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REFORMING THE MORTGAGE INTEREST DEDUCTION

by Jason Fichtner and Jacob Feldman



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Abstract

The \$69 billion mortgage interest deduction (MID) is often viewed as an element of the tax code that promotes middle-class prosperity. However, 64 percent of the benefits, as measured by effective tax reduction, goes to households earning more than \$100,000 per year. The large variation in nominal benefits is one of the reasons why many economists state that the MID is regressive. High-income earners average a tax benefit nearly nine times greater than a tax filer earning \$50,000–\$100,000. The effective tax reduction of the MID per return among tax filers earning between \$100,000 and \$200,000 is \$1,420. That is still nearly 10 times larger than the \$150 saved by taxpayers earning between \$30,000 and \$50,000. With 65.2 percent of all tax filers claiming to make less than \$50,000, only 9.8 percent of these returns used the mortgage interest deduction. In order to create a simpler, more efficient tax code, policymakers should take care to effectively align tax policy with housing objectives.

JEL codes: E62, H23, H71

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Reforming the Mortgage Interest Deduction

Jason Fichtner and Jacob Feldman

I. Introduction

The mortgage interest deduction (MID) is viewed by consumer advocates as a benefit for lower- and middle-income taxpayers.¹ Yet fewer than 9.8 percent of tax filers earning less than \$50,000 claim the MID, and these are the very same households that would gain the most from the sociological benefits of homeownership. The fact is that most of the dollar benefits from the MID go to high-income earners whose average tax benefit from the MID is nearly nine times greater than that of households earning \$50,000–\$100,000.

This paper examines two fundamental problems with the MID. First, the mortgage interest deduction, as currently structured, does not encourage greater homeownership, although it does encourage higher levels of debt and borrowing. The primary beneficiaries of tax-subsidized interest payments on housing are high-income earners who are more likely to own homes in the first place. The second problem is that the MID creates economic inefficiencies, particularly among high-income households, diverting resources from more socially valuable investments into larger homes. All else being equal, lower levels of economic efficiency mean fewer jobs and less prosperity.

One of the difficulties with today's tax code is that the closing of one loophole can merely result in a transfer of much of the government-subsidized spending to a different special tax provision. For example, when the tax deduction for consumer interest was eliminated in the Tax Reform Act of 1986, high-income earners increased their use of housing interest by 67–86

¹ Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in *Tax Policy and the Economy*, ed. James M. Poterba (Cambridge, MA: MIT Press, 2003), 17:37–82.

cents for every dollar lost in consumer interest.² Today there is still reason to believe that the existing tax bias toward housing is diverting resources away from other areas of the economy. Writing about a slightly different tax code in 2005, the US Treasury found that owner-occupied housing had a marginal effective tax rate of nearly 0 percent as a result of capital gains exclusion on the sale of primary residences, while noncorporate businesses and corporate businesses were taxed at 17 and 26 percent, respectively.³ In *Progressive Consumption Tax*, American Enterprise Institute economist Alan Viard and his coauthor, Robert Carroll, find that the existing tax code bias toward housing via the MID diverts resources away from other productive investments.⁴

The MID likely could be eliminated with minimal effects on low- and middle-income taxpayers because over 64 percent of the MID tax benefits go to tax filers earning more than \$100,000. Elimination of the MID in exchange for lower marginal rates and a higher standard deduction would represent a general improvement in the standard of living for almost all low- and middle-income taxpayers.

However, given the political constraints surrounding repeal of the MID, we also present a second-best option. If the federal government is going to maintain a tax-preferred housing policy with the goal of increasing homeownership, this policy should be effective. As this paper will show, the MID principally benefits households that would acquire homes even without the MID.

We suggest later in the paper that the MID could be reformed into a nonrefundable credit of

² Jonathan Skinner and Daniel Feenberg, “The Impact of the 1986 Tax Reform Act on Personal Saving” (NBER Working Paper No. 3257, National Bureau of Economic Research, February 1990), <http://www.nber.org/papers/w3257.pdf>; Dean M. Maki, “Household Debt and the Tax Reform Act of 1986,” *The American Economic Review* 91, no. 1 (March 2001): 305–19.

³ President’s Advisory Panel on Federal Tax Reform, “Simple, Fair, and Pro-growth: Proposals to Fix America’s Tax System,” November 2005 report, figure 5.5, “Comparison of Effective Tax Rates on Different Types of Investment,” <http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf>.

⁴ Alan D. Viard and Robert Carroll, *Progressive Consumption Tax: The X-Tax Revisited* (Washington, DC: AEI Press, 2012).

approximately \$1,070 that would encourage homeownership and provide a stronger benefit among low-income households—the households that stand to gain the most from the sociological benefits of homeownership. Adoption of a mortgage interest credit may increase homeownership among low- and middle-income households by as much as 5 percent while only decreasing homeownership rates among high-income households by 1 percent.

II. Who Benefits from the Mortgage Interest Deduction?

One of the most commonly cited justifications for the mortgage interest deduction is that the deduction promotes homeownership among the middle class and supports industries that employ middle-class workers.⁵ About six in every ten Americans oppose getting rid of the MID, and one out of every four claim it on tax returns.⁶ By an economic valuation, the MID is a sizable tax subsidy—the third-largest tax deduction in the code (behind the exclusion of employer contributions for medical insurance premiums and the exclusion of net imputed income), which decreased federal revenues by \$69 billion in 2013. (There was an additional \$160.6 billion of potentially forgone revenues for other housing credits and deductions in 2013 as well.)⁷ While the upper middle class does benefit from the deduction, the vast majority of the dollar benefits goes to higher-income taxpayers and little to no dollar benefits go to low-income households that purchase a home (see figure 1). On average, wealthier households borrow more debt and have higher rates of homeownership (see figure 2). One reason that low-income and many middle-income taxpayers

⁵ Rick Judson, “Keep Homeowners’ Tax Deduction: Opposing View,” *USAToday*, April 2, 2013, <http://www.usatoday.com/story/opinion/2013/04/02/mortgage-tax-deduction-editorials-debates/2047927/>.

⁶ Jeffrey M. Jones, “Americans Oppose Eliminating Income Tax Deductions,” Gallup Politics website, April 15, 2011, <http://www.gallup.com/poll/147125/americans-oppose-eliminating-income-tax-deductions.aspx>; Statistics of Income Division of the IRS, “2010 Estimated Data Line Counts Individual Income Tax Returns,” rev. 11-2012, <http://www.irs.gov/pub/irs-soi/10inlinecount.pdf>.

⁷ Office of Management and Budget, “Analytical Perspectives, Budget of the United States Government, Fiscal Year 2015,” March 4, 2014, p. 206, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/receipts.pdf>.

are unlikely to use the MID is that the standard deduction for an individual taxpayer in 2014 is \$6,200 (\$12,400 if married and filing a joint tax return). Unless annual mortgage interest expenses (combined with any other expenses that are allowed as itemized tax deductions) are greater than the standard deduction, a taxpayer will not opt to itemize deductions. Instead, the individual will take the simpler and more financially sound route of using the standard deduction.⁸

The purported public policy role of housing-related tax deductions and credits is to increase homeownership. In this section, we show how much of the MID goes to higher-income earners who would likely purchase homes even without the aid of the MID. Economists Edward Glaeser and Jesse Shapiro reached a similar conclusion—that the MID has little impact on the homeownership rate.⁹ As currently structured, the MID fails to significantly increase homeownership among its intended beneficiaries, and it encourages greater debt among homeowners.¹⁰ In short, the MID is generally giving a tax break to households that would likely purchase homes anyway and enabling high-income households to buy homes that are roughly 10–20 percent larger than those they would buy otherwise.¹¹ This paper does not examine the social benefits of owning a larger home, but section 3 does find a mix of social benefits and costs for homeownership.

