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| More Housing or More Housing for Some?  By Brian Handshy |
| An analysis of the Mortgage Interest Deductions effect on tax equity and effectiveness in meeting the implicit federal housing preference for home-ownership in the United States through the tax code |
| This paper integrates primary research with literature reviews on U.S. federal housing policy as it pertains to the U.S. tax code. Specifically, the ubiquitous mortgage interest deduction (MID), will be assessed in terms of taxpayer equity and program effectiveness. The author examines these concerns from an economic utility framework. However, elements of social equity and capital shall be employed to a limited degree for discussion. |
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he existence of a monolithic and comprehensive federal housing policy is steeped in the emergence and convergence of 26 major legislative acts and related acts since 1934 (Landis & McClure, 2010). The majority of these items focus on creating a liquid secondary mortgage market that utilizes the fixed-rate, fully amortized, 30–year mortgage. In addition, loan guarantees for single-family ownership, tax expenditures for home-ownership, direct spending on affordable home-ownership for low to moderate-income families, and public housing expenditures for low-income renters, serve to increase the affordable housing stock in the U.S. (Brown, 2009; Landis & McClure, 2010; Congressional Budget Office, 2009a ; Congessional Budget Office, 2009b). The popular and political foundation for many of these acts was based on the notion of an ‘American Dream’ that ostensibly provides each citizen equal access to a private home, individual wealth and a reasonable vehicle for its distribution to future generations through such ownership. However as the literature on this matter shows, home-ownership, while idealized for all Americans, has not proven to be a unified vision in practice. Rather, it has been shown to be highly supportive of high-income, high-wealth households, as well as having affordable access divided along racial lines; although such latter delineations have been reduced explicitly through federal legislation from the 1960’s onward (Brown, 2009; Landis & McClure, 2010). While there are numerous direct-spending housing drivers such as the federal Department of Housing and Urban Development’s (HUD)*Community Development Block Grant* and *HOME Investment Partnership programs, HOPE VI Public Housing Assistance, Section 8 Housing Choice Vouchers, and* various state mortgage revenue bond programs*;* this paper will focus on the effects of the tax expenditures for home-ownership preference promulagated through the U.S. Internal Revenue Service’s (IRS) tax code. Namely, the mortgage interest deduction’s effects on taxpayer equity and policy efficacy.

This author recognizes that recently energized political focus on balancing the federal budget and reducing the long-term national debt has sparked a wave of popular claims against government spending on social programs, while others, have focused on the need for sustained spending and increased taxation on wealthy Americans and large corporations. Such claims are beyond the scope of a policy analysis and are better left to political scientists and pundits. However, such claims are a sound impetus for examining the tax equity and efficiency of the mortgage interest deduction if public sentiment reflects accurate values for how the U.S. government spends money, or in this matter, does not collect its revenues evenly based on preferential tax treatment of a normal good such as housing. If the United States as a whole espouses simultaneous norms toward the expansion of ownership over renting, equitable access to housing for all, and efficient allocation of federal financial resources, then one might reasonablly expect to find a strong positive correlation between ownership tenure rates over time and expenditure rates. Concurrently, one might also expect that tax treatment of home-ownership would preserve tax equity along horizontal and vertical lines, to reflect the net progressivity of the current federal tax system; *ceterus paribus*. In reality, the empirical data suggests that neither equity nor efficiency are fully preserved through use of the mortgage interest deduction (Gale, Gruber, & Stephens-Davidovwitz, 2007; Glaeser & Shapiro, 2003; Hilber & Turner, 2010; Prante, 2006; Toder, Turner, Lim, & Getsinger, 2010).

To substantiate these finding, this author uses cross-sectional data from the IRS, U.S Census American Housing Survey/American Community Survey, and Bureau of Labor Statistics to create three methodological approaches: single-year distributional analyses, multi-year marginal analysis, and a multi-year constant cost analysis. These analyses were then assessed using a neoclassical economic utility framework that assumes individuals and firms will rationally maximize resources and for reference only, also considers social returns to home-ownership that are beyond purely utilitarian functions. Therefore, the remainder of this paper is structured along the following lines. **Part 1** is a brief history of U.S. housing markets and policy since the Great Depression in the 1930’s. **Part 2** is a primer on the mortgage interest deduction’s functionality. **Part 3** is a review of the author’s primary research and findings. **Part 4** is a listing of corroborative scholary literature on the mortgage interest deduction. **Part 5** enumerates some possible policy implications of the status quo and possible alternate policies. **Part 6** elucidates the author’s limitations in researching this matter and possible future research inquiries.

