



Battle Over Mortgage Interest Deduction Continues in House Committee

by Jann Swanson Apr 25 2013

The House Ways and Means Committee heard a wide variety of opinions today at a hearing on housing tax incentives. Representatives of the housing, building and real estate industries as well as policy experts spoke both in favor and against the mortgage interest deduction (MID) tax deductions for property taxes, the real estate capital gains exemption and the low income tax credit.

Robert Dietz, assistant vice president of the National Association of Home Builders (NAHB), called on Congress to maintain its support for vital housing tax incentives. "Home building is an industry dominated by small businesses, so the idea of simplifying the complicated tax rules related to business has great appeal. At the same time, our industry remembers painful lessons from the 1986 Tax Reform Act, when the commercial and multifamily sectors experienced a downturn due to unintended consequences," Dietz said. "Moreover, when housing fares well, it spurs job and economic growth.

Dietz spoke favorably about the continued need for the Low Income Housing Tax Credit as a way to attract investment then addressed what he said were a number of false assumptions regarding the MID.

"First, we frequently hear that few home owners benefit from the mortgage interest deduction because itemization is required," he said. "In fact, most home owners will claim it. In 2009, 35 million taxpayers, or 70 percent of home owners with a mortgage, claimed the mortgage deduction in that year. Among all home owners who have ever held a mortgage, the vast majority have claimed the home mortgage deduction for years at a time."

It also does not necessarily encourage the purchase of larger homes. Larger families need larger homes and will therefore have a higher interest deduction. "The need for a larger home created the higher home loan deduction, not the other way around," said Dietz.

He also noted that the cost of housing varies greatly across the nation, so what appears to be a large deduction for a given home in one area may reflect a modest home in a high-cost area.

Moreover, the mortgage interest and real estate tax deductions are two of the few elements in the tax code that that account for differences in cost-of-living.

"The real estate tax deduction is an important reminder that home owners pay more than \$300 billion in property taxes each year. This fact is often ignored in the federal tax debates because these taxes are collected by state and local governments," said Dietz.

There is also a direct correlation between the age of a home owner and their resulting benefit from the mortgage interest deduction. As a share of household income, the largest deductions are for those 35 and younger. The benefit of a deduction that reduces the net cost of monthly house payments is particularly important to these home buyers, who typically have less equity, tighter household budgets, and must meet the needs of a growing family.

"Given this demographic connection, NAHB believes that any policy change that makes it harder to buy a home, or forces young families to defer home purchases, will have a significant impact on wealth accumulation and the makeup of the middle class," said Dietz.

Dietz also defended the MID for second homes which he said is important for many who don't think of themselves as owning two homes. Repealing the deduction for second homes would penalize millions of home owners who move from an existing home and buy a second home in a given tax year. There would be further negative economic consequences in terms of lost home sales, home construction and local tax revenues.

Eric Toder, Co-Director of the Urban-Brookings Tax Policy Center (TPC) said, if the Committee is to achieve its stated goals of reducing the top individual income tax rate to 25 percent and maintaining receipts at their baseline projected level of 19.4 percent of GDP by the end of the decade, it will be necessary to eliminate or pare back some major tax expenditures. But the mortgage interest deduction is one of the most popular benefits in the tax law, and politicians have in the past viewed it as untouchable.

The mortgage interest deduction is a subsidy that favors investment in home ownership over investment in rental housing and most other business assets. The main beneficiaries are upper-middle-income households, and use of the deduction varies greatly among states. If the goal is to promote home

ownership, the mortgage interest deduction should be restructured, with more of the subsidy directed to low- and middle-income taxpayers who are more likely to be deciding whether to own or rent.

Eliminating the MID would raise taxes by \$696 per household by 2022 or 0.66 percent of income. Payers in the upper brackets except the top 1 percent would experience a larger average increase. The impact on those in the lower brackets would be smaller in part because fewer of those tax payers itemize.

Another suggested change includes capping the deduction at the first \$500,000 of home debt. This would raise taxes by an average of \$84 per household or 0.08 percent of income with taxpayers in the 80th to 99th percentile experiencing larger than average increases, those in the bottom four quintiles seeing little or no tax increase, and the top 1 percent an increase only slightly less than the average for the entire population. This would disproportionately impact a few high housing cost areas and have the biggest effect on younger, very high income earners who have not yet paid down their mortgage debt.

