On the making of perfect and beautiful social programs

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When Charles Darwin first published *On the Origin of Species*, a reviewer in the *Athenaeum* thought fit to demolish his thesis with the following comment:

In the theory with which we have to deal, Absolute Ignorance is the artificer; so that we may enunciate as the fundamental principle of the whole system, that, IN ORDER TO MAKE A PERFECT AND BEAUTIFUL MACHINE, IT IS NOT REQUISITE TO KNOW HOW TO MAKE IT. This proposition will be found, on careful examination, to express, in a condensed form, the essential purport of the Theory, and to express in a few words all Mr. Darwin's meaning: who, by a strange inversion of reasoning, seems to think Absolute Ignorance fully qualified to take the place of Absolute Wisdom in all the achievements of creative skill.¹

What appeared to be a devastating comment in an age that believed in a Master Artificer has since been accepted as a succinct conclusion regarding the processes of evolution. That is, mindless mutation and cumulative chance, when coupled with the operation of natural selection, may work together to produce a wonderfully complex system.

ON PERFECT AND BEAUTIFUL SOCIAL PROGRAMS

Although the Master Artificer may have yielded to Absolute Ignorance as an explanation for the development of complex phenomena in the natural sciences, in the fields of social science and policy analysis, this is not yet the case. Here the ideal of an artificer of social policy still reigns supreme. Ignorance is pitied, if not despised, as being incapable of creating effective policy. Although the social policies devised in the 1960's (particularly the overtly redistributional ones) are now widely acknowledged largely to have failed, the fault is believed to lie in the poor quality of their craftsmanship, not with the concept of craftsmanship itself. These policies failed, it is explained, because they were not skillfully wrought, and because the workers were still apprentices who did not fully understand the limitations of the materials at hand. But recognition that successful results in social programs can also be accomplished through ineptness and ignorance, and that this success can be maintained through "benign neglect," has not yet been widely forthcoming. It may prove instructive, therefore, to present an example of an almost perfect and beautiful social program (whose only flaw lies in its peculiar social effects). This program is subtle in its workings, robust in its adaptability, and powerful in its social impact. Yet it was deliberately designed by no one: It was an accident. I am speaking of the homeowner deduction provisions in the federal income tax. These provisions comprise a housing subsidy program which makes the deliberately created direct housing programs look feeble in impact, and inept in program effectiveness.2

Homeowners have the right to deduct mortgage interest and property taxes from their adjusted gross income before having to compute their income tax. These are just special cases of two general classes of allowable deductions—deductions for interest and deductions for taxes. Nevertheless, they comprise the bulk of these types of deductions and jointly comprise an indirect housing subsidy

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2 Some may question whether these deductions properly constitute a "program." They were not established with a program in mind; they have only recently been widely viewed as having the effect of a "tax expenditure" program. This concept stems from economists' efforts to devise a true measure of income and a pure theory of income tax. In the process, they have unwittingly evolved a peculiar notion of government vis-à-vis the governed. Carried to the extreme, such a theory of tax expenditures would view any income left to the individual after taxes as a mere residual, the result of a governmental act of grace. This point has been most recently argued in these pages by Irving Kristol (Public Interest, No. 37, Fall 1974). Nevertheless, to ignore the effects of these exemptions and deductions is to accord them some divine rights, beyond all scrutiny. In the case of the homeowner deductions, the magnitude of their impact, the scope of their coverage, and the rate of their growth are all too important to ignore. Placing them in the context of a program affords the opportunity for some interesting comparisons with more accepted notions of programs.
for homeowners: Their effect is to “save” taxpayers from paying a portion of their taxes which otherwise would have to be paid. The amount saved is dependent upon the applicable tax bracket. If the taxpayer is in the 14 per cent bracket, home-related deductions totaling $1,000 are worth $140. If the 50 per cent bracket is applicable, then the saving, or subsidy, is $500.

The details of these deduction provisions, and their intricacies and justifications, have been reported elsewhere and need not be elaborated here. Instead, we will compare the workings of this indirect housing subsidy program and its effects with the direct housing subsidy programs administered by the Department of Housing and Urban Development (HUD). While the recent 1974 Housing and Community Development Act has abolished (at least temporarily) the HUD programs used for comparison here, the thinking which lay behind them and their parallel with other socially oriented programs make them a useful vehicle for comparison. The difference between the direct housing subsidy programs and the more indirect subsidies accruing from homeowner deductions is so great, and the HUD programs fare so badly by comparison, that in order to avoid the charge of bias, the source used, wherever possible, will be HUD’s recent report, Housing in the Seventies.

