Income Tax Incentives to Housing Sector

Assessing the Benefits

R. KAVITA RAO
Senior Fellow
Tax Research Unit

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National Institute of Public Finance and Policy
18/2, Satsang Vihar Marg, New Delhi 110067.

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"Shelter is considered a basic human need next only to food and clothing."[1] The Census of India documents that 13.3 percent of all households and 33 percent of those living in urban areas do not own the dwelling they reside in. Further, there are over 10 percent of households who are classified as houseless. The census estimates the shortage of housing at 24.7 million, in 2001. More recent estimates for the urban sector alone suggest a housing shortage to the tune of 24.7 million taking into account congestion and obsolescence.[2] The National Housing Policy too highlights the need for concerted effort to address this problem. These persistent characteristics among others constitute one of the driving forces for finding ways to augment investment in housing in the country. Tax incentives provided to housing sector can be viewed as one of the measures to address this concern.

This is a study seeking to identify the potential beneficiaries of the incentives provided in the tax codes to encourage investment in housing. In attempting to identify and quantify the impact of incentives on the individuals in the economy, it is useful to keep in mind that the incentives provided may induce changes in the behaviour of the people and in the overall parameters of the system, such that the extent of benefit derived may differ from the perceived direct benefit. This study therefore is presented in two parts – One part looks at the direct beneficiaries and the extent of direct benefits received. The second part seeks to identify potential indirect benefits to individuals or to the economy as a whole. It provides a summary of the discussion in the international literature on the impact of such incentives on the housing market and therefore on the potential beneficiaries of the incentive programmmes. Using this discussion, a preliminary attempt is made to explore trends in the data available for India, to assess possible similarities in experience. However, given the lack of data on the housing prices

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[1] Preamble of the National Urban Housing and Habitat Policy 2007, http://www.mhupa.gov.in/policies/duepa/HousingPolicy2007.pdf.
[2] Report of the Eleventh Five Year Plan Working Group on Urban Housing with Focus on Slums, http://planningcommission.nic.in/aboutus/committee/wrkgrp11/wg11_housing.pdf.

in India, in any standardized comparable format, a comprehensive assessment is not feasible. The discussion is organized as follows. Section 1 provides a brief assessment of the provisions of the income tax Act which provide concession and incentives for investment in housing. Section 2 explores the impact of two of the main incentives remaining which affect the decisions of households to invest in house property. Section 3 uses the discussion in the international literature to assess indirect benefits/effects of the provisions and in the process sets out to identify all the potential beneficiaries of the incentive measures. Section 4 provides some concluding remarks.

1. Nature of incentives:

The incentives provided within the income tax act can be broadly summarized as follows. While income from house property is taxable under section 22, there is no provision for imputing income for owner occupied houses. This provides an edge to owner occupied houses over rented accommodation, since only a limited deduction is available for rentals paid, under section 80GG. Further, it also encourages investment in housing when compared to investment in other instruments, since returns to the other forms would be taxable which returns from investment in housing would not be. (See Bourassa and Grigsby, 2000[3], for a detailed discussion of the pros and cons of such a provision.) This however is not considered a statutory exemption or concession. It is a part of the structure of the income tax law and implicitly provides some incentives to encourage owner occupied houses. Given the difficulties with imputing incomes, and the relatively poor link to ability to pay, this provision however, corrections for such an exemption are difficult to implement.

The major explicit incentives provided for investment in housing for individual households is in the form of sections 24, 80C and 54. Section 24 allows for the deduction of interest payable on capital borrowed towards constructing or renewing the house

[3] Bourassa, S.C. and William G. Grigsby (2000): "Income Tax Concessions for Owner-Occupied Housing", Housing Policy Debate, Vol 11, Issue 3, Fannie May Foundation. http://www.fanniemayfoundation.org/programs/hpd/pdf/hpd_1103_bourassa.pdf.

property, to the extent of Rs 1.5 lakh per annum, since 2002. [4] Prior to 1999, the deductions allowed on account of interest payment were Rupees Thirty thousand. From April 1, 1999, this amount was raised Rupees One Lakh. This provision is not unique to India. United States of America for instance, has similar deductions available within its laws governing income tax. There is fairly extensive debate on the impact of this provision in the context of the USA. (See Bourassa and Grigsby (2000), James Poterba (1991), Feldstein (1992). [5]Such a provision has been argued to encourage investment in housing as against other forms of investment, like investment in productive activities. They are also expected to encourage home ownership over rentals.

