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THE ACCIDENTAL DEDUCTION: A HISTORY AND CRITIQUE OF THE TAX SUBSIDY FOR MORTGAGE INTEREST

DENNIS J. VENTRY, JR.*

I
INTRODUCTION

In late 1988, the National Association of Realtors (NAR), still stinging from the Tax Reform Act of 1986,[1] which cut into the value of housing tax subsidies,[2] launched a campaign to bolster support for the mortgage interest deduction (MID). Among other tactics,[3] the NAR ran a radio spot on stations across the country warning that Congress was about to eliminate the tax subsidy propping up homeownership. A sappy, melodramatic song foreshadowed the end of the American Dream: "Where she can be what she wants to be. Where you can live when he's all grown. Where she keeps her memories. It's a home of his own."[4] Politicians were about to dash the Dream. "Don't let Congress eliminate your mortgage interest deduction. Keep the American Dream alive."[5] The somber voice hastened listeners to contact their elected officials and to tell them that their family's economic well-being depended on the MID.

Never mind that changes to the tax code in 1986 had made the deduction worthless for most Americans. At a time when fewer than 30% of all families

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1. Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter TRA86].

2. *See infra* notes 357–62 and accompanying text (discussing the effects of TRA86 on housing tax subsidies).

3. The NAR attacked members of Congress in their home districts for lukewarm support of the MID. *See* Pat Jones, *Housing Industry Lobbying Campaign Rankles Some Taxwriters*, 42 TAX NOTES 409, 409–10 (1989). The National Association of Home Builders adopted a slightly less aggressive strategy, but also mobilized "to fight hard for the retention of the mortgage deduction." *Id.* at 409 (quoting the Association's president).

4. *Id.* at 411.

5. *Id.*

reported income over $40,000,[6] households reporting less than $42,500 received almost no benefit from the MID due to reduced tax rates, a higher standard deduction, and repeal of the consumer interest deduction.[7] Never mind, too, that economists had already indicted the MID for distorting the cost of owner-occupied housing relative to other investments,[8] contributing to overinvestment in the asset class and misallocation of capital stock,[9] artificially raising housing prices,[10] disproportionately favoring high-income taxpayers,[11] encouraging over-consumption of bigger and more-expensive homes,[12] and having ambiguous effects on tenure choice (that is, the decision to own or rent).[13] The housing industry still considered preserving the MID its "biggest issue,"[14] and a near-unanimity of Americans still considered it the key to homeownership[15] even though a mere one-fourth reaped its benefits.[16]

Anxiety over the fate of the MID in the late 1980s was overwrought. The deduction was already widely considered the "most sacred tax break in the

6. U.S. CENSUS BUREAU, HISTORICAL TABLES—FAMILIES, TABLE F-1, INCOME LIMITS FOR EACH FIFTH AND TOP 5 PERCENT OF FAMILIES: 1947–2007 (2008), *available at* http://www.census.gov/hhes/www/income/histinc/f01AR.html.

7. *See* James R. Follain & David C. Ling, *The Federal Tax Subsidy to Housing and the Reduced Value of the Mortgage Interest Deduction*, 44 NAT'L TAX J. 147, 154 (1991) (citing the $42,500 figure); James Poterba, *Taxation and Housing: Old Questions, New Answers*, 82 AM. ECON. REV. 237, 238–40 (1992) (finding similar results).

8. *See* James Poterba, *Tax Subsidies to Owner-Occupied Housing: An Asset Market Approach*, 99 Q.J. ECON. 729, 748–49 (1984); Patric Hendershott & Joel Slemrod, *Taxes and the User Cost of Capital for Owner-Occupied Housing*, 10 AREUEA J. 375, 375–76 (1983).

9. *See* Dale Jorgenson & Kun-Young Yun, *Tax Reform and U.S. Economic Growth*, 98 J. POL. ECON. 151, 190 (1988) (finding that housing tax subsidies account for half of all distortions from misallocated capital in the economy); Edwin S. Mills, *Has the United States Overinvested in Housing?*, 15 J. AM. REAL EST. & URB. ECON. ASS'N 601, 601 (1987) (estimating that the housing stock is 33% higher than the efficient allocation).

10. *See* Harvey S. Rosen, *Housing Subsidies: Effects on Housing Decisions, Efficiency, and Equity*, *in* 1 HANDBOOK OF PUBLIC ECONOMICS, 375, 395–402 (Alan J. Auerbach & Martin Feldstein eds., 1985) (discussing earlier research on elasticities of housing demand and supply).

11. *See* Alan L. Feld, *Redeployment of Tax Expenditures for Housing*, 23 TAX NOTES 1441, 1443 (1984) (reporting that tax benefits for housing "flow disproportionately" to high-income taxpayers because they are tied to marginal tax rates, rise with increased housing consumption, and are unavailable to nonitemizers); Harvey S. Rosen, *Housing Decisions and the U.S. Income Tax: An Econometric Analysis*, 11 J. PUB. ECON. 1, 21–22 (1979) (finding that eliminating tax subsidies for homeownership would reduce income inequality).

12. *See* Rosen, *supra* note 11 (finding that without tax subsidies, U.S. taxpayers would be living in homes that were 9% to 17% less valuable).

13. *See* Rosen, *supra* note 10, at 395–402 (discussing earlier studies on tenure choice).

14. Jones, *supra* note 3, at 411.

15. *See* Steven V. Roberts, *Opposition to Carter on Economic Affairs Reaches 54 Percent in Poll*, N.Y. TIMES, Apr. 12, 1978, at A17 (reporting on a 1978 New York Times–CBS News poll that found nearly 90% of respondents favored preserving the deductions for mortgage interest and property taxes).

16. *See* IRS, SOI BULLETIN, HISTORICAL TABLE 7: STANDARD, ITEMIZED, AND TOTAL DEDUCTIONS REPORTED ON INDIVIDUAL INCOME TAX RETURNS, 1950–2006 (2008), *available at* http://www.irs.gov/taxstats/article/0,,id=175812,00.html [hereinafter INDIVIDUAL DEDUCTIONS] (showing only 28.5% of all income tax returns reported itemized deductions for tax year 1989).

code,"[17] the "third rail of tax reform,"[18] a member of the "Holy Trinity of U.S. social programs,"[19] and "an American birthright"[20] so "sacrosanct"[21] that the "mere thought of tampering with it was unpatriotic."[22] Moreover, only a few years had passed since President Reagan declared the MID off-limits to tax reformers, instructing his Treasury Department in 1984 to "preserve that part of the American dream which the home mortgage interest deduction symbolizes."[23] Not only was the MID immunized from reformist threats, it became more entrenched with each passing year. In 1986, the MID reduced tax revenues by $27 billion.[24] Between 1986 and 1996, it doubled in cost and then doubled again over the next fifteen years such that its price tag is estimated to reach $108 billion in 2010.[25] Since 1996, the MID has never ranked lower than third on the government's list of costliest tax expenditure items.[26] In fact, since 2003, only the exclusion for employer-provided contributions for medical-insurance premiums and medical care has ranked higher.[27]

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17. JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 246 (1987).

18. Bruce Bartlett, *Tax Reform's "Third Rail": Mortgage Interest*, 139 NCPR POL'Y BACKGROUNDER 1 (1996).

19. CHRISTOPHER HOWARD, THE HIDDEN WELFARE STATE: TAX EXPENDITURES AND SOCIAL POLICY IN THE UNITED STATES 93 (1997). Howard identifies Social Security and Medicare as the other two members of the "trinity."

20. *Id.*

21. Jones, *supra* note 3, at 409.

22. BIRNBAUM & MURRAY, *supra* note 17, at 246.

23. Lou Cannon, *Reagan to Keep Home Mortgage Tax Deduction*, WASH. POST, May 11, 1984, at F1. Reagan's announcement, delivered personally to the National Association of Realtors, exasperated tax experts even within his own administration. *See infra* notes 323–30 and accompanying text.

24. JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS, 1986–1990, at 13 (1985).

25. U.S. OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE U.S. GOVERNMENT, FISCAL YEAR 2010, at 300 (2009) [hereinafter O.M.B. Report [year]]; O.M.B. Report 1996, at 43 (reporting cost of $57 billion).

26. *Id.* for FISCAL YEARS 1996–2010 (for 1996, *id.* at 64; 1997, at 86; 1998, at 79; 1999, at 99; 2000, at 114; 2001, at 117; 2002, at 63; 2003, at 107; 2004, at 110; 2005, at 294; 2006, at 324; 2007, at 296; 2008, at 296; 2009, at 298; 2010, at 308).

27. *Id.* (corresponding to years 2003–2010). The MID is not the only tax expenditure item related to housing. In 2010, tax expenditures related to housing will cost the federal government $175 billion. In addition to the MID, other items include the exclusion for gains on home sales ($30.46 billion), the deduction for state and local property taxes ($14.98 billion), the accelerated depreciation on rental housing ($10.77 billion), the exception from passive loss rules for rental loss ($9.16 billion), the credit for low-income housing investments ($4.34 billion), the deferral from income of installment sales ($1.37 billion), the exclusion of interest on mortgage subsidy bonds ($1.03 billion), the exclusion of interest on rental housing bonds ($0.93 billion), and the discharge of mortgage indebtedness ($0.26 billion). O.M.B. Report, *supra* note 25, at 330. The $175-billion figure would be even higher but for the recent precipitous drop in the value of the exclusion for net imputed rental income, which, according to the OMB, will fall from $35.68 billion in 2008 to *negative* $2.2 billion in 2010. *Id.* The explanation for the dramatic decline is simple: growth in owner-occupied housing expenses has outpaced growth in gross rental value of owner-occupied housing. I thank David Joulfaian of the Department of Treasury's Office of Tax Analysis and Denise McBride of the Department of Commerce's Bureau of Economic Analysis for this information. For a definition of imputed rent, see *infra* note 30.

Not bad for a subsidy that was never explicitly identified in the internal revenue laws until 1986.[28] Technically, the MID has been part of the federal income tax from the very beginning. But the Revenue Act of 1913 did not include any mention of a deduction for interest paid on owner-occupied residences. Instead, it provided for a general offset for "all interest paid within the year by a taxable person on indebtedness,"[29] a treatment that, at least in theory, embodied the principle of a net income tax by allowing an offset to tax owed for costs associated with generating taxable income. At the same time, however, the 1913 income tax law violated this principle by excluding from gross income imputed rent from owner-occupied housing, while also allowing offsets for interest and property taxes on that nontaxable form of income.[30]

Indeed, the historical record fails to indicate why Congress allowed a deduction for personal interest in 1913. Commentators have surmised that the deductibility of consumer interest "may have been less a matter of principle than a reflection of the practical difficulty of distinguishing personal from profit-seeking interest."[31] And in fact, the 1913 law contained a separate deduction for "the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses."[32] Whatever the original motivation for the consumer interest deduction, one thing is clear: Congress did not see it as a way of promoting homeownership. Rates of owner-occupied housing were low—less than 50% until after World War II—and Congress had yet to embrace taxation as a vehicle for rewarding or encouraging certain kinds of behavior. As law professor and Treasury official, Stanley Surrey, once observed, the MID, like other tax provisions "whose origins are cloudy," only later became "defended on incentive grounds."[33]

This article traces the MID from accident to birthright, from one of many deductible personal interest items to one of the few still standing, and from a negligible tax offset to the second most expensive tax subsidy. Part II of this article examines the origins of the deduction for personal interest alongside the birth of the modern federal income tax and concludes that the deduction had nothing to do with encouraging or rewarding homeownership. A growing

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28. *See* I.R.C § 163(h)(3) (1986).

29. Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114, 167.

30. "Imputed rent" corresponds to the sum of the market value of untaxed housing services enjoyed by homeowners. If homeowners were treated like investors of other asset classes, they would include as taxable income the value of net imputed rent, reflecting the rent a homeowner would have received had she leased the property to someone else less the cost of generating that income (such as mortgage interest payments, property and real estate taxes, economic depreciation, and maintenance expenditures).

31. Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679, 713 (1987). *See also infra* notes 51–58 and accompanying text.

32. Revenue Act of 1913, 38 Stat. at 167.

33. STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 127 (1973). Surrey included in this group the deductions for property taxes, other state and local taxes, and depreciation, the last of which he termed "inadvertent" and said was created by "happenstance." *Id.* at 127, 364.

number of Americans were using mortgages to finance home purchases, but the ratio of home mortgage debt to total consumer debt remained low. Moreover, tenure choices followed historic patterns, reflecting a nation of renters, not homeowners. In addition, the income tax remained a class-based levy until World War II, with just a fraction of wealthy Americans paying income taxes, precisely those households least likely to finance home purchases.

Part III examines national rates of homeownership during depression, war, and postwar affluence. Homeownership rates stagnated and then receded during the Great Depression, with the housing industry and homeowners together suffering choked lines of credit and historically high foreclosure rates. The federal government responded in unprecedented fashion with a litany of new agencies and emergency stabilization policies that infused credit into housing markets, underwrote government-insured mortgages, and reversed rates of foreclosure by purchasing defaulted loans and then reinstituting them under more favorable terms. These programs reshaped the residential housing and mortgage markets by institutionalizing long-term, fixed-rate, fully amortizing loans; by establishing considerably higher loan-to-value ratios; and by creating a vibrant secondary mortgage market. These innovative federal housing policies stabilized the housing sector during the Depression and fueled a postwar housing boom.

As rates of homeownership jumped in the postwar period, housing tax subsidies went along for the ride. Americans bought homes due to loosened credit, long-term loans, low down payments, higher real incomes, and changing demographics—but *not* for tax reasons. Still, sharply rising mortgage debt accompanied increased homeownership. Part IV describes how the tax benefits associated with mortgage debt increased significantly under the federal income tax that emerged from World War II. Characterized by rates exceeding 90% and a broad base, the postwar income tax created tens of millions of new taxpayers, all of whom had the opportunity to reduce their tax liabilities through itemized deductions. These generous tax offsets not only reduced revenues, but insidiously eroded the tax base, distorted economic activity, and kept tax rates unduly elevated. Analysts began to quantify the cost of these tax giveaways. In the process they reported that the personal interest deduction had been rising faster than any other itemized deduction, driven in large part by skyrocketing mortgage interest payments. The MID was now on the radar of experts and politicians, a growing number of whom formed a postwar tax-policymaking consensus that sought tax reform alongside tax cuts. Eliminating tax subsidies like the MID could pay for significant rate reduction, as much as 30% across the board.

As part V details, postwar tax reformers attacked the MID and other housing tax subsidies on grounds of protecting revenue as well as on principle. Under a net income tax, offsets were justified for expenses associated with generating taxable income. The deductions for mortgage interest and property taxes, on the other hand, offset costs for generating excluded net imputed rental

income. Thus, a long-term strategy emerged among reformers—many of whom later worked in the Treasury Department during the 1960s—aimed at undermining housing tax subsidies: (1) raise the standard deduction as a way to extend comparable tax savings to nonitemizing taxpayers and to erode public support for the itemized subsidies, and (2) develop an annual accounting of all "tax expenditure" items that deviated from a comprehensive base so that policymakers could reevaluate them on an annual basis. Restating tax programs in traditional budget language, reformers thought, could help identify the inefficient, "upside-down" subsidies.

The Treasury's formulation of the tax expenditure budget coincided with sweeping, comprehensive studies that, in 1969, culminated in significant tax reform. Reformers' long-term strategy appeared to be working, with Congress raising the standard deduction and removing millions of MID beneficiaries. Congress again raised the standard allowance in the mid-1970s such that by decade's end only slightly more than one-quarter of all taxpayers reaped the benefits of housing tax subsidies—which by this point had gotten not only more regressive but considerably more expensive. Even as analysts and policymakers highlighted the subsidies' costs and inequities, popular support for the MID grew and then accelerated as inflation eroded the value of tax-free thresholds, creating new recipients of itemized deductions while reinforcing old recipients.

The MID appeared immune to reform. But as part VI explains, the fiscal crisis of the early 1980s provided reformers with a unique opportunity. As part of his Administration's attempt to right the slumping economy and to stanch the exploding budget deficit, President Reagan gave his Treasury Department the green light to root out revenue. Everything appeared to be on the table—that is, until Reagan immunized the MID, immediately injecting politics into the tax reform effort and belying his earlier support for fundamental reform. In the end, the Tax Reform Act of 1986 accomplished a great deal. But with the MID cordoned off, the restructured tax code challenged existing housing tax policies only tangentially. Moreover, the challenge was short-lived, for, the following year, Congress enacted the tax allowance for home equity loans, turning houses into credit cards.

Over the next twenty years, housing tax subsidies became even more indefensible and hastened the collapse of the housing and financial markets. But the die had been cast in the mid-1980s with Reagan's capitulation, the subsequent short-circuiting of fundamental tax reform, and the preservation of the MID.

This article concludes with a eulogy to the MID that is more applicable today than at any time during its nearly 100-year history.

II

HOMEOWNERSHIP AND THE MODERN FEDERAL INCOME TAX

In 2004, the rate of homeownership in the United States reached 69%, an all-time high.[34] In each of the next four years, homeownership receded slightly from its high-water mark such that, by 2008, the percentage of owner-occupied dwellings had fallen to 67.8%.[35] Notwithstanding the recent downturn, the current rate of homeownership remains high by historical standards. In 1890, just 47.8% of households were owner-occupied, a figure that fluctuated only slightly until the 1930s.[36] The exigencies of the Great Depression—protracted joblessness, tight credit, and massive foreclosures—contributed to the rate of homeownership falling more than four percentage points to 43.6%.[37] Beginning in 1940, however, the number of owner-occupied households experienced extraordinary growth, rising steadily and rapidly over the next twenty years from less than 44% to 61.9%.[38] For the next thirty years, homeownership stagnated before rebounding in the 1990s, reaching its historic peak in 2004.

What factors contributed to the waxing and waning and then waxing again of homeownership in the United States? Not the tax system, at least until after World War II.

In February 1913, three-quarters of the states ratified the Sixteenth Amendment, and nine months later President Woodrow Wilson signed the modern federal income tax into law.[39] The Revenue Act of 1913 assessed a modest, "normal" tax of one percent on incomes above $3000 for single individuals and $4000 for married couples as well as a progressive "surtax" ranging from 1% to 6% on net income above $20,000.[40] As its Progressive Era advocates had envisioned,[41] the tax fell disproportionately on the rich. Adjusted

34. U.S. CENSUS BUREAU, HOUSING VACANCIES AND HOMEOWNERSHIP (CPS–HVS), HISTORICAL TABLES, TABLE 7: ANNUAL ESTIMATES OF THE HOUSING INVENTORY (2009), *available at* http:// www.census.gov/hhes/www/housing/hvs/historic/index.html.

35. U.S. CENSUS BUREAU, PRESS RELEASE, REPORTS ON RESIDENTIAL VACANCIES AND HOMEOWNERSHIP 3 (2009).

36. BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970, at 646 (1975), *available at* http://www2.census.gov/prod2/statcomp/documents/ CT1970p1-01.pdf. Between 1890 and 1930, the U.S. Census reported homeownership rates of 47.8% in 1890, 46.7% in 1900, 45.9% in 1910, 45.6% in 1920, and 47.8% in 1930. *Id.*

37. *Id.*

38. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 1999, at 727 (118th ed. 1999), *available at* http://www.census.gov/prod/99pubs/99statab/sec25.pdf.

