

# Tax Expenditure Reviews

*(Attachment—original pages 15-35)*

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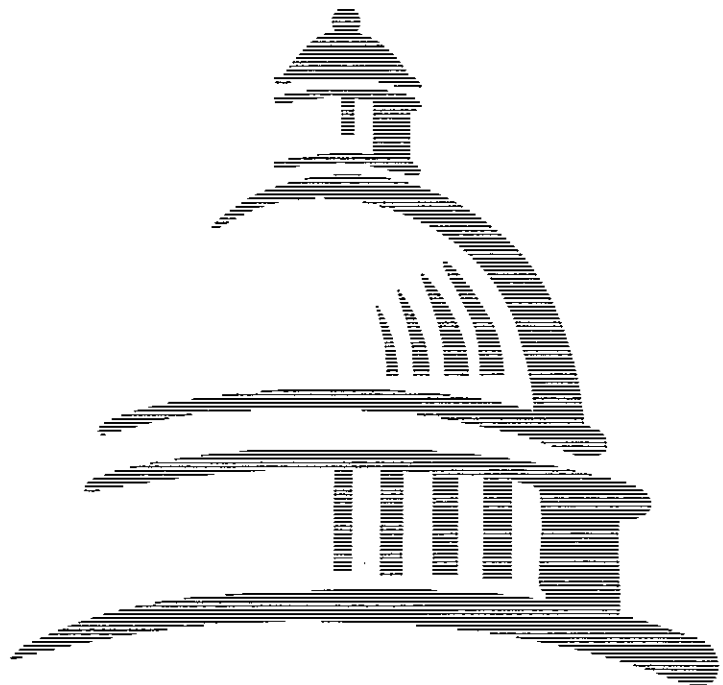
LEGISLATIVE ANALYST'S OFFICE

Prepared for:

Senate Committee on Revenue and Taxation

Assembly Committee on Revenue and Taxation

Joint Legislative Budget Committee



## **MORTGAGE INTEREST DEDUCTION**

In this section, we provide an analysis of the state's largest TEP—the mortgage interest deduction. We discuss the program's basic structure and underlying rationale, how its benefits are distributed, and its overall performance. We then offer recommendations for making the program more effective as a policy tool.

### **Summary and Recommendations**

Our principal findings and recommendations are as follows:

- In theory, good tax policy should generally strive to raise revenue without inadvertently causing people to change their behavior. Economists refer to this principle as “economic neutrality.”
- Sometimes, however, tax policies are designed specifically to induce behavioral changes. Such policies may be appropriate when, without intervention, the economic marketplace would produce either too little of a good or service that provides broad social benefits or too much of a good or service that imposes broad social costs.
- Homeownership is one area where many people argue that the free market does not produce an optimal outcome for society as a whole. Their view is that homeowners provide benefits to society by maintaining their homes better and by

participating more actively in civic affairs than do renters. According to this view, government policies aimed at increasing the percentage of people who own their own homes may, therefore, be appropriate.

- There are a number of different tax policies that encourage homeownership. The largest is the mortgage interest deduction (MID).
- The MID can be claimed on both federal and California PIT returns. In 2007-08, it is estimated that the state mortgage interest TEP will reduce California tax revenues by approximately \$5 billion.
- Under its current structure, the benefits of the MID are poorly targeted. This is because only a small share of its benefits accrues to people who would not own their homes in the absence of this policy, and many of its benefits go to higher-income individuals who purchase expensive homes that arguably should not be subsidized by other taxpayers.
- Therefore, we provide several options for improving the effectiveness and efficiency of the MID's homeownership incentive in the California tax code. We offer both ways to better target the existing deduction and the alternative of replacing the MID with a more limited and better-targeted credit for home purchases.

## **Organization**

In this review, we first briefly discuss the rationale for having the MID. (The Appendix provides background on what the tax code would look like if its primary objective was to provide an economically neutral treatment of housing, and then discusses the case for using the tax code explicitly to encourage homeownership.) Next, we describe current government policies, including several features of the tax code, that affect housing. We then examine the use of one particular provision of the tax code—the MID. We present evidence suggesting that the MID does not effectively and efficiently promote the goal of homeownership. We describe a variety of policy options for more effectively targeting the MID. We then suggest that another alternative—replacing the MID with a credit—would be both more effective and efficient in achieving policy objectives.

## **Rationale for the MID**

California has, for many years, chosen to provide substantial benefits to its homeowners by allowing them to claim a mortgage interest deduction when computing their income taxes. This subsidy to homeowners is similar to the one offered by the federal government and currently costs California taxpayers and the state budget approximately \$5 billion annually. Most economists take the view that the tax structure should be “economically neutral” (see discussion in Appendix), meaning that the structure of the tax system should not influence economic decisions unless there are compelling reasons for doing so. In the case of the MID, the primary justification generally offered for providing the subsidy is that homeownership is good for society, and thus should be encouraged.

## Current Government Policies Affecting Housing

### Housing-Related Tax Provisions

Several provisions of both the federal and California tax codes affect the housing industry. These are discussed below and summarized in Figure 2.

<b>Figure 2</b>	
<b>Housing-Related California Tax Provisions</b>	
<b>Major Provisions</b>	
✓	Deductibility of mortgage interest
✓	Exclusion of capital gains on principal residences
✓	Step-up in basis for residences upon death
✓	Deductibility of residential property taxes
<b>Other Provisions</b>	
✓	Homeowner's exemption for property taxes
✓	Use of tax-exempt bonds to finance certain housing
✓	Exclusion of capital gains for like-kind exchanges involving similar properties
✓	Exclusion from income of housing allowances for the clergy
✓	The Renters' Credit
✓	The Low-Income Housing Credit and Farmworker Housing Credit
✓	The California Homeowners' and Renters' Assistance Program

***Deductibility of Mortgage Interest.*** One of the most important provisions of the federal and state tax codes is the MID. Under this provision, taxpayers may claim as an itemized deduction their interest payments on mortgages of up to \$1,000,000 for joint filers and \$500,000 for single filers on their first and/or second homes, and on home equity loans of up to \$100,000 for joint filers and \$50,000 for single filers.

