Bloomberg BNA

Daily Tax Report®

Tax Expenditures

Ike Brannon of Capital Policy Analytics and the Cato Institute argues that tax reform should include the elimination of the mortgage interest deduction, which he says is costly, accrues only to the wealthy, and is not particularly effective at boosting rates of homeownership.

The Mortgage Interest Deduction Must Go

BY IKE BRANNON

In a tax code that is littered with wasteful, unproductive, and costly tax breaks, the mortgage interest deduction reigns supreme in this category.

That it fails to achieve its ostensible goal of boosting homeownership rates is not in question: Only 30 percent of all taxpayers—the richest 30 percent—find it worth their while to itemize deductions, which is necessary for a taxpayer to deduct mortgage interest from income. That means that the people in the bottom two-thirds of the income distribution—which encompasses the entire universe of people who might need some financial assistance to afford to purchase a home—receive nothing from the tax break. Research suggests that the bottom two-thirds may face higher home prices because of the deduction, which means the deduction may actually *depress* homeownership.

Not only does the mortgage interest deduction accrue only to the wealthy, the benefits go up disproportionately with income, so that the wealthiest taxpayers in the priciest houses receive the greatest tax savings from the deduction. As a result, most of the dollars forgone because of the mortgage interest deduction go to the denizens of wealthy suburbs and prosperous neighborhoods in the well-to-do cities along the east and west coasts of the country.

What's more, the deduction does not even help aspiring homeowners from the middle or upper classes afford a home because the tax benefit is already capitalized in the property market. By boosting the overall demand for homes, it pushes up prices *ex ante*, benefiting those who already own a house or who profit from higher home prices, such as real estate agents, homebuilders, and mortgage bankers.

Ike Brannon is president of Capital Policy Analytics and a visiting fellow at the Cato Institute.

Politicians offer a facile defense of the mortgage interest deduction by insisting that they are merely in favor of increasing homeownership. That may seem unobjectionable, but the mortgage interest deduction is hugely harmful for our economy: Rather than use the tax code to encourage *bona fide* investment or actually reduce the cost of homeownership for those who need it, we effectively tilt our tax code for the benefit of real estate agents and builders and the current wealthy homeowners, which leaves us the need to generate additional revenue in economically harmful ways—which we do by maintaining higher taxes on the returns to work and savings.

Finally, the very goal of increasing homeownership rates is dubious. The notion that owning a home inculcates greater civic engagement or other salutary pro-community behavior—a commonly offered observation—does not stand up to scrutiny, and studies that do purport to show such a relationship invariably conflate cause and effect.

Problems with the Mortgage Interest Deduction

1. It's Expensive

The mortgage interest deduction is one of the costliest tax expenditures in the tax code. According to the Joint Committee on Taxation, the Treasury Department will forgo $75 billion in 2017 because of the deduction and nearly $800 billion over the next decade, making it the fourth costliest tax expenditure in the tax code.

Table 1 contains a list of major federal tax expenditures.

TABLE 1
Largest Tax Expenditures
Billions of dollars, 2016

Rank	Tax expenditure	Billions ($)
1	Exclusion of employer contributions for medical insurance premiums and medical care	216.1
2	Capital gains (except agriculture, timber, iron ore, and coal)	93.0
3	Exclusion of net imputed rental income	82.4
4	Mortgage interest expense on owner-occupied residences	75.3
5	Defined contribution employer plans	73.9
6	Deferral of income from controlled foreign corporations (normal tax method)	67.8
7	Step-up basis of capital gains at death	66.7
8	Earned income tax credit[a]	63.8
9	Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	51.2
10	Deductibility of charitable contributions, other than education and health	47.4
11	Defined benefit employer plans	46.3
12	Child credit[b]	46.3
13	Refundable premium assistance tax credit[c]	42.7

Sources: Budget of the United States Government, 2016, Analytical Perspectives, Table 14.3; and author's addition of outlays for refundable credits.
(a) Includes outlays of $58.7 billion.
(b) Includes outlays of $22.2 billion.
(c) Includes outlays of $45.8 billion.

Source: Tax Policy Center

The tax code provides other tax breaks for homeowners, such as the exclusion of the capital gains tax for owner-occupied housing and the deductibility of property taxes on a home. The three sum to $125 billion per annum (JCT, ''Estimates of Federal Tax Expenditures for 2015-2019,'' JCX-141R-15).