39. For the ratification movement, see W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY 36–46 (1996); JOHN D. BUENKER, THE INCOME TAX AND THE PROGRESSIVE ERA (1985); SIDNEY RATNER, AMERICAN TAXATION: ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY 250–340 (1942).

40. Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114. "Normal" income tax rates were assessed on taxable income above the exemption levels and below $20,000, while graduated "surtax" rates were assessed on taxable income above $20,000.

41. *See* 1 CORDELL HULL, THE MEMOIRS OF CORDELL HULL 71 (1948) (primary author of the 1913 Revenue Act calling the income tax "the one great equalizer of the tax burden and therefore a tremendous agency for the improvement of social conditions"); Roy G. Blakey, *The New Income Tax*, 4

for inflation, exemption levels created a tax-free threshold for singles and married couples of $65,000 and $85,000 respectively (2009 dollars). Only taxpayers with inflation-adjusted incomes exceeding $500,000 (2009 dollars) were subject to tax rates above 1%, with the top marginal rate of 7% assessed only on incomes approaching $11,000,000 (adjusted).[42] Generous zero-bracket levels exempted 98% of all households,[43] such that the Bureau of Internal Revenue, precursor to the Internal Revenue Service, processed just 358,000 individual income tax returns in 1913, netting only $28 million.[44] Between 1916 and 1918, and to finance World War I,[45] Congress significantly raised rates[46] and lowered personal exemptions,[47] creating four million new taxpayers.[48] Despite the lower exemptions and broader base, the levy remained a class-based tax, affecting only 15% of all households.[49] Meanwhile, the wealthiest 1% of Americans accounted for 80% of income tax receipts and were subject to effective tax rates exceeding 15%.[50]

The early internal revenue laws also provided allowances for certain expenses when calculating total taxable income. The Revenue Act of 1913 enumerated eight such deductions. None of the eight allowances provided an explicit carve-out for mortgage interest, but one of them afforded an offset for consumer interest,[51] a provision that remained largely unchanged for seventy years.[52] By all accounts, consumer interest payments in 1913 "were minimal,"[53]

AM. ECON. REV. 25, 33 (1914) (considering progressive taxation a symbol of economic and social justice); Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive Era Political Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793 (2005) (exploring legal and economic arguments for redistributive, ability to pay taxation); Edwin R.A. Seligman, *The Income Tax*, 9 POL. SCI. Q. 610, 648 (1894) (calling for a federal income tax to "round out the existing tax system in the direction of greater justice").

42. The top marginal rate of 7% began at $500,000, unadjusted.

43. W. Elliot Brownlee, *Historical Perspective on U.S. Tax Policy Toward the Rich*, *in* DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 29, 41–42 (Joel B. Slemrod ed., 2000).

44. Scott Hollenbeck & Maureen Keenan Kahr, *Ninety Years of Individual Income and Tax Statistics, 1916–2005*, *in* IRS STATISTICS OF INCOME BULLETIN 144 (Winter 2008), *available at* http://www.irs.gov/pub/irs-soi/16-05intax.pdf.

45. *See* W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, PROC. AM. PHIL. SOC'Y 129, 173–210 (1985).

46. By war's end, individual income tax rates ranged between 12% and 77%, and estate tax rates reached 25%. Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057, 1062.

47. *Id.* at 1069.

48. Hollenbeck & Kahr, *supra* note 44, at 144.

49. BROWNLEE, *supra* note 39, at 44.

50. *Id.*

51. *See supra* note 29. The other seven deductions included offsets for (1) business expenses, (2) state and local taxes, (3) losses (both capital and casualty), (4) bad debts, (5) depreciation and depletion of business property, (6) dividends received, and (7) tax paid or withheld.

52. *See* Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756, 759; Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057, 1067–68; Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227, 239; Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253, 270; Revenue Act of 1926, Pub. L. No. 69-20, 44 Stat. 9, 26; Revenue Act of 1928, Pub. L. No. 70-562, 45 Stat. 791, 799; Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169, 179; Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680, 688; Revenue Act of 1935,

and the ratio of nonfarm mortgage debt to total consumer debt was low.[54] Moreover, even though legislative debates in 1913 reveal some awareness among members of Congress that taxpayers might deduct mortgage interest payments under the proposed allowance for consumer interest,[55] there is no evidence that Congress viewed the deduction as a vehicle for promoting homeownership. The better interpretation for why legislators included the deduction in the original Revenue Act is that it was extraordinarily difficult, both practically and administratively, to differentiate between the personal and profit-seeking expenses of family-run farms, small businesses, and individual proprietors.[56] Given these difficulties, Congress provided full deductibility of

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Pub. L. No. 74-407, 49 Stat. 1014; Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648, 1659; Revenue Act of 1940, Pub. L. No. 76-656, 54 Stat. 516; Revenue Act of 1941, Pub. L. No. 77-250, 55 Stat. 687; Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798; Revenue Act of 1943, Pub. L. No. 78-235, 58 Stat. 21; Individual Income Tax Act of 1944, Pub. L. No. 78-315, 58 Stat. 231; Revenue Act of 1945, Pub. L. No. 79-214, 59 Stat. 556; Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 110; Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906; Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 452; Internal Revenue Code of 1954, Pub. L. 83-591, 68A Stat. I, 46; Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960; Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19; Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, 82 Stat. 251; Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487; Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497; Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26; Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520; Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, 91 Stat. 126; Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324; Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

53. Rosen, *supra* note 10, at 388.

54. *See* SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 284 (1961) (reporting nonfarm mortgage debt in 1914 as 11.7% of total debt).

55. The only discussion I found reflecting legislators' awareness in 1913 that taxpayers might deduct mortgage interest under the proposed consumer interest deduction involved an excerpt from debate on the Senate floor:

> If I understand [the deduction for consumer interest], it would result in this sort of a situation: Here is one man, for example, who has purchased a home. He has given a mortgage upon it for its price or a large part of it, and is paying, let us say, $1,000 in interest. Under this bill that would be deducted from his net income. But if his neighbor has rented a house, and instead of virtually paying what the first-named man does in the form of interest he pays directly $1,000 rent. He gets no deduction whatever, and yet the situation of the two is to all intents and purposes precisely the same. One has made a purchase and is paying interest which virtually amounts to rent. The other has not made a purchase, but pays the rent direct. One gets the exemption and the other does not.

50 CONG. REC. 3848 (1913) (statement of Sen. Sutherland).

56. *See* Koppelman, *supra* note 31; C. HARRY KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 12–13 (1960) (calling the "lack of distinction between personal expenses on the one hand and business expenses and losses on the other" the "primary reason" legislators provided a deduction for personal interest in 1913); Stanley S. Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 825 (1958) (surmising that the deduction was included "because it was thought difficult to separate personal interest from business interest").

interest on debt for business expenses[57] in addition to debt for pseudo-business and personal expenses.[58]

Americans were using mortgages to finance the purchase of personal residences even if most policymakers did not recognize the practice. In 1890, 27.7% of all owner-occupied nonfarm units were secured by a mortgage.[59] By 1910, 33% of homeowners carried a mortgage on their primary residences, and by 1920, the figure topped 40%.[60] Moreover, contrary to the popular image of early twentieth-century America as largely agrarian with farms outnumbering owner-occupied residences and farm mortgage debt exceeding home mortgage debt,[61] the value of outstanding nonfarm mortgages in 1910 ($4.5 billion) was markedly greater than that of farm mortgages ($3.2 billion[62]), with the disparity widening each passing year. In 1920, homeowners serviced $9.35 billion in mortgage debt versus farmers' mortgage obligations of $7.86 billion.[63] By 1930, the discrepancy had grown to $30.2 billion versus $9.6 billion.[64]

Only a fraction of the interest on escalating home mortgage debt was eligible for the deduction under the nascent federal income tax. Except for the war years when Congress lowered personal exemptions, the number of homeowners and mortgaged primary residences exceeded the number of tax

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57. *See supra* note 51.

58. At least one member of Congress recognized that the deduction for consumer interest violated the principle of a net income tax that taxpayers should be allowed offsets only for items that generate taxable income:

> This whole paragraph [involving the proposed deduction for consumer interest] is framed upon the idea that the capital of the individual must be protected intact, must be preserved; that he can use any part of the income he likes for the repair of the capital with which he entered the year and have it deducted from the income. The principle is wrong. It ought not be in any income tax law. It is not a part of the purpose of an income tax law to guarantee that the capital shall be maintained. If the capital is lost, there will be a diminished income the following year upon which to levy the tax; but the taxable income should not be depleted by withdrawing from it a sum sufficient to maintain the capital, unless the income arose out of a business in which the capital was employed.

50 CONG. REC. 3846 (1913) (statement of Sen. Cummins).

59. BUREAU OF THE CENSUS, *supra* note 36, at 651.

60. *Id.*

61. *See, e.g.*, Roger Lowenstein, *Who Needs the Home Mortgage-Interest Deduction?*, N.Y. TIMES, Mar. 5, 2006, Magazine, at 79 ("It was not until the 1920s and the spread of the automobile that home mortgages outnumbered farm mortgages.").

62. For nonfarm mortgages, see BUREAU OF THE CENSUS, *supra* note 36, at 648. For farm mortgages, see L.M. Graves, *Interest and Taxes in Relation to Farm Income*, 117 ANNALS AM. ACAD. POL. & SOC. SCI. 35, 35 (1925).

63. BUREAU OF THE CENSUS, *supra* note 36, at 648.

64. For nonfarm mortgages, see BUREAU OF THE CENSUS, *supra* note 36 at 648. For farm mortgages, see U.S. CENSUS BUREAU, SPECIAL REPORTS, FARM MORTGAGE DEBT: COOPERATIVE REPORT 12 (1952); BUREAU OF THE CENSUS, *supra* note 36 at 466. These numbers tell the story of a stagnant farm population and a rapidly increasing nonfarm population: between 1910 and 1930, the number of owner-occupied farms shrank from just under 3.84 million to 3.45 million while the number of owner-occupied nonfarm residences doubled from 5.25 million to 10.55 million. CENSUS, *supra* note 36, at 646.

returns filed.[65] Moreover, after seizing control of Congress in 1920, Republicans wasted no time in removing millions of homeowners from the income tax rolls and in reducing the value of tax benefits for those still subject to tax.[66] Republicans raised exemptions for both single and married taxpayers, instituted the preferential treatment for capital gains, and drastically lowered tax rates across the board while cutting the top marginal rate from 77% to 25%.[67] Also, between 1913 and 1930, the average annual earnings of nonfarm workers never exceeded the tax-free threshold for married couples.[68] Untold numbers of these workers had purchased homes, many with the help of a mortgage, but none of them received any tax benefit from homeownership.

The interest deduction was not for average Americans, nor for middle- or even upper-middle-class Americans. It was reserved for a limited few, wealthy enough to be subject to the class-based income tax; in other words, those households whose tenure decisions had nothing whatsoever to do with a tax deduction.

III

FROM ECONOMIC STABILIZATION TO HOMEOWNERSHIP: DEPRESSION, WAR, AND AFFLUENCE

The 1920s witnessed significant growth in rates of homeownership and in home mortgage debt. Between 1920 and 1930, the number of Americans owning homes rose two percentage points, from 45.6 to 47.8%.[69] In addition, the value of residential mortgage debt more than tripled, jumping from $9.35 billion to $30.18 billion.[70] In fact, according to one account of housing patterns in the first half of the twentieth century, "The general economic expansion of [the 1920s] found no more dramatic expression in any area than in that of mortgage

65. In 1913, taxpayers filed 358,000 returns at a time when there were 5.25 million homeowners and 1.7 million mortgaged homeowners. In 1920, with the personal exemption still at a wartime low, 7.26 million returns were filed for a population including 7.04 million homeowners and 2.7 million mortgaged homeowners. In 1930, returns barely topped 3.7 million at a time when over 4.7 million out of 10.56 million homeowners carried a mortgage. *See* BUREAU OF THE CENSUS, *supra* note 36, at 1110; Hollenbeck & Kahr, *supra* note 44, at 144.

66. Between 1920 and 1931, the number of annual income tax returns plummeted from 7.26 million to 3.23 million, while income tax receipts dropped from $1.08 billion to $246 million. *See* BUREAU OF THE CENSUS, *supra* note 36, at 1110; Hollenbeck & Kahr, *supra* note 44, at 144.

67. *See* Revenue Act of 1921, 42 Stat. at 232–37 (lowering top marginal rate to 58% and providing favored rates for capital gains); Revenue Act of 1924, 43 Stat. at 262–64, 272 (raising exemptions and lowering the top rate to 46%); Revenue Act of 1926, 44 Stat. at 21–23 (lowering top rate to 25%).

68. BUREAU OF THE CENSUS, *supra* note 36, at 164. In fact, it was not until 1942 that the average annual earnings of nonfarm workers exceeded the tax-free threshold, a milestone that was due as much to the falling exemption (which had been lowered to $1200) as to elevated incomes. *Id.*

69. *See* BUREAU OF THE CENSUS, *supra* note 36, at 646.

70. *Id.* at 647.

lending."[71] As dramatically as the housing market ascended in the 1920s, its collapse in the 1930s was swifter still.

Housing went the way of the banking system during the Great Depression. Property values fell by 50% relative to their peak in the mid-1920s.[72] Millions of Americans had financed their home purchases with mortgage loans that were short-term (typically three to ten years) and nonamortizing (that is, structured with interest-only or minimal principal payments such that the balance remained high until term). These mortgages carried variable rates of interest, loan-to-value ratios below 50%, and "balloon" or "bullet" payments on high principal balances due in full at the end of the term.[73] Lenders, many of whom were trying to service their own debt and pay off their own creditors, refused to restructure or refinance loans when they came due. At a time when nearly 25% of Americans were out of work,[74] millions of borrowers were short sufficient cash to make mortgage payments, and home values dipped below principal mortgage balances, forcing one-time homeowners to go into default. Massive foreclosures ensued. Between 1931 and 1935, an average of 250,000 mortgages went into default,[75] such that 10% of homes were in foreclosure,[76] flooding the market with low-value, repossessed homes and further eroding the value of the existing, nondefaulted housing stock.

Homeownership rates tumbled more than four percentage points to 43.6%.[77] The number of mortgaged homes, which had jumped in the 1920s from 7.04 million to 10.55 million, stagnated in the 1930s.[78] Total home mortgage debt also fell during the decade from an all-time high of $30.2 billion in 1930 to $23.9 billion in 1939.[79] Moreover, construction for new housing plummeted from

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71. Ernest M. Fisher, *Changing Institutional Patterns of Mortgage Lending*, 5 J. FIN. 307, 307 (1950); *see also* Charles E. Persons, *Credit Expansion, 1920 to 1929, and Its Lessons*, 45 Q.J. ECON. 94, 96–100 (1930) (describing the role of mortgage debt in the massive expansion of credit in the 1920s).

72. Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 94 (2005).

73. *See* WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES: PRODUCTS, ANALYSIS, TRADING 5–6 (1989); Albert Monroe, *How the Federal Housing Administration Affects Homeownership* 30–32 (Harvard Joint Ctr. for Hous. Studies, Working Paper No. 02-4, 2001), *available at* http://www.jchs.harvard.edu/publications/governmentprograms/monroe_w02-4.pdf. Not all home mortgages were short-term, nonamortizing loans prior to the 1930s. Savings and loan associations (or "building and loan" associations, as they were called) accounted for about 50% of the mortgage market and offered qualifying borrowers fully amortized loans with terms as long as fifteen years. Michael S. Carliner, *Development of Federal Homeownership "Policy,"* 9 HOUSING POL'Y DEBATE 299, 304 (1998); *see also* Robert E. Lloyd, *Government-Induced Market Failure: A Note on the Origins of FHA Mortgage Insurance*, 8 CRIT. REV. 61, 62 (1994).

74. *See* W. ELLIOT BROWNLEE, DYNAMICS OF ASCENT: A HISTORY OF THE AMERICAN ECONOMY 409 (1988).

75. BARTLETT, *supra* note 73, at 5

76. Green & Wachter, *supra* note 72, at 94–95.

77. BUREAU OF THE CENSUS, *supra* note 36, at 651.

78. *Id.*

79. LEO GREBLER, DAVID M. BLANK & LOUIS WINNICK, CAPITAL FORMATION IN RESIDENTIAL REAL ESTATE: TRENDS AND PROSPECTS 467 (1956).

509,000 to 93,000 units between 1929 and 1933,[80] causing the value of new housing construction to drop even more precipitously from $3.19 billion to $319 million (and significantly off its high of $5.06 billion in 1926).[81]

Farmers fared worse than homeowners. Dramatic declines in farm commodity prices during the 1930s caused farmers to lose their land and homes.[82] The number of farms,[83] mortgaged farms,[84] and farm mortgage debt[85] all fell between 1930 and 1940. In addition, tight credit, shrinking incomes, depreciating land values, and fixed-rate, inflexible mortgages combined to force huge numbers of foreclosures.[86]

The federal government scrambled to shore up the disintegrating mortgage market. Prior to the 1930s, Washington had left regulation of the mortgage industry to the states, with only a few exceptions. In 1916, Congress had enacted the Federal Farm Loan Act to extend real estate mortgage credit to members of Farm Loan Associations through twelve regional Farm Loan Banks under the supervision of the Federal Farm Loan Board.[87] The experiment in cooperative mortgage regulation had been viewed at the time as "the farmer's road to a debt-free Utopia."[88] And in fact, some of the mortgage reforms from this early period had been successful enough to be adopted by federal agencies in the 1930s on a much larger scale, including the use of long-term, amortized loans.[89] Nonetheless, the federal experiment in aiding agricultural and real estate markets in the late 1910s and 1920s had been qualitatively different than what followed the onset of the Great Depression. To combat the severe macroeconomic downturn of the 1930s, the federal government took "direct action to control production [most famously through the Agricultural Adjustment Act[90]], to raise farm prices, to make credit available on favorable terms, and to supplement farmers' cash income."[91] Though earlier aid "operated largely at the periphery of a more or less automatic economic system, [that] of

80. BUREAU OF THE CENSUS, *supra* note 36, at 640.

81. *Id.* at 618.

82. The calamitous trend for farmers was already underway in the 1920s. *See, e.g.*, L.C. Gray, *The Trend in Farm Ownership*, 142 ANNALS AM. ACAD. POL. & SOC. SCI. 20, 25 (1929).

83. BUREAU OF THE CENSUS, *supra* note 36, at 11 (falling from 6.3 to 6.1 million).

84. *Id.* (falling from 2.52 to 2.36 million).

85. *Id.* (falling from $9.63 to $6.59 billion).

86. *See, e.g.*, E.C. Young, *The Farm Mortgage Credit Situation in the United States*, 17 J. FARM ECON. 260, 261 (1935) (discussing farmers' short credit, limited provisions for debt retirement, and inability to refinance).

87. *See* Donald C. Horton & E. Fenton Shepard, *Federal Aid to Agriculture Since World War I*, 19 AGRIC. HIST. 114, 116 (1945); Morton Bodfish, *Government and Private Mortgage Loans on Real Estate*, 11 J. LAND & PUB. UTIL. ECON. 402, 402 (1935).

