The Hidden Cost of Federal Tax Policy

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CHAPTER 6
Why Should Congress Reform the Mortgage Interest Deduction?

Consumer advocates view the mortgage interest deduction (MID) as a benefit for lower- and middle-income taxpayers.[1] Yet fewer than 9.8 percent of tax filers earning less than $50,000 claim the MID, and these are the same households that would gain the most from the social benefits of homeownership. Instead, most of the monetary benefits from the MID go to high-income earners, whose average tax benefit from the MID is nearly nine times greater than that of households earning $50,000 to $100,000.

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

One of the difficulties with the existing US tax code is that closing one loophole can result in a transfer of much of the government-subsidized spending to a different special tax provision. For example, when the tax deduction for consumer interest was eliminated with the Tax Reform Act of 1986, high-income earners increased their use of housing interest by 67 to 86 cents for every dollar lost in consumer interest.[2] Today, there is still reason to believe that the existing tax bias toward housing is diverting resources from other areas of the economy. Writing about a slightly different tax code in 2005, the US Treasury found that investments in owner-occupied housing had a marginal effective tax rate of nearly 0 percent as a result of capital gains exclusion on the sale of primary residences, whereas investments in noncorporate businesses and corporate businesses were taxed at 17 and 26 percent, respectively.[3] Alan Viard and Robert Carroll find that the existing tax code bias toward housing through the MID diverts resources from other productive investments.[4]

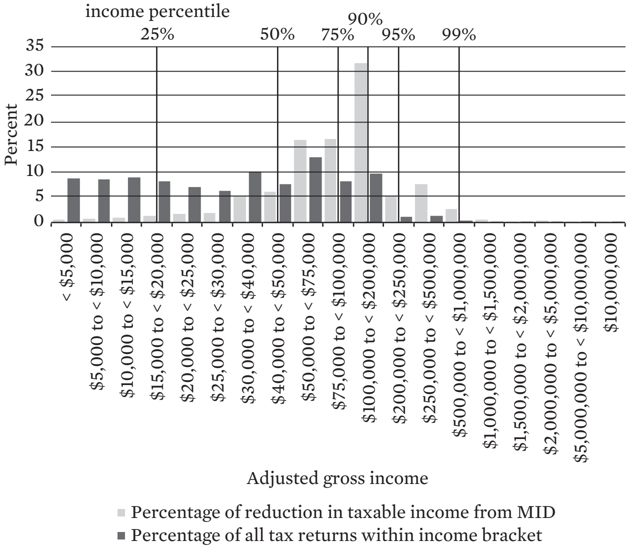
The MID likely could be eliminated with minimal effects on low- and middle-income taxpayers because over 64 percent of the MID tax benefits go to tax filers earning more than $100,000 annually. Eliminating the MID in exchange for lower marginal rates and a higher standard deduction would represent a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

However, given the political constraints surrounding repeal of the MID, we also present a second-best option. The MID could be reformed into a nonrefundable credit of approximately $1,070, which would encourage homeownership and provide a stronger tax benefit for low-income households—the households that stand to gain the most from the sociological benefits of homeownership. Adoption of a mortgage interest credit could increase homeownership among low- and middle-income households by as much as 5 percent while decreasing homeownership rates among high-income households by only 1 percent.

WHO BENEFITS FROM THE MORTGAGE INTEREST DEDUCTION?

One of the most commonly cited justifications for the MID is that it promotes homeownership among the middle class and supports industries that employ middle-class workers.[5] About six in every ten Americans oppose elimination of the MID, and one in every four claim it on their income tax returns.[6] By an economic valuation, the MID is a sizable tax subsidy—the third-largest deduction in the US tax code (behind the exclusion of employer contributions for medical insurance premiums and the exclusion of net imputed income). In 2013, the MID decreased federal revenue by $69 billion.[7] Although the upper-middle class does benefit from the deduction, most of the monetary benefits go to higher-income taxpayers and little to none go to low-income households that purchase a home (see figure 6.1). On average, wealthier households borrow more money and have higher rates of homeownership (see figure 6.2, page 132). One reason low-income and many middle-income taxpayers are

Figure 6.1. Benefits of the Mortgage Interest Deduction by Adjusted Gross Income



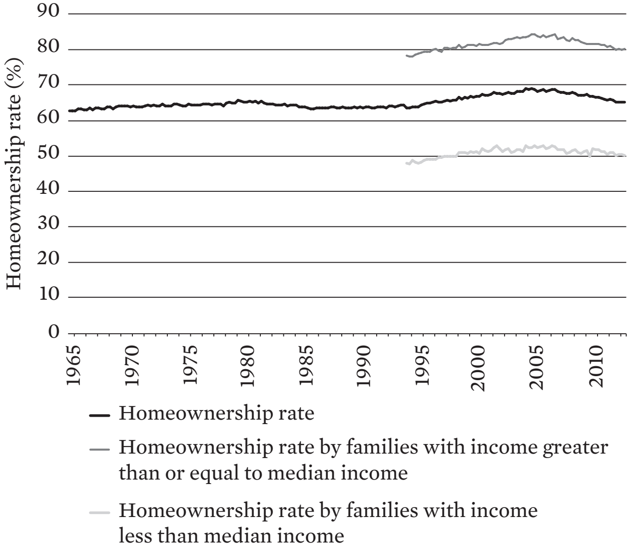
Source: Data from Internal Revenue Service, “Table 1.1—All Returns: Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2010,” July 2012, and “Table 3.1—Returns with Modified Taxable Income: Adjusted Gross Income and Tax Items,” 2010.

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

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

Figure 6.2 shows that the homeownership rate is distinctly higher for households with incomes greater than the median, suggesting that, not surprisingly, income is a significant determinant of ownership. The figure also suggests that the MID is not a significant equalizer of outcome when it comes to homeownership. According to a 1997 paper, 45 percent of the aggregate benefit of the MID went to the 9.8 percent of taxpayers with annual incomes over $100,000.[12] Compared to 1997 nominal household income in 2010, 48.5 percent of the aggregate benefit of the MID goes to 13 percent of taxpayers with incomes over $100,000 (see table 6.2, page 136).[13]

Figure 6.2. Homeownership Rate by Income



Source: Data from the US Census Bureau.

Note: Homeownership rates above and below median family income are not available before 1993.

Many other countries have a mortgage interest deduction, too. Although various social and economic factors contribute to a country's homeownership rate, a side-by-side comparison of countries indicates an inconclusive relationship between the MID and homeownership (see table 6.1). In the United Kingdom, which phased out the MID between 1975 and 2000, the homeownership rate rose from 53 percent in 1974 to 68 percent in 2001.[14] Despite the lack of a statistically strong relationship between tax subsidies and homeownership rates, the United States boasts the world's most generous tax subsidies for

Table 6.1. Homeownership Rates and Mortgage Interest Deductibility for Selected Economies

COUNTRY	HOMEOWNERSHIP RATE (%)	IS MORTGAGE INTEREST DEDUCTIBLE?
Singapore	87	No
Taiwan	84	Yes[a]
Spain	82	Yes
Ireland	77	Yes
Norway	77	Yes
Portugal	75	Yes
Greece	72	Yes[b]
Italy	71	No
Australia	70	No
Canada	68	No
United Kingdom	68	No
New Zealand	67	No
United States	65	Yes
Finland	64	Yes
Belgium	63	Yes[b]
Japan	61	No
Sweden	60	Yes
Poland	59	No[b]
France	55	No[c]
Korea, Rep.	54	No
Netherlands	50	Yes[b]
Austria	49	Yes
Germany	42	No
Switzerland	35	Yes[b]

(*continued*)

Table 6.1. (*continued*)

Source: Steven C. Bourassa, Donald R. Haurin, Patric H. Hendershott, and Martin Hoesli, “Mortgage Interest Deductions and Homeownership: An International Survey,” Research Paper 12-06, Swiss Finance Institute, Geneva, February 9, 2012.