**Part 1- Housing in the United States: Since the Great Depression**

A brief history lesson tells us that prior to the 1930’S, and our nation’s largest financial meltdown in absolute wealth lost, that there was no intelligible national housing policy. Instead, housing was a local and highly commercial process between individuals and their banks (Weicher, 1980). Not till the aftermath of the Depression and a widespread housing foreclosure crisis was there sufficient gravity to conjoin a national housing policy. From this calamity comes the housing manifestation we know well today where single family homes dominate, financed through long-term debt from institutional lenders rather than local commercial banks (Landis & McClure, 2010). It is not necessary to know intimately the continued history of U.S. housing demographics and policy over the latter half of the twentieth century, in order to assess some of its more current protractive features as a wealth investment and nationalized ideal. It is useful to know that what most people popularly perceive as the true value of home-ownership, a tax-shelter from federal and state taxes, is mostly a product of the last 25 years - the Tax Reform Act of 1986 (Toder, Turner, Lim, & Getsinger, 2010).

Much like the current budget challenges, the executive and the legislative branches in the 1970’s and early 1980’s, faced budget deficts and dwindling federal revenues. As such, there was a strong movement towards removing expenditures from the tax code that would limit the types of interest that taxpayers could deduct from their taxable income. While some were left in tact for various reasons; it was the continuance of the mortgage interest deduction for residential real estate that would implicitly link the ‘American Dream’ to home-ownership over other forms of tenure (Toder, Turner, Lim, & Getsinger, 2010; Congressional Budget Office, 2009a; Congessional Budget Office, 2009b).

**Part 2- What does the deduction do?**

Put simply, the deduction works to reduce tax liability, proportionally to an individuals marginal tax-rate, or the value of the last dollar of income made. **Table 1 below,** demonstrates how this works in a simplified manner.

**Table 1 Simplified MID Calculation**

|  |  |  |  |
| --- | --- | --- | --- |
| A:Gross Income | B:Mortgage Interest | C:Marginal Tax rate | D:MID  (B\*C) |
| $100,000 | $10,000 | 35% | $3,500 |

In this example, we see that a household with $100,000 in taxable income and $10,000 in mortgage interest, receives a $10,000 deduction on income, lowering the tax liability by $3,500. In reality, a household would take advantage of numerous other credits, exemptions and deductions available. However, one can see from this simple instance that owning a home served to reduce taxable income, although it was the household’s marginal tax rate and interest spent that determined the magnitude of that deduction. This point induces many to ask the question, “Why doesn’t everybody do this?” The short answer is that not everyone can. To claim this deduction on the household tax return, one must make a choice to take the *standard deduction*, that issues a deduction based on governmental averages of common taxpayer needs, or it must *itemize*, or aggregate all personal deductions from the past tax year (FairTax.org, 2010; Hilber & Turner, 2010). If a household does not have a level of deductible expenses greater than the standard deduction, then it will most likely choose to take the standard deduction to maximize the reduction in tax liability. Again, a simple table can demonstrate the comparative effects of one deduction framework over another **(Table 2)[[1]](#footnote-1).**

Table 2 Household tax choices for deductions

|  |  |  |
| --- | --- | --- |
|  | Standard deduction | Itemization |
| Gross Income | $100,000 | $100,000 |
| Mortgage Interest | $10,000 | $10,000 |
| Marginal Tax Rate[[2]](#footnote-2) | 35% | 35% |
| Deduction Allowed | $11,400 | $10,000 |
| Reduction in Tax Liability | $3,990 | $3,500 |

As illustrated, the standard deduction household takes home a $490 advantage over the itemizing household, all else equal. Economic rationality in public policy analysis tells us that individuals will seek to maximize their resources. Therefore, in this example, although a home offers an explicit reduction in tax liability of $3,500 for itemizers, those that take the standard deduction are $490 better off whether they own a home or not. This leads to a net indifference between owning a home and not owning. It is noteworthy that itemizing households can offset this disadvantage by increasing their level of itemized expenses, perhaps by buying a more expensive home or having a higher interest rate; thus, increasing the itemized deduction relative to the standard deduction. Doing so is not expressly a function of owning a home, and is more explcitly about owning interest. Nevertheless, an assessment of economic and demographic data from over the past 35 years, shows that households have been offered increasingly larger economic subsidies for home-ownership despite negligible rises in net overall ownership levels and marginal shifts from ownership to renter tenure .

