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TAX REFORM AND RESIDENTIAL REAL ESTATE

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

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CONTENTS

	Page
Advisory of April 25, 2013 announcing the hearing	2

WITNESSES

Mark A. Calabria, Ph.D., Director of Financial Regulation Studies, Cato Institute, Washington, DC	45
Robert Dietz, Assistant Vice President for Tax and Policy Issues, National Association of Home Builders, Washington, DC	125
Mark Fleming, Ph.D., Chief Economist, CoreLogic, McLean, VA	6
Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service, Washington, DC	33
Thomas F. Moran, Chairman and Managing Partner, Moran & Company, Chicago, IL, on behalf of the National Multi Housing Council and the National Apartment Association	161
Robert Moss, Senior Vice President, Boston Capital, Boston, MA, on behalf of the Housing Advisory Group	174
Phillip L. Swagel, Professor of International Economic Policy, University of Maryland School of Public Policy, College Park, MD	64
Gary Thomas, President, National Association of Realtors, Washington, DC	103
Eric J. Toder, Institute Fellow, Urban Institute, and Co-Director, Urban-Brookings Tax Policy Center, Washington, DC	12

TAX REFORM AND RESIDENTIAL REAL ESTATE

THURSDAY, APRIL 25, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 9:38 a.m., in Room 1100, Longworth House Office Building, Hon. Dave Camp [Chairman of the Committee] presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
Thursday, April 18, 2013
No. FC–06

CONTACT: (202) 225–3625

Camp Announces Hearing on Tax Reform and Residential Real Estate

Congressman Dave Camp (R–MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on Federal tax provisions that affect residential real estate as part of the Committee's continued work on comprehensive tax reform. **The hearing will take place on Thursday, April 25, 2013, in Room 1100 of the Longworth House Office Building, beginning at 9:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

A number of different Federal tax provisions directly affect residential real estate and the housing sector. The mortgage interest deduction and the deduction for State and local real property taxes are available to the roughly one-third of taxpayers who itemize their deductions, but not to the roughly two-thirds of taxpayers who instead take the standard deduction. For some taxpayers, however, these deductions are reduced by the recently reinstated "Pease" limitation on itemized deductions, and the real property tax deduction is completely disallowed for taxpayers subject to the Alternative Minimum Tax (AMT). Other significant housing-related tax provisions include the exclusion of gain on the sale of a principal residence, the low-income housing tax credit, the temporary exclusion from income of cancellation of mortgage debt, and numerous other provisions.

In announcing this hearing, Chairman Camp said, **"As we continue to work toward comprehensive tax reform that makes the Code simpler and fairer so that more jobs with better pay are created, it is important to do a top to bottom review of the Code. Home ownership is an integral part of the American dream, and the Tax Code has long provided a variety of incentives to make it easier for families to buy and own a home. Before considering any proposal, the Committee must better understand how tax reform might affect the housing sector and this hearing is an opportunity to hear directly from both academic experts and industry stakeholders."**

FOCUS OF THE HEARING:

The hearing will consider how certain Federal tax provisions affect the housing sector and home ownership—and the benefits of such investment. It will explore how tax policy affects the relative level of investment between residential real estate and other parts of the economy (such as business investment).

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "Hearings." Select the hear-

ing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, May 9, 2013**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–3625 or (202) 225–2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TDD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at: *http://www.waysandmeans.house.gov/*.

Chairman CAMP. Good morning. The Committee will come to order.

Good morning and thank you for joining us today as we continue our dialogue with individuals, families, and job creators of all sizes about the critical steps that Congress can take through tax reform to get our economy back on solid footing.

My position is well known: It is important for Congress to fix our broken Tax Code. As anyone in this room who just completed their taxes in the last few weeks will tell you, today's Tax Code is far too complex, it takes far too much time and too much money to comply with. And while I often joke that the Code is more than 10 times the size of the Bible with none of the good news, what I should also add is that not everything in the Code is bad. However, with more than 4,000 changes made to the Tax Code in the last decade alone, more than one per day, it is tough to imagine that all those changes have made the Code more user friendly. It is just the opposite. And that is why we owe it to the American people to go line by line through the Code to see how we can make it work better for hard-working taxpayers, not just those who can afford a good accountant.

The two primary keys to tax reform are to make the Tax Code simpler, fairer, and more transparent for families and employers, and to strengthen the economy so that we can create more jobs and increase wages for American families.

So today, as part of our top-to-bottom review of the Code, we will examine how tax policy related to residential real estate lines up with those goals, and we will do so with two questions in mind. Does current tax policy help American families and does it make our economy stronger?

Home ownership is an integral part of the American dream, and the Tax Code has long provided a variety of incentives to make it easier for families to buy and own a home. We also know that the real estate industry plays a large role in our economy. So this is an area that needs careful, thoughtful review.

A number of Federal tax preferences provide for benefits for residential real estate. While some are very familiar, others are lesser known. Although these provisions all pertain to housing, each is governed by different rules and criteria. If we are looking to understand how complex, confusing and costly our Code can be, consider just a few of the following examples involving residential real estate.

Perhaps the most well known tax provision affecting real estate is the mortgage interest deduction, which has specific rules and limitations. For instance, only taxpayers who itemize their deductions may deduct mortgage interest. Other interactions within the Tax Code can also limit the use of this provision.

By way of example, the deduction for interest on home equity indebtedness is disallowed for purposes of the alternative minimum tax. Furthermore, Federal tax benefits for real estate treat homeowners differently than renters. A taxpayer who pays $1,000 per month to rent an apartment may not deduct that amount from income, but a taxpayer who pays mortgage interest of $1,000 may take a deduction if they itemize.

Though these examples are from real estate provisions, this complexity plagues the entire Code and underscores one simple fact: The Tax Code is a mess. You shouldn't need an army of lawyers and accountants to understand our Tax Code and it shouldn't take American taxpayers over 6 billion hours and $168 billion every year to comply with the Code. We should get rid of the loopholes in the Code and make it more efficient and effective for hard-working taxpayers.

However, as we get started today, let me emphasize that not every credit or deduction is a loophole. The largest investment most people have is their home. And as I noted earlier, policies like the home mortgage interest deduction have played a big role in home ownership.

I also believe that tax reform, which can help us to create a stronger economy with higher paychecks, is one of the best ways we can help families struggling to save for college, save for retirement, or of particular interest to some on our second panel today, save for a downpayment on that first home.

So I look forward to the testimony of both panels today and I hope that the witnesses will help this Committee better understand how we can balance the goal of that simpler and fairer Code with

the needs facing consumers in the residential marketplace. Both are important to American families, and your expertise and insight will be critical to all of us in meeting their needs.

Thank you.

I will now recognize the Ranking Member for his opening statement.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome to our panel.

The topic before us is an important one. The Federal Government, through the Tax Code, has been involved in promoting home ownership for over a century. Let's be clear: There are many egregious loopholes in the Tax Code, but the main provisions incentivizing home ownership are policies, not loopholes.

The failure to differentiate which is which between policies and real loopholes has led to some facile proposals. Among them are proposals that begin without the mortgage interest or any other deductions, or proposals that simply pick a much lower tax rate than present law without any suggestions as to how to fill the trillions in lost revenue that would result.

Such proposals have failed to take into account some basic facts, including the growing income gap, and they have failed to consider adequately whether policies are significant for a strong middle class or mainly for very wealthy families. According to the Joint Committee on Taxation, two-thirds, 70 percent of the benefit of the mortgage interest deduction goes to households earning less than $200,000 a year. Less than a third of the benefit, 30 percent, goes to those who make more than that.

By comparison, the reduced rate for capital gains almost exclusively benefits the very wealthy. More than 70 percent of the benefit of that lower rate flows to people making more than $1 million a year, just 12 percent to those making less than $200,000.

These tax policies deserve, indeed, serious consideration beyond the easy rhetoric about simply broadening the base and reducing rates. So I hope that today this hearing will be a step in the direction of this serious consideration.

Thank you, Mr. Chairman.

Chairman CAMP. Well, thank you, Mr. Levin.

Now it is my pleasure to welcome our first panel of experts, all of whom bring a wealth of experience from a variety of perspectives. Their experience and insights will be very helpful as the Committee considers the impact of Federal tax reform on residential real estate.

First, I would like to welcome Mark Fleming, the Chief Economist at CoreLogic. Mr. Fleming has over 15 years of experience in the mortgage and property analysis business.

Second, we will hear from Eric Toder, Institute Fellow at the Urban Institute and Co-Director of the Urban-Brookings Tax Policy Center in Washington, D.C. Mr. Toder is a veteran of the Treasury Department, CBO, and the IRS.

Third, we will hear from Jane Gravelle, Senior Specialist in Economic Policy and a long-time veteran of the Congressional Research Service.

Fourth, we will hear from Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, also in Washington, D.C. Mr. Calabria has had a broad career, spending time at HUD, the

National Association of Home Builders, the National Association of Realtors, and the Senate Banking Committee.

Finally, we will hear from Phillip Swagel, Professor of International Economic Policy at the University of Maryland School of Public Policy in College Park. Mr. Swagel is a former Assistant Secretary for Economic Policy at the Treasury Department.

And thank you all for being with us today. The Committee has received each of your written statements and they will be made part of the formal hearing record. Each of you will be recognized for your oral remarks for 5 minutes.

And so, Mr. Fleming, we will begin with you. You have 5 minutes. Welcome.

STATEMENT OF MARK FLEMING, PH.D., CHIEF ECONOMIST, CORELOGIC, MCLEAN, VA

Mr. FLEMING. Thank you. Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee on Ways and Means, CoreLogic appreciates the opportunity to submit this testimony regarding tax reform and residential real estate.

My name is Mark Fleming, and I am Chief Economist for CoreLogic, a leading global provider of consumer, financial, and property information, analytics and services to businesses and government. Our company combines public, contributory, and proprietary data to develop predictive decision analytics and provide business services that bring dynamic insights to our customers in the residential mortgage origination, securitization, and servicing markets, as well as other private sector institutions and government.

One of the brightest spots within the uneven economic recovery at the moment is the housing sector. Residential investment contributed about half a percentage point to GDP growth in Q4 of 2012, very significant for a single industrial sector. In March of 2013, residential investment continued to grow. Housing starts increased to an annualized rate of 1 million, which is 47 percent above the level for the same month a year earlier and the largest increase in more than 20 years. Home prices consequently have rose 10.2 percent year-over-year, the largest increase in nearly 7 years, and our pending house price index indicates that price growth in March will continue the trend.

One of the features of the American Recovery and Reinvestment Act of 2009 was a first-time home buyer tax credit aimed at stimulating the real estate sales market. In the first half of 2009, before the impact of the tax credit could be felt, home sales were declining at a rate of 15 percent from the prior year. However, by September of 2009, sales were at the same level as the prior year, and by November 2009, the month of expiration, sales were up 34 percent from the prior year, nearly a 50 percentage point improvement in under 1 year.

When the tax credit was extended to April of 2010, sales increased at an average rate of 12 percent annualized until expiration of the credit. However, as soon as the tax credit expired, the volume of home sales dropped, averaging a rate of 18 percent annualized for the remainder of the year. Furthermore, prior to the expiration of the tax credit, expensive home sales increased more

rapidly than low and moderately priced home sales. The tax credit stimulated current demand at the expense of future demand, but did not have a permanent impact on the market.

While the first-time home buyer tax credit resulted in home buyers buying sooner than otherwise, the Tax Relief Act of 1997 causes a subset of sellers to defer sales to a later date. The Tax Relief Act exempts from taxation the profits on the sale of a residence of up to $500,000 for married couples filing jointly and $250,000 for singles if the property has been a principal residence in 2 of the last 5 years.

Since the Act's tax exclusion can only be applied if the owner has been living in the property for at least 2 years, it clearly applies to existing homes and not new homes. Therefore, the law only impacts existing home sales, but not new sales. For the 5 years prior to 1997, the existing home sales share of total sales, new and existing combined, averaged 84 percent. However, as discussion of the Act became public, the share declined to below 83 percent as sellers waited for the law to be enacted, so as to take advantage of the tax exclusion. After the law was enacted, the share rose above the previous average for several months, before returning to its long-term average. In the case of the first-time home buyer tax credit and the capital gains tax exclusion, market participants changed their behavior in the short term.

The existing literature on the societal value of home ownership generally shows that, relative to renting, home ownership is associated with better-cared-for homes, increased participation in the community, and better students with lower likelihood of needing welfare. Assuming that increasing home ownership to capture these social benefits is a goal of tax policy, there is a significant amount of economic literature that studies existing and proposed policies and their implications for the decision to own versus rent, the amount of house consumed, and the implications of policy changes on house prices.

CoreLogic is thankful to the Committee for the opportunity to provide testimony on the meaningful impact that tax policy has on participants in the real estate market. We are encouraged by the Committee's recognition of how data and analytics can help inform a better understanding of the relationship between tax policies and the real estate market, especially as the housing market once again contributes to our fragile economic recovery. Thank you.

[The prepared statement of Mr. Fleming follows:]

Testimony of Dr. Mark Fleming, Ph.D

Chief Economist, CoreLogic

Before the U.S. House of Representatives Ways and Means Committee

Hearing on Tax Reform and Residential Real Estate

1100 Longworth House Office Building at 9:30AM

April 25th, 2013

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Testimony of Dr. Mark Fleming, Ph.D

Chief Economist, CoreLogic

Before the U.S. House of Representatives Ways and Means Committee

Hearing on Tax Reform and Residential Real Estate

April 25th, 2013

Chairman Camp, Ranking Member Levin, and distinguished members of the Committee on Ways and Means, CoreLogic appreciates the opportunity to submit this testimony regarding tax reform and residential real estate.

My name is Mark Fleming and I am Chief Economist for CoreLogic. CoreLogic is a leading global provider of consumer, financial, and property information, analytics and services to businesses and government. Our company combines public, contributory, and proprietary data to develop predictive decision analytics and provide business services that bring dynamic insights to our customers in the residential mortgage origination, securitization, and servicing markets as well as other private sector institutions and government.

CoreLogic's information resources include over 500 million historical real property and mortgage transaction records, monthly performance information on the vast majority of conforming as well as private label securitized loans, insights on a majority of loan applications being originated today, and the nation's largest contributory mortgage fraud database.

CoreLogic

One of the brightest spots within the uneven economic recovery is the housing sector. Residential investment contributed 0.4 percentage points to GDP growth in Q4 2012, significant for a single industrial sector. In March 2013, residential investment continued to grow. Housing starts increased to an annualized rate of 1 million, which is 47 percent above the level for the same month a year earlier and the largest increase in more than 20 years. Home prices rose 10.2 percent year-over-year, the largest increase in nearly seven years. Home prices have been rising consistently since February 2012, and our pending HPI index indicates that price growth in March will continue the trend.

One of the features of the American Recovery and Reinvestment Act of 2009 was a first-time homebuyer tax credit aimed at stimulating the real estate sales market. In the first half of 2009, before the impact of the tax credit could be felt, home sales were declining at a rate of 15 percent from the prior year. However, by September 2009 sales were at the same level as the prior year and by November 2009 – the month of expiration – sales were up 34 percent from the prior year – a nearly 50 percentage point improvement in under a year. When the tax credit was extended to April 2010 sales increased at an average rate of 12 percent annualized until expiration of the credit. However, as soon as the tax credit expired the volume of home sales dropped, averaging a rate of 18 percent annualized for the remainder of 2010. Furthermore, prior to the expiration of the tax credit, expensive home sales increased more rapidly than low and moderately priced home sales. The tax credit stimulated current demand at the expense of future demand, but did not have a permanent impact on the market.

While the first-time home buyer tax credit resulted in homebuyers buying sooner than otherwise, the Tax Relief Act of 1997 causes a subset of sellers to defer sales to a later date. The Tax Relief Act of 1997 exempts from taxation the profits on the sale of a residence of up to $500,000 for married couples filing

jointly and $250,000 for singles if the property has been a principal residence in 2 of the last 5 years of ownership. Since the Act's tax exclusion can only be applied if the owners have been living in the property for at least two years, the Act clearly applies to existing homes and not new homes, therefore the law only impacts existing home sales but not new sales. For the 5 years prior to 1997, the existing home sales share of total sales, new and existing sales combined, averaged 84 percent. However, as discussion of the Act became public, the share declined to below 83 percent as sellers waited for the law to be enacted so as to take advantage of the tax exclusion. After the law was enacted the share rose above the previous average for several months, before returning to its long-term average. In the case of first-time homebuyer tax credit and the capital gains tax exclusion, market participants changed their behavior in the short-term but it did not materially change the structure of the industry.

CoreLogic is thankful to the Committee for the opportunity to provide testimony on the meaningful impact that tax policy has on participants in the real estate market. As a provider of transparency-based information on the real estate and mortgage finance markets, we are encouraged by the Committee's recognition of how data and analytics can help inform a better understanding of the relationship between tax policies and the real estate market, especially as the housing market is once more contributing to our fragile economic recovery.

Chairman CAMP. Well, thank you, Mr. Fleming.

Mr. Toder, you are recognized for 5 minutes.

STATEMENT OF ERIC J. TODER, INSTITUTE FELLOW, URBAN INSTITUTE, AND CO-DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER, WASHINGTON, DC

Mr. TODER. Thank you very much.

Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for inviting me to testify today on reforming the mortgage interest deduction. My statement represents my views alone and should not be attributed to the Tax Policy Center or to the Urban Institute, its trustees, or its funders.

The mortgage interest deduction is one of the largest individual tax preferences in the Internal Revenue Code. The Joint Tax Committee estimates it will cost $380 billion between 2013 and 2017. The Tax Policy Center estimates that about 40 million taxpayers will benefit from the deduction in 2015.

The current mortgage interest deduction does little to promote home ownership because it provides no subsidy to taxpayers who do not itemize deductions and only a very modest subsidy to taxpayers in the 15 percent bracket. The subsidy value is largest for families in high tax brackets, who are the ones most likely to own a home without a subsidy. Other countries without a mortgage interest deduction have home ownership rates as high or higher than the United States. Instead, the deduction mostly encourages homeowners to buy larger and more expensive homes with borrowed money.

Either a uniform percentage tax credit for mortgage interest or an investment credit for first-time home purchase would be a more effective home ownership subsidy. Replacing the deduction with an interest credit has been endorsed by the President's Advisory Panel on Federal Tax Reform appointed in 2005 by President Bush, the National Commission on Fiscal Responsibility and Reform, and the Debt Reduction Task Force of the Bipartisan Policy Center. Other proposed reforms include reducing the size of a mortgage qualifying for a subsidy, limiting the subsidy to a principal residence, and eliminating the subsidy for home equity.

The tables in my testimony display the effects on tax burdens and average tax rates of four potential reforms: Eliminating the deduction, limiting it to interest on the first $500,000 of home acquisition debt, replacing it with a 15 percent refundable credit on the first $25,000 of eligible interest, and replacing it with a 20 percent nonrefundable credit for interest on the first $500,000 of home acquisition debt. All of these options would raise taxes the most on upper-middle-income taxpayers, and replacing the deduction with a credit would reduce tax burdens on average in all groups in the bottom 80 percent of the income distribution.

The revenue gains, I should note, from all these options would be lower if introduced as part of a reform that lowered marginal income tax rates. With lower rates, eliminating deductions raises less money, but new credits would cost just as much.

Proposals to pare back the mortgage interest deduction could adversely affect housing prices. Reform should be introduced slowly

to avoid risks to the housing market, but transition rules would reduce revenue gains from the options and delay their benefits.

In conclusion, the mortgage interest deduction is difficult to justify on policy grounds. It does little to encourage home ownership, but instead mostly encourages upper-middle-income households to buy larger and more expensive homes. Converting the deduction to a credit, placing additional limits on the amount of debt eligible for the subsidy, and denying the preference to home equity loans and second homes would result in a larger home ownership subsidy to those who might act on it at a lower fiscal cost.

But any reform undertaken must take account of short-run adverse effects on housing markets. Designing appropriate transition rules that prevent market disruption, while retaining the benefits of removing or redirecting the preference, will be challenging. Thank you very much.

[The prepared statement of Mr. Toder follows:]

Options to Reform the Home Mortgage Interest Deduction

Eric J. Toder
Institute Fellow, Urban Institute, and co-director, Urban-Brookings Tax Policy Center
www.taxpolicycenter.org

Testimony Before the Committee on Ways and Means
United States House of Representatives
Hearing on Tax Reform and Residential Real Estate

April 25, 2013

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

Chairman Camp, Ranking Member Levin, and Members of the Committee:

Thank you for inviting me to testify today on reforming the mortgage interest deduction. The mortgage interest deduction is one of the largest individual tax preferences in the Internal Revenue Code. The Joint Tax Committee (2013) estimates that the deduction will reduce federal receipts by about $70 billion in fiscal year 2013 and by about $380 billion between fiscal years 2013 and 2017. Homeowners also benefit from the deduction of real property taxes ($153 billion between 2013 and 2017) and the exemption of the first $250,000 ($500,000 for joint returns) of capital gains on the sale of principal residences ($130 billion between 2013 and 2017).

If the Committee is to achieve its stated goals of reducing the top individual income tax rate to 25 percent and maintaining receipts at their baseline projected level of 19.4 percent of GDP by the end of the decade, it will be necessary to eliminate or pare back some major tax expenditures. But the mortgage interest deduction is one of the most popular benefits in the tax law, and politicians have in the past viewed it as untouchable. The mortgage interest deduction is the only tax benefit that President Reagan promised to protect in 1984 when his Treasury Department was preparing the wide-reaching reform proposals that would form the basis for the 1986 Tax Reform Act.[1] In 2015, according to Tax Policy Center (TPC) estimates, about 40 million taxpayers will benefit from the deduction.

In my testimony, I will provide some brief historical background on the mortgage interest deduction and then discuss the reasons for reform and some of the major proposals that have been put forward in the past few years. I will conclude with an assessment of the effects of proposed reforms on the size and distribution of federal tax burdens, and comment on how it might affect housing markets.

Background on the Home Mortgage Interest Deduction

The mortgage interest deduction was not originally placed in the income tax law to subsidize home ownership. When Congress enacted the modern federal income tax in 1913 shortly after ratification of the 16th amendment to the U.S. Constitution, the tax code allowed deductions for all interest payments. Congress viewed interest payments as an expense of earning business and investment income and therefore not a part of a taxpayer's net income. Congress made no distinction between interest incurred to generate taxable income and interest on loans used to finance the purchase of household assets such as homes, cars, and other consumer durables that do not generate taxable income. Subsequently, however, Congress did eliminate

[1] In January 1984, President Reagan asked the Treasury Department to develop a plan to "simplify the tax code sot that all taxpayers big and small are treated fairly and make the tax base broader so that personal tax rates could come down, not up." The president allowed the Treasury wide discretion to eliminate tax preferences, except for a specific commitment in a May 1984 speech that the administration would retain the home mortgage interest deduction.

deduction of interest used to finance the purchase of tax-exempt municipal securities.[2]

In the early years of the federal income tax, the deductibility of mortgage interest hardly affected the housing market. Until World War II, exemptions were high enough to exclude the vast majority of households from paying any income tax. And the rate of home ownership was much lower than it is today.

World War II and the post-war boom that followed changed all that. Lower amounts of exempt income converted the income tax from a class tax to a mass tax. Home ownership rates increased with postwar prosperity, the availability of 30-year fixed-rate mortgages with low down payments, and low interest rates. As marginal tax rates facing middle-income Americans increased, the mortgage interest deduction became a major subsidy for middle- and upper-middle-income home owners. From the 1970s, when the Office of Management and Budget (OMB) and congressional agencies first began publishing annual lists of tax expenditures, until now, the mortgage interest deduction has been one of the most costly preferences in the tax law.

The 1986 Tax Reform Act (TRA 86) eliminated many preferences in the federal individual and corporate income taxes to finance reduced marginal tax rates on individuals and corporations. Among other provisions, TRA eliminated the deductibility of all consumer interest, including credit card debt and loans to finance cars, furniture, and other consumer durable items. But Congress left the deductibility of mortgage interest largely intact. It limited the amount of debt eligible for the interest deduction to the first $1 million incurred to purchase or refinance a principal or secondary residence and permitted taxpayers to deduct interest on an additional $100,000 of loans secured by home equity.[3] These limits were not indexed to changes in the consumer price index and have remained the same since 1988.

Although the mortgage interest deduction was not originally put into the tax code as an incentive for home ownership, and at first only affected a very small share of taxpayers, many people regard it today as a critical support for the American dream of home ownership. But in recent years, designers of tax reform proposals have questioned its effectiveness in promoting home ownership. In the following section, I review possible rationales for the deduction and discuss reasons for eliminating or restructuring it.

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[2] An exception to this limitation for commercial banks was repealed in 1986.
[3] In practice, home equity loans are often used to finance the purchase of cars and other household durables.

Reasons for Reform

In this section, I make four main points:

- The mortgage interest deduction is a subsidy that favors investment in home ownership over investment in rental housing and most other business assets.
- The main beneficiaries of the deduction are upper-middle-income households, and use of the deduction varies greatly among states.
- The issue of whether home ownership should be subsidized is debatable, with points to be made on both sides of the issue.
- If the goal is to promote home ownership, the mortgage interest deduction should be restructured, with more of the subsidy directed to low- and middle-income taxpayers who are more likely to be deciding whether to own or rent.

Is the Deduction a Subsidy or an Appropriate Adjustment for Measuring Income?

Under a comprehensive income tax, returns to investment, net of investment expenses, are included in taxable income. The taxation of income from rental properties largely conforms to income tax principles. Owners of rental properties must include gross rents received in their income but can deduct expenses of owning and operating their properties, including costs of repairs and maintenance, depreciation, interest payments, and residential property taxes. Any gains from the subsequent sale of rental properties are treated as taxable capital gain.[4] Rental housing receives some tax subsidies, including somewhat accelerated depreciation schedules for residential structures, the low-income housing tax credit, and limited availability of tax-exempt financing for some rental properties. But these tax subsidies are small compared with the subsidies for home ownership.

Home owners, in contrast, are not taxed on the gross rental returns on their housing properties—that is, on the gross rent the home owner would have to pay to rent the same property from someone else. In other words, one can view the return to the home owner as the saving in rent she would otherwise pay to live in an equivalent dwelling. But, although the home owner is not taxable on this gross "imputed rental income," she can nonetheless under current law deduct interest payments and residential property taxes as if they were costs of earning income and use those deductions to offset tax on her wages and other sources of income.[5] In addition, single homeowners can exempt the first $250,000 of gain on the sale of any personal

[4] Long-term capital gains from the sale of rental housing are taxed at favorable rates, but no more favorable than rates applied to long-term gains from sales of corporate shares or ownership shares in other businesses.

[5] The OMB (2014) includes the exclusion of net imputed rent in its list of tax expenditures, but the JCT does not. On both administrative and political grounds, no one in the United States is seriously considering including imputed rent in the tax base. Gale, Gruber, and Stephens-Davidowitz (2007), citing Sorensen (2001), note that some European countries do tax imputed rental income.

residence owned for at least two years and lived in for two of the five years before the sale, and married homeowners can exempt $500,000 of such gains.

The main argument for retaining a mortgage interest deduction under an income tax is that it treats equally people who must borrow to buy a home and people who are wealthy enough to purchase a home by selling other assets. For example, if all returns are taxable, and the interest rate is 5 percent, a taxpayer in the 28 percent rate bracket who finances a home purchase by selling taxable bonds will sacrifice 3.6 cents in income per dollar invested in her home. If mortgage interest were not deductible, however, a taxpayer with the same income who needs to borrow money to buy home would face a net interest cost of 5 percent. The deduction, by this reasoning, equalizes the costs of debt and equity finance, by extending the subsidy to equity finance from the exclusion of imputed rent to those without sufficient wealth to purchase a house outright. Of course, by so doing, it extends the subsidy from the small share of taxpayers with sufficient wealth to purchase a house outright to the much larger number who must use debt finance.

The above argument presumes, however, that the alternative to buying a house for most taxpayers is to invest in an asset that generates taxable investment income. With the expansion of access to tax-deferred retirement saving accounts and increases in contribution limits, most wealth held by people outside the very highest income groups is either in home equity or in tax-deferred retirement saving accounts (Toder 2009). The return to these assets is tax free, so in reality most taxpayers do not pay any capital income tax on the vast majority of their investment returns. And interest on other forms of non-business borrowing is not deductible. Increasingly, the deduction for mortgage interest stands out as the only way most individuals can finance the purchase of a household asset at an after-tax interest cost. The exception is a minority of wealthy and mostly older households who have sufficient financial assets that generate taxable income to enable them to pay down their mortgage debt if the deduction were eliminated without incurring a net increase in tax liability.

Who Benefits from the Mortgage Interest Deduction?

The mortgage interest deduction (MID) provides the largest benefits in total and as a share of income to upper-middle-income taxpayers (table 1). The Tax Policy Center (TPC) estimates that 24 percent of tax units will benefit from the deduction in 2015, compared with 47 percent who will have some mortgage interest expense.[6] The percentage of tax units who will benefit ranges from over 60 percent for taxpayers with cash incomes between $100,000 and $500,000 in 2012 dollars to less than 10 percent for taxpayers with incomes less than $40,000.[7] Low-income

[6] Tax units are either married couples or single individuals (including head of household filers), but exclude those who are dependents of other tax units. Tax units include both filing units and non-filers.

[7] The Tax Policy Center's measure of pretax cash income starts with AGI and adds tax-exempt interest, the untaxed portion of Social Security benefits, employer-paid payroll taxes and the

households receive less benefit from the MID than others because fewer of them own homes, and many who are paying mortgage interest either have no positive income tax liability or claim the standard deduction, and therefore do not benefit from itemized deductions. A larger share of the highest-income households benefits from the MID than for the population as a whole, but a smaller share benefits than among those in upper-middle-income groups. Some of the very highest income households have already paid off their mortgages; and, among those paying mortgage interest, some could sell off taxable assets to paid down debt and thereby avoid a tax increase if the MID were eliminated.

Upper-middle-income households also receive the largest benefits from the MID as a share of their income. Households with cash incomes between $75,000 and $500,000 (27 percent of all tax units) will earn 48 percent of all cash income in 2015 but will receive 77 percent of the tax savings from the mortgage interest deduction. The tax benefit from the MID is worth more than 1 percent of pretax income on average to them, compared with 0.6 percent for the population as a whole and 0.1 percent or less for tax units with incomes under $30,000 and those with incomes over $1,000,000. The latter receive relative little benefit from the MID as a share of income because their housing expenses do not rise in proportion to their incomes and, for many of them, their mortgage debt is either paid off or could be paid off from the proceeds of other assets if the deduction were removed.

Use of the MID varies considerably among regions, with home owners in large metropolitan regions benefiting more from the preference than others (Gyourko and Sinai, 2003). Use of the MID also varies significantly among states (table 2), with relatively more deductions claimed in high-tax states and states with high housing costs. IRS data for tax year 2011 show that 24 percent of tax return filers claimed mortgage interest deductions amounting to 4.3 percent of adjusted gross income (AGI). The share of filers claiming MID ranged from over 30 percent in Colorado, Connecticut, Maryland, Massachusetts, Minnesota, New Jersey, Oregon, Utah, and Virginia to less than 20 percent in Arkansas, Florida, Louisiana, Mississippi, North Dakota, Oklahoma, South Dakota, Tennessee, Texas, West Virginia, and Wyoming. Deductions as a share of AGI ranged from over 6 percent in California and Hawaii to 1.8 percent in North Dakota.

Should Home Ownership Be Subsidized?

The main justification for the MID is that it may encourage more people to own homes instead of renting them. Proponents of home ownership subsidies cite social benefits of home ownership in excess of the direct benefits received by owners. A large body of research cited in Toder et al. (2010) has found evidence that owner-occupied homes are better maintained than rental properties, home owners have higher rates of civic participation than renters, and crime rates are lower in areas

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taxpayer's estimated share of the burden of the corporate income tax. See Rohaly, Carasso, and Saleem (2005).

with more home owners, after adjusting for other determinants of these behaviors.[8] It is difficult to demonstrate, however, whether home ownership causes these benefits or whether people who are civic-minded or less likely to commit crimes are the ones more likely to purchase homes. Others suggest that promoting home ownership may help low-income individuals accumulate wealth and thereby promote social mobility. On the other side, home ownership may limit job market mobility because of the large transactions costs associated with house purchases. And, as we have seen in the past few years, excessive home mortgage debt can expose individuals and the broader economy to significant risks.

In summary, while arguments can be made in favor of taxpayer subsidies for home ownership, the case for such subsidies is by no means conclusive.

Is the Mortgage Interest Deduction the Most Effective Way to Promote Home Ownership?

Assuming that promoting home ownership is a desirable goal, the current mortgage interest deduction is not a very effective instrument. The MID provides no subsidy to taxpayers who do not itemize deductions and only a very modest subsidy to taxpayers in the 15 percent rate bracket. The subsidy value is largest among upper-middle-income taxpayers, who are the ones most likely to own a home without a subsidy. Instead, the main incentive the MID provides is an incentive for those who would own a home without a subsidy to purchase larger or more expensive homes.

Some empirical research and observations confirm this lack of a relationship between the MID and home ownership rates. Glaeser and Shapiro (2003) and Gale, Gruber, and Stephens-Davidowitz (2007) find no evidence that change in the value of the MID over time has affected home ownership rates in the United States. Gale (1997) finds a similar result for the United Kingdom when it reduced their mortgage subsidy. Looking across similar countries, home ownership rates in countries culturally similar to the United States including Canada, New Zealand, and Australia have in recent years been at least as high as in the United States even though they do not allow deductibility of mortgage interest.

If the goal is to use tax subsidies to increase the rate of home ownership, a better approach would be to focus the subsidies on those who might be on the margin of buying or renting and reduce the subsidy rate for high-income borrowers. This could be done by converting the MID to either a uniform percentage tax credit for mortgage interest or an investment credit for first-time home purchases. The lower subsidy rate for mortgage interest borrowers in high tax brackets would help pay for expanding mortgage subsidies to individuals who currently do not itemize deductions or, beyond that, to individuals without positive income tax liability.

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[8] Researchers who have identified these social benefits of homeownership include DiPasquale and Glaeser (1999); Galster (1983); Glaeser and Sacerdote (2000); Glaeser and Shapiro (2003); and Rossi and Weber (1996).

Further budgetary savings could be achieved by lowering the cap on the amount of debt eligible for a tax subsidy, limiting the deduction to principal residences only, and eliminating the deductibility of interest on home equity loans.

Major Reform Proposals

In recent years, tax reform plans by presidential commissions and prominent private groups have included proposals to limit and restructure the MID:

- The President's Advisory Panel on Federal Tax Reform (2005), appointed by President George W. Bush, proposed replacing the MID with a nonrefundable credit, available to both itemizers and non-itemizers, equal to 15 percent of interest paid on a principal residence. The panel also proposed to limit the amount of debt eligible for the credit to 125 percent of the median sale price in each county and to eliminate the subsidy for home equity loans.
- The National Commission on Fiscal Responsibility and Reform (2010), appointed by President Barack Obama and chaired by Erskine Bowles and Alan Simpson, proposed to replace the MID with a 12 percent nonrefundable credit for all taxpayers on principal residences only and to reduce the cap on debt eligible for an interest subsidy to $500,000.
- The Bipartisan Policy Center Debt Reduction Task Force (2010), chaired by Alice Rivlin and Pete Domenici, proposed to replace the MID with a 15 percent refundable credit on up to $25,000 of interest on a principal residence.

These proposals were included as part of broader tax reform plans that reduced personal and corporate income tax rates, eliminated the alternative minimum tax, and eliminated or scaled back many other tax preferences. So the panels that proposed these plans were not targeting the home mortgage interest alone. Nonetheless, it is significant that all the major tax reform review panels in recent years have included proposals to scale back the mortgage interest deduction and substitute in part some form of mortgage credit in their overall reform packages.

President Obama has proposed limiting the tax saving from itemized deductions and some other tax preferences to 28 percent of the amount of the deductions and exclusions, most recently in the fiscal year 2014 budget released in April 2013. The president has not singled out the MID but has included it among the benefits he would limit. During his 2012 presidential campaign, Governor Mitt Romney proposed a fixed dollar cap on itemized deductions, which again would have limited the MID without singling it out specifically. The Obama and Romney MID proposals are both more limited than the proposals of the tax reform and debt reduction commissions, and both would reduce benefits mainly for very high income taxpayers. Obama's proposal would raise taxes only on those taxpayers in the 28 percent bracket and above. The Romney proposal introduced in the election

campaign would have affected only taxpayers with very large absolute amounts of itemized deductions.

Analysis of Proposals

TPC has recently analyzed four proposals to reform the mortgage interest deduction in two recent documents: a report on an expert conference on how reforming the mortgage interest deduction would affect the housing market (Turner et al. 2013) and a report prepared for the National Low Income Housing Coalition that analyzed the effects of replacing the mortgage interest deduction with a nonrefundable credit and lowering the cap on the amount of debt eligible for the subsidy to $500,000 (Eng et al. 2013).

The proposals are as follows:

- Eliminate the mortgage interest deduction entirely
- Reduce the cap on the amount of deductible interest to $500,000
- Replace the mortgage interest deduction with a refundable credit of 15 percent of mortgage interest paid, and limit the amount of creditable interest to $25,000 a year
- Replace the mortgage interest deduction with a nonrefundable credit of 20 percent of mortgage interest paid, and reduce the cap on the amount of creditable interest to $500,000

TPC scored all the proposals against current law as of January 2013. The model TPC used to score the estimates has been updated to include the effects of the American Tax Relief Act of 2012 (ATRA) enacted at the end of 2012 but has not yet been updated to incorporate the most recent CBO economic projections. These estimates will change once we have updated our baseline projections to account for the new economic assumptions.

Distributional Effects

Eliminating the mortgage interest deduction would raise taxes by $696 per household in 2022, including both those affected and those not affected by changing the deduction (table 3, first column). The tax increase as a percentage of income would be 0.66 percent for all households (table 4, second column). Taxpayers in the 60–99th percentiles would experience on average a larger increase in their tax rate than all households and taxpayers in the bottom three quintiles, and the top 1 percent would face a smaller increase in their tax rate. The largest tax increase as a share of income (1.28 percent) would be faced by households in the 80th–90th percentiles—that is, those who are in the bottom half of the top quintile of the income distribution. Tax increases would be relatively small in the bottom three quintiles because in those income groups the share of home owners in the population is smaller than average, a large proportion of taxpayers claim the

standard deduction, and those who do claim a mortgage deduction are mostly in the 10 and 15 percent brackets so they would not experience that big a tax increase per dollar of additional taxable income. Tax increases would be relatively small in the top 1 percent because those taxpayers have smaller mortgage payments as a share of income, and some will be able to pay down their mortgage and avoid a tax increase when the deduction is eliminated.

If marginal tax rates were lowered as part of tax reform, the revenue increase from eliminating the MID would be smaller, and a relatively smaller share would be paid by the highest-income households, who would no longer benefit from as large an interest subsidy at the lower rate.

Capping the deduction to the first $500,000 of home acquisition debt would raise taxes by an average of $84 per household, about one-eighth of the increase from eliminating the deduction entirely (table 3, column 3). The proposal would have only a minimal effect on the bottom four quintiles because few taxpayers in those income brackets have that much mortgage debt. But taxpayers in the top 1 percent of the distribution would face a tax increase almost half as large as from eliminating the deduction entirely. Taxes would rise by 0.08 percent of income overall, with taxpayers in the 80th–99th percentiles of the distribution experiencing larger than average increases in tax rates, taxpayers in the bottom four quintiles seeing little or no tax increase, and taxpayers in the top 1 percent experiencing a tax rate increase only slightly less than the average for the entire population (table 4, column 3).

The effect of a $500,000 cap would be felt disproportionately in a small number of geographic areas with high housing costs. It would have the biggest effect on younger very high income earners who have not yet accumulated enough wealth to pay down their mortgage debt.

Replacing the mortgage interest deduction with a 15 percent refundable credit and capping eligible interest at $25,000 would raise taxes in some income groups and lower taxes in others. This is the option included in the Bipartisan Policy Center (BPC) reform plan. The BPC plan would reduce individual income tax rates to 15 and 27 percent and convert those tax subsidies they are not eliminating (the MID and charitable deduction) into refundable credits at a 15 percent rate. BPC would also eliminate the current law provisions to relieve low-income families of income tax burdens (the standard deduction, the earned income tax credit, the child credit, and head of household filing status) and substitute two new tax benefits: a fixed dollar per child credit and a flat-rate percentage earnings credit up to a maximum earnings level. BPC would deliver the charitable and mortgage interest credits as matching payments to charities and financial institutions, so individuals would not have to claim these benefits on their tax returns. The motivation behind these broad changes in the basic structure of the income tax is to enable many taxpayers (about 50 percent by TPC's 2010 estimate of the BPC proposal) to escape a requirement for

filing tax returns. These simplification benefits would not be achieved by enacting only the mortgage interest proposal without the other parts of the BPC plan.

The BPC proposal for reforming the MID, when scored against the current-law baseline without including the other parts of the BPC plan, would raise taxes by an average of $105 per household (table 3, column 4). Households in the bottom four quintiles in the income distribution would see their taxes fall. Many of these households cannot claim the current mortgage interest deduction either because they have no income tax liability or because they claim the standard deduction, but they would be able to claim the refundable credit. Even some taxpayers currently claiming the MID would come out ahead because they would not have to give up the standard deduction to claim the new credit. Taxpayers in the top quintile of the distribution would pay more tax, however, because the 15 percent interest subsidy is less than the subsidy they receive from the current MID and because of the $25,000 cap on creditable interest. Overall, taxes would increase by 0.12 percent of income (table 4, column 4). Taxpayers in the 95th–99th percentiles of the distribution would experience the biggest tax increase as a share of income (0.77 percent), while taxpayers in the bottom quintile would receive the largest proportional tax cut (0.54 percent of income).

Replacing the mortgage interest deduction with a 20 percent nonrefundable credit and capping eligible debt at $500,000 would have similar effects as the BPC proposal, but it would provide relatively smaller benefits to the lowest-income households and larger benefits to middle-income households and raise taxes slightly less on upper-middle-income households. This option would be close to revenue neutral, raising taxes by an average of $8 per household (table 3, column 5). Like the BPC option, it would reduce taxes on average for households in the bottom four quintiles, but the largest benefit as a share of income would go to the middle quintile (0.36 percent of income) instead of the lowest quintile (table 4, column 5). The benefits to the bottom quintile would be limited because many in those groups (especially families benefiting from the current-law earned income and child credits) face little or no positive income tax liability and therefore would not be able to use the credits. Middle-income taxpayers with positive liability who currently claim the standard deduction would benefit from the new credit and some taxpayers who currently itemize would benefit from switching to the standard deduction and claiming the credit. Upper-income taxpayers would experience net tax increases, as in the BPC proposal, but the net tax increases would be smaller because the 20 percent credit would replace more of their lost MID subsidy than the 15 percent credit.

Effects on the Housing Market

The biggest concern about proposals to pare back the mortgage interest deduction is how they might affect housing prices. Many housing markets across the country are just beginning to recover from the large drop in prices that occurred over the past few years, but the overall market is still fragile. And any precipitous shock to

the housing market could endanger the economic recovery that appears to have begun.

