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Cover Page Footnote

Adjunct Professor, Master of Professional Accounting - Taxation Program, Michael G. Foster School of Business, University of Washington. J.D. 2003, Yale Law School. LL.M. - Taxation 2010, University of Washington School of Law. After completing her LL.M. in Taxation, and prior to purchasing her first home, the author endeavored to calculate the value of the mortgage interest deduction she would receive following her first year of homeownership. Approximately twenty frustrating minutes later, she determined that the answer was zero dollars, for reasons described in more detail in Part II(C)(1). She bought the home anyway and looks forward to next year, when she will become one of the 54 percent of American homeowners who do receive a financial benefit from the mortgage interest deduction. She would like to thank Ian Ayres, Jessica Clarke, Andrew Dyer, Robert and Catherine Morrow, Elizabeth Morrow, Matthew Stock and Kimberly Zelnick for their encouragement and comments on this article.

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ABSTRACT

The mortgage interest deduction is an incredibly popular, politically well-supported and hugely expensive tax incentive. Yet economic studies consistently show that the mortgage interest deduction fails to advance its fundamental purpose. It does not increase the rate of homeownership. On the contrary, to the extent that it is effective in influencing human behavior, it does so by inflating home prices and encouraging borrowing against equity. These effects – inflated home prices and excessive borrowing – contributed to the economic crisis of 2008. In the years leading up to the crisis, Americans spent billions of tax dollars further inflating a dangerously unstable housing bubble. Even if we had the will to change this policy, we did not have the means. The mortgage interest deduction is insensitive to market conditions and resistant to change. These attributes make the mortgage interest deduction bad policy. Rather than perpetuating this costly deduction, Congress should phase it out in its entirety and replace it with targeted tax incentives designed to stimulate the housing market only when the market is weak. Future tax incentives should avoid the structural flaws that caused the mortgage interest deduction to fail by focusing on market responsiveness, timing and flexibility.

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> While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble . . . that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008.
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> Financial Crisis Inquiry Commission Report[1]

INTRODUCTION

Tax incentives for homeownership are some of the most expensive subsidies in the Internal Revenue Code. The mortgage interest deduction, the exclusion of gain from the sale of a primary residence and the deduction for real property taxes together cost $183.83 billion annually in lost revenue, and that number is growing rapidly.[2] The mortgage interest deduction alone is a $119.75 billion annual tax expenditure.[3] Tax incentives for homeownership have been allowed because Americans have long believed that widespread homeownership is a critical feature of a strong economy and a valuable part of the

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1. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, xvi (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter FCIC REPORT]; *see also* DEP'T OF THE TREASURY AND U.S. DEP'T OF HOUSING AND URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 31 (2011), http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf [hereinafter TREASURY AND HUD REPORT TO CONGRESS] ("The housing finance system *must* be reformed . . . . We allowed its flaws to go unchecked for too long, contributing to a financial collapse that has strained families, decimated communities, and pushed the economy into the worst recession since the Great Depression.").

2. *See* OFFICE OF MGMT. AND BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 2010 299-301 (2009), http://www.gpoaccess.gov/usbudget/fy10/pdf/spec.pdf [hereinafter 2010 FEDERAL BUDGET] (estimating that for 2011, the mortgage interest deduction was a $119.75 billion tax expenditure, the exclusion of gain upon the sale of a principal residence was a $39.53 billion tax expenditure and the federal income tax deduction for real property taxes paid on homes was a $24.55 billion tax expenditure); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-769, HOME MORTGAGE INTEREST DEDUCTION: DESPITE CHALLENGES PRESENTED BY COMPLEX RULES, IRS COULD ENHANCE ENFORCEMENT AND GUIDANCE 6 (2009) [hereinafter GAO-09-769] (reporting that the total amount of mortgage interest deduction claimed by taxpayers increased from $323 billion in 2001 to $437 billion in 2006, an over 35 percent increase in 5 years).

3. *Id.* at 299-301 Table 19-1.

American dream. And yet, the 2008 economic collapse was sparked by overinvestment in real property.[4] Homeowners were not establishing economic security by building equity in their homes, but were borrowing against the perceived increased values of their homes through home equity lines of credit, the interest on which was deductible.[5] Real estate "flipping" was viewed as an arbitrage opportunity, rather than the incredibly risky, transaction cost heavy, undiversified investment scheme it is. Mortgage lenders assisted borrowers in taking out huge debts, with both sides of the transaction assuming that rising home prices would guard against the risk of default.[6]

In the wake of the economic crisis, Americans are beginning to question the assumed value of homeownership incentives. This article advances a broader challenge to homeownership subsidies and argues that the Internal Revenue Code significantly over-incentivizes homeownership in statistically ineffective and economically unsophisticated ways.

The mortgage interest deduction is an extremely expensive incentive that is ineffective at increasing rates of homeownership, nonresponsive to economic conditions, resistant to change and structurally flawed. It inflates housing prices even in times of unsustainable appreciation. It should be repealed and replaced with

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4. *See* FCIC REPORT, *supra* note 1, at 5 (explaining that the economy was destabilized when consumers purchased homes that were too large and too expensive); *Id.* at xxvi (describing the "failure to effectively rein in excesses in the mortgage" market as a principal cause of the economic crisis).

5. *See* FCIC REPORT, *supra* note 1, at 5 ("Homeowners pulled cash out of their homes to send their kids to college, pay medical bills, install designer kitchens with granite counters, take vacations or launch new businesses. They also paid off credit cards, even as personal debt rose nationally.").

6. *See* FCIC REPORT, *supra* note 1, at 5-6 (Angelo Mozilo, CEO of Countrywide Financial described to the Federal Crisis Inquiry Commission that "a 'gold rush mentality' overtook the country during these years, and that he was swept up in it as well: 'Housing prices were rising so rapidly—at a rate that I'd never seen in my 55 years in business—that people, regular people, average people got caught up in the mania of buying a house, and flipping it, making money.' [Consumers and lenders were encouraged by the surface prosperity in the real estate market]" and "[i]n fact, some of the largest institutions had taken on what would prove to be debilitating risks. Trillions of dollars had been wagered on the belief that housing prices would always rise and that borrowers would seldom default on mortgages, even as their debts grew.").

targeted, time-limited and economically-responsive homebuyer tax credits. These tax credits should increase homeownership incentives when the economy is weak, decrease them when the economy is strong and eliminate them when housing bubbles threaten to undermine economic stability.

Part I of this article describes the mortgage interest deduction and presents data strongly indicating that it fails to increase rates of homeownership, increases housing prices and increases borrowing against equity. Part II identifies the attributes of the mortgage interest deduction that make it fail. Part III presents a proposal to entirely phase out the mortgage interest deduction and replace it with targeted and time-limited homebuyer tax credits aimed at promoting economic stability in the real estate economy. Finally, this article concludes with a discussion of why now is the time to eliminate the mortgage interest deduction.

I. THE MORTGAGE INTEREST DEDUCTION FAILS TO ACHIEVE ITS GOAL OF PROMOTING HOMEOWNERSHIP

For as long as America has had an income tax, taxpayers have been allowed to deduct the interest they pay on their mortgages. When the United States imposed its first income tax in 1913, all interest was deductible.[7] That policy remained in effect until the Tax Reform Act of 1986. Under the terms of the Act, the deduction for most forms of personal interest was phased out over five years.[8] However, the deduction for "qualified residence interest" (i.e., the mortgage interest deduction) was retained.[9]

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7. GAO-09-769, *supra* note 2, at 3.

8. Andrew Schreier, *New Rules on Deductibility of Home Mortgage Loan Interest*, 2-AUG PROB. & PROP. 34 (1988); *see also id.* at 3.

9. Schreier, *supra* note 8. When the deduction was phased out for all other forms of personal interest, it was retained for active business interest, taxable investment interest, passive activity business interest, estate tax interest, educational loan interest and "qualified residence interest" (here referred to as mortgage interest), all of which remain regular itemized deductions. Regular itemized deductions are itemized deductions other than miscellaneous itemized deductions. While miscellaneous itemized deductions may only be deducted to the extent they, in aggregate, exceed two percent of the taxpayer's adjusted gross income, regular itemized deductions are fully

The goal of the mortgage interest deduction is a popular one—to increase the rate of homeownership in America. The reason cited by Congress in 1986 for preserving the mortgage interest deduction was the promotion of homeownership.[10] Congress believed that encouraging homeownership was an important policy goal and retained the mortgage interest deduction in an effort to advance that goal. In a government publication explaining the Tax Reform Act of 1986, for example, the Joint Committee on Taxation, a committee including Senators and Members of the House of Representatives, described the reason for preserving the mortgage interest deduction as furthering the policy goal of promoting homeownership. It stated: "Congress . . . determined that encouraging homeownership is an important policy goal, achieved in

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deductible by any taxpayer who itemizes. A taxpayer should itemize if total itemized deductions exceed the standard deduction. For 2012, the standard deduction is $5950 for single taxpayers and married taxpayers filing separately, $8700 for head of household taxpayers and $11,900 for married filing jointly taxpayers.

10. *Introduction: The Most Serious Problems Encountered by Taxpayers,* TAXPAYER ADVOCATE SERV. - 2010 ANNUAL REPORT TO CONGRESS – VOLUME ONE, 10 (2011), http://www.irs.gov/pub/irs-utl/2010arcmsp1_taxreform.pdf [hereinafter TAXPAYER ADVOCATE REPORT INTRO]; *see also* JOINT COMM. ON TAXATION, JCX-40-11, PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF HOUSEHOLD DEBT, 24 (2010) [hereinafter JCX-40-11] ("Congress described the reason for preserving a deduction for home mortgage interest as furthering the social policy goal of promoting home ownership: 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 home ownership 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)."); Christian A.L. Hilber & Tracy Turner, The Mortgage Interest Deduction and its Impact on Homeownership Decisions 2 n.5 (unpublished draft Aug. 12, 2010), *available at* http://personal.lse.ac.uk/hilber /hilber_wp/hilberturnerv024.pdf ("While the federal income tax put in place by [the] 16th Amendment to the U.S. Constitution allowed for the deduction of any interest paid and did not distinguish mortgage interest, the intent of keeping mortgage interest deductible in the 1986 Tax Reform Act was to promote homeownership. In a 1984 speech regarding his tax reform agenda, President Reagan stated he would 'preserve the part of the American dream which the home mortgage interest deduction symbolizes.'").

part by providing a deduction for residential mortgage interest."[11] In an effort to advance the policy goal of homeownership, mortgage interest was saved from the phase out of the deduction for other forms of personal interest. The mortgage interest deduction has received significant public and political support because of the strong belief that high rates of homeownership are critical to a strong economy and society, as well as the assumption that the mortgage interest deduction increases the rate of homeownership.

The current deduction for mortgage interest is provided by Internal Revenue Code Section 163(h)(2)(D).[12] For the interest to be deductible, the mortgage need not be on a principal residence. It can be used on up to two homes.[13] The mortgage, however, must be secured by a home and recorded.

Mortgage interest is deductible[14] if it is on a mortgage that was:

1) Grandfathered Debt: mortgage debt incurred before October 13, 1987;
2) Home Acquisition Debt: debt incurred to buy, build or improve a home but only to the extent that total home acquisition debt is $1,000,000 or less[15]; or
3) Home Equity Debt: other debt secured by a home, which can be used for any purpose (including personal

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11. JOINT COMM. ON TAXATION, JCS-10-87, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 263 (2011) [hereinafter JCS-10-87]; *see also* JCX-40-11, *supra* note 10, at 24.

12. 26 U.S.C. § 163(h)(2)(D) (2006).

13. *Id.* § 163(h)(2)(D), (h)(3).

14. Note that special rules will limit the mortgage interest deduction if the home is rented, if debt on the home exceeds its value or if part of the home is used as a home office and the taxpayer claims other tax benefits associated with that home office.

15. The total home acquisition debt includes home acquisition debt on the main home and a second home. For example, if the mortgage on the main home is $1,000,000, the cap is fully satisfied by that mortgage and no mortgage interest deduction will be available for the second home. If the mortgage on the main home is $800,000, all interest paid on that mortgage is deductible and interest paid on the mortgage on a second home is deductible to the extent it is attributable to the first $200,000 of indebtedness on that second home. The cap is $500,000 for married filing separately taxpayers. 26 U.S.C. § 163(h)(3)(B).

consumption) but only to the extent that total home equity debt is $100,000 or less.[16]

For taxpayers who qualify, the value of the mortgage interest deduction is equal to the amount of mortgage interest paid in a year multiplied by the taxpayer's marginal tax rate. For 2012, tax rates range from 10 percent to 35 percent.[17] However, since the mortgage interest deduction is only available to taxpayers who itemize their deductions, it only benefits taxpayers whose itemized deductions exceed the standard deduction. For 2012, the standard deduction is $5950 for single taxpayers and married taxpayers filing separately, $8700 for head of household taxpayers and $11,900 for married taxpayers filing jointly.[18] Thus, a married couple that pays less than $11,900 mortgage interest in a year and has no other itemized deductions will receive no benefit from the mortgage interest deduction. If that same married couple pays $12,000 in mortgage interest and has no other itemized deductions, the value of the mortgage interest deduction will depend on the couple's marginal rate. If the couple's marginal rate is 10 percent, the mortgage interest deduction will save the couple $10.[19] If the couple's marginal rate is 35 percent, the mortgage interest deduction will save the couple $35. The value of the mortgage interest deduction equals the taxpayer's marginal rate multiplied by the amount of mortgage interest paid that is in excess of the standard deduction.

The mortgage interest deduction is an enormous tax expenditure.[20] The United States Office of Management and Budget estimates that

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16. The cap is $50,000 for married filing separately taxpayers. 26 U.S.C. § 163(h)(3)(C).

17. Rev. Proc. 2011-52 § 3.01.

18. *Id.* § 3.11.

19. Assuming the couple has no other itemized deductions, the value of the mortgage interest deduction equals the couple's marginal rate of 10 percent multiplied by the $100 in mortgage interest paid that is in excess of the standard deduction ($11,700 mortgage interest paid minus the forgone standard deduction of $11,600).

20. 2010 FEDERAL BUDGET, *supra* note 2, at 297 ("The Congressional Budget Act of 1974 . . . requires that a list of 'tax expenditures' be included in the [United States Federal] budget. Tax expenditures are defined in the law as 'revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax

between the years 2010 and 2014 alone, revenues collected will be approximately $646 billion less due to the mortgage interest deduction.[21] Only the tax subsidy for employer contributions to employee medical care constitutes a costlier tax expenditure.[22] The tax subsidy for mortgage interest is larger than the subsidies for contributions to 401(k) plans, IRAs and Keogh retirement plans combined.[23] It is more than 16 times costlier than the combined HOPE and Lifetime Learning tax credits.[24]

Despite the large associated cost, the mortgage interest deduction benefits a small number of taxpayers. Only 23 percent of Americans receive any benefit from the mortgage interest deduction.[25] Many Americans who pay mortgage interest receive no benefit. For example, in 2005, only 54 percent of American homeowners received any benefit

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or a deferral of liability.' These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs.").

21. *Id.* All tax expenditure estimates in the 2010 budget and in this article "are based upon current tax law enacted as of December 31, 2008," "reflect preliminary 2010 Budget economic assumptions" and attempt to compare revenue that would be collected in the absence of a tax exception with revenue collected given that exception. *Id.* It is important to note, however, that estimates for tax expenditures "do not necessarily equal the increase in Federal revenues (or the change in budget balance) that would result from repealing these special provisions" because "eliminating a tax expenditure may have incentive effects that alter economic behavior" and thus the amount of the tax expenditure, and "tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions." *Id.* at 298. The Office of Management and Budget cautions "for this reason, the estimates [of income tax expenditures] should be regarded as approximations." *Id.*

22. 2010 FEDERAL BUDGET, *supra* note 2, at 299-301.

23. The Tax Expenditure Budget ("TEB") estimates that between 2010-2014, 401(k) plans will constitute a $343,000 million expenditure, Keogh plans will constitute an $87,000 million expenditure, and IRAs will constitute a $79,000 million expenditure, totaling $509,000 million ($137,080 less than the mortgage interest deduction). *Id.* Table 19-3.

24. The TEB estimates that between 2010-2014, the Hope Credit will be a $24,560 million tax expenditure and the Lifetime Learning Credit will be a $15,730 million tax expenditure, totaling $40,290 million. *Id.*

25. David Leonhardt, *Why Taxes Will Rise in the End*, N.Y. TIMES, July 12, 2011, at B14.

from the mortgage interest deduction.[26] Owners of less-expensive homes and homeowners who have built up equity in their homes tend not to receive any benefit from the mortgage interest deduction because their potential mortgage interest deduction is less than the standard deduction. Of the 54 percent of homeowners who do receive a benefit from the mortgage interest deduction, the amount of benefit is skewed strongly in favor of high income taxpayers with large mortgages.[27]

Despite its enormous cost and failure to provide any benefit to many homeowners, the mortgage interest deduction has long received enormous political and public support. When the mortgage interest deduction was saved from elimination in 1986, lawmakers recognized that few Americans could afford to buy homes outright and saw subsidizing mortgage borrowing as a way to incentivize homeownership.[28] One Senator described the mortgage interest

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26. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 74 (Nov. 2005) [hereinafter 2005 PRESIDENT'S ADVISORY PANEL]; *see also* CONG. BUDGET OFFICE, PUB NO. 3191, BUDGET OPTIONS VOLUME 2 188 (2009) [hereinafter CBO PUB. NO. 3191].