Section 54 provides that on sale of residential house property, if the capital gains from the same are utilized for purchase or construction of another house, with the prescribed period, or are invested in specified schemes, no capital gains tax would apply. Given the focus on encouraging investment in housing by individual households, this provision goes a next step and protects the value of assets of a household in the context of a re-allocation provided the investment remains within housing. This provision allows for upgradation of housing in correspondence with the needs and means of a household without imposing substantial transition costs on the same.

Section 80C currently allows for a deduction of any costs of repayment of a loan or payment of instalment or part payment of the amount due in a self financing or in a cooperative scheme. The maximum amount deductible from taxable income under this section is Rs 1 lakh and includes a number of instruments like life insurance premia, contributions to provident funds and to pension funds, investments in selected equity

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[4] Prior to 2002, the Act provided for a series of other deductions including for insurance premium, any taxes payable on state governments on the property, any ground rents, etc., up a maximum of the annual value of the property. Many of these deductions have been eliminated now and a standard deduction of thirty percent of the annual value of the property is allowed, in addition to the deduction of interest payable on capital borrowed.

[5] James Poterba (1992): " Tax Policy and Housing: Old Questions, New Answers", American Economic Review, Volume 82, No.2.

Martin Feldstein (1992): " Commentary: Investment Policies to Promote Growth", Presentation at a Symposium on Policies for Long Run Economic Growth, organized by the Federal Reserve Bank of Kansas City. http://www.kansascityfed.org/Publicat/Sympos/1992/s92felds.pdf.

shares and debentures, as well as for payment of stamp duties and registration fees for the purposes of transfer of house property.[6]

Apart from the above which relate to individual households investing in a house property, the law also has provisions for providing incentives to the real estate developers. Section 80 IB provides 100 percent tax free income from projects involving "small flats", provided the investor obtains approval for the project on or before March 31, 2008, and completes the project with four years of the date of approval. These incentives are available to projects where the size of the individual housing unit is less than 1500 square feet and where the commercial space within the complex is less than 5 percent of the built up area. This option is no longer open for new projects.[7] As a part of the overall scheme of special economic zones, 80 IAB currently provides incentives for construction of social and economic infrastructure related to the primary activity of the zone. While these incentives are not directly related to housing, as a part of the social infrastructure, the promoter is allowed to develop a pre-determined number of residential units. The incentives applicable to productive investments in infrastructure in the zone would apply these investments as well. No attempt is made to assess the impact of these incentives, as it depends on the number of zones that emerge and the extent of investment in the social infrastructure in these zones, all of which are in the evolutionary stages at the present juncture.

2. Direct Beneficiaries of the incentive regimes:

From the above discussion of the incentives available to the housing sector, the explicit incentives that need evaluation relate to loan financed investments by individual households, where the loan is contracted from formal sector financial and non-financial

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[6] Prior to 2006, these provisions were governed by section 88, with the benefits limited to 20 percent of the aggregate amount, deductible from income tax payable.

[7] A note prepared by Magic Bricks, an internet based realty company makes a case to suggest that this provision should be extended since real estate developers began availing of the opportunities underlying these provisions only after 2002. While it was not possible to get any concrete information from this company or from any of the other apex bodies for real estate developers, the investment initiative as suggested by this report seems to coincide with a demand stimulus for houses rather than an incentive led expansion. To this extent, the need for incentives is not justified.

institutions. The benefits, in nominal terms, in this category as noted above have increased over time. The extent of deduction for repayment of loans and the incentive associated with payment of interest on a housing loan have been enhanced in 2006 and 1999 followed by 2002, respectively. Such a provision immediately suggests that the cost of a loan against which such incentives are available is effectively lower. A lower cost of borrowing should induce three kinds of effects

a. People already in the market for a home, could explore the possibility of purchasing a larger property
b. The balance could be tipped in favour of investment in a house, for people at the margin.
c. Depending on the dimensions of the incentives and the perceived potential appreciation of real estate values, people could choose this form of investment over other forms.