I have not conducted an independent assessment of the effects of reforming the MID on housing prices, but the issue was discussed recently by a panel of experts at the Urban Institute (Turner et al. 2013). Some past research has found substantial effects on prices of eliminating current law housing tax incentives. For example, a widely cited paper by Capozza, Green, and Hendershott (1996) estimates that eliminating the mortgage interest and property tax deductions would reduce housing prices in the short run by average of 13 percent nationwide, with changes among regions ranging from 8 to 27 percent. The authors calculated the effects of changes in tax provisions on the amount home owners should be willing to pay for houses producing a given rental value and validated their predictions by examining the relationship between their measure of the user cost of housing and price-to-rent ratios among different regions. An attempt to replicate these results with 2006–10 data, however, failed to identify any effect of the MID on housing prices. It is possible that the recent unsettled housing market conditions, however, made it difficult to identify a relationship between prices and tax provisions that in fact will hold up in more normal periods.

Participants in the Urban Institute roundtable cited several reasons changes in the MID might not have as large an effect on housing prices as previously estimated. The points participants raised included:

- With interest rates so low, the MID has less effect on housing costs than in earlier time periods, so eliminating it would have less effect on housing prices
- The current low price-to-rent ratio is attracting investors into the market who would be not affected by elimination of the MID for home owners
- Affluent home owners with high wealth could pay off a portion of their mortgage debts, a possibility not considered in the earlier estimates
- Many reform proposals would increase tax subsidies for some buyers, leading to a firming up of housing prices in some markets

All that said, however, it would be prudent to introduce changes in the MID slowly to avoid risking a major market disruption. And any transition rules adopted would reduce short-term revenue gains from any reform.

Conclusions

The mortgage interest deduction is one of the largest tax subsidies in the Internal Revenue Code. Achieving a revenue-neutral tax reform that reduces marginal tax rates significantly would be difficult or impossible to achieve without cutting back the mortgage interest deduction or some other equally popular and widely used provisions.

Among the incentives in the income tax, the MID is one of the most difficult to justify on policy grounds. Both theory and available evidence suggests it does little to encourage home ownership, but instead mostly encourages upper-middle-households to buy larger and more expensive homes. It would be possible to provide a larger incentive for home ownership at a lower fiscal cost by converting the deduction to some form of uniform credit and placing additional limits on the amount of debt eligible for the subsidy and the use of the subsidy for home equity loans and second homes. Bipartisan tax reform and debt reduction commissions have endorsed this type of approach.

But any reform undertaken must take account of possible short-run adverse effects on housing markets. Designing appropriate transition rules that prevent market disruption while retaining the benefits of removing or redirecting the preference will be challenging.

Table 1. Tax Units That Benefit from the Mortgage Interest Deduction (MID) by Cash Income Level, Tax Year 2015

Cash income level (2012 dollars)	Percent of tax units	Percent of cash income	Percent within group with mortgage interest	Percent within group benefiting from MID	Benefit from MID as percent of cash income	Percent of benefit from MID
Less than $10,000	8.6%	0.6%	17.6%	*	*	*
$10,000–$20,000	14.2%	2.8%	22.9%	1.1%	*	0.1%
$20,000–$30,000	11.9%	3.9%	31.9%	3.8%	0.1%	0.5%
$30,000–$40,000	11.0%	5.2%	42.5%	8.6%	0.2%	1.3%
$40,000–$50,000	9.1%	5.4%	51.1%	16.8%	0.3%	2.5%
$50,000–$75,000	16.8%	13.6%	58.0%	29.6%	0.6%	11.7%
$75,000–$100,000	9.7%	11.2%	64.3%	47.1%	0.8%	13.4%
$100,000–$200,000	13.6%	23.6%	71.5%	63.1%	1.1%	40.1%
$200,000–$500,000	3.7%	13.5%	75.1%	67.4%	1.1%	23.9%
$500,000–$1 million	0.5%	4.7%	70.1%	55.9%	0.6%	4.3%
More than $1 million	0.4%	15.9%	59.8%	34.1%	0.1%	2.2%
All tax units	**100.0%**	**100.0%**	**47.1%**	**24.1%**	**0.6%**	**100.0%**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0412-8)
Notes:
* less than 0.05 percent
Data include both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

Table 2. Percentage of Tax Returns Claiming Mortgage Interest Deduction (MID) and Ratio of MID to Adjusted Gross Income (AGI) by State, 2011

State	Percent claiming MID	Ratio of MID to AGI	State	Percent claiming MID	Ratio of MID to AGI
All USA	24.4%	4.3%	Missouri	23.6%	3.7%
Alabama	22.0%	3.8%	Montana	22.7%	4.2%
Alaska	21.0%	3.8%	Nebraska	23.0%	3.0%
Arizona	25.8%	5.4%	Nevada	22.2%	4.9%
Arkansas	18.3%	2.9%	New Hampshire	28.9%	4.5%
California	26.1%	6.2%	New Jersey	31.1%	4.6%
Colorado	31.1%	5.5%	New Mexico	20.3%	4.2%
Connecticut	32.2%	4.1%	New York	22.4%	3.3%
Delaware	29.4%	5.4%	North Carolina	27.0%	4.6%
DC	24.4%	4.5%	North Dakota	14.7%	1.8%
Florida	17.9%	3.8%	Ohio	24.5%	3.5%
Georgia	25.8%	4.9%	Oklahoma	19.4%	2.7%
Hawaii	22.6%	6.3%	Oregon	30.2%	5.8%
Idaho	26.0%	5.0%	Pennsylvania	24.2%	3.6%
Illinois	27.1%	4.1%	Rhode Island	28.9%	4.6%
Indiana	21.8%	3.3%	South Carolina	23.8%	4.4%
Iowa	23.6%	3.0%	South Dakota	14.4%	2.3%
Kansas	23.2%	3.1%	Tennessee	18.6%	3.5%
Kentucky	23.1%	3.6%	Texas	19.0%	2.9%
Louisiana	17.9%	2.9%	Utah	31.2%	5.7%
Maine	24.8%	4.1%	Vermont	23.6%	3.8%
Maryland	35.5%	6.1%	Virginia	31.9%	5.8%
Massachusetts	30.4%	4.4%	Washington	28.8%	5.5%
Michigan	24.3%	3.8%	West Virginia	14.7%	2.4%
Minnesota	31.4%	4.8%	Wisconsin	28.2%	3.9%
Mississippi	16.8%	3.0%	Wyoming	18.8%	3.0%

Source: Internal Revenue Service, Statistics of Income Division, at http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2

Table 3. Average Change in Tax Burdens for Selected Options by Income Group, Tax Year 2022 (in dollars)

Income group	Eliminate the MID	Cap home acquisition debt at $500,000	Replace the MID with a 15% refundable credit and cap eligible interest at $25,000	Replace the MID with a 20% nonrefundable credit and cap home acquisition debt at $500,000
Lowest quintile	9	0	-104	-17
Second quintile	95	1	-219	-136
Middle quintile	408	10	-199	-270
Fourth quintile	948	40	-33	-334
80–90th percentiles	2,088	174	698	215
90–95th percentiles	2,987	363	1,570	1,034
95–99th percentiles	4,573	1,145	3,118	2,577
Top 1 percent	4,215	2,082	3,657	3,453
All tax units	**696**	**84**	**105**	**8**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0412-8)

Note: The income percentile classes in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks (in 2012 dollars) are: 20% $27,797; 40% $48,516; 60% $76,595; 80% $$113,780; 90% $181,697; 95% $227,157; 99% $657,697.

Table 4. Average Change in Tax Burdens as Percentage of Cash Income for Selected Options by Income Group, Tax Year 2022

Income group	Eliminate the MID	Cap home acquisition debt at $500,000	Replace the MID with a 15% refundable credit and cap eligible interest at $25,000	Replace the MID with a 20% nonrefundable credit and cap home acquisition debt at $500,000
Lowest quintile	0.05%	0.00%	-0.54%	-0.09%
Second quintile	0.21%	*	-0.48%	-0.30%
Middle quintile	0.55%	0.01%	-0.27%	-0.36%
Fourth quintile	0.82%	0.03%	-0.03%	-0.29%
80–90th percentiles	1.28%	0.11%	0.43%	0.13%
90–95th percentiles	1.21%	0.15%	0.63%	0.42%
95–99th percentiles	1.14%	0.28%	0.77%	0.64%
Top 1 percent	0.13%	0.07%	0.12%	0.11%
All tax units	**0.66%**	**0.08%**	**0.10%**	**0.01%**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0412-8)

Note: The income percentile classes in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks (in 2012 dollars) are: 20% $27,797; 40% $48,516; 60% $76,595; 80% $$113,780; 90% $181,697; 95% $227,157; 99% $657,697.

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Chairman CAMP. Thank you very much, Mr. Toder.

Ms. Gravelle, you are recognized for 5 minutes.

STATEMENT OF JANE G. GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC

Ms. GRAVELLE. Thank you.

Since the interest in housing tax expenditures is part of a general investigation of broadening the income tax base to either permit a lower rate or to prevent rates from rising, I would like to begin first with some general comments on tax reform, based on a CRS report that we did last summer.

First, it is very difficult to identify base-broadening provisions in general that might allow significant rate reductions. About 30 percent of tax expenditures relate to savings incentives, such as retirement savings, exempting capital gains at death, and lower rates on capital gains and dividends, which some who are concerned about saving would probably like to retain. Others are unlikely candidates for technical reasons or because they are crucial to low-income individuals or because of particular merits or popularity and broad use. Our analysis suggested very limited possibilities for rate reduction.

It is even more difficult to identify provisions that would allow significant reductions of the top rate while maintaining the current distribution of tax benefits. About 70 percent of the revisions we identified as being significant at the top, again, were related to savings.

Finally, if the goal of lowering tax rates is to encourage supply-side responses, base broadening increases effective marginal tax rates in the same way as statutory rate increases, because if part of an additional dollar of income is devoted to a tax-deductible use, eliminating that deduction will raise the share of taxes paid at the margin. For example, eliminating all itemized deductions, we estimated, would allow a statutory rate reduction of the top between 4 and 5 percentage points, but the loss of deductions themselves would increase the effective marginal tax rate by about 4.5 percentage points, essentially leaving effective marginal rates unchanged.

How do the primary provisions affecting housing, mortgage interest deductions, property tax deductions, and exclusions of capital gain fit into this framework? First, although their broad use and popularity may be political barriers to major revisions, many economists have criticized these provisions as distorting the allocation of resources, diverting capital from other uses, encouraging the overconsumption of housing, and treating renters differently from owner occupants. There may, however, be merits to owner-occupied housing, such as the neighborhood benefits that have already been mentioned.

Perhaps more importantly, a home is an important asset in retirement. Since investment in a home is a form of automatic savings, accumulating equity as the mortgage is paid, that saving may be in part an increase rather than a substitute for other savings. If a goal of tax reform is to encourage saving, these subsidies may be justified.

Finally, in terms of fairness, mortgage interest deductions increase fairness between homeowners who rely largely on mortgages and those who finance out of assets.

There are some additional justifications for retaining the capital gains exclusion. Capital gains taxes on home sales discourage labor mobility by increasing the cost of relocating. They cause real lock-in effects, such as discouraging older individuals from scaling down their homes as their families become smaller or moving to rental housing, since taxpayers can avoid tax on the gain by holding their home until death. They impose taxes on certainly elderly individuals, who are forced to sell, for example, for health reasons, and not on others. And the lock-in effect, about which we know very little, may significantly reduce the potential revenue gain.

Transition issues also arise for individuals who have recently acquired large mortgages, and there are also immediate concerns on the housing demand, because the economy and the housing market are still very fragile. And transition rules, as long as you know they are happening, might not do much on that demand, for preventing a reduction in that demand.

Now, looking at distribution, these housing provisions are not that important relative to income for taxpayers facing the top marginal tax rates, and so they would do very little to permit those rate reductions. Also, high-income taxpayers could avoid the effects by paying off their mortgages.

The same sort of marginal effects on effective tax rates and supply-side responses with the loss of deductions raising effective marginal tax rates and offsetting statutory rate reductions would also occur with these provisions, but they would take a little longer and, most importantly, they would be focused on the sort of middle-class or upper-middle-class taxpayers generally with incomes between $100,000 and $250,000. Thank you.

[The prepared statement of Ms. Gravelle follows:]

Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service
Before
The Ways and Means Committee
United States House of Representatives
April 25, 2013
on
Tax Reform and Residential Real Estate

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform and residential real estate.

I would like to begin with some comments on overall tax reform, because the congressional debate indicates that interest in tax expenditures associated with residential real estate is part of a general investigation of broadening the income tax base to either permit a lower rate, or to prevent rates from rising if additional revenue is needed. Then I would like to discuss the tax expenditures associated with residential real estate in that context. The most significant provisions affecting housing, measured by potential revenue gain, are associated with owner-occupied housing.

General Tax Reform Issues

In considering the general context of tax reform, I would like to discuss three points. First, it is difficult to identify base broadening provisions that realistically might

be considered to allow significant rate reductions. Secondly, it is even more difficult to identify provisions that would allow significant reductions of the top rate, while maintaining the current distribution of tax burdens. Finally, if the goal of lowering tax rates is to lower marginal rates to encourage supply side responses, base broadening will increase effective marginal tax rates and offset in part or in full, or even more than offset (depending on the provision) the incentive effects of lowering statutory tax rates.

A recent CRS study outlined the challenges to base broadening and elimination of tax expenditures that would permit significant individual income tax rate reductions, such as the often-cited objective of lowering the top rate to 25%.[1] One way of examining the potential for rate reduction is to convert the base broadening provisions into an across the board reduction in rates, and calculate the new rate. This report estimated that if all individual income tax expenditures were eliminated, individual income tax rates could be reduced around 43% and the top rate could be reduced to a little less than 23% in a revenue neutral revision.

However, when the specifics of tax expenditures are considered, the outlook appears less than promising. For example, about 30% of tax expenditures relate to savings incentives (such as lower rates on capital gains and dividends, and retirement subsidies). Repealing these provisions would raise taxes on savings and are probably not likely to be considered, given the objectives of tax reform. Some of these provisions and some others are likely to present significant technical problems such as imputing income for employer fringe benefits provided in kind. For example, employer provided health insurance accounts for 14% of all tax expenditures. Some provisions affect lower and

[1] CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

moderate income taxpayers so significantly they may not be likely to be considered, such as the earned income credit, exclusion of Medicare benefits from income, or the deduction of catastrophic medical expenses, which together account for another 13% of total tax expenditures. The child credit might also fall into this category, and account for 4% of tax expenditures. And of the remaining provisions that might be considered, among them itemized deductions, many of these are popular, present difficult transition issues, and may have some important justifications.

The challenges to lowering the top statutory rate become greater if proposals intend to maintain the current progressivity of the tax system. This report identified a handful of major tax expenditures that are likely to be important to taxpayers subject to the top rates: pension benefits, lower rates on capital gains and dividends, exclusion of capital gains at death, tax exempt bond interest, and itemized deductions for state and local income taxes and charitable contributions. Of these, over 70% of the revenue is from provisions that are subsidies for saving.[2]

Finally, the trading off of base broadening for lower tax rates may be more apparent than real when considering supply side effects, such as labor supply and saving. Broadening the base, in most cases, has the same kinds of effects on marginal incentives as raising rates. Whereas the statutory rate is set in law, the effective tax rate at the margin is the share of an additional dollar of income that is paid in taxes. If part of an additional dollar of earnings is spent in a way that generates a tax deduction, it reduces the marginal effective tax rate. If that deduction is eliminated, then the effective marginal

[2] These provisions are employee pensions, lower rates on capital gains and dividends and exclusion of capital gains at death.

tax rate rises. It is the effective marginal tax rate—not the statutory tax rate—that economic theory indicates would provide disincentives for the supply of labor or savings.

The most straightforward example of this effect is the itemized deduction for state and local income taxes. According to IRS statistics in 2010, the value of the average deduction on itemized returns for state and local income taxes was 5.5% of income for those with an AGI of $200,000 or greater.[3] Since most state income tax rates are progressive, income taxes paid as a share of income would be even higher at the margin. Using an example of a 6% state income tax rate, if the federal statutory income tax rate is 39.6%, and the state income tax is deductible, the total effective marginal tax rate is 39.6% plus 6% minus the value of the tax deduction (0.396 times 6%), or 43.2%. If the state and local income tax deduction is eliminated or capped, the effective marginal tax rate rises to 45.6% (39.6% plus 6%). On average then, disallowing the state income tax deduction is the equivalent of raising the effective marginal tax rate by 2.4 percentage points for those tax filers that would otherwise claim the deduction. Or put another way, retaining the state and local deduction and simply raising the federal statutory rate to 42.1% for this bracket would achieve the same effect.[4]

A CRS report in progress considers this effect for the top rate. The study examines the effect of eliminating all itemized deductions. The estimates suggest that this revision would permit a 4.2 percentage point reduction in the top statutory rate, if rates were reduced proportionally across the board, and about 5 percentage points if a revenue neutral and distributionally neutral change were made. However, for a "typical taxpayer,"

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[3] Internal Revenue Service, Statistics of Income 2010, Individual Income Tax Returns with Itemized Deductions, at: http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income.

[4] This number is the solution to x in the equation $x+0.06*(1-x) = 0.41$.

facing the top tax rate, estimates indicate that the marginal effective tax rate (largely because of the loss of charitable contributions and state and local tax deductions) would rise by about 4.4 percentage points.[5] Essentially, the effect of base-broadening at the margin offsets the reduction in the statutory rate. Thus if the primary objective of tax reform is to lower the marginal tax rates that drive supply side responses, tax reform may not accomplish its purpose.

Specific Issues Associated With Housing Provisions

How do the provisions affecting residential real estate fit into this framework? This section considers, mapping into the discussion of tax reform in general, whether these provisions might be feasible to revise, how they might affect taxpayers in the top marginal rate, and the consequences for effective marginal tax rates.

The most significant housing provisions are associated with owner-occupied housing. Based on the Joint Committee on Taxation's estimates,[6] the three major provisions associated with owner-occupied housing are mortgage interest ($75 billion in FY2015), real property tax deductions ($30.4 billion in FY2015) and the exclusion of capital gains on owner occupied housing ($26.0 billion in FY2015).[7] The other tax expenditures classified as housing benefits are much smaller, with the low income housing credit (which is largely a corporate tax expenditure) reducing revenues by $7.2

[5] Based on estimates from IRS Statistics of Income for 2010, indicating these two provisions account for around 11% of income.
[6] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, February 1, 2013.
[7] The Administration also considers another subsidy similar in size to mortgage interest that economists recognize as a tax benefit for owner-occupied housing: the exclusion of imputed net rent on owner occupied housing. Their estimates were prepared before the legislation extending most of the 2001-2003 tax cuts, but they indicate the revenue loss of this provision is about 70% of the size of the home mortgage however. See "Tax Expenditures" in *Analytical Perspectives*, Fiscal Year 2014 Budget of the United States, pp. 242-277. This provision is, for technical reasons, unlikely to be a suitable candidate for base broadening, since it would involve imputing income.

billion in FY2015, accelerated depreciation on rental housing at $4.1 billion in FY2015, private activity bonds at $4.1 billion in FY2015, and rehabilitation credits at $0.9 billion in FY2015. The subsequent discussion will focus on the major owner-occupied housing provisions.

Two of the three major owner-occupied housing provisions are already subject to caps. The home mortgage interest deduction is subject to a cap on the interest that can be claimed, up to a $1 million of mortgages, plus $100,000 of home equity loans. The capital gains exclusion on owner-occupied housing is capped at $500,000 for joint returns and $250,000 for single returns. Note, however, that the so-called itemized deduction phaseout, popularly referred to as Pease, does not generally constrain itemized deductions, but is rather in the nature of an additional tax rate.[8]

Are these provisions desirable candidates for base broadening? Many economists have criticized the provisions for owner-occupied housing as distorting the allocation of resources, diverting capital from other uses, encouraging the overconsumption of housing, and treating renters differently from owner-occupants. The CRS report cited earlier noted that while these provisions would be technically easy to eliminate or cut back and can be viewed as causing distortions, the broad use and popularity of these provisions were potential barriers to major revisions.[9] The report also noted some

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[8] Pease is not a true limit on itemized deductions because it is triggered by an AGI threshold—not the amount of deductions claimed. For affected tax filers, the total of certain itemized deductions is reduced by 3% of the amount of adjusted gross income (AGI) exceeding the threshold. The total reduction cannot be greater than 80% of the deductions. A $1.00 increase in AGI will increase taxable income by $1.03 because itemized deductions have been decreased by $0.03. Consequently, the effective marginal tax rate will be 3% higher than the statutory marginal tax rate. For example, a tax filer in the 33% tax bracket faces an effective marginal tax rate of 33.99%—an increase of about 1 percentage point. These effects are not directly linked to deductions: an increase of itemized deductions of $1 will continue to decrease taxable income by $1. Only if the 80% ceiling is reached, which is unlikely, will itemized deductions be reduced.
[9] CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

arguments in favor of these provisions. There may be merits to home-ownership in neighborhood effects (keeping up properties better, being more civically involved, producing more stable neighborhoods) and costs as well (such as exclusionary policies).

Another aspect of owner-occupied housing that may justify encouraging its purchase is that, for many middle income families, it is one of the important sources of assets available in retirement. Subsidies for owner occupied housing are directed at savings, and to the extent that one objective of tax reform is to encourage saving, it may be justified on these grounds. It might be better to save in a more diversified fashion, but to the extent that investment in a home is a form of automatic savings (accumulating equity as the mortgage is paid), that saving may be, in part, an increase rather than a substitute for other saving. For those who favor preserving housing tax benefits to encourage saving, this issue might be relevant.

Also in terms of fairness, homeownership subsidies favor homeowners over renters. However, in the case of the mortgage interest deduction, the provision increases fairness between homeowners who rely largely on mortgages and those who finance out of assets. This argument does not apply to the property tax deduction.

A CRS report also noted some particular justifications for retaining the provision excluding capital gains on owner occupied housing from income.[10] Capital gains taxes, if imposed with no relief on housing, have the potential for several distorting effects that may outweigh any negative aspects from incentives they might have had for originally purchasing owner-occupied housing. Capital gains taxes on home sales discourage labor mobility by increasing the cost of relocating. Capital gains taxes in general cause lock-in

[10] The issues associated with capital gains on owner-occupied housing are addressed in detail in CRS Report RL32978, *The Exclusion of Capital Gains for Owner-Occupied Housing*, by Jane G. Gravelle and Pamela J. Jackson.

effects that may cause portfolio imbalances. Capital gains taxes on owner occupied housing cause lock-in effects with consequences for consumption as well as investment choices, such as discouraging older individuals from scaling down their homes or moving to rental housing, since taxpayers can avoid tax on gains by holding the asset until death. They impose taxes on certain elderly individuals who are forced to sell, for example, for health reasons. And, as in the case of capital gains assets in general, this lock-in effect may significantly reduce the potential revenue to be gained.

Transition issues also arise. Individuals, particularly those in the middle incomes, who have recently entered into large mortgages with the expectations of deductions, may find immediate elimination of these provisions difficult to budget for since they will not likely receive full offsets in rate cuts. If the mortgage interest deduction were eliminated, grandfathering existing mortgages or slowly phasing out the deduction may be needed, either of which reduce the potential revenue gain. Second, given a still-fragile economy and housing market, making changes affecting the demand for housing at the current time may cause wider problems in the economy. Grandfathering existing mortgages would not offset these effects on demand, and phasing in the elimination would nevertheless leave new homebuyers with the awareness that their benefits would not last.

In sum, while the subsidies for owner occupied housing divert investment out of other uses into housing and encourage the over consumption of housing, the costs and benefits of these provisions are not entirely clear.

The second issue discussed above regarding general tax reform relates to the distributional issue and contributions of base broadening in lowering the top rate. Owner-occupied housing subsidies are not generally the tax preferences that are the most

significant to those in the top brackets. While the mortgage interest deduction as a share of income for taxpayers who itemized deductions was 7.2% in 2010, the mortgage interest deduction as a share of income for itemizers with $500,000 to $1 million in income was 2.9% and the share for taxpayers with income over $1 million claiming the deduction was 0.6%. A similar, although less pronounced pattern can be found for real estate taxes, where the average deduction is 3.1% of income but those with incomes between $500,000 and $1 million have a deduction of 1.9% of income and those over $1 million have a deduction of 0.8% of income. These patterns are partly because of caps, but also because as incomes become relatively high, spending on housing does not keep up, and because high income taxpayers are less in need of mortgages. In addition, high income individuals probably have a greater ability to avoid increased taxes from housing subsidies by paying off their mortgages and avoiding sale of their homes.

The increase in effective marginal tax rates through eliminating deductions for owner-occupied housing are not likely to be important for taxpayers in the top statutory rate bracket where these deductions are not very important relative to income. They would, however, increase effective marginal tax rates and offset statutory rate reductions for taxpayers in the middle and upper middle income levels. For example, adjusted by the rate of itemization, the mortgage interest is around the same share of income for adjusted gross income from $100,000 to $250,000.[11] This similarity suggests that the mortgage interest deduction has marginal effects through this income range as well as lower income ranges for homeowners who itemize.

[11] In 2010, according to IRS statistics, mortgage interest was 7.8% of income and 85% of taxpayers itemized in the $100,000 to $200,000 income levels. For the $200,000 to $250,000 income bracket, mortgage interest was 6.3% and 95% itemized.

These observations on marginal effective tax rates suggest that decisions on broadening the base should focus on the merits of the individual provisions rather than their contribution to base broadening to permit lower statutory rates. A review of these provisions suggest the case for eliminating these subsidies is uncertain, and may be quite weak for the capital gains exclusion.

Chairman CAMP. All right. Thank you very much, Ms. Gravelle. Mr. Calabria, you are recognized for 5 minutes.

STATEMENT OF MARK A. CALABRIA, PH.D., DIRECTOR OF FINANCIAL REGULATION STUDIES, CATO INSTITUTE, WASHINGTON, DC

Mr. CALABRIA. Chairman Camp, Ranking Member Levin, other distinguished Members of the Committee, I thank you for the invitation to appear at today's hearing.

Let me first say that I believe housing is a critical component of our economy. More importantly, I think we need to keep in mind that housing is one of the basic necessities of life. Without stable, decent, and affordable housing, many other goals in life become quite difficult, if not impossible to achieve.

With that in mind, it is my opinion that our current Tax Code actually does little to help achieve these goals. I believe a Tax Code that would improve economic growth and housing affordability would ultimately be a Code with low, simple, flat rates, with few, if any, deductions. Accordingly, I would urge the Committee, as an ultimate objective, to entirely eliminate the mortgage interest deduction and the deduction for local property taxes. I would also encourage the Committee do so in a budget-neutral manner, lowering overall rates.

As households have made significant investments and decisions based upon the current Tax Code, such a change should, of course, be phased in over a reasonable number of years. I would suggest no more than 7. I recognize that such a change immediately raises questions as to any adverse impact. I would be the first to agree that no policy is without both costs and benefits. There are no freebies. Before we can properly assess those costs and benefits, however, we must start from a position of understanding.

As it relates to the mortgage interest deduction, we can think about, or at least I think about homeowners as broken down into roughly three near-equal-size groups. The first third is homeowners who have no mortgage at all. That is about a third of owners who own their homes free and clear, deriving no benefit from the mortgage interest deduction. I will note as an aside, prior to 1960, the majority of homeowners actually owned their homes free and clear without any mortgage at all. The second third have mortgages that are simply too small for these households to benefit from itemizing as opposed to taking the standard deduction. The last third are those who would potentially benefit from the mortgage interest deduction. These households also tend to be the most highly leveraged and the highest income households.

The good news, in my opinion, from a transition is that those who currently benefit from the mortgage interest deduction are also those most likely to be homeowners with or without the mortgage interest deduction. I think the academic evidence is very clear that the mortgage interest deduction does almost nothing to increase home ownership rates. I have included in my written testimony a chart showing that changes over time in the value of the deduction have not been correlated with changes in the home ownership rate.

We should also recognize that some portion of the subsidy behind the mortgage interest deduction is captured by lenders in the form of higher rates. This subsidy also differs dramatically across housing markets. In tighter markets, such as in San Francisco, the buyer gets almost no value from the subsidy, as it ends up being almost entirely captured by the seller. In looser markets there is very little price impact, as the buyer retains the majority of that subsidy.

I would also argue that any price declines that result from the removal of the mortgage interest deduction would largely occur in markets where we would want housing prices to fall, in my opinion. Again, you look at San Francisco. The median house price is almost eight times median income. It is a simply unaffordable place to live by any stretch of the imagination.

The Committee should also keep in mind that the value of the mortgage interest deduction increases with the level of interest rates outstanding in the economy. Quite simply, the higher our interest rates, the higher the value of the mortgage interest deduction. This also implies that the higher mortgage interest rates are the greater the impact of the mortgage interest deduction on house prices, to the extent that they are capitalized into house prices.

Obviously the converse of that holds. The lower the rates are, the lower the value of the mortgage interest deduction and thus the lower the house price impact. So if we wish to minimize the impact of reducing or eliminating the mortgage interest deduction, then all else equal, we should do so at a time when interest rates are at their lowest. I would submit to you that it is pretty hard for me to believe that rates are getting lower than they are today. So if there is a time to eliminate or change the mortgage interest deduction, the optimal time would be now.

We should not, of course, forget that rental properties enjoy many of the tax benefits that owner-occupied properties also get. Mortgage interest property taxes can all be expensed. The true advantage that the Tax Code offers to homeowners over renters is that rental income is taxed, whereas imputed rent that owners pay to themselves is not taxed. Economists have estimated that the value of this non-imputed taxation of owners' imputed rent is about twice the aggregate size of the mortgage interest deduction.

While a handful of countries do tax imputed rent, I believe a much fairer and simpler system for achieving tenure neutrality in the Code would be to end the taxation of rental income. My back-of-the-envelope calculation is that such would score about $6 billion annually.

Let me wrap up by emphasizing that extremely high levels of leverage on the part of households and financial institutions was a direct contributor to the recent financial crisis. As the mortgage interest deduction is less a subsidy for home ownership than a subsidy for home debt, its existence, while not a major driver of the crisis, was a contributor. Reducing household leverage would improve the stability of our financial system and our economy.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Calabria follows:]

Testimony of Mark A. Calabria, Ph.D.

Director, Financial Regulation Studies, Cato Institute

Before the

U.S. House Committee on Ways and Means

On "Tax Reform and Residential Real Estate"

April 25, 2012

Mark A. Calabria, Ph.D. is Director of Financial Regulation Studies at the Cato Institute. Before joining Cato in 2009, he spent seven years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. Prior to his service on Capitol Hill, Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and also held a variety of positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders and the National Association of Realtors. He has also been a Research Associate with the U.S. Census Bureau's Center for Economic Studies. He holds a doctorate in economics from George Mason University.
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Testimony of Mark A. Calabria, Ph.D.

Director, Financial Regulation Studies, Cato Institute

Before the

U.S. House Committee on Ways and Means

On "Tax Reform and Residential Real Estate"

April 25, 2012

Chairman Camp, Ranking Member Levin, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen, a homeowner and a taxpayer, I have no direct financial interest in the subject matter before the Subcommittee today, nor do I represent any entities that do.

As the Committee will note from my biography, I have spent most of the last two decades involved in various aspects of housing and mortgage finance policy. Without a doubt, I believe housing is a critical component of our economy. Moreover, I believe that housing is one of the basic necessities of life, if not the most important. Without stable, decent, and affordable housing, many other goals in life become quite difficult, if not impossible, to achieve.

With that in mind, our current tax code does little in helping to achieve those goals. A tax code that would both improve economic growth and housing affordability would ultimately be a code with low, simple, flat rates with few, if any, deductions. Accordingly I would urge the Committee, as an ultimate objective, to entirely eliminate the mortgage interest deduction (MID) and the deduction for local property taxes. I would also encourage the Committee to do so in a budget-neutral manner, lowering overall tax rates. As households have made significant investments and decisions based upon the current tax code, such a change should be phased in over a reasonable number of years. I would suggest no more than 7 years.

Residential Housing and the Tax Code

The tax code provides for four "preferences" for residential real estate: 1) the deductibility of mortgage interest; 2) the deductibility of local property taxes; 3) the non-taxation of "imputed rent" for homeowners relative to renters; and 4) the exclusion of capital gains on the sale of a primary residence for most owners. It should be emphasized that the deductibility of mortgage interest and property taxes is not exclusive to homeowners, in that landlords can also expense these items as well as claim a depreciation allowance for rental properties. It is the

differential taxation of imputed and actual rents that favors homeownership, not the mortgage interest deduction.

Before I go into additional detail, it is worth summarizing what the academic literature has to say in relation to tax preferences for residential real estate, particularly for the mortgage interest deduction. Almost all of these conclusions reflect a general consensus within the academic community. Despite the public disputes over issues like stimulus spending or monetary policy, there is actually a very broad and consistent consensus on tax preferences for homeownership:

- The mortgage interest deduction does **not** have a significant impact on homeownership rates.
- The housing price impact of the MID differs dramatically across U.S. cities, with the largest impact in cities with constrained housing supply and while insignificant in relatively elastic ("loose") markets.
- Benefits of the MID are highly concentrated among both the highest income and most-leveraged households.
- Tax "savings" from the non-taxation of imputed rent is almost twice that of the MID; tax savings from property tax deduction is much smaller than either.[1]
- Some portion of the subsidy value of the MID is captured by lenders via higher mortgage rates.[2]

[1] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income." *American Economic Review: Papers and Proceedings* 2008, 98:2, 84-89.

[2] Andrew Hanson, "The Incidence of the Mortgage Interest Deduction: Evidence from the Market for Home Purchase Loans," *Public Finance Review*. 2012.

- The value of the MID is positively related to the level of outstanding interest rates.
- To the extent that high mortgage loan-to-values contributed to the recent financial crisis, removal of the MID would improve financial stability.

Profile of Households and Mortgages

As a frame of reference, there are currently just over 76 million owner-occupied housing units in the United States. Of those, almost 26 million own their home free and clear of any mortgage, or almost a third of all homeowners. About half of these "free and clear" owners are aged 65 or older. Surprisingly, 4.8 million homeowners, living below the poverty level, also own their homes free and clear; a substantial portion of these households are elderly. Households that own free and clear are disproportionately, but far from exclusively, living in rural and suburban areas.

According to the Census Bureau's American Housing Survey, about 50 million homeowners have either a regular mortgage, home equity loan and/or reverse mortgage. 43 million of these hold only a single mortgage. The typical (median) mortgagor has been paying on their mortgage for seven years and has an outstanding balance of $120,000, representing a median loan-to-value of 71 percent. The median monthly mortgage payment is $1,015 on a loan with a median interest rate of 5.3 percent. Five and a half million owners currently have rates of over seven percent.

Median and average values can be informative, but also misleading. If we assume a marginal effective tax rate of 25 percent, the typical median married family with a standard deduction of $11,900 would need a mortgage of at least $180,000 before it would become attractive to itemize based *solely* on their

mortgage interest. So as a "back of the envelope" calculation around 25 million owners, or about half those with a mortgage, have mortgages that are simply too small for them to benefit from itemizing solely based upon the MID, which is usually a household's largest deduction. Of course, combined with other deductions, use of the MID can become attractive for these households.

The Joint Committee on Taxation's most recent estimates suggest that 34 million returns claim the mortgage interest deduction, totaling $68 billion in deductions. Seventy-six percent of the value of the MID is taken by households earning over $100,000.

The Joint Committee on Taxation estimates the value of the MID steadily increasing, on an annual basis, to $83 billion by 2017. Total value over the period of 2013 to 2017 is estimated to equal $379 billion. Of course, these estimates are extremely sensitive to the forecast of future interest rates. Much higher rates could easily increase these estimates considerably.

While the preceding is meant to offer a general frame of reference for the mortgage market, it also helps to remind us that about a third of owners do not have a mortgage and another third do not have a mortgage large enough to justify claiming the MID, leaving only a third of owners really impacted by any change to the MID. This, of course, says nothing about renters, who represent about a third of our population.

Mortgage Interest and Homeownership

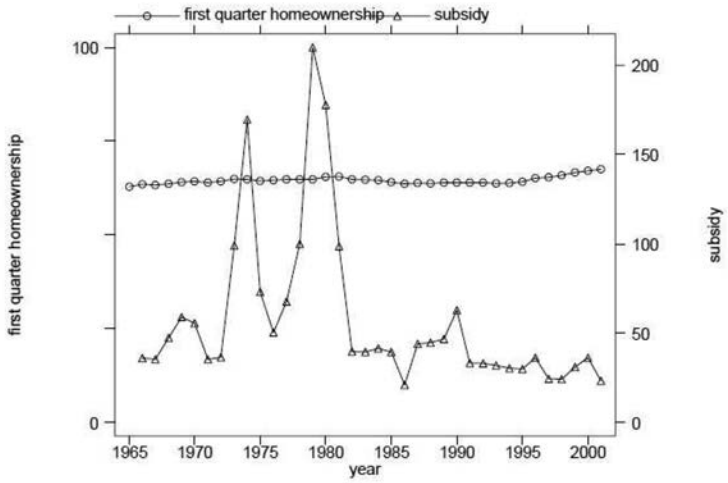
Setting aside the obvious fact that the MID is a preference for home debt, not homeownership per se, the MID's ability to lower the cost of housing is

matched by the deductibility of mortgage interest on rental properties. Accordingly, the cost of mortgages on both rental and owner-occupied properties is lowered, with the net impact on tenure choice depending on both market conditions and the propensity of relevant households to itemize (currently the only way to take advantage of the MID). The propensity to itemize is positively related to income. Thus, at lower levels of household income, tax preferences to rent are stronger, whereas tax preferences to own dominate at higher income levels. As the lack of sufficient income is the foremost obstacle to homeownership, the current structure of real estate tax preferences encourages those to buy who are already likely to buy, whereas those likely to rent are encouraged to rent.

The lack of impact on homeownership from the MID is not simply a theoretical curiosity, but supported by the empirical evidence. Glaeser and Shapiro (2002) for instance calculate the annual value of the MID for 1965 to 2000 (see Figure 1 below)[3]. The aggregate value of the MID shows considerable variation over time. For instance, the after-inflation value of the MID in 1990 was about one-fourth of that in 1980, without a noticeable change in homeownership rates during the intervening decade. There is simply no empirical relationship in the United States between the value of the MID and the homeownership rate over this period.

[3] Edward Glaeser and Jesse Shapiro. 2002. The Benefits of the Home Mortgage Interest Deduction. Harvard Institute of Economic Research. Discussion Paper #1979.

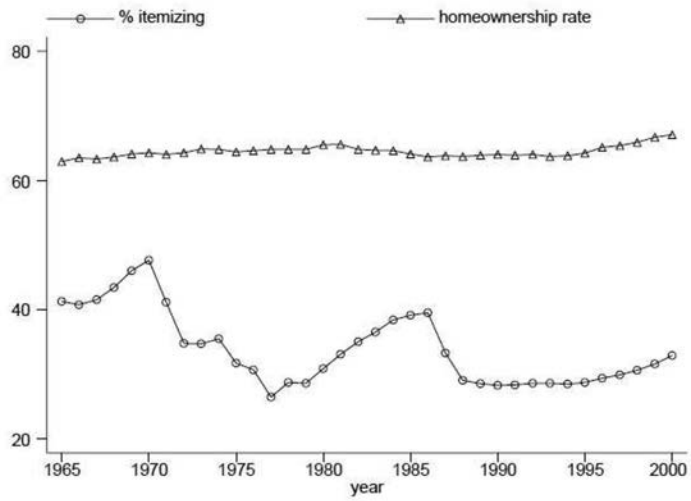
Figure 1: Homeownership and inflation, 1965-2000



Notes: Subsidy series shows the effect of federal taxes on the price of owner-occupied housing, based on the twelve-month CPI inflation rate prior to the first quarter of each year. Data from www.freelunch.com. See Section III for a discussion of the calculation of the subsidy. Homeownership rate is estimated rate for first quarter of each year. Data from www.census.gov.

Nor (as illustrated in Figure 2) has this trend been driven by trends in the percent of households itemizing. After tax reform in 1986, the percent of returns itemizing declined dramatically, again with no noticeable impact on home-ownership rates. Comparing across states, Glaeser and Shapiro find that the higher the value of the average MID subsidy, the *lower* the state's homeownership rate—the opposite of what one would expect if the MID increased homeownership.

Figure 2: Trends in itemization, 1965-2000



Notes: Series is percent of all federal tax returns itemizing deductions. Data from www.irs.gov.

It is worth mentioning that it is not inconsistent for the MID to have no impact on homeownership rates but still have a positive impact on the amount of housing consumed. At least over the short run, the MID likely facilitates the purchase of larger homes that would otherwise be built and consumed. Clearly, some amount of that subsidy will be captured by the seller (or builder) depending upon local supply conditions. So to the extent we debate the merits of the MID, it is really a debate about how much housing is consumed, rather than about the level of homeownership. While there is a sizable literature demonstrating a positive correlation for homeownership, on average, and a variety of positive social outcomes, this literature has not demonstrated a social benefit from larger house or lot sizes. And, of course, homeownership is not without its costs, as some scholars

have found that higher homeownership rates are associated with higher levels of structural unemployment, as well as increased NIMBYism.

Geography of the Mortgage Interest Deduction

Rather than providing a uniform subsidy across American states and cities, the impact of the MID is highly concentrated. Sinai and Gyourko (2004) estimate that around a fifth of the value of the MID is received by households residing in California.[4] Other high-cost housing states such as New York, Illinois, Massachusetts, and New Jersey are not far behind. Large population states such as Florida and Texas also receive substantial aggregate amounts due to the size of their population. That New Jersey receives more MID benefits than all of Texas illustrates those differences are being driven by housing prices, as well as the propensity to itemize across states.

One might argue that removal of the MID would have a disproportionately negative impact on those areas currently receiving the bulk of the benefits. I would argue, however, that these areas would in fact be the largest beneficiaries, as removal would help improve the affordability of housing in those locations. Generally, the bulk of the benefits of the MID go to areas where median housing prices are several times that of median incomes. For instance, in San Francisco, the median existing home price is almost eight times the median income. Such a disparity forces potential buyers to stretch to afford homeownership and to do so in a manner that makes them particularly vulnerable to any adverse economic shocks.

[4] Todd Sinai and Joseph Gyourko. 2004. The (Un)changing Geographic Distribution of Housing Tax Benefits: 1980 to 2000. National Bureau of Economic Research. Working Paper #10322. Also see Ike Brannon, Andrew Hanson, and Zackary Hawley, "The Geographic (and Political) Distribution of Mortgage Interest Deduction Benefits," 2011.

Given that it is appears quite unlikely that median income in San Francisco will increase by 100s of percentage points anytime soon, family stability would be greatly improved by declines in house prices that would occur by removal of the MID. Given that about a fourth of San Francisco homeowners spend 40 percent or more of their income on housing, as reported by the Census Bureau, it would appear that a decline in prices is exactly what is needed there.

MID and Interest Rates

Figure 1 (above) illustrates how sensitive the value of the MID is to the outstanding level of interest rates in the economy. Quite simply, the higher the interest rates, the higher the value of the MID. This also implies that the higher the interest rates are, the greater their impact of the MID on house prices. Obviously the converse holds; the lower the interest rates are, the lower the value of the MID, and thus the lower the house price impact of a removal.