27. *See, e.g.*, John E. Anderson, Jeffrey P. Clemens, & Andrew R. Hanson, *Tax Reform and Incentives to Encourage Owner-Occupied Housing: Analysis of the President's Tax Reform Panel Recommendations to Convert the Mortgage Interest Deduction to a Tax Credit* 23 (paper prepared for presentation at *Closing the Wealth Gap: A Policy Research Forum* sponsored by the Community Affairs Offices of the Federal Reserve System and CFED, September 19-21, 2006, Phoenix, Arizona) ("over 70% of tax filers did not receive any benefit from the [mortgage interest deduction] in 2002 . . . more than 55% of the estimated [mortgage interest deduction] tax expenditure went to the 12% of taxpayers with cash incomes in excess of $100,000 in 2004.").

28. As is explained by Law Professor Dennis J. Ventry, Jr., all policy justifications for the mortgage interest deduction have been made after the deduction already existed. The deduction was not created to advance any policy purpose. On the contrary, the deduction has existed since the income tax was enacted and was simply retained in 1986, when the deduction for other forms of personal interest was eliminated. *See* Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest,* 73 WTR LAW & CONTEMP. PROBS. 233, 236 (2010) (explaining that "the historical record fails to indicate why Congress allowed a deduction for personal interest in 1913 [when the income tax was enacted]" but the purpose did not appear to be promotion of homeownership.). *But see supra* note 10 and accompanying text (the purpose of retaining the mortgage interest deduction in 1986 was to promote homeownership).

deduction as "one of the most sacred parts of the Tax Code."[29] Another Senator effused, "[t]here is no basic principal in tax law that is more supported by the American people than the principal that you ought to be able to deduct interest on your home from your taxes."[30] In a recent poll conducted by The New York Times, more than 90 percent of respondents supported the mortgage interest deduction.[31] The mortgage interest deduction enjoys significant political and public support because of the strong belief that high rates of homeownership are critical to a strong economy and the entrenched assumption that the deduction increases the rate of homeownership.

A. DOES NOT INCREASE RATES OF HOMEOWNERSHIP

Despite the overwhelming political and public belief in the notion that the mortgage interest deduction should increase rates of homeownership, available data indicate that it does not. Since the mortgage interest deduction was instituted at the same time as the federal income tax, we have no direct evidence of how much, if at all, it initially increased rates of homeownership. We do, however, have data on homeownership rates in countries with and without mortgage interest deductions, in states with and without mortgage interest deductions from their state income taxes, in times when the mortgage interest deduction has been more and less valuable, and economic projections based on these data.[32] These sources overwhelmingly suggest that the mortgage

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29. Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TULANE L. REV. 373 n.123 (1994) (quoting 132 CONG. REC. 14,824 (1986) (statement of Sen. Pryor)).

30. *Id.* (quoting 132 CONG. REC. 13,591 (1986) (statement of Sen. Gramm)).

31. Brian McCabe, *Despite Benefit Disparities, Middle Class Supports Mortgage Interest Deduction*, N.Y. TIMES FIVETHIRTYEIGHT BLOG (July 13, 2011, 4:04 PM), http://fivethirtyeight.blogs.nytimes.com/2011/07/13/despite-benefit-disparities-middle-class-supports-mortgage-deduction/ (including polls finding that more than 90 percent of Americans support the mortgage interest deduction).

32. *See* Part I(A)(1) (International Comparisons), I(A)(2) (Interstate Comparisons), I(A)(3) (Time-Based Comparisons) and I(A)(4) (Economic Models).

interest deduction does little, if anything, to cause people to become homeowners.[33]

1. International Comparisons

Despite the tremendous tax expenditure made by the United States to incentivize homeownership, rates of homeownership are no higher in the U.S. than in other countries. International comparisons made in several different time periods find no correlation between mortgage interest deductions and high rates of homeownership.

In 2000, Professor Roberta Mann compared homeownership rates in ten developed countries against the level of tax subsidy provided in each country. She concluded that "[n]o apparent pattern emerges."[34] Switzerland, which allowed a mortgage interest deduction, had the lowest homeownership rate of the ten countries studied, at 28 percent.[35] Australia did not allow a mortgage interest deduction, but had the highest homeownership rate of the countries studied, at 70 percent.[36] Britain and the U.S. both allowed a mortgage interest deduction and had comparable rates of homeownership.[37] However, as Mann explained, "the maximum subsidy Britain provides for homeownership (about $4,700) is a third less than the average home mortgage interest deduction taken by a U.S. taxpayer (about $7,163)."[38] The equivalent rates of homeownership in these two countries thus indicated that a

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33. *See, e.g.*, William G. Gale, Jonathan Gruber, & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code,* TAX NOTES 1171, 1171 (June 8, 2007) ("Evidence suggests, however, that the mortgage interest deduction (MID) does little if anything to encourage homeownership."); Hilber & Turner, *supra* note 10, at 4 ("Overall, our findings cast serious doubt on the benefits of the mortgage interest deduction as a policy for boosting homeownership rates, particularly in more urbanized places and among low income and minority households, who tend to live in the more urbanized places.").

34. Roberta Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347, 1385 (2000).

35. *Id.* at 1385. Note that while Switzerland permits a mortgage interest deduction, it includes imputed rental income (the fair market value of living in one's home) in the calculation of taxable income.

36. *Id.*

37. *Id.*

38. *Id*.

more generous subsidy was not associated with a higher rate of homeownership. Mann concluded that "comparing data from other countries suggests that the home mortgage interest deduction does not necessarily impact home ownership rates."[39]

In 2005, the President's Advisory Panel on Federal Tax Reform compared homeownership rates of various developed countries and also questioned the efficacy of the mortgage interest deduction. The bipartisan panel, established by President George Herbert Walker Bush, was charged with recommending changes to make the tax code simpler, fairer and more pro-growth.[40] However, it was also specifically instructed by the President to recognize "the importance of homeownership and charity in American society."[41] Despite the presidential finger on the scale in favor of tax subsidies for homeownership, the Panel concluded that tax subsidies had little to no effect on homeownership rates. It stated, "[a]lthough the deduction for home mortgage interest is often justified on the grounds that it is necessary for promoting homeownership, it is unclear to what extent rates of homeownership depend on the subsidy."[42] Using statistics from the United States Census Bureau, the Panel determined that in 2005, the United States had a homeownership rate of 69 percent. This rate fell into the middle of the range of homeownership rates of other developed countries that did not provide a mortgage interest deduction. For example, while Canada's homeownership rate was slightly lower (approximately 66 percent), the U.K.'s rate was comparable and Australia's rate was higher (approximately 70 percent), even though none of those three countries allowed a mortgage interest deduction.[43] The Panel concluded that the high levels of mortgage interest subsidy

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39. *Id.*

40. *See* Exec. Order No. 13,369, 70 Fed. Reg. 2323 § 3(a)-(c) (Jan. 7, 2005), *available at* http://georgewbush-whitehouse.archives.gov/news/releases/2005/01/20050107-1.html (directing the panel to "simplify Federal tax laws," "share the burdens and benefits of the Federal tax structure in an appropriately progressive manner" and "promote long-run economic growth and job creation.").

41. Exec. Order No. 13,369, 70 Fed. Reg. 2323 §3(b) (Jan. 7, 2005), *available at* http://georgewbush-whitehouse.archives.gov/news/releases/2005/01/20050107-1.html.

42. 2005 PRESIDENT'S ADVISORY PANEL, *supra* note 26, at 72.

43. *Id.*

provided in the United States did not appear to be necessary to ensure high rates of homeownership.[44]

Finally, in 2009, the Congressional Budget Office observed that the homeownership rate in the United States (with its generous mortgage interest deduction) was comparable to homeownership rates in countries that did not offer a mortgage interest deduction, including Australia, Canada and the U.K.[45] It speculated that the mortgage interest deduction's "effect on home buying may be small because people in lower-income households – who confront other barriers to home ownership – benefit less from the deduction than higher-income households do."[46] Regardless of the cause, the mortgage interest deduction did not lead to a higher rate of home ownership in the United States than in other developed countries without mortgage interest deductions.

For years, scholars both inside and outside of government have recognized that the American mortgage interest deduction has not caused the homeownership rate in the United States to be higher than that of other countries. To be fair, however, international comparisons of homeownership rates are necessarily flawed. The housing industry is affected by many federal organizations (including Fannie Mae and Freddie Mac, the Federal Housing Administration ("FHA") and the Department of Veteran Affairs ("VA") in the United States), by direct federal grants, by levels of government-owned housing and by the demographics and social attitudes of its citizens.[47] Nevertheless, the

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44. *Id.*

45. CBO PUB. NO. 3191, *supra* note 26, at 188.

46. *Id.*

47. *See, e.g.*, FCIC REPORT, *supra* note 1, at xxvii ("[F]or decades, government policy has encouraged homeownership through a set of incentives, assistance programs and mandates. These policies were put in place and promoted by several administrations and Congress—indeed, both Presidents Bill Clinton and George W. Bush set aggressive goals to increase homeownership."); Ventry, *supra* note 28, at 106 (homeownership rates "jumped" following World War II after government interventions including "a litany of new agencies and emergency stabilization policies that infused credit into housing markets, underwrote government-insured mortgages and reversed rates of foreclosure by purchasing defaulted loans and then reinstituting them under more favorable terms. These programs reshaped the residential housing and mortgage markets by institutionalizing long-term, fixed-rate, fully amortizing loans;

international data is persuasive because it is consistent with interstate data, time data and economic projections.

2. Interstate Comparisons

Interstate comparisons look at the rates of homeownership in various U.S. states and compare them to the total housing subsidies provided against both federal and state taxes in those states. These comparisons indicate that the mortgage interest deduction is ineffective at increasing rates of homeownership.

Recently, for example, economics professors from the London School of Economics and Kansas State University teamed up to analyze homeownership data collected from 1984 to 2007.[48] They noted that, while residents of all states qualify for the same mortgage interest deduction against their federal income tax, individual states have different policies regarding deductibility against state income taxes. When state and federal subsidies are considered together, states including California, Delaware, Maine, Massachusetts and North Carolina have much more valuable combined mortgage interest deductions (since they have high state income taxes against which mortgage interest deductions are allowed) while other states including Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have much less valuable combined mortgage interest deductions (since they have no state income tax and no mortgage interest deduction against state taxes).[49] By looking at combined state and federal tax subsidies for mortgage interest compared to homeownership rates across the various states, these researchers measured the effect of larger total tax subsidies on homeownership rates. They concluded that the level of tax subsidy for mortgage interest "has no statistically significant impact on the likelihood of homeownership, not even for the highest income households . . . who

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establishing considerably higher loan-to-value ratios; and by creating a vibrant secondary mortgage market. These innovative federal housing policies stabilized the housing sector during the Depression and fueled a postwar housing boom."); *id.* at 118-122 (describing how federal agencies including the FHA, Fannie Mae and the VA "reshaped housing and homeownership in the United States").

48. Hilber & Turner, *supra* note 10, at 3.

49. *Id*. at 1.

tend to receive the greatest tax breaks from this feature of the tax code."[50] There was no association between the generosity of a state's mortgage interest deduction and its homeownership rate.

An earlier study had indicated that states with more generous mortgage interest deductions might even have slightly lower rates of homeownership. That study, completed in 2002 by researchers from Harvard University and the National Bureau of Economic Research,[51] compared homeownership rates for states with high tax subsidies against rates for states with low tax subsidies using data collected from 1990 to 2000.[52] It noted that "[p]laces with a bigger subsidy tend to have slightly lower homeownership rates" than states with a smaller subsidy.[53] This association might occur because more generous tax subsidies make homeownership more valuable and can, therefore, drive up home prices (a principal known as price capitalization, which is described in more detail below). Regardless, while a slight counter-association between tax subsidies and homeownership rates was noted, these researchers also concluded that "there is essentially no relationship" between the relative value of tax subsidies and the rate of homeownership in a state.[54] The researchers identified as their "basic point" the conclusion that a more

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50. *Id*. at 16.

51. *History of NBER*, NAT'L BUREAU OF ECON. RESEARCH, http://www.nber.org/info.html (last visited Aug. 2, 2011) ("The NBER is the nation's leading nonprofit economic research organization. Eighteen of the 33 American Nobel Prize winners in Economics and six of the past Chairmen of the President's Council of Economic Advisers have been researchers at the NBER. The more than 1,000 professors of economics and business now teaching at colleges and universities in North America who are NBER researchers are the leading scholars in their fields. These Bureau associates concentrate on four types of empirical research: developing new statistical measurements, estimating quantitative models of economic behavior, assessing the economic effects of public policies and projecting the effects of alternative policy proposals.").

52. Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction* (Harvard Inst. of Econ. Research, Discussion Paper No. 1979, Oct. 2002), 38 *available at* http://papers.ssrn.com/abstract=343800.

53. *Id*. at 40.

54. *Id.*

generous mortgage interest deduction is not associated with a higher rate of homeownership.[55]

Interstate studies indicate that states with more generous combined state and federal mortgage interest deductions do not have higher homeownership rates than their low subsidy neighbors.[56] There is no indication that increasing the value of the mortgage interest deduction increases the rate of homeownership, or that decreasing its value decreases the rate of homeownership.

3. Time-Based Comparisons

Time-based studies look at the rates of homeownership at various times in U.S. history and compare them to the relative value of the mortgage interest deduction at those times. Time-based studies similarly indicate that the mortgage interest deduction fails to promote homeownership.[57]

While the mortgage interest deduction has allowed a taxpayer who itemizes his deductions to fully deduct the mortgage interest he pays on mortgages up to $1,100,000 since 1987,[58] the value of that deduction has changed over time. For example, since the mortgage interest deduction is an itemized deduction, it is more valuable when the standard deduction is small. Since the value of the deduction is based on the amount of mortgage interest paid multiplied by the taxpayer's marginal rate, it is also more valuable when marginal income tax rates are high. Changes in tax law have significantly affected the value of the mortgage interest deduction over time. For example, the net state tax subsidy for

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55. *See id*. (concluding that "home mortgage interest deduction doesn't have much to do with the homeownership rate.").

56. *Id.*

57. *See infra* note 62 and accompanying text.

58. While the mortgage interest deduction was saved from the phase out of the general personal interest deduction in 1986, the $1,100,000 cap went into effect in 1987. JCX-40-11, *supra* note 10, at 23-24 ("When the deduction for personal interest was phased out generally under the 1986 Act, deductibility was nevertheless retained for interest on debt on the taxpayer's principal residence and second home. The Omnibus Budget Reconciliation Act of 1987 . . . modified this provision to permit a deduction for interest . . . on home equity debt of up to $100,000, and on home acquisition debt of up to $1 million.").

homeownership roughly doubled between 1984 and 2007 in Arizona, New York and Wisconsin.[59] This amount of variance should indicate whether more valuable mortgage interest deductions increase homeownership rates. Yet, while researchers studying homeownership rates and the value of the mortgage interest deduction at various periods in American history found that higher tax subsidies can affect certain individual buying decisions,[60] they did not find that higher tax subsidies were associated with higher overall rates of homeownership.[61] Researchers who conducted a time-based study in 2010 concluded that the mortgage interest deduction is an ineffective policy to promote homeownership.[62]

An earlier time-based study, completed in 2002 by researchers from Harvard University and the National Bureau of Economic Research, controlled for variation in mortgage interest rates over time and

59. Hilber & Turner, *supra* note 10, at 1.

60. Hilber & Turner, *supra* note 10, found that higher tax subsidies slightly increase home purchases by high income taxpayers living in suburban areas while they decrease home purchases by moderate-income taxpayers living in cities and have no effect on low-income taxpayers. They attribute this finding to the differential impact of price capitalization. The mortgage interest deduction makes homeownership more valuable and in higher demand. The suburban real estate market can respond to the increased demand by increasing the supply of housing (building more houses). The urban real estate market cannot respond to the increased demand by increasing housing supply (cities often have more restrictive zoning laws and less available raw land). Since the urban real estate market cannot increase supply to meet the increased demand for housing motivated by the mortgage interest deduction, it responds to that increased demand by increasing home prices. Moderate-income taxpayers will be less able to afford a home in a city, and their rates of homeownership will drop. Because low-income taxpayers generally receive no benefit from the mortgage interest deduction and generally live in low-priced homes, they are unaffected both by the mortgage interest deduction and the potential price capitalization resulting from the deduction.

61. *Id*. at 23; *see also* William G. Gale, Jonathan Gruber, & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code,* TAX NOTES 1171, 1180 (2007) ("Time-series evidence in the U.S. provides little reason to believe that the [mortgage interest deduction] has a substantial influence on homeownership. The value of the deduction increases with the inflation rate and independent increases in the value of itemization (such as increases in tax rates). Despite substantial variation in the values of inflation and itemization – and thus the [mortgage interest deduction] – over the past 40 years, the homeownership rate has barely budged.").

