The Mortgage Interest Deduction

Debates and Possible Reforms

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The Mortgage Interest Deduction (MID) has been under hot debate since before the Tax Reform Act of 1986. This paper reviews the MID debate, focusing on its efficiency in promoting homeownership and its redistributional effects. I examine whether or not the MID promotes homeownership, reveal why it is often believed to fail to achieve its intended incidence, discuss which groups of people benefit from it, and present the most referred proposals to replace it. Based on this analysis, I advocate that the MID be reformed and call for a wider public recognition of the issues surrounding it.

In "The American metropolis at century's end: Past and future influences," Robert Fishman (2000) ranks "Federal Housing Administration (FHA) mortgage financing and subdivision regulation" second among the top ten influences on the American metropolis in the past 50 years. Planners commonly cite Fishman's opinion that FHA mortgage financing and regulations, along with subdivision regulation, are largely responsible for increasing the American homeownership rate, suburbanization, and racial segregation between 1945 and 1965 (Fishman, 2000). While most planners have a general knowledge of FHA financing policies and regulations, important policies such as the Mortgage Interest Deduction (MID) are not as well understood. The MID is a tax policy; planners focus more on housing policies that directly relate to community development and housing opportunities, such as the Home Choice Voucher program and Low Income Housing Tax Credit (LIHTC) program. Nevertheless, understanding the MID and its challenges is helpful and even necessary to achieve planning goals.

Through the lens of planning, this paper discusses the problems with and possible reforms of the MID's current structure. In many cases, narrowly focusing on certain policies and subtly fine-tuning them without a structural change to the general policy framework makes little difference. For example, most planners advocate for the Voucher projects and LIHTC projects, yet they often find that, because of funding shortages, the results are merely adequate, despite many efforts to refine these projects. After all, federal funding is a zero-sum game: funding some programs is done at the expense of funding others. Therefore, to better promote effective housing opportunities, planners should not only study these programs but also evaluate their funding competitors, among which the MID is the most expensive and contentious.

The MID is the third-largest federal tax expenditure. Although it is charged with promoting homeownership, critics frequently claim it does not accomplish this goal. The MID has cost more than $70 billion annually during the past five years, and in 2013, a time of budget crisis in the United States, it cost approximately $100 billion. In comparison, the Voucher and LIHTC programs, two programs that effectively promote affordable housing, have budgets that combined never exceed $30 billion per year. If a costly policy like the MID is not effective in achieving its intended goals, we must reevaluate and reform or eliminate it. In fact, the MID has been under debate since the Tax Reform Act of 1986 when most other personal interest deductions were phased out. Given this context, the purpose of this paper is to examine the MID debate, to judge the opinions of both sides, and to provide some recommendations.

This paper is divided into three sections. The first section briefly introduces the MID and provides a brief overview of the debate. The second section offers a close examination of the major critiques of the MID, centering on its relationship to homeownership—that it does not promote homeownership, is regressive, and introduces a price capitalization effect. Both sides of the debate are synthesized to provide an informed argument about the MID and to shed light on the major concerns that alternative policies should address. The third section reviews some proposed alternatives to the MID. This paper concludes that the MID is a poorly designed policy and we should replace it with a mortgage interest credit.

A Brief Introduction of the MID and its Debate

The Mortgage Interest Deduction

The MID allows taxpayers who purchase their homes to reduce their annual taxable income by the amount of interest paid on their home loan each year. Although it was not originally designed to promote homeownership, it is generally regarded as a tax policy that achieves this goal (Carliner, 1998). However, according to the U.S. Internal Revenue Code, taxpayers must meet several conditions to qualify for the MID. First, they must itemize deductions rather than choose the standard deduction. Second, the deduction is limited to interest on debts secured by a principal residence or a second home. Third, interest is deductible on only the first $1 million of debt incurred to buy, build, or improve a home, or on other debt secured by a home, which can be used for any purpose but only to the extent that total home equity debt is $1 million or less. For qualified taxpayers, the value of the mortgage interest deduction is equal to the taxpayer's marginal tax rate multiplied by the amount of mortgage interest paid that is in excess of the standard deduction (Morrow, 2012). For example, in 2013, married couples who jointly filed taxes received a $12,200 standard deduction. If a married couple with a marginal tax rate of 15 percent pays $12,300 in mortgage interest in 2013, the MID will save the couple $15, 15 percent of the difference between the mortgage interest paid and the standard deduction.