If we wish to minimize the price impact of eliminating or reducing the MID, then, all else equal, we should do so at a time when interest rates are at their lowest possible levels. It is difficult to imagine a time when mortgage rates will be lower than they are today. Accordingly, for the purposes of minimizing any adverse impact on the housing market, the optimal time for elimination of the MID is right now. As interest rates begin to increase, the cost and impact of doing so will only increase.

Towards Tenure Neutrality

As indicated in the preceding, the real reason the tax code favors owning over renting is not due to the MID but rather to the non-taxation of owners'

imputed rent. Although a handful of countries do tax owners' imputed rent, I believe a far simpler system would be to move towards tenure neutrality by eliminating the taxation of rent.

My estimate, based upon Census data, is that renters pay around $33 billion annually in rent. As landlords can expense mortgage interest, repairs, fees and depreciation, I suspect only about two-thirds of that amount, or $22 billion, shows up as net rental income. Assuming an average effective tax rate of 25 percent, it is likely that somewhere around $6 billion is collected as tax revenue on rental income. Interestingly enough, this is roughly the amount spent on the low-income housing tax credit (LIHTC). Swapping out the LIHTC for a reduction in tax on rental income would shift much of the benefit away from larger developers to smaller property owners and individual landlords. As the LIHTC does add some new units to the stock (although there is considerable "crowd-out"), the question becomes whether a supply response by smaller property owners would be sufficiently large to offset any reduction by large developers dependent on the LIHTC. Swapping a reduction in rental income tax for the LIHTC would have the benefit of reducing transaction costs, as some amount of the LIHTC is captured by lawyers and syndicators.

Improving financial and macroeconomic stability

A significant driver of the recent housing boom and bust, as well as the financial crisis, was the increasing leverage of household balance sheets. There are a number of reasons for this increase. One of these, however, is the tax treatment of mortgage interest. After the elimination of deductibility of non-mortgage interest in 1986, many households shifted their borrowing from consumer credit to

home equity lines or other types of mortgage credit (see Maki 1996)[5]. There were certainly some benefits to households by doing so, but this shift induced households to reduce their home equity, leaving many in a more vulnerable position when housing prices inevitably declined. It should be noted that this effect was far from uniform. The increase in the standard deduction in 1986 induced some households at the margin to reduce their mortgage debt and switch away from itemizing. Dunsky and Follain (2000) estimate that about 4.5 million homeowners households switched from itemizing in 1983 to taking the standard deduction in 1989, while reducing their mortgage debt by an average of $8,000.[6] On an aggregate level, this effect was however swamped by the number of households who increased their mortgage debt from 1983 to 1989.

Property tax and Capital Gains

My focus has been on the mortgage interest deduction. The tax code also provides deductions and exclusions for property taxes paid on residential real estate and capital gains on the sale of principal residences. The Joint Committee on Taxation estimates these provisions are worth (2012) $24.5 billion and $22.3 billion respectively. Since landlords can expense property taxes paid, there is no net preference for homeownership that arises from property tax deduction. The subsidy is inherently one for local governments. The deduction likely reduces the monitoring and pressure on local governments from local citizens, leading to

[5] D.M. Maki. 1996. "Portfolio Shuffling and Tax Reform" *National Tax Journal* XLIX(3): 317-329.

[6] Robert Dunsky and James Follain, "Tax-Induced Portfolio Reshuffling: The Case of the Mortgage Interest Deduction." *Real Estate Economics* 28(2000)#4:683-718.

reduced efficiency and accountability. This deduction should be phased out in favor of a simpler and more neural tax code.

The exclusion for capital gains on the sale of a primary residence is a much harder issue to address. As the recent housing boom and bust illustrates, often what appears to be capital gains is merely illusory. As Yale Professor Robert Shiller has demonstrated, over long periods of time the after-inflation return from housing has been quite low. In general, I do not believe we want to tax households on inflation-driven gains. On the other hand, the exclusion of capital gains in housing likely adds to speculative behavior in the housing market. Given that over long periods of time most of the "gains" on housing are due from inflation and are quite volatile over the short run, the current exclusion of capital gains on a primary residence might be the least-bad policy. A family having to sell their home in 2009 (or 2003) would have recognized much smaller capital gains than a family selling in 2006, all else equal. It seems unwise to encourage families to time major life decisions based upon where we are in the housing cycle.

A note of caution on scoring

As discussed in the preceding, households do not sit passively in the face of changes to the tax code. They "reshuffle" their assets and liabilities. In fact, one of the reasons to change the tax code is to influence household behavior. So while elimination of the MID would decrease households' demand for mortgage debt, thereby reducing the leverage in our mortgage finance system, households will seek other avenues for reducing their tax liability, including a shift towards taking the standard deduction. For this reason, among others, estimates as to tax savings from the elimination of the MID should be taken with considerable caution.

Follain and Melamed (1998) argue that in the face of household portfolio shifts that we can reasonably expect the scoring of elimination of the MID to be only around a fourth of the official "tax expenditure" figures.[7] Beracha and Tibbs (2010) argue the actual benefits range between 50 and 75 percent of the estimates produced by JCT.[8] I do not believe, however, such concerns should deter us from elimination of the MID, as the policy grounds for doing so dominate whatever the actual scoring might be.

Budget Neutrality

Elimination of the MID and deductions for local property taxes can be expected to increase tax revenues by tens of billions of dollars annually. Any estimate will have a very large margin of error. I am reluctant to offer a point estimate, but would suggest that removing these two reductions would increase revenues by between $30 and $40 billion annually, after households have adjusted. I would urge that instead of using removal as a method to raise revenue, Congress uses that "savings" to lower marginal rates.

A carefully structured reduction in marginal rates can "hold harmless" most households, in that their net tax liability would be unchanged or be subject to only minor changes. Essentially, I am suggesting that we lower tax rates largely on the same households that currently receive the most benefit from the MID. For instance, increasing the standard deduction by $500, as an offset for the MID, would hold harmless the vast majority of taxpayers with incomes under $100,000.

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[7] James Follain and Lisa Sturman Melamed, "The False Messiah of Tax Policy: What Elimination of the Home Mortgage Interest Deduction Promises and a Careful Look at What It Delivers." *Journal of Housing Research* 9(1998)#2: 179-200.

[8] Eli Beracha and Samuel L. Tibbs, "A Closer Look at the Value of Tax Benefits for Homeowners," *Journal of Real Estate Practice and Education*. 13(2010)#2:131-139.

In fact, increasing the standard by only $200 would hold harmless the majority of filers with incomes below $75,000. This would induce a restructuring of household balance sheets in a manner that would both improve financial stability and economic growth.

To use myself as an illustration, always a risky exercise I recognize, I reside here in the District of Columbia. As a homeowner here in a relatively expensive housing market, I have a relatively large mortgage. I have some ability to pay down a portion of that mortgage and reduce my overall leverage. I suspect I am not alone and that many households would prefer to be less leveraged. Should I do so, however, I would face a significant tax penalty. I would suggest that any tax system which punishes households for wanting to become more financially responsible is one we should change.

Conclusions

Our current tax code introduces significant, and costly, distortions into our housing and financial markets. As a general matter, I do not believe government should pick winners or losers. I would extend this point to the choice between renting and owning, as well as the choice between debt and equity. Currently our tax code favors owning for some households and renting for others. For all households, our tax code favors debt over equity. Reform of the current tax preferences for real estate should aspire to be tenure-neutral, debt-equity neutral and budget-neutral.

To achieve these aspirations, I would suggest the Committee adopt the following: full elimination of the deductibility of mortgage interest and property taxes, along with the elimination of taxing rental income. The net tax "savings" of

such should be used to lower marginal tax rates so as to reduce the current tax penalty on labor income.

Reducing the code's subsidies for mortgage debt would also induce investment to flow away from housing as an asset and toward productive capital. We should not forget that what ultimately grows wages and incomes is an increase in labor productivity, which comes about from an increase in productive capital, human or otherwise. Encouraging households to take on additional mortgage debt has not ultimately made them any wealthier or any more productive. Using the tax code to increase asset prices (such as houses) primarily benefits those who already hold those assets. These policies are inherently regressive and add to current levels of wealth inequality.

Chairman CAMP. Thank you very much, Mr. Calabria.

Mr. Swagel, you are recognized for 5 minutes.

STATEMENT OF PHILLIP L. SWAGEL, PROFESSOR OF INTERNATIONAL ECONOMIC POLICY, UNIVERSITY OF MARYLAND SCHOOL OF PUBLIC POLICY, COLLEGE PARK, MD

Mr. SWAGEL. Thank you. Thank you, Chairman Camp, Ranking Member Levin, and the Members of the Committee for the opportunity to testify.

In the immediate aftermath of the financial crisis, I think it was understandable for housing market participants and for the housing industry to urge that policymakers "do no harm to housing" or "make no changes." I think that time has passed. Housing is in recovery and cannot be left on the sidelines of tax reform. Instead, housing must be part of a thoughtful tax reform that boosts growth, simplifies the tax system, and maintains progressivity. Even more, the stronger sustained rate of U.S. economic growth from reform will be an important long-term positive for housing.

So I would urge that changes to the tax treatment of housing be made as part of an overall pro-growth tax reform and not as an ad hoc revenue grab to support higher spending, as unfortunately is the case in the Administration's budget proposal.

Other developments will affect housing at the same time as reform, including the normalization of interest rates by the Fed, perhaps progress on housing finance reform, and other things.

On the other hand, affordability remains very high with low interest rates, and the housing sector is at the beginning of a time of recovery. So even if tax reform whittles away some of the benefits that lead to a diversion of resources from other forms of investment, the housing sector and the housing recovery will continue going forward.

So tax reform should address the incentives in the Code that lead Americans to purchase larger homes with more debt than otherwise and that distort the allocation of resources. This distortion reduces U.S. productivity growth and thereby reduces the growth of wages and income.

As others have said, the benefits of the tax subsidies for housing accrue disproportionately to high-income families. Three out of four dollars of the tax benefits for housing go to families with incomes above the definition of the middle class put forward by President Obama's chief economist.

Housing plays an important role for American families, businesses, and the overall economy, and the Code reflects this important role. As discussed in my written testimony, reforms to the mortgage interest deduction can preserve the support for housing in the Code while boosting U.S. growth and improving measures of distribution.

It is not very common in economics that policy changes can improve both efficiency and equity, and that is possible here, reflecting the considerable bias in the Tax Code. And as others have said, an appropriate transition period can be put in place to smooth the impact of tax reform on housing, but the key is really to focus the tax benefits more carefully.

One measure of the distortion in the economy implied by the tax subsidies for housing can be seen in a calculation of the effective tax rate for investment in different types of activities. So in 2007 the Treasury Department calculated that the tax rate on an incremental dollar of investment in housing was 3.5 percent, where the tax rate on business investment, overall business investment, was 25.5 percent. And since 2007, taxes on business investment have gone up, with higher taxes on dividends, capital gains, and higher taxes on the flow-through income of businesses.

So it is vital to support housing, but it is also important to understand the disparity that the Tax Code presents between investment in housing and investment in other forms of activity, including business investment.

The tax system also provides support for affordable housing. I would like to mention that very briefly in concluding. A key question that I think is worth further examination is whether the benefits that the Tax Code has for affordable housing are well targeted. In other words, do the dollars actually reach the people who most need help with affordable housing or do the benefits instead go to other parties, such as real estate developers?

In general, a sound principle is for any tax subsidies to target people rather than places, and this suggests a focus on demand-side tax subsidies for affordable housing, such as the Housing Choice Voucher, the so-called Section 8 program.

In contrast, the Low Income Housing Tax Credit has the potential to boost construction of affordable housing units. I think it would be useful for Congress and for the Committee to mandate careful empirical analysis—data, not anecdotes—to assess whether this is the case. And the idea is for tax policy to ensure that taxpayer resources be used in the most effective way to support the vital goal of affordable housing. Thank you very much.

[The prepared statement of Mr. Swagel follows:]

Testimony of

Phillip L. Swagel

Before the Committee on Ways and Means

U.S. House of Representatives

"Tax Reform and Residential Real Estate"

Thursday, April 25, 2013

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

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

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

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

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

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

Tax Subsidies for Housing

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

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

There are tradeoffs involved, however. The mortgage interest deduction encourages Americans to buy larger homes and use more debt to finance those homes. By providing a subsidy to use debt through the deductibility of mortgage interest payments, the tax code gives an incentive for the overuse of leverage in the form of mortgage borrowing. The tax benefit from the home mortgage interest deduction rises with the amount of debt financed: the more debt, the greater the tax benefit. The events of the recent financial crisis illustrate the potential dangers to the economy of over-investment in housing. The tax advantages for housing are longstanding features of the U.S. tax code, and as such cannot have been the

driving force behind the crisis. They were the background, not the immediate cause. Nonetheless, the tax bias for debt finance contributes to increased use of leverage that makes the financial system more fragile and susceptible to distress during economic downturns.

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

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

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

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

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

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

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

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

Possible Tax Reforms for Housing

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

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

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

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

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

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

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

- Reduce the amount of mortgage debt that can be deducted. The current deduction of the interest on $1.1 million of mortgage debt (including home equity lines of credit) could be reduced to an amount such as $500,000. This option would retain the link between the value of the tax subsidy and the size of the mortgage and homeowner tax rate, by only up to the reduced limit. An alternative would be to limit the amount of mortgage interest that could be deducted rather than the amount of debt—for example, to allow only, say, $10,000 of interest paid per year to be deductible. This would lead to greater volatility in the value of the tax subsidy, since the amount of interest expense for each homeowner would depend not just on the amount of

the mortgage but also on the mortgage interest rate, which might well vary considerably across homeowners even with similar sized homes or mortgages depending on interest rate conditions at the time of the purchase (or vary even more for homeowners with adjustable interest rate loans).

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

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

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

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

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

immigration reform and continued deployment of advances in new technologies for energy production and transportation). In short, the pro-growth benefits of tax reform will have a positive impact on the overall economy that will in turn boost the housing sector and offset some of the drag on housing from the tax policy changes.

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

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

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

Tax Policy Relating to Affordable Housing Policy

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

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

Conclusion

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

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

Chairman CAMP. Well, thank you very much, Mr. Swagel.

Thank you all for your testimony. We are now going to move into the question-and-answer phase of the hearing, and each Member who seeks recognition will be given 5 minutes in which to ask questions and receive answers.

Let me start, and I will start with you, Mr. Swagel. I just want to go over a point you made in your testimony. I mean, clearly, over the last 2½ years, this Committee has been engaged very heavily in tax reform. We have had over 20 hearings. We are determined to fix a Tax Code that many of us view as broken and really presents too much of a burden on taxpayers, it is too costly.

You mentioned a pro-growth tax reform model that could help bring about general economic growth and job creation. And if that is the case, would that help the housing sector?

Mr. SWAGEL. Oh, I think it would. Even if some of the benefits, such as the mortgage interest deduction, are reduced, the overall effect in boosting economic growth from reducing the tax on saving and the tax on investment in the U.S. Tax Code would boost the overall economy, and this would flow back into housing. It is hard to say, you know, that tax reform will pay for itself in the form of stronger growth, but there will definitely be a strong offset.

Chairman CAMP. Mr. Calabria, do you have any comment on that?

Mr. CALABRIA. I would agree. I think over time, ultimately in the long run, what should and what does drive house prices are incomes. And certainly I think one of the mistakes we made in the financial crisis was to try to get people to stretch above and beyond their means. And so to me, a pro-growth Tax Code is going to be one that increases labor productivity, increases wages, increases incomes, and makes housing more affordable by making people wealthier, not making them more indebted.

Chairman CAMP. There has been some testimony, Mr. Toder, particularly yours, on the importance of transition rules with regard to any tax changes, or, you know, for the tax benefit regarding housing. Can you kind of elaborate a little bit more on that in terms of why transition rules are important? And do you have any recommendations on specifics of how transition rules should work?

Mr. TODER. Okay. I wish I had thought about that a little bit more before throwing it out there. But part of the reason I did make that comment, there are studies out there which show fairly substantial effects on house prices of, for example, removing the mortgage interest deduction.

They may not be as serious as those studies show. Interest rates are very low today. There are other people moving into the market who are not affected by the mortgage interest deduction. So I think they may be exaggerated, but nonetheless, we have had a very fragile housing market, as you know, and big losses. That has affected the construction industry, it has affected employment. And I think at this time, with the recovery a little fragile, you have to be a little bit careful about taking away those props.

So whether this happens through gradually phasing out elimination of the deduction or grandfathering it for existing owners, there are a lot of different ways of doing this.

Chairman CAMP. Sure.

Any thoughts on transition rules, Mr. Calabria or Mr. Swagel?

Mr. SWAGEL. Sure. Transition rules are important, and one could imagine phasing in the reduction of the mortgage interest deduction. I wanted to mention, it is possible to go too far also. Imagine a transition rule that entirely excludes existing homes and says, you know, only new homes won't have the mortgage interest reduction. Well, that will reduce the supply of new homes and could actually give a benefit to old homes. So anyone with an existing home could be better off. So the transition rules are really important. It is just as important to get that balance so that everyone is going to have to contribute something in tax reform.

Chairman CAMP. Sure. Mr. Calabria.

Mr. CALABRIA. Certainly there is a tradeoff, in my mind, between a reasonable phase-in, which I think is important—as I mentioned in my testimony, people have made investments based on this—versus simplicity. So I would, maybe to parse out something that Phil said, I would have the phase-in targeted to the person and the mortgage rather than the house. We know, for instance, historically the median life of a mortgage is about 7 years. So I think in this interest rate environment, it will probably be closer to 8 or 9, but having this, the mortgage you have today, or if you have it already on the books, remain deductible, you could have some sort of glide path where that diminishes over time, but with somewhat new mortgages coming on in the future.

I will emphasize again the value of the deduction is related to the value of interest rates and the economy. And, again, they are not going to get any lower, they are only going to get higher. My point would be this will only get more difficult in the future, so doing it earlier rather than later.

Chairman CAMP. All right.

And, Mr. Fleming, any thoughts on this idea of pro-growth reform and sort of the idea of general economic growth and job creation, what that might mean in the housing sector?

Mr. FLEMING. Yes. I agree with what has been said. You know, a better growing economy, particularly with broad-based income growth, is helpful to the housing market. That is how people buy homes. That is how house prices rise in the longer run.

And this is a very sticky wicket in the sense of, with all the deductions and the transition rules, in that, for example, a lot of the studies we look at look at the user cost of comparing renting to owning. But a lot of people don't just consider user costs. It is not a purely financial decision to buy a home, right? I mean, much as we economists like to believe that we act individually, financially, rationally, I don't know that that is often the case, and that we don't have a lot of other driving forces. And that is really what is behind this.

If you incorporate user cost, which is where the tax policy is interacting and adjusting user costs to the benefit of home owning over renting, it is influential in the decision of tenure choice. You know, the studies have shown empirically it is influential, but it is not the only influential thing. Other things just as important are your overall income level. That is where the economy would flow in. What your marital status is, what your family size is. There are many other factors, as we know.

It also shows, and some of the best economic research I have seen are these models that sort of take those decisions into two parts, which is the choice to buy or rent, and then once you have made the choice to buy, then it is a question of how much. Now, it also shows that it influences the "how much" component.

So the question, I think, always gets back to, what is our public policy goal? Is it simply to spur home ownership? Is it home ownership in combination with increased investment in housing, which is where it stands today? I mean, we need to start with what the public policy perspective and goal is in the very first place before we attempt to redesign and figure out how to do the transition.

Chairman CAMP. Okay. Thank you.

And I just want to note that in terms of tax expenditures, 40 percent of the base broadening in the 1986 Act did not involve tax expenditures. So tax expenditures are not the only way of base broadening in order to lower rates as we go forward.

So with that, I would recognize Mr. Levin.

Mr. LEVIN. Thank you. Welcome. I am glad we are having this discussion.

You know, I think everybody favors economic growth. I do think we need to look at prior periods of economic growth when there was a dramatic increase of home ownership in this country and to take a look at the role that the mortgage interest deduction played. My guess is, if you go into a middle-class area like I represent, more or less, more than less, I think you would have testimony from people who bought their homes in the 1950s, 1960s, and 1970s as to the importance of the mortgage interest deduction.

And it is interesting, Mr. Calabria, I think you mentioned a third are without a mortgage. I think we need to know how many of the people in that third paid off their mortgage over the years, and not just say a third.

I have this chart as to who uses the mortgage interest deduction. I think we need to take into account the President's proposal relating to a cap of 28 percent. It would mostly affect those with income over $200,000. And it is interesting, of those with income between $100,000 and $200,000, it appears about two-thirds itemize and use the mortgage interest deduction. That is 14 million of 22-plus million. So we are talking about a major policy impact. And for those with income between $75,000 and $100,000, of the 16.5 million, over 6 million use the mortgage interest deduction.

I think we need to be very careful. And when we talk that this is mostly a high-income deduction, that is sometimes said, it really challenges us to look at what we mean by high income, because I think people who are making between $50,000 and $200,000, most of them are comfortable, I don't think they would call themselves high-income wage earners.

So I would like to ask, Ms. Gravelle, you mention in your testimony that as to tax expenditures and their elimination, the tradeoff "may be more apparent than real when considering the supply-side effects, such as labor, supply and saving." If you could elaborate on what you mean by that.

Ms. GRAVELLE. Well, basically, if I am going to earn an extra dollar and, say, I am paying 5 percent of that, say in State and local income taxes to take a simple example, and get a deduction

for it, if I lose that deduction that is going to raise my effective marginal tax rate.

Well, every tax expenditure, virtually, except those for very low-income people, has those relationships to income. So if I spend an additional dollar and some tax-favored spending is part of that dollar, taking that away is no different from raising the statutory rate. It varies across the income classes, but what it means is that if you are thinking about trading up most base broadening for rates, you are not going to change the effective tax rate that affects labor supply or savings or entrepreneurship or whatever you are looking for. It is just not there in the works.

And if you do dynamic scoring based on statutory tax rates, you will greatly exaggerate, probably greatly exaggerate any growth effects. In fact, there might not be any growth effects, depending on what kind of subsidy you are talking about.

Mr. LEVIN. Okay. My time is almost up. I just want to say, I think, Mr. Swagel, it is true that the tax rate on investment is higher than on home ownership. I just think we need to be careful when we make those comparisons to take into account what home ownership has meant in this country. And we need to take a look at other countries which have had high rates of home ownership to see what the structures are there which perhaps encouraged home ownership. I think we need to be really careful when we make comparisons of any kind on this.

Chairman CAMP. All right. Mr. Johnson is recognized for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman. Thanks for holding this important hearing on tax reform and residential real estate. And also, Mr. Chairman, thank you for asking me to serve as Chair of the Real Estate Working Committee. I very much enjoyed working with the Vice Chair, the gentleman from New Jersey, Bill Pascrell, and we had our fill of meetings on real estate.

So I don't know if you guys can tell us any more than we have been hearing over the past 4 weeks or not, but I met with local homebuilders in my district, we met with them up here in Washington, we met with the realtors in both places. And I was once a homebuilder, so I understand the important role housing plays in our economy. At the meeting, one of the things I heard was that it would be more difficult for folks, especially first-time home buyers, to get a mortgage if the mortgage interest deduction was significantly cut back or eliminated entirely.

Mr. Calabria, as someone who knows a thing or two about housing and who supports getting rid of the mortgage interest deduction, I would like to hear from you whether you think there is any truth to what I heard from the homebuilders, in that it would be more difficult for folks to qualify for mortgages if the deduction was cut back in some way or eliminated.

Mr. CALABRIA. I think it depends on what you assume about house prices. And, you know, I think you will hear on the second panel, you have heard here that if we get rid of it, house prices will come down. And so I want to go to the point that the Ranking Member raised, which is I as a homeowner, if the choice given to me was would I like to pay a little bit less for that house or would I like to have the mortgage interest deduction and those two cases

leave me equal payments, I would rather pay less for the house, quite frankly.

I think it is not going to be any harder, because prices will come down, which means people have to save less to buy that house. So, again, there are going to be price effects, but I think that is actually a plus, not a minus.

Mr. JOHNSON. Well, as a builder, we never include that as part of our computation. You know, you build a house for X amount of dollars and you put the profit on there and you charge the people that price, and it doesn't make any difference what the deduction is.

Mr. CALABRIA. And I would certainly agree. As a builder or realtor, you have to take the market as a given, you know, because you don't necessarily drive the market, but the overall interest deduction does drive the market to a degree.

Mr. JOHNSON. Mr. Toder, your thoughts on that same question, please.

Mr. TODER. Well, you know, from people I have talked to, and maybe someone else can contradict this, I am not aware of banks, and I have dealt with several lately, asking anybody what their tax situation is when they are applying for a loan. They want to know your wealth, your income, your assets, but whether you are benefitting and how much from the deduction is not something that ever gets on the form, so I am not quite sure how it——

Mr. JOHNSON. No. They want to know if you can afford the payments.

Mr. TODER. Yeah.

Mr. JOHNSON. Okay. Thank you.

Mr. Calabria, later on we will be hearing from Gary Thomas, the President of the National Association of Realtors. And in his testimony, he argues that the tax system supports home ownership by making it more affordable. So is Mr. Thomas wrong here, or do you think the mortgage interest deduction inflates home prices? You have said it does, I guess.

Mr. CALABRIA. I think the mortgage interest deduction inflates home prices by a degree. I also think it is important to parse out, you know, the mortgage interest deduction is a subsidy for debt, not home ownership. We can come up with a variety of ways. I would argue if we want to subsidize home ownership, we should be subsidizing home equity. Give households something to pass on, not debt.

So, again, part of my objective here is not to change effective tax rates or not to change home ownership rates, but to change the amount of leverage and indebtedness we have in the system so that households have real wealth in that house, not just a big mortgage.

Mr. JOHNSON. So in other words, you believe repealing the mortgage interest deduction would reduce home prices. How much do you think it would reduce them?

Mr. CALABRIA. Let me first say, it depends on the markets. I think if you looked at someplace like Houston, where it is incredibly easy to build, there will be zero price impact. You look at someplace like San Francisco, and I think prices will come down something like 10 percent. So it really depends on how tight the

supply is in that market. You are not going to see a uniform impact.

I would also add, it is my belief the prices will come down in markets that are, in my opinion, way overpriced as it is. So, again, there is not going to be an impact in most of Texas.

Mr. JOHNSON. Yeah. I think I agree with you.

Mr. Toder, do you care to comment on that?

Mr. TODER. I agree. I think it is just very variable. I think probably there will be some impact immediately in all markets, because it is hard for housing to adjust immediately, but that will be very, very variable across markets.

Chairman CAMP. All right. Thank you very much.

Mr. Rangel is recognized.

Mr. RANGEL. Thank you, Mr. Chairman, for calling these hearings.

Ms. Gravelle, could you expand on the idea that if we reduce the top rate and broaden the base, that it could be a disadvantage to moderate and higher—it could be an advantage for the moderate—it could be an advantage for the higher income, but moderate and middle-income people could be adversely affected?

Ms. GRAVELLE. Well, if you want to achieve some of the rate reductions at the top that have been talked about, like going to, say, 25 percent, it is very hard to see a way to do that through tax expenditures or even—there are not that many nontax expenditures you can think of for individuals, either.

So if you lower those rates and then do tax reform, and it is revenue neutral, then you would have to raise the tax burden on the middle class or low-income people. You know, there are only so many pieces of this puzzle. So either you can't lower those top rates with base broadening or people at higher incomes get a reduction in their tax burden and somebody else has to pay for it.

Mr. RANGEL. Well, the theory that most of us use is that there are some preferential treatments that are given to individuals and corporations that if they ever had a reason for being, it no longer exists, and that the system is unfair, and that by eliminating what some call loopholes or others call unnecessary incentives, that this would give us the funds to reduce the rates without having a severe impact on the incentives that we talk about here.

So one person's loophole is another person's incentive, but basically speaking, you are saying that you could not reduce the top rates to 25 percent, even eliminating the so-called loopholes, that it would adversely affect the moderate and middle income because we will be taking away from them tax benefits that they now enjoy?

Ms. GRAVELLE. If you are willing to raise the tax on capital gains to ordinary rates and change the scoring for that, that the Joint Tax Committee does, without big behavioral responses, if you are willing to tax capital gains at death, if you are willing to tax defined benefit pension plans and 401(k)s, there are some things there. What I am saying is I think most of those things are things that the people are interested in trying to retain in a tax reform that will accommodate growth, they are not some of the things they want to do. So if you take those off the table you have very little left.

Mr. RANGEL. So basically what you are saying is that, politically, we would not be closing the so-called loopholes in order to raise the type of revenue that would be necessary to lower the top rates.

Ms. GRAVELLE. Unless you are willing to go after those kinds of provisions.

Mr. RANGEL. It's just that, you know, every time we talk about closing loopholes we get support from the Republicans until we try to do it. Then they say we are raising taxes on those people that we thought was equity. And then we have some people out there saying that they don't want any more revenue because more revenue means tax increases.

We have to find what you have said, which is clear, that if you are going to close loopholes or bring equity to the system, somebody is going to get hurt. You can call it just treatment under the Code or you can say they have to pay more taxes. But your statement is based more on the political will to do what we have to do than the fact that we can raise the money if we had the will to do it.

Ms. GRAVELLE. Well, it is not just political will. It is whether you think there are merits. I think there are a lot of difficulties in taxing capital gains at death, for example, or imputing incomes from defined pension plans. So we laid out all of those. Some of it is practical. Some of it is provisions of merit. Some of it is political. But it all looks to us very difficult to come up with the base broadening that you would need, particularly at the top.

Mr. RANGEL. Thank you.

Chairman CAMP. Thank you, Mr. Rangel. I certainly appreciate your comments but I think we will let the Committee have a try on how difficult this will be.

Mr. RANGEL. That is all right.

Chairman CAMP. Mr. Tiberi is recognized for 5 minutes.

Mr. TIBERI. Thank you, Mr. Chairman. Mr. Calabria and Mr. Swagel, I found your testimony fascinating. I didn't agree with it all, but found it fascinating. Mr. Calabria, I love your last name by the way. You make a great point that is not often made in your written testimony on page 3: It should be emphasized that the deductibility of mortgage interest and property taxes is not exclusively to homeowners, in that landlords can also expense these items as well as claim a depreciation allowance for rental properties.

Here is the point. And I don't think you realize you made this point. If I own rental property and my taxes go up, I increase rents. If you take this away—not you, we—if we take this away from an owner of rental property, you don't think rents are going to go up? They are. I am not going to allow you to answer, because I have to tell you I own property and they are. They are going to go up. That wasn't a question. That wasn't a question.

And so here is another point I wanted to make and then I will let you guys shout if we have any time left. Mr. Swagel, higher income households tend to purchase larger homes with greater home mortgage debt and thus receive larger tax subsidies. You forgot to mention the AMT. The more people, taxpayers, have deductions and credits, the more they have higher income, higher mortgage interest deduction, higher property taxes, higher deductions on their

return, the more likely they are going to be subject to the AMT. And I am painfully aware of that.

So the other point that you both made was with respect to higher income. The data that I have in front of me from Joint Tax from 2004 show that 75 percent of the mortgage interest deduction benefit was collected by those earning less than $200,000. And the majority of those earning less than $200,000 made less than $100,000. And I would argue—I don't have the stats for this—the closer you are to $200,000, the more likely you are going to be subject to the AMT, which will, again, mean you are going to be paying more taxes.

My final point deals with theory versus reality. As somebody on the street who was a realtor, I will tell you my bias. I was a realtor. Never once did I have a client say to me, Pat, I want to buy this house because I can get a higher mortgage interest deduction or I want to buy this house because the property taxes are higher. Actually, people wanted to go where property taxes were lower. Even if they were actually itemizing their deductions, they didn't say, boy, I want to go pay more taxes so I can deduct more of my income. I have never seen that behavior as a realtor.

One more point and then I would love to have maybe your thoughts, both of you, Mr. Swagel in particular, you mentioned the low-income housing tax credit. As a Republican I would argue if you look at all the housing policy that the Federal Government does, and unfortunately Mr. Camp doesn't have jurisdiction over all of it. We only have jurisdiction over some of it. Whether it is at HUD, whether it is Section 8 housing—I'm very familiar with both programs—or whether it is the low-income housing tax credit, as someone who tilts to the right from your testimony, why wouldn't we be encouraging public-private sector support? Maybe the amount is wrong, maybe the subsidy is wrong, but isn't it a good thing to get the public and private sector working together, which is exactly what the low-income housing tax credit does? It gets the best of both worlds. It has the Federal Government involved. It has the private sector involved. It has nonprofits involved.

In my community, I have to tell you, if you and I went to tour housing for low-income people in my community in central Ohio and you looked at HUD property and you looked at Section 8 property and you looked at low-income housing tax credit property, there is no comparison in terms of what is the best managed, the best utilized, the best housing for low-income individuals.

And I take issue with the fact that we don't have low-income housing. I can give you a property in my district on Livingston Avenue that has homeless veterans transitioning in their lives in property. They went literally from the streets into low-income housing tax credit property into the workforce. It is a fabulous, fabulous property. Go ahead.

Mr. SWAGEL. I would say the goals of both the mortgage interest deduction and the low-income housing tax credit are laudable and I fully support the goals. The question, as I have written in my testimony, is the targeting. And it is an open question in the economics literature for the LIHTC how effective it is. Do the benefits of this taxpayer support, to what extent do they result in new units?

Mr. TIBERI. Help us improve it. Help us improve it.

Mr. SWAGEL. That is exactly it.

Chairman CAMP. The time has expired. Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. Russell Long, the old Finance Chairman in the Senate, once said that tax policy is "Don't tax you, don't tax me, tax the guy behind the tree." I appreciate you having this hearing because I think we need to wake up the people because they are the people behind the tree in this one.

And Ms. Gravelle, Mr. Calabria and Mr. Toder concede that the elimination of the mortgage interest deduction would reduce housing prices. They seem to think it might be a good thing since it would lower cost presumably for new buyers.

Now, we already heard that 70 percent of the people who get this deduction are making less than $200,000. And I want to know how such a policy would affect seniors or people who are soon to retire who may have a significant portion of their savings in their house. To see their house drop by 10 percent or whatever, we don't know, we are just guessing how much percentage. In Seattle they dropped about 30 percent in 2007. So we don't know what is going to happen.

But we are setting in motion a policy to pay for a reduction in corporate taxes down to 25 percent by taking it away from homeowners and people who were told by their father, as everybody on this dais was and practically half the people in the audience, when you get a chance, buy a house. Everybody in this country was told that. And some make it and some don't. So what happens to those people?

Ms. GRAVELLE. Well, in every transaction on the demand side there is somebody on the supply side and if we use housing that is the seller. Clearly, if house prices fall the people who are selling their houses are going to lose money from that. I would say, though, I am not convinced there is going to be a large effect, at least not in the long run. We are talking about permanent tax policy. Simply because in the long run the supply curve for housing is probably pretty flat, the only thing that would have an effect would be land. Maybe land would have an effect.

But in the short term, the people who are within the few years while the market is adjusting, yes, it is going to be like a one-time—if you have a price fall it would also be partly a one-time hit to them as well as a hit to the demanders who are having a direct tax reduction.

Mr. MCDERMOTT. Suppose this Committee decided that we would allow you to have a deduction for interest on any loan under $300,000. How would that affect the country? I mean, I look at the loan amounts State-by-State and all of the ones who are in the top 14, with the exception of North Dakota and Utah, are on the coast. They are either Hawaii, Washington, Oregon, California or you start down the east coast and you get all the way down to Virginia. So what would happen if we set a cap? Let's say we will allow you a deduction up to $300,000?

Ms. GRAVELLE. Well, that is the proposal people are talking about now, lowering the cap. I mean, it just depends on where in the income distribution you want to constrain this benefit. So if you lower the cap to $300,000—mortgage interest you are talking

about—then you are going to have a smaller part of the community of homeowners having a marginal deduction.

One of the problems, though, with these caps on deductions is they kind of worsen the problem that I talked about. I mean, you are creating essentially a bigger inframarginal benefit. So you are going to have more marginal tax that is sort of raising effective tax rates at the margin to trade off against the rates. But, basically, that is distributional. Right now the limit is $1 million and you will reduce substantially the benefits of the upper-middle-income-class individuals. And you would retain benefits for say the $75,000, $100,000, those kinds of taxpayers.

Mr. MCDERMOTT. Yes, go ahead.

Mr. CALABRIA. I want to make two quick points which, as I suggest in my testimony, I think we can do in a way where the same households who would be losing the mortgage interest deduction also see a corresponding decline in their tax burden so that we can construct this in a way that those households are held harmless tax wise.

And, second, let me say, you know, on average overwhelmingly homeowners are wealthier than renters. And so to me, I think if we made it easier for renters to buy at the expense of households, that reduces wealth inequality, which is something I think we are concerned about.

Mr. MCDERMOTT. We are talking about simplifying the Code, aren't we? And you are talking about adding 53 more pages to talk about this tradeoff between—I don't see how you make it simpler for the average person. For instance, John and I both got extensions.

Chairman CAMP. Thank you. Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman. Thank you for being here with us today.

All of us in this room, and across the country recognize how difficult it is going to be to accomplish tax reform. But the process that we have been going through over the last couple of years now has been one of the most open. And I am only—this is my ninth year in Congress. I had a career prior to arriving here. But in my tenure here this has been one of the most open and transparent processes that I have been engaged in and I think most Members of this panel will agree with that.

As the Chairman mentioned, we have had over 20 hearings regarding tax reform, all aspects of tax reform. One hearing associated with the working group that I work on—that I co-chair on tax exempt organizations—one hearing was 8 hours, 42 witnesses just a month or so ago. We have had working groups with hearings and discussions, open to all the Members here on this panel and open to all of you and the public.

We have had discussion papers issued for people to review, open and transparent and all recognizing that we need to do tax reform.

And this political rhetoric from an old cop's perspective is really becoming tiring. What we need to do is work together for the American people to make sure that the tax law works for them, that we are not continually taking away from the American worker, from the hard working citizen every day. They need a simpler tax form.

They need a fairer tax form. And I think, again, every Member of this panel would agree with that.

So to throw political bombs every time we have one of these hearings is becoming pretty hard to stomach from my point of view.

I know there are people listening today across this country who, when they see this on some sort of a rerun sometime this evening, are thinking, you know, I am a family and I am looking to buy a home. My first home. Or if I have now owned my home for a while and am a family that has been able to work up the ladder, the economic ladder, and now I want to buy a second home. Or later in life, now over 60 like I am, maybe I am thinking about buying or selling my home and how does that affect me as I exit the home market, the discussion we are having?

So, for at least these three points, the first home buyer, the family looking to buy a second home, or we have someone who is nearing retirement and looking at maybe selling their home, can you tell me how the mortgage interest rate deductions affect all of the families that I have just mentioned in each situation? Mr. Swagel, would you care to comment, please?

Mr. SWAGEL. Sure. I would focus on the first one that you mentioned, because I think it is critically important to support the goal of home ownership and getting people from rental to home ownership. And mortgage interest deduction helps, it is just the benefits of that are mainly to people who don't need the help. I mean, it is the structure of our Tax Code. Most first-time home buyers are not spending a million—don't have a mortgage of a million dollars. We subsidize a million dollars, 1.1 including home equity. So the first-time home buyer gets help. Probably most of the benefits go to people who are not in that category.

If we are exiting then, if we are someone who exits home ownership and goes into rental, they are losing the tax benefit. For many people home ownership as they age isn't the right thing. And if this were providing them an incentive, the tax system is biasing their choices. To me, that is the biggest problem. We don't want the tax system to tell people what to do or to bias them on what to do. And I think that is the case.

Mr. REICHERT. If you have a senior, for example, my father-in-law has just sold his home. His spouse, my mother-in-law, passed away 3 years ago. He sold his home and guess who he is moving in with. But he has been able to pay off his home. So we tax his income, income that he could use from that home to help subsidize his retirement, medical bills, et cetera, that he might have. That doesn't make sense to me that the government is going to take away from a prudent man who has worked hard his entire life who is 88 years old. We are now going to take away some of his ability to pay for his retirement. Does that make sense to you?

Mr. SWAGEL. I actually support the exemption for capital gains, the capital gains exemption.

Chairman CAMP. All right. We will have to leave it at that.

Mr. Lewis is recognized.

Mr. LEWIS. Thank you very much, Mr. Chairman. And thank you so much for holding this hearing. I want to thank all of the witnesses for being here.

Ms. Gravelle, since the stock market crashed in 2008, my district in Metro Atlanta has been troubled with foreclosures. I want to go to what Dr. McDermott implied. Communities and families were turned upside down and there are still many of these families in the communities and neighborhoods that are troubled.

In 1944, when I was only 4 years old, my father had saved $300. He bought a house, a home. He had been a share cropper. Bought a house and 110 acres of land. I know this is not 1944, but is it right, is it fair, would it be just for us to say to a working family, to a middle-class family that we are going to snatch the rug from under you?

We have been told over and over again buy a piece of the rock. Own your little piece of land. Own a house. The Federal Government should be about helping, caring. Could you comment?

Ms. GRAVELLE. Well, I think—first of all even though there is only about a third of people who use the mortgage interest deduction, two-thirds of people, families have their homes. And, as I said, I think one important issue to keep in mind is this is an asset for middle-class families. They have——

Mr. LEWIS. It is a major investment for middle——

Ms. GRAVELLE. If we look at the data we see one of the ways that people save is by acquiring a home. And whether they sell that home or whether they have a home that they don't have a mortgage on when they retire, either one of them helps in their retirement benefit.

So I think that is something to take into account. A lot of economists are very critical of the mortgage interest deduction for a lot of the reasons I have heard here and I am certainly aware of those. But I do think that is an important issue. And, by the way, my daddy was a share cropper too, and I came from Georgia, so we have some things in common here.

Mr. LEWIS. Thank you. Well, you understand.

Ms. GRAVELLE. I understand poverty.

Mr. LEWIS. Thank you very much. I yield back.

Chairman CAMP. Thank you.

Mr. Roskam is recognized.

Mr. ROSKAM. Thank you, Mr. Chairman. I just want to thank the panel. I feel like Tevye here in *Fiddler on the Roof*. On the one hand and on the other hand. I could listen to you talk for quite a while because I am finding myself learning things and that is what hearings are for. So thank you for your testimony and the sincerity with which you are approaching this.

Mr. Calabria, a question for you as it relates to transitions. Let's assume for the sake of argument that there is a sunset on the home interest deduction. How do you contemplate a good transition, a good set of transition rules, or how does that play into somebody that has operated on an assumption, that is a reasonable assumption, and that is hey, this thing is here to stay and they take on a 30-year obligation? What is the transition that is reasonable and fair and doesn't pull the rug out from underneath the taxpayer?

Mr. CALABRIA. Let's start with the observation that it is a 30-year obligation, but the median life of a mortgage has historically been about 7 years. And in this interest rate environment I think

it will be closer to 8 or 9 because people are less likely to want to get a new mortgage with these low rates that they have today. With that said, the transition window doesn't need to be 30 years. I think 7 or 8 would be the outside transition window that I would have.

But you certainly could say whether you have a mortgage today versus people getting new mortgages coming in, I do think there are ways to make people held harmless.

