of gains on home sales and the capital gains exclusion

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5. Only 40 percent of all net long-term capital gains (net gains on assets held for one year or more) are included in taxable income, so the maximum tax rate on taxable gains from home sales would equal 0.40 times the top 50 percent marginal rate, or 20 percent (0.40 x 0.50 = 0.20).

6. Current law allows a step-up in basis for property acquired from a decedent, thus eliminating any tax liability on the gains during the decedent's lifetime. See IRC §1014.

for persons 55 and older. Under this option, taxpayers would simply include in taxable income some fraction of the gain on the sale of their homes.[7] To avoid hardship for those whose moves were involuntary, and to continue some preference for home sales, the fraction subject to tax could be set at a figure such as 10 or 20 percent of the recognized gain from the sale, compared to the 40 percent that applies to other long-term capital gains. Under these circumstances, taxpayers would face at most a 5 or 10 percent tax on the gain from selling their homes, and even less if their marginal tax rate was below the top rate of 50 percent.

Replacing the current tax treatment of capital gains on home sales with a small tax at the time of realization would have a number of advantages. First, it would simplify both tax administration and taxpayer compliance by reducing the need for homeowners to keep track of gains and expenses on a lifetime of principal residences. Second, it would reduce some of the disparities in tax treatment between capital gains on home sales and sales of other assets, which are taxed when realized. Under this option, capital gains from home sales would still be taxed at a lower rate than sales of other assets, but the difference in tax treatment would be smaller. Third, taxing gains when realized would remove the disincentive against purchasing a less expensive residence when one's current home is sold at a profit. This change could lead to greater investment in financial assets, as it became more attractive for middle-aged homeowners to shift some of their assets from their homes into stocks and bonds.

Taxing capital gains on home sales at the time of realization would have some important disadvantages, however. First, taxpayers selling their homes would be faced with higher tax bills than at present. For example, homeowners netting a $100,000 profit on their homes after selling expenses could experience up to a $10,000 tax on the transaction, if 20 percent of the gain was included as taxable income.[8] This would reduce the equity available for

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7. Previously deferred gains on past homes could also be partially taxed under this option, or the tax on those gains could be forgiven.

8. Calculated as $20,000 gain times the top marginal rate of 50 percent. The actual tax would be smaller if the taxpayer could use income averaging.

purchasing a new residence or investing in other assets.[9] It should not, however, create a cash burden at tax time unless the gains reflect a general rise in house prices, since the proceeds of the sale could be used for the tax. This last problem could be reduced, at a cost of greater complexity, by indexing capital gains on home sales for inflation. Second, taxpayers might be more reluctant to accept job changes that involved relocation, because they could face additional tax liability when they moved. This might have some undesirable effects on employment markets. Third, removing the disincentives to "trade down" houses might encourage some taxpayers in their 30s and 40s initially to purchase more expensive homes than now in the hope of using their profits to finance other purchases when they sell their homes, although this development seems unlikely.

To further moderate the effects of current tax law on investment in housing, the Congress might consider policy options such as indexing all capital gains for inflation and expensing capital assets that would lessen the increase in tax rates on dividends and business earnings during periods of inflation. Analyzing various approaches toward this goal is beyond the scope of this paper. Nevertheless, the Congress could go beyond the changes recently enacted in the Economic Recovery Tax Act of 1981 if further measures to redirect savings toward nonresidential investment are desired.

Creating New Tax Benefits for Renters

A fourth policy option that would serve primarily to reduce the imbalance between tax benefits for homeowners and renters would be to establish new tax benefits for renters. Under this approach, renters might receive either a tax credit or a deduction for part or all of their rent payments. A tax credit for rent payments, like other credits, would provide a constant rate of subsidy for all qualifying rent payments while a deduction would provide a rate of subsidy that rises with taxable income.

Providing tax credits or deductions for rent payments would offset some of the distortions favoring homeownership in current

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9. While this might reduce investment in productive assets by affected taxpayers, the effects for the economy as a whole could be largely offset by using any revenue gain to finance an across-the-board tax cut.

law without requiring a cutback in existing tax benefits for homeowners. In so doing, however, it would provide more incentives for investment in rental housing over other assets. It could also create sizable new revenue losses. For example, CBO estimates that even a 7 percent refundable tax credit for gross rent payments could cost more than $5.1 billion at calendar year 1981 income levels. To offset this revenue cost, marginal tax rates would have to be increased, and that would raise the value of tax benefits to homeowners.