The Mortgage Interest Deduction Debate

As mentioned above, the MID has been under debate for decades. Many critics argue that the bulk of its benefits go to high-income households who could afford a home without assistance, while nearly half of middle- and low-income homeowners1 with a mortgage receive no benefit at all (Glaeser & Shapiro, 2002; Landis & McClure, 2010; Morrow, 2012; Prante, 2006). Because of its regressive nature, this extremely costly tax expenditure has no significant impact on homeownership (Morrow, 2012; Toder, Austin, Lim & Getsinger, 2010). Moreover, the MID is criticized for resulting in overinvestment in owner-occupied housing at the expense of other business investment, as the government subsidy distorts capital prices in the market (Morrow, 2012). Finally, some critics argue that the MID contributes to the foreclosure crisis by encouraging borrowing against equity while contributing to suburbanization and the plight of the inner cities, as most housing subsidized

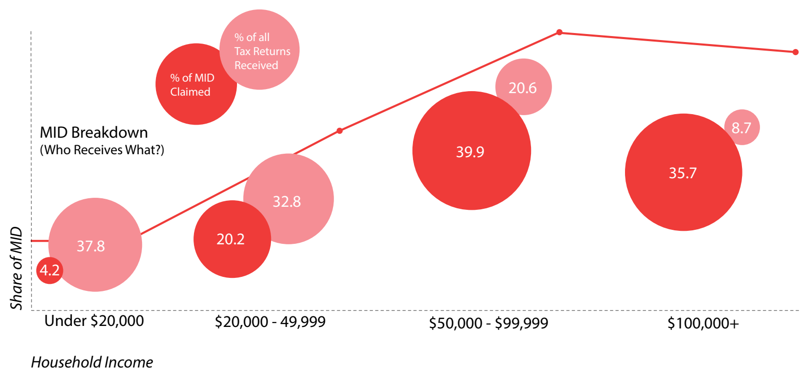

Fig. 7.1: The MID Benefits Received by Households of Different income Levels
Source: Internal Revenue Service, Tax Foundation calculations.

by the MID is in the suburbs (Voith, 2001). They argue that this results in additional negative redistributional effects.

While opponents of the MID strive to prove that it is an ineffective tax policy that we should reform or eliminate, the policy also has many proponents. Supporters argue that the MID makes homeownership more affordable, especially for young middle- and high-income families since the proportion of interest is highest in the early years of a mortgage. They argue that eliminating the MID would increase the average age for first-time homeowners. Some proponents also argue that most critics overstate both the cost and redistributional effects of the MID (Follain & Melamed, 1998; Gervais & Pandey, 2008; Woodward & Weicher, 1989). Taking into account behavioral changes, especially wealthy households reshuffling their portfolios, these studies find that the redistributional effects of the MID are much less regressive than they seem, and eliminating it would mainly impact younger, upper-middle-income households. As for the charge that the MID results in overinvestment in owner-occupied housing, defenders argue that it is actually the untaxed imputed rent rather than the MID that distorts the market (Follain & Melamed, 1998; Gervais & Pandey, 2008; Woodward & Weicher, 1989). Finally, proponents of the policy argue that eliminating or reducing it would cause home prices to fall and unfairly hurt existing homeowners, which is especially undesirable in a depressed housing market.

Both opponents and proponents of the MID raise many valid arguments. However, the proponents' arguments that the opponents' studies are imprecise and that the risks of eliminating the program are too high do not justify the continuation of the current policy, especially considering that a better alternative could achieve the stated benefits of the MID with greater efficiency. Many empirical studies have shown that the MID is ineffective at promoting homeownership and at providing households with the means to successfully transition from the rental market to the owner market. These households are considered part of the homeownership margin; in theory, they are the target market for MID policy. Many alternative policies have been proposed to reform this problematic tax policy. Such a reform requires extensive public support, but, unfortunately, a 2011 New York Times poll shows that about 90 percent of Americans support the MID, indicating a lack of public recognition of its problems (McCabe, 2011). The following sections provide a more detailed discussion of critiques of the MID and proposals to reform it in order to promote a better understanding and to garner more public support towards its reform.