88. J.K. Galbraith et al., *Farm Mortgage Loan Repayment: A Survey of Existing Plans and Some Possible Alternatives*, 19 J. FARM ECON. 764, 764 (1937).

89. *See* F.F. Hill, *Flexible Payment Plans for Farm Mortgage Loans*, 20 J. FARM ECON. 257 (1938) (discussing some of these innovations in the farm context); Galbraith et al., *supra* note 88 (same).

90. Pub. L. No. 73-10, 48 Stat. 31 (1933).

91. Horton & Shepard, *supra* note 87, at 117.

the 1930s often involved the merging of governmental action with the economic forces operating through the market."[92]

The government intervened directly in the agricultural sector with a number of new agencies. In 1933, Congress authorized the Emergency Farm Mortgage Act to recapitalize the land banks, cut interest rates, extend repayment schedules, and offer emergency financing to individual farmers facing foreclosure. Also in 1933, Congress enacted the Farm Credit Act (FCA),[93] which, in the short-term, offered low-interest loans to farmers for agricultural production and refinancing mortgages. In the long term, the FCA consolidated regulatory authority for providing agricultural credit and revamped the Farm Credit System created in 1916. Finally, the Federal Farm Mortgage Corporation, created in 1934, assumed control for issuing bonds guaranteed by the federal government and infused capital into the agricultural real estate and mortgage markets.[94]

These experiments in federal agricultural aid were significant, but the largest departures from prior practice were reserved for the residential housing market.[95] As originally conceived, the innovative measures and ABC agencies were designed to carry out temporary, emergency policies of providing short-term credit to struggling homeowners, slowing and preventing foreclosures, and stabilizing the housing industry along with the entire financial system. Expanding homeownership "may have played a role" in the creation of various agencies, but the policies pursued "were primarily attempts to preserve the financial system."[96] Whatever the original objectives of the emergency stabilization programs, they quickly became the norm rather than the exception. Indeed, as one group of commentators observed, with the benefit of hindsight, the programs became "deeply imbedded in the processes of capital formation and financing in residential construction. Although [the] objectives, methods, and intensity of aids have changed, the aids themselves have become widely accepted as essential parts of the institutional framework in which new housing is produced and financed."[97] Three agencies in particular reshaped housing and homeownership in the United States: the Home Owners' Loan

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92. *Id.*

93. Pub. L. No. 73-75, 48 Stat. 257 (1933).

94. *See* Bodfish, *supra* note 87, at 403.

95. President Herbert Hoover's Administration was also active in combating the unstable housing market, establishing the Federal Home Loan Bank Board (which chartered and supervised savings and loans, and established the Federal Home Loan Banks that extended credit to S&Ls) and the Reconstruction Finance Corporation (RFC) (which provided emergency funds for ailing financial institutions). *See* Bodfish, *supra* note 87, at 403–04. But these agencies were modeled largely on past experiments in emergency aid.

96. Carliner, *supra* note 73, at 305.

97. GREBLER ET AL., *supra* note 79, at 143.

Corporation (HOLC), the Federal Housing Administration (FHA), and the Federal National Mortgage Association (popularly known as Fannie Mae).[98]

Congress authorized the HOLC in 1933 as a quintessential emergency measure. It would infuse credit into housing markets, refinance homes to prevent foreclosures, and then liquidate itself (which it eventually did in 1951, though it stopped lending funds in 1935 when its appropriation dried up). More specifically, the HOLC purchased defaulted mortgages from private lenders with proceeds from government-guaranteed bond sales. It then reinstituted the mortgages under new terms and conditions, primarily by converting variable-rate, short-term (three- to ten-year), nonamortizing mortgages into fixed-rate, long-term (twenty- to twenty-five-year), fully amortizing mortgages, and by putting borrowers on monthly payment schedules.[99] Its efforts "not only helped to restabilize the economy but in converting loans to an amortized basis prevented thousands of homes from falling into foreclosure."[100] Indeed, in its first three years, the program refinanced over one million homes.[101] Its mission was always to stabilize the housing market, however, not to promote homeownership.[102]

The FHA was also established as an emergency stabilization program, but soon emerged as the nation's primary promoter and guarantor of homeownership. The 1934 hearings and debates over the agency's creation contained "an almost exclusive concern with stimulation of residential construction and home purchase and modernization, as part of an economic recovery program and with improvement of the mortgage system."[103] There was no discussion among members of Congress or testimony from the Roosevelt Administration about using FHA insurance as a vehicle "for making new or better housing available to consumers who would otherwise be unable to afford it."[104] The program would encourage lending by financial institutions rather than borrowing by particular groups of debtors. Over time, the FHA became synonymous with homeownership in the United States, becoming "the largest

98. Sundry other agencies played a less direct role in the reformulation of U.S. housing markets and policy. The Federal Deposit Insurance Corporation (FDIC), created in 1933, shored up depositor and investor confidence in the nation's banking system by providing deposit insurance to member banks. The Federal Savings and Loan Insurance Corporation, enacted in 1934 as part of the National Housing Act, insured deposits of federally chartered savings and loans, much like its counterpart, the FDIC, which insured deposits in commercial banks. Even the iconic Public Works Administration contributed to the effort through its Housing Division, which built and operated urban and low-income housing projects. *See* Bodfish, *supra* note 87, at 406.

99. Green & Wachter, *supra* note 72, at 95.

100. BARTLETT, *supra* note 72, at 5–6.

101. *Id.* at 6.

102. *See* Green & Wachter, *supra* note 72, at 95 (writing that the HOLC's use of "the fixed-rate, self-amortizing, long-term mortgage was, above all else, a response to a general financial crisis, as opposed to a design for the promotion of homeownership per se").

103. GREBLER ET AL., *supra* note 79, at 150.

104. *Id.*

mortgage insurer in the world,"[105] and insuring over 34 million home mortgages and more than 47,000 multifamily-project mortgages.[106] The agency remade the mortgage industry by insuring long-term (eventually extended to thirty-year terms), fixed-rate, fully amortizing loans.[107] It also insured loans for renovation of existing housing, created and oversaw national mortgage associations, and regulated interest rates and terms for its insured mortgages.[108] Perhaps most importantly, the FHA established loan-to-value ratios (LTV)—historically set below 50%—first to 80% and eventually to as high as 95%. In combination with more favorable mortgage terms for borrowers, the LTV innovations significantly increased the number of people who could afford a down payment on a house and successfully service monthly payments.[109]

In 1938, Congress added Fannie Mae to the federal housing effort. It authorized the agency to create a secondary mortgage market for FHA-insured loans. By purchasing and securitizing mortgages, Fannie Mae allowed lenders to issue new mortgages to homebuyers without having to wait for borrowers to pay back enough of their original debt before issuing new debt. In this way, Fannie Mae added significant liquidity to the mortgage market.

Together, the New Deal agencies and the innovations they ushered in substantially stabilized the residential housing and mortgage markets. Foreclosures slowed and then fell steadily beginning in 1935, dropping from 229,000 to 185,000 in 1936, to 151,000 in 1937, all the way down to 59,000 by 1941.[110] Home mortgage debt, which had fallen precipitously from a high of $30.2 billion in 1930 to $23.9 billion just five years later, held firm at about $25 billion for the next ten years.[111] Moreover, new housing starts jumped dramatically from 93,000 in 1933 to over 700,000 by 1941,[112] while the amount spent on new housing construction climbed from $319 million in 1933 to $3.22 billion in 1941.[113]

The intervention of World War II and the accompanying wholesale conversion from a consumer to a wartime economy retarded recovery in the housing industry. But once hostilities ended in 1945, an unprecedented housing boom ensued. In 1940, the national rate of homeownership stood at 43.6%. By

105. *See* U.S. DEPT. OF HOUSING AND URBAN DEV., ABOUT HOUSING (Mar. 26, 2009), *available at* http://www.hud.gov/offices/hsg/hsgabout.cfm.

106. *See* U.S. DEPT. OF HOUSING AND URBAN DEV., THE FEDERAL HOUSING ADMINISTRATION (Sept. 6, 2006), *available at* http://www.hud.gov/offices/hsg/fhahistory.cfm.

107. Observers at the time considered the FHA's used of long-term, fixed-rate, amortized mortgages "[p]robably the most important general effect" of its involvement in the mortgage market. Arthur M. Weimer, *The Work of the Federal Housing Administration*, 45 J. POL. ECON. 466, 476 (1937).

108. Bodfish, *supra* note 87, at 403.

109. Green & Wachter, *supra* note 72, at 96; *see also* Carliner, *supra* note 73, at 306 (calling the LTV innovations "the most notable liberalization at that time, requiring changes in state laws limiting loan-to-value ratios").

110. GREBLER ET AL., *supra* note 79, at 149.

111. BUREAU OF THE CENSUS, *supra* note 36, at 647.

112. *Id.* at 639–40.

113. *Id.* at 618.

1950, it had jumped an amazing 11.4 percentage points to 55%, with nearly all of the increase occurring between 1945 and 1950.[114] Ten years later, nearly 62% of Americans owned their own homes.[115] Related indexes reflected a booming industry. Housing starts quadrupled between 1945 and 1947, rising from 326,000 to 1.7 million and then averaging 1.46 million until 1960.[116] The value of new construction paralleled the leap in housing starts, increasing from $3.3 billion in 1946 to $11.2 billion in 1948, and then averaging $17 billion until 1960.[117] Meanwhile, debt more than doubled between 1945 and 1950,[118] doubled again by 1956,[119] and topped $175 billion by the end of 1961.[120]

The postwar housing boom was fueled in large part by New Deal agencies.[121] The FHA helped millions of Americans keep their homes or become first-time homeowners. In its first two years of operation (1935 and 1936), the FHA insured mortgages for 6% and then 16% of all new homes.[122] Over the next three years, it insured one-third of all new dwelling units.[123] And in each year between 1942 and 1944, FHA-guaranteed loans financed more than 50% of all new construction, including 80% of all privately financed dwelling units in 1943.[124] In total, from its inception in 1934 until 1956, the FHA insured nearly $31 billion in home mortgages on 4.6 million owner-occupied homes, helping transform the United States from a nation of renters to a nation of homeowners.[125]

The Servicemen's Readjustment Act of 1944[126] (popularly known as the G.I. Bill of Rights) combined with the FHA to accelerate homeownership in postwar America. The G.I. Bill established the Veterans Administration (VA) mortgage insurance program, which guaranteed low-interest mortgages with high LTV ratios (and, under certain conditions, no down payments) to help

114. *See id*. at 646; *see also id.* at 651 (reporting that the number of owner-occupied residences rose from 11.4 million to 19.8 million during the 1940s).

115. *Id.*

116. *Id.* at 639.

117. *Id.* at 618.

118. *See* GREBLER ET AL., *supra* note 79, at 467 (reporting mortgage debt rising from $25.4 billion to $54.9 billion).

119. *See* BUREAU OF THE CENSUS, *supra* note 36, at 647 (citing $112 billion in mortgage debt for 1956).

120. *Id.* The figure continued on an upward trajectory, climbing to $250 billion by 1965 and $340 billion by 1970.

121. *See* CHARLES M. HAAR, FEDERAL CREDITS AND PRIVATE HOUSING 34 (1960) (explaining the "extraordinary growth in homeownership" in postwar America as primarily due to "the national housing credit programs that have translated the wish [for homeownership] into a financial possibility").

122. GREBLER ET AL., *supra* note 79, at 146.

123. *Id.*

124. *Id.*

125. HAAR, *supra* note 121, at 34. By 1945, 53.2% of Americans owned their own homes. BUREAU OF THE CENSUS, *supra* note 36, at 647.

126. Pub. L. No. 78-346, 58 Stat. 284.

returning veterans secure homeownership and to stimulate housing starts.[127] Together, the FHA and VA programs insured mortgage loans on 6.5 million new homes in the first fifteen years following World War II,[128] representing more than 30% of all new dwelling units between 1946 and 1960.[129] Moreover, between 1950 and 1957, the two agencies insured no less than 42% of the outstanding mortgage debt in the United States.[130] In these ways, they played a vital role in driving the rate of homeownership in postwar America from 53.6% to 61.9% between 1945 and 1960.[131]

Both public and private credit was readily available for homebuyers. In the early 1950s, a conventional mortgage fluctuated between 4.6% and 5.0%, while VA- and FHA-insured mortgages came in slightly lower at, respectively, 4% and 4.25% to 4.50%.[132] As we have seen, mortgage debt soared in the postwar period, rising from $25 billion in 1945 to $55 billion in 1950 to $162 billion in 1960 and to $338 billion in 1970.[133] Sharply rising mortgage debt produced sharply rising interest payments. Assuming an interest rate of 4.5%, mortgage interest payments equaled $2.5 billion in 1950, $7.3 billion in 1960, and $15.2 billion in 1970.[134]

These escalating interest payments were fully tax deductible as part of the catchall tax provision for personal interest expenses.[135] Moreover, the deduction was now available for the first time to tens of millions of taxpayers rather than just to the highest income earners. Wartime finance exigencies had forced Congress to transform the federal income tax from a class-based to a mass-based regime.[136] Lower personal exemptions created more than 35 million new taxpayers.[137] Between 1940 and 1945, the number of tax returns jumped from

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127. *See* BARTLETT, *supra* note 73, at 7 (describing terms of and effect of VA loans); GREBLER ET AL., *supra* note 79, at 149 (same).

128. BUREAU OF THE CENSUS, *supra* note 36, at 641.

129. *Id.* at 639.

130. HAAR, *supra* note 121, at 132.

131. BUREAU OF THE CENSUS, *supra* note 36, at 646. *See also* Fisher, *supra* note 71, at 313 (reporting that between 40% and 45% of total mortgage indebtedness by 1960 was "protected by some form of government insurance or guaranty").

132. KLAMAN, *supra* note 54, at 285, 287.

133. *See* BUREAU OF THE CENSUS, *supra* note 36, at 647.

134. *See* KAHN, *supra* note 56, at 110 (attributing sharp increase in the value of interest deductions to "itemized personal interest expenditures . . . largely . . . of homeowners with mortgages, who tend to have sizeable outlays for interest").

135. The personal interest deduction was recodified multiple times and redesignated permanently as § 163 in 1954. *See* Internal Revenue Code of 1954, Pub. L. 83-591, 68A Stat. I, 46 (1954); *supra* note 52.

136. *See* Carolyn Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685, 686 (1988).

137. Between 1940 and 1945, the personal exemption fell from $1000 for singles and $2500 for married couples to, respectively, $500 and $1000. *See* Revenue Act of 1940, Pub. L. No. 76-656, 54 Stat. 516 (lowering personal exemptions for singles from $1000 to $800 and for married couples from $2500 to $2000); Revenue Act of 1941, Pub. L. No. 77-250, 55 Stat. 687 (lowering exemptions for singles to $750, for married couples to $1500); Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798 (lowering exemptions for singles to $500, for married couples to $1200); Individual Income Tax Act of 1944, Pub. L. No. 78-315, 58 Stat. 231 (lowering exemptions for married couples to $1000).

14.7 million to nearly 50 million,[138] while the number of taxable returns rose from 3.9 to 42.7 million.[139] By war's end, the broad-based tax was also characterized by steeply progressive rates ranging from 23% to 94%.[140] Rates remained high for the next twenty years, with the top marginal rate falling below 91% only briefly between 1946 and 1949.[141] Meanwhile, the personal exemption fell in value with each passing year, holding mercilessly steady until 1969 at $600 for singles and $1200 for married couples.[142]

In 1944, Congress adopted the standard deduction to simplify the increasingly complex income tax law and to save millions of taxpayers the trouble of accounting for miscellaneous deductible expenses.[143] The new standard deduction limited the potential number of taxpayers claiming the itemized deduction for mortgage interest. Indeed, in 1950, less than 20% of all taxpayers itemized deductions; the other 80% used the standard deduction.[144] Nonetheless, the number of itemizers in 1950 (10.3 million)[145] still exceeded the number of mortgaged owner-occupied homes (7.83 million[146]). Moreover, the percentage of itemizers among all taxpayers grew rapidly in the 1950s and 1960s, far outpacing the impressive growth in the number of mortgaged homeowners.[147] In 1955, 29% of taxpayers itemized deductions.[148] By 1960, the number had climbed to 39.5% and then to 47.6% by 1970.[149]

Despite the rapid growth in the number of mortgaged, taxpaying homeowners, policymakers and taxpayers were still not thinking of the deduction for mortgage interest as an integral part of national housing policy. Indeed, in a 1950 study on government housing programs, the Housing and Home Finance Agency (predecessor to the Department of Housing and Urban Development) failed to mention the MID.[150] So did the most comprehensive study to date on capital formation in owner-occupied housing, published in

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138. Hollenbeck & Kahr, *supra* note 44, at 144.

139. BUREAU OF THE CENSUS, *supra* note 36, at 1110.

140. IRS, SOI BULLETIN HISTORICAL TABLE 23, U.S. INDIVIDUAL INCOME TAX: PERSONAL EXEMPTIONS AND LOWEST AND HIGHEST BRACKET TAX RATES, AND TAX BASE FOR REGULAR TAX, TAX YEARS 1913–2008 (2009), *available at* http://www.irs.gov/taxstats/ article/ 0,,id=175910,00.html.

141. *Id.*

142. *Id.*

143. Individual Income Tax Act of 1944, Pub. L. No. 78-315, 58 Stat. 231, 236–37 (1944). *See* RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 379–86 (1954) (describing the 1944 simplification efforts).

144. Calculated from INDIVIDUAL DEDUCTIONS, *supra* note 16.

145. *Id.*

146. BUREAU OF THE CENSUS, *supra* note 36, at 651.

147. In 1960, there were 16 million mortgaged homeowners and 24 million itemizers. By 1970 there were 20 million mortgaged homeowners and 35 million itemizers. *Id.* at 651; Individual Deductions, *supra* note 16.

148. Calculated from Individual Deductions, *supra* note 16.

149. *Id.* By comparison, only 35.5% of taxpayers itemized in 2006. *Id.*

150. HOUSING AND HOME FINANCE AGENCY, A SUMMARY OF THE EVOLUTION OF HOUSING ACTIVITIES IN THE FEDERAL GOVERNMENT (1950).

1956.[151] These omissions were about to disappear. In fact, some analysts were already observing that tax subsidies like the MID were "in line with, if not specifically designed for, encouragement of homeownership" and "consonant with the subsidy objective."[152] Moreover, as the number of taxpayers itemizing deductions grew, it was hard to ignore the escalating costs of the tax offsets.

Every additional itemizing taxpayer reduced total taxable income, an effect accentuated by high postwar marginal tax rates.[153] In 1950, itemized deductions shunted $9.9 billion from tax; ten years later, it protected $35.3 billion.[154] Tax experts and reformers decried the discrepancy between total income and taxable income. They were less concerned with lost revenue associated with the standard deduction, for the standard allowance was not indexed for inflation and posed less of a threat to federal revenues over time.[155] Itemized deductions, however, undermined the base of the federal income tax, distorted economic activity, and kept rates unnecessarily high. Moreover, according to one prominent study, the personal interest deduction, with mortgage interest comprising a substantial percentage, rose faster than any other itemized deduction in the postwar period.[156] For reasons of equity, efficiency, and revenue, it was time for Congress to reconsider tax subsidies for homeownership, including the MID.

