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Comment on Steven C. Bourassa and William G. Grigsby's "Income Tax Concessions for Owner-Occupied Housing"

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Abstract

The article by Bourassa and Grigsby is another in a series of studies evaluating alternatives to homeownership incentives in the Internal Revenue Code. A consensus has emerged that the current structure of tax incentives may not be an optimal way to enhance homeownership, especially among low- to moderate-income or minority households. After evaluating the efficiency and equity of the four existing tax incentives, they recommend that the mortgage interest and property tax deductions be eliminated.

I agree with many of the points they raise. However, I argue that they need to incorporate the social benefits of homeownership into their analysis, to further consider allocative efficiency and distributional equity, and to recognize political acceptability as an important criterion for evaluation. I also believe that the administrative costs of compliance would not be especially burdensome, that housing shortages would not be a problem, and that additional homeownership tax concessions may be feasible.

Keywords: Homeownership; Tax policy

Introduction

This article is one of a series of recent (and some not so recent) studies evaluating alternatives to current homeownership incentives in the Internal Revenue Code (see, for example, Dreier 1997; Follain, Ling, and McGill 1993; Follain and Melamed 1998; Green and Vandell 1999; Gyourko and Voith 1997; Rosen 1979a, 1979b, 1985; Simonson 1981; Tretzger 1998; White and White 1977). A consensus has emerged that the current structure of tax incentives (including the mortgage interest and property tax deductions and the exclusion of imputed net rental income and capital gains from sale) may not be optimal from the standpoint of its intent to enhance homeownership in a cost-effective and equitable manner. Recent studies have looked at both the inadequacies of the current structure and the desirability of alternatives.

Bourassa and Grigsby's contribution is to attempt to evaluate each of the four existing tax incentive components on the basis of their allocative efficiency and equity characteristics and make recommendations as to which ought to be retained or discarded. The authors constrain their analysis to be independent of the benefit side of the ledger. They

are concerned only with the extent to which each of the four elements (1) commit "excessive" resources to investment and consumption in the owned housing sector at the expense of other more productive sectors of the economy; (2) actually increase the rate of homeownership, especially among certain designated household classes, such as minority and low- to moderate-income families; (3) increase the rate of supply of affordable housing; (4) have adverse impacts on different classes of households in the form of affecting opportunities for homeownership and/or house prices; and (5) are administratively easy to design and implement.

The authors conclude by recommending that the net rental income and capital gains exclusions be retained and that the mortgage interest and property tax deductions be jettisoned. With respect to taxing imputed net rents, they reason that (1) the administrative difficulty of estimating net incomes and examining 65 million Schedule C income and expense statements, (2) the fact that the tax would bear little relationship to capacity to pay or true return on capital, and (3) the fact that the tax would be effectively a tax on wealth (which at the federal level is not taxed except for estates) outweigh the desirable aspects of such taxation—creating a level playing field by treating investment in self-occupied housing the same as other forms of investment.

With respect to the taxation of capital gains, the authors further argue that the cons outweigh the pros in that a large part of the gain is really inflation (hence is fictitious), that a large part of the stock actually depreciates in the absence of modernization, and that record-keeping requirements would be onerous, offsetting the fact that nontaxation encourages overinvestment in housing and distributes such benefits regressively.

With respect to the mortgage interest deduction, however, the authors feel that the merits of maintaining it are outweighed by the costs. They observe (consistent with most empirical work, for example, Follain and Dunsky 1997, Follain and Melamed 1998, Green and Vandell 1999, and Rosen 1979a and 1979b; for a contrary view, see Woodward and Weicher 1989) that at best, the deduction has only a marginal impact on the overall rate of homeownership and mostly affects those with higher incomes. Furthermore, many who are encouraged to become homeowners only become so earlier than they would otherwise. The deduction also distorts housing consumption by advantaging self-occupied housing investment in preference to other forms of investment, especially among higher-income households, and does little to encourage new housing construction. These negatives more than make up for the major disadvantage of removing the deduction, in their opinion, which is the adverse effect on the capital value of owned housing stock. They contend that most of this effect would be restricted to the most expensive stock and could be rendered negligible if the deduction were eliminated over a 15- to 20-year period.

Finally, with respect to the property tax deduction, the authors claim many of the same negatives associated with the mortgage interest deduction. On the one hand, the local property tax is often levied in a very arcane and capricious fashion, which is offset to some extent by permitting a deduction against federal income taxes. Furthermore, property taxes tend to be regressive, and deductibility reduces this tendency. On the other hand, this is offset in their view by the fact that, because housing deductions in and of themselves are regressive, deductibility does not offset the regressivity of the property tax, and without the mortgage interest deduction, the only households that would remain as itemizers, hence benefiting from the deduction, would be higher-income households with high nonhousing deductions.

