Testimony of Richard K Green to US Senate Finance Committee

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Chairman Baucus and Ranking Member Hatch, I want to thank you for the opportunity today to present my views on the issue of housing and tax reform. My name is Richard Green, and I am a professor in the School of Policy, Planning and Development and the Marshall School of Business at the University of Southern California. I have published extensively on the issue of the Mortgage Interest Deduction, and in particular published a paper co-authored with Dennis Capozza and Patric H. Hendershott on housing and fundamental tax reform for the Brookings Institution[1].

My general philosophy is that the tax code should be as broad-based and efficient as possible, while maintaining vertical and horizontal equity to the best extent possible. I find many of the ideas proposed by Robert Hall and Alvin Rabushka to be quite appealing, and to me, in an ideal world, we would have something quite similar to the tax code they propose, albeit with an earned income tax credit added. That said, we are manifestly not in an ideal world, and issues of transition matter. As I wrote in 1996, a rapid change in tax policy could have a traumatic impact on the economy, so it is important that

[1] Dennis Capozza, Richard Green and Patric Hendershott (1996), Taxes, Mortgage Borrowing and Residential Land Prices in H. Aaron and W. Gale, ed. *The Economic Effects of Fundamental tax Reform*, Washington, DC Brookings Institution Press: 171-210

congress phase in any major changes to tax policy involving housing.

That said, I have long thought that the Mortgage Interest Deduction is a residual of the 1913 tax code, accomplishes little that its supporters claim for it, pushes capital away from plant and equipment toward housing, and benefits high income (although perhaps not very high income) households more than the remainder of the country.

I will divide my remarks into 8 parts; (1) I will argue that the Mortgage Interest Deduction is a residual of the 1913 tax code, and was not created to encourage homeownership; (2) that those on the margin of homeowning get little-to-no benefit from the Mortgage Interest Deduction, and that the policy therefore does little to encourage homeownership; (3) that the Mortgage Interest Deduction does encourage those who would be homeowners anyway to purchase larger houses than they otherwise would; (4) that even in the absence of the Mortgage Interest Deduction, owner-occupants receive a large tax benefit; (5) that phasing out the Mortgage Interest Deduction would encourage households to pay down their mortgages more quickly, and would therefore encourage households to rely less on leverage; (6) household deleveraging would lead to greater market stability, but would also mean that the revenues generated by the elimination of the deduction would be smaller than static estimates suggest; (7) at a time when the housing market remains quite weak, it is important that the Mortgage Interest Deduction be phased out carefully; (8) that if we do wish to encourage homeownership via tax policy, a targeted, refundable credit would be more effective than the current Mortgage Interest Deduction.

I. The Mortgage Interest Deduction is a Residual of the 1913 Tax Code

Before the Tax Reform Act of 1986, consumer interest had generally been deductible from gross income. Indeed, the original income tax act of 1913 allowed for the deduction of consumer interest (see Pechman (1987)). But since 1986, the only interest expense that consumers have been able to completely deduct from gross income in order to calculate taxable income has been interest paid on specified of types home mortgages.

Donald Regan proposed the Reagan Administration's first program for Tax Reform. The proposal was known as Treasury I, and in exchange for eliminating nearly all deductions, it offered substantial reductions in marginal tax rates on ordinary income. In the end, the elimination of many deductions allowed for the top marginal tax rate to be reduced from 50 percent to 28 percent.

Among the deductions to be eliminated was the deduction for all consumer interest, including the Mortgage Interest Deduction. As tax reform evolved many deductions were indeed phased out, but thanks in part to ingenious lobbying from housing industry groups, including the National Association of Realtors, the National Association of Home Builders, and the Mortgage Bankers Association of America, congress was convinced that retaining the Mortgage Interest Deduction was necessary to promote homeownership.[2] At the time, virtually no one questioned that homeownership was a virtue.

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[2] For an excellent discussion of how the Mortgage Interest Deduction avoided the chopping block, see Charles McLure and

But another change in the tax code reduced the effectiveness of the Mortgage Interest Deduction as a tool for promoting homeownership. And this gets me to point II.

II. Those on the margin of homeowning get little-to-no benefit from the Mortgage Interest Deduction, and that the policy therefore does little to encourage homeownership

With the Tax Reform Act of 1986, the standard deduction was raised from $3400(in 1984) to $5000 for married couples filing jointly[3], meaning that many fewer taxpayers became itemizers. The deduction has since risen with the cost of living, and is at more than twice its level at that time. This has implications for the value of the Mortgage Interest Deduction to those at the margin of homeowning.