The main benefit from establishing a tax credit or deduction for renters is that it would reduce some of the discrimination aginst renters now in the income tax. Whether a new subsidy would have much effect on private housing decisions is uncertain. Unless the magnitude of tax benefits provided was large compared to those for homeownership, not many households would be encouraged to rent rather than own. If so, the effects on rental housing construction and rental unit conversions might be small. The largest impact of new benefits might be to enable existing tenants to afford higher rent payments. This could lead to better apartment maintenance, if rent levels were allowed to increase and maintenance improved correspondingly, or to smaller rent burdens for low-income families. It would not have much impact on the supply of low-rent housing, however, because building costs are generally too high to enable low-income families to afford newly-built rental units without large federal subsidies.

OPTIONS TO RETARGET BENEFITS AND REDUCE ALLEGED INEQUITIES IN TAX TREATMENT

If the Congress wants to retarget the tax benefits now provided by the tax provisions affecting homeownership or to reduce alleged inequities in those provisions, other policy options are available. In this report, three sets of retargeting alternatives are considered, in addition to the provision of new tax benefits for renters discussed earlier. One is to convert the present home mortgage interest deduction to a flat-rate tax credit. The second is to limit the deductibility of mortgage interest and property taxes to a taxpayer's primary residence--an option that might eliminate some tax benefits now used for vacation homes. The third set consists of several proposals designed to direct a larger share of tax benefits toward first-time homebuyers, whose cash flow problems in acquiring their homes have increased significantly because of higher house prices and interest rates.

Converting the Mortgage Interest Deduction to a Tax Credit

If shifting assistance to moderate- and middle-income homeowners is a major concern, one way to achieve this would be to replace the present mortgage interest deduction with a tax credit against mortgage interest costs. Under this option, taxpayers could receive a fixed percentage of mortgage interest costs as a direct offset to tax liabilities, rather than as a reduction in taxable income.

Rationale. Converting the mortgage deduction to a tax credit would serve two primary objectives. First, it could extend the present tax subsidy to virtually all homeowners with mortgages. As noted in Chapter II, the current deduction reaches only about 63 percent of homeowners with mortgages, because many low- and moderate-income homeowners take the standard deduction rather than itemize. With a tax credit, these homeowners would receive subsidies as well.

Second, converting the deduction to a tax credit would equalize the rate of subsidy provided to homeowners with mortgage interest payments. Under the present deduction, taxpayers receive for each dollar of mortgage interest expense a subsidy roughly equal to their marginal tax rate. Thus, a taxpayer in the 40 percent tax bracket generally receives a subsidy of 40 cents for each dollar of mortgage interest payments, while a taxpayer in the 20 percent bracket with the same interest expenses receives about a 20-cent subsidy. Since higher-income taxpayers generally fall into higher tax brackets, a tax credit would concentrate more tax savings on low- and moderate-income families.

In addition to these objectives, making the mortgage deduction a tax credit could significantly reduce the number of taxpayers who itemize deductions. Tax simplification, thus, would be advanced while the administrative workload on the IRS would decrease.

Revenue Effect. The revenue effect of shifting to a tax credit would depend on the size of the credit and, to a lesser extent, on whether it is refundable.[10] Refundable credits and

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10. Refundable credits, which provide direct cash payments to those whose total tax liability is less than the amount of the credit, would help mostly older, retired homeowners who pay little or no income tax.

credits offering a higher rate of subsidy would provide greater tax savings but impose greater costs in federal revenues. CBO estimates that converting the present deduction to a 25 percent nonrefundable tax credit, effective January 1, 1982, would increase federal revenues by roughly $2.4 billion in fiscal year 1982 and almost $7.9 billion a year by fiscal year 1986. These increases would occur because revenue gains from higher-income taxpayers, who now receive more than a 25 percent subsidy on their mortgage payments, would exceed the rise in tax savings to low- and middle-income taxpayers. Converting the deduction to a 30 percent nonrefundable tax credit would reduce federal revenues by about $500 million at 1981 income levels, while converting to a 35 percent tax credit could reduce revenues by as much as $3.9 billion at 1981 income levels.

Distributional Effects. Converting the deduction to a tax credit would target more of the mortgage interest subsidy on low- to middle-income taxpayers. On average, higher-income homeowners would receive a smaller subsidy rate than at present, while low- and middle-income homeowners would receive a higher rate of subsidy or, in some cases, a subsidy for the first time. Table 11, which describes the likely effect of a 25 percent nonrefundable credit at 1981 income levels, indicates that taxpayers with incomes below $30,000 would in general experience a tax decrease under this proposal, while those with incomes of $30,000 and above would on average pay higher taxes. In particular, interest subsidies for taxpayers with incomes of $50,000 or more would be cut in half by this option (compare the last two columns of Table 11).