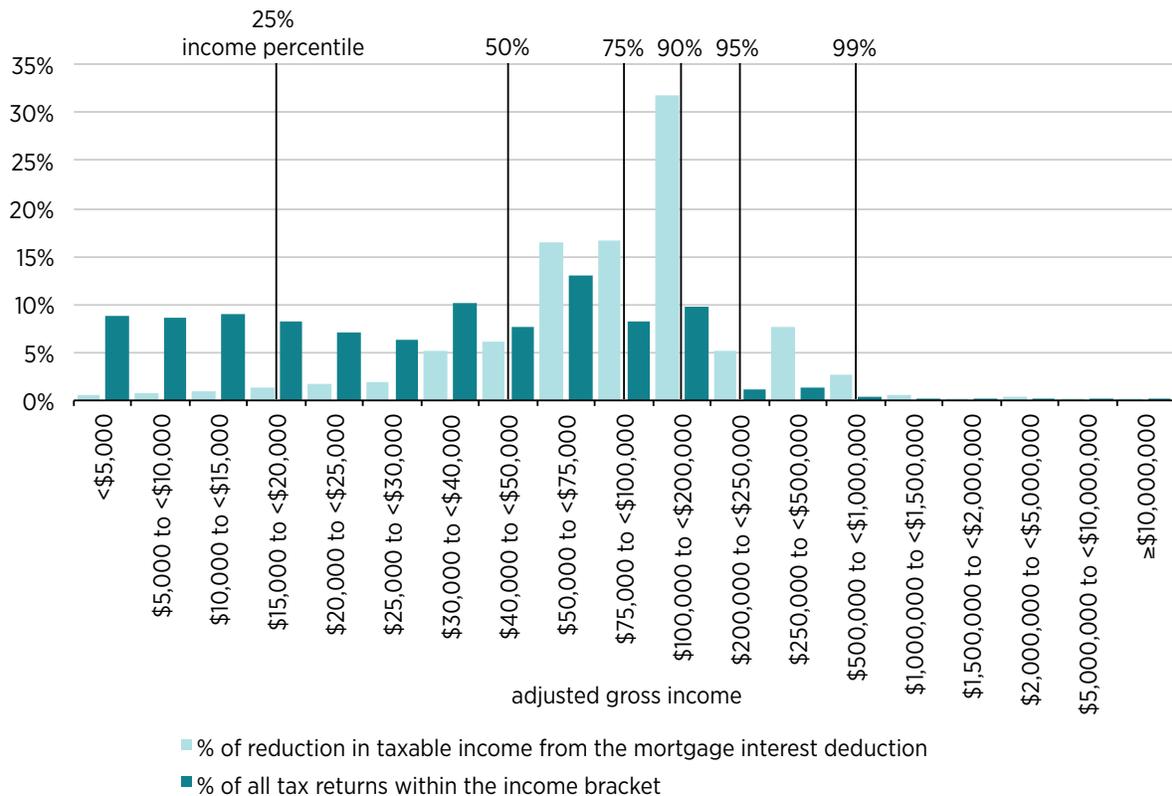
⁸ The standard deduction serves two important roles: to simplify the tax code and to favor lower-income taxpayers by making the tax code more progressive. Part of the design of the standard deduction is rendering it unnecessary for some taxpayers to track their tax-related expenditures throughout the year, since that cumulative effort wouldn't exceed the standard deduction. For millions of taxpayers, simply taking the standard deduction saves time and resources. However, the standard deduction is also designed to reduce the taxable income of low-income taxpayers, regardless of whether any tax-related expenditures have been incurred. (Along these lines, tax-related expenditures might be viewed as having gone to waste. In short, in a world where there must be tax-favored spending, it seems that increasing the number of low- and middle-income housing units would reap more social benefits than an equal amount of money in subsidies given to high-income earners.)

⁹ Glaeser and Shapiro, "Benefits of the Home Mortgage Interest Deduction."

¹⁰ David C. Ling and Gary A. McGill, "Evidence on the Demand for Mortgage Debt by Owner-Occupants," *Journal of Urban Economics* 44, no. 3 (1998): 391–414; James R. Follain and Lisa Sturman Melamed, "The False Messiah of Tax Policy: What Elimination of the Home Mortgage Interest Deduction Promises and a Careful Look at What It Delivers," *Journal of Housing Research* 9, no. 2 (March 2000): 179–99.

¹¹ John E. Anderson, Jeffrey Clemens, and Andrew Hanson, "Capping the Mortgage Interest Deduction," *National Tax Journal* 60, no. 4 (December 2007): 769–85; Harvey S. Rosen, "Housing Decisions and the U.S. Income Tax: An Econometric Analysis," *Journal of Public Economics* 11, no. 1 (February 1979): 1–23.

Figure 1. Benefits of the Mortgage Interest Deduction by Adjusted Gross Income



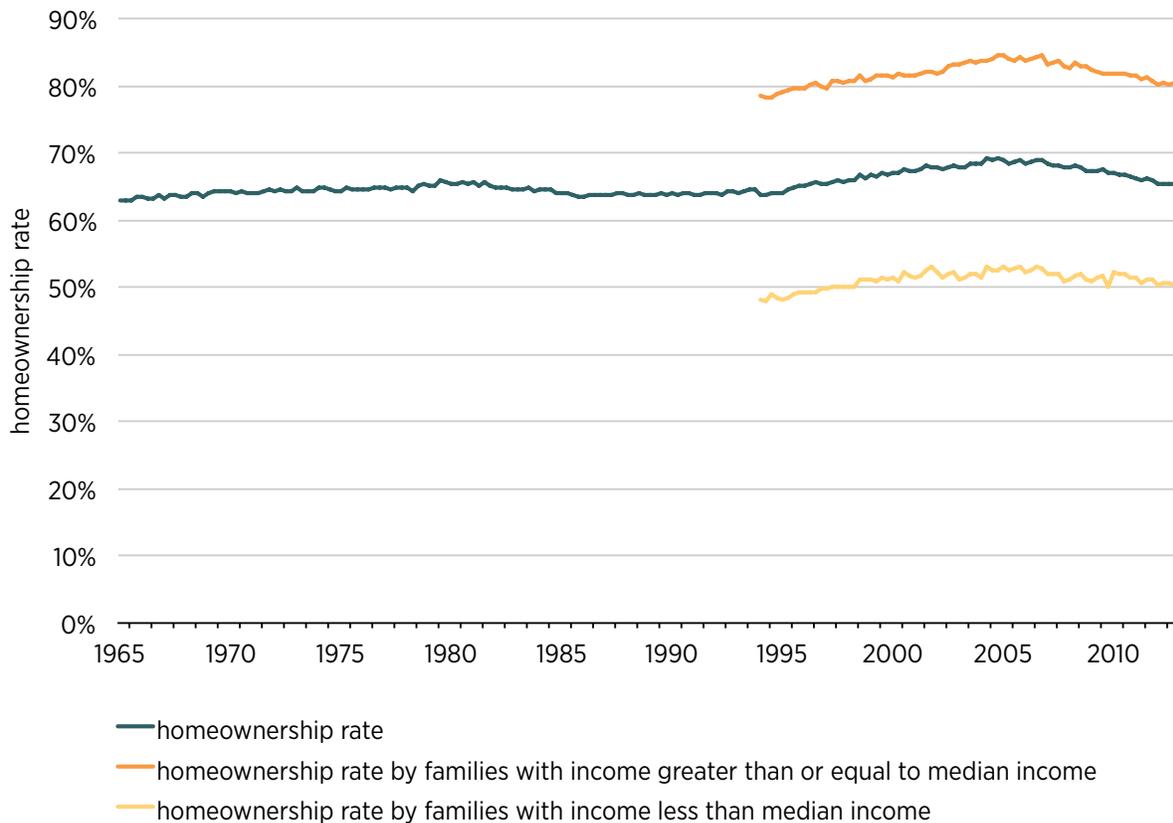
Source: Authors’ calculations, using data from the Statistics of Income Division of the IRS, table 1.1, “All Returns: Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2010,” July 2012, http://www.irs.gov/file_source/PUP/taxstats/indtaxstats/10in11si.xls, and table 3.1, “Returns with Modified Taxable Income: Adjusted Gross Income and Tax Items,” 2010, http://www.irs.gov/file_source/PUP/taxstats/indtaxstats/10in31mt.xls.

