

**TAX REFORM OPTIONS:
INCENTIVES FOR HOMEOWNERSHIP**

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED TWELFTH CONGRESS
FIRST SESSION

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OCTOBER 6, 2011
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TAX REFORM OPTIONS: INCENTIVES FOR HOMEOWNERSHIP

THURSDAY, OCTOBER 6, 2011

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Wyden, Nelson, Cardin, Hatch, Grassley, Snowe, and Coburn.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Ryan Abraham, Tax Counsel; and Jonathan Goldman, Law Clerk, Tax. Republican Staff: Tony Coughlan, Tax Counsel; Jim Lyons, Tax Counsel; and Maureen McLaughlin, Detailee.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. The committee will come to order.

I want to advise everyone, the chairman and the ranking member are engaged in the China currency bill, and of course our chairman in the special committee dealing with the debt. They will be here, but we have a vote at 10:30, so we want to start so that we can accommodate our witnesses. We thank them all for being here.

We believe this is a very important hearing, talking about Tax Reform Options: Incentives for Homeownership. We deeply appreciate the participation of the witnesses here today. We believe you will make a valuable contribution to the work of the committee on this important issue.

With that, we are going to begin with our former colleague, Senator Breaux. We are delighted that you are here. Senator Breaux was a member of this committee, a very valuable member not only of this committee, but of the U.S. Senate. We miss him. It is good to have him back.

Welcome, Senator Breaux. Please proceed.

STATEMENT OF HON. JOHN B. BREAUX, SENIOR COUNSEL, PATTON BOGGS, LLP, WASHINGTON, DC

Senator BREAUX. Thank you very much, Mr. Chairman and Senator Wyden. I am glad to be back. Senator Grassley was here; give him my regards as well. It is an honor to come back to the Finance Committee where I had the great privilege of serving for about 15 years.

I think sitting from the outside and looking at this committee, I can really say that this is truly the greatest committee in the Congress. I say that based on the ability of this committee to work together across party lines.

When I was here, this committee did NAFTA, this committee did the SCHIP program, this committee did welfare reform, this committee did the prescription drug benefit under Medicare. While either side could have blocked the other side from achieving any of those accomplishments, this committee was able to breach the party lines and come up with substantial reform on things that made a big difference.

When we talk about tax reform, I think that now is the time, and this is the committee that can put it together better than any other place. If this committee cannot do it, I do not think any committee has the capacity to do it.

Right after I got out of the Senate, President Bush asked me and Connie Mack, two former members of this committee, to chair the Tax Reform Simplification Commission. We met for over 10 months. We had hearings in five cities all across the country. We had countless meetings here in Washington, and we produced a product that had to be progressive, it had to be simple, it had to be fair, and I think we accomplished that.

I want you to know that after we finished—I still have the book. After we finished, I got this note written by our good friend John Snow. In the front of the book he said, “John, thanks for your great work. Now it’s up to us. John Snow.” Well, after we did that report, I think they put it in a hermetically sealed box and locked it up and threw away the key and buried it somewhere underneath the Capitol dome, and no one wanted to touch it.

We were able to succeed in part because none of us on the panel was running for reelection. We had some great tax experts, and a couple of ex-politicians, and we were able to make these tough recommendations because we did not have to fear the political liability of getting clobbered with these recommendations.

We did some serious things. Number one, we recommended that the personal income tax exclusion for employer-provided health insurance, where you get the premium and you do not count it as income, should be capped at the level of the average plan. If you want to buy a Cadillac plan, the government should not have to subsidize it. So, we made that recommendation.

Second, we said that the payment of State and local taxes should not be deductible on your Federal income tax. Someone in North Dakota should not have to be paying for someone in Beverly Hills who has 24-hour-a-day police protection, fire protection, underground lighting, and all the things that they get because they pay high local taxes, but your State is subsidizing. So we recommended you should not be able to do that.

We also changed the Mortgage Interest Deduction. We did not eliminate it, but we changed it. Now, those were tough things to recommend. That is probably why they put it in a lockbox. But with that, we were able to lower all the rates across the board: 35 percent became 33, 33 became 28, and right across the board. And corporate taxes we were able to lower from 35 percent to 30, and we eliminated the Alternative Minimum Tax. So it is a trade-off.

If you are going to do some of these hard things, you can use it to do good things on the other side, and that is why I thought that our package was balanced.

Let me talk a little bit about the specific housing tax incentives. If you add up all the housing tax incentives, it is about \$140 billion a year. The total amount of tax we take in is \$1 trillion or \$1.1 trillion a year. If you eliminated it completely, this suggests you could lower the rates by somewhere between 12 and 14 percent across the board for individuals.

We are not recommending that, but that is how large these benefits are. And the other fact is that most people do not get the mortgage deduction benefit. Seventy percent of tax filers do not get it because they do not itemize; it goes to a relatively few number of people who itemize their deductions.

What we recommended is that the deduction should not be eliminated. We did not want to eliminate incentives for homeownership, although I would point out that many countries like Australia, Canada, and the U.K. do not have a mortgage deduction for housing, and their housing ownership rates are about the same as ours, and in some cases a little bit higher, even though they do not have the deduction.

We did not recommend eliminating it, but we recommended changing it. What we did was say, number one, instead of a 100-percent deduction, you would get a home tax credit. The home tax credit would be capped. The credit would be available to all taxpayers, not just to those who itemize. Everybody would get the home tax credit, and it would be 15 percent of the mortgage interest payment that you have been paying on your home mortgage on your housing debt.

We also limited the credit to the average price of a single family home in the United States, and adjusted it for a county-to-county basis. They do that already. IRS does it; FHA figures out those numbers, and those numbers are readily available. So we said a 15-percent tax credit, and it would be capped on interest payments on the average mortgage in the area that you happen to live in.

Back in 2005 when we issued our report, the top amount would be about a \$415,000 home. And interestingly enough, about 85 percent of the people then would not have been adversely affected by that cap. Given that caps already exist for the current deduction of mortgage interest and we need to decide what that cap should be moving forward, I would suggest that, if you use what we were recommending at that time, it would be equitable and available for all taxpayers.

Further, if you were to ask someone in this country today whether they would take a lower interest deduction in return for a substantial reduction in their individual rates and their corporate rates, most people would say, yes, I will take that deal right now. So, I would just conclude by saying how much this committee can do to change the nature of the debate and get Republicans and Democrats to join hands and do what is best for the country. I thank you for your attention.

[The prepared statement of Senator Breaux appears in the appendix.]

Senator CONRAD. Thank you, Senator Breaux. Let me just say to you, before I go to our next witness, that you may have thought that your recommendations were locked in a hermetically sealed box somewhere and never looked at, but on the Bowles-Simpson Commission we actually did very carefully review your recommendations. I think if you look at what came out of Bowles-Simpson, you can take real pride in that a lot of the ideas that you surfaced in your work were adopted by the Bowles-Simpson Commission. And by the way, those things are being very carefully reviewed by the special committee now.

Senator BREAUX. Great.

Senator CONRAD. So, you know, sometimes it is very frustrating around here because you do a lot of work to come up with ideas, and then you wonder if they ever see the light of day. I want to assure you, the work of your group really has seen the light of day. I believe at the end of this exercise, you are going to find a lot of the things that your group recommended will have been adopted, and we thank you for the extraordinary work that you, and the other members of that group, did. I think Connie Mack was part of your group, as I recall.

Senator BREAUX. Co-chair.

Senator CONRAD. So there are better days ahead.

Senator BREAUX. Unlock the box.

Senator CONRAD. Senator Wyden?

Senator WYDEN. Because it is going to be tight for time, if I could just make one quick comment apropos of that.

Senator CONRAD. Yes, sir.

Senator WYDEN. I, too, want to commend Senator Breaux for his outstanding work. I remember, after you all offered up your report, you and Senator Mack were here, and we talked about where you would go in the days ahead, and we asked you specifically about the viability of the principles of 1986, where you go in there and clean out a boatload of these preferences, use those very same dollars to hold down marginal rates, and keep progressivity.

Like Chairman Conrad, I happen to think that those ideas which you and Connie Mack said were still valid when you did your report, still as valid as in 1986, I think they are going to be right at the center of the next major tax reform, and I want to commend you. Thank you, Chairman Conrad, for the opportunity to make that statement. I again commend Chairman Baucus for this ongoing series of hearings.

Senator CONRAD. Thank you. We should thank you, Senator Wyden, because I will tell you, there are very few Senators who have done more to come up with comprehensive proposals of tax reform than Senator Wyden, and he is not a committee chairman, so he does not have the staff.

Yet he and Senator Gregg, and now Senator Wyden with Senator Coates, have come up with a comprehensive tax reform proposal that also heavily informed the work of the Fiscal Commission and heavily informed the work of the Group of Six. So, you know, again, sometimes you wonder, is any of this stuff ever going to actually happen? I honestly believe, before it is done, what you, Senator Breaux, did with Connie Mack and your group, what Senator

Wyden, Senator Gregg, now Senator Coates have done, really will form the basis of what ultimately happens. It really has to happen.

With that, we will go to our next witness, Dr. Karl Case, professor of economics emeritus of Wellesley, and senior fellow, Joint Center for Housing Studies at Harvard. Welcome, Dr. Case. Very good to have you here.

Please proceed.

STATEMENT OF DR. KARL "CHIP" CASE, PROFESSOR OF ECONOMICS EMERITUS, WELLESLEY COLLEGE, AND SENIOR FELLOW, JOINT CENTER FOR HOUSING STUDIES, HARVARD UNIVERSITY, WELLESLEY, MA

Dr. CASE. Thank you, Mr. Chairman. I want to second and third the work of this committee over the years. I was standing out in Gucci Gulch outside here, thinking of the Tax Reform Act of 1986 and what an incredible story it was, when Senator Packwood and Dan Rostenkowski and the President got together, and they said, distributionally neutral, they said revenue-neutral, and let us do it. It took Treasury I, which was a beautiful document that died because of some of the things that were suggested, and turned it into the greatest piece of tax legislation ever passed. So I want to add my thanks.

I have to talk fast because no economist can say anything in 5 minutes, but I am going to do my best.

Let me start by outlining a couple of major provisions that I need to include to make the rest of my comments clear. First of all, a major part of the yield on investment in a house comes in the form of 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, part of the yield on your investment. It also is treated as taxable income. But now, if you buy a house and live in it outright, you get paid an income flow. It does not show up as a transaction, but it is an income, and it comes in the form of valuable services which we call imputed rent.

Now, it is not taxable. Some people cringe when you raise the topic of imputed rent, and I understand why. But if you think about it, it is an investment that, if you make it, you get a 6-percent dividend which is indexed for inflation, in real terms, it cannot be taken away as long as you maintain the house, and it is guaranteed. In real terms and inflation-adjusted, that is what a house is, if you buy it with no taxation of imputed rent. You would think I were crazy if I told you I had an investment like that.

But it is not going to be changed. No one is going to tax imputed rent—despite the fact that taxation of imputed rent is the one big-ticket item in all the things that are on the plate today—no way in this world is anybody going to pass taxation of imputed rent. And people would go crazy if you did, so that is basically off the table.

But a number of other specific subsidies directly aimed at housing are written into the tax code that have to be viewed in the context of keeping that imputed rent from being taxed. A number of other specifics include, of course, the homeowner deductions for mortgage interest and property taxes. They are a flag that goes up

and gets people very worked up, and I suspect you will hear some of that from me today.

So, if imputed rent were taxed, it would be appropriate to allow the deduction for the cost of earning income, which means you would take the financing expenses and interest off, if imputed rent was taxed, but we allow you to have an interest deduction even though the imputed rent is not taxed.

Also, the property tax, let us take a look at the property tax really quickly. You can view the property tax in two ways. First of all, as a tax which is paid that reduces your disposable income, and taxing it without allowing deductibility would be, in fact, taking away income you never really received. It is never really received if you do not allow it to be deducted.

But, in fact, the other way of viewing it is as the price we pay for local public services. It determines the price we pay for local public services. If you look at the property tax as a payment for things we might want, obviously making it deductible could expand the demand for local public services because it is below cost.

Should homeowners receive preferential treatment? Just let me touch on that argument in general. If a house were like any other investment, the principle of neutrality would apply. Differential tax treatments can lead to distortions that impose excess burdens. We all know that. By the way, in your report there is a beautiful primer on tax policy that you guys wrote that was just—I use it in class. It is terrific.

Senator BREAUX. I needed the primer.

Dr. CASE. So a subsidy to owner-occupied housing can of course lead people to own who otherwise would not. It could lead people to buy bigger and more expensive homes, to over-leverage. Those who say we need this subsidy to housing, favorable treatment is justified by external benefits in the form of public goods. Homeowners are more likely to maintain their property, be more attracted or attached to their communities, and so forth. Richard Green has done some work on that measure. It is legitimate work.

But on the other side, one of the arguments for not reducing subsidies, at least in the short run, is it would be a major blow to an important sector of the economy that is already reeling from a catastrophic series of events.

Right now the housing market is almost in unbelievable shape. I was talking just a few minutes ago about giving a talk to the Joint Center for Housing Studies a couple of years ago, back in 1986. They wanted to throw me out for saying that the starts were going to go below 1.5 million. In fact, they have now been below 700,000 for 34 consecutive months. That is an 80-percent reduction in the product of that industry, and it is very painful, as we all know. It has led to contagion.

We have a clogged pipeline of foreclosures, roughly 10 million properties under water. There is great uncertainty about the interest rates as the government moves to transfer the risk that has been on Fannie and Freddie's books and is going to have to be cleared off of there, and on the actual balance sheet of the Fed itself.

Very low rates of household formation have shocked everybody, and, if you look at some of the numbers coming out, they could be

actually negative right now. That is what used to clear the market when you disentangled starts and household formations. Household formations were always up over 1 million.

The bottom line in the housing market is this: during the period of 2000 to 2006, the Nation added about \$5 trillion in new structures and \$5 trillion in new land value to the balance sheet of the household sector. In the following 5 years it went away—\$7 trillion of it went away—and we have not figured out who is going to bear that cost yet.

So, in the short run, I would strongly recommend against any major potentially destabilizing changes to the housing market, but, in the long run, I do favor looking very seriously at the interest deduction and the property tax deduction. I agree with the conclusions of your committee on that, but I certainly have to admit I would not do it now.

For the record, I just think that the methodology that was used for getting this thing through in 1986 is a model, and your following it, Senator Breaux, was also terrific.

So, I almost made it. Thank you.

Senator CONRAD. You did well.

[The prepared statement of Dr. Case appears in the appendix.]

Senator CONRAD. Dr. Dietz, the assistant vice president for tax and policy issues at the National Association of Home Builders, welcome. Thank you so much for being here. Please proceed. I do not imagine you will be endorsing imputed interest. [Laughter.]

Dr. DIETZ. It is an interesting concept, and I hope actually we get to talk about it in Q&A, because there is a good connection to property tax.

Senator CONRAD. I do not think we need to spend a whole lot of time on it. [Laughter.]

Dr. DIETZ. All right.

Senator CONRAD. It is not going anywhere.

Dr. DIETZ. So get it out of the way.

Senator CONRAD. Dr. Dietz, please go ahead.

STATEMENT OF DR. ROBERT D. DIETZ, ASSISTANT VICE PRESIDENT FOR TAX AND POLICY ISSUES, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Dr. DIETZ. Members of the committee, thank you for the opportunity to testify today. My name is Robert Dietz. I am an economist with the National Association of Home Builders.

The Internal Revenue Code currently provides incentives covering both owner-occupied and rental housing, ranging from low-income housing tax credits to the Mortgage Interest Deduction. The focus of this hearing is owner-occupied housing, and I will direct my testimony to those rules.

In reforming the tax code in 1986, Congress maintained the popular home Mortgage Interest Deduction, or MID, for short. Recently, a number of misleading claims have been made concerning the MID, suggesting only a small number of high-income homeowners benefit from it. In fact, 90 percent of the people claiming the MID are homeowners with economic income of less than \$200,000, and these households collect 70 percent of the tax benefit.

For taxpayers with AGIs less than \$200,000, the Mortgage Interest Deduction is worth, on average, 1.76 percent of AGI. For those above \$200,000, it is worth less, only 1.5 percent of AGI. These data show that the Mortgage Interest Deduction is a progressive middle-class tax break.

Another misleading claim is that few homeowners benefit from the MID because itemization is required. This is false. Thirty-five million taxpayers claimed the MID in 2009 out of 75 million homeowners; however, of that 75 million, a third of those homeowners own their homes free and clear, but likely benefitted from the MID in the past.

Senator CONRAD. Can you just repeat that?

Dr. DIETZ. Sure. So in 2009 we had 35 million taxpayers who received a direct benefit.

Senator CONRAD. Right.

Dr. DIETZ. There are 75 million homeowners in the country. A third of those 75 million own free and clear. In other words, they have paid their mortgages off.

Senator CONRAD. Yes. A third have no mortgage.

Dr. DIETZ. Right.

Senator CONRAD. Yes.

Dr. DIETZ. And so, of the rest of the 35 million who benefit, that represents 70 percent of homeowners with a mortgage who claimed the MID and benefitted from that tax benefit.

Senator CONRAD. All right.

Dr. DIETZ. And, on average over the last 10 years, 86 percent of mortgage interest paid has been reported on Schedule A as a deduction, so most of the mortgage interest that is paid by homeowners with a mortgage shows up on Schedule A. Itemization does exclude some people.

Senator COBURN. Is that by dollars or numbers?

Dr. DIETZ. Seventy percent is the number of taxpayers, 86 is by dollars.

Senator COBURN. All right.

Dr. DIETZ. And, of those who do not benefit, in other words in that 30 percent of the 70 percent, most are older homeowners who are in the later years of a mortgage where you are paying mostly principal and relatively less interest.

It is also often claimed that the MID encourages the purchase of a larger home. These claims ignore the role of family size. In fact, the IRS data show that larger families see a larger benefit, which is intuitive with the notion that growing families with children require larger homes and therefore claim a larger MID benefit.

Moreover, the cost of housing varies greatly across the Nation, so what may appear to be a large deduction for a large home may reflect a modest home in a given area that has high costs. Indeed, the MID and the real estate tax deductions are two of the few elements of the tax code that account for differences in cost of living.

There is also a connection between the age of the homeowner and the resulting benefit of the MID. We just talked about household formations. This is particularly important when we talk about younger home buyers. As a share of household income, I find that the largest benefit goes to those aged 35 and under.

This should make sense because these homeowners are paying more interest in the early years of a mortgage. Given this demographic connection, NAHB believes that any policy change that makes it harder to buy a home, or delays the purchase of a home, will have a significant long-term impact on wealth accumulation and the make-up of the middle class.

Perhaps the least understood rules of the MID involve second homes. While many think of expensive beach property, such homes are likely to be owned free and clear or rented, which excludes them from the rules of the MID. In practice, the second home deduction is important for many who do not think of themselves as owning two homes. For example, the second home deduction facilitates moving when owning two principal residences within a tax year.

The second home MID rules also permit existing homeowners to claim interest in a construction loan for a future residence. Nearly every State has areas with significant numbers of second homes. Forty-nine States have a county where at least 10 percent of the housing stock consists of second homes, and 26 counties in the country had 50 percent or more of the housing stock consisting of second homes. Repeal of the second home MID rules would affect large sections of the country in nearly every State. There would be negative economic consequences in terms of lost home sales, home construction, and price effects.

Homeowners may also deduct interest on up to \$100,000 of home equity loan debt. It is important to keep in mind that half of all home equity loans are used for remodeling. Remodeling and home improvement are important economic activities for a Nation with an aging housing stock.

As we have mentioned, many in this committee can look back to the tax reform efforts in 1986 as a guide, and there are important lessons to draw from that experience. First, it is possible to achieve low tax rates and maintain strong incentives for housing. But in 1986 we also saw a crisis in commercial real estate due to tax policy changes enacted at that time.

How housing is treated in any future tax reform will shape the economy going forward. This is particularly important now, as Dr. Case explained. Home building usually leads the economy out of recession. After other post-World War II recessions, residential construction grew at an average rate of 30 percent in the first year of recovery. This time residential construction has grown at a lackluster 5 percent. Housing provides the momentum behind an economic recovery because home building employs such a wide range of workers.

On average, construction of a single-family home creates three full-time jobs. Housing can be a key engine of job growth that this country needs. As the committee moves forward on tax reform, NAHB wants to be a constructive partner.

Thank you, and I look forward to more questions.

The CHAIRMAN. First, I apologize for being late. Second, I thank my colleague, Senator Conrad. Thank you very much, Dr. Dietz.

[The prepared statement of Dr. Dietz appears in the appendix.]

The CHAIRMAN. I suppose, Dr. Green, you are next.

Dr. GREEN. I guess I am.

The CHAIRMAN. You are now.

Dr. GREEN. Well, thank you. Thank you, Chairman Baucus.

The CHAIRMAN. Have you been introduced?

Dr. GREEN. I suppose I have not.

The CHAIRMAN. Well, let me introduce you. You are Dr. Green.

[Laughter.]

Dr. GREEN. Yes I am.

The CHAIRMAN. And you are the director of the Lusk Center for Real Estate at the University of Southern California.

Dr. GREEN. That is correct.

The CHAIRMAN. Why don't you proceed?

Dr. GREEN. All right. Thank you.

STATEMENT OF DR. RICHARD GREEN, DIRECTOR, LUSK CENTER FOR REAL ESTATE, UNIVERSITY OF SOUTHERN CALIFORNIA, LOS ANGELES, CA

Dr. GREEN. Thank you for the invitation to be here today. When I was listening to Senator Breaux worry about his work not being paid attention to, I could not help but think about the fact that I have been a professor for 21 years, and I have been writing about this stuff for about 21 years, and I feel like this may be the first time it has been paid attention to. So, I am really thrilled to be here today.

The CHAIRMAN. Good for you.

Dr. GREEN. I should also say that, as a Californian with a mortgage, I should, if anything, be a strong proponent of the Mortgage Interest Deduction. Nevertheless, my work of the last 21 years prevents me from doing so.

Let me just make eight quick points. The first is, when the Mortgage Interest Deduction was created, it was not created as an instrument of housing policy; it was just interest, just like any other consumer interest that was deductible under the terms of the 1913 tax code. With the Tax Reform Act of 1986, it was excluded as special relative to all other consumer interests, but I do not know that the analytics behind the saving of it at the time were particularly strong with respect to homeownership.

Second, I do have to argue that those at the margin of home owning get little to no benefit from the Mortgage Interest Deduction. The issue is, again, itemization. Now, think about a homeowner in Texas who has a \$100,000 house. You can get a \$100,000 house in Texas. There is no State income tax at all. The chances are they are not going to itemize. Let us put that homeowner in Wisconsin where there is a State income tax. Now they might itemize, but the value of the itemized deduction is going to be small relative to the standard deduction.

The real issue is, does the policy, in a targeted way, encourage homeownership? I would argue that it does not. I have done stuff called regressions and simulations and so on, and, in my view, if the Mortgage Interest Deduction were removed, the long-term impact on homeownership rates would be pretty small. There would be an impact, but it would be in the area of 1 percentage point, so hardly catastrophic.

On the other hand, I do actually think the Mortgage Interest Deduction encourages people to buy larger houses and therefore

moves money toward the housing sector and away from plant and equipment. And again this is not just an association, it is based on regression results that control for things like family size, control for things like location that a family lives in, control for things like marital status, and so on. When you control for all those things, you still find that tax policy encourages people to buy bigger houses than they otherwise would.

We could have an argument about whether that is a good thing or not, but I think it should be pretty uncontroversial that it matters. We think incentives matter. The design of the Mortgage Interest Deduction is such that, the higher your income, the higher the benefit, because the higher your marginal tax rate is, the greater the encouragement is to take advantage of it and buy a larger home.

That said, if the Mortgage Interest Deduction were removed, homeownership would still be heavily subsidized for reasons that my friend Professor Case mentioned, as I do not think anyone is proposing that we tax imputed rent. I actually would be against it on the grounds that I think taxes are something you should be able to explain to people who are being taxed, and I have been trying to explain imputed rent to students for 21 years now, and I seem to do a pretty lousy job of it. So, as a result of that, there will still be a real subsidy.

One of the impacts of that subsidy would be that it would encourage people to pay off their mortgages faster because now you would have tax-preferred equity. You would not have tax-preferred debt, and so people would be encouraged to not hang onto their mortgages for quite as long. In work I did some years ago with Pat Hendershott, we found that in countries where there was no Mortgage Interest Deduction—Australia and Canada—while people bought their houses with mortgages that were about as big as Americans', they actually paid off their mortgages more quickly in those other countries.

This would lead, in my view, to greater stability. I think having households de-lever might be a good thing in the long term, but it also means we should recognize that the revenue benefits of eliminating or modifying the Mortgage Interest Deduction would be more modest than those that static estimates would suggest because, as people sell assets in order to pay off their mortgage more quickly, the tax revenue generated by the Mortgage Interest Deduction would be smaller than the roughly \$105 billion that it is scored at right now.

My reading of the literature suggests that that revenue benefit would be somewhere between 20 or 40 percent less than the static estimates. All that said, a couple of things. One, to follow up again on Professor Case's point, the housing market is very weak right now and knocking underpinnings out from under it at the moment does not make a lot of sense.

So I would suggest that, if one were to phase out the Mortgage Interest Deduction, that the phase-out not start until there was evidence that housing was in recovery. To me, that evidence would be that house prices were rising by at least the rate of inflation. One could use the Case-Shiller Index or the Federal Housing Finance Agency Index, or whatever you like, in order to do that.

The second thing for it to be an orderly—once the phase-out began it should be a phase-out. It should not be eliminated overnight. The way one could do this is by reducing the Mortgage Interest Deduction by \$100,000 a year over a period of 10 years, at which point it would be phased out.

But for all that, if it is determined that the tax code must subsidize homeownership, it would be far better to do what Senator Breaux has recommended, which is to use a credit which is independent of income in terms of the value of the tax benefit and that would be better targeted. As a result, I would take a refundable credit. It would be more sensible if the purpose of the tax code is actually to encourage homeownership.

Thank you very much for this opportunity.

The CHAIRMAN. Thank you, Dr. Green.

[The prepared statement of Dr. Green appears in the appendix.]

