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## ***SUMMARY***

One of this morning's headlines in the national press warned that "the American Dream is quickly disappearing for growing numbers of Americans". Even for those who already own homes, it was reported, middle and low income families are sacrificing and stretching precariously to make housing payments, because housing prices have accelerated so much faster than wages in most of the country. The tax policy decisions before your panel now have the ability to literally save that Dream, and to prevent the dire social consequences which we will be facing if we let the current codes stand.

Many other countries have recognized that housing price inflation relative to real wages is socially quite destructive. It has also been recognized that tax policy has contributed to much of the problem, and that through wise tax policy, the tide can be stemmed. Some have instituted new taxes on any residential real estate other than primary homes or farms, which would of course never be tolerated in this country. However, by applying our deductions and exclusions more judiciously, we can accomplish much towards making our system fairer for the majority, and possibly preserving the quality of life for working Americans that we have come to expect, and that has made us the land of opportunity.

For the first time in our history, we are facing the fact that we do have significant constraints on our housing supply, and that the normal housing cycles which have kept the playing field fairly level in the past – are no longer at work. A variety of novel factors have come together to radically alter the fundamentals of the housing supply and demand equation.

While the goal of "promoting homeownership" is a noble one, it must be focused in the reality of where we are today. Policies that perhaps made sense 5 or 10 years ago are no longer logical in our new paradigm. The sooner we recognize how much of a "sea change" has occurred, and just how profound it's effects will be, the more likely we are to hopefully find the political will to address these critical issues that truly define what America has always meant to so many. If we fail to act by keeping with the status quo, we will have lost a golden opportunity to preserve it.

## ***I. PROPOSALS:***

**1.** Treat capital gains on real estate as any other capital gains are treated (eliminate the $500,000 every two years exclusion from Code 121).

**2.** Eliminate IRS code 1031 exchanges for single family homes and duplexes.

**3.** Allow mortgage interest deductions on a primary residence ONLY.

**4.** Consider some sort of renters' credit – NOT income limited - for those who have not owned property in the prior 5 or 10 years.

**5.** VAT or other tax on foreign investors of residential real estate (at least while the dollar is so weak).

The 1997 tax revision that created the current IRS Code 121 does NOT help to promote homeownership – instead, it has helped shift the view of what a home means, by helping to promote speculation. In so doing, it has had a decidedly negative impact on the very people who need assistance in realizing their dreams of homeownership. By offering $500,000 of tax-free profits every two years, without limit, this perverse code has been the most frequently hyped reason to become a real estate investor, if not speculator. It has been affectionately referred to by those who encourage speculators as 'the great federal give-away'. By claiming one's rental or vacation home as one's primary residence for two years, according to investment promoters, one can then start the 'tax-free game' all over again with another property (which, by the way, is all too easily abused). For every investor that purchases a single family home, a potential first time home buyer is priced out of the market. In most areas of the country there is a limited supply of housing, and experts expect this to be the case for the foreseeable future.

Recognizing that the political will may not exist to eliminate ALL capital gains exclusions for profits on real estate, in the very least, the 'reforms' of 1997 need to be reversed. The code it replaced was more than generous enough. Again, if the goal is homeownership for the greatest number of people, then anything that increases demand and lessens supply (by spurring people to purchase residential real estate for investment), is counter-productive. There are MORE than enough incentives (intrinsic and financial) for home ownership – the way to increase the opportunity for homeownership for those who aren't yet homeowners, is NOT through making it more attractive (to anyone) – but rather, at this point, to DIScourage investing in residential real estate for other than primary homeowners. By ending the tax subsidies to real estate investors (through the elimination of deductions for other than primary homes, and taxing profits as any other capital gain), we can greatly help to restore some equilibrium to an increasingly imbalanced housing market, and thereby TRULY promote homeownership. Hopefully, policy makers will see the importance of restoring the concept of a 'home', as opposed to a tax-preferred investment vehicle.

## ***II. IMPACT of PROPOSAL RELATIVE TO CURRENT SYSTEM***

This is easy. By narrowing the scope of home mortgage deductions to a primary residence, and eliminating the capital gains exclusion for real estate profits, the system will be both more simple and most importantly – more fair. Just as with the recent proposal now being considered to eliminate deductions of second mortgages and equity lines of credit, based in part on the rationale that those in areas that have not seen as much appreciation are unable to enjoy this exclusion – the same argument can be made for eliminating second home mortgage deductions. If you are living in an area with little appreciation, or were not a beneficiary of the recent equity explosion because you were renting, you cannot as easily afford a second home, and can therefore not take advantage of this deduction.

In terms of economic growth and competitiveness - in the long run, if housing is more affordable, everyone benefits. With a smaller percentage of income going towards housing, people can save more, and will also have more to spend. If housing prices are allowed to continue to rise due to our current tax policies, eventually there will be less and less consumer spending, and savings rates will continue to fall. If capital gains are treated equally between investments, and if real estate is no longer overheated by misguided tax 'incentives', investors may return to the stock market, which should help business (which may translate to jobs), not to mention the retirement plans for those whose 401K's have been so badly punished.

Again, most importantly, we will have restored the American Dream, and lessened the possibility of widening a dangerous wealth gap.

## ***III. SPECIAL ISSUES***

We are at a watershed moment in our history. If we truly want to promote homeownership for all, then what is needed is a drastic re-thinking of what the current housing situation in this country means now, and for our future. The unprecedented creation of wealth in the past few years from real estate equity gains has the potential to undermine the fundamental meaning of the American Dream. There has been such an explosion of unearned, untaxed wealth that has fallen to those who bought at the 'right time', in the 'right area' – that for any future would-be buyer in any of these numerous areas, the barriers to homeownership will be insurmountable. The disparity in wealth will be directly traceable to having owned property 'pre-boom', or not. Even highly paid professionals are now priced out of many real estate markets – it is not just the lower-income worker or young, first-time home buyers. Now for the first time in our history, we will see barriers the likes of which our country has not known. Those who do not inherit wealth or property will be permanent tenants, in many areas. While not widely discussed, this reality has been acknowledged by academicians who study such issues.

