Testimony of

Dr. Robert Dietz

On Behalf of the
National Association of Home Builders

Before the
United States Senate
Committee on Finance

Hearing on

<u>Tax Reform Options: Incentives for Homeownership</u>

October 6, 2011

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

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

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

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

The Benefits of Homeownership

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

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

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

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

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

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

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

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

[2] C. J. Mayer, K. V. Simons, Reverse mortgages and the liquidity of housing wealth, AREUEA Journal 22 (1994) 235-55.
[3] S. Macintyre, A. Ellaway, G. Der, F. Graeme, K. Hunt, Do housing tenure and car access predict health because they are simply markers of income or self-esteem? A Scottish study, Journal of Epidemiology and Community Health 52 (1998) 657-664.
S. A. Robert, J. S. House, SES differentials in health by age and alternative indicators of SES, Journal of Aging and Health 8 (1996) 359-388.
[4] M. Shaw, D. Dorling, N. Brimblecombe, Life chances in Britain by housing wealth and for the homeless and vulnerably housed, Environment and Planning A 31 (1999) 2239-2248.
[5] F. Finnas, Economic determinants of divorce in Finland, Ekonomiska Samfundets Tidskrift 53 (2000) 121-132).
[6] M. Bracher, G. Santow, S.P. Morgan, J. Trussell, Marriage dissolution in Australia – models and explanations, Population Studies 47 (1993) 403-425.
[7] S. Lane, J. Kinsey, Housing tenure status and housing satisfaction, Journal of Consumer Affairs 14 (1980) 341-65.

[8] T. P. Boehm, A. M. Schlottman, Does homeownership by parents have an economic impact on their children? Journal of Housing Economics 8 (1999) 217-232.
[9] R. K. Green, M. J. White, Measuring the benefits of homeowning: Effects on children, Journal of Urban Economics 41 (1997) 441-461.

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

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

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

Capital Gains Exclusion

<u>Brief History of the Capital Gains Exclusion</u>

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

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

---

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

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

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

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

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

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

<u>Simplification Arrives: The Changes of 1997</u>

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

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

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

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

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

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

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

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

Mortgage Interest Deduction

<u>Brief History of the Mortgage Interest Deduction</u>

When Congress created the modern income tax code in 1913, Congress recognized the importance of allowing for the deduction of interest paid on debt incurred in the generation of income. In this early code, taxpayers were permitted to deduct a wide-range of interest from business and personal debts, including mortgage interest. The mortgage interest deduction came into its own after World War II, when home ownership became more accessible and a rite of passage for the middle class. Deductions for mortgage interest grew in absolute numbers, homeownership rates increased during this period, and today two-thirds of American households own a home.[15]

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

Tax Rules for the Mortgage Interest Deduction

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

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

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

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

Who Benefits from the Mortgage Interest Deduction

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

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

[15] U.S. Census Bureau: http://www.census.gov/hhes/www/housing/hvs/qtr211/q211ind.html
[16] "General Explanation of the Tax Reform Act of 1986", Joint Committee Print, Prepared by the Staff of the Joint Committee on Taxation, May 4, 1987. Pg 263-264.
[17] Bureau of Labor Statistics CPI Inflation Calculator. $1,000,000 in 1987 equates to $1,994,234 in 2011. http://www.bls.gov/data/inflation_calculator.htm

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

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

According to the distributional tax expenditure estimates from the Joint Committee on Taxation (JCT), <u>90% of mortgage interest deduction beneficiaries earn less than $200,000 in economic income.</u> And 70% of the net tax benefits are collected by homeowners with economic income of less than $200,000.[18] It should be noted that the income classifier used by Joint Tax for these distribution analyses is economic income, a definition that generates incomes higher than adjusted gross income (AGI) (for example, economic income includes employer-paid health insurance premiums and payroll tax). Accordingly, these estimates understate the benefits collected by the middle class on the more recognized AGI income definition.

