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Chairman Pascrell, Ranking Member Kelly, and Members of the Committee,

Thank you very much for inviting me to testify. I am honored to be here.

I am a Professor of Law at Georgetown University, where I teach and write about federal income taxation, tax policy, and international taxation.

My goal today is not to advocate for a particular policy. Instead, my goal is to talk about the design choices that Congress makes when crafting tax policy. There are various tax policy tools that Congress can use to encourage home ownership and expand access to housing and I plan to highlight the distributional effects and behavioral incentives associated with different design choices.

When designing tax incentives, there are three fundamental questions that Congress should be asking. First, is this helping the Americans that Congress is aiming to help? Second, is this creating an incentive for the behavior Congress intends to encourage? And, finally, does this have unintended consequences in terms of either behavioral incentives or distributional effects that suggest a different policy tool would be better?[1]

In order to help you answer these questions, I am first going to set out several tax policy design choices that Congress must make when designing any incentive. I am then going to consider four tax incentives that many observers associate with access to housing: the home mortgage interest deduction, the state and local tax deduction, the first-time homebuyer credit, and the low-income housing tax credit. Congress has made different design choices with all four of these, and I will highlight how those design choices have affected who benefits from each tax incentive and how effective those tax incentives are at achieving their goals.

I. Tax Policy Design Choices

When designing a tax incentive, Congress needs to make three important design choices. First, should this incentive be a deduction or a credit? Second, should this incentive be limited based on taxpayer income or on another rubric? Third, what is the focus of this tax incentive? Alongside these design choices, Congress also needs to determine whether the incentive should be in the Internal Revenue Code or whether a direct subsidy administered by an agency other than Treasury and the Internal Revenue Service would be more appropriate. This section considers all four of these design choices and highlights the effects of each choice.

A. Deductions versus credits

[1] Tax policy experts often also ask whether a tax is complex. I am incorporating complexity into these questions because the concern with complexity is generally that it raises equity or distributional issues or that it creates problematic behavioral incentives. For example, if a tax provision is so complex that it is only really available to higher-income taxpayers with access to tax lawyers and accountants, that tax provision raises equity issues and is not available to all Americans. Or if a tax provision pushes taxpayers to engage in inefficient structuring or record-keeping, that tax provision is creating problematic behavioral incentives.

First, if you are providing a tax benefit, should it take the form of a deduction or the form of a credit?

Deductions generally provide greater benefits to higher-income taxpayers, and not all deductions are available to all taxpayers. Deductions can be either above-the-line deductions or below-the-line (itemized) deductions. Above-the-line deductions are available to all taxpayers regardless of whether they itemize their deductions. Below-the-line deductions, in contrast, are only available to taxpayers that itemize their deductions and do not take the standard deduction. Whether or not a taxpayer itemizes depends on whether that taxpayer's aggregate below-the-line deductions are greater than the standard deduction. In other words, the more below-the-line deductions a taxpayer takes, the more likely the taxpayer is to be able to itemize those deductions. Currently, only about 10% of taxpayers itemize,[2] which means most Americans will not get any benefit from a tax incentive if it is designed as a below-the-line deduction.

For taxpayers who do benefit from a deduction (whether that is because it is an above-the-line deduction or because the taxpayer itemizes), the value of the benefit increases as a taxpayer's marginal tax rate increases. This means that taxpayers with higher marginal tax rates reduce their taxes more than those with lower marginal tax rates. To see how this works, take two single taxpayers who each qualify for a $10,000 above-the-line deduction. The first taxpayer has a 10% marginal tax rate and the second taxpayer has a 37% marginal tax rate. Even though both of them can take the $10,000 deduction, the effect of this is to reduce the first taxpayer's taxes by only $1,000, while the second taxpayer's taxes are reduced by $3,700. Note that a third taxpayer whose income is sufficiently low that they have a 0% tax rate would get no benefit at all from the $1,000 deduction. Since our tax system is designed so that higher-income taxpayers are the ones with higher marginal tax rates, this means that higher-income taxpayers therefore benefit from deductions more than lower-income taxpayers.

The fact that the value of the benefit increases as a taxpayer's marginal tax rate increases also means that the amount foregone by the government increases as the taxpayer's marginal tax rate increases. So, for the taxpayer above with a 10% tax rate, the government only lost $1,000 in revenue. For the taxpayer with the 37% tax rate, the government lost $3,700 in revenue. This is why deductions are known in the tax policy literature as "upside-down subsidies."[3] When Congress provides a tax incentive in the form of a deduction, higher-income taxpayers benefit more than lower-income taxpayers, which means that the government is subsidizing higher-income taxpayers more than lower-income taxpayers.

