Common Sense Reform is Needed Now for Oregon's Tax Code

The Impact of Oregon's Mortgage Interest Deduction

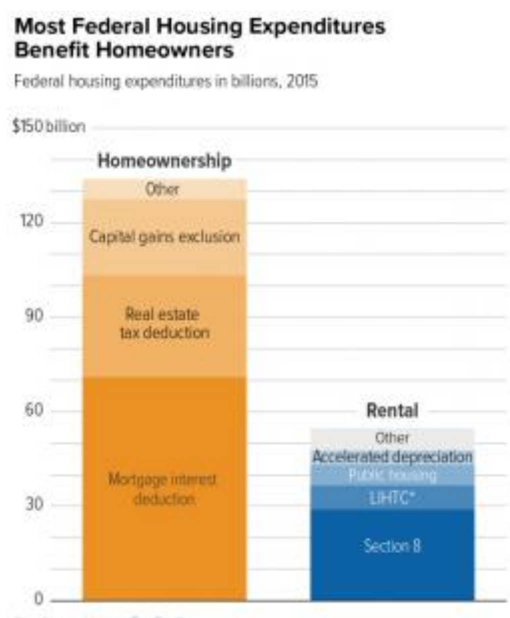
The tax code in Oregon, like the federal tax code, allows some filers to reduce the size of their tax bills by allowing a deduction for mortgage interest (on loans up to $1 million). In 2013 alone (the latest year for which figures are available), it cost the state about $380 million, according to the Dept. of Revenue's latest tax expenditure report.

The stated purpose of this provision is "to promote home ownership by lowering the cost of mortgages," but this benefit is not targeted to those who most need assistance; rather, it is available only to those who itemize deductions on their tax returns. In 2013, only 30% of all full-year returns claimed the mortgage interest deduction (MID), and **the wealthiest 20% of the state's taxpayers (annual incomes > $84,000) received 60% of the benefit ($220 million) from this tax break**.* Thus, in actual practice, the biggest consequence of this tax provision is to subsidize mortgage payments for some of the state's wealthiest home buyers.

The Big Picture on Housing Assistance

It is important to put this situation in a larger perspective. Most housing subsidies (including both tax expenditures, such as the MID, and direct budget allocations) come through the federal government, and they are largely biased in favor of higher-income home-owning households. According to a national study released in November 2016 by the Center for Budget and Policy Priorities:

> *The federal government spent $190 billion in 2015 to help Americans buy or rent homes, but little of that spending went to the families who struggle the most to afford housing… Lower-income renters are far likelier than homeowners or higher-income renters to pay very high shares of their income for housing and to experience problems such as homelessness, housing instability, and overcrowding. Federal rental assistance is highly effective at helping these vulnerable families, but rental assistance programs are deeply underfunded and as a result reach only about one in four eligible households.*



According to U.S. Census statistics, in 2013 60% of Oregon households lived in owner-occupied units, with a median family income (MFI) of $66,000. The other 40% were renters, with an MFI less than half that – around $32,500 (ACS 1-yr. est.).

The Households That Truly Need Housing Support in Oregon

HUD's latest analysis of Census data shows that the Oregonians most likely to experience housing problems (especially disproportionate cost burden) are the poorest renter households. In line with nationwide trends, the majority of these households receive little or no government housing assistance. **One in four renter households is paying over half of total income for housing costs** (which HUD considers a "severe cost burden"), and the overwhelming majority are among the poorest:

Oregon Renter Households By Income Group	Renter Households	% of Total Renter Households	Households with Severe Cost Burden	% in Income Group with Severe Cost Burden
Very Low/Extremely Low Income (<= 50% MFI)	223,555	39%	131,550	59%
Low/Moderate Income (51 - 100% MFI)	184,370	32%	16,000	9%
All other households (>100% MFI)	168,385	29%	2,050	1%
Totals	**576,310**		**149,600**	

Summary: The Oregon Mortgage Interest Deduction in Perspective

Oregon is in the midst of an affordable housing crisis. Housing costs are rising at an unprecedented rate in every corner of the state, requiring an immediate response at the state level. At this moment, can Oregon afford to provide a $220 million annual housing subsidy for those among the wealthiest fifth of the state's taxpayers? For the sake of comparison, consider that the state, in the most recently completed Legislatively Adopted Budget (2015-17 biennium), committed $42 million to what the Housing and Community Services Department calls "Safety Net Programs," which fund services such as rental assistance and help for the homeless. This figure includes both state and federal contributions for two years (or, annually, about 10% of the above-mentioned mortgage subsidy).

While the largest cities and towns receive some additional funding directly from the federal government for these needs, we know from the sources cited that this funding as well assists far too few of the most deserving households: the elderly and others on fixed incomes, growing families with young children, and first-time homebuyers.

What Can We Do Right Now?

The **Homeownership and Housing Opportunity Bill** (HB 2006) proposes common-sense reforms for the state's mortgage interest deduction. HB 2006 will rebalance the Oregon MID so that we can make historically proven investments that work to address the statewide housing crisis. I respectfully urge all members of the House Human Services and Housing Committee to support this legislation.

* *from* State of Oregon Dept. of Revenue Tax Expenditure Report 2017-19, *p. 89*:

1.212 HOME MORTGAGE INTEREST

Internal Revenue Code Section: 163(h) **Oregon Statute:** 316.695 (Connection to federal personal deductions) **Federal Law Sunset Date:** 12-31-16 (deduction of mortgage insurance premiums) **Year Enacted in Federal Law:** 1913

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2013 Personal Income Tax Filers

Income Group of Full-Year Filers*	Number of Filers Taking Deduction	Average Deduction	Total Deducted ($ millions)	Revenue Impact ($ millions)	Percent of Revenue Impact by Income Group
Below $12,800	16,800	$7,970	$133.9	$0.5	<1%
$12,800 - $26,700	24,600	$6,560	$161.3	$7.1	2%
$26,700 - $47,600	63,200	$6,710	$424.0	$32.7	9%
$47,600 - $84,300	147,800	$7,580	$1,120.3	$97.2	27%
Above $84,300	237,500	$10,140	$2,407.2	$218.3	61%
All Full-Year Filers	489,900	$8,670	$4,246.7	$355.9	100%
Part-Year and Nonresident Filers	74,800	$3,720	$278.3	$22.1	

**Each income group contains 20 percent of the full-year filers (approximately 327,000)*

tax analysts special report

How and Why States Use The Home Mortgage Interest Deduction

by Donald Morris and Jing Wang

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Introduction

Until 1986 the Internal Revenue Code permitted an itemized deduction for interest on personal debt, including interest paid on personal credit cards, car loans, and home mortgages. The Tax Reform Act of 1986 eliminated the deduction for most forms of personal interest but retained the deduction for interest on home mortgages.[1] This deduction purportedly encourages homeownership or makes owning a home more affordable, especially for taxpayers at the lower end of the economic spectrum — those on the margins of affordability. In its General Explanation of the Tax Reform Act of 1986, the Joint Committee on Taxation said:

> While Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, Congress nevertheless determined that encouraging homeownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the personal interest limit does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or second residence, to the extent of the basis of the principal residence (or second residence).[2]

Whether the intent of Congress in retaining the deduction for home mortgage interest lines up with economic reality has been the subject of previous research. Glaeser and Shapiro, for example, question the congressional reasoning regarding the incentive benefits of the deduction and find that the home mortgage interest deduction "disproportionately favors the wealthy" and "is a particularly poor instrument for encouraging homeownership because it is targeted at the wealthy, who are almost always homeowners."[3] A 2010 JCT report said that "the average tax savings from the mortgage interest deduction increases as annual household income increases,"[4] a function of the progressive tax rate structure. Despite these concerns at the federal level, three-fourths of the states that impose an income tax also permit a mortgage interest deduction, but for reasons presumed to be largely political window dressing — for example, because their

[1]IRC section 121. All references are to the Internal Revenue Code of 1986 as amended. For purposes of the home mortgage interest deduction, a home includes a house, condominium, cooperative, mobile home, house trailer, or boat. Also, the interest on up to $100,000 of home equity debt is deductible.

[2]Tax Reform Act of 1986, U.S. Senate, Report of the Committee on Finance, to accompany H.R. 3838, 99th Cong., 2d Sess., May 29, 1986, Internal Revenue Cumulative Bulletin, 1986-3, vol. 3, p. 804; Report of the Committee on Ways and Means, House of Representatives, to accompany H.R. 3838, 99th Cong., 1st Sess., Dec. 7, 1985, Internal Revenue Cumulative Bulletin, 1986-3, vol. 2, p. 297.

[3]Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy* 17, Cambridge, Mass.: The MIT Press (2003).

