National Low Income Housing Coalition

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THE NEED TO LIMIT HOMEOWNER DEDUCTIONS

Statement of Cushing N. Dolbeare, President, National Low Income Housing Coalition, before Committee on Ways and Means, House of Representatives

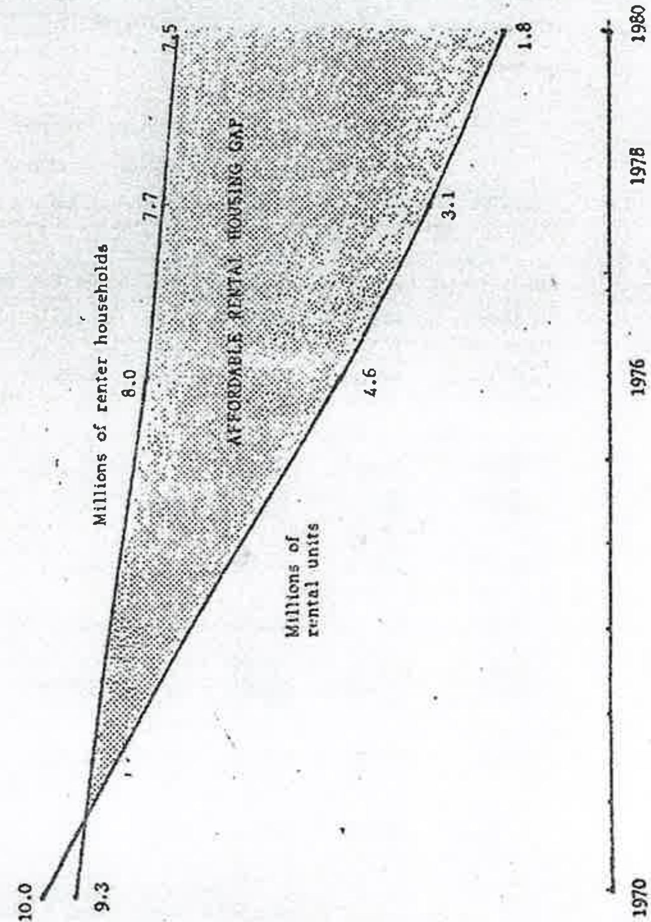
The National Low Income Housing Coalition greatly appreciates this opportunity to testify on the Administration's tax proposals as they relate to low income housing. The Coalition is a public interest organization with a broad and diverse membership, including individuals and organizations from all 50 states, as well as a range of national organizations. As our name implies, we deal with the housing needs of low income people — people who are unable to obtain decent housing at costs they can afford.

The Coalition is concerned both at what the Administration's Economic Recovery Program does with respect to low income housing, and with what it fails to do. While making a one-third cut in the level of housing assistance for lower-income people and changing depreciation rules so as to curtail rental housing production, the Administration leaves home owner deductions untouched. Yet these deductions, unless constrained, are not only inordinately costly, they are inflationary and they have pernicious effects on rental housing -- the chief source of housing for low and moderate income people.

The National Low Income Housing Coalition urges immediate action to limit homeowner deductions and convert them to tax credits. Doing this will reduce their costs, curb their most pernicious aspects, and benefit the majority of home owners (who now do not take these deductions).

Low income housing needs are increasing

During the last decade, the housing needs of low income people grew at an accelerating rate. Low and moderate income people, with few exceptions, cannot become homeowners. Unless they were owners before their incomes fell, they are forced to rent. As the chart on housing need demonstrates, the supply of low rent housing has been declining at a rate of about 500,000 units annually. In 1970, there were 9.3 million renter households with incomes below $5,000. There were some 10 million rental units, most of them unsubsidized, that rented at $105 per month or less, which is what they could afford at 25 percent of income. By 1980, we estimate that the number of units renting at $105 per month or less had decreased to fewer than two million, almost all of them subsidized, while the number of very low income renter households had decreased far less: to an estimated 7.5 million. Thus, there was an affordable housing "gap" of over five million units. This analysis understates the problem, because it ignores the important factors of location, availability, and quality.