62. Hilber & Turner, *supra* note 10, at 23.

similarly concluded that time periods with more generous mortgage interest deductions are not associated with higher homeownership rates. It looked at homeownership rates in the United States from 1965 to 2000.[63] While the study recognized that the value of the mortgage interest deduction is higher in years when taxpayers pay more interest (due to higher mortgage interest rates), it controlled for variation in mortgage interest rates. Since high mortgage interest rates are also associated with high housing prices and high housing prices can separately affect homeownership rates, the study controlled for changes in interest rates while analyzing the data.[64] It measured the relative value of the mortgage interest deduction based on inflation and the percentage of taxpayers itemizing their deductions. It concluded that "[i]ncreases in [tax-subsidies for homeownership] cause the homeownership rate to increase, but the effect is slight and insignificant. A one percent increase in the subsidy rate causes homeownership to rise by .0009 percent."[65] Depending on the variable for which researchers controlled, increases in the subsidy rate were also associated with decreases in the homeownership rate.[66] After analyzing the data in various ways, researchers concluded that "the home mortgage interest deduction is really not a pro-homeownership policy in any meaningful sense. It subsidizes housing consumption [meaning that people who would buy houses anyway might buy slightly larger houses], but its impact on the homeownership rate appears to be minimal."[67] They noted that our "best evidence on the irrelevance of the deduction to the homeownership rate is that over the past 40 years as the deduction's implicit subsidy has soared and crashed, homeownership has barely budged."[68] Time studies find that when the mortgage interest deduction is made more generous, homeownership rates do not increase. When the mortgage interest deduction is made stingier, homeownership rates do not decrease. These studies indicate that the mortgage interest deduction fails to promote homeownership.

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63. Glaeser & Shapiro, *supra* note 52.
64. *Id*. at 39.
65. *Id*.
66. *Id*. at 39-40.
67. *Id*. at 41.
68. *Id*.

4. Economic Models

Using the data and studies described above, researchers have developed new ways to measure and convey the practical impact of the mortgage interest deduction. Their work points to the extreme cost-ineffectiveness of the mortgage interest deduction as a tool for increasing homeownership.

The mortgage interest deduction is an extraordinarily expensive tool for increasing homeownership. Researchers have measured the net number of taxpayers who probably would not have bought their homes but for the mortgage interest deduction.[69] By dividing the tax expenditure cost of the mortgage interest deduction by the net number of households apparently motivated to buy a home because of the mortgage interest deduction, researchers estimate that "to move a renter household into homeownership through the [mortgage interest deduction] costs US taxpayers $53,590 in foregone tax revenue annually."[70] This is the equivalent of the government making a 20 percent down payment for each new homeowner on a $267,950 home. Moreover, economists consider this cost calculation a "lower bound estimate."[71] When state time-trends are considered, the estimate becomes $75,920 annually per converted homeowner.[72] When other factors are considered, no positive estimate can be made because the mortgage interest deduction is associated with a decrease in the overall rate of homeownership (meaning that if we increase the value and expense of the mortgage interest deduction, the result will be fewer homeowners).[73] The potential causes for such negative correlations are described in more detail below. Regardless, these statistics powerfully point to two realities: (1) the mortgage interest deduction is incredibly expensive, and (2) it does not meaningfully affect homeownership rates.

Whether we focus on international comparisons, state comparisons, comparisons over time or economic models, the overwhelming weight

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69. Hilber & Turner, *supra* note 10, at 19.

70. *Id*. at 20-21.

71. *Id*. at 21.

72. *Id*.

73. *Id*. (citing 2010 FEDERAL BUDGET, *supra* note 2) (other internal citations omitted).

of the evidence indicates that the mortgage interest deduction fails to increase homeownership rates.

Before moving onto a discussion of what the mortgage interest deduction does do, it is worth noting that Americans have lost billions of dollars of potential tax revenue annually because of a policy aimed at increasing rates of homeownership without demanding proof of the effectiveness of that policy.[74] In the last several years, Americans have been in extreme need of revenue for expensive economic bailout programs, post-war efforts, domestic programs and deficit reduction. Yet, attributes of the mortgage interest deduction insulated it from public scrutiny. That insulation allowed an incredibly expensive and ineffective program to continue. The causes of insulation, expense and ineffectiveness should be identified (as they are in Part II of this article) and avoided in other tax policies.

B. Inflates Home Prices

The mortgage interest deduction fails to promote homeownership, in large part, due to price capitalization. Price capitalization is the increase in the price of an asset due to the increase in the value of an asset caused by a subsidy or incentive.[75] Price capitalization undermines the effectiveness of the mortgage interest deduction.[76] Its effects depend on whether the supply of housing in a particular area can be increased to

74. *See supra* notes 2-3 and accompanying text (describing the amount of revenue lost due to the mortgage interest deduction); *infra* note 214 and accompanying text (describing public support for the mortgage interest deduction).

75. *See, e.g.*, Hilber & Turner, *supra* note 10, at 6 (describing "capitalization and the homeownership rate" and explaining that a tax subsidy increases consumer demand for housing. As a result, either the supply of housing will increase to meet this increased demand, or, if supply cannot be expanded, capitalization will occur and the price of housing will "rise by the full amount of the present discounted value of the tax subsidy.").

76. *See, e.g.*, *id.* at 3-4 (testing the proposition that "the capitalization of the [mortgage interest deduction] into higher house prices offsets the positive effect of the [mortgage interest deduction] on homeownership attainment" and finding that the data generally support that proposition).

meet increased demand or whether the supply of housing in that area is fixed.[77]

The amount of price capitalization varies geographically. The mortgage interest deduction increases the value of, and thus the demand for, housing. This increased demand will either be met by an increased supply of housing, which is often available in the suburbs but not in cities or other areas with restrictive zoning laws or limited available land,[78] or by increased price. In economic theory, and assuming an efficient market, when demand increases and supply stays fixed, the price of housing will increase until the extra value provided by the mortgage interest deduction is fully included in the price of housing (full capitalization).[79] When demand increases and supply increases to meet it, capitalization either will not occur or will be limited.

For opponents of the mortgage interest deduction, price capitalization is a double-edged sword. While it further supports efforts to eliminate the mortgage interest deduction (why support a tax expenditure that makes housing less affordable?), it also makes elimination of the incentive more risky (how much will home values drop as the incentive is phased out? Will the housing market crash as a result of across-the-board price declines?). Regardless, sound policy can only result from good information. Thus, it is worthwhile to attempt to determine the extent to which the value of the mortgage interest deduction is capitalized into home prices.

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77. *See, e.g.*, *id.* at 5 (summarizing studies indicating that when the supply of housing is inelastic, the mortgage interest deduction will have "price rather than quantity effects," causing the price of housing to increase but not increasing the number of homeowners).

78. In *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, Roberta Mann argued that because demand for housing can only be met with increased supply in suburban and rural areas, the mortgage interest deduction contributes to residential sprawl and the resulting environmental harms. Mann, *supra* note 34.

79. Hilber & Turner, *supra* note 10, at 6 (the "standard model of housing market dynamics" predicts that "[i]n the short run, the consumer's willingness to pay for new or expanded housing increases according to the present discounted value of the tax subsidy. The stock of housing is fixed in the very short run, thus the tax policy results in disequilibria in the housing market, and, depending on the extent to which a supply side adjustment is expected, the price of housing in the short run may rise by the full amount of the present discounted value of the tax subsidy.").

Many scholars have identified some amount of price capitalization. They note that tax subsidies for homeownership primarily generate price effects, increasing the price of housing[80] and lament that "such price capitalization effects may create a perverse outcome whereby the [mortgage interest deduction] adversely affects the homeownership attainment of certain groups" by pricing them out of the market.[81] Specifically, increases in the mortgage interest deduction "may decrease the likelihood that down-payment-constrained households will be able to purchase a house in order to take advantage of the mortgage subsidy."[82] While the goal of the mortgage interest deduction is to increase rates of homeownership, price capitalization causes the opposite effect by making housing less affordable.

While scholars generally agree that the mortgage interest deduction has been capitalized into home prices to some extent, they disagree on how much home prices have increased due to the mortgage interest deduction. Economists from the Massachusetts Institute of Technology and the Wharton School of Business estimate that "repealing the mortgage interest deduction, with no change to loan-to-value ratios, would raise the average user cost [of housing] by seven percent."[83] Previously, other researchers estimated that eliminating the mortgage interest deduction and the property tax deduction simultaneously would

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80. Hilber & Turner, *supra* note 10, at 6 (citing Dennis R. Capozza, Richard K. Green & Patric H. Hendershott, *Taxes, Mortgage Borrowing, and Residential Land Prices*, *in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 171-98 (Aaron and Gale, ed., 2006)); *see also* Gale et al., *supra* note 61, at 1179 ("[T]he main effect of the [mortgage interest deduction] appears to be to raise housing prices and increase loan-to-value ratios.").

81. Hilber & Turner, *supra* note 10, at 2.

82. *Id.*

83. James Poterba & Todd Sinai, *Tax Expenditures for Owner-Occupied Housing*: *Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income* 6 (Jan. 5, 2008), *available at* http://real.wharton.upenn.edu/~sinai/papers/Poterba-Sinai-2008-ASSA-final.pdf. As these authors note, however, homeowners can reduce their otherwise rising costs by paying down their mortgages more quickly. "Martin Gervais and Manish Pandey (2006) note that changing the tax treatment of mortgage interest might have little impact on the user cost if households altered their loan-to-value ratios [by paying down their mortgages] in response." *Id.* at 6.

reduce house prices by 2 percent to 13 percent depending on the area.[84] Price reductions are likely to be greater in areas with high home values and high loan-to-value ratios (where the mortgage interest deduction is most valuable) and lower in areas with low home values and low loan-to-value ratios.[85] Further, because price capitalization generally is more pronounced in areas with a fixed housing supply,[86] price reductions are likely to be greater in cities and restrictively zoned areas.

C. INCREASES BORROWING AGAINST EQUITY

The mortgage interest deduction may have an odd structure because it was never affirmatively designed as a tax incentive, but was instead retained when the deduction for other forms of personal interest were phased out. The goal of the mortgage interest deduction is to increase rates of homeownership.[87] Yet, homeowners who own their homes outright receive no benefit from the mortgage interest deduction. Similarly, homeowners whose mortgages are small receive little to no benefit. The mortgage interest deduction does not provide a direct incentive for the purchase or even continued ownership of a home. Rather, it provides a benefit for homeowners who have borrowed significantly in order to purchase their homes. It incentivizes highly leveraged purchases. By incentivizing borrowing, rather than purchasing

84. Hilber & Turner, *supra* note 10, at 5 (citing Capozza et al., *supra* note 80, at 171-98).

85. *See* Hilber & Turner, *supra* note 10, at 5 (the mortgage interest deduction is greater for "higher income homeowners and homeowners residing in regions with high incomes and high house prices"); *id.* at 6 (however a more generous mortgage interest deduction may cause the price of housing to "rise by the full amount of the present discounted value of the tax subsidy.").

86. *Id.* at 17 (the generosity of the mortgage interest deduction, the "mortgage rate subsidy," "has no statistically significant impact on the likelihood of owning if a household lives in a metro area with an average degree of regulatory restrictiveness. If a household lives in a place with relaxed land use controls the [mortgage rate subsidy] will have a positive impact on homeownership attainment, whereas the effect is negative in more tightly constrained locations, in line with our theoretical conjectures."); *id.* at 2 ("In places with tight land use regulation (inelastic supply) . . . the tax subsidies will tend to be capitalized into house prices, and the housing stock will not expand to facilitate higher homeownership rates.").

87. *See supra* note 10.

or owning a home, the mortgage interest deduction fails to benefit or incentivize many homeowners, and instead encourages excessive borrowing. These risky incentives have been described in detail in previous scholarship,[88] but are summarized here with an explanation of how they undermine the purpose of the mortgage interest deduction and contribute to an unstable real estate economy.

The incentive to borrow is a risky incentive for American homeowners. Americans generally have less equity in their homes than do homeowners in other developed countries. They generally make smaller down payments, pay down mortgages less quickly and borrow against their homes more extensively using tools like home equity lines of credit.[89] As a result, Americans often have mortgage balances that approach, equal or exceed the fair market value of their homes. Unfortunately, the mortgage interest deduction encourages taxpayers to have high loan-to-value (LTV) ratios. Greater tax benefits can be received if a taxpayer takes out a larger mortgage, pays the mortgage down more slowly or even finances consumer spending through use of home equity lines of credit.[90] High LTV ratios are associated with higher rates of mortgage default, foreclosure and economic instability.[91] Thus, in some cases, the mortgage interest deduction incentivizes a behavior

88. *See, e.g.*, Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TULANE L. REV. 373 (1994); Allen Holzer, *Restructuring the Tax Treatment for Home Equity Draws: Implementing Consumption Tax Fundamentals to Preserve Home Equity,* 24 BYU J. PUB. L. 225 (2010).

89. *See*, *e.g.*, FIN. CRISIS INQUIRY COMM'N, PRELIMINARY STAFF REPORT – THE MORTGAGE CRISIS 26 (2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-PSR_-_The_Mortgage_Crisis.pdf [hereinafter FCIC MORTGAGE CRISIS REPORT] ("[F]rom 2003 to 2006, median combined LTV, which is the ratio of total debt outstanding on the house and the value of the home (times 100), rose from 90 to 100 for subprime mortgages and from 90 to 95 for alt-A mortgages. A borrower with combined LTV of 100 has no equity in his house . . . . Mayer, Pence, and Sherlund (2009) conclude that increases in combined LTV and in low or no documentation loans were substantial contributors to the poor performance of loans during the mortgage crisis.").

90. *See, e.g.*, Patterson Forrester, *supra* note 88, at 3-4 (explaining how tax benefits encourage excessive borrowing against home equity).

91. *Id.* at 381 n.37; FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 23.

(i.e. excessive borrowing against one's home) that can lead to foreclosure and can undermine a stable and high rate of homeownership.

The incentive for excessive borrowing created by the mortgage interest deduction is also problematic because it undermines economic stability. Indeed, the high LTV ratios held by many American homeowners contributed to the recent economic crisis. Homeowners with high LTV ratios lose their homes to foreclosure more frequently than homeowners with low LTV ratios.[92] When a homeowner with a low LTV ratio becomes unable to pay his mortgage, he may sell his home and cash out his equity interest. In contrast, homeowners with high LTV ratios often cannot satisfy their mortgages through potential sale proceeds and are forced to default. Accordingly, "[a] standard model of mortgage default is known as the *double-trigger* model."[93] The double-trigger model observes that "borrowers typically default on a mortgage only if they have both *negative equity* —- i.e., they owe more on the house than it is worth —- and they experience some sort of *income shock*, such as job loss, that makes it difficult to continue making payments on the mortgages."[94] The high LTV ratios, which were encouraged by the deductibility of mortgage interest, thus contributed to the recent foreclosure crisis.[95]

Unfortunately, in addition to incentivizing high LTV ratios, the mortgage interest deduction further contributed to the housing bubble by artificially inflating housing prices through price capitalization. Artificially inflated housing prices have been identified as "a second major contributor to the increase in defaults during the mortgage crisis."[96] Even homeowners with significant equity in their homes did not have enough equity to cushion the extreme crash in prices that followed the bubble. "[S]tates with particularly large rises and falls in housing prices —- namely California, Florida, Arizona and Nevada —- experienced default rates of roughly twice the national average."[97] Extreme drops in housing prices caused many homeowners to

92. *Id*.
93. *Id*. at 25.
94. *Id*.
95. *Id*. at 23.
96. *Id*. at 27.
97. *Id*.

experience negative equity.[98] Homeowners with negative equity who were unable to pay their mortgages had high rates of default. Because the mortgage interest deduction both contributed to price inflation during a housing bubble and encouraged high LTV ratios, it likely increased the number of mortgage defaults and worsened the economic crisis.

Studies indicate that the mortgage interest deduction not only theoretically incentivizes borrowing, but is in fact associated with high LTV ratios. Indeed, the elimination of the mortgage interest deduction likely would lead to a reduction in LTV ratios. For example, a 1998 U.S.-based study "predicted that removal of the mortgage interest deduction would lower mortgage debt by 41 percent."[99] When the U.K. phased out its mortgage interest deduction, its initial LTV ratios decreased by approximately 25 to 30 percent.[100] Since the U.K. mortgage interest deduction was less generous than the U.S. mortgage interest deduction, it is reasonable to anticipate that the U.S. would experience a greater reduction in its LTV ratios by eliminating the deduction. The reduction in LTV ratios occurs because homebuyers are motivated to make larger down payments, pay off their mortgages more quickly and avoid the use of home equity lines of credit in the absence of a mortgage interest deduction.

The reduction in LTV ratios associated with the elimination of the mortgage interest deduction would have several stabilizing effects on the economy.[101] First, it would protect against high rates of default.

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98. FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 25 ("The sharp drop in housing prices beginning in 2006 left many borrowers with negative equity.").

99. Patric Hendershott, Gwilyn Pryce & Michael White, *Household Leverage and the Deductibility of Home Mortgage Interest: Evidence from UK House Purchasers* 4 (NBER Working Paper 9207, 2002), http://www.nber.org/papers/w9207 (citing James R. Follain & Lisa S. Melamed, *The False Messiah of Tax Policy: What Elimination of the Mortgage Interest Deduction Promises and a Careful Look at What It Delivers,* 9 J. OF HOUS. RESEARCH 2, 179-99 (1998)).

100. *Id.* at 19.