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

b. Greece, Belgium, Poland, the Netherlands, and Switzerland all have imputed rent taxes, although Greece’s tax applies only to large dwellings. Calista Cheung, “Policies to Rebalance Housing Markets in New Zealand,” OECD Economics Department Working Paper 878, Organisation for Economic Co-operation and Development, 2011.

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

owner-occupied housing.[15] Much of the justification for the subsidies is focused on encouraging individuals to have better household saving plans. Yet as Yale economist Robert Shiller points out, foreign countries such as Switzerland have higher rates of household savings without high homeownership rates.[16]

A successful tax-favored housing policy would be designed to encourage inframarginal households to purchase a home—people who would like to own homes but who would not do so without a federal subsidy.[17] In 1973, Stanley Surrey, who served as assistant secretary of the treasury for tax policy from 1961 to 1969, wanted to reform the MID to subsidize such households.[18] However, the decision to purchase a home is influenced by a variety of factors, including socioeconomic status and local housing prices. Economists Peter Brady, Julie-Anne Cronin, and Scott

Houser examine some primary factors in the decision to itemize deductions: income, various demographics, and housing prices, as well as federal, state, and local tax policies.[19] They conclude that over 60 percent of the probability of itemizing deductions versus taking the standard deduction is accounted for by regional variation in housing prices and housing tax policies. For many low- and middle-income taxpayers, tax-favored housing policies are often out of reach because the itemized benefit of the MID is not greater than the standard deduction (currently $6,200 for individuals and $12,400 for joint filers). In many cases, using the MID—and any other applicable itemized tax deductions—only makes sense if the taxpayer earns a certain level of income. According to IRS data, three-fourths of tax filers who use the MID have an income of at least $100,000 (see table 6.2). A reform that increased low-income taxpayers' access to tax-favored housing policies would need to take demographics and housing prices into account.

Lowering the marginal tax rates reduces high-income taxpayers' incentive to use the MID. Referring to the 1986 Tax Reform Act, economists James Follain and David Ling say, "All else equal, these reductions in marginal tax rates lower the subsidy to housing."[20] In other words, because such taxpayers are taxed at a lower marginal rate, the MID has less value. As their income increases, taxpayers increasingly benefit from the MID. According to the most recent data, from 2010, households in the bottom 65 percent of the income distribution obtained 18 percent of the reduction in taxable income from the MID, whereas households

Table 6.2. Benefits of the Mortgage Interest Deduction by Income, 2010

	LEVEL OF INCOME		
	UNDER $15,000	**$15,000 TO $29,999**	**$30,000 TO $49,999**
Total number of tax returns	35,036,910	30,890,795	25,621,630
Number of itemized tax returns	1,872,849	3,875,849	7,500,859
Number of tax returns claiming MID	1,036,535	2,409,435	5,511,974
Share of tax returns claiming MID (%)	2.96	7.80	21.51
Share of itemized returns claiming MID (%)	55.35	62.17	73.48
Reduction in taxable income from MID ($ thousands)	8,229,943	18,121,315	42,626,632
Reduction in taxable income from MID per return ($)	230	590	1,660
Reduction in taxable income from MID per itemized return ($)	4,390	4,680	5,680
Average reduction in taxable income from MID per returns claiming MID ($)	7,940	7,520	7,730
Effective tax rate for all returns (%)	5.81	6.25	8.83
Effective tax reduction of MID/static revenue loss ($ thousands)	478,263	1,132,671	3,765,705
Effective tax reduction from MID per return	14	37	147

Source: Data from Adrian Dungan and Michael Parisi, "Individual Income Tax Returns, Preliminary Data, 2010," *SOI Bulletin* 31, no. 3 (Winter 2012): 5–18, 6–8, figure A.

$50,000 TO $99,999	$100,000 TO $199,999	$200,000 TO $249,999	$250,000 AND ABOVE	ALL LEVELS OF INCOME
30,627,721	14,008,889	1,537,297	2,738,863	140,462,105
17,272,112	11,881,416	1,451,691	2,650,754	46,505,530
14,025,505	10,157,415	1,193,764	2,027,798	36,362,426
45.79	72.51	77.65	74.04	25.89
81.20	85.49	82.23	76.50	78.19
127,173,272	122,119,547	19,521,612	42,883,844	380,676,165
4,150	8,720	12,700	15,660	2,710
7,360	10,280	13,450	16,180	8,190
9,070	12,020	16,350	21,150	10,470
11.59	16.34	21.72	27.37	17.33
14,739,119	19,950,535	4,239,460	11,736,078	56,041,831
481	1,424	2,758	4,285	470

in the top 35 percent accounted for 82 percent of the reduction in taxable income (see table 6.2).[21]

However, these measurements of taxable income understate the realized benefit of the deduction to higher-income households. Because higher-income taxpayers pay a higher marginal rate on their taxable income, any deduction that decreases taxable income is more valuable to a high-income taxpayer than to a low-income taxpayer. Looking at the aggregate effective tax break for low-income households compared to high-income households, one finds that the 2 percent of income earners who make more than $250,000 annually receive nearly 25 times more from the MID than those who earn less than $15,000 (see table 6.2).

Looking at average effective tax breaks per return, one discovers that the difference between income brackets is even greater because less than 3 percent of households earning $15,000 or less claim the MID. The average effective tax reduction for each return among the lowest-income families is $14. Compare that to the average $4,285 tax reduction for tax filers who earn $250,000 or more. The large variation in nominal benefits is one reason that many economists consider the MID to be a regressive tax policy. High-income earners receive an average tax benefit that is nine times greater than that of tax filers earning $50,000 to $100,000 (see table 6.2). The effective tax reduction of the MID per return for tax filers earning $100,000 to $200,000 is $1,424, which is nearly 10 times the $147 saved by taxpayers earning $30,000 to $50,000.