I also would note for families under $100,000 in income, the average I believe they are getting is about $200 in value annually from the mortgage interest deduction. For these families you could certainly just increase the standard deduction by $200 or $300 and they are held harmless post tax wise.

So part of this question is do you hold them harmless on their mortgage? Do you hold them harmless on their tax burden? And so I think we could actually do this simply. Because you could certainly do it through standard deductions. You could do it through other ways that are not all that complicated. Of course you can also do it in complicated ways.

Again, I would not have a transition period that goes for more than 7 or 8 years tops. But I think you can front load that in 3 or 4 years and most of the benefits and most of the costs would be there. But, again, I want to emphasize I believe it should be done in a budget neutral way where you are leaving the same families more or less the same after tax. They are just not tied to their mortgage.

Mr. ROSKAM. I understood everything you just said. What about the person, though, that isn't part of the average or isn't part of the mean, they are outlier and they tend to write their Members of Congress, and they say, look, you know I have a 30-year mortgage. So are they pressing their nose up against the glass looking in or do they get accommodated somehow?

Mr. CALABRIA. Again, the question is whether you want to hold them harmless on the house, which, again, only matters in tight housing markets. In places like Houston there is not really going to be a long-run price impact. Are you going to hold them harmless after tax? Now, I think you could hold them harmless after tax by again looking at things like whether you want to give a special deduction for your homeowner. And if you want to subsidize ownership, you can give a deduction for a homeowner whether they have a mortgage or not.

My primary point here today is that if we care about home ownership, we should not be tying it to a mortgage, we should be tying it to home ownership which, again, I am skeptical whether the benefits outweigh it but, again, that is what the discussion should be about, not about having a bigger mortgage.

Mr. ROSKAM. The phrase that you used during your testimony or during one of the responses, you said give households something to pass on, not debt. What did you mean by that?

Mr. CALABRIA. If I want to have a variety of ways to try to get people into home ownership, certainly some sort of matched down payment assistance could be a direction. If you want to help them try to build equity—I will use myself, I live in the District of Columbia so, unsurprisingly, I have a large mortgage. I think what

bothers me is the fact that—and, again, I don't want to paint myself as representative, but I would like to pay more of it down. But the fact that I will be penalized by the Tax Code for reducing my own leverage strikes me as ridiculous. It is making me make bad decisions.

Mr. ROSKAM. Thank you. I yield back.

Chairman CAMP. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Thank you to the panelists. There are few items in economics that touch every aspect of economics like housing. Income elasticity, supply, demand, tax policy. And I associate myself with Mr. Tiberi and Mr. Lewis on this, because I think still trying to get people into home ownership is a desirable goal.

My public life was in local government and trying to generate new units and trying to find a place where interest rates and price would get people into the market. We were able to come to one fast conclusion. Once people owned a home they really helped to transform the neighborhood. They made pretty good decisions every day. If you are working and you own a home, it is part of building a community.

I think one of the dangers of the tax reform discussion we are having, and it is a long way off I think to conclusion, but certainly a compliment to the Chairman as well on conversational tone of these get-togethers we have had, because they really have been learning experiences. But I think we need to be mindful of what broadening the base could mean.

Broadening the base really could mean that middle-income people are going to be paying more in an effort to cut that rate from 35 to, as the President has suggested, 28 and Members on the other side have suggested 25. But the homeowner deduction really does serve a very necessary purpose and that purpose is getting people who can do it—I think one of the outcomes of the financial crisis that we witnessed was—albeit a slow discovery, but renting is a good idea for some. But, nonetheless, still in an old city in New England home ownership is essential.

I thought that some of the testimony, particularly from Ms. Gravelle, you suggested that identifying tax provisions that would allow significant reductions in the top rates while maintaining the current distribution of tax burdens, what do you mean by that exactly?

Ms. GRAVELLE. Well, again, in our report we identified a handful of provisions that are significant at the top. That is capital gains, capital gains at death, dividends, pensions, and then the two itemized deductions really important for those folks, charitable contributions and State and local income tax deductions. But 70 percent of those provisions are related to savings incentives.

So if you are reluctant to go after those savings incentives, and there are reasons you might want to be, that makes it very hard. If we eliminate all itemized deductions as we said, we have about 5 percentage points. So that is a long way from the distance that people were talking about for the top rate.

Mr. NEAL. Well, I have an interest in savings here, how to generate greater savings, and as you have described it, maybe you could comment on this. I suspect the answer might be in some

measure a bit illusive. But there are some who put the devil's advocate hat on that say that after you do home improvements and after you keep adding on an additional room or you keep exploring new ways to improve the property that in some measure it might not look quite as good or as appealing as it originally did as you relate it to the whole notion of savings. Could you speak to that?

Ms. GRAVELLE. I'm sorry; could you clarify?

Mr. NEAL. Well, there are those who argue from time to time that after one gets done improving a home over the course of a 30-year mortgage and all the things you do, because as you improve the home property taxes go up and even the value of the home might not go up, given what has happened in the last 5 years which remains fairly stable, there are those who say it is not quite as good a deal as it ordinarily would be. But is that a vagary of the marketplace or just a——

Ms. GRAVELLE. Well, I think that is the marketplace. I mean, if you look at housing before the housing bubble burst, housing looked like a very, very good investment. At least my house was a good investment. It fell down a little bit. It is going to come back up. I mean, this is a blip in the market.

So I think homes are not a bad investment. The only way in which they are kind of questionable is if you put too much of your money in a home you don't diversify your portfolio very much. But then that is savings that you wouldn't have had anyway and people do tend to be a little myopic about savings sometimes. They don't really think about the future as much as perhaps we economists say they should. If it is just extra saving, then that is all to the good for your ability in retirement to have a decent standard of living.

Mr. NEAL. Mr. Calabria is pining to get an opportunity here.

Mr. CALABRIA. I just wanted to make two quick points. Professor Schiller at Yale has estimated—put together a price series for the last 100 years and has found that the after-tax return of housing over the last 100 years has averaged 1 percent annually. So I do think the last——

Chairman CAMP. We are going to have to leave it right there. We will go to Mr. Buchanan.

Mr. BUCHANAN. Thank you, Mr. Chairman. And I want to thank each of our witnesses for being here today. I am a Member from Florida and this recession has been brutal on homebuilders and jobs. Florida is growing at a thousand people a day, you know, over the last couple of decades or so. We are in a tendency now where we are starting to come back. A lot of our builders have been basically put out of business, but they are starting to come back, as well.

But I will tell you this, what I have seen lately and really over the last 30 years, the interest deduction does make a difference. I see a lot of homes that are being built in our area, the ones that can afford to buy a second home or buy a home, a lot of them, 70 percent, are paying cash. But the other part of it in terms of southwest Florida, there are a lot of people who are buying homes for $200, $250, $280 thousand. That is where the marketplace is. I think of two or three of our largest homebuilders that have survived this and that is where their focus is.

A lot of those are young families, first and second home buyers. A lot of them have student loans or they are people that are working, technicians in our area. They are making $50,000 a year. They are being squeezed in terms of higher health costs and everything else in their area. But the interest deduction to a lot of them is a difference of $200 or $300 when they look at the overall payment that they are going to get back or to have that break in terms of going forward.

So I would just ask, Mr. Fleming, when you look at this, this hasn't just been a recession in Florida. I hate using this word, but it has been a depression. We are starting to get some momentum coming back, especially in terms of homes $250,000 and under. What impact will this have, do you think, on eliminating that deduction? I just see this having a huge impact on a lot of people in our area.

Mr. FLEMING. Yes, it is true. You unfortunately are from one of the poster childs of everything that went wrong in the housing market over the last 5 years. And there is recovery there. In large part, actually, the housing recovery that you are seeing is being driven by what are typically abnormal forces in the housing market. Institutional investor activity, lots of cash buyers. These are not the normal things that drive prices up. It is typically growing incomes and first-time home buyers entering the market and things like that.

It is hard to say, I guess. I was laughing with a colleague of mine this morning saying the only thing I can be absolutely sure about with the mortgage interest deduction is that given that it creates both the incentive to consume more homes and some level of increased home ownership in and of itself. But all of that urban sprawl and traffic that I had to drive through to get here this morning can be attributed in part to mortgage interest deduction. Of that I am sure.

But in other terms I think we have to be very careful. The price responds to something like a change, any sudden change. My testimony kind of gets to the point that suppliers, sellers, and buyers immediately respond to temporary change or immediate shock. Right? And we saw it in the first-time home buyer tax credit, we saw it with the capital gains tax.

So the idea of an immediate shock happening, yes. The magnitude, harder to tell. Most of the models that we look at, the econometric models that come up with estimates of the price changes, basically hold the supply side inelastically fixed. In other words, there is no supply response to the impact. So of course the price response is bigger. In the immediate term that is true. It takes on average 9 months to build a home. Right? But in the longer run, of course there is going to be some sort of supply response to it.

So it really gets down to, yes, maybe there is an immediate shock but the overall longer-run benefit is not necessarily as strong as the estimates that are empirically derived show.

Mr. BUCHANAN. Any of the other panelists, I would like to get your thoughts.

Mr. CALABRIA. I will make a couple of quick—clearly in my proposal I want to hold those families harmless after tax. I want to emphasize that. Second, $180,000 and below, if that is your only

deduction is the mortgage interest deduction, you are better off itemizing. And we see that. And, third, as I mentioned in my testimony, the value of the mortgage interest deduction fluctuates with interest rates and, interestingly enough, if you did a time series when you value the mortgage interest deduction at its highest it is actually when construction is at its lowest. So they are inversely related. I have seen very little, if any, evidence to suggest to me that we see extra construction because of the mortgage interest deduction. Ultimately construction is driven by population and household formation.

Mr. BUCHANAN. The point I was trying to make, in the real world just looking on the ground there, there are a lot of families, whether they are 30, 35, two workers in the family, that deduction of $200 or $300 makes a difference per month because that is what they are going to see. And the second point is we are historically low in terms of our interest rates at 3 or 4 percent. If you go back over 30 years, I remember you could not get a mortgage rate under 10 percent, but normally 7 or 8 percent. Again, that would even be a bigger issue for them going forward.

Chairman CAMP. Mr. Pascrell is recognized.

Mr. PASCRELL. Thank you, Mr. Chairman. As was mentioned previously by Chairman Johnson, we worked over the last several weeks having I think seven really concrete meetings with different groups and looking at the possibility, not only in residential but commercial real estate. And our objective, Mr. Chairman, was to see whether some sheltering of income, some incentives, or any of them, made sense in terms of economic strength and fairness. I think that was significant in every group that we talked with, and it was certainly an elevated discussion all the time and it was civil and thanks to Mr. Johnson I think we did a lot of work in a very short period of time.

The Tax Code has many provisions that impact residential real estate. And some of them, including mortgage interest deduction and deduction for State and local property taxes, are among the largest expenditures.

It is not a surprise that they would be looked at in a quest to eliminate expenditures to lower the rates. But I think we need to proceed with caution. And you heard that this morning from our great panelists here.

These expenditures are large not by accident. They are large because they are well understood and utilized by the middle class. We can't simply do tax reform and we can't do tax reform simply for tax reform's sake. We want to come out of this. I mean, most of the pages that are written in the Code were not written by you, Mr. Chairman, or me. They were not written by average middle-class folks. Huge groups that could afford a lot of lawyers, wanted to hide certain parts of their income. They are not criminals to do that. But we are looking at what is fair and what is not fair. And I think both sides would agree to that simple statement.

Ms. Gravelle, I have a question. In your testimony you made a point that the tax preferences for owner-occupied houses like the mortgage interest deduction and the deduction for State and local taxes, are not the tax preferences most significant to the top tax brackets. I think that is what you said. Am I correct?

Ms. GRAVELLE. Yes. Yes, that is right.

Mr. PASCRELL. I strongly believe that we need to do something about income inequality in this country. Now, according to a recent study by Samuel Saez of the University of California Berkeley, the top 1 percent of households captured 121 percent of income gains between 2009 and back to 2001. The 99 percent actually grew poorer. Between 1993 and 2011 the top 1 percent income grew by 57.5 percent while income for the rest grew 5.8 percent.

What is the percentage of taxpayers with incomes over $1 million who take the mortgage interest deduction? Do you know that?

Ms. GRAVELLE. I think it is a large percentage. But it is a small percentage of their income. High-income people have houses and sometimes they have mortgages, but I imagine Eric is pointing his finger here; he knows this answer better than I do.

Mr. PASCRELL. Go ahead.

Mr. TODER. I think about a third of the people with income over $1 million take the mortgage interest deduction. And many of them have already either paid down their mortgages or, actually, I should say benefited from it, because we assume that if you eliminated the mortgage interest deduction many of those people would just simply pay off their mortgages.

Mr. PASCRELL. Does that hold also for State and local taxes?

Mr. TODER. Almost all of them would be taking State and local tax deductions.

Mr. PASCRELL. So pretty much the same; right?

Mr. TODER. Right.

Mr. PASCRELL. According to the Joint Committee on Taxation, 75 percent—75 percent of the MID is claimed by taxpayers with incomes below $200,000. That is what Mr. Tiberi and Mr. Levin pointed out before. It is about the same for State and local taxes. And I agree and associate myself with the words of Mr. Levin and Mr. Tiberi. If we eliminate the deductions for mortgage interest and State and local taxes, how much would tax rates have to come down in order to ensure the middle class is going to be paying an overall lower effective rate?

Chairman CAMP. If you could answer briefly because time has expired.

Ms. GRAVELLE. Just from memory, I think it is somewhere—that class of those deductions are about 10 percent of income. So you are talking about a 10 percent rate reduction.

Chairman CAMP. Thank you.

Ms. Jenkins is recognized.

Ms. JENKINS. Thank you for being here. Thank you, Mr. Chairman.

Mr. Toder, your testimony comes to the conclusion that the mortgage interest deduction does a poor job at promoting home ownership. It mentions studies that have compared home ownership rates in countries like Canada, the United Kingdom and Australia. Can you just elaborate for us on how the U.S. compares in terms of overall home ownership rates to those similar countries and what sort of policies those other countries employ to promote home ownership?

Mr. TODER. I am not sure what all the policies are in terms of their financial market policies, but Canada, Australia and New

Zealand have all eliminated the mortgage interest deduction, which they previously used to allow. The United Kingdom has been phasing it out over a long period of time. They were actually doing it through the banks, so you would get it at the basic rate. The people above the basic rate wouldn't benefit from it. But they gave the subsidy to the lender and that had the same effect, really had the same effect as the proposals I am talking about, of converting the deduction to a credit, which would give the same percentage subsidy to everybody. So that was the way they did it. But in all of those places the home ownership rate is at least as high as it is in the U.S.

Ms. JENKINS. Okay. Speaking of that, you noted that recent major tax reform proposals, including Simpson-Bowles and the President's 2005 Tax Reform Advisory Panel and the Bipartisan Policy Center, have all recommended moving from an interest deduction to tax credits.

The general consensus appears to be between 12 to 15 percent credit and either refundable or nonrefundable. I believe that you worked with the Bipartisan Policy Center on developing their tax reform proposals. So could you just describe for us how the determination was made to arrive at that credit level, whether to make it refundable, and what sort of deliberations took place?

Mr. TODER. Sure, I would be happy to. I was a consultant to them. I was not a decisionmaker but I was helping them with the analysis.

Ms. JENKINS. Okay.

Mr. TODER. They were trying to get a much broader tax reform as part of an overall package to reduce the deficit, so their tax reform was actually raising revenue a bit. They started out with the idea that they wanted to get rid of as many tax expenditures as possible but came to the conclusion that some of them had to be retained in some form, one of which was mortgage interest, another one was charitable.

They also developed the very far-reaching idea that they would like to get many people out of having to file tax returns. So the way they went about that was they restructured all of the basic benefits. They eliminated the standard deduction, personal exemptions, and the earned income credit. They replaced them with a flat child credit and a flat earning subsidy.

So they set it up so that if you were in the lowest tax bracket, and you didn't have a lot of capital gains, you didn't have to file a return. It would all come out through withholding. And so this kind of mortgage interest subsidy fit into that. It was a subsidy at the basic rate of 15 percent, which was the bottom rate in their proposal.

Ms. JENKINS. Yes, Mr. Swagel.

Mr. SWAGEL. I would just like to add to what Eric said, the comparison between a credit and a deduction is an important one. The deduction is valuable to people at the bottom, but it is really valuable to people at the top. Whereas the credit, of course, is the same amount for everyone, depending on whether it is refundable or not.

So in the sense of moving from deduction to credit it probably better focuses the taxpayer resources on lower incomes. Because for

the person starting out, Ms. Jenkins, a person buying a $250,000 house, they will get the same credit as someone using the full $1.1 million of deduction, whereas in the current system they don't.

Ms. JENKINS. Thank you.

Mr. JOHNSON [presiding]. Mr. Davis, you are recognized.

Mr. DAVIS. Thank you, Mr. Chairman. I want to thank all the witnesses for coming. Ms. Gravelle, the National Housing Trust Fund was authorized in the Housing Economic Recovery Act of 2008 specifically to address the housing needs of extremely-low-income households. The NHTF is a block grant to States that, once funded, can be used to produce, preserve, rehabilitate and operate rental homes for very-low-income households. At least 90 percent of the funds must be used for rental housing and at least 75 percent must benefit extremely-low-income households.

The NHTF is intended to be a permanent program with dedicated sources of funding, not subject to the annual appropriations process. The funds are to be distributed by a formula based on factors detailed in the statute with a $5 billion investment. Michigan would receive $146.1 million. The NHTF was initially to be funded by contributions from the government-sponsored enterprises Fannie Mae and Freddie Mac; however, shortly after HERA was enacted the financial crisis hit and of course these agencies were taken over by a conservatorship and funding was suspended. And, of course, Congress has never actually put the money in in the first place.

The National Low Income Housing Coalition has talked a great deal about assistance to renters, that these individuals need some kind of help and could benefit greatly from it. And there have even been some who have talked about a renter's tax credit. How do you respond to those kind of thoughts?

Ms. GRAVELLE. Well, you could have a renter's tax credit for low-income people if you make it refundable. But it wouldn't work otherwise, because very low-income people don't generally pay taxes because of the earned income credit and other provisions. I mean, for getting money to low-income housing there are a lot of different routes. The low-income housing credit in the Tax Code is one method, but it has to pass through a lot of middle men on the way so a lot of folks think that grants would be better.

The other thing you could do is give people vouchers for rental housing directly from the government. Or, as I said, you could do it through refundable tax credit. The problem is people who don't file taxes then would have to file. A lot of people do, if they are working, because of the earned income credit. But there is always—for this particular objective there are a lot of different ways to get there.

And I would say—maybe Eric can tell me what he thinks—the consensus is that usually these things are better done through spending rather than routing them through the tax system.

Mr. DAVIS. Are there any other thoughts or ways that we might want to look at or could look at to try to make sure that these individuals or this category of citizens actually get some benefit that might move them a little bit beyond where they are relative to decent housing?

Ms. GRAVELLE. Low-income housing issues in general are not really something that I have studied a great deal. But I think there

has been a concern about diversifying the neighborhoods so you don't have pockets of low-income people in the same place. Those are some of the issues I know that come up with public housing.

But I think an economist might say the easiest way is to give people a voucher to help pay their rent. That might be the easiest and most straightforward way to do it.

Mr. CALABRIA. I will just quickly mention, because I mentioned in my testimony, the real difference between owners and renters is that we don't tax imputed rent for owners. And I suggested in my testimony that we stop taxing rent and we could limit that to rents charged below a certain level that are affordable. And if the market is competitive in certain places that will get passed on to the renter.

Mr. DAVIS. Thank you both very much. Thank you, Mr. Chairman. And I yield back.

Mr. JOHNSON. Thank you. Mr. Paulsen, you are recognized.

Mr. PAULSEN. Thank you, Mr. Chairman. I have actually found this testimony very enlightening. It is part of that whole process of really diving in deep as to what the Tax Code is really about, because it is deep. If you do make changes in one area, it impacts quite a few different areas in other sections of the Code.

Again, this is not about doing tax reform for tax reform's sake. This is about finding real solutions for a broken Tax Code. Everyone acknowledges the Tax Code is broken and we need a Tax Code that helps America compete and win, that grows the economy, that grows jobs. And we need a Tax Code that is a lot simpler and fairer so that an average family can actually do their own taxes.

I find it astonishing that still nine out of ten American families are either required to pay someone else to do their taxes or purchase some sort of commercial software in order to do those taxes. And that is just not a Tax Code that is designed for the average person obviously in terms of simplicity. That is a Tax Code that is designed for accountants and lawyers and others.

There is a lot of inefficiency and it really is time for us—and we are doing the right thing in terms of having 20-plus hearings, laying the groundwork, moving forward with these working groups, to making sure it is not going to be a continuing process of just special interests and handouts and bailouts, but really getting into the details.

But I want to dive a little bit more into the low-income tax credit. This is an area where I have spent some time with some folks in Minnesota. I have seen the homes that the low-income tax credit has actually produced through rehabilitation and loans to individuals. I do hear from the providers all the time that this is a credit that is a very effective way of producing affordable housing and providing homes for those who need them.

So knowing that is the case—and part of the problem in the past has been I wonder is this tax provision going to be extended, is it going to be extended once again? So there is no certainty, there is no predictability for building the housing. So that is one of the goals of tax reform, to make sure that we have predictability and certainty.

But just to follow up, what would happen if that tax credit just went away? Would making that tax credit permanent improve re-

sults or whatever takes its place improve results? And is there a way we can actually improve that credit for better results? It has been a public-private partnership. Mr. Swagel, you talked a little bit about that in your testimony. I know this is a long section of the Tax Code. But can you just maybe elaborate a little bit more?

Mr. SWAGEL. Sure. I think the permanence would be really important. It could get at this uncertainty. The other thing that would help is that the value of the tax credit varies with the economic cycle and the demand for it. And so there is a sense in which it is not clear that the Tax Code is the best way to do this. If we want more supply of affordable housing units, which I think as a Nation we do, it is probably better done as spending and not to run it through the Tax Code.

The other thing that might be considered, and, again, it is not argument to say do less of it, it is really do it better. But I think my testimony questions its effectiveness. And really it is that, is it effective and what is the best way to make it effective? Because we want to do both supply and demand, not supply or demand. The vouchers will help on the demand side and I think the affordable housing tax credit, if there were a better way of doing it, could help on the supply side.

Mr. PAULSEN. Mr. Calabria.

Mr. CALABRIA. Honestly, I have been a little skeptical and certainly looked at the low-income tax credit over time. I certainly understand why users of a program think it is a great program. But to me the academic evidence suggests: (a) There is a tremendous amount of crowd-out and about half of the units would have gotten built otherwise; and (b) There is evidence to suggest that most of the subsidy ends up with developers, syndicators, and lawyers. And I have nothing against developers, syndicators, and lawyers, all good people, but they are not necessarily who I think we should prioritize subsidizing.

And so I am skeptical of it as a delivery vehicle. My tendency—I really—I know that public-private always sounds like a good thing, but I remember for years telling what a great public-private partnership Fannie Mae was for the government and that didn't turn out so well.

So I do think we need to rethink some of what that means. I think Phil alluded to this earlier. I think that we should directly subsidize the people that we want to directly subsidize. If we care about low-income households, let's subsidize low-income households. I am very skeptical of doing roundabout ways through intermediaries. If the problem is somebody is poor, let's make them not poor. That seems like a pretty straightforward way of doing it to me.

Mr. SWAGEL. One other thought to add, what you heard from the constituents in Minnesota is on the upkeep. And that really is the case. That the tax credit subsidized units do have better upkeep and that eventually those units go back to a fully private model. And I think that is the challenge. How do we get that? How do we make sure that low-income subsidies are not just Section 8, not just for low-income people, but have the diversity and that incentive for better upkeep?

Mr. CALABRIA. The geographic evidence suggests to me that tax credit properties do get built in areas that are already high concentrations of race and poverty. So I tend to be more preferential to vouchers because I think we want to be able to get people into good communities rather than continuing to build properties in neighborhoods that already have problems and high concentrations of poverty to begin with.

Chairman CAMP [presiding]. Time has expired. Ms. Sanchez is recognized.

Ms. SANCHEZ. Thank you, Mr. Chairman. And I want to thank all of our panelists for sharing their thoughts with us today.

I represent a pretty working class district in southern California and my constituents work very hard, often long hours and multiple jobs in order to just save up the money to purchase their first home. So for me it is incredibly important to make sure that we don't make it more difficult for working people to achieve the American dream of owning their own home. And that is why I am a little bit skeptical of changes to the Tax Code that would have the effect of putting that goal for them out of reach.

Just last month we did a housing event in one of the cities in my district, Pico Rivera, that was aimed at doing two things: Helping current homeowners keep their homes and educating potential first-time home buyers about the process of purchasing a home. And at that event for the first time in a long time we started to hear many positive signs about the local housing market improving and gaining strength.

And that was in marked contrast to the past several years when housing or the fear people had about losing their housing was overwhelmingly the number one issue that constituents were calling into my office and asking for help on.

So targeted provisions in our Tax Code, things like excluding the discharge of principal residence indebtedness from income, have helped turn that tide and have gotten the housing market back on the right track. With the turning of that tide I think come good paying jobs in both the construction and the housing industries, good paying jobs that help a new group of people in turn achieve their dream of home ownership.

Some of the overarching themes in the tax reform discussions that we have had are a little bit concerning to me. My biggest concern is that we not pay for tax reform on the backs of working people. Broadening the base and lowering the rate sounds great, it is a great bumper sticker, it is a great slogan, but that can't come at the cost of working class families.

We have heard from some of the panelists today that targeted housing provisions in our Code create economic and market distortion, but many tax expenditures are essential to maintaining parts of our market and economy that help create good paying jobs. Many provisions discussed today help serve that very purpose.

So my first question, Ms. Gravelle, could you elaborate a little bit further on just how hard it will be to achieve the Majority's tax reform principle, this broadening the base and lowering the rate, especially with respect to those tax incentives that are net positive with respect to job creation?

Ms. GRAVELLE. In our study, we took the top 20 tax expenditures, which account for 90 percent of the revenue, and we went through them one by one and said, okay, what are these, what are the merits of these, what are the objectives. And, again, a large fraction of those provisions relate to savings. Or just take something like capital gains. Even if you wanted to tax capital gains at ordinary rates, the scoring methodology would not give you revenue from capital gains.

Some of them are very difficult technically. For example, even though a lot of people talk about taxing employee health benefits, it is actually very difficult to impute the value of that to people in many different circumstances. And that came up during health reform. That is very hard to do, and that is why they ended up with a very limited, sort of the Cadillac of tax provisions.

Defined benefit pension plans. How do you impute income? Do we really want to tax Medicare recipients on the value of their Medicare benefits? What do we want to do? Do we want to leave the earned income credit in place? Do we want to disallow the taxation for catastrophic medical expenses?

We went through each of those one by one, and when we finished examining them, we just concluded that, for a whole variety of reasons, the objectives, the technicalities, the merits in general, that it was just very hard to have a large base broadening. If you eliminated every tax expenditure, we found that you could get the top rate down to about 23 percent, but once you start cutting those out, it gets harder and harder to do that. And that CRS report is out there, you know, it is available for people to look at. It shows how careful we were going through each provision one by one.

Ms. SANCHEZ. And each of those provisions you just discussed, I am assuming probably affect middle-income and low-income people more than any other group.

Ms. GRAVELLE. We look at some that affect middle-income and some high-income, but many of these provisions, like employee health insurance, really are a middle-income——

Chairman CAMP. All right. Time has expired.

Mr. Kelly is recognized.

All right. Mr. Griffin is recognized.

Mr. GRIFFIN. Thank you, Mr. Chairman. Thank you all for being here today. I appreciate it. This has been a very helpful hearing.

And I want to echo some of the comments I have heard from some of my colleagues, in that we are taking a comprehensive look at the Tax Code because most folks agree that it is a mess and it is counterproductive. And if we are going to encourage economic growth and job creation, the Tax Code right now, in my view, is a barrier to that. That is why we are doing this. We are not doing it for the sake of it because we don't have anything else to do. We are doing it because it is helpful to this country to fix this Tax Code.

You know, on the way back from Afghanistan about a year and a half ago, while the pilots were resting, we stopped in Estonia, and we met with the former Prime Minister, who is now the Defense Minister, and he was telling us about his tax system. They said they pay in Estonia, they pay their income tax online in about

15 minutes. The average Estonian takes 15 minutes to pay their tax. Now, I am not promoting their particular way of taxation, but the point is that we can do much, much better. Whatever that looks like, we can do much, much better. And, you know, we certainly can do as well as the beautiful country of Estonia.

And I would say that the best thing for working families, working families in Arkansas that I represent, or wherever, the best thing for them is a growing economy and remaining competitive internationally. So that is why we are doing this.

To address the mortgage interest deduction, I would like to say that I think it has been well said by many others here today that you can talk about, you know, the high-income folks that take advantage of it or whatever, but at its core, this benefits middle-class, working Americans. A lot of people count on this provision, and I think the statistics show this, whether you are looking at the percentage that are under $200,000 in income or $100,000.

But one thing that I wanted to explore a little bit, Mr. Calabria, if you could talk a little bit about your comment earlier where you said, I think it was you, you said that the mortgage interest deduction incents more higher debt, not equity, not ownership. And if you could talk a little bit about that and your proposal to address that.

Mr. CALABRIA. Sure. Let me start off by saying, you know, my proposal, I want to try to keep those families held harmless after taxes, not see their tax increase, but what we were doing is allowing them to prioritize, because, you know, I think housing is important, but I think education is important, I think healthcare, I think food is important, but I don't think the direction to go is here in Washington where we decide what people should consume or where they put their marginal dollar. I think they are smart enough to figure that out for themselves, quite frankly.

So the thing is to reduce these tax connections to various consumption items and let people make those decisions for themselves while keeping their taxes low. My point being, I think we can tie that in that way, leaving these families the same after tax, you know, in very much the same way.

Mr. GRIFFIN. You would acknowledge, would you not, that some of the proposals for a credit instead of a deduction, if you left the tax rate the same, would really hit a lot of the folks that take advantage of the deduction, if you left the marginal rates the same.

Mr. CALABRIA. It would. And so I do think——

Mr. GRIFFIN. Because it would be far less than the deduction.

Mr. CALABRIA. So one of the objectives should be to try to lower marginal rates, because ultimately at the end of the day what we should be trying to achieve is growing household income and reducing the taxation of income, because income is what makes everything else in the world possible. So, you know, you could have all the mortgage interest deduction you want in the world, if the family doesn't have the income to afford the house to begin with, it doesn't matter.

So, again, growing income should be our primary objective here, in my opinion. And I think a flat low rate like they have in Estonia should actually be something that we try to achieve and we should

try to reduce some of the complexity in the tax system while reducing the penalty to work.

Mr. GRIFFIN. Is it fair to say that a lot of the reforms that you propose would depend upon that lower tax rate, it would not be to the Code as it currently is constituted?

Chairman CAMP. And if you could answer briefly.

Mr. CALABRIA. Yes or no, I think it is important to reduce leverage even if we don't reduce overall tax rates, but I do think reducing tax rates should be part of that.

Chairman CAMP. All right.

Mr. GRIFFIN. Thank you, Mr. Chairman.

Chairman CAMP. Mr. Renacci is recognized.

Mr. RENACCI. Thank you, Mr. Chairman. And I want to thank all the panel for being here today also.

You know, it is interesting. Of course, a lot of the questions have already been answered, but in my past life, before I got here, I was a CPA, and I remember sitting down with many people who walked in, some people just with a W–2, who said, help me do my tax return. So, again, I am going to repeat, as many of my colleagues have said, we need to make sure we have a simpler tax return so people can just file their tax return and not be concerned when they just have that W–2.

But it is interesting, when it comes to home ownership, I had many that would come in and say, I am buying a home, but they never really asked what the interest deduction would do for them, either. And the question I always asked them was, well, you know, you are going to buy a home, have you looked at whether the economic value of buying that home is worth it, if the interest deduction is even going to help you? Are you better off to rent? In today's day and age housing is not, you know, the old, I am going to buy a home and I will pay my mortgage down and housing prices are going to go up, I am going to have a nest egg at the end. I am not sure we are there today, when housing prices are not moving up as fast as they used to and at the same time the debt you are paying in some cases, because we already have the standard deduction of $6,500, is not even a deduction for you. So it is interesting how complicated the Tax Code can be. But what is more interesting is that many people, as I said, really don't even care about the interest.

My dad bought his first house, God love him, 30-plus years ago for $11,000 and probably never cared one bit about the interest deduction, and sold it 30 years later for $6,000. So it wasn't an economic advantage to him to have that house. But my friend's daughter is acquiring a house. She just got out of college. And she is not looking at—you know, I said to him, "Has she looked at the interest deduction?" And my friend said, "No, she doesn't care, she just wants to own a home."

So it gets back to something you said, Mr. Calabria, which is interesting to me. You said that, and you didn't finish, but the average after-tax return is less than 1 percent on home ownership. Could you explain that, go into more detail?

Mr. CALABRIA. Sure. Bob Shiller, a finance professor at Yale, has put together a price series from 1890 to today, you know, when you put inflation in there, and so his calculation is after inflation

on an annual basis, housing returns about 1 percent for the value of the house. Now, of course, the retort is that, well, it can be massively leveraged and therefore your return is on that leverage. But as we have learned repeatedly, this was not the first financial crisis we had, and sadly, I don't think it is going to be our last, that this massive leverage in the system repeatedly comes back and haunts you. Leverage maximizes gains, but it also maximizes losses.

So my point here throughout the testimony is not—I think home ownership is a great thing, I think it is a good thing. I think households being massively leveraged is not a good thing and I don't think we need—I think we can achieve high home ownership without massive leverage on the part of households.

Mr. RENACCI. Mr. Fleming.

Ms. GRAVELLE. Could I just make a comment about——

Mr. FLEMING. I will just say quickly, the idea of—and I think this is something that many forgot during the most recent crisis was you gain utility of shelter primarily from housing, not as a financial——

Ms. GRAVELLE. Absolutely. That is what I was going to say. That is the return.

Mr. FLEMING [continuing]. Not as a financial investment. And to your point, many people make the decision about their tenure choice of how to achieve that shelter not by looking at the financial model of user costs. I mean, if you ask them, well, what did you use, did you look at the user costs of renting versus buying, they give you a blank stare, right? So it is about your position with, are you getting married, are you having children, you know, all these household and demographic types of things that drive that decision, and in some cases on the margin, maybe the financial decision, maybe the financial decision of, oh, I can get that mortgage interest deduction and that helps me make on the margin that choice of becoming a first-time home buyer.

But honestly, first-time home buyers, their bigger constraint is the downpayment; not making the payment when they are in there, but getting access to a downpayment.

Mr. RENACCI. If there was an opportunity to build savings before you went into home ownership, and then use that savings to buy that home, that is something that we probably should look at, too.

Mr. FLEMING. Right. That is the challenge. And you see the first-time home buyer tax credit most recently clearly drew in a lot of demand. People were able to overcome that building of downpayment problem to get at buying a home.

Mr. RENACCI. Mr. Calabria, there was one other comment you made that I just want to understand. You said something about the renter, no tax for the—I am trying to figure that out.

Mr. CALABRIA. Yeah. I know imputed rent is not necessarily a straightforward concept. So if you think about it, you know, you rent a unit, you are paying rent, the landlord is paying tax on that rent. And so the economists tend to think, well, if you bought a unit, you are renting it from yourself, but you are not paying tax, and so that makes the choice between you becoming a renter less attractive if you were an owner. Because remember, all the mortgage interest, all the property tax stuff, that is expensible for the

landlord, too, so there is a quality there. And so the real impact, again, is, as I would suggest, if we stop taxing rent, we will level the playing field between renters and homeowners.

Mr. RENACCI. All right.

Chairman CAMP. Thank you.

Mr. RENACCI. Thank you.

Chairman CAMP. We have two people who are going to come question and then I am going to the second panel. So we will go to Mr. Blumenauer and then to Mr. Reed, and then we will go to the second panel.

Mr. BLUMENAUER. Thank you, Mr. Chairman. And I appreciate the way the two panels have been structured to, I think, walk us through the big picture. It is actually one of those rare times when the written testimony is actually better on both panels, and we really appreciate that.

I would like to just take a slight, it is not a digression, but take one aspect of this. I have spent a lot of time working with a number of the organizations that will be testifying dealing with trying to have a functional flood insurance program that adds stability to the market. We have also spent a lot of time working on disaster relief, prevention, recovery, which, because of what has happened with climate instability, these costs are skyrocketing for the Federal Government.

I am interested in any observations that you might have, and I would look for some from the other panelists later, to the extent to which we are using the tax system to subsidize people living in places where it has repeatedly been shown that nature may not want them. We have legislation that prohibits Federal investment dating back to the Reagan era, the Coastal Barriers Protection Act, where we don't put infrastructure there, yet we allow mortgage interest deductions for second homes in places that have been wiped out and we are spending money recovering.

Do you have any thoughts about whether, regardless of what we do with mortgage interest reduction and tax reform, we might do a deeper dive to limit the exposure to the taxpayer paying twice, once to subsidize people living in a place that they probably shouldn't be, and then repeatedly going back in, cleaning up, paying disaster payments, and then allowing continued subsidization of that development? Any thoughts?

Mr. CALABRIA. I will just mention, I will preface with, while staff on Senate Banking, I worked on all of our flood insurance issues and I actually headed our Katrina response for the Committee as well. And so I would certainly agree that we subsidize a number of policies that, in my opinion, do tremendous harm to the environment. For instance, I believe Fish and Wildlife Services have concluded that the flood insurance program has adversely impacted salmon runs. So there is a variety of negative impacts for subsidizing development in very sensitive areas, and I certainly think we should reconsider those subsidies.

And, of course, it is also important to keep in mind, you know, while climate has changed, to me it looks like the evidence suggests the biggest problem is less that the disasters have gotten worse, but that we have moved to the disasters in a very big way.

And, of course, I do think our subsidies have been a very big part of that.

Ms. GRAVELLE. If you are thinking about vacation homes on the coast and things like that, obviously one thing to consider would be to disallow some of these deductions for second homes. But aside from that, I mean, there is still, for wealthy people who are doing this, for high incomes, there is still the exclusion of imputed rent. Even if you don't have a mortgage interest deduction, if you don't have a mortgage, you still are not implicitly paying tax on that. And that is a trickier thing to try to attack.

The other thing is, again, I just know a little bit about the whole flood issue, but I think most economists would say the fundamental problem here is not a proper market pricing of flood insurance. So if you have something that floods and you know you can expect it all the time, then the insurance should reflect the price of that, and then you leave, you know, the benefits for extraordinary, unusual calamities.

Mr. SWAGEL. Right. I was just going to echo that. The flood insurance program has the unintended effect that you mentioned. And we see that in the State of Florida, which has almost driven private insurance out of the home sector.

Mr. BLUMENAUER. Mr. Chairman, just one subset, and I will yield back my time in a moment. But it just seems to me that one of the things that ought to be examined, if you are going to be subsidizing second homes, for instance, with a mortgage interest deduction, at a minimum, the reduction for people that are in extreme—and it is not just flood. I mean, we have places in the flame zone. One in four homes in the flame zone is a second or third or fourth home, where we are paying huge sums of money in the west to try to protect them and then we go in afterwards.

And I would think that this might be something that is worth looking at that wouldn't be wildly disruptive to a real estate market. It might actually help stabilize it, but it would prevent the taxpayers from paying two or three times in areas where the costs are going up exponentially.

Chairman CAMP. All right.

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

And I think we are done with our questions. So I want to thank this panel of witnesses for their testimony. The Committee greatly appreciates your testimony and your perspectives. And I also want to ask that if there are any questions that you want to submit in writing, we can add those to the formal hearing record. So, again, thank you for being here.

I would like to call our next panel of witnesses forward, please.

Mr. LEVIN. Mr. Chairman.

Chairman CAMP. Also, I would like to recognize Mr. Levin.

Mr. LEVIN. I would also like to thank the panel.

And as we are shifting here, there is a gentleman behind me, Mike Hauswirth, who has been a valuable member of our staff since February of 2011, and before that, he was on Joint Tax. Mike is going to be leaving us to undertake new adventures. And I would like all of us to join in thanking Mike for all of your service both on our tax staff, but also on Joint Tax.

Chairman CAMP. Thank you. And if our second panel could come forward, please. I appreciate your patience this morning. I know many of you were in the room during all of the first panel.

Now I would like to welcome our second panel, I know all of whom bring important perspectives on the residential real estate industry with them.

And, again, thank you for your patience. I saw you sitting in the room during all the morning testimony.

First, I would like to welcome Gary Thomas, President of the National Association of Realtors. Mr. Thomas has worked in realty for over 35 years.

Second, we will hear from Robert Dietz, Assistant Vice President for Tax and Policy Issues at the National Association of Home Builders. Mr. Dietz formerly served as a revenue-estimating economist for housing issues at the Joint Committee on Taxation.

Third, we will hear from Thomas Moran, Chairman and Managing Partner of Moran & Company in Chicago, Illinois, also appearing on behalf of the National Multi Housing Council and the National Apartment Association. Mr. Moran has specialized in private housing development for over four decades.

Finally, we will hear from Robert Moss, a Senior Vice President at Boston Capital in Boston, Massachusetts, also appearing on behalf of the Housing Advisory Group in Boston. Mr. Moss serves on the boards of at least five housing associations.

Again, thank you all for being with us today. The Committee has received each of your written statements and they are part of the formal hearing record. Each of you will be recognized for 5 minutes for oral remarks.

And, Mr. Thomas, we will begin with you. Welcome. And you are recognized for 5 minutes.

STATEMENT OF GARY THOMAS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. THOMAS. Thank you. Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for this opportunity to testify on behalf of the 1 million members of the National Association of Realtors, who practice in all areas of residential and commercial real estate.

My name is Gary Thomas and I serve as the 2013 President of the National Association of Realtors. And I, like most Americans, agree that a major goal of tax reform should be simplification. But simplification does not necessarily equal elimination. The Code currently contains simple, easy-to-understand housing-related tax provisions, enjoyed by millions of Americans, that have helped facilitate home ownership, build wealth, and provide stability to families and communities.

In case there is any doubt, Realtors support maintaining current law for residential real estate tax provisions. Specifically, we urge you to maintain the current deduction for home mortgage interest, the deduction for real property taxes paid, and the capital gains exclusion for proceeds from the sale of a principal residence.

My written testimony details these and other provisions, but I would like to focus on the mortgage interest deduction. Let me first clarify who benefits from the MID. In 2010, 37 million tax filers

claimed the mortgage interest deduction. Of those filers, 63 percent earned less than $100,000 and 91 percent earned less than $200,000. Roughly half of those claiming the MID were under the age of 45. Many of these filers also claimed dependents or credits for children. Moreover, homeowners pay between 80 and 90 percent of all Federal income tax.

If you want to know the majority beneficiary of the MID, the answer is not the rich; rather, it is young middle-class families with children who already carry more than their fair share of the tax burden. If Congress were to eliminate the mortgage interest deduction, it could mean an average tax increase of over $2,500 per family.

Realtors realize that most believe Congress would not attempt to completely eliminate the MID. We hope they are right. However, there have been several proposals to change the deduction or eliminate it for certain taxpayers. Let me briefly respond to three of the most frequently mentioned proposals.