The CHAIRMAN. The next witness is Mr. Nelson. Mr. Nelson, I will introduce you as vice president and assistant secretary of PulteGroup. Is that right? How do you pronounce it?

Mr. NELSON. Yes, sir. PulteGroup.

The CHAIRMAN. PulteGroup. Thanks. Well, thank you very much for coming to give us your thoughts. Why don't you proceed?

First, I might say that a vote is occurring. What I might do, I suggest that—he's not here now, Senator Wyden. But we will have a rolling attendance here, as we keep asking questions for you, but Senators will be coming and going over the next period of time in which we can ask questions.

I will stay as long as I can, but then I will leave as soon as I get into the 15 minutes. But Senators, I urge you, if you want to come back, to leave now, and then come back and ask questions when I have to leave.

Mr. Nelson?

STATEMENT OF GREGORY M. NELSON, VICE PRESIDENT AND ASSISTANT SECRETARY, PULTEGROUP, INC., BLOOMFIELD, MI

Mr. NELSON. Thank you, Mr. Chairman, Senator Hatch, and members of the committee, for inviting me to testify today. My name is Greg Nelson, the vice president of PulteGroup responsible for taxes and corporate real estate. Pulte, in its 60 years of history, has delivered more than half a million houses and is currently one of the Nation's largest home builders.

My testimony today will be focused on the Mortgage Interest Deduction, although many of my observations included apply also to other incentives for homeownership the committee is considering, such as the deduction for State and local property taxes.

Today's hearing takes place at a time when the Nation's housing industry is mired in the 6th year of the worst housing crash since the Great Depression. Annual new home sales have crumbled from a recent peak of 1.3 million to less than 300,000 homes currently. While home prices have dropped to 10-year lows, erasing an estimated \$7.4 trillion of wealth from the American people, the collapse of U.S. housing has in turn wiped out millions of construction jobs. Yet, even with this severe economic downturn, survey after survey demonstrates that the American dream of homeownership is alive and well. A recent survey this week suggested that as high

as 70 percent of renters and people who are on the sidelines want to own a house at some point.

This committee's work is to reform the Federal tax code, and it is certainly to be applauded. However, it is not hyperbole to say that elimination of the Mortgage Interest Deduction could, and likely would, have a cascading disastrous impact on the country, the economy, and the American people.

Home prices have dropped, mortgage interest rates are approaching record lows, and the job market is stabilizing, yet would-be homeowners remain on the sidelines for fear that a home bought today will be worth less tomorrow. Eliminating the Mortgage Interest Deduction would quickly turn that fear into a reality and send us into another negative feedback loop of falling house prices, hundreds of thousands of mortgages sinking underwater, and more house foreclosures hitting the banks' balance sheets in the resale market. This would, in turn, result in more pressure on home prices, which would then feed back into the loop and cause the economy to further contract.

The end result: more stress throughout the economy, and likely a double-dip recession the government has fought so consistently and hard to avoid. The Mortgage Interest Deduction did not contribute to the housing bubble. It has been part of the tax code for nearly 100 years and has helped to ensure a strong homeownership rate among American families. These incentives remain important factors in making the lifetime decision of buying a home.

The Mortgage Interest Deduction allows families to become homeowners, to build wealth, to support their communities. It is vital to restoring stability to the American housing market and the overall economy, since it facilitates homeownership by reducing the carrying costs of owning a home. To millions of hardworking middle-class families, these savings can make the difference between achieving and not achieving their dream of homeownership. The obvious flip side of this coin is that reducing or eliminating the Mortgage Interest Deduction equates to a tax increase on homeowners at a time when they can least afford it.

Homeowners already pay 80-plus percent of U.S. Federal income taxes, but, if the Mortgage Interest Deduction is eliminated, that number could quickly rise to 95 percent. The Mortgage Interest Deduction is a tax break aimed squarely on the middle class, as almost two-thirds of those who claim it are middle-class earners. We should continue to encourage homeownership with our tax policies, not penalize it.

The home building industry has led this country out of every recession but for one. We may say that this time it will be different, but it never is. We need to put construction workers back to work and get the economy back on track. The way to do this is to reduce uncertainty, build confidence, and support housing. I would strongly encourage this committee to reaffirm its commitment to homeownership, and to leave the important tax provision in place.

We should not change the rules of the game for those who have already made the decision to purchase a home in reliance on the Mortgage Interest Deduction, and we should tell those potential home buyers sitting on the fence that it is safe to buy a home; the rules are not going to change.

We face a chicken-or-the-egg dilemma: can housing get better without recovery of the economy, or can the economy get better without first seeing a rebound in housing? Either way, there is growing acceptance that the U.S. housing industry must get healthier as part of a robust and self-sustaining economic recovery.

In order to put Americans back to work, the administration and Congress have been considering various ways of putting more money into the hands of consumers, including helping homeowners to refinance at historic low interest rates. Eliminating or significantly reducing the Mortgage Interest Deduction would do the complete opposite and take away discretionary spending from homeowners. Government decision-makers should ask themselves, do they wish to increase or decrease the cost of homeownership at this precarious time?

The administration's refinancing initiative is aimed directly at decreasing that cost, particularly the cost of monthly mortgage payments, largely for the purpose of stimulating consumer expenditures on other purchases. The Mortgage Interest Deduction proposals under consideration, on the other hand, would increase the effective cost of homeownership, forcing homeowners to reduce their consumption of other things. This anti-stimulative behavior is exactly the sort of conduct government should discourage at this point in time.

While I appreciate the daunting task this committee has before it to reform the Nation's tax code, I would urge you to remember just how bleak the housing market is for American families before considering reductions in the Mortgage Interest Deduction. A further erosion of home values now, 6 years into the worst housing recession in more than 7 decades, could have a devastating effect on the broader economy.

I know that you intend to fully consider the consequences of all current tax expenditures during your tax deliberations, and I am confident that, when you do so for the Mortgage Interest Deduction, you will recognize just how valuable the provision is to American families, the American way of life, and will keep it in place as our economy begins to recover.

Thank you for the opportunity to testify.

The CHAIRMAN. Thank you, Mr. Nelson. Time goes by pretty quickly here.

[The prepared statement of Mr. Nelson appears in the appendix.]

The CHAIRMAN. Dr. Green, what about the argument that, gee, at this time housing is in such a sad plight that it does not make sense to reduce or phase out the interest deduction?

Dr. GREEN. That is why I wrote in my testimony, I would not do it at this moment. I mean, in a perfect world I would, but that is manifestly not the world we live in. It is why I proposed a rule that says, have a metric for when housing has recovered. It may be sometime before that occurs.

The CHAIRMAN. What about, if this Congress does tax reform this year or next, converting the deduction, as has been suggested, to a credit?

Dr. GREEN. Well again, if the deduction is converted to a credit for most people, particularly outside the coasts, it could wind up being a larger subsidy, particularly if it is a credit you are allowed

to take even if you are not an itemizer. So it depends on how the credit is constructed.

The CHAIRMAN. All right.

Mr. Nelson, do you think that this country should undertake tax reform, corporate and, say, individual? And, if we do, do you suggest we cut back on some of the other types of expenditures, but not the Mortgage Interest Deduction?

Mr. NELSON. Well, we clearly need tax reform. But I would not touch the tax benefits associated with homeownership. We have millions of people who have bought homes based on the rules as they know them. They are simple, they are easy to understand, and that is what they bought into. They made their decision to buy their house based on those economics, and I think at this point in time, or any time in the near future, to change the rules of the game and pick winners and pick losers is a big mistake.

The CHAIRMAN. But what if we were to, just across the board, start to pare back, but say provided something that would not go into effect until a later date, so people have notice, they have the ability to plan?

Mr. NELSON. But people have made decisions. They are committed to a 30-year mortgage, a 20-year mortgage, and we are tinkering with their cost of occupancy of the homes.

The CHAIRMAN. Have you looked at grandfather provisions?

Mr. NELSON. I think that would have to be considered. To be fair, there would have to be grandfathering. But again, that gets complicated, as usual, right?

The CHAIRMAN. Right.

Mr. NELSON. Homeowners bought before this.

The CHAIRMAN. What I am trying to get at, obviously, is the degree to which we should reform the code, and the degree to which anybody should be exempt from that reform effort.

Mr. NELSON. I just believe that we ought to leave housing alone. I understand tax reform is very important here, but we have an enormous housing crisis in this country, and we should do nothing to affect that, and we should work on housing first.

The CHAIRMAN. Yes. I have a ton of questions, but I have to run if I want to vote. The hearing will stand in recess until another member returns. But thank you very much. If you would hold on for just a few minutes.

[Whereupon, at 10:46 a.m., the hearing was recessed, reconvening at 11:04 a.m.]

Senator NELSON. The hearing will resume.

I always wanted to be chairman of the Finance Committee. [Laughter.]

Senator Breaux, you never got to be chairman of the Finance Committee.

Senator BREAUX. I used to sit right there.

Senator NELSON. May I ask any of you, given that economists generally agree that the value of the Mortgage Interest Deduction is imbedded in the price of housing, with our home prices down so much—nationally it is almost 30 percent from the peak back in 2007—how much more would housing values fall if you eliminated the Mortgage Interest Deduction? Senator Breaux?

Senator BREAUX. Well, Senator Nelson, I think that what we recommended in our report has to be looked at in its totality. Number one, we did not recommend eliminating the mortgage deduction, we recommended exchanging it for a 15-percent tax credit and capped that to interest payments attributable to the average cost of a house in your area. It is important to note that what we did with those savings was to eliminate the Alternative Minimum Tax and to reduce the individual rates. The top rate, from 35 percent, went to 33, 33 went to 30, and 28 went down to 25. So, it was revenue-neutral in the sense that you got a lot in tax savings and were able to use that to lower rates. What we did was to keep the tax incentives in the tax code for buying a house, but reduced them somewhat.

I guess the thing that we heard in testimony was, if I have a choice between having my mortgage deduction reduced a little in exchange for a reduction in my individual rates, I will take the individual rate deduction any time.

Now, we phased it in over 5 years. You know probably better than anyone that housing is in terrible shape, particularly in Florida. So I think the committee could adjust that and make it a longer phase-in if you thought it was feasible. There are things you could do to make it work better.

Senator NELSON. Anybody else? Yes.

Mr. NELSON. I think it is safe to say, no one knows. For that reason we ought to leave it alone, because it clearly is not going to go up, it is going to go down some indeterminable amount. Also, does it increase the cost of homeownership for people who are on the edge now? They are struggling to make mortgage payments now. They may be under water. Now the monthly cost effectively goes up, and do they reach a point where they are ready to send the keys in? If they send the keys in, we are back into that loop of foreclosure, short sale, what have you. I think, given where the housing industry is right now, it likely would be more than it should be. But clearly, I do not think anybody knows.

Senator NELSON. Would this have the effect of more mortgages under water? Dr. Case?

Dr. CASE. I think that is absolutely right. I think you are absolutely right, Senator. If you look at this, there are 10 million properties potentially under water. We do not know for sure how many, but the best guess is it is something around 10 million. You have a lot of buyers who are waiting, and sellers who have property that is not under water trying to sell, and they are holding out. Everybody is waiting for this thing to do what it has done in the past, which is to clear. But the process that cleared the markets in the past is not working today.

We are not having household formations. People are doubling up, tripling up. They are going home because we are not treating them well when they get here, and there are no jobs. So the household formations are down, vacancy rates are still up. It kind of makes you nervous. I produce these house price indexes that come out once a month, and I am nervous as the devil when they come out because, if it starts to go downhill, there are a lot of people sitting and waiting who are going to decide not to go into the market and stabilize it. So I think it potentially could be a tipping phenom-

enon. It could be quite bad, where you have just tracts of housing for sale and no one dealing with it. But to just reinforce what my colleague was saying, it could stabilize, it could go back up, but it does not seem to be going in that direction given all the things that are happening. So it is potentially just damaging, and it could push it over the edge.

Dr. DIETZ. And just a 5-percent additional price decline, which might be at the low end of estimates of what would happen if you totally eliminated the deduction—those could be as high as 15 percent—a 5-percent price decline would increase the number of underwater mortgages by 2 million. We are at about 11, 12 million. That is, 25 percent of homeowners with a mortgage are underwater right now. To add 2 million on top of that, particularly in certain geographic areas, would be devastating.

Senator NELSON. What about the cap of a million dollars of mortgage for deducting interest?

Dr. DIETZ. Well, a common proposal for that is to limit it to \$500,000. We think, at NAHB, that that too would also have strong negative effects in certain high-cost areas. For example, something like 10 percent of the housing stock in the country is priced \$500,000 or above. It sounds like a small number, 10 percent, but it is highly geographically concentrated.

Something like one-third of those homes are located in just four States: New York, New Jersey, California, and Virginia. So lowering the cap would make it more expensive to buy what could be an ordinary single-family home in a high-cost area that could cost \$600,000. The question is, who bears the burden if you do that?

Well, it is going to be the younger home buyer who does not have the wealth to pay cash, or the investor buyers, who are increasingly a large share of the market right now—it is those younger home buyers. As Dr. Case said, that means fewer household formations, which is what the economy needs right now to absorb excess inventory: marriages, children, the creation of the middle class in the long run.

Senator NELSON. Senator Hatch?

Senator HATCH. Well, thank you, Senator Nelson. I have been waiting a long time to get Senator Breaux in front of the committee, I will tell you. We welcome you. We appreciate you. And we certainly enjoyed serving with you in the U.S. Senate. We are happy you are doing so well on the outside.

Dr. Dietz, in your testimony you note that President Obama's proposed 28-percent cap on deductions could reduce housing prices by another 10 percent in larger metropolitan areas. Now, you also note that it would disadvantage many construction and manufacturing businesses which are organized as pass-through entities. At least, that is my interpretation.

It seems to me to be the last thing that we should be doing right now. Can you elaborate on the negative impacts this proposal could have on the economy, in the housing sector in particular, particularly as it relates to economic growth in jobs? Mr. Nelson, I would like to hear your thoughts as well on this.

Dr. DIETZ. The 28-percent cap would have strong negative effects on housing. The cap would apply to itemized deductions, including the Mortgage Interest Deduction, the Real Estate Tax Deduction,

so it would hurt housing demand in high-cost areas. We just talked about the \$500,000 cap. It would have similar effects to that. It would also add complexity to the code, which is kind of ironic, as we are trying to look for provisions that would reduce complexity.

As you mentioned, it would actually have an affect on the business side, too. It affects the section 199 deduction. Eighty percent of NAHB's members are pass-through entities. They are small builders organized as partnerships and S corporations. That 28-percent cap would take a hit at their tax deduction for the Production Activities Deduction, which would hurt jobs. It is important to keep in mind, in terms of home building's long-run economic impact, every single family home constructed creates three full-time jobs.

Senator HATCH. Mr. Nelson, you have been in this business a long time. Pulte is one of our great home building companies. Could you answer that question in your viewpoint?

Mr. NELSON. I *have* been in this business a long time, actually 30 years, and have sat through a number of recessions and downturns, and this one is unlike, of course, anything I have seen in my career. I think moving down to 28 percent at the margin has the potential, of course, to cause a recalibration of prices not only for people who have bought houses and made the decision based on a higher tax benefit—so their effective cost of ownership is going to go up, which reduces discretionary spending on their part—but on our part for new construction, with homeowners doing the calibration, calculating their cost of ownership, and looking at their tax benefit at 28 percent versus perhaps 35 percent, or maybe 39 percent when the Bush tax cuts are changed. So I think it has an impact, again, of driving values down, Senator. That is the last thing we need right now. We need things to support and stabilize values, and should do nothing to drive values down.

Senator HATCH. Dr. Green, this one is for you. You advocate phasing out the Mortgage Interest Deduction. Because of concerns over the shock to the fragile housing market a phase-out would have, you suggest not even beginning the phase-out until government housing statistics demonstrate a sustained recovery in housing prices. Now, to what extent would your proposal, if enacted, in and of itself depress house prices?

Dr. GREEN. So, because of expectations about the Mortgage Interest Deduction, I did an estimate with Pat Hendershott about 15 years ago, looking at what would happen if the Mortgage Interest Deduction were just eliminated overnight. We came up with an estimate, if I remember, in the neighborhood of 9, 10 percent. But things were very different in 1996 than they are right now.

One big thing that is true about housing markets around the country right now is there are a number of places where prices are less than replacement cost, which means that, if you are living in a place where you think there is going to be any population growth, any household formations at all, in the long run prices should recover at least to replacement cost. So the long-term impact of this on those places, I think, is pretty remote.

As a consequence, so long as the phase-out was long-term, orderly, and people could deal with it, I think it would have a fairly minimal impact. That said, there are a few places in the country,

such as where I live, the coasts, California, New York, Boston, Washington, where the impact in the long run would certainly be substantial. It could be in the neighborhood of 15, 20 percent in some of these markets, because these are places where we do see a lot of capitalization of taxes into values.

From a long-term perspective, however, what this will do is make these areas more affordable. For those who do not get the benefit of the Mortgage Interest Deduction, it might allow them to buy a house that they would not otherwise be able to buy. So I am not sure that, as a policy standpoint, that would be a bad outcome, but I understand transition at the moment is really problematic because we are in such a weak housing market and such a weak economy.

Senator HATCH. All right. Thank you.

Dr. Case, you note that housing starts are still at “Depression-era numbers” and that a further decline in home prices now would be devastating. Now, as a result, you state that a proposed phase-out of the Mortgage Interest Deduction would get your support “if the housing market gains stability.” I have to say I share your concern that we should be very careful not to do anything that would actually make the current situation worse. I think almost all of you agree with that. With unemployment stuck at over 9 percent, and Depression-level numbers in housing, people of this country really are hurting.

So I want to ask you to elaborate a bit. When you say that the housing market “must first gain stability,” can you tell me what housing stability would look like and what you think we might see, or when you think we might see that type of stability occur?

Dr. CASE. Well, if you think about what house prices are telling you, about 5 million properties change hands in a given year—at annual rates. Right now we are running about 5.03, I think the latest figure was, 5.03 million. That sounds like a lot, but it is less than 5 percent of the stock. What we do with the number when we get house prices—we get transactions as houses sell. We look up when those properties changed hands last, and we put it into an index. We look at those indexes, and we observe what takes place and then impute that value to the whole stock of housing in the country, and we say wealth went up by \$1 trillion or down by \$1 trillion. It is really what those 5 percent of buyers are doing. It does not take a lot to move them, and they are, by and large, optimists.

So these are people who actually bought houses who end up in these price indexes. So my point is that it is fragile right now because, if you tip the scale against it, and it starts to decline, there is a lot of evidence there is inertia. So, what I would say “stabilized” means is that prices at least are flat for a couple of years, they are not falling.

You go back to 2006 and look what happened to prices. We never had a year—we never had a single quarter actually—in these price indexes over a 30-, 40-year period where house prices fell nationally at all. That is what got us into trouble. When they fell, they went down 33 percent nationally. That is a huge hit at \$7 trillion, if you do the arithmetic I was talking about. So it puts you in a

kind of precarious position, unless you really see that rapid decline stopping.

The Housing Tax Credit did stop it for a period of about 8 months. The index went up to \$6.5 million from \$5 million as a result of that credit, and then, when the credit went away, it went right back down to where it was before. So I would say right now you are starting to see some stability. When those diagrams stop going down, they go flat, and existing sales and prices are the key. You watch those, and, when they start to get stable, I think there is a chance we have a good recovery.

But the economy has to keep going. If the economy goes into a double dip, other things happen. It is not just the responsibility of this deduction, it is everything else that is going on that is driving emotions. There is inertia, and it is a precarious position that the market is in. I think that is what we are worried about. I think it is kind of like other things, you know it when you see it. Stability starts to show up, and things will pick up if it is there.

Senator HATCH. Thank you.

Senator Grassley?

Senator GRASSLEY. Thank you. I only have a question or two in one area, so it will not take very long. The Joint Committee on Taxation prepared a document for today's hearing including data on homeownership and the interest deduction of OECD countries.* According to this document, in addition to the United States, 18 OECD countries allow a deduction for mortgage interest expense. Fifteen of these countries have higher rates of homeownership, while 3 have lower rates. Conversely, 11 OECD countries do not provide a deduction for mortgage interest. Of these, Canada's and Australia's homeownership rates are about the same as the United States', while the rates in Germany and Japan are significantly lower.

One aspect of this I want to ask Senator Breaux, and another aspect I want to ask Dr. Case and Dr. Green. In the case of Senator Breaux—and I will state both of these questions, and you can take turns answering them.

Could you tell us, Senator Breaux, whether the tax reform panel you chaired with Senator Mack considered whether or not and how other countries incentivized homeownership, and whether that ought to have any impact on our policies here in this country?

And for Dr. Case and Dr. Green, I would appreciate your thoughts on why the data on homeownership rates vary so significantly among OECD members regardless of whether they provide a tax deduction for mortgage interest.

Senator BREAUX. Well, Senator Grassley and Senator Hatch, thank you for letting me speak here today. Before you came in, I suggested that this committee, more than any other committee in Congress, has the ability to put together a tax reform package. You all have had a history of working across party lines, and have major accomplishments to show for it.

No other committee, I think, in this Congress has the capacity to do what you all are being challenged to do. I would also suggest

*For more information, *see also*, "Present Law, Data, and Analysis Relating to Tax Incentives for Homeownership," Joint Committee on Taxation staff report, September 30, 2011 (JCX-50-11), <http://www.jct.gov/publications.html?func=startdown&id=4366>.

that no one who has tax benefits in the tax code is going to come up to this witness table and ask you to change them. They are going to give you their best argument as to why things ought to stay just as they are, and I understand that. I have heard that as long as all of you have.

What we have recommended in our commission was not to eliminate the deductibility of mortgages completely. We spend \$140 billion a year through the code on incentives for homeownership in this country. If you got rid of all of them, you could reduce the tax rates in this country by 12 to 13 percent right across the board. We did not recommend that. We recommended phasing in a new program over 5 years. You could do it over a longer period of time. We gave a tax credit of 15 percent to everybody on their home on interest that they pay. About 70 percent of the people in the country do not get the benefits because they do not itemize.

Our proposal would give it to everybody, whether they itemize or not. Fifteen percent of the interest rate is deductible and capped. You could cap it at a half-million dollar home. That would affect a smaller percentage of homeowners because most of them are under half a million dollars. But you cannot look at that in isolation.

What we did with those revenues, and the others we raised, was to reduce the corporate rate from 35 to 30, the top rate from 35 to 33, the 33-percent rate went down to 30, and the 28-percent went down to 25. Then we eliminated completely the AMT. So a lot of people would say, if I have that deal, and I could have my rates reduced, and I do not have to worry about AMT, and I can still get a credit for buying a house, I think that is a pretty good deal. That was the plan that we had submitted.

Senator GRASSLEY. In that process you went through then, you did not anticipate what was working or not working in other countries?

Senator BREAUX. Yes, we certainly did. I mean, Australia, the United Kingdom, and Canada have no deductibility on interest rates for homeownership. Some of them had higher rates of ownership than we do, some of them have about the same. I would make the argument that there would not be that much change if you can also reduce the individual tax rates. That is a huge incentive. That is money in people's pockets to be able to buy a house and still get some credit on that purchase. And every home owner would get it as opposed to just a few.

Senator GRASSLEY. Dr. Case and Dr. Green, do you need to have me repeat what I asked you?

Dr. CASE. No.

Senator GRASSLEY. Go ahead, then.

Dr. CASE. I mean, I think when you look across countries, there are a whole lot of things at play, like the posture of monetary policy. It explains not just differences in the homeownership rate, it explains the difference in prices, and differences in the dynamics. I went down to a conference that was in Australia called by Ian Macfarlane, who is head of the Central Bank, the Reserve Bank of Australia, in 2003.

The question on the table was, can monetary policy be used to pierce an asset bubble? We had prices rising rapidly in this coun-

try. Australia was in fear of having that happen down there. He made the decision to go after it a little bit. They tried to slow it down, and it basically worked. That ends up putting Australia in a different position than we were in, and it had nothing to do with the homeowner deduction.

It is just, when you sort it out, there are economies that have been very pro-homeownership as a whole. We have Fannie and Freddie. We have no capital gains on the sale of homes. We had a system that was set up, not just with the deductibility of credit in the non-taxation, we had a system set up where we were really fanning the fires on the way up, and there was nothing, no reason for people to resist because housing prices had gone up for 35 years nationally without anything stopping.

So, if you look at Texas, there was a problem, in New England there was a problem, but they were regional, they went away. Optimism was the rule, and we threw everything at housing. I think that is the reason some of us up here would like to see some of that reduced, but we have just been through a horrible collapse of the economy, and it is really housing at the center of it. That is what scares us all.

Senator GRASSLEY. Dr. Green?

Dr. GREEN. Yes. I think we tend to think of tenure as being taken one of two forms, you either are an owner or renter, and it is a little more complicated than that. So institutions vary a lot by country, so Germany, for example, has a low ownership rate, in my view, for the same reason that New York City has a low ownership rate, which is tenant rights are very strong in Germany.

So to some extent, if you are a German and you are a renter, you get a lot of the benefits of home owning without the headaches of it. Somebody else has to take care of your house, but you get to live there pretty much as long as you like. Eviction is very difficult, and there is a limit to how much landlords are allowed to raise the rent. They can raise it, but it is tied to a price index.

On the other end of the spectrum, Spain has, I believe, the highest homeownership rate in Europe, at 80 percent. The reason for that is, anyway my understanding is, their rental market is so dysfunctional that nobody, no sensible investor, would be willing to invest in rental housing. So people become owners because there really is no alternative. So to try to pin differences in homeownership rates on differences in tax codes is really problematic. I think these other institutional features are more important.

Senator GRASSLEY. Thank you very much. Thank you.

Senator HATCH. Thank you.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. My apologies to our panelists. This is excellent panel.

I wonder if one of you would be interested in taking on the question of, how much has current housing policy contributed to the economic hard times that we are seeing today? Because it strikes me that you have to get at that question in order to go on to the debate about various kinds of alternatives. Let me ask you that, Dr. Green.

