Using Tax Policy to Subsidize Homeownership

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Introduction

Encouraging homeownership has long been a cornerstone of U.S. domestic policy, and homeownership is an important goal for most American families. For some it is an affirmation of being part of the middle class; for others it is a means of accumulating assets. The popularity of homeownership helps explain why leaders of both political parties have consistently pursued policies designed to expand homeownership.

While it is easy to understand why subsidizing homeownership is politically popular, many economists argue that subsidies can be justified only if the decision of an individual household to own a home has benefits for the rest of society. Although data indicate that, compared with renters, homeowners take better care of their homes, live in neighborhoods with less crime, are more likely to participate in neighborhood organizations, have children who do better in school, and are less likely to end up on welfare, it is difficult to prove that homeownership *per se* leads to these desirable outcomes.

Even if the external benefits of homeownership are not large, there may be other reasons for the federal government to subsidize it. U.S. housing policy, primarily through Section 8, subsidizes rental for low-income households. As Carasso, Steuerle, and Bell (2005) demonstrate, these rent subsidies create a *negative* incentive for homeownership for households with incomes below about $30,000. Gale, Gruber, and Stephens-Davidowitz (2007) suggest that one justification for subsidizing homeownership for low-income households would be to "keep renting and owning on a level playing field" by offsetting the negative homeownership subsidies now in place.

One lesson from the recent sub-prime mortgage debacle is that, given the chance, many households want to own houses, even if they have low or uncertain incomes and few if any assets. Although the evidence is unclear, some maintain that widespread availability of "teaser" rates and no-down-payment loans during the first part of the decade beginning in 2000 led to an upsurge in homeownership among low-income households. Lenders also came to believe that credit score models alone were sufficient for underwriting, and often ignored payment-to-income ratio guidelines or failed to document income and down-payment sources. Whether it was greed, foolishness, or ignorance on the part of borrowers; or deceptive practices, the exploitation of unsophisticated borrowers, or outright fraud on the part of lenders and mortgage brokers, it is certainly clear in retrospect that homeownership is inappropriate for many people who took out mortgages.

Households with very low or fluctuating/uncertain incomes, those whose jobs are likely to require frequent moves, or those who can afford housing only in blighted neighborhoods, might do well to avoid homeownership.[1] Nevertheless, many families not only want to own their own home, but for them homeownership makes economic sense. However, many of these households cannot now afford to become homeowners without some outside assistance. Given that the U.S. government currently subsidizes homeownership for most middle- and high-income households, it is reasonable to argue that the government should do more to subsidize homeownership for at least some households who cannot currently afford it.

Since the late 1950s the homeownership rate in the U.S. has exceeded 60 percent. In 2004 it reached a peak of 69 percent, and in the first quarter of 2010 stood at 67.1 percent. Despite the relatively high overall rate of homeownership in the U.S., there are large disparities among racial and income groups (U.S. Census Bureau, 2010). The homeownership rates among African Americans (46.1

[1] See Denton (2001) for a discussion of the benefits and disadvantages of homeownership for low-income households.

percent) and among Hispanics (48.5 percent) are both less than two-thirds the rate among non-Hispanic whites (74.5 percent). Despite the relative economic gains of minorities over the past few decades and government efforts to reduce housing market discrimination, there has been little reduction in the racial disparities in homeownership.[2] Between 1989 and 2008, the percentage difference in homeownership rates between black and non-Hispanic white households remained virtually unchanged. In 2009, however, the gap grew by one percent. Hispanic homeownership rates showed a modest two percent increase relative to rates among non-Hispanic whites over this period (U.S. Census Bureau, 2009). It is also noteworthy that the racial/ethnic differences in homeownership rates persist even among high-income households (Gale, Gruber, and Stephens-Davidowitz, 2007).

In recent years, a number of studies (ably surveyed by Haurin, Herbert, and Rosenthal, 2007) have attempted to explain the persistent racial gaps. Although discrimination in mortgage and housing markets plays a role, the empirical evidence suggests that the strongest factors in the homeownership gaps are differences among racial and ethnic groups in income, wealth, and marital status. This finding seems to suggest that tax policy, if appropriately targeted to households with low incomes and wealth, could help reduce existing homeownership gaps.

Reflecting broad public support, there has been strong bipartisan support for policies that provide subsidies for homeownership. Although a number of small programs assist first-time homeowners by providing direct cash subsidies for down payments, the largest source of subsidies by far operate through the tax system. These tax provisions primarily function by reducing the annual costs of homeownership. They not only provide an incentive for renter households to become homeowners, but by reducing annual housing costs they may reduce (though certainly not eliminate) the chances of foreclosure for homeowners struggling to remain in their homes.