The current real estate boom is not just another cycle. After adjusting for inflation, the price appreciation has been nearly triple that of other boom cycles. What should have occurred over a generation has in many areas happened in a few short years.

This is a watershed not only due to the unprecedented rate of inflation in housing, but also because we have reached a point in history where the constraints on housing supply are going to influence the future fundamentals of housing affordability. Demographic demands, zoning laws, land constraints and tax policy and even overseas investment all influence the supply-demand equation (and therefore, prices), like never before. In brief, there have been and are numerous factors which, taken together, will drastically alter the opportunities for homeownership in many areas throughout the country. Many areas which have not been directly in the path of rampant inflation have the potential to be, as those who are priced out of one area flee to lower-priced markets.

The President's noble goal of promoting homeownership needs to be focused in the context of a new paradigm. In the words of the National Association of Realtors own chief economist – "there has been a sea change in the role of real estate in the nation's economy…What we're seeing is that real estate is no longer just a place to live. It's a viable alternative to stocks and bonds…Sept 11. changed real estate forever, the way people look at it…They're nervous about stocks and bonds and they're placing money in real estate, which has proven to be a wealth-building asset". He is (inadvertently) making exactly the pertinent point that should guide our tax policy. It is a different world, and the new reality is that "real estate" has become the hottest investment vehicle around, largely because of tax policy. We don't need incentives to encourage real estate as an investment. We are years beyond that concept. The pendulum has swung in the other direction, and the new fundamentals in the housing market mentioned above (demographics, land constraints, immigration, overseas investment, etc.), together with a much more efficient, tightly managed building industry, will keep demand high and supply low for the foreseeable future. What we DO need is the elimination of tax policies that drive competition for limited resources up, and thereby further price renters out of the market. [Those whose life work is around the issue of affordable housing would do well to recognize that the impact of moderating inflation of housing prices through tax policy reform should be their focus, rather than the piecemeal approval of below market units here and there.]

Yes, homeownership rates have risen, but this has been primarily due to extraordinarily low interest rates and the accompanying loosening of credit –NOT due to tax incentives, but despite them. Would-be homeowners are HURT, not helped by tax policies that subsidize (and therefore increase the number of homes sold to investors, against whom they must compete for the limited supply of houses), or that in any way promote the concept of housing as “an investment”.

Many other countries have recognized that housing price inflation relative to real wages is socially quite destructive.  We need to realize this, too.

In a report from the Bank of England last year, they wrote:  “…rising house prices do not create genuine wealth in aggregate.  Those who have yet to buy a home suffer a loss of purchasing power, so rising prices redistribute wealth, they do not create it…”  Ironically, many buyers who are priced out of the market in England are now pricing many Americans out of homes in their own towns, by bidding up prices in this country.  England has tax-free capital gains of real estate profits…

If the goal of “promoting homeownership” is to make the dream of owning one’s home a reality for the greatest number of Americans, then the path is obvious.  It should be to make housing more affordable across the board, and thereby for first time buyers, as well as those who careers or family needs require them to live in pricier areas.  Current tax laws work against this purpose.  Many economists have recognized this dirty little secret, which it seems few politicians, if any, may be willing to touch.  Our tax laws have fueled housing inflation, redistributing wealth in unhealthy ways, and making homeownership MORE difficult.  For many first time buyers, the only way to get a foot in the door has been to risk their financial well-being by stretching well beyond their means, often with risky financing choices.

Since we are facing a housing supply shortage for the foreseeable future in this country – why would we willingly subsidize the distribution of this limited commodity to fewer people, effectively shrinking the supply even further?  What is needed are policies that help to level the playing field, removing inflationary incentives that constrict supply.  Hard working citizens should not be denied the opportunity for homeownership because our tax laws are subsidizing investors and vacations homes.

According to a first-of-its kind report released last month by the National Association of Realtors, more than one of every three homes sold last year was not as a primary residence. 23% were strictly for investment, while another 13% were reported to be used as a second-home (for vacation, or vacation and rental).

Finally, it is increasingly being recognized that foreign investors are having a substantial impact on the US housing market. There are recent developments which together represent a real threat that these effects have the potential to be far-reaching and permanent. Some of these new factors include the impact of the internet on the whole marketing and shopping experience; the reality of the euro making previously attractive ‘bargains’ in other countries much less attractive than before, when compared to the US; the strength of the Euro as compared with the weak dollar; the explosion of flexible and creative financing vehicles; and of course, the greater ease of travel between the US and other countries due to substantially cheaper airfares. Lastly, the enormous world-wide zeal for real estate as an investment alternative to stocks (following the market crash), fueled by globally low interest rates, are obviously huge factors. Buyers from Europe and Asia have helped to bid up prices and push homes out of reach of many local residents in areas around the country. Some estimate that approximately one third of apartment purchases in Manhattan during 2004 were by foreign buyers, which has had the effect of pushing up home prices not only in Manhattan, but indirectly in boroughs such as Brooklyn and Queens. The foreign demand in Florida is so strong, that some new developments have seen as much as 71% of their sales go to overseas investors. This is not the same small effect as had been seen in earlier ‘cycles’. I think the American people will be most unhappy to look back and wonder why nothing was done to curb this, before it became too destabilizing. Is there a place for taxation of overseas investments in residential real estate? I hope so!