Housing Market Consequences. Refocusing tax subsidies on moderate- and middle-income families would bring about certain changes in housing markets. The demand for housing among less-affluent households would probably increase, thereby raising prices for less expensive units. Some first-time homebuyers thus might find it harder to purchase a home, since first-time buyers typically purchase less expensive units. Prices of more expensive homes, by contrast, would probably fall relative to the mean, since tax subsidies for higher-income households would decrease. Owners of more expensive units could thus experience capital losses.

Possible Modifications. Because of the negative effects a credit might have on higher-income taxpayers, the Congress might want to consider some modification of a straightforward tax credit if the tax credit approach received close attention. The credit

could also be combined with a ceiling to achieve a more stringent limitation on revenue losses.

--Retain the deduction as an option. One way to protect high-bracket taxpayers would be to retain the deduction as an option. This approach was used between 1972 and 1978, when taxpayers were allowed to choose between a credit or a deduction for contributions to political candidates. Retaining the deduction as an option, however, would substantially increase the cost of providing a tax credit and add to the complexity of the tax system. It would also eliminate the ability of the credit to moderate price rises for more expensive homes.

--Retain the deduction as an option only for current owners. Another way to reduce the costs of shifting to a credit would be to retain the deduction specifically for current homeowners. This approach, which could be described as "grandfathering," would create smaller revenue losses than a general deduction option because only present homeowners could qualify. Retaining the deduction for current owners, though, could bring about many of the side effects from grandfathering current owners described earlier for a ceiling on deductible home mortgage interest payments.

--Combine the tax credit with a limit on qualifying expenses. To increase the revenue gains from converting the mortgage interest deduction to a credit, the Congress could couple this change with a limit on the amount of mortgage interest expenses qualifying for it. This option would concentrate still more tax benefits on low- to middle-income taxpayers and impose greater losses on high-bracket taxpayers and owners of more expensive homes. It would also shift demand even more heavily in favor of less expensive units, magnifying the relative price change that would come from converting the deduction to a tax credit. Estimates with the Treasury's Tax Calculator suggest that a 25 percent nonrefundable tax credit with a $1,500 maximum would increase revenues by $4.6 billion at 1981 income levels, or $1.6 billion more than the simple conversion to a tax credit (see Table 12). Most of the additional revenue gains would come from taxpayers with incomes of $30,000 to $100,000. First-time homebuyers would also face greater burdens under this variant, since many of them face very high mortgage payments because of high housing prices and interest rates.

TABLE 11. EFFECT OF CONVERTING THE MORTGAGE INTEREST DEDUCTION TO A 25 PERCENT NONREFUNDABLE TAX CREDIT AT 1981 INCOME LEVELS

	Taxpayers Experiencing a Tax Decrease		
Expanded Income Levels (in thousands of dollars)	Number of Returns (in thousands)	Total Decrease in Income Class (in millions of dollars)	Average Decrease for Affected Taxpayers (in dollars)
Below 5	720	-67	-93
5 - 10	3,129	-631	-202
10 - 15	2,791	-681	-244
15 - 20	2,788	-602	-216
20 - 30	4,448	-732	-165
30 - 50	760	-146	-193
50 - 100	24	-6	-235
100 - 200	2	a	-266
200 and Above	a	a	-270
Totals	14,662	-2,864	-195

(Continued)

TABLE 11. (Continued)

Taxpayers Experiencing a Tax Increase			All Taxpayers	
Number of Returns (in thousands)	Total Increase in Income Class (in millions of dollars)	Average Increase for Affected Taxpayers (in dollars)	Net Tax Change (in millions of dollars)	Net Change from Repeal of Deduction Alone (in millions of dollars)
a	a	0	-67	23
a	a	0	-631	216
3	a	15	-680	407
282	20	71	-582	995
2,266	239	105	-493	4,035
7,163	2,447	342	2,300	9,328
2,243	2,306	1,028	2,301	4,998
334	639	1,911	639	1,159
70	186	2,673	186	313
12,362	5,837	472	2,974	21,476

SOURCE: Treasury Tax Calculator, 1981 Tax Law at 1981 income levels.

a. Less than 0.5.