<u>The Mortgage Interest Deduction is Progressive</u>

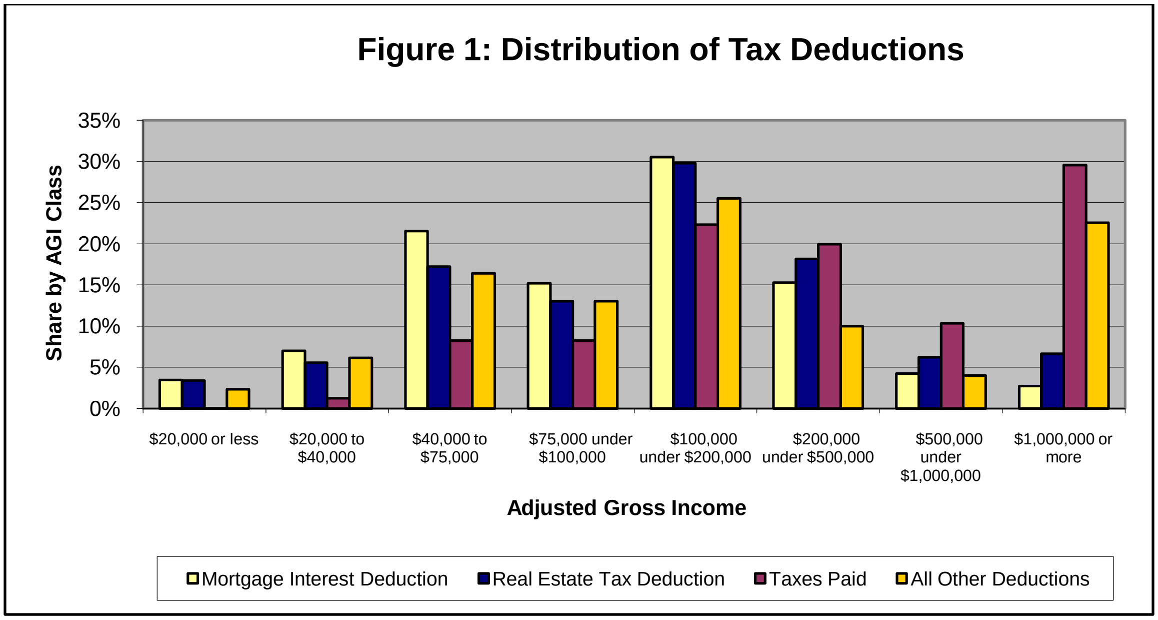
A progressive tax system is one for which low-income taxpayers pay a smaller percentage of their income in taxes than high-income taxpayers pay. A policy that reduces tax liability for low-income taxpayers lowers their average tax rate and thus makes the income tax system more progressive.

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

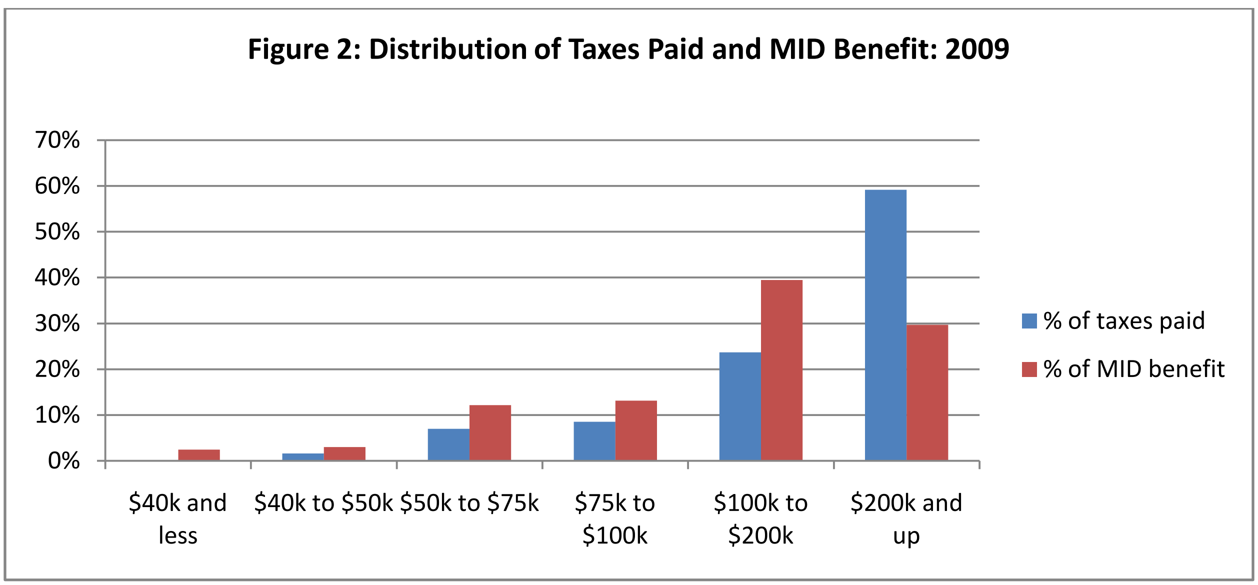
As seen in the chart below, Figure 1 illustrates the critical point when considering the income distribution of the housing tax deductions relative to other tax expenditures.