[4]Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014" (JCS-3-10), Dec. 15, 2010, p. 60.

neighboring states do so[5] — or for administrative convenience.[6] According to Brunori, "conformity with the federal tax system lessens the burdens of compliance with state income taxes."[7] However, the primary administrative convenience achieved by states results from using federal adjusted gross income as the tax base, a method used by 28, or 68 percent, of the 41 states that impose tax on all forms of income. That is because two-thirds of taxpayers don't use itemized deductions,[8] and also because most tax cheating involves unreported income rather than overstated deductions.[9] Thus, most IRS audits are aimed at increasing AGI — and the resulting audit-adjustment information is shared with the states, reducing the states' need to perform basic income-level audits.

Following the Federal Model

Of the states with an individual income tax, 31 directly or indirectly follow the federal government's lead in permitting the deduction of home mortgage interest. Although lessening the burdens of state income tax compliance is important, the efficacy and wisdom of states following the federal income tax model can be questioned on other grounds. For example, the problems states face are geographically limited, and potential solutions are bounded by factors of each state's economic condition and outlook. The depressed housing market that began in the United States in 2006, for example, affected some states to a greater extent than others. At the same time, as the U.S. economy entered a recession, some states positioned themselves to withstand its stresses while others only took action as conditions became critical.

Regarding the deduction for home mortgage interest — generally the largest itemized deduction[10] — critics question its justification at the federal level,[11] and the same questions can be raised at the state level. Also, whatever benefits the deduction is alleged to accomplish at the federal level, in terms of encouraging homeownership, are less in most states because of the lower state tax rates in contrast to the federal. In this report, we question the use by the states of this deduction and show that, measured by the tax savings as a percentage of the mortgage interest expense, its primary benefits go to higher-income taxpayers — those who would likely own a home without a government subsidy.

> ***Each state should examine the housing needs of its citizens and determine whether the forgone tax revenue resulting from the subsidy provided to homeowners is money well spent.***

An alternative policy approach to following the federal government would require each state to examine the housing needs of its citizens and determine whether the forgone tax revenue resulting from the subsidy provided to homeowners is money well spent, or whether those funds could be allocated more effectively to help those most in need of a housing subsidy (as the federal government does with low-income housing, for example). Based on that analysis, states could not only tailor their solutions to the specific needs of their citizens but also serve a broader role. Rather than assuming that Congress has achieved the optimal solution to dealing with the housing needs of the citizens through an income tax deduction, state legislatures should focus on the most effective use of their state's scarce resources to address housing problems and direct their state's tax policy to supplement and overcome weaknesses in the federal law's design. In this role, states can act as innovators, testing grounds, and incubators for unique ideas and solutions. Under this approach, federal and state income tax policies could be complementary rather than duplicative.

Of the 41 states that impose a tax on all forms of income, 31 (75 percent) permit income to be reduced

[5]According to a former Nebraska state legislator, "If we are asked why [we offer a particular credit or deduction] we frequently answer, 'Because other states are doing it and we cannot afford to be outdone.'" Sen. Don Wesely, "Myths and Realities of Economic Development Incentives: Who's Giving Away the Store? Revisited," *State Tax Notes*, Sept. 20, 1993, p. 645, or *93 STN 185-18*. Lhlanfeldt argues, "Many states have adopted tax incentives scarcely well founded on economic theory or empirical evidence. Frequently, poor incentives are contagious, as states become copycats by responding to their competitors by passing their own similar incentives," Keith R. Lhlanfeldt, "Ten Principles for State Tax Incentives," *Economic Development Quarterly* 9, no. 4, 1995 (Nov.): 353.

[6]David Brunori, "State Personal Income Taxation in the Twenty-First Century," *The Future of State Taxation*, ed. David Brunori, The Urban Institute Press, Washington, D.C. 1998.

[7]*Id*.

[8]IRS 2009. SOI Table 2.1. Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income.

[9]According to the IRS, understated income, not overstated deductions, produces over 80 percent of individual underreporting, while business activities, not wages or investment income, generated most of the understated individual income. IRS, "The Tax Gap Facts and Figures," Mar. 2005.

[10]Leonard E. Burman, "Is the Tax Expenditure Concept Still Relevant?" *National Tax Journal*, vol. 56, no. 3 (Sept. 2003): 1-20.

[11]Glaeser and Shapiro, *supra* note 3.

(at least potentially) by a deduction for home mortgage interest. Of those 41 states, 28 (68 percent) use federal AGI as a starting point for developing their tax base. An additional six states (15 percent) use federal taxable income as the starting point in developing their tax base. For the remaining seven states, taxable income is computed independently of the federal formula. Also, two states (Tennessee and New Hampshire) tax only investment income and seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) impose no income tax. These results are summarized in Table 1, along with the number of each of those states that offers a deduction for home mortgage interest.

Table 1.
Tax Base for State Income Tax

Basis for Computing State Income Tax	All States	Mortgage Interest Deduction
States using federal AGI as a starting point	28	21
States using federal taxable income as a starting point	6	6
States not employing federal subtotals as starting point	7	4
States imposing a full income tax (subtotal)	**41**	**31**
States taxing only investment income	2	
States with no income tax	7	
Total	**50**	**31**

For states that base their taxes on federal taxable income, the effect is the same as that for states permitting the federal itemized deduction for home mortgage interest. In either case, only interest costs exceeding the standard deduction will reduce taxable income.[12] Although most states use the federal standard deduction (directly or indirectly), several states assign their own standard deduction amounts (see tables 2 (p. 704) and 3 (p. 706)).

The Federal Deduction

In this report, we first examine the federal deduction for home mortgage interest to determine what the benefits are to taxpayers at two different income levels. The IRS provides data on this deduction both nationally and by state. Although the IRS also breaks down the data into four income ranges, we use only the highest and lowest of those ranges for our analysis. That provides a contrast of the benefits of the home mortgage interest deduction for average- or lower-income taxpayers (those with AGIs of $50,000 or less) and higher-income taxpayers (those with AGIs of $200,000 or more). It should be noted, however, that while we use $50,000 as the lower end, it is also roughly the median U.S. household income, according to the U.S. Census Bureau. It represents what some would assume to be the target audience for a government incentive or subsidy to purchase a home.[13] According to the U.S. Census Bureau, 62.3 percent of households with income between $50,000 and $59,999 own homes.[14] Also, according to the National Association of Realtors, the median sales price of an existing single-family home in 2010 was $173,300.[15] If we begin with the traditional guideline that a homeowner's debt payments should not exceed 28 percent of gross income, for a taxpayer earning $50,000 AGI, the annual amount available for servicing the debt would be $14,000, which corresponds to a mortgage of $217,327 (at 5 percent interest amortized over 30 years). Thus, taxpayers with $50,000 AGI are capable of purchasing a median-priced house and therefore represent a useful category for analysis.

As noted, IRS data are presented in terms of ranges of income. We believe, however, that in dealing with the individual states — and the relative benefits the home mortgage interest deduction provides at the state level — discrete points are more useful than the ranges of income provided by the IRS. At the state level, using two points allows us to calculate the exact tax savings for a particular level of home mortgage interest for a taxpayer with an AGI of $50,000 compared with one with an AGI of $200,000, and to examine the difference this makes in the deduction's impact on the taxpayer.

The Tax Expenditure Model

Rather than taxing all income "from whatever source derived," as permitted by the 16th Amendment, Congress decided early on to exclude some potential sources of income through deductions, exemptions, credits, and exclusions. According to Fox's calculations, "The tax laws currently allow massive amounts of income to be [legally] siphoned away from

[12]There are limited exceptions to this general rule, discussed later.

[13]For 2009 the U.S. Census Bureau reported that the median household income was $49,777. "Income, Poverty, and Health Insurance Coverage in the United States: 2009," *available at* http://www.census.gov/prod/2010pubs/p60-238.pdf.

[14]The rate of home ownership increases with household income to a high of 91.8 percent for households with income of $120,000 or more. American Housing Survey: 2009, U.S. Census Bureau.