Deductions versus subsidies

In 1972, the federal subsidized housing programs provided approximately $2.5 billion in subsidy. These programs included public housing, 221(d)(3) housing (below market interest rate), rent supplements, and section 235 (homeownership) and 236 (rental) housing. These programs served low- and moderate-income households, with incomes generally ranging between $2,000 and $7,000 annually.

By contrast, the housing assistance provided by homeowners’ deductions in 1972 amounted to $6.2 billion. Other income tax provisions (deferred payment of capital gains and special provisions for the elderly) conferred another $1.7 billion on homeowners. The combined total amounted to almost $8 billion. This total counts neither the subsidy provided to homeowners through deferred capital gains from past years (amounting to approximately $1.3 billion) nor the value of imputed rent to homeowners (the value of the

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*See for instance, Henry Aaron, Shelter and Subsidies (Washington, D.C., Brookings, 1972) and U.S. Department of Housing and Urban Development, Housing in the Seventies (mimeograph, October 1973).*
housing services received during the year less the cost of providing the housing\(^4\)), which was estimated at an additional $6 billion.

Unlike the direct housing subsidies, these homeowner deductions and other tax programs largely benefited the middle- and upper-income classes. Of the $6.2 billion accruing to homeowners through deductions alone, $5.5 billion (89 per cent) went to taxpayers with incomes of $10,000 or more. Upper-income taxpayers benefited even more than did middle-income taxpayers: Homeowners with incomes between $10,000 and $15,000 received a $153 average annual subsidy, whereas those with incomes between $50,000 and $100,000 received an average of $1,397.

In other words, by conservative estimate, low- and moderate-income households received only about one-third the amount from direct subsidy programs that middle and upper incomes did from indirect subsidies. Even if that portion of assistance from welfare payments that is spent on housing (about $2.6 billion in 1972) is added to the direct housing subsidy programs, the combined total is still only 70 per cent of the amount from homeowner income tax deductions alone.

A related consideration is the number of households served by the different programs. In 1972, approximately 1.7 million households were assisted by the direct subsidy programs. During the same year, about 24 million households were assisted by the homeowner income tax deductions. In other words, the income tax deductions assisted 14 times as many households as did the direct subsidy programs.

It is true that the average direct subsidy per household was three to five times that for the average homeowner declaring the deductions. The nature of the direct subsidy programs is such that a small proportion of those eligible receives a substantial subsidy while the majority receives nothing. The income tax deduction provisions insure that the federal largesse is distributed somewhat more widely among eligible households. Even so, the subsidy accruing to those with incomes of $100,000 or more was 2.5 times larger, on average, than the subsidy going to, say, public housing recipients with incomes of $3,000 or less.

Finally, the housing programs demonstrated a capacity for growth—partly because their starting base was so meagre. In 1960 some

\(^4\) Technically, imputed rent can be calculated for any owned capital good, e.g., an automobile, a washing machine, etc. In the case of housing, imputed rent is the net rental value, which equals the gross rental value minus maintenance expense, depreciation, mortgage interest, taxes, and insurance.
446,000 households were served by the housing programs. This increased to 1.73 million by 1972, or a 300 per cent increase. The amount of subsidy increased from $221 million to $2.5 billion—a more than 1,000 per cent increase. By comparison, the homeowner income tax deductions covered about 15 million households in 1960, and increased to 24 million by 1972, or only a 60 per cent increase; but the absolute increase was 7.5 times larger than for the direct subsidy programs. Similarly, the amount of subsidy increased by $2.6 million, a 210 per cent increase; and, despite a lower percentage increase, the absolute amount was nevertheless larger than that of the direct subsidy program.

Standards for comparison

Clearly, the number of households involved and the amount of subsidy provided demonstrate that the homeowner deduction provisions comprise a major social program. Unlike so many social programs, these provisions have “worked” remarkably well in making an impact. Indeed, it may be argued that they have worked too well. By encouraging middle- and upper-income households to “over-consume” housing, they may have made more difficult (and costly) the intended impact of the direct housing programs.

But the comparison between the two types of programs need not end here. While it is important to know the ultimate impact of programs, an even more important consideration is whether that impact was intended. Here we should go beyond simple descriptions of who gets what expressed only in terms of different income classes receiving certain amounts of subsidies. We should know, for instance, if some within an income class are legally or administratively ineligible to receive assistance or are otherwise discriminated against. Similarly, we should be interested in knowing not only how much assistance is received but also when it is received. Finally, we should like to know whether these aspects taken collectively accomplish national goals.