[18] Estimates of Federal Tax Expenditures for Fiscal Years 2010 – 2014. http://www.jct.gov/publications.html?func=startdown&id=3718

[19] Who Benefits from the Housing Tax Deductions? http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311



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



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

The Majority of Homeowners Will Claim the Mortgage Interest Deduction

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

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

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

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

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

Family Size Matters

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

[20] Who Benefits from the Housing Tax Deductions? http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

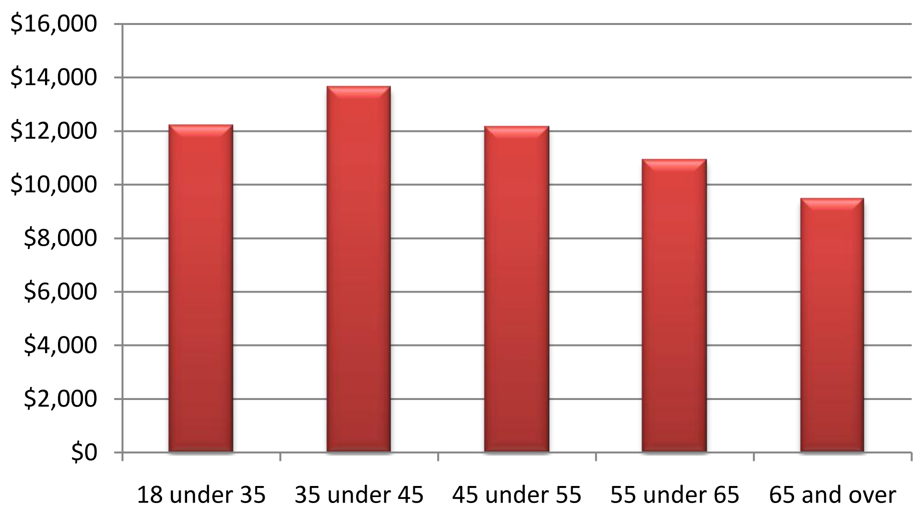
with four dependents had an average benefit of approximately $1,950. In fact, the benefit increased correspondingly from one dependent to five-plus dependents, which is intuitive with the notion that larger families require larger homes. Moreover, the cost of living, particularly for housing, varies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

And Age Matters

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

Using IRS data, I have examined the age characteristics of taxpayers claiming the mortgage interest deduction. Figure 3 plots the average mortgage interest deduction[21] by age cohort.

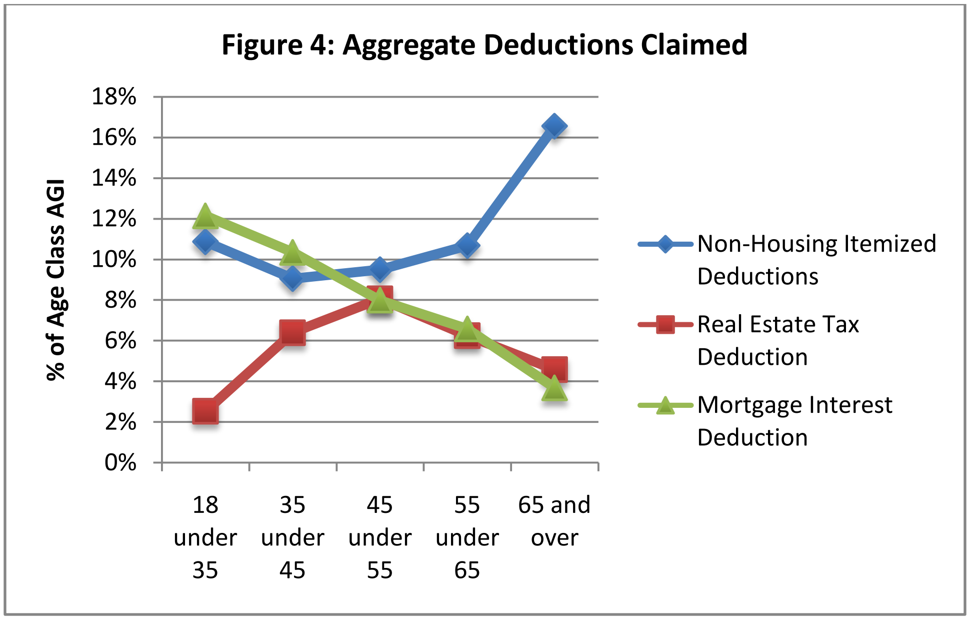
Figure 3: Average Mortgage Interest Deduction