TABLE 12. EFFECT OF CONVERTING THE MORTGAGE INTEREST DEDUCTION TO A $1,500 MAXIMUM, 25 PERCENT NONREFUNDABLE TAX CREDIT AT 1981 INCOME LEVELS

	Taxpayers Experiencing a Tax Decrease		
Expanded Income Levels (in thousands of dollars)	Number of Returns (in thousands)	Total Decrease in Income Class (in millions of dollars)	Average Decrease for Affected Taxpayers (in dollars)
Below 5	720	-67	-93
5 - 10	3,129	-631	-202
10 - 15	2,791	-680	-243
15 - 20	2,777	-598	-215
20 - 30	4,256	-680	-160
30 - 50	705	-135	-191
50 - 100	23	-5	-231
100 - 200	2	a	-267
200 and Above	0	0	-281
Totals	14,403	-2,795	-194

(Continued)

TABLE 12. (Continued)

Taxpayers Experiencing a Tax Increase			All Taxpayers	
Number of Returns (in thousands)	Total Increase in Income Class (in millions of dollars)	Average Increase for Affected Taxpayers (in dollars)	Net Tax Change (in millions of dollars)	Net Change from Credit Without Cap (in millions of dollars)
a	a	0	-67	-67
a	a	0	-631	-631
3	a	15	-679	-680
295	22	75	-576	-582
2,466	328	133	-351	-493
7,219	3,039	421	2,904	2,300
2,245	2,897	1,291	2,892	2,301
335	828	2,475	828	639
70	248	3,563	248	186
12,632	7,363	583	4,568	2,974

SOURCE: Treasury Tax Calculator, 1981 Tax Law at 1981 income levels.

a. Less than 0.5.

Eliminating Mortgage Interest or Property Tax Deductions for Second Homes

Another option the Congress could consider to focus more of the subsidy on those with the greatest need would be to eliminate the deductibility of home mortgage interest or property tax payments on second homes. Under this option, taxpayers would be allowed to deduct only interest or property tax payments for mortgages on their primary residences. Thus, these expenses for vacation homes and secondary residences would no longer be a deductible expense.

Limiting the deductibility of mortgage interest or property tax payments to a taxpayer's primary residence could eliminate some tax benefits for households with multiple homes, a group that includes mostly higher-income taxpayers. The revenue savings from this change might be small, however, for two reasons. First, property tax payments on vacation homes represent only a small part of total property tax payments, so the net revenue gain from eliminating the deductibility of this item would be fairly low--probably not more than $250 million in fiscal year 1982.[11] Second, many vacation homeowners have other assets against which they could borrow, including unused equity in their primary residences, if mortgage interest deductions were limited to a taxpayer's primary residence. Thus, many owners of multiple homes might simply replace vacation-home mortgages with loans against business assets or second mortgages against their primary residences if deductions for mortgage interest payments on second homes were disallowed. Restrictions against using business assets for nonbusiness borrowing or second mortgages for other homes would limit this effect, but such restrictions might not be altogether effective. These same dangers, of course, exist for limiting home mortgage deductions in general, but owners of multiple homes are

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11. The 1979 Annual Housing Survey indicates that about 4.9 percent of all homes are seasonal units and homes held for occasional use, while a 1969 Forest Service study suggests that vacation homes cost, on average, about half of what primary residences do, and that 5 percent of these homes are rented out. If these figures apply to property tax payments, then the share of the current tax expenditure for the property tax deduction on second homes should be about $250 million in fiscal year 1982: $10,705 million x 0.049 x 0.50 x 0.95 = $249.2 million.

far more likely to be upper-income households with other assets to which home mortgage loans could be shifted.

If owners of multiple homes did not shift their loans to circumvent a deductibility prohibition, limiting deductible interest payments to those for a primary residence could increase federal revenues by $500 to $750 million in fiscal year 1982. The likely revenue effect of this proposal, however, seems far less--possibly as low as $100 to 200 million, because of the opportunity for owners to shift mortgages.

Targeting More Benefits on First-Time Homebuyers

A third option for retargeting benefits would be to concentrate more tax savings on first-time homebuyers. As discused in the previous chapter, the interaction of existing benefits with inflation and fixed-rate mortgages has helped house prices to rise much faster than the inflation rate, providing windfall gains to existing owners but making it harder for first-time homebuyers to finance a home than was true during the early 1970s. Since tax benefits were partly responsible for these increases, the Congress might want to provide some compensation to those who were disadvantaged.

Similarly, the Congress may want to provide special treatment for first-time homebuyers if it decides to limit or reduce existing tax benefits for homeownership. For example, if a ceiling is placed on home mortgage interest deductions, a higher limit might be applicable to first-time buyers for a specified time period. Other, more extensive options are also available, including the creation of tax-subsidized savings accounts, the provision of tax credits, and the promotion of alternative mortgage instruments that impose lower costs on buyers during the early years of ownership.

