AN EXAMINATION OF TAX EXPENDITURES FOR MORTGAGE INDEBTEDNESS: A POLICY ANALYSIS

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ABSTRACT
Given the challenges that consumers have been facing since 2009 in securing mortgage indebtedness, as well as in securing re-financing on existing residential mortgages due to the Credit Crisis, one of the central driving benefits realized by taxpayers who own residential real estate is the home mortgage deduction under Internal Revenue Code (IRC) §163 (h)(3). The home mortgage interest deduction is one of the largest tax expenditures in the Code (Howard, 1997). The purpose of this paper is to examine the mortgage interest deduction by examining the expenditure use ratio, a brief overview of the legislative history, the challenges to the deduction during the Tax Reform Act of 1986 debate, the arguments for repealing the deduction for second residences, and some prominent tax proposals to convert the home interest deductibility into a tax credit (National Commission on Fiscal Responsibility and Reform, 2010; President's Advisory Panel, 2005). As Congress begins to grapple with ways to raise revenues and clean up the U.S. Tax Code, this paper will make the arguments for and against placing additional limitations on deductibility of mortgage interest of primary residences as well as arguing for the repeal of deductibility of interest on second residences.

INTRODUCTION
The home mortgage interest deduction under §163 (h)(3) has a very long and rich history in the development of the Internal Revenue Code of 1986 ("the Code"). According to research conducted by the Pew Charitable Trusts (2013), in 2011 taxpayers deducted approximately $360 billion in home mortgage interest, which resulted in approximately $72 billion in lost revenues to the federal government (Pew, 2013, p. 4). The home mortgage interest deduction is ranked second or third (depending on the year) in the Code behind the exclusion for employer-provided health insurance (see IRC §105(b)). Table 1 below highlights how the mortgage interest deduction is one of the most costly tax expenditures in the U.S. Tax Code (Burman and Slemrod, 2013, p. 153). There are many reasons for this. Since the deduction was created in 1913 as an "offset" to income, the deduction has grown considerably to one of the most significant tax expenditures in the U.S. Tax Code. Moreover, the powerful interests that influence lawmakers into preserving the deduction (and not further limiting it) include the banking, construction, realtor, as well as the leisure and retired person's (AARP) lobbies—all have a significant vested interest in preserving the home mortgage interest deduction.

Table 1: Largest Tax Expenditures, FY 2011

Provision	**Amount (in billions)**
Exclusion for Employer-provided health insurance	$ 294.3
Home mortgage interst deduction	100.9
IRC §401(k)	72.7
Lower rate on capital gains	62.0
Earned Income Tax Credit	55.7
Pensions	52.3
State and local tax deductions (excluding property taxes)	46.3
Tax deferral for multinational corporations	41.8
Child Tax Credit	40.8
Charitable contributions (other than education, health)	39.8

Source: Burman and Slemrod (2013) using U.S. Budget Analytical Perspectives, FY 2013, authors' calculations, p. 153.

The purpose of this paper is to examine the mortgage interest deduction up close by examining the expenditure use ratio, a brief overview of the legislative history, the challenges to the deduction during the Tax Reform Act of 1986 debate, the arguments for repealing the deduction for second residences, and some prominent tax proposals to convert the home interest deductibility into a tax credit (National Commission on Fiscal Responsibility and Reform, 2010; President's Advisory Panel, 2005). As Congress begins to grapple with ways to raise revenues and clean up the U.S. Tax Code, this paper will make the arguments for and against placing additional limitations on deductibility of mortgage interest of primary residences as well as arguing for the repeal of deductibility of interest on second residences.

CURRENT LAW

The existing law under IRC §163(h)(3) allows taxpayers, in lieu of taking the standard deduction, to claim an itemized deduction for qualified residence interest, subject to limitations, notwithstanding the general rule that *personal interest* is nondeductible. Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness. Acquisition indebtedness is indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer. Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing. The indebtedness must be secured by the qualified residence and is limited to $1 million ($500,000 for married persons filing a separate return). A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat. Section 163(h)(4) defines qualified residence to include both a principal residence within the meaning of §121 (relating to an exclusion of capital gain upon sale of a personal residence) and a *second residence* that satisfies the terms of §280A(d)(1) (relating to whether a dwelling unit is used as a residence for purposes of the disallowance of certain deductions) (Joint Committee on Taxation, 2013).

