Testimony of

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Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for the opportunity to testify on the subject of tax reform and residential real estate. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a senior fellow with the Milken Institute's Center for Financial Markets and a visiting scholar at the American Enterprise Institute. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009. My testimony draws on research on the costs and benefits of tax subsidies for housing that I conducted jointly with Robert Carroll and John F. O'Hare and that was published in June 2011.[1]

Housing plays an important role for American families, businesses, and in the overall U.S. economy. Even with the collapse of the recent house price bubble, homeownership remains a goal for Americans. The tax code reflects this aspiration, with considerable tax subsidies for housing in general and especially for owner-occupied housing. These provisions support the housing sector and promote homeownership, but the tax benefits for housing accrue disproportionately to middle- and upper-income households, many of whom likely would purchase homes even without the tax incentive. The tax treatment of housing further tends to distort investment away from non-housing business activity.

Tax reforms are possible that recognize the societal value of housing and of homeownership, but with fewer undesirable consequences for the broad economy. The key to reforming the housing tax subsidies, while at the same time recognizing the importance of homeownership, is to encourage home ownership but lessen or remove the bias in favor of the purchase of large homes and the overuse of debt finance. Such a change would promote homeownership, but not any particular size of home or type of financing. Thus, reform that improves incentives in the housing sector would generally reduce or break the link between the value of the tax subsidies and the amount of home purchase and mortgage loan. This type of reform would encourage people to buy a home, but not provide an incentive to buy a large or small home; that choice would be a personal decision rather than one influenced by the tax system.

[1] www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Pew_Housing_Report.pdf. A recent paper by Alan Viard likewise considers tax policy options for housing: "Replacing the Home Mortgage Interest Deduction," http://www.brookings.edu/research/papers/2013/02/replace-mortgage-interest-deduction

Such a reform will have beneficial long-term effects for the overall U.S. economy, but pose challenges for housing as reduced tax subsidies affect the demand for housing and new construction and thus the supply of housing. It is thus appropriate to phase in changes to the tax treatment of housing. Moreover, it would be desirable for such housing-related tax policy changes to be made as part of an overall pro-growth tax reform. This would have the beneficial effect that the increased economic growth from the tax reform will provide a macroeconomic boost to housing that helps to offset impacts of the gradual realignment of tax subsidies for housing.

The fiscal challenge facing the United States means that all aspects of federal spending and revenue programs must be up for consideration. The tax policy options for housing share the unusual feature of not just increasing economic efficiency and growth, but also spreading the tax subsidies for housing more broadly and to families where it is most likely to have a major impact on their housing decisions. This reflects the nature of the current subsidies, which favor people who buy large homes and take out a large amount of debt, and favor people who itemize on their tax returns over others who do not. Tax reform for housing could actually boost overall homeownership by refocusing subsidies on potential homeowners who would benefit relatively little from current tax provisions.

Tax Subsidies for Housing

Under the current U.S. income tax system, homeowners may deduct both property taxes and interest paid on mortgages for both first and second homes up to $1 million in mortgage debt, plus the interest on an additional $100,000 of debt through home equity lines of credit. In addition, the first $500,000 of capital gains realized upon the sale of a home for a couple ($250,000 for individuals) are excluded from income tax entirely. The exclusion of the implicit or imputed rental value of owner-occupied housing from the tax base is perhaps not as readily apparent as the other subsidies, but my research with Carroll and O'Hare finds that this exclusion is even larger than the tax benefits for property taxes and mortgage interest. Many other tax policies affect housing, including provisions that support the construction of affordable housing and that provide rental assistance to families with low incomes.

Tax subsidies encourage taxpayers to invest in housing because the purchase of a home is subsidized and a substantial amount of the price appreciation is not taxed. These tax subsidies thus have the important effect of boosting homeownership by lowering the cost of owning a home relative to renting. Increased homeownership is associated with stronger and more cohesive neighborhoods, as owner-occupants invest in the development and safety of their communities.

There are tradeoffs involved, however. The mortgage interest deduction encourages Americans to buy larger homes and use more debt to finance those homes. By providing a subsidy to use debt through the deductibility of mortgage interest payments, the tax code gives an incentive for the overuse of leverage in the form of mortgage borrowing. The tax benefit from the home mortgage interest deduction rises with the amount of debt financed: the more debt, the greater the tax benefit. The events of the recent financial crisis illustrate the potential dangers to the economy of over-investment in housing. The tax advantages for housing are longstanding features of the U.S. tax code, and as such cannot have been the driving force behind the crisis. They were the background, not the immediate cause. Nonetheless, the tax bias for debt finance contributes to increased use of leverage that makes the financial system more fragile and susceptible to distress during economic downturns.