IV

TAX REFORMERS AND HOMEOWNERSHIP IN POSTWAR AMERICA

Reconsidering tax subsidies for homeownership in postwar America reflected a larger effort to reform the federal income tax. Little more than three decades old, the income tax that emerged from World War II was characterized by steeply graduated rates and a porous base. In 1940, the individual income tax generated just 13.62% of all federal receipts.[157] Four years later, it produced 45% of federal revenues and never contributed less than 40% to the federal

151. GREBLER ET AL., *supra* note 79.

152. Individual Deductions, *supra* note 16.

153. For a taxpayer subject to the 90% marginal tax rate, for example, every $1.00 of itemized deduction equaled $0.90 of tax saving. By comparison, if this taxpayer were subject to a 30% marginal tax rate, every $1.00 of itemized deductions would be worth $0.30.

154. KAHN, *supra* note 56, at 113–14.

155. Between 1950 and 1960, the cost of the standard deduction grew only slightly in absolute terms from $12 billion to $13.1 billion. *Id.*

156. *See* Daniel H. Holland & C. Harry Kahn, *Comparison of Personal and Taxable Income*, *in* JOINT COMMITTEE ON THE ECONOMIC REPORT (JCER), FEDERAL TAX POLICY FOR ECONOMIC GROWTH 313 (ed. U.S. Cong., 1955) [hereinafter JCER] ("[T]he postwar upsurge in consumer debt, interest rates and home ownership caused interest deductions to grow more rapidly than any of the other deductible items.").

157. Calculated from FACTS AND FIGURES ON GOVERNMENT FINANCE 85 (Sumeet Sagoo ed., 38th ed. 2005).

coffers between 1945 and 1960.[158] The levy's increasingly swiss-cheese qualities, however, threatened its revenue viability and long-term integrity. In the late 1950s, Harvard law professor and future Assistant Secretary of the Treasury for Tax Policy, Stanley Surrey, wrote that the law "in its initial sections presents the picture of an income tax of extremely wide sweep applied at most severe rates, especially in the upper brackets," as high as 90%.[159] "[Y]et the average of the rates actually paid in the upper brackets," Surrey estimated, "is 48 percent. It is thus obvious that the power and sweep of the initial sections are not matched by the end result."[160] High statutory rates were merely "paper rates," with various carve-outs creating "a distinct narrowing of the tax base."[161] Indeed, in the words of Randolph Paul, prominent tax lawyer and former advisor to Franklin Roosevelt, "the bark of our individual income tax is much worse than its bite."[162]

Exclusions and deductions eroded the tax base. "Striking discrepancies"[163] existed between official national income and product accounts and adjusted gross income reflected on individual returns. In fact, researchers estimated the "gap" at $55 billion in 1952, or more than 20% of the potential tax base.[164] The federal income tax was a net income tax, and "as such should certainly make allowance for expenses incurred in earning the income which is taxed."[165] It was even reasonable for policymakers to use the tax instrument to encourage certain behavior or as "a matching grant to taxpayers who make expenditures that serve particular social policy objectives."[166] But the U.S. regime was "unique" among other income tax systems with respect to its allowances for "nonbusiness expenses not related to the production of income."[167]

As importantly, exclusions from income and personal deductions deviated from a baseline concept of economic income, including the definition embraced

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158. *Id.* The power of the federal income tax was even more robust when accounting for the corporate income tax. Together, the two taxes produced 79% of federal receipts in 1944, 66.5% in 1950, and 67.3% in 1960. *Id.*

159. Surrey, *supra* note 56, at 815–16.

160. *Id.* at 816.

161. *Id.* at 829. Surrey had started referring to the statutory rates as "paper rates" as early as 1953. Stanley S. Surrey, Our Schizophrenic Income Tax 5 (1953) (unpublished manuscript, on file with Law & Contemporary Problems and The Stanley S. Surrey Papers, Harvard Law School Library, Modern Manuscript Division, Box 23, Folder 7).

162. Randolph E. Paul, *Erosion of the Tax Base and Rate Structure*, 11 TAX L. REV. 203, 204 (1956).

163. *Id.* at 212.

164. Holland & Kahn, *supra* note 156, at 313–14 (estimating and discussing the gap); *see also* Samuel H. Hellenbrand, *Itemized Deductions for Personal Expenses and Standard Deductions in the Income Tax Law*, *in* HOUSE COMM. ON WAYS & MEANS, 86TH CONG., TAX REVISION COMPENDIUM: COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 375, 387–88 (Comm. Print 1959) (examining discrepancies between national income and product accounts and taxable income); S. REP. NO. 84-1310, at 5 (1955) ("[O]nly about 40 percent of . . . personal income enters the tax base.").

165. Surrey, *supra* note 56, at 825.

166. C. Harry Kahn, *Personal Deductions in the Individual Income Tax*, *in* TAX REVISION COMPENDIUM, *supra* note 164, at 391, 392.

167. Surrey, *supra* note 56, at 824; *see also* Joseph A. Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1, 6 (1957) ("In theory, the only deductions that are absolutely essential under a personal net income tax are those which make allowances for the cost of earning income.").

by economists and legal academics and conceived by Robert Haig and Henry Simons. According to the Haig–Simons definition of income, personal income reflected "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights" between two specified periods.[168] Personal income, Simons wrote, "connotes, broadly, the exercise of control over the use of society's scarce resources,"[169] or, in Haig's words, "the money value of the net accretion to one's economic power between two points of time."[170] Under this accretion- and consumption-based definition of income, the value of imputed rental income from owner-occupied homes was fully taxable as net income.[171] "[W]hen property is employed directly in consumption uses," Simons wrote in 1938, "there is the strongest case for recognizing an addition to taxable income."[172] Deviations from a comprehensive income definition, others argued, "must depend on the efficiency with which they serve other economic or social objectives."[173] An increasing number of observers believed that the subsidies were neither economically efficient nor socially equitable.[174]

Reformers set about laying bare the inefficiencies and inequities. Some proposed "an official publication" containing "a formal definition of personal income, a frank discussion of the difficulties in translating it into a measurable concept, and a detailed examination of the relationship borne to it by each of the important provisions of the tax law."[175] Others adopted a less theoretical approach, preferring to depict the "leakages" in the tax base in stark, numeric

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168. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); *see also* Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup eds., 1959). The "Haig–Simons" definition of income is more accurately termed the "Schanz–Haig–Simons" definition. According to Simons himself, German economist Georg Schanz articulated an "original and challenging" concept of income, SIMONS, *supra*, at 60, which "influenced Simons considerably," KAHN, *supra* note 56, at 121. *See also* SIMONS, *supra*, at 58–99 (treating Schanz prominently in discussing the income concept). Almost no modern treatments of the income concept give Schanz his due. *But see* J. Clifton Fleming & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 450 (2008) (discussing the baseline for traditional tax expenditure analysis as the "Schanz–Haig–Simons" definition of income).

169. SIMONS, *supra* note 168, at 49.

170. ROBERT M. HAIG, THE FEDERAL INCOME TAX 7 (1921).

171. *See* Richard Goode, *Imputed Rent of Owner-Occupied Dwellings Under the Income Tax*, 15 J. FIN. 504, 504 (1960) (stating that "services of the dwelling give the owner power to satisfy his wants, and that power is susceptible of valuation in terms of money").

172. SIMONS, *supra* note 168, at 112. Simons considered the failure of the federal income tax to impute rent an "egregious discrimination between renters and homeowners." *Id.; see also* HAIG, *supra* note 170, at 7–8, 14–15.

173. Melvin I. White, *Deductions for Nonbusiness Expenses and an Economic Concept of Net Income*, *in* JCER, *supra* note 156, at 353–54.

174. For a classic discussion of the income concept and interest deductibility, see KAHN, *supra* note 56, at 118–25.

175. White, *supra* note 173, at 365; *see also* Kahn, *supra* note 166, at 391–92 (observing that most tax subsidies had never been subject to "any systematic legislative review" respecting "their consistency with the income concept underlying the tax, or alternatively their suitability in furthering certain social and welfare objectives").

terms.[176] Economist Joseph Pechman, for one, estimated in a widely read study that exclusions and deductions in 1956 had shrunk the tax base by $43 billion, nearly one-third of that year's net taxable base.[177] Deductions alone reduced the tax base by $34 billion, $13 billion through the standard deduction and $21 billion through itemized deductions, including the personal interest deduction which ranked as the third most expensive offset.[178] Given the eye-popping figures, Pechman and others felt that the taxpaying public, if presented the choice between "preferential provisions and high rates vs. a comprehensive base and low rates," would "be more receptive to a thoroughgoing tax revision than the policymaker or technician might suppose."[179]

Trading tax reform for tax cuts became the rallying cry for reformers of all stripes. In fact, a tax-policymaking consensus emerged in the postwar period that perceived economic and political benefits to closing loopholes as a way to pay for rate reduction.[180] Fewer loopholes increased revenue as well as fairness, while lower rates removed distortions and undermined self-serving justifications for new tax preferences.[181] Removing "leakages" in the individual income tax could generate enough revenue for Congress to slash rates by 20%, 25%, and even 33%.[182] Thanks in large part to a series of legislative hearings in the 1950s presided over by Wilbur Mills (D-AR), Congress became well-acquainted with the tax-cuts-for-tax-reform strategy. In 1955, as Chairman of the Subcommittee on Tax Policy for the Joint Committee on the Economic Report (later the Joint Economic Committee), Mills convened hearings to examine "Federal Tax Policy for Economic Growth and Stability," which included written and oral testimony from more than eighty economists, accountants, lawyers, and other

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176. Pechman, *supra* note 167, at 2.

177. *Id.* at 3.

178. *Id.* at 9. At $4 billion, the interest deduction cost slightly less than the deductions for charitable contributions ($4.4 billion) and taxes ($5.1 billion). *Id.*

179. *Id.* at 3; *see also* Bruce Lee Balch, *Individual Income Taxes and Housing*, 11 NAT'L TAX J. 168, 182 (1958) (arguing that "the costs of all forms of housing should be recognized openly" and that the "present system conceals [the] effects and has created conditions nearly the opposite of what would prevail if the facts were known to all").

180. *See, e.g.*, Paul, *supra* note 162, at 220 (calling for "the reduction of the high rates in exchange for the elimination of special favors"); Surrey, *supra* note 161, at 23 ("Tax reforms are easiest to accomplish as part of an overall tax reduction."). For a discussion of this consensus, see Dennis J. Ventry, Jr., *Equity vs. Efficiency and the U.S. Tax System in Historical Perspective*, *in* TAX JUSTICE: THE ONGOING DEBATE 25, 34–50 (Joseph J. Thorndike & Dennis J. Ventry, Jr., eds., 2002).

181. *See* Paul, *supra* note 162, at 213 (stating that advocates seeking special treatment under the income tax "are able to make their arguments sound more convincing" due to the "apparently high but unreal rate structure").

182. *Federal Tax Policy for Economic Growth and Stability: Hearings Before the Subcomm. on Tax Policy of the Joint Comm. on the Economic Report*, 84th Cong. 283 (1956) [hereinafter *Hearings on Tax Policy*] (statement of Mr. Holland) (20%); *id*. at 243 (statement of Harold M. Groves) (25%); C. Harry Kahn, *Personal Deductions in the Individual Income Tax*, *in* TAX REVISION COMPENDIUM, *supra* note 164, at 405 (noting that eliminating all deductions and exclusions could pay for a 20% tax cut); Pechman, *supra* note 167, at 3 ("by at least 25 percent" and as much as 33% if Congress eliminated income splitting); Surrey, *supra* note 56, at 829 ("about one-quarter").

tax experts.[183] In 1957, Mills oversaw hearings that invoked tax policy repeatedly in terms of both revenue collection and as a delivery mechanism for subsidizing social and economic behavior.[184] The capstone effort, however, occurred in 1959 when Mills held hearings as Chairman of the House Committee on Ways and Means that aimed to achieve "reduction in tax rates without sacrificing revenues."[185] More than 160 tax experts helped generate a 2382-page compendium of papers that became the "'tax law bible' for two generations of policymakers."[186]

Each of these legislative episodes included significant criticism of existing housing tax policies. The exclusion of imputed rental income and the deduction for mortgage interest drew particular fire from the analysts and experts.

Researchers had been estimating the annual cost of excluding rental income from the federal income tax well before World War II.[187] But the discussion did not directly inform tax-policymaking debates until the 1950s. Tax experts noted the "regressive" and "immense tax benefit to the person who occupies his own home."[188] Omitting rental income from taxable income was "inequitable and decidedly unneutral in its effect on the decision to invest in homeownership as compared with alternative assets."[189] After all, "[t]he rent which a homeowner does not have to pay implies income just as dividends spent on rent constitute income."[190] Moreover, the benefits of omitting rental income from taxable income accrued disproportionately to wealthy taxpayers with big homes. "To the extent that the value of the home and the taxpayer's income are positively correlated," economist Melvin White argued, "the omission of the imputed rental is doubly deprogressive."[191] The inequity resulted in more than $4 billion of lost tax revenues.[192] Other countries imputed rental income from owner-

183. *See Hearings on Tax Policy*, *supra* note 182.

184. *See generally Federal Expenditure Policy for Economic Growth and Stability: Hearings Before the Joint Economic Comm.*, 85th Cong. (1957).

185. TAX REVISION COMPENDIUM, *supra* note 164, at ix.

186. JULIAN ZELIZER, TAXING AMERICA: WILBUR D. MILLS, CONGRESS, AND THE STATE, 1945–1975, at 138 (1998).

187. *See, e.g.*, SIMON KUZNETS, NATIONAL INCOME AND ITS COMPOSITION, 1919–1938, at 735 (1941) (calculating net imputed rent for 1938 at $1.42 billion); Donald B. Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514, 522 (1943) (estimating gross imputed rent for 1940 at $4.75 billion and net imputed rent at $1.9 billion). The Department of Commerce Bureau of Economic Analysis provided figures on *gross* rental income as early as 1929. *See* BUREAU OF ECON. ANALYSIS, NATIONAL ECONOMIC ACCOUNTS, TABLE 1.12, IMPUTATIONS IN THE NATIONAL INCOME AND PRODUCT ACCOUNTS (2008), http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=299&Freq=Year&FirstYear=2006&LastYear=2007.

188. Balch, *supra* note 179, at 169.

189. Melvin I. White, *Consistent Treatment of Items Excluded and Omitted from the Individual Income Tax Base*, *in* TAX REVISION COMPENDIUM *supra* note 164, at 317, 323.

190. Kahn, *supra* note 166, at 403.

191. White, *supra* note 189, at 323.

192. *See* Holland & Kahn, *supra* note 156, at 315 (measuring net rental income of owner-occupied farm and nonfarm dwellings at $4.7 billion for 1952); Goode, *supra* note 171, at 509 (estimating failure to tax imputed rent cost $1.2 billion in 1958); Surrey, *supra* note 56, at 821 (measuring net rental income of owner-occupied farm and nonfarm dwellings at $4 billion for 1956).

occupied housing, why not the United States?[193] Although the Supreme Court had yet to rule on the constitutionality of taxing imputed income,[194] there was domestic precedent for the practice: the state of Wisconsin had experimented with taxing net rental income under its income tax.[195] And though supporters of taxing imputed rental income acknowledged that imputation faced measurement, administrative, and political difficulties,[196] "the practical problems [were] not insurmountable."[197] Tax officials could estimate gross rental value based on neighboring properties or according to property tax assessments and allow deductions for the cost of generating the imputed rent.[198] A more accurate measurement might involve imputing some rate of return to the homeowner based on net equity[199] or imputing a return on the fair market value of the home and allowing a deduction for mortgage interest.[200]

Without the imputation of rental income from owner-occupied housing, the mortgage interest deduction was indefensible.[201] The allowance was "logical only as [a] deduction[] from gross rent."[202] Under a net income tax, the expense was "not only personal in nature, completely foreign to business activities, but . . . unrelated to an income-tax-producing asset."[203] Moreover, it "discriminate[d] against the tenant,"[204] providing "a considerable subsidy to property owners, especially those who are mortgagors."[205] It also reflected the fastest-growing

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193. *See* SIMONS, *supra* note 168, at 112 (noting the practice in various countries); Ray Holland & Kahn, *supra* note 156, at 316 n.6 (observing that "Britain and a number of other countries in the Commonwealth" tax net rental income); Trammell, *Personal Deductions and the Federal Income Tax*, *in* TAX REVISION COMPENDIUM, *supra* note 164, at 457, 467 (noting British taxation of imputed rent).

194. The Supreme Court had in fact ruled that *excluding* imputed rent did *not* violate the Constitution. *See* Brushaber v. Union Pac. R.R., 240 U.S. 1, 23–24 (1916) (considering and rejecting the argument that "[d]iscrimination and want of due process results . . . from the fact that the owners of houses in which they live are not compelled to estimate the rental value in making up their incomes, while those who are living in rented houses and pay rent are not allowed, in making up their taxable income, to deduct rent which they have paid").

195. Holland & Kahn, *supra* note 156, at 316 n.6.

196. *See* Balch, *supra* note 179, at 178 (observing that as "a matter of practical politics it will be impossible to take away a tax benefit vested in 60 per cent of the population"); Surrey, *supra* note 56, at 821–22 (writing that taxing imputed income "would involve severe administrative difficulties").

197. Pechman, *supra* note 167, at 14.

198. *See, e.g.*, *id.* (suggesting such a calculation).

199. *See, e.g.*, White, *supra* note 173, at 359.

200. WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 19–21 (1947).

201. *See, e.g.*, Kahn, *supra* note 166, at 403 (observing that without imputing rental income "it seems doubtful that we move closer to the ideal solution by widening the area of discrimination as is done by the current practice of allowing the deduction of personal interest").

202. White, *supra* note 173, at 358.

203. Trammell, *supra* note 193, at 468.

204. White, *supra* note 173, at 358; *see also* Bruce Lee Balch, *Appraisal of Personal Deductions*, *in* TAX REVISION COMPENDIUM 435, *supra* note 164, at 435–36 (criticizing treatment whereby "a person purchasing a home under a long-term mortgage is permitted to deduct a large portion of his housing expenses, while a person renting similar accommodations receives no deduction").