101. However, the reduction in LTV ratios will also decrease the tax expenditure savings incurred due to elimination of the mortgage interest deduction. *See id.* at 8 (explaining that the reduction in LTV ratios associated with the elimination of the mortgage interest deduction would also reduce the amount of additional revenue that the government could collect due to elimination of the mortgage interest deduction. Estimates of the tax expenditure cost of the mortgage interest deduction are based on

Second, it would offset the real estate price reductions that would otherwise be associated with phasing out the mortgage interest deduction.[102] As homeowners move to lower LTV ratios, they value the deductibility of interest less.

II. WHY THE MORTGAGE INTEREST DEDUCTION FAILED

Having determined in Part I that the mortgage interest deduction failed to promote homeownership and instead inflated housing prices and encouraged excessive borrowing, Part II identifies the flaws in the mortgage interest deduction that caused it to fail.

A. INSENSITIVE TO MARKET CONDITIONS

The first significant flaw of the mortgage interest deduction is its insensitivity to market conditions. The mortgage interest deduction is intended to be an incentive for a taxpayer to buy a home. Because it increases the value of (and thus the demand for) homes at all times, the mortgage interest deduction increases the price of homes. There are many economies, including the real estate economy of 2006, in which increasing the price of homes and further incentivizing consumption of real estate is bad public and economic policy.[103] Unfortunately, the availability of the mortgage interest deduction does not depend on whether the taxpayer purchases a home at a time when doing so will stimulate a weak real estate economy or at a time when doing so will

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the value of the deduction currently claimed by taxpayers. If taxpayers changed their behavior, including by decreasing their LTV ratios, they would reduce the amount of deduction they might otherwise claim and reduce the tax expenditure cost of the mortgage interest deduction). Even though reducing LTV ratios would reduce the additional revenue that the government could collect by eliminating the mortgage interest deduction, lower LTV ratios would add to the stability of our real estate economy and should be encouraged.

102. *See id.* at 20 ("Changes in household leverage would significantly offset the negative impact of the removal of interest deductibility on house prices, housing consumption, and homeownership.").

103. *See, e.g.*, FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 27 (places with particularly large increases in housing prices tended to experience more significant price declines and default rates).

only further drive up unsustainably inflated home prices. The incentive is available at all times, even when it affirmatively undermines economic stability.

Unfortunately, the mortgage interest deduction not only provides some level of subsidy in economies that are damaged by it, it provides the same level of subsidy in those economies as it provides in economies that are helped by it. Like its availability, the value of the mortgage interest deduction is insensitive to market conditions. From the perspective of a taxpayer, the value of the mortgage interest deduction is a function of the amount of mortgage interest paid by that taxpayer (reflecting mortgage terms, interest rate and outstanding mortgage balance), the taxpayer's marginal income tax rate, the taxpayer's other itemized deductions and the amount of the standard deduction. From the perspective of the United States Treasury, the tax expenditure cost of the mortgage interest deduction is a function of the number of taxpayers claiming it, each claimant's marginal tax rate and the amount of mortgage interest paid by each claimant.[104] Neither the taxpayer's benefit from the mortgage interest deduction nor the government's cost is affected by economic conditions.[105] The incentive does not increase in value to motivate home purchases during weak economies, or decrease in value to deflate market bubbles.

The insensitivity to market conditions of the mortgage interest deduction's availability and value is a critical failure. There are times when buyers in the housing market do not need to be and should not be further incentivized to consume housing. For example, many buyers in the market for a home in early 2006 participated in a flurry of bidding activity, sending in above-price offers on sight-unseen homes shortly after they were listed for sale. The market was hot, and buyers needed no incentive to participate other than excessive demand and extreme

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104. *See, e.g.*, GAO-09-769, *supra* note 2, at 6 (showing how the total amount of mortgage interest deduction taken by United States taxpayers depends on the number of taxpayers claiming the deduction and the amount of deduction claimed by each, which is a function of the price of homes, the amount of loans on homes, mortgage rates and marginal tax rates).

105. Interest rates to some extent reflect economic conditions, however, the interest rate that affects the value of the mortgage interest deduction is not the current interest rate but the rate reflected in the taxpayer's mortgage. Such rates can be up to thirty years old.

competition.[106] In retrospect, that activity was threatening to the economy and counter-productive. It drove house prices up to unsustainable levels.[107] Even if we are unable to identify these real estate bubbles as they are occurring, we should be able to identify them as markets in which tax incentives are unnecessary to maintain high levels of homeownership or housing prices. Unfortunately, the mortgage interest deduction continues its subsidy of home purchases during these times. At best, it is unnecessary and therefore wasteful in bubble economies. At worst, it is an economically damaging expenditure. Yet the structure of the mortgage interest deduction makes the incentive available and equally valuable under all economic conditions.

It would make good economic sense instead to reserve tax incentives for use in times of actual crisis in the housing market, identified by attributes including high foreclosure rates and large numbers of bank-owned properties. By using tax incentives only in periods of weak or crisis economies, the potential for price capitalization is significantly reduced, tax expenditure costs are slashed and housing bubbles are not further inflated.

B. RESISTS CHANGE

A second significant flaw of the mortgage interest deduction is its resistance to change. From 2000 to 2006, it was clear that housing prices were increasing at historically unprecedented rates and that homeowners were more highly leveraged in their homes than they had been previously.[108] It would have made good economic sense, even if tax incentives for homeownership were not already tied to economic indicators, for politicians to have the option to decrease these incentives at that time. Unfortunately, the structure of the mortgage interest deduction made its modification very difficult. First, the mortgage

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106. *See* FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 13 ("[T]he dramatic increase in real housing prices beginning in the late 1990s and subsequent fall from 2006 is striking and unprecedented. The size of the increase from 1998 to the peak in 2006 is substantially greater than any previous increase.").

107. *See id.* at 17 (explaining that the housing bubble was unsustainable and when expectations about the future changed, housing prices declined rapidly).

108. *See infra* notes 129-30 (regarding price increases); *infra* notes 133-34 (regarding excessive borrowing).

interest deduction is not enjoyed at the time of purchase.[109] A tax incentive that is provided in full at the time of purchase can easily be increased or decreased to reflect market conditions or even to reflect available government resources. A tax incentive provided gradually over time is more difficult to change. Since most American mortgages are thirty-year mortgages,[110] the mortgage interest deduction is paid out over decades. Politicians wishing to change the level of incentive for homeownership would have to upset the expectations of taxpayers who already own their homes. Even if they were willing to upset long-standing expectations, they would be limited in their ability to affect market conditions or homeowner behavior. A taxpayer who was initially incentivized to buy her home based on the promise of the mortgage interest deduction is unlikely to sell her home once the mortgage interest deduction is reduced or eliminated. Once people make purchases, loss aversion decreases the probability that they will then sell the asset even if it experiences depreciation. Thus, even politicians savvy to market conditions could not increase or reduce the mortgage interest deduction in ways that would effectively slow a bubble economy or stimulate a bust economy.

The mortgage interest deduction is inferior to first-time homebuyer tax credits because of its resistance to change. A first-time homebuyer tax credit can offer almost instant stimulus to a bust economy and can be eliminated in strong economic times. Further, if a first-time homebuyer tax credit is determined to insufficiently advance its goals, it can be easily modified. For example, in response to increasing loan-to-value ratios, a first-time homebuyer tax credit can easily be amended so that only purchasers with sufficiently large down payments qualify for it. In contrast, Congress had no effective way to amend the mortgage interest deduction so that underwater or delinquent homeowners failed to qualify. Since these homeowners had already purchased their homes, even a denial of the mortgage interest deduction triggered by their

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109. *See infra* Part II(C)(2).

110. *See, e.g.*, FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 10 (detailing the increase of interest only, optional adjustable rate mortgages and balloon mortgages relative to traditional, 30-year fixed rate mortgages between 2004 and 2007, but showing that 30-year fixed rate mortgages remained most common throughout that period).

delinquent status would have occurred too late to change their behavior. Similarly, if the government determined that the mortgage interest deduction caused social problems (such as excessive sprawl[111] or racial segregation,[112] as has been suggested by some critics), it would not have effective ways to alter the deduction to combat those problems. In contrast, a first-time homebuyer tax credit could easily be structured so that only purchasers of high-density housing or only purchasers in racially diverse neighborhoods would qualify. It could be structured so that only people purchasing "green" homes, homes in areas that had suffered rapid depreciation in prices, homes near interstates or mass transit lines or homes in cities with high levels of residential vacancies qualified. The first-time homebuyer tax credit can effectively be changed to influence future behavior. To the extent that the mortgage interest deduction influences behavior, it does so well in advance of when it is paid out. Once a purchase decision is made, the mortgage interest deduction has no way to influence behavior, despite continuing to provide significant economic benefits to the homeowner. It functions as an entitlement rather than an incentive of socially- or economically-desirable behavior.

The economic crisis of 2008 provided a basis for reducing or eliminating the mortgage interest deduction. Yet it also pointed to the mortgage interest deduction's resistance to change. It is a tax incentive that pays homeowners for decades without having an effective ongoing ability to influence their behavior. Since homeowners are promised decades worth of financial benefit, the structure of the deduction requires that the expectations of homeowners be upset in order to affect simple changes in policy. The mortgage interest deduction invites reliance, commits huge government resources for long periods of time and has only a limited effect on behavior. This makes it bad policy and points to an inflexibility that should be avoided by future tax incentives.

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111. *See* Mann, *supra* note 34, at 1350 (arguing that the mortgage interest deduction increases urban sprawl and the associated environmental harms of sprawl).

112. *See* Dorothy Brown, *Shades of the American Dream,* 87 WASH. U. L. REV. 329 (2009) (arguing that the mortgage interest deduction increases geographic racial segregation).

C. FAILS TO ACCOUNT FOR HUMAN BIAS

The National Association of Realtors ran an ad during the economic crisis that depicts a young couple at their housewarming party.[113] Motioning over a table filled with multiples of the same present from various guests, the wife says "we really appreciate all the dip trays . . . we love dip." Then, she opens a present offered by Uncle Sam. It is an envelope filled with $8000 cash, representing the First-Time Home Buyer Tax Credit that the couple will receive on their next tax return. The couple is overwhelmed by the gift.

If the ad had instead depicted Uncle Sam delivering the financial benefits of the mortgage interest deduction, it would be much less compelling. Uncle Sam would deliver an empty envelope to the 46% of American homeowners who receive no benefit from the mortgage interest deduction. To the 54% of American homeowners who do receive some benefit from the mortgage interest deduction, Uncle Sam would not deliver cash, but instead an IOU, payable over the next few decades, declining over time, probably not payable for the couple's first year of ownership and revocable if the couple paid off their mortgage too quickly.[114] Unless Uncle Sam was a tax expert with access to an amortization schedule, a calculator and the amount of the couple's charitable contributions and other itemized deductions, the amount payable on the IOU would be unidentified - neither he nor the couple would know how much benefit they would receive over time due to the mortgage interest deduction. Even if the amount of future savings could be known, future savings would have to be discounted to their present values. In short, the gift would look hypothetical, conditional and odd. It might seem surprising to the couple and to Uncle Sam if the gift turned out to be extremely expensive. The National Association of Realtors does not run such an ad. Doing so would expose the problems of the mortgage interest deduction: its value to a taxpayer is unpredictable and

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113. RealtorActionCenter, *Housewarming,* YOUTUBE (July 30, 2009), http://www.youtube.com/watch?v=wDblN0PSPA8.

114. The mortgage interest deduction is often not available for the first year of homeownership because less than a full year's worth of mortgage interest is paid. For example, for a November 1 home purchase, only two months' worth of mortgage interest is paid, which makes it unlikely that the potential mortgage interest deduction will exceed the standard deduction.

often zero, it is poorly timed, it fails to incentivize behavior and for those it helps, it becomes an expensive entitlement.

The mortgage interest deduction is intended to encourage taxpayers to become homeowners.[115] Unfortunately, because the incentive does not account for, or take advantage of natural human biases, it fails to effectively influence our behavior.

1. Difficult to Predict Value

Because it is difficult to calculate the value of the mortgage interest deduction[116] its effectiveness as an incentive is undermined. First, the value of the mortgage interest deduction depends on the amount of mortgage interest paid by a taxpayer in a given year, which in turn depends on the terms of the mortgage. Even for homeowners with simple, thirty-year-fixed-rate mortgages, the amount of interest paid on the loan in any particular year must be determined by calculating the diminishing amount of interest paid on the loan as part of each monthly payment and then adding the monthly totals to achieve a yearly total. For the first month's payment, the amount of interest paid equals the principal amount of the mortgage multiplied by the annual interest rate divided by 12 months. However, for all subsequent monthly payments, the amount of interest paid equals the remaining loan balance (i.e., the initial principal amount reduced by all prior principal payments) multiplied by the annual interest rate divided by 12 months. The loan balance, the amount of principal paid and the amount of interest paid change each month as the mortgage is paid down. Only after the amount of interest paid each month is calculated and those monthly amounts are compiled into a yearly total is the amount of mortgage interest paid in a given year known.

The calculation of interest paid in a given year is even more difficult for negative amortization mortgages and adjustable rate

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115. *See supra* note 10.

116. *See* GAO-09-769, *supra* note 2, at 10-11 ("The complexity of the laws that govern the mortgage interest deduction are evident in the guidance IRS has published. . . . [T]he flowchart in IRS's 16-page instructions to taxpayers – Publication 936: *Home Mortgage Interest Deduction* . . . leads taxpayers through as many as seven decision points and still sometimes requires them to consult another part of the publication.").

mortgages. For negative amortization mortgages (loans in which interest exceeds payments so that the outstanding balance increases over time), interest payments will increase over time. For adjustable rate mortgages, the amount of interest paid in any given year will depend on the interest rate in effect at that time as well as amounts previously paid and still outstanding.

Once the amount of mortgage interest paid in a given year is calculated, the value of the mortgage interest deduction can be determined through application of tax calculations. For home purchasers who previously used the standard deduction, the value of a mortgage interest deduction must be offset by the forgone value of the previously-claimed standard deduction and increased to reflect the taxpayer's newly-available itemized deductions. Thus, it will often be the case that the value of the mortgage deduction equals:

- ((Mortgage interest paid in a year plus the amount of all other itemized deductions, accounting for the 2 percent haircut[117] on miscellaneous itemized deductions[118]) minus the standard deduction) multiplied by the taxpayer's marginal rate.[119]

117. Miscellaneous itemized deductions are only allowed to the extent that such deductions (in the aggregate) exceed two percent of the taxpayer's AGI. Thus, if a taxpayer has $100,000 AGI, she may only claim miscellaneous deductions to the extent they exceed $2000. If she has $2500 total miscellaneous itemized deductions only $500 are in fact deductible given application of the 2 percent haircut.

118. Miscellaneous itemized deductions are all itemized deductions *other than* the twelve deductions listed in § 67(b) (the twelve items listed are regular itemized deductions, not subject to the 2 percent haircut). The twelve regular itemized deductions are: 1) interest deductible under § 163 (including mortgage interest), 2) taxes deductible under § 164, 3) casualty or theft losses deductible under § 165, 4) charitable contributions deductible under § 170 and 642(c), 5) medical expenses deductible under § 213, 6) impairment-related work expenses, 7) deductible estate tax paid on income in respect of the decedent under § 691(c), 8) deductible personal property used in short sale, 9) deduction available when taxpayer restores a substantial amount held under claim of right, 10) deduction for annuity payments ceased before investment recovered, 11) deduction for amortizable bond premiums, 12) deduction for cooperative housing corporations.

119. The calculation is more complicated for taxpayers with high adjusted gross incomes due to the overall limitation on itemized deductions in 26 U.S.C. § 68.

Since the taxpayer's marginal rate depends on her taxable income (income remaining after all deductions are taken), the mortgage interest deduction can cause a taxpayer to move into a lower rate bracket.

Assuming that a taxpayer navigates these complicated calculations accurately, any tax benefit she receives will also depend on the timing of her home purchase. Even a taxpayer with a very high interest rate and jumbo loan likely will not receive any year-of-purchase benefit from the mortgage interest deduction if she purchases her home in November, since she will pay less than two months' worth of interest in the year of purchase and likely will not have enough itemized deductions to exceed the standard deduction. Such a taxpayer will run complicated calculations only to be disappointed by the answer that her benefit is at least another year off.

Further, the value of the mortgage interest deduction is complicated by timing. Since the mortgage interest deduction is paid out over a period of many years, future benefits must be discounted to their present values to determine the time-of-purchase value of the mortgage interest deduction. The anticipated value of the mortgage interest deduction will prove inaccurate if tax brackets or rates change (which they often do), if the amount of the standard deduction changes (which it periodically does because of indexing) or if the taxpayer's income increases or decreases enough to change her marginal rate. For a taxpayer taking on a thirty-year mortgage, the practical answer is that the present value of the mortgage interest deduction that will be available over the life of the mortgage cannot be calculated.