**Part 3- What the research says.**

To survey for observable effects of home-ownership preference from the tax code, cross-sectional national data from several sources such as the I.R.S. *Statistics of Income Individual Return data for 2007,*U.S. Census *American Community/Housing Survey household data from 1997-2009,* Joint Committte on Taxation expenditure projections for 2010-2014, and the Bureau of Labor Statistics *Consumer price Index-Urban Midwet housing data from 1975-2009;* were used to create three methods of observation*.* The first method was a series of single-year distributional analyses that related tax liability, mortgage interest value, itemizing incidence, and housing tenure to adjusted gross income for tax year 2008. Second, a marginal analysis of prior year housing tenure for the years 1997-2009 was conducted to examine the net shifts in renters versus owners bi-annually. Lastly, a constant-cost expenditure analysis was used to measure the longitudinal value of the MID (constant 2009) in relation to the home-ownership average over the period from 1975 to 2009.

The basis for these observations was two-fold. First, the level of taxpayer equity, vertical and horizontal[[3]](#footnote-3), was one unit of analysis. The other was the degree to which the MID was meeting its implied goal of increasing overall home-ownership. Based on the empirical data, neither equity nor efficacy were preserved in the implementation of the MID over the period from 1975-2009.

In terms of vertical equity, the distributional analyses **(Figs. 1-3, appendix)** establish a clear pattern of increasing incidence of itemization at higher adjusted gross income brackets. In **Fig. 1 & 2** respectively we can see that an overwhelming majority of both tax liability and incidence of itemization occur in household income ranges that are well above the national median average of $52,029 in 2009[[4]](#footnote-4). In absolute value, **Fig.3** shows that 80% of national MID value was captured by the top two household income groups ($100-200K, and > $200K), as compared to only 20% for the bottom four household income groups. This introduces a level of regressivity in that after-tax income rises for higher income brackets relative to lower ones due to increased access to taking the MID and an increase in its value.

To a lesser degree, horizontal equity is also violated, although more in theory than in practice, by the interaction of household marginal tax rates and the level of mortgage interest. Similar to **Table 2** on page 4, **Table 3 next page,** shows the comparative effect of two households with similar incomes and interest but different tax rates.

Table 3 Effect of marginal tax rate on MID

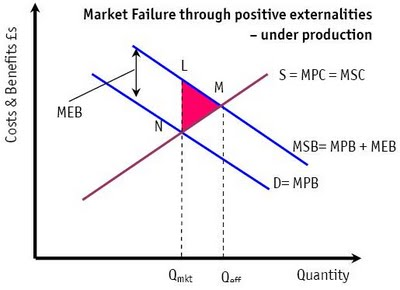
|  |  |  |
| --- | --- | --- |
|  | Household A | Household B |
| Gross Income | $100,000 | $100,000 |
| Mortgage Interest | $10,000 | $10,000 |
| Marginal Tax Rate[[5]](#footnote-5) | 10% | 28% |
| Reduction in Tax Liability | $1,000 | $2,800 |

In this example, it is evident that two households with the same ability-to-pay, are treated differently with respect to the tax code in terms of how much deduction they can claim. While this is a facile example, it is instructive in illustrating the possible violation of equity principles that many hold as an ideal.

Program effectiveness was also measured for observable effect and was found to have no significant positive bearing on influencing the home-ownership rate over time, based on information gathered from **Fig. 4** and **Fig.5 (in appendix).** **Figure 4**, the constant–cost expenditure analysis, shows that from 1975-2009, the MID grew positively by about $62 billion per every five years. In contrast the trendline for the the home-ownership data over the same period shows only a one-sixth percent positive growth rate. While this analysis does not control for the annual change in population as an independent variable, nor the aggregate economic value of a percent shift in home-ownership; it is still a valuable observation in terms of alerting policy makers of the magnitude of the expenditure cost without knowing the value of the benefit.

Marginal analysis of the *American Housing Survey* data from 1997-2009 exhibits a pattern suggesting that the expenditure has not worked, presumably where policy makers would want it to, at the margin between households that are renters and homeowners. As a proxy for this margin, the author used the AHS data that shows prior year numbers of household samples that were both moving from renters to owners, and owners to renters. In **Fig. 5,** all but one of seven observed periods (2005) had a net shift in households towards renter tenure despite large tax expenditures to promote the opposite. This implies that either there is no association between housing expenditures and ownership rates, that tax policy is not targeted at those on the margin, or that some other force beyond observation is at play in this relationship. All are plausible, but this author is not focused on speculating as to what the connection is presently; only whether the status quo policy increases ownership levels. The answer to the latter question both on the average and at the margin seems to be that it is not.