Critiques of the MID

The MID Does Not Promote Homeownership

Although the MID is the largest source of federal assistance to housing and the most important federal policy charged with promoting homeownership, studies provide almost no direct evidence to justify the extent to which it raises the homeownership rate—if it raises it at all. Some studies have shown that the tax system's favorable treatment of owner-occupied housing raises the rate of homeownership (Hendershott & Shilling, 1980; Rosen & Rosen, 1980). For example, Rosen & Rosen (1980) estimate that tax subsidies for owner-occupied housing, including the MID, raised the homeownership rate by about four percent in 1974 and that these subsidies contributed to about one-quarter of the growth in homeownership since 1945. These empirical studies are considered by some proponents of the MID as indirect evidence that it promotes homeownership, but other experts argue that, rather than the MID, the critical ingredient of the homeownership subsidy is the omission of imputed rental income from taxable income (Follain, Ling, & McGill, 1993; Poterba & Sinai, 2008). The estimates of both Follain, Ling, & McGill (1993) and Poterba & Sinai (2008) show that taxing the implicit rental income would lead to substantially higher tax burdens for homeowners than eliminating the mortgage interest and property interest deduction. These empirical studies suggest that, although subsidies of owner-occupied housing increase the homeownership rate, it is more a result of the untaxed imputed rental income than the MID.

"The MID costs about $100 billion in 2013 and ranks as the 3rd largest federal tax expenditure..."

In fact, most scholars believe that the MID is not a pro-homeownership policy in any meaningful sense (Glaeser & Shapiro, 2002; Hanson, 2012; Landis & McClure, 2010; Morrow, 2012). Using time series data from 1965 to 2000 to examine the relationship between homeownership rate, inflation rate, and the degree of itemization, Glaeser & Shapiro (2002) show that there was essentially no relationship between the subsidy rate and the level of homeownership. Hansen (2012), who examines how the MID affected housing purchases, finds that it was responsible for a 10.9 to 18.4 percent increase in the size of home purchased, but did not find a relationship between the MID and homeownership. By summarizing many empirical studies, Morrow (2012) concludes that international, interstate, and time-based comparisons of homeownership data and economic projections based on these data overwhelmingly suggest the MID does little to promote homeownership. Some results even show that the MID may discourage homeownership (Glaeser & Shapiro, 2002). Ironically, Glaeser & Shapiro (2002) find that states with bigger subsidies tend to have slightly lower homeownership rates than those with smaller subsidies.

The critical reason the MID fails to promote homeownership is that people on the homeownership margin rarely use the MID; the bulk of the tax money goes to high-income households whose tenure choices are barely affected by the tax policy (Fischer & Huang, 2013; Glaeser & Shapiro, 2002; Landis & McClure, 2010). As mentioned above, the MID is only available to taxpayers who itemize their deductions and, for qualified taxpayers, its value is closely related to their marginal tax rate. Most low- and middle-income households use the standard deduction because it usually exceeds or approximates their itemized deduction, whereas high-income householders tend to itemize because it benefits them. Even if low- and middle-income households itemize their taxes, the received benefits are often negligible compared to those of high-income households. Therefore, the bulk of the benefits go to the pockets of higher-income households who do not need subsidies. Conversely, households who struggle through the homeownership margin and desperately need help receive little of the assistance.

The MID is Regressive

The above analysis reveals that the MID is ineffective in promoting homeownership. Many critics also raise the issue of equity—they point out that available data show that the MID is far too regressive (Fischer & Huang, 2013; Prante, 2006; Rosen, 1985). Internal Revenue Service (IRS) data from 2003 show that few low- and middle-income taxpayers benefited from the MID, while those earning over $75,000 in adjusted gross income (AGI) claimed the vast majority of deductions2 (see Table 1). According to a more recent study, homeowners with incomes above $100,000 received 77 percent of the more than $70 billion tax expenditures on the MID in 2012, while homeowners with incomes below $50,000, who face severe housing cost burdens, received only three percent of the benefits (Fisher & Huang, 2013). This study also reveals that nearly half of the homeowners who pay mortgage interest received no benefits from the MID, and only about 30 percent of eligible taxpayers actually used it.