To examine the impact of such a regime and to understand the impact of change in the limits, we consider some representative income categories and attempt to derive the implications. We assume 10 percent rate of interest on diminishing balance on the 20-year loan, with "EMI" mode of servicing the loan. The extent of interest paid and the extent of loan repaid can be computed for each month and therefrom, for each year for the duration of the loan. Assuming a loan of Rs 1 lakh, interest payment decreases from Rs 9926 in the first year to Rs 604 in the terminal year. On the other hand, the repayment of loan increases from Rs 1655 for the first year to Rs 10977 in the terminal year. Since the extent of incentive is related to the amount of loan repaid and the interest paid, Table 1 below presents a comparison of the extent of benefit delivered for different levels of borrowing. As reflected in the table, the extent of incentive stays stable for investments below Rs 10 lakh, and beyond this level, there is a gradual decline in the extent of incentive realizable when viewed as a percentage of loan taken.[8] Since the interest payment and repayment are spread over time, it is appropriate to look not at the nominal values but at the discounted value of the corresponding incentives. In terms of present

[8] While the nominal level of incentive received would increase with increase in the loan amount, since the incentive is seen as a measure to deliver relief to the borrower, the extent of relief is assessed in comparison to the amount of loan taken.

Table 1: Potential Beneficiaries and Extent of Benefit: A Thought Experiment

Loan Amount	Total Value Interest	Total Value Repayment	Incentive as % of loan	Present Value Interest	Present Value Repayment	incentive/loan
1 lakh	131605	100000	69.48	67246	31343	29.58
2 lakh	263210	200000	69.48	134493	62686	29.58
3 lakh	394816	300000	69.48	201739	94029	29.58
4 lakh	526421	400000	69.48	268986	125371	29.58
5 lakh	658026	500000	69.48	336232	156714	29.58
6 lakh	789631	600000	69.48	403479	188057	29.58
7 lakh	921236	700000	69.48	470725	219400	29.58
8 lakh	1052842	800000	69.48	537972	250743	29.58
9 lakh	1184447	900000	69.48	605218	282086	29.58
10 lakh	1316052	990234	69.19	672464	311977	29.53
11 lakh	1447657	1069959	68.66	739711	340168	29.45
12 lakh	1579262	1141113	68.01	806957	366827	29.34
13 lakh	1710868	1205363	67.30	874204	392140	29.22
14 lakh	1842473	1264133	66.57	941450	416306	29.09
15 lakh	1974078	1318641	65.85	1008697	439543	28.96
20 lakh	2355566	1528073	58.25	1150229	539652	25.35
50 lakh	2791678	1974137	28.59	1244415	828556	12.44
1crore	2910361	2000000	14.73	1263710	851356	6.35
1.5 crore	2940542	2000000	9.88	1268196	851356	4.24

Note: The extent of incentive is derived using a tax rate of 30 percent.

value, too, the pattern remains the same, however, the extent of incentive, as a percentage of loan amount is lower, for all levels of loans. The maximum benefit is available on loans upto Rs 10 lakh – 29.6 percent of the loan amount is receivable as incentives in the form of lower tax liability. It should be mentioned here that the computation assumes that the benefits on account of deduction of loan repayment could extend upto Rs 1 lakh as per the provisions of the law. However, since this cap applies jointly for a number of investments, the effective cap could be significantly lower for a number of the potential investors. For instance, since all borrowers are encouraged to take life insurance of dimensions similar to the housing loan so as to hedge against the possibility of a default in the event of demise of the earning member of the family, the insurance premium would take up part of the space. Similarly, for a salaried employee, the mandatory provident fund contributions would compress the space available for claiming deductions on account of repayment of housing loans. Assuming that the incentive amount is limited to deductions on account of interest payments alone would reduce the extent of benefits obtained. The extent of incentives in this case can be worked out to be 39 percent in nominal terms and 20 percent in present value terms. It may be mentioned that the extent of incentive in this case declines only loan amounts beyond Rs 15 lakh.

