# Testimony of

**Gary V. Engelhardt**

**Maxwell School of Citizenship and Public Affairs**

**Syracuse University**

**Before the**

**U.S. House of Representatives**

**Committee on Small Business**

**Hearing on**

**The Housing Crisis: Identifying Tax Incentives to Stimulate the Economy**

**June 5, 2008**

Chairwoman Velazquez, Ranking Member Chabot, and other committee members:

Thank you for the opportunity to testify at this hearing. While I will focus my remarks on how tax incentives for the housing sector affect economic activity and small businesses, there are a set of basic principles that should guide any discussion of changes to the tax system and will help frame my comments below:

- **Tax policy should promote long-term growth—**Design tax changes with long-term growth in mind. Tax policy is typically not well suited to manage short-term economic fluctuations.
- **Broaden the tax base; level the playing field; lower tax rates—**Eliminating loopholes and preferential tax treatment, and simultaneously lowering marginal tax rates will increase economic efficiency and maintain revenue.
- **Reduce complexity**
- **Generate stability—**A stable tax structure allows individuals and businesses to make good economic decisions without having to the face the uncertainty about whether the system will change in the near term. Reduce the current reliance on sun-setting.
- **Target tax preferences to promote new investment, saving, and increased work effort—**After base broadening, any remaining special preferences should be targeted to those businesses and individuals who, in response, would demonstrably and substantially increase new business capital formation (investment), personal saving, and work effort.

## 1. The Current State of the Housing Sector

In the recent boom, home buyers in many markets took out adjustable-rate (ARMs) and sub-prime mortgages far beyond their means, many with little to no down payment and deferred repayment schedules, in the anticipation of either further strong gains in house prices or growth in future earnings. As many housing and labor markets have cooled and house prices leveled off, delinquencies and foreclosures have risen, especially for homeowners with ARMs and sub-prime mortgages. This has led to downward pressure on house prices in markets with a large percentage of this type of homeowner, such as in Florida and California. However, not all markets have been affected in this manner.

What has made the problems in the housing sector more problematic is that most mortgages were packaged and sold to investors as mortgage-backed securities, the purchases of which were heavily leveraged. The rise in delinquencies and foreclosures has resulted in a sharp decline in the value of mortgage-backed securities that, in turn, has spilled over into broader financial markets. The tightening of general credit markets has not only reinforced the downward pressure on house prices in many markets, but also made borrowing difficult for households and firms in the non-housing sectors of the economy.

While much of the shake-out for financial companies has already occurred in the form write-downs, housing markets have yet to stabilize. In particular, prices will not stabilize until the large unsold inventory of houses in many markets has been flushed out.

## 2. Analysis of Recently Proposed Tax Incentives

These challenges have led for calls for new federal legislation to both stabilize in the short run and promote growth in the long run in the housing sector. In particular, the American Housing Rescue and Foreclosure Prevention Act of 2008 (H.R. 3221) would expand tax incentives targeted to housing through a new refundable first-time home buyer tax credit, a new standard deduction for property taxes paid, a temporary increase in existing tax-exempt mortgage bond authority, and a temporary increase in the existing low-income housing tax credit for developers of affordable rental housing. Additional proposals would allow for tax relief for all businesses in the form of income averaging through net loss carry-backs. I briefly discuss the most important of these incentives.

### 2.1. Net Loss Carry-Backs

Traditionally, the tax system has allowed entities to average their income across years through net loss carry-forwards, in which losses in the current year can be used in part to offset taxable income in a future year. This type of income averaging can be thought of as a form of insurance that allows businesses to smooth taxable income across future years and is potentially very valuable to businesses, big and small.

A net loss carry-back works in the opposite way: losses in the current year can be used in part to offset taxable income from a *prior* year. Whereas carry-backs obviously provide reduced tax payments for businesses with current net operating losses, they are not elements of good tax policy for two reasons. First, because carry-backs apply to decisions made and income earned *in the past*, they are tax preferences that do not generate new investment. Consequently, they will not generate any new long-term growth opportunities. Second, because there is some discretion as to the year in which to claim losses for tax purposes, some businesses will use carry-backs strategically to claim losses now and receive tax benefits in way that would not otherwise occur in the absence of carry-back provisions. This is distortionary and economically inefficient. The proposed temporary nature of carry-back provisions will only exacerbate this.