One proposal would eliminate the deduction for second homes. While critics portray second homeowners as millionaires with mansions by the ocean, this ignores the facts. NAR research shows that the median income of a second-home buyer last year was $92,000 and the home they purchased cost $150,000. NAR research further shows that second-home sales make up 10 percent of all home sales each year. And all but one State has at least one county where 10 percent or more of their real estate market is composed of second homes. The economic impact second homes have on these communities should not be ignored, either.

Another proposal is to cut the amount of eligible mortgage debt that can be deducted in half. While $500,000 might buy the most expensive house in some of your districts, in my own market, in Southern California, it might buy a starter home. Homeowners in high-cost markets already pay a higher percentage of their income for housing than those in less expensive parts of the country. This proposal would make home ownership even more expensive in markets where affordability is already a problem.

Finally, we have heard proposals to change the deduction to a tax credit. While this discussion of credits versus deductions may make for great debate, the bottom line for current homeowners is this: If you are in a tax bracket higher than the credit amount, a credit will cause your taxes to go up and the value of your home to go down.

Housing has helped lead us out of four of the last six recessions, and it appears to be doing so again. Americans are regaining confidence in real estate. Demand is increasing, and so are home prices. The greatest hurdle to full recovery in housing is uncertainty here in Washington.

The mortgage interest deduction, along with other tax provisions, makes sustainable home ownership more affordable for millions of middle-class families who are the backbone of America. Congress must remember this as it pursues tax reform, and first, do no harm. I look forward to answering your questions. Thank you very much.

[The prepared statement of Mr. Thomas follows:]

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TESTIMONY OF

GARY THOMAS
2013 PRESIDENT
NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

HEARING TITLED

TAX REFORM AND RESIDENTIAL REAL ESTATE

APRIL 25, 2013

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Introduction

Chairman Camp, Ranking Member Levin, and members of the Committee; my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of REALTORS® (NAR).

I am here to testify on behalf of the 1 million members of the National Association of REALTORS®. NAR's members are real estate professionals engaged in activities including real estate sales and brokerage, property management, residential and commercial leasing and appraisal. The business model of REALTORS® is a highly personal, hands-on, face-to-face model, focused on a family's fundamental needs for shelter. NAR has long prided itself as a voice for not only its members, but for America's 75 million homeowners, as well as the millions of Americans who aspire to one day own their own home.

We thank you for the opportunity to present our views on how tax reform could affect residential real estate. Residential real estate is touched by a number of highly popular tax provisions that are utilized by millions of Americans. As it pursues tax reform, Congress must have a full understanding of the impact these provisions have on residential real estate markets, as well as American taxpayers.

NAR Principles for Tax Reform

If one were designing a tax system for the first time, one might come up with something that is remarkably different from what we have today. But we're not starting from scratch, particularly in the context of housing. Some provisions in the tax code, such as the deductions for mortgage interest and state and local taxes paid, have been part of the federal tax code since the income tax was introduced 100 years ago. Thus, the values of such tax benefits are both directly and indirectly embedded in the price of a home. While economists agree that there is no accurate measure of the value of those embedded tax benefits, they all generally agree that the value of a particular home includes tax benefits.

Real estate is the most widely-held category of assets that American families own, and for many Americans, the largest portion of their family's net worth, despite the price declines of the Great Recession. Therefore, while NAR agrees that reform and revision to different portions of the individual tax code may be warranted, we remain committed to preserving the current law incentives for homeownership and real estate investment.

NAR believes that individual tax rates should be as low as possible while still providing for a balanced fiscal policy. NAR further believes that there should be a meaningful differential between the rates paid on ordinary income and capital gains on investments. However, NAR does not endorse a particular rate, nor does it believe that long established provisions in the code should be changed or eliminated solely to lower marginal rates. When Congress last undertook major tax reform in 1986, it eliminated a large swath of tax provisions, including major real estate provisions, in order to lower rates, only to increase those rates just five years later in 1991. Most of the eliminated tax provisions never returned and in the case of real estate, a major recession followed. Congress must be mindful that eliminating widely-used and simple tax provisions can have harsh and dangerous unintended consequences, particularly if the sole purpose of eliminating non-abusive provisions is to obtain a particular marginal tax rate. NAR also notes that American homeowners

now pay between 80 and 90 percent of all federal income taxes. Congress should avoid further raising taxes on homeowners in a quest for additional revenue while federal spending is at record highs. Congress must first look to reduce spending in order to get our nation's fiscal house in order.

Homeownership and American Culture

Policymakers should not dismiss or underestimate Americans' passion for homeownership, notwithstanding the most recent economic crisis. Calling homeownership the "American Dream" is not a mere slogan, but rather a bedrock value. Owning a piece of property has been central to American values since Plymouth and Jamestown. Homes are the foundation of our culture, the place where families eat and learn together, the basis for community life. The cottage with a picket fence is an iconic part of our heritage.

Research has consistently shown the importance of the housing sector to the economy and the long-term social and financial benefits to individual homeowners. The economic benefits of the housing market and homeownership are immense and well documented. The housing sector directly accounted for approximately 15 percent of total economic activity in 2012. Household real estate holdings totaled $17.7 trillion in the last quarter of 2012. After subtracting mortgage liabilities, net real estate household equity totaled $8.2 trillion.

In addition to tangible financial benefits, homeownership brings substantial social benefits for families, communities, and the country as a whole. These benefits include increased education achievement and civic participation, better physical and mental health, and lower crime rates.

The tax system does not "cause" homeownership. People buy homes to satisfy many social, family and personal goals. The tax system *facilitates* ownership. The tax system supports homeownership by making it more affordable. While it is true that only about one-third of taxpayers itemize deductions in any particular year, it is also true that, over time, substantially more than one third of taxpayers receive the direct benefit of the mortgage interest deduction. Over time, mortgages get paid off, other new homeowners enter the market and family tax circumstances change. Individuals who utilize the mortgage interest deduction (MID) in the years right after a home purchase are, over time, likely to switch to the standard deduction.

Arguably, the standard deduction gives non-itemizing taxpayers a "better" deal than utilizing the mortgage interest deduction, so it is not clear that non-itemizers are put at a disadvantage. Indeed, in *proportional* terms, the standard deduction can be characterized as a *deeper* subsidy than itemizing taxpayers receive because the standard deduction ($12,200 for married couples filing jointly in 2013) likely represents an amount that is significantly larger than the couple's total itemized deductions. In essence, the standard deduction, for many, is "free" money.

When academics talk about the MID and refer to it as an expenditure, they are speaking in the language of macroeconomics. In reality, the billions of tax dollars they see as an expenditure are the individual savings of millions of families. Every time homeowners make a mortgage payment, even in today's market, they are generally creating non-cash wealth. Many of our seasoned REALTORS® describe their satisfaction in helping a family secure its first house and then a larger home(s) for raising families. The most satisfying of a long-term series of transactions is helping a couple buy its last house *without a mortgage*. Those couples are able to make this "last" purchase because ownership

over a long term of years has resulted in savings sufficient to meet their needs.

The federal policy choice to support homeownership has been in the Internal Revenue Code since its inception. We see no valid reason to undermine that basic decision. Indeed, we believe that the only *viable* tax system is one that would continue to nurture homeownership.

Current State of the Housing Market

In 2012, the Census Bureau estimated that there were nearly 133 million housing units in the United States. The vast majority of these housing units—nearly 115 million—were occupied by households while the remaining 18 million were vacant for a variety of reasons[1]. Since 1965, the homeownership rate has fluctuated between 63 and 69 percent, and in 2012 was 65 percent. That translates to 75 million owner-occupied households and roughly 40 million renter households.

In any given year, a good number of households are in transition. In 2012, 4.66 million existing homes and an additional 370,000 new homes were sold for a total of 5 million properties for which ownership transitioned. While all homeowners interact with the tax code, the transition of ownership leads to additional tax interactions. Measured by sales activity, the housing market has recovered substantially but not fully since the housing and economic crisis. Total sales in 2012 for new and existing properties exceeded 5 million whereas from 1999 to 2008 existing home sales alone exceeded 5 million every year, in spite of the fact that there were 5 to 10 million fewer households. In addition to additional tax considerations as a result of a transition of ownership, research shows that additional economic activity is generated, making a healthy housing market a foundation of economic health. For example, the Harvard Joint Center for Housing Studies reports that 60 percent of owner-occupant purchasers made improvements averaging $11,100, and investor purchasers spent more per unit on average[2].

Homeownership is often referred to as the American Dream, and the realization of this dream takes some time. A strong correlation between the homeownership rate and age of the household head is the result—the older the head of household, the more likely the household is to own a home. Further, the median or typical age of a first-time home buyer in the US was 31 in 2012 and has ranged between 30 and 32 for the last decade[3]. Because homeownership delivers current consumption value—it provides shelter—and investment value, roughly 90 percent of home buyers finance their home purchase, and younger buyers are more likely to finance the home purchase. These trends are long-standing and were little-affected by the recession.

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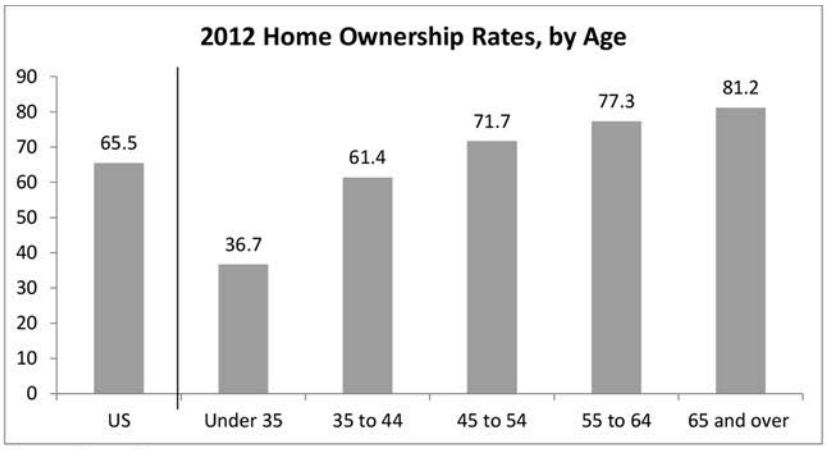
[1] Roughly a third of these vacant properties are in some form of transition or being marketed for transition and a quarter are seasonal properties not intended for year-round occupancy. Census Bureau, 2012 Housing Vacancy Survey

[2] Harvard Joint Center for Housing Studies. *The US Housing Stock: Ready for Renewal.* January 23, 2013. http://www.jchs.harvard.edu/research/publications/us-housing-stock-ready-renewal

[3] National Association of Realtors. *Profile of Home Buyers and Sellers,* various years.



Source: Census Bureau

Residential Real Estate Tax Provisions

There are a number of tax provisions that affect residential real estate in one form or another. These range from relatively small temporary provisions to major provisions of the tax code utilized by millions of taxpayers. While NAR generally supports tax provisions that encourage sustainable homeownership and that incentivize investment and improvement of real estate, we will focus here on the most prominent and widely used provisions for individual homeowners.

The Mortgage Interest Deduction

The deduction for mortgage interest paid has been part of the federal income tax code since its inception in 1913. Despite a century of additions, modifications, deletions, and overhauls of the tax code, Congress has left the mortgage interest deduction in place. Current law allows a homeowner to deduct the interest on up to $1 million in total acquisition debt for a principal residence and a second, non-rental, home. Homeowners are also allowed to deduct the interest on up to $100,000 in home equity debt.

Prior to 1986 there was no limit on the amount of home mortgage interest that could be deducted. The Tax Reform Act of 1986 imposed the first limitation on the MID, allowing it for allocable debt used to purchase, construct or improve a designated primary residence and one additional residence (Second home).

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 half since 1987; in 2013 dollars, the original cap would be equal to just over $2 million today had it been indexed.

Who Benefits from the Mortgage Interest Deduction?

The mortgage interest deduction (MID) is often criticized on two fronts – that it favors wealthier taxpayers at the expense of those with more modest incomes, and that it benefits only those relatively few taxpayers who are eligible to itemize their deductions. Since taxpayers who itemize are often those with higher incomes, these criticisms are related.

In 2010, the tax year for which the most complete data are available, 36.7 million tax filers claimed a deduction for mortgage interest. There are many ways to frame this number in context, and the conclusions drawn about the importance of the mortgage interest deduction (MID) are strongly affected.

Tax filers claiming the MID account for only 25 percent of the total number of tax returns filed; however, returns claiming the MID represent roughly half of owner-occupied households and roughly three-quarters of home-owners whose homes are mortgaged[4]. How can these statements all be true? When examining the question of who benefits from the mortgage interest deduction, it is helpful to keep in mind that households are not the same thing as tax-units and multiple tax filers can and do come from the same household. In 2011, for example, there were roughly 114 million households and 145.6 million individual income tax returns or more than 30 million tax returns filed by those in a household with another tax filer[5]. Further, the MID would only apply directly to the tax situations of the 75 million home owners and more specifically to the roughly 50 million homeowners nationally who have a mortgage or other debt on their residence. The tables below detail these shares by state which vary due to state differences in homeownership rates, incidence of mortgage debt, and the incidence of other itemized deductions. In some states, more than 90 percent of the target population of homeowners with a mortgage claims the MID.

By income, we see that the MID is valuable to households across the spectrum. Sixty-three percent of those claiming the MID in 2010 earned less than $100,000 and 91 percent earned less than $200,000 in Adjusted Gross Income (AGI)[6]. Breaking down the benefits of the MID by age, we see further evidence of the lifetime it takes to achieve the American Dream. Roughly half of those claiming the MID and half of the amount claimed went to households under the age of 45[7].

Some claim that since the economic downturn has reduced interest rates, we should look at data from the economically stronger years preceding the recession. Fair enough. A look at 2007 indicates a very similar finding. Eighty-two percent of the value of the MID in 2007 went to those making under $200,000, and this group represented 91 percent of all tax filers that year.

Furthermore, it is important to realize that MID utilization data offer just a snapshot in time. Over the course of an owner's tenure in a home, an individual may itemize in the early years of

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[4] National Association of REALTORS® Calculations of IRS and Census Bureau data.

[5] Taking households that do not file taxes into account would push this number up while taking into account taxes filed for those who are deceased would decrease this figure. Filing for the economic stimulus boosted the number of returns filed in 2007 vs 2006 or 2008 by roughly 15 million while roughly 2.5 million individuals passed away in 2011.

[6] National Association of REALTORS® calculations of IRS data.

[7] Jeff Curry and Jonathan Dent, "Individual Income Tax Returns, by Age of Primary Taxpayer, Tax Years 1997 and 2007," Statistics of Income (SOI) Bulletin, Spring 2011.

homeownership, when the interest expense is high relative to the principal paid, but then not itemize in later years. Mortgages get paid off, other non-MID deductions rise and fall, individuals down-size, divorces occur, a spouse dies or needs to simplify living arrangements. These and other life events may convert itemizers into standard deduction taxpayers. Thus, in any given year, we may not see the full contingent of homeowners who use the MID.

Taking a longer view shows the real picture. Of the nearly 76 million homeowners in 2007, 62 percent had a mortgage on their home. However, about 85 percent of homeowners took out a mortgage when they purchased the home. Of course, many taxpayers eventually pay off their mortgages. Only a fourth of homeowners with heads of household age 65 and over have a mortgage. Of households that still had one in 2007, almost 90 percent claimed the MID. NAR estimates that over 70 percent of homeowners will utilize the MID over their lifetimes, regardless of whether they own or rent a home in a particular year. This greatly exceeds the 37 percent of households that claimed the MID in 2007.

Mortgage Interest Deduction Claimers as a Share of Various Target Groups

	MID Claimers as a Share of		
	Tax Filers	Home Owners	Mortgaged Home Owners
UNITED STATES	25.5%	49.0%	72.9%
ALABAMA	22.4%	37.0%	60.8%
ALASKA	21.7%	49.9%	72.1%
ARIZONA	28.0%	50.1%	71.6%
ARKANSAS	18.8%	30.6%	53.0%
CALIFORNIA	27.4%	66.1%	88.1%
COLORADO	32.8%	60.1%	79.7%
CONNECTICUT	34.3%	64.1%	89.7%
DELAWARE	30.6%	54.6%	76.7%
DISTRICT OF COLUMBIA	25.3%	76.1%	98.7%
FLORIDA	19.4%	39.0%	61.1%
GEORGIA	27.2%	54.2%	76.2%
HAWAII	23.3%	59.0%	87.1%
IDAHO	27.4%	45.2%	65.8%
ILLINOIS	27.5%	51.6%	74.7%
INDIANA	22.8%	39.1%	55.8%
IOWA	24.4%	38.6%	61.8%
KANSAS	24.1%	42.0%	65.6%
KENTUCKY	23.9%	38.4%	61.8%
LOUISIANA	17.8%	31.0%	55.5%
MAINE	25.7%	40.5%	62.2%
MARYLAND	36.8%	71.9%	94.0%
MASSACHUSETTS	31.4%	64.2%	88.9%
MICHIGAN	26.0%	43.3%	65.6%
MINNESOTA	32.7%	54.9%	77.9%
MISSISSIPPI	17.2%	29.3%	53.6%
MISSOURI	24.9%	41.3%	62.7%
MONTANA	23.4%	39.7%	67.2%
NEBRASKA	23.8%	41.9%	65.7%
NEVADA	24.6%	55.0%	72.3%
NEW HAMPSHIRE	30.3%	54.5%	78.3%
NEW JERSEY	32.1%	65.4%	92.0%
NEW MEXICO	21.0%	36.8%	60.5%
NEW YORK	23.0%	54.7%	84.2%
NORTH CAROLINA	28.2%	48.0%	71.5%
NORTH DAKOTA	15.0%	26.5%	49.6%
OHIO	25.6%	45.0%	66.2%
OKLAHOMA	20.1%	33.0%	54.7%
OREGON	31.4%	58.1%	83.1%
PENNSYLVANIA	24.8%	43.9%	70.0%
RHODE ISLAND	29.7%	61.9%	84.8%
SOUTH CAROLINA	24.8%	42.0%	66.8%
SOUTH DAKOTA	15.5%	28.2%	48.2%
TENNESSEE	19.5%	33.4%	53.2%
TEXAS	19.9%	39.3%	62.8%
UTAH	32.6%	60.1%	80.9%
VERMONT	24.4%	42.9%	64.0%
VIRGINIA	33.2%	61.1%	84.9%
WASHINGTON	30.2%	58.2%	80.3%
WEST VIRGINIA	15.0%	21.2%	42.7%
WISCONSIN	29.3%	51.3%	75.5%
WYOMING	20.2%	36.0%	59.8%

The Enigma of the Standard Deduction

While it is true that a taxpayer must itemize in order to claim the mortgage interest deduction, it is not true that those who do not itemize get no value from the MID. In order to appreciate this conundrum, one must look at the history of our modern tax system. In 1913, Congress and the President enacted the income tax. The original tax law provided for both a deduction for interest paid and for state and local taxes paid (including property taxes). These two deductions, plus the deduction for charitable contributions, which was added to the tax law in 1917, together comprise the great majority of itemized deductions that are claimed each year.

For many years, the tax law provided that taxpayers who paid interest, state and local taxes, and/or made charitable contributions could take a deduction for them. A few other deductions, such as for casualty and theft losses or for medical expenses, were also allowed. However, in order to qualify for these deductions, taxpayers actually had to incur these expenses and keep track of them.

This changed in 1944, when Congress decided to simplify the tax law by providing for the standard deduction. Legislative history (both original and subsequent) shows that the standard deduction was based on a composite basket of typical deductions that taxpayers claimed, including the MID, taxes paid, charitable contributions made, and so forth. The simplification came about by Congress deeming that all individuals were to receive a certain amount of generic deductions, represented by the standard deduction. Taxpayers claiming the standard deduction did not need to prove that any amounts were actually paid in order to take the standard deduction. Congress simply designated that all taxpayers could claim the standard deduction whether they made the deductible expenditures or not.

In enacting the standard deduction, Congress did not modify the deductions themselves. Rather, taxpayers who paid deductible expenditures in excess of the standard deduction were allowed to claim the actual amounts as what was (from then on) called itemized deductions. Taxpayers with deductions totaling an amount below the standard deduction threshold could simply claim the standard amount and not worry about even keeping track of what was actually paid. This represented a huge step toward simplifying the lives of millions of American taxpayers.

What is often not recognized today is that the standard deduction represents a tax giveaway for virtually all taxpayers who claim it. This is because if a taxpayer has deductions in excess of the standard deduction, he or she may claim the higher amount. But those who have actual deductions less than the standard are given the benefit of the standard deduction amount whether or not they actually incurred the expenses. Thus, the giveaway equals a range of as much as the standard deduction for taxpayers who have absolutely no deductions on the high end, to as little as $1 for taxpayers whose actual deductions come just $1 short of the standard deduction amount on the low end.

For example, assume a married couple's actual expenses for state and local tax, mortgage interest, and charitable contributions for 2013 total $12,000. With the standard deduction for a couple currently at $12,200, this family would be receiving an extra tax deduction for $200 in expenditures they never made. If they were in the 28 percent bracket, this would amount to a $56 tax "freebie" ($200 excess x 28%). Suppose another couple had just $2,000 of state and local taxes, but no mortgage interest and no charitable contributions. This family would also get to take the standard

deduction of $12,200, for a subsidy of $10,200 ($12,200-$2,000), which would be worth $2,856 in tax savings, assuming they were also in the 28 percent tax bracket ($10,200 x 28%).

The point is that whether a taxpayer is being subsidized a little bit (as with the first couple), or a lot (as with the second couple), or not at all (as with the case of a couple who has enough deductions to itemize), each couple is benefitting from the mortgage interest deduction. Just because the standard deduction does not specifically indicate which portion of it is attributable to the mortgage interest deduction (or any other deduction), does not mean that the MID is not part of the benefit being given.

When Congress first established the standard deduction in 1944, more than 82 percent of taxpayers were able to utilize this simplification tool, meaning that just 18 percent itemized. According to the Joint Committee on Taxation (JCT), by 1969 this proportion had dropped to 58 percent. In explaining the reason for Congress increasing the standard deduction in the Tax Reform Act of 1969, JCT stated that since 1944, "higher medical costs, higher interest rates, higher State and local taxes, increased homeownership, and more expensive homes have made it advantageous for more and more taxpayers to shift over to itemized deductions."

Thus, it is clear that even though no specific portion of the standard deduction is tied to the MID, Congress crafted the standard deduction to be a proxy for allowable deductions (i.e., itemized deductions), including the MID, and when the underlying amount of these deductions increase, Congress has believed that it is appropriate for the standard deduction to also increase. It is also clear that Congress intended that very few people would have to itemize (18 percent in 1944) and when this proportion was eroded by inflation and other factors, Congress increased the standard deduction to keep it closer to its original percentage.

Arguments that the mortgage interest deduction benefits only those who itemize simply do not hold water.

The Real Property Tax Deduction

The income tax system of the United States has provided a deduction for state and local taxes, including property taxes, since its inception. To do otherwise would violate two fundamental and widely accepted principles of good tax policy – the avoidance of double taxation and the need to recognize the taxpayer's ability to pay.

Taxes paid at the state and local levels to benefit the general public are in nature and purpose similar to the federal income tax in that they both fund essential government services. Therefore, allowing a deduction for these state and local taxes for federal income tax purposes is essential to avoiding double taxation on the same income (i.e. a tax on a tax). Our federal tax law follows this same principle in connection with the payment of taxes to other nations. In the case of foreign taxes, however, the law goes even further and provides taxpayers with a choice of claiming a deduction for foreign taxes paid, or taking a credit, which is a dollar-for-dollar reduction in tax owed.

While state and local taxes vary greatly, two aspects that do not change are that they are ubiquitous throughout the nation, in one form or another, and they are largely involuntary. It is true that we can exercise some degree of choice over how much we pay in state and local taxes by deciding

where we live and what we buy. However, avoiding these levies altogether is not a practical option. Obviously, paying taxes to state and local governments leaves taxpayers without the income used to pay the taxes. The extraction of state and local taxes is tantamount to the money never being earned by the taxpayer in the first place. Our tax system recognizes this fact by providing a deduction for the payment of these taxes.

Eliminating the deduction for state and local taxes would fly in the face of these fundamental tax policy principles that have been ingrained in our income tax law from its beginnings.

Along with other state and local taxes, the Internal Revenue Code has provided a deduction for real property taxes paid since its enactment in 1913. To be deductible, a real property tax must be levied for the general public welfare. Thus, taxes paid for local improvements such as sidewalks and similar betterments that directly benefit the property are not deductible.

For homeowners, real property taxes represent an unending obligation, at least as long as they own their homes. The other major deduction for most homeowners, the mortgage interest deduction, does not continue if or when the mortgage is paid off, and it usually diminishes as the mortgage principal is being paid down. Property taxes, on the other hand, often increase over the years, as assessments on property increase and as local governments increase their levy rates. For these reasons, the deduction for real estate property taxes is often the one most-claimed by homeowners. In fact, more taxpayers claim the real property tax deduction than claim the deduction for mortgage interest. In 2010, for example, 41.1 million wrote off real property taxes while 36.7 million deducted mortgage interest.

As with the mortgage interest deduction, critics sometimes claim that the deduction for property taxes is misguided because it gives the lion's share of its benefit to the wealthy and little to the rest of us. However, this is just not the case.

Much of this criticism is centered on the fact that taxpayers must itemize in order to take the deduction. As discussed above (please see The Enigma of the Standard Deduction), taxpayers who claim the standard deduction also benefit from the property tax deduction.

Further, because real property taxes are assessed based on property values, one would expect the deduction to be much more utilized at higher incomes. Moreover, most local governments grant real property tax relief to lower-income taxpayers.

Surprisingly, however, 75 percent of the value of real property tax deductions in 2012 went to taxpayers with incomes of less than $200,000, according to an estimate prepared by the staff of the Joint Committee on Taxation. The typical real estate tax deduction beneficiary has an adjusted gross income slightly less than $81,000.

In addition, the tax law already includes a provision designed to limit the tax benefit of the real property tax deduction to the "wealthy." Specifically, the deduction is disallowed for purposes of the alternative minimum tax.

Estimated Tax Savings by State from Mortgage Interest and Property Tax Deductions at a 25% Marginal Rate

	Average MID Claim	Estimated Tax Savings	Average Real Estate Tax Claim	Estimated Tax Savings
UNITED STATES	10,640	2,660	4,232	1,058
ALABAMA	8,610	2,153	1,286	321
ALASKA	11,120	2,780	3,943	986
ARIZONA	11,282	2,820	2,458	615
ARKANSAS	7,764	1,941	1,589	397
CALIFORNIA	15,755	3,939	4,788	1,197
COLORADO	11,746	2,936	2,404	601
CONNECTICUT	10,970	2,742	6,707	1,677
DELAWARE	10,811	2,703	2,266	567
DISTRICT OF COLUMBIA	14,976	3,744	3,853	963
FLORIDA	11,163	2,791	4,202	1,051
GEORGIA	9,590	2,398	2,931	733
HAWAII	14,955	3,739	1,920	480
IDAHO	9,461	2,365	2,017	504
ILLINOIS	9,969	2,492	5,909	1,477
INDIANA	7,757	1,939	2,043	511
IOWA	7,177	1,794	2,814	704
KANSAS	7,846	1,961	3,053	763
KENTUCKY	7,553	1,888	2,005	501
LOUISIANA	9,009	2,252	1,812	453
MAINE	8,297	2,074	3,580	895
MARYLAND	12,448	3,112	4,141	1,035
MASSACHUSETTS	11,366	2,842	5,116	1,279
MICHIGAN	8,324	2,081	3,567	892
MINNESOTA	9,757	2,439	3,251	813
MISSISSIPPI	7,649	1,912	1,756	439
MISSOURI	8,332	2,083	2,627	657
MONTANA	8,973	2,243	2,416	604
NEBRASKA	7,479	1,870	3,635	909
NEVADA	12,192	3,048	2,828	707
NEW HAMPSHIRE	10,206	2,551	6,329	1,582
NEW JERSEY	11,411	2,853	8,944	2,236
NEW MEXICO	9,858	2,465	2,239	560
NEW YORK	10,639	2,660	7,346	1,836
NORTH CAROLINA	9,050	2,262	2,493	623
NORTH DAKOTA	7,920	1,980	3,241	810
OHIO	7,551	1,888	3,488	872
OKLAHOMA	7,645	1,911	2,119	530
OREGON	10,533	2,633	3,382	846
PENNSYLVANIA	8,835	2,209	4,434	1,108
RHODE ISLAND	9,626	2,407	4,851	1,213
SOUTH CAROLINA	9,021	2,255	1,815	454
SOUTH DAKOTA	8,580	2,145	3,230	807
TENNESSEE	9,419	2,355	2,371	593
TEXAS	9,109	2,277	5,199	1,300
UTAH	10,204	2,551	2,085	521
VERMONT	8,502	2,125	4,980	1,245
VIRGINIA	12,591	3,148	3,524	881
WASHINGTON	12,615	3,154	3,865	966
WEST VIRGINIA	8,132	2,033	1,458	364
WISCONSIN	7,793	1,948	4,406	1,101
WYOMING	10,392	2,598	2,242	560

NAR calculations based on IRS Data

Proposals to Eliminate or Modify Itemized Deductions

Over the past several years different plans have emerged proposing the reduction, modification, or complete elimination of itemized deductions. Each of these proposals would limit the value of the deduction and/or have a negative impact on the value of housing. In many cases, the largest impact would be felt by middle-class families, not necessarily by the individuals or families categorized by the media as "the rich." The following is an examination of each of these proposals.

Capping Itemized Deductions

Two proposals have repeatedly been floated to cap the value of all itemized deductions. The first is a proposal made each year in President Obama's budget to cap itemized deductions for upper-income taxpayers at 28 percent. As itemized deductions follow taxpayers' top marginal rate, this would have the effect of lessening the value of all itemized deductions for individuals in the 33 percent, 35 percent and 39.6 percent brackets. It is important to note that many of these taxpayers have already had the value of their deductions limited by the reinstatement of the complex and burdensome "Pease" limitation that now applies to individuals with adjusted gross income above $250,000 ($300,000 for couples) as part of the American Taxpayer Relief Act of 2012.

The 28 percent cap focuses on the tax filer's income, rather than the total dollar amount of itemized deductions. This proposal adds, rather than removes, complexity from the tax code and would be hard to plan for. An individual, particularly one who owns a business or who is self-employed, may be in different tax brackets from year to year. These individuals have a particularly difficult time estimating their incomes and tax liability, particularly in today's uncertain economic and legislative climate. They do not need added burdens of complexity or unanticipated tax increases. A reduction in the mortgage interest deduction (MID) would further complicate their family finances.

Some will say that putting a limitation on the deductions of upper income taxpayers would cause no harm for those in lower brackets. However, when reduced tax benefits reduce the value of a home, the value of all homes decreases. A collapse or reduction in home values at the top end of the market causes downward pressure on all other homes. That is, when the value of my neighbor's house declines, then the value of my house declines, as well.

The second proposal to cap itemized deductions comes in the form of a hard dollar cap on all itemized deductions. Most prominently proposed by Republican nominee Mitt Romney during the 2012 Presidential election, a dollar cap would disallow deductions above a certain dollar figure regardless of income.

As the cap is not based on income, but rather the amount of deductions claimed, this proposal would potentially raise taxes on Americans of all income levels regardless of where the dollar amount of the cap was set. For example, if the cap on total deductions were set at $25,000, households with cash incomes as low as $30,000 would be impacted, according to the Tax Policy Center (TPC). TPC further estimates that 35 percent of households with cash incomes between $100,000 and $200,000 would see a tax increase averaging almost $2,500 if itemized deductions were capped at $25,000.

Not only does a dollar cap affect taxpayers of all income levels, it also penalizes those who live in areas with higher housing costs or higher state and local taxes. Taxpayers living in these areas have somewhat "fixed" deduction costs when it comes to their mortgage and tax levels. Their property tax levels are directly tied to the value of their property and the local tax rate. While, in theory, they can pay down their mortgage amount and reduce their interest paid if they have the financial ability to do so, neither the mortgage nor the tax amount paid are discretionary, as is a charitable donation. Therefore, while it is widely viewed that charities would take the biggest hit from a dollar cap on total itemized deductions, one could argue the biggest losers would be younger families living in high cost housing markets who have both larger mortgage interest payments and high state and local tax bills. Their tax increase would be the most pronounced and painful, despite the idea that a dollar deduction cap is designed to simply make "the rich" pay their fair share.

If a dollar cap were implemented on itemized deductions, no matter the dollar amount, more and more taxpayers would be subject to it if Congress failed to index that amount for inflation. This would create the same kind of tax nightmare that came about as a result of the Alternative Minimum Tax, as more and more middle class taxpayers became subject to the cap as home values and taxes paid rose, simply because of inflation. After spending years trying to exempt most middle class taxpayers from the AMT, it would seem odd Congress would choose to proactively introduce another one. A dollar cap further ads one more layer of complexity to the tax code and seems a rather blunt instrument to raise revenue.

Converting the Mortgage Interest Deduction to a Tax Credit

Many economists have traditionally favored tax credits over tax deductions because tax credits provide more benefit to those in lower tax brackets. This ignores the reality that, in a progressive tax system like ours, an individual in the 15 percent bracket receives only 15 cents of tax reduction for each dollar of interest deducted, while an individual in the 35 percent bracket receives a tax benefit of 35 cents on the dollar. The mathematics of this assertion are correct, but asymmetrical: The tax benefit analysis of a deduction ignores the balance between tax rates and individual income taxation. An individual in the 15 percent bracket pays only 15 cents of tax on the dollar, while an individual in the 35 percent bracket pays tax of 35 cents on the dollar. Thus, tax rates balance, rather than distort, the value of deductions.

In 2005, President Bush's tax reform advisory council proposed converting the deduction to a 15 percent non-refundable tax credit. The Simpson-Bowles Commission proposed a 12 percent non-refundable tax credit along with its proposals to eliminate the deduction for second homes and cap the total amount of eligible mortgage debt at $500,000. Others have proposed credits of different amounts and with different limitations on the total amount of mortgage debt that could be claimed or the number of homes. In order to more carefully weigh the pros and cons of converting the deduction to a credit, NAR commissioned outside research in 2005 to study the effects of such a conversion.

While the conclusions are now somewhat dated, they present a striking contrast with the 12 percent or even 15 percent credit proposals. In 2005, NAR asked its consultants to design a revenue-neutral tax credit based on data then currently available. (Revenue-neutral was intended as a design under which the total amount of the tax expenditure associated with mortgage interest was neither increased nor decreased.) That analysis showed that in 2005, a revenue-neutral rate for a credit

would have been 22 percent – markedly more beneficial to taxpayers than a 12 percent or 15 percent credit.

The amount of the credit percentage would greatly affect the amount of winners and losers in any conversion. However, different studies have consistently shown that the tax increases for the losers would be far greater than the tax savings experienced by the winners. Furthermore, a conversion to a credit would upend 100 years of established tax law. The effects that drastic of a change would have on consumers and the real estate markets are unknowable. In this case, we think Congress would be well advised to adopt the mantra of "do no harm."

Eliminating the Deduction for Second Homes

Several recent proposals for tax reform, including Bowles-Simpson, have included a proposal to eliminate the deduction for second homes. Critics of the second home deduction argue that it primarily benefits rich owners of expensive vacation homes in resort areas like Aspen or Cape Cod. In reality, those taxpayers are not the beneficiaries of the deduction.

When a Second Home is not a "Second Home"

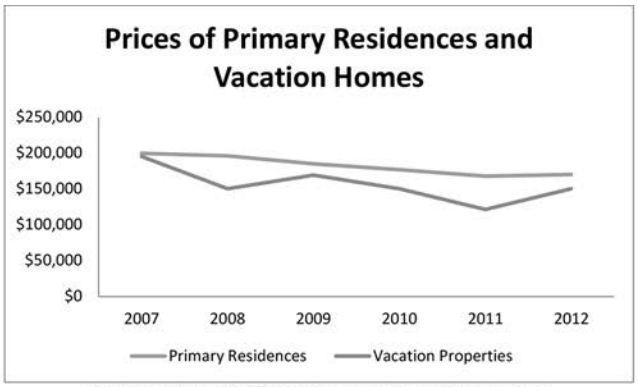
One overlooked reason for the code allowing a deduction for mortgage interest paid on a second home in a tax year is the most fundamental part of residential real estate: buying and selling. If a family has a mortgage on their primary residence, and then sells that residence in order to purchase another home in the same tax year, they have owned two homes in that year. Removing the deduction for second homes would only allow the family to deduct the interest for one of those residences and essentially introduce a tax on moving. Families move for many different reasons: more space for a growing family, downsizing once the kids are gone, economic challenges, or a new job. NAR estimates that as many as three million households take part in a move that would qualify them for a "second home" deduction in a tax year even though none of those families would consider themselves second home owners.

Second homes are both geographically concentrated and diverse

While the image conjured up by critics of a second home is a multi-million dollar property in a tony resort area, the fact is that most of those homes are bought with cash. In reality, second homes nationally have a lower median sales price than principal residences.

(It is important to note that for the discussion of second homes we are referring to the traditional definition of a vacation home used for recreational purposes by the owner. Homes rented for more than 14 days in a tax year are considered rental properties and subject to different tax rules.)

Every year NAR conducts an Investment and Vacation Home Buyers Survey. Over the past decade, the median price of a second home has always trailed the median price of a principal residence. Moreover, the median price of a second home has decreased over the past decade. In 2003, the median price of a second home was $190,000. Medians for second homes peaked in 2004 at $204,100. Currently, the median price of a second home is $150,000 – nearly 25 percent less than it was at the top of the 2004 market.



National Association of REALTORS® Investment and Vacation Homebuyers Survey

The tax returns of second home owners show that more than half – 54 percent -- are in income classes below $200,000. In fact, the largest single category of second home owners is in the $100,000 - $200,000 AGI range. NAR data show that in 2012 the median income of a second homebuyer was $92,100. While that income level is above the national median, it is not the definition of "rich" that lawmakers targeted in recent tax debates.

NAR's second-home survey also shows that the age of second-home purchasers is increasing. After remaining flat at approximately age 45 during the period 2004 – 2008, the median age of second home buyers in 2012 was creeping toward 50, suggesting that owning a second home is as much a retirement strategy as it is a recreation proposition. In fact, NAR research shows that 27 percent of second home purchasers in 2012 listed their top reason for purchase was to use the property as a principal residence in the future.

Finally, NAR has compiled data identifying all US counties in which more than 10 percent of the housing stock is second homes. Currently, about 900 of the nation's 3068 counties (roughly 30 percent) fall into this group. In some counties with very small populations, second homes can represent about 40 percent of the housing stock. In Meagher County, Montana, for example, the population is only 1,891 people, but second homes represent 42 percent of the housing stock. That area is doubtlessly dependent on the jobs and property taxes generated by those second homes.

Thus, about 30 percent of US counties have a stake in retention of the mortgage interest deduction for second homes. Those properties generate valuable jobs and property and sales taxes for the communities. To eliminate the MID for second homes would have at least as dramatic an impact on those communities as it would the taxpayer/owners themselves. Congress needs to carefully consider the economic impact on these communities, often located in rural areas with little other economic resources vs. the amount of revenue that could be raised from eliminating the deduction for second homes. The decline in home values and economic activity in those areas where the

economy is driven by second homeowners could very well eclipse the small amount of revenue that could be gained by increasing taxes on these homeowners.

Reducing the Amount of Qualified Mortgage Debt

Another proposal to "raise revenue" is to lower the cap on the amount of acquisition debt eligible for the mortgage interest deduction from $1 million to $500,000. As previously discussed, the $1 million limitation was put in place in 1987 and is not indexed for inflation. Consequently the value of the MID has eroded by roughly half in 25 years.

Critics of the MID argue that lowering the limitation to $500,000 would affect a relatively small number of wealthy taxpayers. In fact, research conducted on behalf of NAR shows that individuals in every adjusted gross income (AGI) class, even as low as $10,000, have mortgage debt in excess of $500,000. Those in the lower income ranges likely include those who are self-employed with minimal income after expenses, those who are business owners with significant losses or retired individuals with other tax-exempt income. No matter what the income category, however, reducing the cap would make their economic positions worse, particularly where there have been losses.

Further findings from research conducted for NAR shows over half of the taxpayers impacted by imposing a $500,000 cap on MID have AGI below $200,000.

Among those who itemize and claim MID, the AGI classes below $100,000 comprise 56 percent of all tax returns. These are primarily working families. Moreover, the AGI classes below $200,000 represent almost 90 percent of all itemized returns. Thus, the overwhelming majority of tax returns with MID are certainly NOT in so-called "Warren Buffett" territory.

Notably, taxpayers with AGI above $200,000 have far more resources with which to reduce their mortgage debt than do those with AGI of less than $200,000. Ironically, a $500,000 cap thus becomes less punitive for very high income taxpayers than it would be for working families – even fairly well-compensated ones with AGI around $200,000. These families have more constraints on their liquidity and cash flow than the very high income families.

A $500,000 cap has wildly divergent geographic implications. The burden of the cap would be disproportionately borne by taxpayers in high costs areas, even though they might not be categorized as "rich" and even though they may have fairly modest homes. Those living in high cost areas pay a disproportionately larger amount of their after tax income toward housing than do taxpayers in other parts of the country. Eliminating part of the MID for them would exacerbate that disparity and in fact make home ownership even less affordable for many families. Some have proposed addressing this geographic issue by tying the limits of the MID to area housing prices in a way similar to formulas used to calculate loan limits for the Federal Housing Administration (FHA). NAR would resist any effort to make the cap on the MID contingent on the taxpayer's place of residence. Such a change would impose significant complexity on what is currently a very simple provision.

Additional Residential Real Estate Provisions

In addition to the deductions for mortgage interest and property taxes paid, there are two other tax provisions that have a large impact on a family's ability to sell their home. One of these provisions is permanent and should be preserved while the other is temporary and should be made permanent.

Capital Gains Exclusion for Sale of a Principal Residence

Prior to 1997, the tax rules that governed the sale of a principal residence were complex and largely ignored (Section 1034 of the Internal Revenue Code). The general rule was that there was no recognition of gain, so long as the seller purchased a home of the same or greater value within a specified time. (This was a particular disadvantage to individuals who relocated from a high cost area to a lower cost area.) The deferred gain from the sale reduced the basis of the new home. Other elaborate rules required taxpayers to track the adjusted basis of the homes they owned so that, in the event that they did not purchase a replacement home or purchased a replacement home of lesser value, the gain on that sale became taxable, as measured from the adjusted basis. Few taxpayers had adequate understanding of the law or sufficient records to enable them to comply with these rules.

In 1997, the Clinton Administration, without input from NAR or others in the housing industry, proposed a complete overhaul and simplification of these rules. Rather than require elaborate basis computations on multiple residences over a term of many years, the new rule simply permitted the seller to exclude up to $250,000 ($500,000 on a joint return) of the gain on the sale. Any excess above these amounts would be currently taxable at the capital gains rate for the year of sale. The reinvestment rules were eliminated, so taxpayers gained mobility and flexibility. The exclusion gives them the ability to downsize, buy more than one property, purchase a non-real estate asset or do anything they choose with the proceeds of the sale. The exclusion is restricted to the sale of only a principal residence, and certain qualifications must be satisfied in order to receive the benefit of the exclusion. As with the MID, the $250,000 and $500,000 amounts are not indexed for inflation.