<u>Tax expenditures are far more important than direct expenditures in dealing with housing.</u>

The primary focus of attention in limiting federal housing expenditures has been placed on programs serving people who can least afford housing: low and moderate income people living in housing subsidized through programs of the Department of Housing and Urban Development or the Farmers Home Administration. These programs have been declining: each year since 1976, fewer assisted units have been provided. Even President Carter's budget request for 1982 called for fewer than half the units actually funded in 1976. A primary reason for this decline, in the face of rising need, is cost. Yet the cost of these programs is dwarfed by federal tax expenditures for housing, primarily homeowner deductions.

Measured in dollar outlays, the Treasury Department has estimated that tax expenditures related to housing account for more than 80% of total housing costs. Moreover, tax expenditures are rising dramatically. The Treasury estimates them at $28.8 billion in 1980, $35.3 billion in 1981 and $44.1 billion in 1982. Meanwhile, direct outlays for housing assistance were estimated at only $6.1 billion in 1980, $7.4 billion in 1981, and $9.0 billion in 1982. Over 99% of housing expenditures for home owners are tax expenditures. For rental housing, however -- the place where both direct and tax expenditures are being cut in the Economic Recovery Program -- tax expenditures are between one quarter and one fifth of total outlays. (<u>Special Analysis G: Budget for Fiscal Year 1982.</u>) The Treasury table follows:

Housing Tax Expenditures and Budget Outlays
(in millions of dollars)

Description	Fiscal year		
	1980	1981	1982
Housing:			
Owner-occupied housing:			
Tax expenditures (outlay equivalent)	26,840	33,170	41,655
Outlays	115	150	310
Total	26,955	33,320	41,965
Tax expenditures as a percent of total	99.6	99.6	99.3
Rental housing:			
Tax expenditures (outlay equivalent)	1,965	2,155	2,410
Outlays	6,025	7,280	8,680
Total	7,990	9,435	11,090
Tax expenditures as a percent of total	24.6	22.8	21.7
Total:			
Tax expenditures (outlay equivalent)	28,805	35,325	44,065
Outlays	6,140	7,430	8,950
Total	34,945	42,755	53,055
Tax expenditures as a percent of total	82.4	82.6	83.1

Table 1, on the next page, shows the amount and cost of the various housing-related tax expenditures for 1980-82. (These figures are lower than those just cited: they use the conventional definition of tax expenditure rather than "outlay equivalent," which is an adjusted figure.)

Table 1

HOUSING-RELATED TAX EXPENDITURES, 1980, 1981, and 1982
(Dollars in millions)

<u>Home Owner Deductions</u>	1980	1981	1982	Change 1981-82	Percent Change
Mortgage interest on owner-occupied homes	$15,615	$19,805	$25,295	+$5,490	+21.7%
Property tax on owner-occupied homes	7,310	8,915	10,920	+2,005	+22.5%
Subtotal (gross)	(22,925)	(28,720)	(36,215)	(+7,495)	(+26.1%)
Subtotal (net)	22,170	28,065	35,465	+7,400	+26.4%
Residential energy credits	485	540	615	+75	+13.9%
Deferral of capital gains on home sales	1,010	1,100	1,220	+120	+10.9%
Exclusion of capital gains on home sales	535	590	650	+60	+10.2%
TOTAL	24,200	30,295	37,950	+7,655	+20.2%
<u>Investor Deductions</u>					
Expensing of construction period interest and taxes	659	745	775	+30	+4.0%
Depreciation on rental housing in excess of straight line	385	410	430	+20	+4.9%
Five-year amortization for rental housing rehabilitation	15	25	35	+10	+40%
Exclusion of interest on state and local housing bonds	447	840	1,220	+380	+45.2%
TOTAL	1,506	2,020	2,460	+440	+21.8%
GRAND TOTAL	$25,706	$32,315	$40,410	+$8,095	+25.0%

Note: Tax expenditures are defined in the budget as "losses of tax revenue attributable to provisions of the Federal income tax laws that allow a special exclusion, exemption, or deduction from gross income or provide a special credit, preferential rate of tax, or a deferral of tax liability affecting individual or corporate income tax liabilities."