Consider a first-time homebuyer that lives in a state with no income tax. If that buyer purchases a $150,000 house with a twenty percent down-payment, and pays a one percent property tax rate, at five percent interest, the deductions for housing are $6000 (for mortgage interest) and $1500 (for property taxes). Suppose the household also makes charitable contributions of $2500. The current standard deduction for married couples filing jointly is $11,600, so a couple under such circumstances in no way benefits from itemizing—the Mortgage Interest Deduction has no value.

But we tilted the field against the Mortgage Interest Deduction a bit by considering states with no income tax. Let's

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George Zodrow (1987) Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform. *Journal of Economic Perspectives*, 1(1): 37-58.

3 See Pechman, J.A., Federal Tax Policy (Fifth Edition), Appendix Table A.1

put this couple in Wisconsin, a state that has somewhat higher than average state income taxes. Let us also push the property tax rate up to two percent. We will assume the couple is childless, and earns $60,000 per year. According to the NBER TAXSIM model, the couple would pay about $2200 in state income taxes in Wisconsin. Summing the deductions, we now have $6000 in mortgage interest, $3000 for property taxes, $2500 for charitable contributions, and $2200 for state income taxed. These deductions sum to $13,700, or more than the standard deduction, so the couple would itemize.

So what is the Mortgage Interest Deduction worth? Take the difference between the itemized deduction and the standard deduction, and one gets a difference of $2100. Using the NBER TAXSIM model again, we see that the couple is in the 15 percent marginal tax bracket, which means the value of the deduction is $2100*.15, or $315 per year. Is this sufficient to turn a renter into an owner? I am skeptical.

Moreover, the $315 subsidy ignores the fact that the structure of the mortgage interest deduction gives high tax bracket taxpayer at incentive to outbid lower tax bracket taxpayers for land. Because the value of the subsidy to someone in the 35 percent tax bracket is more than twice the size of someone in the 15 percent bracket (see discussion below), it is entirely possible that the existence of the deduction pushes net costs up for low bracket taxpayers beyond what they would be in the absence of the deduction.

III. The Mortgage Interest Deduction encourages large home purchases.

While the Mortgage Interest Deduction has small value for those at the margins of homeownership, it is very valuable for high

income individuals who purchase expensive homes. Consider a taxpayer in the 35 percent tax bracket who owns an $800,000 home with 75 percent equity. The value of that person's mortgages is $600,000. At five percent interest, the interest cost, and therefore deduction, is $30,000 per year. At a 35 percent marginal tax rate, the value of this deduction is $10,500 per year. Depending on assumptions about the cost of maintenance and property taxes, as well as expected appreciation, the effective subsidy for this housing choice could range from 10 to 30 percent. Based upon literature for housing demand, this means that the Mortgage Interest Deduction will lead individuals in the 35 percent tax bracket to demand between 5 and 15 percent more housing than they might in the absence of the Mortgage Interest Deduction. While there is nothing wrong with large houses per se, the Mortgage Interest Deduction encourages investment capital to move toward housing, perhaps at the expense of other capital goods, such as plant and equipment.

A corollary to the fact that the Mortgage Interest Deduction encourages people to purchase large houses is that the benefits of the deduction tend to be distributed to higher income individuals. Eric Toder, Margery Turner, Katherine Lim and Liza Getsinger of the Urban Institute find[4]:

> The percentage reduction in after-tax income from eliminating the deduction would be largest for taxpayers in the 80th to 99th percentiles of the distribution. These upper-middle-income households would be affected more than tax units in the bottom four quintiles because they are more likely to own homes and itemize deductions and because the higher marginal tax rates they face make deductions worth more to them than to lower-income taxpayers. The very

[4] See E Toder, MA Turner, K Lim and L Getsinger, Reforming the Mortgage Interest Deduction, Urban Institute and Tax Policy Center.

> highest income taxpayers, however, will experience a relatively small drop in income (about 0.4 percent on average) because, at the very highest income levels, mortgage interest payments decline sharply as a share of income.

So the Mortgage Interest Deduction is somewhat unusual in that it is clearly a benefit for the upper-middle-class to lower-rich part of the income distribution, but it is not particularly beneficial to the very rich. Put another way, the elimination of the Mortgage Interest Deduction would make the tax code more progressive, but it would not do much for implementing the "Buffett Rule."

IV. Even in the Absence of the Mortgage Interest Deduction, Housing would receive a large subsidy from the tax code

A fact that is not controversial among economists, but seems to generate consternation among policy makers, is that owners of houses without mortgage earn tax-free income. This income is known as imputed rent, and refers to the fact that owner-occupants pay *themselves* rent.