[15]National Association of Realtors, 2010 "Median Sales Price of Existing Single-Family Homes for Metropolitan Areas."

taxable income."[16] Fox added, "Congress undermines the effectiveness of progressive tax rates by allowing so much income of middle- and upper-income taxpayers . . . to escape status as taxable income."[17] More than 45 percent of the income potentially available for taxation is legally excluded, although that untaxed income is not spread proportionately to taxpayers' incomes — that is, the primary benefits go to those in the highest tax brackets.[18] This is an extension of what sociologist Robert Merton called the Matthew Effect:[19] "For whosoever hath, to him shall be given, and he shall have more abundance."[20]

The term "tax expenditure" is used by economists and politicians who deal in tax policy to differentiate what avoids taxation (or reduces what is taxed), and is thereby subsidized, from what is taxed. Income earned but used to pay deductible mortgage interest is an example. Fox said, "Congress subsidizes all sorts of programs . . . by creating special provisions in the tax laws that reduce government receipts."[21] "Tax expenditure" is an unfortunate term, for it further obfuscates the ordinary taxpayer's understanding of the tax regime. In everyday English, a tax expenditure sounds like spending money generated from taxes. That is not its meaning on Capitol Hill. One economist said, "The term 'tax expenditure' refers to departures from the normal tax structure designed to favor a particular industry, activity, or class of persons."[22]

The U.S. Government Accountability Office lists as examples of tax expenditures "tax exemptions, exclusions, deductions, credits, and deferrals"[23] and has criticized their widespread use in the code. Effectively, tax expenditures represent the cost — in lost tax revenue — from items afforded special tax status and benefiting special groups of taxpayers. As a consequence of "having placed so much income beyond the government's reach," according to Fox, "Congress adopts much higher tax rates than would otherwise be necessary to raise a given amount of tax revenue."[24] Ronald Pasquariello said, "The effect of tax expenditure is to subsidize a particular activity. The home mortgage interest deduction subsidizes home buying. In this sense, it is no different from a budget outlay."[25] Furthermore, Leonard Burman said, "The mortgage interest deduction is the largest housing subsidy by far and dwarfs the size of not only other tax expenditures but also other direct expenditures for housing in the federal budget."[26]

Home Mortgage Interest Deduction

As noted, according to the JCT, "The distributional impact of the mortgage interest deduction indicates that the largest tax expenditures accrue to those households with the highest incomes, who may have purchased homes even in the absence of the deduction."[27] Although it stands to reason that many tax incentives, including deductions, exemptions, reduced capital gains rates, and other breaks, are of the greatest potential benefit to taxpayers in the highest marginal tax brackets, crafting tax breaks specifically for those in the highest brackets, as Fox said, undercuts the original purpose of a progressive tax rate system.[28] In a 2011 article in *The New York Times*, billionaire Warren Buffett said of these tax breaks, "These and other blessings are showered upon us by legislators in Washington who feel compelled to protect us, much as if we were spotted owls or some other endangered species."[29] This congressional tendency affects the vertical equity of the progressive tax rate structure (its design to tax higher levels of income at higher rates). The problem, according to Buffett, is that "while the poor and middleclass fight for us in Afghanistan, and while most Americans struggle to make ends meet, we mega-rich continue to get our extraordinary tax breaks."[30] Brunori concurs: "While the personal income tax is generally applied to most income

[16]John O. Fox, *If Americans Really Understood the Income Tax: Uncovering Our Most Expensive Ignorance* (Boulder, Colo.: Westview Press, 2001), p. 49.

[17]*Id*. at p. 39.

[18]*Id*. at p. 49. Fox provides a full explanation of this feature of our income tax system.

[19]Merton used the term "Matthew Effect" in referring to the accumulation of advantages and disadvantages and in particular the tendency of scientists who were already famous to become more famous. Robert K. Merton, *On Social Structure and Science*, ed. with an introduction by Piotr Sztompka (Chicago: The University of Chicago Press, 1996), p. 160.

[20]Bible KJV Matt.13:12. This is followed by, "but whosoever hath not, from him shall be taken away even that he hath."

[21]Fox, *supra* note 16, p. 77.

[22]Burman, *supra* note 10.

[23]House of Representatives, testimony before the Committee on the Budget, statement of Michael Brostek, director, tax issues, strategic issues, Government Accountability Office, "Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap," GAO-07-488T (Feb. 16, 2007), p. 11.

[24]Fox, *supra* note 16, p. 12.

[25]Ronald Pasquariello, *Tax Justice: Social and Moral Aspects of American Tax Policy* (Lanham, Md.: University Press of America, Inc., 1985), p. 81.

[26]Burman, *supra* note 10.

[27]Joint Committee on Taxation, "Present Law and Background Relating to Tax Treatment of Household Debt" (JCX-40-11), July 11, 2011, p. 4, *available at* www.jtc.gov.

[28]It should be noted that specific tax breaks, including a number of credits such as the earned income tax credit, have been enacted to benefit lower-income taxpayers as well.

[29]Warren E. Buffett, "Stop Coddling the Super-Rich," *The New York Times* (Aug. 14, 2011).

[30]*Id*.

sources, the proliferation of personal loopholes [also] cuts against the horizontal equity of the tax."[31] Indirect evidence of those facts is provided by former IRS Commissioner Charles Rossotti, who reported that 83 percent of the tax code is directed at only 29 percent of taxpayers, providing exceptions and special breaks for favored constituents.[32]

If, as Fox claimed, the progressive rate system has been so emasculated through numerous deductions, exemptions, and credits benefiting mostly those at the high end of the economic spectrum[33] that it is actually regressive, "the comparison of formal definitions of *regressive* and *progressive* may be less useful than a comparison of the results of these systems once they have been retrofitted to the needs of those inside the Beltway."[34] Aggravating that problem at the state level, Brunori said, is that states also have been "steadily increasing the number of deductions over the years."[35]

In political speeches, the home mortgage interest deduction is popularly characterized as an incentive or benefit aimed at helping the struggling average taxpayer. It is further claimed that without that help, the construction industry would suffer and fewer people would own homes. The stated policy justification for some tax benefits is the advantages they offer to middle- or lower-income taxpayers, but they do those taxpayers little good and instead benefit the wealthiest among us. The curtain hiding this policy flaw is drawn back, exposing an issue Congress has long been aware of but so far has chosen not to confront: The greatest benefit now goes to "those whomsoever already hath," those who would own a home without the subsidy.

The Incentive Value of the Deduction

At first glance, the deduction for home mortgage interest appears to be an incentive — it's the government's way of encouraging homeownership. If it helps someone who might not otherwise buy a house to afford the monthly payments, the deduction can be seen as encouraging taxpayers on the margins of affordability to take the step from renting to buying. In theory the additional cost of the mortgage payment is subsidized by a deduction for the mortgage interest paid. But that deduction is available only to people who itemize deductions — roughly 33 percent of taxpayers[36] — leaving no benefit to those at the lower end of the home buying spectrum, those who use the standard deduction and are frequently less affluent. As Glaeser and Shapiro said, "The groups that are really on the homeownership margin (the poor and the young) rarely use the deduction, even when they are owners. Thus the deduction is unlikely to influence the homeownership rate."[37]

> ***The home mortgage deduction is available only to people who itemize deductions — roughly 33 percent of taxpayers.***

To provide any tax relief as an itemized deduction, the mortgage interest paid plus other itemized deductions must exceed the standard deduction. For 2010, for example, for a married couple, the federal standard deduction was $11,400. Added to other itemized deductions, the benefit derived from the mortgage interest deduction is only the amount greater than the standard deduction. As noted, the median sales price of an existing single-family home in 2010 was $173,300.[38] If the mortgage on this home is $155,970 (90 percent), for example, the interest paid for the year would be $7,799 (at a 5 percent interest rate). To obtain a benefit from even $1 of deduction for the mortgage interest, the taxpayer would have to report additional itemized deductions of at least $3,602 to exceed the standard deduction ($11,401 - 7,799 = 3,602).[39] "Even among homeowners," according to Glaeser and Shapiro,

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[31]Brunori, *supra* note 6. Horizontal equity refers to the principle that taxpayers with similar amounts of income should be taxed at the same rate. The problem in measuring horizontal equity under the current tax code is the exclusion of numerous kinds of potential income from the definition of taxable income. Thus two, or 10, individuals receiving the same amount of spendable income may each have different tax rates because of the sources of their income.

[32]Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* (Boston, Mass: Harvard Business School Press, 2005), p. 274.

[33]Fox, *supra* note 16, p. 49.

[34]Donald Morris, *Tax Cheating: Illegal — But Is It Immoral*? (Albany, N.Y.: State University of New York Press, 2012), p.179.

[35]Brunori, *supra* note 6.

[36]IRS SOI, Table 1.1 Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2009. Number of returns filed 140,494,127. IRS SOI, Table 2.1 Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2009. Number of returns with itemized deduction 45,695,736. Returns with itemized deductions: 32.53 percent; with standard deduction: 67.47 percent.

[37]Glaeser and Shapiro, *supra* note 3. Also, they report, "Slightly over one-half of the itemizers are in the top two income deciles. More than 50 percent of the overall itemized income is in the top decile alone. The poorest 40 percent of the population contains only 5 percent of the itemizers, and they are responsible for 3.5 percent of the itemized income."