2. It Goes Only to the Wealthy

For a deduction that costs as much as the mortgage interest deduction, it had better be spectacularly effective at what it does. In fact, the deduction is spectacularly *ineffective*: Few families own a home because of the mortgage interest deduction.

There is no real evidence that the deduction increases homeownership rates in the slightest: Figure 1 shows that the proportion of homeowners in the United States is not particularly high amongst developed countries even though virtually no other country avails itself of such a housing tax subsidy.

Its inefficacy owes to the combination of progressivity and the standard deduction. Taxpayers subtract various expenses that are pertinent to activities that Congress wants to incentivize, such as saving for college or retirement, giving to charity, buying an energy-efficient car, and owning a home. If a family's deductions pertinent to these things sum to less than $12,700, then they can simply claim the standard deduction and skip the math, which is what two-thirds of all households do.

It is easiest to conceive of the mortgage interest deduction's impact by dividing up the country into income terciles. The bottom tercile neither itemizes nor owns a home, so the deduction is irrelevant to them.

The wealthiest tercile overwhelmingly own homes and also itemize their taxes, so they take the mortgage interest deduction. Of course, this group generally needs no help to afford to purchase a home.

It is the middle tercile that contains any aspiring owners who might need financial assistance to afford a home. However, few of them can take the deduction, because their deductions simply don't clear the standard deduction, and those that do scarcely benefit.

The ability to rack up deductions is easier for the wealthy than for a middle-class family, since they are likely to allocate disproportionately more money to various tax-preferred expenditures than the middle class. Besides the mortgage interest deduction, they spend more money on property and state income taxes, retirement saving, charitable donations, and everything else that has a tax preference.

For a couple with an income in the five figures, the standard deduction can be difficult to exceed; data show a clear threshold around $100,000 separating itemizers from those who take the standard deduction. A taxpayer who does not itemize sees no reduction in tax obligations from the mortgage interest deduction. In Washington, D.C., for instance, five out of six homeowners above $100,000 take the deduction, while only 25 percent of those below use it (Andrew Hanson, Ike Brannon, and Zack Hawley, ''Rethinking Tax Benefits for Homeowners,'' National Affairs, Spring 2014).

The line below which the mortgage interest deduction doesn't much matter may soon move up along the income distribution if tax reform includes a proposal to disallow the deductions for state and local tax payments. The mortgage interest deduction and the deduction for state and local taxes have a multiplicative effect on each other, and by allowing people to deduct property taxes and state income taxes, more people will find it worth their while to take the mortgage interest deduction. More relevantly, it also means that if one of these were to disappear, many fewer taxpayers would itemize and take the other deduction.

This interaction means that advocates for the mortgage interest deduction must fight for all tax breaks that affect housing—and fight against any increase in the standard deduction as well. The National Association of Realtors estimated that getting rid of the deduction for state and local taxes, combined with doubling the standard deduction—a proposal in the House ''Better Way'' plan—would reduce the proportion of tax filers who itemize to just 5 percent, making the deduction even more difficult to defend (Kenneth Harney, ''Trump's Tax Plans May have Effects on Real Estate Market,'' The Washington Post, Nov. 16, 2016).

But the mortgage interest deduction disproportionately benefits the wealthy not only because they have bigger mortgages and thus pay more interest but also because they can deduct a greater proportion of their interest. Tax rates increase with income in our progressive system: People making $75,000 have a marginal tax rate of 15 percent, but someone at $250,000 has a marginal tax rate of 35 percent. As a result, a middle-class family with $10,000 of mortgage interest will reduce its taxable income by $1,500, but the wealthier family can deduct over twice as much with the same amount of mortgage interest.

But since the wealthy family has more money, it will likely buy a bigger home and have a bigger mortgage and more interest to deduct, each dollar of which reduces its tax bill more than the middle-class homeowner. Should the family making $250,000 buy a

ISSN 0092-6884

million-dollar house, it would save $14,000 in taxes the first year; the family earning the median income buying the median-priced home would save less than $2,500 from the deduction, and only if it has enough other deductions to itemize, which is doubtful.