### 2.2. Low-Income Housing Tax Credits

The Low-Income Housing Tax Credit (LIHTC) is a place-based subsidy to developers who construct new, affordable rental housing. The LIHTC has grown rapidly. Now, more is spent on this program than on public housing projects. H.R. 3221 would raise LIHTC funding temporarily, by roughly 10%, in an effort to increase affordable housing construction.

The extent to which this increase stimulates construction depends on the extent to which LIHTC-financed projects substitute for, or “crowd out,” private low-income construction that would have otherwise occurred in the absence of the LIHTC program. Economists who have studied public-housing subsidies in general and the LIHTC in particular have arrived at a wide range of crowd-out estimates. Sinai and Waldfogel (2005) estimated for all place-based federal housing subsidies (including, but not limited to, the LIHTC) that crowd-out was 70%. More recent studies by Eriksen and Rosenthal (2007) and Baum-Snow and Marion (2008) of the LIHTC specifically found that crowd-out was 60-100% for affordable multi-family rental housing in higher-income neighborhoods, but 0-20% in poor neighborhoods.

Crowd-out of 60-100% means that the LIHTC generates little, if any, new rental housing investment in higher-income neighborhoods. It simply finances construction that would have been done anyway by the private market. Roughly two-thirds of LIHTC funds are spent in higher-income neighborhoods.

For poor neighborhoods, the story is different. Crowd-out of 0-20% means the LIHTC generates substantial new rental housing investment. LIHTC-funded developments would not have occurred otherwise in these neighborhoods. Therefore, the currently proposed increase in LIHTC funding could be better targeted if it were limited to construction in poor neighborhoods. Because the construction industry is dominated by smaller establishments, this would help to promote small business activity in the housing sector.

### 2.3. First-Time Home-Buyer Tax Credits

Refundable tax credits for first-time home purchase represent a new tax preference for investment in owner-occupied housing that has found its way into recent proposals for tax reform. For example, H.R. 3221 includes a provision for a refundable credit equal to the lesser of 10 percent of the purchase price of the home or $7500 and fully available to first-time home buyers with adjusted gross income of $70,000 or less ($140,000 if married, filing jointly). For those with income above these thresholds but less than $90,000 ($160,000 if married, filing jointly), the credit is gradually phased out. The label "credit" is something of a misnomer, as the $7500 would be repaid without interest over a 15-year period (commencing the second year after home purchase), so that this so-called "credit" is really an interest-free loan of $7500 from the government to first-time home buyers.

The rationale for the credit, which sunsets in 2010, is to provide temporary short-run stimulus to the demand for owner-occupied housing, helping to stabilize prices and generate additional economic activity in the housing sector.

#### 2.3.1. Evidence from Washington, DC

Unfortunately, little is known about the potential impact of a federal first-time home buyer on the national housing sector, as such a credit does not currently (or did not recently) exist. Therefore, I discuss the impact of a similar policy, the $5000 federal tax credit for first-time home buyers available to residents of the District of Columbia, to help provide some basic evidence on the potential impact of a national credit on economic activity in the housing sector.

Beginning in 1997, the credit was available to DC residents who were first-time buyers and was phased out for higher-income households. In fact, the income limits for the proposed national credit were based on the limits for the DC credit. Unlike the currently proposed credit, the DC credit was truly a credit against taxes paid and not an interest-free loan.

Zhong Yi Tong, an economist at Fannie Mae, has studied the impact of the DC credit. From 1997-2001, the credit was claimed on almost 22,000 federal tax returns, and just under $77 million was disbursed under the program (Tong, 2005). The bulk of participants had adjusted annual gross income of $30,000-$75,000. In particular, Tong examined the impact of the credit on house price appreciation in the District relative to four neighboring counties (Arlington, VA; Fairfax, VA; Prince George, MD; Montgomery, MD) and Alexandria City, after versus before the enactment of the credit in 1997. He found that the credit had a substantial impact on house price appreciation: housing capital gains were 4.9 percentage points higher per year in DC relative to the five comparison areas after relative to before the adoption of the credit. In addition, the program generated an estimated $2 billion in additional housing wealth and about $50 in new District property tax revenues.