Some have suggested reducing the amount of the exclusion on the rationale that home values have declined so the amount of excludable gain should decline, as well. NAR rejects this reasoning. In fact, homeowners have a very justifiable claim that they made a major contribution to any appreciation in their home, and so should be allowed to retain what, for many, would be the full value of that appreciation.

No data is publicly available that allows either NAR or its consultants to evaluate the impact of possible changes to these rules. No public IRS records present information about Forms 1099 that are filed for home sale transactions, and no capital gains data are separately presented to show the amount of taxable gain reported on homes sales in a particular year. In addition, there is no way to ascertain the value of unrecognized gain that has accumulated in homes that are not currently on the market. Finally, long-term holders are far more likely to have larger appreciation amounts and so should not be penalized for that long tenure.

We note that this provision is among the most taxpayer-friendly sections in the entire Code. When enacted, it was a substantial simplification from prior law. It allows a great deal of flexibility in the

financial planning for families. Notably, the gain on the sale of a principal residence is a significant factor in the retirement savings plan of many older Americans. They anticipate downsizing and then using the remaining proceeds to supplement any retirement income they have. Prior law penalized individuals over age 55 by limiting an exclusion to just once in a lifetime. Today's rules reflect far more accurately the homeownership patterns over a lifetime. The exclusion functions as a sort of "Housing Roth IRA" in that the gains made over long periods (in many cases with improvements made from after-tax dollars) are free of tax at the time of sale. At a time when policymakers are contemplating changes to entitlement programs and Americans are struggling to save more for retirement, Congress should continue to recognize the important role the principal residence exclusion plays in supplementing retirement savings. NAR urges Congress to retain the exclusion at current levels or secure its importance for future generations of homeowners by indexing it for inflation.

Cancellation of Mortgage Indebtedness for Principal Residence

Under general tax principles, when a lender cancels a portion or all of a debt, including mortgage debt, the borrower is required to recognize the forgiven amount as income and pay tax on it at ordinary income rates. An exception is provided for some mortgage debt that was or will be forgiven between January 1, 2007 and December 31, 2013. When this relief was initially considered in 2007, the Ways and Means Committee reported it as a permanent provision. The final version, however, was temporary and in place only through December 31, 2009. That date was extended through December 2012 as part of the flurry of legislation enacted at the height of the 2008 financial crisis. The American Taxpayer Relief Act of 2012 subsequently extended the expiration date to December 31, 2013.

While the volume of short sales and foreclosures has receded from record highs, there are still a significant number of families struggling to keep up with their mortgage payments and banks are still working to conduct loan modifications as a result.

NAR believes the tax code should not discourage homeowners from trying to take proactive steps to avoid foreclosure by taxing them on phantom income, especially when the federal government has devoted considerable resources to help modify mortgages and lessen the impacts of foreclosure.

We urge Congress to make mortgage cancellation relief a permanent provision.

Additional Views on Proposed Tax Systems – The Flat Tax and The Fair Tax

While we recognize the prospect of converting the entire tax code to a completely new system of taxation is not necessarily the goal of the Committee, we do wish to briefly note our views on the proposed Flat Tax and Fair Tax models to indicate our opposition to them.

NAR aggressively opposed the flat tax as it was proposed in 1995 by then-Representative Dick Armey (R-TX) and later during the 1996 Presidential primary campaign of Steve Forbes. The Armey-Forbes flat tax, based on the so-called Hall-Rabushka model, would have repealed all deductions, including the mortgage interest deduction and state and local tax deductions and instituted a single income tax rate.

Our internal research and the research of outside experts consistently has shown that *an overnight or even a phased loss of these deductions would cause the value of existing housing to fall by as much as 25 percent. The average loss of value would be 15 percent. This is simply unacceptable, particularly because our research also has shown that this loss of value is never fully recouped.*

Under current law, no federal-level tax applies to the purchase of a house. Thus, we would oppose any new, transaction-type tax on the sale or purchase of a house. We have no formal position on the system set forth in the National Retail Sales Tax ("The Fair Tax"), but we are dismayed that the sales tax rate of that model would likely range between 30 percent and 45 percent of the purchase price on a tax-exclusive basis.

We are unable to imagine how buyers, sellers or housing markets could bear the burden of The Fair Tax as it would impose this heavy sales tax on the sale of a home. We question whether prudent lenders would or should finance the sales tax cost, as a long-term financing mechanism would almost certainly require mortgages that would exceed either the fair-market value or the after-tax value of the home.

If a home that had been subject to the sales tax were sold before the sales tax liability had been extinguished (which we believe would be the general case), the owner would likely realize no cash, as the outstanding tax and mortgage liabilities could easily use up most or all of the proceeds from the sale. Short sales would be epidemic. Thus, a tax on home purchase is ill-advised.

Conclusion

NAR would like to thank the Committee for its open and collaborative process as it seeks to reform our Nation's tax code. In order to devise a fairer and simpler tax code, the input of stakeholders at all levels is imperative to avoid unintended consequences.

The residential real estate market in America is a large driver of the economy. When housing does well, America does well. The Nation has been led out of four of the last six recessions by a recovery in the housing market and it appears that housing is poised to lead us to yet another economic recovery.

Despite the price declines, foreclosures, and economic hardship that has befallen our housing market in the past five years, Americans remain committed to the principles of homeownership. They continue to hold the vast majority of their personal wealth in their homes. They continue to believe that ownership of real property is part of the American Dream that was envisioned from the very beginning by our Founders. That is why even high numbers of those who rent consistently support tax incentives for home ownership. Congress should continue to support these same ideals as it seeks to reform the tax code.

Chairman CAMP. Well, thank you, Mr. Thomas.

Mr. Dietz, you are recognized for 5 minutes.

STATEMENT OF ROBERT DIETZ, ASSISTANT VICE PRESIDENT FOR TAX AND POLICY ISSUES, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. DIETZ. Thank you for the opportunity to testify today. My name is Robert Dietz, and I am an economist with the National Association of Home Builders. NAHB represents all sectors of residential real estate development, single family, multifamily, remodeling, and businesses connected with supplying and financing those activities.

Homebuilding is an industry dominated by small businesses, so the idea of a simpler, less complex Tax Code has great appeal. At the same time, our industry remembers painful lessons from the 1986 Tax Reform Act when the commercial and multifamily sectors experienced a downturn due to unintended consequences. For this reason, we urge you to be cautious and thoughtful when it comes to housing and tax reform.

We have seen over the last 5 years the influence housing can have. When housing fares well, it is positive for the economy. The year 2012 was a year of expansion off of great recession lows, but recent data, such as NAHB's measure of builder confidence, has suggested the recovery will have starts and stops. In particular, the share for some home buyers remains below historic norms.

Given the state of the industry, I would like to highlight a few key tax issues. NAHB strongly supports the Low Income Housing Tax Credit. Created in the 1986 reform effort, it is the most effective tool for the creation of affordable rental housing. Utilizing a public-private partnership to attract investment, the tax credit has created over 2 million affordable rental units. The needs for such housing remain significant and we strongly urge the Committee to protect this program.

Also, the completed contract rules in Section 460(e) are essential to homebuilders and offer a case in point about tax reform. Absent this fix to changes made in 1986, many builders would need to pay taxes on homes prior to sale.

However, when it comes to housing, the spotlight typically falls on the mortgage interest deduction, or MID. A few thoughts. First, we frequently hear few homeowners benefit from the MID because itemization is required. In fact, most homeowners will claim it. In 2009, for example, 35 million taxpayers claimed the MID out of 50 million homeowners with a mortgage. This means, of homeowners with a mortgage, 70 percent claimed the MID in that year. And typically more than 80 percent of mortgage interest paid by homeowners is reported as a deduction. Over the course of a homeowner's time of ownership, the majority will claim the MID for years at a time.

It is also claimed that the MID encourages the purchase of a larger home. These claims ignore the role of family size. The data show that larger families see a larger benefit, which is intuitive with the notion that families with children require larger homes. Also, the cost of housing varies greatly across the Nation, so what may appear to be a large deduction may reflect a modest home.

Moreover, the MID and the real estate tax deductions are two of the few elements in the Tax Code that account for differences in cost of living. Indeed, the real estate tax deduction is an important reminder that homeowners pay over $300 billion in property taxes each year. This fact is often ignored in Federal tax debates, because these taxes are collected by State and local governments.

There is also a connection between the age of a homeowner and the resulting benefit of the MID. As a share of household income, the largest deductions are for those 35 and younger. This makes sense, because these are the homeowners that are paying more interest in the early years of a mortgage.

Given this demographic connection, NAHB believes that any policy change that makes it harder to buy a home or that delays the purchase of a home will have a significant impact on the wealth accumulation and makeup of the middle class.

Now, a few thoughts on the MID rule for second homes. While many think of expensive beach property, such homes are often owned free and clear or rented, which excludes them from the MID. In practice, the second home deduction is important for many who do not think of themselves as owning two homes. For example, the second home deduction facilitates moving when owning two homes during the tax year. The second home MID rules also permit existing homeowners to claim interest on a construction loan for a future home being built.

Repeal of the second home MID rules would affect large sections of the country in nearly every State. There would be negative economic consequences in terms of lost home sales, home construction, and lost tax revenues.

How housing is treated in any future tax reform will shape the economy going forward. This is particularly important now. Housing provides the momentum behind an economic recovery, because homebuilding and associated businesses employ such a wide range of workers. Housing could be a key engine of job growth that this country needs.

As the Committee moves forward on tax reform, NAHB wants to be a constructive partner. Thank you, and I look forward to your questions.

[The prepared statement of Mr. Dietz follows:]

Testimony of

Dr. Robert Dietz

On Behalf of the
National Association of Home Builders

Before the
United States House of Representatives
Committee on Ways and Means

Hearing on

Tax Reform and Residential Real Estate

April 25, 2013

On behalf of the 140,000 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 is a Washington, D.C.-based trade association whose broad mission is to enhance the climate for housing, homeownership and the residential building industry. We represent builders and developers who construct housing ranging from single-family for-sale homes to affordable rental apartments and remodelers. About one-third of NAHB's members are home builders and/or remodelers. The others are associates working in closely related specialties such as sales and marketing, housing finance, and manufacturing and supplying building materials.

The Internal Revenue Code currently provides numerous housing-related rules and incentives covering both owner-occupied and rental units. There are key tax provisions geared toward rental housing, which help facilitate the production of new rental housing and also specifically target affordable rental housing. These include the Low Income Housing Tax Credit (LIHTC); accelerated depreciation; Section 142 multifamily rental bonds; and carried interest.

There are also a number of owner-occupied housing tax incentives 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.

NAHB has spent several years researching the housing tax incentives to determine how they impact builders, remodelers, homebuyers, homeowners, and renters. Many assumptions are made about various housing policies. NAHB has sought to move away from assumptions to a fact-based approach as we evaluate these tax incentives in preparation for tax reform. My testimony explores the lessons learned from that research.

Balance Between Rental Policies and Owner-Occupied Policies

Questions are frequently raised whether there is a balanced policy between rental and owner-occupied housing. There exist justifiable reasons to support both forms of housing with policy – be it to ensure the availability of high quality, affordable rental housing or support homeownership and enable its benefits for families and communities. However, there is, in some circles, an assumption that renters are getting the short end of the stick.

NAHB has looked at the tax and spending policies that impact both rental and owner-occupied housing: the mortgage interest deduction; the real estate tax deduction; capital gains exclusion; mortgage revenue bonds; Section 108 relief; and HOME, CDGB, USDA, and other appropriations. According to numbers published by the Joint Committee on Taxation (JCT) and the Congressional Research Service (CRS) for Fiscal Year 2012, federal owner-occupied housing support totaled $120 billion.

NAHB also looked at policies supporting rental housing: Low Income Housing Tax Credit; preferential rate on capital gains; accelerated depreciation on rental housing; bonds; like-kind exchanges; the

historic credit; tenant-based and project-based Section 8; public housing funding; and other appropriations such as HOME, CDBG, and USDA. According to numbers published by the Joint Committee on Taxation (JCT) and the Congressional Research Service (CRS) for Fiscal Year 2012, rental housing support totaled $61.6 billion.

To determine if the appropriate policy balance has been struck, it is necessary to look at the U.S. population share living in each type of housing. Based on the numbers above, 66.1 percent of the policy support goes towards owner-occupied housing; 65.35 percent of the U.S. population lives in owner-occupied housing, according to the 2010 American Community Survey. In comparison, 33.9% of the policy support is targeted to rental housing; 34.65% of the U.S. population lives in rental housing.

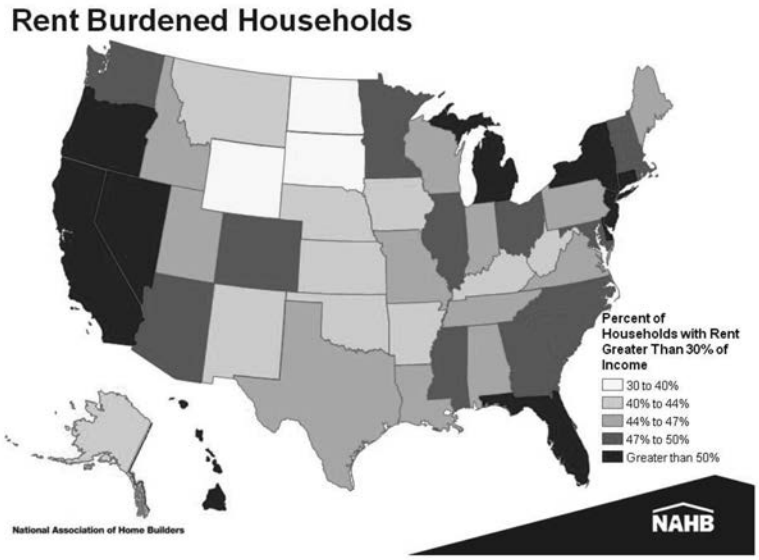
Based on the population living in each type of housing, the data indicate that policy support between rental and owner-occupied housing is evenly balanced.

Rental-focused Tax Policies

Low Income Housing Tax Credit

According to Census data, over 40 percent of renters are rent-burdened, and the need for affordable rental options remains acute. One of the major corporate tax provisions is the Low Income Housing Tax Credit (LIHTC). The Low Income Housing Tax Credit (LIHTC) was created as part of the Tax Reform Act of 1986 as a more effective mechanism for producing affordable rental housing. We urge Congress to maintain this critical affordable rental housing program.

The Low Income Housing Tax Credit is the most successful affordable rental housing production program in U.S. history. Since its inception, the LIHTC has produced and financed more than 2 million affordable apartments. As LIHTC properties must generally remain affordable for 30 years, they provide long-term rent stability for low-income households around the country. But the demand for affordable housing is acute and exceeds the availability of financing through the LIHTC program. We believe that the solution is not to eliminate the most successful affordable housing program in the country, but to provide it with the resources necessary to meet the nation's affordable housing needs.



As the preceding map shows, every state has a large population of rent burdened households. Correspondingly, demand for credits greatly outstrips the resources available. According to the most recently available annual survey released by the National Council of State Housing Agencies (NCSHA), state housing finance agencies generally receive $2 in requests for every $1 in LIHTCs available. In 2010, state agencies received applications for $2,235,447,946 in credits. Total allocations were $917,428,932, which means that for every tax credit allocated, there was a demand for approximately 2.4 tax credits.[1]

Demand does vary somewhat by state. In 2010, New York saw about $2.50 in requests for every $1 allocated; New Jersey experienced nearly $3.50 in requests for every $1 allocated; and Texas had $2.10 in requests for every $1 allocated.

Nationally, demand varies somewhat from year to year but generally remains high. It is useful to compare the 2010 national numbers against 2008. 2008 was the height of the financial crisis, and multifamily development generally was at a low point. Many traditional investors in LIHTC projects were not investing during this time period, which made putting together deals much more challenging. Nationally, there were applications for $1,873,311,018 in credits. Allocated in 2008 were $939,924,853

[1] State HFA Factbook: 2010 NCSHA Annual Survey Results, pg 90

in credits[2]. At this point, demand fell, but was still double the amount of available credits, even in what was one of the most challenging times for real estate development.

Again, looking back to better times in 2006, there were applications for $1,509,779,928 in credits. Credits allocated were $691,073,326[3]. 2006 had approximately $2.20 in credit requests for every $1 available. We can see over several years in different economic environments, demand for tax credits remained steady at double or more of the available credits.[4]

LIHTC development remains stable over time because the need for affordable housing is significant. The consistent demand for credits also reflects the advantage of creating this credit in the tax code. Investors have confidence in the predictability of the tax code, which allow LIHTC developments to continue even during economic downturns. The LIHTC enables a fairly constant demand for affordable housing, as well as a financing mechanism that ensures long-term operation of affordable housing. In fact, low income housing tax credit projects outperform the rest of the multifamily housing sector in one key measure. These properties are very well managed, with an annualized foreclosure rate of less than one tenth of a percent.[5] This is a third of the rate for other multifamily properties. The success of these projects reflects, in part, the ever-present threat that the government can recapture tax credits if the project fails.

A key component to the LIHTC success story is the flexibility the state agencies have to target specific types of affordable housing developments. For example, a state with a large population of seniors may offer a developer bonus points on an application for focusing on senior housing. Nationally, in 2010, approximately 26% of LIHTCs were directed to senior housing.[6] Other targeted projects include assisted living; family housing; homeless; and housing for the disabled. Veterans housing is also increasing in focus in some states. By allowing the states to direct tax credits, the program allows each state to determine what types of affordable housing are best suited to the demographics of their state, rather than applying a single, national standard. Ultimately however, a great deal of need remains unmet as the demand simply outstrips the availability of credits.

The LIHTC is a unique private-public partnership. The benefits of this structure are evident in the quality of the projects. Moreover, NAHB estimates that the LIHTC annually produces 95,000 new, full-time jobs, adds $7.1 billion into the economy, and generates approximately $2.8 billion in federal, state, and

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[2] State HFA Factbook: 2008 NCSHA Annual Survey Results, pg 92

[3] State HFA Factbook: 2006 NCSHA Annual Survey Results, pg 88

[4] These numbers represent all LIHTC credit types. There are several different types of credits: credits used for new construction or for substantial rehabilitation (sometimes referred to as the 9% credit), which are design to provide 70% of the cost of construction; and a credit used for acquisition and light rehabilitation (sometimes referred to as the 4% credit), which is designed to cover 30% of the cost of acquiring the property or for light rehabilitation. The amount of credits available for each use is set in law. The data does not break out demand for the 9% and 4% credits separately, but anecdotally, NAHB hears from developers that the competition for 9% credits is the fiercest. Demand for 9% credits is likely much higher than double the amount of available credits.

[5] "The Low Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies," by Novogradac & Company, LLP, 2011, Page 4
http://www.novoco.com/products/special_reports/Novogradac_HAG_study_2011.pdf

[6] State HFA Factbook: 2010 NCSHA Annual Survey Results, pg 109

local tax revenue. Unfortunately, the supply of private, affordable housing stock is rapidly shrinking. According to a 2011 Harvard study:

> … the private low-cost stock is rapidly disappearing. Of the 6.2 million vacant or for-rent units with rents below $400 in 1999, 11.9 percent were demolished by 2009. Upward filtering to higher rent ranges, conversions to seasonal or nonresidential use, and temporary removals because of abandonment added to the losses. On net, more than 28 percent of the 1999 low-cost stock was lost by 2009.[7]

And the private marketplace is simply unable to replace those lost units with new construction. The Harvard study notes that "[t]he rising costs of construction make it difficult to build new housing for lower-income households without a subsidy."[8] In 2009, the median asking rent for new unfurnished apartments was $1,067; for minimum-wage workers, an affordable monthly rent using the 30-percent-of-income standard is just $377.[9] The study calculates that to develop new apartments with rents affordable to households with incomes equivalent to the full-time minimum wage, the construction costs would have to be 28 percent of the current average.[10]

Without federal assistance, it is financially infeasible to construct new, unsubsidized affordable rental units. It is a critical program, and as noted in the study, "[a]t present, the Low-Income Housing Tax Credit (LIHTC) program is nearly alone in replenishing the affordable stock, supporting both new construction and substantial rehabilitation of existing properties including older assisted developments."[11]

Make the Fixed Floor Rate for 9% and 4% Credits Permanent

Under the Low Income Housing Tax Credit (LIHTC) program, affordable housing developments receive tax credits which are used to attract equity capital. There are two types of tax credits: one credit provides 70% of the financing cost and is used for new construction and substantial rehabilitation; and a second credit that provides 30% of the financing cost which is used to acquire an existing property for rehabilitation. These are often referred to as the 9% and 4% credits respectively because that was the original credit amount when the program was created in 1986.

The *Tax Reform Act of 1986* did not fix those credit rates at 9 and 4 percent, but rather created a floating rate system where the credit rates are adjusted on a monthly basis. The IRS calculates the monthly values of the credits based on the cost of borrowing by the federal government. As a result, today's low federal borrowing costs produce very low credit rates, which reduces the amount of private equity invested in LIHTC development. For April 2013, the 9% credit was only worth 7.43%; the 4% credit was

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[7] "America's Rental Housing: Meeting Challenges, Building on Opportunities" Joint Center for Housing Studies of Harvard University, 2011. Page 6.
http://www.jchs.harvard.edu/publications/rental/rh11_americas_rental_housing/AmericasRentalHousing-2011.pdf
[8] Pg 23
[9] Page 23 and 21
[10] Page 24
[11] Page 5

worth 3.19%. These low rates reduce the amount of equity properties could receive by more than fifteen percent, making it more difficult to do LIHTC developments, particularly as state and federal governments cut back on direct spending that is used to fill financing gaps for LIHTC properties. The "floating rate" system also creates uncertainty for owners and investors and complicates state administration of the program.

In response to the declining rates, the *Housing and Economic Recovery Act of 2008* (HERA) set the rate for new construction and substantial rehab credits from each state's allocation at no less than 9 percent, which was the rate when the program was created. The provision was then extended for credits allocated by the end of 2013 through the *American Taxpayer Relief Act of 2012* (ATRA). However, this provision expires at the end of 2013.

If this provision is not extended, developments will need to be underwritten at the floating rate, which would mean a sudden and substantial reduction in the amount of equity that a development could receive for its allocation. Making the fixed floor rate permanent would not increase the number of LIHTCs allocated, as they are capped annually; it just affects how much allocation each project may receive. NAHB strongly supports making the 9 percent credit rate floor permanent.

While neither HERA nor ATRA addressed the 4% credit, NAHB also strongly believes that the LIHTC program would benefit greatly by fixing both credit rates. In addition to the 9% LIHTC, states are allowed to provide credits from their capped allocation for the acquisition of existing property, an important tool for affordable housing preservation. Acquisition Housing Credits are currently set by the floating rate system just like new construction. Applying the fixed floor rate for acquisition Housing Credits at no less than 4 percent would similarly remove the uncertainty and financial complexity of the floating rate system, simplify state administration, and facilitate preservation of affordable housing at little or no cost to the federal government. According to the National Council State Housing Agencies, Acquisition Housing Credits are less than 10 percent of all allocated Low Income Housing Credits so the incremental additional cost of extending the fixed floor rule to acquisition Credits would be minimal.

Carried Interest

The taxation of a capital gain due to a carried interest is an important issue for the real estate industry and particularly for the multifamily housing sector, both market-rate rental and Low Income Housing Tax Credit. Under present law, a capital gain classified as a carried interest is taxed like any other capital gain. Carried interest has come under attack for how it is used by the hedge fund industry, but broad attacks on carried interest ignore the key role it plays in real estate development.

The use of partnerships and other pass-thru entities is common in the home building industry and the construction sector generally. In a common arrangement, a builder/developer performs the role of the general partner and outside investors act as limited partners, who provide much of the initial equity financing. Typically, the general partner receives a developer's fee (and possibly subsequent fees for owning and operating the property) and the limited partners receive a specified rate of return on their investment. Any residual profits are split between the multifamily builder/developer/property owner

and the investors as defined by the partnership agreement. Of course, the particulars differ depending on the nature of the project, the types of developers, and the role of outside investors.

In many cases, the developer's share of the residual profit, if it is realized (uncertain at the time of the deal), is classified as a "carried interest ," which is an allocation of profit that as a share of total profit exceeds the share of the developer's initial equity investment in the project.[12] The carry can be ordinary income or capital gain, but the current policy debate is limited to a carried interest that is due to a capital gain at the partnership level. Carried interest that is paid as ordinary income is unaffected by the proposals being debated in Congress. Capital gain typically arises in such arrangements through the sale of a tangible, depreciable asset that is held for more than one year. For example, this situation would include a building that was constructed, owned and operated for a period of time and then sold to other investors.

Table 1 illustrates this in more detail for a hypothetical partnership with $100 million in initial equity financing ($95 million from outside interests, and $5 million from the home builder), a 10% preferred return for the limited partners, and a 50%-50% division of residual profit. Under this example, the multifamily developer's capital gain income is a carried interest (portion in excess of 5% - the initial equity stake) and would be subject to additional tax under existing proposals.

Table 1: Illustration of Partnership Income Distributions and Tax Consequences

	Partnership Level	Home Builder: General Partner	Share	Outside Finance: Limited Partners	Share
Equity Invested	$100.00	$5.00	5.00%	$95.00	95.00%
Capital Gains Income: First Distribution	$9.50	$0.00	0.00%	$9.50	100.00%
Residual Capital Gains	$10.50	$5.25	50.00%	$5.25	50.00%
Total Return	$20.00	$5.25	26.25%	$14.75	73.75%
Carried Interest Test under H.R. 4213		26.25% > 5%		73.75% > 95%	
Carried Interest		Yes		No	
Tax Rate under Present Law		15%		15%	
Taxes Paid under Present Law		$0.7875		$2.2125	
Tax Rate under Proposal		35%		15%	
Taxes Paid under Proposal		$1.6375		$2.2125	
Difference in Taxes Paid		$0.8500		$0.0000	

Assumptions:
Dollar amounts in millions
Project yields 20% return over time period
All income is capital gains at partnership level
LPs receive first 10% return
Residual gains beyond first 10% are split 50% each to GP and LPs
Partners face ordinary income tax rate of 35%

Putting aside the tax issues, the carried interest in the above multifamily development example serves two important economic purposes. First, it provides an incentive for the multifamily developer and property owner to control costs and operate the property efficiently in order to generate a profit for the outside investors. This incentive makes the investment more attractive for investors, helping to attract

[12] Note that technically this definition describes both promoted and carried interests. A "promote" is often used to refer to any share of profit allocation greater than the initial equity stake, and a "carry" is a type of promote for which there is little or no equity stake. However, in the current debate, the term "carried interest" now captures all of these scenarios.

investment for multifamily projects, particularly those in higher risk environments, such as economically-distressed areas.

Second, the carried interest transfers business risks associated with the development project to the multifamily builder and owner, who may be more familiar with market conditions and in better position to manage the risks. These risks include changes in administrative expenses, local regulations, and of course local market conditions, which is of particular importance given the existing weakness in many local housing markets. Further, a multifamily developer may assume additional risk by making additional guarantees to the outside investors. For example, the developer can guarantee the completion of the project, or the servicing of debt used to finance the project. Carried interest allows multifamily builders to be compensated for making these guarantees and assuming the risks. Hence, partnerships with carried interest mechanisms are excellent financial arrangements for allowing multifamily developers and outside investors to share business risks efficiently.

Increasing the tax on carried interest for the real estate sector also results in a transfer of tax revenue from state and local governments to the federal government by reducing the value of multifamily investments, thereby lowering property tax collections at the local level.[13] Based on proposals considered by Congress in 2010 which would tax carried interest as ordinary income, NAHB estimated that the total amount of property taxes lost to state and local governments for the real estate sector would be approximately $1.2 billion per year.[14] Given that the federal revenue estimate for the carried interest proposal, at that time, was $24.6 billion, this $12 billion ten-year estimate demonstrates that the proposal generates a significant transfer of tax revenues from state and local governments to the federal government.

NAHB supports the current carried interest tax rules as they apply to commercial and residential real estate. Should Congress decide to make changes to current law, it is absolutely essential that the transitional rules include a grandfathering provision for current contracts. As many multifamily projects are held for years before a gain is realized, a sudden shift in tax policy will have a significant and negative impact on real estate. As a word of caution, Congress failed to include adequate transition rules when it sharply limited the ability of individual taxpayers to claim passive losses in the 1986 tax reform act. As a result, there was a collapse of the commercial and multifamily real estate sectors that ultimately contributed to the S&L crisis.

Depreciation

Rental property can be depreciated on an accelerated timeframe over a period of 27.5 years, versus a 39 year depreciation schedule for commercial real estate. In addition, individual components can be depreciated under various, shorter timeframes through the use of cost segregation rules.

Maintaining a reasonable depreciation period for rental housing is critical. If the period is too long, it will increase costs and make it harder to develop rental housing. Changes to the depreciation schedule

[13] For more detail on how NAHB calculated the impacts, see: http://www.nahb.org/generic.aspx?sectionID=1081&genericContentID=131457#top2

[14] NAHB's analysis was based on H.R. 4213 in the 111th Congress

will impact the financial viability of existing multifamily buildings, which could result in foreclosures and price declines. Depreciation is also a key to attracting outside investors.

For these reasons, NAHB opposes changes to the depreciation rules that would extend the depreciation period of property associated with residential rental property. It is also worth noting that while Congress has enacted and continues to debate the value of various expensing proposals (e.g. bonus depreciation), such rules typically exclude structures such as apartment buildings (property with more than 20 years of economic life).

Owner-Occupied Tax Policies

The Benefits of Homeownership

Homeownership offers a wide range of benefits to individuals and households.[15] 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 2010 Federal Reserve Survey of Consumer Finances (SCF), the median family net worth of a homeowner is $174,500; 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 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%.[16]

Data from the 2010 SCF illustrates the importance of housing wealth, particularly for moderate and low income senior households. For example, for seniors aged 55 to 74 and income of $25,000 to $50,000, total housing assets constituted 48% of household net worth. For those with slightly higher incomes, the importance of housing wealth remained but declines somewhat. Housing is also a significant portion of wealth for seniors above age 75: for those with incomes of $25,000 to $50,000, housing wealth made up 58% of net worth. For lower income seniors above age 75 (incomes below $25,000), housing wealth totaled 55% of net worth.

These data illustrate the importance of housing wealth and suggest caution with respect to policies that would reduce these wealth holdings, based on decisions made over a lifetime, via direct policy changes

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

[16] C. J. Mayer, K. V. Simons, Reverse mortgages and the liquidity of housing wealth, AREUEA Journal 22 (1994) 235-55.

(such as weakening the section 121 gain exclusion for principal residences) or indirect changes (such as price declines induced by weakening the mortgage interest deduction).

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.[17] For these and other positive impacts, homeownership has and should continue to have a favorable place in the tax code.

Completed Contract Rules

Brief History of the Rules

Under current law, a long-term contract is defined as a building, installation, construction, or manufacturing contract that is not completed by the end of the taxable year in which it is entered into.

Prior to the changes made in the *Tax Reform Act of 1986*, taxpayers could generally elect to account for income and expenses attributable to long-term contracts under the percentage of completion method or the completed contract method. Under the completed contract method, the gross contract price is included in income in the taxable year in which the contract is completed. Under the percentage of completion method, income is taxed according to the percentage of the contract completed during each taxable year.

Certain other limitations and rules applied, and there were additional rules for "extended period" long-term contracts—contracts not expected to be completed within 24 months. An exception to these "extended period" rules was provided for contracts for the construction of real property if the contract was expected to be completed within three years, or if the contractor's average gross receipts for the previous three years did not exceed $25 million.[18]

Changes in the *Tax Reform Act of 1986*

Congress believed that the completed contract method permitted an "unwarranted deferral of the income from those contracts."[19] Specifically, the Joint Committee on Taxation reported to Congress that certain large defense contractors had negative tax rates due to net operating loss carryforwards generated through use of the completed contract method. In response, the *Tax Reform Act of 1986* adopted a modified percentage of completion method that would apply to all long-term contracts.

The Act did include a modest exception for small construction contracts. Contracts for the construction or improvement of real property, if the contract is expected to be completed within two years, could be

[17] 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.
[18] General Explanation of the Tax Reform Act of 1986, published by the Joint Committee On Taxation (JCS-10-87), pg. 524-526
[19] Ibid, pg 527

accounted for under the previous completed contract rules. However, the exemption was limited to taxpayers whose average gross receipts in the previous three tax years fell below $10 million.

Unintended Impacts on New Home Construction and the Home Construction Contract Exemption

Congress' intent in changing the completed contract rules was aimed largely at defense contractors who were deferring income taxes on projects that had a multi-year contract, such as during the lengthy construction period for an aircraft carrier. Defense contractors generally received substantial progress payments from the government, and taxing these types of contracts under the percentage of completion method is appropriate. In enacting the *Tax Reform Act of 1986*, Congress also attempted to ensure that residential construction was largely unaffected by these changes, as seen by the inclusion of the exception for small construction contracts. At the time, home builders largely believed these changes did not impact them because their agreements with their customers were viewed as sales contracts, not construction contracts.

However, in 1988, the IRS released Advance Notice 88-66, which would have adversely affected the operations of home builders. NAHB realized at this time that the protections Congress included through the exemption for small construction contracts fell short. Prior to this notice, residential real estate developers took the position that the typical agreements of sale entered into for the sale of a new home were not "construction contracts" subject to the accounting rules under Section 460. Home sales agreements differed considerably from a typical construction contract, particularly when compared to the contracts a defense contractor entered into with the government. A home sales agreement involves a developer agreeing to sell the home to the buyer in the future, with the developer retaining title to the property and bearing all economic risks until closing, with no progress payments, and typically only backed by a small deposit. Builders normally do not realize any profit until closing, which occurs after the home is constructed.

The IRS was proposing to tax home builders on income they had not yet received. Due to the length of home construction, it is common for a new home to straddle two tax years. Although home builders viewed these agreements as contracts of sale rather than as construction contracts as defined by Section 460, the IRS Advance Notice revealed that the government viewed these sales contracts as long-term construction contracts subject to the new accounting rules. This change would mean that home builders would need to significantly alter their business model.

Although buyers put down a deposit, the deposit is generally kept in an escrow account and cannot be used to cover construction costs or tax payments. Moreover, unlike with defense contracts, progress payments are not typical because most homes are financed by a mortgage at closing. If these homes were subjected to the new accounting rules, most builders are very small businesses, so they would be forced to finance the tax payments through a construction loan, which would increase the cost of home construction for the buyer.

Certainly, the proposed changes would have caused significant cash-flow problems for home builders and imposed a larger barrier for smaller homebuilders who lack the financial means to cover the tax payments. In response, Congress included relief in the conference report for the *Technical and*

Miscellaneous Revenue Act of 1988 by clarifying in Section 460(e) that "home construction contracts" were not subject to the percentage of completion accounting methods. The conference report describes a home construction contract as one where "80 percent or more of the estimated total costs to be incurred under the contract are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or improvements to real property directly related to and located on the site of, dwelling units in a building with four or fewer dwelling units."[20]

NAHB believes that Section 460(e) is consistent with both Congress' intent in 1986 to shield the residential construction industry but also with the unique contractual agreements used for home construction. This is a case where a broad definition of "construction" resulted in unintended consequences that were potentially harmful to home builders and buyers alike. NAHB believes that it did not make sense to apply an accounting method to home builders that was really targeted to address other tax problems, and that same rationale continues to support maintaining Section 460(e) as Congress considers tax reform.

Capital Gains Exclusion

Brief History of the Capital Gains Exclusion

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.

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.

Simplification Arrives: The Changes of 1997

[20] H.R. Conf. Rep. No. 100-1104, pg 118

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."[21] 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 recordkeeping 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.

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.

Impacts from Eliminating the Gains Exclusion

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

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

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 principal residence sales, in an environment where home prices are down 29% on a national basis (per Case Shiller), 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. Analysts debating federal tax policy often ignore the state and local government tax burden placed on housing via property tax. 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 unlike other investments.

With a minimum two year ownership period, the requirement that the home be used as a principal residence, and the closing of the second home loophole in 2008, the gains exclusion is targeted in a manner where real estate speculators or investors seeking a tax shelter will find no benefit. This is a tax benefit aimed exclusively at long-term owners of a principal residence. As a home is typically the largest source of household wealth, the home has become a retirement vehicle for many Americans. In some ways, the capital gains exclusion functions much like a Roth IRA, where the retirement gains are also completely excluded from the taxpayer's income.

State and Local Real Estate Deduction

Brief History of the State and Local Real Estate Tax Deduction

The deductibility of state and local real estate taxes has been part of the tax code since the U.S. income tax code was enacted in 1913. This deduction aligns with a general principle of fair taxation: taxes paid to a local or state government should not be taxed as income by the federal government. If the goal of an income tax regime is to tax changes in wealth, income which is ultimately paid out as a tax does not represent a change in wealth.

Housing is taxed in many ways unlike other investments, particularly via property taxes. While other investments are taxed when sold and the tax is based on their gain in value, housing is the only investment which is taxed annually on the value of that investment, irrespective of any increase in value. This tax burden faced by homeowners is often lost in the federal debate since these revenues are not collected at the federal level. It is not, however, lost on the homeowner paying property taxes. For 2012, total property tax collections by state and local governments summed to $474 billion. NAHB estimates that two-thirds of these collections were due to housing for a total of $316 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.

Who Benefits from the State and Local Real Estate Deduction?

A common criticism of deductions is that taxpayers in higher income brackets realize a higher dollar benefit from the deduction. This leads some critics of the current tax code to suggest that deductions are inherently unfair. However, looking at tax fairness in nominal dollars ignores that these higher income taxpayers also pay a larger dollar amount in taxes. NAHB believes that the most even-handed approach to looking at the progressivity of a deduction is as a percentage of a taxpayer's adjusted gross income.

Using IRS data, for taxpayers with an adjusted gross income (AGI) of less than $200,000, NAHB calculated that the average real estate deduction is worth 0.7% of AGI. For taxpayers with an AGI above $200,000, the benefit falls to 0.5% of AGI.[22]

Table 5: Real Estate Tax Deduction

AGI	NAHB Estimates *Based on AGI*				
	Returns		Amount		Average RE Tax Benefit, Percentage of AGI
	Number (Ths)	Share	Amount ($M)	Share	
Under $10,000	4	0%	$0	0%	0.6%
$10,000 under $20,000	757	2%	$107	1%	0.9%
$20,000 under $30,000	2,027	6%	$399	2%	0.8%
$30,000 under $40,000	3,340	10%	$739	4%	0.6%
$40,000 under $50,000	3,940	11%	$1,231	6%	0.7%
$50,000 under $75,000	9,366	27%	$3,747	19%	0.6%
$75,000 under $100,000	7,110	20%	$3,889	20%	0.6%
$100,000 under $200,000	7,342	21%	$6,757	34%	0.7%
200,000+	1,103	3%	$2,918	15%	0.5%
Total	34,989	100%	$19,788	100%	0.7%

Source: 2004 Statistics of Income (SOI), IRS, NAHB Estimates

As a result, elimination of this tax provision would result in a higher tax burden, as measured by a percentage of AGI, on middle class taxpayers.

Another way to look at progressivity in the tax code is to measure the share of the benefit flowing to an income class relative to taxes paid. According to the latest estimates by the Joint Committee on Taxation, 75% of the benefit from the real estate tax deduction goes to taxpayers with an economic income[23] below $200,000[24]. The same taxpayers pay approximately 40% of all income taxes. Because

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

[23] 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

this class of taxpayers receives a larger percentage benefit relative to their actual taxes paid, by this measure, the real estate deduction increases the progressivity in the tax code.

Nationally, for taxpayers with an AGI of less than $200,000, the mean real estate tax deduction is $3,581. There are significant variances on a state-by state basis: those same taxpayers in Texas have an average deduction of $4,265, while in New Jersey their deduction averages $7,398. But the principle behind the deduction remains valid 100 years after the first income tax code was adopted: real estate taxes paid should not be considered as taxable income.

Mortgage Interest Deduction

Brief History of the Mortgage Interest Deduction

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.[25]

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."[26] Aside from some adjustments in 1987, the mortgage interest deduction remains unchanged since Congress' historic rewrite of the tax code 26 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).

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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.

[24] Estimate of Federal Tax Expenditures for Fiscal Years 2012-2017, published by the Joint Committee on Taxation, February 1, 2013, (JCS-1-13)

[25] U.S. Census Bureau: http://www.census.gov/hhes/www/housing/hvs/qtr211/q211ind.html

[26] "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.

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 half since 1987; in 2013 dollars, the original cap would be equal to just over $2 million.[27]

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

The Mortgage Interest Deduction is Progressive

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.

One of the most common erroneous claims we hear 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), 86% of mortgage interest deduction beneficiaries earn less than $200,000 in economic income. And 65% of the net tax benefits are collected by homeowners with economic income of less than $200,000, yet these same taxpayers pay only about 40% of all income taxes.[28]

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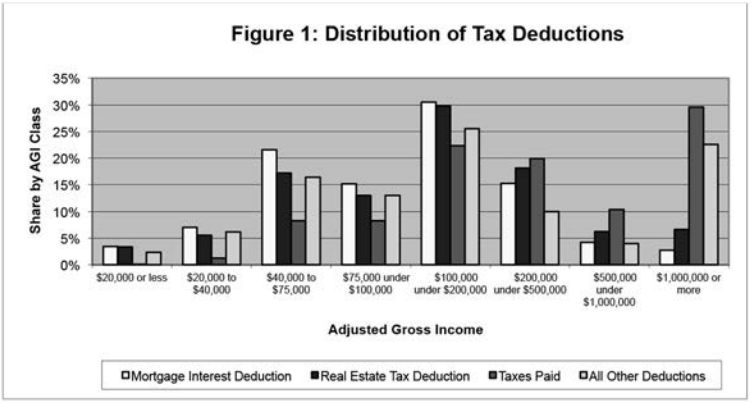
[27] Bureau of Labor Statistics CPI Inflation Calculator. $1,000,000 in 1987 equates to $2,043,715 in 2013. http://www.bls.gov/data/inflation_calculator.htm

[28] Estimates of Federal Tax Expenditures for Fiscal Years 2012 – 2017. https://www.jct.gov/publications.html?func=startdown&id=4504

One way of measuring progressivity is as a percentage of income. 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. [29] 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, using 2005 IRS data, illustrates the critical point when considering the income distribution of the housing tax deductions relative to other tax expenditures.



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.