The value of the tax subsidy rises with income, because higher tax rates for families with higher incomes mean that deductions and exclusions are more valuable. Higher-income households are more likely to itemize deductions, while those who do not itemize receive no benefit from the home mortgage interest and property tax deductions. Higher-income households tend to purchase larger homes with greater home mortgage debt and thus receive larger tax subsidies. As show in Table 3 on page 37 of the background publication for this hearing from the Joint Committee on Taxation, over $52 billion of the $68 billion tax expenditure associated with the mortgage interest deduction in 2012 accrued to the top 20 percent of households filing tax returns—those with incomes over $100,000.[2] The White House has put forward a definition of the middle class as households with the median income plus or minus 50 percent.[3] The median income of family households in 2011 was $62,273 (this leaves out individuals, who tend to have lower incomes; the median income for all households in 2011 was $50,054). This would give a maximum income for middle class families as defined by the White House as just less than $94,000. Three out of four dollars of the tax subsidy involved in the mortgage interest deduction thus accrue to households with incomes above the top of the White House definition of middle class. Similar results obtain for the value of the tax subsidy in the deductibility of property taxes (Table 4 in the JCT background publication).

Tax subsidies for housing further affect the allocation and use of the nation's financial resources. For the economy as a whole, the tax code favors capital investment in residential housing over business investment. This has important macroeconomic consequences since housing-related activity likely displaces other types of investment. This raises the question of whether the tax code encourages over-investment in housing at the expense of other productive uses.

Economists often use marginal effective tax rates to measure the impact of taxes on investment decisions and the extent to which the tax code favors one type of investment over another. These rates capture how various provisions in the tax code, including the statutory tax rate, depreciation deductions, interest deductions, deferral of tax liability and both the individual and corporate levels of tax affect the after-tax rate of return on a new investment.

Many types of investment face uneven treatment because of the various ways in which tax rates, depreciation deductions, deferral of tax and inflation all interact and lead to different effective tax rates on different types of investment. A project facing a higher tax rate must have a larger economic return to offset the increased taxes—meaning that, conversely, a tax subsidy will lead some projects to be undertaken despite subpar economic returns.

The Treasury Department in 2007 calculated that owner-occupied housing faced a marginal effective tax rate of 3.5 percent, compared to an economy-wide marginal effective tax rate of 17.3 percent for all

[2] "Present Law, Data, and Analysis Relating to Tax Incentives for Residential Real Estate," JCX-10-13, April 22, 2013.
[3] See http://www.whitehouse.gov/sites/default/files/krueger_cap_speech_final_remarks.pdf

investment, and a 25.5 percent rate for business investment.[4] Tax changes since 2007 have likely increased the advantageous tax treatment of housing relative to business investment. This is because tax rates on business income have risen with higher rates on dividends and capital gains, and a higher tax rate for the top bracket that applies to a considerable amount of income from businesses whose earnings flow through to individual tax returns (expanded depreciation allowances would reduce the marginal effective tax rate on business investment). From the perspective of housing, the higher income tax rate that took effect in 2013 boosts the value of the deductibility of mortgage interest and capital gains, and the value of excluding imputed rent from income.

The tax-induced bias for capital to flow into housing-related uses rather than other types of projects means that businesses are less likely to purchase new equipment and less likely to incorporate new technologies than otherwise might be the case. Less business investment results in lower worker productivity and ultimately lower real wages and living standards. While the housing sector provides employment and has other positive effects on the overall economy and on society, the resources employed in the housing sector displace investment that would otherwise occur in the business sector were it not for the favored tax treatment of housing. The resulting distortion in the allocation of capital likely lowers overall output, because resources are allocated based on tax considerations rather than economic merit. In effect, the United States has chosen as a society to live in larger, debt-financed homes while accepting a lower standard of living in other regards.

Possible Tax Reforms for Housing

A tax reform that completely leveled the playing field between housing and other forms of investment would allow for the deductibility of the costs of housing investment, including retaining the mortgage interest deduction, but tax homeowners on the imputed rental income from owner-occupied housing. In reality, taxing imputed rent would involve considerable administrative difficulties. Proposals to reform the tax treatment of housing thus generally focus on changes to the mortgage interest deduction. In this case, the portion of a home funded with equity rather than debt would continue to receive the tax preference compared to rental housing because the implicit rent corresponding to the flow of housing services associated with the equity remains untaxed.

Changes to the mortgage interest deduction could take a variety of forms, including:

- <u>Credit instead of a deduction</u>. The deduction could be turned into a tax credit, whether refundable or not. The credit could be a flat amount or instead equal to a specified percentage of the homeowner's mortgage interest, and could be made available to all taxpayers or only to those who itemize. A flat credit would break the link between the size of a home or mortgage and the tax benefit, while specifying a percentage credit would reduce the link and generally

[4] The marginal effective tax rate in 2007 was 39.7 percent on business investment in the corporate sector funded by equity, 20 percent in the non-corporate business sector, and -2.2 percent for debt-financed investment (because of the deductibility of interest payments on top of other provisions).

reduce the tax bias for over-leverage, particularly among higher-income households who are in tax brackets above the credit percentage and thus would face higher marginal tax rates than with the mortgage interest deduction (the precise outcome depends on the design of the credit).

