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Tax benefits for housing not as outsized as previously thought, study says

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Although popular with the public, reforming the existing system of tax benefits to housing, including the ever-popular deductions for mortgage interest and property taxes, would likely make the housing market more efficient, says research co-written by David Albouy, a professor of economics at Illinois. Credit: David Albouy

New research co-written by a University of Illinois expert in urban economics indicates that tax benefits for housing, including the ever-popular mortgage interest deduction and the property tax deduction, are not as distortionary as previous research and some prominent critics suggest.

The existing system of tax benefits for housing caused the typical house to be 4 percent too large in 2007, creating a national economic waste of $7 billion per year – a figure that is substantially smaller than recent estimates by other economists, including some who have pegged the figure in the $16 billion to $36 billion range, says David Albouy, a professor of economics at Illinois.

"These deductions, especially for mortgage interest, have long been criticized for being expensive, regressive and not well targeted to their stated goal of subsidizing home ownership," Albouy said. "Although these criticisms have some merit, I went into this project thinking it was much worse than it actually turned out to be."

Although popular with the public, the mortgage interest deduction isn't the best policy because it's not very progressive, Albouy says. Getting rid of it would likely make the housing market more efficient.

"The people who are reaping the biggest benefits from the mortgage interest deduction and other housing tax benefits are the same people who have the biggest houses and the biggest incomes," he said. "That said, people in bigger houses do pay more in property taxes, without getting much more in local services. When we think about the size of a house, property taxes are like an excise tax. Property taxes encourage people to consume smaller houses while federal tax benefits do the opposite, and go somewhat overboard in doing so."

According to the paper, which was co-written by Andrew Hanson of Marquette University, housing tax benefits affect not only the quantity of housing that people consume, but also where housing is located. The paper's simulations show that 15 percent of the population is "inefficiently located" at a cost of $26 billion annually.

"It turns out that, because of the federal tax code, houses are not only slightly too big, but also rather badly located," Albouy said. "In general, workers are discouraged from living in high-wage areas because they pay more in federal taxes without receiving more in federal benefits."

Housing tax benefits offset this second "locational" distortion because high wage areas also tend to have high housing prices. For example, a worker in Illinois who moves from downstate Bloomington to Chicago will earn more and pay higher housing prices. They then pay higher federal and state taxes on their income, but can claim larger deductions from their bigger mortgages.

"It's almost like their taxes are being lowered to account for their higher costs-of-living," Albouy said. "And unlike owners, renters receive no such break."

On the other hand, one of the consequences of housing tax policy that Albouy found "curious" is that it encourages too many people to buy houses in places with the highest quality of life – "places that are beautiful, sunny and coastal."

"Take someone who owns a very expensive beach bungalow in Honolulu," he said. "Chances are they've paid a lot for that bungalow, and so they are receiving a huge tax write-off. Workers also tend to earn lower incomes in Honolulu than in, say, Chicago. So they're making less, and writing off more, meaning the federal tax code is implicitly subsidizing people to live by the beach. Employers will follow suit, as this implicit loophole is similar to an untaxed fringe benefit like a company car. The federal tax code may be one reason why Google just opened an office in the Los Angeles beach town of Venice."

According to Albouy, there is "no apparent reason" for the government to subsidize living in these high quality-of-life areas.

"Economists believe it is efficient for buyers to bid competitively over desirable land," he said. "But to encourage their bidding war by lowering their tax burden when they bid higher appears wasteful."

Eliminating the favorable tax treatment of housing would produce few gains in location, as people tend to pay higher housing prices for jobs rather than for quality-of-life reasons. More efficient reforms might eliminate housing benefits altogether and deflate taxable income by local costs-of-living, Albouy said.

"Such an indexing could be further improved by adjusting for local quality of life, which would be equivalent to indexing taxes to local wage levels for different skill-levels of workers," he said. "In either case, more would need to be done to tie property taxes to local services used, rather than to the size of a house."

While lowering federal tax benefits to housing would likely be efficient, eliminating them completely would cause houses to be too small by about 2 percent, the paper says. Without any offsetting compensation for local cost-of-living, a complete elimination of federal tax benefits for housing would also cause workers to live further away from higher-paying jobs, causing an economic waste of roughly $20 billion per year.

In general, reforming the tax code for housing tends to be quite popular with economists, but not with the public, Albouy said. In a recent poll, 77 percent of tax economists favored repealing the mortgage interest deduction, while only 10 percent of the public favored repealing the popular tax break.

"There's a big chasm of understanding between economists and the public over the mortgage interest deduction," he said. "Hopefully, we can meet somewhere in the middle. "

Albouy's next research project examines the rising cost of housing as a share of household income.

"As society gets richer, one would expect to spend less on housing – but that's not the case," he said. "Our economy has grown richer, but we spend a greater proportion of our income on housing. And the reason why is that housing has gotten more expensive relative to other goods."

More information: The paper, "Are Houses Too Big or In the Wrong Place? Tax Benefits to Housing and Inefficiencies in Location and Consumption," is available online.

Provided by University of Illinois at Urbana-Champaign

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