The Tax Treatment of Housing: The Potential Impacts of Tax Reform on the Housing Market

Introduction

The purpose of this testimony is to explore the impacts of a number of proposed changes to the tax code on the housing market. My remarks and my written comments will describe the current conditions in the housing market and how the markets are likely to respond to a major change like the repeal of the mortgage interest deduction.

I have not done any original research for the purposes of this testimony. I will rely heavily on three excellent papers for estimates of the revenue costs, potential efficiency gains and equity (Poterba and Sinai (2008), Coulson and Li (2010) and Carroll, O'hare and Swagel (2011)). Over the years I have written extensively on the behavior of the housing markets and the macroeconomic consequences of boom and bust cycles, and I will focus on housing market effects in the short and long runs.

Housing as a Consumer Durable Good

The major portion of the yield on an investment in a house comes in the form of the housing services that it produces over time. If you are a landlord and you rent a house to a tenant, the rent that you are paid (net of maintenance and taxes) is part of your income. It is part of the yield on your investment in the house. It is also treated as taxable income for income tax purposes in the U.S. If you live in a house that you own and do not pay rent, you still receive a flow of income from your investment. It simply comes to you directly in the form of "real" valuable housing services. Excluding it from taxable income is still a subsidy that accrues to owners.

The same argument can be made about any consumer durable good like a car. However, taxing these "invisible flows" is difficult both practically and politically. But from the standpoint of an investor, imputed rent is the equivalent of a tax free dividend that cannot changed in real terms as long as you own the house and maintain it.

Survey Research shows that people in the last 25 or 30 years tend to think of a house as an investment more than as a consumer durable good (Case and Shiller on going). They think primarily of the yield as the appreciation it will earn when house values rise. They understand that a car loses its value over time but it is generally a reasonable investment because it generates transportation services over time. A house generates housing services which we call imputed rent.

Subsidies to Housing

A number of specific subsidies directly aimed at housing are written into the Tax Code. The most beloved of these are the homeowner deductions for mortgage interest and

property taxes. Most people are unaware of the largest subsidy, the exclusion of net imputed rent. If, however, Congress decided to tax imputed rent, you would find out quickly how much they would hate having it taxed!

The Exclusion of Net Imputed Rent

There is no tax on net imputed rent in the U.S. It is simply not reported and is excluded from the tax base. The benefit of exclusion to an owner occupant is that the tax bill is reduced by the amount of the exclusion times the marginal tax rate of the buyer.

The Deductibility of Mortgage Interest

If imputed rent were taxed, it would be appropriate to allow for the deduction of the costs of earning that income including financing expenses like mortgage interest. But we allow the deduction of mortgage interest despite the fact that imputed rent is not taxed .

The Deductibility of Property Tax Payments

The property tax can be viewed in two ways. First, if you ignore the expenditure side of local government and think of the property tax as a simple tax on the value of your property which reduces disposable income, then the property tax would be a tax on income that you never receive. On the other hand many view the property tax as the price paid for local public goods such as public safety, fire protection and schools. Assuming residents have choices, allowing a deduction for property taxes reduces the cost of those goods and can lead to added spending.

My comments today will focus on the three provisions above. Many additional parts of the tax code affect the cost of housing, and the Federal Government has additional non-tax ways of influencing the housing market. To name just a few:

- **The treatment of capital gains on the sale of a house**: for most households, capital gains are virtually tax free.

- **The existence of Fannie Mae, Freddie Mac, the FHA, etc.**, which were charged with maintaining a flow of mortgage credit to the housing sector using securitization, diversification, risk rating, implicit guarantees, and other forms of credit enhancement.

- **The Low Income Housing Tax Credit** which has been responsible for a substantial portion of the finance of rental housing for low and moderate income housing built since the Tax Reform Act of 1986.

- **The use of accelerated depreciation** for certain classes of housing.

- **Federal Reserve monetary policy** and open market purchases of mortgage backed securities held on the Fed balance sheet. The real key to reducing the price of housing has been to lower interest rates and to expand underwriting standards. The reverse occurs when credit is tightened and rates rise.

- **Direct subsidies to low and moderate income housing**: Section 8, Section 502, Low Rent Public Housing etc.

I think it is safe to say that with the "twist," the government has gone "all in," doing everything conceivable to save housing.