Establishing Tax-Subsidized Savings Accounts for First-Time Homebuyers (IHAs). One option that could assist first-time homebuyers would be to establish tax-subsidized savings accounts for this purpose, called "individual housing accounts" or IHAs. These accounts, which would operate similarly to individual retirement accounts, would permit prospective homeowners to deposit a maximum amount of money into a savings account whose balance could be used only toward the purchase of a first home. As with the IRAs, annual contributions to the account would be either tax-deductible or would qualify for tax credits, while interest earnings would be tax-free. Unlike IRAs, however, account balances would probably be

limited to a maximum size. One such proposal would allow taxpayers to contribute and deduct from their taxable incomes $1,500 a year for 10 years to a tax-free housing account with a limit on total contributions of $15,000. Married couples filing jointly could contribute up to $3,000 a year, with a maximum balance of $30,000, under this proposal.[12]

IHAs would help first-time buyers by enabling them to accumulate a down payment more quickly than would otherwise be possible. For example, a married couple in the 40 percent tax bracket who invested $3,000 in an IHA paying 11 percent interest could receive tax benefits totalling about $1,340 under the IHA plan described above, thus increasing the value of their savings by nearly 42 percent.[13] Thus, IHAs would be a good vehicle to help persons who can accumulate savings toward buying a home.

A major drawback with IHAs as a way of enabling more families to afford a home is that their benefits would not be well-targeted on those most in need of assistance. IHAs would provide tax savings to those who can accumulate substantial savings toward a first home. This group is more likely to include higher-income taxpayers than it is the less-affluent households for whom high prices and interest rates have made affording a home particularly difficult. Under many IHA plans, benefits would be even more strongly directed at high-income households because contributions

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12. See S. 24, introduced by Senator Dole of Kansas, which would also create special, tax-subsidized savings accounts to pay for college expenses.

13. With the IHA plan described above, the couple could receive $1,200 in tax benefits from its $3,000 in contributions. In addition, it could receive up to an additional $139.51 in interest earnings, because interest on the account would no longer be taxable. Annual interest earnings on $3,000 at 11 percent, compounded daily, would be $348.78 after taxes, versus $209.27 (60 percent of $348.78) if the earnings were taxed; $348.78 - $209.27 = $139.51. If these tax benefits were also saved, the couple's savings could equal $4,548.78 ($3,000 + $348.78 in after-tax interest + $1,200 in tax savings from the deposits) versus $3,209.27 if the funds were deposited at the beginning of the year in a taxable account paying the same interest rate ($3,000 + $209.27), or almost 42 percent more ($4,548.78 ÷ $3,209.27 = 1.417).

to an IHA would qualify for a deduction from taxable income, rather than a tax credit. Deductions and exclusions from taxable income provide greater savings to taxpayers in high marginal tax brackets, and high-income taxpayers are generally in higher tax brackets than are those with lower incomes.

IHAs also have defects as a way of encouraging personal savings, because the high-income taxpayers that they are most likely to benefit are also the ones with the greatest incentives to buy a home using the smallest possible down payment, thus maximizing their mortgage interest deductions. The tax advantages of IHAs would be substantial enough that many of these higher-income taxpayers would still set up IHAs, since these would be better savings vehicles for accumulating a down payment than other financial investments. But IHAs would then simply be displacing saving that would take place in other forms, rather than providing an incentive for new saving.

IHAs would also have a high budgetary cost. CBO estimates that the establishment of IHAs along the lines of the proposal described earlier, effective January 1, 1982, could reduce federal revenues by about $300 million in fiscal year 1982, $5.7 billion in fiscal year 1983, and $7.8 billion annually by fiscal year 1984. IHAs could thus absorb much of the revenue gains from a $5,000 ceiling on deductible home mortgage interest payments (see Table 9).

Providing Limited Tax Credits for First-Time Homebuyers. Another way to concentrate more tax benefits on first-time homebuyers would be to provide them with limited tax credits based on the purchase price of the unit. First-time buyers, for example, might be given a one-year tax credit equal to 5 percent of the purchase price, with a maximum credit of $2,500. This sort of credit, which is similar to one that was available for all homebuyers for most of the years 1975-1976,[14] might cost between $2.5 billion and $4.0 billion at fiscal year 1982 levels if the number of first-time homebuyers ranged from 1 million to 1.6 million, as it has in recent years.

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14. See 26 U.S.C. §44 (1975). This provision authorized a 5 percent tax credit for the first $40,000 of house price for most home purchases between March 12, 1975, and December 31, 1976.

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A flat-rate tax credit for first-time homebuyers would be more effective than an IHA proposal at reaching families who face great difficulties in becoming homeowners, because it would benefit those who cannot accumulate significant savings and would provide the same rate of subsidy to homebuyers at all income levels. Like IHAs, however, much of the tax savings would reach those who could afford a home anyway, unless the credit was limited to taxpayers with incomes below a certain level. This could be done, for example, by phasing out the credit as income reached a target figure. A further problem with tax credits is that they could raise prices for so-called "starter" homes, thereby reducing their effectiveness as subsidies. In addition, like IHAs they could aggravate the problem caused by the existing provisions affecting homeownership unless paired with a significant reduction in current tax benefits.