Even if a taxpayer could estimate the present value of the mortgage interest deduction that will be available over the life of the mortgage, that taxpayer's estimates would prove incorrect if the taxpayer became liable for the Alternative Minimum Tax ("AMT"). While it allows a deduction for acquisition indebtedness, the AMT does not allow a deduction for home equity indebtedness.[120] Further, the AMT does not allow deductions for property taxes paid or various other itemized deductions.[121] Thus, a taxpayer who managed to correctly calculate the value of his mortgage interest deduction under the standard income tax could have his expectations upended by the AMT. Since taxpayers who

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120. 26 U.S.C. § 56 (b)(1)(C)(i), (e) (2006).
121. *Id*. § 56 (b)(1)(A)(ii).

receive mortgage interest deductions tend to be high earners, they are the group of taxpayers most likely to be liable for the AMT.

In sum, home purchasers simply cannot calculate the value of the mortgage interest deduction at the time of their purchases with a high degree of precision or certainty. This fact betrays a significant weakness of the mortgage interest deduction and a potential explanation for its ineffectiveness. People are far more likely to engage in action when the incentives are clearly known. We are careful to nail down a clear compensation package before accepting a job. We do not take on risk in an investment unless we are compensated with an appropriate risk premium. We like to know exactly what benefits are coming. That home purchasers have only a vague sense of the amount of benefit they will receive from the mortgage interest deduction likely explains why few homeowners buy because of that incentive.[122]

2. Delays Receipt of Value

As detailed above, the value of the mortgage interest deduction depends on the amount of mortgage interest paid in any given year. Because few people buy their homes on January 1, the amount of mortgage interest paid in the first year of ownership is often lower than the amount paid in second and third years. Indeed, many new buyers will receive no benefit from the first year of homeownership as a result of purchasing late in the year. Even after a homeowner starts receiving benefit from the mortgage interest deduction, that benefit is not paid all in one year. On the contrary, the benefit is provided very gradually over time, theoretically up to the thirty-year term of most mortgages in the United States, unless the amount of mortgage interest paid by the taxpayer decreases to the point that the taxpayer's total potential itemized deductions are less than the standard deduction. This fact points to a second defect in the structure of the mortgage interest deduction and a possible explanation for its ineffectiveness. Humans

122. Programs like the First-Time Homebuyer Tax Credit, with its clearly defined $8000 benefit, are much more likely to influence behavior. Indeed, while past first-time homebuyer tax credits phased out at higher incomes, it is worth considering whether the incentive goal of a defined $8000 benefit for all eligible taxpayers outweighs the progressivity goal of an income phase out.

strongly prefer immediate payoffs relative to delayed payoffs. A taxpayer who engages in behavior that the government intends to incentivize wants an immediate reward. The denial of that reward for the year of purchase runs directly contrary to our strong preferences. While we can be expected to tolerate the declining value of the deduction over time,[123] we are unlikely to be motivated by an incentive that provides little benefit promptly.

3. Encourages Risky Behavior

The economic crisis of 2008 was perhaps an overly difficult lesson in human bias. "[I]n 2008[,] our nation was forced to choose between risking the collapse of our financial system and economy, or committing trillions of taxpayer dollars to rescue major corporations and our financial markets."[124] Despite huge investments in economic stimulus programs by the government, almost $11 trillion in wealth vanished in the crisis,[125] and housing prices dropped 30 percent in the few years following the price peak in 2006.[126]

This crisis was preceded by a dangerous real estate bubble. From the end of World War II until the late 1990s, home prices remained steady or experienced moderate increases coupled with periodic slight decreases.[127] In contrast, the dramatic increase in housing prices beginning in the late 1990s and ending at the peak in 2006 was "striking

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123. The mortgage interest deduction declines over time for the most common form of mortgage—a fixed interest rate term loan. It can increase over time for adjustable rate mortgages (ARMs) and for negative amortization loans.

124. *Media Advisory, Financial Crisis Inquiry Commission Releases Report on the Causes of the Financial Crisis,* FIN. CRISIS INQUIRY COMM'N, 2 (2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-news/2011-0127-fcic-releases-report.pdf.

125. FCIC REPORT, *supra* note 1, at xv.

126. FIN. CRISIS INQUIRY COMM'N, SELECTED FINANCIAL MARKET & ECONOMIC DATA 7 (2010) (citing the First American CoreLogicLoanPerformance Home Price Index).

127. FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 13 (citing data from Robert Shiller, *Online Data Robert Shiller*, YALE DEP'T OF ECONOMICS, http://www.econ.yale.edu/~shiller/data.htm); U.S. Home Prices *available at* http://fcic.law.stanford.edu/img/resource-graphics/full/fig6.2_prices.jpg.

and unprecedented."[128] During this period, the rate of housing appreciation was incredibly high and rapidly accelerating.[129] United States home prices rose 86 percent in the less than 10 years from late 1996 to the peak in early 2006. The housing boom was unsupported by economic fundamentals.[130] Rather than relying on the appreciation to build wealth, many American households cashed out the equity from their homes to finance consumption. In the years leading up to the financial crisis, "trillions of dollars worth of financial decisions were made across the U.S. economy and around the world on the faulty expectation that national housing prices would only rise. Twenty years of economic stability had desensitized every player in the housing market to the possibility that home prices could fall."[131] Homeowner reliance on increasing prices resulted in huge increases in borrowing. From 2001 to 2007, mortgage debt in America almost doubled[132] and the amount of mortgage debt per household rose more than 63 percent from \$91,500 to \$149,500, despite stagnant wages.[133] Artificially high housing prices and excessive borrowing, often supported by perceived increases in home values, created an unstable real estate market.[134] When housing prices dropped, many homeowners who had actively stripped equity from their homes did not have enough equity left to avoid defaulting on their mortgages.[135] Mortgage defaults led to

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128. *Id.* at 13 (citing data from Robert Shiller, *Online Data Robert Shiller*, YALE DEP'T OF ECONOMICS, http://www.econ.yale.edu/~shiller/data.htm).

129. See FIN. CRISIS INQUIRY COMM'N, SELECTED FINANCIAL MARKET & ECONOMIC DATA 7 (2010) (citing the First American CoreLogicLoanPerformance Home Price Index).

130. Robert J. Shiller, *Understanding Recent Trends in House Prices and Home Ownership* 4 (NBER Working Paper No. 13553, 2007).

131. TREASURY AND HUD REPORT TO CONGRESS, *supra* note 1, at 4.

132. FCIC REPORT, *supra* note 1, at xx.

133. *Id.*

134. FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 23.

135. Even homeowners who experience significant income losses can often avoid defaulting on their mortgages if they have positive equity in their homes. Such homeowners can sell their homes for a profit or to break even and avoid defaulting on their mortgages. For this reason, economists refer to a "double-trigger model of mortgage default" where the triggers of negative equity and income shock both precede a default. *See*, *e.g.*, FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 25.

foreclosures and a glut of foreclosed homes on the market. The resulting oversupply of bank-owned homes forced prices even lower.

To be sure, overinvestment in real estate was not the only factor leading to crisis. However, overinvestment in real estate and "excessive borrowing" were significant contributing factors.[136] As the Federal Crisis Inquiry Commission found, "[w]hile the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble . . . that was the spark that ignited a string of events, which lead to a full-blown crisis in the fall of 2008. Trillions of dollars in risky mortgages had become embedded throughout the financial system . . . [w]hen the bubble burst, hundreds of billions of dollars in losses" were realized.[137] Economic stability was significantly undermined by an unsustainable increase in housing prices and a dramatic rise in household mortgage debt.[138]

Collectively, we regret not having questioned or slowed the unprecedented appreciation in real estate values in the years leading up to the crisis, but doing so would have run directly contrary to our biases. We tend to be economic optimists who prefer to make decisions that appeal to our hopes rather than likely outcomes,[139] to be overconfident in our own decisions, to disregard regression toward the mean and expect extreme performance to continue based on observations of extreme performance in the recent past,[140] to overestimate our own ability to control external events, to ignore strongly negative

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136. *Media Advisory, Financial Crisis Inquiry Commission Releases Report on the Causes of the Financial Crisis,* FIN. CRISIS INQUIRY COMM'N, 1 (Jan. 27, 2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-news/2011-0127-fcic-releases-report.pdf.

137. FCIC REPORT, *supra* note 1, at xvi.

138. *Id.* at xvii.

139. *See, e.g.*, Robert J. Shiller, *Bubbles, Human Judgment, and Expert Opinion* 10 (Yale Cowles Foundation Discussion Paper No. 1303, 2001), *available at* http://papers.ssrn.com/abstract_id=275515Shiller (explaining the role of "high expectations" in the housing bubble).

140. *See, e.g.*, Shiller, *supra* note 130, at 17 (noting that "[b]oom psychology encouraged potential homeowners and encouraged lenders as well. Home buyers were encouraged by the potential investment returns. Mortgage lenders were encouraged since the boom reduces the default rate on lower-quality mortgages." Both homeowners and mortgage lenders anticipated that extreme rates of appreciation would continue.).

possibilities if they have a low probability of occurrence and (to the extent we do question our own optimism or overconfidence) to be quickly reassured by the fact that we see people around us engaging in similar behaviors.[141]

The housing boom was supported by a collective social bias, as well as our individual biases. Economists have noted that "a significant factor in this boom was a widespread perception that houses are a great investment, and the boom psychology that helped spread such thinking."[142] Some have called this collective social bias a speculative bubble. As Yale economist Robert Shiller explains "[t]he venerable notion of a speculative bubble can be described as a feedback mechanism operating through public observations of price increases and public expectations of future price increases. The feedback can also be described as a social epidemic, where certain public conceptions and ideas lead to emotional speculative interest in the markets and, therefore, to price increases; these, then, serve to reproduce those public conceptions and ideas in more people. This process repeats again and again, driving prices higher and higher, for a while. But the feedback cannot go on forever, and when prices stop increasing, the public interest in the investment may drop sharply: the bubble bursts."[143] By expressing to each other our individual impressions that real estate

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141. *See*, *e.g.*, *id*. at 8-9 ("[T]he notion of a speculative bubble is inherently sociological or social-psychological, and does not lend itself to study with the essential tool bag of economists. In my book *Irrational Exuberance* (2000, 2005), named after a famous remark of Alan Greenspan, I developed this popular notion of bubbles. I argued that various principles of psychology and sociology whose importance to economics has only recently become visible to most economists through the developing literature on behavioral economics help us to lend more concreteness to the feedback mechanism that creates speculative bubbles. These principles of psychology include psychological framing, representativeness heuristic, social learning, collective consciousness, attention anomalies, gambling anomalies such as myopic loss aversion, emotional contagion, and sensation seeking."); Shiller, *supra* note 139, at 1 (noting the role of representativeness heuristic, overconfidence, attentional anomalies, self-esteem, conformity pressures, salience and justification in market bubbles).

142. Shiller, *supra* note 130, at 7.

143. *Id.* at 8.

appreciation would continue, we reinforced our own biases and the biases of others.[144] We inflated the bubble until it burst.

While some economists, including Professor Shiller, properly identified the extreme appreciation in home prices from 2000 to early 2006 as an unsustainable bubble at the time it was occurring,[145] other economists and many consumers believed that these increased prices reflected an overall increase in economic well-being and that prices would continue to rise.

Unfortunately, the mortgage interest deduction only reinforced our biases. We were incentivized to take out loans with high loan-to-value ratios because the more interest we paid, the larger the deduction we received. Many Americans refinanced in 2006, taking cash out of their homes, and were rewarded by the government with higher tax breaks. Many others dangerously and unnecessarily secured consumer debts against their homes through the use of home equity lines of credit in order to take advantage of the deduction for home equity indebtedness. The mortgage interest deduction reinforced, instead of counteracting, our natural biases and encouraged risky behavior prior to the market crash.[146] Its propensity to encourage risky behavior is another significant flaw of the mortgage interest deduction.

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144. *Id.* at 9 ("I argued that the feedback that creates bubbles has the primary effect of amplifying stories that justify the bubble; I called them "new era stories." The stories have to have a certain vividness to them if they are to be contagious and to get people excited about making risky investments. Contagion tends to work through word of mouth and through the news media. It may take a direct price-to-price form, as price increases generate further price increases.").

145. *See*, *e.g.*, Jonathan R. Laing, *The Bubble's New Home,* BARRON'S, June 20, 2005; Paul R. Krugman, *That Hissing Sound,* N.Y. TIMES OP ED, Aug. 8, 2005, http://www.nytimes.com/2005/08/08/opinion/08krugman.html.

146. *See*, *e.g.*, Shiller, *supra* note 130, at 19 (noting that there is "likely to be a limit on how far public policy should attempt to encourage homeownership . . . . [C]reating too much attention to housing as investments may encourage speculative thinking, and therefore, excessive volatility in the market for homes. Encouraging people into risky investments in housing may have bad outcomes. It is possible that some countries have overreached themselves in encouraging homeownership.").

D. FAILS TO INFLUENCE THE PURCHASE DECISION

The international comparisons, interstate comparisons, time-based comparisons and economic regressions described above collectively tell us that the mortgage interest deduction fails to increase rates of homeownership. This is partially based on price capitalization (the mortgage interest deduction causes homes to be more valuable and therefore more expensive) and partially based on the failure of the mortgage interest deduction to influence the decision to purchase.

1. Fails to Provide Value When It Is Needed Most

The mortgage interest deduction fails to influence the decision to purchase a home because it fails to provide value at the time of the purchase, when it is most needed. Many taxpayers who hope to become homeowners identify the need to save up a down payment as the most significant barrier to their entry into the real estate market.[147] In addition to making a down payment, homebuyers must also pay significant closing costs at the time of purchase. Ideally, tax incentives would be paid just prior to the time of purchase, so that home purchasers could use their tax savings to make larger down payments or to cover closing costs. However, the Internal Revenue Service is not well-positioned to make payments other than in connection with tax returns.[148] The next best alternative would be for homeownership tax incentives to be paid in full in connection with the tax return immediately following the year of purchase. If the tax incentive was provided in full in the year following a purchase, it could be used by taxpayers to replenish their savings (often depleted in order to make a down payment), to help cover the costs of moving to the new residence or to provide funds to furnish or improve

147. FANNIE MAE, NATIONAL HOUSING SURVEY FIRST QUARTER 50 (May 2011), http://www.fanniemae.com/resources/file/research/housingsurvey/pdf/National-Housing-Survey-q12011.pdf [hereinafter FANNIE MAE 1ST Q 2011 HOUSING SURVEY] (having enough for a down payment is identified as one of the three biggest obstacles to homeownership, along with insufficient income and a poor credit history).

148. Providing payments outside of the tax return cycle, monitoring taxpayer behavior to assure that the planned home purchase was in fact made and addressing failed transactions likely would impose overly demanding administrative burdens on the Service.

the new residence. Additionally, as explained above, it appeals to taxpayers' strong preferences for immediate benefits.

The mortgage interest deduction fails as an incentive in part because it does not provide economic benefit when it is most needed (at or near the time of purchase), and instead provides economic benefits when they are least needed (in the decades following a home purchase) and least likely to affect the decision to buy.

2. Provides Little to No Benefit to Many Buyers

It is a common misconception that everyone who pays mortgage interest receives the mortgage interest deduction. In truth, in 2005, only 54 percent of America's homeowners received any benefit from the mortgage interest deduction.[149] Almost half of the total number of homeowners receive no benefit because their potential mortgage interest deductions are less than the standard deduction. These homeowners are overwhelmingly in lower- or middle-income tax brackets. When non-homeowners are considered, only 23 percent of Americans receive any benefit from the mortgage interest deduction.[150]

Even among the homeowners who do receive a financial benefit from the mortgage interest deduction, the effects of the deduction are extremely regressive.[151] Scholars have referred to it as "an upside down subsidy"[152] since it so strongly helps the rich while providing fewer benefits (or potentially harms in the form of increased home prices) to homeowners who are not rich. Homeowners in the lowest 60 percent of the income distribution obtain only 3 percent of the benefits of the

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149. 2005 PRESIDENT'S ADVISORY PANEL, *supra* note 26; CBO PUB. NO. 3191, *supra* note 26, at 188.

150. Leonhardt, *supra* note 25.

151. *See, e.g.*, Poterba & Sinai, *supra* note 83, at 11 tbl. 1 (showing for homeowners between the ages of 25-35 who have annual household income in excess of $250,000, the average tax savings from the mortgage interest deduction is $7077; for homeowners over the age of 65 who have household income less than $40,000, the average tax savings from the mortgage interest deduction is only $5; since homeowners over the age of 65 often have very low loan-to-value ratios, they save an average of only $149 due to the mortgage interest deduction across all income levels).

152. Gale et al., *supra* note 61, at 1178.

mortgage interest deduction[153] while homeowners in the top 20 percent of income distribution receive 83.7 percent of its benefits.[154] The difference in the amount of benefit enjoyed by individual high-income households as compared to individual low-income households is substantial. Among homeowners who benefit from the mortgage interest deduction, "tax savings for those at the median top 10 percent of the income distribution ($4,151) will be about 16.5 times the tax savings for those at the median of the bottom 20 percent ($252)."[155]

There are many reasons for the regressive nature of the mortgage interest deduction. First, higher income taxpayers are more likely to own their own homes and, potentially, to own second homes. Second, and more surprisingly, among homeowners, higher income homeowners are more likely to have mortgages and home equity lines of credit on their homes, while lower income homeowners are more likely to own their homes outright.[156] Third, higher income households are more likely to have expensive homes and high mortgage balances.[157] Fourth, higher income households are more likely to itemize their deductions.[158] Indeed, few low- and moderate-income families itemize because few pay enough mortgage interest to exceed the standard deduction. Finally,

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153. *Id.*

154. *See id.* at 1179.

