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How Federal Tax Expenditures That Support Housing Contribute to Economic Inequality

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Introduction

Approximately two-thirds of American households own their housing and one-third rent. The households that rent have significantly lower household income and net worth than those that own. Yet, federal income tax laws provide substantial tax savings to owners but none to renters and these tax savings are concentrated among the most affluent owners.

In the last decade, the household income of renters has declined while the total costs of renting have increased. A majority of renters now pay more than 30 percent of their income for housing. Low income renters are finding it increasingly difficult to pay for housing.

The purpose of this article is to examine how federal income tax laws benefit more affluent owner households but provide no benefits to economically-strapped renter households. This article proposes that the tax savings currently accruing to affluent owners be reduced and that the resulting increase in revenue to the federal government be appropriated to subsidize the rents of low income tenants who are eligible for government rental assistance.

A. Federal Tax Expenditures

Federal tax expenditures[1] is a term of art that refers to any reduction in federal income tax liability that results from tax law provisions that benefit particular taxpayers. To laypersons, tax expenditures are referred to as "tax breaks". Tax expenditures are designed to promote social

[1] Tax expenditures mean those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability. 2 U.S.C. 622(3).

goals.[2] For example, in order to encourage charitable giving, some tax filers are allowed to deduct the amount of their charitable donations from their taxable income on their federal income tax returns, resulting in reduced tax liability.

Tax expenditures are available to both corporations and individuals who file federal income tax returns.[3] This article focuses on tax expenditures available to individual federal income tax filers, particularly those tax expenditures that support housing.

It is estimated that in 2014 the tax savings from all tax expenditures available to individual federal income tax filers will be $1.036 trillion.[4] This amount of tax expenditures is projected to be approximately six percent of national Gross Domestic Product.[5] In 2014, there were 136 tax expenditures available to individual federal income tax filers.[6]

Federal tax expenditures are similar to direct federal spending in that both seek to provide a benefit to Americans to achieve social goals. However, federal tax expenditures provide the benefit indirectly by reducing the federal income tax liability of taxpayers rather than directly providing a benefit to them. For example, the federal government appropriates funds annually to pay a portion of the rents of some low income tenants. These partial rent payments are an example of direct federal spending. On the other hand, some owners of private residences are

[2] Congressional Budget Office, The Distribution of Major Tax Expenditures in the Individual Income Tax System (May, 2013), 7.
[3] Alan Cole, Corporate vs. Individual Tax Expenditures (Tax Foundation, April 23, 2014), 1-2.
[4] *Id.*
[5] Daniel Baneman, Joseph Rosenberg, Eric Toder, Roberton Williams, Curbing Tax Expenditures (Urban-Brookings Tax Policy Center, January 30, 2012), 4.
[6] Office of Management and Budget, Fiscal Year 2016, Analytical Perspectives, Budget of U.S., 234-39.

annually allowed to deduct certain housing expenses (e.g. mortgage interest payments and property tax payments) from their taxable income, thereby reducing their federal income tax liability. These deductions are examples of federal tax expenditures.

Federal tax expenditures are often criticized as unwise public policy. Unlike federal spending programs that undergo review by Congress in the annual appropriations process, federal tax expenditures do not undergo periodic, systematic review by Congress[7] or by the federal agencies that administer spending programs.[8] Federal tax expenditures contribute to the complexity of the federal income tax system.[9] Approximately 70 percent of individual federal tax expenditures increase in value as household taxable income rises, providing higher tax savings to more affluent households who are less likely to financially need them.[10] In general, federal tax expenditures are a stealth form of public policy – little understood by the public and subject to limited official scrutiny – even though they constitute a huge public expense and contribute significantly to the national debt.

