

## Tax Expenditures and the Subsidization of Homeownership

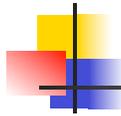


2009 FTA Revenue Estimation & Tax Research Conference  
Des Moines, Iowa, September 15, 2009

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## Homeownership is a Core American Political Value

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*“...homeownership lies at the heart of the American Dream. It is a key to upward mobility for low and middle income Americans. It is an anchor for families and a source of stability for communities. It serves as the foundation of many people’s financial security. And it is a source of pride for people who have worked hard to provide for their families”*

George W. Bush (2001)

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## Homeownership as a Core American Political Value (cont.)

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- Encouraging homeownership has had strong bipartisan support through both Republican and Democratic administrations
- The vast majority of federal government subsidies of homeownership have operated through the tax system
- FY2009 *tax expenditures* related to homeownership ~ \$150 billion

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## Homeownership-Related Tax Expenditures, FY2009



	(billions)
Mortgage interest deduction	\$97.3
Property tax deduction	\$20.9
Capital gains exclusion on home sales	\$28.0
Credit for first-time homebuyer	\$1.2
Interest exclusion of owner-occupied mortgage subsidy bonds	\$0.7
Exclusion of net imputed rental income	-\$5.9
Total homeownership-related tax expenditures	\$142.2

**Source:** *Budget of the U.S. Government, FY2010, Analytical Perspectives.*

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### The Largest Tax Expenditures, 2009-2013



Tax Expenditure	Projected Revenue Effect for 5-year period (billions)
Exclusion of employer contributions for medical insurance premiums and medical care	<b>\$1,051.95</b>
Deduction of mortgage interest on owner-occupied homes	<b>\$ 576.68</b>
401(k) plans	<b>\$ 325.00</b>
Deductibility of charitable contributions (excluding education and health)	<b>\$ 273.99</b>
Accelerated depreciation of machinery and equipment	<b>\$ 270.04</b>
Capital gains (except agriculture, timber, iron ore, and coal)	<b>\$ 257.23</b>
Deductibility of nonbusiness State and local taxes other than owner-occupied homes	<b>\$ 256.54</b>
Employer plans	<b>\$ 216.31</b>
Step-up basis of capital gains at death	<b>\$ 197.79</b>
Capital gains exclusion on home sales	<b>\$ 191.77</b>

*Source: Budget of the U.S. Government, Analytical Perspectives, Fiscal Year 2009*

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## Why Do We Subsidize Homeownership?

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- Political popularity—subsidies benefit the middle class
- *External* benefits – better home maintenance; results in higher student achievement, better neighborhoods, etc.
  - Quantifying external benefits is difficult
  - Empirical evidence is mixed
- Important form of asset accumulation, especially for minorities
- Offsets *negative* homeownership incentives created by rent subsidies (Section 8)

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## Should We Expand Homeownership Subsidies?

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- Clearly, homeownership not appropriate for everyone
- Given that we now subsidize most middle and high income households, why not expand subsidies to qualified lower-income buyers?

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## Homeownership Rates by Race/Ethnicity

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- 2008 rate for African-Americans (47.4%) & Hispanics (49.1) < 2/3<sup>rd</sup> rate for non-Hispanic whites
- Despite income growth by minorities, very little reduction in racial gap in homeownership rates

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## Our Research Question

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- Can tax policy be reformed so as to do a better job in encouraging homeownership?
- Results based on housing tenure and housing expenditure regressions and tax simulation model
  - Probability of owning is a function of the *user cost* of owning relative to renting
- Data primarily from the 2000 Census PUMS (1% sample)

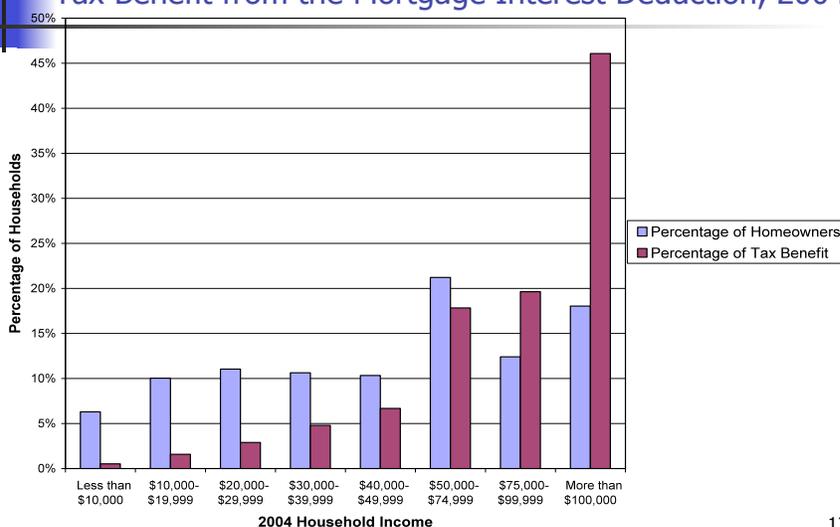
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## What's Wrong with the Mortgage Interest Deduction?