Research by Andrew Hanson and Hal Martin bear witness to the stark inequality of the benefit. Using IRS tax and Census data, they find that the overwhelming preponderance of tax savings from the mortgage interest deduction go to the denizens of the wealthy suburbs in the major metropolitan areas along the east and west coasts. For instance, almost 50 percent of the households in the San Francisco neighborhood of House Minority Leader Nancy Pelosi (D-Calif.) take the deduction, versus 9 percent in Mossville, Illinois, a small working-class town in the outskirts of Peoria (Hanson and Marin, ''Metropolitan Home Prices and the Mortgage Interest Deduction,'' Regional Science and Urban Economics, 2016).

A Mossville family buying a $200,000 house—the median home price in the area is $88,100—with a $160,000 mortgage will pay mortgage interest of $6,350 their first year. If their income is $75,000, they save $1,600 in taxes—and only if they itemize. That means the average mortgage benefit per taxpayer in the area would be the product of $1,600 times the 9 percent of residents who take the deduction, or $150.

However, the San Francisco family that takes out a $1 million mortgage (the median home price in the city is $1.5 million) and has an income of $500,000 will pay $40,000 in mortgage interest. In the 39.6 percent tax bracket they save $16,000 per year. That equates to an annual savings of $8,000 per year per San Francisco taxpayer, 50 times higher than in working-class Mossville. (Note that instead of doing a straight multiplying of the interest rate times the loan principal, we are using amortization tables to calculate the actual amount of interest paid in year one. In the initial years of a mortgage, most of the payments are for interest, and at the end most of it pays down principal.)

This is not a middle-class benefit by any stretch of the imagination.

3. It Accrues to Existing Homeowners and Not Aspiring Homeowners

The beneficiary of a tax break is not necessarily the entity that receives the tax break on a Form 1040. For instance, economists aver that the employer ''paying'' half of the payroll tax is just an accounting fiction and that employees effectively pay the employer portion via lower wages. Because labor supply is relatively inelastic while demand is more elastic, wages adjust more than employment because of the tax (John Olson, ''What Are Payroll Taxes and Who Pays Them?'' Tax Foundation Brief, June 2016).

Similarly, aspiring homeowners do not receive much of a benefit from the anticipated tax deductions from the mortgage interest deduction. Those savings have already accrued to the homeowner in the form of higher home prices.

The deduction does allow aspiring homeowners to spend more on their housing, but if the supply of housing is relatively inelastic, the demand increase won't increase the amount of new housing available by much—it will increase the price of housing instead. This is what seems to be occurring in most markets—or at least the markets where incomes and housing prices are high enough for a significant proportion of homeowners to take the deduction.

Governments in these areas tend to constrain the construction of new housing. For instance, environmental regulations can drag out the approval time necessary for a developer to get the requisite permits to build a new development in these places—sometimes by as much as a decade or more (Richard Epstein, ''The Environmental Permit Menace,'' Defining Ideas, Fall 2016). New regulations over the last 10 years have boosted the cost of constructing new housing by upwards of 30 percent, according to a study by the National Association of Home Builders (Chris Kirham, ''Regulatory Prices Inflate New Homes Cost,'' Wall Street Journal, July 22, 2016). In 2015 housing starts were at a post-2008 high, but still just 60 percent of what they were in 2000-2007 (Brannon, ''Time to Fix Fannie and Freddie,'' Weekly Standard, April 10, 2016).

Governments also tend to give greater deference to the pleadings of current homeowners, who invariably worry that additional housing construction could reduce their own property prices or that new homes will boost competition for services, increasing their costs or lessening their access. There are more people affected in denser communities, and their homes are worth more.

For instance, the pitched battles over scarce on-street parking in the wealthy residential neighborhoods in Washington, D.C.—scarce because it is priced at just $25 a year, or 1 percent of the market price—results in fights over every new building that could bring new car owners into the area. These fights often turn into costly litigation that can drag out for years and typically results in developers acquiescing by reducing the number of units in a development (Brannon, ''The Tyranny of Free Parking,'' Cato Unbound, July 2016).

In places where home construction is easier because there is more land and/or fewer restrictions on its use, higher demand pushes prices up less, and the mortgage interest deduction would be more likely to boost supply dollar for dollar.