<u>Source</u>: Compiled by LIHIS from <u>Special Analyses, Budget of the United States Government, 1982</u>.

Home owner deductions, which are not dealt with in the Administration's proposals, constitute over 90% of all housing-related tax deductions. And by far the largest home-owner deductions are those for mortgage interest and property taxes. The contrast between the growth of these deductions and outlays for housing assistance is shown in our second chart (page 6). Moreover, these are conservative estimates. The rate of increase beyond 1982 is 18% annually. The Congressional Budget Office projects a much higher rate of increase, about 25%, for mortgage interest deductions between 1980 and 1982.

Costing less, but still significant, are provisions providing for deferral or exclusion of capital gains on home sales. Not estimated is a major tax benefit for home owners, the imputed income for rent on owner-occupied homes.

Homeowner tax preferences create inequities in the tax system and are inefficient as a subsidy mechanism.

William F. Hellmuth, in a paper prepared for a Brookings Institution conference, has commented on the effects of homeowner tax preferences on the tax system and the economy, as follows:

-- They create horizontal inequities in the income tax system in that they provide tax savings for homeowners over tenants with comparable incomes, and differential savings between different homeowners with comparable incomes.

-- The cause vertical inequities in the tax system. Since homeownership rises with income, the values of homes purchased increase as a proportion of income as incomes rise (that is, are income elastic), and the value of homeowner preferences is directly related to the marginal tax rate of the homeowner, high-income recipients benefit more from these preferences than do low-income recipients.

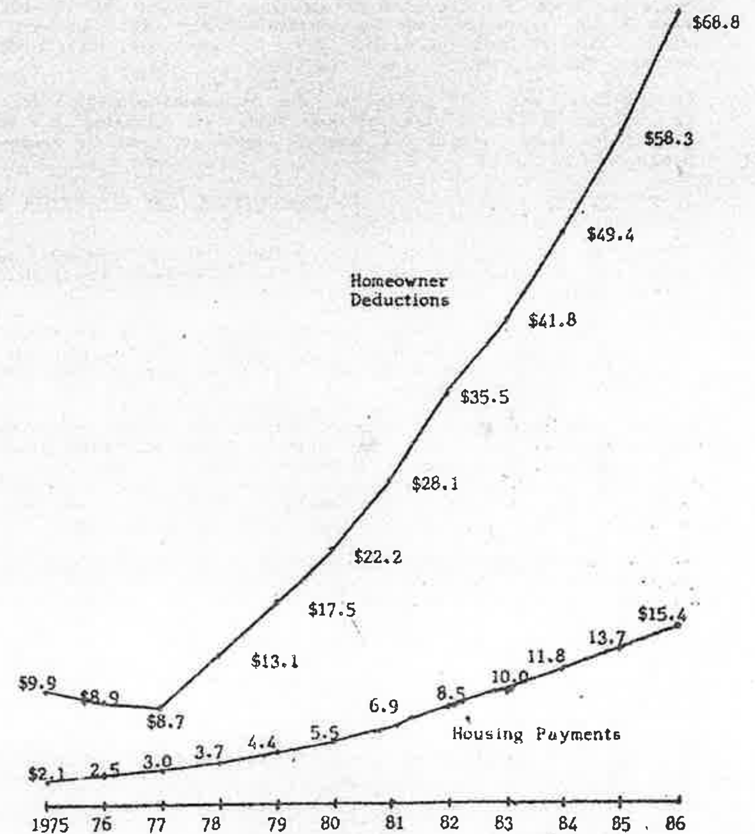
-- They interfere with the allocation of resources between residential construction and other uses of resources. The tax expenditures favoring homeowners lower the cost of housing services and increase the after-tax rate of return on investment in homes, relative to other choices that consumers and individual investors have for the use of their funds. Tax incentives thus draw more resources into housing than would occur in the absence of such preferences.

