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]

		Number of Homeowners with Outstanding Mortgages (millions)				
Adjusted Gross Income (in thousands of dollars)	Number of Homeowners in Class (millions)	Claiming the Deduction	Not Claiming the Deduction	Total Homeowners Without Mortgages (millions)	Percent of Homeowners in Class Claiming the Deduction	Percent of Homeowners with Mortgage 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

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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

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]

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