Perhaps the following example will clarify why homeowners receive non-taxable income from themselves. Suppose two neighbors own identical houses. Suppose they switch houses and pay each other rent. They are materially in the same position they would be if they remained in their own houses. But because they pay each other rent, and because rent is taxable income, by renting to each other they incur a tax liability that they would not if they remained in their own house. The example illustrates the benefit of "non-taxation of imputed rent." The Office of Management and Budget estimates that the tax expenditure associated with this was about $27 billion in 2009[5].

[5] See http://www.gpoaccess.gov/usbudget/fy11/pdf/spec.pdf.

The Organization of Economic Cooperation and Development has argued that imputed rent should be taxed. I do not agree. The question is how does one go about taxing imputed rent? It is not easy. One could start by imposing an ad valorem tax on property values (such as a local property tax), but that doesn't tax imputed rent per se, because it does not take into account expected inflation (if one person expects her house to go up in value, and another does not, the rent the first person pays is lower than the second). Alternatively, one could find comparables in the rental market and attribute rents found there to the owner market. But owner and rental markets are so segmented that this would be difficult to do.

This has implications for fairness; if we don't know what we are taxing, it is hard to know how much to tax it. Moreover, it is important for people to understand the foundation for their tax liabilities, and I think imputed rent is too subtle a concept to communicate to taxpayers.

That said, imputed rent is a very real thing, and in the event the Mortgage Interest Deduction were to be eliminated, households would continue to benefit from the fact that their housing equity goes untaxed. This leads to point V.

V. A Phase-out of the Mortgage Interest Deduction would lead to household deleveraging.

People take on mortgages for two reasons: to smooth their consumption of owner-occupied housing over their life-times, and to get the tax benefit of the Mortgage Interest Deduction.

In the absence of mortgages, households would have to save for many years before they were able to purchase a house. Let us assume a good rule-of-thumb is that households buy houses whose

prices are three times annual income. If a household were to save ten percent of its income for the purpose of buying a house, and its income remained flat, it would take 30 years for it to buy a house (of course, incomes tend to rise as people age so it would actually take less time to save for a house, but it would still take a long time). On the other hand, if a household can get a loan with a 20 percent down payment, it could accumulate the equity necessary to purchase a house in six years, given the same assumptions. For this reason, many people will decide to buy a house with a mortgage, even if mortgages carry no tax benefits.

On the other hand, once people buy a house with a mortgage, a tax code that does not contain a Mortgage Interest Deduction would encourage people to shift out of non-tax preferred debt into tax-preferred equity. Dennis Capozza, Patric Hendershott and I observed that in Australia, where there is no Mortgage Interest Deduction, people purchased houses using about as much debt as Americans, but they paid off that debt much more quickly than Americans[6].

As a policy matter, I think there are profound benefits to encouraging people to pay off their mortgages more quickly, rather than less quickly. It is important in general to recognize that while consumer debt can provide people (and the broader economy) benefits, it can also be too much of a good thing.

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[6] See Dennis Capozza, Richard Green and Patric Hendershott, Taxes, Mortgage Borrowing and Residential Lan Prices in H. Aaron and W. Gale, ed. *The Economic Effects of Fundamental tax Reform*, Washington, DC Brookings Institution Press: 171-210 and Dennis Capozza, Richard Green and Patric Hendershott (1999) Tax Reform and house Prices: Large or Small Effects. *Proceedings of the 91st Annual Conference of the National Tax Association*: 19-24.

My parent's generation behaved differently than mine in all sorts of ways. Another paper of mine with Hendershott shows that they spent less, controlling for education, etc., throughout their life cycle than any other generation. One of the reasons for this is that they paid off their mortgages. According to the American Housing Survey, 70 percent of households headed by someone over the age of 65 have no mortgage at all. Loan amortization became a mechanism for forced saving, and as a result, those born during the depression are in pretty decent shape financially. A Pew Survey shows that those over the age of 65 feel much more in control of their finances than younger people.

My generation is different. Even under the most benign circumstances, we refinance in a manner that slows amortization. I personally have refinanced several times to take advantage of lower interest rates--this was, of course, the right thing to do financially. But each time, the amortization schedule reset, and so it extended the period at which the mortgage would pay off. Now yes, one can take the money one doesn't put into home equity and put it in other savings vehicles, but it is not clear that everyone does that. Forced saving is slowed.

I did a quick comparison of average household income for 1989 and 2007 (using the census) and average mortgage debt for those that had mortgage debt (using Survey of Consumer Finances data)[7]. In both cases I looked at 45-54 year olds.