In general, taxpayers may claim as an itemized deduction, interest on their principal residence and a second home or an equity loan on the principal residence. The home mortgage interest deduction is not subject to the 3 percent limitation on itemized deductions (sometimes referred to as the Pease limitation) and is fully offset in calculating the alternative minimum tax (AMT)—in other words, the home mortgage

interest deduction is not a preference item under IRC §55; however, home equity loan interest deduction is not allowed in computing alternative minimum taxable income

HISTORICAL BACKGROUND

There is a rich historical background of the home mortgage interest deduction, starting with its inception in 1913 when Congress created the Internal Revenue Code through the Revenue Act of 1913. When the Code was enacted, there was no specific deduction for the home mortgage interest deduction—it allowed a general offset for all interest paid on all indebtedness, personal or otherwise. This did not change for nearly seven decades, as consumer interest was deductible as an offset to income. According to Howard (1997), all personal interest costs as revenue losses cost the federal government approximately $827 million in 1927, increasing to $900 million by 1930, then declining significantly during the Depression (p. 96). By 1939, the deduction for personal interest had declined to $383 million. During President Franklin D. Roosevelt's presidency, prior to World War II, several New Deal legislative acts created protections for homeowners, including the creation of the Federal Housing Administration (FHA) (1944), which created mortgage insurance for private lenders. In addition, Congress created the Federal National Mortgage Association (FNMA) in 1938, which created a secondary market for mortgages. During the War, Congress passed the Servicemen's Readjustment Act of 1944 (also known as the G.I. Bill), creating the Veteran's Administration and created a new loan insurance program allowing returning veterans with high loan-to-value ratios to purchase a home. The G.I. Bill mortgage provisions allowed tens of millions of taxpayers to benefit from personal interest deductions, not just wealthy tax filers (Ventry, 2009, p. 250). From 1940 to 1945, the number of tax filers increased from 14.7 million to nearly 50 million, "while the number of taxable returns rose from 3.9 to 42.7 million" (Ventry, 2009).

This was a significant shift in the number of tax returns filed in the United States. In 1944, Congress created a standard deduction in the Individual Income Tax Act of 1944 in order to allow a general offset for all taxpayers; in effect, the standard deduction significantly limited the number of tax filers claiming itemized deductions. By 1950, according to Ventry, the number of itemizers were only 20 percent, while standard deduction claimants comprised of the remaining 80 percent (p. 251). This did not last very long, as the number of tax filers who claimed itemized deductions in 1955 were approximately 29 percent, increasing to 39.5 percent in 1960, increasing to 47.6 percent by 1970 (Ventry, 2009, p. 251). This was mainly due to the significant increase in homeowners by the 1950s and the significant population increase (mainly in child births) following World War II and the Korean War.

In 1951, Congress enacted IRC §1034, which allowed taxpayers to defer any gains on the sale of a residence as long as the proceeds were then rolled into a new residence. This allowed taxpayers to move from smaller residences to larger more expensive ones, avoiding realization of capital gains. In the Revenue Act of 1964, Congress also enacted IRC §121, which allowed taxpayers over the age of 55 a one-time only exclusion of gain on the sale of their personal residence. These provisions were meant to protect homeowners from having to pay taxes on their homes upon moving—and America is a very mobile nation.

By 1969, Congress enacted the Tax Reform Act of 1969, which again increased the standard deduction, again reducing the number of tax filers claiming the itemized deduction. According to Ventry (2009), the number of claimants itemizing deductions fell from 47.6 percent in 1970 to 34.8 percent in 1972. The home mortgage interest deduction remained relatively static until the deliberations began over the Tax Reform Act of 1986.

President Ronald Reagan proposed reforming the U.S. Tax Code in his 1984 State of the Union Address prior to running for a second term. The president instructed his Treasury Secretary, Donald Regan, to study recommendations for tax reform to be reported after the election that year. However, in an effort to stave off criticism, President Reagan in the summer of 1984 told the National Association of Realtors that

the home mortgage interest deduction was off the table and would be preserved. This shut down any proposals in the Treasury I report, released later that year, to remove the deduction on primary residences. Instead, Treasury I recommended eliminating deductibility of interest on second residences. The Treasury II proposal, crafted in the second Reagan term by Treasury Secretary James Baker and Assistant Treasury Secretary, Richard Darwin, proposed limiting deductibility to only second homes. At the end of the near two years of deliberations, the home mortgage interest was preserved in the final tax reform bill. In fact, Internal Revenue Code Section 163(h)(3) was created as its own specific statutory section. The Tax Reform Act of 1986 preserved the deductibility of both primary and secondary residences. It was not subject to any limitation until 1987.