Dr. GREEN. I do not want to take up everybody else's time, and I see I have 4 minutes and 20 seconds here. That is quite a ques-

tion. Let me tell you what. I think our obsession with homeownership led us to forget what being a homeowner really means. There was a view that, if you had your name on a title, even with a 100-percent mortgage, you were an owner, when in fact, if you have no money in your house, you are not really an owner—you own a call option to buy a house some day. So, if the value goes down, you have every reason to leave, and, if it goes up, you have every reason to stay.

This moves outside of tax policy; this gets to underwriting policy and to, I think, a misguided effort to call people homeowners who really were not. So, from a long-term housing policy perspective, I think making sure people have some sort of, to use a cliché, skin in the game when they buy a house, is really important. It is controversial how much that has to be. I really do not know the number, but we have a long history with programs where people did not put their own money into houses, and things turned out badly. The HUD section 235 program of the 1970s was like that.

Senator WYDEN. Let me just move on—particularly since we have you here, Senator Breaux—to the importance of tax reform, and the urgency of it all, because, as you know, a big part of the discussion now is, is there time, how would you do it, and all of the issues that are inevitably part of a Washington, DC debate.

The one consideration to me, in terms of the urgency, is that I believe tax reform is the one unused tool in the economic toolshed. If you look at where we are today, we have seen stimulus bills, we have seen automobile bills. We have seen all kinds of legislation, and here you have tax reform almost sitting there in the tool shed, rested and ready, and there is some proven experience here of great benefit.

I went to the Bureau of Labor Statistics' numbers, and we found that, in the 2 years after the 1986 Tax Reform bill, the country created 6.3 million new jobs. Now, nobody can conclude that every one of those jobs was due to tax reform. Nobody ought to go out and about and try to make that argument. But clearly, it was beneficial.

What is your sense about how urgent this is? Because, as you know, the super committee is trying to find a way to go forward, and obviously this committee is working on it. So I would like to hear your sense about the urgency of all of this.

Senator BREAUX. Well, I think it was urgent when we recommended it in 2005, and I think it was urgent when they did it in 1986. I think probably it is more urgent today because of the economic conditions we face in this country, and we can reform the code in order to promote growth and stability economically. I hope that the super committee could recommend tax reform. I do not think they are going to be able to do it. They do not have enough time to do it.

Tax reform has to come from this committee, and it has to come from the Ways and Means Committee, where the talent and expertise on reforming the code lies, from a professional standpoint. I think they could make some recommendations that would instruct the committees to come back with a tax reform recommendation which meets certain targets, in 6 months or 8 months. But I think

waiting for the super committee to do tax reform might not be possible.

So, can you do it in an election year, a presidential election year? I tend to doubt it, as optimistic as I try to be. I think it is going to be very difficult to do major tax reform this year out of the super committee, and it will be very difficult to do it in a presidential election year, which means then we are looking at 2013.

But, if any committee can do it, it has to be this committee. I mean, if you look at the things I said earlier, we did NAFTA, we did SCHIP, we did prescription drugs, we did welfare reform. Either side could have stopped the other side, but they did not, and you produced legislative proposals that are still there today and serving us very well. It is urgent, and it is time to start, and this committee is the place to start it.

Senator WYDEN. Senator Hatch, could I ask one more question?

Senator HATCH. Sure.

Senator WYDEN. Thank you.

I want to ask one other question, again about the prospect of bringing both sides together. As you know, Senator Breaux, one of the most contentious issues in Washington, DC has been this question of revenue. When the word "revenue" is offered up, there are folks, conservative folks, who will say, ah, the Democrats are just out to raise taxes. That is sort of the refrain. When Democrats hear that comment, that all they are doing is trying to raise taxes, well, all the conservatives want to do is protect the wealthy.

What to me is appealing is that tax reform is an opportunity for both sides to agree on revenue, that there is a chance, as I mentioned with those numbers from the 1986 Tax Reform bill, to create jobs in the private sector, to generate revenue in the private sector, have folks who are unemployed, for example, going back into the private economy. This is a chance to bring both sides together.

I asked this question of Maya MacGuineas, who is the president of the Committee for a Responsible Federal Budget, and she said "yes." She said tax reform is the one approach to revenue that both sides can agree with and that also helps to make the case for using tax reform to break this gridlock on how we move the economy forward. Would you agree with Ms. MacGuineas? What are your thoughts on that?

Senator BREAUX. I agree with both. I have a great deal of respect for the work their group does; it is outstanding work. I agree with your premise. I think that what we tried to do was to eliminate and reduce some of the incentives, if you would call them that, and special carve-outs and benefits in the code, but we used those revenues to reduce the rates across the board and eliminate the AMT.

You cannot look at it in a vacuum. You cannot say, oh, the Democrats are raising taxes by eliminating some of these preferences, when you are at the same time advocating using those revenues to reduce the tax rates in other areas. If you can reduce the tax rates across the board and eliminate the AMT, you give the people that choice instead of looking at it in a vacuum of, oh, you are going to do away with my home mortgage? Well, number one, we did not, we still keep it and transform it, but we use that to reduce everybody's Federal tax liability. Then they say, oh, really? But then that is a good trade-off. That is a legitimate trade-off.

Senator WYDEN. Mr. Chairman, I have one last question, but I will wait until you take your next round.

Senator HATCH. Go ahead, Senator.

Senator WYDEN. One last question. I would ask this of the entire panel. When you look back at the experience of 1986, one of the considerations that hits you first is that, basically as soon as the ink was dry on the reform bill in 1986, everybody went back to business as usual. You would essentially come back to this committee—Senator Breaux is smiling because he remembers this, because everybody—

Senator BREAUX. I did some of them.

Senator WYDEN. You did some of them. Everybody came back and started offering various deductions and credits and the like, and essentially the good work to kind of drain the swamp that was done in 1986 began, in effect, to unravel. I have been looking hard at the question of how, as part of tax reform, this time you take steps to fight that kind of backsliding.

Now, the first consideration is, no current Congress can ever permanently bind the action of future Congresses, but surely you can make it hard to unravel tax reform this time. In other words, you can force votes, you can force, for example, preferences to be examined in groups, to have them costed out as tax expenditures.

I would be interested in your thoughts. Maybe we will start with you, Senator Breaux, because you went this route. Any thoughts on how, as part of this tax reform effort, the Finance Committee members, members of Congress, could take some steps to make sure that, after this current battle to bring both sides together—picking up on the principles of 1986 where you get rid of preferences, hold down marginal rates, keep progressivity—that you do not see, come the next year, and the next year basically, everything begin to unravel? Any thoughts on that? I would be interested in your thoughts, Senator Breaux, and others'.

Senator BREAUX. Thank you, Senator. When we did our report in 2005, we found out that, between 1986 when the tax code was cleaned up and when we did our report, there were over 15,000 amendments to the tax code that put everything they took out back in. It is probably well over 20,000 amendments since then. That is just a fact of life. If you clean up the code and do away with all the preferences, there will be people at this table, myself probably included, trying to get them back in. That is why this committee has to monitor that.

But, if what you do in cleaning it up works, then there will be a lot less incentive for somebody coming in to say, oh, we need some special incentives. That is just the way a democracy works. I mean, you clean it up in 2011, and in 2012 there will be people advocating going right back to where we were, and the committee has to be strong enough to say, no, we do not need to do that again. But they are going to come back. That is the nature of government.

Senator WYDEN. Other witnesses on that point?

Dr. CASE. I would just make a small point. There is a subtle difference between what was done in 1986 and what is being proposed here. That is, they came to an agreement, before they started, that it would be revenue-neutral, right? And the distributionally neutral rule that they set down, I think, led to the passage of that bill.

So maybe you give up on revenue as your target in a decision. If you set net revenues equal to zero, it is revenue-neutral, what we are going to do. You can get a lot of the benefits without having the fact that it either raises or lowers revenue on the table.

Senator WYDEN. The only question there is, how do you deal with this compulsion? As Senator Breaux says, it is almost in the human DNA to just want to come back. I think we can deal with some of the considerations you are talking about. If you look, for example, at a number of legislative efforts, you see an element of what is essentially called static scoring, where you take away preferences, use those very same dollars to hold down rates, and that is of course attractive to conservatives, but you generate revenue because, as you broaden the base, you are taking steps to encourage growth.

A number of groups, Heritage and others, have scored the proposals as generating revenue. I think we can get at the question you are talking about. I am more concerned about the point Senator Breaux has raised, that it is almost like you would have to change the gene pool or something to keep people from coming back, but at least we ought to make it harder.

Maya MacGuineas, again, made some very constructive recommendations on this point. She talks about, once you have an ongoing disclosure of tax expenditures—and then our idea has been to perhaps look at forcing some votes so that, if you were to unravel something, people could understand the pluses and minuses. But I gather our friends the home builders have some ideas on that, and we would like to hear them.

Dr. DIETZ. When tracking tax expenditures, more information is definitely better. Some tax expenditures are narrowly claimed by only a few thousand, a few hundred thousand taxpayers. The Mortgage Interest Deduction is clearly something that is claimed by 35 million people. It is not a loophole per se; it has been around a long time. It is not one of those items that was added in these rounds.

But more information is definitely better. For example, Joint Tax does a great job in providing the income distribution of the tax benefits of some of the larger itemized deductions and some of the other tax expenditures. Not to add work to their plate, but it would be very useful to provide demographic distribution. It is something we argue in our written testimony. Who claims these by age cohort?

I think that is important because, for example, in the 2005 panel, you did have a weakening of the Mortgage Interest Deduction down to a 15-percent tax credit. A revenue-neutral tax credit would probably be something like 20 percent. So you weaken the housing item to pay for things like AMT repeal. So who pays AMT? If you look at it by age, it is typically older taxpayers. So there you had maybe, on a revenue-neutral basis, neutrality, but you definitely had winners and losers among age cohorts. Obviously from housing, that is very particularly important because those new household formations are what determine housing demand, housing construction. Anything that squeezes the people who have to buy homes with debt, that is going to reduce housing demand and hurt housing prices.

Senator WYDEN. That is an attractive idea. Certainly, with respect to disclosing the nature of who is making up those purchases and looking at the age distribution, that makes a lot of sense to me, and we will want to follow up on that.

Dr. DIETZ. I would say, in any comprehensive tax reform, income distribution tables need to be accompanied by generational distribution tables as well, particularly if we are talking about entitlements.

Senator WYDEN. I want to let the other witnesses respond, if they are inclined. But, Mr. Chairman, you have given me an awful lot of time, and that is because you are invariably such a gracious soul, and I do not want to impose.

Senator HATCH. Well, thank you, Senator Wyden. I think this has been a particularly good panel, and we appreciate your efforts, and appreciate you being here. Senator Breaux, it is always good to see you. We appreciated you when you were in the Senate, and I appreciate you since you left the Senate. We just want to thank all of you for being here. With that, I think we do not have anybody else. We will recess until further notice.

[Whereupon, at 11:44 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

**Testimony of Senator John Breaux
United States Senate
Committee on Finance
Tax Reform Options: Incentives for Home Ownership
October 6, 2011**

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.

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

Testimony of Karl E. Case

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 change 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 lead 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 in 1982 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 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 either 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:

Coulson, 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

SENATE COMMITTEE ON FINANCE HEARING
“Tax Reform Options: Incentives for Homeownership”
October 6, 2011
Responses to Questions for the Record From Dr. Karl “Chip” Case

Questions from Chairman Baucus

- By almost any measure, Americans are taking on more mortgage debt. They have more per capita debt, and own a smaller percentage of their home than any time in the post-War period. In your studies of housing, have you seen this increase in leveraging? How much do you think this is a result of the home mortgage interest deduction? Do you think the large amount of home mortgage debt has had a negative impact on households?

ANSWER: Debt is a two edged sword. If I buy a home that costs two or three times my income, I am forced to borrow to finance the purchase. This is both reasonable and desirable. In buying a house I receive benefits over a lot of years. It is perfectly appropriate to borrow in order to pay for it over time. In good times leverage allowed the benefits of a rising market to flow to rich and poor alike. Work done for the Ford Foundation a few years ago showed the substantial benefits to households with low and moderate incomes when prices boomed. On the other hand, the American Dream became a nightmare when house prices fell and households found them selves under water or in foreclosure due to a loss of job.

Obviously, borrowing money involves risk to the lender and to the borrower. Some buyers are cautious, opting for a fixed rate self amortizing loans in which the monthly cost is fixed in nominal terms (continuously falling in real terms). That is a good savings program. Others opt for more exotica like pay option ARM's which increase the risk exposure of the household going forward.

Note also that leverage can increase basically in two ways. First, declining home prices reduce the equity and increase the loan-to-value ratio on properties carrying existing mortgages. This has led to large number of properties under water. Second, people can borrow more from the outset by simply taking bigger mortgage. Lower underwriting standards and deductibility have clearly contributed to high-leverage buying over the last decade. But there was little downside as long as home prices stayed up.

If you look at the Federal Reserve Flow of Funds data (Table B.100) you can see what has happened to household borrowing over the past decade. Household real estate holdings peaked in 2006 at \$22.7 trillion. It has since fallen steadily to \$16.2 trillion in second quarter of 2011. Household mortgage liabilities peaked in 2007 at \$10.5 trillion and have fallen to \$9.9 trillion. Owners' equity in household real estate has fallen from 59.8% in 2005 to 38.6%. Aggregate figures like these, however, mask vast differences among households.

It's important to understand that there are millions of households that own but carry no debt. At the same time perhaps as many as 10 million households are under water, which means they

have seen values erode their equity to the point where it is negative. On the other hand, there are large numbers of people, particularly on the coasts, who lost paper wealth since the bubble burst, but retain significant equity earned on the way up. Last month the National Association of Realtors reported 4.9 million existing home sales at annual rates (SAAR) - a substantial number of these have been cash sales. While some of these are foreign buyers the bulk seem to be late baby boomers that are moving.

The bottom line is that buying a house is risky. Leverage increases that risk. But without leverage there is no home ownership at all. The key is to be cautious when buying. What matters the most is can you afford it and will it be risky if you have to move for some reason.

Questions from Senator Hatch

- Many of you recommend replacing the mortgage interest deduction with a tax credit. Some of you even suggest that this tax credit should be refundable. Considering that the mortgage interest deduction is already one of the most utilized tax expenditures in the Code and over half of Americans do not pay income taxes, would a refundable tax credit push even more taxpayers into the majority of Americans who do not pay income taxes?

ANSWER: That is absolutely correct. According to Carroll, O'Hare, and Swagel (2011), which I cited in my testimony, replacing the mortgage interest deduction with a fixed credit (say 15%) would reduce the tax bias for over leverage, but would have other unfortunate consequences. As you suggest, it would substantially increase the number of households that pay no tax, and increase the tax rate for those households that do pay income taxes. Households with incomes over \$200,000 would see substantial increases in their taxes, while about 51.2 million households would receive reductions. Replacing the mortgage interest deduction with a refundable credit of 15% of mortgage interest would actually raise \$16.3 billion in revenues.

I do not like the fact that the current law allows mortgage interest as a deduction. That makes it worth more to a higher income taxpayer, since the value of a deduction depends on the marginal tax rate. At least a shift to a credit, if refundable, goes to everybody in proportion to the interest they pay. On the other hand, I am opposed to favorable treatment for mortgage interest as long as imputed rent remains untaxed. I must admit I share your concern that it is not a good thing when some families pay no tax, whatever the reason. The real gains made in the 1986 act involved reigning in the abusive tax shelter industry, which had substantially weakened the income tax.

- The Mortgage Interest Deduction is allowed for the indebtedness to buy a home -- both the house structure itself, as well as the land that the structure is on. Do you believe there is a stronger case to make for allowing the deduction to the extent the indebtedness is incurred to buy the structure, as opposed to the land?

ANSWER: The argument here is that land is fixed at a given location and any tax on it at a uniform rate will produce little distortion of economic activity. Effectively raising the tax on

land by allowing deductibility only against structures would go some way toward minimizing tax distortions. The social philosopher, Henry George, came to the conclusion that governments should rely on a single confiscatory land tax to finance all public expenditures.

This is unfortunately not easy to do. First of all, it is quite difficult to separate the value of the structures and of the land on a parcel by parcel basis. Particularly, in the past 15 years when demand has been quite volatile, most of the volatility is due to inflation and deflation in land values. Housing construction costs have risen only at about the rate of inflation nation-wide. Most people who have studied land values, including myself, have used Census data from the Construction Division to calculate replacement costs. The replacement costs are subtracted from total parcel values to derive land values. This could substantially increase the volatility of the base if more tax is placed on land. In fact, land under both commercial and residential property has been extremely volatile.

- Dr. Case, in your testimony, you discuss “imputed rental income” or the belief that a portion of an investment in a house comes in the form of the housing services that it produces over time. You admit, based upon experiences, that including “imputed rental income” as taxable income is difficult politically and administratively. Could you explain the difficulties that arise when trying to define “imputed rental income” as taxable income?

ANSWER: First of all, any time you suggest taxing income that is not directly received in pecuniary form, you run into trouble. If income is received in pecuniary form generated by observable transactions, taxpayers are more willing to accept it. On the other hand, to tell someone that you’re going to tax income that you never receive in a pecuniary form seems unreasonable to people. Despite this, it seems that people understand and accept that some benefits paid in-kind can be considered part of their incomes. My wife and I ran a dormitory at the university where I was a graduate student. We received room and board as part of our compensation for running the dorm and we recognized it as a form of payment/income. But there again, there are transactions to observe, which give you a fairly hard number on which to base the tax.

The problem with housing is first of all, that housing is an enormously heterogeneous asset – no two houses are the same. Most rental housing is in multi-family buildings and often times in different neighborhoods than the bulk of owner-occupied properties, which are largely single-family homes. Coming up with a value for imputed rent for single-family houses is simply a very difficult task.

- Dr. Case, you recommend against abruptly eliminating housing subsidies until Fannie Mae and Freddie Mac issues have been resolved and mortgage risk has been taken off the government’s books. Could you elaborate how getting rid of certain subsidies, such as the mortgage interest deduction, would have a substantial impact on the government’s involvement with Fannie Mae and Freddie Mac?

ANSWER: We know that there is a train coming down the track at a very high speed. The total assets of Fannie Mae and Freddie Mac, which still carry the implicit guarantee is enormous. We also know that banks, mortgage companies, and mono-line insurance companies all own

securities and REO that are not currently held on the books at their market values. In addition, I think there is no stomach in Washington for a system in which the entire risk of a massive portfolio is going to be held in the long-run by the government. So how will the risk be transferred to the private sector? Essentially, as securities are sold back into the marketplace, risk premiums will rise as the value of securities falls, producing a system of risk-based pricing. There is no doubt that this will cause a substantial rise in long-term mortgage rates, which some have estimated at 300 or 400 basis points. The combination of very substantial increases in risk premiums at the same time as regulated banks have stayed away from high LTV lending and the threat of a new regulatory environment will no doubt come as a big blow to an industry already hit by declining wealth and a potential double-dip recession. Housing starts have been at 60 year low levels for 35 months and prices are holding their own only begrudgingly. I think the Fed has been doing the right thing by trying to keep the industry afloat. In the long run, however, assets should be marked to market, except in extreme circumstances.

Testimony of

Dr. Robert Dietz

**On Behalf of the
National Association of Home Builders**

**Before the
United States Senate
Committee on Finance**

Hearing on

Tax Reform Options: Incentives for Homeownership

October 6, 2011

On behalf of the 160,000 members of the National Association of Home Builders (NAHB), I appreciate the opportunity to testify today. My name is Robert Dietz, and I am an economist and Assistant Vice President for NAHB. My area of focus is housing tax policy. I received my Ph.D. in economics from The Ohio State University in 2003.

NAHB represents builders and developers who construct housing ranging from single-family for-sale homes to affordable rental apartments and remodelers. The Internal Revenue Code currently provides numerous housing-related rules and incentives covering both owner-occupied and rental units, ranging from the Low Income Housing Tax credit to the mortgage interest deduction. The focus of this hearing today is owner-occupied housing tax policy, and I will direct my testimony to those tax rules.

Few industries have struggled more during the Great Recession than the homebuilding industry. The decline in home construction has been historic and unprecedented. Single-family housing production peaked in early 2006 at an annual rate of 1.8 million homes but construction fell to 353,000 per year in early 2009, an 80% decline in activity. A normal year driven by underlying demographics should see 1.5 million single-family homes produced. If home building were operating at a normal level, there would be 3.3 million more jobs in home building and related trades.

There are a number of owner-occupied housing tax incentives in the Code that help make owning a home affordable and accessible to millions of Americans. These include the mortgage interest deduction, the deduction for local property taxes, the principal residence capital gains exclusion, and mortgage revenue bonds. In addition, Congress in recent years has also provided as part of the annual tax extenders package an additional standard deduction for property taxes that can be claimed by non-itemizers. In my testimony, I will be focusing today on the mortgage interest deduction and the capital gains exclusion.

The Benefits of Homeownership

Homeownership offers a wide range of benefits to individuals and households.¹ These include increased wealth accumulation, improved labor market outcomes, better mental and physical health, increased financial and physical health for seniors, reduced rates of divorce, and improved school performance and development of children. These beneficial financial and social outcomes are due to the stability offered by homeownership, as well as the incentives created by the process and responsibilities of becoming and remaining a homeowner.

An important motivating factor in the pursuit of homeownership is the investment opportunity it offers for many families. Despite recent price declines, equity in a home constitutes a substantial proportion of a typical American family's wealth. According to the 2007 Federal Reserve Survey of Consumer Finances, the median net worth of a homeowner is \$234,600; for renters, it was \$5,100.

Homeownership also provides advantages for seniors. A significant proportion of a household's wealth is in the form of equity of owner-occupied housing, and this wealth provides significant advantages in

¹ R.D. Dietz and D.R. Haurin, The social and private micro-level consequences of homeownership, *Journal of Urban Economics* 54 (2003) 401-50.

retirement. Mayer and Simons (1994) indicate that equity in the home and the use of a reverse mortgage could increase liquidity for senior households by as much as 200%.²

Research in the social sciences and the medical field has often noted the benefits offered by homeownership with respect to the mental and physical health of household members. Numerous studies find that homeowners have better health and greater life expectancy than renters.³ Homeowners tend to better maintain their dwellings, and this effect may be responsible for the observed benefit on physical health.⁴

Homeownership also improves the strength of families by reducing the probability of divorce.⁵ Bracher *et al.* (1993) attribute this positive effect to the financial and residential stability offered by homeownership.⁶ This effect may also be related to the increased life satisfaction reported by homeowners.⁷

Among the social benefits of homeownership, the impact on a household's children is potentially the most far reaching. The set of impacts favorably affected by homeownership includes health, school performance, graduation rates, probability of teen pregnancy and other behavior measures.⁸ In addition to a reduced probability of divorce, social scientists have suggested several reasons why homeownership status for a household improves this set of outcomes for children. First, becoming a homeowner requires skills and characteristics that are useful for parenting.⁹ Other skills, such as financial sophistication and job market success, become observed behavior and are passed to children. Homeowners tend to reside in a location for a longer period of time, and this stability helps parents monitor and mentor children. Finally, as stakeholders in the community, homeowners are concerned with their property values, and this incentive leads homeowners to be concerned with the activities of

² C. J. Mayer, K. V. Simons, Reverse mortgages and the liquidity of housing wealth, *AREUEA Journal* 22 (1994) 235-55.

³ S. Macintyre, A. Ellaway, G. Der, F. Graeme, K. Hunt, Do housing tenure and car access predict health because they are simply markers of income or self-esteem? A Scottish study, *Journal of Epidemiology and Community Health* 52 (1998) 657-664.

S. A. Robert, J. S. House, SES differentials in health by age and alternative indicators of SES, *Journal of Aging and Health* 8 (1996) 359-388.

⁴ M. Shaw, D. Dorling, N. Brimblecombe, Life chances in Britain by housing wealth and for the homeless and vulnerably housed, *Environment and Planning A* 31 (1999) 2239-2248.

⁵ F. Finnas, Economic determinants of divorce in Finland, *Ekonomiska Samfundets Tidskrift* 53 (2000) 121-132.

⁶ M. Bracher, G. Santow, S.P. Morgan, J. Trussell, Marriage dissolution in Australia – models and explanations, *Population Studies* 47 (1993) 403-425.

⁷ S. Lane, J. Kinsey, Housing tenure status and housing satisfaction, *Journal of Consumer Affairs* 14 (1980) 341-65.

⁸ T. P. Boehm, A. M. Schlottman, Does homeownership by parents have an economic impact on their children? *Journal of Housing Economics* 8 (1999) 217-232.

⁹ R. K. Green, M. J. White, Measuring the benefits of homeownership: Effects on children, *Journal of Urban Economics* 41 (1997) 441-461.

their own children, their peers, and those institutions responsible for children's development and growth.¹⁰

Another social impact of homeownership is the likelihood of suffering from crime. A review of the research concerning the determinants of crime reveals that homeownership status for a household or individual reduces their likelihood of suffering a loss from criminal activity. For example, Alba *et al.* (1994) examine the incidence of property and violent crime in the suburbs of the metropolitan area of New York City.¹¹ Among their findings, the authors report that homeownership status significantly reduces a household's incidence of crime. Indeed, homeownership proves to be the second most powerful variable, income being the first, for explaining the incidence of crime. In another study, Glaeser and Sacerdote (1999) examine city crime rates using FBI data.¹² Their analysis indicates that homeowners have significantly less risk of being subject to a violent assault.

Overall, economists, sociologists and other social scientists have found significant, positive homeownership-related impacts on a large set of outcomes associated with households and communities.¹³ For these and other positive impacts, homeownership has and should continue to have a favorable place in the tax code.

Capital Gains Exclusion

Brief History of the Capital Gains Exclusion

Prior to 1997, capital gain due to sale of a principal residence was governed by a complicated set of rollover and exclusion rules.

The *Revenue Act of 1951* allowed a taxpayer to "roll over" the capital gains received from the sale of a principal residence if, within one year, the taxpayer used the gain to acquire a new residence of equal or greater value. The roll over period was later extended to 18 months under the *Tax Reduction Act of 1975* and to 24 months in the *Economic Recovery Tax Act of 1981*. Thus no capital gains taxes were generated until a homeowner purchased a principal residence of smaller value than their previously owned residence or ceased to be an owner of a principal residence.