Each year, the President is required by law to produce a tax expenditure budget as part of his annual budget submission to Congress. Tax expenditures are estimates of the revenue losses from various tax provisions, such as exclusions, deductions, exemptions, credits, or other preferential treatment for activities that Congress wishes to encourage. For fiscal year 2010, tax expenditures related to homeownership totaled nearly $185 billion (Office of Management and Budget, 2010). By far the largest of these tax provisions is the mortgage interest deduction, which provides tax savings of $92.2 billion. Other large tax expenditures are the deduction of state and local government property taxes on owner-occupied homes ($18.9 billion) and the exclusion from income taxation of the capital gains from the sale of an owner-occupied home ($24 billion).[3] Not surprisingly, as housing prices have fallen across the country over the past few years, the value of the capital gains exclusion has dropped.[4]

Here we will focus primarily on the mortgage interest deduction (MID). All taxpayers who itemize deductions on their federal income tax returns can deduct annual mortgage interest payments on mortgage loans of up to a million dollars on their primary and secondary residences. As deductions reduce *taxable income*, every dollar of additional MID reduces income taxes by a taxpayer's marginal tax

[2] In 1975, the median income of black households was 60 percent of the median income of white households. By 2007 median incomes of blacks had risen to 65.1 percent of the median income of whites. The relative growth of income among Hispanics went from 71.8 to 74.2 percent over this period (U.S. Census Bureau, 2008).

[3] Married couples can exclude from income taxation up to $500,000 of capital gains on the sale of their principle residence ($250,000 for taxpayers filing single returns). To take advantage of this provision a taxpayer must have owned the property for two years and occupied it for at least two of the past five years (Auten and Reschovsky, 1998).

[4] Just three years ago, in the President's fiscal year 2007 budget, the estimated tax expenditure for fiscal year 2009 for the capital gains exclusion on owner-occupied homes was $41 billion.

rate on their last dollar of taxable income.[5] Under the federal income tax system, marginal tax rates rise as incomes rise. As a result, higher-income taxpayers derive larger tax savings from an extra dollar of mortgage interest than lower-income taxpayers. For example, a $1,000 MID would reduce the federal tax liability of a taxpayer at the 10 percent marginal rate by $100 (10 percent of $1,000) and the tax liability of someone facing the 35 percent marginal tax rate by $350.

If one set out to design a policy to encourage homeownership, it would make sense to target the largest subsidies to the households least likely to be homeowners, while providing little or no subsidy to households likely to become homeowners even without a subsidy. Data from countries that do not subsidize homeownership (such as Canada, Australia, and Japan) indicate, not surprisingly, that homeownership rates rise with household income. This suggests that a policy to encourage homeownership should give the largest incentives to households with modest incomes and no subsidies to high-income households.

The MID, however, does exactly the opposite. For low- to middle-income taxpayers, the mortgage deduction provides little financial incentive to abandon renting for homeownership. For those purchasing modestly priced houses and facing the lowest marginal tax rate (currently 10 percent) the benefits of the mortgage deduction are small. In fact, for households with low state income taxes, the mortgage deduction may be of no value at all, because the mortgage deduction, even when combined with other itemized deductions, may be smaller than the standard deduction.

For most high-income taxpayers, the tax savings resulting from the MID are a minor influence on their decision to become homeowners; these households are likely to own a home regardless of the tax treatment of housing. Rather than encouraging homeownership among high-income households, the MID provides an incentive to buy a larger house and to take out a bigger mortgage. Economists have long argued that the result is an inefficient pattern of investment, with too many resources invested in housing and too few resources placed in more productive investments in factories and machinery (Mills, 1989; Poterba, 1992).

Given that the MID is both exceedingly expensive and ineffective at increasing the homeownership rate, the most sensible policy would be to eliminate the deduction and replace it with a more effective, and perhaps less expensive, subsidy for homeownership.

We will analyze a proposal from the President's Advisory Panel on Federal Tax Reform (2005) to replace the MID with a 15 percent *Home Credit*. Unlike a deduction, under which the tax benefit depends on the taxpayer's marginal tax rate, tax credits provide the same dollar tax benefit to all eligible taxpayers. Despite the advantages of eliminating the MID, we regretfully came to the conclusion that the elimination of the deduction is a politically unlikely. We reached this conclusion after reviewing the political history of the MID and recognizing that the proposal of the President's tax reform panel was met by strong opposition from the home building and real estate industries and was never given serious consideration by Congress.[6]

If it is impossible to eliminate the MID, yet the goal of subsidizing homeownership for low-income and minority qualifying remains, the best alternative may be an "optional" mortgage credit allowing taxpayers to choose between the existing mortgage interest tax deduction or a new mortgage interest tax credit. Our analysis indicates that the optional credit would substantially increase the homeownership rate for households with modest incomes, especially minority households. Also, in the

[5] Since 1990, itemized deductions have been limited for higher-income taxpayers. For the 2008 tax year, the income above which deductions were limited was $159,950 (or half that amount for married couples filing separately).

[6] Even President Obama's proposal to scale back modestly the mortgage interest deduction was met with such hostility that he quickly abandoned the idea.

long run, as fewer households benefit from the deduction, it may become politically feasible to either limit or even completely eliminate the MID.

