



Unmasking the Mortgage Interest Deduction: Who Benefits and How Much?

by Anthony Randazzo and
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INTRODUCTION

The United States federal income tax code is full of complicated deductions, credits and loopholes, the largest of which is the mortgage interest deduction (MID). According to the Internal Revenue Service (IRS), itemized deductions excluded \$1.26 trillion in income from the 2008 tax base, amounting to 15 percent of total adjusted gross income (AGI). The mortgage interest deduction was the largest of these deductions, accounting for \$470.4 billion, about 36 percent of the total. As Congress continues to discuss and debate the future federal budgetary and tax philosophy, it should consider reforming the overly complex, highly inefficient American tax code, particularly the mortgage interest deduction. And given the housing market's importance to the economy and economic growth, it is especially critical to review who would be affected by reforming the MID.

THE EFFECTS OF THE MORTGAGE INTEREST DEDUCTION

The MID Does Not Increase Homeownership

One of the reasons often cited for preserving the mortgage interest deduction is the belief that it helps increase the homeownership rate. But as it turns out, the MID is a fairly ineffective tool for increasing homeownership. Since 1994, the homeownership level has gone from 64.2 percent in 1994 up to 69.2 percent in 2004 and then down to 66.4 percent today. The recession and collapse of the housing market is certainly responsible for the decrease in homeownership. If the mortgage interest deduction were driving people to buy homes we would expect to see some correlation between homeowner-

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ship rates and the use of the deduction, but we don't. The total mortgage interest deduction subsidy has grown from roughly \$50 billion to \$80 billion since 1994 with little impact on homeownership.

This is because those households that rent but would prefer to own a home—if they had just a bit more financial flexibility—are typically low-income families. And if they bought a home they would be much less likely to itemize their deductions and claim the MID because they are low-income in the first place. As a result, rather than increasing the homeownership rate, the primary impact of the MID is to increase the amount spent on housing by consumers who would likely choose to own a home anyway, subsidizing spending on housing rather than homeownership.

The MID Promotes Increased Mortgage Debt and Contributes to Housing Bubbles

The mortgage interest deduction encourages housing consumers to use debt rather than their own assets to finance home purchases. In fact, economists James Poterba and Todd Sinai estimate that taxpayers could reduce their mortgage debt by nearly 30 percent by using other financial paper assets, such as savings and brokerage accounts, to pay off loans. One reason for not choosing this financial course: people want the tax break. Plus, by creating favorable tax treatment for housing compared to other investments, the mortgage interest deduction encourages individuals to overinvest in housing, arguably one of the main causes of the recent housing bubble.

The MID Moderately Inflates Housing Prices

Proponents of the mortgage interest deduction argue that getting rid of it would cause housing prices to fall as much as 15 percent. However, this assumes that all of the tax savings from the MID are used to buy bigger homes, which often times is not the case. A June

2011 study by Poterba and Sinai examined the impact of the MID across income levels and age groups and found that the MID raises prices by only about 3 to 6 percent. Our own estimate looks at the monthly payment savings from the MID and suggests the MID changes prices by less than 1 percent. Together, these studies indicate that a complete elimination of the deduction would not cause a substantive reduction in home values. (For more details see Appendix E in the policy study, “Unmasking the Mortgage Interest Deduction.”)

BENEFICIARIES OF THE MORTGAGE INTEREST DEDUCTION

The mortgage interest deduction is almost exclusively claimed by households in the top income brackets and younger individuals with large mortgages who have not paid off much of their loans. It provides little to no benefit to low-income families, seniors and Americans without mortgages.

In 2009, only about 33 percent of income tax returns filed with the IRS contained itemized deductions, automatically eliminating most taxpayers from receiving any direct benefit from the mortgage interest deduction. And not everyone who itemizes has mortgage interest to deduct: about 20 percent of itemizers do not take the MID. As a result, only one-fourth of taxpayers in 2009 claimed the mortgage interest deduction. And this has been the relatively stable historical trend, with between 21 and 26 percent of taxpayers claiming the MID each year since 1991.

Most of the mortgage interest deduction is claimed by young, wealthy households. As Table 1 shows, the largest portion of the MID is concentrated among households that make \$250,000 a year and are between 25 and 35 years old.

Using the most recent data from the Congressional Joint Committee on Taxation (JCT) and IRS, we broke

Table 1: Average Size of Mortgage Interest Deduction, 2009

Age	< 40K	40-75K	75-125K	125-250K	250K+
25-35	\$212	\$571	\$1,801	\$3,468	\$7,711
35-50	\$244	\$747	\$1,525	\$3,534	\$6,575
50-65	\$161	\$491	\$1,034	\$2,095	\$5,741
> 65	\$21	\$178	\$329	\$981	\$1,322

Source: Joint Committee on Taxation

up taxpayers into nine income brackets and used the combined data to show how many taxpayers actually claim an MID and what the relative values are of the deduction's benefit (see Table 2).

Those households making \$75,000 and above are 60 percent of MID claimants, while those at the median household income level of \$49,777 and below are just 18 percent of those taking the MID. The average tax savings from the mortgage interest deduction for a median income household is \$120, compared to \$1,862 in annual tax savings for families making \$200,000 a year or more.

PROPOSED REFORM

Ideally, the mortgage interest deduction should be completely eliminated from the tax code. This would remove one of the major distortions in the housing market, reducing the likelihood of another economy-destroying housing bubble being created. While it would be felt by young, wealthy homeowners the most, it would have little negative impact on most other households. Housing prices might decline slightly, but not enough to trigger another recession or foreclosure crisis. In fact, low-income families would likely be positively affected, since any decline in home values would make housing more affordable.