In 1987, a $1 million cap was inserted on the total principal that was allowable on interest deductibility. In addition, home equity loans were created that, in essence, allowed taxpayers to borrow a limited portion of the equity in their homes and deduct the interest.

Ten years later, Congress passed the Taxpayer Relief Act of 1997, which changed the provisions of IRC §121 from a one-time only exclusion of gain from the sale of a residence for taxpayers over the age of 55 to an exclusion of up to $250,000 in principal residence sales for single filers ($500,000 for married filers), allowable every two years, with exceptions. Taxpayers benefited greatly from this change to the Code, allowing them to move their equity every 24 months into a new residence tax-free for gains falling below the given threshold.

Table 2 below highlights the significant legislative acts impacting the home mortgage interest deduction.

Table 2: Legislative History of Impact on Home Mortgage Interest Deduction

Impact on Deduction	Year	Legislation
General offset provided on all interest paid within the year by a taxable person on indebtedness	1913	Revenue Act of 1913, Pub. L. No. 63-16.
Low-interest mortgages guaranteed with high loan-to-value ratios to assist returning veterans purchase homes	1944	Servicemen's Readjustment Act of 1944, Pub. L. No. 78-346.
Standard deduction is adopted by Congress, greatly reducing the need to itemize deductions by many Americans	1944	Individual Income Tax Act of 1944, Pub. L. No. 78-315.
IRC §1034 was enacted to allow gain deferral on home sales if proceeds were rolled into another prinicipal residence.	1951	Revenue Act of 1951, Pub. L. No. 183-521
IRC §121 was enacted, providing taxpayers a one-time-only exclusion on the sale of a principal residence for taxpayers over the age of 55	1964	Revnue Act of 1964, Pub. L. No. 88-272
Standard deduction was significantly increased, reducing the number of taxpayers eligible to itemize deductions, including mortgage interest deduction claimants	1969	Tax Reform Act of 1969, Pub. L. 91-172.
IRC §163(h)(3) was enacted, segregating "qualified residence interest" from other types of interest in the Code; this included primary and secondary residences; deduction was exempt from the newly enacted 2% AGI floor on miscellaneous itemized deductions	1986	Tax Reform Act of 1986, Pub. L. 99-514.
Acquisition indebtedness principal for deductibility was limited to $1 million that could qualify for the home mortgage deduction; a home equity indebtedness provision limitation was enacted where the interest was limited to amounts not to exceed the lesser of the fair market value of the residence, less the acquisition indebtendness, or $100,000.	1987	Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203.
IRC §1034 was repealed and IRC §121 was converted to an exclusion of the gain on the first $250,000 (for single filers) $500,000 (for married filers).	1997	Taxpayer Relief Act of 1997, Pub. L. 105-34.

ECONOMISTS' VIEW OF THE HOME MORTGAGE INTEREST DEDUCTION

On January 25, 1984, President Ronald Reagan in his State of the Union address vowed meaningful and comprehensive tax reform to address the budget deficit and to stimulate the then sluggish economy. The goal of this major reform effort was tax fairness, tax compliance simplicity, and economic growth. Everything was on the table including the mortgage interest deduction. The political pressure from lobbyist for the real estate industry in an election year was intense and the mortgage interest deduction was no longer an item under consideration in the comprehensive tax reform effort. In a speech to 4,000 members of the National Association of Realtors President Reagan stated that he instructed the Treasury Department to "preserve that part of the American dream which the home mortgage interest deduction symbolized". The mortgage interest deduction at that moment became untouchable. The mortgage interest deduction was now seen and believed to be a necessary element to achieving the American dream of home ownership. As described in a New York Times article, "*The Sacrosanct Mortgage Interest Deduction*," by Bruce Bartlett, a senior policy advisor to both Presidents Ronald Reagan and George H.W. Bush, the mortgage interest deduction was then and now the "sacred cow" in the tax code.

Sacred cow or not, the question remains: Does the mortgage interest deduction promote homeownership? This question was asked and answered by Harvard economists Edward L. Glaeser and Jesse M. Shapiro (2003) in their paper *The Benefits of the Mortgage Interest Deduction*. Glaeser and Shapiro looked at 40 years of data in several time series analysis and concluded there is no meaningful connection between the mortgage interest deduction and homeownership. "Our best evidence on the irrelevance of the deduction compared to the homeownership rate is that, over the past 40 years, as the deduction's implicit subsidy has soared and crashed, the rate of homeownership has barely budged" (2003). Glaeser and Shapiro state that though the home mortgage interest deduction may be a tool to make the income tax less progressive and may be a direct subsidy to housing consumption, it is does not have a major impact on the rate of homeownership.