The above table however, does not map the loans on to any income levels. To derive a corresponding income coordinate, the industry benchmark for loans can be used – as a rule of thumb, loan tends to get limited to 4 times the gross annual income of the borrower. In the above table, the corresponding income for the first 4 categories of loans would be lower than the exemption threshold for individual income tax payers. For individuals not paying income tax, the incentives being discussed have no relevance. The benefit therefore is zero. The beneficiaries are people with incomes exceeding the exemption threshold, at the minimum.

A study on the profile of borrowers from housing finance corporations, suggests that the average loan size was closer to twice the total annual income of the borrower. (Table 2) With a ten percent interest rate and a 20 year loan term, a loan of 4 times the annual income, results in a monthly instalment of 46 percent of monthly income. On the other hand, if the loan amount was about 2 times the annual income, the EMI was a more reasonable 23 percent of the monthly income. It is therefore assumed that the loan amount is closer to twice the annual income of the borrower. This suggests that loans below 5 lakh are taken by people with incomes below or close to the exemption threshold. The tax exemption delivers benefits only to people above this threshold.

Table 2: Characteristics by Size class of loans

	average monthly income	Presence of co-applicants	Share of upgradation loans	Self employed	average annual income
<1 lakh	9682	29.9	38.5		116184
1-2 lakh	10590	31.3	14.6	4.67	127080
2-5 lakh	15949	42.2	6.53	6.97	191388
5-10 lakh	34686	55	2.52	12.32	416232
>10 lakh	86254	62.6	0.95	18.02	1035048

Source: Annual report of National Housing Bank, 2005.

Ideally, to estimate precisely, the extent of benefits available by people under the present scheme, it would be desirable to look at the database of housing loans. Since this information is not readily available, an approximation can be derived, using the size composition of total outstanding debt. Here while the size composition of housing loans disbursed is readily available, the same for stock of outstanding debt is available only for scheduled commercial banks.[9] Based on these figures for the year 2006, a ratio of debt to total outstanding loans is derived, which is then applied to the stock of debt at the beginning of 2007 and/or 2008, to arrive an estimate of the extent of incentives availed in the relevant year.

Since this exercise attempts to identify the annual impact of the incentives, the average annual amount of incentive is derived by applying a tax rate of 30 percent to the average annual debt servicing over the life of the loan, for which potentially an incentive or deduction can be claimed.[10] For each of the available categories of loan, the per capita loan derived is used as the reference level to compute the extent of incentives associated. In Case 1 the incentives are assumed to include both deductions of interest liability from taxable income and full deduction of the repayment of loan as well. Given the number of borrowers in each of these categories, the total incentive associated with each category and overall categories is derived. (Table 3).

Since the component of repayment of debt may not be available as an incentive to all tax payers – they would be claiming section 80C deductions for a number of other reasons like providend fund contributions, tuition fees of children and premia for insurance policies – case 2 in the table captures the scenario if the only incentive available is on account of interest payment on the debt. This scenario suggests annual quantum of incentives at 0.98 percent of the volume of loans outstanding. Since these figures are derived using only a subset of the population of outstanding loans, it can only be used to extrapolate the impact on all beneficiary borrowers put together. The ratio of incentives availed to total loan outstanding is used for this extrapolation.

[9] Since Scheduled commercial banks account for an increasing share in total disbursements, it is reasonable to expect the composition of outstanding debt to follow the same pattern. Therefore this exercise uses the size composition of scheduled commercial banks to derive the dimensions of the incentives availed.

[10] The average annual figure is considered appropriate since the outstanding debt would be of varying vintages and therefore would have differing liabilities on account of interest payment and repayment. The average therefore is closer to the numbers that may apply for any given year, in the absence of comprehensive data on profile of housing loans.