Figure 2 shows that the homeownership rate is distinctly higher for households with incomes greater than the median, suggesting that, not surprisingly, income is a significant determinant of homeownership. Figure 2 also suggests that the MID is not a significant equalizer of outcome when it comes to homeownership. According to a 1997 paper, 45 percent of the aggregate benefit of the mortgage interest deduction went to the 9.8 percent of taxpayers with incomes over \$100,000.¹² Compared to 1997 nominal household income in 2010, 48.5 percent of

¹² Richard K. Green and Andrew Reschovsky, “The Design of a Mortgage Interest Tax Credit,” Final Report submitted to the National Housing Institute, September 1997.

the aggregate benefit of the mortgage interest deduction goes to 13 percent of taxpayers with incomes over \$100,000 (see table 2, “Reduction in taxable income from MID” row).¹³

Figure 2. Homeownership Rate by Income



Source: Authors’ calculations, using data from the US Census Bureau. Homeownership rates above and below median family income not available before 1993.

¹³ Authors’ calculations. Internal Revenue Service, “Individual Income Tax Returns, Preliminary Data, 2010,” *SOI Bulletin: A Quarterly Statistics of Income Report* 31, no. 3 (Winter 2012): figure A, pp. 6–8, <http://www.irs.gov/pub/irs-soi/12winbul.pdf>. An inflation-adjusted income would be approximately \$136,000 in 2010. Unfortunately, more specific data on MID use could not be obtained. IRS data only examine adjusted gross income in a distribution ranging from \$100,000 to \$200,000.

Table 1. Homeownership Rates and Mortgage Interest Deductibility for Selected Countries

Country	Percentage	Mortgage interest is deductible	Country	Percentage	Mortgage interest is deductible
Singapore	87%	NO	United States	65%	YES
Taiwan	84%	YES ^(a)	Finland	64%	YES
Spain	82%	YES	Belgium	63%	YES ^(b)
Ireland	77%	YES	Japan	61%	NO
Norway	77%	YES	Sweden	60%	YES
Portugal	75%	YES	Poland	59%	NO ^(b)
Greece	72%	YES ^(b)	France	55%	NO ^(c)
Italy	71%	NO	Korea	54%	NO
Australia	70%	NO	Netherlands	50%	YES ^(b)
Canada	68%	NO	Austria	49%	YES
United Kingdom	68%	NO	Germany	42%	NO
New Zealand	67%	NO	Switzerland	35%	YES ^(b)

(a) Although Taiwan has a mortgage interest deduction, it is tied to another deduction that is available to renters. Steven C. Bourassa and Chieng-Wen Peng, “Why Is Taiwan’s Homeownership Rate So High?,” *Urban Studies* 48, no. 13 (2011), 2887–904.

(b) Greece, Belgium, Poland, the Netherlands, and Switzerland all have imputed rent taxes, although Greece’s applies only to large dwellings. Calista Cheung, “Policies to Rebalance Housing Markets in New Zealand” (Working Paper No. 878, OECD Economics Department, 2011).

(c) France instated mortgage interest credits for first-time buyers in 2007 but abolished them in 2011.

Source: Steven C. Bourassa et al., “Mortgage Interest Deductions and Homeownership: An International Survey” (Swiss Finance Institute Research Paper Series 12-06, February 9, 2012), http://hofinet.org/upload_docs/UPLOADED_int%20survey%20mortgage%20interest%20deductions%202012.pdf.

Many other countries also have a mortgage interest deduction. While many social and economic factors contribute to a country’s homeownership rate, a side-by-side comparison of various countries indicates an inconclusive relationship between the MID and homeownership (see table 1). In the case of the United Kingdom, which phased out the MID between 1975 and 2000, the homeownership rate rose from 53 percent in 1974 to 68 percent in 2001.¹⁴ Despite the lack of a statistically strong relationship between tax subsidies and homeownership rates, the

¹⁴ Will Fischer and Chye-Ching Huang, “Mortgage Interest Deduction Is Ripe for Reform: Conversion to Tax Credit Could Raise Revenue and Make Subsidy More Effective and Fairer,” Center on Budget and Policy Priorities, June 25, 2013, <http://www.cbpp.org/files/4-4-13hous.pdf>.

United States boasts the world's most generous tax code for owner-occupied housing.¹⁵ Much of the justification for these owner-occupied housing subsidies is focused on encouraging individuals to have better household saving plans. Yet, as Yale economist Robert Shiller points out, other foreign countries such as Switzerland have higher rates of household saving even without high homeownership rates.¹⁶

A successful tax-favored housing policy would be designed to encourage inframarginal households to purchase a home—homeowners who would like to own homes but would not do so without a federal subsidy.¹⁷ In 1973, former Assistant Secretary of the Treasury Stanley Surrey wanted to reform the MID in order to subsidize such households.¹⁸ However, the decision to purchase a home is influenced by a variety of factors, including socio-economic characteristics, income, and local housing prices. Economists Peter Brady, Julie-Anne Cronin, and Scott Houser examined some primary factors in the decision to itemize deductions: income, various demographics, and housing prices, as well as federal, state, and local tax policies.¹⁹ Brady, Cronin, and Houser conclude that over 60 percent of the probability in itemizing deductions versus taking the standard deduction is accounted for by regional variation in housing prices and housing tax policies. For many low- and middle-income taxpayers, these tax-favored housing policies are often out of reach because the itemized benefit of the MID is not greater than the standard deduction otherwise taken (\$6,200 for individuals and \$12,400 for joint filers).

¹⁵ David Ling and Gary A. McGill, "The Variation of Homeowner Tax Preferences by Income, Age and Leverage," *Real Estate Economics* 35, no. 4 (2007): 505–39.

¹⁶ Robert J. Shiller, "Owning a Home Isn't Always a Virtue," *New York Times*, July 13, 2013, <http://www.nytimes.com/2013/07/14/business/owning-a-home-isnt-always-a-virtue.html>.

¹⁷ Calvin H. Johnson, "Was It Lost? Personal Deductions under Tax Reform," *SMU Law Review* 59, no. 2 (August 23, 2006), <http://www.utexas.edu/law/faculty/calvinjohnson/WasItLost.pdf>.

¹⁸ Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge, MA: Harvard University Press, 1973).

¹⁹ Peter Brady, Julie-Anne Cronin, and Scott Houser, "Regional Differences in the Utilization of the Mortgage Interest Deduction," *Public Finance Review* 31, no. 4 (2003): 327–66.

In many cases, it is a rational decision to use the MID, and any other applicable itemized tax deductions, only if one earns a certain level of income. According to IRS data, it is only after reaching \$100,000 in income that three-fourths of those tax filers use the MID (see table 2). A reform that increased low-income access to housing tax policies would increase the relative importance of demographics and housing prices in the decision to purchase a home by a lower-income taxpayer.

Use of the MID by high-income taxpayers can be discouraged by lowering the marginal tax rates. Economists James Follain and David Ling put it this way: “All else equal, these reductions in marginal tax rates lower the subsidy to housing.”²⁰ As income increases, taxpayers increasingly benefit from the MID. Looking at the most recent data, from 2010, households in the bottom 65 percent of the income distribution obtained 18 percent of the reduction in taxable income from the MID while households in the top 35 percent of the income distribution accounted for 82 percent of the reduction in taxable income (see table 2, “Reduction in taxable income from MID” and “All tax returns” rows).²¹

However, these measurements of taxable income understate the realized benefit of the deduction to higher-income households. Because higher-income taxpayers pay a higher marginal rate on their taxable income, any deduction that decreases taxable income is more valuable to a high-income taxpayer than to a low-income taxpayer. When looking at the aggregate effective tax break for low-income households compared to high-income households, the 2 percent of income earners who make more than \$250,000 receive nearly 25 times more from the MID than wage earners of less than \$15,000 (see table 2).

²⁰ James R. Follain and David C. Ling, “The Federal Tax Subsidy to Housing and the Reduced Value of the Mortgage Interest Deduction,” *National Tax Journal* 44, no. 2 (June 1991): 147–68.

²¹ Internal Revenue Service, “Individual Income Tax Returns, Preliminary Data, 2010.”