B. Distribution of Federal Tax Expenditures Among Individual Income Tax Filers

One of the criticisms of individual federal tax expenditures is that the tax savings from them disproportionately benefit more affluent income tax filers. The Tax Policy Center estimated the

[7] U.S. Government Accountability Office, Tax Expenditures: Background and Evaluation Criteria and Questions (GAO-13-167SP, November 12, 2012), 1.
[8] Congressional Budget Office,supra note 2, at 8.
[9] *Id*.
[10] Chuck Marr, Chye-Ching Huang and Joel Friedman, Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction (Center on Budget and Policy Priorities, February 27, 2013), 4.

distribution of the benefits of all individual tax expenditures among federal income tax filers by income quintiles in 2011:[11]

Income Quintile	Maximum Income ($)	Average Federal Tax Reduction ($)	Share of Total Federal Tax Reduction (%)
Lowest	16,812	686	2.8
Second	33,542	2,272	7.8
Middle	59,486	3,175	9.5
Fourth	103,465	5,581	13.8
Top	➢ 103,465	30,714	66.1

Tax-filing households in 2011 in the top income quintile (with income in excess of $103,465) received two-thirds of the total tax savings from individual federal tax expenditures with an average tax savings of $30,714 per household.[12] In contrast, the households in the bottom three quintiles (with income of less than $59,487) received just one-fifth of the total tax savings from individual federal tax expenditures with an average tax savings of approximately $2,044 per household.[13] The tax savings from individual federal tax expenditures are skewed to higher income households.

C. <u>Federal Tax Expenditures that Support Housing</u>

There are ten individual federal tax expenditures that support housing. Five of them will provide tax savings totaling an estimated $10.16 billion in 2014 to developers or financiers of housing,

[11] These data are derived from the Tax Policy Center's estimates of the distributional effects of various tax policies: Table T11-0322-Eliminate all Individual Income Tax Expenditures/Distribution of Federal Tax Change by Cash Income Percentile, 2011.
[12] *See* Baneman, Rosenberg, Toder and Williams, *supra note* 5, at 8.
[13] *Id.*

both owner-occupied and rental.[14] The other five federal tax expenditures will provide tax savings to owners of housing that they occupy:[15]

Federal Tax Expenditures for Owner-Occupied Housing	**Total Estimated Tax Savings FY 2014** (in $ billions)
Mortgage Interest Deduction	66.91
Property Tax Deduction	31.59
Capital Gains Exclusion on Sales	35.54
Net Imputed Rental Income Exclusion	75.24
Discharge of Mortgage Indebtedness Exclusion	3.1
Subtotal:	**212.38**

Federal income tax filers who own their housing will be eligible for tax savings of substantial estimated value, $212.38 billion, in Fiscal Year 2014. Federal income tax filers who rent their housing have no federal tax expenditures earmarked for them and, therefore, they receive no tax savings for being renters.[16] Ironically, the rent paid by renters to their landlords are the likely primary source of their landlords' mortgage interest and property tax payments that landlords can deduct on their income tax returns as business expenses.

[14] These five federal tax expenditures are: the exclusion of interest on owner-occupied mortgage subsidy bonds; exclusion of interest on rental housing bonds; passive loss exception for rental loss; credits for low income housing investments; and accelerated depreciation on rental housing. Office of Management and Budget, Fiscal Year 2016 Analytical Perspectives Budget of the U.S. Government, Table 14-2B Estimates of Total Individual Income Tax Expenditures and Individual Income Taxes for Fiscal Years 2014-2025, 235-36, 248-49.

[15] *Id.*

[16] The federal government does provide direct rent subsidies to approximately 4,870,000 low-income renter households, but this serves only 23.8% of the income-eligible households. Joint Center for Housing Studies of Harvard University, America's Rental Housing (2013), 7, 35. In 2014, Congress appropriated $44,326,000,000 for direct rental subsidy programs through the Department of Agricultural and the Department of Housing and Urban Development. Low Income Housing Coalition, FY 15 Budget Chart for Selected HUD and USDA programs. In addition, The Low Income Housing Tax Credit, a federal tax expenditure, provides approximately 2,000,000 affordable units to low-income renter households each year. Joint Center for Housing Studies of Harvard University, Americas Rental Housing (2013), 36. The federal tax expenditures for the Low Income Housing Tax Credit in 2014 was $8,120,000. Office of Management and Budget, See supra note 14, at 230, 236.

