

## *Point of Contention: The Home Mortgage Interest Deduction*

*For this issue's Point of Contention, we asked four observers with substantial knowledge of the topic to argue for or against the following proposition—"The federal mortgage interest deduction serves a public purpose that justifies the potential drawbacks of the tax expenditure." Please contact [alastair.w.mcfarlane@hud.gov](mailto:alastair.w.mcfarlane@hud.gov) to suggest other thought-provoking areas of controversy.*

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# The Efficiency and Equity of the Home Mortgage Interest Deduction

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Economists strongly favor an economically neutral tax system, and, when the National Commission on Fiscal Responsibility and Reform (the Simpson-Bowles Commission) suggested terminating the mortgage interest deduction for homeowners, many economists agreed on the basis that the deduction creates a bias in favor of homeownership. This argument would be valid if housing were simply a consumer good, but that perspective is incomplete. An owner-occupied home is an asset in addition to being a place to live. It is, as many in the housing industry have often said, "the biggest investment most people will ever make." A homeowner is therefore both an investor and a consumer—someone who owns a house and is renting it to himself or herself. Economic neutrality requires taking both aspects into consideration.

Like any other businessperson, a landlord can deduct business expenses. For rental housing, such expenses include interest on the mortgage, property taxes, maintenance expenditures, and depreciation on the property. After deducting these business expenses, the landlord has to pay tax on the rent he or she receives. A homeowner has the same business expenses but cannot deduct all of them. The homeowner can deduct mortgage interest and property taxes but cannot deduct maintenance or depreciation. The homeowner also does not have to pay taxes on the rental value of the home.

Homeowners therefore have a tax advantage over landlords because owners do not pay taxes on the rental value of their home, and landlords have a tax advantage over homeowners because they can deduct maintenance and depreciation. The treatment of capital gains also differs between the two groups. Homeowners do not pay taxes on the capital gain from the sale of their home, up to a gain of \$500,000 for married couples (\$250,000 for single individuals). Gains of more than these amounts are taxed at a rate of 15 percent. Rental property owners can defer taxes on the capital gain from the sale of a rental property if they buy another rental property of equal or greater value

with the proceeds, and they can continue to defer taxes on the capital gain each time they engage in the same sale and purchase process (known as a Section 1031 exchange). When they sell a property and do not buy another one, however, rental property owners have to pay taxes on all the capital gains deferred from the past sales. Homeowners and landlords are treated equally regarding mortgage interest and property taxes, however. Both can deduct these expenses.

Perhaps the question should be, “Does the exclusion of imputed rental income from the federal income tax serve a public purpose that justifies the potential drawbacks of the tax expenditure?” For that matter, “Is there a social cost from home maintenance and depreciation to justify the absence of a deduction for these expenses of property ownership?”

The mortgage interest deduction facilitates a more equal distribution of wealth in American society. Since 1992, the equity in owner-occupied homes has consistently amounted to between 20 and 25 percent of all household wealth; even after the housing finance collapse, home equity represented 21 percent of household wealth. Home equity is one of the three major components of household wealth, the others being financial assets (including retirement accounts) and equity in unincorporated business. Together these three components have consistently accounted for two-thirds to three-fourths of all household wealth. Unlike the other two components, however, home equity is widely distributed. The richest 1 percent of households own more than one-half of the equity in unincorporated business, and one-third of financial assets, but only about one-eighth of all home equity. At the other end, home equity accounts for more than one-half of the net worth of households in the lower income half of the wealth distribution.<sup>1</sup> As a society, we are rightly concerned with the distribution of economic well-being; the mortgage interest deduction is a significant contributor to a more equal distribution of wealth. To be clear, the distribution of wealth is very far from being equal, but it would be still more unequal without the mortgage interest deduction.

Homeownership may also provide other social benefits. About 15 years ago, Richard Green and Michelle White found that children of homeowners were more successful than children of renters, in several respects: they were more likely to finish high school, they had fewer behavioral problems, and teenage girls were less likely to become pregnant (Green and White, 1997). This article has been seminal. For several decades previously, economists had believed that homeownership did not generate any social benefits. The research underlying that conclusion had focused on adults rather than children, however. Green and White’s paper generated a substantial body of research on the benefits to children of homeownership and a vigorous professional controversy, demonstrated by the discussion in the Point of Contention in the July 2013 issue of *Cityscape* (Barker, 2013; Green, 2013; Haurin, 2013; Newman and Holupka, 2013). It is not my intention in this article to assert that either side has predominated in this literature, but instead to point out that the question of social benefits is now an open question, at the least. It would be ironic if the mortgage interest deduction and, for that matter, other policies to promote homeownership were to be terminated, at the same time that the professional argument concerning social benefits and externalities, so long dismissed, has reopened.