A full repeal of the mortgage interest deduction in 2008 would have broadened the tax base by \$470.4 billion, and the full amount could have been used to

lower the federal deficit. However, total elimination of the MID without any other adjustments would increase taxes for the one-fourth of taxpayers who use the MID to lower their taxable income. Had the MID been fully eliminated in 2008, households earning between \$100,000 and \$200,000 a year would have seen a collective tax increase of \$10.2 billion that year. Households earning less than \$100,000 per year would have paid \$4.2 billion more in taxes.

A Revenue-Neutral Approach

Given the potentially harmful consequences of such a tax increase, we argue that the best policy is to combine the elimination of the mortgage interest deduction with reductions in marginal income tax rates, making the repeal revenue-neutral.

We estimate that if the MID had been repealed in 2008, the average tax rate could have been reduced from 18.2 percent to 16.8 percent, a total reduction of 8 percent (not percentage points), while maintaining the amount of revenue collected.

We acknowledge that since only about 25 percent of taxpayers take the MID, combined with the fact that the rate reduction would go to all taxpayers, the net effect for those who continue to itemize would still be an effective tax increase. The largest increase, both in dollar terms and percentage terms, would be for those with the lowest income. A household making \$45,000 that continued to itemize would see their tax bill increase \$864, or 32.8 percent, compared to house-

**Table 2: Who Benefits from the MID and by How Much?
(Distribution by Income Class of Mortgage Interest Deduction, at 2009 Rates and Income Levels)**

Income Class	Total Tax Returns Claiming MID	Percent of MID Claims	Total Amount of MID (millions)	Average Annual Amount of MID	Average Tax Bill	Average Tax Savings from MID	Average Tax Saving as Percent of Tax Bill
Below \$10,000	< 500	0.0%	< \$0.5	\$ --	-\$475	\$ --	-- %
\$10,000 to \$20,000	311,000	0.9%	\$88	\$283	-\$1,421	\$ --	-- %
\$20,000 to \$30,000	1,000,000	2.9%	\$521	\$521	-\$1,120	\$ --	-- %
\$30,000 to \$40,000	2,023,000	5.8%	\$1,292	\$639	\$6	\$64	1105.4%
\$40,000 to \$50,000	2,923,000	8.4%	\$2,329	\$797	\$1,058	\$120	11.3%
\$50,000 to \$75,000	7,603,000	22.0%	\$9,332	\$1,227	\$2,522	\$184	7.3%
\$75,000 to \$100,000	6,754,000	19.5%	\$10,066	\$1,490	\$4,953	\$373	7.5%
\$100,000 to \$200,000	10,594,000	30.6%	\$30,261	\$2,856	\$11,946	\$714	6.0%
\$200,000 and over	3,424,000	9.9%	\$22,768	\$6,650	\$105,011	\$1,862	1.8%
Total	34,632,000	100%	\$76,656	\$2,213			

Source: Authors' calculations from IRS and JCT

holds with over \$87,500 in annual income facing an \$803 increase in taxes, or 10.5 percent. However, only about 23 percent of taxpayers in the \$40,000–\$50,000 income group claim the MID, so that result only applies to a small number of taxpayers.

For the other 77 percent of taxpayers in that income group who do not claim the MID, and instead claim the standard deduction, they would see an 8 percent reduction in their taxes due to the lower tax rates. In general, for taxpayers who chose not to continue itemizing, a revenue-neutral elimination of the mortgage interest deduction would harm the lower-income earners less, since households earning \$62,500 would see a \$687 higher tax bill while households pulling in \$150,000 would face a \$1,223 higher tax bill (see Tables 6 and 7 in the policy study, “Unmasking the Mortgage Interest Deduction”). And in this way, choosing the standard deduction will help protect lower income taxpayers from too sharp an increase in their tax bill.

It is likely that a full and immediate MID repeal would face staunch opposition—especially from realtors, homebuilders, tax accountants, mortgage brokers and wealthier homeowners who benefit substantially from the deduction. An alternative would be to end the MID for new mortgages and phase it out for existing mortgages, in much the same way deductions for credit-card and car-loan interest were phased out in the 1980s. For example, policymakers could target a specific tax year that the MID would cease for existing mortgage holders, and reduce the mortgage interest cap a certain percentage each year.

WINNERS AND LOSERS OF REVENUE-NEUTRAL REFORM

The mortgage interest deduction, which allows individual taxpayers to each deduct up to \$1.1 million in home loan-related interest payments from taxable income, has been in existence as long as the income tax itself. It remains popular in large part because of a misunderstanding by the public of its true impact. But given that the MID is such a poorly designed tax-incentive program that fails to promote homeownership while creating problems through economic distortion, the logical reaction would be to simply remove it from the tax code.

Winners if the MID were eliminated as we propose:

- The American economy—since a simpler tax code that removes the distortion of capital would allow for a better use of resources in the economy and more growth;
- Renters—since they would no longer be discriminated against in the tax code;
- Taxpayers who are non-itemizers—since they would see lower tax rates and would not have their housing values decline too drastically from the reform.

Losers if the MID were eliminated as we propose:

- Realtors, homebuilders and mortgage bankers—since they would lose the subsidy that artificially boosts demand for their industry;
- Those with large mortgage debt—since the interest payments on the large debt that the MID creates incentives for would no longer be deductible;
- Young, high-income homeowners—since they enjoy a subsidy in the form of lower taxes for owning homes that they would have likely purchased even without the mortgage interest deduction.

A revenue-neutral change that would eliminate the mortgage interest deduction, as we have proposed, would enable tax rates to be reduced without reducing the amount of revenue collected. And those rate reductions would benefit all taxpayers in the form of lower rates and less distortion while the limited adverse effect of the elimination of the deduction subsidy would only pertain to a few. ■

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