In terms of effective tax reduction, taxpayers earning more than $100,000 (13 percent of tax returns) receive more than $35 billion in tax reductions, whereas taxpayers earning less than $50,000 (65 percent of tax returns) receive a little more than $5 billion. Less than 20 percent of all income tax returns that report less than $40,000 in earnings claim the MID, whereas approximately 75 percent of income tax returns with reported earnings of $100,000 to $1 million claim the MID (see table 6.3). Because of the extreme differences in who benefits from the MID, many scholars believe that it is highly skewed toward high-income households.[22]

In addition to favoring higher-income earners, the benefits associated with the MID favor particular geographic locations. According to economists Todd Sinai and Joseph Gyourko's study on tax-favored housing for the years 1980–2000, the biggest benefits went, in descending order, to Washington, DC; Hawaii; California; New York; Massachusetts; Connecticut; and New Jersey—5 of which are among the top 14 median state incomes.[23] Owner-occupied benefits exceeded $8,000 in each of these high-income states, which also have the highest state marginal tax rates. In another study, Gyourko and Sinai find that three metropolitan areas—New York–northern New Jersey, Los Angeles–Riverside–Orange County, and San Francisco–Oakland–San Jose—received 5 percent of net positive benefits from the MID.[24]

MID state tax policies suffer from equity and efficiency problems similar to those of federal tax policy. As Richard Green and Andrew Reschovsky

Table 6.3. Share of Taxpayers Claiming the Mortgage Interest Deduction in 2010, by Income Range

ADJUSTED GROSS INCOME RANGE ($)	SHARE WHO ITEMIZE MORTGAGE INTEREST DEDUCTION (%)
All	25.86
0–4,999	1.97
5,000–9,999	2.77
10,000–14,999	3.85
15,000–19,999	5.78
20,000–24,999	8.02
25,000–29,999	11.45
30,000–39,999	17.80
40,000–49,999	27.38
50,000–74,999	40.45
75,000–99,999	56.21
100,000–199,999	73.28
200,000–249,999	78.63
250,000–499,999	77.54
500,000–999,999	72.64
1,000,000–1,499,999	66.37
1,500,000–1,999,999	64.57
2,000,000–4,999,999	60.98
5,000,000–9,999,999	53.99
10,000,000 and above	47.39

Source: Data from the Statistics of Income Division of the Internal Revenue Service.

explain, “In 33 of the 42 states with individual income taxes, mortgage interest is deductible in the calculation of state income tax liabilities, further increasing the tax subsidy to homeownership.”[25] In fact, all states with an MID (except Alabama) favor high-income households relative to middle-income households.[26] Table 6.4 shows a state-by-state comparison of the percentage point reduction in effective tax rates among households with $50,000 in earnings and those with $200,000 in earnings that claim a state MID. The table also provides a ranking of the difference in effective tax rate reduction by state. These data suggest that state MIDs offer a more significant decrease in effective tax rates for high-income earners than for middle-income households. Thus, the economic distortions caused by the state MIDs, and their regressive effects, go even beyond those at the federal level.

The demographics of the main beneficiaries of the MID are more particular than just income and geography. Because the MID is something that is used over an extended period of time, MID users who recently purchased a home have a particularly strong interest in continuation of the MID in the tax code. Young, high-earner homeowners would be the most disadvantaged by its repeal.[27] Evidence also suggests that two-earner households would be particularly affected by changes to the MID, because they tend to use greater amounts of debt to finance their homes.[28]

The MID thus frequently gives higher-income taxpayers a tax deduction for a purchase that they would have made anyway.[29] Glaeser and Shapiro conclude that the MID does little to increase the country’s

Table 6.4. State Mortgage Interest Deduction Favors High-Income Earners, 2010

		$50,000 ADJUSTED GROSS INCOME		$200,000 ADJUSTED GROSS INCOME		DIFFERENCE	
STATE	STATE MID?	EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE	EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE	EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE
North Carolina	Yes	0.03	0.00	0.55	5.45	–0.52	–5.45
Missouri	Yes	0.00	0.00	0.46	5.35	–0.46	–5.35
Arkansas	Yes	0.00	0.00	0.43	5.29	–0.43	–5.29
California	Yes	0.24	1.97	1.05	7.17	–0.81	–5.20
Georgia	Yes	0.00	0.00	0.55	5.16	–0.55	–5.16
Wisconsin	Yes	0.00	0.00	0.41	5.00	–0.41	–5.00
Virginia	Yes	0.00	0.00	0.50	4.28	–0.50	–4.28

Iowa	Yes	0.38	1.99	0.43	6.13	–0.05	–4.14
Kansas	Yes	0.00	0.00	0.31	3.97	–0.31	–3.97
Maryland	Yes	0.00	0.00	0.45	3.92	–0.45	–3.92
Maine	Yes	0.00	0.00	0.29	3.51	–0.29	–3.51
Montana	Yes	0.19	0.37	0.34	3.81	–0.15	–3.44
Minnesota	Yes	0.00	0.00	0.33	3.32	–0.33	–3.32
Idaho	Yes	0.00	0.00	0.32	3.27	–0.32	–3.27
South Carolina	Yes	0.00	0.00	0.32	3.13	–0.32	–3.13
Rhode Island	Yes	0.00	0.00	0.27	3.07	–0.27	–3.07
Delaware	Yes	0.54	1.69	0.46	4.65	0.08	–2.96
Arizona	Yes	0.06	0.16	0.32	2.63	–0.26	–2.47
Colorado	Yes	0.00	0.00	0.25	2.26	–0.25	–2.26
New York	Yes	0.00	0.00	0.25	2.22	–0.25	–2.22
Oregon	Yes	0.99	5.28	0.78	7.35	0.21	–2.07
Mississippi	Yes	0.32	1.48	0.28	3.54	0.04	–2.06

(*continued*)

Table 6.4. (*continued*)

		$50,000 ADJUSTED GROSS INCOME		$200,000 ADJUSTED GROSS INCOME		DIFFERENCE	
STATE	STATE MID?	EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE	EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE	EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE
Hawaii	Yes	1.35	4.96	0.90	6.96	0.45	–2.00
Vermont	Yes	0.00	0.00	0.15	1.97	–0.15	–1.97
New Mexico	Yes	0.00	0.00	0.18	1.89	–0.18	–1.89
Nebraska	Yes	0.00	0.00	0.11	1.48	–0.11	–1.48
Kentucky	Yes	0.50	3.83	0.41	5.17	0.09	–1.34
Oklahoma	Yes	0.00	0.00	0.10	1.32	–0.10	–1.32
Louisiana	Yes	0.00	0.00	0.09	1.15	–0.09	–1.15

North Dakota	Yes	0.00	0.00	0.03	0.50	–0.03	–0.50
Alaska	No	0.00	0.00	0.00	0.00	0.00	0.00
Connecticut	No	0.00	0.00	0.00	0.00	0.00	0.00
Florida	No	0.00	0.00	0.00	0.00	0.00	0.00
Illinois	No	0.00	0.00	0.00	0.00	0.00	0.00
Indiana	No	0.00	0.00	0.00	0.00	0.00	0.00
Massachusetts	No	0.00	0.00	0.00	0.00	0.00	0.00
Michigan	No	0.00	0.00	0.00	0.00	0.00	0.00
Nevada	No	0.00	0.00	0.00	0.00	0.00	0.00
New Hampshire	No	0.00	0.00	0.00	0.00	0.00	0.00
New Jersey	No	0.00	0.00	0.00	0.00	0.00	0.00
Ohio	No	0.00	0.00	0.00	0.00	0.00	0.00
Pennsylvania	No	0.00	0.00	0.00	0.00	0.00	0.00
South Dakota	No	0.00	0.00	0.00	0.00	0.00	0.00
Tennessee	No	0.00	0.00	0.00	0.00	0.00	0.00

(*continued*)

Table 6.4. (*continued*)