Credits, in contrast, are dollar-for-dollar reduction in taxes, so a taxpayer's marginal tax rate does not affect the benefit. This means that taxpayers benefit equally regardless of their income level and that the government does not forego more revenue for higher-income taxpayers

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[2] The Internal Revenue Service reports that 11.4% of tax returns itemized their deductions for taxable year 2018. Internal Revenue Service, *SOI Tax Stats – Tax Stats-at-a-Glance FY 2019*, *available at* https://www.irs.gov/statistics/soi-tax-stats-tax-stats-at-a-glance. This number is much smaller than the number of itemizers prior to the 2017 tax reform known as the Tax Cuts and Jobs Act, which increased the standard deduction significantly and therefore sharply reduced the number of itemizers.

[3] Stanley S. Surrey, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (Harvard Univ. Press, 1973).

compared to lower-income taxpayers. One design question with credits, however, is whether to make them refundable or non-refundable. If they are refundable, taxpayers receive the full value of the credit regardless of their tax liability, so lower-income taxpayers can benefit fully. If they are non-refundable, they are limited to a taxpayer's tax liability, so higher-income taxpayers are more likely to receive the full benefit since they generally have higher tax liability.

B. Caps, cliffs, and phase-outs

A second policy design choice is whether and how to limit the benefits of a tax incentive. Congress can limit benefits based on taxpayer income, or Congress can impose a limit on the overall amount of the deduction that a taxpayer is allowed to take.[4] If benefits are limited based on taxpayer income, which I will refer to as an income limit here, that means that higher-income taxpayers will not benefit from the deduction, and the choice of income level where the deduction cuts off is a statement by Congress of which taxpayers have sufficiently high income that they are not the focus of the benefit. Congress can impose an income limit through a cliff, which means that, once a taxpayer's income hits the cut-off amount, the taxpayer loses the benefit, but cliffs can create unintentional behavioral distortions by discouraging taxpayers from earning extra income.[5] Congress can also impose an income limit through a phase-out, which means that taxpayers gradually lose the tax benefit as their income increases. A phase-out allows taxpayers to continue to receive some amount of benefit even as their income exceeds the start of the phase-out, and it dulls the disincentive to earn more income.

Instead of limiting benefits based on taxpayer income, Congress can limit the benefit itself. I will call this a benefit limit. A cap on the benefit means that taxpayers can receive the tax incentive regardless of income but that some taxpayers who incur larger expenses may not be able to take a deduction for their full expenses. Often – but not always – this indirectly limits the benefit that higher-income taxpayers can receive since they are more likely to incur larger expenses.

If any of these limits is not doubled for married couples filing jointly, that will create a marriage penalty, whereby taxpayers will receive up to double the benefit just by remaining unmarried and will lose part of their tax benefit just by getting married. Although this may not induce many couples to get divorced or discourage many unmarried couples from getting married, it is a behavioral incentive that may not be desired by Congress unless Congress's sole intended focus is unmarried individuals.

C. Focus of the tax incentive

Tax incentives are generally reductions in tax based on an expense incurred by a taxpayer. When designing these tax incentives, a third design choice is what expenses to subsidize by way of the

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4 Another way of limiting benefits is to include a floor in a tax incentive, pursuant to which a taxpayer only receives the benefit if the taxpayer's income exceeds a certain amount or percentage. *See, e.g.*, 26 U.S.C. 213. I do not consider these here because the reason for Congress to include a floor is to limit Congress's role as an insurer in certain contexts (e.g., losses due to flood, medical care). Congress is not taking on the role of an insurer in the provisions being discussed here.

5 *See* Daniel Shaviro, *Effective Marginal Tax Rates on Low-Income Households*, *available at* http://users.econ.umn.edu/~erm/data/sr472/Data/MicroData/EPI/EffMargRates.pdf.

incentive. Subsidizing the wrong expenses can have the effect of not encouraging the behavior Congress hopes to incentivize or of creating unintended consequences.

When looking at housing policy, Congress can focus on a variety of issues: the supply of affordable housing, the ability of individuals and families to incur the initial expenses of renting a home (i.e., multiple months' rent and a security deposit), the ongoing rental payments, the ability of individuals and families to incur the initial expenses of buying a home (i.e., the down payment and closing costs), and the ongoing cost of home ownership after the initial expenses are incurred. Many economists suggest that the main barrier to home ownership is the ability of buyers to pay the down payment and closing costs,[6] but Congress needs to determine which of these issues to address to achieve its goals and which expenses are most appropriate to subsidize in order to address those issues.