Table 3: Aggregate Annual Incentives for SCB Loans, 2006

Size Classes of Loans (Rs Lakh)	No. of accounts	Amount	Per capita loans (Rs lakh)	Case 1 incentive per loan (Rs)	Case 1 Total incentive	Case 2 Incentive per loan (Rs)	Case 2 Total Incentive
<.25	220,483	310	0.14	0		0	
0.25 – 2	1,886,439	19295	1.02	0		0	
2 – 5	1,441,806	44020	3.05	0		0	
5-10	635,462	41345	6.51	22581	1435	12831	815
10-25	277,189	37215	13.43	45171	1252	26650	739
25-50	47,111	13472	28.60	64889	306	38804	183
50-100	9,547	5652	59.20	72454	69	42489	41
100- 400	2,829	4352	153.82	74108	21	44108	12
400-600	199	830	416.97	75000	1	45000	1
600-1000	159	1018	639.96	75000	1	45000	1
1000-2500	160	2201	1375.46	75000	1	45000	1
>2500	147	12459	8475.42	75000	1	45000	1
Total	4521531	182167			3088		1793
	Ratio of total incentive to Total Loans outstanding (percent)				1.695		0.984

Note: All figures are in Rs crore, unless otherwise indicated.
Source: Computed using Basic Statistical Returns RBI.

Using the figure for total outstanding loans as on February 15, 2008, at Rs 251688 crore for scheduled commercial banks alone, the impact can be estimated at Rs 4266 crore in case 1 and 2477 crore in case 2. Scheduled Commercial Banks are only one of the many players in the market. The actual value of incentives delivered therefore would be significantly larger than the figure derived above. If Scheduled Commercial Banks for instance are assumed to account for 50 percent of the market, the dimensions of the total incentive received would be Rs 8500 crore in case 1 and 4900 crore in case 2.

An important change that has taken place in the policies of the lending institutions relates to the way the maximum loan amount for a property is decided. The official value for a sale transaction is normally the benchmark for determining the quantum of loan that can be obtained. However, recognizing the existence of undervaluation in property values, financial institutions are now willing to lend amounts higher than the registered or recorded value of the property – amounts which are alluded to as costs of improvements and enhancements to the property. Part of the need for such an approach could have come from the perceived expansion in the potential size of the lending market, specifically triggered by rapid growth in services sector and by the potential for an incentive built into the tax statutes. This process of augmenting the formal value of the property could exert some downward pressure on the extent of "black" component of the transaction. It would however not be appropriate to assume that the "black" component would disappear completely, as a result of these policies. This could be considered a benefit to the investing individuals as well as to the economy as a whole.

3. Indirect Impact of tax incentives:

This section seeks to address two related questions: who are the beneficiaries, and what is the impact on the housing market of the incentive regime. It is useful to examine the extent of penetration of institutional lending in financing private investment in housing. As per the Handbook of Housing Statistics, private investment in residential housing accounts for about 36 percent of Gross Fixed Capital Formation in Housing, in 2003-04. This ratio has declined during the period since 1993-94 from a high of 48 percent. Incentives related to servicing of housing loans can be related only to this segment of investment in housing. Of the private investment in residential housing, since not all home owners take a loan from institutional sources to finance the purchase, the benefit of an incentive would not be uniformly spread across all investors. NSS data for 2002 indicates that the share of institutional loans in financing investment in a house is about 13.5 percent in rural areas and 24.6 percent in urban areas. While there is an increase in the share of institutional finance over time – the shares in 1992-93 were 9.02 and 16.03 for rural and urban areas respectively – the limited spread suggests that the benefits are limited in coverage. Further, since, as discussed above, the beneficiaries were identified as income tax paying citizens of the country, i.e., those with incomes higher than the exemption threshold, turning to table 4, it would be apparent that only a fraction of the borrowers are beneficiaries – they would account for about 22 percent of the number of people taking housing loans with a share of about 65 percent in the total outstanding loans for housing purposes. This discussion suggests that the direct beneficiaries constitute only a small fraction of the total activity in the housing sector.

The above figures suggest that barely 15 percent of household investment in housing is eligible for incentives offered under the Income tax Act.

It is possible to argue that a part of the lower coverage is a result of the poor coverage of income tax – people who evade taxes, would not be able to avail of the incentives offered in the Act. To the extent these incentives are effective, at the margin, some improvement in compliance may be induced.