***Exclusion of Capital Gains on Principal Residences.*** Another important housing-related tax provision is the exclusion of capital gains on the sale of a principal residence. When taxpayers sell a home that has been their principal residence for two of the previous five years, the first \$500,000 of capital gains for joint filers (or \$250,000 for single filers) earned on the sale is not included in taxable income.

***Basis Step-Up.*** Although they are not specific to housing, the rules on asset basis step-up at death benefit housing. When an heir sells a house, the capital gains on the sale are calculated from the home's value at the time of inheritance rather than from its value at the time it was originally purchased.

***Deductibility of Property Taxes.*** The final major housing-related provision of the tax code is that taxpayers may claim an itemized deduction for real property taxes paid on their homes. This deduction is allowed only for property taxes and not for the various other things that can appear on property tax bills, such as specific fees assessed for parks and other public services, landscaping fees, and so-called Mello-Roos fees in California.

***Other Provisions.*** Several other provisions of both federal and California tax law also affect the housing industry, but on a smaller scale than the major programs identified above. For example:

- State housing agencies are allowed to issue tax-exempt bonds and use the proceeds to issue loans at below-market interest rates to low- and moderate-income home buyers.
- The provisions for like-kind exchanges (commonly referred to as Section 1031 exchanges) provide benefits to a variety of taxpayers, including some owners of housing.
- An exclusion from income of housing for clergy also exists, and may influence the type of housing occupied by members of the clergy.

Finally, some provisions specific to the California tax code also affect the housing market:

- The California Constitution provides that the assessed value of owner-occupied homes be reduced by \$7,000. This results in an annual property tax reduction of approximately \$75 per homeowner.
- The California renter's credit provides a small annual subsidy to lower-income taxpayers.
- The low-income housing credit and the farmworker housing credit subsidize the production of low-income housing.
- Lastly, California's Homeowner's and Renter's Assistance Program subsidizes the cost of housing for low-income Californians.

### **Non-Tax Government Policies Affecting Housing**

In addition to the tax-related programs described above, at least two other types of government programs also affect the housing market. First, there are direct expenditure programs aimed at subsidizing low-income housing. This category includes government subsidies for the production of low-income housing (almost all rental units) and government subsidies for rent paid by low-income people. These rent subsidies may encourage a few people to rent rather than own their home, although most of the people receiving these subsidies would probably have been renters anyway due to their income levels.

The government also influences the housing market by regulating the market for mortgages. One important federal influence is through the benefits conferred on government-sponsored enterprises (such as Fannie Mae and Freddie Mac) that help finance mortgages. Also, a number of federal and state agencies insure mortgage loans for particular groups of borrowers. In addition, the state offers mortgage subsidies for qualified first-time homebuyers. These types of government assistance almost certainly encourage homeownership.

## **Issues to Consider in Evaluating Housing Tax Policy**

As described above, both the federal and California governments have adopted a number of policies that influence the housing market. Many (although not all) of these policies are tax expenditures that reduce the taxable income of homeowners and likely, therefore, work to encourage increased homeownership.

The main avenue by which these tax policies work is their overall effect on *reducing the cost* of acquiring and living in homes, and this reduction appears to be substantial. According to the *Final Report of the President's Advisory Panel on Tax Reform* issued in 2006, for example, the tax rate on investment in owner-occupied housing is 14 percent lower than investments generally and this difference flows through to lowering the cost of acquiring housing.

The precise effect of this subsidy on *homeownership rates*, however, is not clear. A portion of the subsidy may induce some people who would otherwise choose to rent housing to purchase homes. Much of the subsidy, however, likely results in people who would own a home anyway purchasing larger and/or fancier homes than they otherwise would have, or even in purchasing additional homes. Another portion of the subsidy may free up resources for people to spend on items other than home purchases (furniture, cars, vacations, and so forth). Also, a portion of the subsidy may simply pass through to home sellers in the form of higher prices without changing what home buyers are acquiring.

Given the variety of outcomes that can result from housing subsidies, there are several questions for evaluating current government policy:

- Are the state's current housing programs actually increasing homeownership, and if so, by how much? Or, are these programs instead driving up prices by increasing housing demand and/or enabling people who would have owned homes anyway to buy additional and/or bigger and more expensive ones or to spend their tax savings on items other than housing?
- Do we need all of the various programs described above to achieve our basic policy goal of encouraging homeownership, or should certain programs be modified or eliminated in order to make our collection of policies more coordinated, efficient, and effective?
- Is the current level of the housing subsidy provided by our housing-related programs appropriate? Or, is it too large or too small given our housing-related objectives and competing, nonhousing priorities?

- Does California need to have its own set of housing-related tax programs and other policy prescriptions in place in order to accomplish its housing objectives? Or, are the state programs' effects so marginal that it can rely primarily on federal programs to accomplish the policy objectives?

Answering all of these questions and evaluating the entire range of housing-related programs that the state offers is beyond the scope of this particular analysis. In the next section, however, we address some of these questions as they relate specifically to the state's largest explicit tax-related housing program—the MID.

## **The State's Mortgage Interest Deduction**

### **Theoretical Perspective**

In the economically neutral tax scheme described in the Appendix, the MID is justified as a deductible expense associated with the generation of income to homeowners. However, if this income is excluded when calculating taxable income, the MID is no longer justifiable as a business expense. Given this, a provision like the MID should be scrutinized closely to ensure that there is an economic justification for it.