The General Arguments for and Against Favorable Treatment of Owners

If a house were like any other investment, the principle of "neutrality" would apply. Differential tax treatments can leads to distortions that impose excess burdens on society. An excess burden arises when the total burden of a tax or a tax change is greater than the amount of tax collected. A subsidy to owner occupied housing can lead people to own who otherwise would not. A subsidy could also lead people to buy bigger and more expensive homes or to over-leverage. While these subsidies clearly had an impact on the remarkable performance of the housing market from 1975-2007, much of the exuberance of buyers came from the price increases themselves: home prices never fell nationally during that entire period.

It is precisely this point that leads to the call *for lower marginal rates* and *a broader base for the income tax*. While there are good reasons for many provisions in the code that are meant to reward meritorious behavior such as charitable giving or to correct previous other distortions, some provisions are simply loopholes. The much hailed and bi-partisan Tax Reform Act of 1986 was built on the notion that broadening the base of the income tax and reducing marginal tax rates was desirable.

Treating homeowners differentially may violate the principal of horizontal equity which calls for the equal treatment of equals. If the choice of income as a tax base is based on the notion that income is a fair measure of ability to pay, then people with equal incomes should pay equal taxes.

On the other hand, many argue that favorable treatment is justified by "external benefits" in the form of public goods. Homeowners are more likely to maintain their property and to be more attached to their neighborhoods because they have "skin in the game." If I invest in my house and keep it up, my neighbors benefit because their property values will be higher. The economic literature points to evidence supporting three classes of external benefits: maintenance and appearance, family life, and citizenship. (For a very credible review of this literature see Coulson and Li (2010)).

Still others argue that homeownership is part of the "American Dream" that ought to be accessible to everyone. This argument is based on concepts of justice and is different from the notion that ownership provides direct and measurable benefits to society.

The Timing of Major Changes such as the Repeal of the Mortgage Interest Deduction

The housing market in the United States experienced increasing volatility in the early 1970's as the baby boomers began to enter the home buying years. A series of regional booms on the coasts, particularly in California and the Northeast in the late seventies and late eighties, saw very high rates of appreciation . In Boston alone a boom from 1985-1989 created over $125 billion in wealth that suddenly appeared on the balance sheet of the household sector.

These booms changed behavior. People saved less, borrowed more, withdrew cash, and spent much of their windfall. Early work showed that these booms could not be explained with "fundamentals" but, instead, were based to some extent on common expectations. If people believe that an asset will increase in value, then they are going to be willing to pay more for it. In 1957 Paul Samuelson wrote, "I have long been struck by the fact and puzzled by it too, that in all the arsenal of economic theory we have absolutely no way of predicting how long such a bubble may last. To say that prices will fall back to earth after they reach ridiculous heights represents a safe but empty prediction." (Samuelson 1957). Those regional booms showed us that from time to time and across regions, the housing market was likely to experience inertia and volatility.

There were a few regional home price busts prior to 2006. The biggest were in Texas (-14%: 1986-88) in San Diego (-15%: 1990-95) and the Northeast (-13%: 1988-91). California and the Northeast accounted for about 40 percent of the owner occupied housing in 1988. These regional busts always came to an end, and in most all cases, hold out buyers who did not sell had their value restored in just a few years.

The strong housing market owed much to the rapid economic growth that took place between 1982 and 2007. House prices nationally rose in virtually every quarter between 1976 and 2007. In fact, the period from March 1991 through March 2001 marked the longest continuous expansion in U.S. history.

In the year 2000 there was a fundamental change. While the regions were each driven by different forces, there were extraordinary increases in value between 2000 and 2006. The stock of housing directly owned by the household sector increased from roughly $14 trillion to $24 trillion. The gain of $10 trillion was made up of half new capital (part of gross private domestic fixed residential investment) and half appreciation of land, particularly on the coasts.

The huge increase in value was fueled by an expansion of credit designed to prevent or reduce the impact of the 2001 recession. During 2001, the Fed brought the Fed Funds rate down from 6.5% to under 2%. This touched off a huge refinancing boom which ultimately saw over $10 trillion in refinance originations. The Fed kept short rates below 2% until 2005. In 2003, the refi boom ended when mortgage rates jumped. That sent the highly competitive mortgage industry to find new homebuyers to fill up the gap left by the end of the refi boom. The only place to find them was in the Sub-prime, A- and Alt A markets.