Our examination is based on the results of a statistical analysis of housing tenure choice (to rent or to own) and housing expenditures. The results were applied to a tax simulation model for tax year 2004 that allows us to calculate federal income tax liabilities of all taxpayers under existing tax policy and under alternative homeowner subsidy proposals.

In the next section, we briefly describe our methodology and data. We then summarize the results of our analysis of the impact of tax policy on the decision of households to become homeowners. In the following section, we evaluate the current MID. We then turn to an analysis of the recommendations of the President's advisory panel on federal tax reform as well as an analysis of our optional tax credit proposal. We conclude the paper with a discussion of the role of tax subsidies in a post-housing-crisis world.

Modeling the Decision to Become a Homeowner

In this paper, we build on past research presenting clear evidence that federal income tax incentives for homeownership do in fact influence families' housing tenure-choice decisions (Rosen, 1979a; Rosen, 1979b; Green and Vandell, 1999). This research is based on the assumption that the decision of a renter household to become an owner depends on a set of characteristics, such as income, household size, marital status, and race, and what economists call the *user cost* of owning relative to renting: the amount of money a household must spend if it owns rather than rents an identical house or apartment. As we will describe below, tax policy can be used to reduce the user cost of owning relative to renting and thus potentially influence households' decisions to purchase a home.

For homeowners the before-tax user cost is the sum of the mortgage interest, the property tax, the net depreciation, and the overall maintenance (which includes insurance and utility costs). As demonstrated by Green and Vandell (1999), the ability of homeowners to deduct their mortgage interest and property tax payments from their gross income reduces the user cost of owner-occupied housing relative to renter-occupied housing by an amount equal to the federal marginal tax rate times the deductible portion of total user cost. Alternatively, giving taxpayers a fixed tax credit for their payment of mortgage interest and property tax reduces the user cost of owner-occupied housing relative to renter-occupied housing by the amount of the credit.

In order to calculate the ratio of user costs of owner-occupied relative to renter-occupied housing and to determine the sensitivity of housing tenure decisions to relative user costs, we employ a model that includes a housing expenditure and housing tenure choice equation. For a detailed description of our methodology to estimate housing tenure, see Green and Vandell (1999) and Green and Reschovsky (2007).

To test the hypothesis that the MID has a direct impact on the rate of homeownership in the United States, we use multivariate statistical techniques to determine whether the deduction leads to an increase in the rate of homeownership by reducing the cost of obtaining a mortgage.[7] Our results provide strong evidence that tax policy influences households' decisions to become homeowners. The tax variable is both large and statistically significant.[8] Separate statistical analyses for households by race/ethnicity revealed that both black and Hispanic households are somewhat more sensitive to mortgage interest-related tax incentives than white households.

[7] We estimate probit regression, where the dependent variable is one if a household owns a home, and zero otherwise. In addition to the tax variable, the regression includes a set of other household characteristics that may influence households' decisions whether to own or rent.

[8] Our results indicate that a one percentage point change in the tax variable results in a 0.63 percentage point change in the predicted homeownership rate for the average household.

Modeling the Tax System

Data regarding the effect of tax policy on the rate of homeownership provides us with only part of the information we need to analyze the full impact of housing-related tax policies. For most households, changes in housing-related tax policies will produce no change in housing tenure, but may well result in substantial changes in income tax liability. In order to evaluate alternative policies, we designed a simulation model to calculate the income tax liabilities of each household in the Public Use Microdata Sample (PUMS) dataset. The model was constructed to allow calculation of tax liabilities under both the existing tax system and a number of policy alternatives. We built our tax simulation model to reflect 2004 tax laws by mimicking the procedure each household would follow in calculating its 2004 federal income tax liability.

Assessing the Mortgage Interest Deduction

The MID is actually a remnant of the original IRS code of 1913, under which all interest was deductible. As very few wealthy taxpayers were subject to the income tax during its early years, it is not likely that Congress thought of the deductibility of mortgage interest as encouraging homeownership. However, over time the favorable tax treatment of mortgage interest has become very popular. In the mid-1980s proposals were advanced to eliminate the deductibility of all consumer interest. In part because of heavy lobbying by the National Association of Realtors, the Mortgage Bankers Association, and the National Association of Home Builders, the resulting legislation, the Tax Reform Act of 1986, phased out deductions for all consumer interest except mortgage interest (Dreier, 2006).

Using our tax simulation model, we estimate the benefits of the MID to households in various income categories. Our model determines whether households with outstanding mortgages itemize on their federal income tax return, and if so, whether they utilize the MID. The model then determines the size of each deduction and the dollar value of the related tax benefit (or tax savings). The tax benefit is calculated by multiplying each household's MID by that household's marginal tax rate. Our simulations indicate that in 2004 the MID provided $67.1 billion in aggregate tax benefits, somewhat larger than the $63.5 billion estimate by the Department of the Treasury of the tax expenditure for the MID.