155. Anderson et al., *supra* note 27, at 14.

156. Annamaria Lusardi, *Americans' Financial Capability, Report Prepared for the Financial Crisis Inquiry Commission* (NBER Working Paper No. 17103, 2010) (noting that homeowners with less than $25,000 annual income do not tend to have mortgages or home equity lines of credit—only 31 percent have a mortgage and 11 percent have a home equity line of credit. Homeowners with $25,000-$75,000 of annual income are more likely to have such debts—61 percent have a mortgage and 20 percent have a home equity line of credit. Homeowners with more than $75,000 of annual income are most likely to have such debts—77 percent have a mortgage and 27 percent have a home equity line of credit. Since these statistics focus on homeowners only, they establish that many low-income homeowners own their homes outright).

157. Poterba & Sinai, *supra* note 83, at 3 ("There is a strong positive relationship between household income and house value. Home value averages $201,700 for families with incomes of $40-75,000, compared with $427,800 for those with incomes between $125,000 and $250,000.").

158. *Id.* at 2 ("More than 98 percent of homeowners with income in excess of $125,000 claim itemized deductions, compared with only 23 percent of those with incomes below $40,000.").

higher income households have higher marginal income tax rates. Collectively, these factors mean that high-income households receive the overwhelming majority of the benefits provided by the mortgage interest deduction.

The extremely regressive nature of the mortgage interest deduction is problematic not only because it undermines the otherwise progressive nature of the income tax, but because it undermines its potential effectiveness as an incentive. Lower-income and middle-income taxpayers likely are not incentivized by the mortgage interest deduction because they receive little to no benefit from it. Any influence that the mortgage interest deduction has on their behavior is likely due to a mistaken belief that it will provide them economic benefit. These taxpayers will have their expectations upset in the first years of homeownership.

While the rich receive significant benefits from the mortgage interest deduction, they are the taxpayers who are most likely to own homes anyway, even in the absence of a subsidy. As the Joint Committee on Taxation recently noted, "[t]he 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."[159]

The mortgage interest deduction's failure to benefit many buyers and payment of significant benefits to buyers who likely would have purchased homes anyway undermines its effectiveness at promoting homeownership.

3. Incentivizes Already Incentivized Buyers

The mortgage interest deduction likely also fails to promote homeownership because it offers financial incentives to people who are acting primarily for non-financial reasons. A national housing survey conducted by Fannie Mae in 2011 found that people from all income levels who purchase homes are motivated primarily by non-financial reasons. "Only 1 in 3 Americans believe that financial benefits of homeownership are superior to the lifestyle benefits . . . [and] every single sub-audience perceives lifestyle benefits (stable home for

159. JCX-40-11, *supra* note 10, at 4.

children, freedom to make improvements and sense of community) as superior to financial benefits."[160]

America's long history of providing tax benefits to homeowners has not changed these priorities. While Americans report that they value the tax benefits of homeownership somewhat, those benefits are rated as significantly less valuable than other benefits of homeownership. For example, the Fannie Mae survey found that while 48 percent of Americans surveyed marked tax benefits as a major reason to buy a home, significantly more (70 percent) marked "control over what you do with your living space, like renovations and updates" as a major reason.[161] Of the 15 potential reasons to buy a home that were polled, tax benefits ranked fourth from last, beating only the reasons that homeownership "gives me something I can borrow against if I need it," is "a symbol of your success or achievement" and "motivates you to become a better citizen and engage in important civic activities . . . ."[162] Only 14 percent of respondents reported that tax benefits caused them to purchase their first homes.[163]

Interestingly, among homeowners, tax benefits were rated as most valuable by homeowners who were delinquent or underwater on their

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160. FANNIE MAE 1ST Q 2011 HOUSING SURVEY, *supra* note 147, at 54.

161. *Id.* at 55.

162. *Id.*

163. *See* FANNIE MAE, FANNIE MAE 2010 NATIONAL HOUSING SURVEY 93 (Apr. 2010), http://www.fanniemae.com/media/pdf/2010/National-Housing-Survey-040610.pdf [hereinafter FANNIE MAE 2010 ANNUAL SURVEY]. When asked "What led you to purchase your first home" only 14 percent of respondents selected "to gain tax benefits" and a disproportionately high number of those who made this selection were delinquent on their mortgages (among delinquent borrowers, 25 percent selected tax benefits as the reason they purchased their first homes). Luckily, the focus on non-financial interests has also led homeowners to pay off their mortgages more quickly than they otherwise might have if they were more influenced by the tax deductibility of mortgage interest. *See* FANNIE MAE, FANNIE MAE 1998 NATIONAL HOUSING SURVEY 8 (1998), http://www.fanniemae.com/global/pdf/media/survey/survey1998.pdf (52 percent of respondents said "I am interested in paying off a mortgage as quickly as possible in order to build equity in my home and minimize the amount I pay in interest on my debt" compared to only 37 percent who said "I prefer to take advantage of the low interest rate and tax deductions on a mortgage to use the equity I have paid into my home to finance other investments, such as stocks or bonds, education expenses or other things, and I will pay my mortgage off more slowly.").

mortgages.[164] Similarly, and perhaps because many renters likely assume that everyone with a mortgage benefits from the mortgage interest deduction, while many homeowners have had a rude awakening to the contrary, renters are more likely to see tax benefits as a major reason to buy a home than are homeowners.[165]

Offering financial incentives to buyers who are motivated primarily by non-financial considerations is a wasteful use of resources and undermines the effectiveness of the mortgage interest deduction.

4. Value of Incentive Is Capitalized into Price

As is described above, the mortgage interest deduction likely fails to increase rates of homeownership because much of its value is capitalized into the price of homes. Since the deduction makes homes more valuable, it makes them more expensive and prevents potential purchasers from being able to afford homes.

Not every tax incentive will be capitalized into the price of an asset. Price capitalization occurs in response to the mortgage interest deduction because the supply of housing is at least partially restricted by the limited nature of buildable land and by zoning laws. Because increased demand cannot be met with increased supply, the incentive drives up costs and proves ineffective. Further, because the mortgage interest deduction is a permanent, or at least indefinite, subsidy for homeownership, the real estate market has time to respond to that incentive by capitalizing it into real estate prices. The market would

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164. FANNIE MAE 1ST Q 2011 HOUSING SURVEY, *supra* note 147, at 55.

165. FANNIE MAE, FACT SHEET: FANNIE MAE NATIONAL HOUSING SURVEY KEY FINDINGS FIRST QUARTER 2011 56 (2011), http://www.fanniemae.com/media/pdf/2011/Housing-Survey-Fact-Sheet-q12011.pdf (48 percent of renters cite tax benefits as a major reason to buy a home while only 42 percent of homeowners do); *see also* FANNIE MAE 2010 ANNUAL SURVEY, *supra* note 163, at 89 (noting that when renters were asked "If you were going to purchase a home, which of the following would play a role in that decision," 20 percent identified tax benefits); FANNIE MAE, FANNIE MAE 1996 NATIONAL HOUSING SURVEY 8 (1996), http://www.fanniemae.com/global/pdf/media/survey/survey1996.pdf (67 percent of low- to moderate-income renters believe that "[d]oing away with the mortgage interest deduction would be an obstacle to homeownership" while only 57 percent of the general adult population surveyed agreed).

have less opportunity to respond if the homeownership subsidy was limited in duration.

The mortgage interest deduction fails to promote homeownership because it indefinitely subsidizes the purchase of an asset that is in limited supply. The failure of the mortgage interest deduction should cause us to be cautious of long-term tax incentives that encourage increased consumption of limited goods. Their effectiveness will be undermined by some amount of capitalization.

III. THE MORTGAGE INTEREST DEDUCTION SHOULD BE REPEALED AND REPLACED

For the reasons described above, the mortgage interest deduction should be repealed in its entirety. It fails to increase rates of homeownership, inflates the price of housing and discourages the entry of potential buyers into the market. By further inflating housing prices, even in times of unsustainable appreciation, it leads to more dangerous economic bubbles and more devastating economic busts. It is insensitive to economic conditions and resistant to change. The mortgage interest deduction should be repealed and replaced with time-limited tax incentives that are provided only when and to the extent necessary to stabilize the housing market during periods of crisis.

A. GRADUAL PHASE OUT

The mortgage interest deduction should be repealed in its entirety. Since its repeal will upend taxpayer reliance and decrease home prices, the repeal should be gradual. However, full repeal, without the grandfathering of existing mortgages, is appropriate. The mortgage interest deduction is an over hundred billion dollar annual tax expenditure that does not meaningfully advance its goal of promoting homeownership and instead contributes to instability in the housing market. It should not be sustained.

In 2005, a bipartisan Advisory Panel on Federal Tax Reform recommended changes to the mortgage interest deduction that provide a helpful starting point for plans to phase out the deduction. These recommendations, with some key modifications, offer an appropriate plan for its gradual phase out.

In 2005, the Panel recommended converting the mortgage interest deduction into a 15 percent tax credit available to all taxpayers regardless of their marginal tax rates. This tax credit would not function like a first-time homebuyer tax credit available in the year of purchase. Rather, like the mortgage interest deduction, it would be payable over the term of the mortgage and its value would be based on the mortgage interest paid in any given year. However, instead of multiplying the amount of mortgage interest paid in any given year by the taxpayer's marginal tax rate (currently up to 35 percent), the amount of mortgage interest paid in any given year would be multiplied by 15 percent. Since a fixed percent would be multiplied by the amount of mortgage interest paid, rather than the taxpayer's marginal tax rate, this incentive was referred to as a mortgage interest credit (rather than a mortgage interest deduction). The Panel also recommended limiting the credit to interest only on mortgages on primary residences and gradually reducing the mortgage cap from $1.1 million to a number reflecting the average regional price of housing (ranging from about $227,000 to $412,000 depending on the location of the home).[166] The proposal was to be phased in over five years for existing mortgages.[167]

The Panel's recommendations are a helpful starting point for plans to gradually eliminate the mortgage interest deduction partially because these recommendations were evaluated in 2005 for their potential impact on the economy. Despite the significant reduction in mortgage caps proposed by the Panel, studies showed that nationally only about 13 percent of mortgage originations would have been negatively affected by the new caps. Only 832,925 mortgage originations of 6.29 million mortgage originations total in one study were for amounts above the proposed caps.[168] The small percentage of homeowners potentially affected by the reduced mortgage caps proposed by the Panel indicates that mortgage caps could be reduced without destabilizing the real estate market.

Studies also showed that, despite the small percentage of homeowners potentially affected by the reduced caps, the proposal would have increased tax revenues significantly. The Congressional

166. 2005 PRESIDENT'S ADVISORY PANEL, *supra* note 26, at 61.

167. *Id.* at 238.

168. Anderson et al., *supra* note 27, at 21.

Budget Office estimated the potential increased revenue available if such a proposal took effect in 2013.[169] It estimated that $12.7 billion more revenue would be collected in 2013, that $51.6 billion more revenue would be collected in 2014 and that a whopping $387.6 billion more revenue would be collected between the years 2013-2019.[170] These revenue increases were available by reducing the mortgage caps to regional averages over a five-year-phase-down period, by converting the deduction to a credit worth 15 percent of the mortgage interest paid by all taxpayers regardless of their marginal tax rates and by limiting the deduction to primary residences.

While the proposal by the 2005 Panel is a helpful starting point to plan for a gradual reduction of the mortgage interest deduction, the data above indicate that several changes would make the phase out more effective and avoid the continued harm caused by mortgage tax incentives.

First, during the phase-down period, the mortgage interest deduction should be capped at a 15 percent rate, not converted to a 15 percent credit for all taxpayers as the Panel had recommended. The Panel proposed that all homeowners paying mortgage interest should receive a credit for 15 percent of the interest they pay regardless of their marginal rates. Since that 15 percent mortgage interest credit would not have been an itemized deduction, it would have been available to all taxpayers, even if they took the standard deduction. Further, since the credit was offered at 15 percent for all taxpayers, it would have increased the tax incentive for taxpayers in the 10 percent bracket. These features of the Panel's proposal likely were efforts to make the mortgage interest incentive more progressive and to increase the rate of homeownership. However, since mortgage interest incentives, including the 15 percent credit proposed by the Panel, are difficult to predict, poorly-timed, insensitive to market conditions, resistant to change and cause price capitalization, they should not be increased for any category of taxpayer, even in the interest of progressivity. Extending the benefits of mortgage interest incentives to new categories of taxpayers (including those taking the standard deduction) serves only to increase taxpayer reliance on a faulty incentive. Instead of offering mortgage interest

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169. CBO PUB. NO. 3191, *supra* note 26, at 187.

170. *Id.*

incentives to taxpayers who do not currently receive them, targeted first-time homebuyer tax credits and direct expenditure programs should be used to increase rates of homeownership by low- and middle-income taxpayers.

Second, mortgage caps should be gradually reduced to zero—eliminating the mortgage interest deduction—not simply reduced to regional averages as the Panel had recommended. While the Panel's recommendation of reducing the mortgage cap over five years from the current cap of $1,100,000 to various caps based on regional averages is prudent and properly avoids disproportionate disruption to areas with higher home prices, the cap should be further reduced over the following five years until the mortgage interest deduction is fully eliminated. The mortgage interest deduction fails to achieve its goal of promoting homeownership, results in a huge loss of potential revenue and exaggerates dangerous boom/bust cycles in the housing market. Tax incentives for mortgage borrowing should not continue. Instead, they should be entirely eliminated and replaced with incentives that are fully paid at the time of a home purchase. Home purchase tax incentives can more effectively respond to market conditions and are easier to change if they fail to achieve desired outcomes.

Finally, a plan to phase down and then eliminate the mortgage interest deduction should coincide with extended homebuyer tax credits used to stabilize the real estate economy during the transition period for reasons described in more detail below.

B. REPLACEMENT WITH TARGETED HOMEBUYER TAX CREDITS

Targeted, time-limited homebuyer tax credits are much more cost-effective tools for incentivizing home purchases during periods of economic bust, stabilizing the real estate market and increasing rates of homeownership. Further, these incentives avoid the price capitalization that causes the mortgage interest deduction to undermine its goal of making housing more affordable, they avoid inflation of dangerous housing bubbles, they are market responsive and they can easily be modified to improve their effectiveness. The First-Time Homebuyer Credits used from 2008 to mid-2010, for example, were significantly more effective policies than the mortgage interest deduction. Similar time-limited credits should replace the mortgage interest deduction as the tax code's primary incentive for homeownership.

Although not a traditional form of tax incentive, Congress enacted the First-Time Homebuyer Credit ("FTHBC") as part of recent economic stimulus efforts to improve a struggling real estate economy and to encourage taxpayers to purchase their first homes. Since the FTHBC was enacted in 2008, it has had three versions. Each version provided an income tax credit to "first-time homebuyers," defined as persons who had not owned homes during the three-year period prior to the date of purchase and each expired automatically at a set date.[171]

The first version of the FTHBC, passed as part of the Housing and Economic Recovery Act of 2008,[172] provided taxpayers a refundable tax credit equal to 10 percent of the purchase price of the home up to a maximum credit of $7500. Taxpayers taking the credit were required to pay the credit back ratably over 15 years, beginning in 2011.[173] The payback requirement was accelerated if the home was sold or was no longer used as the taxpayer's primary residence. The credit phased out for higher income taxpayers (phase out occurred for single filers with modified adjusted incomes[174] between $75,000 and $95,000, and for married filing jointly taxpayers with incomes between $150,000 and $170,000).[175]

The second version of the FTHBC was passed as part of the American Recovery and Reinvestment Act of 2009. It retained the earlier version's refundable credit for 10 percent of the purchase price and retained the levels of income phase out, but increased the credit's

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171. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-1025R, TAX ADMINISTRATION: USAGE AND SELECTED ANALYSES OF THE FIRST-TIME HOMEBUYER CREDIT 1 n.1 (Sept. 2010) [hereinafter GAO-10-1025R]; 26 U.S.C. § 36(c)(1) (2006).

172. GAO-10-1025R, *supra* note 171, at 3; Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3011, 122 Stat. 2654, 2658 (2008).

173. GAO-10-1025R, *supra* note 171, at 3; Housing and Economic Recovery Act § 3011.

174. Modified adjusted gross income is AGI plus certain income not included on the tax return including some types of foreign income. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-166T, FIRST-TIME HOMEBUYER TAX CREDIT: TAXPAYERS' USE OF THE CREDIT AND IMPLEMENTATION AND COMPLIANCE CHALLENGES 8 (2009) [hereinafter GAO-10-166T].

175. *Id.*

cap to $8000 and provided that for homes purchased in 2009, no repayment was required unless the home was resold or ceased to be a primary residence within 3 years of purchase.[176]

The third version, passed as part of the Worker, Homeownership, and Business Assistance Act of 2009, extended the timeframe in which taxpayers could buy a home to qualify for the credit from November 30, 2009 to April 30, 2010, increased income phase outs to $125,000-$145,000 for single taxpayers and $225,000-$245,000 for joint taxpayers[177] and provided an additional credit of up to $6500 for long-term homeowners who bought new homes.[178] The Homebuyer Assistance and Improvement Act of 2010 extended the required closing date deadline from June 30 to September 30 for any eligible homebuyer who had entered into a binding real estate purchase and sale agreement before April 30, 2010.[179]

Each version of the FTHBC was limited in time, meaning that only taxpayers who purchased homes during a set period of time qualified for the incentive. Collectively, the FTHBC covered purchases from April 9, 2008 until June 30, 2010,[180] a period of significant weakness in the real estate market. More than 3.3 million taxpayers took advantage of the FTHBC.[181] The Joint Committee on Taxation estimates that the three FTHBC programs combined will result in about $22 billion of lost revenue through 2019.[182]

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176. *Id.* at 3; American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, 316 (2009).