-- They also distort the housing market choices in favor of residential construction suitable for homeowners, creating a demand for more single-family homes and apartments for purchase than for rental units.....

Further, these homeowner tax preferences are relatively inefficient and expensive if they are considered as incentives to promote homeownership and the construction of more homes. The incentives are most valuable to those with higher marginal tax rates, the income class that would find it easiest to buy homes in the absence

HOMEOWNER DEDUCTIONS AND HOUSING PAYMENTS, 1975 THROUGH 1986

Amount of assisted housing payments (housing subfunction of function 600) in billions of dollars, compared with estimated cost of homeowner mortgage interest and property tax deduction, also in billions. (Source: Relevant volumes of Budget of the United States and Special Analyses, with homeowner deductions projected beyond 1982 at rate of 18% per year.)



of tax incentives. And the incentives for homeownership are much weaker for families in the lower tax brackets whose income levels also make homeownership more difficult. Tax incentives are, of course, of no value to those whose income is so low that they pay no federal income tax. And to the extent that the tax preferences increase the demand for owner-occupied homes, the price of such dwelling units rises and puts them further beyond the reach of low- and modest-income persons. The greater value of these preferences for persons with high incomes and high marginal tax rates is likely to draw more resources into the construction of large and expensive homes: on the other hand, income-neutral incentives would be likely to result in more dwelling units to meet the housing needs of more people.

William F. Hellmuth, "Homeowner Preferences," in Joseph A. Pechman, Comprehensive Income Taxation, Brookings Institution, 1977.

Homeowner tax preferences weren't planned, they just grew.

It might be assumed that the home owner preferences were a conscious policy decision, made after careful consideration of their impact and resting on the advantages of encouraging home ownership. This, however, is not the case. According to George Peterson of the Urban Institute:

the laws establishing mortgage interest and property tax payments as allowable deductions from homeowner incomes were adopted by Congress during the Civil War, when the treatment of housing costs was debated briefly before passage of the emergency tax act which helped to finance the North's war effort. Since that time, the country has merely applied old definitions of taxable income in its successive income tax laws, despite a total transformation in the personal income tax system. The longstanding homeowner deductions did not take on true significance until World War II, when the marginal federal tax rate paid by most Americans was suddenly jumped from 4 percent to 25 percent, making the deductibility of homeowner expenses far more valuable than it previously had been, and in the process creating an important after-tax gap between homeownership and rental costs. (George Peterson, "Federal Tax Policy and Urban Development," Testimony before Subcommittee on the City of the House Banking Committee, June 16, 1977.

Most homeowners do not benefit from the deductions.

Peterson finds the growing importance of homeowner preferences a major cause of the increased rate of homeownership since 1950, particularly for middle and upper income families. But changes in tax laws have led to a "bracket creep" for homeowner deductions: they are concentrated increasingly at the upper end of the income distribution:

Without much fanfare, however, recent tax changes have worked to diminish the tax benefits of owner occupancy by making it more

attractive for taxpayers to claim the standard deduction. The proportion of taxpayers itemizing their returns — and thus gaining the full benefits of the tax advantages for homeownership — fell from 58 percent in 1969 to 31 percent in 1975. After the recent tax revision of 1977, further increasing the standard deduction, it is estimated that only 20-25 percent of taxpayers will itemize their returns in 1978. Ironically, the tax code then will be restricted primarily to subsidizing the housing costs of the affluent, encouraging them to consume more expensive and larger housing without greatly affecting homeownership rates over the rest of the income distribution. This shift in the tax structure will also make it more difficult to apply federal tax benefits to any but the most lavish condominiums, since most households with earnings of less than $24,000 to $26,000 will find it to their advantage to claim the standard deduction. (Ibid.)