STATE	STATE MID?	$50,000 ADJUSTED GROSS INCOME: EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	$50,000 ADJUSTED GROSS INCOME: EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE	$200,000 ADJUSTED GROSS INCOME: EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	$200,000 ADJUSTED GROSS INCOME: EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE	DIFFERENCE: EFFECTIVE STATE TAX BENEFIT AS % OF INCOME	DIFFERENCE: EFFECTIVE TAX BENEFIT AS % OF INTEREST EXPENSE
Texas	No	0.00	0.00	0.00	0.00	0.00	0.00
Utah	No	0.00	0.00	0.00	0.00	0.00	0.00
Washington	No	0.00	0.00	0.00	0.00	0.00	0.00
West Virginia	No	0.00	0.00	0.00	0.00	0.00	0.00
Wyoming	No	0.00	0.00	0.00	0.00	0.00	0.00
Alabama	Yes	0.68	4.89	0.41	4.46	0.27	0.43

Source: Authors' calculations and data from Donald Morris and Jing Wang, "How and Why States Use the Home Mortgage Interest Deduction," *Tax Notes* 64 (June 4, 2012): 697–713.

homeownership rate; rather it increases the demand for debt and modifies the progressivity of the tax code.[30] A similar conclusion was reached by Thomas Boehm and Alan Schlottmann, who find that across the 1970s and through the 1990s, the MID increased demand for housing by 2.6 to 3.5 percentage points but that the MID may have had greater influence in the 1970s and 1980s because of an increased likelihood that a given person was a homeowner in the 1990s.[31] An effective federal tax policy that promotes homeownership should ensure that any tax benefit goes to households at the margin—those that would not necessarily purchase a home without the tax benefit. As long as housing tax policy exists, it should be designed to encourage access to the social benefits among potential homeowners who would not otherwise buy a home. Some of these social benefits are discussed in the next section.

SOCIAL BENEFITS AND COSTS OF HOMEOWNERSHIP

The social benefits discussed in this section are a summary of research on the positive and negative externalities associated with homeownership. To the extent that the MID increases homeownership rates, these issues are influenced by tax policy as well (see table 6.5).

Positive externalities from homeownership may include benefits to the next generation as well as better property maintenance and stronger communities. In their 1997 study, economists Richard Green and

Table 6.5. Positive and Negative Externalities of Homeownership

TYPE	SOCIAL OUTCOME AND SUPPORTING RESEARCH
Positive externalities	
Better property maintenance	Rental homes depreciate at a faster rate than owner-occupied single-family homes (DiPasquale and Glaeser 1999; Shilling, Sirmans, and Dombrow 1991; Galster 1983).
More pleasant community	A significant amount of spending in expensive areas of the country is on land or community amenities (Glaeser and Gyourko 2001). Homeowners are more likely to make political choices that favor the long-run health of their community (as measured by school funding and road maintenance). Municipalities with a higher level of renters, who have an incentive to favor policies with short-run gains, vote for policies favoring social welfare and hospitals (DiPasquale and Glaeser 1999; Monroe 2001). Homeowners are more likely to invest in communities because of the high cost of moving (DiPasquale and Glaeser 1999; Monroe 2001).
More politically informed residents	Homeowners are more likely to be informed about political figures and to be active in local politics (Glaeser and Shapiro 2003).
More successful children	Children of homeowners are 9 percent less likely to drop out of school than children of comparable renters (Green and White 1997).
Negative externalities	
More unemployment	Higher homeownership rates lead to high levels of unemployment. Areas with renters can move more quickly in response to an economic shock (Oswald 1999).

(*continued*)

Table 6.5. (*continued*)

TYPE	SOCIAL OUTCOME AND SUPPORTING RESEARCH
More income segregation	Encouraging more housing consumption encourages wealthier people to leave small city apartments for larger homes on the fringe of the city, thereby imposing negative social costs on people remaining in the city and increasing segregation by income (Voith 1999).
	Homeownership can cause political behavior that restricts the supply of new housing via zoning and other land-use controls in order to raise prices (Glaeser and Shapiro 2003).

Sources: Edward L. Glaeser and Jesse M. Shapiro, “The Benefits of the Home Mortgage Interest Deduction,” in *Tax Policy and the Economy*, vol. 17, ed. James M. Poterba (Cambridge, MA: MIT Press, 2003), 37–82; Denise DiPasquale and Edward L. Glaeser, “Incentives and Social Capital: Are Homeowners Better Citizens?,” *Journal of Urban Economics* 45, no. 2 (March 1999): 354–84; James Shilling, C. F. Sirmans, and Jonathan Dombrow, “Measuring Depreciation in Single-Family Rental and Owner-Occupied Housing,” *Journal of Housing Economics* 1, no. 4 (December 1991): 368–83; George Galster, “Empirical Evidence on Cross-Tenure Differences in House Maintenance and Conditions,” *Land Economics* 59, no. 1 (February 1983): 107–13; Edward L. Glaeser and Joseph Gyourko, “Urban Decline and Durable Housing,” NBER Working Paper 8598, National Bureau of Economic Research, Cambridge, MA, November 2001; Albert Monroe, “The Effects of Homeownership on Communities” (PhD diss., Harvard University, May 2001); Richard Green and Michelle White, “Measuring the Benefits of Homeowning: Effects on Children,” *Journal of Urban Economic*s 41, no. 3 (May 1997): 441–461; Andrew J. Oswald, “The Housing Market and Europe’s Unemployment: A Non-technical Paper,” Working Paper, University of Warwick, Coventry, UK, 1999; Richard Voith, “Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?,” *Federal Reserve Bank of Philadelphia Business Review*, March–April 1999, 3–16.

Michelle White find that children of homeowners were 9 percent more likely to stay in school than the children of renters.[32] Green and White monetized the value of a low-income renter becoming a homeowner at $31,000.[33] Economists Glaeser and Shapiro also find evidence that homeowners take better care of their property and tend to work harder at making their community more pleasant. Homeowners tend to be more interested in their community because of high mobility costs and because the value of their asset is tied to the quality of their community.[34] These fixed interests also lead homeowners to be more involved politically.

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

Other authors, including Henry Aaron, Harvey Rosen, Kenneth Rosen, James Poterba, and Edwin Mills, have examined the social costs associated with the MID.[36] This chapter does not attempt to conclude whether the externalities from homeownership are a net social gain or loss. But it seems likely that the effect of any positive externalities from homeownership would be relatively greater for low-income taxpayers than for high-income taxpayers.

ECONOMICS OF THE MORTGAGE INTEREST DEDUCTION

In addition to the social effects of the MID, it has economic and public policy implications. One of the main objections to the MID is that preferential housing encourages overinvestment in housing. Although the MID has little effect on the homeownership rate, it does have a significant role in increasing the amount of debt and the size of a home that is purchased. Studies estimate that the MID encourages people to acquire homes that are 10 to 20 percent larger than they would have purchased without the MID.[37]

Such investment occurs at the expense of investments in plants and equipment.[38] Money should be invested at the most economically efficient point. Tax deductions create an artificially low hurdle for investment dollars. The healthiest economy is one in which the most valued investments are not discouraged in place of government-favored alternatives.