Table 1 illustrates how the use of the MID rises with income. Although 46 percent of households had incomes below $40,000 in 2004, only 38 percent of homeowners had incomes under $40,000. The last two columns help illustrate why low- and moderate-income homeowners (and potential homeowners) get so little benefit from the MID. At household incomes below $30,000 (in 2004 dollars), fewer than half of all homeowners have mortgages. In contrast, at incomes above $75,000 approximately four out of five homeowners have mortgages. One reason that so few lower-income homeowners have mortgages is that many are elderly and have already paid off their mortgage. Census data indicate that 54 percent of homeowners with incomes under $25,000 are over 65, and two-thirds of those over 65 have no mortgage. The final column in Table 1 demonstrates that, while among those with incomes above $75,000, nearly all homeowners with mortgages take advantage of the MID, many homeowners, especially those with incomes below $30,000, do not itemize deductions. In nearly all cases, homeowners who do not itemize gain a larger tax benefit from utilizing the standard deduction. However, the net result is that for these homeowners, the U.S. tax system provides no subsidy for mortgages.[9]

The focus of Table 2 is homeowners who do take advantage of the MID. Clearly the tax subsidies provided by the MID are relatively modest for most low- and middle-income itemizers. Because both the probability of taking the MID and the amount of the tax benefit from the deduction rise with income, it

[9] It should be noted that all homeowners, including non-itemizers, benefit from the exclusion from taxation of the imputed rent from homeownership.

is not too surprising that nearly half of the total tax benefit from the MID accrues to the 18 percent of homeowners who have incomes (in 2004) exceeding $100,000. The U.S. government is currently spending about $100 billion per year to subsidize homeownership through the MID. Table 2 demonstrates that not only are the benefits of this subsidy flowing primarily to Americans with above-average incomes, but that the many homeowners who are now struggling to fend off foreclosure receive little benefit. The bottom line is that the MID does almost nothing to encourage and facilitate homeownership for households wanting to own their own home or to assist those in danger of losing their homes.

Replacing the MID with a Mortgage Tax Credit

In 2005, President Bush appointed an advisory panel and charged it with developing proposals for reforming the federal tax system. The panel's final report included a proposal to eliminate the MID and to replace it with a 15 percent non-refundable tax credit on mortgage interest paid on a principal residence (President's Advisory Panel on Federal Tax Reform, 2005). Because the new credit would be non-refundable, the maximum credit a household could receive would be limited to the size of the household's pre-credit federal income tax liability. Data from the IRS indicate that in 2006, 29 percent of all taxpayers who took the MID and had adjusted gross incomes below $40,000 did not have a positive income tax liability (Internal Revenue Service, 2008). None of these homeowners would be eligible for a mortgage tax credit under the advisory committee's proposal. The proposal also placed a limit on the size of the credit any household could receive, by specifying that interest on mortgage loan amounts of over $412,000 would not be eligible for the 15 percent credit.[10]

In principle, this proposal would achieve several goals. First, it would reduce the overall size of the mortgage interest–related subsidy to homeowners, because the revenue gained by eliminating the MID would be greater than the cost of the proposed credit. Second, as the credit received by each household varies by the amount of mortgage interest paid, but not by the homeowner's marginal tax rate, the share of the mortgage subsidy going to low- and middle-income homeowners would increase and the share going to high-income homeowners would decrease. Third, because larger mortgage interest-related subsidies would flow to households with modest incomes, the replacement of the deduction with a credit should encourage homeownership among such households.

We used our tax simulation model to predict whether the proposal by the Advisory Panel would in fact achieve its goals. We began by considering how much money the U.S. Treasury would gain by eliminating of the MID. However, obtaining the answer is not as simple as looking up the value of the tax expenditure associated with the mortgage deduction. Unless prohibited by the terms of their mortgage, taxpayers may respond to the loss of the deduction by paying off, in part or in full, their mortgage balance. One reason taxpayers may want to accelerate paying off their mortgage once it loses its tax-preferred status is that homeowner equity (effectively, the net imputed rent on their home) would remain untaxed. If taxpayers sold interest- or dividend-producing taxable assets in order to pay off their mortgage, the revenue gain to the Treasury from the elimination of deductibility would be diminished.

Data from the Federal Reserve Bank's *Survey of Consumer Finance* demonstrates that most homeowners have few financial (non-retirement) assets. This means that most households have quite limited ability to pay off their mortgages early. As a result, we estimate that if the Advisory Panel's proposal to replace the MID with a non-refundable 15percent mortgage interest credit had been implemented in 2004, the Treasury would have gained a relatively small amount in revenue: about $9 billion.

[10] This limit would apply to houses in parts of the country with the highest housing prices. Homeowners in parts of the country with cheaper housing would be subject to lower limits, with the limit set at $227,000 in areas with the nation's lowest housing prices.

Table 3 details how the Advisory Panel's proposal would redistribute income tax burdens. The average affected homeowner (i.e., those with mortgages) would pay $267 in additional income taxes (indicated in Table 3 as a loss of tax benefits). As expected, a larger share of homeownership-related tax subsidies would now flow to those with lower incomes. On average, homeowners with incomes below $80,000 would benefit under the proposals, while those with higher incomes would lose.