Prante (2006) believes that four key factors make the MID more valuable for high-income earners than low-income earners. First, as discussed above, taxpayers must itemize to claim the MID, but low-income taxpayers are less likely to itemize. Also, as itemized deductions are proportionate to the taxpayers' tax bracket, the value of itemized deductions rises as income

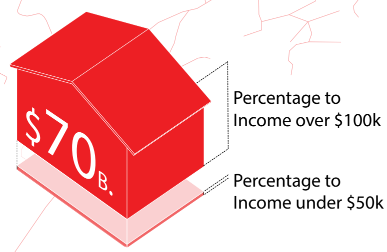

Fig. 7.2: Breakdown of Tax Expenditures on MID in 2012.
source: Fisher and Huang, 2013

rises. Second, high-income taxpayers are more likely than low-income taxpayers to own homes. Third, high-income homeowners tend to buy more valuable homes and thus have to pay more mortgage interest. Finally, speculators tend to earn high incomes and have a higher loan-to-value ratio3 than low- and middle-income households.

Whereas opponents of the MID cite these data to illustrate its regressivity, proponents believe its cost and redistributional effects are greatly overstated (Follain & Melamed, 1998; Gervais & Pandey, 2008). For example, Follain and Melamed (1998) estimate that the revenue gain from eliminating the MID in 1997 was roughly $10 billion, rather than the $40 to $50 billion estimated by the Joint Committee on Taxation and the Congressional Budget Office. Elimination of the MID will not likely affect households with the highest incomes that are considered to receive the largest amount its benefits, because such households can reshuffle their portfolios (Follain & Melamed, 1998). Proponents also argue that the MID levels the playing field between equity and debt, and thus potentially benefits the poor and young homebuyers who rely on debt to purchase houses (Gervais & Pandey, 2008; Woodward & Weicher, 1989). Woodward and Weicher (1989) promote this argument, claiming the MID accommodates the smoothing of income over time, correcting the tilt of the real payment burden of the mortgage in the beginning of the loan. While these results provide some support for the current MID policy, they do not refute its regressive nature. Even if the cost and redistributional impact of the MID are overstated, these arguments do not justify its continuation.

Proposal	Limit on Interest Covered	Credit %	Credit for 2nd Homes	Type of Credit
Bush Tax Reform Panel	Interest on mortgages up to 125% of median price in area	15	No	Non-Refundable Owner-Claimed
Rivline-Domenici Commission	$25,000	15	No	Lended-Claimed
Bowles-Simpson Illustrative Plan	Interest on mortgage up to $500,000	12	No	Non-Refundable Owner-Claimed
Ellison Bill	Interest on mortgages up to $500,000	15	Yes	Non-Refundable Owner-Claimed
Viard Paper	Inerest on mortgages up to $300,000	15	No	Refundable Owner-Claimed

Fig. 7.3: Comparison of Mortgage Interest Credit Proposals
Source: Fischer and Huang, 2013

The MID Results in Price Capitalization

Another critique of the MID is that it leads to price capitalization, which is the increase in the price of an asset due to its increased value caused by a subsidy or incentive. This undermines the effectiveness of the MID because it capitalizes the increased value of housing into its price. Higher home prices could offset the increased demand to own homes resulting from the MID, or even discourage housing demand by making homeownership more difficult for less well-off households that receive little or no benefit from the MID. Because those on the margin of tenure choice receive little help from the MID, price capitalization may cause the MID to negatively influence homeownership rates.