### **Historical Perspective**

When the U.S. adopted the PIT in 1913, consumer borrowing was extremely rare and most borrowing was for business purposes. At that time, all interest payments were made deductible, because they generally were a business expense incurred in order to produce income. This even generally applied with respect to mortgages, since there were relatively few in existence and most of the mortgages that did exist were for farms and could, therefore, be viewed as business lending.

Financial markets subsequently developed extensively over the course of the twentieth century and borrowing by individuals expanded greatly, both to acquire homes and to finance consumption spending. All interest on such loans was originally tax deductible. However, the federal Tax Reform Act of 1986 eliminated the deduction for interest payments for most consumer borrowing. The deduction was retained, though, for mortgage borrowing up to the limits described previously. Thus, the MID simply evolved from the historic treatment of business interest and was later justified as being a beneficial policy tool.

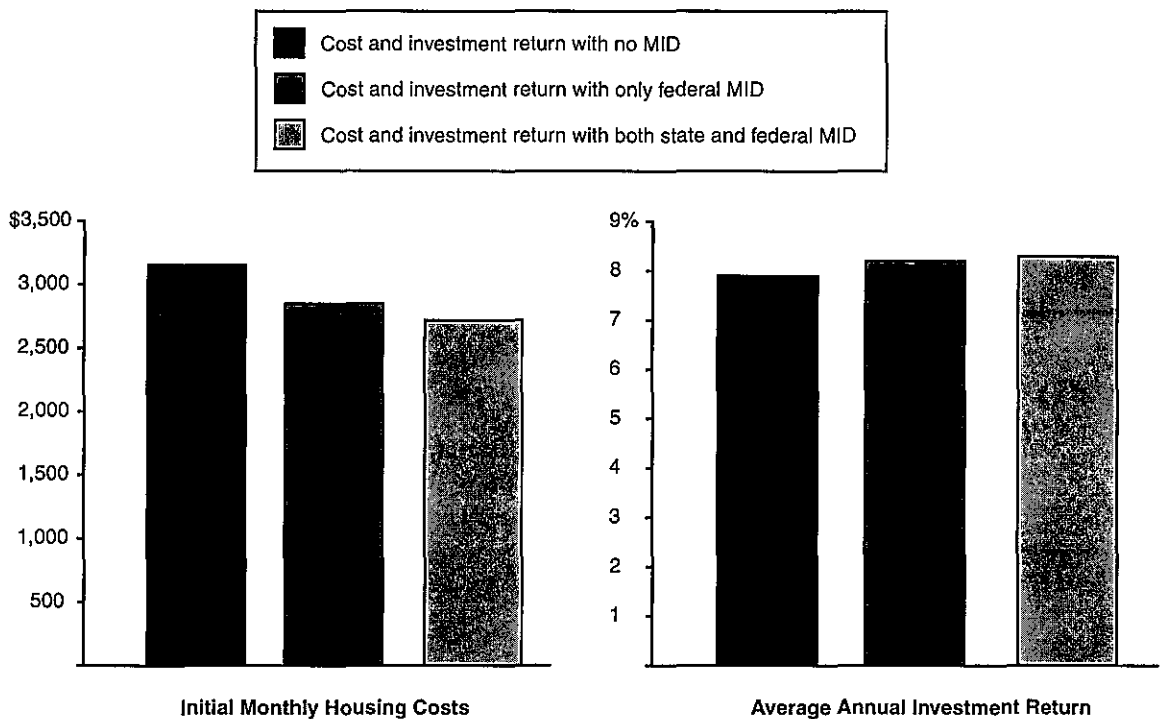
### **What Effect Does the MID Have on the Cost of Housing?**

As noted above, the MID reduces the cost of housing by lowering the taxable income of homeowners based on the amount of mortgage interest they pay. Figure 3 provides an illustrative example of the impact of the federal and state MID on the monthly costs in the first year of ownership and the average annual investment return of a California home purchase under one common set of conditions. The example shows the initial monthly housing costs for a family of four having an adjusted gross income of \$80,000 that purchases a \$450,000 house. It also assumes a 10 percent down payment and a 30-year fixed-rate mortgage at 6 percent interest annually. As shown:

- The federal MID by itself reduces the monthly costs of housing in the first year by about \$300 (roughly 10 percent) relative to what they would be without the deduction, and the state MID reduces these costs of another roughly \$130 (about 4 percent).
- The federal MID increases the rate of return on this housing investment by about three-tenths of 1 percent, and the state deduction further raises it by about another one-tenth of 1 percent.

Figure 3

**Illustrative Example: How the MID Can Affect Initial Monthly Housing Costs and Investment Returns for a Homeowner**



**Assumptions:** Example assumes the purchase of a California home for \$450,000 with a 10 percent down payment, and a 30-year fixed-rate mortgage loan at 6 percent interest per annum. Example also incorporates assumptions regarding property taxes, other housing expenses, home price appreciation, income tax rates, and value of housing services consumed.

**Revenue Impact of the MID**

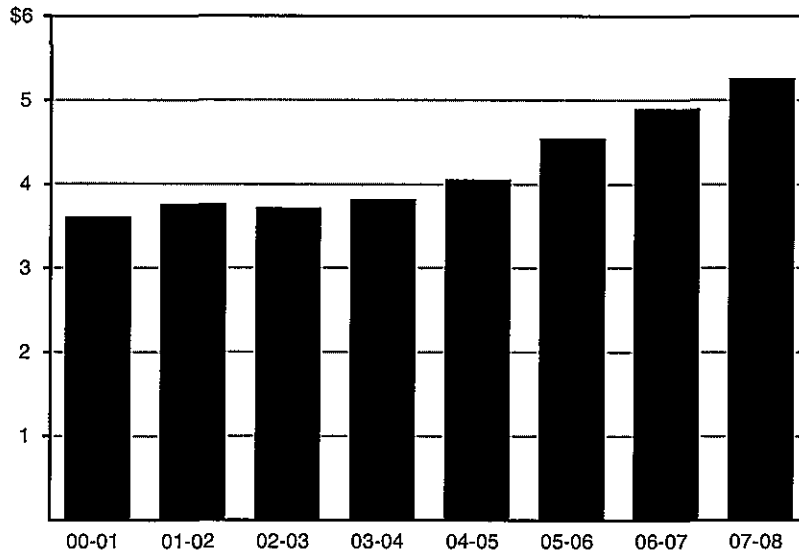
We estimate that in 2006-07, California taxpayers used the MID to reduce their income tax liabilities by \$4.9 billion. As can be seen in Figure 4, the value of the MID has increased substantially in recent years. For example, the MID cost \$3.6 billion in 2000-01. As shown in Figure 5, the MID is now the largest tax expenditure in California.