A final remark on policy efficacy is framed in terms of Pareto optimality[[6]](#footnote-6). To achieve this optimal balance of resources between parties, theory says that all possible trades of goods should be made until no party’s gain comes at anothers loss (Levy, 1995). While this is nearly impossible to achieve in reality, the theory does point to some qualified conclusions about the aim of the existing tax preference for ownership. One is that tax policy expands economic preference for a normal good for one consumer subset (owners) over another (non-owners). Thereby, the optimality of the situation is not obtainable because an externality is introduced, and theory dictates that Pareto optimality can only exist in a world free of externalities. Further, the idea that home-ownership needs to be preferenced comes from a supposition that there is a market failure in housing consumption and therefore subsidies are needed to rectify this matter. **Figure 6** **(above, opposite)** illustrates the graphical model of this relationship.



In this graph, the area in pink is the welfare gain in consumption that would accrue to society if the government subsidized housing to align marginal social benefit and marginal social cost (MSB=MSC). The issue with this model is that only the cost is defined. The size of social benefit is not. While there is considerable research espousing the social value of housing, there is no defined economic value that can serve to be compared with the cost. This introduces the strong possibility that as a society, we are expending a valuable resource (tax revenue) to purchase an undefined asset (home-ownership).

**Part 4- What the literature says.**

The body of literature surrounding the policy implications of the mortgage interest deduction is substantial, dating back to at least the late 1980’s in the aftershocks of the Tax Reform Act of 1986 that extinguished deductibility of interest on all but a few items in the tax code. While many articles and research have come to the aid of the MID (Woodward & Weicher, 1989; Weicher, 1980); many more have observed similar results to what this research found in terms of the MID’s association with taxpayer equity and program effectiveness.

For instance, in relation to equity, Poterba and Sinai (2008) while examining microdata of over 25,000 non-farm households in 2004, found that the percent of households with income over $125,000 itemized 98 percent of the time, while only 23 percent for households with an income of $40,000 and less. This is important because as referenced earlier in this paper, itemization is a requisite step to utilizing the MID. In a similar analysis using data from the Joint Committee on Taxation (2004) on tax expenditures by income class; Carrasso (2005) found that tax subsidies for home-ownership disproportionately go to higher-income households with 72 percent of mortgage interest deduction value going to households with income over $75,000, and 54 percent to those over $100,000. Harris and Baneman (2011) find using the Urban-Brookings Tax Policy Center Microsimulation model, that the top income bracket receives a 4.4 percent rise in after-tax income after itemizing versus only a 1 percent rise for itemizers in the lowest income bracket. While this is not all attributable to the MID, it is greatly influenced by it as a percentage of total deductions in higher income brackets that routinely have more mortgage interest as a tax shelter. In contrast, the effects of MID at lower itemizing income brackets is neglibile due to lower home-ownership levels and less expensive homes.

The last point on equity is based on work by Landis and McClure (2010), who find that utilization of the mortgage interest deduction by those that could afford homes anyways, serves to inflate prices through (capitalization)- making them less affordable to those at lower income levels. From this research we see that government intervention may actually prejudice lower-income buyers of housing as a function of the MID.

Program effectiveness was also called in to question by the literature. Gale, Gruber & Stephens-Davidowitz (2007) made a striking report on how the MID imputes bias to the tax system because lower income households have more earnings income that is subject to payroll taxes, which are not deductible; whereas higher-income households have a greater ratio of non-earnings income which is subject to deductibility. This former attribute, lends itself to a system that allows the MID to be utilized by higher-income households at greater rates, creating more housing consumption in one income range rather than proportionally across all income ranges. In a study of inflation, which has a positive growth effect on the MID, Glaeser and Shapiro (2003) found that from 1965-2000 while inflation grew and contracted erractically; home-ownership rates remained consistently stable implying from this research that many that own homes must not be using the MID. This concept has implications for policy makers because if a large proportion of owners are indifferent to the benefit of the mortgage deduction or cannot use it, then perhaps it is an expenditure that is misapplied. This was alluded to by economists at the Organisation for Economic Co-operation and Development (OECD) in a recent working paper on global housing markets (2011). In it, the report stated that world-wide reduction in housing wealth is due to the United States’ policy of expanding home-ownership through the tax code which drives housing prices artificially ahead of inflation and historic appreciation rates.

Although beyond the scope of the author’s research, Turner and Hilber (2010) conclude that in addition to creating an incentive to capitalize interest into purchase prices and favoring higher household incomes, that the MID adversely affects housing tenure choice through tightly-regulated land use restrictions (restricting size and availability of larger households for purchase).