Promoting Mortgage Instruments with Low Early-Year Costs. If the Congress wants to assist first-time homebuyers without providing substantial new tax benefits, one option would be to encourage the use of mortgage instruments that require lower down payments or impose lower monthly payments during the early years of ownership. These types of mortgage instruments, which include graduated payment (GPMs) and shared appreciation (SAMs) mortgages, as well as conventional, fixed-interest rate mortgages with longer terms and lower down payments, reduce the cash-flow problems normally incurred by first-time homebuyers during a period of significant inflation.[15] Many analysts believe that these cash-flow problems, rather than any fundamental decrease in the ability to afford a home, are the real barrier facing first-time homebuyers in periods like the present.[16]

Of the many ways to encourage the use of alternative mortgage instruments that would favor first-time homebuyers, perhaps the

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15. For a further discussion of alternative mortgage instruments, see Appendix B.

16. See, for example, William Poole, "Housing Finance under Inflationary Conditions," in Federal Reserve Board Staff Study, Ways to Moderate Fluctuations in Housing Construction (Washington: Board of Governors of the Federal Reserve System, 1972), pp. 355-75; and J.R. Kearl, "Inflation, Mortgage and Housing," Journal of Political Economy, vol. 87 (October 1979), pp. 1115-39.

most effective would be a general increase in the supply of mortgage credit. Federal regulations now enable federally-insured savings and loans to issue 5 percent down-payment, 40-year conventional mortgages, in addition to graduated-payment, variable-rate, and shared-appreciation mortages.[17] Thus, the major obstacle to their use appears to be the reluctance of lenders to provide these loans--a reluctance encouraged by the high interest rates lenders must pay to obtain funds and the need to ration credit among current borrowers. Future inflows of additional mortgage money might increase the willingness of lenders to provide mortgage loans on more favorable terms. On the other hand, with substantial pent-up demand for housing and with lenders' net worth already lowered by the large stock of outstanding, low-interest-rate mortgages, a very substantial influx of funds would be needed for lenders to find it profitable to issue such mortgages. Such an increase seems unlikely if interest rates remain at very high levels.

Another option that would address particularly the reluctance of lenders to make graduated payment loans would be to count as taxable income only the cash payments received from these loans. This would represent a change from current law for the many lenders who are "accrual" taxpayers, because they would no longer be taxed on the "negative amortization" from graduated payment mortgages, although they have a right to receive this income.[18] As such, it would represent a departure from the normal tax treatment of constructively-realized income.

Changing the tax treatment of graduated payment mortgages in this way would increase the effective rate of return on these loans, because lenders would no longer be taxed in the present on mortgage payments actually received in later years. Whether this change would have much effect on the supply of GPMs is uncertain, however, because lenders still might find it more profitable to offer other loans requiring level payments at any given interest rate.

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17. See "Revision of Real Estate Lending Regulations," Federal Register, vol. 45 (November 18, 1980), pp. 76095 ff., esp. 76095-97 and 76099, affecting 12 CFR §545.6.

18. Current law makes taxable both cash payments and "negative amortization"--the amount by which payments fall short of paying off a loan and thus increase the actual mortgage balance. See IRS Revenue Ruling 77-135, Cum. Bull. 1977-18 (May 2, 1977), affecting 26 CFR §1.466-1.

APPENDIXES

APPENDIX A. FEDERALLY-CHARTERED AGENCIES AND DIRECT EXPENDITURE PROGRAMS THAT PROMOTE HOMEOWNERSHIP

In addition to the tax benefits described in this report, the federal government charters and, in some cases, funds through direct expenditures a number of agencies that promote homeownership. Some of these agencies provide loan guarantees and other services so that homebuyers can obtain more favorable mortgage loans. Others regulate and expand the supply of funds for home mortgage lending. Six of these agencies and their programs are described briefly in this appendix: the Federal Housing Administration (FHA), the Veterans Administration (VA), the Federal Home Loan Bank System (FHLBS), the privately-owned Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC).

LOAN GUARANTEES AND RELATED SERVICES

The federal government funds two major insurance activities to provide homebuyers with more favorable mortgage loans: the mortgage insurance and graduated payment mortgage programs of the Federal Housing Administration (FHA) and the mortgage guarantee and direct loan programs of the Veterans Administration (VA).

Federal Housing Administration (FHA)

The Federal Housing Administration (FHA), founded in 1934, provides a number of services designed to promote homeownership. The best known of these is the FHA mortgage insurance program, a self-financing activity under which the federal government guarantees 100 percent of all qualifying mortgage loans in return for a lender's offering certain lending terms favorable to borrowers. Another FHA activity that has gained prominence recently is its promotion of graduated payment loans through the Section 245 program.