205. Surrey, *supra* note 56, at 826; *see also* Paul, *supra* note 162, at 211 (noting the MID's "discrimination in favor of borrowers and homeowners"); *Hearings on Tax Policy*, *supra* note 182, at 304 (statement of Mr. Ture, Congressional Joint Economic Committee economist, calling the MID

deduction[206] in the income tax and one of the "principal leakages" in the tax base.[207] Worse, only a fraction of homeowners received the subsidy because most taxpayers claimed the standard deduction,[208] resulting in an inequity that prompted reformers to seek repeal of the standard deduction and to limit all itemized deductions to expenses exceeding some percentage of adjusted gross income.[209]

Reformers argued that even if promoting homeownership was a worthy policy goal, bestowing tax subsidies on wealthy debtors was inefficient and inequitable. The exclusion for imputed rental income and the deductions for mortgage interest and property taxes produced overinvestment in owner-occupied housing.[210] The tax subsidies resulted in zero and even negative rates of tax, by far the most preferential treatment among any form of capital income.[211] Moreover, the subsidies were difficult "to condone in the interests of equity" in that they "provide[d] increasingly large financial advantages to homeowners as the value of the house occupied and income increases."[212] The tax advantages were also "inefficient in the sense that aid in acquiring a home is most needed by persons in the lower brackets,"[213] yet the tax subsidies were "greatest at the top of the income scale where the need for such a stimulus is least."[214]

If Congress wished to promote homeownership, it should eschew using the "concealed, nonexplicit technique" of taxation and instead provide direct subsidies.[215] Ultimately, "direct action in the housing and home finance area and perhaps through fiscal aid to local governments" would result in "less sacrifice

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"equivalent to a reduction in the interest rate which the homeowner-borrower must pay on his mortgage").

206. Holland & Kahn, *supra* note 156, at 328.

207. Paul, *supra* note 162, at 211; *see* Pechman, *supra* note167 (reporting that the deduction for personal interest was the third most expensive of all itemized deductions).

208. *See* Balch, *supra* note 179, at 175 (noting that the "benefit of itemized deductions is now largely lost to the lower brackets because these taxpayers usually use the standard deduction"); INDIVIDUAL DEDUCTIONS, *supra* note 16 (showing that more than 60% of taxpayers still took the standard deduction as late as 1960).

209. *See, e.g.*, White, *supra* note 173, at 365; Balch, *supra* note 179, at 175.

210. *See* White, *supra* note 189, at 323 (stating that the exclusion was "inequitable and decidedly unneutral in its effect on the decision to invest in homeownership as compared with alternative assets"); *Hearings on Tax Policy*, *supra* note 182, at 288 (statement of Mr. Kahn, National Bureau of Economic Research, noting "awareness on the part of the prospective purchasers of homes that they will have an imputed nontaxable income, in the sense that they will own an asset the income from which is not taxed"); *id.* at 305 (statement of Mr. Ture, testifying that the MID results in "some redirection of resource use").

211. *See* JANE G. GRAVELLE, CRS REPORT FOR CONGRESS: HISTORICAL EFFECTIVE MARGINAL TAX RATES ON CAPITAL INCOME 2–3 (2004) (reporting marginal effective tax rates on owner-occupied housing between -1% and 1% from 1953 to 1967 and between 70% and 45% on corporate capital income).

212. Harvey E. Brazer, *The Deductibility of State and Local Taxes Under the Individual Income Tax*, *in* TAX REVISION COMPENDIUM, *supra* note 164, at 407, 414.

213. Trammell, *supra* note 193, at 468.

214. VICKREY, *supra* note 200, at 18.

215. White, *supra* note 189, at 297.

of equity,"[216] more efficient allocation of resources, a "publicized and controlled" approach,[217] and a "fairer and more efficient" strategy.[218]

V
MEASURING TAX SUBSIDIES FOR HOMEOWNERSHIP AND INCHING TOWARD REFORM

Rather than seek fundamental reform of national housing tax policies as recommended by a consensus of postwar tax experts, politicians guarded existing tax subsidies for homeowners while creating new giveaways. In 1951, Congress added § 1034 to the Internal Revenue Code,[219] allowing taxpayers to defer recognition of gain from home sales so long as the gains were rolled over into another principal residence, which Congress hoped would encourage homeowners to "trade up" and buy increasingly more expensive, bigger homes. In 1964, Congress enacted yet another tax handout for homeowners in the form of § 121, which provided a one-time exclusion of capital gains on the sale of principal residences for taxpayers over the age of fifty-five.[220] Together, the two provisions effectively excluded from tax all gains from the sale of principal residences.[221]

Reformers were undeterred by tax politics, finding encouragement in the increasingly powerful postwar tax policymaking consensus. At the heart of the movement was Stanley Surrey. In 1961, Surrey joined President Kennedy's Treasury Department as Assistant Secretary for Tax Policy, a position that he occupied for the next eight years.[222] In addition to advocating the efficiency and equity benefits of trading tax cuts for tax reform,[223] Surrey was on record as

216. White, *supra* note 173, at 360

217. Balch, *supra* note 179, at 169.

218. White, *supra* note 189, at 305.

219. Revenue Act of 1951, Pub. L. No. 183-521, 65 Stat. 452.

220. Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19. In 1964, Congress set the exclusion at $20,000 at a time when the median home value was roughly $12,000. *See* U.S. CENSUS BUREAU, HISTORICAL CENSUS HOUSING TABLES, HOME VALUES (2004), http://www.census.gov/hhes/www/housing/census/historic/values.html.

221. When one considers these two provisions alongside § 1014 (tax-free step-up in basis at death for qualifying gifts), it becomes even clearer that nearly all gains from the sale of a principal residence would have escaped tax.

222. Surrey was without question the most influential postwar figure in tax law and policymaking. As a professor at Harvard Law School for more than forty years, he founded the school's renowned international tax program and taught several generations of domestic and international tax lawyers, officials, and policymakers. He served on numerous postwar tax missions, setting up tax regimes around the world. In addition, he published widely on U.S. and international tax systems, authoring hundreds of articles and books, many of which argued forcibly for a tax expenditure budget. In addition to his tenure as Assistant Secretary, Surrey served as Treasury's Tax Legislative Counsel from 1942 through 1944 and again from 1946 through 1947, Special Counsel to the House Ways and Means Subcommittee on Internal Revenue Administration from 1951 through 1952, and Consultant to the Treasury and Congress between 1953–54 on codification of the internal revenue laws.

223. *See supra* notes 159–62, 180, 182 and accompanying text.***

criticizing housing tax policies, including the failure to tax imputed rent,[224] deductions for "nonbusiness expenses not related to the production of income,"[225] the misallocation of capital created by the special subsidies,[226] and associated lost revenues.[227] Only months after assuming office, Surrey identified the imputation of gross rental income as a fruitful area of research. He noted that other countries had incorporated imputed rent into their tax bases and called for a study to research "all facets of the problem—economic consequences, tax effect, technical problems, and so on."[228] No policy would be immune from reexamination during Surrey's tenure as Assistant Secretary, an approach that was theoretically pure as well as politically naïve.

In 1963, the Treasury Department proposed limiting all itemized deductions to amounts exceeding 5% of adjusted gross income (AGI). Surrey and other Treasury officials viewed the proposal as a simplification and base-broadening measure that could free up revenue for rate reduction.[229] The use of itemized deductions had escalated between 1950 and 1963, with the percentage of itemizers among all taxpayers jumping from 19% to 44% and the cost of itemized deductions increasing from $10 billion to more than $46 billion.[230] At the same time, the number of itemizers was increasing from 10.3 million to 24.1 million, and the number of taxpayers taking the standard deduction dropped from 42.7 million to 36.5 million, a trend that added considerable complexity to the income tax for both taxpayers and tax administrators.[231]

The Treasury proposal met massive and widespread opposition. Universities and charities predicted a devastating drop in charitable giving. State and local governments warned that a public-financing disaster would ensue if taxpayers could no longer fully deduct state and local taxes on their federal tax forms, with states and localities being forced to raise taxes and cut public services.[232] Even the American Medical Association objected to the proposal, arguing that it reduced the value of the deduction for qualifying medical expenses.[233] The housing lobby was a particularly vocal opponent. According to the National Association of Home Builders, the plan would "diminish the benefits of home

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224. *See supra* note 192 and accompanying text.

225. *See supra* note 167 and accompanying text.

226. *See supra* note 205 and accompanying text.

227. *See supra* note 192 and accompanying text.

228. Stanley S. Surrey, Agenda for Consideration of Tax Research Topics Possessing a Significant Legal Orientation 35–36 (1961) (unpublished manuscript, on file with Law & Contemporary Problems and with The Stanley S. Surrey Papers, Harvard Law School Library, Modern Manuscript Division Box 23, Folder 7).

229. *See* Stanley S. Surrey, *Conference on Revenue Act of 1964* (1964), *in* TAX POLICY AND TAX REFORM: 1961–1969, at 57, 59 (William F. Hellmuth & Oliver Oldman eds., 1973) (describing the measure as a "proposal to broaden the tax base by limiting personal deductions and to use the revenue gained to further reduce rates").

230. Calculated from INDIVIDUAL DEDUCTIONS, *supra* note 16.

231. *Id.*

232. HOWARD, *supra* note 19, at 103 (briefly describing reaction to the 1963 plan).

233. *Id.*

ownership."[234] For its part, the National Association of Real Estate Boards (precursor to the National Association of Realtors) asserted that "the brunt of the proposal would fall on the homeowner, who now can deduct interest on his mortgage and his real estate taxes," and that it would "absolutely slow the purchase of homes and . . . certainly . . . slow the construction of homes."[235] Years later, Surrey described reaction to the 1963 plan as "real estate associations joining with the charities and state and local governments in quickly establishing strong Congressional opposition to the proposal."[236] It was a valuable lesson in housing tax politics. In fact, the experience prompted Surrey to note that "Congress appears decidedly to favor assisting home ownership, and apparently is not about to consider the question whether this should be done under the tax system or through direct expenditure policies."[237]

Going forward, Surrey and his tax reform cohort adopted a long-term, multipronged approach to challenging tax subsidies for homeownership. Rather than take away housing deductions from itemizers, they would seek increases in the standard deduction that effectively extended similar tax savings to nonitemizers. Investing more taxpayers in the standard deduction regime had the added benefit of simplifying the tax code[238] and eroding public support for preserving or expanding itemized deductions. In addition, under Surrey's direction the Treasury Department began to develop a budgeting of all tax provisions that deviated from a comprehensive base. Surrey and his staff would encourage policymakers to treat this "tax expenditure budget" as an analog to the direct expenditure budget, and to evaluate the effectiveness of tax programs on an annual basis like other federally funded subsidies. Surrey would spend the remainder of his professional life restating tax expenditures as direct expenditures to illustrate how money spent through the tax system created upside-down subsidies that for equity or efficiency or administrative reasons would never get funded directly.

A. Tax Subsidies for Housing and the Tax Expenditure Budget

Surrey publicly introduced the concept of a tax expenditure budget in 1967.[239] He called for a "full accounting" of the "content and scope" of the

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234. *Builders Oppose Exemption Limit, Assail New Tax Plan to Cut Home-Owner Deductions*, N.Y. TIMES, Feb. 12, 1963, at A9.

235. *Realty Men Call Tax Bill a Blow to the Homeowner*, N.Y. TIMES, Feb. 20, 1963, at 1.

236. SURREY, *supra* note 33, at 234.

237. *Id.*

238. *See Tax Reform Act of 1969: Hearings on H.R. 13270 Before the S. Comm. on Finance*, 91st Cong. 669, 672 (1969) (statement of Mr. Surrey, noting that since enactment of the standard deduction "important gains in simplicity and equity have steadily eroded away . . . . The result is increased complexity for taxpayers and a greater spread of actual tax liabilities for taxpayers largely similarly situated.").

239. Surrey was not the progenitor of the idea for a budget-like accounting of federal revenues spent through the tax system. *See supra* notes 174–79 and accompanying text. But he pursued the concept more rigorously than anyone before or after him, leveraging the full resources of the federal government to formulate the first comprehensive analog to the direct expenditure budget. Neither the

federal income tax so that policymakers "could intelligently pass judgment on its effects."[240] The fact of the matter, Surrey explained, was that "[t]hrough deliberate departures from accepted concepts of net income and through various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures—in effect to produce an expenditure system described in tax language."[241] The government's failure to include line items in the federal budget "for these tax expenditures . . . lessens public understanding of significant segments of our tax policies,"[242] provides escape routes from high statutory rates,[243] overloads the tax system with administrative and policy burdens better shouldered by other programs and agencies,[244] restricts thinking about how to approach pressing economic and social problems,[245] and results in "back door" spending[246] hidden from the regular appropriations process.[247] "Out of sight," Surrey warned, "out of mind."[248] It was imperative that the government include in the federal budget a full accounting of "the expenditure equivalents of tax benefit provisions"[249] so that Congress could evaluate which

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concept of tax expenditure analysis nor the creation of a tax expenditure budget went unopposed by Surrey's contemporaries. Boris Bittker was particularly suspicious of the concept, especially its assumption of a touchstone definition of income. *See, e.g.*, Boris I. Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 207–09 (1973); Boris L. Bittker, *Accounting for Federal "Tax Subsides" in the National Budget*, 22 NAT'L TAX J. 244, 261 (1969). Surrey responded gamely to these criticisms. *See generally* Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget: Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969). The debate over the efficacy of tax expenditure analysis has raged for over forty years. For a wonderful entrée into this debate, see Fleming & Peroni, *supra* note 167.

240. Stanley S. Surrey, *The United States Income Tax System—The Need for a Full Accounting*, *in* TAX POLICY AND TAX REFORM: 1961–1969, *supra* note 229, at 575, 575–76.

241. *Id.* at 576–77; *see also* Stanley S. Surrey, *The Tax Expenditure Budget: A Conceptual Analysis*, *in* TAX POLICY AND TAX REFORM: 1961–1969, *supra* note 229, at 587, 588 (noting that the budget "understates the role of Federal Government financial influences on the behavior of individuals and businesses on income distribution").

242. *Id.* at 577.

243. *Id.* at 581 (discussing differences in statutory and effective tax rates for corporate taxpayers).

244. *Id.* at 583–84. Surrey returned repeatedly to the theme of overburdening the tax instrument. *See, e.g.*, Stanley S. Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Change*, 12 TAX NOTES 179, 190 (1981) (stating that "Congress and the Executive are using our tax system to carry far too great a load").

245. *Id.* at 584–85 (arguing that overuse of the tax system had blocked "imaginative and broad thinking" about alternative policy solutions).

246. *Id.* Surrey was invoking Wilbur Mills here. *See* 113 CONG. REC. 36404–05 (1967) (statement of Rep. Mills describing and criticizing "back-door spending" through the tax code). He did likewise elsewhere to underscore the affinity between the tax expenditure budget and influential members of Congress. *See* Stanley S. Surrey, *Taxes and the Federal Budget*, *in* TAX POLICY AND TAX REFORM: 1961–1969, *supra* note 229, at 613, 619–20.

247. *See* Surrey, *supra* note 240, at 575, 585. *See also* Surrey, *supra* note 246, at 621 ("Since the tax expenditure programs are imbedded in the revenue side of the Budget and their cost is not disclosed, they go essentially unexamined for long periods, in contrast with direct expenditures.").

248. Stanley S. Surrey, *Tax Assistance for Housing: Its Implications for the Federal Tax Structure and the Federal Budget*, *in* TAX POLICY AND TAX REFORM: 1961–1969, *supra* note 229, at 625, 633.

249. Surrey, *supra* note 239, at 575, 578.

provisions should remain part of the tax system, which should "be taken outside the tax system," and which should be eliminated altogether.[250]

In 1968, the first tax expenditure budget appeared in the Annual Report of the Secretary of the Treasury.[251] It contained fifty-one line items reflecting $44.5 billion of federal spending through the tax code.[252] These figures included $3.95 billion for housing, including $1.9 billion for the mortgage interest deduction and $1.8 billion for the property tax deduction.[253] It did not include the cost for excluding imputed rental income, which, according to the Treasury, would have "involve[d] not only a conceptual problem but difficult practical problems such as those of measurement."[254] It was important that theory not get in the way of pragmatic budget analysis and, ultimately, of fundamental tax reform.[255]

Under Surrey's direction, the Treasury challenged policymakers to acknowledge the massive spending through the tax code and to evaluate its

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250. *Id.* at 585. Surrey's primary motivation for creating a tax expenditure budget was to "restate the tax program as a direct expenditure program and ask whether, as such, it represents desirable policy." SURREY, *supra* note 33, at 37. *See also* Surrey, *supra* note 246, at 621 ("I doubt that any of these special tax treatments could withstand the scrutiny of careful program analysis, and I doubt that if these were direct programs we would long tolerate the inefficiencies that such program analysis would disclose.").

251. The entire report is reprinted in Stanley S. Surrey, *The Tax Expenditure Budget: A Conceptual Analysis*, *in* TAX POLICY AND TAX REFORM: 1961–1969, *supra* note 229, at 587–612.

252. Comparatively, the official 2010 tax expenditure budget includes 165 line items reflecting over $1 trillion in foregone revenue. O. M.B. Report, *supra* note 25, at 299–302.

253. Surrey, *supra* note 241, at 611. The remaining $250 million reflected the expenditure for excess depreciation on rental housing. In this first accounting of tax expenditures, the MID ranked seventh in terms of cost.

254. *Id.* at 593. In this way and others, Treasury's tax expenditure analysis did "not attempt a complete listing of all the tax provisions which vary from a strict definition of net income." Most of the omissions were attributable to measurement difficulties and to "where the case for their inclusion in the income tax base stands on relatively technical or theoretical tax arguments." *Id*. Today's tax expenditure estimators face the same considerations and in fact draw different conclusions with respect to what to include in the accounting. The JCT does not impute rental income in its analysis, for instance, preferring to treat subsidies for housing as part of "a social policy agenda that transcends the tax law" and "as an exception to the general rule for personal expenditures (no deduction of interest expense or other costs)." Edward D. Kleinbard, Chief of Staff, Joint Committee on Taxation, Address to Chicago-Kent College of Law Federal Tax Institute: Rethinking Tax Expenditures (May 1, 2008); *see also* JOINT COMMITTEE ON TAXATION, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 13, 45 (2008). The OMB, on the other hand, includes net rental income as a tax expenditure item on grounds that a comprehensive "baseline tax system generally would tax all income under the regular tax rate schedule," and "would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income." O.M.B. Report, *supra* note 25, at 317.

255. Between 1968 and 1973, the Treasury produced an accounting of tax expenditures using Treasury Bureau of Accounts data that looked to prior years. In early 1974, the nonprofit Tax Analysts & Advocates (TA/A) (now known as Tax Analysts) produced a prospective-looking tax expenditure budget. Authors Jere Brannon (longtime Director of Treasury's Office of Tax Analysis and supervisor of Treasury's tax expenditure research from 1966 through 1969), Samuel Hastings-Black (tax attorney), and James S. Byrne (Director of TA/A) generated an accounting of tax expenditures that Congress could analyze alongside the regular direct expenditure budget. Gerard M. Brannon, Samuel Hastings-Black & James S. Byrne, *Fiscal Year 1975 Tax Expenditure Budget*, 2 TAX NOTES 4 (1974). Due to TA/A's efforts, Congress began requiring the Treasury to publish a current-year accounting of tax expenditures that accompanied the President's direct expenditure budget. *See* Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297, 323.

effectiveness on an item-by-item basis. In the event Congress determined that a particular subsidy was worth preserving for economic or social reasons, Surrey and his cohorts further challenged policymakers to consider whether the tax system was the most effective delivery mechanism. With respect to national housing policy, Surrey was unequivocal: government assistance should take the form of direct expenditures rather than tax expenditures. "There are effective nontax route methods available to assist and support our housing efforts: direct grants, loans, loan guarantees, interest subsidies, rent supplements, the creation of new financial institutions such as an urban development bank, and the strengthening of the existing structure of savings and credit institutions."[256] Eliminating some or all of the tax expenditures for housing would free up revenue to fund direct programs for existing and would-be homeowners.