[29] Who Benefits from the Housing Tax Deductions?
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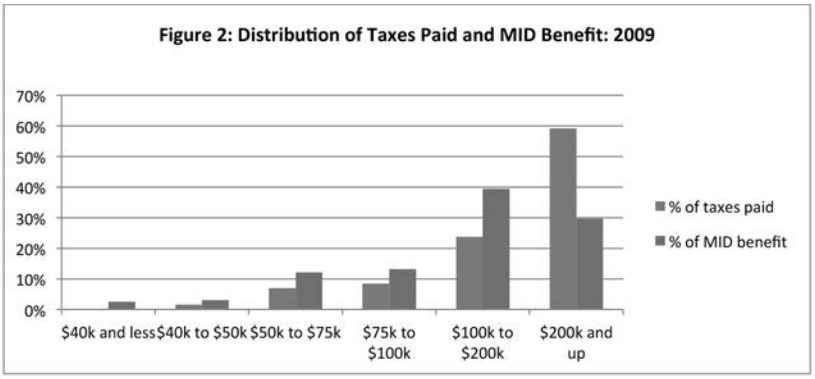
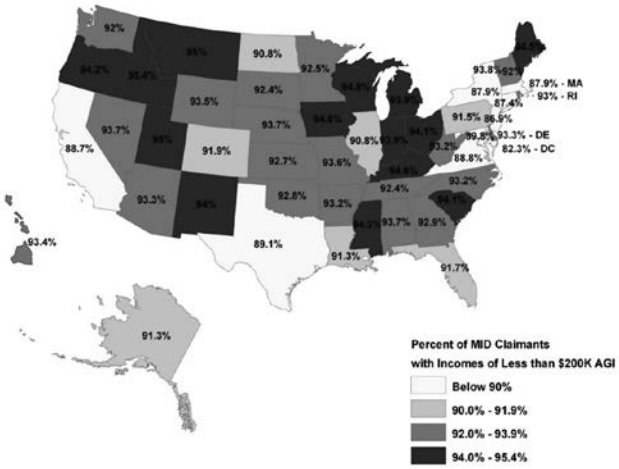


Using 2010 tax year data, NAHB has further broken down the distributional data to examine how many taxpayers, with AGI below $200,000, claim the mortgage interest deduction, by state:

Percentage of MID Claimants with Incomes of Less than $200K AGI



These numbers range from a low of 82.3% in Washington, DC, which is a small geographic area with high housing costs and high incomes, to a high of 95.4% in Idaho. In large part, there is little variance from

state to state, with nearly all states ranging from 88% to 93%. The data is clear that the mortgage interest deduction is overwhelmingly a middle class deduction, regardless of where a homeowner lives.

It is worth noting a technical point about all of these distribution claims. First, the JCT analysis use economic income, which includes items many people would not consider "income," thus placing them in a higher income class than they would expect. Examples would be employer paid payroll tax and employer paid health insurance. Second, these are ***household*** income measures. Thus, married couples with dual incomes are going to be concentrated at the top. Given the connection between marriage and homeownership, it is important to keep in mind what household economic income of $200,000 means: it could be a married couple both earning $85,000.

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. IRS data reveal that 36.7 million taxpayers claimed the MID for tax year 2010. While this number represents approximately a quarter of all tax returns, it is nearly half of all taxable returns and about 70% of itemizing returns. The more relevant numbers, however, are the shares of homeowners. There are nearly 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, more than 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, 80-90% of all mortgage interest paid has been claimed as a deduction on Schedule A. Clearly, the mortgage interest deduction is broadly claimed. It is also important to keep in mind that 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.

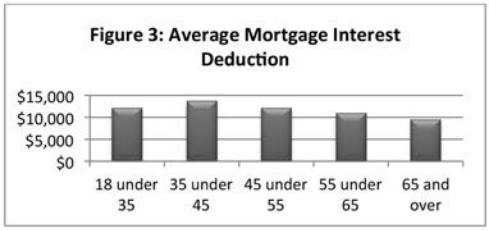
Family Size Matters

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.[30] Taxpayers with two exemptions – a proxy for size - who claimed the MID had an average tax benefit of $1,500. Taxpayers with four exemptions had an average benefit of approximately $1,950. In fact, the benefit increased correspondingly from one exemption to five-plus exemptions, which is intuitive with the notion that larger families require larger homes.[31] 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, NAHB has examined the age characteristics of taxpayers claiming the mortgage interest deduction. Figure 3 plots the average mortgage interest deduction[32] by age cohort.



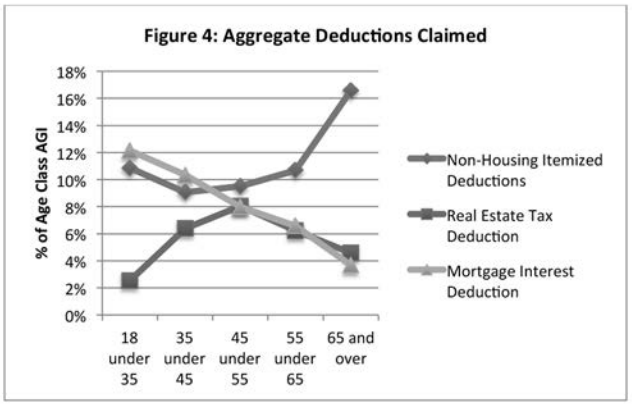
[30] Who Benefits from the Housing Tax Deductions?
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

[31] The data also show that income rises with the number exemptions for those claiming the MID. For taxpayers with AGI less than $50,000 who claim the MID, the mean number of exemptions was 2.01 in 2004. It was 2.57 for those with AGI $50,000 to $75,000, 2.89 for those with $75,000 to $100,000 in AGI, and 2.98 for those between AGI $100,000 and $200,000 and 3.03 for those above these AGI levels.

[32] 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

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.



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.

The importance of this deduction to younger buyers can be seen by looking at the United Kingdom.[33] In the 1980s and 1990s, the U.K. phased out its mortgage interest deduction. Some opponents of the mortgage interest deduction cite the U.K. when calling for eliminating the deduction in the U.S. However, the changes in the U.K. have had a dramatic impact on younger homebuyers. From 1984 to just recently, the average age of a first time homebuyer in the UK rose from 31 to 38. This is a significant delay that will have dramatic demographic impacts.

NAHB believes 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. Delayed investment in homeownership may translate into lower assets at retirement or a later retirement. 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.

[33] Analysts often make cross country comparisons when discussing the MID, noting differences or similarities in homeownership rates. We note that there are multiple factors that determine the homeownership rate, which is the number of homeowning households divided by the number of households. Thus policies that discourage household formations can have complicated impacts. Additionally, factors like average population age (older populations will have more homeownership) and urbanization rates (more urbanized nations will have lower homeownership) matter as well. For example, the U.S. is a "younger" nation (36.9) compared to the U.K. (40.5) and Canada (40.7). The U.S. is also more urbanized (82.4%) than the U.K. (79.6%) and Canada (80.7%).

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.[34]

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.

When evaluating options for tax reform, NAHB would urge the Committee 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. Generational impacts are not typically 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, Affordability, and Household Net Worth

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).[35] The exact amount depends to a great degree on how much of the tax benefit is capitalized into prices, which in turn 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.

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

[35] Some recent analysis suggests that recent data yield uncertain price effects. This has been interpreted incorrectly by some as suggestive of no price impact. This is incorrect. The inconclusive results are just that – inconclusive – given the historic movements in price and interest rates in recent years. NAHB looks to studies of older periods with less statistical noise as better guides of policy impact.

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 2009 values of 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[36]. And all existing homeowners suffered a 10% windfall loss to housing wealth due to the price decline. The winners from this policy change are cash and investor buyers, for whom the housing market is currently historically dependent on for homebuyer demand. These are not the typical owner-occupants that generate and collect the private and social benefits of homeownership.

Besides affordability, price declines would affect net worth of homeowning households. Even small price shocks can have huge impacts on housing wealth. According to the first quarter 2013 Federal Reserve Flow of Funds, household owned housing real estate totaled $17.65 trillion. At these levels, a one percentage point decline would wipe out $176 billion in wealth. A 6% decline would eliminate more than a trillion dollars of homeowner wealth. And a 15% decline would destroy more than $2.5 trillion of housing asset value. These are no trivial numbers, even at the low end. Even opponents of the MID acknowledge these points. The message is clear. Raising revenue through weakening of the MID is an expensive way to raise tax revenue, in terms of effects on homeowner wealth, and the resulting

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

spillover effects in terms of reduced consumption by these households and reduced property taxes for state and local governments.

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[37] 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.

When is a Second Home not a Second Home?

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—even if both homes are not owned concurrently. 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. This would not only act as a tax on moving, but it could distort consumer behavior by discouraging relocation or leading to homeowners moving only at the start or end of a tax year in order to minimize the tax implications.

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.[38] This rule provides parity for custom home building where the eventual 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. While both of these issues are technical and easily fixed as part of transition, NAHB raises them for consideration because no reform proposal that eliminates the second home deduction has ever considered the implications on homeowners who move or take on a 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.

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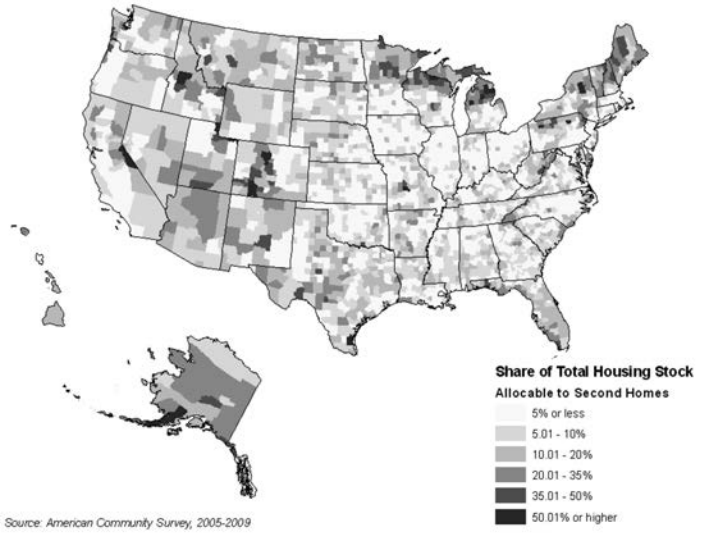
[37] Interest on debt used to acquire rental units may also in general be deducted under the tax code, but not under the mortgage interest deduction; it is a general business expense.

[38] Treasury Regulations 1.163.

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.[39] 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 the next map shows, second homes are found throughout the country.

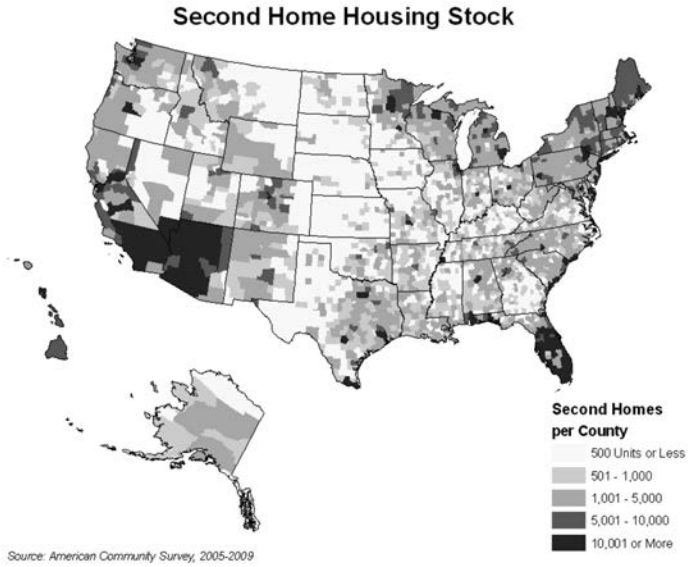
Second Home Housing Stock



Source: American Community Survey, 2005-2009

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. The next map illustrates the count of second homes throughout the country.

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



An examination of the geographic location of second homes also shows that most second homes are located in areas of the country that are generally affordable. Based on this observation, NAHB believes that homeowners using the second home deduction for a vacation home may have lower incomes than commonly recognized. Because the IRS does not require homeowners to differentiate between principal and second home mortgage interest on their tax forms, there is no IRS data available. However, NAHB has used the Consumer Expenditure Survey released by the Bureau of Labor Statistics to match the average household income to homeowners who have a mortgage on a second home. According to NAHB's analysis, the average household income is only $71,344. This is, frankly, significantly lower than many would expect. And for homeowners living in high cost areas, such as Washington, DC, or New York, having two homes at this income level may appear unfeasible, but for many areas of the country, it is possible. And the maps above correspond with many of those affordable markets. In fact, according to the 2011 survey by the National Association of Realtors, the median sales price of a second home was just $121,300.

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. This is particularly important as many impacted communities lack a diverse tax base, and second homeowners are the ideal taxpayers, often paying a higher property tax rate while not placing heavy demands on local government services.

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 that are either used for purchase, construction or improvement purposes or as a means to access equity. The type of use of the home equity loan is important in the rules for the Alternative Minimum Tax. In general, deductions for mortgage interest may be claimed against AMT taxable income. However, interest on home equity loans **not** used for home improvement purposes may not be claimed against AMT tax liability.

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.[40] 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

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.

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

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 family faces a 25% marginal income tax rate. Under present law, a dollar of mortgage interest paid for an itemizer with other Schedule A deductions 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. Further increasing the homeowner's tax burden, this proposal would also completely eliminate the deduction for state and local real estate taxes.

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 a year's 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.

In total, the Simpson-Bowles proposal imposes a significant tax increase on homeowners. As the data shows that the mortgage interest deduction largely benefits younger, middle class households, particularly those with families, the dramatic cuts proposed by moving to a mortgage interest credit, eliminating the gains exclusion, and eliminating the deduction for real estate taxes, would make homeownership much more difficult to achieve for millions of middle class families. And while some proponents of this approach have suggested that the lower marginal rates would offset the loss of these tax benefits, they ignore the fact that, according to the proposal's own distributional analysis, every taxpayer would face a large tax increase, ranging from 4.1% to a 13.5% increase, with an average increase across all tax ranges of 9.3%.[41] Surprisingly, the largest tax increase falls not on the top end, but rather on the 2nd quintile.

In fact, the use of a quintile-based table based on household income is a less transparent way of examining distributional changes compared to the income-based tables the Joint Committee on Taxation prepares. The largest problem with using the quintile approach is that it is essentially measuring whether a taxpayer is married or not. Based on 2011 Census data, the top quintile begins at $101,582 in household income—an income level considered solidly middle-class—but also reflects a taxpayer class where 78.2% are married couples. So while a married couple, both earning $55,000 a year, falls into the top quintile, a single taxpayer earning $55,000 sits within the middle quintile;

[41] The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010, pg. 32 figure 8.

correspondingly, only about half of taxpayers in the middle quintile are married. The marriage rate falls to 16.7% of taxpayers who are in the bottom quintile; these taxpayers have household income under $20,262. What the Commission's report actually shows is that household income increases when taxpayers get married.

Since the utilization of the mortgage interest deduction increases when a taxpayer is married with children, it is also interesting to note the homeownership rates within each quintile, as reported by the 2011 Consumer Expenditure Survey. The second quintile, which has a household income between $20,262 and $38,520, 35.7% of these households are married and 53% own their home. At the middle quintile, with a household income between $38,520 and $62,434, 48.3% are married and 65% own their home. The fourth quintile, with household incomes between $62,434 and $101,582, 64.5% are married and 79% own their home. In the top quintile, 78.2% are married and 88% own their home. Of course, what is missing in the Commission's report is both an income distributional analysis for high-income taxpayers, but also a breakdown of the income levels for each of three proposed tax brackets.

SOI data for those claiming the MID show a similar pattern. Almost 57% of the total deductions claimed (not final tax liability impact) of the MID for married taxpayers are claimed by taxpayers filing joint returns with more than $100,000 in AGI. It is only 17% for single taxpayers with more than $100,000 in AGI. Married taxpayers filing separately offer a useful check. They should reflect the distribution of single taxpayers more than joint returns, and this is the case. Only 14% of MID is claimed by married-separate returns with more than $100,000 in AGI.

Back to Simpson-Bowles—while the low tax rates promised have certainly caught a lot of attention, it is important to note that the Commission appeared to use tax expenditure estimates to calculate the revenue necessary to achieve them. 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 than 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 a tax increase 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. Since so much of the benefits from the housing tax incentives flow to the middle class, the proposals to eliminate or curtail them will certainly impact the middle class more significantly.

Also often lost in the debate is that the Illustrative Example, in its sweeping note that "nearly all other tax expenditures are eliminated," is proposing to end key affordable housing programs such as the Low Income Housing Tax Credit, as well as a multitude of other tax provisions that impact real estate.

NAHB would also note that several other reform proposals, including Rivlin-Domenici and the 2005 tax reform advisory panel under then-President Bush, both made recommendations similar to Simpson-Bowles. In NAHB's opinion, these reform proposals all fail to recognize the impact of real estate on the economy or an understanding of how the tax code impacts housing.

Limiting Deductions to the 28% Bracket

On several occasions, President Obama has proposed limiting itemized deductions to the 28 percent bracket. 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.[42] As we have seen in the past few years, price declines result in significant market disruptions and cause ripple effects across the economy.

The Administration's 28 percent cap proposal would also impact other areas. Under the most expansive variant of the 28 percent cap, 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 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.

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,

[42] http://www.taxpolicycenter.org/UploadedPDF/1001364_reforms_metro_housing.pdf

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 a 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 capital 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. 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.

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, particularly the middle class. 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 these homeowners is fair.

Many in Congress 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 and multifamily real estate the perils of significant tax policy changes. Most economists agree that the changes in the 1986 Act led to a crisis in commercial and multifamily 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.

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 changing 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.

Chairman CAMP. Thank you very much.

Mr. Moran, you are recognized for 5 minutes.

STATEMENT OF THOMAS F. MORAN, CHAIRMAN AND MANAGING PARTNER, MORAN & COMPANY, CHICAGO, IL, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

Mr. MORAN. Thank you. Chairman Camp and Ranking Member Levin, the National Multi Housing Council and the National Apartment Association would like to thank you for this opportunity to testify on the multifamily industry's priorities for tax reform.

My name is Tom Moran. I am the Chairman of Moran & Company from Chicago. I have been in the multifamily business for 40 years. My firm operates nationwide. We develop, own, manage, and sell apartments. I happen to also be a CPA and a lawyer, and I am acutely aware of the critical tax issues confronting our apartment industry.

The apartment industry builds vibrant communities by offering housing choices. Currently, there are 19.3 million apartment units with 35 million residents, which contribute $1.1 trillion annually to the economy and helps support nearly 26 million jobs. The demand for apartments continues to grow thanks to the changing demographic. Harvard University research shows that half of all the new households formed this decade could be renters, which is up to 7 million. Home ownership has declined from 69.2 percent to 65.5 percent in December of 2012. A 1 percent change in home ownership represents approximately 1.1 million new apartment households.

The demand for apartments is surging, but supply is not keeping up. We need to build at least an estimated 300,000 to 400,000 units per year, yet last year we delivered only 158,000 units.

Like many small businesses, the apartment industry has a considerable stake in tax reform. We ask that tax reform take special care not to harm the thousands of existing real estate businesses which provide housing for 35 million residents.

First, we believe that tax reform must be comprehensive and encompass both individual and corporate taxes, but done at the same time.

Second, more than 75 percent of all real estate businesses are formed as partnerships or LLCs, which are flow-through entities where the owners and individuals are taxed individually each year at ordinary income tax rates except in the year of sale. These entities set forth the risk and obligations of the operating partner, the financial obligations of the investing partners. These documents are extensively negotiated and are an integral part of the real estate industry as well as other small businesses. Tax reform should not affect the way that business is transacted in the future, and the current regulations pertaining to capital debt and bases should not be changed.

Third, the carried interest proposal as drafted should not apply to real estate since real estate developers and owners take substantial risks in developing and rehabbing real estate. They take development risks in buying the land, zoning the property, and guaranteeing the construction costs. They take financial risks in securing

a construction loan with a 100 percent construction guarantee and a 25 percent payment guarantee. They have investor risk. If you do not find an investor, you can lose your entire investment. If you secure an investor, he will receive a negotiated return and recoup his investment prior to any return on the carried interest.

The current interest proposals do not have a current effective date. It applies to all buildings and partnerships retroactively. Thus, if you have owned a building for 30 years and have a substantial profit, primarily due to cost inflation, the carried interest proposal would be retroactively recharacterizing the capital gain to ordinary income. This retroactive recharacterization of ordinary income is most unfair and would cause transactional havoc in partnerships, where the general partners would be taxed at 40 percent and the limited partners at 20 percent. Real estate developers take the risk, create the jobs, and should be taxed at lower capital gain rates, the same as founder shares and other capital assets.

Tax reform must retain 100 percent deduction for business interest. Real estate buildings are expensive and debt is a major portion of the capital stack. Thus, interest is an ordinary and necessary expense of doing business.

Fourth, we must protect and make permanent the Low Income Housing Tax Credit, since Harvard is currently estimating that we have a shortage of at least 3 million affordable units.

Fifth, tax reform should respect and not change the estate tax legislation enacted in January of this year.

Finally, we strongly support extending and modifying the 179 energy provisions by enabling more properties to qualify for the incentive.

On behalf of the apartment industry and our 35 million residents, we thank you for the opportunity to testify today and we look forward to answering any questions you may have.

[The prepared statement of Mr. Moran follows:]

STATEMENT BY
THOMAS F. MORAN
CHAIRMAN AND MANAGING PARTNER
MORAN & COMPANY
ON BEHALF OF THE
NATIONAL MULTI HOUSING COUNCIL
AND THE
NATIONAL APARTMENT ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
FOR THE HEARING ON
"TAX REFORM AND RESIDENTIAL REAL ESTATE"

APRIL 25, 2013

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Chairman Camp and Ranking Member Levin, the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) would like to thank you for this opportunity to testify on the multifamily industry's priorities for tax reform. We applaud your efforts to examine the nation's tax code with an eye toward enacting tax reform that simplifies the nation's tax laws while promoting economic growth and job creation.

NMHC/NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships engage in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. NAA is a federation of 170 state and local apartment associations comprised of approximately 60,000 multifamily housing companies representing more than 6.6 million apartment homes throughout the United States and Canada.

Background on the Multifamily Housing Sector

Prior to addressing the multifamily housing industry's recommendations for tax reform, it is worthwhile to take a moment and note the fundamental role multifamily housing plays in providing safe and decent shelter to millions of Americans, as well as the sector's considerable impact on our nation's economy.

In communities across the country, apartments work – helping people live in a home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice to meet their specific housing needs.

Apartment homes and our 35 million residents contribute $1.1 trillion annually to the economy. That is nearly 26 million jobs in construction, operations, leasing, management and skilled trades, as well as all the local businesses supported by apartments and the millions who live there. This tremendous economic impact is comprised of the following:

- New apartment construction produced $14.8 billion in spending, supported 323,781 jobs, and had a total economic contribution of $42.5 billion.

- The operation of the nation's existing apartments accounted for $67.9 billion in outlays, 2.3 million jobs, and a total economic contribution of $182.6 billion.
- Apartment resident spending totaled $421.5 billion, supporting 22.8 million jobs and a total economic contribution of $885.2 billion.

Demand for apartments continues to grow. With 77 million Baby Boomers who may consider downsizing and nearly 80 million Echo Boomers beginning to enter the housing market, it is no surprise that Harvard University research suggests that up to seven million new renter households will form this decade.

Unfortunately, supply is already falling short of meeting this demand. An estimated 300,000 to 400,000 units a year must be built to meet expected demand; yet just 158,000 apartments were delivered in 2012 – not enough to even replace the units lost every year to demolition and obsolescence. Furthermore, while the market continues to work through an oversupply of single-family housing, the nation could actually see a shortage of multifamily housing. The shortage is particularly acute for low- and moderate-income households. The Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of three million units.

Key Priorities for Tax Reform

Like many other small businesses, the apartment industry has a considerable stake in tax reform. In addition, we provide homes for millions of Americans covering the entire socioeconomic spectrum. We pay taxes when properties are built, operated, sold, or transferred to heirs. As the Committee drafts legislation, we ask that tax reform takes special care not to harm the thousands of businesses in the industry or the 35 million residents who call an apartment home.

Priority 1: Tax Reform Must Not Harm Pass-Through Entities

The multifamily industry is dominated by "pass-through" entities (e.g., LLCs, partnerships and S Corporations) instead of publicly held corporations. Indeed, over three-quarters of properties are owned by pass-through entities. This means that a company's earnings are passed through to the partners, who pay taxes on their share of the earnings on their individual tax returns. This treatment contrasts with the taxation of large publicly held corporations or C corporations that

often face two levels of tax. Those entities remit tax at the corporate level under the corporate tax system. Shareholders are then taxed upon the distribution of dividend income.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities. For example, given that Congress recently raised marginal tax rates on ordinary income to as high as 39.6 percent as part of the *American Taxpayer Relief Act of 2012*, rates should certainly not be increased once again. Additionally, while many are calling for a reduction in the nation's 35 percent corporate tax rate, flow-through entities should not be called upon to make up the lost revenue from this change. Nor should flow-through entities be subjected to a corporate-level tax as President Obama proposed be examined in the White House's February 2012 report, *The President's Framework for Business Tax Reform*. Finally, a corporate rate cut should not be financed by denying flow-through taxpayers credits and deductions.

Priority 2: Maintain the Current Law Tax Treatment of Carried Interest

NMHC and NAA would also like to use this opportunity to underscore our strong opposition to proposals to change the current law governing the tax treatment of carried interest. If enacted, this proposal would significantly reduce the ability to develop or rehab apartments across the nation.

A "carried interest," also called a "promote," has been a fundamental part of real estate partnerships for decades. Carried interest was designed to offset the considerable financial risks our firms take – including recourse debt on construction and rehabilitation loans, litigation, refinancing risk, cost overruns, and environmental remediation. In fact, one in ten multifamily projects never break ground. These risks have major financial consequences that carried interest helps offset, justifying capital gains treatment.

Current tax law, which treats carried interest as a capital gain, is the proper categorization of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue is inappropriate. Notably, any fees that a general partner receives that represent payment for operations and management activities are today properly taxed as ordinary income.

Taxing carried interest at ordinary income rates will adversely affect real estate partnerships. At a time when the nation already faces a three million unit shortage of affordable rental housing, increasing the tax rate on long-term capital gains will discourage real estate partnerships from investing in new construction. Furthermore, such a reduction will translate into fewer construction, maintenance, on-site employee, and service provider jobs during a period in which the unemployment rate remains abnormally high.

For these reasons, in 2010, both the U.S. Conference of Mayors and the National Association of Counties passed resolutions opposing this proposal as it relates to real estate partnerships and urged Congress to maintain the current law-capital gains treatment of "carried interest," noting that any change would bring extremely negative consequences to "main streets" throughout the country.

Additionally, it should be noted that proposals that have been made to tax carried interest at ordinary income rates as opposed to capital gains tax rates would retroactively recharacterize income from capital gain to ordinary. It is extremely unfair to change not just the tax rate, but also the characterization of income in such a retroactive manner, which, in many cases, could be well over a decade after the underlying partnership was formed. Moreover, modifying the tax treatment of carried interest would force the general partner to face ordinary income tax rates while the limited investment partners would see capital gains rates. There is little justification for such a disparity that would certainly disrupt the decision making of real estate partnerships that never anticipated that the character of income would be changed. Thus, if Congress were interested in modifying the tax treatment of carried interest, it should do so only with respect to real estate that comes into existence after the effective date of the proposal.

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. Enacting a bad tax law, such as changing the taxation of carried interest, merely to gain revenue to make other tax changes, is a distorted view of tax policy, which demands that each tax proposal be judged on its individual merits.

Priority 3: Retain the Full Deductibility of Business Interest

Under current law, business interest is fully deductible. However, efforts to prevent companies from overleveraging are leading to an examination of whether the current 100 percent deduction for business interest expenses should be curtailed. Unfortunately, reducing this deductibility would greatly increase the cost of debt financing necessary for multifamily projects, curbing development activity at a time when supply is falling well short of demand.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities. Because such entities often look to debt markets to garner capital, the full deductibility of interest expenses is critical to promoting investment. Indeed, according to the Federal Reserve, as of September 30, 2012, total multifamily debt outstanding was $846.6 billion. Reducing the full deductibility of interest would undoubtedly increase costs for owners and developers of multifamily housing and negatively impact aggregate construction.

In addition to harming the multifamily industry, it is also instructive to note that modifying the full deductibility of business interest would be precedent setting. In fact, Drs. Robert Carroll and Thomas Neubig of Ernst & Young LLP concluded in their analysis, *Business Tax Reform and the Tax Treatment of Debt*:

> The current income tax generally applies broad income tax principles to the taxation of interest. Interest expenses paid by borrowers are generally deductible as a business expense, while interest income received by lenders is generally includible in income and subject to tax at applicable recipient tax rates. With this treatment, interest income is generally subject to one level of tax under the graduated individual income tax rates. This is the same manner in which most other business expenses, such as wages payments to employees, are taxed, and also follows the practice in other developed nations.

Priority 4: Protect the Low-Income Housing Tax Credit and Make Permanent the Flat 9 Percent Credit

The Low-Income Housing Tax Credit (LIHTC) has a long history of successfully generating the capital needed to produce low-income housing while also enjoying broad bipartisan support in Congress. According to the National Council of State Housing Agencies, the program has led to the construction of more than 2.4 million units since its inception in 1986. Maintaining this supply of affordable housing is critical given that the market is short at least three million affordable

rental units, according to Harvard University estimates. The program has also been an important source of economic development for many communities, helping to revitalize struggling neighborhoods. At its peak, the LIHTC program created approximately 140,000 jobs and $1.5 billion in state and local tax revenues annually.

The LIHTC has two components. The so-called 4 percent tax credit can be used to subsidize 30 percent of the unit costs in an acquisition of a project and can be paired with additional federal subsidies. In contrast, the 9 percent tax credit supports new construction by subsidizing 70 percent of the costs.

Developers receive an allocation of LIHTCs from state agencies through a competitive application process. They generally sell these credits to investors, who receive a dollar-for-dollar reduction in their federal tax liability paid in annual allotments, generally over 10 years. The equity raised by selling the credits reduces the cost of apartment construction, which allows the property to operate at below-market rents for qualifying families; LIHTC-financed properties must be kept affordable for at least 30 years. Property compliance is monitored by state allocating agencies, the Internal Revenue Service, investors, equity syndicators and the developers.

First and foremost, Congress should retain the LIHTC as part of any effort to overhaul the nation's tax code. It should also improve the LIHTC by making the flat 9 percent and 4 percent tax credit rates permanent. Because these rates float and are not fixed, their value can be reduced by as much as 50 basis points, which, in turn, reduces the amount of resources available to finance affordable housing.

Notably, in January 2013, Congress enacted the *American Taxpayer Relief Act of 2012* that extends the temporary fixed rate on the 9 percent tax credit for projects that received a LIHTC allocation prior to January 1, 2014. Given the current low interest rate environment, the actual value of the credit is likely to fall below the 9 percent mark for projects receiving an allocation following the deadline, reducing investors' activity in the affordable housing sector. For this reason NMHC and NAA propose to make the fixed 9 percent credit permanent and to extend the fixed rate policy to the 4 percent tax credit, keeping financing flowing for acquisitions.

Priority 5: Preserve Current Law Estate Tax

As part of the *American Taxpayer Relief Act of 2012*, Congress has enacted permanent estate tax relief legislation. The Act sensibly establishes an exemption level of $5.25 million (indexed for inflation) and a top tax rate of 40 percent. It also retains the stepped-up basis rules applicable to inherited assets. NMHC and NAA believe that the current structure of the estate tax effectively enables owners, operators and developers of multifamily housing to transfer assets to future generations. The law should not be further modified as part of tax reform.

There are three key elements to the estate tax: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements are important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- *Exemption Levels:* The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. In 2013, there is a $5.25 million exemption.
- *Tax Rates*: The estate tax rate applies to the value of an estate that exceeds the exemption level. The maximum rate is 40 percent.
- *Basis Rules:* The basis rules determine the tax basis of inherited property. There are generally two different types of basis rules—stepped-up basis and rollover basis. The estate tax today features stepped-up basis rules, and under this regime, the tax basis of inherited property is reset to reflect the fair market value of the property at the time of the inheritance. By contrast, under rollover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor. This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Retaining a stepped-up basis rule is critical for estates that contain significant amounts of depreciated real property as it helps heirs reduce capital gains taxes and maximize depreciation deductions.

Priority 6: Provide Incentives for Improving Energy Efficiency in Commercial Buildings and Large Multifamily Properties

As the Committee considers how the tax code could be used to facilitate national priorities in the energy sector, we wish to call your attention to the Energy Efficient Commercial Buildings Tax Deduction (Sec. 179D of the Internal Revenue Code of 1986) and the importance of this incentive in achieving improved environmental quality, reinforcing our national security, creating jobs

in the construction and manufacturing sector and increasing housing affordability by decreasing utility expenses for millions of Americans who live in apartment homes.

S. 3591, the *Commercial Building Modernization Act*, which was introduced in the 112th Congress, provides a responsible plan for enhancing the current Sec. 179D to assist property owners to make meaningful improvements in the energy performance of their properties. Many older properties have been unable to fully utilize the current-law incentive because they have had difficulty in achieving the requisite 50 percent improvement in building energy performance over the level specified in the 2001 version of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) 90.1 code. While S. 3591 includes updated energy code references against which whole building performance will be measured for many properties, it also includes a pathway for older properties to qualify for incentives that will assist property owners in making building system upgrades that will yield significant energy savings.

Older building structures face technical limitations in achieving the energy performance metrics specified by the current code, let alone reaching the incremental "above-code" performance characteristics required to claim the current deduction under Sec. 179D. S. 3591 establishes a sliding scale of energy improvements, using the property's current energy performance as the baseline. This pathway of significant improvement in energy performance relative to the property's own baseline performance will provide a much-needed financial tool for property owners who want to make these types of investments but have not been able to do so.

Advances in residential construction methods have improved the energy use profile of new buildings; however the majority of the nation's building stock predates the use of highly energy efficient products and techniques. The U.S. Department of Energy (DOE) reports that housing built after 2000 used 14 percent less energy per square foot than housing built in the 1980s and 40 percent less than housing built before 1950.[1] As such, there is considerable room for improvement in energy performance even among well designed, constructed and maintained properties. A recent study conducted by CNT Energy and the American Council for an Energy-Efficient Economy finds that "[b]uilding owners often need financial incentives to adopt new technologies or equipment with higher up-front costs. Despite this, studies have documented

[1] U.S. Department of Energy, 2011 Buildings Energy Data Book. March 2012. Chapter 2.

that affordable housing, often multifamily, receives a disproportionately small share of available energy efficiency funding."[2]

According to the American Housing Survey (2009), almost 81 percent of the nation's stock of apartment properties (with 5 or more units) was constructed prior to 1990, which marks the decade in which the first building energy codes were implemented. This older stock of housing, which is an important source of affordable housing, represents a significant opportunity for achieving energy savings while at the same time adding to the available spending capacity of individuals who live in these apartment homes. This is a significant consideration given that in 2010 approximately 70 percent of renter households had incomes below the *national median* and more than 40 percent had incomes in the bottom quartile.[3] Furthermore, "energy costs as a share of gross rents rose from 10.8 percent to 15.0 percent between 2001 and 2009. Lowest income renters saw the largest increase in their utility share, a jump from 12.7 percent to 17.4 percent."

There is a direct relationship between the age of a residential building and energy expenditures. The per-square-foot energy costs of housing constructed between 1980 and 1989 is 16 percent higher than that of a building constructed after 2000. Those expenditures soar to a 28 percent increase in residential buildings built between 1970 and 1979 over post-2000 properties.[4] Energy efficiency in multifamily properties could be economically improved by 30 percent with a savings of $9 billion in averted energy costs not to mention the substantial savings in greenhouse gas emissions.[5]

NMHC/NAA believe that a sound national tax policy can be used to catalyze a market transformation marked by significant improvements in building energy performance. A meaningful and predictable tax incentive would leverage private investment in qualified building retrofits and would have a positive effect on the economy as it would result in increased demand for construction services, materials and equipment.

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[2] CNT Energy and American Council for an Energy-Efficient Economy, Engaging as Partners in Energy Efficiency: Multifamily Housing and Utilities. January 2012. http://www.cntenergy.org/media/Engaging-as-Partners-in-Energy-Efficiency-MF-Housing-and-Utilities-Final-012512.pdf. p.4.

[3] Joint Center for Housing Studies of Harvard University. America's Rental Housing-Meeting Challenges, Building on Opportunities. 2011. p. 17 http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/americasrentalhousing-2011.pdf; U.S. median household income fell from $51,144 in 2010 to $50,502 in 2011 according to the *United States Census, American Community Survey Briefs*, September 2012, Appendix Table 1, page 5.

[4] U.S. Department of Energy, *supra* note 1, at p. 2-20 derived from Table 2.3.12.

[5] Joint Center for Housing Studies of Harvard University, *supra* note 2, at p.33.

Conclusion

In closing, NMHC/NAA look forward to working with the House Ways and Means Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. On behalf of the apartment industry and our 35 million residents, we stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide.

Chairman CAMP. Well, thank you, Mr. Moran.

Mr. Moss, you are recognized for 5 minutes.

STATEMENT OF ROBERT MOSS, SENIOR VICE PRESIDENT, BOSTON CAPITAL, BOSTON, MA, ON BEHALF OF THE HOUSING ADVISORY GROUP

Mr. MOSS. Chairman Camp, Ranking Member Levin, Members of the Committee, thank you for inviting me to appear today to discuss the Low Income Housing Tax Credit. My name is Bob Moss and I am the Senior Vice President for Affordable Housing at Boston Capital, a real estate finance and investment firm that raises capital for investment in affordable rental housing. I am here today also on behalf of a broad coalition of over 450 State, national and local affordable housing organizations, the Affordable Rental Housing Action Campaign.

The housing credit is a bipartisan product of tax reform and a permanent feature of the Tax Code. Today the housing credit is generally recognized as the most successful housing production and preservation program. The housing credit is actually two programs. First, it is a capped tax credit program where States receive an annual amount of tax credits based on their population, and second, it is a bond credit program which combines fewer tax credits with tax-exempt multifamily bonds.

One of the essential elements of the housing credit program is the role that State housing finance agencies play in administering the program. States annually prepare and publish qualified allocation plans that lay out State housing needs and priorities after soliciting public input through a transparent and open process.

Our Nation is experiencing a crisis in affordable housing. This is not a new crisis, but it has grown worse in recent years. One quarter of all renters pay half or more of their income in rent. Nearly two-thirds of extremely-low-income household renters pay at least half of their income in rent. And the reason low-income households face such high rent burdens is the shortage of affordable housing. On average, State housing finance agencies receive applications annually for more than twice as much housing credit as they have available.

Federal priorities have a major impact in how States run their housing credit program. And while the statute permits targeting to households with incomes up to 60 percent of area median income, according to a recent study by the Furman Center at New York University, the program in fact reaches much further down the income scale, where the need is greatest.

Since the housing credit program was established in 1986, it has made possible the development of more than 2.5 million rental homes. Each year about 100,000 new rental homes are developed or preserved under the program. This program also accounts for 95,000 jobs annually. This produces almost $8 billion of local income through wages for workers and profits for small businesses, and about $1 billion in taxes and other revenues for local governments.

The housing credit serves the full spectrum of housing need, including housing for families, seniors, people with special needs, veterans, and the homeless, in all geographic areas. Many local

governments have used the housing credit over the years to spark neighborhood revitalization and help restore blighted areas.

There are several key elements of the program that have led to its success. First, State housing finance agencies administer the program. This ensures that properties are developed according to local housing needs. Second, the private sector provides market discipline. And, third, the housing credit program is well designed within the Internal Revenue Code. Tax credits are not earned until the development is completed, it is in operation and housing qualified residents. This means that real estate construction and other risks are borne by the private sector, not the Federal Government.

This threat of recapture imposes a powerful discipline on the program that ensures the properties are properly underwritten at the outset and diligently managed throughout the compliance period. Housing would not be built or preserved but for the capital contributed because of the housing credit. It is a safety net program that requires continued Federal support.

This Committee did great work in 1986 when it created the housing credit. You designed a critically important program to maximize its efficiency, ensure investment occurs where it is needed the most, and harness private sector business discipline to achieve an important public policy objective.

I thank you for the opportunity to address you today. Thank you.

[The prepared statement of Mr. Moss follows:]

Testimony of Robert Moss
Senior Vice President, Boston Capital

Committee on Ways and Means
Hearing on Tax Reform and Residential Real Estate
April 25, 2013

Chairman Camp, Ranking Member Levin, and members of the Ways and Means Committee, thank you for inviting me to appear before you to discuss the Low-Income Housing Tax Credit program.

My name is Bob Moss and I am Senior Vice President for Affordable Housing Origination at Boston Capital, a real estate finance and investment firm that raises capital for investment in affordable rental housing. I also serve as Chairman of the Housing Advisory Group, an organization founded to advocate on behalf of affordable housing.

I appear today on behalf of a broad coalition of over 450 national, state and local affordable housing organizations, the Affordable Rental Housing A.C.T.I.O.N. campaign. Through advocacy and education efforts around the Housing Credit, the A.C.T.I.O.N. campaign focuses on ensuring that low-income working families throughout the nation have access to decent, safe, affordable rental housing. The mission of the A.C.T.I.O.N. campaign is to protect and preserve the Housing Credit as a means of providing a wide variety of affordable rental housing options to low-income families, seniors and veterans in communities across the nation.

The Housing Credit is a product of tax reform. It was enacted into law the last time this Committee undertook the enormous task of reforming the federal income tax system in the Tax Reform Act of 1986. According to the "General Explanation of the Tax Reform Act of 1986" as prepared by the Joint Committee on Taxation, the Housing Credit was enacted because "Congress was concerned that the tax preferences" then in effect "were not effective in providing affordable housing for low-income individuals. Congress believed a more efficient mechanism for encouraging the production of low-income rental housing could be provided through the low-income rental housing tax credit."

Today, the Housing Credit is a great success across the nation. It is generally recognized as the most successful housing production and preservation program in the nation's history.

Program Basics

The Housing Credit is actually two programs: First, it is a capped tax credit program where states receive an annual amount of tax credits based on their population, and then allocate those credits to developers who build rental housing according to the affordable housing needs of the state. Second, it is a bond credit program which combines fewer tax credits with tax-exempt multifamily bonds.

The allocated tax credits are provided to property developments over a ten-year period and are designed to subsidize up to 70% of the cost of new and rehabilitated property, and up to 30% of the cost of acquiring existing affordable housing property. The bond tax credits are also claimed over a ten-year period and are designed to subsidize up to 30% of the cost of the property.

Under the Housing Credit program, developers have the option of setting aside at least 20% of the apartments within a development for residents with incomes at or below 50% of the area median income (AMI); or they may set aside 40% of the apartments to residents with incomes at or below 60% of AMI. In practice, however, most developments are 100% targeted to qualified residents. Residents pay rent limited to 30% of qualifying income.

Developments must remain affordable and subject to IRS compliance rules for 15 years, but the program requires the property to remain affordable for 30 years, though many state and local governments require longer affordability periods.

One of the essential elements of the Housing Credit program that has made it so successful is the role that state housing finance agencies play in administering the program. States annually prepare and publish Qualified Allocation Plans (QAPs) laying out state housing needs and priorities, after soliciting public input through a transparent and open process. States typically use a scoring system that awards points based on meeting the detailed housing priorities of the state. Developers compete to score the highest points under the QAP so that they are awarded an allocation.

The tax credits enable developers to raise equity capital from investors who earn their return from the tax benefits, not from the property's cash flow.