Figure 4

**The MID's Cost Has Risen Significantly in Recent Years**

*Fiscal Year (In Billions)*



Note: Data for 2005-06 onward are estimates.

Figure 5

**The MID Is California's Largest TEP**

*(In Millions)*

Top 12 TEP Programs	Type of Provision	2006-07 Revenue Reduction
Mortgage interest expenses	PIT deduction	\$4,885
Food products	SUT exemption	4,748
Employer contributions to pension plans	PIT exclusion	4,450
Employer contributions to accident and health plans	PIT exclusion	3,975
Basis step-up on inherited property	PIT exclusion	3,030
Gas, electricity, and water	SUT exemption	2,468
Prescription medicines	SUT exemption	1,926
Capital gains on sales of principal residences	PIT exclusion	1,770
Dependent exemption	PIT credit	1,650
Charitable contributions	PIT deduction	1,600
Subchapter S corporations	CT special filing status	1,500
Real property taxes	PIT deduction	1,315

Note: Amounts shown for SUT exemptions include both state and local revenue reductions.  
MID=mortgage interest deduction; TEP=tax expenditure program; PIT=personal income tax; SUT=sales and use tax; and CT=corporation tax.

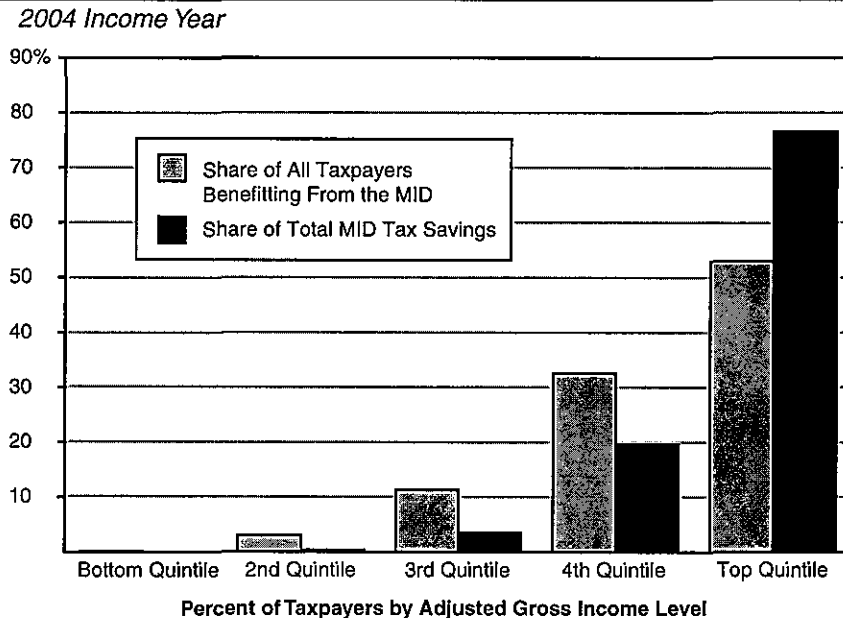
## Who Benefits From the MID?

Figures 6 and 7 show how many California taxpayers claim the MID and the amount of tax savings at each income level. The benefits of the MID are strongly skewed toward higher-income taxpayers. As discussed below, this is because higher income households both purchase more housing and are taxed at higher marginal income tax rates (which causes the MID's benefit for each dollar of interest paid to rise with income).

<b>Figure 6</b>					
<b>How the MID's Benefits Are Distributed by Income Group</b>					
<i>(2004 Income Year)</i>					
	<b>Taxpayers Benefiting</b>		<b>Tax Reduction</b>		
	<b>Number (In Thousands)</b>	<b>Share of Total</b>	<b>Amount (In Millions)</b>	<b>Share of Total</b>	<b>Average Tax Reduction</b>
<b>Income Quintile</b>					
Bottom	8	0.2%	\$1	— <sup>a</sup>	\$108
Second	117	3.0	15	0.4%	128
Third	442	11.2	132	3.5	298
Fourth	1,281	32.6	743	19.6	582
Top	2,080	52.9	2,907	76.5	1,398
<b>Totals</b>	<b>3,930</b>	<b>100.0%</b>	<b>\$3,798</b>	<b>100.0%</b>	<b>\$968</b>
<b>Breakout Within Top Quintile</b>					
Top 10 percent	1,091	27.8%	\$1,868	49.2%	\$1,713
Top 5 percent	535	13.6	1,049	27.6	1,960
Top 1 percent	93	2.4	201	5.3	2,158
<sup>a</sup> Less than one-tenth of 1 percent. Detail may not total due to rounding. MID = mortgage interest deduction.					