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

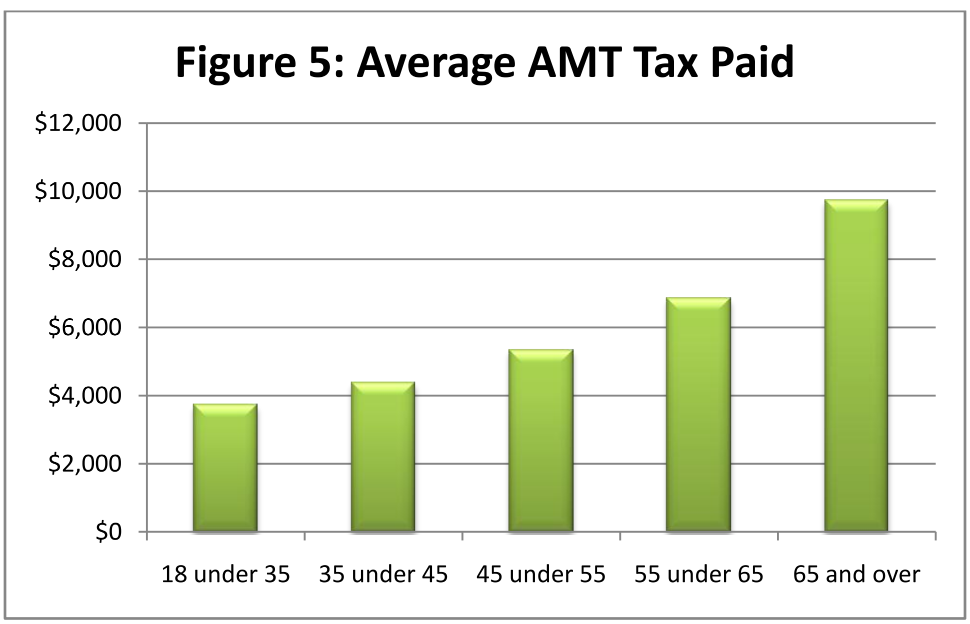
Figure 4 shows this data as shares of AGI. The data reveal that the mortgage interest and the real estate tax deductions fall as a share of taxpayer income for older taxpayers.

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



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

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



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

Home Prices and Affordability

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

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

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

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

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

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

Despite the 10% decline in price, the total cost of servicing the debt for the home increased. The after-tax interest payment in the MID regime is $5,692 ($7,289 minus the $1,597 MID benefit) compared to $6,560 with no MID and a 10% price reduction. In other words, despite the price decline, the after-tax user cost of the home actually increased $868[22]. And all existing homeowners suffered a 10% windfall loss to housing wealth due to the price decline.

Second Homes and the Mortgage Interest Deduction

Tax Rules for the Second Home

Homeowners may deduct interest payments on up to two homes in a given tax year: a primary residence and one other residence. The amount that may be deducted is still limited to the combined cap of $1 million in acquisition debt. A second home is one that is not rented[23] and is not the homeowner's primary residence. In addition, a second home can also be a home under construction for which the homeowner has an outstanding construction loan.