I find myself largely in agreement with many of the issues raised by Bourassa and Grigsby and with their general analysis, at least at the macro level. There is clearly increasing agreement that the current structure of mortgage interest and property tax deductions is not as effective as it might be in encouraging homeownership, especially among low- to moderate-income and minority households. There is also a consensus that the current system of homeowner tax incentives results in higher levels of housing consumption than the marketplace would otherwise generate. However, there are six areas where I would take issue with their premise, the scope of their analysis, or their conclusions as to the desirability of retaining or eliminating various homeowner tax concessions.

The need to consider the benefits of homeownership

First, Bourassa and Grigsby explicitly state that their evaluation is made "without endorsing or rejecting the various arguments that have been put forward over the years about the benefits of homeownership" (524). They thus consider the benefit side to be independent of the desirability of the various tax concessions. I am not so certain that this can be done successfully and still result in policy recommendations that make sense. A growing body of literature provides empirical support for the notion that encouraging homeownership yields significant social benefits, for example in the form of accumulation of wealth and savings behavior (Goodman 1974), neighborhood stability (Galster 1987; Rohe and Stewart 1996), developmental outcomes for children (Boehm and Schlottmann 1999; Green and White 1997; Haurin, Parcel, and Haurin 2000), self-esteem (Rohe and Basolo 1997; Rohe and Stegman 1994b), and community participation and other social behaviors (Cox 1982; DiPasquale and Glaeser 1999; Rohe and Stegman 1994a; Rossi and Weber 1996). (See Rohe, McCarthy, and Van Zandt 2000 for a summary of this research.) Moreover, these benefits at the margin may well be distributed differentially across household classes such as low-to moderate-income or minority households. In the presence of a distri-

bution of such positive externalities associated with encouraging homeownership, neither equity nor allocative efficiency depends only on equivalent marginal tax rates applied to the homeownership and rental or other investment sector. Rather, conclusions about equity and allocative efficiency are also based on these homeownership externalities. This proposition will be formally evaluated next.

The need for explicit and consistent evaluation criteria

One fundamental requirement for evaluating the goodness of the various tax concessions associated with encouraging homeownership is that goodness be defined explicitly. Unfortunately, Bourassa and Grigsby have been less than explicit and seem at times to mix the evaluation criteria in an ad hoc way. They say that they are concerned with "allocative efficiency" and "equity" (523) but their operative definitions are less than satisfactory.

They equate allocative efficiency with equalization of the cost of investing in owner-occupied housing versus other forms of physical capital, requiring neutrality or common tax treatment across all investment sectors. It should first be recognized that this criterion is not the same one that has been discussed in most of the policy literature dealing with the tax advantages of homeownership. In this literature (see, for example, Follain, Ling, and McGill 1993; Green and Vandell 1999; Ling and McGill 1992; Rosen 1979a, 1979b; Rosen and Rosen 1980; and White and White 1977), the comparison is wholly between the ownership and rental sectors of the housing market. This difference is important, since within the broader context that Bourassa and Grigsby employ, the housing investment sector as a whole is tax advantaged. Rental housing has historically always enjoyed more rapid depreciation than other commercial property sectors as well as other favorable treatment (in the recapture treatment of capital gains, for example), presumably to encourage a greater supply of rental housing and lower rents. In fact, although it has seldom been recognized, this favorable treatment of depreciation and capital gains was actually more favorable than in the ownership sector, where no depreciation could be taken. Such an advantage was not sufficient to render the tax advantages of rental housing comparable to those of ownership (especially today with the recent elimination of capital gains taxation in the ownership sector), but it serves to emphasize that both housing sectors were—and continue to be—favored. Eliminating all or a portion of the ownership tax concessions to render the owned-housing sector more neutral with respect to other physical investment classes will implicitly reduce its advantages—and may even disadvantage it—relative to the renter sector. This is certainly an issue worthy of recognition and discussion in their study.