More complex alternatives would involve replacing the MID with a 15 percent refundable credit and capping interest deductions or replacing the MID with a 20 percent nonrefundable credit and capping eligible debt at \$500,000.

Toder said his biggest concern is how paring back the MID is how it might affect housing prices. Some past research has found eliminating housing tax incentives has substantial effects on prices but others have found confounding factors mitigating the effect such as low interest rates or active investor presence. "All that said, however it would be prudent to introduce changes slowly to avoid a major market disruptions."

Mark A. Calabria, Director of Financial Regulation Studies, Cato Institute told the committee members that a tax code that would improve both economic growth and housing affordability would ultimately be one with low, simple flat rates and few if any deductions.

He urged the committee to eliminate the MID and the local property tax deduction in a budget-neutral manner, lowering overall tax rates for the following reasons.

The MID does not have a significant impact on homeownership rate.

Its housing price impact differs dramatically across U.S. cities

Benefits are highly concentrated among the highest income and most leveraged households

Tax "savings from the non-taxation of imputed rent is almost twice that of the MID. Tax savings from the property tax deduction is much smaller than either.

Some value of the MID is actually captured by lenders via higher mortgage rates.

The value of the MID is positively relate to interest rates.

To the extent that high loan-to-value rates contributed to the recent financial crisis, removal of the MID would improve financial stability.

Because households have made investments and decisions based on the current tax code, he said, changes should be phased in over a reasonable number of years, but no more than seven.

Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service (CRS) told the Committee that in considering tax reform there are three points to consider.

It is difficult it identify base broadening provisions that realistically will allow significant rate reductions.

It is even more difficult to identify provisions that would allow significant reductions of the top rate while maintaining the current distribution of tax burdens

If the objective of lowering tax rates is to lower marginal rates to encourage supply side responses, base broadening will increase effective marginal tax rates and offset in part or in full the incentive effects of lowering statutory tax rates.

The most significant housing provisions are associated with owner-occupied housing - mortgage interest deductions (75 billion in revenue in FY 2015), real property tax deduction (\$30.4 billion) and the exclusion of capital gains (\$26.0 billion.) By comparison, the low income housing credit reduces revenues by \$7.2 billion.

Two out of three of these owner-occupied provisions are already subject to caps. Are these provisions desirable candidates for base broadening? Many economists have criticized the provisions as distorting the allocation of resources, diverting capital from other uses, encouraging overconsumption of housing, and treating renters differently than owner-occupants.

As CRS reported earlier, these provisions would be technically easy to eliminate or reduced and can be view as causing distortions, but the broad use and popularity of the provisions are barriers to major revisions. There are also arguments in favor of keeping them.

Encouraging home ownership has positive neighborhood effects and is a source of wealth building and enforced savings for middle-income families.

In terms of fairness, homeownership subsidies do favor homeowners over renters but the MID increases fairness between homeowners who mortgage and those who finance out of assets.

There are particular justifications for the capital gains exclusion. Requiring capital gains taxes would discourage labor mobility by increasing the cost of relocation, discourage older individuals from scaling down. and impose a penalty on elderly individuals who are forced to sell for health or financial reasons. This "lock-in" effect may significantly reduce the potential revenue to be gained.

There are transition issues, particularly for those in the middle incomes who have recently entered into large mortgages and may find it difficult to budget if they do not receive a full offset in in rate cuts. Grandfathering provisions would not offset effects on housing demand and phasing in would leave new homeowners with the awareness their deductions will not last.

Owner occupied subsidies are not generally the most significant tax preferences to those in the top brackets, partially because of caps but also because as incomes rise, spending on housing does not keep up. Also high income taxpayers are less in need of mortgages and may avoid increases taxes by paying off mortgages or avoiding sale of their homes.

The increase in effective marginal tax rates through eliminating deductions for owner-occupied housing are also not likely to be important for top-bracketed payers whose deductions are not very important relative to income but they would increase effective marginal tax rates and offset statutory rate reductions for taxpayers in the middle and upper income levels.

Gravelle concluded by suggesting that decisions on broadening the base should focus on the merits of the individual provisions rather than their contribution to base broadening to permit lower statutory rates.

The committee also heard testimony from Mark Fleming, Chief Economist, CoreLogic; Phillip Swagel, Professor of International Economic Policy, University of Maryland School of Public Policy; Gary Thomas, President, National Association of Realtors; Thomas Moran

Chairman, Moran & Company, and Robert Moss, Boston Capital, appearing on behalf of the Housing Advisory Group spoke principally