Within the group of beneficiaries, a related question is whether the perceived gains can be appropriated by this group or not. Literature on housing incentives in the context of the United States of America suggests that some or all of the gains from the tax incentive can be whittled away through higher prices. Dennis R. Capozza, Richard Green, Patrick H. Hendershott (1997) establish that the tax benefits are fully capitalized in housing values.[11] In other words, the incremental income may not translate into higher access to housing or into demand for larger homes, if there is a related increase in real estate prices.

The logic underlying these arguments can be translated as follows: expanded demand for housing faces limited supply of land which can only translate into higher prices for land and therefore for the property built on the land. This effect can be further compounded by the fact that there would be some gestation lag in the developers taking advantage of the opportunities. While there are no standard norms for the gestation lags in this sector, a bulk of the gestation lag would be associated with the regulatory framework in place in the country/economy.[12] (Standard projects in a country like India suggest a gestation lag in the range of 3-4 years.[13]) Since all the prospective investors are

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[11] Dennis R. Capozza, Richard Green, Patrick H. Hendershott (1997) : "Taxes and House Prices", The Charles A. Dice Center Working Paper Series 97-16, Ohio State University.

[12] For examining the impact of the regulatory mechanism on the prices in housing sector, see S. Malpezzi and S. K. Mayo (1997), "Getting Housing Incentives Right: A Case Study of the Effects of Regulations, Taxes and Subsidies on Housing Supply in Malaysia", Land Economics, Vol 73, No.3. Using comparisons between US, Thailand, Malaysia and Korea, the paper concludes that countries with more stringent regulatory environments face less elastic supply of housing.

[13] New projects which are open for investments by prospective purchasers show a three year time frame. Since the project is already conceptualized and worked out before purchase options are made available to

not on board at the word go, the supply response could take anywhere between 6-9 years. In this if the industries which maintain a close backward linkage with construction are not operating with adequate capacities, the supply responses might be constrained to that extent. In the recent Indian experience, there is a rise in the prices of steel and cement, which suggests limitations in the supply responsiveness to expanded demand for housing in this country.

Another dimension to the expanded demand for credit and housing could be an overall increase in the interest rates prevailing in the economy. The tax incentives expand the scope of demand for housing loans and in the process allow the banks to get rid of their excess liquidity, resulting in higher interest rates, not only for the housing loans but for other loans as well. For the economy as a whole, this could discourage investment in other productive activities. Linking back to housing, the supply response of housing too could be impeded in the input producing industries. These effects would be further enhanced by government spending and/or support to low cost housing

All the above suggest that there are mechanisms whereby the gains from the incentive mechanism may not completely accrue to the intended beneficiaries. To the extent the penetration of the financial sector in financing housing purchases is limited, the impact too could be limited. While the lack of reliable data on the trends in real estate prices makes it difficult to rigorously assess whether there is any relation between the tax incentives offered and applicability of this theory, in what follows, an attempt is made to examine the available evidence in this context. The National Housing Bank has recently launched a Residex, to capture changes in housing prices over time. While this index has only just been launched for a few cities in India, it does capture the substantial increase in prices, during 2000-2005, a period which includes a sharp increase in the incentives as well. (See Table 4) Using alternative information on prices recorded in property transactions, one of the rare studies on potential bubbles in the Indian housing market concludes that amongst the various factors that have a bearing on housing prices in the

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the buyers, the overall time can be placed in the range of four years, at the minimum, provided the housing market does not experience a down turn on the interim.

period 2002 to 2005, interest rate and credit growth play a critical role (Joshi, 2006, RBI Occasional Papers). Together they explain a large part of the forecast error variance in housing prices. Further, the study also suggests that there is “low order of persistence of housing prices”, implying that a shock in these explanatory factors could induce a quick reversal in these prices. If the expansion in credit supply to housing sector is even partly explained by the increase in the incentive associated with servicing housing loans, the increase in prices of real estate too are at least partly, a result of this feature.