The extent to which the MID increases home prices depends on the elasticity of housing supply; the effect of the MID on housing prices varies across and within regions due to differences in local housing prices, loan-to-value ratio, local income and property taxes, and the availability of new housing supply (Bourassa & Yin, 2008; Capozza, Green, & Hendershott, 1996; Hilber & Turner, 2013). While maintaining the stock of prime residential land inelastic, Capozza et al. (1996) estimate that eliminating the MID and property tax deduction4 simultaneously would reduce housing prices by two to 13 percent in 63 metropolitan areas. Bourassa and Yin (2007) estimate that, due to effects on housing prices, the MID and property tax deductions reduced the homeownership rate of urban adults between 25 and 34 years old. Hilber and Turner (2013) find that the MID had both positive and negative impacts on individual homeownership decisions, depending on the restrictiveness of land use regulations at the place of residence and the income status of the household: the MID had a positive effect on homeownership attainment for higher income groups in places with elastic housing supply, no impact on low-income households, and a negative impact on homeownership attainment in restrictive urban places.

Price capitalization also demonstrates that it is better to reform or replace the MID with other alternatives than to simply eliminate it. While price capitalization certainly weakens the arguments for the MID, its elimination is risky, as it could result in a decline in home values and the potential crash of the housing market (Morrow, 2012). Some defenders use this reason to claim that existing homeowners would suffer from eliminating it, which is particularly important consideration since the U.S. housing market is still gradually recovering from the sub-prime crisis (NPR Diane Rehm Show, 2012). Conversely, opponents of the current policy believe that the current recovery makes this precisely the right time to replace it with other, more effective policies to incentivize low- and middle-income households to become first-time homebuyers and to serve as the potential solution to the recent foreclosure crisis.

Other Critiques of the MID

This paper focuses on the relationship between the MID and homeownership, but there are a number of other critiques. Because they are tangential to my main argument, I will not go into detail, but they are worth noting. Among these, the most commonly mentioned is that the MID skews the allocation of capital across the economy by lowering taxes on owner-occupied housing investment relative to other business investments (Gale, Gruber & Stephens, 2007; Morrow, 2012). Also, Morrow (2012) argues that the MID encourages risky behaviors by incentivizing highly leveraged purchases, which led many homeowners to have high loan-to-value ratios and thus contributed to the foreclosure crisis. Moreover, the MID—usually paid out over 30 years—is insensitive to market conditions: it continues to subsidize home purchases when the market is already functioning effectively but then fails to provide timely incentives during depressed housing market conditions (Morrow, 2012). In addition, some critics accuse the MID of magnifying the impact of economic forces that lead to decentralization, disproportionally favoring homeownership in the suburbs, contributing to high concentrations of poverty in central cities, and thus discouraging the homeownership rate in these locations (Voith, 1999).

Proposals to Reform the MID

The MID is problematic because it requires taxpayers to itemize deductions and its benefits increase with taxpayers' marginal tax rate, which results in its regressive distributional effects. These challenges contribute to the policy's ineffectiveness in promoting homeownership by limiting access and providing unequal benefits. Therefore, the simplest way to reform the MID is to replace it with a tax credit that applies to every household. Indeed, many researchers believe that a mortgage interest credit better targeted at families in need would have a modest influence on the housing market and is likely to cost less than the MID (Fischer and Huang, 2013; Morrow, 2012; Toder, Austin, Lim & Getsigner, 2010).

Since the beginning of the MID debate, many alternative tax credit policies have been suggested (Carasso, 2005; Gale, Gruber, & Stephens-Davidowitz, 2007; Green & Vandell, 1999). Green and Vandell (1999) estimate that the overall homeownership rate could increase by three percent if the government replaced the mortgage interest and property tax deductions with a revenue-neutral credit of $1,173 for all homeowners. They argue that this new policy would significantly help households with an annual income of less than $40,000. Carasso et al. (2005) propose replacing the MID with a revenue-neutral, fully refundable credit equal to 1.03 percent of the first $100,000 of a home's value. Following such a policy, they estimate that nearly 50 percent of tax units would see a tax cut. Gruber and Stephens-Davidowitz (2007) argue that a targeted tax credit—that is, a refundable first-time homebuyers credit equal to $6,000 for married couples and $3,000 for others —would more efficiently promote homeownership. These solutions would all create a more progressive system, thus addressing a major problem with the current MID.