177. GAO-10-1025R, *supra* note 171, at 6.

178. *Id.* at 3; Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 11, 123 Stat. 2984, 2989 (2009).

179. GAO-10-1025R, *supra* note 171, at 2; Homebuyer Assistance and Improvement Act of 2010, Pub. L. No. 111-198, 124 Stat. 1356, 1356 (2010).

180. GAO-10-1025R, *supra* note 171, at 6.

181. *Id.* at 3-4 (reporting that about 1 million claimants claimed $7.3 billion in interest-free loans through the Housing Act provision, about 2.3 million claimants claimed the credits offered by the Recovery Act and Assistance Act which did not need to be repaid and these numbers are "likely to increase because the IRS is still processing FTHBC returns.").

182. *Id*. at 1 n.3 (2010) (citing JOINT COMM. ON TAXATION, JCX-33-08, ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN H.R. 3221 (2008); JOINT COMM. ON TAXATION, JCX-64-08, "THE HOUSING AND ECONOMIC RECOVERY ACT OF 2008" SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY

Targeted, time-limited homebuyer tax credits, like the FTHBCs used from 2008 until the middle of 2010 have several advantages over the mortgage interest deduction: they take advantage of human bias by providing prompt benefits, are more progressive and better target homebuyers who might not otherwise buy, are cost-effective, are market responsive, help stabilize the real estate economy, avoid price capitalization and are easy to change.

Homebuyer tax credits are more effective incentives because they take advantage of human bias in ways that the mortgage interest deduction does not. Each version of the FTHBC provided its full benefit to taxpayers in the year immediately following the year of purchase. In contrast to the mortgage interest deduction, which often provides little to no benefit in that year, and then provides remaining benefits gradually over time, this timing is significantly more effective at influencing the purchase decision. Additionally, the first version of the FTHBC took particular advantage of the human bias in favor of prompt benefits and delayed costs. It provided taxpayers a prompt benefit (a 10 percent credit up to $7500 for home purchases) and required the taxpayers claiming the credit to ratably repay it over 15 years beginning in 2011. One million people[183] happily took advantage of a credit that, ignoring the time-value of money, gave them no net benefit. It was effectively an interest-free loan from the government. The credit was effective in incentivizing behavior in part because it appealed to our natural bias in favor of immediate benefits and delayed costs, and provided a financial benefit when it was most needed—near the time of purchase.[184]

23, 2008 (2008); JOINT COMM. ON TAXATION, JCX-19-09, ESTIMATED BUDGET EFFECTS FOR THE REVENUE PROVISIONS CONTAINED IN THE CONFERENCE AGREEMENT FOR H.R. 1, "THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009" (2009); JOINT COMM. ON TAXATION, JCX-45-09, ESTIMATED REVENUE EFFECTS OF CERTAIN PROVISIONS CONTAINED IN THE "WORKER, HOMEOWNERSHIP, AND BUSINESS ASSISTANCE ACT OF 2009" (2009)).

183. GAO-10-1025R, *supra* note 171, at 3-4 (reporting about 1 million claimants claimed $7.3 billion in interest-free loans through the Housing Act provision).

184. Some critics argue that the first time homebuyer tax credit incentivizes risky behavior because, while home purchasers appreciate the benefit they receive on the first tax return after their purchase, they underestimate the negative impact of repaying the benefit over the next 15 years. This criticism has some merit. However, it is offset by the fact that homeowners often have a greater ability to pay taxes in the years following

Homebuyer tax credits are more progressive and better target potential homebuyers who might otherwise not purchase homes. An October 2009 report by the Government Accountability Office found that for 2008 and 2009, "[t]he FTHBC was disproportionately claimed by taxpayers in the $25,000 to $100,000 AGI range."[185] While this group represented 46 percent of taxpayers, it represented 74 percent of taxpayers benefiting from the FTHBC.[186] Likely due to the income phase out, more than half (59 percent) of those benefiting from the FTHBC had adjusted gross incomes of $50,000 or less.[187] In contrast to the highly regressive mortgage interest deduction, the FTHBC is a much more progressive tax incentive and likely facilitates the entry of new buyers into the housing market.

Homebuyer tax credits are more cost-effective than the mortgage interest deduction at promoting homeownership. Given that the mortgage interest deduction costs almost $120 billion annually and is growing each year, while the FTHBC is expected to cost $22 billion total through 2019, targeted incentives like the FTHBC can easily be funded by increases in revenue resulting from the phase-out of the mortgage interest deduction. According to CBO estimates, per dollar of revenue lost, tax credits appear to be more effective than the mortgage interest deduction at promoting homeownership.[188]

Homebuyer tax credits are more responsive to economic conditions than the mortgage interest deduction. Homebuyer tax credits avoid many of the harms caused by the mortgage interest deduction because they are time-limited interventions in the market. Indeed, when Congress enacted the FTHBC, lawmakers identified it as a short-term tool to "reduce the glut of foreclosed homes available in the real estate market."[189] They recognized that it should not be an indefinite market intervention. Rather, the credit was allowed only to the extent it helped remedy the

a home purchase than in the year of a home purchase, when they must spend their available cash on a down payment and closing costs.

185. GAO-10-166T, *supra* note 174, at 3.

186. *Id.* at 4.

187. *Id.*

188. CBO PUB. NO. 3191, *supra* note 26, at 189.

extreme economic collapse in the real estate economy in 2008 to mid-2010.

Lawmakers acknowledged that long-term or indefinite intervention in the real estate market was not justified. For example, Senator Baucus stated, "the short-term nature of this credit is also critical because it would avoid over-subsidizing the housing industry in the long run."[190] Similarly, Senator Isakson argued, "[w]e cannot regulate ourselves, as a nation, into a strong economy. But we can incentivize people to get confidence to the financial markets and restore what is a very shaky economy."[191] Lawmakers seemed to realize that indefinite market interventions cause price capitalization and can inflate unsustainable bubbles. They avoided such economic distortions by making the FTHBC time-limited.

Homebuyer tax credits help stabilize the real estate economy in times of crisis. The first-time homebuyer tax credits used from 2008 until mid-2010 proved to be effective market interventions. They helped stabilize the real estate economy at a time of crisis. "[W]e absorbed a tremendous amount of the standing inventory [of unsold homes]. Values came back in the United States and the housing market responded."[192] After months of record low home sales, sales rose markedly when the first-time homebuyer tax credit was available, as buyers rushed to take advantage of the incentive before it expired.[193] While proponents of the first-time homebuyer tax credit acknowledge that the policy might not significantly increase homeownership rates in the long run, the credit provided short-term economic stimulus during a housing bust.[194] In contrast, the mortgage interest deduction cannot help stabilize crisis economies, and even contributes to them by artificially inflating home prices during real estate bubbles.

Homebuyer tax credits better avoid price capitalization. Since homebuyer tax credits generally only provide incentives to buyers who have not previously owned homes and since they are time-limited, they only increase demand in a share of the total market and only for a short period of time, within which prices are less likely to respond with full price capitalization. Additionally, since sellers have an incentive to close their deals before the credits expire, they have an incentive to keep their prices low while credit is available.

Homebuyer tax credits are easy to change and properly subject to periodic review. One important indicator that the FTHBCs used from 2008 to mid-2010 were successful policies is the fact that they expired. While these credits were twice renewed and expanded during a period of economic crisis, they ended in June 2010. Lawmakers allowed the credits to expire despite strong pro-homeownership attitudes, the financial interests of their constituents and pressures from the housing industry. The same pressures that have kept the mortgage interest deduction in place for decades, despite its huge expense and ineffectiveness, did not keep the homebuyer tax credits in effect. Given the benefits of short-term interventions and the harms of long-term interventions in the real estate market, the expiration of the FTHBC is proof of its policy advantage over the mortgage interest deduction.

Targeted tax incentives like the first-time homebuyer tax credit, which are payable in full around the time of purchase, should be used immediately in an effort to stabilize the housing market as the mortgage interest deduction is phased out and reverse-capitalization decreases home prices. These targeted tax incentives should also be used in periods of significant instability in the housing market. They should not be used to artificially inflate housing prices or to support unstable housing bubbles. In order to guard against the risk that they will be used to artificially inflate housing prices, these incentives should be presumed inappropriate except when the rate of foreclosures is high or when there is an oversupply of bank-owned properties on the market. Tax incentives for homeownership should be used to address market crashes, but should not be used, as the mortgage interest deduction has been, as a permanent intervention into the market.

C. CRITIQUES

While there are risks associated with eliminating the mortgage interest deduction,[195] these risks do not justify continuing a deduction that is ineffective at promoting homeownership and is extremely expensive.[196]

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195. Those who support continuation of the mortgage interest deduction often argue that homeownership should be encouraged because homeowners are more invested in and do more for their communities. They argue that because homeowners have both personal and financial interests in the community, they work harder than renters to keep their communities strong and, therefore, home values high. For example, economists have argued that "the homeowner has a powerful financial incentive to play an active role in dealing with some social problems that we, as citizens, must address collectively." Joseph W. Trefzger, *Why Homeownership Deserves Special Tax Treatment*, 26 REAL EST. L.J. 340, 345 (1998). While there is a lively debate about whether high rates of homeownership improve communities, with proponents saying that homeowners better maintain their homes and gardens, support their local schools and participate more in local politics and opponents saying that homeowners prefer geographic segregation of races and classes, cause urban sprawl and support restrictive zoning measures that inflate housing prices, this debate is only relevant if the mortgage interest deduction actually increases the rate of homeownership. Since the evidence overwhelmingly indicates that the mortgage interest deduction does not increase rates of homeownership, this article will not address critiques based on the assumption that it does. *See*, *e.g.*, Glaeser & Shapiro, *supra* note 52, at 5-6 (discussing correlation of homeownership with better maintenance of the housing stock, higher levels of local voting, support for school spending, opposition to social welfare and hospital spending and "more aggressive" opposition to "racial integration"); Gale et al., *supra* note 61, at 1177 (arguing that "while there are some compelling arguments in theory for external benefits from homeownership, there is little evidence in practice to support those arguments. That does not prove that the arguments are wrong, but the burden should be on advocates of homeownership subsidies to make the case, and that case has not yet been made in a compelling fashion.").

196. On the opposite end of the spectrum from mortgage interest deduction proponents are tax theorists who argue that even if the mortgage interest deduction is eliminated, the tax treatment of homeownership still violates horizontal equity and offends notions of income and wealth. They point out that the most significant tax incentive provided to homeownership is not a credit or a deduction but an omission. The tax code does not tax imputed rental income—the benefit enjoyed by a homeowner for the right to live in her own home. Landlords receive rent from tenants (paid by tenants with after-tax dollars) but must pay income tax on the rent they receive. In contrast, homeowners live in their homes without paying income tax on the fair market value of the rent. Several other countries avoid this inequitable treatment of landlords

1. Home Prices Will Fall

One risk of eliminating the mortgage interest deduction is the risk of declining home prices. The deduction should be reduced gradually over time to slow the reverse-capitalization of housing prices and avoid a housing bust. Further, the housing market should be monitored carefully for signs of instability. While some drop in home prices is to be expected (and likely is a necessary result of eliminating the incentive), significant increases in mortgage default rates or in the supply of bank-owned homes remaining on the market for extended periods of time would indicate that additional housing incentives were appropriate. However, for the reasons detailed throughout this paper,

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(who we anticipate pass on their increased tax costs to their tenants) and homeowners by taxing the homeowners on the imputed rental value of their homes. *See*, *e.g.*, Gale et al., *supra* note 61, at 1182 tbl. 6 (explaining that Switzerland, Sweden and the Netherlands are among the countries that tax imputed rent). Solving the problems created by the mortgage interest deduction by taxing imputed rental income appears to be an elegant and intellectually satisfying solution. Horizontal equity can be restored and homeowners can properly continue taking the mortgage interest deduction (indeed they should be able to deduct the entire mortgage payment—income and principal—as an ordinary and necessary cost of earning the imputed rental income) while paying a more fair share of taxes. However, in addition to the valuation problems of this proposal, it would lead to dramatic increases in the cost of housing at an inopportune time. "Taxing net imputed rent would lead to substantially higher tax burdens for homeowners. Average taxes would rise by almost $1900, and age 50+ households making $250,000 or more would owe $10,000 or more in additional taxes." Poterba & Sinai, *supra* note 83, at 9. The notion of most upsetting the reliance of taxpayers who have lived in their homes for many years and paid off significant portions of their mortgages with significant tax increases seems unfair and potentially economically devastating. More importantly, like the mortgage interest deduction, taxation of imputed rental income is dangerous economic policy because it is insensitive to market conditions. Taxation of housing would depend only on the fair market value of rent and the taxpayer's marginal rate, leaving insufficient flexibility. While the mortgage interest deduction stands in the way of properly decreasing incentives during periods of economic boom, the taxation of imputed rental income would stand in the way of properly increasing incentives during periods of economic bust. While a detailed discussion of taxation of imputed rent is beyond the scope of this article, such a discussion is provided in William Mathias, *Curtailing Economic Distortions of the Mortgage Interest Deduction,* 30 U. MICH. J.L. REFORM 43 (Fall 1998).

housing incentives in the form of time-limited homebuyer tax credits will more effectively address a housing bust.

Fortunately, homebuyer tax credits are more suited to current economic conditions. William Wheaton, Economics Professor from the Massachusetts Institute of Technology recently argued that the primary threat in our current real estate economy is not the drop in prices but the increase in foreclosures. The foreclosure crisis, he argued "just keeps dumping houses on the market. And the problem is that there's not enough first-time buyers left in the current situation to absorb those houses once they get in the market."[197] Luckily, the first-time homebuyers needed to restore stability in the housing economy will not be significantly affected by reductions in the mortgage interest deduction.[198] Given that the glut of foreclosed homes is the most significant threat to the current real estate economy, and that lower- and middle-income first-time homebuyers are the potential solution, the mortgage interest deduction can be phased out at the same time as the current real estate market is stabilized by homebuyer tax credits.

Unfortunately, it is reasonable to anticipate that some price reduction will occur as the mortgage interest deduction is eliminated.[199] However, available information from the U.K. indicates that this risk may be overstated. Like the U.S., the U.K. initially provided tax subsidies for personal interest. In 1974, the U.K. eliminated tax subsidies for most forms of personal interest, but retained a deduction for mortgage interest on a taxpayer's principal residence, provided that the interest was on a loan up to £25,000.[200] The limit was raised to £30,000 in 1983, however, since it was not indexed for inflation, it stayed fixed and affected an increasing number of homeowners over time.[201] By 1995 to 1998, two-thirds of new mortgage originations were

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197. William Wheaton interview with Robert Siegel, NPR, July 20, 2011, *available at* http://www.npr.org/2011/07/20/138555793/mit-professor-discusses-mortgage-deduction-reform?ft=1&f=2.

198. *Id.*

199. *See* Robert J. Aalberts, *Will the Mortgage Interest Tax Deduction Ever Be Eliminated?*, 40 REAL EST. L.J. 1, 2 (2011) ("Although few think of the deduction as a type of subsidy for those who own real estate, that's precisely what it is. And a subsidy always increases the price that someone has to pay, including buyers of real estate.").

200. Gale et al., *supra* note 61, at 1180; Hendershott et al., *supra* note 99, at 6.

201. Gale et al., *supra* note 61, at 1180; Hendershott et al., *supra* note 99, at 6.

above the cap.[202] Increasing mortgage balances and other factors meant that the mortgage interest deduction became less valuable to U.K. taxpayers over time. "Because of inflation, declining interest rates, and lower subsidy rates, the value of the [mortgage interest deduction in the U.K.] fell by about 90 percent between 1974 to 1996."[203] In an action that compounded the already declining value of the deduction, the U.K. government then decided to phase-out the mortgage interest deduction entirely. The mortgage interest deduction was initially allowed at the taxpayer's marginal income tax rate but "beginning in 1993, the maximum rate at which interest under that [£30,000] ceiling could be deducted was reduced in four steps to zero in 1999."[204] Since 1999, the U.K. has not allowed a deduction for mortgage interest. The elimination of the mortgage interest deduction did not decrease rates of homeownership in the U.K.[205]

Even more encouragingly, real estate prices stayed high in the U.K. during and after the elimination of the deduction. Like the U.S., the U.K.

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202. Hendershott et al., *supra* note 99, at 6.

203. Gale et al., *supra* note 61, at 1181.

204. Hendershott et al., *supra* note 99, at 6 ("[T]he maximum tax rate at which interest could be deducted was cut from the 40 percent maximum income tax rate to 25 percent in 1992, to 20 percent in 1994, to 10 percent in 1995, and finally to zero in 1999.").