Taxpayers reshuffle their investment portfolios in response to changes in the tax code. For example, when the Tax Reform Act of 1986 ended the deductibility of consumer debt, high-income taxpayers increased their consumption of the MID. Economists Jonathan Skinner and Daniel Feenberg found that high-income earners increased their consumption of interest on housing by 67 to 86 cents for every dollar decrease in consumer interest paid.[39] Dean Maki draws similar conclusions.[40]

Another important implication of the Skinner and Feenberg study is that estimates about revenue lost from the MID overstate the true loss in government revenue. Taxpayers adjust their behavior in response to changes in tax-preferred investments in an effort to minimize their tax burden. These behavioral responses reduce the tax revenue that could be expected to be gained by ending any given tax expenditure. First, revenue may be lower than anticipated because taxpayers may transfer some investments into a different form of tax-preferred investment. Second, if mortgage interest were no longer a tax-preferred investment, taxpayers would draw down on holdings of interest, dividends, and capital gains to reduce their principal and interest payments. Because other forms of taxable income would be used to lower outstanding debt, there would be less government revenue from taxing those alternative forms of investment.[41] As a result, estimates of what portion of the MID would be collected as revenue in the provision's absence vary: James Follain and Lisa Sturman Melamed estimate 25 percent; Martin Gervais and Manish Pandey estimate 58 percent; William Gale, Jonathan Gruber, and Seth Stephens-Davidowitz estimate 84 percent; and James Poterba and Todd Sinai estimate 80 percent.[42] Therefore, even if the MID were eliminated, it would not lead to an instant $69 billion in annual tax revenue for the US Treasury.[43]

Last, the MID increases the demand for housing, thus increasing both the price of homes and interest rates. Estimates of how much the MID increases housing prices range from 10 to 15 percent.[44] Lawrence Yun, chief economist for the National Association of Realtors, claims that eliminating the MID would result in trillions of dollars of wealth destruction and uncertainty.[45] One study finds that the increase in housing prices is largely driven by the demand for homes that are 10 to 20 percent larger than the homes buyers would choose in the absence of the MID.[46] Marquette University economist Andrew Hanson estimates that the MID increases home sizes by as much as 1,400 square feet.[47] A rise in homeownership rates further increases local prices, perhaps by as much as a 1.5 percent for every 1 percent increase in homeownership.[48] And because the MID increases the demand for debt, banks lend money at higher interest rates. Hanson estimates that 9 to 17 percent of the MID subsidy is offset by higher interest rates.[49]

PAST REFORMS AND POLICY OPTIONS

The Tax Reform Act of 1986 significantly reduced the value of the MID by reducing marginal tax rates and increasing the standard deduction. James Follain and David Ling estimate that the deadweight economic loss of housing subsidies was decreased by one-third as a result of the lower marginal tax rates mandated in the act.[50] The lower tax rates significantly diminished use of the MID by lower-income households, although the reduction in use was not quite as great as for high-income households. Furthermore, increases in the standard deduction made it less desirable or unnecessary for low-income households to claim itemized deductions, thus sparing these taxpayers associated tax complexities. Follain and Ling report that in 1991 the interest deduction became “essentially worthless” for a household with a typical loan–to–market value ratio and an annual income below $42,500.[51] In inflation-adjusted terms, this amount would be nearly $73,000 in 2014.[52] Consistent with other data, there seems to be an increase in homeownership and in the use of the MID beginning around this income level (see tables 6.2 and 6.3, pages 136 and 140).

In light of the regressive nature of the MID’s benefit distribution and the lack of desired policy outcomes, there are reforms to housing tax policy that could more effectively help the intended beneficiaries. Many of these policy changes might not—and likely would not—solve many of the economic and investment inefficiencies that a housing subsidy creates. Before moving on to policy recommendations, we describe three alternative reforms considered by others in the literature: (a) refundable and nonrefundable tax credits on mortgage interest, (b) a fixed tax credit for homeownership, and (c) a one-time home-buyer credit.

One of the first options addressed in the literature is a refundable tax credit for mortgage interest payments. Green and Reschovsky estimate that a credit equal to 21 percent of mortgage interest payments would raise total homeownership by 3 percent. Households earning less than an estimated inflation-adjusted

$145,000 ($100,000 in 1997) would experience an increase in homeownership, whereas the wealthiest households would experience less than a 1 percent decrease.[53] These changes in homeownership rates from the simulation models run by Green and Reschovsky imply that nearly 3.1 million households would become homeowners, while only about 30,000 high-income homeowners would choose to become renters.[54] The refundable tax credit could lower tax liabilities to below zero for many homeowners with mortgage interest.

In 2010, the National Commission on Fiscal Responsibility and Reform (otherwise known as the Simpson–Bowles Commission) suggested reforming the MID into a nonrefundable tax credit for mortgage interest. Nonrefundable tax credits can lower tax liabilities down to zero but not below. The commission proposed imposing a 12 percent tax credit cap on interest paid and lowering the maximum qualifying debt from $1 million to $500,000.[55] Changing the cap would significantly scale back housing tax subsidies to high-income earners because only 0.39 percent of mortgages exceed the current $1 million cap.[56] The commission also revisited one of the policy ideas of the 2005 President's Advisory Panel on Federal Tax Reform. The panel had considered reforming the MID into a credit on 15 percent of eligible mortgage interest to encourage homeownership in general, not just the purchase of bigger homes.[57] The ceiling on eligible mortgage principal would have been limited to between $227,000 and $412,000 (approximately $272,000 and $493,000, adjusted for inflation), depending on average regional housing costs. Economists David Ling and Gary McGill examine a 15 percent credit in their 2007 paper. Without accounting for behavioral effects, they find that the credit would decrease tax liabilities for low-income households, whereas some households earning in excess of $75,000 would see their tax burdens rise.[58] In an earlier paper, James Follain, David Ling, and Gary McGill petition for the introduction of a flat nonrefundable tax credit.[59] Amanda Eng, Harvey Galper, Georgia Ivsin, and Eric Toder present two different proposals for a nonrefundable credit of 15 percent and 20 percent, respectively, of eligible mortgage interest to replace the existing MID.[60] These two policy proposals offer a good starting place for reform, but setting the tax credit at a specific value could be a simpler and more effective way to encourage low-income homeownership.

A second option for reform is an annual tax credit for owning a home. Adam Carasso, Eugene Steuerle, and Elizabeth Bell examine a 1.03 percent credit, in 2005, based on a home purchase price of up to $100,000 (an inflation-adjusted $119,000)—regardless of whether a mortgage is held. According to their analysis, households in the bottom four quintiles would experience a decrease in taxes, whereas the top quintile would experience a tax increase of 2.5 percent.[61] Similarly, politics professor Peter Dreier argues for a complete substitution of the MID for a housing credit.[62] The proposal is interesting, but Dreier does not estimate how the proposal would affect housing demand.

A third potential reform discussed in the literature is replacement of the MID with a one-time home-buyer credit on a first home. According to Richard Green and Kerry Vandell, this subsidy would be approximately $33,000 for the 2 million people annually who are first-time home buyers.[63] David Ling and Gary McGill claim that the first-time home-buyer credit would have a particularly strong effect on promoting homeownership among low-income households.[64] However, economists Matthew Chambers, Carlos Garriga, and Don Schlagenhauf find that the one-time credit actually backfires on the intent of increasing aggregate homeownership levels.[65] According to their research, the effects of the credit on home prices, in addition to offsetting increases in marginal rates, actually decrease the aggregate homeownership rate among young and poorer households. However, these authors examined only the effect of the credit on renters with offsetting increases in marginal rates without accounting for conversion of the MID into a credit.