Further evidence of the lack of connection between the deductibility of mortgage interest and homeownership can be seen by comparing U.S. homeownership rates to those of other countries where the deductibility of mortgage interest is not permitted. According to Alex Pollock, former president and CEO of the Federal Home Loan Bank of Chicago and a current resident of the American Enterprise Institute, the mortgage interest deduction does not materially promote homeownership. In a hearing, which Mr. Pollock gave on June 12, 2013 before the Committee on Financial Services in the U.S. House of Representatives, the U.S. ranked rather low among 27 other economically advantaged countries. Of the 28 countries on the list the United States ranked 20th. Ownerships rates in Singapore are over 90%, in Australia 69%, in Canada 67%, in New Zealand 66.9 %, and in the United Kingdom 65.3%. Each of these countries does not allow a deduction for mortgage interest. The U.S., which does allow for mortgage interest deduction, trails behind at a 65% ownership percentage. It appears that the mortgage interest deduction does not play a major role in homeownership.

Similarly, Bourassa et al. (2013) also analyzed homeownership rates from an international perspective. The study also shows that the mortgage interest deduction does not materially promote homeownership. In the Bourassa paper, citing the empirical research of others, the non-deductibility of mortgage interest does not have a significant impact on ownership percentages. Examples cited in the paper to support the position that a mortgage interest deduction is not a material factor in homeownership include the experience in the United Kingdom and France. In 2000, the United Kingdom repealed the deductibility of mortgage interest. The impact of this action had no material effect on the rate of homeownership. When we compare the homeowner percentage in the U.K. with the homeownership percentage in the United States, we see that the U.K. percentages are slightly higher than that of the U.S. France reported a positive effect on homeownership percentages with the removal of their mortgage interest deduction.

In 2013, the Urban Institute, addressed the mortgage interest deduction issues. On the issue of support for the mortgage interest deduction, the article referred to a recent survey of over 100 economists, real estate experts, and housing market investors and strategists. Only 1 in 10 support the deduction in its current form. The majority of these experts support the elimination of the deduction or a phase out over a number of years.

Not only is it the long held view of most economists that the deduction does not promote homeownership, many economist are of the opinion that the mortgage interest deduction is in fact harmful to the economy in general and homeownership specifically. Dennis J. Ventry Jr. (2009) opined and echoed the opinion of others that the mortgage interest deduction fueled the boom and exacerbated the bust in the U.S. housing market. The deduction has distorted the cost of owner-occupied housing over the years, artificially driving up the cost of a home. In addition, Ventry argues that the deduction has resulted in a misapplication of capital, moving resources away from other investments in favor of housing. The deduction has promoted the building and buying of bigger more expensive houses solely for the larger tax deduction. Further, it has encouraged risky behavior by both borrowers and lenders permitting imprudently higher loan to value ratios. The deduction has played a role in fostering suburban sprawl and the related problems of overcrowded schools, traffic congestion, and overdevelopment. In short, the deduction is inefficient and ineffective in its stated goal of promoting homeownership.

The Brookings Institution (Katz, 2012) examined the opportunity costs of the mortgage interest deduction. The projected lost tax revenue attributable to the deduction is over $600 billion. To make matters worse, the lost revenue only benefits a small number of taxpayers. In 2009, only 26% of the $140.5 million taxpayers claimed the deduction. Meaningful reform would generate billions of dollars in revenue and promote a more fair tax system for all taxpayers. Revenue projections range from $378 to $790 billion over a ten-year period depending upon the reform proposal adopted. The revenues could then be used to reduce the federal budget deficit and to pay for productive and high return investments in the areas of innovation, infrastructure, and human capital. Katz recommends using the revenue for innovation, with a permanent reauthorization of the Research and Experimentation Tax Credit and investments in clean energy. Under infrastructure, increased revenue would fund a revival of the Build America Bonds program and capitalize a National Infrastructure Bank. Additionally, one of the human capital initiatives that could be funded with the increased revenues would be for community colleges create a Career fund.