In recent years, the share of FHA-insured home mortgages has declined significantly, to between 10 and 15 percent of all new home mortgages, because of the growth of private mortgage insurance

and the gradual acceptance of low-down-payment, long-term-amortized mortgage loans. During fiscal year 1981, the FHA is authorized to commit nearly $34.2 billion in mortgage loan guarantees.

Veterans Administration (VA)

Since the enactment of the GI Bill following World War II, loan guarantees and direct mortgage loans have been among the most popular services offered by the Veterans Administration. VA loan guarantees are normally limited to the lesser of 60 percent of the mortgage or a specified dollar amount, now set at $27,500. Because the guarantee normally exceeds the loss from foreclosure for all except relatively expensive homes, many VA loans require little or no down payment. During fiscal year 1981, the VA is expected to guarantee an estimated $10.5 billion worth of new home mortgage loans. For fiscal year 1982, the total is expected to reach $11.2 billion.

REGULATION AND EXPANSION OF MORTGAGE LENDING

Four other federally-sponsored organizations serve to regulate and expand the volume of home mortgage lending in the United States: the Federal Home Loan Bank System (FHLBS), the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC). Each of these institutions promotes these objectives in a somewhat different way.

Federal Home Loan Bank System (FHLBS)

The Federal Home Loan Bank System (FHLBS), consisting of a Federal Home Loan Bank Board (FHLBB) and 12 regional home loan banks, performs many of the same activities for federally-insured savings and loan (S&L) associations that the Federal Reserve System undertakes for commercial banks. The FHLBS monitors savings and loan activities, advancing money to S&Ls in need of additional funds. The FHLBB regulates all savings and loan deposit and lending activities of federally-insured S&Ls. Thus, it determines what types of loans and deposits S&Ls may offer.

Federal National Mortgage Association (FNMA)

The Federal National Mortgage Association (FNMA), founded in 1938 and made a private corporation in 1968, is the oldest of the

federally-sponsored agencies providing additional funds for mortgage lending through the creation of a "secondary market" for mortgage loans. FNMA has traditionally served as a mortgage dealer, alternatively buying and selling mortgages to maintain the liquidity of the home mortgage market. Since the mid-1960s, however, FNMA has been required to purchase certain types of mortgages involving low- and moderate-income homebuyers, thus becoming a net holder of home mortgages. Although FNMA is authorized to borrow some funds from the federal government, its activities have thus far been financed solely by the sale of its own bonds.

Government National Mortgage Association (GNMA)

The Government National Mortgage Association (GNMA) was created in 1968 to assume some of the more specialized duties originally assigned to FNMA. Thus far, GNMA has performed two major tasks. One is to expand the secondary mortgage market by creating a new type of federally-insured security, the GNMA mortgage-backed security. The other has been to subsidize mortgage lenders, by purchasing below-market-rate mortgages at par and selling them at market value--what is called the GNMA "Tandem" plan. GNMA's Tandem activities are supported directly by federal appropriation; its mortgage-backed security activities are self-financing. In fiscal year 1981, GNMA is expected to increase its net commitments of mortgages by about $650 million, while its guarantees for mortgage-backed securities are authorized to reach $53 billion. The income from this last activity is expected to exceed expenses by about $89.4 million.

Federal Home Loan Mortgage Corporation (FHLMC)

The Federal Home Loan Mortgage Corporation (FHLMC) is the newest of the federal mortgage assistance agencies. It serves to purchase mortgages directly from mortgage originators, primarily savings and loan associations. Founded in 1970, FHLMC has acquired over $27.3 billion in mortgages and other loans receivable. Like FNMA and GNMA, it supports its activities by raising funds through the sale of low-rate federal bonds. FHLMC stock is owned by the regional home loan banks of the Federal Home Loan Bank System.

APPENDIX B. RECENT INNOVATIONS IN HOME MORTGAGE INSTRUMENTS

Significant changes in home financing have occurred in the last several years. In place of the traditional, level-payment, fixed-interest-rate mortgage, lenders and homebuyers have increasingly opted for a number of different mortgage instruments. Some of these provide lenders more protection against unexpected fluctuations in interest rates by allowing changes in the mortgage rate itself and corresponding alterations in monthly payments. Others permit buyers to afford more expensive homes by allowing mortgage payments to rise over the term of the loan in place of the constant, level payment. Still other mortgages allow homebuyers to reduce their monthly mortgage payments by giving lenders part of the increase in the value of their homes when they are later sold or after a specified time. Each of these new mortgage instruments represents a market response to the effects of inflation on house prices and interest rates. Nevertheless, certain obstacles may limit the spread of these new instruments. Following is a brief discussion of the major innovations in home mortgage finance and their potential hazards.[1]

