
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 homeownership 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 = 24.6 percent
 \$9,074.40

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: = $\frac{\$ 5,573.88}{\$14,724.00}$ = 37.9 percent

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 per- cent)	After- Tax Rate of Return (in per- cent)
			Operating Costs	Property Taxes	Mortgage Interest	Amorti- zation		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

<u>ASSUMPTIONS:</u> ^a	Sale price:	\$71,000 ^b
	Selling costs:	5,325 (7 1/2% of sale price)
	Mortgage balance:	<u>21,054</u> (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% $\frac{(37,721)}{37,721-5,281} = 116.3 \text{ percent}$

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 homeownership 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

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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

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.

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 the 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 buildings¹⁵

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).

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

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.

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 ($\$39.1 \text{ billion} \div \$3.56 \text{ billion per 1 percent change in rates} = 11.0 \text{ percent increase in marginal tax rates}$).