[38]National Association of Realtors, 2010 "Median Sales Price of Existing Single-Family Homes for Metropolitan Areas."

[39]Note that even if we used the mortgage balance of $217,237 representing the amount a taxpayer earning

(Footnote continued on next page.)

"itemizing is extremely rare in the bottom deciles of the population."[40] Thus, except for those with hefty mortgages in which the interest component greatly exceeds the amount of the standard deduction, the purported tax savings benefit can be greatly diluted or largely illusory.

To illustrate further, assume that the married taxpayers' marginal tax rate is 25 percent and their itemized deductions as a result of their home mortgage interest are $12,400; in this case, the taxpayers' benefit from the mortgage interest deduction is only $250 ($12,400 - 11,400 = 1,000 x 0.25 = $250), or 2 percent of the interest paid.[41] It is unlikely that that meager savings would encourage the taxpayers to purchase a house, with all the attendant risk and looming costs.

At the other end of the economic spectrum, the greatest tax benefits from the mortgage interest deduction go to those paying taxes at the highest marginal tax rates. Those are also taxpayers who, as noted, would likely buy a house even without a government subsidy (though perhaps a smaller one). If the taxpayers' mortgage interest is $50,000[42] and their marginal tax rate is 35 percent, their benefit is $13,510 ($50,000 - 11,400 = 38,600 x 0.35 = $13,510), or 27 percent of the interest paid, a significant subsidy. This is an after-tax reduction in the interest rate on their mortgage to 3.86 percent.[43] Also, the mortgage interest deduction is available to those with a second home, meaning the government's subsidy for the mortgage interest on the second home is effectively greater than the mortgage interest subsidy for the first home because the standard deduction has already been subtracted from the benefit of the interest on the first mortgage. For the second home, then, the tax savings as a percent of the interest expense will necessarily be the same as the taxpayer's marginal tax rate. Glaeser and Shapiro have also shown that as a result of the benefits of the home mortgage interest going to higher-income taxpayers, the deduction encourages the purchase of larger homes.[44] Following that reasoning, because a home mortgage is secured by the house and the land, the deduction also subsidizes the purchase of more land surrounding the house. Upscale homes are frequently built on 1-, 5-, or 20-acre lots, for example. That externality was presumably not intended by Congress or the states.

Burman said, "The subsidy has been criticized as an upside down subsidy that provides the greatest benefit to upper-middle class and upper-class homeowners, while the greatest needs are among lower-income families struggling to pay rent or afford a home."[45] The GAO concurred:

> Tax expenditures may not be an effective way to achieve federal goals if targeting them to entities or activities meant to receive the benefits is difficult, if they subsidize activities that would have been undertaken without their stimulus, or if they serve to exacerbate other key private sector and public policy challenges.[46]

The government breaks encouraging homeownership for higher-income taxpayers, the primary beneficiaries of the mortgage interest deduction, is an example of a subsidy for an action that would have been undertaken without this stimulus.

Also, others have pointed out that if the deduction were an effective incentive, the amount of mortgage debt, and hence the amount of deductible interest (assuming a constant interest rate), would increase as tax rates go up and decrease as tax rates go down. However, over the past 60 years, household mortgage debt has increased in total and as a percent of GDP although tax rates have generally come down. In 1960 home mortgage debt was $141.3 billion; by 2010 the total had increased to $10 trillion.[47] But over this period, according to the JCT, "the value of the mortgage interest deduction declined. This decline was partly due to declines in income tax rates."[48] However, while "the declining value of the home mortgage interest deduction created incentives for households to reduce their quantity of mortgage debt,"[49] the housing bubble continued to grow until 2006.

$50,000 could afford using the standard 28 percent of income rule, the annual interest — at 5 percent — would still be less than the standard deduction at $10,866.

[40]Glaeser and Shapiro, *supra* note 3.

[41]The more a person's itemized deductions surpass the standard deduction the greater the benefit provided by the itemized deductions. This is limited to some extent for taxpayers affected by the AMT; *see* Form 6251 lines 2-5.

[42]For example, a $1 million mortgage with a 5 percent interest rate would generate $50,000 of interest expense.

[43]For a taxpayer earning $200,000, using the standard 28 percent of income model, the taxpayer could afford a mortgage of $869,313, which would generate mortgage interest of $43,466 (at a 5 percent annual interest rate).

[44]Glaeser and Shapiro, *supra* note 3.

[45]Burman, *supra* note 10, citing Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton, N.J.: Princeton University Press, 1997).

[46]GAO, "Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined," GAO-05-690 (Sept. 2005), p. 50.

[47]Board of Governors of the Federal Reserve System. Cited in Joint Committee on Taxation, "Present Law and Background Relating to Tax Treatment of Household Debt" (JCX-40-11), July 11, 2011, p. 11, *available at* www.jtc.gov.

[48]*Id.*

[49]*Id.*

How the States Use the Home Mortgage Interest Deduction

The IRS provides data on the amounts claimed on each line of Form 1040 by year.[50] Those data are presented in total and also by state. From those data it is possible to determine the average deduction per return, for each state, for home mortgage interest (as well as other itemized deductions and line items on Form 1040). Also, those data are provided by the IRS at different income levels, including AGIs of $50,000 and $200,000.[51] Using that per-state average, we can scale the amount of home mortgage interest claimed per return to the relative housing costs of each state for the specific AGI levels desired. Because each of the 41 states that imposes an income tax applies its own tax rate structure — reflecting the economic conditions of that state, as well as its policy choice as to what percent of that state's tax revenue is to come from the income tax — using state-specific home mortgage interest data reflecting those economic conditions and policy considerations enhances comparability between the states regarding the effective state tax savings resulting from the deduction for home mortgage interest.[52]

> ***A credit for interest on a home mortgage is not affected by the progressive tax rate structure, and could provide a greater relative economic benefit to lower-income taxpayers.***

In tables 2 and 3, we provide data on each of the 41 states imposing an income tax. The tables show whether each state uses federal AGI or federal taxable income in the calculation of its tax base, or computes its tax base independently. Also displayed are the ranges of tax rates for each state as well as the marginal tax rate applied to the state taxable income resulting from a federal AGI of $50,000 (Table 2) or $200,000 (Table 3). Each table shows the state taxable income resulting from the deduction of the state-average amount of home mortgage interest for the respective level of income ($50,000 or $200,000 AGI). Finally, each table computes the difference between the income tax without the deduction for home mortgage interest and with the deduction, and computes the percentage that this tax savings represents of the average amount of home mortgage interest deducted for that state at the specific income level indicated.

In preparing these tables, we sought to answer two primary questions. First, for each state, what is the effective tax savings achieved from permitting a deduction for home mortgage interest at the $50,000 AGI and $200,000 AGI levels?[53] The answer to this question is affected by each state's tax rates and standard deduction, if one is used. In many instances, the average mortgage interest for the state at the $50,000 AGI level is less than the state's standard deduction, providing no tax benefit. Second, is the effective tax savings, as a percent of mortgage interest deducted, greater for those taxpayers at the $50,000 or the $200,000 AGI level? If the purpose of the state deduction for home mortgage interest is to encourage homeownership, as it is for the federal tax deduction, we would expect taxpayers at the $50,000 level to achieve the lion's share of the economic benefit as measured by the relative tax savings for the average amount spent on home mortgage interest. However, since most states (34 states of 41), like the federal government, use a progressive tax rate structure and a standard deduction, the desired result of benefiting potential homeowners, especially those at the lower end of the economic spectrum, will predictably not occur unless the states have instituted particular measures to overcome the effects of the progressive tax rates. For example, Wisconsin permits a credit for itemized deductions rather than allowing the deductions themselves to reduce income. A credit for interest on a home mortgage is not affected by the progressive tax rate structure, and could provide a greater relative economic benefit to lower-income taxpayers (depending on how the credit is designed, a topic discussed in the conclusion).

(Text continued on p. 708.)

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[50]IRS SOI Table 2. Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2009, *available at* www.irs.gov.

[51]Because the average deduction for home mortgage interest is provided by the IRS for a range of income, rather than at specific points, there is likely some distortion in the results we present. However, we believe any distortion is immaterial in the broader context of a state-to-state comparison since the same problem affects each state's average home mortgage interest deduction for those respective levels of income.

[52]In contrast, we feel that using one national average home mortgage interest deduction figure across all states could distort the results by ignoring the differences in average home prices (and hence mortgages) from one state to another.