Table 2. Benefits of the Mortgage Interest Deduction (MID) by Income, 2010

	<\$15,000	\$15,000 to <\$30,000	\$30,000 to <\$50,000	\$50,000 to <\$100,000	\$100,000 to <\$200,000	\$200,000 to <\$250,000	≥\$250,000	ALL
All tax returns	35,036,910	30,890,795	25,621,630	30,627,721	14,008,889	1,537,297	2,738,863	140,462,105
Itemized tax returns	1,872,849	3,875,849	7,500,859	17,272,112	11,881,416	1,451,691	2,650,754	46,505,530
Tax returns claiming MID	1,036,535	2,409,435	5,511,974	14,025,505	10,157,415	1,193,764	2,027,798	36,362,426
Percentage of all returns claiming MID	2.96%	7.80%	21.51%	45.79%	72.51%	77.65%	74.04%	25.89%
Percentage of itemized returns claiming MID	55.35%	62.17%	73.48%	81.20%	85.49%	82.23%	76.50%	78.19%
Reduction in taxable income from MID (\$1,000)	\$8,229,943	\$18,121,315	\$42,626,632	\$127,173,272	\$122,119,547	\$19,521,612	\$42,883,844	\$380,676,165
Reduction in taxable income from MID per return	\$230	\$590	\$1,660	\$4,150	\$8,720	\$12,700	\$15,660	\$2,710
Reduction in taxable income from MID per itemized return	\$4,390	\$4,680	\$5,680	\$7,360	\$10,280	\$13,450	\$16,180	\$8,190
Average reduction in taxable income from MID per returns claiming MID	\$7,940	\$7,520	\$7,730	\$9,070	\$12,020	\$16,350	\$21,150	\$10,470
Effective tax rate (all returns)	5.81%	6.25%	8.83%	11.59%	16.34%	21.72%	27.37%	17.33%
Effective tax reduction of MID / static revenue loss (\$1,000)	\$478,263	\$1,132,671	\$3,765,705	\$14,739,119	\$19,950,535	\$4,239,460	\$11,736,078	\$56,041,831
Effective tax reduction of MID per return	\$14	\$37	\$147	\$481	\$1,424	\$2,758	\$4,285	\$470

Source: Authors' calculations. Internal Revenue Service, *SOI Bulletin: A Quarterly Statistics of Income Report* 31, no. 3 (Winter 2012), figure A, pp. 6–8, <http://www.irs.gov/pub/irs-soi/12winbul.pdf>.

When looking at the average effective tax breaks per return, the difference between income brackets is even greater, since less than 3 percent of households earning less than or equal to \$15,000 claim the mortgage interest deduction. The average effective tax reduction for each return among the lowest-income families is \$14. Compare that to the average \$4,285 of tax reduction benefits for tax filers claiming to have earned \$250,000 or more. The large variation in nominal benefits is one of the reasons why many economists state that the MID is a regressive tax policy. High-income earners average a nearly nine times greater tax benefit than the average tax filer earning \$50,000–\$100,000 (see table 2). The effective tax reduction of the MID per return among tax filers earning between \$100,000 and \$200,000 is \$1,424. That is still nearly 10 times larger than the \$147 saved by taxpayers earning between \$30,000 and \$50,000.

In terms of effective tax reduction, households earning more than \$100,000 (13 percent of tax returns) receive more than \$35 billion in tax reductions, while households earning less than \$50,000 (65 percent of households) receive a little more than \$5 billion. Less than 20 percent of all income tax returns reporting less than \$40,000 in earnings claim the mortgage interest deduction while approximately 75 percent of income returns with reported earnings between \$100,000 and \$1,000,000 claim the MID (see table 3). Because of these extreme differences in who benefits from the MID, many scholars find that the MID is highly skewed toward high-income households.²²

²² Follain and Ling, “Federal Tax Subsidy to Housing.” Although the alternative minimum tax (AMT) limits the deductibility of all itemized deductions for some high-income taxpayers, there is still some benefit to itemizing and claiming the mortgage interest deduction. The regular income tax allows a taxpayer to deduct mortgage interest from a primary residence on the primary mortgage as well as interest on a home equity line of credit (up to \$100,000 of loan value). Under the AMT, however, the interest on home equity is disallowed; the primary mortgage is allowed but limited.

Table 3. Percentage of Taxpayers Claiming the Mortgage Interest Deduction in 2010, by Income Range

Adjusted gross income range	Share who itemize mortgage interest deduction
ALL	25.86%
<\$5,000	1.97%
\$5,000–\$9,999	2.77%
10,000–\$14,999	3.85%
\$15,000–\$19,999	5.78%
\$20,000–\$24,999	8.02%
\$25,000–\$29,999	11.45%
\$30,000–\$39,999	17.80%
\$40,000–\$49,999	27.38%
\$50,000–\$74,999	40.45%
\$75,000–\$99,999	56.21%
\$100,000–\$199,999	73.28%
\$200,000–\$249,999	78.63%
\$250,000–\$499,999	77.54%
\$500,000–\$999,999	72.64%
\$1,000,000–\$1,499,999	66.37%
\$1,500,000–\$1,999,999	64.57%
\$2,000,000–\$4,999,999	60.98%
\$5,000,000–\$9,999,999	53.99%
>\$9,999,999	47.39%

Source: Authors’ calculations, using data from the Statistics of Income Division of the IRS.

In addition to favoring higher-income earners, many of the federal benefits of the MID favor particular geographical locations. According to economists Todd Sinai and Joseph Gyourko’s study on tax-favored housing between 1980 and 2000, the biggest benefits went in descending order to Washington, DC; Hawaii; California; New York; Massachusetts; Connecticut; and New Jersey—five of which are among the top fourteen of median state incomes.²³ Owner-occupied benefits exceeded \$8,000 in each of these high-income states, which also have the highest state marginal tax rates. In a separate study, Gyourko and Sinai found that three metro areas—New York–northern New Jersey, Los Angeles–Riverside–

²³ Todd Sinai and Joseph Gyourko, “The (Un)changing Geographical Distribution of Housing Tax Benefits: 1980 to 2000,” in *Tax Policy and the Economy* (Cambridge, MA: MIT Press/NBER, 2004), 18:175–208; US Census Bureau, “Median Household Income (in 2012 Inflation-Adjusted Dollars) by State Ranked from Highest to Lowest Using 3-Year Average: 2010–2012,” http://www.census.gov/hhes/www/income/data/incpovhlth/2012/stateonline_12.xls.

Orange County, and San Francisco–Oakland–San Jose—received five percent of net positive benefits from the MID.²⁴

Even MID state tax policies suffer from equity and efficiency problems similar to those of the federal tax policy. As Richard Green and Andrew Reschovsky put it, “In 33 of the 42 states with individual incomes taxes, mortgage interest is deductible in the calculation of state income tax liabilities, further increasing the tax subsidy to homeownership.”²⁵ In fact, all states with an MID (except for Alabama) favor high-income households relative to middle-income households.²⁶ The table in the appendix (page 29) shows a state-by-state comparison of the percentage point reduction in effective tax rates among households with \$50,000 in earnings and those with \$200,000 in earnings that claim a state MID. The third column of table 5 ranks the difference in effective tax rate reduction by state. The data suggest that state MIDs also offer a more significant decrease in effective tax rates for high-income earners than for middle-income households. Thus, the economic distortions caused by the state MIDs, and their regressive effects, go even beyond the federal level.

The demographics of the main beneficiaries of the MID are more particular than just income and geography. Because the MID is something that is utilized over an extended time, MID users who just purchased a home have a particularly strong interest in its continuation. Thus, young, high-earning homeowners would be most disadvantaged by its repeal.²⁷ There is

²⁴ Joseph Gyourko and Todd Sinai, “Spatial Distribution of Mortgage Deduction Benefits across and within Metropolitan Areas in the United States,” in *Using Tax Policy to Increase Homeownership among Low- and Moderate-Income Households*, ed. Richard Green and Andrew Reschovsky (New York: Ford Foundation, 2001), 137–86.

²⁵ Green and Reschovsky, “Design of a Mortgage Interest Tax Credit.”