¹⁰ D. R. Haurin, T. L. Parcel, R. J. Haurin, The impact of homeownership on child outcomes, in: N. Retsinas and E. S. Belsky (Eds.), *Low-Income Homeownership: Examining the Unexamined Goal* Brookings Institution Press, Washington, DC, 2002, pp. 427-446.

¹¹ R. D. Alba, J. R. Logan, P. E. Bellair, Living with crime: The implications of racial/ethnic differences in suburban location, *Social Forces* 73 (1994) 395-434.

¹² E. L. Glaeser, B. I. Sacerdote, Why is there more crime in cities? *Journal of Political Economy* 107 (1999) S225-S258.

¹³ Two comprehensive literature reviews detailing the impacts of homeownership are: W. M. Rohe, G. McCarthy, S. Van Zandt, *The social benefits and costs of homeownership: A critical assessment of the research*, Research Institute for Housing America, Working Paper No. 00-01 (2000). R. Dietz and D. Haurin, The social and private micro-level consequences of homeownership, *Journal of Urban Economics* 54 (2003) 401-50.

The *Revenue Act of 1964* introduced the first exclusion of capital gains arising from the sale of a principal residence. Under this law, taxpayers 65 years or older could exclude up to \$20,000 in capital gains if they owned the house for at least eight years and lived in the home for at least five. The *Tax Reform Act of 1976* later increased this exclusion to \$35,000.

The *Revenue Act of 1978* made a series of additional changes to the tax treatment of capital gains on the sale of principal residence. It lowered the minimum eligible age for the gains exclusion from 65 to 55 and increased the exclusion amount to \$100,000. It also allowed a taxpayer to elect a one-time capital gains exclusion on the sale of a principal residence as long as the taxpayer lived in the home for three of the last five years. The *Economic Recovery Tax Act of 1981* increased the \$100,000 exclusion to \$125,000.

Simplification Arrives: The Changes of 1997

The Taxpayer Relief Act of 1997 vastly simplified the complicated roll over and gains exclusion rules by repealing them and starting over. In their place, Congress allowed a taxpayer to exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion could be claimed no more than once every two years. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.

These changes represented a significant improvement over what was, according to the Joint Committee on Taxation, “among the most complex tasks faced by a typical taxpayer.”¹⁴ As Joint Tax noted, despite the fact that most homeowners never paid tax on the sale of their principal residence due to the previous rollover and exclusion roll rule, it was necessary to keep detailed records of both purchase and sales transactions, but also remodeling expenditures in order to accurately calculate the tax basis of their home. Adding complexity to this record keeping requirement was separating expenditures for repair and improvement that added basis to the home and those that did not. Finally, the deferral of gain based on purchasing a more expensive home as a homeowner moved through their lifecycle was also inefficient in that it may have deterred some homeowners from moving from high-cost to low-cost areas.

Congress has adopted one subsequent change that was included in the *Housing and Economic Recovery Act of 2008* (HERA) to prevent speculators from abusing the capital gains exclusion. The 1997 reforms established the “two-of-five” test that defined a principal residence as one where a homeowner had used the home as a primary residence for two years of the five year window prior to sale. This created a scenario whereby an owner of a residence could hold the property for a long period of time, reside in it for two years, and then claim the gain exclusion. While this taxpayer may have owned the residence, they were most likely using it as a rental property for the majority of the years of ownership. This “gaming” of the system was inconsistent with the spirit of the law, which had a focus on principal residence ownership.

¹⁴ General Explanation of Tax Legislation Enacted in 1997, Joint Committee on Taxation, December 17, 1997, JCS-23-97).

The National Association of Home Builders supported the fix Congress passed to prevent a taxpayer from excluding the gain earned during periods of nonqualified use. The HERA change effectively shut down the ability of speculators to use the gain exclusion while protecting the 1997 enacted reduced recordkeeping and calculation requirements.

Removing or otherwise weakening the gain exclusion for the sale of a principal residence would have two strongly negative effects for existing homeowners. First, it would lay a direct and unexpected tax bill on homeowners who expected to use housing equity as a source of retirement wealth. Second, weakening the gain exclusion would reduce demand for housing by increasing the lifetime tax burden on principal residences. A reduction in demand would push housing prices down, thereby inflicting a windfall loss on existing homeowners. Of course, since a significant share of homeowner wealth is due to housing equity, eliminating the gains exclusion would have far reaching consequences.

While much of the attention of the tax policy community is on the gain rules for principle residence sales, in an environment where home prices are down 30% on a national basis, it is also worthwhile to note the limitations on claiming a tax loss from the sale of a principal residence. In general, a loss incurred on the sale of a personal residence is a nondeductible personal loss for income tax purposes. It is worth noting this rule is different than losses for the sale or exchange of a financial investment for which the loss can be deducted against capital gains income.

Overall, it is also important to remember that there are various—and sometimes differing—tax benefits and burdens that are levied on investments, both housing and financial. And analysts debating federal tax policy often ignore the state and local government tax burden placed on housing via property tax—a tax burden not placed on financial investments. For 2010, total property tax collections by state and local governments summed to \$472.5 billion. NAHB estimates that two-thirds of these collections were due to housing for a total of \$315 billion. Data from the Census Bureau indicates that the average homeowner pays property tax at an effective tax rate of 1.1% of the market value. Such tax on property value differs from income tax in that the tax is levied on the value of the asset rather than a flow of net income. While housing receives some unique benefits in the tax code, like the capital gains exclusion, housing also faces a tax burden that other investments do not.

Mortgage Interest Deduction

Brief History of the Mortgage Interest Deduction

When Congress created the modern income tax code in 1913, Congress recognized the importance of allowing for the deduction of interest paid on debt incurred in the generation of income. In this early code, taxpayers were permitted to deduct a wide-range of interest from business and personal debts, including mortgage interest. The mortgage interest deduction came into its own after World War II, when home ownership became more accessible and a rite of passage for the middle class. Deductions

for mortgage interest grew in absolute numbers, homeownership rates increased during this period, and today two-thirds of American households own a home.¹⁵

In reforming the tax code in 1986, Congress disallowed the deduction of interest payments for certain types of debt but maintained the popular deduction for mortgage interest. In doing so, "...Congress nevertheless determined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest."¹⁶ Aside from some adjustments in 1987, the mortgage interest deduction remains unchanged since Congress' historic rewrite of the tax code 25 years ago.

Tax Rules for the Mortgage Interest Deduction

Homeowners may deduct interest from up to \$1 million of acquisition debt and up to \$100,000 of home equity loan debt. Mortgage debt from the taxpayer's principal residence, as well as a second, non-rental home qualifies. Mortgage interest paid for the purposes of acquiring, building, or substantially improving a qualified home may also be claimed against the Alternative Minimum Tax (AMT).

The \$1 Million Cap and Limits to the Mortgage Interest Deduction

Starting with the first tax code in 1913, there was no limit on the amount of home mortgage interest that could be deducted. However, the *Tax Reform Act of 1986* imposed limits on the deduction. This law limited the deduction to interest allocable to debt used to purchase, construct or improve (acquisition debt) a designated primary residence and one other residence.

The Omnibus Budget Reconciliation Act of 1987 further limited the deduction to interest allocable to up to \$1 million in acquisition debt. This limit is not adjusted for inflation. Factoring in the impact of inflation, the value of the cap has eroded by nearly half since 1987; in 2011 dollars, the original cap would be equal to nearly \$2 million.¹⁷

Who Benefits from the Mortgage Interest Deduction

Within the tax policy circles, there are a number of repeated criticisms of the mortgage interest deduction. Some of these claims are misleading, while others ignore the importance of debt, lifecycle, and geography in attainment of homeownership. NAHB has published a number of papers using Internal Revenue Service Statistics of Income data, estimates from the Joint Committee on Taxation, and general housing data from the U.S. Census to examine these claims.

A common, though misleading, criticism of the mortgage interest deduction is that it is claimed by a relatively small number of taxpayers, and the benefits accrue mostly to higher-income taxpayers. When viewed relative to the reporting of taxable income, the distribution of tax liability, and the use of other

¹⁵ U.S. Census Bureau: <http://www.census.gov/hhes/www/housing/hvs/qtr211/q211ind.html>

¹⁶ "General Explanation of the Tax Reform Act of 1986", Joint Committee Print, Prepared by the Staff of the Joint Committee on Taxation, May 4, 1987. Pg 263-264.

¹⁷ Bureau of Labor Statistics CPI Inflation Calculator. \$1,000,000 in 1987 equates to \$1,994,234 in 2011. http://www.bls.gov/data/inflation_calculator.htm

tax preferences, these claims lack merit. These inaccurate observations also lead to flawed conclusions regarding the distribution of impacts associated with these housing deductions.

For example, the most common erroneous claim is that the mortgage interest deduction is regressive and only benefits the wealthy. Not only is the mortgage interest deduction a middle-class tax break, but it makes the tax code more progressive.

According to the distributional tax expenditure estimates from the Joint Committee on Taxation (JCT), 90% of mortgage interest deduction beneficiaries earn less than \$200,000 in economic income. And 70% of the net tax benefits are collected by homeowners with economic income of less than \$200,000.¹⁸ It should be noted that the income classifier used by Joint Tax for these distribution analyses is economic income, a definition that generates incomes higher than adjusted gross income (AGI) (for example, economic income includes employer-paid health insurance premiums and payroll tax). Accordingly, these estimates understate the benefits collected by the middle class on the more recognized AGI income definition.

The Mortgage Interest Deduction is Progressive

A progressive tax system is one for which low-income taxpayers pay a smaller percentage of their income in taxes than high-income taxpayers pay. A policy that reduces tax liability for low-income taxpayers lowers their average tax rate and thus makes the income tax system more progressive.

The mortgage interest deduction has this effect on the tax code. Taxpayers with economic income of less than \$200,000 pay only 43% of all income taxes paid, yet receive 70% of the mortgage interest deduction benefit. Using IRS data, NAHB has calculated that for taxpayers with AGI less than \$200,000, the mortgage interest deduction is worth on average 1.76% of AGI. For taxpayers with AGIs above \$200,000, it is worth less, only 1.5% of AGI.¹⁹ Not only is the benefit of the mortgage interest deduction realized predominantly by the middle class, but the data clearly shows that the benefit declines in value as a percentage of income as income rises.

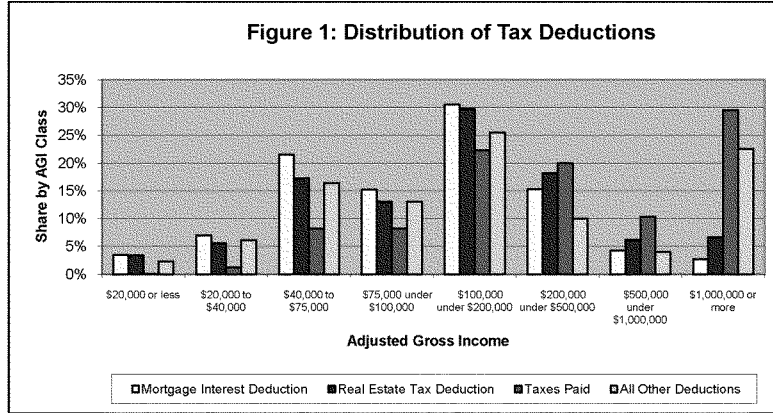
As seen in the chart below, Figure 1 illustrates the critical point when considering the income distribution of the housing tax deductions relative to other tax expenditures.

¹⁸ Estimates of Federal Tax Expenditures for Fiscal Years 2010 – 2014.

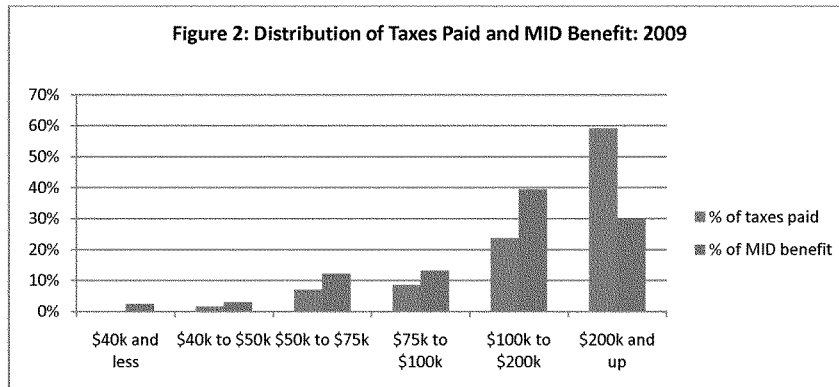
<http://www.jct.gov/publications.html?func=startdown&id=3718>

¹⁹ Who Benefits from the Housing Tax Deductions?

<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311>



The progressive nature of these tax preferences can be seen by noting that claims of the mortgage interest deduction (as well as the real estate tax deduction) exceeds final tax liability for AGI classes up to \$200,000. Figure 1 presents deduction amounts, but it can also be seen for the final distribution of tax benefits (i.e. tax expenditures) relative to taxes paid. Figure 2 demonstrates this with 2009 JCT data. Again, the benefit of the mortgage interest deduction exceeds taxes paid for income classes up to \$200,000.



In other words, if the mortgage interest deduction were eliminated, the income tax system would become less progressive. Moreover, these housing deductions are more progressive than the set of other itemized deductions.

The Majority of Homeowners Will Claim the Mortgage Interest Deduction

Another misleading claim is that few homeowners benefit from the MID because itemization is required. Opponents of the mortgage interest deduction note, for example, that only a quarter of tax filers itemize, leading some to conclude that only a small percentage of homeowners claim the MID. This is false.

The most important determinant of taxpayer itemization is homeownership. The Joint Committee on Taxation (JCT) estimates reveal that 34.6 million taxpayers claimed the MID for tax year 2009. While this number represents 22% of all tax returns, it is in fact 46% of all taxable returns and nearly 70% of itemizing returns. The more relevant numbers, however, are the shares of homeowners. There are 75 million homeowners in the U.S., so approximately half *in a given year* claim the MID. However, approximately 25 million of that 75 million own their homes free and clear of a mortgage (but likely benefited from the MID in the past). This means of the homeowners with a mortgage, 70% claim the MID.

Of those who do not, most are older homeowners in the later years of the mortgage when they are paying relatively more principal and relatively less interest. For these homeowners, the standard deduction is a better option.

Using Bureau of Economic Analysis data, NAHB estimates that over the last decade, 86% of mortgage interest paid has been claimed as a deduction on Schedule A. Taxpayers benefit from the homeownership tax deductions at specific times during their lives. And cumulatively, these numbers illustrate that over the tenure of homeownership, almost all homeowners will claim the MID for years at time, particularly as first-time homebuyers paying large amounts of interest and relatively little principal.

As an analogy, consider the following non-housing example. The 2005 IRS SOI data reveal that only 8 million taxpayers benefited from the tax code's interest deduction for student loans. This represents approximately 6 percent of all taxpayers. Nonetheless, the student loan interest deduction is, like the mortgage interest deduction, a tax preference claimed at a particular time in an individual's life, and does not represent a tax preference that benefits only a narrow set of taxpayers, despite its low number of claimants in a single year.

Family Size Matters

The lifecycle aspects of homeownership also produce another interaction with housing tax preferences. It is often claimed that the mortgage interest deduction encourages homeowners to purchase a larger home. This presents a rather narrow view. Homeowners with a larger family need a larger home and will therefore have a large mortgage interest deduction. The need for a larger home created the larger mortgage interest deduction, not the other way around. And NAHB analysis of SOI data confirms this.²⁰ Taxpayers with two dependents who claimed the MID had an average tax benefit of \$1,500. Taxpayers

²⁰ Who Benefits from the Housing Tax Deductions?

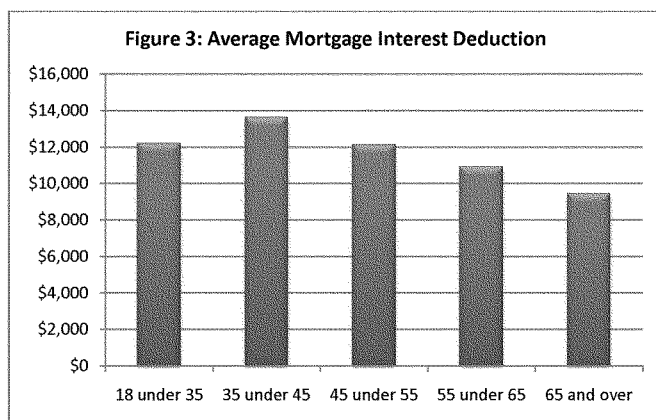
<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311>

with four dependents had an average benefit of approximately \$1,950. In fact, the benefit increased correspondingly from one dependent to five-plus dependents, which is intuitive with the notion that larger families require larger homes. Moreover, the cost of living, particularly for housing, varies greatly from city to city, so what may appear to be a large deduction for a given home in one area, may in fact reflect a modest home in a high cost area. Indeed, the MID and the real estate tax deductions reflect one of the few elements in the tax code that account for differences in cost-of-living.

And Age Matters

Along with the lifecycle associated with family size, we also see a direct correlation between the age of the homeowner and their resulting benefit from the housing tax incentives. Unlike other itemized deductions, the total benefits of housing-related deductions, such as the mortgage interest deduction, generally *decline* with age. After all, it is younger households who typically have new mortgages, less amount of equity, and growing families.

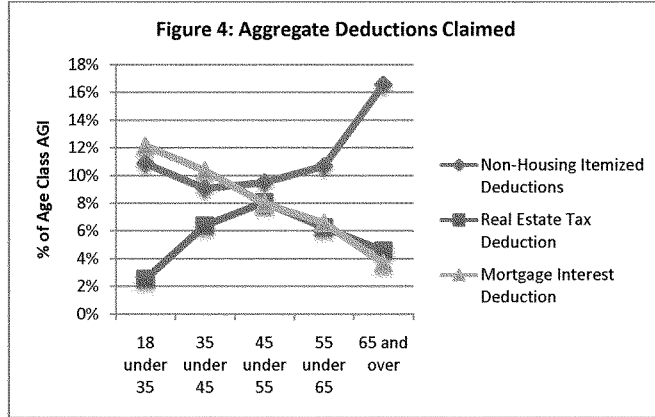
Using IRS data, I have examined the age characteristics of taxpayers claiming the mortgage interest deduction. Figure 3 plots the average mortgage interest deduction²¹ by age cohort.



This is consistent with the deduction for mortgage interest peaking soon after the taxpayer moves from renting to homeownership and then declines as homeowners pay down their existing mortgage debt.

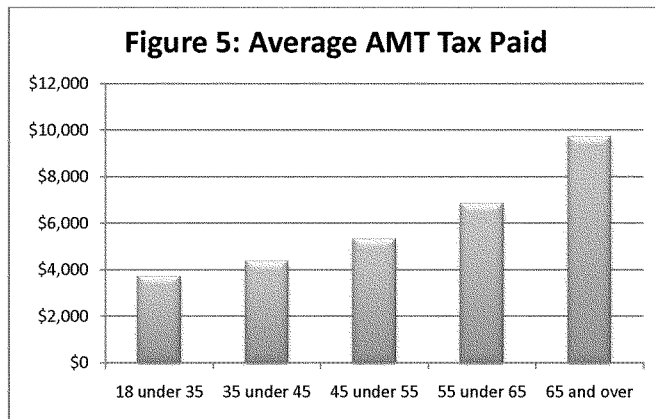
Figure 4 shows this data as shares of AGI. The data reveal that the mortgage interest and the real estate tax deductions fall as a share of taxpayer income for older taxpayers.

²¹ This includes the deduction for home equity loans and real estate tax deductions. See *Housing Tax Incentives: Age Distribution Analysis*, by Robert Dietz, May, 2, 2010. http://www.nahb.org/fileUpload_details.aspx?contentID=149284&fromGSA=1



As a share of household income, the largest benefit goes to those aged 18 to 35. Together, this data highlights the fact that the mortgage interest deduction strongly benefits younger households who tend to be recent homebuyers with less home equity.

NAHB would urge the committee, if considering possible changes to the housing tax discussions, to request that the Joint Committee on Taxation look beyond the typical income distribution analysis. The conclusions presented here suggest that proposals to change these deductions should also examine the generational or age-cohort consequences. For example, President Bush's 2005 tax reform panel recommended limiting the real estate and mortgage interest deduction to pay for, among other items, a reduction in the AMT. As Figure 5 shows, the average AMT tax paid increases significantly with age.



While the tax reform panel's suggestion may not have shown as a major change in an income distribution analysis, Figure 5 and the results outlined above indicate that such a proposal would reduce a tax benefit that is of relative importance to younger households in order to increase a tax benefit for older households. Generational impacts like this are often not discussed by tax policy analysts in lieu of traditional income distributional analysis, but the long-term effects are potentially significant. This is why NAHB believes that part of designing a fair tax system involves looking at the effects on both income distribution and across age groups.

Home Prices and Affordability

Most studies find that elimination or significant weakening of the mortgage interest deduction would reduce prices for owner-occupied homes, perhaps by as much as 15% depending on local market conditions (average income, housing supply response, and other economic factors). The exact amount depends to a great degree on how much of the tax benefit is capitalized into prices, which in turn depends on the ease of home builders to provide additional housing units. In markets where new supply is difficult to add, the capitalized value may be large. In markets where new supply is easier to add, the capitalized value may be small.

This is important because one claim made by opponents is that eliminating the deduction would cause prices to fall and affordability to increase. But this claim ignores the role that debt plays in buying a home. If the after-tax cost of servicing the mortgage increases due to the removal of the interest deduction, the cost of homeownership can actually rise even as the price of the home falls. For example, assume a married couple earning \$90,000 and in the 25% tax bracket. Suppose the household buys a \$200,000 home and puts down 20% (\$40,000). They obtain a \$160,000 mortgage at a 5% interest rate. In the first year of their mortgage, they will pay approximately \$2,159 in principal and \$7,289 in interest.

Now the value of their mortgage interest deduction is based on the amount of the interest payment that exceeds the difference between the standard deduction and the sum of their other Schedule A items. If the sum of their Schedule A possible deductions is less than the standard deduction, they of course do not itemize. If only \$1,000 of mortgage interest exceeds the standard deduction, when stacked on top of all other itemized deductions, then only that \$1,000 yields a tax benefit from the MID.

Using 2009 Statistics of Income data from the IRS, we can estimate reasonable values of these itemized deductions for a taxpayer in this income class. Assume the couple pays \$4,500 in state/local income taxes, \$2,200 in property taxes (Census data indicate an average 1.1% effective tax rate on homes), \$2,500 for charitable deductions, and a little more than \$1,500 for all other Schedule A items. This yields a total of \$10,700 for non-mortgage interest deduction Schedule A items, and total deductions of \$17,989.

To properly account for the tax benefit from the mortgage interest deduction, we subtract the standard deduction for a married couple (\$11,600) from the total of non-mortgage interest deductions (\$10,700), for a difference of \$900. The mortgage interest deduction benefit should then be reduced by \$900 to a total of \$6,389 in order to estimate the realized benefit: \$6,389 times 25% or \$1,597.

Suppose, as a counterfactual, the mortgage interest deduction has been eliminated and home prices fall by 10%. The couple now purchases a revised priced \$180,000 home. They use a 20% downpayment and obtain a mortgage of \$144,000 at a 5% interest rate. They now pay \$6,560 in interest and \$1,943 in principal in the first year.

Despite the 10% decline in price, the total cost of servicing the debt for the home increased. The after-tax interest payment in the MID regime is \$5,692 (\$7,289 minus the \$1,597 MID benefit) compared to \$6,560 with no MID and a 10% price reduction. In other words, despite the price decline, the after-tax user cost of the home actually increased \$868²². And all existing homeowners suffered a 10% windfall loss to housing wealth due to the price decline.

Second Homes and the Mortgage Interest Deduction

Tax Rules for the Second Home

Homeowners may deduct interest payments on up to two homes in a given tax year: a primary residence and one other residence. The amount that may be deducted is still limited to the combined cap of \$1 million in acquisition debt. A second home is one that is not rented²³ and is not the homeowner's primary residence. In addition, a second home can also be a home under construction for which the homeowner has an outstanding construction loan.

The Geographic Distribution of Second Homes

NAHB estimates that there are 6.9 million non-rental second homes, which totals more than 5% of all housing units in the United States. When most Americans think of second homes, thoughts typically go to expensive beach homes. However, such homes are more likely to be owned by higher-income families who own the home free and clear of a mortgage—or rent out the home, in which case the owner does not claim the mortgage interest deduction. The face of the typical second home owner is more varied than most realize.

In practice, the second home deduction is important for many households who in fact do not think of themselves as owning two homes. For example, the second home deduction facilitates claiming the mortgage interest deduction during a period of homeownership transition, such as when a family relocates and will own two separate principal residences in a given tax year. In theory, without the second home MID, this family would only be able to claim an interest deduction on a portion of their total mortgage interest payment. Further, the second home rules allow up to 24 months of construction loan interest on a newly-constructed home to be claimed while the family resides in their existing principal residence.²⁴ This rule provides parity for custom home building where the eventual

²² If principal payments, which represent savings, are included, housing costs increase by \$652.

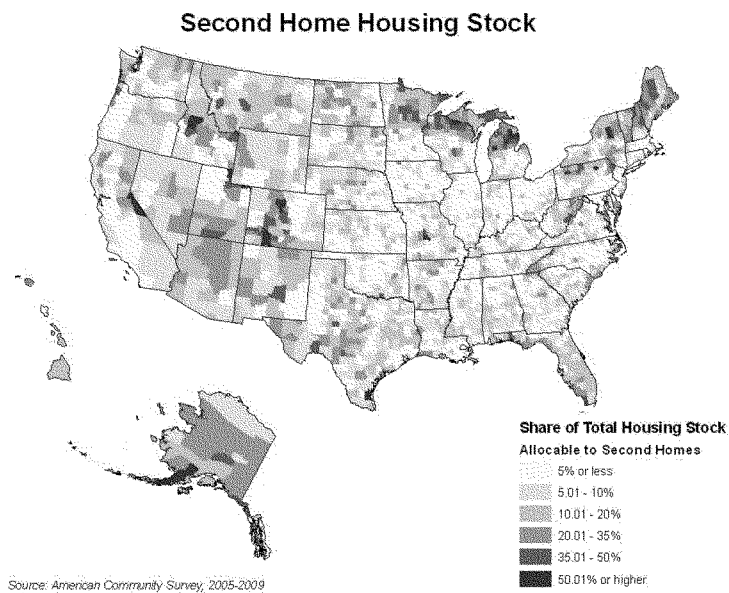
²³ Interest on debt used to acquire rental units may also in general be deducted under the tax code, but not under the mortgage interest deduction; it is a general business expense.