[53]It may be objected that our results distort the effects of the home mortgage interest because we have excluded other potential itemized deductions such as state income taxes, real estate taxes, or charitable donations. Although it is true that including these and other itemized deductions could be construed as increasing the effectiveness of the home mortgage deduction, the purpose of our study is to isolate the specific effects of the home mortgage interest deduction, because the congressional policy cites the promotion of home ownership in isolation and not in conjunction with the benefits of charitable donations or the payment of state or local taxes.

Table 2.
Effective Tax Savings at $50,000 AGI*

	State Uses Federal AGI	State Uses Federal Taxable Income	State Income Tax Rates Low to High	Median Household Income, 2008	Federal Adjusted Gross Income	Marginal State Income Tax Rate for Taxable Income	State Taxable Income Without Deduction	State Taxable Income With Deduction	State Standard Deduction	Average State Deduction for Home Mortgage Interest	Differences Between Taxable Income With and Without Deduction	State Income Tax Without Mortgage Interest	State Income Tax With Mortgage Interest	State Tax Savings	Tax Savings as a Percentage of Interest Expense
Oregon	Yes	No	5%-11%	$50,169	$50,000	9.000%	$43,039	$37,571	$3,900	$9,368	$5,468	$3,447	$2,952	$495	5.28%
Hawaii	Yes	No	1.4%-11%	67,214	50,000	7.600%	43,920	34,317	4,000	13,603	9,603	2,414	1,739	675	4.96%
Alabama	No	No	2%-5%	52,029	50,000	5.000%	39,939	33,167	4,000	6,947	6,772	1,918	1,578	340	4.89%
Kentucky	Yes	No	2%-6%	41,538	50,000	5.800%	47,790	43,470	2,210	6,530	4,320	2,586	2,336	250	3.83%
Arkansas	No	No	1%-7%	38,815	50,000	7.000%	46,000	43,379	4,000	6,621	2,621	2,348	2,159	189	2.85%
Iowa	No	No	0.36%-8.98%	48,980	50,000	7.920%	45,540	44,025	4,460	5,975	1,515	2,577	2,458	119	1.99%
California	Yes	No	1.25%-9.55%	61,021	50,000	4.250%	42,660	36,427	7,340	13,573	6,233	997	729	268	1.97%
Delaware	Yes	No	0%-6.95%	57,989	50,000	5.550%	43,500	40,662	6,500	9,338	2,838	2,029	1,871	158	1.69%
Mississippi	No	No	3%-5%	37,790	50,000	5.000%	33,400	31,453	4,600	6,547	1,947	1,520	1,423	97	1.48%
Montana	Yes	No	1%-6.9%	43,654	50,000	6.900%	37,760	37,309	7,980	8,431	451	2,109	2,078	31	0.37%
Arizona	Yes	No	2.59%-4.54%	68,460	50,000	2.880%	36,446	35,857	9,354	9,943	589	991	975	16	0.16%
Colorado	No	Yes	4.63%	56,993	50,000	4.630%	31,300	31,300	11,400	10,196	0	1,447	1,447	0	0.00%
Connecticut	Yes	No	3%-6.7%	68,595	50,000	5.000%	50,000	50,000	0	8,988	0	849	849	0	0.00%
Georgia	Yes	No	1%-6%	50,861	50,000	6.000%	41,600	41,600	3,000	8,231	0	2,239	2,239	0	0.00%
Idaho	Yes	No	1.6%-7.8%	47,576	50,000	7.400%	31,300	31,300	11,400	8,703	0	1,864	1,864	0	0.00%
Illinois	Yes	No	3%	56,235	50,000	3.000%	46,000	46,000	0	8,580	0	1,380	1,380	0	0.00%
Indiana	Yes	No	3.4%	47,966	50,000	3.400%	48,000	48,000	0	6,569	0	1,632	1,632	0	0.00%
Kansas	Yes	No	3.5%-6.45%	50,177	50,000	6.250%	39,500	39,500	6,000	6,432	0	1,645	1,645	0	0.00%
Louisiana	Yes	No	2%-6%	43,733	50,000	4.000%	46,139	46,139	0	7,579	0	1,165	1,165	0	0.00%
Maine	Yes	No	2%-8.5%	46,581	50,000	8.500%	34,750	34,750	9,550	7,460	0	1,690	1,690	0	0.00%
Maryland	Yes	No	2%-6.25%	70,545	50,000	4.750%	39,600	39,600	4,000	9,915	0	1,830	1,830	0	0.00%

Table 2.
Effective Tax Savings at $50,000 AGI*
(continued)

	State Uses Federal AGI	State Uses Federal Taxable Income	State Income Tax Rates Low to High	Median Household Income, 2008	Federal Adjusted Gross Income	Marginal State Income Tax Rate for Taxable Income	State Taxable Income Without Deduction	State Taxable Income With Deduction	State Standard Deduction	Average State Deduction for Home Mortgage Interest	Differences Between Taxable Income With and Without Deduction	State Income Tax Without Mortgage Interest	State Income Tax With Mortgage Interest	State Tax Savings	Tax Savings as a Percentage of Interest Expense
Massachusetts	No	No	5.3%	$65,401	$50,000	5.300%	$39,200	$39,200	0	$9,381	0	$2,078	$2,078	$0	0.00%
Michigan	Yes	No	4.35%	48,591	50,000	4.350%	42,800	42,800	0	7,041	0	1,862	1,862	0	0.00%
Minnesota	No	Yes	5.35%-7.85%	57,288	50,000	7.050%	31,300	31,300	11,400	8,131	0	1,677	1,677	0	0.00%
Missouri	Yes	No	1.5%-6%	46,867	50,000	6.000%	31,339	31,339	11,400	7,083	0	1,655	1,655	0	0.00%
Nebraska	Yes	No	2.56%-6.84%	49,693	50,000	5.120%	38,600	38,600	11,400	6,241	0	1,386	1,386	0	0.00%
New Jersey	No	No	1.4%-8.97%	70,378	50,000	1.750%	48,000	48,000	0	9,197	0	770	770	0	0.00%
New Mexico	Yes	No	1.7%-4.9%	43,508	50,000	4.900%	30,300	30,300	11,400	8,788	0	1,074	1,074	0	0.00%
New York	Yes	No	4%-8.97%	56,033	50,000	6.850%	35,000	35,000	15,000	9,017	0	1,652	1,652	0	0.00%
North Carolina	No	Yes	6%-7.75%	46,549	50,000	7.000%	39,000	39,000	6,000	7,589	0	2,519	2,519	0	0.00%
North Dakota	No	Yes	1.51%-3.99%	45,685	50,000	1.510%	31,300	31,300	11,400	6,328	0	576	576	0	0.00%
Ohio	Yes	No	0.618%-6.24%	47,988	50,000	4.327%	46,800	46,800	0	6,351	0	1,402	1,402	0	0.00%
Oklahoma	Yes	No	0.5%-5.25%	42,822	50,000	5.250%	36,600	36,600	11,400	6,425	0	1,584	1,584	0	0.00%
Pennsylvania	No	No	3.07%	50,713	50,000	3.070%	50,000	50,000	0	7,195	0	1,535	1,535	0	0.00%
Rhode Island	Yes	No	3.75%-9.9%	55,701	50,000	3.750%	33,150	33,150	9,550	8,462	0	1,244	1,244	0	0.00%
South Carolina	No	Yes	0%-7%	44,625	50,000	7.000%	31,300	31,300	11,400	7,780	0	1,729	1,729	0	0.00%
Utah	Yes	No	5%	56,633	50,000	5.000%	50,000	50,000	11,400	9,708	0	1,811	1,811	0	0.00%
Vermont	No	Yes	3.55%-9.4%	52,104	50,000	3.550%	31,300	31,300	11,400	7,627	0	1,113	1,113	0	0.00%
Virginia	Yes	No	2%-5.75%	61,233	50,000	5.750%	42,140	42,140	6,000	9,683	0	2,166	2,166	0	0.00%
West Virginia	Yes	No	3%-6.5%	37,989	50,000	6.000%	46,000	46,000	0	7,208	0	1,935	1,935	0	0.00%
Wisconsin	Yes	No	4.6%-7.75%	52,094	50,000	6.500%	38,066	38,066	10,534	6,694	0	2,171	2,171	0	0.00%

Wisconsin provided a tax credit for itemized deductions rather than permitting the deductions directly.