²⁶ Donald Morris and Jing Wang, “How and Why States Use the Home Mortgage Interest Deduction,” *Tax Notes* (June 4, 2012): 697–713. The specific policy reason for this statistical anomaly in Alabama is unclear. However, the state of Alabama has a very low standard deduction amount, which likely results in more people itemizing deductions on their Alabama state tax return as compared with other states. The data used come from the IRS tables referenced in the paper.

²⁷ James M. Poterba and Todd Sinai, “Revenue Costs and Incentive Effects of the Mortgage Interest Deduction for Owner-Occupied Housing,” *National Tax Journal* 62, no. 2, part 2 (June 2011): 531–64.

also evidence suggesting that two-earner households would be particularly affected by changes to the MID, as they tend to use greater amounts of debt to finance their homes.²⁸

Thus, the MID frequently gives higher-income taxpayers a tax deduction for a purchase that they would have made anyway.²⁹ Economists Glaeser and Shapiro conclude that the MID does little to increase the homeownership rate; rather it increases the demand for debt and modifies the progressivity of the tax code.³⁰ A similar conclusion was reached in a 2011 article published in *Real Estate Economics* by Thomas Boehm and Alan Schlottmann. They find that across the 1970s and through the 1990s, the MID increased demand for housing between 2.6 and 3.5 percentage points, but that the MID may have had greater influence in the 1970s and 1980s because of an increased likelihood that a given person was a homeowner in the 1990s.³¹

An effective federal tax policy that promotes homeownership should ensure that the tax benefits go to households at the margin, those that would not necessarily purchase a home without the tax benefit. As long as housing tax policy exists, it should be designed to encourage access to the sociological benefits among potential homeowners who would not otherwise buy a home. We document some of these sociological benefits in the next section.

III. Benefits and Costs of Homeownership

These sociological benefits are a summary of research on the positive and negative social externalities associated with homeownership. To the extent that the MID increases homeownership rates, these sociological issues are influenced by tax policy as well (see table 4).

²⁸ Ling and McGill, “Evidence on the Demand for Mortgage Debt by Owner-Occupants.”

²⁹ Green and Reschovsky, “The Design of a Mortgage Interest Tax Credit.”

³⁰ Glaeser and Shapiro, “The Benefits of the Home Mortgage Interest Deduction.”

³¹ Thomas P. Boehm and Alan M. Schlottmann, “Market Conditions and Housing Choices: A Comparison of Homeownership across Three Decades,” *Real Estate Economics* 39 (2011): 547–600.

Positive externalities from homeownership include benefits to the next generation as well as better property maintenance and stronger communities. In their 1997 study, economists Richard Green and Michelle White find that children of homeowners were 9 percent more likely to stay in school than the children of renters.³² Green and White monetized the value of a low-income renter becoming a homeowner at \$31,000.³³ Economists Glaeser and Shapiro also find evidence that homeowners take better care of their property and tend to work harder at making their community more pleasant. Homeowners tend to be more interested in their community because of high mobility costs and because their assets are tied to the quality of their community.³⁴ These fixed interests also lead homeowners to be more involved politically.

Greater political activity around a set of concentrated interests can also produce negative externalities. According to Richard Voith, a former economist at the Federal Reserve Bank of Philadelphia, the mortgage interest deduction promotes zoning laws that increase neighborhood gentrification. For example, a zoning law that mandates a minimum lot size works in favor of high-income households and against low-income households, making lot purchases cost prohibitive for some low-income households. Hence, larger suburban plots attract higher-income households while low-income households are concentrated in older, denser city neighborhoods.³⁵ Gentrification can have significant implications for the provision of certain public goods and for school systems.

³² Green, and White, “Measuring the Benefits of Homeowning.”

³³ Assumes each household has exactly one child. The benefit is higher with an increased number of children.

³⁴ Glaeser and Shapiro, “The Benefits of the Home Mortgage Interest Deduction.”

³⁵ Richard Voith, “Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?,” *Business Review* (March 1999): 3–16.

Table 4. Positive and Negative Externalities of Homeownership

POSITIVE EXTERNALITIES	
Better property maintenance	Rental homes depreciate at a faster rate than owner-occupied single-family homes. ^(a)
More pleasant community	A significant amount of spending in expensive areas of the country is on land or community amenities. ^(b) Homeowners are more likely to make political choices that favor the long-run health of their community (as measured by school funding and road maintenance). Municipalities with a higher level of renters, who have an incentive to favor policies with short-run gains, vote for policies favoring social welfare and hospitals. ^(c) Homeowners are more likely to invest in communities because of the high cost of moving. ^(c)
More politically informed residents	Homeowners are more likely to be informed about political figures and to be active in local politics. ^(d)
More successful children	Children of homeowners are 9 percent less likely to drop out of school than children of comparable renters. ^(e)
NEGATIVE EXTERNALITIES	
More unemployment	Higher homeownership rates lead to high levels of unemployment. Areas with renters can move more quickly in response to an economic shock. ^(f)
More income segregation	Encouraging more housing consumption encourages wealthier people to leave small city apartments for larger homes on the fringe of the city, thereby imposing negative social costs on people remaining in the city and increasing segregation by income. ^(g) Homeownership can cause political behavior that restricts the supply of new housing via zoning and other land-use controls in order to raise prices. ^(h)

Sources: Edward L. Glaeser and Jesse M. Shapiro, “The Benefits of the Home Mortgage Interest Deduction,” in *Tax Policy and the Economy*, ed. James M. Poterba (Cambridge, MA: MIT Press, 2003) 17:37–82.

(a) Denise DiPasquale and Edward L. Glaeser, “Incentives and Social Capital: Are Homeowners Better Citizens?,” *Journal of Urban Economics* 45, no. 2 (March 1999): 354–84; James Shilling, C. F. Sirmans, and Jonathan Dombrow, “Measuring Depreciation in Single-Family Rental and Owner-Occupied Housing,” *Journal of Housing Economics* 1, no. 4 (December 1991): 368–83; George Galster, “Empirical Evidence on Cross-Tenure Differences in House Maintenance and Conditions,” *Land Economics* 59, no. 1 (February 1983): 107–13.

(b) Edward L. Glaeser and Joseph Gyourko, “Urban Decline and Durable Housing” (NBER Working Paper No. 8598, National Bureau of Economic Research, November 2001).

(c) DiPasquale and Glaeser, “Incentives and Social Capital”; Albert Monroe, “The Effects of Homeownership on Communities” (PhD diss., Harvard University, May 2001).

(d) Glaeser and Shapiro, “Benefits of the Home Mortgage Deduction.”

(e) Richard Green and Michelle White, “Measuring the Benefits of Homeowning: Effects on Children,” *Journal of Urban Economics* 41, no. 3 (May 1997): 441–461.

(f) Andrew J. Oswald, “The Housing Market and Europe’s Unemployment: A Non-technical Paper” (University of Warwick working paper, 1999).

(g) Richard Voith, “Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?,” *Federal Reserve Bank of Philadelphia Business Review* (March 1999): 3–16.

(h) Glaeser and Shapiro, “Benefits of the Home Mortgage Deduction.”

Other authors, including Henry Aaron, Harvey Rosen, Kenneth Rosen, James Poterba, and Edwin Mills, have examined social costs associated with the MID.³⁶ This paper does not attempt to conclude whether the externalities from homeownership are a net social gain or net social loss. However, it seems likely that the impact of any positive externalities from homeownership would be relatively greater for low-income workers, compared to high-income households, which might lack the same social or economic capital.

IV. Economics of the Mortgage Interest Deduction

In addition to the sociological impacts of the MID, there are economic and policy implications. One of the main objections to the MID is that preferential housing encourages overinvestment in housing. This malinvestment in housing occurs at the expense of investments in plants and equipment.³⁷ Although the MID has little effect on the homeownership rate, it does have a significant role in increasing the amount of debt and the size of the home purchased. Studies estimate that the MID encourages people to acquire homes that are 10–20 percent larger than they would have purchased without the MID.³⁸

These dollars should be invested at the most economically efficient point. Tax deductions create an artificially low hurdle for investment dollars. The healthiest economy is one where the most valued investments are not disincentivized for government-favored alternatives.