Two recent studies have evaluated and compared the effects of replacing the MID with mortgage interest credits (Fischer & Huang, 2013; Toder, Austin, Lim, & Getsinger, 2010). Toder, Austin, Lim & Getsinger (2010) use the Tax Policy Center micro-simulation model to estimate the effects of eliminating the MID, replacing it with four options that have approximately the same cost: a 20 percent, non-refundable interest credit; a 17 percent refundable interest credit; a non-refundable, 100 percent credit on the first $2,030 of mortgage interest; and a refundable, 100 percent credit on the first $1,490 of mortgage interest. Although these four options would have different consequences, they are all potentially more effective in promoting homeownership and have more even distributional effects. In other words, they would all make the tax code more progressive (Toder, Austin, Lim & Getsinger, 2010). Fischer and Huang (2013) compare five influential proposals to reform the MID, including the proposals from the Bush Tax Reform Panel, the Rivlin-Domenici Commission, the Bowles-Simpson Illustrative Plan, the Ellison Bill, and the Viard Paper (see Table 2). They concluded that "converting the deduction to a well-designed credit would be more effective in promoting homeownership while generating substantial revenues and making the tax code fairer" (Fisher & Huang, 2013, p. 6). Both of these studies have pointed out the great advantages of mortgage interest credits over the MID. While it is difficult to judge which of these alternatives is most well-designed and certainly all of them call for public deliberation, they provide some options for MID reform.

Replacing the MID with a mortgage interest credit could give this tax policy better vertical equity; however, those who propose to completely eliminate it raise the issue of horizontal equity.5 Owner-occupants' imputed rental income is not taxed in the United States, which lowers the after-tax cost of owner-occupied housing capital compared to that of the rental market. In fact, many find that the real tax subsidy to homeownership is not the MID or property tax deduction, but the untaxed imputed rental income (Aaron, 1972; Follain, Ling and McGill, 1993). If renters and owners are treated fairly to achieve horizontal equity, then owner-occupants' imputed rental income should be taxed, or mortgage interest and property tax deductions should be eliminated (Green & Malpezzi, 2003). The increased burden to existing homeowners makes both choices politically contentious and extremely difficult to implement. Therefore, even though many people recognize the horizontal inequity between owners and renters, most tend to focus on the issue of vertical inequity. Moreover, the universal social norm seems to support homeownership, which means a certain amount of homeownership subsidy is appropriate. The issue of horizontal inequity is negligible if everyone intends to become a homeowner eventually.

Conclusion

While the Tax Reform Act of 1986 phased out many forms of personal interest deduction, the MID was retained as a means to promote homeownership and to preserve the part of the American Dream that homeownership symbolizes (Carliner, 1998). However, extensive studies have shown that the MID is a poorly designed policy that fails to achieve its intended incidence because rich homeowners receive the bulk of its benefits, while those on the margin of homeownership barely benefit from it. If people still consider the MID as useful for raising the homeownership rate, it is time to reconsider this ineffective yet costly tax policy and reform it. Replacing the MID with a mortgage interest credit is likely to have more progressive redistributional effects, promote homeownership more effectively, and potentially reduce federal costs and lessen the federal fiscal crisis. ■

Notes

1. Using 2012 as the reference year, I define low-income households as those whose annual household income is less than $50,000 (about the American median household income in 2012), middle-income households as those whose annual household income is between $50,001 and $100,000, and high-income households as those whose annual household income is more than $100,000.

2. The table shows the household income in 2003, when the median household income was $42,560; therefore households with an income above $75,000 could roughly be considered as high-income households.

3. Loan-to-value ratio is the ratio of a loan to the value of an asset purchased. In general, high-income families have a higher loan-to-value ratio than low- and middle-income families for two main reasons. The first is that they have a better chance of borrowing money. The second is that they tend to borrow more to put their own equity into high-yield investments.

4. The property tax deduction, like the MID, is also an itemized deduction that allows homeowners to reduce their annual taxable income by the state and local property taxes paid. Together with the MID, these two deductions are the most common tax deductions for homeowners and thus are often discussed together.

5. Vertical equity implies that people with higher incomes should pay more in taxes, and tax revenues should be distributed in a progressive way. Horizontal equity implies that people at an identical income level should be treated equally (be taxed equally and receive the same amount of benefits).

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