²⁴ Treasury Regulations 1.163.

homeowner finances the cost of construction. This form of construction is a larger share of home building today due to the recent decline in the housing market.

Using Census data, NAHB estimated the stock and share of such tax definition-based second homes and the results contrast with the stereotyped view of the second home mortgage interest deduction favoring beach homes. Nearly every state has areas with significant numbers of second homes; 49 states have a county where at least 10 percent of the housing stock consists of second homes.²⁵ The data showed 26 counties where 50 percent or more of the housing stock is second homes. Six of those counties are in Michigan; five in Colorado, two each in Pennsylvania, Utah, Massachusetts, and California, and one each in New York, Alaska, Idaho, Missouri, Wisconsin, Texas, and New Jersey. As Figure 6 shows, second homes are found throughout the country.

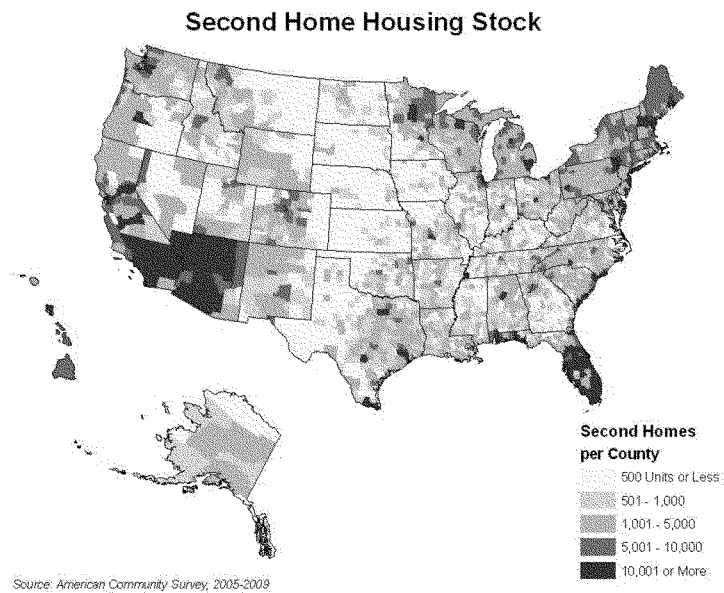
FIGURE 6



²⁵ Connecticut is the only state that did not have at least one county where 10% of the housing stock was a second home.

It is also important to look at geographical breakout based on aggregate numbers of second homes. Dense urban areas may have a significant number of second homes but they may represent only a small number of the total housing stock. In fact, there are 12 states with at least one county with 25,000 or more second homes: Florida, California, New Jersey, New York, Texas, Delaware, Michigan, South Carolina, Nevada, Massachusetts, Illinois, and Arizona. Figure 7 illustrates the count of second homes throughout the country.

Figure 7



Clearly, the issue concerning second homes and the mortgage interest deduction is more complicated than many expect. Repeal of the second home mortgage interest deduction rules would impact large sections of the country and nearly every state. There would be negative economic consequences throughout the nation in terms of lost home sales, home construction, as well as price impacts. And those price declines would of course be more significantly realized in those areas of the country for which second home ownership is more common. As home values directly correlate with property taxes, repealing the second home mortgage interest deduction would not just touch the homeowner, but the broader community, as local governments would face additional revenue shortfalls.

Home Equity Deduction

Present tax law also permits homeowners to deduct interest allocable to up to \$100,000 of home equity loan debt. Such loans are defined as mortgages taken against a home that are not used for purchase, construction or improvement purposes. This distinction carries over in the rules for the Alternative Minimum Tax. In general, deductions for mortgage interest may be claimed against AMT taxable income. However, there is an exception for home equity loans not used for home improvement purposes.

According to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is, of course, another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

There is no data that indicates what the remaining half of home equity loans are used for, but anecdotal evidence suggests that those purposes include college expenses, health emergencies and some consumption purposes.

Remodeling and home improvement are important economic activities for a nation with an aging housing stock. Remodeling expenditures totaled \$147 billion for professional remodeling jobs, according to 2009 American Housing Survey data. Every \$100,000 in remodeling expenditures creates 1.11 full-time equivalent jobs according to NAHB estimates.²⁶ So this economic activity supported 1.63 million jobs in the construction and related sectors (such as manufacturing and retail).

Recent Proposals to Reduce the Mortgage Interest Deduction

National Commission on Fiscal Responsibility and Reform: Simpson-Bowles

Last year, under the auspices of the National Commission on Fiscal Responsibility and Reform, a tax reform proposal was released by the two co-chairmen, Alan Simpson and Erskine Bowles. While their proposal was not adopted by the Commission, their illustrative example for tax reform has drawn much attention.

In their illustrative example, they proposed to create three marginal tax rates—12%, 22%, and 28%—in exchange for eliminating nearly every deduction and tax credit. The plan does not eliminate the mortgage interest deduction but would convert it into a 12% non-refundable tax credit. The current \$1 million mortgage cap would be lowered to \$500,000. And no deduction/credit would be permitted for second homes or home equity.

This proposal would have a significant impact on middle-class homeowners. For example, suppose a married couple, both of whom work and earn \$45,000 for a total household income of \$90,000. The

²⁶ <http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311>

family faces a 25% marginal income tax rate. Under present law, a dollar of mortgage interest paid is worth on a marginal basis 25 cents of reduced tax liability. Under the commission's proposal, the marginal value would fall more than half to 12 cents. For an average sized home and mortgage for a family with this income, the MID is worth about \$3000.²⁷ Under the tax credit, it would be worth less than \$1,500. That is the equivalent of raising their mortgage payment by \$125 per month.

The plan also would eliminate the capital gains exclusion and would tax capital gains at ordinary income rates. This would have a dramatic impact on older homeowners, particularly those depending on their home equity for retirement. Without the gain exclusion, sale of a home may result in the taxpayer appearing to be a high income earner, when they are really just reporting years worth of capital gains due to a home sale in a single tax year. This "King for a Day" effect would likely push the homeowner into the top tax brackets, a significant tax increase from a gain that is currently excluded from any tax. This effect can also be true for stocks and other financial investments, but of course the nature, size and scale of a home make this problem a much more significant issue for homeowners.

While the low rates have certainly caught a lot of attention, it is important to note that the Commission appeared to use tax expenditure estimates to estimate the revenue necessary to achieve its proposed tax rates. Many in the tax community have also used these estimates to propose lower rates, but a tax expenditure estimate is not a revenue estimate. A revenue estimate includes microdynamic changes in taxpayer behavior (while still holding GDP constant). And weakening the mortgage interest deduction would certainly cause changes in behavior that would lower the anticipated revenue. This is true of other tax expenditures as well. Moreover, summing tax expenditure estimates generates double counting due to the role of the standard deduction and other more complicated tax factors. On the whole, the result is that actual revenue estimates would be significantly lower than the summation of tax expenditure estimates. If the Commission had used conventional revenue estimates, they would not be able to achieve the rates proposed.

But another issue is worth considering. Lower rates do not necessarily imply lower tax liabilities. While lower marginal income tax rates can spur economic growth, average tax rates (taxes paid divided by income) matter as well. Lower rates on a larger tax base can yield higher taxes paid. And in fact, the Commission's report indicated that all taxpayers would face an average tax increase of 9.3 percent despite the lower marginal tax rates. This is important to keep in mind when considering the impacts on comprehensive tax reform proposals and their effect on housing and other economic activities.

Limiting Deductions to the 28% Bracket

On several occasions, President Obama has proposed limiting itemized deductions to the 28 percent bracket. Most recently, the President included an expanded version of this limitation as a recommended pay-for for the proposed *American Jobs Act*.

²⁷ The example assumes the couple itemizes given reasonable values of real estate taxes, state/local income taxes, personal property taxes, and other Schedule A items.

This proposal would limit the size of certain deductions and exclusions to a 28 percent rate for high-income taxpayers (single taxpayers reporting more than \$200,000 in adjusted gross income (AGI) and joint filers who report more than \$250,000 in AGI). As in previous versions of this proposal, the change would reduce the value of the mortgage interest deduction and the real estate tax deduction. For a taxpayer who lives in a high cost area and faces a 33% marginal tax rate, the value of the housing-related tax deductions could be reduced by up to 15%, thereby producing significant tax increases.

The impact of this proposal would not be limited to tax increases of affected homeowners. According to an analysis done by the Tax Policy Center, such a move could reduce housing prices in large metropolitan areas by as much as 10 percent.²⁸ As we have seen in the past few years, price declines result in significant market disruptions and cause ripple effects across the economy.

However, the 28 percent cap proposal in the *American Jobs Act* is even larger than previous versions. Tax-exempt bonds would no longer be tax-exempt. A portion of the bond income would now be taxable for high-income taxpayers, who being a significant portion of bond buyers could produce negative impacts for state and local governments to raise funds. Among the bonds that would be affected would be tax code section 142 multifamily rental bonds and section 143 mortgage revenue bonds, which provide funds for affordable mortgage financing for homebuyers.

Moreover, the proposed 28 percent cap would also affect a number of above-the-line deductions (deductions that can be claimed by itemizers and non-itemizers), such as the adjustment for qualified moving expenses, as well as the section 199 domestic production activities deduction. The reduction of the section 199 deduction, which can reduce taxable income up to 9 percent for home builders and other construction and manufacturing businesses, is particularly troublesome in that it would single out businesses organized as pass-thru entities (such as S Corporations and LLCs) but leave C Corporations unaffected.

Limiting Deductions to 2% of AGI

Martin Feldstein and his colleagues recently recommended capping itemized deductions and certain tax credits to a maximum tax expenditure value of 2 percent of adjusted gross income.²⁹

This proposal would have significant consequences for housing markets because of the importance of the mortgage interest deduction and the real estate deduction to homebuyers, particularly younger homebuyers in the early years of a mortgage when they are paying relatively more interest and less principal on a loan.

To see just how restrictive a two percent AGI cap is, NAHB estimates that for taxpayers with less than \$200,000 in income, the average tax benefit of the mortgage interest deduction is 1.76 percent of AGI and 0.7 percent of AGI for the real estate deduction. Thus, without even considering the state/local income tax deduction, the charitable deduction, and many other tax expenditures that most

²⁸ http://www.taxpolicycenter.org/UploadedPDF/1001364_reforms_metro_housing.pdf

²⁹ http://www.nytimes.com/2011/05/05/opinion/05feldstein.html?_r=2

homeowners typically claim, the average homeowner is over the limit and subject to tax increases under the proposal.

Since the mortgage interest deduction is primarily a middle-class tax break, the impacts of the proposal are concentrated on the middle class. As a percentage of AGI, taxpayers earning \$50,000 to \$300,000 would see their taxes increase by 3.4 percent of AGI. Taxpayers earning more than \$500,000 would see a decline of only 2.7 percent of AGI, because they have lower tax expenditure claims, as a share of household income, and higher AGI cap.

As measured by current tax expenditure claims, the biggest hit from the proposal falls on those making \$100,000 to \$200,000, who lose 95 percent of the tax expenditure benefit they receive today. In contrast, taxpayers earning \$200,000 to \$300,000 lose a smaller share (82 percent) and those above \$300,000 lose about 66 percent.

One of the asserted benefits of this approach is "tax simplification." The proponents estimate that the cap would induce nearly 75% of current itemizing taxpayers to claim the standard deduction (from about 48 million taxpayers to about 12 million).

However, it is hard to imagine how this proposal would simplify the tax filing process. First, it is worth noting that filling out Schedule A is not among the most complicated parts of the tax code today.

But more specifically, under the proposal, taxpayers would have to fill out Schedule A as they do now, and then use a new worksheet to determine if they are subject to the 2% cap (not an easy calculation since the 2% is determined by tax benefit, not sums of deductions or exclusions). Moreover, taxpayers would be required to report additional information, such as the amount their employer spends on their behalf for health insurance.

An ironic aspect of this proposal to cap tax expenditures is that there already exists a complicated, unpopular rule in the tax code that claws back the value of certain tax deductions and credits, that disproportionately affects the upper middle class and those in high-cost areas, that adds to complexity in the code, and was originally proposed as a means of forcing wealthy taxpayers to pay more: it is called the AMT. The AMT is often cited as one of the reasons the nation's tax code needs reform.

How Voters View the Housing Tax Incentives

On behalf of the National Association of Home Builders, Public Opinion Strategies and Lake Research Partner conducted a national survey of 2,000 likely 2012 voters. The survey was conducted May 3-9, 2011, and has a margin of error of +2.19%. Due to the large sample size of our survey (2,000 respondents compared to the typical political survey ranging from 900 to 1,200), we are able to show key data among both homeowners and renters.

Despite the housing crisis, the survey results showed that owning a home is still very much a part of the American dream. Americans believe that owning their own home is as important as being successful at their job or being able to pay for a family member's education. Seventy-five percent of Americans said that owning a home is worth the ups and downs of the housing market, and 67 percent of renters say

that owning a home is the best long-term investment they can make. In fact, 73 percent of voters who do not currently own a home say that it is a goal of theirs to eventually buy one. This is even higher when looking at the 18 to 54 age bracket, where 83 percent aim to eventually buy a home.

When looking at the housing tax incentives, Americans across party lines believe it is appropriate and reasonable for the federal government to provide tax incentives to encourage homeownership; 73 percent agree this is a good idea. And a strong majority of voters oppose eliminating the home mortgage interest deduction, with 71 percent opposed.

Although the housing market continues to struggle in this economy, for many Americans, owning a home is part of their American dream, and the housing tax incentives play an important role in making that dream come true.

Conclusion

NAHB is an organization that represents all facets of the residential construction industry, including for-sale builders of housing, multifamily developers, remodelers, manufacturers, and other associate members. As such, NAHB defends housing choice. While homeownership offers communities and households numerous benefits, it is important to recognize that for every family there is a time to rent and time to own a home.

For these reasons, NAHB also supports policies that promote a healthy rental housing sector, including support for the Low-Income Housing Tax Credit, which was created as part of the *Tax Reform Act of 1986* and has become a successful public-private partnership that assists in the development of affordable housing.

Since most homeowners benefit from the mortgage interest deduction, and most of that benefit flows to younger, middle class families, making homeownership less accessible is likely to diminish the financial success of future generations. And as owning a home is a significant means for savings for most homeowners, the capital gains exclusion protects that investment. Without the mortgage interest deduction, NAHB believes that disparity in economic income would increase, and the middle class would continue to shrink.

Home ownership is the major path to wealth for the middle class. While there are many factors influencing wealth accumulation, according to the 2007 Federal Reserve Survey of Consumer Finances, the median net worth of a homeowner is \$234,600; for renters, it was \$5,100. We believe that any policy change that makes it harder to buy a home, or delays the purchase of the home until an older age, will have significant long-term impacts on household wealth accumulation and the makeup of the middle class as a whole.

It is also worth noting in this vein that the largest homeownership declines as a result of the Great Recession have occurred among younger homeowners. This has two causes. One, fewer households are being formed as younger individuals double up or, as a second reason, such individuals choose to live with their parents or other family. NAHB estimates that 2.1 million households have not formed for

these reasons, and thereby constitute “pent-up housing demand.” The Census Bureau has found similar estimates.³⁰

Given that the MID offers large benefits, as a share of household income, for younger homeowners, the loss of this benefit will only make homeownership less-accessible to those younger households who have been devastated by the ongoing housing crisis. Weakening the mortgage interest deduction, particularly in high cost areas (which are high cost because housing demand is high, typically because jobs are in supply), means shutting out younger, aspiring middle class Americans from homeownership, which could have far reaching social and economic outcomes. As an example, CDC fertility rate data indicate that as a result of the Great Recession, the number of births in the United States is declining, and this decline is particularly being recorded among those future middle class Americans.

Unfortunately, none of us have to guess what will happen if we have a prolonged decline in home prices. We are living it. The housing market remains in a depression, and further weakening demand, or increasing user costs, will further restrict economic growth or risk a double-dip recession.

Some policymakers have suggested converting the mortgage interest deduction to a credit because it would be “fairer.” As previously mentioned, Simpson-Bowles is one of the more recent proposals to make this recommendation. But when these proposals have been brought forward and detailed, it turns out that transforming the deduction to a credit is just a means of reducing the benefits going to homeowners. As noted earlier, in the Simpson-Bowles illustrative example even modest-income homeowners would see their housing costs—and taxes—increase. NAHB does not see a circumstance where raising taxes on homeowners is fair.

Many on this committee have looked back to the tax reform efforts in 1986 as a guide forward for today. And there are some important lessons to remember from that experience. First, it is possible to achieve those low rates and maintain strong incentives for housing. But we also saw for commercial real estate the perils of significant tax policy changes. Most economists agree that the changes in the ‘86 Act led to a crisis in commercial real estate. How housing is dealt with in tax reform will shape the economy moving forward. Housing can be a key engine of job growth that this country needs.

In fact, home building usually leads the US economy out of recession. In all the past WWII recoveries except the most recent, residential construction grew at an average rate of 30% in the first year of recovery. This time around residential construction grew at 5%. Housing provides the momentum behind an economic recovery because home building employs such a wide range of workers. Constructing 100 single-family homes generates the equivalent of 300 full-time positions for a year. More importantly, half of those jobs are on-site construction jobs and half are in diverse industries such as appliances, carpets, plumbing fixtures and professional services such as architects, attorneys and bankers. NAHB estimates that housing starts will rise to 1 million by the end of 2013, more than two years away. But at that point, total production will still be less than 60% of a ‘normal’ year of 1.7 to 1.8 million housing starts.

³⁰ <http://blogs.census.gov/censusblog/2011/09/households-doubling-up.html>

NAHB supports the goal of many in Congress to reform the tax code. NAHB believes that lower rates, simplification, and a fair system will spur economic growth and increase competitiveness. And that's good for housing, because housing not only equals jobs, but jobs means more demand for housing. To foster that virtuous cycle for economic growth, we believe strongly that you must look upon the homeownership tax incentives with caution. As the committee moves forward on tax reform, NAHB wants to be a constructive partner and help this committee with this important issue.

SENATE COMMITTEE ON FINANCE
“Tax Reform Options, Incentives for Homeownership”
October 6, 2011
Dr. Robert D. Dietz

Questions from Senator Hatch

- Many of you recommend replacing the mortgage interest deduction with a tax credit. Some of you even suggest that this tax credit should be refundable. Considering that the mortgage interest deduction is already one of the most utilized tax expenditures in the Code and over half of Americans do not pay income taxes, would a refundable tax credit push even more taxpayers into the majority of Americans who do not pay income taxes?

Answer: NAHB opposes altering the present law rules for the mortgage interest deduction. The current rules have been in place since 1913, broadly utilized since World War II, and protected during the 1986 tax reform process. Current homeowners, especially those in the early years of a mortgage, bid home prices and obtained financing for a home based on those rules. Changing the rules of the game, especially during this fragile period for the nation’s housing market, would be very harmful for homeowners and the economy as a whole.

It is also worth noting that typically proponents of change for the mortgage interest deduction assume a revenue neutral credit (if non-refundable). Such a credit would be equivalent to a 20 to 21 percent tax credit rate. If refundable, the rate would need to be lower to be revenue neutral, perhaps 16 to 17 percent. And this would indeed cause more taxpayers to pay no (or even negative) income tax liability.

Given that the 2005 tax reform panel suggested a 15 percent rate (with a lower cap) and the co-chairs of the Bowles-Simpson commission proposed a 12 percent rate, it is clear that a revenue neutral transformation is not on the table among prominent tax reform plans. Indeed, the proposed tax credits represent significant tax increases for homeowners, and this weakening of the housing tax rules that would generate windfall losses, in the form of housing price reductions, for the nation’s 75 million homeowners.

- Your written testimony stated that there is great correlation between homeownership and a number of positive social effects, such as stronger families, reduced divorce rates, lower crime, greater neighborhood stability, better health and wealth, and so forth. However, do the various tax preferences for homeownership cause a greater rate of homeownership than would be the case without such tax preferences?

Answer: It is without a doubt true that the mortgage interest deduction (MID) helps facilitate homeownership. Consider how the benefits of the tax rule are collected. New homebuyers, in the early years of a mortgage, are paying mostly interest and relatively little principle. This is particularly true for younger homebuyers who have less access to wealth to put down a substantial downpayment. As such, the MID generates the largest benefits, as a share of household income, for such younger homebuyers. This enables households who are qualified under today's significantly tighter lending standards to achieve homeownership.

Often, opponents cite cross-country comparisons to argue nation X has a similar or even higher homeownership rate but no MID. This is simplistic and misleading analysis. First, there are many factors that determine a nation's homeownership rate, including urbanization rates, average income, average age, average family size, cost of living, and tax, finance and regulatory rules. Further, preferences regarding ownership may also vary (Germany is a good example, with a lower homeownership rate that reflects historical preference among families).

For this reason, a singular focus on the homeownership rate is misleading. Given NAHB's recent research on the age-distribution effects of the MID (discussed in my written testimony), an examination of the average age of first-time homebuyer is useful. For example, consider the United Kingdom, which phased out its MID in the year 2000. As a result, the average age of first time homebuyers increased to 34 by 2004 (and to 37 by 2010) (the average age of a first-time homebuyer is 27 in the U.S.). And the share of first-time homebuyers fell from 50% of the market in 1984 to 29% in 2004 (first-time buyers typically make up 40% of the market in the U.S.).

Thus eliminating the MID in the UK had the impact of delaying homeownership, which has significant impacts on marriage, children, wealth accumulation and the makeup of the middle class. This delay was caused due to the increase in the cost of homeownership for those who require debt to purchase a home (particularly younger households).

Finally, as a technical matter, a focus on the homeownership rate is also misleading because of how it is calculated. The rate is equal to: number of homeowning households divided by the number of households. A policy that reduces the number of homeowning households *and* reduces the total number of households (by forcing some potential households to disappear, as people move in with additional roommates or family) will show a significantly smaller impact on the homeownership rate because both the numerator and denominator are changing. A similar and well known issue occurs with the unemployment rate, which can counter intuitively rise in periods of job creation as discouraged workers re-enter the job market, thereby affecting both the numerator (the number of unemployed) and the denominator (the number of people actively in the labor force) at the same time.

- In your written testimony, you write: “Many on this committee have looked back to the tax reform efforts in 1986 as a guide forward for today. And there are some important lessons to remember from that experience. First, it is possible to achieve those low rates and maintain strong incentives for housing. But we also saw for commercial real estate the perils of significant tax policy changes. Most economists agree that the changes in the ‘86 Act led to a crisis in commercial real estate. How housing is dealt with in tax reform will shape the economy moving forward. Housing can be a key engine of job growth that this country needs.”

Will you please elaborate on your statement? What provisions in the 1986 Act led to a crisis in commercial real estate, and what should we be concerned about today so as to not make similar mistakes with respect, for example, to residential real estate?

Answer: Economists generally agree that two actions led to a significant crisis in commercial real estate, by undermining demand for commercial properties, which resulted in declining commercial property prices and resulting economic crisis. First, the passive loss rules were enacted which reduced demand for real estate among many taxpayers. Second, the depreciation rules were weakened for real estate, including the establishment of the 39 year period for commercial and multifamily properties.

Setting aside the merit or lack of merit of these provisions, the enactment of the *changes* had significant negative impacts given that the existing rules were capitalized into real estate values. The period of transition from the prior tax regime to the post-86 regime was painful for the commercial real estate, and offers a warning for proposed changes to the tax rules for owner-occupied housing.

The lesson is clear: moving from one set of tax rules to another will have major transition costs that are often ignored by proponents of change. The most obvious is that a weakening of the MID could cause housing prices to fall by as much as 15%. If house prices were to fall just 5%, an additional 2 million homeowners would go underwater given prior price declines.

- Dr. Dietz, the effects of the Mortgage Interest Deduction is multifaceted. While it is aimed at encouraging homeownership, it subsidizes the cost of borrowing and sometimes promotes over-leveraging. Do you think that Mortgage Interest Deduction could be better tailored to encourage people to purchase homes that they otherwise would not? If so, how could an incentive be better tailored?

Answer: Designing a “better” MID is in my opinion a mostly academic question. Any transformation that expands the size of the tax expenditure number for the MID is likely not on the table. Any transformation that is revenue neutral is going to create winners and losers. And any transformation that significantly reduces the size of the tax expenditure of the MID will produce many more losers than winners.

As a practical, non-academic matter, moving from one set of rules to another will cause housing prices to adjust. Under the most common proposals (12% or 15% MID credits), such adjustments will produce windfall losses for existing homeowners in the form of price reductions.

It is important to keep in mind that 70% of taxpayers with a mortgage benefit from the MID in any given year (with almost all benefiting from the MID at some point during their tenure as homeowners), and over the last 10 years, 86% of mortgage interest was claimed as a deduction. While moving to a tax credit would help some, many of those helped would be older homeowners in the later years of a mortgage, when they are paying mostly principal and little interest. Moving to a tax credit would hurt many others, particularly younger households in higher cost areas.

- Dr. Dietz, tax reform is a very complicated task. Eliminating tax expenditures is often easier said than done. I have been told of your idea that tax reform involves a trilemma or a difficult choice from three options, where only two of three options can be true at a given moment. Could you please explain to this Committee how a trilemma evolves in the context of tax reform and give us some examples.

Tax reform involves more than just selecting, as if off a menu, which tax rules to keep, modify, or eliminate. The real challenge is establishing transition rules to get from an existing set of rules to a new, desired set of tax law.

With this in mind, I have discussed something I call the Tax Reform Trilemma. A trilemma is a construct of three elements, for which only two of the three can be true at a given moment.

Typically, the desired goals of comprehensive tax reform are: increase revenue, increase simplicity, and increase fairness. I have stated that when asset prices (e.g. house prices) are in part determined by existing tax rules, that a trilemma exists for would-be tax reformers; that it is impossible to increase revenue, increase simplicity *and* increase fairness. One of these goals must fail in attaining the other two.