[7] Survey of Consumer Finance Data is available at http://www.federalreserve.gov/pubs/oss/oss2/2007/scf2007home.html Mortgage Interest Deduction

In 1989, average household income among 45-54 year olds was $39,934; average mortgage debt outstanding among those who had debt was $39,300, so the ratio was about one-to-one.

In 2007, average household income among 45-54 year olds was $83,100; average mortgage debt outstanding among those who had debt was $154,000, so the ratio was just under two-to-one.

In 1989, the share of households in the age group with a mortgage was 58.3 percent; in 2007 it was 65.5 percent. In short, people who are facing retirement within the next 10 to 20 years own less of their house than their counterpart of a generation ago. A policy that encourages people to pay off their mortgages more quickly will benefit everyone. Phasing out the Mortgage Interest Deduction will do just that.

VI. Static scoring of the Mortgage Interest Deduction will overstate the revenue benefits of its elimination.

As I just noted, eliminating the Mortgage Interest Deduction will encourage people to pay off their mortgages more quickly. From a revenue generating standpoint, this means that its elimination will produce smaller gains than static analysis would predict.

If the Mortgage Interest Deduction were scaled back or eliminated, some households would sell assets with taxable returns to pay down their mortgages, thus reducing the net tax revenue arising from the policy change[8]. Based on my reading of

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[8] James Follain was among the first to develop this insight. See James Follain (1998) The False Messiah of Tax Policy: What Elimination of the Mortgage Interest Deduction Promises and a Careful Look at What It Delivers. *Journal of Housing Research*. 9(2):179-199.

the literature on the demand for debt (as opposed to the demand for housing), in the long run the government would capture between 60 to 80 percent of the current tax expenditure arising from the mortgage interest preference. This is still substantial revenue, but it is (obviously) substantially less than the current value of the tax expenditure.

VII. The Mortgage Interest Deduction should be phased out; not eliminated overnight.

The housing market is currently very fragile, and it almost certainly doesn't need another negative shock at the moment. A further negative shock would not only have implications for housing, but also for household balance sheets, which remain fragile.

At the same time, many people made decisions about housing based on the current tax code, and it would be unfair to these people to make a substantial change to the tax code they relied on in one quick stroke.

I would consequently suggest two transition rules for eventually eliminating the deduction: (1) that the deduction should be phased out over ten years by reducing the mortgage cap by $100,000 per year from the current $1,000,000 cap and;(2) that the phase-out not begin until the Federal Housing Finance Agency's house price index shows year-over-year growth equal to the rate of consumer price index growth.

The first of these phase-out rules would allow people to adjust to the new mortgage interest regime in an orderly fashion. Among other things, it would allow people to accelerate financing their houses with equity. As such, it keeps

substantial subsidy in place and prevents some of the dislocation in the housing market.

The second rule recognizes the current weakness in housing, and awaits the day in which housing markets are more or less in equilibrium before gradually reducing the subsidy. It basically codifies the idea that the housing market—and the broader macroeconomy—cannot afford a shock at the moment, but also develops a rule that specifies when the market will be better able to withstand such a shock.

VIII. If Congress wished to encourage homeowning through the tax code, a refundable credit would be more effective than the Mortgage Interest Deduction.

One of the reasons the Mortgage Interest Deduction is not an effective instrument for encouraging homeowning is that it is not targeted—as I discussed earlier, people who would be homeowners in the absence of the deduction get a large tax benefit, while those who are at the margin of owning get little to no benefit.

A refundable tax credit of 15 percent that would be available to those who use the standard deduction would provide a substantial incentive for homeowning for those at the margin. Consider again a potential buyer looking at purchasing a $150,000 house with 20 percent down. The value of a 15 percent credit on a five percent mortgage would be $120,000*.05*.15, or $900. While this is hardly huge, at roughly $80 per month it could tilt the balance between homeowning or renting[9].

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[9] For more detail, see Richard K Green and Andrew Reschovsky (2011) Using Tax Policy to Subsidize Homeownership,) in A Steiger and D. Black, ed, Smart Subsidy for Community

My work on the benefits of homeowning has found mixed results, but in the end I am convinced that homeownership actually creates people who are more involved with their communities and parents who are more involved with their children. As such, I view small, targeted subsidies that could push people into homeownership as sensible policy.

The Mortgage Interest Deduction is not, however, either small or targeted. It is time to reform it in a sensible, orderly fashion.

Development, Aspen Institute and Federal Reserve Bank of Boston, pp. 76-93.