Figure 7

### The MID Disproportionately Benefits Higher Income Taxpayers



In particular, the figures show that in 2004 (the latest year for which detailed data are currently available):

- 3.9 million Californians were able to reduce their tax liability via the MID.
- In the bottom three income quintiles combined (that is, the lowest income 60 percent of taxpayers), only 570,000 taxpayers—about 1 out of every 14 taxpayers in these groups—used the MID to reduce their tax liability. In the top income quintile, by contrast, more than 2 million taxpayers used the MID to reduce their tax liability, more than three-fourths of the taxpayers in this group.
- Almost one-half of the tax reductions from the MID went to the top 10 percent of the income distribution (taxpayers making more than \$113,900 in 2004).
- The average per taxpayer savings for taxpayers who received some tax benefit from the MID was \$108 in the bottom quintile, \$298 in the middle quintile, and \$1,960 for taxpayers in the top 5 percent.

#### To What Extent Does the MID Actually Promote Homeownership?

As noted above, the MID both reduces the cost of owner-occupied housing and increases its rate of return as an investment. This has the effect of increasing the demand for homeownership. This increase in demand can have several different effects. First, it may lead to an increase in the price of housing. Second, it may result in more units of

housing being constructed and sold. Third, it may lead to an increase in average home size and/or quality. The exact mix among these three effects is influenced by such factors as the nature of the demand and supply for housing, as well as taxpayers' demand for goods other than housing. The precise split of increased expenditures between greater homeownership and the acquisition of larger and more expensive homes or other goods is difficult to isolate, however. This is partly because the effects of changes in the cost of homeownership can vary considerably both over time as well as among different geographic regions or localities within regions.

There is much evidence, though, that suggests the MID does not have a substantial impact on homeownership rates per se. One piece of evidence comes from comparisons across states. Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, and West Virginia all have a PIT, but do not allow for a MID. The homeownership rate in these states, however, is *higher* than the national average—just the opposite of what one would expect if the deduction were an effective incentive for homeownership. Similarly, there seems to be little difference in the homeownership rates between countries that allow a MID and those that do not (such as Australia, Canada, France, Germany, Israel, Japan, and New Zealand).

Additional evidence suggesting that the MID is ineffective at increasing homeownership comes from studies of the U.S. over time. The value of the MID varies depending on a number of factors such as inflation, marginal tax rates, and rules concerning other itemized deductions. These factors have changed substantially over the last 40 years. Homeownership rates, however, have not responded much to these changes.

*What Explains This Limited Effect?* It is not surprising that the MID appears ineffective at significantly stimulating increases in homeownership rates when one looks at the design of the deduction. This is because the deduction is much more valuable for people who are relatively well off or likely to be established homeowners purchasing a larger house, than for first-time homebuyers purchasing a starter house who often have more limited incomes. This is demonstrated in Figure 8, which shows as an illustration how the MID's benefits (in both dollar terms and as a percent of mortgage costs) differ for four hypothetical households having very different income and housing situations. One example of the varying effects of the MID on different taxpayers is that the state tax savings for the household in Case C is almost 300 times as large as for the household in Case A.

**Figure 8**

**Comparisons of How Much the MID's First-Year Savings Can Vary for Different Types of Taxpayers**

Taxpayers	Amount	Percent of Mortgage Costs
<b>Case A—\$45,000 Income and \$200,000 Home Price</b>		
Federal MID benefits	\$562	4.3%
State MID benefits	16	0.1
<b>Case B—\$75,000 Income and \$350,000 Home Price</b>		
Federal MID benefits	\$2,370	10.5%
State MID benefits	1,062	4.7
<b>Case C—\$150,000 Income and \$750,000 Home Price</b>		
Federal MID benefits	\$13,012	25.4%
State MID benefits	4,536	8.9
<b>Case D—\$800,000 Income and \$3,000,000 Home Price</b>		
Federal MID benefits	\$34,185	16.7%
State MID benefits	7,267	3.5

Note: Calculations assume 10 percent down payment; 30-year fixed-rate mortgage at 6 percent for conforming loans or 6.5 percent for jumbo loans; no closing costs; 2006 tax brackets; charitable deductions equal 2 percent of income; and joint-return taxpayer with two dependent children and other standard assumptions.

Figure 9 provides actual California tax-return data that further explains why the structure of the current MID tends to promote the purchase of larger and more expensive homes rather than basic homeownership (especially for first-time homebuyers). These data show that:

**Figure 9**

**How Factors Affecting MID Benefit Differ by Income Groups**

<i>2004 Income Year</i>									
Income Group Quintile	Income Range	Adjusted Gross Income			Mortgage Interest Itemized Deductions				Average Marginal California PIT Rate
		Amount (Billions)	Percent Share of Total	Probability Taxpayers Itemize	Number of Returns		Amount of Deductions		
					(In Thousands)	Percent of Total	(Dollars in Billions)	Percent of Total	
Bottom	\$0 - \$13,100	\$19	2.2%	17.1%	133	2.9%	\$1	2.1%	0.06%
Second	\$13,100 - \$25,600	54	6.4	17.9	328	7.1	3	5.4	0.45
Third	\$25,600 - \$43,400	90	10.6	35.5	671	14.5	7	11.1	1.91
Fourth	\$43,400 - \$75,800	152	17.9	60.5	1,318	28.6	15	24.2	4.93
Top	\$75,800 and up	534	62.8	84.7	2,164	46.9	36	57.2	8.15
All Taxpayers		\$849	100.0%	43.2%	4,614	100.0%	\$62	100.0%	6.10%

Detail may not total due to rounding.  
MID = mortgage interest deduction; PIT = personal income tax.

- One of the key reasons that the benefits from the MID accrue primarily to high-income taxpayers is that they are much more likely than low-income taxpayers to itemize their deductions. As shown in Figure 9, almost 85 percent of taxpayers in the top income quintile itemize, compared to less than 18 percent of taxpayers in the bottom two quintiles.
- The second key reason why the benefits from the MID accrue primarily to high-income taxpayers is that these taxpayers receive larger tax benefits than do low-income taxpayers for the same-sized deduction. This is because of their different marginal PIT rates. The average marginal tax rate for MID claimants is 0.06 percent in the bottom quintile and 8.15 percent in the top quintile. Thus, for each \$1,000 of interest deducted, the bottom-quintile taxpayers will reduce their taxes by 60 cents, while the top-quintile taxpayers will reduce their taxes by \$82.