In the comprehensive expanse of literature covering the MID, there seems to be a collective understanding even by proponents of the policy, that it may not be the most effective or equitable for increasing ownership. The data suggest that it promotes consumption rather than expansion of housing. Moving beyond analysis of data, policy makers must now consider the implications of the status quo and any other alternative plans.

**Part 5- Policy Implications**

The implications of one policy framework over another in a democratic society is a product of what behavioral model best encompassess the collective desires, needs and values of its constituents. To a large extent, this paper set out to follow the neoclassical ideal of the *economic man* in which rational decision making based on maximizing economic utility was the norm. However, there are competing normative models of decision making that couple social value with economic value, and in some instances completely ignore the latter in lieu of some other basis. While this author respects and even supposes that some of these models may return more accurate representations of our behaviors; it is from the economic model that many of our current policies come and from this economic model it will be judged.

If it is accepted that collectively our nation is expending too much for too little return, one rational choice is to remove the MID and recoup the forgone tax revenue. However, there are implications to such a choice. First, making such a decision has the likely return of diminished housing consumption at higher-income levels which reduces the need for many construction jobs and related capital ventures. Second, under this decision, housing prices might drop, decreasing household wealth for those that currently own. Conversely, the choice to remove the MID could possibly create more demand for housing at lower-income levels owing in part to the drop in housing prices. Under this assumption, the likely winners are younger households and many minority, middle-income households that have less money for larger downpayments, and more time to grow equity in their homes.

An alternative plan may be to remove the MID but change the expenditure amount to a credit which is more targeted and includes greater oversight (congressional). In this event, there is the possibility of increased ownership at lower-incomes because the credit is not tied to the size of the mortgage and is not influenced directly by the household’s marginal tax rate, allowing for more horizontal and vertical equity as well as increasing program effectiveness.

Overall, there are an unending number of plans that could be enacted to deal with the issue of home-ownership, each bringing with it it’s very unique set of political hurdles and value questions.

**Part 6- Limitations and Future Research**

As with any research methodology, there are certain limitations upon which the validity and reliability of the data will be determined. This paper is no different. First, as a paper that deals with housing choices, this paper is undeniably weaker due to its focus on economics alone. While the values of ownership are mostly defined in economic terms; social aspects are well-recognized by researchers in terms of their observed influence on family solidarity, increased neighborhood quality, and improved education and work productivity (Habitat for Humanity, 2010). Future research should look to expand the definition of ownership benefits in terms of these social returns.

In terms of methodology, this author would specifically like to revisit the distributional analyses undertaken, and expand them to a longer horizon. The current application of this method to only one year of data is less instructive than a look at the same data over time (i.e; 25 years versus 1 year). This of course would be helpful in finding patterns and trends that may not be observable in short durations considering that ownership levels are normally price inelastic in the short-term.

A looming weakness of this research is its lack of explanation for *why* the MID is not well correlated with ownership levels. While there are specualtions, it does not go far enough in trying to isolate independent variables in a model that may weight and predict what is and what is not influencing tenure choices.

Some imminent research topics that may help to bring these questions into view are:

* More research on comparative wealth strategy of housing investment versus other capital investment vehicles (longer than 10 years; Return on Investment analysis).
* Trying to transform the qualitative values of home-ownership into quantifiable value for economic model building.
* Investigating the effect of more housing at any household income level versus distributed ownership across all household incomes.
* Contemplating if housing appreciation is naturally cyclical or a product of government intervention? In the absence of intervention, is their less benefit to owning a home?

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**Appendix**

**Figure 1:**

**Figure 2:**

**Figure 3:**

**Figure 4:**

**Figure 5:**

1. Assumes 2010 rates, ‘married, filing joint return’ status and considers that the household has no other itemized expenses. This mirrors the situation of many low and middle-income tax filers in the U.S. [↑](#footnote-ref-1)
2. This is the highest individual marginal tax rate in 2010 and is used only for illustration. [↑](#footnote-ref-2)
3. **Vertical equity** usually refers to the idea that people with a greater ability to pay taxes should pay more. **Horizontal equity** is the idea that people with a similar ability to pay taxes should pay the same or similar amounts. [↑](#footnote-ref-3)
4. http://quickfacts.census.gov/qfd/states/00000.html [↑](#footnote-ref-4)
5. This is the highest individual marginal tax rate in 2010 and is used only for illustration. [↑](#footnote-ref-5)
6. See John M. Levy, Essential Microeconomics for Public Policy Analysis 1995. Page 67 [↑](#footnote-ref-6)