The federal government spends less on housing for low and moderate income households than for upper income people.

In 1979, the most recent year for which figures were available, mortgage interest or property taxes were deducted from 25.6% of all returns filed. Peterson's prediction was correct: at least 95% of the value of the deductions was received by taxpayers with incomes above the median, and almost 60% went to taxpayers with incomes in the top 10% of the income distribution.

Thus, the notion that the homeowner deductions go largely to middle income families is wrong. Moreover, homeowner deductions are entitlements: they may be taken by all who qualify, regardless either of need or of the cost to the federal government. In contrast, only one household in ten who qualifies for and needs low income housing assistance actually receives it.

Indeed, the pattern of housing assistance provided by the federal government is so inequitable that, were we to start fresh with a clean slate in designing housing assistance programs, and propose a pattern of entitlements, benefits, and assistance that is equivalent to what is now in place today, not only would it fail to pass the Congress, but it is doubtful if anyone could be found who would introduce it.

Benefits from federal housing programs are so skewed that the total of all the assisted housing payments ever made under all HUD assisted housing programs, from the inception of public housing in 1937 through 1980, was less than the cost to the federal government of housing-related tax expenditures in 1980 alone. Assuming that the beneficiaries of direct and tax expenditures are arrayed, by income group, as they were in 1977, the latest year for which such an analysis is available, we would find that, for 1980:

- o $4.2 billion, or 14.1%, of all direct and indirect housing expenditures went to people at the bottom of the income scale,

Table A-2

Revenue Cost of Allowing Homeowners' Deductions for Mortgage Interest and Real Estate Taxes

(1979 Law, 1979 Levels)

Expanded income class	Returns with tax savings: Number of returns	Returns with tax savings: Percent of all returns filed in class	Average tax savings (returns with savings)	Total revenue cost	Revenue cost as percent of total tax paid by members of class
($000)	(thousands)	(percent)	(dollars)	($ millions)	(percent)
Under 5	83	0.4%	$ 104	$ 9	1/
5 - 10	1,083	5.8	172	167	2.8%
10 - 15	2,553	17.6	254	649	3.7
15 - 20	3,955	33.3	331	1,310	5.4
20 - 30	8,153	51.7	536	4,369	8.3
30 - 50	5,924	73.9	1,023	6,058	11.9
50 - 100	1,658	82.9	2,048	3,395	11.0
100 and over	375	85.6	3,320	1,245	4.2
Total	23,785	25.6%	$ 724	$17,221	8.1%

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: Details may not add to totals because of rounding.

1/ Total tax paid by members of this class is a negative amount.

Source: Reproduced from U.S. Department of Housing and Urban Development, 1980 Housing Production Report, Appendix A.

those with household incomes below $5,000. Only one household in eight received housing assistance, and the average monthly expenditure, per recipient, was $132.

- $7.5 billion, or 25.5%, of all direct and indirect housing expenditures went to people with incomes above $50,000. More than four fifths of all households in this income bracket received tax benefits, and the average monthly amount per recipient was $309.

- $16.7 billion, or 56.4%% of all direct and indirect housing expenditures, went to people with incomes between $20,000 and $50,000. Two fifths of all households in this range received housing benefits and the average amount per recipient was $67 per month.

- Only $1.2 billion, or 4.0% of direct and indirect housing expenditures, went to households with incomes between $5,000 and $10,000. Fewer than one household in ten in this income range received housing benefits, and the average monthly amount, per recipient, was $60.

Homeowner tax preferences contribute to inflation in the housing market.

The tax system is a major factor in encouraging investment in housing. The tendency of people who are already adequately housed -- indeed, generously housed by the standards that are applied to lower income people -- to purchase bigger and more expensive houses drives up prices. Indeed, the widespread tendency to purchase housing more as an investment than as a necessity has led George Sternlieb to coin the term "post-shelter" society.