- The MID is highly ineffective in encouraging homeownership
  - Small or no incentives to those who are not now homeowners
  - Largest incentives to those who would be homeowners even in absence of the MID
- Tax benefits concentrated among households with high incomes
- Encourages over investment in housing and too few resources in more productive investments

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Distribution by Income Class of Homeowners and of the Tax Benefit from the Mortgage Interest Deduction, 2004



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### Distribution of Mortgage Interest Deductions 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%

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### Distribution of the Tax Benefits from the Mortgage Interest Deduction by Income Class, 2004

2004 Household Income	For Households Taking the Mortgage Deduction			Percent of Total Tax Benefit from the MID*
	Average Mortgage Interest Deduction	Marginal Income Tax Rate	Average Tax Benefit from 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%

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## Why Don't We Get Rid of the Mortgage Interest Deduction?

- Elimination is politically impossible
  - Obama's proposal to cap the MTR at 28% for the purpose of calculation deductions went nowhere in Congress
  - The proposal of Bush's Advisory Panel on Tax Reform (2005) to replace the deduction with a credit was "dead on arrival"
  - The real estate and housing industries are opposed and both are politically powerful

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## Why Don't We Get Rid of the Mortgage Interest Deduction? (cont.)

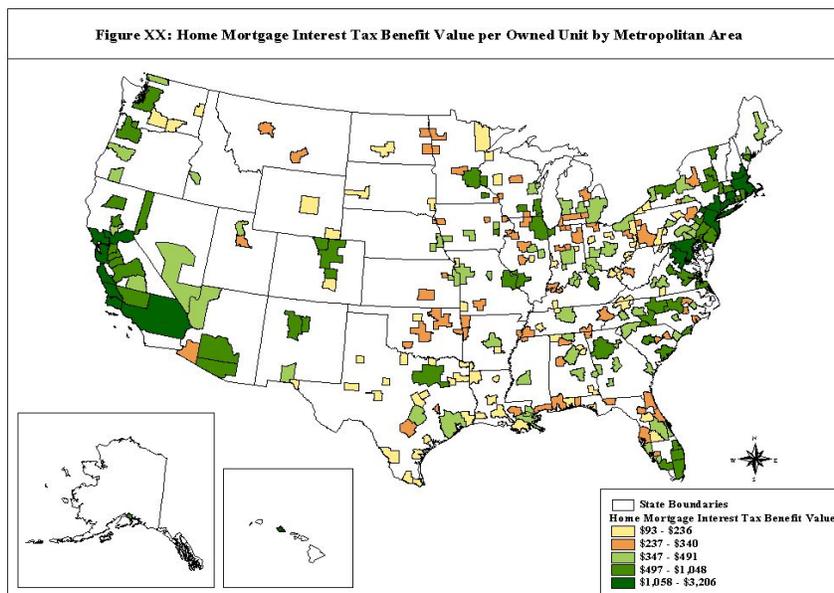
- Eliminating the MID will generate less than its \$95 billion tax expenditure
  - Without deduction some taxpayers will payoff part or all of mortgage balance
    - Equity—net imputed rent—remains untaxed
  - Revenue gain to Treasury diminished if income producing assets are sold to finance mortgage payoff
- Eliminating the MID will be capitalized into somewhat lower housing prices, especially in the high-income market

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## Why Don't We Get Rid of the Mortgage Interest Deduction? (cont.)

- The tax benefits are spatially concentrated
  - Gyourko and Sinai (2003) show that replacing the MID with equal/HH payments will create more winners than losers, **but**
    - winners generally get small gains
    - Many losers have big losses, and
    - losers are concentrated in a relatively few areas and thus have a strong incentive to fight against any change

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## So, What's To Be Done?