Take as an example, a proposal to replace the MID with a 12% tax credit. The proposal would raise significant tax revenue by increasing taxes on homeowners, particularly younger homeowners paying large interest payments. The proposal does not change simplicity very much, perhaps a marginal increase. However, the proposal decreases fairness by imposing a windfall loss on existing homeowners by producing price declines in areas where a 12% tax credit represents a significantly less valuable housing tax rule. This would be particularly true in high cost areas.

Suppose a would-be tax reformer acknowledges the potential for current housing market losses via price declines and suggests that the proposal not be effective for 10 years, the average ownership period for a homeowner. The Trilemma strikes again however. The long phase-in period, while satisfying the simplicity and fairness tests, fails on raising revenue by moving expected higher taxes from homeowners outside the 10-year budget window.

Suppose the tax reformer suggests a phased-in change with incremental changes moving from a deduction to a credit over a number of years, creating separate rules for new homebuyers and existing homeowners. While this version may raise revenue and be fairer, it fails on the simplicity test by creating constantly changing tax rules and additional tax forms.

I argue that such concerns can be raised for other proposals, including the 2005 tax reform commission, the 28% itemized deduction cap, the Bowles-Simpson proposal, and the Feldstein 2% AGI limitation proposal. All face a tradeoff between raising revenues (by delaying enactment as part of transition), increasing complexity due to transition rules, and hurting fairness (via price declines for existing homeowners) due to lack of transition rules. This Trilemma is particularly true for housing because of the fact that current tax rules are capitalized in current housing prices and homeowner wealth.

Question from Senator Menendez*Low-Income Housing Credit*

- In my view, not only does the Low Income Housing Tax Credit improve access to affordable housing for lower income Americans, but it also is a great driver of private investment and creates thousands of jobs in the real estate industry. The success of the LIHTC in the 25 years since it was enacted has led to a huge increase in demand for the credit – a demand which far exceeds the availability of the credit. What sort of impact on job creation do you think increasing the number of LIHTCs available to better meet the demand for these credits in the market would have, and how do you believe that could impact the economic recovery?

Answer: The Low Income Housing Tax Credit (LIHTC) was created as part of the Tax Reform Act of 1986 as a more effective mechanism for producing affordable housing and is the most successful affordable rental housing production program in U.S. history. Through construction of new apartments, preservation of existing affordable housing, and rehabilitation of older multifamily buildings, the LIHTC enables the nation to maintain the supply of affordable housing.

Since its inception, the program has produced and financed more than two million affordable apartments. The LIHTC serves households earning 60% or less of the area median income with rents restricted to keep the units affordable. According to 2009 American Community Survey data, more than 17 million American households, or 46% of total renters, are rent burdened, paying more than 30% of their household income toward rent.

Recently, the program resulted in approximately \$6.8 billion in additional income and 90,000 full time jobs per year across all U.S. industries. These impacts are broad-based and include jobs, income, and taxes in industries such as manufacturing, trade, and services, in addition to construction. The jobs are measured in full-time equivalents—that is, enough work to keep a worker employed full time for a year. Income includes business profits as well as wages and salaries paid to workers.

NAHB estimates that the impact from constructing 100 new apartments is 116 full-time jobs, \$8.7 million in income, which includes wages and profits for small businesses and corporations, and \$3.3 million in taxes and other revenue for federal, state and local governments.¹ Without question, the LIHTC is a job creation tool. As demand for affordable housing continues to outstrip supply, increasing the number of credits allocated would both spur job creation and fill a critical need.

¹ The Direct Impact of Home Building and Remodeling on the U.S. Economy. NAHB Housing Economics paper. <http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311>

In recent years, the LIHTC has produced approximately 75,000 new apartments annually, which is not sufficient to replace the number of affordable apartments lost each year to obsolescence, conversions to other uses and demolitions. The latest rental dynamics study produced by the Department of Housing and Urban Development shows that between 6 million and 7 million existing affordable housing units were lost through conversions (from rental to owner) and filtering (rents increasing relative to incomes) over a two-year period, which was roughly offset by a similar number of existing units becoming affordable through conversion and filtering in the opposite direction. According to the 2011 Harvard study, "America's Rental Housing: Meeting Challenges, Building on Opportunities," more than 28% of the 1999 low-cost stock was lost by 2009. These numbers are large relative to the amount of rental housing that can be produced even with maximum effort in a given year.

Finally, according to the 2011 Harvard study construction costs would have to be 28% of the current average to feasibly build housing to serve renter households earning the minimum wage. This is not possible without the LIHTC or other government programs, particularly in the areas of the country that have demand for jobs and a need for affordable housing.

Testimony of Richard K Green to US Senate Finance Committee

Lusk Chair in Real Estate

University of Southern California

October 6, 2011

Chairman Baucus and Ranking Member Hatch, I want to thank you for the opportunity today to present my views on the issue of housing and tax reform. My name is Richard Green, and I am a professor in the School of Policy, Planning and Development and the Marshall School of Business at the University of Southern California. I have published extensively on the issue of the Mortgage Interest Deduction, and in particular published a paper co-authored with Dennis Capozza and Patric H. Hendershott on housing and fundamental tax reform for the Brookings Institution¹.

My general philosophy is that the tax code should be as broad-based and efficient as possible, while maintaining vertical and horizontal equity to the best extent possible. I find many of the ideas proposed by Robert Hall and Alvin Rabushka to be quite appealing, and to me, in an ideal world, we would have something quite similar to the tax code they propose, albeit with an earned income tax credit added. That said, we are manifestly not in an ideal world, and issues of transition matter. As I wrote in 1996, a rapid change in tax policy could have a traumatic impact on the economy, so it is important that

¹Dennis Capozza, Richard Green and Patric Hendershott (1996), Taxes, Mortgage Borrowing and Residential Land Prices in H. Aaron and W. Gale, ed. *The Economic Effects of Fundamental tax Reform*, Washington, DC Brookings Institution Press: 171-210

congress phase in any major changes to tax policy involving housing.

That said, I have long thought that the Mortgage Interest Deduction is a residual of the 1913 tax code, accomplishes little that its supporters claim for it, pushes capital away from plant and equipment toward housing, and benefits high income (although perhaps not very high income) households more than the remainder of the country.

I will divide my remarks into 8 parts; (1) I will argue that the Mortgage Interest Deduction is a residual of the 1913 tax code, and was not created to encourage homeownership; (2) that those on the margin of homeownership get little-to-no benefit from the Mortgage Interest Deduction, and that the policy therefore does little to encourage homeownership; (3) that the Mortgage Interest Deduction does encourage those who would be homeowners anyway to purchase larger houses than they otherwise would; (4) that even in the absence of the Mortgage Interest Deduction, owner-occupants receive a large tax benefit; (5) that phasing out the Mortgage Interest Deduction would encourage households to pay down their mortgages more quickly, and would therefore encourage households to rely less on leverage; (6) household deleveraging would lead to greater market stability, but would also mean that the revenues generated by the elimination of the deduction would be smaller than static estimates suggest; (7) at a time when the housing market remains quite weak, it is important that the Mortgage Interest Deduction be phased out carefully; (8) that if we do wish to encourage homeownership via tax policy, a targeted, refundable credit would be more effective than the current Mortgage Interest Deduction.

I. The Mortgage Interest Deduction is a Residual of the 1913 Tax Code

Before the Tax Reform Act of 1986, consumer interest had generally been deductible from gross income. Indeed, the original income tax act of 1913 allowed for the deduction of consumer interest (see Pechman (1987)). But since 1986, the only interest expense that consumers have been able to completely deduct from gross income in order to calculate taxable income has been interest paid on specified of types home mortgages.

Donald Regan proposed the Reagan Administration's first program for Tax Reform. The proposal was known as Treasury I, and in exchange for eliminating nearly all deductions, it offered substantial reductions in marginal tax rates on ordinary income. In the end, the elimination of many deductions allowed for the top marginal tax rate to be reduced from 50 percent to 28 percent.

Among the deductions to be eliminated was the deduction for all consumer interest, including the Mortgage Interest Deduction. As tax reform evolved many deductions were indeed phased out, but thanks in part to ingenious lobbying from housing industry groups, including the National Association of Realtors, the National Association of Home Builders, and the Mortgage Bankers Association of America, congress was convinced that retaining the Mortgage Interest Deduction was necessary to promote homeownership.² At the time, virtually no one questioned that homeownership was a virtue.

²For an excellent discussion of how the Mortgage Interest Deduction avoided the chopping block, see Charles McLure and

But another change in the tax code reduced the effectiveness of the Mortgage Interest Deduction as a tool for promoting homeownership. And this gets me to point II.

II. Those on the margin of homeownership get little-to-no benefit from the Mortgage Interest Deduction, and that the policy therefore does little to encourage homeownership

With the Tax Reform Act of 1986, the standard deduction was raised from \$3400 (in 1984) to \$5000 for married couples filing jointly³, meaning that many fewer taxpayers became itemizers. The deduction has since risen with the cost of living, and is at more than twice its level at that time. This has implications for the value of the Mortgage Interest Deduction to those at the margin of homeownership.

Consider a first-time homebuyer that lives in a state with no income tax. If that buyer purchases a \$150,000 house with a twenty percent down-payment, and pays a one percent property tax rate, at five percent interest, the deductions for housing are \$6000 (for mortgage interest) and \$1500 (for property taxes). Suppose the household also makes charitable contributions of \$2500. The current standard deduction for married couples filing jointly is \$11,600, so a couple under such circumstances in no way benefits from itemizing—the Mortgage Interest Deduction has no value.

But we tilted the field against the Mortgage Interest Deduction a bit by considering states with no income tax. Let's

George Zodrow (1987) Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform. *Journal of Economic Perspectives*, 1(1): 37-58.

³See Pechman, J.A., *Federal Tax Policy* (Fifth Edition), Appendix Table A.1

put this couple in Wisconsin, a state that has somewhat higher than average state income taxes. Let us also push the property tax rate up to two percent. We will assume the couple is childless, and earns \$60,000 per year. According to the NBER TAXSIM model, the couple would pay about \$2200 in state income taxes in Wisconsin. Summing the deductions, we now have \$6000 in mortgage interest, \$3000 for property taxes, \$2500 for charitable contributions, and \$2200 for state income taxed. These deductions sum to \$13,700, or more than the standard deduction, so the couple would itemize.

So what is the Mortgage Interest Deduction worth? Take the difference between the itemized deduction and the standard deduction, and one gets a difference of \$2100. Using the NBER TAXSIM model again, we see that the couple is in the 15 percent marginal tax bracket, which means the value of the deduction is $\$2100 \cdot .15$, or \$315 per year. Is this sufficient to turn a renter into an owner? I am skeptical.

Moreover, the \$315 subsidy ignores the fact that the structure of the mortgage interest deduction gives high tax bracket taxpayer an incentive to outbid lower tax bracket taxpayers for land. Because the value of the subsidy to someone in the 35 percent tax bracket is more than twice the size of someone in the 15 percent bracket (see discussion below), it is entirely possible that the existence of the deduction pushes net costs up for low bracket taxpayers beyond what they would be in the absence of the deduction.

III. The Mortgage Interest Deduction encourages large home purchases.

While the Mortgage Interest Deduction has small value for those at the margins of homeownership, it is very valuable for high

income individuals who purchase expensive homes. Consider a taxpayer in the 35 percent tax bracket who owns an \$800,000 home with 75 percent equity. The value of that person's mortgages is \$600,000. At five percent interest, the interest cost, and therefore deduction, is \$30,000 per year. At a 35 percent marginal tax rate, the value of this deduction is \$10,500 per year. Depending on assumptions about the cost of maintenance and property taxes, as well as expected appreciation, the effective subsidy for this housing choice could range from 10 to 30 percent. Based upon literature for housing demand, this means that the Mortgage Interest Deduction will lead individuals in the 35 percent tax bracket to demand between 5 and 15 percent more housing than they might in the absence of the Mortgage Interest Deduction. While there is nothing wrong with large houses per se, the Mortgage Interest Deduction encourages investment capital to move toward housing, perhaps at the expense of other capital goods, such as plant and equipment.

A corollary to the fact that the Mortgage Interest Deduction encourages people to purchase large houses is that the benefits of the deduction tend to be distributed to higher income individuals. Eric Toder, Margery Turner, Katherine Lim and Liza Getsinger of the Urban Institute find⁴:

The percentage reduction in after-tax income from eliminating the deduction would be largest for taxpayers in the 80th to 99th percentiles of the distribution. These upper-middle-income households would be affected more than tax units in the bottom four quintiles because they are more likely to own homes and itemize deductions and because the higher marginal tax rates they face make deductions worth more to them than to lower-income taxpayers. The very

⁴See E Toder, MA Turner, K Lim and L Getsinger, Reforming the Mortgage Interest Deduction, Urban Institute and Tax Policy Center.

highest income taxpayers, however, will experience a relatively small drop in income (about 0.4 percent on average) because, at the very highest income levels, mortgage interest payments decline sharply as a share of income.

So the Mortgage Interest Deduction is somewhat unusual in that it is clearly a benefit for the upper-middle-class to lower-rich part of the income distribution, but it is not particularly beneficial to the very rich. Put another way, the elimination of the Mortgage Interest Deduction would make the tax code more progressive, but it would not do much for implementing the "Buffett Rule."

IV. Even in the Absence of the Mortgage Interest Deduction, Housing would receive a large subsidy from the tax code

A fact that is not controversial among economists, but seems to generate consternation among policy makers, is that owners of houses without mortgage earn tax-free income. This income is known as imputed rent, and refers to the fact that owner-occupants pay *themselves* rent.

Perhaps the following example will clarify why homeowners receive non-taxable income from themselves. Suppose two neighbors own identical houses. Suppose they switch houses and pay each other rent. They are materially in the same position they would be if they remained in their own houses. But because they pay each other rent, and because rent is taxable income, by renting to each other they incur a tax liability that they would not if they remained in their own house. The example illustrates the benefit of "non-taxation of imputed rent." The Office of Management and Budget estimates that the tax expenditure associated with this was about \$27 billion in 2009⁵.

⁵ See <http://www.gpoaccess.gov/usbudget/fy11/pdf/spec.pdf>.

The Organization of Economic Cooperation and Development has argued that imputed rent should be taxed. I do not agree. The question is how does one go about taxing imputed rent? It is not easy. One could start by imposing an ad valorem tax on property values (such as a local property tax), but that doesn't tax imputed rent per se, because it does not take into account expected inflation (if one person expects her house to go up in value, and another does not, the rent the first person pays is lower than the second). Alternatively, one could find comparables in the rental market and attribute rents found there to the owner market. But owner and rental markets are so segmented that this would be difficult to do.

This has implications for fairness; if we don't know what we are taxing, it is hard to know how much to tax it. Moreover, it is important for people to understand the foundation for their tax liabilities, and I think imputed rent is too subtle a concept to communicate to taxpayers.

That said, imputed rent is a very real thing, and in the event the Mortgage Interest Deduction were to be eliminated, households would continue to benefit from the fact that their housing equity goes untaxed. This leads to point V.

V. A Phase-out of the Mortgage Interest Deduction would lead to household deleveraging.

People take on mortgages for two reasons: to smooth their consumption of owner-occupied housing over their life-times, and to get the tax benefit of the Mortgage Interest Deduction.

In the absence of mortgages, households would have to save for many years before they were able to purchase a house. Let us assume a good rule-of-thumb is that households buy houses whose

prices are three times annual income. If a household were to save ten percent of its income for the purpose of buying a house, and its income remained flat, it would take 30 years for it to buy a house (of course, incomes tend to rise as people age so it would actually take less time to save for a house, but it would still take a long time). On the other hand, if a household can get a loan with a 20 percent down payment, it could accumulate the equity necessary to purchase a house in six years, given the same assumptions. For this reason, many people will decide to buy a house with a mortgage, even if mortgages carry no tax benefits.

On the other hand, once people buy a house with a mortgage, a tax code that does not contain a Mortgage Interest Deduction would encourage people to shift out of non-tax preferred debt into tax-preferred equity. Dennis Capozza, Patric Hendershott and I observed that in Australia, where there is no Mortgage Interest Deduction, people purchased houses using about as much debt as Americans, but they paid off that debt much more quickly than Americans⁶.

As a policy matter, I think there are profound benefits to encouraging people to pay off their mortgages more quickly, rather than less quickly. It is important in general to recognize that while consumer debt can provide people (and the broader economy) benefits, it can also be too much of a good thing.

⁶See Dennis Capozza, Richard Green and Patric Hendershott, Taxes, Mortgage Borrowing and Residential Land Prices in H. Aaron and W. Gale, ed. *The Economic Effects of Fundamental Tax Reform*, Washington, DC Brookings Institution Press: 171-210 and Dennis Capozza, Richard Green and Patric Hendershott (1999) Tax Reform and House Prices: Large or Small Effects. *Proceedings of the 91st Annual Conference of the National Tax Association*: 19-24.

My parent's generation behaved differently than mine in all sorts of ways. Another paper of mine with Hendershott shows that they spent less, controlling for education, etc., throughout their life cycle than any other generation. One of the reasons for this is that they paid off their mortgages. According to the American Housing Survey, 70 percent of households headed by someone over the age of 65 have no mortgage at all. Loan amortization became a mechanism for forced saving, and as a result, those born during the depression are in pretty decent shape financially. A Pew Survey shows that those over the age of 65 feel much more in control of their finances than younger people.

My generation is different. Even under the most benign circumstances, we refinance in a manner that slows amortization. I personally have refinanced several times to take advantage of lower interest rates--this was, of course, the right thing to do financially. But each time, the amortization schedule reset, and so it extended the period at which the mortgage would pay off. Now yes, one can take the money one doesn't put into home equity and put it in other savings vehicles, but it is not clear that everyone does that. Forced saving is slowed.

I did a quick comparison of average household income for 1989 and 2007 (using the census) and average mortgage debt for those that had mortgage debt (using Survey of Consumer Finances data)⁷. In both cases I looked at 45-54 year olds.

⁷Survey of Consumer Finance Data is available at [http://www.federalreserve.gov/pubs/oss/oss2/2007/scf2007home.htm](http://www.federalreserve.gov/pubs/oss/oss2/2007/scf2007home.html)
l Mortgage Interest Deduction

In 1989, average household income among 45-54 year olds was \$39,934; average mortgage debt outstanding among those who had debt was \$39,300, so the ratio was about one-to-one.

In 2007, average household income among 45-54 year olds was \$83,100; average mortgage debt outstanding among those who had debt was \$154,000, so the ratio was just under two-to-one.

In 1989, the share of households in the age group with a mortgage was 58.3 percent; in 2007 it was 65.5 percent. In short, people who are facing retirement within the next 10 to 20 years own less of their house than their counterpart of a generation ago. A policy that encourages people to pay off their mortgages more quickly will benefit everyone. Phasing out the Mortgage Interest Deduction will do just that.

VI. Static scoring of the Mortgage Interest Deduction will overstate the revenue benefits of its elimination.

As I just noted, eliminating the Mortgage Interest Deduction will encourage people to pay off their mortgages more quickly. From a revenue generating standpoint, this means that its elimination will produce smaller gains than static analysis would predict.

If the Mortgage Interest Deduction were scaled back or eliminated, some households would sell assets with taxable returns to pay down their mortgages, thus reducing the net tax revenue arising from the policy change⁸. Based on my reading of

⁸James Follain was among the first to develop this insight. See James Follain (1998) *The False Messiah of Tax Policy: What Elimination of the Mortgage Interest Deduction Promises and a Careful Look at What It Delivers*. *Journal of Housing Research*. 9(2):179-199.

the literature on the demand for debt (as opposed to the demand for housing), in the long run the government would capture between 60 to 80 percent of the current tax expenditure arising from the mortgage interest preference. This is still substantial revenue, but it is (obviously) substantially less than the current value of the tax expenditure.

VII. The Mortgage Interest Deduction should be phased out; not eliminated overnight.

The housing market is currently very fragile, and it almost certainly doesn't need another negative shock at the moment. A further negative shock would not only have implications for housing, but also for household balance sheets, which remain fragile.

At the same time, many people made decisions about housing based on the current tax code, and it would be unfair to these people to make a substantial change to the tax code they relied on in one quick stroke.

I would consequently suggest two transition rules for eventually eliminating the deduction: (1) that the deduction should be phased out over ten years by reducing the mortgage cap by \$100,000 per year from the current \$1,000,000 cap and; (2) that the phase-out not begin until the Federal Housing Finance Agency's house price index shows year-over-year growth equal to the rate of consumer price index growth.

The first of these phase-out rules would allow people to adjust to the new mortgage interest regime in an orderly fashion. Among other things, it would allow people to accelerate financing their houses with equity. As such, it keeps

substantial subsidy in place and prevents some of the dislocation in the housing market.

The second rule recognizes the current weakness in housing, and awaits the day in which housing markets are more or less in equilibrium before gradually reducing the subsidy. It basically codifies the idea that the housing market—and the broader macroeconomy—cannot afford a shock at the moment, but also develops a rule that specifies when the market will be better able to withstand such a shock.

VIII. If Congress wished to encourage homeownership through the tax code, a refundable credit would be more effective than the Mortgage Interest Deduction.

One of the reasons the Mortgage Interest Deduction is not an effective instrument for encouraging homeownership is that it is not targeted—as I discussed earlier, people who would be homeowners in the absence of the deduction get a large tax benefit, while those who are at the margin of owning get little to no benefit.

A refundable tax credit of 15 percent that would be available to those who use the standard deduction would provide a substantial incentive for homeownership for those at the margin. Consider again a potential buyer looking at purchasing a \$150,000 house with 20 percent down. The value of a 15 percent credit on a five percent mortgage would be $\$120,000 \cdot .05 \cdot .15$, or \$900. While this is hardly huge, at roughly \$80 per month it could tilt the balance between homeownership or renting⁹.

⁹For more detail, see Richard K Green and Andrew Reschovsky (2011) Using Tax Policy to Subsidize Homeownership,) in A Steiger and D. Black, ed, Smart Subsidy for Community

My work on the benefits of homeownership has found mixed results, but in the end I am convinced that homeownership actually creates people who are more involved with their communities and parents who are more involved with their children. As such, I view small, targeted subsidies that could push people into homeownership as sensible policy.

The Mortgage Interest Deduction is not, however, either small or targeted. It is time to reform it in a sensible, orderly fashion.

United States Senator Orrin G. Hatch
Hearing on Tax Reform Options: Incentives for Homeownership
United States Senate Committee on Finance
October 6, 2011

Chairman Baucus, thank you very much for calling this hearing. By addressing the issue of homeownership, and the tax incentives that encourage it, this committee is considering a matter of critical importance to our economic recovery. Homeownership is often identified with the American dream. Yet far too many Americans have awoken from that dream in recent years to face an unpleasant reality.

Over the last decade, many of our fellow Americans bought homes they could not afford. Their plans depended on continued increases in real estate values. Having bought homes with adjustable rate mortgages, they would either refinance and stay in the home or sell the house at a profit if they could no longer afford the mortgage. However, starting in 2006 in most parts of the country, house prices ceased to climb, and often went down — way down. The result has been nothing short of carnage in the residential real estate market.

We have suffered record numbers of foreclosures.

Those who are able to remain in their houses are often under-water, undercutting our economic recovery by contributing to low consumer-confidence and undermining the employment mobility necessary for a vibrant economy.

The ripple effects of this collapse in real estate values have been tremendous — failing banks, high unemployment, a severe recession, and a stalled recovery. The impact of America's depressed housing market is felt not just here at home, but throughout the world.

This is a horrible spiral. A weak housing market contributed to a weak economy, and a weak economy puts further downward pressure on home prices.

We must not allow rhetoric about fixing the housing market to get ahead of reality. We are not in these straits because of a failure of government intervention. Both before and after this crisis, the federal government has been actively involved in housing policy, and according to many this government intervention actually helped to drive the housing bubble that is still deflating.

Given the still precarious status of the nation's housing markets, and past mistakes made by government to prop up these markets, it is fair to say that Congress needs to tread carefully when addressing policies that effect real estate. With respect to the tax code, there are a number of proposals that would alter the treatment of housing, but any changes should happen only with the utmost care and significant transition periods.

The justification for homeownership tax preferences is simple: Homeownership helps create a more stable society. It encourages virtues of solid citizenship by giving homeowners a vested interest in their communities. By having a greater stake in their community, homeowners provide social stability by contributing to crime-control, schools, churches, beautification, and local government. To put it in economic terms, not all of the benefits of homeownership go to the homeowner. Homeownership has certain positive externalities.

Our tax code has long recognized the positive features of homeownership. For as long as our country has had an income tax — since 1913 — a deduction for mortgage interest has been allowed. There have been proposals over the decades to get rid of the home mortgage interest deduction, but none of them have succeeded.

Now President Obama has proposed to reduce the benefit of the mortgage interest deduction. He would give upper-income taxpayers a tax benefit as if they were in the 28 percent tax bracket, even though they are in a higher tax bracket. It is a bad proposal. It is complicated and ill-conceived. And it also is poorly timed given the fragility of the housing market.

There are other — more simple and fair — ways to proceed. I would recommend to President Obama the example of his predecessor President Reagan. When President Reagan took office, the highest tax bracket was 70 percent, but when he left office, it was only 28 percent. So, in a certain sense, someone in the 70 percent tax bracket valued their mortgage interest deduction much more than after the '86 Tax Reform Act. At a highest bracket of 28 percent, the deduction was not worth as much anymore. By reducing marginal rates, President Reagan did in effect lessen the value of the mortgage interest deduction.

So, if President Obama wants to reduce the mortgage interest deduction as if the highest bracket were only 28 percent, I recommend that he consider President Reagan's example and simply advocate that the highest tax bracket *actually be* 28 percent. It would be simpler, it would achieve President Obama's goal of lessening the mortgage interest deduction benefit to higher-income Americans, it would reduce marginal tax rates allowing for greater productivity and growth, and it would attract bipartisan support.

I would also remind the President of a principle that I, and many of my colleagues, think is of paramount importance. If lawmakers reduce a housing tax preference — or any tax preference for that matter — the increased revenues should be used solely to reduce individual income tax rates. Americans are already taxed enough to pay for a government that is too large, and growing by the day. We should not be raising the net tax burden on the American people beyond the historically high levels that we are already projected to hit in coming years.