The perfection and beauty of social programs, however, is not confined solely to their impact. Just as we marvel at species of animals and plants for what they do, so also do we wonder at their ability to survive and evolve over time despite a merciless environment. A program’s capacity for longevity in a political environment where many are short-lived must be considered an important facet of its construction. The key is the ability to adapt to a changing environment—even to make the changes work to one’s advantage.
The homeowners' deduction provisions are remarkable social mechanisms by these criteria as well. Their processes are considerably more subtle yet harder than the processes of the direct subsidies—and not least their art of camouflage. Furthermore, they tend to amplify the above-noted differences in impact, particularly those which do the most to thwart the effects of redistributive programs.

To make further comparisons between the two types of programs, it will be helpful to indulge in a fiction. We can pretend that the direct housing subsidies are for the purpose of helping low- and moderate-income households, whereas the homeowner income tax deductions are for the purpose of assisting middle- and upper-income households. Thus each program has a client group to be served as effectively as possible. This is not an unrealistic fiction. Although the homeowner deductions were never originally designed to help the middle- and upper-income classes, the inequities of the program have been ignored for a long enough period, and subsequently shielded enough times from adverse changes, to indicate that Congress is not displeased with its results. Armed with this fiction, we can analyze the programs from several additional aspects.

**Congressional oversight**

From the perspective of a client group, it is desirable to have Congressional good will toward an assistance program, but not too much scrutiny. Other interest groups inevitably raise issues of program abuse, cost-overruns, and general misallocations (if not misappropriations) of the taxpayer's money. The two types of housing programs are excellent examples of two different Congressional and Executive approaches to this problem.

Most direct subsidy programs are designed as closed systems, and hence they ensure close scrutiny. The upper limit to the authorizations and appropriations are specified; frequently maximum costs per household are spelled out as well. Since it is sometimes recognized that different communities across the nation do not face a uniform environment, certain exceptions to the limits are allowed which partially acknowledge such differences. Nevertheless, the legislation is so designed that the programs are unable to react to changed national circumstances until subsequent amendatory legislation is passed.

There may be good reason for exercising this control: It provides a means for projecting the upper limit of expenditures; it provides
a check on administrative interpretations of legislative intent; it reduces uncertainty regarding programmatic operations during a designated period; and in general, it provides for priorities among different programs. But from the clients’ point of view such controls are vexing indeed. It is preferable to have an open system which merely specifies general procedures to be followed in distributing subsidies, and then allows outside events or the clients themselves to shape the magnitude of the program.

The differences between open and closed systems are those between the indirect and direct housing assistance programs. Each of the different HUD assistance housing programs had an appropriation which specified the upper limit of expenditures for the program as a whole, and sometimes for a household or dwelling unit as well. The homeowner deductions have no such limits. The amount of the subsidy both per household and per dwelling unit, as well as the amount of subsidy for the total program, is left to the discretion and resources of the clients. The only limit is a self-imposed one, governed by the taxpayer’s income and assets, the cost of the home, the amount of mortgage interest and property taxes, and the frequency with which the homeowner decides to buy a new home or to re-finance the existing one. Indeed, not only is there no monetary limit per household, there is not even a legislated limit to the number of housing units per household that may be counted in the deductions.

Eligibility requirements

Closely associated with the HUD expenditure limits is the issue of eligibility for program assistance. From the recipients’ perspective, a minimum of eligibility hurdles is desirable. Eligibility requirements impose time and psychic costs upon the applicants (uncertainty of administrative determinations of eligibility) and are at times so onerous as to discourage application. In the case of the direct subsidy housing programs, the eligibility criteria are income of the household (both maximum and, surprisingly, sometimes minimum as well), family size, age of the head of the household (in the case of programs designed for the elderly), condition of the unit previously occupied (e.g., substandard), and reason for having to move (e.g., displaced by governmental action such as code enforcement or renewal). Clearly these criteria serve to screen out otherwise deserving households. They become a rationing device for limited funds.
In the case of the homeowner deductions there is only one eligibility requirement: The household must own its home. No other consideration is important, not even how high the household’s income is. Furthermore, there is no special processing of forms or administrative review prior to receiving the benefits. The taxpayer makes his own self-evident determination of eligibility in the course of filling out his income tax form. Further, there is no limit to the income tax subsidies, in contrast to the direct housing subsidies. For those who can afford it, the house in an exclusive portion of the city, the cottage by the beach, and the condominium at a ski resort are all simultaneously eligible for subsidy. No rationing device under the guise of eligibility requirements need be applied—the funds are potentially unlimited.

