

Tax Expenditures

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One of the primary instruments of federal government housing policy is a set of provisions in the tax law that encourage homeownership, subsidize investment in housing, or avoid bottlenecks in the housing market that might occur due to tax considerations. The deductibility of home mortgage interest expense is the most prominent of these tax preferences.

Annual Tax and Revenue Estimates

Each year, as part of the annual budget process, the Office of Tax Analysis (OTA) in the Treasury Department prepares estimates of "tax expenditures." The Congressional Joint Committee on Taxation (JCT) prepares similar estimates.

Although tax preferences are not subject to the annual budget authorization and appropriation process like direct expenditures, the tax expenditure estimates are an attempt to quantify the value of foregone revenue in a form that is comparable to direct government expenditures. The estimates are even presented in functional categories comparable to those used in the budget.

The tax expenditure estimates are not estimates of the additional revenue that would be collected if the tax preferences were eliminated. Unlike "revenue estimates" prepared by the same analysts, tax expenditures do not account for likely changes in behavior resulting from tax law changes. Rather, tax expenditures are calculated as the difference in tax liability if each preference in the tax law were eliminated and nothing else changed.

OTA vs. JCT Estimates

Table 1 shows the OTA and JCT estimates of 1991 tax expenditures for

Table 1 1991 Tax Expenditures For Housing-Related Provisions —(\$ billions)

	OTA	JCT
Deductibility of mortgage interest on owner-occupied homes	\$40.9	\$31.9
Deductibility of property tax on owner-occupied homes	12.4	8.3
Deferral (roll-over) of capital gains on sales of principal residences	13.3	10.9
Exclusion of capital gains on sales of principal residences for persons 55 and over	3.2	3.6
Exclusion of interest on state and local bonds for owner-occupied housing	1.6	1.7
Exclusion of interest on state and local bonds for rental housing	1.1	0.8
Depreciation of rental housing in excess of alternative depreciation system	1.5	0.8
Low Income Housing Tax Credit	0.6	0.6
Exception from passive loss rule for \$25,000 of rental losses	6.4	NA
Exclusion of interest on state and local bonds for veterans' housing	0.2	0.2

NA = Not Available

housing-related provisions. Although the two agencies cooperate in the preparation of tax expenditure estimates, their estimates are generally not identical. In part, that reflects different concepts of what is a normal preference-free tax system. But those differences in preference-free benchmarks should not affect the major homeowner preferences such as the home mortgage interest deduction. Rather, the differences reflect the inexact nature of tax expenditure estimates.

One reason why the tax expenditure estimates are inexact, and why the OTA and JCT estimates are so different, is that the estimates are based on a sample of actual tax returns, and the actual returns used are several years out of date. The latest estimates are based on 1987 returns.

Adjusting for changes since 1987 requires some assumptions. For example, OTA assumed that a significant increase in mortgage debt will take place as taxpayers substitute home equity loans for unsecured consumer loans.

The OTA estimate of the 1991 tax expenditure value of the home mortgage interest deduction is \$40.9 billion. (The figure shown in the budget document is \$46.6 billion, but conversations with the OTA staff revealed that to have been an error.) The corresponding JCT estimate is \$31.9 billion. Even in Washington, a difference of \$9 billion is a lot of money, but the exact source of the discrepancy is not clear.

Preference Categories

The deduction of expenses connected with producing income is not considered to be a preference.

The reason given why home mortgage interest expense is considered a preference, while investment interest is not, is that the rental value of owner-occupied housing is not taxed, so the costs of generating that implicit income are not logically deductible. A similar argument applies to property tax. But not all expenses connected with owner occupancy are deductible. In particular, maintenance and depreciation on owner-occupied dwellings is not deductible.

The standard deduction is also not considered to be a preference, but to be part of the normal tax system.

In calculating the tax expenditure value of the mortgage interest and property tax deductions, OTA and JCT only take into account deductions in excess of the standard deduction. Because of this, the reduction in taxable income attributable to either the mortgage interest deduction or the property tax deduction is less than the aggregate amount of the deduction. Moreover, the tax expenditure estimates are calculated separately for each preference, and the interaction with the standard deduction becomes even more important when considering combinations of deductions. Thus, the combined tax expenditure value of the mortgage interest deduction and the property tax deduction is much less than the sum of the two separate tax expenditure values, even without taking into account changes in behavior or changes in macroeconomic activity.

Other Tax Expenditure Items

IDBs and MRBs

The tax expenditures associated with the exclusion of interest on state and local bonds to finance home mortgages and rental housing are estimated as the amount of additional tax that taxpayers would have had to pay if that interest had been taxable. As with other investor incentives, the benefits of this tax preference actually go primarily to borrowers in the form of lower interest rates.

Most of the 1991 tax expenditures from tax-exempt housing bonds are due to bonds issued before the 1986 tax reform curtailed the use of tax-exempt financing. The size of the tax expenditure for tax-exempt housing bonds has been declining.

Depreciation

The estimates of tax expenditures for depreciation shown in Table 1 are based on a comparison of actual deductions for depreciation compared to depreciation calculated using the 40-year straight line method. Currently, for purposes of the regular tax, residential property is depreciated on a 27.5-year straight line basis. For property placed in service before December 31, 1986, more accelerated depreciation was permitted, and much of the current tax expenditure is still due to depreciation allowances under the earlier rules.

LIHTC

Both the OTA and JCT estimates of tax expenditures for the low income housing tax credit are rather modest. Unlike most tax preferences, these tax credits are not available to everyone, but are allocated by state and local agencies, subject to a per capita state ceiling. Both OTA and JCT indicate

that these credits are expected to primarily affect individual rather than corporate tax revenue, meaning most investments will come from individuals, despite the severe restrictions placed on individual investors' use of the credits.

The OTA estimates a surprisingly large tax expenditure for the special "Mom and Pop Landlord" exception to the rule that "passive" losses are not deductible from other types of income. In general, the Tax Reform Act of 1986 defined any income or loss from rental real estate as "passive," even if the taxpayer manages the property on a full-time basis. The exception allows taxpayers with incomes below \$100,000 to deduct up to \$25,000 in losses from rental properties if they "actively" manage the property. Taxpayers with incomes between \$100,000 and \$150,000 are allowed to deduct smaller losses. The OTA estimate of a tax expenditure of \$6.4 billion makes this the largest preference for rental housing.

In their latest estimates, the JCT does not count that exception to the passive loss rules as a tax expenditure at all, but considers it to be a feature of the normal tax law against which preferences are measured. Last year, (March 1989) JCT did consider the exception to the passive loss rule to be a preference, and they estimated the corresponding 1991 tax expenditure as \$3.8 billion.

Clearly, tax expenditure estimates are inexact measures of the net cost to the government of supporting activities through the tax system. These estimates do, however, illustrate that tax incentives are generally a more extensive instrument of housing policy than the limited direct spending by the federal government to support home ownership and affordable rental housing.