The Geographic Distribution of Second Homes

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

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

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

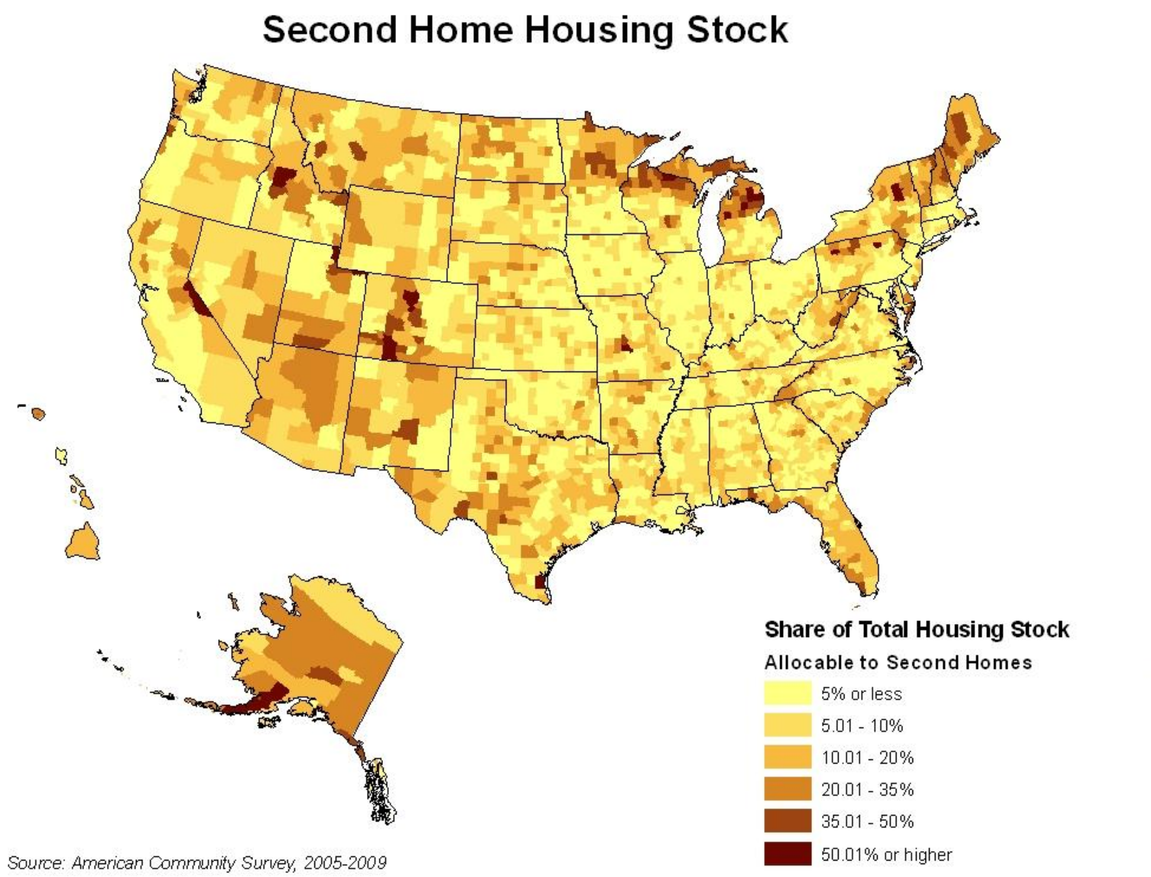
[23] Interest on debt used to acquire rental units may also in general be deducted under the tax code, but not under the mortgage interest deduction; it is a general business expense.

[24] Treasury Regulations 1.163.