Table 3.
Effective Tax Savings at $200,000 AGI*

	State Uses Federal AGI	State Uses Federal Taxable Income	State Income Tax Rates Low to High	Median Household Income, 2008	Federal Adjusted Gross Income	Marginal State Income Tax Rate for Taxable Income	State Taxable Income Without Deduction	State Taxable Income With Deduction	State Standard Deduction	Average State Deduction for Home Mortgage Interest	Differences Between Taxable Income With and Without Deduction	State Income Tax Without Mortgage Interest	State Income Tax With Mortgage Interest	State Tax Savings	Tax Savings as a Percentage of Interest Expense
Oregon	Yes	No	5%-11%	$50,169	$200,000	9.000%	$190,250	$172,901	$3,900	$21,249	$17,349	$16,695	$15,133	$1,562	7.35%
California	Yes	No	1.25%-9.55%	61,021	200,000	9.550%	192,660	170,627	7,340	29,373	22,033	13,819	11,714	2,105	7.17%
Hawaii	Yes	No	1.4%-11%	67,214	200,000	8.250%	194,294	172,564	4,000	25,730	21,730	14,536	12,744	1,792	6.96%
Iowa	No	No	0.36%-8.98%	48,980	200,000	8.980%	195,540	185,924	4,460	14,076	9,616	15,849	14,986	863	6.13%
North Carolina	No	Yes	6%-7.75%	46,549	200,000	7.750%	190,000	175,792	6,000	20,208	14,208	13,763	12,661	1,102	5.45%
Missouri	Yes	No	1.5%-6%	46,867	200,000	6.000%	174,400	158,957	11,400	17,321	15,443	10,239	9,312	927	5.35%
Arkansas	No	No	1%-7%	38,815	200,000	7.000%	196,000	183,595	4,000	16,405	12,405	12,841	11,973	868	5.29%
Kentucky	Yes	No	2%-6%	41,538	200,000	6.000%	197,790	183,971	2,210	16,029	13,819	11,533	10,704	829	5.17%
Georgia	Yes	No	1%-6%	50,861	200,000	6.000%	191,600	173,302	3,000	21,298	18,298	11,236	10,138	1,098	5.16%
Wisconsin	Yes	No	4.6%-7.75%	52,094	200,000	6.750%	198,600	198,600	0	16,430	0	12,607	11,785	822	5.00%
Delaware	Yes	No	0%-6.95%	57,989	200,000	6.950%	193,500	180,414	6,500	19,586	13,086	12,222	11,312	910	4.65%
Alabama	No	No	2%-5%	52,029	200,000	5.000%	148,470	131,934	4,000	18,534	16,536	7,342	6,515	827	4.46%
Virginia	Yes	No	2%-5.75%	61,233	200,000	5.750%	192,140	174,732	6,000	23,408	17,408	10,791	9,790	1,001	4.28%
Kansas	Yes	No	3.5%-6.45%	50,177	200,000	6.450%	189,500	179,905	6,000	15,595	9,595	11,278	10,659	619	3.97%
Maryland	Yes	No	2%-6.25%	70,545	200,000	4.750%	192,400	173,455	4,000	22,945	18,945	9,087	8,187	900	3.92%
Montana	Yes	No	1%-6.9%	43,654	200,000	6.900%	187,760	177,918	7,980	17,822	9,842	12,459	11,780	679	3.81%
Mississippi	No	No	3%-5%	37,790	200,000	5.000%	183,400	172,306	4,600	15,694	11,094	9,020	8,465	555	3.54%
Maine	Yes	No	2%-8.5%	46,581	200,000	8.500%	184,750	178,037	9,550	16,263	6,713	14,368	13,797	571	3.51%
Minnesota	No	Yes	5.35%-7.85%	57,288	200,000	7.850%	181,300	172,974	11,400	19,726	8,326	12,609	11,955	654	3.32%
Idaho	Yes	No	1.6%-7.8%	47,576	200,000	7.800%	181,300	173,072	11,400	19,628	8,228	13,475	12,834	641	3.27%
South Carolina	No	Yes	0%-7%	44,625	200,000	7.000%	181,300	172,069	11,400	20,631	9,231	12,225	11,579	646	3.13%
Rhode Island	Yes	No	3.75%-9.9%	55,701	200,000	7.750%	183,150	176,210	9,550	17,477	6,940	11,318	10,781	537	3.07%

Table 3.
Effective Tax Savings at $200,000 AGI*
(continued)

	State Uses Federal AGI	State Uses Federal Taxable Income	State Income Tax Rates Low to High	Median Household Income, 2008	Federal Adjusted Gross Income	Marginal State Income Tax Rate for Taxable Income	State Taxable Income Without Deduction	State Taxable Income With Deduction	State Standard Deduction	Average State Deduction for Home Mortgage Interest	Differences Between Taxable Income With and Without Deduction	State Income Tax Without Mortgage Interest	State Income Tax With Mortgage Interest	State Tax Savings	Tax Savings as a Percentage of Interest Expense
Arizona	Yes	No	2.59%-4.54%	$68,460	$200,000	4.240%	$186,446	$171,210	$9,354	$24,590	$15,236	$6,727	$6,081	$646	2.63%
Colorado	No	Yes	4.63%	56,993	200,000	4.630%	181,300	170,407	11,400	22,293	10,893	8,394	7,890	504	2.26%
New York	Yes	No	4%-8.97%	56,033	200,000	6.850%	185,000	177,842	15,000	22,158	7,158	12,673	12,182	491	2.22%
Vermont	No	Yes	3.55%-9.4%	52,104	200,000	8.250%	181,300	177,443	11,400	15,257	3,857	10,922	10,621	301	1.97%
New Mexico	Yes	No	1.7%-4.9%	43,508	200,000	4.900%	181,300	174,133	11,400	18,567	7,167	8,474	8,123	351	1.89%
Nebraska	Yes	No	2.56%-6.84%	49,693	200,000	6.840%	188,600	185,449	11,400	14,551	3,151	11,522	11,306	216	1.48%
Oklahoma	Yes	No	0.5%-5.25%	42,822	200,000	5.250%	186,600	182,981	11,400	15,019	3,619	9,833	9,634	199	1.32%
Louisiana	Yes	No	2%-6%	43,733	200,000	6.000%	160,992	158,027	11,400	15,519	2,965	6,973	6,795	178	1.15%
North Dakota	No	Yes	1.51%-3.99%	45,685	200,000	3.130%	181,300	179,566	11,400	13,134	1,734	5,490	5,424	66	0.50%
Connecticut	Yes	No	3%-6.7%	68,595	200,000	5.500%	200,000	200,000	0	22,921	0	9,600	9,600	0	0.00%
Illinois	Yes	No	3%	56,235	200,000	3.000%	196,000	196,000	0	20,464	0	5,880	5,880	0	0.00%
Indiana	Yes	No	3.4%	47,966	200,000	3.400%	198,000	198,000	0	15,797	0	6,732	6,732	0	0.00%
Massachusetts	No	No	5.3%	65,401	200,000	5.300%	189,200	189,200	0	20,707	0	10,028	10,028	0	0.00%
Michigan	Yes	No	4.35%	48,591	200,000	4.350%	192,800	192,800	0	17,784	0	8,387	8,387	0	0.00%
New Jersey	No	No	1.4%-8.97%	70,378	200,000	6.370%	198,000	198,000	0	20,596	0	8,570	8,570	0	0.00%
Ohio	Yes	No	0.618%-6.24%	47,988	200,000	5.741%	196,800	196,800	0	15,961	0	9,372	9,372	0	0.00%
Pennsylvania	No	No	3.07%	50,713	200,000	3.070%	200,000	200,000	0	17,582	0	6,140	6,140	0	0.00%
Utah	Yes	No	5%	56,633	200,000	5.000%	200,000	200,000	11,400	20,324	0	10,000	10,000	0	0.00%
West Virginia	Yes	No	3%-6.5%	37,989	200,000	6.500%	196,000	196,000	0	14,833	0	11,615	11,615	0	0.00%

*Wisconsin provides a tax credit for itemized deductions rather than permitting the deductions directly.

Unsurprisingly, as reported on tables 2 and 3, the greatest share of the benefits from the state tax deduction for home mortgage interest go to those with AGIs of $200,000. Of the 41 states that impose a general income tax 31 (75 percent) permit some level of tax savings from the deduction at the $200,000 AGI level, while the deduction benefits taxpayers at the $50,000 AGI level in only 11 states (27 percent). Also, at the $200,000 AGI level, taxpayers in seven states (23 percent) receive a tax savings return (tax savings as a percent of home mortgage interest deducted) that is higher than any of the states provide at the $50,000 AGI level, because of the graduated tax rates.[54] Thus, though we would expect the absolute amount of tax savings at the $200,000 AGI level to be greater than at the $50,000 AGI level, for about half the states, the tax savings as a percent of interest expense is also higher.

