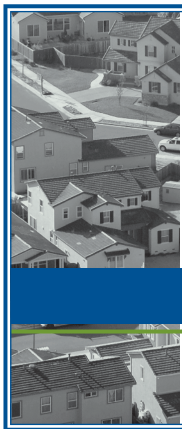

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Costs and Benefits of Housing Tax Subsidies

Pew Fiscal Analysis Initiative and Subsidyscope

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EXECUTIVE SUMMARY

Proposals to change the federal tax code are part of the emerging debate over America's long-term fiscal challenges, and tax expenditures have been one element of that discussion. Tax expenditures are reductions in tax liability that the federal government allows for certain activities, and they affect the nation's balance sheet in the same way that direct spending does. According to Department of the Treasury estimates, there are 173 tax expenditures in the federal income tax system in fiscal year (FY) 2010 that total nearly $1 trillion (not including interactions or outlay effects).

Research has attributed many economic and social costs and benefits to housing. This study, authored by Robert Carroll, John F. O'Hare and Phillip L. Swagel, public finance and tax experts, assesses one very targeted component of this complex issue—the fiscal costs and benefits of the housing subsidies that currently exist in the U.S. income tax system and the impact of several alternatives. This analysis was commissioned by the Pew Fiscal Analysis Initiative and Subsidyscope—projects designed to inform the policy debate with non-partisan facts and analysis. Pew has no position on this issue.

As calculated in this report, the three main tax subsidies for housing totaled about $304 billion in FY 2010. This includes the well-known subsidies under which homeowners who itemize deductions on their income tax returns can subtract property taxes and mortgage interest payments from their gross income. The analysis in this report also includes a less-discussed housing tax subsidy, the exclusion of "imputed rent" from a taxpayer's gross income, where imputed rent is the amount of income a homeowner could receive if he or she rented out his or her home instead of living there.

Benefits and Costs of Housing Tax Subsidies

In addition to the budgetary implications, these housing tax subsidies have important benefits and costs for individual households and the economy as a whole. One of the principal benefits is that they encourage homeownership and thereby promote stronger and more cohesive neighborhoods. Homeowners' attachment to their communities is associated with greater civic participation and lower rates of crime.

At the same time, these tax subsidies also distort the housing market and affect the allocation of capital across the economy. The current housing tax subsidies—for example, the mortgage interest deduction in particular—leads people to borrow more money and buy larger homes than they would otherwise, making the overall economy more leveraged. By effectively lowering the price of owner-occupied housing relative to other goods and services, housing tax subsidies encourage investment in and consumption of housing, particularly owner-occupied housing, over other types of investments, goods and services. The resulting distortion in the allocation of capital likely lowers overall output and leads Americans to have personal assets that are more heavily skewed toward housing at the expense of diversification in other investments.

Distribution of Housing Tax Subsidies

The structure of the housing tax subsidies has important distributional implications, with the tax benefits accruing disproportionately to upper-income households. These subsidies benefited 84 percent of homeowners (69.9 million out of 82.9 million in FY 2010, see tables B-1 and B-3) in some way, but with considerable variation in the average subsidy across income levels: the average subsidy for the lowest income category is $370, while families in the highest income category receive a tax subsidy on average of almost $18,000.

Fewer than half of homeowners benefit from the mortgage interest deduction. The benefit of this deduction rises with the size of the mortgage: the bigger the mortgage, the greater the tax benefit. The benefit also rises with a taxpayer's marginal tax rate, which, in part, explains why higher-income taxpayers receive a disproportionate share of the benefit. Furthermore, the current deduction is available only to homeowners who have tax liability and who itemize their deductions.

Alternatives to the Current Housing Tax Subsidies

This report examines several possible alternatives to the current housing tax subsidies, showing their impact on the distribution of benefits and their costs and demonstrating that it is possible to sever the links between the subsidy, the size of the house and the amount of mortgage debt used to finance it. The report begins by considering the elimination or replacement of all three federal housing tax subsidies. It also assesses more modest changes to the mortgage interest deduction alone, which the report estimates will account for $80 billion of housing tax subsidies in FY 2010. More specifically, two alternatives analyzed involve eliminating some or all of the subsidies, three involve converting subsidies to a refundable credit and one entails limiting the deductibility of mortgage interest.

As policy makers seek to address the fiscal challenges our nation faces in the coming years, all revenue and spending options will likely be considered, including popular tax expenditures that have wide support, such as housing tax subsidies. This report will inform that debate by looking at the current distribution and costs of these tax subsidies and several alternatives.

SUMMARY OF ALTERNATIVES TO THE HOUSING TAX SUBSIDY

Eliminate Housing Tax Subsidies

Eliminating the housing tax subsidies discussed in this report would require the taxation of net imputed rent (the amount of income homeowners could earn if they chose to rent their home instead of live in it) and the elimination of the current deductions for mortgage interest and property taxes. This would remove the tax incentives for the purchase of large homes, and overuse of debt finance, as well as the incentive for homeownership, although the taxation of net imputed rent would raise significant administrative issues. These changes would raise $304 billion in federal revenues in FY 2010 alone, mostly from homeowners with moderate to high marginal tax rates (currently more than 80 percent of the existing subsidy goes to homeowners with incomes over $50,000). The revenue raised under this scenario would be equivalent to a 28.2 percent across-the-board increase in the income tax rates currently paid by every U.S. household.