D. Is a tax incentive the correct policy tool?

One final design consideration worth considering is whether an incentive should be in the Internal Revenue Code at all. Although we have many home ownership and affordable housing incentives in the Internal Revenue Code right now, many of the design issues above would be eliminated if these were instead direct subsidies administered by the Department of Housing and Urban Development or another appropriate agency. They would be unlikely to be structured as upside-down subsidies benefiting higher-income Americans more than lower-income Americans, Americans would not be limited in their ability to benefit from a program by whether or not they take a sufficient amount of other deductions, and there would not be concerns about whether or not a taxpayer's tax liability was sufficient to offset the subsidy. While these characteristics are also true of refundable credits, direct subsidies have the further benefit of not being as attenuated from a taxpayer's decision as tax credits. Unlike a refundable credit, which requires a taxpayer to come up with the money up front and then wait until he or she files a tax return several months later to receive the benefit, a direct subsidy could be paid to the renter or home buyer at the time of the transaction, which could create more of an incentive to enter into renting or buying transactions.

II. Four Tax Provisions Related to Housing Access

With the above background on design choices, I will now outline the four main tax provisions that many people argue encourage home ownership or otherwise expand access to housing. My aim here is to show how Congress has made the design choices I mention above in creating and modifying each of these four provisions. Since all four of these tax incentives are in the Internal Revenue Code, I do not consider whether these provisions should have been restructured as direct subsidies administered by a different agency, but I do highlight how the decision to place at least one of these in the Internal Revenue Code may have had an impact on its effectiveness.

A. Home mortgage interest deduction

[6] Mark P. Keightley, *An Economic Analysis of the Mortgage Interest Deduction*, Congressional Research Service R46429, 12-13 (June 25, 2020).

The home mortgage interest deduction (26 U.S.C. 163(h)(3)) is a below-the-line deduction that currently allows taxpayers to deduct the interest on up to $750,000 of borrowing for up to two homes. (Prior to the 2017 tax reform bill known as the Tax Cuts and Jobs Act, this deduction allowed taxpayers to deduct the interest on up to $1,000,000 of borrowing for up to two homes and $100,000 of home equity borrowing. These numbers are scheduled to come back into effect on January 1, 2026.)

Deductions versus credits

Since this is a below-the-line deduction, the only taxpayers who can benefit from this are those who itemize, so the majority of taxpayers do not benefit from this deduction. Since this is a deduction, it also provides greater benefits to higher-income taxpayers and acts as an upside-down subsidy.

Caps, cliffs, and phase-outs

This deduction has a benefit limit rather than an income limit, which means that all taxpayers can qualify for this regardless of their income, but taxpayers with home mortgages higher than $750,000 will only be able to deduct some of their interest. This benefit limit is not doubled for married couples.

Focus of the tax incentive

The home mortgage interest deduction focuses entirely on the continued cost of home ownership and not on the supply of housing or the initial costs of purchasing a home.

This raises the question of whether this tax incentive encourages home ownership, and the economic literature suggests that the home mortgage interest deduction does not create an incentive for taxpayers who would not otherwise have bought a home to purchase a home. Instead, the literature suggests that the deduction creates an incentive for taxpayers who would already have bought a home to buy a more expensive home. In other words, the home mortgage interest deduction is capitalized into the price of homes,[7] which means that it leads to increased home prices, which in turn can have an impact on who is able to afford a home.[8] This effect may partly be due to the fact that the incentive does not focus on the initial costs of home ownership. It may also be due to the fact that the home mortgage interest deduction is one of the more salient deductions in the Code, which means that many taxpayers are aware of the deduction and perhaps believe they would benefit from it even if this is not the case. This in turn may mean that

[7] *See, e.g.*, Kamila Sommer and Paul Sullivan, *Implications of US Tax Policy for House Prices, Rents, and Home Ownership*, 108 AM. ECON. REV. 241 (2018), *available at* https://doi.org/10.1257/aer.20141751; Jonathan Gruber, Amalie Jensen, and Henrik Kleven, *Do People Respond to the Mortgage Interest Deduction? Quasi-Experimental Evidence from Denmark*, NBER Working Paper 23600 (July 2017), *available at* http://www.nber.org/papers/w23600.