Tong's analysis did not examine the impact on business activity from the adoption of the credit. So, in preparation for this testimony, Michael Eriksen of Syracuse University and I have analyzed the short-run impact of the adoption of the DC credit on four broader economic outcomes—total number of establishments, total employment, average annual pay, and the establishment-size distribution of businesses—for the construction sector, using data from 1994-2001 drawn from the Census Bureau's *County Business Patterns* database. In particular, in a manner similar to what Tong did, we compared these outcomes for the construction sector relative to all other sectors, after relative to before the enactment of the credit in 1997, for DC relative to the four neighboring counties (Arlington, VA; Fairfax, VA; Prince George, MD; Montgomery, MD).[1] We also examined county-level building-permits data.

While the details of our study are available upon request, the short-run impacts on the construction sector, defined as over the first four years of the program, can be summarized as follows:

- The credit raised the total number of business establishments in the construction sector in DC by 21%;
- Total employment in the construction sector in DC rose by 32%;
- Average annual pay for those employed in the construction sector rose by 9%;
- The bulk of the increase in business establishments in the construction sector occurred in small businesses; and,
- Building permits more than doubled.

However, for the District economy *as a whole*, the impact of the DC credit program was negligible in terms of total number of business establishments and employment. This means that the gains in the construction sector listed above came in the short run at the expense of other sectors in DC economy.

#### 2.3.2. Potential Implications for the Newly Proposed Federal Credit

Although the DC credit appears to have been a success in promoting the housing sector in the District, there are a number of reasons to be less optimistic about the ability of a *temporary* national credit to stimulate housing sector activity in the short run. First, a credit at the national level is not a well-suited policy to bring a substantial number of new home buyers into the market in the very near term. This is because home buying is not a snap decision. It depends on a range of long-term non-housing factors, including employment stability and income growth, over which there is substantial uncertainty. The DC credit was enacted during a period of substantial earnings growth across all segments of the labor market that is not the case currently.

Second, new buyers will not enter markets in decline, taking immediate capital losses. While the period prior to the enactment of the DC credit (1994-6) was toward the end of the trough of a real estate cycle, prices were much more stable than today—and certainly not declining 15%, as is now the case. As mentioned above, prices will not stabilize nationally until

[1] Unfortunately, complete data were not available for Alexandria City.

the large unsold inventory of houses in many markets has been flushed out. Any benefits of a credit likely will not accrue until the medium term. Moreover, the proposed credit is temporary, sun-setting in 2010, potentially altering the timing of some home purchases, but over the long-run not raising the total number of new home buyers in the market.

Third, the recently proposed national credit has a maximum of $7500, which is far less generous than the DC credit. In particular, the proposed credit is really an interest-free loan of $7500, repaid over a 15-year "recapture" period. At a 3 percent real rate of return, the present value of the recapture payments is $5625, so that the actual tax subsidy from the "credit" is $1875 (i.e., $7500-$5625=$1875). In contrast, a $5000 credit in 1997 (when the DC credit was enacted) is equivalent to $7000 in today's dollars because of inflation. This means that the proposed national credit is only 27% as generous as the DC credit expressed in today's prices. This substantial reduction in generosity will result in far less take-up of a national credit than the DC credit, and, hence, far less housing-sector stimulus.

Finally, a maximum tax benefit of $1875 is a larger subsidy as a percentage of the purchase price in lower-priced housing markets. Hence, a national credit would provide a larger stimulus in cheaper markets. However, the markets with the greatest price declines and policy challenges are *relatively expensive* markets that saw substantial price run-ups. If such a credit is being proposed as an economic stabilization tool, it paradoxically would be targeted in a manner exactly opposite to what would be desired.

The appendix table illustrates the generosity of the tax benefit from the credit expressed as a percentage of area median house prices in the committee members' home districts. The subsidy ranges from 0.4% to 1.94% of the purchase price in the most expensive (Brooklyn) and least expensive (Buffalo) districts. New underwriting guidelines at Fannie Mae require conforming loans with 5% down payments. Therefore, the subsidy from the credit would cover between one-twelfth and two-thirds of down payment, depending on the housing market examined.

### 3. Concluding Remarks

Because financial markets and Federal Reserve policy result in economic adjustments that occur with greater speed than most tax-based policies, new tax incentives for housing are not an attractive solution to problems in the housing sector in the very near term. As indicated in my opening comments, tax changes are best designed with long-term growth in mind. Effort is probably better spent on permanent tax changes that seek to broaden the tax base, reduce tax rates, and reduce complexity, allowing for improved long-run functioning of the economy and future revenue needs to meet forecast obligations in social insurance and other programs. To the extent that a definite need for additional preferences for housing is identified, new tax incentives should be specifically targeted toward promoting new investment and personal saving.