Replace Housing Tax Subsidies with a Flat Credit

Replacing the $304 billion in housing tax subsidies with a cost-neutral flat credit of $3,700 available to all 82.9 million homeowners (including those who do not itemize and have no tax liability) also would entail the taxation of net imputed rent and elimination of the current deductions for mortgage interest and property taxes. This scenario would promote homeownership by keeping a subsidy in place, but would sever the links between the subsidy, the size of the house and the amount of mortgage debt used to finance it. A flat credit would provide the same subsidy to all homeowners and thereby increase progressivity.

Eliminate the Mortgage Interest Deduction

Under current law, taxpayers who own a home, itemize their deductions and have income tax liability may deduct mortgage interest from their gross income. Taxpayers who claim this deduction receive a benefit that is proportional to their marginal tax rate: taxpayers in higher brackets receive a larger subsidy than those in lower brackets. About 37.5 million homeowners (fewer than half of all the 82.9 million current homeowners) claim this deduction. Completely eliminating the mortgage interest deduction would raise $80 billion in federal revenues in FY 2010, equivalent to a 7.5 percent across-the-board increase in individual income tax rates for all taxpayers. This alternative would reduce the existing incentive to overuse debt finance to purchase a large home, but it also would end a popular subsidy on which American homeowners have come to rely.

Replace the Mortgage Interest Deduction with a Tax Credit

Replacing the mortgage interest deduction with a refundable tax credit that is 15 percent of the homeowner's mortgage interest would reduce the incentive to overuse debt finance to purchase a large home, but would not eliminate it. Under this alternative, all homeowners would essentially receive a check equivalent to 15 percent of their mortgage interest, regardless of their tax bracket and whether or not they itemize or have tax liability. Therefore, taxpayers who today could deduct mortgage interest at tax rates up to 35 percent would see a reduction in their tax benefit. Homeowners today who do not have income tax liability would benefit from this alternative and would receive a refund in the amount of this credit. This option would cost $16.3 billion less than the current mortgage interest deduction in FY 2010, primarily at the expense of taxpayers with marginal tax rates above 15 percent. Restricting this alternative to include only homeowners with income tax liability would cost $22.9 billion less than the current deduction.

Replacing the mortgage interest deduction with a refundable tax credit that is 25 percent of the homeowner's mortgage interest would cost $26.5 billion more than the current mortgage interest deduction. Restricting this alternative to homeowners with income tax liability would lower the overall cost to $11.7 billion above the current costs for the mortgage interest deduction.

Replace the Mortgage Interest Deduction with a Tax Credit and a Cap on Mortgage Value

Under current law, homeowners can deduct interest only on the first $1 million in mortgage debt. Lowering the allowable threshold to $500,000 would remove some of the incentive to purchase large homes and the overuse of debt finance. Coupling a lower mortgage cap with the refundable tax credit equal to the value of 15 percent of the mortgage interest would cost $20.3 billion less than the current mortgage interest deduction in FY 2010. Restricting this alternative to include only homeowners with income tax liability would cost $26.5 billion less than the current deduction.

Combining the $500,000 cap with a refundable tax credit equal to the value of 25 percent of the mortgage interest would cost $19.7 billion more than the current deduction. Restricting the alternative to include only homeowners with tax liability reduces the cost to $5.9 billion more than the current mortgage interest deduction.

Limit the Value of the Mortgage Interest Deduction to 28 Percent

President Obama's FY 2011 Budget included a proposal to limit the value of all itemized deductions to 28 percent for all taxpayers. Under this proposal, only the mortgage interest deduction would be limited to 28 percent. Homeowners with marginal tax rates above 28 percent would receive less benefit than under the existing mortgage interest deduction, and taxpayers with marginal tax rates below 28 percent would receive the same tax benefit as they now receive for their deduction. As calculated in this report, this scenario would cost $5.6 billion less than the current mortgage interest deduction.

The Pew Fiscal Analysis Initiative seeks to increase fiscal accountability, responsibility and transparency by providing independent and unbiased information to policy makers and the public as they consider the major policy issues facing our nation. Together with outside experts from across the political spectrum, the Initiative provides new analysis and more accessible information to inform the debate on these issues.

Subsidyscope aims to raise public awareness about the role of federal subsidies in the economy. The project aggregates information on federal spending and subsidies from multiple government sources, serving as a gateway for press, policy makers, advocates and the public. The comprehensive and objective data presented by Subsidyscope will contribute to an informed debate about how to best allocate scarce government resources.

For additional information, please visit www.pewtrusts.org or contact Samantha Lasky at slasky@pewtrusts.org or 202-540-6390.