There is also a second issue relating to the adequacy of their operative definition of allocative efficiency. In perfect competition, allocative efficiency exists at that point at which price equals marginal cost, marginal benefits from another unit of production equal the marginal costs of that unit, and there can be no gains from exchange. Allocative efficiency, however, does not relate to a requirement that all investment sectors face the same cost structure or identical tax treatment. In the more general social welfare context, allocative efficiency requires that the marginal social benefit be equal to the marginal social cost and that the tax level in each sector be set such that this relationship holds. In the presence of positive spillover effects from homeownership (see the earlier discussion), this may require that the marginal tax rate on owned housing be reduced relative to that of other investment sectors.[1] In my opinion, Bourassa and Grigsby are too narrow in their definition, hence in their criterion, for the acceptability of homeownership tax concessions.

Their operative definition of equity seems to be that any homeownership tax concession must maintain the progressivity of the federal income tax with respect to all households—lower income as well as higher income and nonitemizers as well as itemizers. Furthermore, they incorporate within the equity discussion (and not within the discussion of allocative efficiency) a requirement that renters be treated the same as owners (presumably renters and owners at the same taxable income level in the tax code before consideration of shelter concessions). This again is a narrow, specific definition that is not necessarily consistent with the treatment of equity by others in the policy literature on homeownership tax concessions. For example, Green and Vandell (1999) implicitly consider a single lump-sum tax credit for all owners (ignoring their relative situation with renters) to represent a more equitable distribution of benefits, while Rosen (1979a, 1979b) considers a deduction at a single tax rate (hence, neutral treatment).

The bottom line is that Bourassa and Grigsby should be explicit and consistent in their operative definitions of allocative efficiency and equity and recognize that any differences in these definitions could be responsible for differences in the perceived desirability of revisions in homeownership tax concessions.

Political feasibility: Another important evaluation criterion

The authors evaluate the tax concessions only on the basis of (1) allocative efficiency (i.e., the tax bias toward homeownership versus rental

[1] It may also require that the marginal tax rate on rental housing be reduced (though possibly less so) in the presence of positive spillover effects from encouraging a greater quantity/quality of housing consumption.

housing or other forms of investment), (2) equity (the favoring of certain taxpayer classes in encouraging homeownership or housing consumption), and (3) administrative feasibility on the part of the household and the Internal Revenue Service (IRS). In fact, there is at least one additional criterion that is equally important and that could affect recommendations for adoption. That criterion is *political acceptability*. Any modification of the status quo with respect to the current tax treatment of homeownership that results in a net loss of tax benefits, either in aggregate or redistributionally across taxpayer classes, would face significant opposition from current and prospective homeowners and industry trade groups, such as builders and lenders. The authors recognize this in their proposal to extend the transition period for eliminating the mortgage interest and property tax deductions. But I argue that this would be insufficient to overcome opposition in the environment in which the authors have framed the policy discussion—one in which there is a net reduction in tax benefits overall directed to the homeownership sector.

IRS administrative costs: It is not that hard

The authors cite as major factors affecting the desirability of maintaining the nontaxation of imputed net rental income and capital gains the purportedly high administrative cost that would be imposed on the IRS. I take issue with that conclusion. Although developing a reasonable system for estimating net rental income may be difficult, it must be remembered that in the 10 countries that currently tax at least some imputed net rental income and the 5 that did so in the recent past, such a system has already been in place. Thus, it is not necessary to reinvent the wheel, only to assess recent experience in each country and improve on existing designs. Moreover, once a system is in place, it would be no more administratively cumbersome or costly to incorporate the modification into the tax forms than it is for many of the other tax law changes that take place annually. Given the computer technology available today for tabulating tax forms, the marginal cost of such tabulation with the modification would be minimal, especially in relation to the revenues generated from the change. This is true whether the net income imputation is simplified or not. Even if all homeowners were treated as landlords and 65 million additional Schedule Cs had to be tabulated, I feel that after a transition period, the marginal cost would still be relatively small.[2]

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[2] The compliance cost of itemizing deductions is considered at length in Pitt and Slemrod (1989) and Slemrod and Sorum (1984).

These arguments are also true with respect to the nontaxation of capital gains. The authors ignore the fact that, until recently, there had been for many years a set of rules in place for homeowners to maintain their basis and calculate their capital gains. Reporting of capital gains by all 4 to 5 million homeowners who sell their homes each year would not be a significantly greater burden for them than it was for those in the past who had to report their capital gains over $125,000. As for the IRS, computer technology can cost-effectively handle the tabulation of the additional Schedule Ds, especially in relation to the incremental tax revenue collected.

There may be good reasons for maintaining the current nontaxation of imputed net rental income and capital gains, but administrative infeasibility is not one of them.