All these policy options provide a starting place for a discussion about reforming the MID. However, none would be as effective as the policy recommendations proposed here in terms of creating economic efficiency and tax code simplicity, as well as encouraging homeownership.

CONCLUSION

Two policy recommendations are made here—one based on tax policy principles and one on improving homeownership rates. The first-best option is to eliminate the MID.[66] Only a full repeal of tax-favorable housing policies in exchange for lower marginal rates will eliminate economic inefficiencies. Economists often point out that lower marginal tax rates in general improve economic efficiency and decrease deadweight loss.

The strength of eliminating the MID is that it would reduce the economic distortions of subsidized housing for higher-income households. Eliminating the MID may slightly decrease the demand for housing among some low-income households that actually have sufficient mortgage interest to itemize. But this decrease seems relatively small, given that the MID is used so infrequently by low-income households,[67] and the bulk of the decrease in the demand for mortgage debt would come from households with large loans that exceed the loan limits of Fannie Mae and Freddie Mac.[68] However, James Poterba and Todd Sinai estimate that, in the event of abolishment of the MID, the few low-income households that now use it would be disproportionately taxed compared to higher-income users.[69] These progressivity concerns would likely be addressed to some degree if lower marginal tax rates or a higher standard deduction were instituted to keep the reform revenue neutral. A cleaner federal tax code would move away from the current tax-driven overvaluation of the housing industry. Eliminating the MID would encourage the purchase of more moderately sized homes, because the existing tax subsidy encourages the purchase of homes that are 10 to 20 percent larger than would otherwise be purchased, predominantly among high-income households.[70] Revenue-neutral tax reform that eliminated the bias toward homeownership would encourage higher-income households to shift some housing investments to more socially productive investments.

A second-best alternative tax reform proposed here is to grant a fixed $900 credit for having a mortgage.[71] Green and Reschovsky consider this form of tax credit in their 1997 paper. They claim that a fixed $850 credit (approximately $1,250 adjusted for inflation for 2014) would increase the homeownership rate by 5.3 percent.[72] Similarly, a revenue-neutral fixed credit of $903 can be estimated by using the most recent tax and housing data, before accounting for behavioral effects.[73] The credit could be granted for a specific number of years for an owner-occupied home. Its fixed property might reduce tax code complexity and would not be weighted toward greater debt financing. The credit should also be adjusted periodically to account for inflation and, if simplicity is desired, rounded up to the nearest $50 or $100. For example, a credit estimated at $903 could be rounded up to $950.

Policymakers should continue to take steps toward greater simplicity and efficiency in the US tax code by lowering tax rates and increasing the standard deduction. A cleaner tax code would bring more equality to investment opportunities and would be a step toward greater tax fairness for renters and homeowners with the same incomes.[74] But given the difficulties of eliminating the MID outright, including the special-interest groups that would oppose any such elimination, tax-favored housing should, at a minimum, promote homeownership, not necessarily larger and more expensive homes or second homes used as vacation properties. A fixed nonrefundable tax credit of approximately $900 for a primary mortgage offers the most effective means of both increasing homeownership and properly aligning the purported policy goals of the MID with desired outcomes.

65. Jesse Edgerton, “Investment, Accounting, and the Salience of the Corporate Income Tax,” Working paper, Oxford University Centre for Business Taxation, Oxford, UK, October 2012.
66. Ibid.
67. David Hulse and Jane Livingstone, “Incentive Effects of Bonus Depreciation,” *Journal of Accounting and Public Policy* 29, no. 6 (2010): 578–603.
68. Research from Eric Zwick and James Mahon of Harvard University finds significant positive effects of changes in accelerated depreciation policy. Most strikingly, they find bonus depreciation raised investment by 17.3 percent on average between 2001 and 2004 and by 29.5 percent between 2008 and 2010. The strong incentive found in this new research may be from the inclusion of small and medium firms, which are more responsive to tax incentives. See Eric Zwick and James Mahon, “Do Financial Frictions Amplify Fiscal Policy? Evidence from Business Investment Stimulus,” Job Market Paper, Harvard University, Cambridge, MA, January 7, 2014.
69. Robert E. Hall and Dale W. Jorgenson, “Tax Policy and Investment Behavior,” *American Economic Review* 57, no. 3 (June 1967): 391–414.
70. Hulse and Livingstone, “Incentive Effects of Bonus Depreciation.”
71. Kevin A. Hassett and Gilbert E. Metcalf, “Investment with Uncertain Tax Policy: Does Random Tax Policy Discourage Investment?,” *Economic Journal* 109 (July 1999): 372–93.
72. *Hearing on Extenders and Tax Reform: Seeking Long-Term Solutions before the United States Senate Committee on Finance*, 112th Cong., 2nd sess. (January 31, 2012) (testimony of Jason J. Fichtner, senior research fellow, Mercatus Center, “Increasing America’s Competitiveness by Lowering the Corporate Tax Rate and Simplifying the Tax Code”).
73. Auerbach, “Modern Corporate Tax,” 12. See also Schuyler, “Comparing the Growth and Revenue Effects of Four Proposed Depreciation Systems.”
74. Entin, “Tax Treatment of Capital Assets,” 19.

CHAPTER 6: WHY SHOULD CONGRESS REFORM THE MORTGAGE INTEREST DEDUCTION?

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

2. Jonathan Skinner and Daniel Feenberg, "The Impact of the 1986 Tax Reform Act on Personal Saving," NBER Working Paper 3257, National Bureau of Economic Research, Washington, DC, February 1990. See also Dean M. Maki, "Household Debt and the Tax Reform Act of 1986," *American Economic Review* 91, no. 1 (March 2001): 305–19.
3. President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-growth: Proposals to Fix America's Tax System," November 2005, figure 5.5.
4. Alan D. Viard and Robert Carroll, *Progressive Consumption Taxation: The X-Tax Revisited* (Washington, DC: AEI Press, 2012).
5. Rick Judson, "Keep Homeowners' Tax Deductions: Opposing View," *USA Today*, April 2, 2013.
6. Jeffrey M. Jones, "Americans Oppose Eliminating Income Tax Deductions," Gallup, April 15, 2011. See also IRS, "2010 Estimated Data Line Counts Individual Income Tax Returns," Rev. 11-2012, Washington, DC.
7. Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2015* (Washington, DC: Government Printing House), March 4, 2014, table 14-1, 206.
8. The standard deduction serves two important roles: to simplify the federal tax code and to favor lower-income taxpayers by making the tax code more progressive. Part of the design of the standard deduction is to render it unnecessary for some taxpayers to track their tax-related expenditures throughout the year, because the cumulative effort would not exceed the standard deduction. For millions of taxpayers, simply claiming the standard deduction saves time and resources. However, the standard deduction is also designed to reduce the taxable income of low-income taxpayers, regardless of whether any tax-related expenditures have been incurred. (Along these lines, tax-related expenditures might be viewed as having gone to waste. In short, in a world where there must be tax-favored spending, it seems that increasing the number of low- and middle-income housing units would reap more social benefits than an equal amount of money in tax subsidies given to high-income earners.)
9. Glaeser and Shapiro, "Benefits of the Home Mortgage Interest Deduction."
10. David C. Ling and Gary A. McGill, "Evidence on the Demand for Mortgage Debt by Owner-Occupants," *Journal of Urban Economics* 44, no. 3 (1998): 391–414. See also James R. Follain and Lisa Sturman Melamed, "The False Messiah of Tax Policy:

What Elimination of the Home Mortgage Interest Deduction Promises and a Careful Look at What It Delivers," *Journal of Housing Research* 9, no. 2 (March 2000): 179–99.