The central panel of the table shows that only about 10 million homeowners would benefit from the proposal. At incomes below $60,000, the majority of homeowners would not be affected by the proposal, primarily because they do not hold mortgages on their homes. The data also show that among high-income homeowners, most would pay higher taxes as a result of the proposal, and a few would see their tax liability decrease. Although not shown in the table, approximately 170,000 renter households would become homeowners. Comparing the final columns of tables 2 and 3 demonstrates that the adoption of the Advisory Panel's proposal would shift the share of total mortgage interest–related tax benefits to households with income below $80,000 (in 2004) from 25 to approximately 45 percent.[11]

Using our model to simulate the impact of the Advisory Panel's proposal on homeownership rates, we predicted a half percent **reduction** in the overall rate. This lowering of the average homeownership rate reflects the fact that some households would decide to become renters in response to an overall reduction in their housing-related tax subsidy. The main beneficiaries of the advisory panel's plan are households with low or moderate incomes. Some are renters who respond to the increased housing subsidy by becoming homeowners. For households with incomes below $10,000, the ownership rate would not change; for those with incomes of $10,000-20,000 and $20,000-30,000, the homeownership rate would rise by 0.5 percent and 0.7 percent, respectively. However, we should note that the statistical precision of our models is not sufficient that these numbers are actually different from zero.

The Political Durability of the MID

Although it is widely recognized that the MID is ineffective as a policy for encouraging homeownership and bestows most of its benefits on high-income homeowners, it appears to be a very well entrenched feature of our tax system. Peter Dreier (2006) has pointed out that the political power of the real estate industry has kept Congressional support for the MID both strong and bipartisan. A recent proposal by President Obama to limit the value of itemized deductions by capping the marginal tax rate applied to deductions at 28 percent was met by fierce opposition and was never seriously considered by Congress.

Another reason it is so politically difficult to eliminate the MID is the spatial concentration of its tax benefits. Gyourko and Sinai (2003) demonstrate the extent to which the largest benefits from the deduction are concentrated in a very small number of metropolitan areas (and hence Congressional districts). They show that if the revenue gained by the Treasury from the elimination of the MID were returned as an equal lump-sum payment to all taxpayers, the number of households that would be "winners" would greatly outweigh the number of "losers." However, the average value of the gains would be small, while many losers would suffer large losses. The political power of the losers is accentuated, because they are concentrated in a relatively small number of Congressional districts, while the winners are spread throughout the country.

[11] The changes in tax benefits shown in Table 3 are probably somewhat underestimated because the estimates assume that changes in tax subsidies will have no impact on the demand for housing. The evidence, however, suggests that the reduction in tax subsidies for high-income homeowners will reduce demand for expensive houses and result in a decline in housing prices (Capozza, Hendershott, and Green, 1996).

Establishing an *Optional* Mortgage Interest Tax Credit

As much as we support the elimination of the MID, such a policy is not politically viable. This realization led us to search for an alternative tax policy that would retain the mortgage interest deduction but also create larger incentives for homeownership for those households, especially those with modest incomes and minorities who are most likely to require financial help in order to become homeowners[12]. Below we analyze a policy that establishes an optional mortgage interest tax credit. Under our proposal, each homeowner with a mortgage (or prospective homeowner) can choose between a 15 percent *refundable* mortgage interest credit and the existing mortgage interest deduction. We assume that taxpayers will choose the option that results in the lowest federal tax liability.

With a refundable credit, if the credit is larger than a taxpayer's previous federal income tax liability, the taxpayer would receive any excess credit as a tax refund. We hypothesize that making the credit refundable will increase the financial attractiveness of homeownership for many minority and low-income households.

We therefore use our model to simulate the impact of the optional credit proposal on housing tenure and on the income tax liability of each household in the PUMS dataset. The results of this exercise on changes in homeownership rates by household income and by race/ethnicity are presented in Table 4. The overall homeownership rate would increase by 2.5 percent. For those households with incomes below $20,000, there would be a 5.2 percent increase in the ownership rate; for those with incomes between $20,000 and $40,000, the rate would increase by 3.8 percent. Our simulations indicate that the optional credit would have a greater impact on minorities than on whites. The optional credit would increase the homeownership rate by 4.2 percent for blacks and by 4.5 percent for Hispanics. These increases partly reflect that fact that black and Hispanic households have lower-than-average incomes, and, based on the results of our model, appear to be more sensitive to tax subsidies than white households at every income level.

Under the optional credit proposal, 22.8 percent of all households would receive a credit, with an average credit of $663 per recipient household. As illustrated in Table 5, the 24 million credit recipients would be made up of 2.6 million renter households who become homeowners as a result of the credit, and 21.4 million current homeowners with mortgages who take advantage of the credit. This latter group includes many homeowners who did not previously benefit from the MID because they were not itemizers. For existing homeowners the credit would play an important role in reducing the financial burden of homeownership.