With hindsight it was easy to make the loose underwriting standards of the day seem ludicrous. But careful analysis shows that it was not the underwriting standards that were to blame. It took a collapse of home prices to multiply the losses at many institutions. There were many analysts who insisted until well into 2007 that the sub-prime underwriting criteria would lead to profitable business. They would have been right if house prices had not fallen.

The housing market virtually collapsed between 2006 and 2008. Led by a declining manufacturing base in economies in the Midwest, dramatic overbuilding in the "Sand States," Florida, Nevada and Arizona, and a continuing cycle on the coasts, the bust turned into a catastrophic decline in home prices.

There are many contributing reasons for what transpired over the last six years. Production as measured by housing starts peaked in January, 2006 before falling to 60 year lows; home prices were down by a third nationwide with a 60 percent decline in some cities; default and foreclosure rates on mortgages hit unthinkable levels; and the entire banking system was shaken to its core.

How Bad is the Housing Market Today?

One of the arguments for not reducing the subsidies to housing now is that it would be a major blow to an important sector of the economy that is already reeling from a catastrophic series of events. The housing sector could, in time, help restore the health of the economy.

- Right now the housing market is facing a very uncertain future. The data through August show a stagnant home building sector stuck at 50 year low levels of production, a clogged pipeline of foreclosures and roughly 10 million households that are underwater. In addition, there is great uncertainty about interest rates as the government moves to transfer risk to the private sector, and there is downward pressure on prices, with wide bid ask spreads and hold out sellers. Very low rates of household formation have kept vacancy rates high despite increasing removals and low levels of production. To make matters worse, there is increasing fear of a double dip recession.

- Despite all of this, the market continues to close over 5 million sales of existing homes at annual rates, and prices have edged up for four consecutive months. It would take a relatively small injection or contraction of demand to tip the markets up or down since our perception of "the market" is defined by the relatively small number of transactions that occur.

- To be more specific, housing production was running at **2.273 million** starts in January 2006. At the same time total fixed residential investment was running at over $800 billion or roughly 6% of GDP. The figure for starts in August 2011 was **571,000**, a drop of 75%, with fixed residential investment at $330 billion or about 2.2% of GDP.

- Between 1959 and the recent peak in January 2006, the *lowest* number of housing starts recorded in any month (at annual rates) was 798,000 in January 1991. *Now, total housing starts have not been above 700,000 for more than 34 consecutive months, running at an average rate of 574,000*. And looking forward they do not seem to be moving up at all. Housing starts have been below one million for a total of only 22 months during the previous fifty years. These are depression level numbers.

- The homebuilding sector has been an important sector. It was the major channel for transmitting Fed interest rate moves into actual spending, driving the economy up when times called for stimulus and down when times called for contraction. Since 2006, the home building sector has been a major drag on the performance of the economy and a catastrophe for those in the industry.

- Today, the Fed has pushed interest rates to very low levels. With the addition of QE1, QE2 and the twist, it has attempted to lower long rates to help the mortgage market. At the same time credit is very tight. Applicants that have not missed a payment are being denied refi applications if there is insufficient equity. Virtually 90% of mortgages written and sold into the secondary markets carry some sort of credit enhancement provided by the Government (Fannie, Freddie, the VA etc.) and of course the recent open market purchases have put over $1 trillion in agencies and mortgage backed securities along with $1.6 trillion of Treasuries directly onto the Fed's balance sheet.

- Estimates peg the number of underwater properties as high as 10 million.

The bottom line on the housing market is this. During the period 2000-2006 the nation added about $5 trillion dollars in new housing structures and another $5 trillion in land value to the household balance sheet. Much of that increase was spent as homeowners, who found themselves with enormous equity, withdrew much of it by taking out home equity lines, second mortgages, refinancing, etc.

Between 2006 and the second quarter of 2011, the household sector lost roughly 7 trillion dollars in housing wealth as home prices fell 33% nationally. The S&P Case-Shiller numbers show that these declines were worse in some markets than in others. The biggest drops from peak were 59 percent in Las Vegas, 56 percent in Phoenix and 51 percent in Miami. The smallest declines were in Dallas, Denver and Charlotte, all under 20%.