Conclusions

Although the legislators in 31 of the 41 states that impose a state income tax may be well meaning and earnestly believe they are encouraging homeownership through the allowance of a deduction for home mortgage interest, the effects of that deduction on taxpayers at the $50,000 and $200,000 AGI levels indicates otherwise. In 20 of the 31 states (64.5 percent) that permit a deduction for home mortgage interest, taxpayers at the $50,000 AGI level achieve no economic benefit. For the 11 states (27 percent) that do offer some benefit at $50,000 AGI, it is relatively minor — ranging from $16 (0.16 of one percent of the interest for Arizona) to $495 (5.28 percent of the interest for Oregon) annually — and it is doubtful whether that amount of savings would help a prospective homeowner afford the investment or take the risk if the federal deduction had not already done so.

Delineation of Tax Policy and Tax Incentives

A central reason for the inadequacy of many tax incentives, including the home mortgage interest deduction, according to Fiekowsky, is the conflation of tax incentives and tax policy; those are two separate dimensions of public finance and the incentives should implement the policy. Fiekowsky said:

> Tax economists' and lawyers' views on tax incentives are flawed in ways that have contributed simultaneously to their assent to unnecessary and counterproductive complication of the tax laws . . . [and to] inefficient, often frivolous, tax incentives that are either unaccounted for in the budgetary process, or frequently understated when they are.[55]

The central cause of those problems, according to Fiekowsky, is that lawmakers, or their advisers, fail to distinguish tax incentive issues from tax policy. Keeping the two separate is critical because "the criteria for evaluating incentive policies differ from those for evaluating tax policies,"[56] obfuscating the evaluation of each, he said.

Alternatives to a Deduction

Although providing tax deductions as incentives is common practice in implementing federal and state income tax policy, policymakers should not assume that it is the best method for encouraging homeownership. Deductions for mortgage interest may be easier to administer than other alternatives, but that does not make granting them a good practice. Although the United States is not alone in providing a deduction for home mortgage interest, studies of Australia, Canada, France, Germany, Japan, and Mexico show that none of those countries permits a similar deduction.[57] Instead, Australia, for example, provides a one-time grant to first-time home buyers, and France allows some limited tax credits on interest for residential mortgages that phase out over the first five years of ownership.[58] The federal government has many tools available, including low interest loans, grants,

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[54]Notes to tables 2 and 3.
Georgia: The standard deduction is $3,000. Even if itemized deductions exceed $3,000, they are not permitted until the total itemized deductions exceed the federal standard deduction of $11,400.
Kansas: The standard deduction is $6,000. Even if itemized deductions exceed $6,000, they are not permitted until the total itemized deductions exceed the federal standard deduction of $11,400.
Louisiana: The standard deduction is $11,400, but it is used only if the taxpayer had itemized deductions in excess of $11,400. Only the amount by which the itemized deductions exceed the standard deduction are permitted as a deduction in computing taxable income.
Maryland: The standard deduction is computed as 15 percent of Maryland Adjusted Gross Income with a lower limit of $3,000 (MFJ) and an upper limit of $4,000 (MFJ). Itemized deductions may be used only if they exceeded the federal standard deduction of $11,400.
Montana: The standard deduction is the lesser of 20 percent of Montana AGI or $7,980.
New Jersey: There is no standard deduction provided but a $2,000 exemption is allowed.
North Carolina: The standard deduction is $6,000. Even if itemized deductions exceed $6,000, they are not permitted until the total itemized deductions exceed the federal standard deduction of $11,400. Only the excess is a permitted as a deduction.

[55]Seymour Fiekowsky, "Tax Incentives as Viewed by Economists and Lawyers," *National Tax Journal*, vol. 44, no. 3 (Sept. 1991).

[56]*Id*.

[57]Joint Committee on Taxation, "Present Law and Background Relating to Tax Treatment of Household Debt"(JCX-40-11), July 11, 2011, p. 49, *available at* www.jtc.gov.

[58]*Id*.

and tax credits. Simply offering a deduction to encourage homeownership without empirically verifying its practical effectiveness is making a hollow promise to taxpayers, and one that generally is broken, at least for taxpayers at the $50,000 AGI level.

The home mortgage interest deduction, as structured by most states, is a costly and ineffective subsidy.

As currently structured by most states, the home mortgage interest deduction is a costly and ineffective subsidy. It is costly on at least three levels.

- It benefits the wrong group of taxpayers, if the incentive's original goal was to subsidize a home purchase by someone otherwise unable to do so. That means that any real help to be given to average- or lower-income taxpayers (if there be any) must use additional state resources.
- Because of that wrongly targeted subsidy, the government has not received the additional taxes from the higher-income taxpayers it should have had the subsidy been targeted more effectively (as an implementation of the stated policy in favor of encouraging home ownership). As a result, since the government has less money to spend than if it had not been subsidizing higher-income taxpayers, it is not as well positioned to offer additional help to those individuals who the government says it would like to help to become homeowners — that is, average- and lower-income taxpayers.
- It is also costly at a moral level in that government promises of help to those desiring to purchase a home are found wanting and unfulfilled. As a result, the government overpromises and underdelivers, and its credibility is further eroded.

Rather than states simply copying the federal government's lead in providing this costly but ineffective deduction, they should assess the nature of their particular housing markets and determine what policy best fits their state's specific needs. In one study of targeting a homeowner tax credit, for example, the authors said that a tax incentive for homeownership "would need to take regional variations in incomes and house prices into consideration."[59] If encouraging homeownership is an important policy goal, and if the federal government is not doing an adequate job, the role of the states should be to innovate and experiment with alternatives to the federal model instead of simply signing on without question. Just as Wisconsin has taken the step of permitting a credit based on the amount of the federal deduction for home mortgage interest — to counteract the natural tendency of deductions to benefit taxpayers in higher tax brackets — other states should examine their specific goals for dealing with their housing problems and design targeted programs to directly address those problems rather than using the federal model of a one-size-fits-all (but fits poorly) itemized deduction.

Rethinking the Incentive

If tax policymakers at the federal and state levels genuinely wish to encourage homeownership, rethinking the implementation of this incentive is in order. That rethinking should begin, however, with the question of whether and why the government should prefer taxpayers to live in houses rather than apartments. One reason previously researched is the idea of community stability. When people own a home, it has been suggested, they get more involved in their community and participate in civic interests (and are more likely to vote). Glaeser and Shapiro reported, "Homeowners face incentives to invest in their communities; [but] they also face incentives to restrict the supply of new housing to raise prices."[60] However, recent history from the housing crisis that started in 2006 shows that the burdens of the debt associated with homeownership can become overwhelming when economic conditions weaken and large numbers of people lose their jobs. And when jobs are lost in one part of the nation, others may be created in another part. But in those circumstances, the ownership of a house can become a constraint on the unemployed who have to sell their homes before they can relocate to a more favorable employment location. Tax subsidies have also been criticized for aggravating housing conditions in the inner cities, because those left behind to rent are the least affluent, leading to further deterioration of already dire conditions.[61] So if policymakers are starting with the assumption that everyone, or as many people as possible, should own a home, the negative consequences of homeownership should not be ignored.

Barriers to Homeownership

But if, despite those concerns, Congress and state legislatures determine that promoting homeownership is an important policy goal, alternatives to an

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[59]J. Michael Collins, Eric S. Belsky, and Nicholas P. Retsinas, "Towards a Targeted Homeowner Tax Credit," Brookings Institution Center on Urban and Metropolitan Policy (Jan. 1999).

[60]Glaeser and Shapiro, *supra* note 3.

[61]*Id.*, citing Richard Voith, "Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?" *Federal Reserve Bank of Philadelphia Business Review*, 1999, 3-6.

income tax deduction should be considered and the barriers to homeownership should be reevaluated. Past research has revealed that (1) the initial down payment is generally the critical problem for first-time home buyers (especially when interest rates are at historic lows and the monthly cost of a mortgage approximates a monthly rent payment),[62] and that (2) poor credit history often prevents taxpayers from accessing mortgages and purchasing homes.[63] In the first instance, the use of a specially designed credit to encourage home buying might be more effective than a deduction for mortgage interest.[64] Even at the federal level, Congress has long recognized that "while deductions favor taxpayers in the higher marginal tax brackets, a tax credit provides relatively more benefit to taxpayers in the lower bracket."[65] That is why other states should note Wisconsin's conversion of the federal deduction for home mortgage interest into a credit. But it may be discovered that although a credit theoretically benefits lower-income taxpayers more than a deduction, lower-income taxpayers may not generate enough tax liability to fully use the credit;[66] or a housing credit may be superseded by other credits, such as the earned income tax credit, also aimed at lower-income taxpayers. For those reasons, states should explore other options for a credit aimed at encouraging homeownership, such as coordinating it with the state EITC, making it refundable, or increasing the rate of the credit as the taxpayer's income decreases. That credit could also be redesigned to be accessed as the down payment for a house, because that is frequently the sticking point for first-time home buyers. In that system the mortgage lender could provide bridge financing for the down payment based on the taxpayer's assignment of the tax credit back to the lender.