Tax concessions and housing supply

In their discussion of the desirability of continuing the mortgage interest deduction, Bourassa and Grigsby consider the possibility that removing the concession could have an adverse effect on housing starts, thus creating a shortage of affordable housing. It is true that any increase in the marginal cost of credit for owned housing (including the elimination of the mortgage interest deduction) will shift the mortgage credit supply curve upward. Depending on the conditions in individual submarkets, there will be a number of housing market responses, which have been broadly discussed by housing economists. These include shifts from debt to equity financing, price reductions at the higher end of the market, downward filtering, temporary increases in prices at the lower end of the market in recognition of shifting demand without immediate increases in supply, shifts in tenure toward rental at the margin, and doubling up. Builders would restrict new supply temporarily and begin building slightly "down-market" when they resume.

However, one would be hard-pressed to understand why shortages would persist once the local market adjusts, unless smaller, somewhat lower-quality units and some doubling up are interpreted as a shortage. The problem in an expensive market such as San Francisco is not strictly speaking a shortage of lower-income housing; lower-income households are simply outbid for space in an amenity-rich, highly desirable submarket.

Contrary to Bourassa and Grigsby's hypothesis, removing the mortgage interest deduction could actually *improve* the lot of lower-income households, relatively speaking, in that they would be less reliant on the tax deduction, and with the downward filtering (after long-term adjustments take place), they might actually find the housing stock somewhat more available and affordable than before.

Elimination versus revenue neutrality versus an "add-on" of concessions

Finally, Bourassa and Grigsby premise their analysis on the complete *elimination* of some or all of the tax concessions associated with homeownership, whereas others such as Green and Vandell (1999) assume that the concessions are applied in a *revenue-neutral* environment in which any reduction in a concession must be balanced by an equivalent-cost alternative concession intended to improve the distribution of homeownership benefits. A third situation, which may be relevant in the context of today's budgetary environment, with a large budget surplus that can be reduced in a variety of ways, is a situation in which certain designated homeownership tax concessions could actually be *added on* to existing concessions. The add-on benefit could potentially be acceptable to Democrats and Republicans alike because it could be sold as a tax cut directed toward encouraging consumption/investment activity both consider desirable.

Each of these three scenarios has very different implications that influence our interpretation of the desirability of alternative approaches to the modification, addition, or elimination of the various tax concessions. For example, in Green and Vandell (1999), where removed mortgage interest and property tax deductions are replaced with a single flat tax credit, equity considerations are related to benefits provided to the low end of the housing market in the form of increased homeownership opportunities and increased stock prices to the detriment of the high end of the market with reductions in stock prices and (to a small extent) reduced homeownership. Allocative efficiency in this scenario is unaffected, since the direction of tax concessions to the homeownership sector overall is maintained at the previous level. Such a situation would pit the gainers (low- to moderate-income households) against the losers (higher-income households with large deductions) in a political battle for adoption.

Bourassa and Grigsby, by considering the elimination of certain homeownership tax concessions, are improving allocative efficiency, as they have defined it, in that they are rendering the homeownership sector closer in tax treatment to other investment sectors. This means that, in the aggregate, homeowners are made worse off.[3] The likelihood of greater encouragement of homeownership among certain household classes depends on the effect of eliminating the concessions on equity. Indeed, if *all* concessions were removed, there would be no tax encouragement of homeownership among any household class; rather, certain classes would be made better off only relative to those most adversely affected.

[3] Of course, the overall change in welfare depends on the alternative application of resources released from the owned-housing market.

It seems difficult to believe that movement toward such a state of affairs would be politically feasible. Bourassa and Grigsby postulate that eliminating the mortgage interest and property tax deductions over 15 to 20 years will minimize the adverse price effects at the high end of the market. I feel that rather than *reducing* the stock price effect, such a transition would instead simply *delay* it, rendering it less noticeable by individual households over time. However, this would not make the proposal any more politically acceptable, since the households to be adversely affected would still anticipate the impact.

The third situation—an add-on of homeowner tax concession—is more likely to pass the political litmus test. The case in which no homeowning household would lose its homeownership tax concessions and certain households would actually gain through a more generous alternative concession is pareto optimal, at least within the homeownership sector. If the spillover social benefits of homeownership were determined to be valued in excess of current homeownership tax concessions, an add-on could actually be pareto optimal in a broader economic context.