Chairman Baucus, we have a great panel here. I'm delighted to see our former Finance Committee colleague Senator Breaux. We have some very learned economists. We have the Vice President of Tax from Pulte Corporation. Thank you for having this hearing and calling these witnesses. I look forward to their testimony.

Testimony of

Gregory M. Nelson
Vice President and Assistant Secretary
PulteGroup, Inc.
Bloomfield Hills, MI

Before the

UNITED STATES SENATE COMMITTEE ON FINANCE

Hearing on

Tax Reform Options: Incentives for Homeownership

October 6, 2011

Thank you, Mr. Chairman, ranking Member Hatch, and members of the Committee for inviting me to testify here today. My name is Greg Nelson, and I serve as Vice President with responsibility for taxes and corporate real estate for PulteGroup in Bloomfield Hills, Michigan. Over its 60-year history, PulteGroup has delivered more than half-a-million homes and is currently one of the nation's largest homebuilders.

My testimony focuses on the mortgage interest deduction ("MID"), although many of the observations included apply also to the other incentives for homeownership the Committee is considering, such as the deduction for state and local property taxes.

Today's hearing takes place at a time when the nation's housing industry is mired in the sixth year of the worst housing crash since the Great Depression. Annual new home sales have crumbled from a recent peak of 1.3 million to less than 300,000 homes currently, while home prices have dropped to 10-year lows, erasing an estimated \$7.4 trillion of wealth from the American people. The collapse of U.S. housing has, in turn, wiped out millions of construction jobs. Yet, even with this severe economic downturn, survey after survey demonstrates that the American Dream of homeownership remains very much alive and well.

While this committee's work to reform the federal tax code is certainly to be applauded, it is not hyperbole to say that eliminating the MID could, and likely would, have a cascading and disastrous impact on the country, the economy and the American people.

Home prices have dropped; mortgage interest rates are approaching record lows; and the job market is stabilizing; and yet would-be homebuyers remain on the sidelines for fear that a home bought today will be worth less tomorrow. Eliminating the MID would quickly turn that fear into reality and send us into another negative feedback loop of falling house prices, hundreds of thousands of mortgages sinking underwater, and more house foreclosures hitting banks' balance sheets and the resale market. This would in turn result in more pressure on home prices, which would then feed back into the loop and cause the economy to further contract. The end result: more stress throughout the economy and likely the double-dip recession the government has fought so consistently to avoid.

The MID did not contribute to the housing bubble. It has been part of our tax code for nearly 100 years and has helped to ensure a strong homeownership rate among American families. These incentives remain important factors in making the lifetime decision of buying a home.

The MID allows families to become homeowners, to build wealth, and to support their communities. It is vital to restoring stability to the American housing market and the overall economy, since it facilitates homeownership by reducing the carrying costs of owning a home. To millions of hard-working, middle-class families, these savings can make the difference between achieving or not achieving their dream of homeownership.

The obvious flipside of this coin is that reducing or eliminating the MID equates to a tax increase on homeowners at a time when they can least afford it. Homeowners already pay 80-plus percent of U.S. federal income tax, but if the MID is eliminated that number could quickly rise to 95 percent. The MID is a tax deduction aimed squarely at the middle-class, as almost two-thirds of those who claim it are middle-income earners. We should continue to encourage such homeownership with our tax policies, not penalize it.

The homebuilding industry has led this country out of every recession but for one. We may say that this time it will be different -- it never is. We need to put construction workers back to work and get the economy back on track. The way to do this is to reduce uncertainty, build confidence and support housing. I would strongly encourage this committee to reaffirm its commitment to homeownership and leave this important tax provision in place. We should not change the rules of the game for those who have already made the decision to purchase a home in reliance on the MID, and we should tell those potential homebuyers currently sitting on the fence that it's safe to buy a home.

We face a "chicken or the egg" dilemma: can housing get better without a recovery in the economy, or can the economy get better without first seeing a rebound in housing? Either way, there is growing acceptance that the U.S. housing industry must get healthier as a part of a robust and self-sustaining economic recovery.

In order to put Americans back to work, the Administration and the Congress have been considering various ways of putting more money into the hands of consumers, including helping homeowners to refinance at historic low interest rates. Eliminating or significantly reducing the MID will do just the opposite and take away discretionary spending from homeowners. Government decision-makers should ask themselves, do they wish to decrease or to increase the cost of homeownership at this precarious time? The Administration's refinancing initiative is aimed directly at decreasing that cost -- particularly the cost of monthly mortgage payments -- largely for the purpose of stimulating consumer expenditures on other purchases. The MID proposals under consideration, on the other hand, would increase the effective cost of ownership, forcing homeowners to reduce their consumption of other things. This anti-stimulative behavior is exactly the sort of conduct Government should be discouraging at this time.

While I appreciate the daunting task this committee has before it to reform the nation's tax code, I'd urge you to remember just how bleak the current housing market is for American families before considering reductions in the MID. A further erosion of home values now, six years into to the worst housing recession in more than seven decades, could have devastating effects on the broader economy. I know that you intend to fully consider the consequences of all current tax expenditures during your tax reform deliberations. I am confident that when you do so for the MID, you will recognize just how valuable the provision is to American families and the American way of life and will keep it in place as our economy begins to recover.

Thank you for the opportunity to testify. I would welcome any questions you may have.

SENATE COMMITTEE ON FINANCE
"Tax Reform Options: Incentives for Homeownership"
October 6, 2011
Responses to Questions for the Record From Mr. Gregory M. Nelson

Question from Senator Hatch

- Many of you recommend replacing the mortgage interest deduction with a tax credit. Some of you even suggest that this tax credit should be refundable. Considering that the mortgage interest deduction is already one of the most utilized tax expenditures in the Code and over half of Americans do not pay income taxes, would a refundable tax credit push even more taxpayers into the majority of Americans who do not pay income taxes?

Answer: While I do not have access to the numbers of taxpayers who currently do not pay income taxes, I believe that the proposals I have seen to convert the deduction to a credit and apply that credit to itemizers and non-itemizers alike would in fact have the effect of increasing the number of Americans who do not pay taxes. This consequence by itself would reduce government revenues, in some circumstances no doubt where such a reduction cannot be justified.

My greater concern, however, relates to the *revenue-raising* elements of the tax credit proposals. These proposals are being developed by commissions and individuals focused on deficit-reduction, and all of the proposals therefore include terms for the credit that will increase government revenues, sometimes dramatically. My testimony argues that this increase in revenues inevitably will come at the expense of homeowners generally and that the additional cost of homeownership to be imposed will lower home values and reduce consumer expenditures at just the wrong time, given our current economic circumstances. The NAHB testimony before the Committee demonstrates that these additional costs of homeownership will be imposed in major part on middle income households. These are the principal reasons in my view that we should not be considering the possibility of moving from a MID to a credit in the manner proposed.

Question from Senator Menendez

Long-Term Confidence

In his recent testimony before Congress, Federal Reserve Chairman Ben Bernanke cited consumer confidence as a major barrier to the overall economic recovery and the housing market in particular. Many people are simply too worried about the future of the economy to purchase new homes. As we debate housing tax reform it is important to remember that whatever actions we do take should raise, not lower, consumer confidence. Creating a healthy housing market is critical to our economic recovery.

- Even if we propose transition rules which would postpone any reforms until after the housing market recovers, could curtailing the mortgage interest deduction still hit consumer confidence in the short-term?

Answer: Absolutely, the current housing depression is unprecedented in its scope and duration. There are numerous uncertainties facing homeowners, potential buyers, lenders and sellers which have combined to cause a dysfunctional housing market. These include high unemployment rates; historic decreases in home values over the past six years which have caused a loss of over \$7 trillion in home equity for American families; a foreclosure crisis that continues to further depress home values; unstable costs of housing driven by increasingly higher annual rental rates; a pending risk retention rule; overly conservative appraisals; debate over potentially higher down payment requirements; and significant difficulty gaining access to credit even for well-qualified borrowers. These issues combined with debate over cutting the mortgage interest deduction have caused homeowners to stay on the sidelines until there is more certainty in the market. Similarly, lenders and appraisers who face put back and litigation risk have become overly conservative, making entry into the housing market increasingly difficult once buyers get off the sidelines.

Congress should delay the debate on any policy, including the MID, that will have negative consequences on the market until it is in a sustained recovery and values begin to increase. Families must begin to restore their equity in their single biggest asset before their confidence will come back. Consumer confidence has been lost and the public debate over future threats to home values is making a bad situation worse. Policymakers should acknowledge this and send a signal that they understand the plight of these homeowners and pledge to do no harm as they try to recover.

Your question also raises the issue of whether an effective grandfather can be designed that would not imperil the recovery, assuming Congress rejects the above advice and decides to go forward with an MID elimination or reduction at this time. I do not believe that it can. If Congress decides to grandfather existing mortgages, it will nonetheless lower home values, since prospective purchasers of existing homes who contemplate a *new* mortgage will no doubt reduce their enthusiasm for the purchase of any such home. I believe it is clear that, if Congress decides to grandfather existing structures, the result will be a serious reduction in demand for new homes and a further impediment to the recovery of the homebuilding industry.

I believe the only responsible course, therefore, is to put aside all discussion of a change to the MID and await a more stable time when productive discussion of that issue can be undertaken without further harm to the economy.

COMMUNICATIONS

United States Senate Committee on Finance

Tax Reform Options: Incentives for Homeownership

Thursday, October 6, 2011, 10:00 AM
215 Dirksen Senate Office Building

By Michael Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, Virginia 22304

Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to address this topic. As ending the Mortgage Interest Deduction seems to be the tax benefit everyone wishes to cut in order to balance the budget, this is a timely topic indeed.

The scheduled witnesses have undoubtedly pointed out that on one side, people took out long term loans in expectation of having this deduction, and therefore limiting it essentially alters the term of their contract. Witnesses on the other side have likely pointed out that this deduction is mostly used when loan balances are high and payments are mostly going to interest, which is not the case later in the loan.

For lower income earners with smaller loan values, or taxpayers with more mature loans, interest may be so low that the standard deduction is more lucrative – unless of course people harvest their equity to pay down other debt or make purchases – however given the state of the economy, I doubt many are advocating that strategy today.

Finally, we sure that someone will mention research that shows the likelihood that no one forgoes a vacation property or upgrades to more luxurious housing because of tax policy, although wealthier homeowners certainly appreciate the tax deduction and may contribute money to keep it. This is a privilege that most borrowers don't have.

In our conversations with other tax reform advocates, we get the impression that they think that repealing the MID may be the sweet spot in getting tax reform done to cut the deficit and lower rates, as if wealthy tax payers won't notice their tax bills rising. As people who make more are generally more savvy at about tax policy, we find such a view lacks basic credulity. Taxes must indeed go up for high earners, either through compromise or, when the economy eventually recovers, through the eventual expiration of the 2001 and especially the 2003 rate cuts on capital gains and dividends – which are essentially automatic if no compromise is reached.

We also do not believe that the housing sector will roll over for the expiration of the MID, as is likely obvious from today's hearings and comments for the record.

The long term problems on the spending side are as important to deal with as the loss of tax revenue from extensions of the Bush/Obama tax cuts, although we believe the latter drives this process. The only reasonable answer to the former problem, however, is to change the demographics.

Life is essentially a Ponzi Scheme, especially as the society ages. This is especially true in modern societies with social welfare systems and market capitalism, but was equally true in ancient times when grandmothers encouraged the birth of grandchildren. Grandma is not stupid – she wants more kids around so she can continue to eat at the family table because kids become workers.

With the dissolution of extended family living, Grandma and now Grandpa rely on both the Social Security, pension and retirement savings systems. All of these require more workers to make things and pay taxes (even when productivity increases) and as importantly more people to buy things – something productivity raises can't mimic. This is especially true for wealthier taxpayers who live off of dividends. You can't eat a bond or stock certificate – someone must buy the underlying product.

For our retirement system to thrive, the thing we need most is not better financial schemes, but more children. As it happens, research shows that the biggest cost of growing a family is the cost of improved housing, although not necessarily purchased housing. This is especially true with the first child, but also with the first child of a different sex – particularly in later years.

Using the expiration of the Mortgage Interest Deduction to simply lower tax rates and pay down debt, if it can be accomplished at all, would miss a golden opportunity to instead expand the Child Tax Credit to something more resembling a living wage, especially if it is made refundable. As the committee may remember, this proposal is a key part of our tax reform proposal.

To refresh your memories, the Center for Fiscal Equity has a four part proposal for long term tax and health care reform. The key elements are

- a Value Added Tax (VAT) that everyone pays, except exporters,
- a VAT-like Net Business Receipts Tax (NBRT) that is paid by employers but, because it has offsets for providing health care, education benefits and family support, does not show up on the receipt and is not avoidable at the border,
- a payroll tax to for Old Age and Survivors Insurance (OASI) (unless, of course, we move from an income based contribution to an equal contribution for all seniors), and
- an income and inheritance surtax on high income individuals so that in the short term they are not paying less of a tax burden because they are more likely to save than spend – and thus avoid the VAT and indirect payment of the NBRT.

The expansion of the Child Tax Credit is what makes tax reform worthwhile. If the goal of tax reform is simply more revenue, that can be accomplished by eventual economic recovery and political gridlock through the automatic return to Clinton era tax rates. Funding health care can happen easily with premium increases, slight benefit cuts and eventual increases to the HI payroll tax. Expanding the child tax cut, however, may well solve the aging crisis.

Adding the Child Tax Credit to the employer paid VAT-like Net Business Receipts Tax (NBRT) rather than retaining it under personal income taxes saves families the cost of going to a tax preparer to fully take advantage of the credit and allows the credit to be distributed throughout the year with payroll. In order to make room in payroll for an expanded child tax credit, salaries would be generally decreased, which both adds a stick to the carrot by encouraging families with less children to have more and removes the perverse incentive to fire older workers as they demand more money to feed their families, or simply because they make more due to seniority.

The only tax filing for most families required in such a reform would be for the employer to send each beneficiary a statement of how much tax was paid, which would be shared with the government. The government would then transmit this information to each recipient family with the instruction to notify the IRS if their employer short-changes them. This also helps prevent payments to non-existent payees.

The expansion of the child tax credit to \$520 per child per month is paid for by ending the tax exemption for children, the home mortgage interest deduction and the property tax deduction. This is more attractive to the housing industry than the alternative proposal, which is to end or limit the credit and use the proceeds to help bring the budget into primary balance.

Assistance at this level, especially if matched by state governments may very well trigger another baby boom, especially since adding children will add the additional income now added by buying a bigger house. Such a baby boom is the only real long term solution to the demographic problems facing Social Security, Medicare and Medicaid, which are more demographic than fiscal. Fixing that problem in the right way definitely adds value to tax reform.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

**Statement of the National Association of Realtors (NAR)
Senate Finance Committee hearing of October 6, 2011
“Tax Reform Options: Incentives for Homeownership”**

The NATIONAL ASSOCIATION OF REALTORS (NAR) is a trade association that represents a variety of real estate professionals engaged in activities including real estate sales and brokerage, property management, residential and commercial leasing and appraisal. NAR has more than one million members, almost all of whom are members in their personal capacity and not as corporate entities. A REALTOR’s business is a highly personal, hands-on, face-to-face model, focused on a family’s fundamental needs for shelter. Real estate investment and operations provide locations where the commerce that drives the economy is conducted.

If one were designing a tax system for the first time, one might come up with something that is remarkably different from what we have today. But we’re not starting from scratch, particularly in the context of housing. The tax system has featured a deduction for mortgage interest from the inception of the system nearly 100 years ago. Thus, its value is deeply embedded in the price of a home. While economists agree that there is no accurate measure of the value of those embedded tax benefits, they all generally agree that the value of a particular home includes tax benefits.

The mortgage interest deduction (MID) is among the most simple and straightforward of all the provisions commonly utilized on Form 1041 and its Schedule A. The deduction is familiar enough that during the current discussion about tax reform any description of a new proposal, whether in the media or in other setting, uses the mortgage interest deduction as a metaphor for the dimensions of sweeping change.

The NATIONAL ASSOCIATION OF REALTORS remains committed to preserving current law incentives for homeownership. Moreover, REALTORS emphasize that there could not be a worse time for even *considering* changes to these incentives. Neither the housing market nor the housing finance system has recovered from the horrors of the market crash that began in 2007. We can identify no benefit to the economy if the market slump is exacerbated by tax law changes.

These comments are a response to proposals that have been put forward recently to reduce the fiscal impact of the mortgage interest deduction. We will also respond to critics’ allegations that we believe misrepresent incentives for homeownership. We note that real estate is the most widely-held category of assets that American families own, so changes to its tax treatment will have far-reaching impact in the economy.

Finally, we emphasize that any change that would erode the value of the tax incentives to homeownership becomes a tax increase and often would often cause a further diminution in the values of homes.

Three Basic Approaches

Over the past ten months, at least three approaches for modifying and/or reducing the mortgage interest deduction (MID) have been launched. These three approaches illustrate fundamental modes of change. Even if some of the details were changed (such as amount of a credit or certain dollar amounts), all would limit the value of the deduction and/or have a negative impact on the value of housing.

We again emphasize in the strongest possible terms that any change to the benefits associated with the mortgage interest deduction would undermine a housing recovery. Any limitation would further erode confidence in a market where confidence in the future is essential.

The three proposals that have come forward would all cause harm. Worse, they confuse consumers who fear that they can predict neither the nature nor the impact that changes would have on them. This uncertainty and confusion have a chilling effect in the market.

The three proposed changes include President Obama's proposal to limit itemized deductions for taxpayers above the current 28% bracket, the Bowles-Simpson proposal to convert all mortgage interest deductions to a tax credit and another Bowles-Simpson proposal that would reduce the cap on mortgages eligible for mortgage interest deductions from \$1 million to \$500,000. Enactment of any of these proposals would be a tax increase felt most keenly by working families, not by that category broadly referred to as "the rich."

The President's 28% limitation proposal is exceptionally complex and cannot be planned for. An individual, particularly one who owns a business or who is self-employed, may be in different tax brackets from year to year. These individuals have a particularly difficult time estimating their tax payments and their incomes, particularly in today's uncertain economic climate. They do not need added burdens of complexity or unanticipated tax increases. A reduction in the mortgage interest deduction (MID) would further complicate their family finances.

Some will say that putting a limitation on upper income taxpayers would cause no harm for those in lower brackets. When reduced tax benefits reduce the value of a home, the value of all homes decreases. A collapse or reduction in home values at the top end of the market cause downward pressure on all other homes. ***That is, when the value of my neighbor's house declines, then the value of my house declines, as well.***

Converting the deduction to a 12% credit that is smaller than all but the lowest tax bracket (10% under current law) would be particularly harmful to the lower and middle segments of the income spectrum. After all, the 10% bracket applies only to income between \$0 and \$8375 on a single return (\$16,750 on a joint return). **All individuals with income in excess of these modest amounts would experience a tax increase.**

In 2005, NAR commissioned outside research on the impact of changing the mortgage interest deduction to a tax credit. While the conclusions are now somewhat dated, the contrast with the Simpson-Bowles 12% credit is nonetheless striking. NAR asked its consultants to design a *revenue-neutral* tax credit based on data then currently available. (Revenue-neutral was intended as a design under which the amount of the tax expenditure associated with mortgage interest was neither increased nor decreased.) That analysis showed that in 2005, a revenue-neutral rate for a credit would have been 22% -- fully ten percentage points *above* the amount of the Simpson-Bowles proposal. **Thus, both mechanically and analytically, the Simpson-Bowles 12% tax credit recommendation becomes a substantial tax increase for all but the lowest income individuals.** Even the Bush Tax Reform Panel's recommendation of converting the deduction to a 15% tax credit would have been a substantial tax increase for most. (Note that NAR will soon have data on the rate under current law for a revenue-neutral tax credit.)

Many economists have traditionally favored tax credits over tax deductions because deductions provide higher tax benefits to upper-income taxpayers. In other words, in a progressive tax system like ours, an individual in the 15% bracket receives only 15 cents of tax reduction for each dollar of interest deducted, while an individual in the 35% bracket receives a tax benefit of 35 cents on the dollar. The mathematics of this assertion are correct, but asymmetrical: The tax benefit analysis of a deduction ignores the balance between tax rates and individual income taxation. An individual in the 15% bracket pays only 15 cents of tax on the dollar, while an individual in the 35% bracket pays tax of 35 cents on the dollar. **Thus, tax rates balance, rather than distort, the value of deductions.**

A \$500,000 cap has very harsh application in high-cost parts of the country. The geographic distribution of such a limitation is particularly uneven and unfair. After all, a \$500,000 home in a medium-size Midwestern city is likely to be far more luxurious than a \$500,000 home in any densely-populated urban area in the East or West. In most high-cost areas, families pay substantial portions of their family income for housing, even when their residences are modest.

The most recent monthly NAR data on existing home sales (August 2011) show improvement for the first time in several months, but underscore just how fragile the market remains. The rate of existing home sales has been on a seesaw for all of the past 12 months, showing no sustained month-to-month improvement for any period longer than November 2010 – January 2011. Notably, the volume of sales reached its 12-month high in January 2011 and has not yet

climbed back to that level. In addition, median prices year over year continue to decline in all regions, with the largest decline occurring in the West. Since the beginning of the 2007 crash, national declines in home values is 30% -- a loss of about \$7 Trillion in family wealth.

Clearly the housing market has not yet reached a stable floor. *Any* change to the economics of homeownership, particularly the tax benefits that are embedded in housing values, would further diminish the pace of recovery and have a further chilling effect in the market place.

There can be no economic recovery until the housing market recovers. Thus, we urge you to do no harm and to oppose any change to the tax laws that apply to housing, particularly the mortgage interest deduction. According to data provided to NAR, 85% of taxpayers who would be negatively affected by reducing the cap to \$500,000 have AGI of less than \$250,000, and roughly 50% of them have AGI below \$100,000.

An oversimplified set of examples of the impact of converting the MID to a tax credit and of limiting the value of the MID for those above the 28% bracket is presented in Appendix A.

Answering the Critics

Critics: Only a third of taxpayers itemize deductions. While it is true that in any particular year only about a third of individuals itemize deductions, this figure is a snapshot. Over the course of an owner's tenure in a home, an individual may itemize in the early years of homeownership, when the interest expense is high relative to the principal paid, but then not itemize in later years. Mortgages get paid off, other non-MID deductions rise and fall, individuals down-size, divorces occur, a spouse dies or needs to simplify living arrangements. These and other life events may convert itemizers into standard deduction taxpayers.

NAR recently (August 31 – September 2, 2011) asked the Harris polling organization to determine the public's (homeowners only) understanding and utilization of MID. That survey showed that 54% of those homeowners surveyed currently utilized the MID, but an additional 16% had taken it in the past. Thus, over time, at least 70% of homeowners have used the MID.

One could just as easily argue that those who utilize the standard deduction – both homeowners and renters – are actually receiving a proportionally deeper subsidy than those who itemize. For example, a married couple's total state and local tax, mortgage interest and charitable contributions might be \$10,000. With the standard deduction currently at about \$12,000, this couple would be receiving tax benefits for \$2000 in expenditures they never made. If they were in a 28% bracket, that would amount to a \$560 tax "freebie." (\$2000 excess x 28%).

Critics: Second Homes are all palaces owned by rich people. Some argue that the government does not have a role in helping to finance second homes. Again, if we were starting from scratch, the tax model for second homes might indeed be different. Notably, however, a mortgage interest deduction for second homes has been allowed for as long as any mortgage interest has been in place. Therefore, the MID is just as deeply embedded in the value of second homes as the deduction for interest on a principal residence. In fact, until 1986, a mortgage interest deduction was allowed for ALL the residences an individual owned and without a dollar limitation.

Presently, second homes account for about 10% of all home sales each year. During the past decade, sales of second homes have been no more than 12% of all sales. The tax returns of second home owners show that more than half – 54% -- are in income classes below \$200,000. In fact, the largest single category of second home owners is in the \$100,000 - \$200,000 AGI range – comfortable, to be sure, but unlikely to own a palace by the sea. NAR data show that **the median income of a second homeowner is \$99,000.**

NAR has routinely surveyed the purchasers of second homes for nearly a decade. Over that period, the median price of a second home has always trailed the median price of a principal residence. Moreover, **the median price of a second home has decreased over the past decade.** In 2003 (the first year of the NAR survey), the median price of a second home was \$190,000. Medians peaked in 2004 at \$204,100. Currently, the median price of a second home is \$150,000 – nearly 25% less than it was at the top of the 2004 market.

NAR's second-home survey also shows that the age of second-home purchasers is increasing. After remaining flat (at around age 45) during the period 2004 – 2008, the average age of second home buyers in 2010 was creeping toward 50, suggesting that owning a second home is as much a retirement strategy as it is a recreation proposition. In fact, NAR research shows that 34% of second home purchasers in 2010 intended to use that property as a principal residence in the future.

Finally, NAR has compiled data identifying all US counties in which more than 10% of the housing stock is second homes. Currently, about 900 of the nation's 3068 (roughly 30%) fall into this group. In some counties with very small populations, second homes can represent about 40% of the housing stock. In Meagher County, Montana, for example, the population is only 1,891 people, but second homes represent 42% of the housing stock. That community is doubtlessly dependent on the jobs and property taxes generated by those second homes.

Thus, about 30% of US counties have a stake in retention of the mortgage interest deduction for second homes. Those properties generate valuable jobs and property and sales taxes for

the communities. To reduce or eliminate the MID for second homes would have at least as dramatic an impact on those communities as it would the taxpayer/owners themselves.

Critics: Only rich people get hurt if the mortgage cap is reduced from \$1 million to \$500,000: It was not until the Tax Reform Act of 1986 that the MID was limited in any way. Before that, *all* interest on *all* mortgages on an *unlimited* number of residences could be deducted. In 1987, the current \$1 million dollar limitation was put in place, along with the restriction that the \$1 million of debt qualifying for an interest deduction was limited to a principal residence and only one other. Note that the \$1 million figure was not indexed for inflation, so, in fact, the value of the deduction has been substantially eroded over the past 24 years.