For nearly a century, the United States government has sought to promote homeownership through a variety of initiatives, including federal tax expenditures that provide income tax savings to homeowners.[17] Federal policy makers generously support homeownership because it contributes to civic and community engagement, supports families, and constitutes the most-important wealth-building asset for most American households.[18] Federal policy makers obviously view renters in a less favorable light than homeowners and have created no tax expenditures for them as renters.

D. Distribution of Federal Tax Expenditures to Owner-Occupied Housing

The Joint Committee on Taxation estimated the distribution in 2014 of two of the major federal tax expenditures that provide tax savings to owners of their residences:[19]

Tax-Filer Adjusted Gross Income ($)	Tax Savings ($ in billions) from Real Estate Tax Deduction	Tax Savings ($ in billions) from Mortgage Interest Deduction
Below 50,000	693	1,443
50,000-75,000	2,190	4,330
75,000-100,000	3,478	6,581
100,000-200,000	13,648	27,421
200,000+	11,798	29,340
Total	31,806	69,115

Of the more than $100 billion in tax savings that is estimated to accrue to owners of their residences in 2014 through these two federal tax expenditures, 81.5 percent will accrue to households with adjusted gross income of more than $100,000 with the majority of that savings

[17] Bipartisan Policy Center, Housing America's Future: New Directions for National Policy (February, 2013), 27.
[18] *Id.*
[19] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018 (JCX-97-14, August 5, 2014), 37.

accruing to households with adjusted gross income of more than $200,000.[20] The higher the owner's household income, the greater are the tax savings from these two federal tax expenditures. As a result, affluent owners are incentivized to purchase more expensive homes and take on higher mortgage debt.[21]

E. Housing Needs of Renters in the United States

In December, 2014, there were 116,647,000 residential households in the United States.[22] Of these residential households, 74,606,000 (64.0 percent) were living in owner housing and 42,041,000 (36.0 percent) were living in rental housing.[23] Ten years earlier, owner rates in the United States were at their historical peak of 69.2 percent and renter rates were at their historical nadir of 30.8 percent.[24]

Both owner and renter rates have changed markedly in the last decade for several reasons. Many American households lost the homes that they owned due to the mortgage foreclosure crisis of the mid-to-late 2000s.[25] It is also now increasingly difficult for many households to finance the purchase of a home due to stagnant household income and tighter credit standards.[26] Moreover, the several million working-age young adults who have joined the labor force in the last decade

[20] There are no estimates available of the distribution by income in 2014 of the other three federal tax expenditures that are available to owners of residential housing that they occupy: capital gains exclusion on sales; net imputed rental income exclusion and discharge of mortgage indebtedness exclusion.
[21] Benjamin H. Harris, C. Eugene Steuerle, Amanda Eng, "New Perspectives on Homeownership Tax Incentives"; Tax Notes, 1318 (2013).
[22] U.S. Census Bureau, Residential Vacancies and Homeownership in the Fourth Quarter 2014 (CB15-08, January 29, 2015), Table 3.
[23] *Id.*
[24] *Id* at Table 4.
[25] Annie Lowrey, Few Places to Go, N.Y. Times, October 10, 2013.
[26] *Id.*

have struggled to develop a strong foothold in the national economy, retarding household growth and home purchases.[27]

As a result of these factors reducing the percentage of American households who own their residences, demand for rental housing has surged.[28] "We are in the midst of the worst rental affordability crisis that this country has known," stated Shaun Donovan, secretary of the U.S. Department of Housing and Urban Development, in 2013.[29] From 2000 to 2012, median monthly renter income declined by 12.7 percent (from $3106 in 2000 to $2,711 in 2012) while median monthly gross rents, including utility costs, increased by 7.3 percent (from $802 in 2000 to $861 in 2012).[30] Rents have been rising in the last decade but renter household income has been declining.