[8] *See* Dorothy A. Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329 (2009), *available at* https://openscholarship.wustl.edu/law_lawreview/vol87/iss2/3.

taxpayers end up making home-buying choices based on the mistaken belief that they will receive the deduction even if they do not itemize.[9]

B. State and local tax deduction

The state and local tax (SALT) deduction (26 U.S.C. 164) is a below-the-line deduction that currently allows taxpayers to deduct up to $10,000 in state and local taxes. (Prior to the 2017 tax reform bill known as the Tax Cuts and Jobs Act, this deduction allowed taxpayers to deduct all of their state and local taxes without limit. This unlimited version of the deduction is scheduled to return on January 1, 2026.)

Deductions versus credits

As with the home mortgage interest deduction, this is a below-the-line deduction. Therefore, the only taxpayers who can benefit from this are those who itemize, so the majority of taxpayers do not benefit from this deduction. Since this is a deduction, it also provides greater benefits to higher-income taxpayers and acts as an upside-down subsidy.

Caps, cliffs, and phase-outs

Similar to the home mortgage interest deduction, this also has a benefit limit. All taxpayers can qualify for this regardless of income, but they can only take up to $10,000, and this amount is not doubled for married couples.

Focus of the tax incentive

To the extent that the SALT deduction focuses on any portion of home ownership, it, like the home mortgage interest deduction, focuses on the continued cost of home ownership. It is worth noting, however, that in the tax policy literature, this is generally not considered to be an incentive for home ownership. The deduction as it exists allows a deduction for state and local property taxes and income taxes, so even taxpayers who do not own a home may get a SALT deduction if they itemize and they pay state and local income taxes. Instead, this is generally viewed as a version of federalism, whereby the federal government foregoes revenue in favor of state and local governments in order to encourage or allow those governments to provide services that the federal government cannot or will not provide.[10] Whether this justifies keeping the SALT deduction or getting rid of the cap is debatable, and I will leave that debate to other scholars in other hearings. But this has generally not been defended as a tool for encouraging home ownership, which is partly because it includes a deduction for taxes other than property taxes and partly because, as with the home mortgage interest deduction, it does not focus on the initial costs of purchasing a home but rather focuses on the later continued costs of home ownership.

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9 *See* Jacob Goldin and Yair Listokin, *Tax Expenditure Salience*, 16 AM. LAW & ECON. REV. 144 (2014); Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. LAW REV. 1307 (2012).

10 *See, e.g.*, Daniel Hemel, *The Death and Life of the State and Local Tax Deduction*, 72 TAX L. REV. 151 (2019).

C. First-time homebuyer credit

The first-time homebuyer credit (26 U.S.C. 36) only applied to homes purchased between April 9, 2008, and May 1, 2010. It was amended several times over its short life, but it was primarily a refundable tax credit of up to $8,000 that could be taken by taxpayers whose modified adjusted gross income fell below a fixed amount and who had not owned a home in the past three years.

Deductions versus credits

This was a refundable credit for most of its life. This meant that all taxpayers that qualified for it could benefit from it, regardless of whether or not they itemized their deductions, and it was a dollar-for-dollar credit that would be paid directly to taxpayers if the credit exceeded their tax liability, so its design did not favor higher-income taxpayers over lower-income taxpayers.

Caps, cliffs, and phase-outs

The first-time homebuyer credit had both an income limit and a benefit limit. The income limit changed over the course of the credit's life, but the final limit took the form of a phase-out where a single taxpayer's credit phased out between income levels of $125,000 and $145,000, while a married couple's credit phased out between income levels of $225,000 and $245,000. Therefore, taxpayers were not able to take the credit at all if their income exceeded the end of the phase-out range, and they took a smaller credit if their income fell within the phase-out range. The benefit limit was the smaller of 10% of the cost of the purchased home or $8,000. While the income limit was adjusted for married couples, the benefit limit was not.