Major New Instruments and Their Hazards

Of the many new mortgage instruments that have become prominent during the last several years, the limited-adjustment variable rate mortgage (VRM), the renegotiable rate mortgage (RRM), the graduated payment mortgage (GPM), and the shared appreciation mortgage (SAM) have received the most attention. In addition to these three new instruments, the Federal Home Loan Bank Board (FHLBB) has recently liberalized mortgage lending rules for federally-insured savings and loan associations. Under these rules, S&Ls can now

1. For more extended discussions of new mortgage instruments, see Rochelle L. Stanfield, "High Interest Rates are Sparking a Revolution in Home Financing," National Journal, vol. 13 (January 31, 1981), pp. 172-76; and Federal Home Loan Bank Board, Alternative Mortgage Instruments Study (November 1977).

make 40-year mortgage loans with down payments as low, in some cases, as 5 percent.[2]

Limited-adjustment "variable rate mortgages" are mortgages in which interest rates and monthly payments may change, based on changes in a predetermined index such as the Treasury bill rate, but not beyond certain limits. Under some mortgages of this type, the interest rate may only change by a limited amount during any time period; for example, some loans prohibit interest rate changes of more than 1/2 percentage point during any 12 months. Some loans also limit the total possible change in interest rates over the term of the mortgage. Other variable rate mortgages allow unlimited changes in interest rates but restrict changes in monthly payments to certain frequencies, such as every several years. Under one such plan, monthly payments remain fixed for five years, but any shortfall of payments from true obligations is used to increase the loan balance. This increase in the loan balance, called "negative amortization," is then used to determine the new set of monthly payments at the end of that five-year period.[3]

While variable rate mortgages protect lenders against interest rate fluctuations, they pass that risk on to borrowers. Many consumer groups have thus objected to VRMs, although likely consumer reactions to them will depend on economic conditions and the range of financing options available.

Renegotiable rate mortgages (RRMs) are another type of mortgage that allows interest rates to change during the term of the loan. With these loans, the lender can renegotiate the interest rate and monthly payments to reflect current conditions at specified intervals. Like VRMs, they let lenders offset the higher cost of funds when interest rates rise and the yields on long-term mortgages fall below current market levels. Their major difference from VRMs is that interest rates are changed only when the loan comes up for renegotiation. Like VRMs, RRMs have also been

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2. See "Revision of Real Estate Lending Regulations," Federal Register, vol. 45 (November 18, 1980), pp. 76096 ff., esp. pp. 76096-97 and 76099, affecting 12 CFR §545.6.

3. See "Buyers Adrift: How Floating Rates Affect More Home Purchasers," Wall Street Journal (May 6, 1981), pp. 1, 20.

criticized by some consumer groups. In addition, some lenders have had to offer them at a discount to attract borrowers.[4]

Graduated payment mortgages (GPMs), pioneered by the U.S. Department of Housing and Urban Development (HUD) through the Section 245 housing program, are loans in which payments begin below the level of full amortization and then rise during the first several years until they reach a level where the balance can be fully paid by the end of the loan term. While payments are rising, the loan balance increases; this represents the negative amortization discussed earlier. These types of instruments can allow young families with prospects for income growth to afford larger mortgages than they otherwise might. They can create problems, however, if family incomes do not grow as anticipated. In addition, they provide lenders with greater risk and lower returns than do conventional mortgages at the same interest rate, because the negative amortization can be taxed even though no cash payments are received.

Shared appreciation mortgages (SAMs), the newest of the alternative mortgage instruments, provide borrowers with below-market interest costs in return for giving the lender a percentage of any increase in the price of a home. Under one type of SAM, borrowers receive a one-third reduction in interest rates in return for allowing the lender a one-third share in any rise in housing value at the date of sale or during the first ten years of ownership. This type of loan may prove advantageous to homeowners expecting large income gains or small increases in house prices. It can pose problems, however, if house price appreciation greatly exceeds the rise in the borrower's income. In addition, some critics fear it could lead to "redlining," because lenders would favor more affluent neighborhoods with greater chances of house price appreciation.[5]

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4. See "Business Struggles to Market the RRM," Savings and Loan News, vol. 110 (July 1980), pp. 30-34.

5. See Kenneth R. Harney, "Criticized SAM Loans in Limbo," Washington Post (January 10, 1981), p. F10; and Stanfield, "High Interest Rates," p. 174. Lenders who did redline could incur penalties under the Community Reinvestment Act of 1977, 12 U.S.C. §§29012905 (1977).