We have estimated that in 2004 the optional credit would have cost approximately $15.1 billion. Although this amount would increase the already large tax subsidy going to homeownership, the additional subsidy is very well targeted to homeowners with low and moderate incomes. The tax benefits are on average largest for households earning less than $40,000 per year, with such households receiving 69.1 percent of the total tax benefits. Although there are very few high-income beneficiaries, these households would continue to receive the full benefit of the MID.

Figure 1 allows us to compare the distribution of mortgage-related homeownership tax benefits under current law to the distribution of total benefits under the optional tax credit, where benefits include both tax savings attributable to the credit for homeowners who choose the credit and tax savings from the MID for homeowners who take the deduction. The adoption of the optional credit proposal would nearly double the share of total mortgage interest–related tax subsidies going to households with incomes (in 2004) below $60,000, from 17 percent to 30 percent. Higher-income

[12] We assume that encouraging homeownership remains a good thing. Whether it is or not is a discussion for another day.

homeowners would receive a smaller share of the total tax subsidy, with the share of tax benefits going to households with incomes above $100,000 falling from 46 to 38 percent.

Conclusions

The United States has a long tradition of using its tax system to subsidize homeownership. Nearly half of the $185 billion tax subsidy currently going to homeowners comes in the form of the mortgage interest deduction. Here we have sought to demonstrate that the MID is a highly inefficient policy for increasing the rate of homeownership. Despite the annual expenditure of billions of dollars, the large gaps in homeownership rates between black and non-Hispanic white households and between Hispanic and non-Hispanic white households have persisted. We also showed that the MID targets most tax subsidies to higher-income households, with nearly half of its benefits going to households who earn more than $100,000 per year, an allocation of benefits that many people would consider unfair.

Despite these serious shortcomings, eliminating or curtailing the MID appears to be highly unlikely. Recent evidence of the political durability of the MID comes from the reaction to the recommendation of a high-level tax reform panel established by President George W. Bush. The panel's recommendation to eliminate the deduction and replace it with a non-refundable mortgage interest credit was considered to be "dead on arrival" and was subsequently ignored by the President. We have demonstrated in this paper that the tax reform panel's proposal would in fact make the tax system fairer, would actually generate some revenue, and would have essentially a neutral effect on the ownership rate.

As an alternative to current law and to the tax reform panel's proposal, we analyzed a proposal to allow homeowners to choose between a 15 percent refundable mortgage interest credit and the existing MID. As our analysis indicates, not only would such a policy shift a larger share of the total mortgage-interest related tax subsidies to households with incomes below $60,000, but would also increase homeownership rates for households with modest incomes, especially minorities. The great political strength of our proposal is that no one would involuntarily forfeit the MID.

In this era of both unmet needs and a rising federal deficit, it is difficult to argue for further increasing the size of the already large federal tax subsidies for homeownership. However, because the MID is so well entrenched, the price of badly needed reform may well be the expenditure of more money. Especially given the current economic and fiscal climate, we would support an increase in individual income tax rates as a means of funding the relatively modest additional costs of an optional mortgage interest credit.

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an advisor to the Financial and Fiscal Commission in South Africa. In addition to his work on tax policy related to homeownership, he is currently conducting research on whether rising property taxes are forcing elderly homeowners to move and on the fiscal condition of central cities. Professor Reschovsky earned his Ph.D. in economics from the University of Pennsylvania.

Table 1

Distribution of Mortgage Interest Deductions (MIDs) by Income class, 2004

2004 Household Income	Number of Households	Percent of Total Households	Percent of Households Who are Homeowners	Percent of Homeowners with Mortgages	Percent with Mortgages Who Take the MID
Less than $10,000	9,539,000	9.0%	47.8%	28.2%	43.1%
$10,000 - $19,999	12,821,800	12.1%	56.7%	32.3%	62.7%
$20,000 – $29,999	13,385,600	12.7%	59.8%	45.2%	65.2%
$30,000 - $39,999	12,418,900	11.8%	62.0%	58.4%	75.0%
$40,000 - $49,999	10,966,500	10.4%	68.2%	66.1%	75.7%
$50,000 - $74,999	20,663,800	19.6%	74.4%	76.3%	76.7%
$75,000 - $99,999	11,008,500	10.4%	81.6%	83.1%	100.0%
More than $100,000	14,675,600	13.9%	89.0%	78.8%	95.7%
Total	**105,479,700**	**100.0%**	**68.6%**	**43.8%**	**80.6%**

Source: Authors' calculations using data from the Public Micro Sample of the 2000 Census and 2004 Statistics of Income. All data have been inflated to 2004 values.