A flat refundable credit would most refocus the tax subsidy for housing on households with lower- to middle-incomes who derive less benefit from the current deduction because they have small mortgages, low tax rates, or do not itemize and thus do not claim the deduction (presumably because of its small value to them). The JCT background publication shows that the average value of the mortgage interest deduction in 2012 was just under $2,000 across all taxpayers, but a revenue-neutral refundable flat credit would inevitably be a smaller amount, since some taxpayers who do not currently itemize and thus do not claim the deduction would do so to claim the greater amount of the flat credit. A flat credit would considerably reduce the value of the tax subsidy for households with incomes starting at $100,000, who now on average get more than a $2,000 subsidy from the mortgage interest deduction (this is on average, not necessarily for every high-income household). On average, households with incomes below $100,000 would gain (again, this is on average—some families would have large mortgages even with moderate incomes and thus might lose from a flat credit). This reform could boost homeownership if the increased benefit leads to new purchases by families that would benefit from the changed tax subsidy, while higher-income families would likely still become or remain homeowners even without several thousands of dollars of annual subsidy (though of course some higher-earners would be renters with this change).

As an illustrative alternative, my research with Carroll and O'Hare found that a modest revenue increase would have resulted in 2010 from replacing the mortgage interest deduction with a refundable credit, equal to the value of 15 percent of mortgage interest, that would be available to all mortgage owners, including non-itemizers. We calculated the amount of increased revenue as $16.3 billion (again, in 2010), which would have been equivalent to a 1.5 percent across-the-board increase in tax rates for all taxpayers – that is, equal to raising the 15 percent tax rate to 15.225 percent (that is, 1.5 percent more than the 15 percent rate), the 25 percent tax rate to 25.375 percent (which equals 25 multiplied by 1.015), and so on. Even with the overall revenue gain, we found that 62 percent of homeowners would benefit from this change, including those who do not itemize or would have no income tax liability.

- <u>Reduce the amount of mortgage debt that can be deducted</u>. The current deduction of the interest on $1.1 million of mortgage debt (including home equity lines of credit) could be reduced to an amount such as $500,000. This option would retain the link between the value of the tax subsidy and the size of the mortgage and homeowner tax rate, by only up to the reduced limit. An alternative would be to limit the amount of mortgage interest that could be deducted rather than the amount of debt—for example, to allow only, say, $10,000 of interest paid per year to be deductible. This would lead to greater volatility in the value of the tax subsidy, since the amount of interest expense for each homeowner would depend not just on the amount of the mortgage but also on the mortgage interest rate, which might well vary considerably across homeowners even with similar sized homes or mortgages depending on interest rate conditions at the time of the purchase (or vary even more for homeowners with adjustable interest rate loans).

- Narrow the deduction such as by allowing for only a single residence or for primary mortgages and not for home equity loans.

- Limit the value of the deduction to a certain percentage such as the 28 percent limit proposed by the administration. This option would partly offset the distortion in incentives by increasing the after-tax cost of borrowing for those in tax brackets above 28 percent. My work with Carroll and O'Hare found that this proposal would affect only 6.7 percent of the 69.9 million homeowners who received some of the housing tax subsidies in 2010. A potential criticism of this proposal, then, is that it does not go far enough in addressing the present biases in the tax code relating to housing—the tax-drive inducement to take on more housing debt embodied in the mortgage interest deduction affects taxpayers at all income levels (at least those with positive tax liability who itemize). It is not clear why the tax bias should be addressed in only a narrow group.

A further criticism of the administration's proposal to limit the value of the deduction for taxpayers in upper income brackets is that it appears to have been made as an ad-hoc revenue grab to support further spending, rather than as part of a thoughtful approach to an economy-wide tax reform that promotes stronger growth, reduces the complexity of the tax code, and maintains progressivity.

This broader point is important because changes that reduce the overall tax subsidy for housing would have impacts on the demand for housing and thus on prices and construction, possibly for the nation as a whole or concentrated in particular areas. Limits to the amount of mortgage debt eligible for the interest deduction, for example, would tend to most affect areas with relatively high housing values, while removing the deductibility of second homes would tend to most affect vacation-oriented areas.