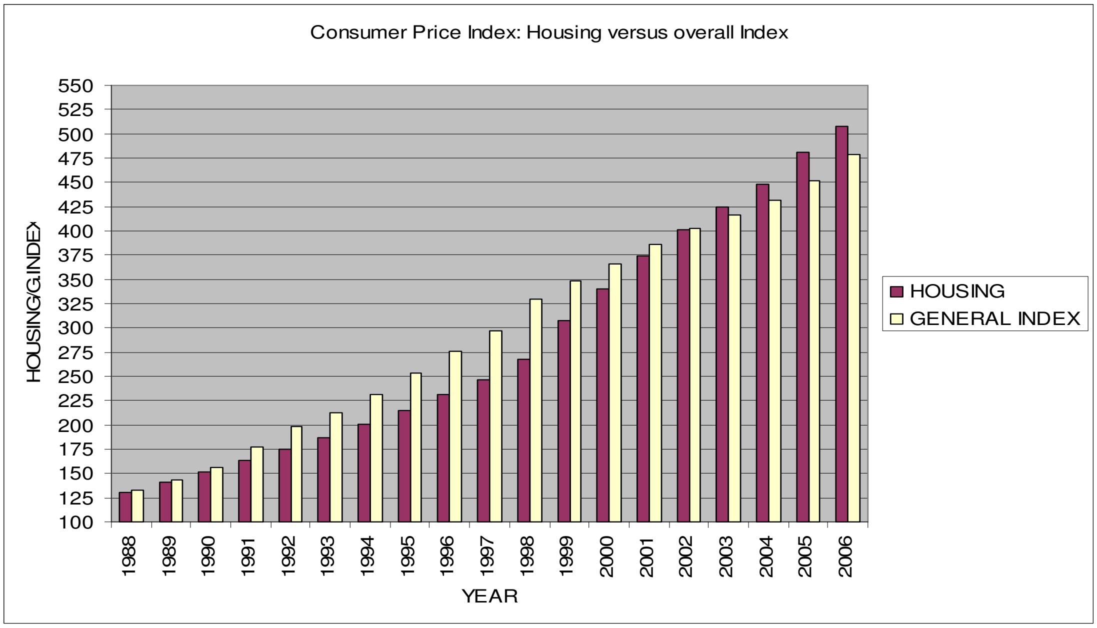
Table 4: Residex for select cities

City	2001	2002	2003	2004	2005
Delhi City	100	106	129	150	201
Mumbai City	100	116	132	149	178
Greater Mumbai City Corp.	100	119	136	159	198
Kolkata City	100	115	129	148	172
Kolkata Municipal Corp.	100	120	136	159	192
Bangalore City	100	133	170	224	275
Bhopal City	100	120	136	154	179

Source: National Housing Bank, 2007.

Corresponding to increases in real estate prices, there is evidence of an increase in rentals as well. The following graph presents the consumer price index for housing rentals and the overall index. While during the nineties, the overall index was growing faster than the cost of rentals, after 2000, the reverse appears to hold good – rentals costs grew faster than the overall index.

While the above does not provide conclusive evidence of a link between the enhanced incentives to the housing sector, it does raise the possibility of a relation between these two events. To the extent there is a relation, the gains to the intended beneficiaries are notional rather than actual.



Source: Computed from CPI (UNME).

4. Conclusions:

This sets out to ask the following questions in attempting to understand the benefits emanating out of the incentives provided to the housing sector.

1. Who are the beneficiaries
2. What is the extent of benefit
3. Is this tangible benefit?
4. what is the impact on the housing market

As discussed above, the incentive programme is targeting households with taxable income, since the form of incentives is a tax deduction. These correspond to households with loans larger than Rs 5 lakh. Given the average income in this category, these represent households with average annual income of Rs 4 lakh. From the survey reported in the Chapter 5 of Report on Trends and Progress of Housing in India, 2005, these loans correspond to an average size of property of 1400 sq. feet. By providing incentives, it is possible to argue, that all else remaining the same, the size of the house/ the size of loan taken by the household would be larger. The need to incentivise these households is not very clear. Interestingly, the incentive extends in an undiluted manner for households with loans upto Rs 15 lakh. These loans are provided for incomes of at least Rs 4.5 lakh per annum. The beneficiaries of these loans and incentives schemes therefore are the salaried middle income and high income households. (Self employed constitute less than 7 percent of borrowers in most loan slabs. Only for loans higher than Rs 10 lakh, the proportion is 18 percent.) The banks tend not to lend to low income households and the amounts of loan eligible are small and the absence of tax incentives for this set of people, makes the loans more expensive than would otherwise have been the case.