Finally, there is another dimension of eligibility: whether the household is eligible for the subsidy regardless of where it is located, or whether the housing unit itself must also pass eligibility muster. The HUD direct housing programs provide that eligible households may receive the assistance only if they locate in a housing unit provided the assistance. That is, if the unit was not financed or otherwise assisted through one of the specific programs, the household cannot receive the assistance. In a tight rental market, this may prove a severe hardship. The members of the household may find that they should move because of a change in job or family circumstance, but then find they cannot take their assistance with them, so the move will mean substantial rental increases for an equivalent unit.

There is no such restriction for the indirect housing subsidy assistance. The subsidy will be provided wherever the household locates, so long as the household owns the unit.

**Bureaucratic response**

Another aspect of the differences between the two systems is in the time of system response. Client groups prefer to receive whatever subsidy is available as soon as possible, without interminable bureaucratic delays. The direct subsidy housing programs were notably slow in delivery of the subsidy. For instance, once a housing program had been passed there was no guarantee that funds would be appropriated for it. If they were, administrative regulations had to be devised to interpret the legislation. Then they had to be disseminated and interpreted at regional offices. Typically, the subsidy was in kind rather than in cash, so the funds were filtered
through financial institutions, the construction industry, real estate developers, and investors. Here again, bureaucracy was largely responsible for delays. For instance, whereas in the private market a multiple housing unit might take from one to one-and-one-half years to be completed, public housing units typically required from three to four years. Processing time for a 221(d) (3) application was estimated at 376 working days, and it took six years to produce the number of units that had been set as an annual goal. Recipients of the direct housing assistance programs could expect to wait a number of years after enactment of legislation before they could enjoy its benefits.

The homeowner's deduction subsidy suffers no such delays. The subsidy is received (or at least taken into the owner's calculations) the day the income tax legislation is passed. To be sure, the Internal Revenue Service (IRS) is not without its own interpretations and clarifications, but these are after the fact, and apply only when the tax returns are challenged.

The anomaly is evident: Direct housing assistance, despite the force of the term, is slow in reaching the recipient and arrives in obfuscated form; the indirect income tax housing assistance is immediate in impact and more sharply defined.

Furthermore, the direct expenditure programs must be formulated each year by the executive branch; presented to the appropriate Congressional committees, where they are revised or eliminated; approved by Congress; and then interpreted by the agencies in charge of implementing the legislation. During the 1960's, major housing bills were enacted almost every other year. If the cost of living rose, new expenditure limits had to be formulated, debated, and voted on or administratively approved. If changes in the demographic characteristics of the nation occurred over time, altering the number of those in need or technically eligible for the program, new evidence had to be presented and debated before change, if any, was forthcoming. The shifting national economic scene during the 1960's, with inflation, increasing propensity to establish separate households, changing cost of money, special increases in construction costs, etc., meant that applicable programs inevitably lagged behind the current situation. The programs ultimately enacted were never precisely tailored for the then current circumstances.

The housing tax expenditure program, on the other hand, although not intentionally, is an instrument remarkably sensitive to the current economic situation. Tax programs affecting housing are not legislated frequently (although when they are, they go through many
of the steps described above). Even more important, the deduction provisions are remarkably sensitive to economic and demographic changes that take place in the nation. House prices rose some 40 percent during the decade. This meant that new buyers continually had to incur larger mortgages. But rather than having to wait for legislation to lift the allowable amount for mortgage deductions, recent homebuyers simply deducted the larger amount. Interest rates also increased during this period, which meant still higher mortgage repayment amounts for interest. Here again, these increased amounts could be deducted automatically. Property taxes rose considerably during this period as well, but these increases also could be immediately included in the homeowner’s deductions.

Similarly, as a result of inflation as well as real gains in salaries and wages, household incomes also increased. This had the effect of placing many households in a higher income tax bracket, meaning that a higher percentage of homeowners’ mortgage and property taxes were subsidized.