Properties are developed primarily with equity capital instead of debt capital as is typical in other real estate transactions. Affordable housing must rely on equity financing as opposed to debt financing because the limited rents on the property prevent there being sufficient cash flow to service high debt costs.

Affordable Housing Needs

The Housing Credit serves a great need.

Our nation is experiencing a crisis in affordable housing. This is not a new crisis but it continues to worsen every year. Several factors -- including national economic weakness, years of stagnating income at the low-end of the economic spectrum, and increasing demands for rental units -- have exacerbated the affordable housing crisis. This means that a rising percentage of renters face high rent burdens.

One quarter of all renters pay half of their income in rent. Nearly two-thirds of extremely low-income renters (those with incomes at or below 30% of area median income) pay at least half their income in rent. When housing costs claim such a high proportion of family income, fewer resources are available for other basic needs such as food and health care, transportation, and education costs. High housing costs often lead to great stress and family instability.

One major reason low-income households face such high rent burdens is the shortage of affordable housing. For every 100 extremely low-income households, there are only about 36 affordable available rental homes. Nationally, the gap between the number of available affordable rental homes and extremely low-income households that need them is more than 6.5 million homes.

State housing finance agencies recognize this problem. There are too few resources available to address needs. On average, state finance agencies receive applications annually for more than twice as much Housing Credit as they have available, while calls increase for the program to meet more and more needs, including for permanent supportive housing and preservation of federally assisted housing.

Because of the acute affordable housing needs of this nation, and the growing claim on the Housing Credit program to serve various needs, the Housing Commission of the Bipartisan Policy Center recommended in a February 2013 report that annual Housing Credit authority be increased by 50 percent to address these unmet needs.

Meeting the Nation's Affordable Housing Priorities

The Housing Credit is largely run by the states which go through a rigorous process to determine their affordable housing needs. However, there are three priorities required under federal law. The Internal Revenue Code requires that states give preference to developments: a) serving the lowest income tenants; b) obligated to serve qualified tenants for the longest period of time; and c) located in qualified census tracts and the development of which contributes to a concerted community revitalization plan.

These federal priorities have a major impact on how states run their Housing Credit program. While the statute permits targeting to households with incomes up to 60% of AMI or less, according to a recent study by the Furman Center at New York University, the program in fact reaches much further down the income scale where need is greatest.

- About 40% of LIHTC residents have incomes at or below 30% of area median income.
- About 60% of LIHTC residents have incomes at or below 40% of area median income.
- Approximately a third of LIHTC residents are charged rents that are at least 20% below the maximum allowable rent.

LIHTC Program Economic Contribution

Since the Housing Credit program was established in 1986, it has made possible the development of more than 2.5 million affordable rental homes.

Each year about 100,000 new rental homes are developed or preserved under the program.

The program also accounts for about 95,000 jobs annually. This produces almost $8 billion of local income through wages for workers and profits for small businesses, and about $1 billion in taxes and other revenues for local governments.

The Housing Credit serves the full spectrum of housing need, including housing for families, seniors, people with special needs, and the homeless, in all geographic areas, including urban, suburban, and rural areas. States tailor their allocation plans each year to respond to emerging needs; most recently to housing homeless veterans, providing supportive housing for those with special needs, and preserving existing federally assisted housing at risk of being converted to market rate housing. Many local governments have used the Housing Credit over the years to spark neighborhood revitalization and help restore blighted areas.

The Keys to Success

There are several key elements of the program that have led to its success.

First, is the role that state housing finance agencies have in administering the program. This has ensured that property is developed according to local housing needs, and without excessive subsidies. Each state underwrites the award of tax credits to determine the amount of tax credits necessary for financial feasibility and long-term viability. Each state also imposes limitations on developer fees.

Second, is the role of the private sector in providing market discipline to the underwriting of the properties. Almost all equity capital in the program today is raised from large corporate investors who carefully underwrite their investments to ensure the long term viability of the property. Most investment capital is raised from financial institutions, largely commercial banks but also from insurance companies.

Third, the Housing Credit program is well-designed within the Internal Revenue Code. Tax credits are not earned until the project is completed, in operation, and housing qualified residents. This means the real estate risk is borne by the private sector not the federal government. The equity capital from investors is contributed up front to develop the properties, but the tax credits are received over ten years and subject to credit recapture over 15 years.

This threat of recapture imposes a powerful discipline on the program that ensures the properties are underwritten correctly at the outset and managed correctly throughout the compliance period. As a result, according to a 2011 study by the national accounting firm CohnReznick, the cumulative foreclosure rate for Housing Credit financed property since the program was created in 1986 is less than 1%. This is a truly remarkable record, far lower than any other real estate asset type.

Conclusion

Unlike most tax expenditures before this Committee, which largely encourage activity at the margin -- activity that would occur at some level without the tax support -- there would be virtually no affordable housing development without the Housing Credit program.

The reason is that the construction of affordable multifamily housing, rented to lower income families at controlled rents, is fundamentally uneconomic without a subsidy.

Housing would not be built or preserved but for the capital contributed because of the Housing Credit. It is the key financing source in almost all affordable rental housing development in this country.

This Committee did great work in 1986 when it created the Housing Credit program. You designed a critically important program to maximize its efficiency, ensure investment occurs where it is most needed, and harness private sector business discipline to achieve an important public policy objective.

Chairman CAMP. Well, thank you. Thank you all very much.

Mr. Thomas, this is directed at you. What is the biggest hurdle for people when they are buying a home? Is it having enough for the downpayment, especially now that we moved away from the zero-down loans that really helped fuel the subprime mortgage crisis? Is it interest rates? Is it some other factor, in your opinion?

Mr. THOMAS. Well, it depends on the time of which you are speaking. If you are speaking of today, it is probably downpayment, because leaders are requiring more downpayment on loans other than FHA or VA, and so you have a bigger hurdle with the downpayment.

Chairman CAMP. All right.

Mr. Dietz, any comment on that? Is that your thought as well?

Mr. DIETZ. The downpayment is a challenge. Labor market stability, wage growth, as the previous panel mentioned. Appraisals are a serious challenge. You can qualify for a mortgage, but if the appraisal comes in and says the home is inconsistent with where the appraisal is, then the sale falls through. And that is a problem for building as well as for home buyers.

Chairman CAMP. All right. Just to sort of educate me and the Committee about the actual real estate market, what percentage of the market is first-time home buyers?

Mr. THOMAS. It is generally about a third. At the present time it may not be quite that high because there has been such an influx of investor buyers, and so it has forced a lot of the first-time home buyers out of the market, because they are having to compete for homes. It is very difficult. In my own area, we have a 1-month supply of homes, and so the first-time home buyer is really at a disadvantage.

Chairman CAMP. Sure. And what percentage would be so-called second homes? And is that obviously in regions of the country——

Mr. THOMAS. Sure.

Chairman CAMP [continuing]. You know, second homes probably make up a larger portion of that.

Mr. THOMAS. Like in yours.

Chairman CAMP. Yes. Especially in the northern part.

Mr. THOMAS. Correct.

Chairman CAMP. Just in general, though, I mean.

Mr. THOMAS. Typically it is about 10 percent.

Chairman CAMP. All right. What percentage of that second-home market is, as I think some of you said, and I think you said in your testimony, people that are, say, maybe moving and they have two homes or they are getting ready for retirement and they buy a second home 5 years before they are going to retire? What percentage of that second-home market is that sort of——

Mr. THOMAS. Unfortunately, we don't have statistics based on exactly what that is, but we know that as people are moving across the country or even within a given area, that this is a factor. But there are a lot of people that do buy second homes in anticipation of retiring into them, so that is a big percentage.

Chairman CAMP. That is what I was wondering about.

Mr. THOMAS. Yeah.

Chairman CAMP. And in terms of home values, how do home values break down nationwide? I mean, what are between, say,

zero and 100, 100 to 200, 200 to 300? Do you have that, or if not, can you get that to me?

Mr. THOMAS. I can get it to you.

Chairman CAMP. All right.

I wondered, Mr. Moss, if you just wanted to comment on the previous panel. There was a lot of testimony about the incentives in the Low Income Housing Tax Credit and maybe it should go more to the individual as opposed to the way it is structured now. I don't know if you had a chance to think about that and if you had any comment on that.

Mr. MOSS. Well, in looking at——

Chairman CAMP. You may want to hit your microphone.

Mr. MOSS. Sorry.

If you look at most of the tax credit properties right now, in terms of achieving deeper targeting, they do. If you look at the Furman Center study and the type of targeting that is going on across the country, most tax credit properties are not just set at 60 percent of area median income. They serve levels at 40, at 30 percent of median income. So there is some targeting going on there that would not be achievable under any other program. And especially with the private capital coming in to leverage these properties, it is not achievable under any other type of spending program.

Chairman CAMP. In terms of the supply of low-income housing, is it in a shortage all over the country or are there regions that that is less the case?

Mr. MOSS. The universe of affordable housing, when you start to talk about all the population types, is dramatic. As I mentioned in my testimony, we are now doing a lot of housing for veterans, returning veterans. There is a shortage. There is a great shortage of affordable housing in the United States in all areas. The nice and the great part about the credit is it is flexible and it can serve to provide housing for a lot of different housing types.

Chairman CAMP. I guess I didn't ask that the right way. Are there areas of the country where the need is greater than others?

Mr. MOSS. Certainly in higher population areas where there is more employment, there is probably more of a need. But also you have to remember that the bond program serves as a useful tool in those areas as well, not just the capped credit. And you are going to see that there is, if you look at the credits across the country with the per capita allocation formula, there is very little that spills over into the national pool that is unused, if any at all.

Chairman CAMP. Mr. Thomas, what is your view on the 28 percent cap in the President's budget?

Mr. THOMAS. We don't support that. We think that is going to raise the rate for many people as to what they actually pay. So it has generally a detrimental effect.

Chairman CAMP. All right.

Mr. Dietz, do the Home Builders have a position on that?

Mr. DIETZ. We are opposed to the 28 percent cap, too. And just to add an item, you know, something you don't see discussed a lot is that the proposal has grown over time as it has appeared in the President's budget proposals year by year. It now includes the Sec-

tion 199 deduction, which would affect a lot of pass-through businesses, other exclusions. So that is an issue.

Chairman CAMP. All right. Thank you.

Mr. Levin is recognized.

Mr. LEVIN. Welcome. You know, I think it is so important for us to dig out the facts, and I think what you have testified to helps us.

I am not in favor of the status quo. I am also not in favor of changes that don't take into account the realities. For example, second homes, Mr. Chairman, I think you and I might agree, I–75 people come up your way on Fridays, and I try to move up I–75 in the suburban area. And when you take into account who is traveling up I–75 from Detroit and suburban Detroit up north, my guess is I think a lot of them are going to small second homes. And I think we simply need to be careful about our proposals.

I also think, though, that we need to make sure that we are not opposed to everything. The 28 percent proposal of the President relates to some of the facts that came out earlier, and that is, who is benefiting, who is taking advantage of accessing the deduction. And in terms of numbers, the largest numbers by far are people under $200,000. It is also true that proportionately a very substantial amount goes to people in higher income brackets. And so I think we just need to take a hard look at that.

Also, I think we would welcome you, if you don't have time through my questions, to take a look at the testimony of others before you, because, for example—by the way, Mr. Moran, I am not going to ask you questions about carried interest, because it doesn't really relate directly to this hearing. The carried interest issue covers more than real estate. So let's have that discussion some other time. Okay? We have been working hard on it and want your views. So many people take risk of all kinds, and they pay ordinary income tax on the benefits. Sometimes they don't receive any benefits from the risky economic effort.

But I think it would be useful if you would take a look at the testimony that came before. And it was really striking, Mr. Toder, if I pronounced his name correctly, on page 7 has this paragraph: "Some empirical research and observations confirmed this lack of a relationship between the MID and home ownership rights."

I think you need to look at testimony like this and give us further indications as to the relationship. For example, I think maybe it was you, Mr. Renacci, I am not sure, who said that when people buy a house they don't look at what their mortgage payment will be in terms of taxation. I find that somewhat hard to understand. I would think most people who are going to itemize if they buy a house would take note of what their monthly payment really would be on their mortgage. I think all of us do that all the time who have mortgages.

So I think it would be useful for you to take a look at the testimony that came earlier—and thank you for your patience—and give us your views on that.

And the same on low-income housing, because while the testimony has been basically positive, I am afraid that there may be suggestions that we would significantly change that. And I am not in favor of the status quo, but I think going after these important

policies, it is not a loophole, the Low Income Housing Tax Credit, it is a policy adopted by this country on a bipartisan basis, and I think we better be careful before we significantly tamper with it.

My time is up. But give us your further ideas. Go back over the testimony that we heard earlier and give us any comments, if you would.

Chairman CAMP. All right. Thank you.

Mr. Johnson is recognized.

Mr. JOHNSON. Thank you, Mr. Chairman.

I would like to start with Mr. Thomas and Mr. Dietz, if you don't mind. On July the 11th, the Joint Committee on Taxation issued a report on the tax treatment of household debt, and in that report there is a chart which shows a surge in home mortgage debt from around 2002 through 2007. I asked them about that at a hearing we had back in July a couple years ago, and I wanted to share with you what Joint Tax had to say in a followup letter addressed to me and get your reaction.

According to Joint Tax, "Given that the home mortgage interest deduction has become less valuable over time, the deduction does not appear to explain the increase in home mortgage debt from 2002 to 2007." I would like to know your thoughts about this. First, Mr. Thomas.

Mr. THOMAS. Well, I am not sure there is a correlation there. I think that the basics of having the mortgage interest deduction allows people to take that deduction and it allows for people to buy a home, especially a first-time home.

You know, the thing that most people don't understand is that you can't take a snapshot at any one given time and get a clean picture of the people that are taking advantage of the mortgage interest deduction. It is really more like a movie, because the majority that take advantage of the deduction are younger and they are building their families and they are starting out, so that a greater portion of their income goes toward the debt of a home. And the mortgage interest deduction is very important to them, because it allows them to buy the size home they need in the community they are in. And that is all factored in when they apply for a loan, because the lender will look at what the mortgage deduction is going to do for them, and that allows them to purchase as much as they can.

Over time, as they pay the mortgage down, the interest deduction is less meaningful, or if they pay their home off, or if they decide in later years to downsize. So all of those factors have to be taken into consideration.

A lot of what we saw in the buildup during that period of time was really due to the price of housing. It had nothing to do with what the mortgage interest deduction did to it. It was really in the pricing of homes.

Mr. JOHNSON. Mr. Dietz.

Mr. DIETZ. I agree with the Joint Tax conclusion. When you look at the run-up in debt, the run-up in housing earlier in the decade, it was a lot of speculative bubbles, flippers and such. The way that the mortgage interest deduction's benefits accrue are, as he mentioned, sort of life cycle, and so they are over a number of years. The MID is not going to fuel a speculative bubble.

And if you want a cross-country comparison, an experiment, so to speak, you can look at when we had housing bubbles in a number of countries around the world. They obviously don't have the same tax laws that we do, so, you know, it is hard to make a connection between the two, so I think Joint Tax is correct.

Mr. JOHNSON. Well, I thank you for that.

Mr. Thomas, and also Mr. Dietz, I wanted to get your reaction to some points made by a couple of the witnesses on the first panel. Two of them, Eric Toder from the Tax Policy Center and Mark Calabria from Cato, both argue the mortgage interest deduction has really no effect on home ownership. I would like to know your thoughts on that.

Mr. THOMAS. Well, I would greatly disagree with that. I think that it does affect home ownership. If you look at Great Britain, which is just in the process of reducing the mortgage interest deduction, the average homeowner entry level into home ownership is now advanced by 7 to 8 years, so it means that they are delaying home ownership by 7 to 8 years. A lot of that is due to the fact that they can't deduct their mortgage interest anymore.

We think we would have the same problem. So we think that there is quite a correlation there.

Mr. JOHNSON. It makes it cost more to get in it, doesn't it?

Mr. THOMAS. Absolutely.

Mr. JOHNSON. Yeah.

Mr. DIETZ. I agree. I think it is not only an impact on the home ownership rate, the number of home-owning households in the country, but the timing of when they become homeowners. And that 7 years, using the United Kingdom as a good example, those are big years in terms of family events, household formations, marriage, children, and most importantly wealth accumulation over a long period of time, because home ownership is a vehicle for accumulating family wealth.

Mr. JOHNSON. You know, the Tax Policy Center also argues that the mortgage interest deduction encourages upper-middle-class households to buy larger and more expensive homes. Cato makes a similar argument, in that the benefits of deductions are highly concentrated among both the highest income and mostly leveraged household. I would like your thoughts on that.

Chairman CAMP. Yeah. Just briefly, please.

Mr. THOMAS. Well, again, if you look at the statistics in our written testimony, that is contrary to what we have, which is that the vast majority of the benefit goes to people that are under $200,000 in income, and that a high percentage goes to those earning under $100,000.

Chairman CAMP. Thank you. I do think we have to be careful in our comparisons to England, because they have large chunks of their country where you cannot get fee simple, you can only get a long-term lease, and that is a very different sort of model than we have in the United States.

Mr. Rangel is recognized.

Mr. RANGEL. Thank you so much, again, for your patience and for sharing your views with us.

I was intrigued by Congressman Johnson's question as relates to the connection between mortgage interest deduction and purchases.

About 10 years ago, or whatever time it was, in Miami, Florida, and throughout Florida, there seemed to be an overdevelopment of luxury condos, and there was the worry that wealthy people in New York could get a condo at a reasonable price without any downpayment based on the tremendous mortgage deduction that they would enjoy and the fact that there was continuous rapid appreciation of the property.

Does that concept make any sense, that they wouldn't need a downpayment, just go down and buy a million-dollar condo based on that concept, appreciation and deductibility?

Mr. THOMAS. Well, I think a lot of them did it because of their anticipation of appreciation. However, that makes no economic sense. No, it never did. And the type of lending that was allowed at that time, we don't want to see that again. So, you know, those were not good elements that went into buying a property. Those were not wise investments, obviously.

Mr. RANGEL. Yeah, but I think if they still own the property and it did appreciate, I doubt whether they didn't pay any downpayment, but, you know, these wealthy people get together and share with each other the great economic ventures that they have had. And I am asking, is it possible that this could have happened, no matter what it looked like, that wealthy people could acquire property without any downpayment just based on appreciation and the fact that the tremendous monthly payments were—the interest was deductible and most of the early payments are interest and not principle?

Mr. THOMAS. The majority of them are interest in the early months of——

Mr. RANGEL. Yeah.

Mr. THOMAS [continuing]. Early years of a mortgage.

Mr. RANGEL. Yeah.

Mr. THOMAS. Absolutely.

Mr. RANGEL. And so isn't it logical that those who did it, whether it is bad economics or not, if they still have those places, notwithstanding the fact that they have leveled off, that at that time it seemed like a good deal and it was?

Mr. THOMAS. Well, at the time they purchased it, I am sure they thought it was a good deal.

Mr. RANGEL. No, no. I didn't ask what they thought. They did it. But I don't know what happened to them since then.

Mr. THOMAS. Well, a lot of those properties dropped in value dramatically.

Mr. RANGEL. Okay. Let me get to the question of carried interest. I assume because you get a favorable and much lower rate with capital gains, that all of you would support it. I am trying to figure out why. What work would you do that would be different from anybody else that is not investing in the project so that their income would be an investment on capital, and therefore they gain, where other people, especially in the venture capital area, who do the same type of work, get taxed at a much higher rate because it is ordinary income?

So with the real estate, recognizing that you take a risk, it is my understanding that anyone who opens a business or takes a position hoping that the business would increase is taking a risk. But

what makes the real estate industry different so that their profits should be treated differently than someone that is being taxed at an ordinary income rate? Mr. Thomas.

Mr. MORAN. Well, I am not sure they should be treated differently than somebody else taking the same type of risk, but the risk that we take in the real estate industry in building buildings, as you know, you are buying land and you are taking the risk on the land, you have to get it zoned, you are getting it zoned, you have to go hire architects, you hire lawyers, and you try to put your package together. And once you have spent a lot of money to put all that together, the key point is, are you generating an economic return that somebody will invest in? And if somebody doesn't invest in it, then you are going to lose all your money.

Mr. RANGEL. But they would be the investor.

Mr. MORAN. Pardon me?

Mr. RANGEL. The investor would be the person that you are turning it over to.

Mr. MORAN. No, no. I am not turning anything over to the investor.

Mr. RANGEL. You don't keep the property——

Mr. MORAN. The investor is coming to me because I have the asset. He is looking to make a return on his money. And I am the one that is going to take all the risk to build the project, to go get the bank loans, to guarantee everything.

Mr. RANGEL. Are all of you satisfied with——

Mr. MORAN. And the only thing the investor would——

Chairman CAMP. Well, I——

Mr. MORAN. Pardon me?

Chairman CAMP. I think time has expired, but——

Mr. RANGEL. I just want to know.

Chairman CAMP. I think, Mr. Thomas, we want to hear your answer on this, too, so we will make an exception here.

Mr. RANGEL. You are a good Chairman.

Chairman CAMP. I will remember that, Charlie.

Mr. THOMAS. Well, we actually agree with the other speaker, and that is that this is something that we do a lot of work for. In many cases we forgo our commissions to put into the project, and so therefore we are invested in the project just like anybody else. It just doesn't mean that we write a check out of it. I guess we could if we took the commission and then turned around and put it back in. But there are rationales for making it the same as the investor.

Chairman CAMP. All right. Thank you.

Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chairman.

As I am sure you are all aware, this Committee has spent the last 2 years having hearings and releasing discussion drafts, and we have been meeting with stakeholders from every industry to build a foundation as we seek to achieve what others have warned us is a nearly impossible feat of giving our constituents a simpler and fairer Tax Code.

Mr. Thomas, in your testimony I read that the effect of the 1986 Act had an effect on the real estate industry. Can you just elaborate for us on what lessons the Committee Members can draw from

the last time we overhauled the Tax Code as it concerns the real estate industry?

Mr. THOMAS. Well, what it did to the commercial arena is that it really negatively affected prices and the exchange of property through that Tax Code change. So if you look at that as history and see that it decimated that particular industry and what it did to savings and loan institutions at the same time, you realize that is the negative effect that you are going to see or could potentially see if you did the same thing on the mortgage interest deduction.

Ms. JENKINS. Okay.

Yes, Mr. Moran.

Mr. MORAN. May I respond to that question? On the 1986 Tax Act there were two things that were very, very detrimental to the commercial part of the business. One of them was retroactive. So a lot of people had made investments 2 or 3 years prior anticipating they would receive certain income tax deductions and the law would remain the same. Obviously, it did not. It changed.

But the major change that caused all the problems was the passive loss rules. What happened is all the capital was coming into the commercial industry and all of it was coming into the apartment industry from individuals. That was your source of capital. And when you passed the passive loss rules and they couldn't take any of their deductions and they were making all these investments, therefore what we told them when they went in, we couldn't deliver, because the law changed.

But the passive loss rules have taken the individual out of the market. Therefore, he wasn't supplying capital. Therefore, you had a recession from 1986 to 1994 before we started getting transactions going again and capital coming back into the business. And it started coming back in through the REITs and through the pension fund advisors, so you had two other types of entities.

Today, for example, individuals are still not investing in real estate because of the passive loss rules. When you get to small towns and you get to secondary and tertiary towns where people in those towns used to invest in real estate, they don't do it because of the passive loss rules. Not only was it devastating between 1986 and 1994, you can still feel the effects today because you are saying where is the capital going to come from to help us fund our businesses?

Mr. DIETZ. One more thing. As I mentioned in my testimony, the completed contract rules were another example in the 1986 Act where a change was made and a fix had to be made 2 years later. It is a reminder in general that real estate, the tax rules manifest themselves in the value of real estate. And so any impact on housing, for example, you get a 1 percentage point drop in housing prices today, it is going to destroy about $177 billion of net worth. You only need a 6 percent decline from where we are today to destroy a trillion dollars. So housing and the tax rules are very much connected.

Ms. JENKINS. Okay. Great. The first panel today discussed some recent options that have been proposed as part of major tax reform, drafts to reform our tax policy as it relates to housing policy and promoting home ownership. Today's testimony noted that recent major tax reform proposals, including Simpson-Bowles,

President Bush's 2005 Tax Reform Advisory Panel, and the Bipartisan Policy Center have all recommended moving from an interest deduction to a tax credit. And I understand that these proposals are concerning to some of you and potentially threaten our recovering housing industry.

So could you just share with us, has the housing industry conducted any analysis on what these policies—what effect they would have on home prices?

Mr. DIETZ. The real problem with the housing credits we have seen as a replacement for the MID is that the rates are so low they become nonstarters. A 12 percent rate is the most common. A revenue neutral tax credit would be something like 20 percent. So when it is down at 12 percent, you are really looking at a big tax hike for homeowners.

In terms of price impacts, the impacts are going to be the largest in those high-cost areas. Where the average income is higher, the marginal income tax rate is going to be higher, so that represents a larger tax hike.

Ms. JENKINS. Okay. I yield back.

Chairman CAMP. Thank you.

Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. Mr. Moss, see, I come from Seattle where we spend a lot of effort politically passing initiatives for low-income housing and we have passed levies on almost a continuing basis for the last few years to build housing. So we have a lot of low-income housing that is managed by a variety of public agencies in some instances, and sometimes private nonprofits are running them. And we have Section 8 going on in our State like everybody else does.

Tell me, from your point of view, the place where we ought to put our emphasis on low-income housing. Where should the money go if you are going to be the most effective? Is it in government building houses as we did before Ronald Reagan or is it in the low-income tax credit stuff in 1986 and thereafter or is it in Section 8?

Because I see us coming to a point where we are having more and more old people in this society who are going to be looking for housing as they are forced out by taxes and other things. I am trying to figure out for the community where is the most effective—or what is the most effective way to put the housing up?

Mr. MOSS. Well, first of all, starting in 1986 when the tax credit was put in place, the low-income housing tax credit, it started to replace all the failed Federal programs that had gone on prior to that time, programs that did not have the private sector involved, that did not have the private sector with risk in the game.

And, today, the low-income housing tax credit is the highest performing real estate class in the United States of any real estate class because of the private sector involvement, because of the State agencies doing the oversight and the underwriting and assessing housing need, and due to the nature of the type housing that is being built, which is very high-quality housing.

The programs from the past, the Federal programs, are now being preserved using the low-income housing tax credit. They are being regenerated by bringing in the private sector.

Mr. MCDERMOTT. You mean you are taking the old federally built ones and turning them into low-income housing tax——

Mr. MOSS. Yes, sir. We are bringing in the investors, renewing the projects, making sure that the units are rehabbed in a sustainable fashion so they will last another 40 years. It is a very important role that the credit plays, in that it can play every position on the team. It can really fix rehab—housing that needs rehab, Federal housing, it can do new construction, it can build housing for those individuals that have disabilities. It can build veterans housing. It is a very, very flexible program. I hope that answers your question.

Mr. MCDERMOTT. There is one in Seattle named the McDermott Place which has 54 homeless veterans living in it, so I know about how it is done. But you didn't say anything about Section 8. Where does Section 8 fit in all of this?

Mr. MOSS. Well, Section 8 is not an operating new construction—production program.

Mr. MCDERMOTT. I know it doesn't produce, but it is a way of saying you haven't got a house, so here is a voucher. Go find someplace in the private sector that will take it. Is that a more effective way than building and operating it as low-income housing?

Mr. MOSS. No, I don't believe it is. I believe that having the private sector involved——

Mr. MCDERMOTT. The private sector is involved in Section 8, aren't they?

Mr. MOSS. They can be, where the project receives project-based funding or vouchers to support extremely low incomes which support the debt service for the property. But those Federal programs also had subsidies for debt when the properties are redone and rehabbed under the tax credit program. It is at conventional debt rates and the vouchers and the subsidy provide subsidy to the renter, not to the property.

Mr. MCDERMOTT. What do you think the deficit is—excuse me. Go ahead.

Mr. MORAN. On the Section 8 question, I agree. When prior to 1985 we did several projects and those projects were Section 8-based projects, that was when passive losses were not a limitation, so we had all private capital doing those. We still have those properties today and those investors are happy with that investment over all the years, but they needed the passive loss rules in order to get that deduction in order to bring that capital into the business. Project-based Section 8 works better than vouchers.

Chairman CAMP. Mr. Renacci.

Mr. RENACCI. Thank you, Mr. Chairman. I want to thank the panel for being here today. This morning I was talking with the earlier panel about simplification, how we have to make this program simpler, because that person that comes in with just a W–2 needs to be able to get their return done without a professional. As I said, I was a professional, I had a CPA practice for many years prior to coming here.

On the other hand, I also indicated there are some people that aren't even aware that the interest deduction helps them, although it does, because of the complications of the Tax Code. And I think,

after everything, they found out that the interest deduction was helpful to them.

But one of the interesting comments in the earlier panel was somebody had indicated that repealing the mortgage interest deduction would reduce home prices by roughly 13 to 15 percent. Any comments on that? I thought that was an interesting number.

Mr. THOMAS. Well, our number is very similar. The number that our economist has come up with is about 15 percent. That would be devastating to this economy if we were to do that. Do you understand what that would do, putting that many more people under water, that would increase the number of foreclosures again. It would blow way out of proportion. We believe it would throw the country back into a recession. So that would be devastating if it were 15 percent.

Mr. DIETZ. Our numbers are—it is smaller, but similar. You could have dueling economists, what is the right price effect? It is going to differ by area, it is going to be larger in high-cost areas. But the big thing is it will impact. And I mentioned before, for every 1 percentage point, it is about $177 billion off of household net worth. If you are talking 15 percent, you are talking up to a $2 trillion windfall loss for homeowners.

Mr. RENACCI. Mr. Moran, President Obama has proposed lowering the corporate tax rate to 28 percent. I heard in your testimony not only are you a CPA but you represent an industry that has a lot of partnerships and LLCs. What would you say to those who advocate for doing corporate tax reform only and how would it affect your members?

Mr. MORAN. Our position has always been we are looking for comprehensive tax reform and to do both the corporate and the individual at the same time, because there would be crossovers on certain provisions. And we don't think one should be penalized—to bring down the rate over in the corporate, we shouldn't penalize the individual. So I think it should be looked at at the same time. We are not averse to the rate coming down. We think the rate should come down overall, because on a competitive basis to bring money into the United States we need to have a global rate that makes sense. And our global rate is higher than that of other people.

Mr. RENACCI. But you are saying corporates, LLCs, partnerships should all be looked at as one corporate rate?

Mr. MORAN. No, no, no, I do not say that. There is 2.5 million partnerships in this country. They control about $12 trillion of assets. They generate $400 billion a year in income. And all of those partnerships are there for a reason. There are different people putting up money. There are different people taking risks and they are allocated differently. So they don't run like corporations.

Mr. RENACCI. I understand that, but when we look at corporate tax reform, I am saying we should be looking at all the entities?

Mr. MORAN. Yes.

Mr. RENACCI. One other question. Mr. Thomas, this is for you but others can answer. The Tax Code currently allows deduction for interest on mortgages up to $1.1 million. Do you think that is appropriate? What is an appropriate level?

Mr. THOMAS. I think it is appropriate because of the area in which I live and work. So, obviously, I think it is appropriate. It is taken where it is needed. Across the country there aren't that many people that go all the way up to the maximum. But, again, in my particular area, $500,000 buys a starter home. If you were to reduce the limit down to $500,000 that is going to negatively affect most of the coastal areas of the country where the prices are much higher. So it would have a negative effect.

Mr. DIETZ. In addition to high-cost areas, you could also have stocking issues. If you have multiple home ownership, for instance someone who is about to retire and they have one home where they work and one home where they plan to retire soon, two they own simultaneously, that limit is for both mortgages, both homes under Section 163.

Mr. RENACCI. Mr. Chairman, I yield back.

Chairman CAMP. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Just a quick comment based on previous experience in terms of dealing with Section 8s. It is the saturation point on Section 8s that begin to change neighborhoods, it is the concentration of Section 8s. I think that is one of the challenges, because as I pointed out to the other panel, there are few issues that are more complex in urban economics than housing. In the experiments we had in the 50s and 60s with many of our veterans coming back, it worked very well. And then as the housing grew much older and there was less money to keep it up to date, in old cities landlords began to walk away from properties. And one of the phenomena during those years was abandonment. For those of us who had to deal with that abandonment issue, it was very significant because we had great difficulty tracking down the landlord. And I think having the private sector involved in helping to discipline the aspects of the marketplace is terribly important.

Mr. Moss, I am surprised that you mentioned the shortage of affordable housing. And it is always important I think to use the term "affordable housing," because the connotation of low-income housing, again, is that you are going back to high-rise developments and that you are going back to a concentration of Sector 8s. But you mentioned that there is a shortage of affordable housing in your testimony. Would you speak to that issue, please?

Mr. MOSS. Yes, the Harvard study that was most recently published, the report showed that only four eligible low-income households out of ten were finding an apartment that achieved affordability for them. Four out of ten. So there are six households out of ten that cannot find an apartment where their rental costs are 30 percent of their monthly income or less. They are paying 50 percent, 60 percent of their monthly income in rent. And so the rent burden is tremendous in this country.

The Harvard report demonstrates that, sir, and also the recent Bipartisan Policy Housing Center report.

Mr. MORAN. One of the confusing things—on affordability, we need to define it. Some people say affordability is 80 percent of the median income. And if you do 80 percent of the median income, like the apartment industry, 90 percent of the available housing is affordable. The low-income, where you can only afford to pay 50 or

60 percent or 40 percent of the median income, is where the real problem is. So it is the low-income which needs to be subsidized and needs to have the credits and needs to have the Section 8s if that gap that is currently there is going to be closed.

Mr. NEAL. But I also think it is fair to say that management is a key issue.

Mr. MORAN. Yes.

Mr. NEAL. On how those units are managed.

Mr. MORAN. Yes.

Mr. NEAL. If you get some first-class management teams nobody would even know it is affordable housing or subsidized housing. And then if you get a bad management team that simply accepts the subsidy and walks away from the property when things start to go south for them on their other investments, and that is frequently what happens, they stop any sort of upkeep to the property. And I think we need to be mindful of that.

How would you strengthen the low-income credit? I have been a supporter of new markets and low-income housing credits. I think it works. How would you propose strengthening the option?

Go ahead.

Mr. DIETZ. Your bill with Mr. Tiberi that——

Mr. NEAL. I was hoping you would say that.

Chairman CAMP. I don't see a prompt here, do I?

Mr. DIETZ. Without that the credit rate on the tax credit falls and it results in 18 percent less equity in the deal. So fixing that rate ensures that a sufficient amount of equity is available, because this is a production program. And we heard in the earlier panel, economists like vouchers in theory. But vouchers don't help build the property. They help allocate the demand after the fact. This program is really useful in the sense that it provides safe affordable housing on the production side.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. I will go to Mr. Blumenauer and then we will close with Mr. Griffin.

Mr. BLUMENAUER. Thank you very much. I appreciate the special emphasis that several of you have made in terms of the low-income tax credit. I think it is important to drive that home when there is so much in flux. I would just put three things on the table because you all represent groups that have certified smart people and it might be useful to get a little context and feedback from you. So I will put the three and then I will get out of your way.

One, you may have heard comments that I made earlier about the impact of the Federal Tax Code subsidizing people who live in areas that are frequently prone to disaster, and in fact some of them are in areas that by Federal law were not supposed to provide infrastructure support from the Federal Government. Yet we are subsidizing, for example, on a second home and then after we pay Federal money to help clean things up, then they go right back and are able to qualify for a deduction. And I would appreciate it if, again, this might be something that some of your certified smart people might be able to help us with in terms of some feedback.

The second deals with strengthening the provisions—I have long felt comfortable with the notion of having the capital gains exclusion for residential real estate, because nobody paid it except the

dumb, the distressed, or the divorced. But there have been instances that have been described to me where people use the provisions under current law where it is two out of the five, but they use it to sort of serially flip, bouncing back and forth with a residential property and switching that advantageously to be able to serially harvest the capital gains exclusion. It is not something that is a long-term residence that they are a part of. If you have some thoughts, or if there is some smart person there that could give us a written response, it would be appreciated.

The final question that is of interest to me is, today, the extent to which residential property represents people's retirement security. Notwithstanding the fact that a lot of folks are under water and they are up and down, but we are watching pensions disappear, we are watching 401(k)s become 201(k)s, we are watching a number of people tapping early retirement because of financial problems. They are retiring early with Social Security. They are taking things out of their 401(k)s, their IRAs. If you could help us identify the role you think residential property plays in retirement security going forward, it would be something that I would be very interested in.

Mr. DIETZ. On the gain exclusion in 2008 in HERA, the Housing Economic Recovery Act, there was a change made in Section 121 to address that two of five provision. And it was a change that was supported by the industry at the time. It stipulates that you can't claim the gain exclusion for years in which you don't use the property as your primary residence. So someone who is using it for speculation or an independent landlord or owning it for a long period of time——

Mr. BLUMENAUER. My question is, is that tight enough to prevent people from intent to reside being able to game the system?

Mr. DIETZ. And on the third issue that you raised, we have papers and research on the importance of housing wealth. It did take a big hit. Household net worths declined 40 percent. Polling surveyed consumer finances from 2000 to 2010. But recent price gains have begun to repair that, and, obviously, for those reasons the housing tax incentives will go in the opposite direction.

Mr. BLUMENAUER. Thank you, Mr. Chairman. I would just welcome any of those little papers that you have in those areas.

Mr. THOMAS. Sure. On the first question that you had I might comment that is really a local land use issue. Because if authorities are going to continue to allow building there, people are going to continue to build. That is where the problem lies.

We, as realtors, supported phasing out subsidized flood insurance last year. So, you know, we understand.

Mr. BLUMENAUER. But if we get rid of the tax deduction it would be recommended. Thank you, Mr. Chairman.

Chairman CAMP. Mr. Griffin is recognized.

Mr. GRIFFIN. Thank you, Mr. Chairman. Thank you all for being here today. And I know that you all share our general goal of simplifying the Code and having a pro-growth Tax Code. There are certainly provisions in it that I know you favor. But we can all agree that it is a mess. And we are trying to make it better.

You have—I assume you heard some of the folks on the first panel give some of their ideas on what they would prefer to see in-

stead of the mortgage interest deduction that we have. One of those proposed is some sort of credit. I would like to first hear from you four—whoever wants to speak—what your opinion is on the credit, and how it would impact what we consider middle-income Americans who rely on the mortgage interest deduction.

Mr. DIETZ. The first problem with the credit is the rates. We saw a 15 percent rate proposed in 2005. A 12 percent rate proposed by recent commissions, including the Bowles-Simpson commission. That rate is so low compared to the marginal tax rates, which is still the comparable value, that it reports a significant tax hike for homeowners.

So the question is who are the winners and who are the losers? There might be some winners, but we most definitely know who the losers would be moving to that kind of credit from the existing deduction. It would be young folks who have to use a mortgage to buy a home in high-cost areas.

Mr. GRIFFIN. I think that it is fair to say and I think you would agree with this, that credits suggested or changes suggested also assumed that marginal tax rates are changed. And some of the analysis that I have seen or heard of the credits—and we discussed this a little bit with the earlier panel—assume that you have to have some sort of change in that marginal tax rate.

Can you comment on it? Because clearly if you took the marginal tax rate down to a high of 25 percent, for example, clearly that is going to be favorable to people like me who count on the mortgage interest deduction, along with a lot of middle-income Americans. So how does that change in any way your analysis?

Mr. DIETZ. Pro-growth tax policy that creates jobs, would raise wages and make the economy grow faster. That is good for housing. But, as you say, there are a lot of assumptions. And, for example, one of the assumptions with moving to a tax credit is what happens to the real estate property tax deduction? The proponents always focus on the MID to a tax credit, but they don't explain, well, we assume the property tax deduction is completely eliminated. That could also reduce the value for home buyers.

Mr. GRIFFIN. Is there anyone else that wants to comment on that? Okay. I thank you all for being here.

Quickly, I think I have another minute, there was a comment made on the previous panel that the mortgage interest deduction incentivizes debt as opposed to equity. Do you have any comment on that?

Mr. DIETZ. My reaction when I hear that is, people don't take out debt to make money. You pay interest; it is a cost. Mortgage interest deduction offsets the cost of that debt. The question is who needs debt to buy homes? Well, it is particularly younger households and, in fact, our research has shown the primary beneficiaries of the mortgage interest deduction with shared household income, is younger households that need the mortgage to buy a home. If you get rid of it, prices are going to fall and who wins? Cash buyers, investor buyers. That is not good policy for a stable middle class.

Mr. THOMAS. Yes, and I would also say that increasing the debt and the amount that you pay on that debt, you are not getting that

entire amount back in a tax benefit so the law doesn't really encourage you to take on more debt.

Mr. GRIFFIN. Well, I think we are all looking very carefully at this because we understand that whatever changes we make are going to have an impact, positive or negative, on a lot of Americans that count on this that are having a hard time making ends meet anyway. But we are focused on having a simpler, fairer Code that encourages economic growth which will benefit us all.

Thank you all for being here today. It was really thoughtful and we appreciate it.

Chairman CAMP. Thank you. We do have one more questioner, Mr. Young, and then we will conclude the hearing.

Mr. YOUNG. Thank you, Mr. Chairman. It has really been a very informative hearing here. I thank all our panelists for appearing here today and for delivering your testimony.

Earlier, we had a panel where we received testimony that a disproportionate share of the home mortgage deduction benefits go to taxpayers in the largest metropolitan areas. One witness testified that 20 percent of the tax benefit is claimed by taxpayers in California.

First, do you have any reason to believe that that testimony was incorrect? And, if not, then do you have concerns about this? Concerns about the disparate benefits between geographic areas and between types of communities across our country as reflected in the Tax Code?

Mr. DIETZ. You know, the mortgage interest deduction obviously is on a nominal dollar basis more valuable in high-cost areas. But, as I mentioned in our testimony, that is actually one of its merits in the sense that it is one of the elements, one of the few elements in the Tax Code that does account for differences in the cost of living. Property tax deduction is the same way. You want an incentive that encourages young home buyers to be able to buy in high-cost areas. Why are they high-cost? They are high-cost because they have dense concentrations of population. That is where things are growing. That is where wages are growing. And if you shut out those younger home buyers from those kinds of markets, that is going to have a distinct economic impact.

Mr. THOMAS. And those areas are obviously very, very concentrated in numbers of households and so you are going to have a disproportionate share. The number of households in California is much higher than in most of the rest of the country anyway. So you are going to have that effect. Plus, just the sheer cost of building in those areas produces higher costs.

Mr. YOUNG. If there is no other thoughts or perspectives on that, I thank you again and I yield back.

Chairman CAMP. Is the 20 percent accurate?

Mr. THOMAS. I don't know that it is. We would have to do research on that. That seems awfully high.

Chairman CAMP. I want to thank this panel. You have been an excellent panel. And I appreciate your views and your perspectives and, obviously, as I have said, tax reform is a critical issue to this Committee and we remain committed to moving forward in an open and transparent manner. And your participation today is obviously a very important part of that process.

I would ask that you promptly respond in writing to any areas where that was requested or would be appropriate, and as we prepare the formal hearing record we will make those written submissions a part of that. So, again, thank you very much for being here. The Committee stands adjourned.

[Whereupon, at 1:05 p.m., the Committee was adjourned.]

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