Research conducted on behalf of NAR shows that individuals in *every* adjusted gross income (AGI) class -- even as low as \$10,000 -- have mortgage debt in excess of \$500,000. Those in the lower income ranges likely include those who are self-employed with minimal income after expenses, those who are business owners with significant losses or retired individuals with other tax-exempt income. No matter what the income category, however, reducing the cap would make their economic positions worse, particularly where there have been losses.

Among those who itemize and claim MID, the AGI classes below \$100,000 comprise 56% of all tax returns. These are primarily working families. Moreover, the AGI classes below \$200,000 represent almost 90% of all itemized returns. **Thus, the overwhelming majority of tax returns with MID are certainly NOT in so-called "Warren Buffett" territory.**

Notably, taxpayers with AGI above \$200,000 have far more resources with which to reduce their mortgage debt than do those with AGI of less than \$200,000. Ironically, a \$500,000 cap thus becomes *less* punitive for very high income taxpayers than it would be for working families -- even fairly well-compensated ones with AGI around \$200,000. These families have more constraints on their liquidity and cash flow than the very high income families.

A \$500,000 cap has wildly divergent geographic implications. The burden of the cap would be disproportionately borne by taxpayers in high costs areas, even though they might not be categorized as "rich" and even though they may have fairly modest homes. NAR would resist any effort to make the cap on the MID contingent on the taxpayer's place of residence. Such a change would impose significant complexity on what is currently a very simple provision.

Critics: A 25% rate would compensate for loss of mortgage interest deductions: For at least the past 30 years, a continuing emphasis on tax rates (rather than the tax base) has obscured the fact that the hardest compliance challenges individuals face is the determination of income -- not the tax rate applied to it. The economic goal of a broad base taxed at the lowest rates has been the Holy Grail. In fact, in 1986, rates were reduced to their lowest point (28%) in the post-

WWII era. That rate was achieved only because of the loss of many tax benefits, particularly those associated with some forms of investment real estate.

Since 1986, the tax base has been modified with nearly every major tax bill. As the chart in Appendix B shows, tax rates have, over the past 30 years, gone up and gone down. In fact, tax rates over the more recent thirty years (1981 – 2011) have proven far more unstable than they were during the previous 30 years (1950 – 1980). In addition, as the columns labeled “Dollar Threshold – Top Rate” show, the dollar threshold for reaching the maximum rate has varied enormously, whether adjusted for inflation or not. There is no reason to think that tax rates, dollar thresholds or the tax base itself will be any *more* stable over the coming years than they have over the past 30.

Even if a 25% tax rate could be achieved without doing any violence to the MID and other important housing incentives, there is no reason to believe, given recent history, that tax rates would remain at the 25% maximum that some seek. Similarly, if the MID and/or other housing incentives were eroded or done away in the context of the current fiscal debate, there is no reason to believe that tax rates would remain fixed at 25% permanently. Similarly, there is no reason to believe that a housing incentive, once curtailed or eliminated, would be restored in the future. There is little available evidence that a tax benefit, once taken away, would be restored, particularly in the real estate industry.

Additional Observations

Capital Gains Exclusion on the Sale of a Principal Residence -- Prior to 1997, the tax rules that governed the sale of a principal residence were complex and largely ignored (Section 1034 of the Internal Revenue Code). The general rule was that there was no recognition of gain, so long as the seller purchased a home of the same or greater value within a specified time. (This was a particular disadvantage to individuals who relocated from a high cost area to a lower cost area.) The deferred gain from the sale reduced the basis of the new home. Other elaborate rules required taxpayers to track the adjusted basis of the homes they owned so that, in the event that they did not purchase a replacement home (or purchased a replacement home of lesser value), the gain on that sale became taxable, as measured from the adjusted basis. Few taxpayers had adequate understanding of the law or sufficient records to enable them to comply with these rules.

In 1997, the Clinton Administration, without input from NAR or others in the housing industry, proposed a complete overhaul and simplification of these rules. Rather than require elaborate basis computations on multiple residences over a term of many years, the new rule simply permitted the seller to exclude up to \$250,000 (\$500,000 on a joint return) of the gain on the sale. Any excess above these amounts would be currently taxable at the capital gains rate for

the year of sale. The reinvestment rules were eliminated, so taxpayers gained mobility and flexibility. The exclusion gives them the ability to downsize, buy more than one property, purchase a non-real estate asset or do anything they choose with the proceeds of the sale. The exclusion is restricted to the sale of only a principal residence, and certain qualifications must be satisfied in order to receive the benefit of the exclusion. As with the MID, the \$250,000 and \$500,000 amounts are not indexed for inflation.

Some have suggested reducing the amount of the exclusion on the rationale that home values have declined so the amount of excludable gain should decline, as well. NAR rejects this reasoning. In fact, homeowners have a very justifiable claim that they made a major contribution to any appreciation in their home, and so should be allowed to retain what, for many, would be the full value of that appreciation.

No data is publicly available that allows either NAR or its consultants to evaluate the impact of possible changes to these rules. No public IRS records present information about Forms 1099 that are filed for home sale transactions, and no capital gains data are separately presented to show the amount of taxable gain reported on homes sales in a particular year. In addition, there is no way to ascertain the value of unrecognized gain that has accumulated in homes that are not currently on the market. Finally, long-term holders are far more likely to have larger appreciation amounts and so should not be penalized for that long tenure.

We note that this provision is among the most taxpayer-friendly sections in the entire Code. When enacted, it was a substantial simplification from prior law. It allows significant flexibility in the financial planning for families. Notably, the gain on the sale of a principal residence is a significant factor in the retirement savings plan of many older Americans. They anticipate downsizing and then using remaining proceeds to supplement any retirement income they have. Prior law penalized individuals over age 55 by making an exclusion a once-in-a-lifetime provision. Today's rules reflect far more accurately the homeownership patterns over a lifetime. They should be retained at their current levels.

Relief for Cancellation of Mortgage Indebtedness -- Under general tax principles, when a lender cancels a portion or all of a debt, including mortgage debt, the borrower is required to recognize the forgiven amount as income and pay tax on it at ordinary income rates. An exception is provided for some mortgage debt that was or will be forgiven between January 1, 2007 and December 31, 2012. When this relief was initially considered in 2007, the Ways and Means Committee reported it as a permanent provision. The final version, however, was temporary and in place only through December 31, 2009. That date was extended through December 2012 as part of the flurry of legislation enacted at the height of the financial crisis.

Regrettably, it presently appears that this relief will be needed beyond 2012. The backlog of short sales and foreclosures shows no sign of clearing. In addition, many individuals are now losing their homes because of unemployment, rather than as a result of irresponsible lending practices that contributed to the financial crisis in 2008. With the unemployment rate still locked in above 9%, there can be no expectation that the housing crisis will have resolved itself by the end of 2012. We therefore urge Congress to make mortgage cancellation relief a permanent part of the Code.

APPENDIX A – VALUE OF MORTGAGE INTEREST DEDUCTION OF \$10,000

Selected Proposals (Over-simplified)

Tax Bracket	Range of Bracket Married filing Joint (2010)	Current Law	Limit to 28% bracket Obama/Jobs Bill	Increase in Taxes (Over Current Law)	12% Tax Credit Bowles-Simpson	Increase in Taxes (Over Current Law)
25%	\$100,000 - \$137,300 <i>Taxable Income*</i>	\$2,500 (\$10,000 x .25)	\$2,500 (Same as current law)	None	\$1,200 (\$10,000 x .12)	\$1,300
28%	\$137,300 - \$209,250 <i>Taxable Income*</i>	\$2,800 (\$10,000 x .28)	\$2,800 (Same as current law)	None	\$1,200 (\$10,000 x .12)	\$1,600
35%	\$209,250 - \$373,650 <i>Taxable Income*</i>	\$3,500 (\$10,000 x .35)	\$2,800 (Limit to 28% bracket)	\$700	\$1,200 (\$10,000 x .12)	\$2,300
39.6%	Not Available	Not Applicable	\$2,800 (Tentative)**	\$1,160 (Tentative)**	\$1,200 (\$10,000 x .12)	\$2,760***

In each of these examples, the impact on any particular individual's *total* tax burden would vary, depending on that individual's overall tax posture. In addition to ordinary income (such as wages, Schedule C), individuals will have varying mixes of lower- taxed income (such as dividends or capital gains), partially- taxed income (such as Social Security Income for some, but not all, recipients) or tax-exempt income (such as state and local bonds).

In addition, the dollar impacts in these examples do not reflect the reality of a progressive tax system.

*Taxable income does NOT include such items as personal exemptions, itemized deductions or tax credits, so adjusted gross income is a larger number than taxable income.

** For comparison only. If Bush tax brackets revert to pre-2001 model, there may not be a 28% bracket. The tentative tax increase shown in the unshaded box is based on the difference between the value of a \$10,000 deduction at 39.6% and at a 28% bracket.

*** The difference between a deduction valued at \$3960 and a tax credit of 12% or \$1200.

APPENDIX B – TAX RATES: THEY GO UP, THEY GO DOWN¹

Selected Years -- 1950 – 2011

YEAR	MAXIMUM REGULAR TAX RATE	NUMBER OF TAX BRACKETS	SURTAX RATES ²	Dollar Amount - Top Rate (Not adjusted for inflation) (Joint Return)	Dollar Amount - Top Rate (Adjusted for inflation – 2011 Dollars)
2011	35	6		\$379,150	\$379,150
2003	35	6		\$311,950	\$380,409
2002	38.6 ³	6		\$307,050	\$382,967
2001	39.1	5		\$279,350	\$376,732
2000	39.6	5		\$288,350	\$375,725
1993	39.6	5		\$250,000	\$388,200
1992	31	3		\$86,500	\$138,338
1990	28 ⁴	2		\$32,450	\$55,709
1988	28	2		\$56,427	\$30,950
1987	38.5 ⁵	5		\$90,000	\$177,766
1986	50	15		\$175,250	\$358,782
1981	70 ⁶	16		\$215,400	\$531,698
1976	70	25		\$200,000	\$788,681
1970	70	25	2.5%	\$200,000	\$1,156,596
1969	70	25	10%	\$200,000	\$1,222,777
1968	70	25	7.5%	\$200,000	\$1,289,538
1967	70	25		\$200,000	\$1,343,591
1964	77	26		\$400,000	\$2,895,221
1963	91	24		\$400,000	\$2,933,067
1954	91	24		\$400,000	\$3,336,500
1953	92	24		\$400,000	\$3,361,492
1950 ⁷	87.2	21	3%, 7%, 9%, 13%	Not Comparable	Not Comparable

¹ Source: The Tax Foundation, US Federal Income Tax Rates History at taxfoundation.org/publications

² Surtaxes were used, in part, to fund World War II and the Viet Nam war.

³ The so-called Bush Tax Cuts enacted in 2001 to reduce the top rate from 39.6% to 35% were in effect for only part of the 2001 tax year, and were phased in during 2002. The 35% rate was fully phased in by 2003.

⁴ Between 1987 and 1990, a so-called "bubble" caused the maximum tax rate to be 33% for certain taxpayers. This occurred because of certain phase-outs of lower brackets for individuals with income between approximately \$71,000 and \$123,000.

⁵ The phase-in of the 28% rate enacted in 1986 was not complete until 1988.

⁶ President Reagan's tax cuts, enacted in 1981, became effective in 1982. In 1982, the top rate dropped to 50%, where it remained through Tax Reform Act of 1986.

⁷ Before the Internal Revenue Code of 1954, the Internal Revenue Code of 1939 had such a different mode of computing income that the "top dollar" concept is not a helpful analytic tool. It is important, though, to note the high tax rates and surtax rates in effect during the war years.

Statement for the Record
For the
Committee on Finance
United States Senate
Hearing on
Tax Reform Options: Incentives for Homeownership
October 6, 2011

Peter Orser
President & Chief Executive Officer
Weyerhaeuser Real Estate Company
400 North Capitol Street NW, Suite 490
Washington, D.C. 20001

Weyerhaeuser Company, one of the world's largest forest products companies, has been producing forest products and providing high-skilled American manufacturing jobs for more than 110 years. We grow and harvest trees, and make a range of forest products essential to everyday lives.

We are also one of the largest U.S. homebuilders through our subsidiary Weyerhaeuser Real Estate Company (WRECO), which builds in Arizona, California, Texas, Nevada, Maryland, Virginia and Washington. At the end of 2010, Weyerhaeuser employed approximately 14,000 employees, and generated \$6.6 billion in sales worldwide.

WRECO is a member of the Leading Builders of America (LBA), which represents the 20 largest builders in the country. Member companies build across the residential spectrum from first-time and move-up to luxury and active-adult housing. In each of these segments, LBA members are leaders in construction quality, energy efficiency, design and the efficient use of land. Our purpose is to preserve home affordability for American families by carefully evaluating the public policy dialog at the federal and state level and becoming actively engaged in issues that have the potential to impact home affordability.

Over the last 25 years, I have been thoroughly immersed in developing neighborhoods and building homes in the Pacific Northwest. Providing housing has been my occupation, as well as my avocation. I have served in a variety of roles in a company that is one of the largest homebuilders in the Northwest, Quadrant Homes. I also volunteer with neighborhood and affordable housing not-for-profit organizations that operate on a local and regional basis. I have just completed my first year as president of WRECO, which has been a very challenging year in the current housing market.

Three of the company's four businesses are directly tied to housing. We are the 17th largest homebuilder in America, as well as the second largest owner of private timberland in the country. Trees from our timberlands supply the wood products market. We are also one of the nation's largest manufacturers of wood products that are used in the construction of homes.

All of Weyerhaeuser's businesses are strengthened by a robust housing market. The unprecedented decline in housing starts in the last few years has led to deep and now entrenched declines in demand for wood products and has had an exponential adverse effect on other housing-related goods and services that support the housing industry. We understand the economic contributions of a healthy housing market and are vitally interested in its recovery.

Our comments outline the importance of the housing market to the U.S. economy and the effect federal policies can have on housing. We will emphasize the value of the Mortgage Interest Deduction (MID), along with other policies Weyerhaeuser and our industry believe encourage responsible homeownership.

The U.S. Economy and the Housing Market

The decline in the U.S. housing market has been significant. Since 2005, according to Zillow.com, home values have fallen at a rate greater than during the Depression (1928 to 1933).

Weyerhaeuser has not been immune. Nearly 40 percent of our wood products employees have lost their jobs due to weak market conditions. The wood products business permanently closed 25 mills or nearly 30 percent of manufacturing capacity since the 2005 peak. Our three wood products manufacturing divisions (Softwood Lumber, Oriented Strand Board and Engineered Lumber) are currently operating at rates ranging from approximately 50 to 80 percent of capacity.

Weyerhaeuser's timberland business is experiencing the lowest domestic log prices since the 1970s and, when adjusted for inflation, those prices are comparable to Depression-era levels. Since 2005, the composite lumber price has fallen 45 percent.

WRECO housing starts have fallen nearly 67 percent over that same period. Those numbers are exacerbated in our markets such as California (74 percent) and Nevada (76 percent), but the impact is much broader. According to CNBC.com, January 2011 marked the 55th consecutive month that home values have fallen nationwide. During that time, home values fell by \$9 trillion, or 40 percent. Martin S. Feldstein, a professor of economics at Harvard, estimates that home values have fallen another \$1 trillion, or 8 percent in the last 12 months ending in June.

Karl Case, the co-creator of the Standard & Poor/Case-Shiller Home Price Indices, which many economists look to as the leading measures for the U.S. residential housing market, estimated the decline in home prices from 2005 to 2009 caused consumer spending to be \$240 billion lower in 2010 than it otherwise would have been. That figure is equal to about 1.7 percent of annual economic activity, which is the difference between the recent mediocre growth and healthy growth. The \$240 billion does not include all the other effects of the housing crash, including the low level of new home construction, that are also weighing on the economy.

The decline in housing has clearly affected the U.S. economy. In most prior recessions, the economy has not recovered without the housing market also recovering. This suggests it is all the more important to enact policies that help facilitate a housing recovery, and do not further harm the already fragile market.

As U.S. Federal Reserve Chairman Bernanke has observed, "The housing sector typically plays an important role in economic recovery. The depressed state of housing in the U.S. is a big reason economic recovery is less vigorous than we would like."

The correlation is clear: the housing market has led our country out of economic downturns before and we are confident that it can lead us out again.

There is a demonstrative value for incentivizing responsible homeownership because it reverberates throughout the economy. Jobs associated with the housing market begin in the industries where lumber, concrete, lighting and plumbing fixtures, appliances, and other products that go into a home are produced. Workers are employed to directly engage in construction activity. More jobs are created when real estate agents, insurance brokers and others provide services to homebuilders and homebuyers. There are also benefits to the furniture industry and other homeowner investments that are a part of every new home purchase. The ultimate effect is a boost for American jobs.

Homebuilders are also community builders as they plan and install the infrastructure required to service a new community including the parks, schools and fire stations necessary for a complete community.

The National Association of Home Builders (NAHB) released the following study on the direct economic impacts of new residential construction and remodeling at the national level:

- 3.05 jobs and \$89,216 in taxes (from building an average new single family home).
- 1.16 jobs and \$33,494 in taxes (from building an average new multifamily rental unit).
- 1.11 jobs and \$30,217 in taxes (from \$100,000 spent on residential remodel).

New construction not only creates jobs and tax revenue, it creates confidence in the market and is an important part of most Americans' views toward their own financial security. Several third party surveys confirm the strength of this enduring value.

A recent Pew Research Center survey found:

- Homeownership topped the list of long term financial goals for Americans.
- Just 24% of renters surveyed said they rent out of choice and 76% said they would like to buy a home.
- 82% of homeowners who indicated their home is worth less than before the recession said homeownership is the best long term investment a person can make.

A 2010 survey by Fannie Mae also found:

- Seven out of ten respondents (70%) said they believe buying a home continues to be one of the safest investments available.

Clearly, the results of these surveys demonstrate the importance of housing to Americans and our economy. It's important that federal policy protect and support responsible homeownership.

We also believe policies are needed to encourage homebuyers to re-enter the market, stabilize home prices, and keep people in their homes. These recommendations may increase or maintain current tax revenue.

Federal Housing Policies

Weyerhaeuser believes lax lending standards and faulty underwriting by credit rating agencies of mortgage backed securities contributed to the unprecedented financial crisis of the past several years. Housing finance standards need to change to create more discipline

in the market, but they should be crafted in a way that does not eliminate qualified, responsible buyers. To drastically change or eliminate critical, broad-based responsible incentives like the MID is also not the solution.

Mortgage Interest Deduction

The MID has been a great asset for homeowners and American neighborhoods. Since its creation in 1946, homeownership has grown from 44 percent to more than 66 percent today. Over this same period Americans have accumulated \$9 trillion in home equity, which has strengthened and expanded the economy over the years. The prominence of businesses, schools, hospitals, churches and other community staples are also connected to a strong housing industry. Through the terms of 17 presidents, the MID has brought remarkable stability to the housing market.

Some are suggesting that the MID be trimmed or eliminated outright in order to save more than \$1 trillion over 10 years. But if the MID is eliminated, what will be the effect; will those savings materialize?

Homeowners already pay 80 to 90 percent of the income tax in our country, and among those who claim the MID, almost two-thirds are middle-income earners. That means those who use it are the backbone of working America and generate nearly all federal income tax revenue. Any change to the MID would be an additional tax burden on the middle class. In the case of elimination, it would cause a 15 percent drop in home values and result in 2 million fewer homeowners according to the National Association of Realtors.

Eliminating the MID would cause a significant disruption in many markets across the U.S., including where we build homes. For example, if a three member household with a combined income of \$75,000 purchased a home with a \$195,000 mortgage, that family would pay nearly \$1,643 in additional taxes or a 43 percent tax increase according to the Leading Builders of America.

There has also been discussion about tweaking subsections of the MID such as eliminating the second home mortgage interest deduction. Some assume this is used for beach homes or lavish properties. However, that characterization is not accurate. In fact, most beach homeowners own the home outright and do not qualify for the MID.

In many cases, the second home deduction is used by homeowners who relocate to another area. It allows homeowners to claim the mortgage interest deduction during a period of homeownership transition, such as when a family moves and will own two separate principal residences in a given tax year.

Using Census data, NAHB compared the actual second homes of those who claimed the MID. They found that nearly every state has areas with significant numbers of second homes – 49 states have a county where at least 10 percent of the housing stock consists of second homes. The data also showed 26 counties where 50 percent or more of the housing stock is second homes.

Repeal of the second home mortgage interest deduction rules would impact large sections of the country and nearly every state. There would be negative economic consequences throughout the nation in terms of lost home prices, sales and construction. The price declines would be more prevalent in areas where second home ownership is common.

Since home values directly correlate with property taxes, repealing the second home mortgage interest deduction would not be isolated to the homeowner, but the broader community, as governments at all levels would face additional revenue shortfalls.

Others have suggested lowering the current cap on the MID or converting it to a tax credit. Such proposals would have significant consequences for housing markets because of the importance of the mortgage interest deduction to homebuyers, particularly younger homebuyers who pay more interest and less principal on a loan in the early years of their mortgage.

The home equity line of credit is another important component of the MID. Currently, more than 50 percent of all home equity loans are used for remodeling. As NAHB estimates, there is a clear trickledown effect on the broader economy from job creation to market stabilization to energy efficiency. Remodeling expenditures totaled \$147 billion for professional remodeling jobs, according to 2009 American Housing Survey data. As I mentioned earlier, every \$100,000 in remodeling expenditures creates 1.11 full-time equivalent jobs according to NAHB data.

The Erskine-Bowles plan, for example, would have a significant impact on middle-class homeowners. Suppose a married couple, both of whom work and earn \$45,000 for a total household income of \$90,000. Their family faces a 25 percent marginal income tax rate. Under present law, a dollar of mortgage interest paid is worth on a marginal basis 25 cents of reduced tax liability. Under the commission's proposal, the marginal value would fall more than half to 12 cents. The MID is worth about \$3,000 to a typical family with this income and mortgage. Under the tax credit plan with a cap, it would be worth less than \$1,500. That is the equivalent of raising their mortgage payment by \$125 per month. Effectively, this would take millions of dollars out of the economy and amount to a tax increase for millions of families.

We realize difficult decisions are necessary to balance the nation's budget. Making such a monumental change in housing policy at this time, when the industry is operating at record lows, will do more damage to the economy than the suggested savings from MID. The industry has proven that it generates jobs and tax revenue when healthy. Future policy should be directed toward insuring the health of the industry.

Increase Conforming Loan Limits

Reauthorizing the recently expired conforming loan limits is another critical step. The reductions for GSEs and FHA made an additional 1.7 million homes ineligible for financing. Yet, we also recognize an across-the-board extension should not be permanent. The extension is important in the short-term, since there is virtually no private mortgage financing in today's market.

Some believe the conforming loan limit reduction provides stability to the housing market and represents substantial savings. We know that analysis is off base. As Moody Analytics Chief Economist Mark Zandi said, "There would be no meaningful cost to taxpayers of delaying a reduction in the conforming loan limits, but the cost to the housing market and economy of a misjudgment would be high." Congress should reauthorize the loan limits to ensure access to credit until the housing market rebounds and stabilizes.

Improve Qualified Residential Mortgage Rules

The Wall Street Reform and Consumer Protection Act, commonly known as the Dodd-Frank Law, introduced a risk retention rule known as Qualified Residential Mortgages (QRM). QRM will greatly affect federal revenue from housing by requiring a 20 percent down payment or equity in an existing home. If the draft QRM rules had been in effect in 2010, 75 percent of homebuyers that year would not have qualified for a loan. Congress should instruct FHFA, HUD, FHA, FDIC and the GSEs to work with lenders to identify barriers that prevent them from making loans to qualified buyers. Furthermore, current FICO Scores, underwriting ratios requiring 20 percent down payments and document verification requirements need to be reset to more reasonable levels, with recognition of compensating factors and judgment.

Reduce Taxpayer Exposure to Government-Sponsored Enterprises (GSEs)

We support a reconstituted form of the GSEs that will reduce taxpayer exposure. Congress should establish a fee on mortgage lenders with the revenues used to create an insurance pool or reserve to cover losses on mortgage securities caused by defaults on the underlying loans. In effect, this would be a self-insurance fund tied to mortgage underwriting to align mortgage lenders with their industry risk. But, we want to be clear here. We believe the Federal Government must remain as the ultimate backstop in order to preserve markets and maintain stability. This proposal appropriately and significantly lowers the risk that the guarantee would ever be called upon.

Reduce Market Inventory

New homes sales are currently stymied due to the immense inventory of used homes on the market. This inventory is a function of foreclosures that remain unsold combined with homebuyers not having access to mortgage lending. Selling foreclosures to investors would help reduce the current backlog of housing inventory and also shore up neighborhoods challenged by vacant homes. Investment groups, including those that professionally manage homes and share profits with the sellers, should be allowed to purchase foreclosures by revising regulations applicable to banks, GSEs, and HUD that prohibit or discourage this strategy. Doing so will stabilize home prices and neighborhoods, reduce housing inventory and stabilize rising rent rates.

Expand the Home Affordable Refinance Program (HARP)

The expansion of HARP to support homeowners who continue paying underwater mortgages is also important. Current foreclosure modification programs only support those who stop making payments. Policymakers and mortgage lenders should allow homeowners who are current on their mortgage payments to refinance at today's low interest rates. There is a good example of this in the state of Washington, which has a foreclosure mediation

program. It is designed to reduce principal amounts of a mortgage equal to the ultimate cost a bank will absorb for a foreclosure. The economic outcome is the same for the bank, but the homeowner is allowed to keep their residence.

Eliminate Distressed Sales from Appraisals

Another burdensome practice that destabilizes neighborhoods and reduces federal revenue is the use of distressed sale prices in new home and non-distressed home appraisals. Currently, appraisers routinely use distressed home sale prices to establish new home and non-distressed home values. Congress should ensure that federal agencies provide guidance to appraisers to limit the use of foreclosures when establishing the value of new homes and non-distressed sales.

As both a homebuilder and a producer of wood products, Weyerhaeuser has a unique perspective on the housing sector and its impact on the American economy. Our experience, supported by economic analysis, is economic stability can only be achieved if there is also a resurgence in homebuilding and homeownership.

We appreciate the opportunity to offer our viewpoint, and look forward to working with this committee on solutions to the current economic situation.