Real and symbolic benefits

The close control exercised over direct subsidy programs meant that beyond some limit there were no more benefits forthcoming per household. While not strictly negative, in the sense that receipt of assistance in one time period reduced the amount received in the next, the programs were designed to provide a previously declared maximum and no more. The only exception was the public housing program, which, because of a maximum income limitation, forced those households who over-earned into worse housing than they received from the public housing authority.

In the case of the homeowners’ deductions, however, the more that is earned, the larger the subsidy for every mortgage interest and property tax dollar expended. This is owing to the progressively higher tax bracket rate applied to increases in income. Further, one part of the subsidy system may assist in enabling homeowners to take advantage of other parts. For instance, the mortgage interest subsidies encourage borrowing on the home. The interest is deductible, and the thinner the equity in an inflationary market, the greater the ability of the homeowner to practice the real estate investor’s principle of leverage. This means that, at the time of sale, a $10,000 gain is a greater percentage return upon a small equity than if the owner had largely paid off the mortgage, and had accumulated a large equity.
Furthermore, payment of any capital gains tax from the increased selling price may be deferred if another house is purchased within the year. This amounts to an interest-free loan by the federal government. To the extent that the deferred capital gains tax is used to assist in buying an even more expensive house, the increased mortgage interest costs, if any, may be deducted, along with the increased property taxes. To be sure, the homeowner will incur increased out-of-pocket housing expenses, but at least a portion of any increase in housing cost will be subsidized. Finally, other benefits may accrue through increased imputed rent. From this perspective it is clear that the homeowner is encouraged to consume just as much housing as he possibly can.

From the clients’ perspective, it is important that their program have the right symbolic connotations. At worst, the program should be perceived as insignificant in the overall scheme of things; more desirably, it should be seen as necessary to the nation’s health and prosperity, and even better, as a fundamental right besides. Such interpretations by the public as well as by Congress do much to ward off attacks on the program and otherwise encourage benign neglect.

The differences between the two types of programs here are remarkable. Welfare or assistance to the poor has at best been grudgingly granted throughout most of the nation’s history, and housing assistance for these groups has been particularly resisted. But housing assistance for middle- and upper-income groups has no such history of resistance. Housing has traditionally symbolized an important facet of the American way of life. The log cabin and subsequently the single-family home have been the physical manifestation of rugged individualism and have been encouraged by homesteading acts, Federal Housing Authority (FHA) and Veterans Administration (VA) programs, and the like. Direct housing assistance to low- and moderate-income households (which is largely for multi-family rental units) challenges this symbol and has been strongly opposed for a long time. Indeed, initial federal intervention in housing was not even for the benefit of those most in need. The first federally-assisted housing was war housing built for defense workers in World War I, and sold following the war. The Depression initially brought forth efforts to help only the middle class with their housing through assistance to the housing finance institutions (Federal Home Loan Bank, FHA, etc.). The first federal effort of any note to assist the poor—public housing—was not commenced until 1937, and it was justified primarily as a basis for stimulating
the economy in the construction field. Differences over public housing provisions delayed the first housing act following World War II for four years (until 1949) despite the lack of housing for returning veterans. The total number of public housing units built by 1969 matched the number that had been authorized to be completed by 1956. Not until the middle 1960's did housing for low- and moderate-income households get built in any significant numbers. Housing assistance for these groups apparently commands little support and even less commitment.

The homeowner income tax deductions have suffered no such stigma. For one thing, they are widely perceived to be a tax program, not a housing program. For another, since they provide a rebate of sorts, they are a popular part of the tax program. Furthermore, because they are one of many “backdoor spending” programs that receive no annual legislative review, the “expenditures” make no political headlines and the complex way of calculating the expenditure does not make for good media copy. Thus program salience is blunted by use of an alternative label, and the significance of the program's impact is obscured by its indirectness and technical complexity.

If the deductions are seen as part of a housing program, it is claimed that they encourage homeownership—a powerful political and cultural symbol. Further, these deduction provisions hark back to the Civil War, when the first income tax was passed, and they were part of the original tax code when the income tax was re-instituted in 1913. They thus take on the symbolic connotations of a fundamental right, established with the founding of the income tax itself.

Without these symbolic connotations it is no wonder that the direct housing programs have endured close scrutiny by many Congressmen fundamentally suspicious of their merit, and have had close legislative supervision of their details. Similarly, it is not surprising that Congress and the Executive branches have largely ignored the homeowner deductions, and turned their attention to seemingly more important social issues.