That the mortgage interest deduction increases disproportionately with income serves to minimize these regional differences: Since the deduction has relatively little value to most homeowners in the low-cost regions of the country, its impact on either prices or supply is minimal, but in the high-cost suburbs and gentrified neighborhoods in major metropolitan areas it significantly increases demand, boosting prices quite a bit. Andrew Hanson and Hal Martin estimate that the mortgage interest deduction pushes up home values in Washington, D.C., by nearly 14 percent, but much less in middle-class communities (Hanson and Martin, ''Metropolitan Home Prices and the Mortgage Interest Deduction,'' Working Paper, Federal Reserve Bank of Cleveland, 2016).

David Rappoport, an economist with the Federal Reserve Board, suggests that when homeowners are especially leveraged and the supply elasticity is low, more than 100 percent of the tax benefit accrues to the sellers, and the mortgage interest deduction actually *reduces* affordability (Rappoport, ''Do Mortgage Subsidies Help or Hurt Borrowers?'' FEDS Working Paper 2016-181).

A recent study by Jonathan Gruber, Amalie Jensen, and Henrik Kleven uses data from a major reform of Denmark's mortgage interest deduction that dramatically scaled back benefits for the well-off and found that homeownership rates were completely unaffected. They conclude that its only measurable impacts of the deduction is to increase home size and indebtedness (''Do People Respond to the Mortgage Interest Deduction? Quasi-Experimental evidence from Denmark,'' NBER Working Paper 23600, July 2017).

Homeownership Is Not an Especially Worthy Goal

The greatest achievement of the housing industrial complex has been to equate homeownership with the American dream. The oft-told post-World War II story is that returning G.I.s yearned to return to a world of normalcy and that owning a home was a central part of their dream. Developers were keen to accommodate them, and the nation's housing stock rapidly expanded in the ensuing decades—making up for a nearly two-decade pause in home construction from 1930-46 while extending single home ownership to a new social stratus.

To abet this trend, homebuilders and real estate agents came to assert that merely owning a home inculcated salutary behavior. Homeowners were said to be more engaged in their community and schools and generally strengthened neighborhood cohesion. Georgetown University sociologist Brian McCabe looks at the pro-homeowner ideology in his book ''No Place Like Home: Wealth, Community, and the Politics of Homeownership'' and finds that such rhetoric has been in place since the First World War, when labor instability and social unrest worried politicians, who came to view owning a home as a salve to those problems.

However, the alleged societal benefits produced by homeownership are rather slight, McCabe (and many others) find. His own surveys find a modicum of evidence that homeowners are a bit more engaged in ''instrumental acts of civic engagement'' but that in broader measures of engagement—like interacting with neighbors, for instance—there is no discernible difference between renters and owners.

The urban economist Ed Glaeser has argued that claims that homeownership imbues owners with some sort of newfound inclination to become more civic-minded conflates cause and effect, and the reality is that people who are more civic-minded tend to also have the wherewithal to save money and obtain a mortgage to purchase a home (Brannon, ''Lure of the Big City,'' Regulation, Summer 2011, pp 48-49).

Even if there were modest social gains from homeownership, they come at a steep economic cost. Glaeser points out that homeownership can make it more difficult for people to move to another community when they lose a job. Selling a house is a costly, complicated transaction, exacerbated by the real estate agents' cartel that imposes a 6 percent commission on sales. People are (perhaps irrationally) reluctant to sell a home at a loss, which means that when they lose their job in a community that itself is shedding jobs, they may resist the lure of going elsewhere because of their home, even when it is economically sensible to sell it for a loss or even abandon it.

The proportion of workers who move to a different community to find work has declined every decade since the 1940s (Stephen Rose, ''Rebound,'' p. 171), and housing contributes to this. To be sure, there are more forces keeping us in place than just our home—the complicated arrangements of a two-worker household each finding new employment in another community can be challenging, for instance—but anything that limits its mobility in a dynamic economy is bad, and the evidence suggests that homeownership does precisely this. The supposed recent trend of lower homeownership rates among millennials has been cited as evidence of a diminution of our living standards (Derek Thompson, ''Millennials: The Mobile and the Stuck,'' The Atlantic, August 2016), but we should treat it as a good thing: It's one less obstacle to searching, finding, and moving to obtain a job that is remunerative and fits one's skills.

There Are Better Ways to Boost Homeownership

If our society still believes there are sufficient social benefits to homeownership to merit encouraging it, there are many better ways to do it than via a tax break to the wealthy, and many states run such programs.

A good exemplar of one is the Wisconsin Housing and Economic Development Authority (WHEDA). The program provides a subsidy for first-time home buyers with a moderate income who are buying a house at or below the median home price for the area.