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

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

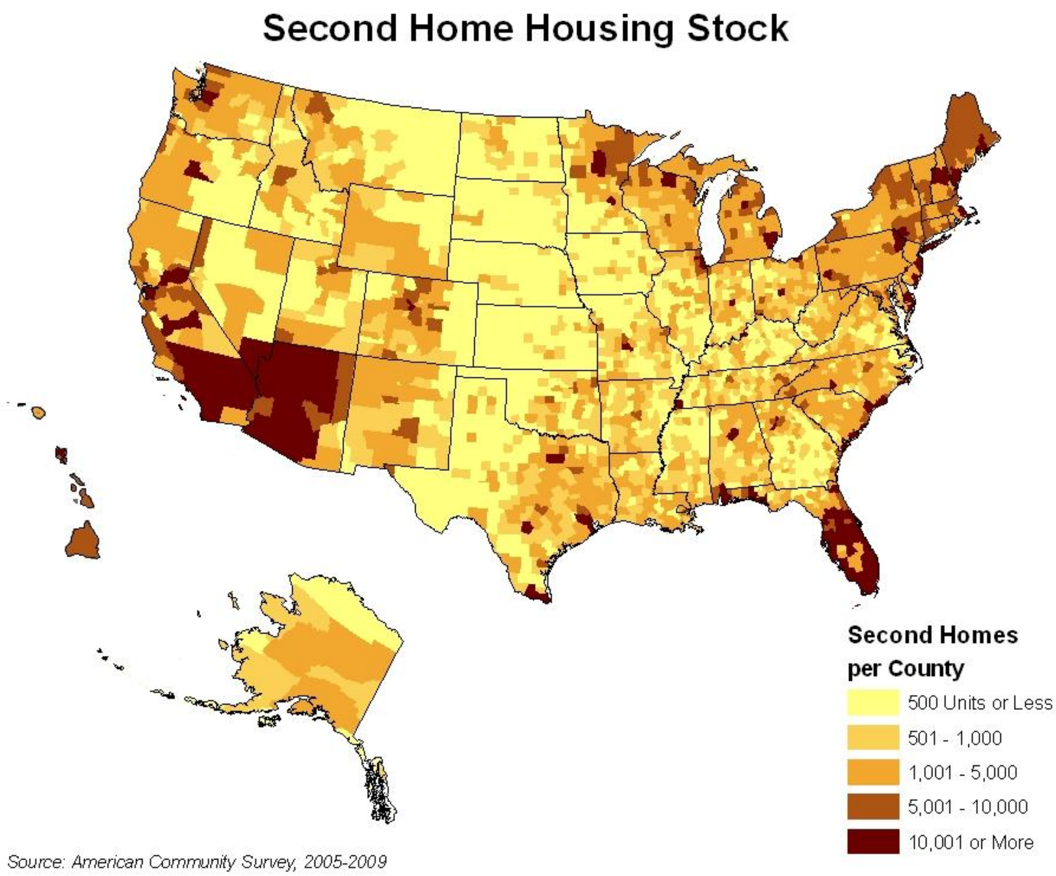
FIGURE 6



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

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

Figure 7



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

Home Equity Deduction

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

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

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

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

Recent Proposals to Reduce the Mortgage Interest Deduction

National Commission on Fiscal Responsibility and Reform: Simpson-Bowles

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

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

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

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

family faces a 25% marginal income tax rate. Under present law, a dollar of mortgage interest paid is worth on a marginal basis 25 cents of reduced tax liability. Under the commission's proposal, the marginal value would fall more than half to 12 cents. For an average sized home and mortgage for a family with this income, the MID is worth about $3000.[27] Under the tax credit, it would be worth less than $1,500. That is the equivalent of raising their mortgage payment by $125 per month.

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

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

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

Limiting Deductions to the 28% Bracket

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

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

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

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

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

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

Limiting Deductions to 2% of AGI

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

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

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

[28] http://www.taxpolicycenter.org/UploadedPDF/1001364_reforms_metro_housing.pdf
[29] http://www.nytimes.com/2011/05/05/opinion/05feldstein.html?_r=2

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

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

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

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

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

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

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

How Voters View the Housing Tax Incentives

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

Despite the housing crisis, the survey results showed that owning a home is still very much a part of the American dream. Americans believe that owning their own home is as important as being successful at their job or being able to pay for a family member's education. Seventy-five percent of Americans said that owning a home is worth the ups and downs of the housing market, and 67 percent of renters say that owning a home is the best long-term investment they can make. In fact, 73 percent of voters who do not currently own a home say that it is a goal of theirs to eventually buy one. This is even higher when looking at the 18 to 54 age bracket, where 83 percent aim to eventually buy a home.

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

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

Conclusion

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

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

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

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

It is also worth noting in this vein that the largest homeownership declines as a result of the Great Recession have occurred among younger homeowners. This has two causes. One, fewer households are being formed as younger individuals double up or, as a second reason, such individuals choose to live with their parents or other family. NAHB estimates that 2.1 million households have not formed for these reasons, and thereby constitute "pent-up housing demand." The Census Bureau has found similar estimates.[30]

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

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

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

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

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

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

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