National housing tax policies were badly misdirected, Surrey believed, and assisted those Americans least in need of assistance. Not only did they bestow benefits exclusively on taxpayers who itemized deductions, they also provided increasingly larger subsidies to wealthier taxpayers—larger because their value corresponded to marginal tax rates and because there was no limit on the value of deductions a taxpayer with sufficient income could enjoy. In other words, they produced an "upside-down result utterly at variance with usual expenditure policies"[257] that if restated as direct expenditures would appear inequitable and inefficient.

Imagine if the deduction for mortgage interest were run through the Department of Housing and Urban Development (HUD), Surrey suggested. For a married couple with annual income exceeding $200,000 ($1 million in 2009 dollars), the newly constituted HUD would pay lenders $70 of every $100 of the couple's mortgage interest, while the couple would pay the remaining $30.[258] By comparison, a married couple with annual income of $10,000 ($50,000 in 2009 dollars) would receive only $19 of assistance from HUD for every $100 of mortgage interest paid, and be stuck with the remaining $81 obligation.[259] For those couples "too poor to pay an income tax," Surrey said, "HUD would pay nothing to the bank, leaving the couple to pay the entire interest cost."[260]

Such a system failed to promote homeownership among those sectors of society most in need of a home. Replacing the deductions for mortgage interest and property taxes with programs that insured mortgages and provided direct loans could better assist Americans otherwise unable to find housing.[261] In addition, the tax expenditures for owner-occupied housing diverted government

256. Surrey, *supra* note 246, at 627.

257. SURREY, *supra* note 33, at 37.

258. *Id.*

259. *Id.*

260. *Id.* Surrey offered similar recharacterizations of other tax expenditure items. *See id.* at 228–29 (restating the deduction for charitable contributions as a direct expenditure program, the Division of Charitable and Educational Assistance, that distributed cash to wealthy donors).

261. Surrey, *supra* note 246, at 591.

spending away from addressing "the woefully inadequate supply of decent housing."[262] Even if Congress converted housing tax expenditures into direct spending, the existing market for low-income housing would be unable to absorb increased demand. Nor should policymakers look to the tax instrument to bridge the shortfall. Surrey counseled "caution" for the approach "that would directly subsidize builders or rehabilitators to provide incentives to expand the supply of low-rent housing."[263] Existing policies, particularly accelerated depreciation for real estate operators and investors, helped builders and lenders rather than would-be homeowners and created a huge market for real estate tax shelters.[264] It was time to restructure government housing policies, and, this time, Surrey felt, the tax system should *not* be part of the solution.

B. The Tax Reform Act of 1969: Swinging for the Fences, Settling for a Double

In early 1969, the Treasury Department released a four-volume report entitled *Tax Reform Studies and Proposals*,[265] reflecting three years' work directed by Assistant Secretary Surrey. Its completion was highly anticipated among Congressional leaders.[266] Ultimately, it was published jointly by Congress's two tax-writing committees, and formed the basis of what would become the Tax Reform Act of 1969.[267]

The Treasury report contained several items relating to housing tax subsidies. First, it recommended a significant increase to the standard deduction. Fewer taxpayers were taking the standard allowance due to Congress's failure to index its value and due to rising real incomes and other inflationary pressures. In fact, Assistant Secretary Surrey testified that between 1944 and 1969 the percentage of taxpayers using the standard deduction fell from 82% to 57%.[268] "The result," Surrey reported, "is increased complexity for taxpayers, and a greater spread of actual tax liabilities for taxpayers largely similarly situated."[269] In addition, these taxpayers did not get the benefit of reduced tax liability through itemized deductions, and they bore the burden for

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262. SURREY, *supra* note 33, at 294.

263. *Id.* at 295.

264. Surrey, *supra* note 241, at 634 (criticizing accelerated depreciation for being "costly and inefficient as a means of getting more housing or other construction" and for spawning the market for real estate tax shelters).

265. DEP'T OF THE TREASURY, TAX REFORM STUDIES AND PROPOSALS (1969).

266. Congress had requested the comprehensive study as part of the Revenue and Expenditure Control Act of 1968, *supra* note 52, but President Johnson decided against releasing the study on grounds of fairness to the incoming Nixon Administration. With the support of Congressional leaders, the Treasury turned its study over to the Nixon team, which subsequently turned it over to the House Ways and Means and Senate Finance committees. *See* DEP'T OF THE TREASURY, *supra* note 265, at v (describing the transmittal process).

267. *See supra* note 52.

268. Stanley S. Surrey, *Tax Reform, 1969*, *in* TAX POLICY AND TAX REFORM: 1961–1969, *supra* note 229, at 646, 650.

269. *Id.*

other taxpayers' ability to deduct personal expenses in the form of higher prices such as increased rents. "In these cases," Surrey explained, "the purpose of the standard deduction is to prevent serious[,] unfair distinctions in tax burdens."[270] Under an elevated standard deduction, "a larger number of renters in effect will be securing deductions approaching, but not equaling, those of homeowners,"[271] thereby increasing equity and at the same time reducing complexity.

The Treasury Department also described the invidious characteristics of itemized deductions, which were eroding the tax base and reducing tax liability to zero for many high-income taxpayers. In fact, the Treasury reported that 155 tax returns from tax year 1967 with adjusted gross income exceeding $200,000 ($1.3 million in 2009 dollars) paid no income tax, including twenty-one returns with incomes above $1 million ($6.4 million, adjusted).[272] The Treasury offered a number of specific recommendations to curb such severe tax avoidance, including limiting the deduction for charitable contributions, restricting the use of interest deductions for debt to carry capital assets resulting in excluded income, shutting down artificial "farm tax losses," limiting the use of accelerated depreciation on buildings, recapturing excess depreciation, taxing appreciated property transferred at death, and imposing a "minimum tax" to ensure that high-income individuals would pay at least some federal income tax.[273]

As part of this base-broadening effort, the Treasury proposed an ambitious "allocation of deductions" proposal. The plan was aimed at preventing taxpayers from enjoying the "double benefit" of excluding certain kinds of income and then receiving a deduction for the cost of generating the excluded income.[274] Specifically, it required taxpayers to allocate itemized deductions between taxable income and excluded income, with amounts allocated to excluded income disallowed as a deduction. The proposal explained, "When an individual receives income in forms that are excluded from taxation . . . it is not consistent or proper to permit him to subtract all of his eligible deduction items from that part of his income which is subject to tax and ignore the excluded part."[275] Congress had already disallowed interest deductions associated with investments in tax-exempt bonds, "[b]ut to confine the restraint on the interplay to this narrow area is obviously inadequate to meet present-day tax-escape sophistication."[276] The Treasury proposed extending the disallowance to a wider

270. *Id.*

271. *Id.*

272. Surrey, *supra* note 268, at 652.

273. *See id.* at 654–62.

274. *Id.* at 658.

275. DEP'T OF THE TREASURY, *supra* note 268, at 15. For a fuller discussion of the proposal, see *id.* at 142–52.

276. *Tax Reform Act of 1969: Hearings on H.R. 13270 Before the S. Comm. on Finance*, 91st Cong. 3404–24 (1969) (statement of Mr. Surrey).

range of currently deductible expenses, including taxes, casualty losses, charitable contributions, and interest, particularly mortgage interest.[277]

Commentators considered the allocation-of-deductions plan "the soundest of all the proposals made by the Treasury or considered by the tax writing committees" in 1969.[278] The House of Representatives endorsed the proposal on grounds that the expenses to be disallowed were "not a part of cost of earning the taxable income and may be paid just as well out of tax-exempt income as out of taxable income."[279] The Senate dropped the provision from the tax bill, however, when, according to Stanley Surrey, "proponents of tax expenditures strongly attacked" it, "with state and local governments, colleges, and oil interests in the forefront."[280] The final bill failed to include the allocation-of-deductions proposal, and taxpayers continued to enjoy full deductibility of personal expenses that produced nontaxable income.

Even without the Treasury proposal, the Tax Reform Act of 1969 contained several important housing-related reforms. It reduced the rate of accelerated depreciation on residential property, tightened recapture rules on residential housing, and allowed taxpayers to depreciate rehabilitation expenses on low- and moderate-income rental housing under the straightline method. More importantly, the Act significantly raised the standard deduction, a long-time priority for reformers, including Surrey, who viewed the allowance as a way to effectively provide nonitemizing taxpayers benefits approximating those of itemizing taxpayers. An elevated standard allowance also reduced the number of itemized deductions, including the MID, thereby reducing complexity and raising revenue. In 1970, before the new standard deduction had taken effect, 35.4 million returns included itemized deductions.[281] Over the next two years, the number of such returns fell to 30.7 million and then to 27 million, such that between 1970 and 1972 the percentage of itemizers plummeted from 47.6% to 34.8%.[282]

The strategy among tax reformers to raise the standard deduction in order to equalize treatment between nonitemizers and itemizers, to simplify the tax code, and to erode public support for upside-down tax subsidies was in full swing.[283] As fewer Americans claimed the special provisions, reformers could ratchet up direct attacks on the subsidies. By the mid-1970's, only 26.4% of all

277. *See* SURREY, *supra* note 33, at 258 (calling it "appropriate" to apply the ratable allocation approach to the MID).

278. Charles Davenport & Kenneth A. Goldman, *The Minimum Tax for Tax Preferences and the Interest Deduction Limitation Under the Tax Reform Act of 1969*, 16 WAYNE L. REV. 1223, 1235 (1970).

279. H.R. REP. NO. 91-413, at 80–81 (1969).

280. SURREY, *supra* note 33, at 257.

281. INDIVIDUAL DEDUCTIONS, *supra* note 16.

282. Calculated from *id.*

283. *See supra* note 238 and accompanying paragraph.

taxpayers itemized.[284] Increased use of the standard deduction meant that primarily wealthy taxpayers benefited from the itemized allowances related to housing.[285] Indeed, as legal scholar Joan Williams observed in 1981, "From being a relatively shallow subsidy to a large proportion of average Americans, from the working poor on up, homeowners' deductions have now become a deep subsidy to a minority of well-to-do Americans."[286] Housing tax subsidies had become not only more regressive but more expensive, costing $4.65 billion in 1971 and $31 billion in 1981.[287]

Tax reformers continued to highlight the costs and inequities of housing tax subsidies throughout the 1970s. According to a 1977 study, eliminating the three major homeowner preferences (the exclusion for imputed rent and the deductions for mortgage interest and property taxes) could raise taxable income by as much $67.3 billion and generate $13.8 billion in tax revenues.[288] Repealing the MID by itself could generate nearly $5.7 billion in additional revenue,[289] while eliminating the property tax could produce $5.8 billion. Imputed rent for owner-occupied housing was calculable,[290] too, and taxing it was "justified under almost any consistent income tax system."[291] Recapturing the lost revenue provided policymakers an opportunity to redirect national housing policy from ineffective tax subsidies for infra marginal homeowners to direct subsidies for would-be homeowners. "As to owner-occupied housing," Stanley Surrey recommended, "the task is to devise a direct subsidy that can replace, for those homeowners for whom assistance is proper, the present tax incentives of the deduction for mortgage interest and property taxes."[292]

Some policymakers took on the housing tax subsidies. In 1976, as part of his call for fundamental tax reform, presidential candidate Jimmy Carter advocated

284. Calculated from INDIVIDUAL DEDUCTIONS, *supra* note 16. The percentage rose to 33% by 1981, an increase that was due primarily to rising interest rates, inflation, an unindexed standard deduction, and bracket creep.

285. In 1969, 18% of taxpayers in the $0–5000 bracket itemized, as did 53% in the $5000–10,000 bracket, and 74% in the $10,000-15,000 bracket. IRS, U.S. DEP'T OF TREASURY, INDIVIDUAL TAX RETURNS FOR 1969, at 82 (1970). By 1977, this figure dropped to only 2%, 8%, and 22%, respectively. IRS, U.S. DEP'T OF TREASURY, INDIVIDUAL TAX RETURNS FOR 1977 34 (1978).

286. Joan C. Williams, *It's High Time to Get Homeowners' Deductions Under Control*, 12 TAX NOTES 963, 968 (1981).

287. *Id.* at 964.

288. William F. Hellmuth, *Homeowner Preferences*, *in* COMPREHENSIVE INCOME TAXATION 163, 166 (Joseph A. Pechman, ed., 1977).

289. *Id.*

290. *See, e.g.*, A.B. Atkinson, *Housing Allowances, Income Maintenance, and Income Taxation*, *in* THE ECONOMICS OF PUBLIC SERVICES (Martin S. Feldstein & Robert P. Inman eds., 1977) (measuring the optimal tax on imputed rent).

291. Gordon A. Hughes, *Housing and the Tax System*, in PUBLIC POLICY AND THE TAX SYSTEM 74 (Gordon A. Hughes & Geoffrey M. Heal eds., 1980).

292. SURREY, *supra* note 33, at 204.

eliminating the deductions for mortgage interest and property taxes.[293] Predictably, the proposal was attacked as "incredible," "outrageous," likely to stoke "a taxpayer's rebellion,"[294] and "a real threat to the solvency of middle- and lower-class homeowners."[295] Criticism of the subsidies reemerged immediately after the election. Senator Edward Kennedy proposed a massive, comprehensive, tax reform effort that included changing the deductions for mortgage interest and property taxes to credits. Kennedy emphasized that the vast majority of homeowners did not benefit from existing tax subsidies: "As a nation, we want to encourage home ownership. But a program that automatically excludes 75% of the people from participation and provides the greatest aid to the richest families is indefensible."[296] Converting the "upside down" homeowner deductions to credits would be "worth more to low- and middle-income families than a tax deduction."[297] Political commentators noted that Kennedy's plan responded directly to the "political forces of the 1970s, the ones that put Carter in office."[298] Other proposals were equally solicitous of middle-class homeowners and included raising the standard deduction while also permitting nonitemizers to claim the MID,[299] limiting certain itemized deductions to a percentage floor of AGI,[300] capping allowable housing deductions,[301] replacing the MID with a tax credit,[302] and enacting an itemized deduction for renters.[303]

Despite the growing interest from experts and legislators to reform housing tax preferences, no changes were made in the 1970s to the tax treatment of imputed rent, mortgage interest, or property taxes. Fundamental tax reform required presidential leadership, and Carter never made it a legislative priority. Thus, the Treasury Department's sweeping 1977 study, *Blueprints for Basic Tax Reform* (which proposed eliminating the deduction for property taxes but preserving the MID) never got off the ground during the Carter presidency.[304]

293. *See* Paul E. Steiger, *Carter Seen Vulnerable for Suggesting an End to Mortgage Tax Break*, WASH. POST, Mar. 6, 1976, at E17 ("Jimmy Carter is not alone in suggesting . . . that the nation should do away with tax deductions for interest payments on mortgage.").

294. *Id.*

295. James T. Wooten, *Carter Charges Jackson with Lies and Distortions*, N.Y. TIMES, Mar. 6, 1976, at 10.

296. 123 CONG. REC. 21988, 21992 (1977) (statement of Sen. Kennedy).

297. *Id.* at 21988.

298. Kenneth Harney, *Tax Credit May Reduce Break on Mortgage Interest Deduction*, WASH. POST, July 16, 1977, at D1.

299. *Brock Proposes "Tax Simplification Act*,*"* TAX NOTES, Mar. 22, 1976, at 22 (describing Sen. Bill Brock's proposal).

300. 123 CONG. REC. at 21992.

301. Harney, *supra* note 298.

302. *Hathaway Would Replace Mortgage Interest Deduction with Credit*, TAX NOTES, June 23, 1975, at 25; *Montoya Would Substitute Credit for Mortgage Interest Deduction*, TAX NOTES, July 21, 1975, at 11.

303. *Koch Defends Property Tax Credit for Renters*, TAX NOTES, Jan. 24, 1977, at 22.

304. *See* DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 77–81 (2d ed. 1984).

More tellingly, despite the steadily shrinking number of housing tax beneficiaries, a near-consensus of Americans continued to endorse the status quo. In 1978, a New York Times–CBS News poll found that nearly 90% of respondents favored preserving the deductions for mortgage interest and property taxes,[305] even though only one-quarter of taxpayers itemized deductions.[306]

At the dawn of the 1980s, tax subsidies for homeownership appeared immune to reform. Homeownership was a hedge against runaway inflation, while tax policies fed and reinforced the hedge for itemizers.[307] Moreover, "bracket creep" and the steady erosion in the value of the standard deduction and personal exemption created new beneficiaries of itemized deductions related to housing and further rewarded existing beneficiaries. Reformers needed a fiscal crisis of massive proportions if they were to accomplish any restructuring of national housing tax policies, let alone fundamental reform of the entire system.

VI

THE PRICE OF THE IMPOSSIBLE DREAM: IMMUNIZING HOUSING TAX SUBSIDIES

In early 1983, the Congressional Budget Office (CBO) reported on the slumping economy and uncontrollable budget deficit. "The American economy faces unprecedented risks in the years ahead," the CBO warned, "unless the federal government takes measures to narrow the gap between tax revenues and spending."[308] The current budget crisis was "cause for alarm,"[309] and threatened to "limit[] future standards of living and American competitiveness in the world economy."[310] Reversing course and paving the road to recovery required "reconsidering all parts of the budget and the tax base."[311]

Even sacred cows were not immune. As part of its comprehensive report on deficit reduction, the CBO offered twenty-nine base-broadening measures to increase federal revenues. A number of the recommendations attacked longstanding housing subsides, including limiting the deduction for personal interest expenses,[312] replacing the deferral and exclusion provisions on gains

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305. Roberts, *supra* note 15.

306. Calculated from INDIVIDUAL DEDUCTIONS, *supra* note 16 (showing that 26.4% of taxpayers itemized in tax year 1977).

307. The deductions for mortgage interest and property taxes eased rising costs associated with homeownership (including rising mortgage payments on newly purchased or refinanced homes) during an inflationary period.

308. CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 1 (1983).

309. *Id.* at 2.

310. *Id.* at 4.

311. *Id.* at 7.

312. *Id.* at 284.

from the sale of principal residences[313] with a 10% tax on capital gains from home sales,[314] and lengthening the depreciation period on buildings.[315] The "chronic federal budget deficit" made all programs fair game.[316] Reform-minded legislators urged Congress not to allow "any government programs—be it a tax benefit from our Internal Revenue Code or a special entitlement program—to be spared at least a critical look by Congress for a possible budget reduction."[317] The housing lobby reacted to reports that its tax subsidies were on the chopping block and argued that disturbing the deduction for mortgage interest would have a "devastating impact . . . on the home building and real estate industries, let alone the status of the average American homeowner."[318] In the absence of strong leadership from the President or Congress, sweeping reforms stalled, and housing tax subsidies remained secure.