- Establish an *optional* 15% refundable mortgage interest tax credit
  - Taxpayers with mortgage interest can choose between a deduction or a credit
  - No taxpayer would lose a tax benefit
  - Credits would be refundable
    - With a non-refundable credit many taxpayers with incomes < \$40,000 would not be eligible for a credit

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## 15% Optional and Refundable Credit Impact on Homeownership Rates

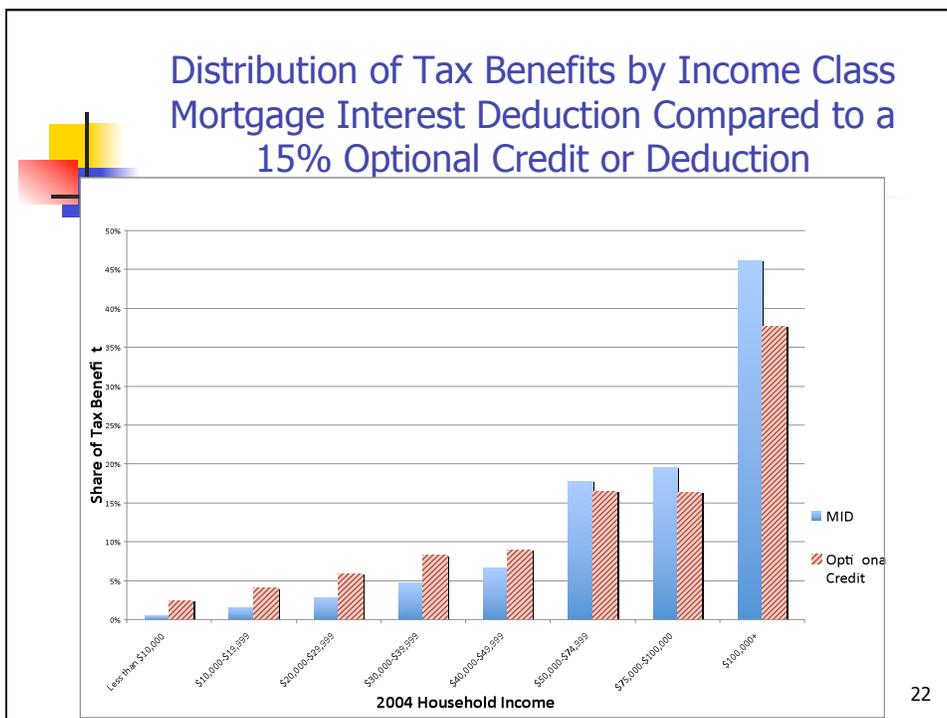
2004 Household Income	All Households		Blacks Only		Hispanics Only	
	Homeownership Rate	% Point Change in Homeownership Rate	Homeownership Rate	% Point Change in Homeownership Rate	Homeownership Rate	% Point Change in Homeownership Rate
	Current Law	Rate	Current Law	Rate	Current Law	Rate
Less than \$10,000	47.7%	6.4	35.4%	7.3	32.7%	7.4
\$10,000-\$19,999	56.7%	4.3	41.1%	5.6	38.2%	6.5
\$20,000-\$29,999	59.8%	3.5	42.5%	4.8	41.6%	5.3
\$30,000-\$39,999	62.0%	4.1	46.0%	5.0	43.3%	6.1
\$40,000-\$49,999	68.2%	2.4	52.7%	3.2	48.3%	3.9
\$50,000-\$74,999	74.4%	0.8	60.0%	1.3	55.0%	2.3
\$75,000-\$99,999	81.6%	0.3	69.2%	0.6	63.2%	1.4
More than \$100,000	89.0%	0.0	79.0%	0.4	74.4%	0.8
Total	68.7%	2.5	49.3%	4.2	47.6%	4.5

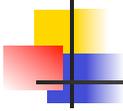
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### 15% Optional and Refundable Credit Distribution of Credits by Household Income and Current Tenure Status

2004 Household Income	Current Homeowners			Current Renters			Percent of Total Credit
	Number Receiving Credit	Percent Receiving Credit	Average Credit	Number Receiving Credit	Percent Receiving Credit	Average Credit	
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%
<b>Total</b>	<b>21,426,800</b>	<b>29.6%</b>	<b>\$701</b>	<b>2,602,339</b>	<b>7.9%</b>	<b>\$346</b>	<b>100.0%</b>

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## Conclusions

- Mortgage interest deduction costs nearly \$100 billion/year, but
  - It does little to encourage homeownership
  - Targets most benefits to high-income households
  - Is politically impossible to eliminate
- A refundable, optional credit would have cost an additional \$15.1 billion in 2004, but
  - It would spur homeownership, especially among minorities
  - It would provide increased tax subsidies to current owners with incomes < \$60,000 (many of whom are now struggling to avoid foreclosure)
- The price of reform may well be additional ownership subsidies, perhaps funded by increased tax rates

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