³⁶ Henry J. Aaron, *Shelter and Subsidies: Who Benefits from Federal Housing Policies?* (Washington: Brookings Institution, 1972); Harvey S. Rosen and Kenneth T. Rosen, “Federal Taxes and Homeownership: Evidence from Time Series,” *Journal of Political Economy* 88, no. 1 (February 1980): 59–75; Harvey S. Rosen, “Housing Behavior and the Experimental Housing Allowance Program: What Have We Learned?” (NBER Working Paper No. 657, National Bureau of Economic Research, May 1985); James M. Poterba, “Tax Subsidies to Owner-Occupied Housing: An Asset-Market Approach,” *Quarterly Journal of Economics* 99, no. 4 (November 1984): 729–52; James M. Poterba, “Taxation and Housing: Old Questions, New Answers,” *American Economic Review* 82, no. 2 (May 1992): 237–42; Edwin S. Mills, “Dividing Up the Investment Pie: Have We Overinvested in Housing?,” *Federal Reserve Bank of Philadelphia Business Review* (March 1987): 13–23.

³⁷ Green and Reschovsky, “Design of a Mortgage Interest Tax Credit.”

³⁸ Anderson, Clemens, and Hanson, “Capping the Mortgage Interest Deduction”; Rosen, “Housing Decisions and the U.S. Income Tax.”

In the past, taxpayers have reshuffled their investment portfolios in response to changes in the tax code. For example, when the Tax Reform Act of 1986 ended the deductibility of consumer debt, high-income taxpayers increased their consumption of the MID. Economists Jonathan Skinner and Daniel Feenberg found that high-income earners increased their consumption of interest on housing by 67–86 cents for every dollar decrease in consumer interest paid.³⁹ An *American Economic Review* article by Dean Maki came to similar conclusions.⁴⁰

Another important implication of the Skinner and Feenberg study is that estimates about revenue lost from the MID overstates the true loss in revenues. Taxpayers adjust their behavior in response to changes in tax-preferred investments in order to minimize their tax burden. These behavioral responses reduce the revenue that could be expected by ending any given tax expenditure. First, revenues may be lower than anticipated because taxpayers would transfer some investments into a different form of tax-preferred investment. Second, if mortgage interest were no longer a tax-preferred investment, taxpayers would draw down on holdings of interest, dividends, and capital gains in order to reduce owed principal and interest payments. Because other forms of taxable income would be drawn upon to lower outstanding debt, there would be less revenue gained by taxing those alternative forms of investment.⁴¹ As a result, there are a variety of estimates about what portion of the MID would be collected in the provision's absence: James Follain and Lisa Sturman Melamed estimate 25 percent; Martin Gervais and Manish Pandey estimate 58 percent; William Gale, Jonathan Gruber, and Seth Stephens-Davidowitz estimate 84 percent; and James Poterba and Todd Sinai estimate 80

³⁹ Skinner and Feenberg, "Impact of the 1986 Tax Reform Act."

⁴⁰ Maki, "Household Debt and the Tax Reform Act of 1986."

⁴¹ Poterba and Sinai, "Revenue Costs and Incentive Effects."

percent.⁴² Therefore, even if the mortgage interest deduction were eliminated, it would not lead to an instant \$69 billion in annual tax revenue for the US Treasury.⁴³

Last, the MID increases the demand for housing, thus increasing the price of homes and interest rates as well. Estimates of how much the MID increases housing prices range between 10 and 15 percent.⁴⁴ Lawrence Yun, the chief economist for the National Association of Realtors, claims that eliminating the mortgage interest deduction would result in trillions of dollars of wealth destruction and uncertainty. One study finds that the increase in housing prices is largely driven by the demand for homes that are 10–20 percent larger than the homes buyers would choose in the absence of the MID.⁴⁵ Marquette University economist Andrew Hanson estimates that the MID increases home sizes by as much as 1,400 square feet.⁴⁶ A rise in homeownership rates further increases local prices, perhaps by as much as a 1.5 percent for every 1 percent increase in homeownership.⁴⁷ All else being equal, because the MID increases the demand for debt, banks lend funds at a higher interest rate. Andrew Hanson estimates that 9 to 17 percent of the MID subsidy is offset by higher interest rates.⁴⁸

⁴² Follain and Melamed, “False Messiah of Tax Policy”; Martin Gervais and Manish Pandey, “Who Cares about Mortgage Interest Deductibility?,” *Canadian Public Policy* 34, no. 1 (2008): 1461–89; William Gale, Jonathan Gruber, and Seth Stephens-Davidowitz, “Encouraging Homeownership Through the Tax Code,” *Tax Notes* (June 18, 2007): 1171–89; Poterba and Sinai, “Revenue Costs and Incentive Effects.”

⁴³ Office of Management and Budget, “Analytical Perspectives, Budget of the United States Government, Fiscal Year 2015,” March 4, 2014, p. 206, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/receipts.pdf>.

⁴⁴ Lawrence Yun, “Why the MID Deserves to Stay,” *Realtor Mag* (September 2010), <http://realtormag.realtor.org/news-and-commentary/economy/article/2010/09/why-mid-deserves-stay>; Dennis R. Capozza, Richard Green, and Patric H. Hendershott, “Taxes, Mortgage Borrowing, and Residential Land Prices,” in *Economic Effects of Fundamental Tax Reform*, ed. Henry J. Aaron and William G. Gale (Washington, DC: Brookings Institution Press, 1966), 171–210.

⁴⁵ Anderson, Clemens, and Hanson, “Capping the Mortgage Interest Deduction”; Rosen, “Housing Decisions and the U.S. Income Tax.”

⁴⁶ Andrew Hanson, “Size of Home, Homeownership, and the Mortgage Interest Deduction,” *Journal of Housing Economics* 21, no. 3 (September 2012): 195–210.

⁴⁷ Glaeser and Shapiro, “Benefits of the Home Mortgage Interest Deduction.”

⁴⁸ Andrew Hanson, “The Incidence of the Mortgage Interest Deduction: Evidence from the Market for Home Purchase Loans,” *Public Finance Review* 40, no. 3 (May 2012): 339–59.

V. Past Reforms and Policy Options

The Tax Reform Act of 1986 significantly reduced the value of the MID by reducing marginal tax rates and increasing the standard deduction. Follain and Ling estimated that the deadweight economic loss of housing subsidies was decreased by about one-third as a result of the lower marginal tax rates mandated in the Tax Reform Act.⁴⁹ The lower tax rates significantly diminished the use of the MID by lower-income households, although the reduction in use was not quite as great for high-income households. Further, increases in the standard deduction made it less desirable or unnecessary for low-income households to file for itemized deductions, thus sparing these taxpayers the costs of tax complexity. Follain and Ling reported in 1991 that the interest deduction became “essentially worthless” for a household with a typical loan-to-market value ratio while earning income below \$42,500.⁵⁰ In inflation-adjusted terms, today this would be nearly \$73,000.⁵¹ Consistent with other data, there seems to be an increase in homeownership and the use of the MID beginning around this income level (see tables 2 and 3).

In light of the regressive nature of the MID’s benefit distribution and the lack of desired policy outcomes, there are reforms to housing tax policy that could more effectively help the intended beneficiaries. Many of these policy changes might not, and likely would not, solve many of the economic efficiencies and malinvestment problems that a housing subsidy creates. Before moving on to our policy recommendations, we provide a brief list of alternative reforms considered by others in the economic literature: (1) refundable and nonrefundable tax credits on mortgage interest, (2) fixed tax credit for homeownership, and (3) one-time homebuyer credit.

⁴⁹ Due to higher statutory tax rates at the time, the tax code encouraged more investments in homeownership. When the statutory rate was lowered, tax loopholes such as the MID were less useful in minimizing taxes. Follain and Ling, “Federal Tax Subsidy to Housing.”

⁵⁰ Ibid.

⁵¹ Authors’ calculations using US Bureau of Labor statistics and CPI Inflation Calculator.