Table 2

Distribution of Tax Benefits from the Mortgage Interest Deductions (MID) by Income Class, 2004

	For Households Taking the Mortgage Interest Deduction			
2004 Household Income	Average MID	Marginal Income Tax Rate	Average Tax Benefit from MID	Percent of Total Tax Benefit from the MID
Less than $10,000	$ 7,280	9.2%	$ 671	0.5%
$10,000 - $19,999	$ 6,658	11.4%	$ 762	1.6%
$20,000 – $29,999	$ 6,756	12.8%	$ 868	2.9%
$30,000 - $39,999	$ 6,850	14.7%	$ 1,005	4.8%
$40,000 - $49,999	$ 7,059	17.9%	$ 1,261	6.7%
$50,000 - $74,999	$ 7,861	17.8%	$ 1,402	17.8%
$75,000 - $99,999	$ 8,814	21.2%	$ 1,869	19.6%
More than $100,000	$12,613	26.3%	$3,316	46.1%
Total	**$ 8,991**	**19.7%**	**$ 1,874**	**100.0%**

Source: Authors' calculations using data from the Public Micro Sample of the 2000 Census and 2004 Statistics of Income. All data have been inflated to 2004 values.

Table 3

Distribution of Tax Resulting from Proposals of President's Advisory Panel on Federal Tax Reform

	Homeowners with Mortgages			Current Homeowners			
2004 Household Income	Average Credit Received	Average Deduction Lost	Average Gain (or Loss)	Number Who Gain	Percent Who Gain	Percent Unaffected	Percent of Total Benefit from Credit
Less than $20,000	$ 92	$ 69	$ 23	728,000	6.9%	93.1%	0.8%
$20,000 - $39,999	$ 281	$ 112	$ 168	3,142,300	19.8%	79.7%	5.6%
$40,000 - $59,999	$ 722	$ 505	$ 217	3,267,000	21.8%	72.1%	17.9%
$60,000 - $79,999	$ 953	$ 837	$ 116	2,259,500	20.4%	67.1%	19.8%
$80,000 - $99,999	$1,027	$1,385	-$ 358	814,000	11.8%	34.6%	14.1%
$100,000 - $119,999	$1,231	$2,000	-$ 769	44,700	1.1%	25.5%	10.7%
$120,000 - $139,999	$1,400	$2,330	-$ 929	21,200	0.8%	22.9%	7.1%
$140,000 - $159,999	$1,517	$2,729	-$1,213	9,900	0.6%	27.2%	4.8%
More than $160,000	$2,302	$4,879	-$2,577	12,800	0.3%	27.7%	19.2%
Total	**$ 882**	**$1,149**	**-$ 267**	**10,299,400**	**14.2%**	**64.2%**	**100.0%**

Source: Author's calculations using data from the Public Use Micro Sample of the 2000 Census (inflated to 2004 values)

Table 4

Impact on Homeownership Rates of an Optional and Refundable 15% Mortgage Interest Tax Credit

	Entire Sample			Blacks Only			Hispanics Only		
2004 Household Income	Number of Households	Homeowners hip Rate Current Law	% Point Change in Homeowners hip Rate	Number of Households	Homeowners hip Rate Current Law	% Point Change in Homeowners hip Rate	Number of Households	Homeowners hip Rate Current Law	% Point Change in Homeowners hip Rate
Less than $10,000	9,539,000	47.7%	6.4%	2,054,100	35.4%	7.3%	1,052,900	32.7%	7.4%
$10,000 - $19,999	12,821,800	56.7%	4.3%	1,808,100	41.1%	5.6%	1,318,300	38.2%	6.5%
$20,000 – $29,999	13,385,600	59.8%	3.5%	1,601,800	42.5%	4.8%	1,374,800	41.6%	5.3%
$30,000 - $39,999	12,418,900	62.0%	4.1%	1,299,000	46.0%	5.0%	1,169,100	43.3%	6.1%
$40,000 - $49,999	10,966,500	68.2%	2.4%	1,025,400	52.7%	3.2%	955,500	48.3%	3.9%
$50,000 - $74,999	20,663,800	74.4%	0.8%	1,666,500	60.0%	1.3%	1,551,100	55.0%	2.3%
$75,000 - $99,999	11,008,500	81.6%	0.3%	764,000	69.2%	0.6%	685,800	63.2%	1.4%
More than $100,000	14,675,600	89.0%	0.0%	742,700	79.0%	0.4%	695,300	74.4%	0.8%
Total	**105,479,700**	**68.7%**	**2.5%**	**10,961,600**	**49.3%**	**4.2%**	**8,802,800**	**47.6%**	**4.5%**

Source: Author's calculations using data from the Public Use Micro Sample of the 2000 Census (inflated to 2004 values)

Table 5

Distribution of Tax Benefits from an Optional and Refundable 15% Mortgage Interest Tax Credit