PROPOSALS

The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest tells of the repeated examination of the deduction and its real cost. Many proposals over many decades were recommended, but none implemented. In 2005, President George W. Bush appointed the Advisory Panel on Federal Tax Reform. They examined the mortgage interest deduction and proposed that the deduction be replaced with a non-refundable credit. The "Home Credit" would be equal to 15% of the interest paid on a principal residence. This credit would be available to taxpayers who itemize deductions and also to those who use the standard deduction. The panel recommended limiting the eligibility for the credit by capping the qualifying debt to 125% of the median sale price in the county of the property situs. The panel also proposed to eliminate the deductibility for interest on second homes and interest on home equity loans.

Tax credit plans, similar to the 2005 by Bush's Advisory Panel were recommended by both the Bipartisan Policy Center's Debt Reduction Task Force, co- chaired by former Senate Budget Committee Chairman Pete Domenici and former White House Budget Director and Federal Reserve Vice Chair, Alice Rivlin, and the National Commission on Fiscal Responsibility and Reform, co-chaired by former U.S. Senator, Alan K. Simpson, and former chief of staff to President Bill Clinton, Erskine Bowles. An important motivation for the shift from a tax deduction to a tax credit is that non-itemizers, who tend to

have lower incomes, would benefit from the subsidy. The Tax Policy Center, a joint venture of the Urban Institute and Brookings Institution, made up of nationally recognized experts in tax, budget, and social policy who have served at the highest levels of government and provide an independent analyses of current and emerging tax policy, projected that revenue from this plan would be approximately $378 billion between 2012 and 2021.

The Bipartisan Policy Center's Debt Reduction Task Force plan proposed not only to change the mortgage interest deduction to a refundable tax credit but to also lower the cap on mortgage value that would qualify for the subsidy. The proposed plan included a 15% refundable tax credit available to all taxpayers and a lowered mortgage limit would from $1.1 million to $500,000. Under this plan, taxpayers were also to lose the ability to deduct mortgage interest for second homes and home equity loans. The National Commission on Fiscal Responsibility and Reform, proposed a very similar plan to Bipartisan Policy Center's Debt Reduction Task Force. The major difference was a non-refundable 12% tax credit as opposed to a 15% refundable tax credit.

During the last Presidential campaign, Republican nominee Mitt Romney's tax reform plan included a proposal to set a cap on itemized deductions, including the mortgage interest deduction. The cap was to be between $25,000 and $50,000. It was estimated that if the cap on itemized deductions was set at $50,000 including the mortgage interest deduction and the charitable contribution deduction, $749 billion in revenue would be raised from 2013 to 2022. If the same policy was implemented but charitable contributions are excluded from the cap, approximately $490 billion in revenues would be raised in that same time period.

Recently, the Obama administration had recommended that the income tax rate at which taxpayers can take itemized deductions, including the mortgage interest deduction, be capped at 28%. This change would only affect married taxpayers who file jointly and have an income over $250,000, and single taxpayers who have an income over $200,000. Projected revenue for the period 2013 and 2022 from this proposal was estimated at $580 billion.

RECOMMENDATIONS

Although the need for meaningful reform is necessary, it is quite unlikely that it will ever materialize. The two main obstacles to mortgage interest deduction reform are: first, the mortgage interest deduction is extremely popular with the American public, and second, there is a very well-funded and well-organized lobby effort against reform.

The mortgage interest deduction is very popular with Americans. A recent poll regarding the elimination of the mortgage interest deduction found that 62 % of the respondents were opposed to such a measure. When asked how important the mortgage interest deduction was to them, approximately 93% of respondents said it was important. In polls taken by the National Association of Realtors, even two-thirds of apartment dwellers support the mortgage interest deduction and see the deductibility under current tax law as part of the American dream of homeownership.

Any proposed change regarding the mortgage interest deduction will be met with serious opposition by both political parties. In a National Public Radio interview with economist Dr. Jed Smith, managing director of quantitative research for the National Association of Realtors, All Things Considered host, Robert Siegel, discussed the lobby effort put forth by the real estate industry in the last presidential election. Data obtained from OpenSecrets.org, the website for the Center for Responsive Politics revealed that in the prior election cycle the real estate lobby spent almost $80 million. Over 500 lobbyists were used to push the industry agenda. The industry hedges its bet. Real estate Political Action Committees (PAC's) spent nearly $9 million in support of both Republicans and Democrats. Even before the major tax reform in 1986, the real estate industry has been vigilant and highly protective of the

mortgage interest deduction. If any change in the current tax law regarding the mortgage interest deduction were to be permitted, it would most likely be the deductibility of mortgage interest on second homes and home equity loans. As for the mortgage interest deduction on primary residence, it shall remain sacrosanct: the sacred cow of the U.S. Tax Code then, now, and always.

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