There are several reasons why marginal tax rates are lower for taxpayers in the lower-income quintiles. The first is that statutory tax rates are lower for low-income taxpayers. Another reason is that low-income taxpayers generally have smaller amounts of other itemized deductions to reduce their taxable incomes than do high-income taxpayers. For low-income taxpayers, therefore, much of the MID may simply replace the standard deduction they might otherwise have claimed, whereas for high-income taxpayers it is more likely that all of the MID will be in addition to other deductions already being claimed. Also, many low-income taxpayers would owe only a small amount of tax without the MID. These taxpayers receive no benefit from any portion of their MID above the amount that is needed to eliminate their tax liability altogether.

The result of the combination of high-income taxpayers being more likely to itemize and also receiving greater proportional benefits when they do itemize is that most of the benefits of the MID are going to the taxpayers who would own a home absent the tax incentives.

## **Policy Options for Improving the State's MID**

The discussion above suggests that a case can be made for not having a state MID. This is primarily because the deduction is an ineffective means of increasing homeownership. In addition, from the state's perspective, any benefits of attaining the goal of more homeownership are achieved by the federal MID. Any additional impact of the state's MID is likely minimal. If the state MID were to be eliminated on a revenue neutral basis, PIT tax rates could be lowered—on average, by roughly 10 percent. Such tax rate reductions could be used to provide general tax relief or to provide each income bracket with relief comparable to the value of the MID that it could no longer claim.

If, however, the Legislature prefers to maintain a state-level tax incentive to promote homeownership, we believe the state should focus subsidies on those taxpayers who are less likely to own a home without tax incentives. A number of different options exist for making state housing tax policy more effective and cost-efficient. These options are listed in Figure 10. The next section describes possible modifications to the MID that would better target the associated tax savings to taxpayers whose homeownership behavior

may be affected by them. The section after that recommends a more substantial change to California's tax policy approach with respect to housing—replacing the MID with a tax credit.

**Figure 10**  
**Options for Modifying California's MID**

- ✓ **Modify the Current MID**
  - Restrict the MID to interest paid on a single principal residence, thereby eliminating eligibility of second homes.
  - Eliminate the current MID for home equity loans.
  - Reduce the current \$1 million cap on the size of a mortgage loan for which interest can be deducted.
  - Apply a means test under which the allowable deduction for mortgage interest phases out as income rises.
  - Restrict the MID to first-time homebuyers.
  - Restrict the MID to a limited number of years once a home is purchased and a mortgage loan is taken out.
  - Make the MID an "above the line" deduction available even to taxpayers who do not itemize their deductions.
  
- ✓ **Replace the MID With a Credit**
  - Replace the current deduction with a nonrefundable credit.
  - Permit carry forwards into future years of mortgage credits not usable in a given year.
  - Replace the current deduction with a refundable credit.
  - Offer a flat dollar credit for homeownership.
  - Base the tax benefit not on the size of the mortgage loan but rather on some other criteria.

MID = mortgage interest deduction.

### Options for Modifying the MID

*Allow the MID Only for Principal Residences.* The MID could be eliminated for purchases of second homes. Taxpayers who own their primary residence—the main policy priority—clearly would do so even if the purchase of a second home were not subsidized.

*Eliminate the MID for Home Equity Loans.* Taxpayers claiming deductions for equity loans already own their homes, so they would be very likely to continue owning a home even without this tax break.

*Reduce the MID Loan Cap.* Presently, the MID can be claimed on payments of interest on loans of up to \$1 million. Most first-time homeowners, however, take out loans substantially smaller than this limit. Reducing the limit would, therefore, be much more likely to affect decisions about how big or expensive a home to buy rather than decisions about whether or not to own a home at all.

*Means Test the MID.* The MID could be phased out as taxpayers' incomes rise. This, again, would probably not significantly affect the decision to own a home. As with all tax benefit phase-outs, however, this approach would increase tax complexity for many Californians.

*Restrict the MID to First-Time Homebuyers.* While this change might dissuade some people who already own houses from moving to larger houses, it is unlikely to induce people who already own a house to stop owning one.

*Limit the Number of Years That the MID Can Be Claimed.* A close variant of the preceding approach would be to allow the MID, but only for up to a specific number of years regardless of whether or not it was the taxpayer's first home. This approach would still primarily target relatively new homeowners, but it would not penalize taxpayers who relocate soon after their first purchase.

*Make the Deduction "Above the Line."* The MID could be made an "above the line" deduction, meaning that it would be available even to taxpayers who claim the standard deduction (and who generally have lower incomes), not just those taxpayers who itemize. This is the only option on this list that would increase the size of the MID tax expenditure's cost.

### **Replace the MID With a Tax Credit**

Alternatively, the Legislature could consider a more significant change in the way it subsidizes homeownership—by replacing the MID with a mortgage tax credit. Instead of allowing a deduction for the amount of mortgage interest paid, the state could offer a credit equal to a specified percentage of the amount of mortgage interest paid. If the MID were replaced with a credit, the value of the tax subsidy per dollar spent on a mortgage would no longer be dependent on one's marginal PIT rate. This change would increase the homebuying tax incentive for taxpayers in low tax brackets relative to the tax incentive for taxpayers in high tax brackets, thereby focusing the tax benefits on the population whose decision whether or not to own a home is most likely to be influenced by the tax policy.