The extent of benefit for an individual borrower is assessed to be 29.5 percent of the loan amount in present value terms, for loans upto Rs 10 lakh and declines moderately thereafter. For a loan of Rs 20 lakh, the present value of benefit is 20 percent of the value of the loan. Since most of these borrowers have reasonable incomes, it is possible to argue that additional benefits under section 80C may not accrue. Even under this assumption, the benefits amount to 20 percent in present value terms for loan amounts upto Rs 15 lakh. On annualized basis, the extent of benefits delivered for all direct beneficiaries is worked out to be 0.984 percent of the stock of housing loans outstanding, under the conservative assumption that only benefits under section 24 are additional benefits for these households. The Report on Trends and Progress of Housing in India, 2005,[14] reports housing loans outstanding as a percentage of GDP as 7.25 percent in 2005 and estimated to climb to 8.5 percent in 2006 and further to 9 percent by the end of the Tenth Five Year Plan. Assuming that the level of 9 percent is reached and sustained, the implied benefits amount to Rs 4165 crore. Under the alternative assumption the benefits could be as high as Rs 7189 crore.

To the next pair of questions, as to whether these are tangible benefits, it would appear to the individual household that the benefits are tangible, since the performance of the market is taken as given. Section three seeks to raise the possibility that such incentives can induce an increase in price such that the gains are no longer appropriable by the investing households. The Residex, even though it is just beginning to take off, suggests substantial increases in prices co-terminus with the expansion in the incentives.

[14] National Housing Bank (2005): Report on Trend and Progress of Housing in India, http://nhb.org.in/Publications/Trend_&_Progress_2005.pdf

That in the context of these increases, the real benefits delivered by the tax policy are reduced is quite clear. To the extent a part of the stimulus for the price increase could be attributed to the tax policy itself, the policy could be counter-productive and yet divert investment from other potentially productive activities.

In the context of similar concessions for the United States, Glaeser and Shapiro (2002) conclude that

> The home mortgage interest deduction creates incentives to buy more housing and to become a homeowner, and the case for the deduction rests on social benefits from housing consumption and homeownership. Externalities from homeownership are larger, but the home mortgage interest deduction is a particularly poor instrument for encouraging homeownership since it is targeted at the wealthy, who are almost always homeowners. The irrelevance of the deduction is supported by the time series which shows that the ownership subsidy moves with inflation and has changed significantly between 1960 and today, but the homeownership rate has been essentially constant. [15]

One important reason why one does not expect a complete replication of the results obtained in the developed countries, is the relatively poor penetration of the financial markets for financing housing.

Finally, to ask most pertinent question in the context of incentives, would these investments in housing have taken place, if the incentive did not exist. Since the beneficiaries are from relatively higher income groups, it would appear that the activity would have existed while the scale might have been smaller. At the margin some expansion in demand too would have taken place. If one looks at the size profile of housing loans of scheduled commercial banks, the share of loans in the range Rs 5 lakh to Rs 50 lakh have increased the fastest, between March 31, 1999 and March 31, 2006. On the other hand, even the nominal credit extended to the lowest slab – less than Rs 25,000 – has declined. While this suggests some expansion in demand in the loan slabs corresponding to taxable incomes, the non-incentivised segments are either squeezed out

[15] Glaeser, Edward L. and Shapiro, Jesse M., "The Benefits of the Home Mortgage Interest Deduction" (October 2002). NBER Working Paper No. W9284. Available at SSRN: http://ssrn.com/abstract=342440

or priced out. If the discussion of housing incentives is located in the context of housing shortage in India, this would appear to be a perverse result.