Racial discrimination

The direct housing subsidy programs have practiced racial discrimination and segregation in the past, although efforts are being made to rectify this. The homeowner deduction program practices no racial segregation—it is unable to dictate where minority groups
can live—but it does assist in racial discrimination, although unintentionally. The discrimination is merely the result of an unequal distribution of wealth and income between the various races. Of all white households in 1970, 65 per cent were owners; of all non-white, only 38 per cent were owners. Thus a smaller percentage of most minority groups are eligible for the homeowners' subsidy to begin with. They cannot pass the single criterion of homeownership, either because they do not have sufficient income, or because even with a sufficient income they do not have enough cash to make a down payment. But the discrimination goes further. The non-white homeowners have, on average, substantially lower incomes than do whites. In 1970, white homeowners had a median income of over $9,700, while non-white homeowners had a median income of approximately $6,500. Thus, on the average, the amount of subsidy per housing dollar expended is slightly lower for non-white households. There is an unintentional and unanticipated skewing of whatever subsidies are available to homeowners away from minority groups—those who in general may be the most in need.

**Absolute Ignorance as artificer**

Clearly, the homeowners' income tax deductions comprise a subtle, powerful, and immensely successful program—albeit with social effects at odds with the goals of direct social programs. More remarkable still, however, was their formulation. The Master Artificer turned out to be Absolute Ignorance. No one intentionally created this program—it was an accident, the unintended but joint effect of several different actions. Nor was the program created overnight in the way so many direct social programs have been. Conception took almost 50 years—from 1861 to 1913; almost 30 more years lapsed before the program took its present shape in 1942. Full growth has taken still another 30 years.

The first income tax in the United States was for purposes of financing the Civil War. Nevertheless, Congress took the time to be more specific about the relation of housing to the income tax than it did in the subsequent re-enactment of the income tax in 1913. During the Civil War not only were homeowners allowed to deduct mortgage interest and property taxes (because interest and taxes in general were deductible), but renters were allowed to deduct their rental payments as well. Even imputed rent was specifically mentioned in the legislation (it was not taxable).

In the 1860's the subsidy effects could not have amounted to
much. The applicable tax brackets were too low; the number of taxpayers, too few. Incomes between $600 and $10,000 were taxed at three per cent; those over $10,000 at 10 per cent. Moreover, the percentage of homeowners was lower than today. Exact percentages are unknown for 1860, but an estimate for 1890 places the proportion at 48 per cent homeowners, 52 per cent renters.

The Civil War income tax expired in 1872. A new income tax was not enacted until 1913, following adoption of the Sixteenth Amendment. The new income tax provisions took less notice of housing than did those during the Civil War. Renters were allowed no deductions, and there was no mention of imputed rent. Interest and taxes were allowed as deductions, in part because Congress appeared oblivious to distinctions between business and personal expenses. The few attempts to point out the differences in how the deduction provisions would effect owners versus renters were ignored by the other members of Congress.

In 1928, an effort was made in the House to permit owners of cooperative housing to deduct their share of the cooperative's interest and property taxes so as to place them in the same position as other homeowners. It was opposed by the Senate because it would be difficult to administer, and because "such deductions were not given to the great number of individuals who lease apartments." In 1942, however, the issue was raised again, this time by the Senate, and it was passed. Neither in 1928 nor 1942 did the proposed legislation engender any Congressional debate. Even the committee reports barely made mention of the provisions.

Again, the net impact of these provisions in terms of homeowners' subsidies probably did not amount to much. Between 1918 and 1938, for instance, only 10 per cent of the nation's total population was covered in the income tax returns. The income tax was not yet a "mass tax." Furthermore, the tax rates were low, so that deductions had less of an impact. Until 1941, there was a two tax system, the normal tax and a surtax. The normal tax was either a single rate or a progressively stepped one (varied over the years) but was never higher than eight per cent, and was a constant four per cent after 1934. The surtax was graduated, but the actual rates fluctuated widely from revenue bill to revenue bill. Summary is difficult without becoming tedious, but in general, the surtax would run from one per cent beginning with incomes of $5,000 and would exceed 50 per cent for incomes over $500,000. Since the average income during this period was roughly $2,000, the progressive nature of the surtax did not affect many taxpayers.
Just as the Civil War was the occasion for the first income tax, World War II gave rise to its present-day form. The two major changes that occurred with the 1942 Revenue Act were the sharp increase in the tax—the starting tax rate was 23 per cent and increased up to 94 per cent for incomes in excess of $200,000—and the markedly larger proportion of income earners who were subject to paying a tax.