There are several different ways in which a tax credit could be allowed to offset taxes:

*Nonrefundable Credits.* With a nonrefundable credit, the dollar amount of the benefit a taxpayer may receive cannot be more than the tax they would otherwise owe. Thus, some taxpayers claiming the credit would not receive their full credit amount, especially if they had lower incomes and, thus, lower tax liabilities. Even a nonrefundable credit, however, would produce substantial shifts in benefits across taxpayers. For the families described in Figure 8, for example, the benefit of a state tax credit for family C would only be about twice as large as the benefit for family B, compared to more than four times as large for the MID.

Because subsidies to higher-income taxpayers would be reduced, the total budgetary cost of a credit would likely be less than for the MID, despite increasing benefits for some taxpayers. For example, if the state replaced the MID with a 5 percent credit on mortgage interest, more than one million Californians would have their tax bills lowered, yet the total cost of the program would drop by over \$1 billion. The associated tax savings could then be used for whatever state policymakers felt was the highest priority, whether this be to reduce overall tax rates (benefiting everyone), to further increase the value of the credit to those who need it most, or for some other alternative.



*Refundable Credits.* Another option would be to issue tax refunds to taxpayers whose mortgage credits were larger than the tax they would owe without the credits. Such an approach would primarily benefit lower-income taxpayers and may, therefore, be an effective tool for increasing homeownership rates.

Tax administrators are often wary of refundable tax credits. This is because of both the processing activities involved and a concern that refundable credits necessitate significant enforcement activities to deal with fraudulent claims (based in part on prior experience with such refundable programs as the earned income tax credit). In this case, however, fraudulent claims might not necessarily be a major problem because the issuance of refunds could be made contingent on verification of eligibility via third-party information reports (primarily Internal Revenue Service Form 1098, which reports on mortgage interest payments).

*Nonrefundable Credits With Carry Forwards Allowed.* When policymakers want to help taxpayers who do not have any tax against which to apply their tax credits, but do not want to allow credits to be refundable, they often allow the credits to be carried forward for use in future tax years. This approach would provide some benefit to households who have low incomes at the time of their home purchase but are able to increase their income in later years. Of course, this benefit would not be as valuable as receiving a tax refund in the early years when their income is low, and this approach would provide no benefits for taxpayers whose income never rises to taxable levels.

In addition to deciding about the type of credit, the Legislature would also face choices about the structure of the credit.

*Limiting the Amount of Interest That Can Generate a Credit.* Any of the policy options described above that could be used to limit the scope of the MID could also be applied to a mortgage tax credit. Thus, interest paid on mortgages for second homes or on home equity loans could be ineligible for the credit. The current cap under which only interest paid on the first \$1 million borrowed is deductible could be retained or lowered with a credit. A credit could also be means tested, restricted to first-time homebuyers, or claimed for only a limited number of years.

*Basing the Credit on Something Other than Interest Payments.* Another policy option that could be considered is basing the size of the credit on something other than the size of the taxpayer's mortgage. For example, the state could provide a flat dollar credit amount to all homebuyers. The housing tax credit could be set equal to a specific amount, such as \$1,000 per year. If a flat credit were adopted, there would be no tax incentive for buyers to buy larger homes rather than smaller ones, and the greatest tax benefit relative to the purchase price would go to those taxpayers struggling to afford any house at all.

## **Reforming the MID at the Federal Level**

Economists and policymakers have considered many of the same policy options discussed above for modifying the federal MID. For example, in its recent review of the budget-balancing options, the Congressional Budget Office identified as options and

analyzed the effects of (1) lowering the cap for the MID from interest on mortgage loans of \$1 million to interest on mortgage loans of \$400,000, and (2) replacing the MID with a 15 percent credit on mortgage interest paid. Similarly, in 2005, the President's Advisory Panel on Tax Reform recommended replacing the MID with a tax credit equal to 15 percent of mortgage interest paid, limited to the amount of interest paid on the average regional price of the housing involved.

### **Practical Considerations—Transitioning to a Credit**

The most difficult aspect of many tax policy changes involves their initial implementation. If the state were to change from the current MID to a credit, the biggest transition issue would be how to treat taxpayers who only recently purchased their homes. To many people, it would seem unfair to change the tax benefits associated with existing mortgages after homes have already been purchased and financial commitments made.

#### **One Possible Solution—Grandfathering**

The above problem can be dealt with by "grandfathering in" the current deduction for existing mortgages. With grandfathering, the tax value of existing mortgages would be unchanged. There are disadvantages to this approach, however. One is the administrative burden arising from having to track and record two different methods of treating home acquisitions. In addition, there would be those who feel it is unfair that some people will continue to enjoy greater benefits than others.

This problem would diminish over time as, each year, there would be fewer grandfathered mortgages remaining. However, it would persist as long as old mortgages are still outstanding. At some point, the administrative burden from maintaining dual systems for both old and new mortgages might become large relative to the perceived unfairness in changing the tax treatment of taxpayers still paying off old mortgages. It might make sense, therefore, to establish a cutoff date—say, 15 years after enactment of a change to a credit—after which the new rules would apply to everyone and deductions would no longer be available.

#### **Another Approach—Phasing-In a Change**

Another approach to the transition that has been suggested by some economists is to ratchet down over time the limit on the interest deduction. For example, the deduction could be limited to the interest paid on \$800,000 of mortgage debt the year after enactment, interest paid on \$600,000 of debt the following year, and so forth. This approach would compress the time needed for the transition to the new tax system. It would, however, place an administrative and recordkeeping burden on both the state and on affected taxpayers. It would also reduce the tax benefits of many existing mortgages.

### **Economic Effects**

The proposed change from a deduction to a credit for homebuyers would benefit some taxpayers and hurt others. It would also have a variety of impacts on the housing sector, consumer spending, and other segments of the economy.

### **Higher-Income Taxpayers**

Those taxpayers in the highest income brackets would receive smaller tax subsidies for their mortgage borrowing. Many of these taxpayers would respond by borrowing less money. For some of these taxpayers, this change would merely represent a portfolio shift. In other words, they would sell some of their other assets to increase their housing-related down payments and do less mortgage borrowing, but still purchase the same house they would have anyway.