An example of the type of add-on concession that may accomplish the aim of directing homeownership incentives to low- to moderate-income households is a flat tax credit permitted as an alternative to the traditional deductions, possibly below a certain adjusted gross income level. In Green and Vandell (1999), such a credit was a universal substitute for existing deductions. The level needed to achieve revenue neutrality was estimated to be $810 per household.[4] Such a credit would be equivalent to a $5,400 deduction at a 15 percent marginal tax rate, which at a mortgage rate of 8 percent would support a mortgage of $67,500. In 1997, there were 26.0 million households with an annual income of between $20,000 and $40,000, 15.4 million of which (59.2 percent) were homeowning households. With such a directed credit in place, Green and Vandell (1999) estimate that homeownership among these households would increase by 3.6 percentage points (by 937,000 households) to 62.8 percent.[5]

We learn from Bourassa and Grigsby's table 2 that there are 3,509,000 mortgage-interest itemizers in the $20,000–$40,000 household income bracket. The weighted average mortgage interest tax concession for those itemizers is $485 per household, which implies a current total tax concession for the income bracket of slightly over $1.7 billion. We

[4] This level was estimated after assuming a shift by households toward equity and away from debt financing in response to the changed incentive to incur mortgage debt and after assuming that certain households would still be constrained by the down payment from entering into homeownership.

[5] The increase in homeownership could be greater if a system were in place to transform the stream of credits, at least partially, into a lump sum available for down payment (discussed briefly in Green and Vandell 1999).

will assume the following: that all 937,000 new homeowning households and that three-quarters of the previous itemizers, or 2,632,000 households, will adopt the tax credit rather than a deduction and that the average tax concession for those who continue to opt for the deduction is $1,000 per household or $877 million, implying that the average deduction among the remaining households is only $313 per household, or $824,865,000. The total cost to the Treasury, therefore, is $758,970,000 from the new homeowning households (937,000 households × $810 per household) plus $1,308,104,000 from existing homeowning households that opted to switch to the more generous credit (2,632,000 households × ($810 – $313) per household incremental tax concession), to equal about $2.1 billion ($2,067,074,000), or an average of $2,206 per household shifting to owner-occupancy.

Of course, it should be noted that there exist other benefits, both housing and nonhousing, to the households in this income bracket beyond the shift of some of them to owner-occupancy. The increased tax concession will encourage many of the existing owners to upgrade their housing consumption or to increase their consumption or investment in other sectors. We have considered only households in the $20,000–$40,000 income bracket, where most of the benefit from a tax credit would fall. At higher brackets, the level of interest deductions will reduce the proportion of those opting to substitute the credit. At lower brackets, households will be constrained from participating in the homeownership market anyway because of lack of liquid assets available for a down payment.[6]

This credit arrangement is only one of an infinite number of possible alternative tax concession arrangements supporting homeownership that could be structured as an add-on to the current system to accomplish the allocative efficiency and distributional equity objectives of the authors without running afoul of political realities.

Conclusions

An add-on flat homeownership tax credit at the low end of the market satisfies all of the evaluation criteria set by the authors in determining the desirability of particular tax concessions:

1. It may reduce *allocative efficiency in the narrow sense* in that it directs more, not less, tax support into the homeownership sector. However, under the assumption that there are additional positive homeownership externalities that remain unencouraged under the current tax system, it could more closely approach a situation

[6] Of course, this situation could change if a means were developed to capitalize the stream of tax credits to supplement the availability of a down payment.

in which marginal social costs equal marginal social benefits (i.e., greater allocative efficiency *in the broad sense*).

2. It enhances *equity* in that it directs incremental homeownership tax benefits to targeted household classes, especially low- to moderate-income households that would otherwise be nonitemizers. If there is a system for transforming the stream of credits into a lump sum supplement to a down payment, it would also benefit those who would otherwise have insufficient liquid wealth available for a down payment. Depending on the level and shape of the credit across different income classes, it could considerably ameliorate the existing regressivity in the pattern of tax benefits.

3. It is *administratively simple* and relatively inexpensive to implement. Mortgage interest and property tax deductions are easy to calculate and are already embedded in the tax code. Nontaxability of imputed net rental income and capital gains would likewise continue, requiring no complex recordkeeping or additional IRS tabulations. The additional credit would be based entirely on homeownership status and possibly adjusted gross income, both easy to ascertain and requiring nothing in the way of additional recordkeeping and little in the way of tax form revision.

Bourassa and Grigsby make a significant contribution to our understanding of the important criteria for evaluation as they relate to the various existing and proposed tax concessions for homeownership. Extending their analysis to incorporate the positive externalities associated with homeownership, the difficult political realities of implementing a benefit-reducing or benefit-redistributing scheme, and the enhanced flexibility permitted under the current budgetary surplus would further enhance their contribution.

Author

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