By 1946, for instance, 87 per cent of the nation’s population was covered. Thus the income tax had changed from an economic elite tax to a “mass tax,” and in addition provided for a high initial tax rate base with steeply increased progressive rates. With these two basic changes, the potential effect of granting homeowner deductions was substantially increased. Not only was the position of homeowners enhanced vis-à-vis renters, but the progressive nature of the tax meant that deduction provisions substantially assisted the wealthy over the poor.

The advent of this new coverage required an offset. The elaborate record keeping required for deductions by wage earners with relatively low incomes has little justification. Accordingly, the standard deduction provision was enacted. Originally, a standard deduction of 10 per cent of income up to $5,000 was permitted. This was subsequently changed to 10 per cent up to $10,000 in 1948. Although the items that presumably composed this standard deduction were never spelled out, they implicitly included housing expenses for both owners and renters, thereby equalizing the housing assistance for owners and renters with low and middle incomes who chose not to itemize.

Although the impact of these changes on housing might have been anticipated by the legislative and executive branches, it appears that it was not, and there was no discussion of possible effects. Congress was too preoccupied with the overall magnitude of the changes (e.g., in the coverage and the tax rates), and with the exigencies of the Second World War and the pressing costs of supporting the war effort.

Thus the overall program was born. The principle and precedent of allowing unlimited mortgage interest and property tax deductions, established in 1913, coupled with the change almost 30 years later of making the income tax a mass tax with high and progressive tax rates, produced the basic program, one that had not even been a gleam in anyone’s eye. The program was to mature in a benign environment of studied neglect along with an occasional low-key (but significant) tax code change.
The failure of reform

In 1951, another income tax provision was added to assist homeowners. Congress permitted homeowners who sold their house and purchased within a year another one of equal or higher value to defer payment of any capital gain realized (sales price of the original house less its original cost plus capital improvements, if any). Furthermore, if the homeowner were to die while deferring the gains, the gains realized were exempt from taxation. The purpose here was to alleviate hardships associated with household relocations brought about by the Korean War mobilization, and to ease the purchase of larger housing by growing families.

Until the 1960's, the two major factors relating to homeowner deductions—the number of persons affected and the applicable marginal tax rate—were determined on income tax policy grounds alone. Considerations as to the effect on housing policy were entirely absent. On the occasions when the income tax was viewed as a vehicle for housing assistance, the result was aid for owners of cooperative housing (few low- and middle-income groups lived in such housing in the 1940's) or tax breaks for homeowners fortunate enough to have a capital gain when they sold—an inducement to such homeowners to consume even more housing if they bought again.

When coupled with the assistance provided homeowners from VA and FHA mortgage guarantees and loans, it is not surprising that the homeowners' income tax provisions helped homeownership increase from 44 per cent of the nation's households in 1940 to 62 per cent in 1960. This growing base of political support may also explain legislative attitudes toward reform efforts during the 1960's. These ranged from benign and studied neglect in Congress as a whole, to outright hostility in committee.

In 1963, the Kennedy Administration proposed a substantial tax reform. Among the provisions was one eliminating a percentage of all personal deductions in order to make up the deficit occasioned by the proposed lowering of marginal tax rates. The lowest marginal rate was to be reduced from 20 per cent to 14 per cent, the highest from 91 per cent to 65 per cent, with similar reductions in the intervening tax brackets. To finance the revenue loss (estimated at $2.3 billion) the Administration proposed broadening the tax base through a means which affected homeowners—limiting itemized deductions to those which were in excess of five per cent of the taxpayer's income.

Although the Kennedy Administration anticipated a fight, it underestimated its intensity. Only one member of the Ways and Means
Committee favored the proposal. Of the more than one hundred groups to testify before the Ways and Means Committee, only one supported it; the opposition ranged from the United States Chamber of Commerce to the Girl Scouts.

Much of the opposition was due to the anticipated effect on charitable contributions, but a sizable proportion revolved around the implications for homeowners. The thrust of the testimony before the Ways and Means Committee on the implications of the reform for housing included one or several of the following eight points:

There were inequities between owners and renters in the reform proposal.
Homeowners were already at a disadvantage vis-à-vis renters, and should be given additional benefits such as deducting depreciation.
Potential homeowners would prefer to rent, whereas national policy was to encourage ownership.
The measure would retard purchasing of houses.
The measure would reduce new homebuilding activity.
Rather than falling most heavily on the upper-income owners, the measure would be borne largely by low- and middle-income owners.
The measure went against precedent stemming back to the Civil War.
The real estate-related industries had not been consulted.