Other high-income taxpayers, however, would respond to the decrease in the tax subsidy for borrowing by reducing the amount that they are willing to spend to purchase houses. As a result, there would be some decline in housing prices at the high end of the market.

To the extent that housing prices dropped, the burden of the reduced value of the tax incentive for home purchases would be shifted from purchasers of houses to people who own homes at the time of the change in tax law. People buying homes would realize losses from the reduced value of the tax break but gains from the price reduction on homes. On the other hand, people who own homes at the time of the law change would be hurt by the reduction in housing prices.

### **Lower-Income Taxpayers**

At the low end of the housing market, prices are not likely to drop, and could even be boosted. This is because many lower-income taxpayers would receive a larger tax benefit under the proposed credit than under the current MID. Therefore, demand for relatively inexpensive housing, and, hence, housing prices should not face much downward pressure in this segment of the market.

In the long run, we would expect home builders to respond to the new tax regime by building relatively more houses for the less expensive segment of the market where demand would be stimulated, and relatively fewer in the expensive segment where demand would decrease. This adjustment would be necessary to restore equilibrium to the housing market.

### **Summary and Conclusions**

Both the federal and California tax codes contain a variety of provisions that subsidize housing purchases. Tax policy generally strives to avoid favoring certain sectors of the economy over others, unless there are persuasive reasons for doing so. Housing does appear to be one sector of the economy for which some preferential treatment may be appropriate. In particular, some level of housing subsidy can be justified on the grounds that, because homeownership appears to provide benefits to society in general, the free market by itself may not produce optimal levels of homeownership.

The largest explicit state housing subsidy is the MID. It is poorly designed, however, for achieving the policy goal of increasing the rate of homeownership. The structure of the MID directs most of its benefits to taxpayers who would own a home even if the MID did not exist, rather than to those whose rent-or-own decision may be influenced by the

presence of the MID. Its benefits are skewed toward higher-income taxpayers, and it encourages the purchase of large and expensive homes.

There are, however, a number of options for modifying the MID to more efficiently achieve the goal of increased homeownership rates. We believe it would be even more beneficial for the Legislature to replace the MID with a tax credit for home purchases.

# APPENDIX

## BACKGROUND RELATING TO HOUSING'S TAX TREATMENT

### What Would an Economically Neutral Tax Treatment Look Like?

A good place to begin in evaluating housing tax policy is to describe the tax treatment that would be appropriate if our only policy objective were economic neutrality. The appropriate tax treatment of housing is complicated by the fact that housing plays two distinct roles in the economy. One of housing's roles is as a business investment that produces a flow of housing services over time. Its second role is as a consumption good whose residents are using housing services over time. Most economists would argue that the tax system should treat business investment in housing like other business investments, and should treat the consumption of housing like the consumption of other goods. That is, homeowners who live in their own houses would be treated both as (1) landlords renting their property (to themselves) and (2) consumers renting their property (from themselves). Under such an approach, the homeowner-landlord can then be treated just like any other landlord, while the occupants of owner-occupied homes can be treated like other consumer-occupants.

#### Tax Treatment as Landlords

Landlords must include rent received as income when calculating their income taxes. To put homeowners on an equal basis, we would need to attribute to them an amount of rent that would have been charged for each house were it occupied by someone other than its owner, and include that amount in the homeowner's income for tax purposes. Landlords also must pay taxes on capital gains received when they sell properties. Thus, to be consistent, homeowners would not receive a capital gains exclusion for sales of their principle residences as they do currently. On the other hand, landlords get to deduct all relevant costs of owning and maintaining houses as a business expense. Therefore, under this approach, homeowners would be allowed to deduct from their taxable income all similar expenses that they incur, including mortgage interest, property taxes, depreciation, and home maintenance expenses.

#### Tax Treatment as Consumers

To be placed on equal footing with housing occupants who are not owners, homeowners would receive the same tax treatment as renters. California's Homeowner's and Renter's Assistance Program follows this guideline for tax relief programs as long as it provides the same amount of assistance to homeowners as to renters with the same level of income. By comparison, the renter's credit would be eliminated in this idealized, economically neutral tax system, because it subsidizes renters and not owners.

### Should Government Try to Influence the Housing Market?

As noted in the text, many people believe that government should encourage homeownership by assisting people who wish to purchase houses. When discussing the programs that the government has adopted in this area and evaluating the MID in particular, it is important to also consider the case for government encouragement of homeownership itself.

According to economic theory, people will choose to purchase homes whenever doing so makes them better off, and choose to not purchase homes when purchasing them would make them worse off. This decision takes into account both what a person *would like* to do and, also, their *ability* to purchase a home. Thus, the decision to buy a home incorporates factors such as the purchaser's income level, housing prices, the costs of other goods and services that they might value, and their preferences.

In some cases, policymakers choose to intervene in the marketplace and make *all* goods and services, including housing, more able to be purchased than otherwise for certain individuals and groups. This is most commonly done specifically to assist lower-income individuals. This type of nonspecific intervention is economically neutral with respect to the different types of goods and services consumed.

In other cases, however, the government adopts policies to encourage the purchase of *specific* types of goods and services, whether for all taxpayers or selected groups. This second approach is especially appropriate when the consumption of a good or service produces a greater value to society than just to the individuals most directly involved.

In the case of housing, this means that government intervention can be justified if society in general benefits from having more individuals own their own homes. There are many reasons to think that such societal benefits exist, such as the incentives homeownership gives the occupants to do a better job of maintaining their residences than landlords and their tenants might. Given such factors, we assume in this report that the state is pursuing a policy goal of increasing homeownership on the grounds that it produces socially valuable benefits.