The prospects for reform improved greatly in early 1984. During his State of the Union address, President Reagan made comprehensive tax reform part of his plan to attack the budget deficit and to stimulate the economy. "To talk of meeting the present situation by increasing taxes is a Band-Aid solution which does nothing to cure an illness that's been coming on for half a century . . . . There's a better way," Reagan argued. "Let us go forward with an historic reform for fairness, simplicity, and incentives for growth. I am asking [the Treasury] for a plan for action to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly . . . [and] to make the tax base broader, so personal tax rates could come down, not go up."[319]

In the months following the State of the Union, Reagan told audiences that he was committed to fundamental tax reform and that his Administration would "study everything we can."[320] The President's words were anathema to industry lobbyists, particularly real estate representatives who feared for the survival of the MID and who "hounded" the Administration for reassurances that their sacred cow would not be sacrificed.[321] With the presidential campaign looming, Reagan and his advisors gave the housing industry and every voting homeowner what they wanted. The President succumbed to political pressure, and immunized the MID from repeal or reform. Speaking to 4000 members of the National Association of Realtors, Reagan said that tax reform remained "a real priority" of his Administration, but that he had explicitly instructed the

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313. *See supra* notes 219–20 and accompanying text.

314. CONGRESSIONAL BUDGET OFFICE, *supra* note 308, at 286–87.

315. *Id.* at 288–89.

316. Feld, *supra* note 11, at 1446.

317. 127 CONG. REC. 4213 (1981) (statement of Sen. Baucus).

318. Focus on Treasury, *Limitation on Mortgage Interest Deduction Would Have "Devastating Impact," Attorney Says*, 12 TAX NOTES 744, 744 (1981).

319. President Ronald Reagan, Third State of the Union Address (Jan. 25, 1984).

320. Cannon, *supra* note 23.

321. BIRNBAUM & MURRAY, *supra* note 17, at 57.

Treasury Department to "preserve that part of the American dream which the home mortgage interest deduction symbolizes."[322] The MID appeared safe.

Reagan's capitulation may have pleased the housing industry, but it exasperated Treasury officials. Treasury experts, particularly the economists, had interpreted Reagan's request for a tax reform initiative to achieve "fairness, simplicity, and incentives for growth"[323] as a mandate to pursue "[u]niform and consistent taxation of all real economic income at relatively low rates, regardless of the source and use of income."[324] That goal, Deputy Assistant Secretary for Tax Analysis Charles McLure Jr. observed, had become "subject to the important political constraint of not reducing the deduction for interest on home mortgages," a constraint that "precludes the achievement of totally uniform and consistent taxation—and therefore the full achievement of the more basic goals of fairness, neutrality, and simplification."[325] Indeed, according to Gene Steuerle, economic coordinator of Treasury's tax reform efforts in the early 1980s, Reagan's capitulation "cause[d] a number of problems, as it immediately made impossible consideration of a number of promising options."[326] Cordoning off the MID, lamented McLure, distorted returns from owner-occupied housing relative to other capital investment, drove the tax rate for debt-financed home purchases below zero,[327] created significant horizontal and vertical inequities in the tax system,[328] and made comprehensive reform "difficult, if not impossible."[329]

In November 1984, the Treasury Department submitted its tax reform plan to President Reagan.[330] As instructed, it dutifully left the MID (largely) untouched.[331] But it treated other housing tax subsidies with less deference. Most prominently, it proposed phasing out the itemized deduction for state and local taxes, including property taxes. These levies reflected "the cost paid by citizens for public services provided by State and local governments, such as

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322. Cannon, *supra* note 23.

323. President Ronald Reagan, Third State of the Union Address (Jan. 25, 1984).

324. Charles E. McLure Jr., *The Tax Treatment of Owner-Occupied Housing: The Achilles' Heel of Tax Reform?*, *in* TAX REFORM AND REAL ESTATE 219, 219 (James R. Follain ed., 1986). For an insider's look at the Treasury's efforts, see C. EUGENE STEUERLE, THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA 99–114 (1992).

325. McLure, *supra* note 324, at 219

326. C. Eugene Steuerle, *Why I Hate Campaign Time*, 72 TAX NOTES 1821, 1822 (1996).

327. McLure, *supra* note 324, at 223; *see also* JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 204 (1994) (estimating that homeowners enjoy "a net subsidy rather than a tax (a negative tax rate)").

328. McLure, *supra* note 324, at 225 ("Even if one grants the case for substantial tax preferences for owner-occupied housing, it is impossible to justify this distributional pattern of benefits. The failure to tax income for owner-occupied housing like other income means, by itself, that the income tax cannot be wholly fair.").

329. *Id* at 219.

330. 1 DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH viii–x (1984).

331. The Treasury proposal preserved the MID for principal residences only, a restriction that disallowed deductions for mortgage interest paid on vacation homes or second homes.

public schools, roads, and police and fire protection. For the one-third of all families that itemize deductions," the Treasury pointed out, "these public services are purchased with pre-tax dollars."[332] In addition, the benefits were "distributed in an uneven and unfair manner," with taxpayers from high-tax states receiving disproportionate allowances subsidized by taxpayers in low-tax or no-tax states.[333] Moreover, among taxpayers resident in the same state, those with higher incomes received the lion's share of the benefits, for the subsidy's value was tied to marginal tax rates. Finally, the deduction was incredibly expensive, estimated to cost $33.8 billion by 1988. "Unless those revenues are recovered," the Treasury warned, "the rates of tax on nonexcluded income will remain at their current unnecessarily high levels," and the dream of trading tax reform for tax cuts would be dashed.[334]

The Treasury report contained several additional reforms related to housing. It proposed restricting the unlimited personal interest or "consumer interest" deduction, which taxpayers used "to acquire personal assets, such as a car or vacation home . . . even though such assets do not generate taxable income."[335] By also restricting the MID to principal residences,[336] the Treasury effectively removed tax subsidies for vacation homes and second homes.[337] In addition, the plan created a new capital cost recovery system that, among other things, adjusted depreciation schedules for low-income housing,[338] repealed rapid amortization rules for expenditures to rehabilitate low-income housing,[339] fully taxed real capital gains at ordinary income rates,[340] and repealed the at-risk exception for real estate.[341]

Five months after receiving his Treasury Department's recommendations for fundamental tax reform, President Reagan released his Administration's comprehensive tax plan.[342] Though the revised proposal differed in some respects from Treasury's template, the most significant proposed reforms to housing tax subsidies were unaltered. The President's plan repealed the deduction for state and local taxes[343] and severely limited personal interest

332. 1 DEP'T OF THE TREASURY, *supra* note 330, at 64.

333. *Id.* at 63.

334. *Id.*

335. *Id.* at 332.

336. *See supra* note 331.

337. The recreational real estate lobby reacted violently. *See* Mary Gael Timberlake, *Treasury's Reform Plan: Congress Is Aloof, Special Interests Are Scrambling*, 25 TAX NOTES 831, 832 (1984) (quoting a lobbyist as stating Treasury's plan would "devastate" recreational real estate and "wipe us out").

338. 1 DEP'T OF THE TREASURY, *supra* note 330, at 152–72.

339. *Id.* at 302–13.

340. *Id.* at 178–88.

341. *Id.* at 334–35.

342. PRESIDENT RONALD REAGAN, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985).

343. *Id.* at 62–69. The President's plan repealed the deduction while the Treasury's phased it out over two years.

deductions.[344] It also immunized the MID, calling it "central to American values" and representative of "America's unequivocal commitment to private home-ownership."[345] The President extended two additional olive branches to the housing industry. He offered a considerably watered-down version of Treasury's proposed capital cost recovery system[346] and replaced the Treasury's indexing plan and full taxation of capital gains at ordinary rates with a 50% exclusion for gains,[347] an alteration that was only slightly less generous than the current law's 60% exclusion.[348]

Over the next year and a half, the politics of tax policymaking unfolded in dramatic fashion,[349] resulting in "one of the most sweeping tax code changes in U.S. history."[350] The Tax Reform Act of 1986[351] represented the crowning achievement in the forty-year effort to accomplish rate reduction alongside meaningful base broadening. It was nothing short of the realization of what reformers once regarded as the "impossible dream."[352]

The new tax law left an indelible mark on national housing policy. First, it preserved the MID, creating an entirely new provision to deal with "qualified residence interest."[353] Internal Revenue Code § 163(h)(3) provided an itemized deduction for interest on indebtedness to acquire or improve a primary or secondary residence, so long as the underlying debt was secured by the residence. Qualifying residence interest also included interest on indebtedness for certain medical and education expenses.[354] In addition, TRA86 preserved the deduction for property taxes, but repealed the deduction for state and local sales taxes.[355] And although TRA86 enacted a new provision providing a 2% AGI floor on miscellaneous deductions, it explicitly exempted from the limitation deductions for home mortgage interest and property taxes.[356]

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344. *Id.* at 322–24.

345. *Id.* at 4.

346. *Id.* at 132–59.

347. *Id.* at 152–72.

348. Despite concessions, real estate lobbyists wanted more. *See* Lee A. Sheppard, *Tax Reform Redux: The State of the Record*, 28 TAX NOTES 1215, 1225 (1985) (writing "they want it all . . . . The NAR's shopping list of preferences it wants to see preserved is a long one; 17 provisions and 70 percent of the Administration plan's revenue raised would be out the door if NAR got its way.").

349. *See generally*, TIMOTHY J. CONLAN, MARGARET T. WRIGHTSON & DAVID R. BEAM, TAXING CHOICES: THE POLITICS OF TAX REFORM (1989); BIRNBAUM & MURRAY, *supra* note 17.

350. *See, e.g.*, C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 130 (2004). For discussion of the successes and failures of TRA86, see *id*. at 127–44; DO TAXES MATTER?: THE IMPACT OF THE TAX REFORM ACT OF 1986, at 130 (Joel Slemrod, ed., 1990).

351. Pub. L. No. 99-514, 100 Stat. 2085 (1986), at 2085.

352. *See* GEORGE F. BREAK & JOSEPH A. PECHMAN, FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM? 126–34 (1975).

353. Pub. L. No. 99-514, 100 Stat. 2085 (1986), at 2246–48.

354. *Id.* at 2247–48.

355. *Id.* at 2116.

356. *Id.* at 2113–16.

Several losses accompanied these victories for the housing industry. In particular, the combined effect of reduced marginal tax rates,[357] a higher standard deduction,[358] and repeal of the consumer interest deduction[359] eroded the value of the restructured MID. In fact, these three changes alone reduced federal subsidies for housing by more than 30%, and made the MID effectively worthless for households with incomes below $42,500 ($80,000 in 2009 dollars).[360] At the same time, TRA86 increased the relative tax advantage of homeownership vis-à-vis other forms of capital investment,[361] and further distorted the choice between debt and equity by making housing tax subsidies considerably more dependent on LTV ratios.

Congress skewed the choice between debt and equity even more one year later. First, it capped at $1 million the aggregate amount of principal indebtedness that could qualify for the MID.[362] This "acquisition indebtedness" was to be used exclusively to buy, build, or improve a qualifying principal or secondary residence.[363] Second, Congress created a new provision for "home equity indebtedness" secured by a qualifying residence not to exceed the lesser of the fair market value of the residence minus the amount of acquisition indebtedness or $100,000.[364] The home equity provision was viewed at the time as a simplification measure. Recall that TRA86 allowed medical and educational expenses to qualify as principal debt under the MID. That provision required taxpayers to trace borrowed funds, however. The generously capped home equity provision freed homeowners from that accounting. But simplification came at a price. "In the name of simplicity," the new home equity provision "essentially restored the old personal interest deduction."[365] In addition, there was evidence that "only a small percentage of home equity loans [were] spent" on medical or educational expenses,[366] with much of the debt financing vacations, cars, boats, and other consumer purchases.[367] Indeed, the home equity provision amounted to "a house-sized credit card" for "consumer-type purchases, the very evil that the interest provisions of the 1986 tax act were designed to eliminate."[368] In combination with the MID, the home equity

357. *Id.* at 2096–99.

358. *Id.* at 2099–102.

359. *Id.* at 2244–49, (especially *id.* at 2246–48).

360. *See* Follain & Ling, *supra* note 7, at 154.

361. *See* Patric H. Hendershott, *Tax Changes and Capital Allocation in the 1980s*, *in* THE EFFECTS OF TAXATION ON CAPITAL FORMATION 259 (Martin Feldstein ed., 1987).

362. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330–385.

363. *Id.*

364. *Id.*

365. Robert J. Wells, *It's Time to Revisit the Interest Deduction Rules*, 60 TAX NOTES 649, 652 (1993).

366. *Id.*

367. *See* Catherine Hubbard, *Home Equity Loans Draw Renewed Concern*, 52 TAX NOTES 872, 872 (1991).

368. Wells, *supra* note 365, at 652, 654.

provision "encourage[d] taxpayers to move from house to house as the primary mortgage on one house was paid off or the house increased in value."[369]

The incentive to view one's home purely as a tax-subsidized, variously collateralized capital investment increased over the next two decades as politicians and Presidents sought to increase rates of homeownership among Americans. In 1997, Congress repealed old § 1034 (tax-free rollover of gains on home sales) and converted former § 121 (exclusion of gains from home sales for elderly taxpayers) to an exclusion of $500,000 for all married taxpayers and $250,000 for all taxpaying singles.[370] The expanded exclusion was part of President Clinton's National Homeownership Strategy, which, according to the President, was designed "to boost homeownership" significantly.[371] The aggressive strategy included loosening lending standards at Fannie Mae and Freddie Mac[372] to allow loans with low down payments, minimal closing costs, and affordable monthly obligations. In addition, the Clinton Administration encouraged Fannie and Freddie to purchase and securitize mortgages of low- and middle-income borrowers.

Federal efforts to raise rates of homeownership accelerated under President Bush. In fact, Bush made homeownership the cornerstone of his initiative to create an "Ownership Society." Like Clinton before him, Bush urged Fannie and Freddie to meet ambitious goals for increasing homeownership among low-income and minority Americans. In particular, his Administration softened lending standards and explicitly encouraged subprime lending, which prompted private lenders to offer teaser rates on adjustable-rate mortgages and to actively peddle interest-only and other "affordable" loans. In addition, President Bush backed federal loans for down payments and closing costs and he pushed Congress to fund a "zero-down-payment" initiative.[373]

At the same time, Bush commissioned a blue-ribbon tax reform panel, and instructed it to develop options "recognizing the importance of homeownership . . . in American society."[374] Though less explicit than Reagan's directive twenty years earlier, Bush's charge for the panel translated, "In plain English: the mother of all tax subsidies, the mortgage interest deduction, shall remain untouched."[375] In 2005, the panel "recommended that tax benefits for home mortgage interest be retained, but shared more evenly" through a tax

369. STEUERLE, *supra* note 350, at 143.

370. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 836-41.

371. William J. Clinton, Remarks on the National Homeownership Strategy (June 5, 1995), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=51448.

372. In 1970, the government created the Federal Home Loan Mortgage Corporation, or "Freddie Mac," to compete with Fannie Mae in the secondary mortgage market. *See* BARTLETT, *supra* note 73, at 7–9.

373. Joe Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 31, 2008, at A1.

374. Exec. Order No. 13,369, 3 C.F.R. 155 (2006), *available at* http://govinfo.library.unt.edu/taxreformpanel/executive-order.html.

375. Martin A. Sullivan, *The Economics of the American Dream*, 106 TAX NOTES 407, 407 (2005).

credit rather than a deduction as a way to "encourage home ownership, not big homes."[376] The panel explained how the MID and other tax subsidies created "overinvestment in housing at the expense of other productive uses"[377] and that the economy-wide tax rate on housing investment was close to zero, while all other forms of business investment were subject to a 22% rate.[378] The panel's policy recommendation for a Home Credit was sound. But its politics were myopic. The President immediately distanced himself from the proposal, along with the rest of the panel's report. Meanwhile, interest groups and members of Congress attacked the MID reform as "discourag[ing] homeownership and stifl[ing] economic growth."[379] The MID, said House Minority leader Nancy Pelosi, was "untouchable."[380]

VII

CONCLUSION: EULOGIZING THE MID

The recent global financial meltdown had roots in the collapse of the housing industry. Increasingly permissive lending practices—encouraged by successive two-term presidential administrations—created a mortgage market flooded with risky, "affordable" loans characterized by subprime, variable, and teaser rates. Robust real estate markets across the country translated into rising home values, which owners further leveraged through maxed-out home equity lines and risky refinancing, raising LTV ratios to historic highs and resulting in distinctly suboptimal portfolio allocations.[381] Meanwhile, Wall Street repackaged the risky, "affordable" mortgages into multi-tiered securities with the help of financial instruments so opaque that no one could tell what they were buying or selling. In addition, purchasers of these securities included commercial and investment banks, hedge funds, and insurance companies, all of whom play a critical role in the economy. As housing markets cooled and then reversed, homeowners faced negative equity positions with mortgage and home equity debt significantly exceeding homes values.[382] At the same time, variable-rate

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376. THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 73 (2005) [hereinafter TAX REFORM PANEL]. The Home Credit was available to all taxpayers with mortgage principal and equaled 15% of mortgage interest paid, subject to regional indexing. The Panel also recommended repealing the subsidy for interest paid on second homes and home equity loans, and extending the length of ownership before a taxpayer could qualify for the § 121 exclusion. *Id.* at 73–75, 237–38.

377. *Id.* at 70.

378. *Id.* at 71.

379. Heidi Glenn, *Tax Reform Panel's Ideas Cause Stir in Washington*, 109 TAX NOTES 415, 418 (2005) (quoting Rep. Katherine Harris).

380. *Id.*

381. In 2001, researchers reported that low- and moderate-income households were already significantly overinvested in housing: 60% of asset holdings versus an optimal portfolio allocation of 10%. George McCarthy et al., *The Economic Benefits and Costs of Homeownership: A Critical Assessment of the Research* 32 (Research Inst. for Hous. Am., Working Paper No. 01-02, 2001).

382. For heavily leveraged home purchases, even nominal price declines of 3% to 5% pushed these households into negative equity positions. *Id.* at 28.

mortgages began to readjust upward, and millions of financially strapped homeowners fell behind on monthly mortgage payments. Foreclosures jumped and then spiraled out of control, throwing financial markets into a tailspin.

Housing tax policies fueled the boom and exacerbated the bust. The MID played a particularly insidious role in the crisis by explicitly promoting overinvestment in housing. "Buy as much house as you can," real estate agents urged clients. "The more you buy, the bigger your tax break."[383] More mortgage debt meant lower taxes, such that the deduction began effectively subsidizing gambles on fluctuations in housing prices. "The deduction essentially encourages us to make leveraged bets on the swings of the housing market," economist Edward Glaeser has written. "That leverage means that housing price swings can easily wipe people out."[384] By rewarding highly leveraged homeowners, the MID distorted household risk profiles which led to rising default rates, which, in turn, raised the cost of credit for homeowners and other owners of capital. Excessively leveraged portfolios also led to "temperance" and a general "flight to safety," whereby highly leveraged households opted for less risky asset investments, such as U.S. Treasuries, as they attempted to balance out top-heavy portfolios, a behavioral response with adverse affects on prices and returns of other asset investments.[385]

The economic case against the MID, strengthening over fifty years, is indisputable. More than ever, the deduction distorts the cost of owner-occupied housing relative to other investments,[386] resulting in economy-wide misallocation of capital stock,[387] artificially elevated housing prices,[388] overconsumption of

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383. Rich Smith, *Raise My Taxes, Please*, MOTLEY FOOL, Mar. 9, 2009, http://www.fool.com/investing/general/2009/03/09/raise-my-taxes-please.aspx (author recalling the words of his real estate agent in 2001).