These were not necessarily unassailable charges. They ignored Treasury presentations, and additional counterarguments could have been marshalled if desired. But the Committee's mind appeared set against the provisions from the start. Indeed, some members of the Committee seemed to encourage testimony along these lines. The issue was not even put to a vote in committee; the status quo was perceived as satisfactory.

The following year Congress exhibited marked concern for a certain class of homeowners— the elderly. The provisions for deferring capital gains had become a hindrance to those elderly who wished to move to a smaller home, and to invest the gain from sale of their house in other revenue-producing assets which would assist in retirement. Accordingly, the Revenue Act of 1964 provided that any capital gain on a house sold by a taxpayer 65 years or older for under $20,000 would not be taxed, and that only a portion of the gain derived from a unit sold in excess of $20,000 would be taxed.

More recently, in 1969, for example, the issue of renters being treated on an equal basis with homeowners was directly raised in a bill which allowed renters to deduct from their income tax their
proportionate share of real estate taxes and mortgage interest accruing to their rented unit. In testimony before the House Committee on Ways and Means, it was argued that such a provision would alleviate a currently inequitable situation between owners and renters, and that this provision would be particularly beneficial to the elderly. The proposal and accompanying testimony elicited little interest on the part of the Committee during the hearings, and the bill died in committee.

The issue has not yet been brought to an end. In recent years there have been numerous bills introduced in Congress pertaining to this area. Some have sought to assist renters through deductions, others to assist homeowners even further through still more deductions. None has met with much success.

The need for humility

The workings of the homeowners' indirect subsidies from income deductions reveal a social program of considerable impact, complexity, and effectiveness. They provide subsidies in an amount many times that provided by the direct housing programs, and to many more households. There is no legislated upper limit per household on the amount of subsidy that can be received, nor are there any onerous eligibility requirements. Furthermore, the assistance is received immediately. Any changes in the nation's economy, such as inflation, are automatically taken into account in the computation of subsidy. In addition, the program is cloaked in the requisite symbolism: It has low visibility, it is deemed to promote a worthy cause, and it is perceived as a virtual right. That it discriminates against minority groups can be explained all too conveniently as merely an unfortunate side effect of its basic workings. While never an intended subsidy, this accidental social program has been shielded from adverse change over a number of years, and occasionally has even been given a low-key but effective boost from Congress. Although Absolute Ignorance was its creator, the workings of the program are worthy of any Machiavellian artificer.

The implications for national housing policy can only be touched upon here. Despite the inequities of the homeowners' income tax deductions, there are some good reasons for not eliminating them, although some reform is obviously warranted. At a minimum, some upper limit should be imposed on the amount of the deductions taken per household. Moreover, closer policy links between the assistance provided by this type of social program and the more di-
rect kinds of housing programs should be considered. To the extent that standard housing is, as Nathan Glazer has suggested,\(^5\) increasingly a relative measure, determined in part by the quality of housing that middle- and upper-income households are able to purchase or consume, the trend of the homeowners' indirect subsidies helps to raise this standard ever higher. This means that still larger subsidies for the low- and moderate-income households will be required in a futile attempt to "narrow" the gap.

A quick reading of the Housing and Community Development Act of 1974 might suggest reason for optimism. By eliminating most of the direct housing programs described above, and substituting a block grant approach, the Act suggests movement in the direction of the indirect subsidies. Still, there are decided differences between block grants and direct individual household assistance. The chances of a marked improvement over the old programs are slim, but perhaps slight improvement is all we should ever hope for. It is clear, however, that the monetary differences between the two types of programs will not change in the near future. Homeowner deductions for fiscal 1975 have been estimated by the Joint Economic Committee at $8.3 billion. The authorization for the Housing and Community Development Act of 1974 is $11.3 billion over a three-year period, or less than half the indirect subsidy amount in any one year.

Regardless of the substantive merits and demerits of the indirect housing subsidies in principle, their impact has been decidedly at odds with accomplishing the goals of the direct housing programs. Furthermore, the very nature of these indirect programs, with their subtle yet vigorous workings that benefit a broad-based clientele, suggests a social program model which bears study and examination by policy artisans, even if it may not warrant emulation. Finally, it suggests the need for a certain degree of humility when we come to designing perfect and beautiful social programs. The task is extremely difficult. So far, Absolute Ignorance has mastered it as well as any policy artificer.

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