The decline in home prices was the ultimate reason for the collapse of the mortgage market. As long as prices held, as they had for over 30 years, lenders and securities holders were covered by the sales of homes which were held as collateral. Without the collapse of home prices most of the sub-prime market would have been marginally profitable or suffered moderate losses but would not have been catastrophic.

Now the question is, who will ultimately bear those losses? How long will it take to sort through the claims and counterclaims that have arisen? We don't know, but it is essential for the economy that this occur. There is already fear in the market, and fear can only be overcome with performance.

A further decline in home prices now would have significant consequences for consumer spending, properties underwater would be further underwater and the litigation costs which will be huge anyway would be much worse.

The housing and mortgage markets are a major part of this economy, and they are coming back. With over 5 million existing home sales (at annualized rates), flat prices and the ultimate cure, a resumption of household formations, the sector will resume modest growth and stabilize.

I would strongly recommend against any major potentially destabilizing changes the trajectory of the housing market until The Fannie and Freddie issues have been resolved and mortgage risk has been taken off the Government's books and sold to profit making professional private firms. This is not to say I am against changing the tax treatment in the longer run. It is a fact that the cost of borrowing for homebuyers is going to go up as the risk premium is shifted to homebuyers and off of the Government.

The Pro's and Cons of Potential Changes in the Tax Code in the Longer Run

In my judgment the Tax Reform Act of 1986 was an exceptional piece of legislation. It succeeded in broadening the tax base, eliminating numerous provisions of ERTA in 1981 and TEFRA in1982 that had led to huge tax shelter opportunities for individuals and corporations. It lowered the top rate from 50 to 28%. The original blueprint, Treasury I, written essentially by Charlie McClure, called for modifying the mortgage interest deduction. With that provision, the bill was DOA and sent back to Treasury.

Over a year later, Senator Packwood and Representative Rostenkowsky worked with President Reagan and came to three agreements which ultimately led to passage: the bill would be revenue neutral, the bill would be distributionally neutral, and the changes to the mortgage interest deduction had to go.

The problem with dealing these changes independently is that there are many interconnected parts. I strongly favor lower marginal rates and a broader base. For those items that remain tax preferenced, I generally favor credits over straight deductibility. But these changes should be made as a part of a more comprehensive look at the issue of overall effective rates. If the Bush tax cuts were to stand, I would worry less about distribution of benefits at the high end.

If I were forced to look at specific tax proposals in a stand alone bill, here is a summary of my recommendations.

1. Full taxation of income *including imputed rent* even with full deductibility of property taxes and mortgage interest would increase revenues by about $330 billion dollars (Carroll), but in my judgment it is a non-starter. It is impossible to sell taxing "imputed income." I have tried. **Taxpayers will not accept the logic.**

2. **If the housing market gains stability**, I would favor a phase out of the interest deduction and the property tax deduction. Note that elimination of deductibility leaves in place the largest subsidy of all: the excludability of net imputed rent. If you accept the notion that homeownership generates external benefits of significant size, this means that there is a still a substantial subsidy to housing even if the deductibility of mortgage interest and property taxes were phased out.

The revenue gains, although not as large as they would be if imputed rent were taxed, are significant. Carroll et al. place the revenue gains from elimination of mortgage interest deductions at $80 billion based on 2010 data, while Treasury's estimate for 2010 is $92.2 billion. The repeal of the property tax deduction would increase revenues by $25 billion according to the Carroll et al. and $18.9 billion Treasury

3. An alternative would be to replace the deductibility with a credit which could be either fundable or non-fundable and ether a flat rate or a percentage rate. This would lead to a sharp reduction in the revenue potential, and both of these would substantially reduce the subsidy for high income households and raise the subsidy substantially for those at the bottom who do not currently itemize. Once again, I would feel more comfortable supporting such provisions if I knew how the overall final decision about the Bush tax cuts was resolved.

Notes:

Cooulson, Edward and Li, “Measuring the External Benefits of Homeownership.” Penn State University, March 4, 2010

Carroll, Robert, John F.O’Hare, and Phillip L. Swagel, “Costs and Benefits of Housing Tax Subsidies,” Pew Fiscal Analysis Initiative, June 2011

Poterba, James and Todd Sinai, “Income Tax Provisions Affecting Owner Occupied Housing: Revenue Costs and Incentive Effects” NBER July 2008