One of the first options addressed in the literature is a refundable tax credit for mortgage interest payments. Green and Reschovsky estimate that a credit equal to 21 percent of mortgage interest payments would raise total homeownership by 3 percent. Households earning less than an estimated inflation-adjusted \$145,000 (\$100,000 in 1997) would experience an increase in homeownership, while the wealthiest households would experience less than a 1 percent decrease.⁵² According to Green and Reschovsky, “These changes in homeownership rates imply that nearly 3.1 million households would become homeowners, while only about 30,000 high-income homeowners would choose to become renters.”⁵³ The refundable tax credit could lower tax liabilities to below zero for many homeowners with mortgage interest.

In 2010, the Simpson-Bowles Commission suggested reforming the MID into a nonrefundable tax credit for mortgage interest. Nonrefundable tax credits can lower tax liabilities down to zero but not below. Simpson-Bowles proposed imposing a 12 percent tax-credit cap on interest paid and lowering the maximum qualifying debt from \$1 million to \$500,000.⁵⁴ Changing the cap would significantly scale back tax housing subsidies to high-income earners because only 0.39 percent of mortgages exceed the current \$1 million cap.⁵⁵ Simpson-Bowles also revisited one of the policy ideas of the 2005 Advisory Panel on Federal Tax Reform. The 2005 panel had considered reforming the MID into a credit on 15 percent of eligible mortgage interest in order to encourage homeownership, not just bigger homes.⁵⁶ The ceiling on eligible mortgage principal would have been limited to between \$227,000 and \$412,000 (between

⁵² Green and Reschovsky, “Design of a Mortgage Interest Tax Credit.” Inflation adjustment is the authors’ calculation.

⁵³ Ibid.

⁵⁴ National Commission on Fiscal Responsibility and Reform, “The Moment of Truth,” December 2010 report, http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

⁵⁵ Anderson, Clemens, and Hanson, “Capping the Mortgage Interest Deduction.”

⁵⁶ President’s Advisory Panel on Federal Tax Reform, “Simple, Fair, and Pro-growth: Proposals to Fix America’s Tax System.”

approximately \$272,000 and \$493,000, adjusted for inflation), depending on average regional housing costs. Economists David Ling and Gary McGill examine a 15 percent credit in their 2007 paper. They find that, without accounting for behavioral effects, the credit would decrease tax liabilities for low-income households while some households earning in excess of \$75,000 would see their tax burdens rise.⁵⁷ In an earlier paper, James Follain, David Ling, and Gary McGill petition for the introduction of a flat, nonrefundable tax credit.⁵⁸ More recently, Urban Institute scholars presented two different proposals for a nonrefundable credit to replace the existing MID at 15 percent and 20 percent of eligible mortgage interest.⁵⁹ These policy proposals offer a good starting place for reform, but setting the tax credit at a specific value could be simpler and more effective at encouraging low-income homeownership.

A second option for reform that is discussed in the literature is an annual tax credit for owning a home. In 2005, Adam Carasso, Eugene Steuerle, and Elizabeth Bell examined a 1.03 percent credit based on a home purchase price of up to \$100,000 (an approximately inflation-adjusted \$119,000)—regardless of whether a mortgage is held. Based on their analysis, households in the bottom four quintiles would experience a decrease in taxes while the top quintile would experience a tax increase of 2.5 percent.⁶⁰ Similarly, politics professor Peter Dreier argues for a complete substitution of the MID for a housing credit.⁶¹ The proposal is

⁵⁷ Ling and McGill, “Variation of Homeowner Tax Preferences.”

⁵⁸ James R. Follain, David C. Ling, and Gary A. McGill, “The Preferential Income Tax Treatment of Owner-Occupied Housing: Who Really Benefits?,” *Housing Policy Debate* 4, no. 1 (March 1993): 1–24.

⁵⁹ Amanda Eng et al., “Options to Reform the Deduction for Home Mortgage Interest,” Tax Policy Center, March 18, 2013, <http://www.urban.org/UploadedPDF/412768-Options-to-Reform-the-MID.pdf>.

⁶⁰ Adam C. Carasso, Eugene Steuerle, and Elizabeth Bell, “Making Tax Incentives for Homeownership More Equitable and Efficient” (Urban Institute Discussion Paper 21, 2005), http://www.taxpolicycenter.org/UploadedPDF/411180_TPC_DiscussionPaper_21.pdf.

⁶¹ Peter Dreier, “The New Politics of Housing: How to Rebuild the Constituency for a Progressive Federal Housing Policy,” *Journal of the American Planning Association* 63, no. 1 (November 27, 2007): 5–27.

interesting, but the author does not provide an estimation of how the proposal would affect the demand for housing.

A third potential reform discussed in the literature is to replace the MID with a one-time first-time homebuyer credit. According to Richard Green and Kerry Vandell, this subsidy would be approximately \$33,000 for the two million annually who are first-time homebuyers.⁶² David Ling and Gary McGill claim that the first-time homebuyer credit would have a particularly strong effect on promoting homeownership among low-income households.⁶³ However, economists Matthew Chambers, Carlos Garriga, and Don Schlagenhauf find that the one-time credit actually backfires on the intent of increasing aggregate homeownership levels.⁶⁴ According to their research, the effects of the credit on home prices, in addition to offsetting increases in marginal rates, actually decreases the aggregate homeownership rate among young and poorer households. However, these authors only examined the impact of the credit on renters with offsetting increases in marginal rates without accounting for conversion of the MID into a credit.

All these policy options provide a starting place for a discussion about reforming the mortgage interest deduction. However, we contend that they would not be as effective as the policy recommendations we propose in terms of economic efficiency and tax code simplicity, as well as in encouraging homeownership.

⁶² Richard K. Green, and Kerry D. Vandell, "Giving Households Credit: How Changes in the U.S. Tax Code Could Promote Homeownership," *Regional Science and Urban Economics* 29, no. 4 (1999): 419–44.

⁶³ Ling and McGill, "Variation of Homeowner Tax Preferences."

⁶⁴ Matthew Chambers, Carlos Garriga, and Don E. Schlagenhauf, "Housing Policy and the Progressivity of Income Taxation," *Journal of Monetary Economics* 56, no. 8 (November 2009): 1116–34.

VI. Conclusion and Policy Recommendations

We provide two policy recommendations—one based on tax policy principles and one based on improving homeownership rates. The first-best option is to eliminate the MID.⁶⁵ Only a full repeal of tax-favorable housing policies in exchange for lower marginal rates will eliminate economic inefficiencies. Economists often point out that lower marginal tax rates in general improve economic efficiency and decrease deadweight loss.

The strength of eliminating the MID is that it would reduce the economic distortions of subsidized housing for higher-income households. Eliminating the MID may slightly decrease the demand for housing among some low-income households that actually have sufficient mortgage interest to itemize. But this decrease seems relatively small, given that the MID is used so infrequently by low-income households,⁶⁶ and the bulk of the decrease in the demand for mortgage debt would come from households with large loans that exceed the loan limits of Fannie Mae and Freddie Mac.⁶⁷ However, James Poterba and Todd Sinai estimate that, in the event of the abolishing the MID, the few low-income households that use the MID would be disproportionately taxed compared to higher-income users of the MID.⁶⁸ These progressivity concerns would likely be addressed to some degree if lower marginal tax rates or a higher standard deduction were instituted to keep the reform revenue-neutral, as in the Tax Reform Act

⁶⁵ Note: A neutral tax system would not allow the deduction of interest to the borrower if interest were not taxable income to the lender. Hence, some have argued that the mortgage interest deduction should not be eliminated because the interest earned on the loan is taxable to lenders. For example, Curtis S. Dubay argues that when considering tax reform proposals, “Congress should never eliminate tax deductions simply to raise revenue. If it decides to reform the tax code, it should establish a neutral tax base. This means that as long as it taxes interest income to lenders, it should keep interest deductible to borrowers.” See “The Proper Tax Treatment of Interest” (Heritage Foundation Backgrounder No. 2868 February 19, 2014). We are inclined to agree but suggest that the perverse incentives caused by the MID require reform. Although fundamental tax reform is outside the scope of this paper, we would support removing the taxation of interest income and capital gains, along with removing the deductibility of interest income to the borrower, not only as a means of adhering to a neutral tax system, but also as a means to increase saving, investment, and economic growth.