In a curious symbiotic relationship, not only do homeowner tax preferences contribute to inflation in housing, but they also make it possible for home owners to benefit from inflation.

In the words of Anthony Downs of the Brookings Institution, "Investment in housing has become far more than a strategy for 'keeping up' with inflation: it helps millions of households gain positive benefits from inflation." (Anthony Downs, "Are We Using Too Much Capital for Financing Housing?") Downs finds that the average house purchased with a 20 percent downpayment in 1976 had shown a 67.5% increase in initial equity by 1980. And, because the tax on capital gains from home ownership can be excluded or deferred, the profits are tax free.

The contrast with return from other types of investment is striking. Downs calculates, for example, that a $10,000 bond purchased in 1970 would have declined in real value by 53% by 1980. But, had the investment been made as a 20% down payment for a house costing $50,000 which increased in value at the national average rate, the gain over the decade would have been 891%. Small wonder that those who can afford to do so purchase their homes.

In addition, the costs of carrying a mortgage -- at least a conventional one -- decline with inflation. Since debt service often accounts for at least half the cost of living in a home, this means that real costs decline. And the deductability of mortgage interest means that after-tax rates of interest are considerably lower than nominal rates. Moreover, the reduction becomes larger as income rises. Thus, a purchaser with a 14% mortgage and taxable income of $12,000 actually pays 11% after taxes, but a purchaser with a $45,000 income pays 8% and one with a $60,000 income pays only 7%.

At these interest rates, there is a temptation to refinance and arbitrage the money by investing in other areas -- or simply to trade up and use part of the profits for personal consumption. According to the U.S. League of Savings Associations, more than four fifths of the people who sold their homes in 1979 did not use all their proceeds for reinvestment in another home. About one third shifted more than half their equity out of housing. The average seller took out about one third. Because of this, Downs suggests that we may be investing too much capital in financing housing and that "much of the increased flow of mortgage funds has gone into raising the prices of existing homes, or even into non-housing consumption, rather than into expanding the housing stock to meet valid social needs."

All of this, of course, makes it harder for households who are left behind: young families and low income families, who need housing for shelter.

The impact on rental housing

The economic advantages of home ownership, fueled by tax preferences, are at the root of a crisis in rental housing production. With inflation, rents in unsubsidized new units have risen to unprecedented levels: $500 monthly or more. At $500, a rent-income ratio of 25% would require an income of $24,000. Yet, only one renter household in twenty at that income level spends as much as 25% of income for rent, including utilities. Assuming a marginal tax rate of 30%, the renter would have to earn $650, before taxes, for each $500 rent check. Contrasting that with the advantages of home ownership means that, in fact, tenure choice is no more real at the upper end of the income scale than it is for lower income people. Small wonder that very little rental housing is now being produced, except with federal subsidy.

Anthony Downs describes the impact of this situation as follows:

> One of the main reasons why so few new unsubsidized rental units are being built is the immense attraction of homeownership. Most households who can afford to pay a significant amount each month for housing prefer to own their own units rather than rent. This extremely widespread preference springs partly from the great financial advantages of investment in homeownership described earlier.

In the past, the overall supply of unsubsidized rental housing was constantly supplemented through new construction of apartments by private developers. Most new apartments had monthly rents that the majority of renting households could not afford. But as these new units aged, many "trickled down" through the income distribution, eventually becoming available to less affluent households. Thus, the willingness of some households to pay relatively high rents for new apartments helped keep the total supply of rental units expanding. It also helped up-grade the rental inventory as these new units replaced the oldest, most deteriorated units removed through demolition and fires.

But when rapid inflation greatly magnified the financial advantages of homeownership in the late 1970s, fewer relatively affluent households were willing to rent. Why should they, when they could enjoy the benefits of owning instead? Hence, production of new unsubsidized rental apartments fell drastically in the late 1970s. This reduced the high-quality inputs into the rental inventory that had kept raising its average quality level. There is now a sizable chance that this quality level will begin deteriorating through overly-prolonged use of older units....