## References

Baum-Snow, Nathaniel, and Justin Marion, “The Effects of Low Income Housing Tax Credit Developments on Neighborhoods,” Brown University, Mimeo., 2008.

Eriksen, Michael, and Stuart Rosenthal, “Crowd Out, Stigma, and the Effect of Place-Based Subsidized Rental Housing,” Syracuse University, Mimeo., 2007.

Sinai, Todd, and Joel Waldfogel, “Do Low-Income Housing Subsidies Increase the Occupied Housing Stock?” *Journal of Public Economics* 89 (2005): 2137-2164.

Tong, Zhong Yi, “Washington, D.C.’s First-Time Home-Buyer Tax Credit: An Assessment of the Program,” *Fannie Mae Foundation, Special Report*, 2005.

**Appendix: Proposed Tax Credit Subsidy as a Percentage of Home Area Median House Price**

| Member | Home Area | Median House Price | Subsidy as a Percent of Price |
|---|---|---|---|
| Chairwoman Nydia Velázquez of New York | Brooklyn | $445,400 | 0.42% |
| Congressman Heath Shuler of North Carolina | Asheville, NC | $192,700 | 0.97% |
| Congressman Charlie Gonzalez of Texas | San Antonio, TX | $149,800 | 1.25% |
| Congressman Rick Larsen of Washington | Everett, WA | $372,300 | 0.50% |
| Congressman Raúl Grijalva of Arizona | Tucson, AZ | $221,000 | 0.85% |
| Congressman Mike Michaud of Maine | Bangor, ME | $234,000 | 0.80% |
| Congresswoman Melissa Bean of Illinois | Lake County, IL | $249,600 | 0.75% |
| Congressman Henry Cuellar of Texas | Laredo, TX | $142,400 | 1.32% |
| Congressman Daniel Lipinski of Illinois | Chicago, IL | $249,600 | 0.75% |
| Congresswoman Gwen Moore of Wisconsin | Milwaukee, WI | $204,400 | 0.92% |
| Congressman Jason Altmire of Pennsylvania | Allegheny, PA | $111,600 | 1.68% |
| Congressman Bruce Braley of Iowa | Dubuque, IA | $130,000 | 1.44% |
| Congresswoman Yvette Clarke of New York | Brooklyn | $445,400 | 0.42% |
| Congressman Brad Ellsworth of Indiana | Evansville, IN | $107,300 | 1.75% |
| Congressman Hank Johnson of Georgia | Dekalb County, GA | $154,000 | 1.22% |
| Congressman Joe Sestak of Pennsylvania | Delaware County, PA | $237,000 | 0.79% |
| Congressman Brian Higgins of New York | Buffalo, NY | $96,600 | 1.94% |
| Congresswoman Mazie Hirono of Hawaii | Honolulu, HI | $620,000 | 0.30% |
| | | | |
| Ranking Member Steve Chabot of Ohio | Cincinnati, OH | $128,500 | 1.46% |

| | | | |
|---|---|---|---|
| Congressman Roscoe Bartlett of Maryland | Frederick, MD | $192,700 | 0.97% |
| Congressman Sam Graves of Missouri | Kansas City, MO | $139,500 | 1.34% |
| Congressman Todd Akin of Missouri | St Louis, MO | $121,400 | 1.54% |
| Congressman Bill Shuster of Pennsylvania | Somerset County, PA | $111,600 | 1.68% |
| Congresswoman Marilyn Musgrave of Colorado | Loveland, CO | $223,500 | 0.84% |
| Congressman Steve King of Iowa | Sioux City, IA | $147,900 | 1.27% |
| Congressman Jeff Fortenberry of Nebraska | Lincoln, NE | $134,000 | 1.40% |
| Congressman Lynn Westmoreland of Georgia | Coweta County, GA | $154,000 | 1.22% |
| Congressman Louie Gohmert of Texas | Tyler, TX | $142,400 | 1.32% |
| Congressman David Davis of Tennessee | Greene County, TN | $146,000 | 1.28% |
| Congresswoman Mary Fallin of Oklahoma | Oklahoma City, OK | $124,900 | 1.50% |
| Congressman Vern Buchanan of Florida | Sarasota, FL | $262,300 | 0.71% |