⁶⁶ Ling and McGill, “Variation of Homeowner Tax Preferences.”

⁶⁷ Follain and Melamed, “False Messiah of Tax Policy.”

⁶⁸ Poterba and Sinai, “Revenue Costs and Incentive Effects.”

of 1986. A cleaner tax code moves away from the current tax-driven overvaluation of the housing industry. The elimination of the MID would encourage the purchase of more moderately sized homes, since the subsidy currently encourages the purchase of 10–20 percent larger homes, predominantly among high-income households.⁶⁹ Revenue-neutral tax reform that eliminated the tax bias toward housing would encourage higher-income households to shift some housing investments to more socially productive investments.

A second-best alternative reform that we propose is to grant a fixed \$900 credit for having a mortgage.⁷⁰ Green and Reschovsky also considered this form of tax credit in their 1997 paper. They claim that a fixed \$850 credit (estimated \$1,230 inflation-adjusted) would increase the homeownership rate by 5.3 percent.⁷¹ Similar to those estimates, a revenue-neutral fixed credit of \$903 can be estimated using the most recent tax and housing data, before accounting for behavioral effects.⁷² The credit could be granted for a specific number of years for an owner-occupied home. Its fixed property might reduce tax code complexity and is not weighted toward greater debt financing. The credit should also be periodically adjusted to account for inflation and, if simplicity is desired, rounded up to the nearest \$50 or \$100. Hence, a credit estimated at \$903 could be rounded up to \$950.

Policymakers should continue to take steps toward greater simplicity and efficiency in the tax code by lowering tax rates and increasing the standard deduction. A cleaner tax code brings

⁶⁹ Anderson, Clemens, and Hanson, “Capping the Mortgage Interest Deduction”; Rosen, “Housing Decisions and the U.S. Income Tax.”

⁷⁰ To avoid potential gaming of the credit, it would only apply to primary residences with a mortgage. It would not be available for second homes or for home equity lines of credit.

⁷¹ Green and Reschovsky, “The Design of a Mortgage Interest Tax Credit.”

⁷² Authors’ calculations. According to the US Census Bureau’s most recent 2009 data on mortgages, there are 76.4 million owner-occupied mortgages in the United States. See US Census Bureau, Table 998, Mortgage Characteristics—Owner-Occupied Units: 2009, *The 2012 Statistical Abstract: The National Data Book*, <http://www.census.gov/compendia/statab/2012/tables/12s0998.xls>. In 2013, \$69 billion was spent on the home mortgage interest deduction. See Office of Management and Budget, “Analytical Perspectives, Budget of the United States Government, Fiscal Year 2015,” March 4, 2014, p. 206, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/receipts.pdf>.

more equality to investment opportunities and is a step toward greater tax fairness among renters and homeowners who earn the same income.⁷³ But given the difficulties of eliminating the mortgage interest deduction outright and the special interest groups that would surely arise to oppose any such elimination, we believe that the tax-favored housing should, at a minimum, promote homeownership, not necessarily larger and more expensive homes or second homes used as vacation properties. A fixed nonrefundable tax credit of \$900 for owning a mortgage offers the most effective means of both increasing homeownership and properly aligning the purported policy goals of the mortgage interest deduction with actual outcomes.

⁷³ Jason J. Fichtner and Jacob M. Feldman, “The Hidden Costs of Tax Compliance” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 20, 2013), http://mercatus.org/sites/default/files/Fichtner_TaxCompliance_v3.pdf; Jason J. Fichtner and Jacob M. Feldman, “When Are Tax Expenditures Really Spending? A Look at Tax Expenditures and Lessons from the Tax Reform Act of 1986” (Working Paper No. 11-45, Mercatus Center at George Mason University, Arlington, VA, November 2011), http://mercatus.org/sites/default/files/publication/Tax_expenditures_FichtnerFeldman_WP1145_0.pdf.

Appendix: State Mortgage Interest Deduction Favors High-Income Earners, 2010

State	State MID?	\$50,000 adjusted gross interest		\$200,000 adjusted gross income		Difference	
		Effective state tax benefit as % of income	Effective tax benefit as % of interest expense	Effective state tax benefit as % of income	Effective tax benefit as % of interest expense	Effective state tax benefit as % of income	Effective tax benefit as % of interest expense
North Carolina	Y	0.03%	0.00%	0.55%	5.45%	-0.52%	-5.45%
Missouri	Y	0.00%	0.00%	0.46%	5.35%	-0.46%	-5.35%
Arkansas	Y	0.00%	0.00%	0.43%	5.29%	-0.43%	-5.29%
California	Y	0.24%	1.97%	1.05%	7.17%	-0.81%	-5.20%
Georgia	Y	0.00%	0.00%	0.55%	5.16%	-0.55%	-5.16%
Wisconsin	Y	0.00%	0.00%	0.41%	5.00%	-0.41%	-5.00%
Virginia	Y	0.00%	0.00%	0.50%	4.28%	-0.50%	-4.28%
Iowa	Y	0.38%	1.99%	0.43%	6.13%	-0.05%	-4.14%
Kansas	Y	0.00%	0.00%	0.31%	3.97%	-0.31%	-3.97%
Maryland	Y	0.00%	0.00%	0.45%	3.92%	-0.45%	-3.92%
Maine	Y	0.00%	0.00%	0.29%	3.51%	-0.29%	-3.51%
Montana	Y	0.19%	0.37%	0.34%	3.81%	-0.15%	-3.44%
Minnesota	Y	0.00%	0.00%	0.33%	3.32%	-0.33%	-3.32%
Idaho	Y	0.00%	0.00%	0.32%	3.27%	-0.32%	-3.27%
South Carolina	Y	0.00%	0.00%	0.32%	3.13%	-0.32%	-3.13%
Rhode Island	Y	0.00%	0.00%	0.27%	3.07%	-0.27%	-3.07%
Delaware	Y	0.54%	1.69%	0.46%	4.65%	0.08%	-2.96%
Arizona	Y	0.06%	0.16%	0.32%	2.63%	-0.26%	-2.47%
Colorado	Y	0.00%	0.00%	0.25%	2.26%	-0.25%	-2.26%
New York	Y	0.00%	0.00%	0.25%	2.22%	-0.25%	-2.22%
Oregon	Y	0.99%	5.28%	0.78%	7.35%	0.21%	-2.07%
Mississippi	Y	0.32%	1.48%	0.28%	3.54%	0.04%	-2.06%
Hawaii	Y	1.35%	4.96%	0.90%	6.96%	0.45%	-2.00%
Vermont	Y	0.00%	0.00%	0.15%	1.97%	-0.15%	-1.97%
New Mexico	Y	0.00%	0.00%	0.18%	1.89%	-0.18%	-1.89%
Nebraska	Y	0.00%	0.00%	0.11%	1.48%	-0.11%	-1.48%
Kentucky	Y	0.50%	3.83%	0.41%	5.17%	0.09%	-1.34%
Oklahoma	Y	0.00%	0.00%	0.10%	1.32%	-0.10%	-1.32%
Louisiana	Y	0.00%	0.00%	0.09%	1.15%	-0.09%	-1.15%
North Dakota	Y	0.00%	0.00%	0.03%	0.50%	-0.03%	-0.50%
Alaska	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Connecticut	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Florida	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Illinois	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Indiana	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Massachusetts	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Michigan	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Nevada	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
New Hampshire	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
New Jersey	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Ohio	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

State	State MID?	\$50,000 adjusted gross interest		\$200,000 adjusted gross income		Difference	
		Effective state tax benefit as % of income	Effective tax benefit as % of interest expense	Effective state tax benefit as % of income	Effective tax benefit as % of interest expense	Effective state tax benefit as % of income	Effective tax benefit as % of interest expense
Pennsylvania	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
South Dakota	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Tennessee	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Texas	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Utah	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Washington	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
West Virginia	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Wyoming	N	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Alabama	Y	0.68%	4.89%	0.41%	4.46%	0.27%	0.43%

Source: Authors' calculations and data from Donald Morris and Jing Wang, "How and Why States Use the Home Mortgage Interest Deduction," *Tax Notes* (June 4, 2012): 697–713.