Testimony of Senator John Breaux
United States Senate
Committee on Finance
Tax Reform Options: Incentives for Home Ownership
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Chairman Baucus, Ranking Member Hatch, and Members of the Committee:

Thank you for inviting me to testify today. It is a pleasure to be back at the Finance Committee, which I had the privilege of serving on for 15 years.

In January 2005, just after I retired from the Senate, President George W. Bush asked me to Co-Chair, along with fellow Senate Finance Committee alumnus Senator Connie Mack, the President's Advisory Panel on Federal Tax Reform. The President directed the Advisory Panel to recommend revenue-neutral tax reform options that would maintain progressivity in the Internal Revenue Code while making it simpler, fairer, and more conducive to economic growth.

Over the next 10 months, our nine-member Panel conducted 12 public meetings, and convened for countless hours of deliberation. In November 2005, we unanimously recommended to Secretary of Treasury John Snow two options for the Administration to consider, a Simplified Income Tax Plan and a Growth and Investment Tax Plan.

Although there were some differences between the proposals, including marginal rate structure as well as the tax treatment of investment income, there were many common elements that formed the basis for both. Both plans would have simplified the tax system by streamlining the filing system for families and businesses, while reducing tax expenditures and lowering marginal rates for individuals and corporations. We saw this as the key to creating a more efficient, more pro-growth tax system.

Of course, producing these options was not without its difficulties, and none of us held elective office at the time. But any serious effort to reform the Code necessitates an examination of the system and all of its component parts, and, yes, a willingness to touch some sacred cows. And that we did.

For example, we recommended that the personal income tax exclusion for employer-provided health insurance be limited to an amount nearer to the average cost of a health plan, and indexed for inflation.

Similarly, we recommended that the deduction for state and local taxes be repealed so as to ensure that lower-tax jurisdictions are not forced to subsidize higher tax jurisdictions.

And, of course, we recommended transforming the mortgage interest deduction in a manner I will explain further.

Taken together, these and our other proposals allowed us to repeal the AMT, lower marginal rates across the board, and streamline the Code in a revenue neutral manner. We thought it was a pretty good start. But, unfortunately, the Administration chose not to act on our recommendations. It was not the time for tax reform. Let me now suggest this is the time, and this is the place where it has to start.

We all know we can and should reform the Tax Code by broadening the base and lowering rates, and making it simpler and more effective for all taxpayers. And, we all know that significant base broadening, while an intuitively attractive concept, is more difficult to achieve in practice than in theory. Yet, any tax reform process must tackle tough issues, with due attention paid to adequate transition periods when justified by the facts.

And it is with all of this in mind that I would like to discuss housing tax incentives and the model proposed by the Advisory Panel.

Very briefly, the housing sector is favored by the tax code by virtue of several major provisions, including (1) the mortgage interest deduction; (2) the exclusion of capital gains from gross income upon the sale of a principal residence; and (3) a deduction for real property taxes paid.

The Advisory Panel addressed all three. I already referenced our recommendation as regards to the repeal of state and local taxes, including personal property taxes. With respect to the capital gains exclusion, we recommended that the length of time in which a taxpayer must own and use a home as a principal residence to qualify for the exclusion of up to $500,000 ($250,000 for single filers) upon sale of the residence should be increased from two out of the last five years to three out of the last five years.

With respect to mortgage interest, the questions framing our thought process were on what level, if any, does it make public policy sense to subsidize the costs of home ownership? Does current law encourage overinvestment in housing at the expense of other productive economic activity? In short, is current policy the best use of scarce tax dollars, or can we achieve similar public policy goals with a different benefit, and use the proceeds to lower individual marginal rates across the board?

Under the current framework, taxpayers can fully deduct mortgage interest payments attributable to $1.1 million of housing debt on first and second homes. For a taxpayer with a million-plus dollar home and a 35 percent tax rate it can be a very generous benefit indeed.

However, this tax benefit is available only to those who itemize deductions, which significantly reduces the number of taxpayers who make use of it. While there are taxpayers in most income cohorts that benefit from current policy, the Tax Panel examined the distribution of tax benefits from the home mortgage interest deduction, and found that there are relatively few filers with income below $50,000 per year able to claim any benefit (over and above the standard deduction, which they are entitled to irrespective of whether they own a home) at all. While the average benefit across all taxpayers was about $600 per tax return, the average on the high end –- filers with income above $200,000 a year – was about $5,000, with some taxpayers benefiting by a considerably higher amount.

In addition, while the mortgage interest deduction is often justified on the basis that it is necessary for promoting home ownership, we found it is unclear to what extent rates of home ownership depend on the subsidy.

However, given the special importance the housing sector has in our society, the Panel determined that the mortgage interest deduction should not be eliminated, but rather should be reformed to a Home Credit with a capped benefit of a lower maximum value as compared to current law. The credit would be available to all taxpayers, not just itemizers, and would equal 15 percent of mortgage interest payments on housing debt.

The Panel also recommended limiting the credit to interest on a standard principal amount, based on the average price of single-family homes in the United States, and adjusted on a county-by-county basis to take into account regional variations in housing costs. In a high cost area, we recommended limiting the credit to 15 percent of mortgage interest up to $412,000. We also recommended that the deduction for interest on second homes and home equity loans be eliminated.

So, by way of example, someone with a $400,000 mortgage and a six percent interest rate would receive a credit of around $3,500 per year under the Tax Panel's proposal, irrespective of whether the filer is in the 15, 28 or 35 percent tax bracket. Contrast that to current law where the maximum benefit, while enjoyed by a relatively small number of taxpayers, can be much higher, while subsidizing the purchase of larger luxury homes and vacation homes.

Now, it is clear that for some this will represent a reduced benefit, and the Committee can – and should – think carefully about doing anything that would affect market dynamics in a fragile economy and an especially depressed housing market. Although the Panel completed our work during a time of ever-increasing home prices, we included in our recommendations a suggestion that any changes to this effect be phased in gradually over a five-year period for those with pre-existing home mortgages. Obviously, market dynamics have changed considerably since then, and great sensitivity must be paid to that.

But as to the question of whether changes should be made, I'd observe the following.

Limitations in the Code in regards to the deductibility of mortgage interest already exist, and this implies that policy makers have long understood that some benefits need to be capped in order to best achieve their public policy goals without over-subsidizing the market. For example, I haven't heard anyone recommend expanding the mortgage interest deduction to interest payments on acquisition debt of, say, $3 million. Doing so would clearly be a subsidy to those on the very highest end of the home buying spectrum, and marginal rates would likely have to increase in order to pay for it.

My point is this: we all think there should be a limit. The question is what that limit should be?

The answer to that question will no doubt vary depending on who you ask, but we recommended moving away from the current system in which a relatively small proportion of taxpayers enjoy the majority of the tax benefit, as they do under current law, to a system in which all homeowners with taxable income receive a generous but more limited benefit; it was a policy meant to incentive home ownership, not the purchase of even larger homes. And, for doing so, we were able to use the increased revenue to lower marginal tax rates for all taxpayers. I think that is a worthy goal, and represents policy that helps achieve the fundamental purpose of tax reform.

In closing, I cannot help but reflect on some of the very difficult issues the Finance Committee tackled over the years in which I served: NAFTA, welfare reform, SCHIP, and the prescription drug benefit under Medicare all come to mind. These were all difficult issues that easily could have resulted in deadlock, but instead became major bipartisan achievements. I am proud to have had the opportunity to work on important issues in this Committee, and I very much hope fundamental tax reform is your next great accomplishment.

Thank you. I look forward to answering any questions you have.