Undertaking housing tax reform as part of an overall pro-growth tax policy would boost the overall economy and thus have positive feedback effects for housing that would help offset any drag from tax policy changes. To be sure, it would be understandable for the housing industry to look cautiously at the trade of a reduction in housing-specific tax benefits for an overall stronger U.S. economy. This combination, however, is well-suited to the present U.S. macroeconomic circumstances in which the housing sector is lagging in the recovery as a result of the lingering effects of the collapse of the housing bubble. In past business cycles, an upswing in housing has generally been a key factor in the recovery, as monetary policy actions boosted interest rate sensitive activities such as construction and home sales. This is not the case today. The housing sector appears (finally) to be in recovery with increases in national measures of home prices and a stabilization of measures of construction and sales. A further strengthening of the housing sector would be most easily effectuated by a stronger overall economy. A pro-growth tax reform is well-suited to provide such a positive macroeconomic impact (along with immigration reform and continued deployment of advances in new technologies for energy production and transportation). In short, the pro-growth benefits of tax reform will have a positive impact on the overall economy that will in turn boost the housing sector and offset some of the drag on housing from the tax policy changes.

Developments outside of tax policy will affect housing sector activity going forward, including a normalization of interest rate policy by the Federal Reserve and reforms of the housing finance system that will involve greater private capital at risk ahead of any secondary taxpayer guarantee on housing credit. Both of these policy areas seem likely to result in a gradual increase in mortgage interest rates. While this might be a headwind for the industry—even if a gentle such wind—the strengthening of housing activity suggests that construction and sales can continue to expand with gradual changes to tax policy along with these other policy changes. Moreover, measures of housing affordability remain high, as the combination of still-low mortgage interest rates and fallen housing prices make home purchases attractive. Further, the financial crisis and ensuing recession led to a considerable decline in the rate of household formation, as young Americans who might otherwise have entered the labor force and sought their own housing instead stayed in school or in other shared living situations (including in their parents' basements). This demographic swing will unwind with the continuing economic recovery, adding a powerful positive force to boost housing demand.

In the immediate aftermath of the financial crisis it was understandable for housing industry participants to urge that policymakers should "do no harm to housing" or "make no changes." That time has passed. Housing is now in recovery and cannot be left on the sidelines. Housing must be part of a thoughtful tax reform. This is especially the case for a reform that strengthens the sustained rate of U.S. economic growth, with attendant long-term positives for housing.

Moreover, changes to tax policy for housing can naturally involve transition periods. Any reduction in the mortgage interest deduction can be undertaken gradually. Asset markets will of course look forward and embody the value of future policy changes in present asset prices—and this includes housing. Even so, a gradual change policy will tend to lessen the degree of any change in housing prices and thus in turn in construction activity.

Tax Policy Relating to Affordable Housing Policy

Several provisions in the tax code provide support for affordable housing activities. These include the low income housing tax credit, which aims to support the construction of housing units aimed at families with low- to moderate incomes tax policy, and the Housing Choice Voucher Program (often referred to as Section 8 housing), which provides eligible families with rental assistance. In general, it is desirable to maintain a suite of policies aimed at supporting affordable housing—after all, economists focus on supply and demand, not just one or the other. The tax credit can be thought of as boosting the supply of affordable housing, while the voucher program provides the resources for families to afford rentals (and thus operates on the economic dimension of the demand for housing).

At the same time, it would be worth assessing the extent to which each of these programs is well-targeted to provide public resources to the desired populations—that is, to ensure that the programs are effective. For the housing tax credit, a natural question to ask is the extent to which the benefits of the tax credit ultimately accrue to low-income families in the form of increased supply of housing, greater availability of affordable housing, and thus lower rents than would be the case without the tax credit. In general, one might expect a subsidy to be better targeted by having it follow people—the families receiving the affordable housing vouchers—rather than locations such as the specific projects that utilize tax credits. In other words, is it generally more effective to focus on people than places. Again, though, this is balanced by the desirability for a comprehensive policy regarding affordable housing to include measures aimed at addressing needs in both supply and demand. This is an area of housing tax policy that would benefit from rigorous research and evaluation.

Conclusion

The U.S. tax system today provides considerable subsidies to owner-occupied housing, favoring investment in residential real estate over other activities. These subsidies reflect the important role of housing in the U.S. economy and in American society. And yet it is vital to consider the impacts of this policy and contemplate improvements. The tax code leads Americans to buy homes rather than to rent, to purchase more expensive homes, and to use more debt financing rather than having more equity in their homes.

Tax policy further affects the overall allocation of capital in the economy, since the tax advantages for owner-occupied housing lead some resources to be devoted to housing rather than to some other potential uses such as building factories, pipelines, or office buildings. This affects the economy-wide allocation of capital and thus has potentially negative implications for overall investment, economic growth, job creation, and wage gains. A pro-growth tax reform will maintain a tax subsidy for housing but reduce the attendant distortions and refocus the tax benefits to families that likely would not be homeowners otherwise. Tax reform for housing thus presents an opportunity to boost U.S. economic growth and improve measures of equity.