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<sup>1</sup> My calculation is from “Tables Based on the Public Data,” expressed in nominal dollars, published by the Federal Reserve Board as part of the 2010 Survey of Consumer Finances, available at [http://www.federalreserve.gov/econresdata/scf/scf\\_2010.htm](http://www.federalreserve.gov/econresdata/scf/scf_2010.htm).

Many critics of the mortgage interest deduction focus on equity rather than efficiency. They argue that the deduction benefits primarily higher income households, because they are disproportionately homeowners and because lower income and moderate-income homeowners often cannot take advantage of the deduction because they do not have enough deductions to itemize. These criticisms overlook the fact that the federal income tax is progressive. In 2007, the last year of the economic expansion before the Great Recession,<sup>2</sup> taxpayers with incomes above \$200,000—the richest 5 percent of taxpayers—received about one-third of the total income of all taxpayers, whereas taxpayers with incomes below \$50,000—the lower half of the income distribution—received only about one-seventh of the total income of all taxpayers.<sup>3</sup> The distribution of the tax burden was much more unequal: the richest 5 percent paid more than one-half of all personal income taxes, whereas the lowest 50 percent paid less than one-tenth (Bryan, 2009). The pattern was similar for 2011, the most recent year for which the Treasury has published individual income tax return data in the *Statistics of Income* (Bryan, 2013).

The claim that the deduction primarily benefits higher income households is far more applicable to two other commonly claimed deductions, those for state and local income taxes and for charitable contributions. In both 2007 and 2011, the richest 5 percent of taxpayers received less than one-fifth of the aggregate deduction for mortgage interest; they received more than one-half of the deductions for state and local income taxes and for charitable contributions.

The argument that many homeowners cannot claim the mortgage interest deduction is also more applicable to these other two common deductions. In 2007, 76 million Americans owned homes, of whom 47 million had mortgages and 41 million—nearly 90 percent of all mortgagors—claimed the deduction. The number claiming the mortgage interest deduction was the same as the number who claimed the charitable deduction and more than the number who claimed the deduction for state and local income taxes (37 million).<sup>4</sup>

Among the 41 million tax filers who claimed the mortgage interest deduction, some 5.6 million paid no income tax because their deductions exceeded their tax liability, which is a good indication that they were in the lower half of the income distribution.

Nearly one-half of the homeowners who did not have mortgages were elderly. Most of them previously had mortgages but had paid them off. Some 85 percent of homeowners in 2007 originally bought their home with a mortgage. It is very likely that they claimed the mortgage interest deduction for a number of years after they moved in.

The 41 million homeowners who claimed the mortgage interest deduction comprised 54 percent of all homeowners and 37 percent of all households. If the share of homeowners and households who claim it is an argument against the mortgage interest deduction, then a parallel, and stronger, argument can be made against the deduction for state and local income taxes. In California, for example, only 4.7 million of the 14.4 million state income taxpayers—less than one-third—were

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<sup>2</sup> The beginning of the recession is dated as December 2007 by the National Bureau of Economic Research.

<sup>3</sup> These data exclude households that did not pay the federal income tax.

<sup>4</sup> The data in this and the next two paragraphs are taken from Weicher (2013).

able to claim a federal tax deduction for their state taxes, and California has one of the highest state tax burdens in the country. In Illinois, which has a moderate tax burden, less than one-third of state taxpayers claimed the deduction; in Arizona, with one of the lowest burdens, about one-fourth claimed the deduction. Those in these and other states who could claim the deduction for state and local income taxes were disproportionately in the richest 5 percent of federal taxpayers. Should we eliminate the state and local income tax deduction because so few taxpayers who pay state and local income taxes are able to itemize their tax payments on their federal tax return?

The mortgage interest deduction provides several benefits, and they are widely diffused among American households. Most of us receive the social benefits from the deduction for most of our lives.

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