THE TAX TREATMENT OF HOMEOWNERSHIP: ISSUES AND OPTIONS

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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.

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CONTENTS

CONTENTS (Continued)

CONTENTS (Continued)

TABLES

TABLES

FIGURES

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.