CHAPTER IV. POLICY OPTIONS FOR THE TAX TREATMENT OF HOMEOWNERSHIP

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

MAINTAIN CURRENT LAW

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

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

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

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

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

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

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

If the Congress wants to reduce the impact of current policy on investment choices and on the decision between rental and owner-occupied housing, a number of options are available. Five specific proposals are considered in this section. One is to limit the amount of deductible home mortgage interest payments. The second is to limit the deductibility of property tax payments on owner-occupied homes. The third is to decrease the exclusion of capital gains on home sales for persons aged 55 and older. The fourth option is to reinstate some tax liability on gains from home sales at the time of sale, a greater revision than merely decreasing the current exclusion. The fifth is to provide renters with new tax credits or deductions equal to a portion of their rent payments.

Limit the Amount of Deductible Home Mortgage Interest Payments

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

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

---

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

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

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

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

SOURCE: Joint Committee on Taxation and Congressional Budget Office.

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

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

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

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

---

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

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

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

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

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

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

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

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

SOURCE: Joint Committee on Taxation.

a. Includes nontaxable returns.

b. Less than 0.05.

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

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

--Gradually falling cap. Another option that would impose an even tighter, phased-in ceiling would be to establish an artificially high cap initially and then lower the amount in subsequent years. Under this approach, the Congress could impose a $20,000 ceiling effective calendar year 1982, for example, and then lower the ceiling by $2,000 each subsequent year until it reached $10,000 in 1987. This option would provide a greater long-term federal revenue gain than the previous one, because a lower ceiling would be effective in later years. At the same time, it would give taxpayers some time to adjust their financial assets if they wished. One problem with this option is that the Congress might be pressured to override the scheduled imposition of lower ceilings as the new amounts took effect.

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

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

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

<u>Limiting the Deductibility of Property Tax Payments for Owner-Occupied Homes</u>

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

11-749 0 - 82 - 6

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

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

Reducing the Exclusion of Gains for Persons 55 and Older

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

---

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

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

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

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

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

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

---

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

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

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

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

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

---

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

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

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

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

<u>Creating New Tax Benefits for Renters</u>

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

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

---

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

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

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

OPTIONS TO RETARGET BENEFITS AND REDUCE ALLEGED INEQUITIES IN TAX TREATMENT

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

Converting the Mortgage Interest Deduction to a Tax Credit

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

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

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

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

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

---

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

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

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

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

Possible Modifications. Because of the negative effects a credit might have on higher-income taxpayers, the Congress might want to consider some modification of a straightforward tax credit if the tax credit approach received close attention. The credit could also be combined with a ceiling to achieve a more stringent limitation on revenue losses.

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

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

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

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

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

(Continued)

TABLE 11. (Continued)

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

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

a. Less than 0.5.

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

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

(Continued)