The traditional affordability standard for housing is that households should pay no more than 30 percent of their income for total housing costs.[31] The federal Department of Housing and Urban Development considers households "cost burdened" if they pay more than 30 percent of their income for housing because they may have difficulty affording other necessities such as food, clothing, transportation and medical care.[32] In 2013, 51.5 percent of renters and 25.5 percent of owners paid 30 percent or more of their income for housing.[33]

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[27] Joint Center for Housing Studies of Harvard University, The State of the Nation's Housing (2014), 2.
[28] Lowrey, supra note 24.
[29] *Id.*
[30] Joint Center for Housing Studies of Harvard University, America's Rental Housing-Evolving Markets and Needs (2013), Table A-1.
[31] See Joint Center for Housing Studies of Harvard University, supra note 26, at 5.
[32] http://portal.hud.gov/hudportal/HUD?src=program_offices/comm_planning/affordablehousing/.
[33] U.S. Census Bureau, 2013 American community Survey 1-Year Estimates (2014), DP04.

Owners not only pay a smaller share of their household income for housing costs than renters but their net worth is supported by home ownership as well. For most American owner households, the largest share of their net worth derives from the equity value of the residences that they own.[34] There are shocking differences in median net worth between owner and renter families:[35]

	Owner Families ($)	Renter Families ($)
Median Net Worth (2013)	195,400	5,400

The median net worth of owner families in 2013 was 36 times that of renter families. Thus, even though owners of housing possess a valuable asset that significantly contributes to their net worth and renters lack this asset, federal tax expenditures still favor owners by providing substantial tax savings to them while none are earmarked for renters.

F. <u>Proposal for Better Balance in Federal Support for Owning and Renting</u>

In general, renters are in a more difficult economic position than owners. In 2013, median household income for renter households ($32,831) was less than 50 percent of the median income of owner households ($66,828).[36] Since renters do not own their homes they also lack this important wealth-building asset and many of them need assistance to build net worth.

Despite the great disparity in economic positions between owners and renters, federal tax expenditures lavish tax savings on primarily affluent owners and provide none for renters. The federal tax expenditures for owners are so generous that interest can be deducted on mortgage

[34] Joint Center for Housing Studies of Harvard University, supra note 29, at 13.
[35] Federal Reserve Board, Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances, Table 2, 12 (September, 2014).
[36] U.S. Census Bureau, 2013 American Community Survey, 1-Year Estimates (2014), B25119.

balances up to $1,000,000 and can also be taken on second homes, even yachts, as well as primary residences.[37] It is difficult to conceive of a federal public policy that more directly promotes economic inequality than the federal tax expenditures that support owners of housing but are not available to renters.

Through direct spending and a tax expenditure for developers of rental housing, the federal government provided $54,446,000 in Fiscal Year 2014 to support rental assistance to low income tenants. [38] This federal support to low income renters amounted to approximately one quarter of the tax savings that will accrue to homeowners due to their federal tax expenditures during the same period.[39] Moreover, less than 25 percent of low income renters who are eligible for federal rent subsidies actually receive them due to limited federal appropriations.[40]

The Congress should reduce the tax savings that accrue to the most affluent owner households under our current federal tax expenditures. Such a reduction in federal tax expenditures would result in increased federal revenue. The Congress should allocate the increased federal revenue to the existing housing assistance programs that subsidize the rents of low income renters. The result of this shift in federal housing policy will be that more low income families who rent their housing will receive much-needed rental assistance. In this way, federal housing policy will shift its support from the affluent to the financially needy and economic inequality in America will be reduced.

[37] Internal Revenue Service, Home Mortgage Interest Deduction, (Publication 936, Nov. 13, 2013), 2, 3.
[38] Supra note 15, 16.
[39] Supra note 15, 16.
[40] Supra note 16.