Though growing out of extraordinary economic circumstances, the short-lived federal first-time home buyer credit was an experiment originally targeted at average- and lower-income taxpayers.[67] Though there was no control group, the credit is assumed, by some politicians at least, to have produced home sales that would not have occurred in its absence. The IRS reports that 479,622 taxpayers in 2009 and 2,197,110 taxpayers in 2010 claimed the credit.[68] Critics argue that the credit had no beneficial effect on the problem it was designed to address.[69] After that experiment, however, states can study the relative effectiveness and implementation of this credit and learn from the federal government's mistakes.[70]

If, in addition to the need for a down payment, lower-income taxpayers attempting to enter the housing market are also hampered by a poor credit history, state governments could look at mortgage guarantee incentives for banks, though, as recent history indicates, that route can lead to a slippery slope.

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[62]In signing the American Dream Downpayment Act of 2003, for example, President George W. Bush said, "One of the biggest hurdles to homeowners is getting money for a down payment" (White House press release, Dec. 16, 2003).

[63]According to Howard A. Savage, "excessive debt, insufficient cash for a down payment [and] a poor credit history" are the major barriers to homeownership. "Who Could Afford to Buy a Home in 2004?" U.S. Census Bureau (May 2009).

[64]For a number of suggested alternatives at the federal level, see Collins, et al., *supra* note 59.

[65]Discussion in the Joint Committee on Taxation Reports regarding the conversion of the deduction for child and dependent care costs to a credit. U.S. Congress, General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th[h] Congress 2nd sess., Public Law 94-455). Prepared by the staff of the Joint Committee on Taxation (Dec. 29, 1976). Reprinted in Internal Revenue Service Cumulative Bulletin 1976-3, vol. 2.

[66]"A disadvantage of nonrefundable tax credits is that the method of reimbursement is a tax offset that reduces the taxpayers' tax liability — this requires that the taxpayer have positive tax liability against which to offset the credit. This may effectively eliminate the capability of lower income people to take advantage of the credit since their tax burden may be insufficient." Kathryn Lancaster, Michael R. Kinney, and Jack Robison, "Evidence on the Effectiveness of Using Tax Credits to Promote Energy Conservation," *Oil, Gas & Energy Quarterly,* 50, no. 2 (Dec. 2001): 383-384.

[67]It was targeted in the sense that there was an upper AGI limit set on eligibility. For 2009 that limit was $170,000 for married filing jointly and for 2010 the limit was raised to $245,000 for married filing jointly.

[68]IRS SOI, First-Time Homebuyer Tax Credit for Homes Purchased in 2009, by State, Fiscal Year 2009, and IRS SOI, Table A. First-Time Homebuyer Credit by State, Fiscal Year 2010.

[69]*See, e.g.*, the Congressional Research Service report prepared by Mark P. Keightley, "An Economic Analysis of the Homebuyer Tax Credit," (7-5700), Dec. 1, 2009, *available at* www.crs.gov. That report says that because housing prices were falling and mortgage interest rates were historically low at the same time the tax incentive was in operation, it is difficult to claim that the credit had its congressionally desired result.

[70]In 2009, for example, prisoners claimed fraudulent refund claims for the first-time home buyer credit with the IRS for $295 million of which $39 million were paid. Generating those refund claims were 4,608 prisoners seeking $8,000 each. Treasury Inspector General for Tax Administration, "Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits," Reference No. 2011-41-035, Mar. 31, 2011, p. 28. The Treasury Inspector General for Tax Administration, "Significant Problems Still Exist With Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud," Dec. 29, 2010, Reference Number: 2011-40-009.

Abandoning Income Tax Incentives

In place of an income tax credit or deduction, states wanting to encourage homeownership (perhaps because they believe ownership would benefit their state's economy) could also consider low- or zero-interest loans to be used by taxpayers for the initial down payment on a house. Those loans could be paid back from future tax refunds or as a surcharge to the normal state income tax.[71] Also, or alternatively, states could offer a matching loan for half of the down payment to encourage the taxpayer to save the other half (and demonstrate the fiscal wherewithal to afford a home). The state would match the amount saved by the taxpayer with a low-interest loan. As an additional incentive, the low-interest loan could be forgiven over a period of years (for example, 20 percent a year) as long as the taxpayers remained current on their income taxes, real estate taxes, and mortgage payments.

Summary

In tables 2 and 3, we have shown the results of state use of the home mortgage interest deduction: Its primary benefits go to higher-income taxpayers. Also, we have examined how states employ the home mortgage interest deduction; presumably it is done for administrative convenience, because other states do so, and out of the undoubtedly beneficent — but perhaps naive — belief that states are thereby encouraging homeownership, especially among those most in need of a government subsidy. States that do not already do so should consider that the administrative convenience achieved by relying on the federal model is primarily the result of using the federal AGI as a tax base — and is largely unrelated to the deduction for home mortgage interest — because that shifts the major burden of enforcement for most taxpayers to the IRS.[72] Regarding competition with other states, it should also be recognized that only a rare taxpayer would relocate from one state to another to take advantage of that state's deduction for home mortgage interest.[73] Without empirical verification of those benefits and a serious attempt to aim the incentive at its intended target, the deduction's stated policy goal remains unfulfilled at both the federal and state levels. States should therefore reconsider the allocation of their scarce resources to that deduction in favor of more direct and less costly alternatives.

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[71]Tracking and enforcing such a program may not be as difficult for states as the first-time home buyer credit was for the federal government. In Illinois, for example, taxpayers may claim a credit against their income tax for the real estate taxes they pay on their home. To claim the credit, however, taxpayers must list the specific parcel number recorded for their property at the county assessor's office. That permits the state to verify that the credit is being claimed for a property that matches the taxpayer's address on the tax return.

[72]Changes in AGI resulting from IRS examinations are shared with the states, largely eliminating the need for states to conduct similar audits.

[73]Brunori reports that, "While there is ample scholarly evidence that taxes do not influence locational decisions of households, there is an undeniable perception among political leaders that taxes matter a great deal." *Supra* note 6.

(Footnote continued in next column.)

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Appendix A.
States Taxing Income at $50,000 and $200,000 AGIs at the Same Marginal Tax Rate

	State	Tax Rate	Mortgage Interest Deduction
1	Alabama	5%	Yes
2	Arkansas	7%	Yes
*3	Colorado	4.63%	Yes
4	Georgia	6%	Yes
*5	Illinois	3%	No
*6	Indiana	3.4%	No
7	Maine	8.5%	Yes
8	Maryland	4.75%	Yes
*9	Massachusetts	5.3%	No
*10	Michigan	4.35%	No
11	Mississippi	5%	Yes
12	Missouri	6%	Yes
13	Montana	6.9%	Yes
14	New Mexico	4.9%	Yes
15	New York	6.85%	Yes
16	Oklahoma	5.25%	Yes
17	Oregon	9%	Yes
*18	Pennsylvania	3.07%	No
19	South Carolina	7%	Yes
*20	Utah	5%	No
21	Virginia	5.75%	Yes

*Indicates that the state has only one tax rate.

Appendix B. States Taxing $50,000 AGI at a Lower Marginal Rate Than $200,000 AGI				
	State	**Marginal Rate at $50,000**	**Marginal Rate at $100,000**	**Mortgage Interest Deduction**
1	Arizona	2.88%	4.24%	Yes
2	California	4.25%	9.55%	Yes
3	Connecticut	5.0%	5.5%	No
4	Delaware	5.55%	6.95%	Yes
5	Hawaii	7.6%	8.25%	Yes
6	Idaho	7.4%	7.8%	Yes
7	Iowa	7.92%	8.98%	Yes
8	Kansas	6.25%	6.45%	Yes
9	Kentucky	5.8%	6.0%	Yes
10	Louisiana	4.0%	6.0%	Yes
11	Minnesota	7.05%	7.85%	Yes
12	Nebraska	5.12%	6.84%	Yes
13	New Jersey	1.75%	6.37%	No
14	North Carolina	7.0%	7.75%	Yes
15	North Dakota	1.51%	3.13%	Yes
16	Ohio	4.327%	5.741%	No
17	Rhode Island	3.75%	7.75%	Yes
18	Vermont	3.55%	8.25%	Yes
19	West Virginia	6.0%	6.5%	No
20	Wisconsin	6.5%	6.75%	*Yes
*As indicated, Wisconsin provides a credit for itemized deductions.				

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