Thus, the outstanding success of public policies designed to increase the attractiveness of homeownership, plus the impacts of inflation, have undermined the market for new rental housing....

This process distorts the entire rental housing market by cutting down the supply of new rental units. That will in turn ultimately cause overly-intensive use of older existing units. This is one important way in which public policies that make homeownership "over-attractive" have negative impacts upon some groups in society, partly offsetting their positive impacts upon homeowners. (Downs, op. cit.)

Rather than inventing new ways of stimulating and subsidizing rental housing production for middle income families, as the House attempted to do last year, would it not make more sense to curb the excessive and costly homeowner preferences which have so inhibited rental housing production?

Tax preferences create condominium conversions.

A major factor in investment in rental housing is the availability of tax shelters. Indeed, for most investors these shelters, rather than anticipated cash flow, are key. The nature of the shelter, however, forces owners to sell after a holding period: the shelter diminishes; cash flow increases, but is not substantial enough to offset the shelter loss; and the recapture period ends. The process of investment and sale to another investor has been going on for years. But now, all too often, the sale is not to an investor in rental housing but to a condominium converter. The result: a diminution of rental housing, displacement, and rising housing costs.

The two sides of the internal revenue code come together here: not only do the incentives to invest in rental housing force its sale, but the homeowner preferences mean that there is a strong demand for converted units. This demand has strengthened as the cost of new single-family houses has risen and household size has declined, so that over half the households in the U.S. now consist of only one or two people. (For further information on the manner in which tax provisions affect condominium conversions, see F. Richard Bourdon, "Condominium Conversions: Possible Changes in Federal Tax Laws to Discourage Conversions and Assist Rental Housing," Congressional Research Service, Report No. 80-71 E, April 1980.)

For all of the above reasons, the unrestrained growth of homeowner deductions cannot be allowed to continue.

The National Low Income Housing Coalition does not advocate repeal of homeowner tax preferences. We do urge that the Congress act promptly, however, to impose some limits on them.

The Congressional Budget Office has suggested that a $5,000 cap on the mortgage interest deduction would save $4.3 billion in 1982 and $35.6 billion by 1986. Moreover, this change would affect only one taxpayer in twenty. Converting the deduction to a 25% tax credit would increase revenues by about $3.5 billion in 1982. Moreover, this approach would make the deduction less regressive.

If either of these steps were taken, the cuts imposed in lower income housing assistance programs could be restored and the programs expanded to a more adequate level without adding to the deficit.

The Urban Institute recently studied the impact of converting homeowner deductions to a 25% tax credit. The shift would cause highest income owners to lose both the price and income subsidies they now receive. They would have no real incentive to consume more housing, since this would increase their taxes. But middle and lower-middle income owners would have lower taxes and an incentive to consume more housing of higher value. New construction would be stimulated. This, in turn, would relieve some of the pressures on the lower end of the housing market, thus making the lot of low income households easier. (Michael W. Andreassi, C. Duncan MacRae, and David I. Rosenbaum, Metropolitan Housing and the Income Tax: Stack Algorithm Sensitivity Analysis, The Urban Institute, February 1980.)

Moreover, if a tax credit limited, say, to a maximum of $5,000, were introduced simultaneously with a cut in individual tax rates, it could be designed so as to have little or no adverse impact. It would increase the tax reductions given to low and middle income people, while the higher tax for a limited number of affluent people could be offset by the reduction in marginal tax rates. If necessary, a "hold harmless" provision could be introduced for the principal residence, until it is sold or the owner moves out.

The National Low Income Housing Coalition is convinced that justice and equity demand that low income people not be asked to bear the brunt of reducing federal housing expenditures. Moreover, a limit on homeowner deductions can again make production of unsubsidized rental housing financially feasible. And, given the other advantages and attractions of home ownership and the high rate of household formation, converting homeowner deductions to a tax credit need not have a negative impact on construction of single family housing for middle income people and younger families.

The challenge is here. The time to act is now.