11. John E. Anderson, Jeffrey Clemens, and Andrew Hanson, "Capping the Mortgage Interest Deduction," *National Tax Journal* 60, no. 4 (December 2007): 769–85. See also Harvey S. Rosen, "Housing Decisions and the U.S. Income Tax: An Econometric Analysis," *Journal of Public Economics* 11, no. 1 (February 1979): 1–23.
12. Richard K. Green and Andrew Reschovsky, "The Design of a Mortgage Interest Tax Credit," final report submitted to the National Housing Institute, Orange, NJ, September 1997.
13. Authors' calculations based on data from Adrian Dungan and Michael Parisi, "Individual Income Tax Returns, Preliminary Data, 2010," *SOI Bulletin* 31, no. 3 (Winter 2012): 5–18, 6–8, figure A. An inflation-adjusted income of $100,000 in 1997 would be approximately $136,000 in 2010. Unfortunately, more specific data on MID use could not be obtained. IRS data examine adjusted gross income only in a distribution ranging from $100,000 to $200,000.
14. Will Fischer and Chye-Ching Huang, "Mortgage Interest Deduction Is Ripe for Reform: Conversion to Tax Credit Could Raise Revenue and Make Subsidy More Effective and Fairer," Center on Budget and Policy Priorities, Washington, DC, June 25, 2013.
15. David C. Ling and Gary A. McGill, "The Variation of Homeowner Tax Preferences by Income, Age and Leverage," *Real Estate Economics* 35, no. 4 (2007): 505–39.
16. Robert J. Shiller, "Owning a Home Isn't Always a Virtue," *New York Times*, July 13, 2013.
17. Calvin H. Johnson, "Was It Lost? Personal Deductions under Tax Reform," *SMU Law Review* 59, no. 2 (August 23, 2006): 689–720.
18. Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge, MA: Harvard University Press, 1973).
19. Peter Brady, Julie-Anne Cronin, and Scott Houser, "Regional Differences in the Utilization of the Mortgage Interest Deduction," *Public Finance Review* 31, no. 4 (2003): 327–66.
20. James R. Follain and David C. Ling, "The Federal Tax Subsidy to Housing and the Reduced Value of the Mortgage Interest Deduction," *National Tax Journal* 44, no. 2 (June 1991): 147–68.
21. Dungan and Parisi, "Individual Income Tax Returns, Preliminary Data, 2010."

22. Follain and Ling, "Federal Tax Subsidy to Housing." Although the alternative minimum tax limits the deductibility of all itemized deductions for some high-income taxpayers, there is still some benefit to itemizing and claiming the MID. The regular income tax allows a taxpayer to deduct mortgage interest from a primary residence on the primary mortgage as well as interest on a home equity line of credit (up to $100,000 of a loan's value). Under the alternative minimum tax, however, the interest on home equity is disallowed; the primary mortgage is allowed but is limited.
23. Todd Sinai and Joseph Gyourko, "The (Un)changing Geographical Distribution of Housing Tax Benefits: 1980 to 2000," in *Tax Policy and the Economy*, vol. 18, ed. James Poterba, 175–208 (Cambridge, MA: MIT Press, 2004). See also US Census Bureau, "Median Household Income (in 2012 Inflation-Adjusted Dollars) by State Ranked from Highest to Lowest Using 3-Year Average: 2010–2012," http://www.census.gov/hhes/www/income/data/incpovhlth/2012/stateonline_12.xls.
24. Joseph Gyourko and Todd Sinai, "Spatial Distribution of Mortgage Deduction Benefits across and within Metropolitan Areas in the United States," in *Using Tax Policy to Increase Homeownership among Low- and Moderate-Income Households*, ed. Richard K. Green and Andrew Reschovsky, 137–86 (New York: Ford Foundation, 2001).
25. Green and Reschovsky, "Design of a Mortgage Interest Tax Credit," 72.
26. Donald Morris and Jing Wang, "How and Why States Use the Home Mortgage Interest Deduction," *Tax Notes* 64 (June 4, 2012): 697–713. The specific policy reason for this statistical anomaly in Alabama is unclear. However, the state of Alabama has a very low standard deduction amount, which likely results in more people itemizing deductions on their state income tax returns compared to other states. The data used come from the IRS tables referenced in Morris and Wang's paper.
27. James M. Poterba and Todd Sinai, "Revenue Costs and Incentive Effects of the Mortgage Interest Deduction for Owner-Occupied Housing," *National Tax Journal* 62, no. 2, part 2 (June 2011): 531–64.
28. Ling and McGill, "Evidence on the Demand for Mortgage Debt by Owner-Occupants."
29. Green and Reschovsky, "Design of a Mortgage Interest Tax Credit."

30. Glaeser and Shapiro, "Benefits of the Home Mortgage Interest Deduction."
31. Thomas P. Boehm and Alan M. Schlottmann, "Market Conditions and Housing Choices: A Comparison of Homeownership across Three Decades," *Real Estate Economics* 39 (2011): 547–600.
32. Richard K. Green and Michelle J. White, "Measuring the Benefits of Homeowning: Effects on Children," *Journal of Urban Economics* 41, no. 3 (1997): 441–61.
33. This calculation assumes each household has one child. The benefit is higher with an increased number of children.
34. Glaeser and Shapiro, "Benefits of the Home Mortgage Interest Deduction."
35. Richard Voith, "Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?," *Federal Reserve Bank of Philadelphia Business Review*, March–April 1999, 3–16.
36. Henry J. Aaron, *Shelter and Subsidies: Who Benefits from Federal Housing Policies?* (Washington, DC: Brookings Institution, 1972); Harvey S. Rosen and Kenneth T. Rosen, "Federal Taxes and Homeownership: Evidence from Time Series," *Journal of Political Economy* 88, no. 1 (February 1980): 59–75; Harvey S. Rosen, "Housing Behavior and the Experimental Housing Allowance Program: What Have We Learned?," NBER Working Paper 657, National Bureau of Economic Research, Washington, DC, May 1985; James M. Poterba, "Tax Subsidies to Owner-Occupied Housing: An Asset-Market Approach," *Quarterly Journal of Economics* 99, no. 4 (November 1984): 729–52; James M. Poterba, "Taxation and Housing: Old Questions, New Answers," *American Economic Review* 82, no. 2 (May 1992): 237–42; Edwin S. Mills, "Dividing Up the Investment Pie: Have We Overinvested in Housing?," *Federal Reserve Bank of Philadelphia Business Review* (March–April 1987): 13–23.
37. Anderson, Clemens, and Hanson, "Capping the Mortgage Interest Deduction." See also Rosen, "Housing Decisions and the U.S. Income Tax."
38. Green and Reschovsky, "Design of a Mortgage Interest Tax Credit."
39. Skinner and Feenberg, "Impact of the 1986 Tax Reform Act."
40. Maki, "Household Debt and the Tax Reform Act of 1986."
41. Poterba and Sinai, "Revenue Costs and Incentive Effects."
42. Follain and Melamed, "False Messiah of Tax Policy." See also Martin Gervais and Manish Pandey, "Who Cares about

Mortgage Interest Deductibility?," *Canadian Public Policy* 34, no. 1 (2008): 1461–89; William Gale, Jonathan Gruber, and Seth Stephens-Davidowitz, "Encouraging Homeownership through the Tax Code," *Tax Notes* 115, no. 12 (June 18, 2007): 1171–89; Poterba and Sinai, "Revenue Costs and Incentive Effects."

43. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2015*.
44. Lawrence Yun, "Why the MID Deserves to Stay," *Realtor Mag*, September 2010. See also Dennis R. Capozza, Richard Green, and Patric H. Hendershott, "Taxes, Mortgage Borrowing, and Residential Land Prices," in *Economic Effects of Fundamental Tax Reform*, ed. Henry J. Aaron and William G. Gale, 171–210 (Washington, DC: Brookings Institution Press, 1996).
45. Yun, "Why the MID Deserves to Stay."
46. Anderson, Clemens, and Hanson, "Capping the Mortgage Interest Deduction." See also Rosen, "Housing Decisions and the U.S. Income Tax."
47. Andrew Hanson, "Size of Home, Homeownership, and the Mortgage Interest Deduction," *Journal of Housing Economics* 21, no. 3 (September 2012): 195–210.
48. Glaeser and Shapiro, "Benefits of the Home Mortgage Interest Deduction."
49. Andrew Hanson, "The Incidence of the Mortgage Interest Deduction: Evidence from the Market for Home Purchase Loans," *Public Finance Review* 40, no. 3 (May 2012): 339–59.
50. Because of higher statutory tax rates at the time, the US tax code encouraged more investment in homeownership. When the statutory rate was lowered, tax loopholes such as the MID were less useful in minimizing taxes. See Follain and Ling, "Federal Tax Subsidy to Housing."
51. Ibid.
52. Authors' calculations using US Bureau of Labor statistics and CPI Inflation Calculator.
53. Green and Reschovsky, "Design of a Mortgage Interest Tax Credit." Inflation adjustment is the authors' calculation.
54. Ibid.
55. National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," Washington, DC, December 2010.
56. Anderson, Clemens, and Hanson, "Capping the Mortgage Interest Deduction."
57. President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-growth."

58. Ling and McGill, "Variation of Homeowner Tax Preferences."
59. James R. Follain, David C. Ling, and Gary A. McGill, "The Preferential Income Tax Treatment of Owner-Occupied Housing: Who Really Benefits?," *Housing Policy Debate* 4, no. 1 (March 1993): 1–24.
60. Amanda Eng, Harvey Galper, Georgia Ivsin, and Eric Toder, "Options to Reform the Deduction for Home Mortgage Interest," Urban Institute–Brookings Institution Tax Policy Center, Washington, DC, March 18, 2013.
61. Adam C. Carasso, Eugene Steuerle, and Elizabeth Bell, "Making Tax Incentives for Homeownership More Equitable and Efficient," Discussion Paper 21, Urban Institute, Washington, DC, 2005.
62. Peter Dreier, "The New Politics of Housing: How to Rebuild the Constituency for a Progressive Federal Housing Policy," *Journal of the American Planning Association* 63, no. 1 (November 27, 2007): 5–27.
63. Richard K. Green, and Kerry D. Vandell, "Giving Households Credit: How Changes in the U.S. Tax Code Could Promote Homeownership," *Regional Science and Urban Economics* 29, no. 4 (1999): 419–44.
64. Ling and McGill, "Variation of Homeowner Tax Preferences."
65. Matthew Chambers, Carlos Garriga, and Don E. Schlagenhauf, "Housing Policy and the Progressivity of Income Taxation," *Journal of Monetary Economics* 56, no. 8 (November 2009): 1116–34.
66. A neutral tax system would not allow the deduction of interest by the borrower if the interest were not taxable income to the lender. Hence, some have argued that the MID should not be eliminated because the interest earned on the loan is taxable to lenders. For example, Curtis Dubay argues that when considering tax reform proposals, "Congress should never eliminate tax deductions simply to raise revenue. If it decides to reform the tax code, it should establish a neutral tax base. This means that as long as it taxes interest income to lenders, it should keep interest deductible to borrowers." See Curtis S. Dubay, "The Proper Tax Treatment of Interest," Backgrounder 2868, Heritage Foundation, Washington, DC, February 19, 2014. We are inclined to agree but suggest that the perverse incentives caused by the MID require reform. Although fundamental tax reform is outside the scope of this chapter, we would support removing the taxation of interest income and capital gains, along with removing the deductibility of interest income by the borrower, not only as a means

of adhering to a neutral tax system but also as a means to increase saving, investment, and economic growth.

67. Ling and McGill, "Variation of Homeowner Tax Preferences."
68. Follain and Melamed, "False Messiah of Tax Policy."
69. Poterba and Sinai, "Revenue Costs and Incentive Effects."
70. Anderson, Clemens, and Hanson, "Capping the Mortgage Interest Deduction." See also Rosen, "Housing Decisions and the U.S. Income Tax."
71. To avoid potential gaming of the credit, it would only apply to primary residences with a mortgage. It would not be available for second homes or for home equity lines of credit.
72. Green and Reschovsky, "Design of a Mortgage Interest Tax Credit."
73. Authors' calculations. According to the US Census Bureau's most recent 2009 data on mortgages, there are 76.4 million owner-occupied homes with mortgages in the United States. See US Census Bureau, *The 2012 Statistical Abstract: The National Data Book* (Washington, DC, 2012), table 998. In 2013, $69 billion was spent on the home mortgage interest deduction. See Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2015*, 206.
74. Jason J. Fichtner and Jacob M. Feldman, "The Hidden Costs of Tax Compliance," Mercatus Center at George Mason University, Arlington, VA, May 20, 2013. See also Jason J. Fichtner and Jacob M. Feldman, "When Are Tax Expenditures Really Spending? A Look at Tax Expenditures and Lessons from the Tax Reform Act of 1986," Mercatus Working Paper 11-45, Mercatus Center at George Mason University, Arlington, VA, November 2011.

CHAPTER 7: HOW DO PEOPLE RESPOND TO THE MARRIAGE TAX PENALTY?

1. James R. Alm and Mikhail I. Melnik, "Taxing the 'Family' in the Individual Income Tax," Andrew Young School of Policy Studies, Georgia State University, Atlanta, July 2004, 19.
2. Married couples must choose to file either a joint return ("married filing jointly") or a separate return ("married filing separately"). But using the "married filing separately" status is not the same as filing as an unmarried person. The "married filing separately" status is generally the least beneficial filing status because the two taxpayers are not allowed to claim all the deductions and credits that are allowed otherwise.