384. Edward L. Glaeser, *Killing (or Maiming) a Sacred Cow: Home Mortgage Deductions*, N.Y. TIMES ECONOMIX BLOG, Feb. 24, 2009, http://economix.blogs.nytimes.com/2009/02/24/killing-or-maiming-a-sacred-cow-home-mortgage-deductions/.

385. For the relationship between "temperance" and prices and returns of other assets, see Michael C. Fratantoni, *Homeownership and Investment in Risky Assets*, 44 J. URBAN ECON. 27, 31 (1998); Marjorie Flavin & Takashi Yamashita, *Owner-Occupied Housing and the Composition of the Household Portfolio over the Life Cycle* 27 (Nat'l Bureau of Econ. Research, Working Paper No. W6389, 1998).

386. *See* John E. Anderson et al., *Capping the Mortgage Interest Deduction*, 60 NAT'L TAX J. 769, 769 (2007) (finding that the MID distorts "the user cost of owner-occupied housing for taxpayers"); Lowenstein, *supra* note 61 (quoting economist Kevin Hassett: "Right now, our tax code says, 'Don't build a factory, build a mansion.' The deduction is the perfect break for bobos in paradise.").

387. *See* Martin Gervais, *Housing Taxation and Capital Accumulation*, 49 J. MONETARY ECON. 1461, 1482 (2002); Lori Taylor, *Does the United States Still Overinvest in Housing?*, FED. RESERVE BANK DALLAS ECON. REV. 10, 16 (1998).

388. *See* William G. Gale et al., *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171, 1171 (2007) (stating that the MID "serves mainly to raise the price of housing and land"); Richard K. Green et al., *Metropolitan-Specific Estimates of the Price Elasticity of Supply of Housing and Their Sources*, 95 AM. ECON. REV. 334, 335 (2005) (finding significant price premiums associated with the MID); Dennis Capozza et al., *Taxes, Mortgage Borrowing, and Residential Land Prices*, in ECON EFFECTS OF FUNDAMENTAL TAX REFORM (Henry Aaron & William Gale eds., 1996) (estimating that the MID increases the price of housing by 10%).

large, expensive homes,[389] and precariously high LTV ratios.[390] Moreover, the MID is "not [even] . . . particularly effective in altering the choice between renting and owning."[391] It encourages suburbanization and decentralization of metropolitan areas,[392] distributes benefits unevenly across different regions of the country,[393] discriminates against minorities and low-income households,[394] raises unemployment,[395] destabilizes the national economy,[396] and may even reduce the supply of housing.[397] In the end, the MID "amounts to a huge subsidy that causes massive, efficiency-draining distortions in the economy," creating "less business capital, lower productivity, lower real wages, and a lower standard of living."[398] In fact, according to Martin Sullivan, nearly every economist believes—and has believed for some time—that "the most sure-fire way to improve the competitiveness of the American economy is to repeal the mortgage interest deduction."[399]

The MID is as inequitable as it is inefficient. It is the quintessential "upside-down subsidy: the greater the need, the smaller the subsidy."[400] It provides ten times the tax savings for households with income exceeding $250,000 compared

389. *See* Anderson et al., *supra* note 386, at 769 ("[The MID] provides an incentive for people to increase their consumption of housing [because] larger subsidies are provided to those purchasing more expensive homes."); Gale et al., *supra* note 388, at 1171 (same).

390. *See, e.g.*, Gale et al., *supra* note 388, at 1179 (concluding that "[b]oth theoretical considerations and empirical evidence suggest" that one of the main effects of the MID is to increase LTV ratios).

391. Anderson et al., *supra* note 386, at 769–70.

392. *See* Joseph Gyourko & Richard Voith, *Capitalization of Federal Taxes, the Relative Price of Housing, and Urban Form: Density and Sorting Effects*, 32 REG'L SCIENCE & URBAN ECON. 673, 685 (2002).

393. *See* Joseph Gyourko & Todd Sinai, *The Spatial Distribution of Housing-Related Ordinary Income Tax Benefits*, 31 REAL ESTATE ECON. 527, 557 (2003); Peter Brady et al., *Regional Differences in the Utilization of the Mortgage Interest Deduction*, 31 PUB. FIN. REV. 327, 360–61 (2003).

394. *See* Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751, 775–79 (1996); Dorothy A. Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. (forthcoming 2010); Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction* 6 (Nat'l Bureau of Econ. Research, Working Paper No. 9284, 2002) (observing that "as owners have organized they have started to act like local cartels, restricting new entry into the market").

395. *See* McCarthy et al., *supra* note 381, at 34 (noting that "[i]ncreased mobility costs" to homeownership "make[] the national economy inflexible").

396. *Id.* at 37 (concluding that "more dramatic swings in employment associated with the construction industry and the volatility of housing investment suggest that the housing market has a *de*-stabilizing effect on the economy as a whole"); Andrew Caplin et al., *Collateral Damage: Refinancing Constraints and Regional Recessions*, 29 J. MONEY CREDIT & BANKING 496, 512–14 (1997).

397. Glaeser & Shapiro, *supra* note 394, at 33 (discussing homeowners' "incentive to restrict supply of new housing in order to raise prices").

398. Sullivan, *supra* note 375, at 407.

399. *Id.* In addition, recent research indicates that the long-touted but unproven putative social benefits associated with homeownership and the policies propping it up remain unsubstantiated. *See* Glaeser & Shapiro, *supra* note 394, at 30 (characterizing these claims as based on observed "correlations without any strong evidence for causality"); McCarthy et al., *supra* note 381, at 43 ("Evidence regarding the societal economic benefits of homeownership is highly conjectural.").

400. Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347, 1361 (2000).

to households earning between $40,000 and $75,000.[401] It is effectively worthless for low- and middle-income households,[402] such that repealing it would significantly increase the progressivity of the income tax.[403] Moreover, the MID has gotten increasingly regressive over the last twenty years. In 1986, tax returns reporting income below $50,000 (indexed to 2009 dollars) received 13.7% of the tax savings associated with the MID, while returns reporting income over $100,000 (also indexed) received roughly 22% of the benefits.[404] By 2007, returns reporting income below $50,000 received just 4.1% of the MID's largesse, while returns reporting income above $100,000 received an astounding 73% of the subsidy's value.[405]

Such disproportionately skewed benefits belie claims of the housing lobby that the MID "is an important factor promoting broad-based home ownership."[406] It does not help 65% of taxpayers taking the standard deduction,[407] nor nearly half of all homeowners,[408] nor 20% of mortgaged homeowners.[409] Moreover, the MID provides no benefits to low-income households and only minimal benefits to middle-income households. It does not help renters. And it gives little assistance to the elderly who either are no longer servicing mortgages or who have too little income to receive any benefit.

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401. James Poterba & Todd Sinai, *Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income*, 98 AM. ECON. REV. 84, 87–89 (2008).

402. Charles A. Capone Jr., *Taxation and Housing Tenure Choice: The Case for Moderate Income Homeownership*, 4 J. HOUSING ECON. 328, 345–47 (1994); Richard Voith, *Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?*, FED. RESERVE BANK OF PHIL. BUS. REV., Mar.–Apr., 1999, at 8. *See also* Adam Carasso et al., *Making Tax Incentives for Homeownership More Equitable and Efficient*, app. at tbl.2 (2005) (reporting that only 3% of the benefits from the MID and the deduction for property taxes go to taxpayers in the bottom three quintiles of taxpayers).

403. John E. Anderson & Atrayee Ghosh Roy, *Eliminating Housing Tax Preferences: A Distributional Analysis*, 10 J. HOUSING ECON. 41, 55–56 (2001).

404. JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1987–2001, at 18 (1986). In 1986, median household income equaled $24,897, and $50,000 indexed to 2009 dollars corresponded to roughly $30,000 in current dollars. U.S. CENSUS BUREAU, HISTORICAL TABLES—HOUSEHOLDS, TABLE H-8, MEDIAN HOUSEHOLD INCOME BY STATE: 1984–2007 (2009), *available at* http://www.census.gov/hhes/www/income/histinc/h08.html.

405. JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008–2012 76 (2008). In 2007, national median household income equaled slightly more than $50,000. U.S. CENSUS BUREAU, *supra* note 404.

406. Gerald Prante, *Who Benefits from the Home Mortgage Interest Deduction?,* TAX FOUNDATION, FISCAL FACTS NO. 49 (Feb. 6, 2006), *available at* http://www.taxfoundation.org/research/show/1341.html.

407. Calculated from INDIVIDUAL DEDUCTIONS, *supra* note 16.

408. In 2005, there were 74.931 million homeowners, U.S. CENSUS BUREAU, 2009 STATISTICAL ABSTRACT, tbl.956 (2009), *available at* http://www.census.gov/compendia/statab/tables/09s0956.pdf, but only 38.575 million taxpayers claimed the MID, INTERNAL REVENUE SERVICE, SOI BULLETIN, HISTORICAL TABLE 1, INDIVIDUAL INCOME TAX RETURNS: SELECTED INCOME AND TAX ITEMS, 1999-2006, *available at* http://www.irs.gov/taxstats/article/0,,id=175788,00.html.

409. Of the 48.4 million homeowners with outstanding mortgage debt, U.S. CENSUS BUREAU, *supra* note 408, only 38.56 million claimed the MID, INTERNAL REVENUE SERVICE, *supra* note 408. The remaining 9.84 million mortgaged homeowners (20%) received no benefit from the MID.

Instead, the subsidy accrues to households least in need of assistance and "encourages larger and more expensive homes among a relatively small share of taxpayers."[410] "What argument can be made," David Cay Johnston asks, "for subsidizing housing for people with seven-figure and larger incomes? And if we continue this subsidy, how do we rationalize giving no subsidy to more than half of homeowners?"[411]

Indeed, if promoting homeownership is the desideratum of U.S. housing policies, then the MID is a terribly inefficient and inequitable policy vehicle. Experts are unanimous in that the MID has "almost no effect on the homeownership rate."[412] Policies promoting homeownership "should seek to increase the number of homeowners," and "should emphasize the purchase decision, not the quantity decision."[413] Any tax subsidy "should be only the minimum amount necessary to switch people from renting to ownership, and it should not be available for anyone who would buy a house anyway."[414] Repealing the MID would mean attacking the "most sacred tax break in the code."[415] And it would result in a drop in home prices,[416] a fear stoked by special interests such as the National Association of Realtors, which takes the position that "any changes to the mortgage interest deduction would de-value homes . . . [and] trigger yet another crisis in home values."[417] But repealing the MID would not affect housing prices nearly as much as doomsayers claim.[418] Moreover, the downturn would be largely temporary, and focused on big, expensive homes.[419] If policymakers were concerned about preserving artificially inflated home values for sellers of large, overpriced homes, the repeal could be phased in over several years.[420] Eliminating the MID would only minimally affect rates of

410. Prante, *supra* note 406.

411. David Cay Johnston, *Can You Hear Opportunity Knocking?*, 120 TAX NOTES 683, 683–84 (2008).

412. Glaeser & Shapiro, *supra* note 394, at 3; *see also* Gale et al., *supra* note 388, at 1179 (concluding that the MID "has little if any positive effect on homeownership").

413. Feld, *supra* note 11, at 1448.

414. Calvin H. Johnson, *Was It Lost?: Personal Deductions Under Tax Reform*, 59 SMU L. REV. 689, 717 (2006).

415. BIRNBAUM & MURRAY, *supra* note 17.

416. *See, e.g.*, Capozza et al., *supra* note 388, at 173, 190–96.

417. Letter from Charles McMillan, President, National Association of Realtors, to President Barack Obama (Feb. 26, 2009) (on file with Law & Contemporary Problems).

418. *See* Donald Bruce & Douglas Holtz-Eakin, *Apocalypse Now?: Fundamental Tax Reform and Residential Housing Values* (Nat'l Bureau of Econ. Research, Working Paper No. 6282, 1997) (calling drastic predictions of declines in housing values from repeal of the MID "overstated").

419. *See* Voith, *supra* note 402, at 7 ("[Eliminating the MID] would lower the demand for housing, especially for large houses, which would result in a short-run oversupply of these homes. The excess supply of large houses would result in declining values for these properties until natural growth in demand restored the balance between supply and demand.").

420. President Bush's tax reform panel, for instance, recommended a five-year phase-in of its plan to replace the MID with a Home Credit. *See* TAX REFORM PANEL, *supra* note 376, at 74.

homeownership, and again only temporarily.[421] It would accelerate the buildup of home equity, increase the saving rate,[422] and help households absorb income shocks.[423] Most importantly, it would make homes less expensive. As law professor Ted Seto has observed, eliminating the MID would mean "we'd all pay less for our housing—substantially less. More affordable homes. Lower home mortgages. Fewer financial eggs in a single basket. Less risk of financial catastrophe."[424]

Assuming that national policymakers and the American public still consider homeownership a worthy goal, repealing the MID would remove an obstacle to achieving that objective. Using the money saved from repeal ($108 billion in 2010[425]) to fund a tax credit rather than a deduction would positively promote homeownership.[426] Unlike the MID, a tax credit for homeowners could be independent of home value or size of debt, which would prevent excessive borrowing and precariously high loan-to-value ratios, precisely the problems that fueled the current housing and financial crises.[427] In addition, a home credit could be capped and indexed to prevent households in high-priced areas from receiving disproportionately large subsidies.[428] It would be a considerably more progressive policy than the MID,[429] simplify the tax code by reducing the number of itemizers,[430] and partially rationalize the treatment of homeownership under a net income tax that currently fails to tax imputed rent.[431] Most importantly, converting the MID to a tax credit would influence the decision of millions of ordinary Americans to own versus rent, thereby substantially increasing the rate of homeownership nationwide.[432]

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421. *See* Steven C. Bourassa & William G. Grigsby, *Income Tax Concessions for Owner-Occupied Housing*, 11 HOUSING POL'Y DEBATE 520, 533–37 (2000); Capozza et al., *supra* note 388, at 173.

422. Capozza et al., *supra* note 388, at 173.

423. McCarthy et al., supra note 381, at 21–22.

424. Theodore P. Seto, *The Problem with Single-Mindedness*, CAL. DAILY J., Apr. 22, 2009, at 6.

425. O.M.B. Report, *supra* note 25, at 300.

426. *See, e.g.*, Gale et al., *supra* note 388; Carasso et al., *supra* note 402.

427. Economist Martin Sullivan has observed, "Isn't it ironic that current tax law provides the least benefit to borrowers most at risk for foreclosure?" Martin A. Sullivan, *Putting Stimulus to Work on the Subprime Crisis*, 122 TAX NOTES 171, 175 (2009).

428. For such a recommendation, see TAX REFORM PANEL, *supra* note 376, at 73–74, 237–38.

429. *See* Peter Dreier, *The New Politics of Housing: How to Rebuild the Constituency for a Progressive Federal Housing Policy*, 63 J. AM. PLANNING ASSOC. 5, 22 (1997); Gale et al., *supra* note 388, at 1184.

430. Some of the simplification gains from repealing the MID would be offset by new complexities associated with administering a housing tax credit.

431. *See* GRAVELLE, *supra* note 327, at 204 ("The major justification for disallowing the deductibility of interest is that it is an indirect way of taxing imputed rental income.").

432. *See* Gale et al., *supra* note 388, at 1183 (estimating that a first-time homebuyer's credit could create as many as 3.5 million new homeowners); Richard K. Green & Kerry D. Vandell, *Giving Households Credit: How Changes in the U.S. Tax Code Could Promote Homeownership*, 29 REGIONAL SCI. & URB. ECON. 419, 439 (1999) (estimating that replacing the MID and deduction for property taxes could raise the rate of homeownership by 5%).

In other words, replacing the deduction for mortgage interest with a tax credit would largely accomplish the goal of postwar tax reformers as discussed in this article. It would tie the subsidy to need rather than marginal tax rates, reduce complexity in taxpaying and tax administration by reducing itemizers, limit reliance on the tax system to deliver benefits and shape behavior, and, if permitted by budgetary realities, allow for rate reduction.

Such reform in the mold of postwar tax reformers is hardly a foregone conclusion. Indeed, politicians appear addicted to subsidizing housing regardless of cost. Immediately following the recent collapse of the housing and financial markets, the federal government began pursuing precisely the same ruinous policy of over-subsidizing housing debt as it had for the last sixty years. In 2007, Congress bailed out homeowners for their bad investments in residential housing by forgiving taxes for discharged mortgage debts.[433] Months later, it created a new first-time homebuyer tax credit.[434] Shortly thereafter, politicians raised the maximum credit and extended the provision once more[435] before extending the subsidy yet again and enacting an entirely new credit not just for first-time homebuyers but also for certain repeat homebuyers.[436] If that were not enough, Congress doubled the maximum principal amount for FHA loans to $730,000 and permitted the agency to underwrite mortgages with LTV ratios as low as 3.5%, resulting in a quadrupling of FHA loans at a time when its default reserves approached zero.[437] Faced with indisputable evidence that an overheated housing market contributed directly to financial Armageddon, politicians responded the only way they knew how: subsidize homeownership to jumpstart and fuel another boom-to-bust cycle.

The policy goals of postwar tax reformers discussed in this article are more than historical relics even if they require a level of political will that most elected officials seem incapable of mustering. A growing number of contemporary policymakers and legislators have begun to embrace comprehensive base-broadening plans, including the proposal offered by Professor Michael Graetz that would free 150 million Americans from filing federal income tax returns by exempting the first $100,000 of income from tax. The plan, Graetz has said, "would also permit reconsideration of the need for [various] deductions and credits," including the subsidy for mortgage interest.[438]

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433. *See* Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. 110-142, 121 Stat. 1803. In 2008, Congress extended this program another four years to 2012. *See* Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, 122 Stat. 3765, 3807.

434. *See* Housing and Economic Recovery Act (HERA), Pub. L. 110-289, 122 Stat. 2654, 2888–91 (2008).

435. *See* American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, 123 Stat. 115, 316–17 (2009).

436. *See* Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. 111-92, 123 Stat. 2984, 2989–91 (2009).

437. David Streitfeld, *With FHA Help, Easy Loans in Expensive Areas*, N.Y. TIMES, Nov. 21, 2009, at B1.

438. MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 104–05 (2008).

In March 2009, President Obama gave reformers additional hope for change by appointing former Federal Reserve Chairman Paul Volcker to head a blue-ribbon panel charged with examining the tax code from top to bottom and "consider[ing] any options of any sort that it sees fit."[439] Whatever the panel's ultimate recommendations, if policymakers wish to avoid repeating the mistakes described in this article, they would do well to break free from the knee-jerk historical reaction to subsidize homeownership at every turn. In particular, they should reconsider the blind allegiance to the inequitable, inefficient, and expensive tax subsidy for mortgage interest.

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439. Roger Runningen & Ryan J. Donmoyer, *Obama Asks Volcker to Lead Panel on Tax-Code Overhaul*, BLOOMBERG PRESS (Mar. 25, 2009), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a8yCQsJfpb24&refer=home.