The agency provides an upfront grant covering most closing costs, which can be daunting for a young family. It then provides a loan that effectively amortizes those costs into the loan itself; however, by doing due diligence on these lenders, the rates they offer are competitive with other mortgages. As a result, the borrowers actually receive most of the benefits from this subsidy while WHEDA covers its costs.

A study by Andrew Hanson, Zack Hawley, and myself finds evidence that this program is effective (''Rethinking Tax Benefits for Homeowners,'' National Affairs, Spring 2014). Despite a median household income below the national average, Wisconsin homeownership rates are well above the national average, which we attribute—in part—to WHEDA's program. That the state has managed to avoid increasing barriers to home construction also helped keep homeownership high.

The role of the federal government in such plans is limited, however: The vast differences in real estate markets across the country suggest that plans need to be contoured to match the heterogeneous markets across the United States and are best left to the states.

The Last, Shaky Defenses of the Mortgage Interest Deduction

One final justification of the deduction that has been proffered is that it represents the only way to adjust for varying cost of living across the United States (Maura McDermott, ''Cutting mortgage deduction would hit Long Islanders hardest, Schumer says,'' Newsday, Feb. 21, 2017).

For instance, a $200,000 income in Boston places a household squarely in the middle class, but that income in Peoria allows a family to easily afford the nicest house in the best school district. The mortgage interest deduction affords the Boston couple a tax break they need for their $900,000 home that the wealthy Peorian wouldn't need, the argument goes. However, since ex-

  DTR ISSN 0092-6884

isting homeowners capture most or all of the tax benefits via higher home values, its benefits nearly wholly accrue to current or previous homeowners.

Another argument for keeping the mortgage interest deduction is that its elimination would depress home prices substantially, reducing the wealth of homeowners, the value of trillions of dollars of mortgage-backed securities, and the fiscal health of Fannie Mae and Freddie Mac, the government-sponsored entities that purchase, collateralize, and then sell mortgage-backed-securities to the broader markets. Together, the argument goes, this reduction may force homeowners to postpone retirement and potentially trigger a housing price collapse not unlike what occurred during the great recession.

The elimination of the mortgage interest deduction would indeed lower home prices, but for a relatively narrow sliver of the housing market—namely, those that are bought by the 80th to 95th percentiles of the population. And any home price reduction would not be significant—David Rappoport, the Federal Reserve economist, estimates that ending the mortgage interest deduction would result in a 7 percent reduction in prices—not insignificant but about the average increase in home prices for a typical two-year period and much less than anything that occurred in 2008-2009. There is no reason to think that the market for mortgage-backed securities or the broader financial market would experience any crisis because of this decline, given the new mortgage strictures in place.

The Mortgage Interest Deduction and Tax Reform

Forecasting the outcome of the tax reform legislation so many anticipate occurring before the 2018 elections is a fool's game, but a few things seem fairly certain to be a part of any final legislation: There would likely be a lower tax rate for corporations and passthrough businesses; reduced tax expenditures, most notably the deduction for state and local taxes; and an increase in the standard deduction.

Reducing deductions and increasing the standard deduction would dramatically diminish the proportion of taxpayers who itemize: The Tax Policy Center estimates that itemizers would fall from the current 30 percent to just 5 percent from a doubling of the standard deduction and an elimination of the deduction for state and local taxes.

While the ''Better Way'' and White House plans explicitly promise that they would keep the mortgage interest deduction, if only the wealthiest 5 percent of households take it, the fiction that it helps the middle class afford a home becomes impossible to maintain.

A Distorting, Unproductive Tax Break

The mortgage interest deduction does not achieve its ostensible purpose of increasing homeownership, and the very goal is dubious to begin with. To maintain this tax preference for the wealthiest 5 percent—as would be the case under the most commonly discussed tax reform plans—would be not only economically unproductive but politically absurd.

Tax reform necessitates Congress making tradeoffs: In order to lower the tax rate for individuals, small businesses, and corporations, it must reduce or eliminate various tax breaks in the code that are relatively unproductive.

No other tax preference in current law is as unproductive as the mortgage interest deduction. It is enormously costly and does nothing to achieve its intended purpose. If fundamental tax reform cannot eliminate a costly, regressive, and ineffective tax break, then it cannot properly be called tax reform at all.

   ISSN 0092-6884