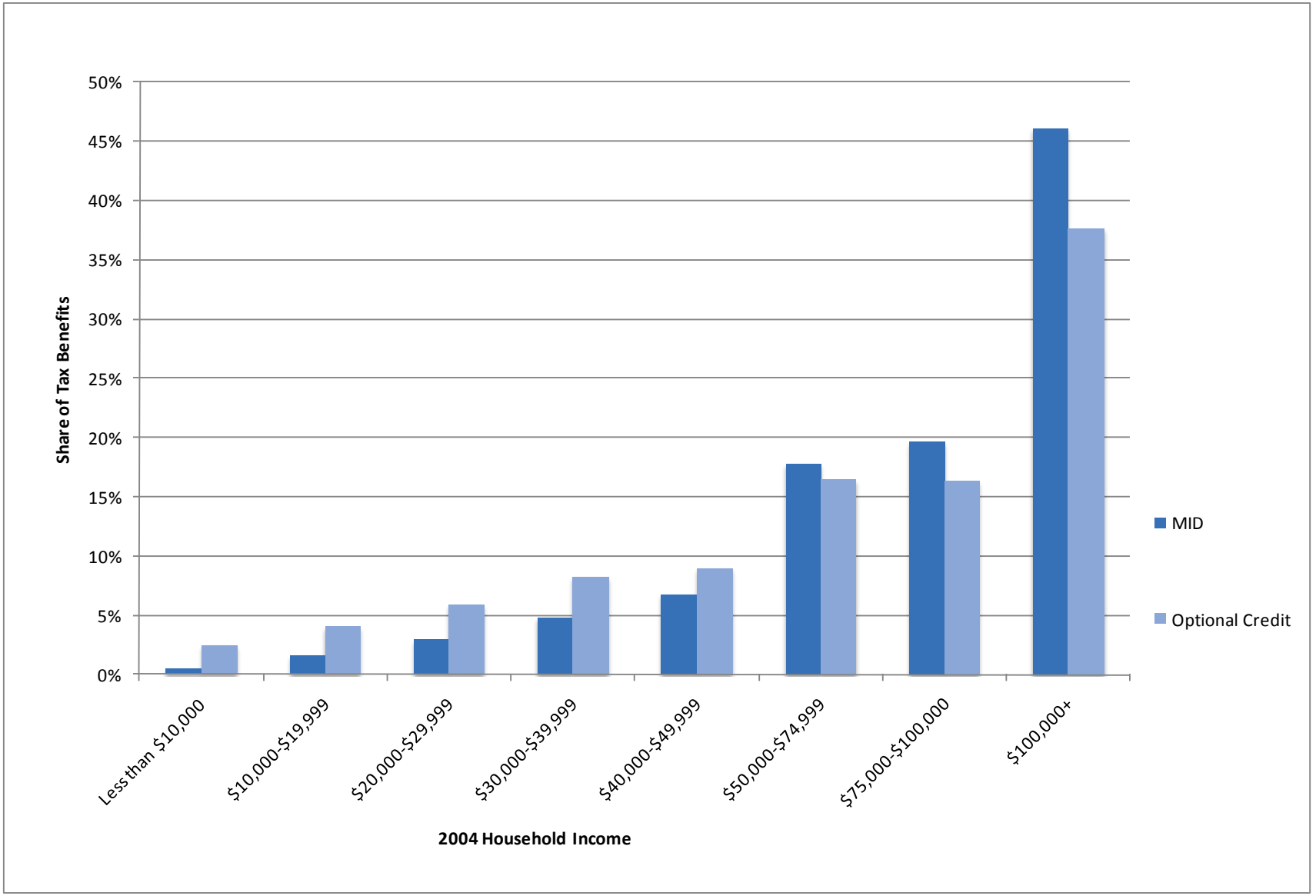
	Current Homeowners			Current Renters			
2004 Household Income	Number Receiving Credit	Percent Receiving Credit	Average Credit*	Number Receiving Credit	Percent Receiving Credit	Average Credit*	Percent of Total Credit Amount
Less than $10,000	1,289,900	28.3%	$ 1,292	610,496	12.3%	$ 215	11.3%
$10,000 - $19,999	2,275,800	31.3%	$ 975	551,337	9.9%	$ 295	15.0%
$20,000 – $29,999	3,495,100	43.7%	$ 829	468,496	8.7%	$ 334	19.2%
$30,000 - $39,999	4,203,000	54.6%	$ 846	509,175	10.8%	$ 383	23.6%
$40,000 - $49,999	3,841,200	51.4%	$ 747	263,196	7.5%	$ 479	18.8%
$50,000 - $74,999	4,601,600	29.9%	$ 341	165,310	3.1%	$ 601	10.5%
$75,000 - $99,999	1,436,000	16.0%	$ 166	33,026	1.6%	$ 838	1.7%
More than $100,000	284,200	2.2%	$ 18	1,303	0.1%	$ 1,506	0.0%
Total	**21,426,800**	**29.6%**	**$ 701**	**2,602,339**	**7.9%**	**$ 346**	**100.0%**

*Average credit among those receiving credits

Source: Author's calculations using data from the Public Use Micro Sample of the 2000 Census (inflated to 2004 values)

Figure 1

Distribution of Tax Benefits for the Mortgage Interest Deduction (MID) and the Proposed Optional Mortgage Interest Tax Credit



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