Focus of the tax incentive

This was a short-lived tax incentive that was enacted during the Great Recession and housing crisis, so not much has been written about its effectiveness in encouraging home ownership since the housing market was facing unique challenges at that time.[11]

Unlike the home mortgage interest deduction and the SALT deduction, this is directly focused on the initial cost of purchase. Since this was designed as a tax credit, however, taxpayers did not immediately receive the funds at the time of closing but instead received them when they filed their taxes, so its effect on home ownership may have been dampened relative to a direct subsidy.[12]

D. Low-income housing credit

The low-income housing credit (26 U.S.C. 42) applies to a different group of taxpayers and a different group of properties than the other provisions I am addressing here. While the other three provisions are focused on taxpayers purchasing homes for themselves, the low-income housing credit is focused on developers who are constructing or modifying affordable rental property. Furthermore, this credit program is administered by state and local governments, which

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11 *See* Sarah J. Webber, *Don't Burst the Bubble: An Analysis of the First Time Homebuyer Credit and Its Use as an Economic Policy Tool*, 45 JOHN MARSHALL L. REV. 23 (2011) (acknowledging that we "may never know the exact impact of the homebuyer credits on the economy").

12 *Id.* at 49 (citing the National Taxpayer Advocate making a similar point).

decide who will receive the amount of credit that is allocated to the states and territories on an annual basis.

Deductions versus credits

This is a non-refundable credit, but it can be carried forward or back along with other business credits under Section 38. This means that, even though it is not refundable in the year in which a taxpayer receives it, qualifying taxpayers do not lose the full value of the credit if their tax liability is not sufficiently high because they can use it against tax liability in the future or past.

Caps, cliffs, and phase-outs

Since businesses developing affordable housing are the focus of this credit, the credit itself does not have a direct income limit, although the state and local government entities administering the credit will determine which housing projects qualify partly based on the income of the residents. The value of the credit itself has a benefit limit in that it is limited to a percentage of the basis of the housing and in that state and local governments are given a limited amount of credits per year, but there is not a cap on the amount each taxpayer can receive.

Focus of the tax incentive

Unlike the above three tax provisions, the low-income housing tax credit is not focused on home ownership, nor is it provided directly to the taxpayer who is occupying the home. Instead, it is focused on increasing the supply of affordable housing, and it does that by setting up a program pursuant to which state and local governments allocate credits to developers of affordable housing that qualifies under state and local rules. The developers then generally sell the credits to investors in order to get more funding for their development.

Whether or not this subsidization of developers with credits that are then sold to investors is the appropriate tool for increasing the stock of affordable housing is debated in the literature. While many consider this credit to have successfully increased the number of affordable housing units,[13] others have critiqued the inefficiency of using credits that have to be sold in order for developers to get direct funding and have pointed out that the number of units that have been produced has not increased in step with the increase in the amount of credits provided by the federal government.[14] Others have critiqued the credit for entrenching racial housing segregation and for being open to fraud and abuse.[15]

III. Conclusion

As I said at the outset, I do not intend to advocate for any specific policy. I hope, however, that I have highlighted how important the design choices you make are to the success of any tax incentive. Seemingly technical details such as whether a deduction is above-the-line or below-

[13] Sagit Leviner, *Affordable Housing and the Role of the Low Income Housing Tax Credit Program: A Contemporary Assessment*, 57 TAX LAWYER 869, 870 (2004)

[14] Blaine G. Saito, *Collaborative Governance and the Low-Income Housing Tax Credit*, 39 VA. TAX. REV. 451, 453-54 (2020).

[15] Michelle D. Layser, *How Federal Tax Law Rewards Housing Segregation*, 93 IND. L.J. 915 (2018); Saito, *supra* note 14, *at* 453, n. 3.

the-line, whether or not there is an income cut-off or benefit cap, and whether taxpayers are receiving a benefit for a down payment or for mortgage interest can make a huge difference in terms of which Americans benefit from the tax incentive and whether or not the tax incentive succeeds at encouraging home ownership and improving access to housing.

The Joint Committee on Taxation estimates that the home mortgage interest deduction and low-income housing tax credit together will cost the government over $175 billion over the next five years.[16] I hope that my testimony today helps you make sure that that money – and all the rest that the government spends on other forms of housing support – is money well spent.

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16 Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024*, JCX-23-20 (November 5, 2020). The home mortgage interest deduction is estimated to cost $125.2 billion from 2020-2024. The low-income housing credit is estimated to cost $54.6 billion over the same period. The state and local tax deduction is estimated to cost $116.6 billion over the same period, but the Joint Committee on Taxation does not treat any of that as a tax expenditure for housing, and it is not clear how much of that is due to property taxes now that it is capped. The Treasury tax expenditure estimates treat $32.75 billion over the same period as the portion of the SALT deduction that is allocable to property taxes from owner-occupied housing. U.S. Department of the Treasury, *Tax Expenditure Budget FY 2022* (June 3, 2021), *available at* https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2022.pdf.