205. There is no indication that the elimination of the mortgage interest deduction negatively affected homeownership rates in the U.K. Between the early 1970s and 1996, the value of the mortgage interest deduction fell by about 90 percent, and yet homeownership rates steadily increased. *See* Dep't of Communities and Local Gov't, Live Table on Household Characteristics http://www.communities.gov.uk/housing /housingresearch/housingstatistics/housingstatisticsby/householdcharacteristics/livetabl es/ (last visited Aug. 5, 2011) (follow "Table 801: Tenure Trend" hyperlink) (In 1971, 51 percent of UK citizens lived in owner occupied homes. By 1996, that number had grown to 68.5 percent). From 1993 to 1999, when the U.K. mortgage interest deduction was formally phased out, U.K. homeownership rates increased from 68.3 to 69.9 percent. *See id*. This was not simply because the decline in homeownership was delayed. "Between 1981 and 2004, the British homeownership rate rose 13 percentage points . . . [while] U.S. homeownership rates rose by less than 4 percentage points over the same period." Gale et al., *supra* note 61, at 1181. Even accounting for the variety of factors that affect homeownership rates in one country versus another country "the double-digit increases in the homeownership rate during the same period as huge reductions in mortgage subsidies is striking evidence against a large effect from the [mortgage interest deduction]." *Id.*

experienced dramatic increases in home prices from 1997 to 2006.[206] While the U.S. and U.K. both experienced declines from 2006 to 2009,[207] U.S. home prices declined more significantly than U.K. home prices.[208] The U.K. eliminated its mortgage interest deduction during a period of economic growth and the elimination of the incentive did not prevent that growth.

While it should be anticipated that U.S. home prices could decrease in response to the elimination of the mortgage interest deduction, such decreases can be countered through time-limited tax credits and direct expenditure programs.[209] Even if the risk of reverse-capitalization and depreciation in home prices is high, however, maintaining the mortgage interest deduction in order to avoid price reductions in housing is economically unsupportable. Artificially inflated housing prices are risky, "possibly leading to larger boom and bust cycles."[210] Further, the mortgage interest deduction becomes a more expensive tax expenditure each year. Thus, we are not only maintaining levels of inefficient price capitalization with our current tax policies, we are increasing these levels each year. While price reductions may be stabilized by a gradual phase-out of the mortgage interest deduction and the simultaneous use of homebuyer tax credits, the fear of price reduction should not cause the continuation of an ineffective incentive.

2. *Taxpayer Reliance*

Another concern about eliminating the mortgage interest deduction is the apparent unfairness of taking away a long-standing incentive after taxpayers have innocently and reasonably relied on its existence. For as

206. FCIC MORTGAGE CRISIS REPORT, *supra* note 89, at 16.

207. *Id.*

208. *Id.* at 17 fig.9 (showing international home prices 1997-2009).

209. *But see* 2005 PRESIDENT'S ADVISORY PANEL, *supra* note 26, at 59 (arguing that because the economy-wide tax rate on housing investment is close to zero, compared with a tax rate of approximately 22 percent on business investment, and 26 percent on corporate investment, the "disproportionately favorable treatment under the tax code" for real estate investment may inefficiently reduce investment in these other sectors).

210. *See* TREASURY AND HUD REPORT TO CONGRESS, *supra* note 1, at 25 ("Government support makes investment in housing more attractive . . . it can inflate the value of housing assets, possibly leading to larger boom and bust cycles.").

long as the income tax has existed, so has the mortgage interest deduction. Taxpayers who purchased homes based on the support provided by the mortgage interest deduction will be harmed by the change. It may feel unfair to have intentionally incentivized their behavior only to change the rules. For example, David Lereah, Chief Economist for the National Association of Realtors, argues that even if the mortgage interest deduction is a flawed incentive, it should not be repealed now that taxpayers have relied on it. "If you're rewriting the book of Genesis[,]" he says, "I might have a different approach. But if you make changes in the middle of the game, it's going to have a negative impact on the value of property . . . reduce people's retirement nest egg, funds they have available for college. You're going to cause a great dislocation."[211] Although this is also to some extent a fair criticism, the criticism needs to be weighed against the benefits of elimination.

The taxpayer reliance critique should not be overstated. A taxpayer who significantly relies on a certain amount of anticipated mortgage interest deduction is either a financial expert, tax expert and policy expert combined, or is relying not on a known value but a vaguely estimated one. For any taxpayer with a fixed rate mortgage, the value of the mortgage interest deduction is expected to decline over time as mortgage payments consist of a smaller share of interest and a larger share of principal. At some point, the amount of mortgage interest will decline so significantly that the standard deduction will exceed the potential mortgage interest deduction and the tax incentive will be lost. Second, the value of the deduction will change as the taxpayer moves marginal tax rates (which can occur either because the taxpayer's taxable income changes or because the government changes the rate schedule). Third, for many taxpayers, existing policies already upset their expectations of value. For example, many first-time homebuyers likely are surprised when they receive no deduction for the first year of homeownership due to their late-in-the-year purchases. Similarly, taxpayers with adjustable rate mortgages ("ARMs") not only experience changes in the interest rates on their mortgage, but experience changes in the amount of potentially-deductible mortgage interest they pay. Finally, taxpayers who become liable for the Alternative Minimum Tax

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211. Roger Lowenstein, *Who Needs the Mortgage-Interest Deduction,* N.Y. TIMES, Mar. 5, 2006.

are very likely to have their expectations regarding the value of the mortgage interest deduction upset.[212] While upsetting taxpayer reliance is never ideal, even current policies upset taxpayer reliance in significant ways. This harm should be minimized—for example, by gradually phasing out the mortgage interest deduction until its eventual elimination—but must be worked through.

3. Public and Political Opposition

A final critique of eliminating the mortgage interest deduction is that the public will not support its elimination.[213] There is no doubt that the mortgage interest deduction is an incredibly popular tax incentive. A recent article in The New York Times included a poll showing that about 90 percent of Americans support the mortgage interest deduction.[214] However, that support likely reflects the public's lack of key information about the deduction. Many Americans probably do not know that the mortgage interest deduction decreases revenue by hundreds of billions of dollars each year, that the expenditure is

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212. Under the AMT, acquisition indebtedness is deductible but home equity indebtedness is not.

213. *See, e.g.*, Kristen McGovern Painter, Note, *There's No Place Like Home: Projections on the Fate of the Home Mortgage Interest Deduction and the Alternative Minimum Tax in Light of Consumer Behavior,* 22 ST. JOHN'S J. LEGAL COMMENT 295, 329 (2007) (those who favor limiting the mortgage interest deduction "should also realize that Americans are not willing to sacrifice their preferences, such as luxury vacation homes or the ability to take out home equity loans to improve their residences."); Mark Andrew Snider, *The Suburban Advantage: Are the Tax Benefits of Homeownership Defensible?,* 32 N. KY. L. REV. 157, 178-80 (2005) ("There is strong democratic appeal in supporting these homeownership tax provisions because, ultimately, these provisions represent the will of the people of the United States, as evidenced through the votes of their elected Congressmen. . . . These homeownership Code provisions are politically sacred and it is likely that without them the Code would be politically untenable. While academics may debate whether homeownership Code provisions fit into the Haig-Simons definition of 'income' and whether the benefits of homeownership amount to 'tax expenditures,' the answer is ultimately irrelevant because the existing Code would be politically impossible without these provisions.").

214. McCabe, *supra* note 31 (including polls finding that more than 90 percent of Americans support the mortgage interest deduction and separate polls finding that 72 percent of Republicans and 59 percent of Democrats oppose efforts to eliminate the deduction); Leonhardt, *supra* note 25.

growing, that only 23 percent of Americans receive any benefit from the mortgage interest deduction,[215] that the vast majority of benefits are enjoyed by the highest income taxpayers, that the mortgage interest deduction has not increased rates of homeownership and that it likely has decreased the affordability of housing. For an issue this expensive, the mortgage interest deduction has received little critical debate.

The lack of scrutiny, by politicians and the public, evidences another flaw of the mortgage interest deduction. As a tax expenditure, rather than a direct expenditure, the mortgage interest deduction is more difficult for the public to understand and is dangerously insulated from an appropriations process that might otherwise expose its flaws. Direct subsidies are politically responsive because they "are continually being assessed as to their effectiveness (in terms of achieving objectives), efficiency (in terms of cost-benefit relationships), equity (in terms of social welfare achieved), and overall priority (in terms of a proper allocation of resources)."[216] Each year, a budget must be written in which various direct expenditures come under fire and must be balanced against multiple proposed alternative uses of available funds. Unlike direct expenditures, tax expenditures do not go through a direct appropriations process each year. "They continue and often expand with no congressional vote."[217]

In her 2010 Annual Report to Congress, the National Taxpayer Advocate observed that while tax expenditure programs are similar to direct spending programs in terms of their impact on beneficiaries,[218]

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215. Leonhardt, *supra* note 25.

216. Stanley Surrey & Paul McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, 287-88 (1979).

217. *Tax Policy Briefing Book, A Citizens' Guide for the 2008 Election and Beyond*, TAX POLICY CENTER, I-8-6 (last visited Aug. 4, 2011), http://www.taxpolicycenter .org/briefing-book/TPC_briefingbook_full.pdf; *Section 6 – Evaluating the Administration of Tax Expenditures,* TAXPAYER ADVOCATE SERV. - 2010 ANNUAL REPORT TO CONGRESS – VOLUME ONE, 104 (May 11, 2011), http://www.irs.gov/pub/irs-utl/vol_1_msp_6_15_taxpayerrights.pdf [hereinafter TAXPAYER ADVOCATE REPORT SECTION 6] ("Tax expenditures continue to proliferate, yet measures of their effectiveness are lacking. Approximately one quarter of government spending consists of tax expenditures.").

218. *See* TAXPAYER ADVOCATE REPORT INTRO, *supra* note 10, at 9 n.37 ("When Congress wishes to spend money, it may do so in either of two ways. It can make

impact on the deficit and policy goals, "the effect of tax expenditures in achieving these goals is rarely studied."[219] She specifically called out the ineffectiveness of the mortgage interest deduction as an example of how tax expenditures are not sufficiently scrutinized. As she explained, "a major justification for the home mortgage interest deduction has been a 'desire to encourage homeownership.' However, economic research has shown that the deduction 'does little if anything to encourage homeownership. Instead it serves mainly to raise the price of housing and land and to encourage people who do buy homes to borrow more and to buy bigger homes than they otherwise would.'"[220]

A key lesson from the long-standing failure of the mortgage interest deduction is that incentivizing behavior through tax expenditures insulates those incentives from political scrutiny. This insulation is extremely risky. In contrast to direct expenditures, the mortgage interest deduction has felt to the public and politicians like a benefit they receive

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expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. This latter category of spending is referred to as 'tax expenditures.' A tax expenditure is essentially any reduction in income tax liability that results from an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate or deferral of tax. As a practical matter, a tax expenditure has the same impact as a government spending program. Assume that an individual facing a 25 percent tax rate pays $10,000 in mortgage interest and that the government wants to provide a subsidy for homeownership. It could accomplish this objective in two ways: (1) it could allow the taxpayer to deduct the $10,000 of mortgage interest from his gross income, which would produce a tax reduction of $2,500, or (2) it could make a direct payment of $2,500 to the taxpayer in lieu of the tax deduction. The taxpayer ends up in the same economic position either way."). Note, however, that this example assumes the taxpayer is already itemizing his deductions. If not, the value of the mortgage interest deduction will be less than $2500 because the taxpayer will have to forego the standard deduction in order to qualify for the mortgage interest deduction.

219. TAXPAYER ADVOCATE REPORT SECTION 6, *supra* note 217, at 107 ("Tax expenditures are similar to spending programs in their impact on the deficit; and like spending, are established to achieve specific national objectives. However, the effect of tax expenditures in achieving these goals is rarely studied.").

220. *Id.* at 118 (citing Gale et al., *supra* note 61, at 1171); 2005 PRESIDENT'S ADVISORY PANEL; NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH: REPORT OF THE NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM 30-31 (Dec. 2010), http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform (recommending reduction of the mortgage interest deduction).

for nothing. In fact, it has cost billions of dollars in lost revenue each year. It is hard to conceive of why the mortgage interest deduction, which is well supported by broad special interests and the highest-income taxpayers, should qualify for such undemocratic special treatment. Rather, the use of direct expenditures for housing consumption exposes these incentives to far greater public and political debate. Similarly, first-time homebuyer tax credits that include expiration dates would be democratically tested each time they were extended.

There are certainly critics who will say that even if Americans were fully informed about its cost and impacts, they would continue to support the mortgage interest deduction because of their overwhelming belief that homeownership is the American Dream. However, Americans recently experienced a huge housing bubble that sparked a collapse not only of the housing market, but of economic markets generally. The recent economic crisis has appropriately led Americans to question, largely for the first time, their assumptions regarding homeownership. In the first quarter of 2011, a majority of Americans, 66 percent, believed that homeownership was a safe investment.[221] While still high, that number represents a significant decline. In 2003, 83 percent of Americans believed that homeownership was a safe investment. This reflects a 17 percent decline in eight years.[222] Younger Americans are the least likely to see homeownership as a safe investment, indicating that a further decline in attitudes about homeownership might be coming.[223] The economic crisis has taught us that homeownership is not as safe an investment as we previously believed, meaning that now may be a time of relative openness to considering new policies. Further, even those Americans who still strongly believe in the value of homeownership should be open to

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221. FANNIE MAE, FACT SHEET: FANNIE MAE NATIONAL HOUSING SURVEY KEY FINDINGS FIRST QUARTER 1 (May 11, 2011), http://www.fanniemae.com/media/pdf/2011/Housing-Survey-Fact-Sheet-q12011.pdf.

222. *Id.*

223. FANNIE MAE, PRESENTATION ABOUT NATIONAL HOUSING SURVEY slide 119 (May 11, 2011), http://www.fanniemae.com/media/survey/index.jhtml (follow "Presentation About National Housing Survey" hyperlink) (thirty-six percent of Generation Y survey participants described buying a home as a risky investment).

arguments that alternative policies will be far better at achieving higher rates of homeownership.

Other critics will point to the self-interest of the large number of Americans who enjoy the benefit of the mortgage interest deduction or believe that they will enjoy this benefit in the future as a barrier to repeal. Accounting for the human tendency to believe that our extreme prosperity is just around the next turn, many Americans will support the mortgage interest deduction either because they are rich or because they believe that they will become rich.[224] However, recent polling indicates that Americans do not intentionally support housing subsidies for the wealthy. As a recent New York Times article explained, "[t]he mortgage interest deduction benefits the set of households that Americans think are least deserving of federal homeownership subsidies. Twenty-six percent of respondents in the Times/CBS poll prefer that low-income homebuyers benefit from federally subsidized home loans. Twenty-four percent prefer that all homebuyers reap the rewards, regardless of their income. And 15 percent believe that middle-class Americans should be the beneficiaries of federal subsidies for homeownership. Although wealthy Americans disproportionately benefit from the mortgage interest deduction, only 1 percent of Americans believe high-income homebuyers should receive federally subsidized home loans."[225] The mortgage interest deduction subsidizes home loans for the group of taxpayers that Americans least want to subsidize.

Certainly critics can dispute the relevance of this polling data, noting that it is easy to check a box indicating support for the poor while it is much more difficult to forgo actual financial benefit in favor of the poor. With that acknowledged, however, the American public has put its money where its mouth is on the subject of housing policy. In the politically-responsive direct expenditure process, incentives for homeownership generally are not aimed at benefiting high-income citizens, but provide significant benefits to low-income citizens, middle-income citizens and citizens from certain defined service classes

224. This human tendency is often cited as a reason why many Americans oppose the estate tax even though it applies only to the extremely wealthy.

225. McCabe, *supra* note 31.

(including veterans).[226] If the mortgage interest deduction was a direct spending item rather than a tax expenditure program, it is hard to imagine that it would receive such high rates of public and political support. "It is difficult to conceive of a defense for a direct spending program that would pay nearly 40% of the cost of a second home for a millionaire[227] while providing no benefit to the average family making less than $42,500."[228] Were the cost, distribution and effect of the mortgage interest deduction more widely known, support for the deduction likely would erode.

Finally, despite the widespread public support for the mortgage interest deduction, the deficit crisis has put it on the political chopping block. The National Commission on Fiscal Responsibility and Reform (commonly known as Bowles-Simpson) proposed a significant reduction to the size and value of the mortgage interest deduction. Under its proposal, mortgage interest would receive a 12 percent credit (rather than a deduction at the taxpayer's marginal income tax rate, which is currently up to 35 percent), interest would be deductible only up to a mortgage cap of $500,000 and the interest on mortgages for second homes would no longer be deductible.[229] While the Bowles-Simpson recommendations did not receive the necessary votes to reach Congress, the mortgage interest deduction is now being challenged by other politicians.

The current administration has proposed reductions to the mortgage interest deduction. In a speech on April 13, 2011, President Barack Obama explained that we must "reduce spending in the tax code . . . the

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226. *See, e.g.*, Gale et al., *supra* note 61, at 1175 ("real federal spending for low-income housing rose substantially between 1970 and 2005.").

227. This estimate is a bit high. The highest marginal income tax rate for 2012 is 35 percent. In the first year of a thirty-year-fixed-rate mortgage, most (but not all) of payments are interest. Thus, a more accurate current estimate is that the mortgage interest deduction pays about 25 percent of the mortgage payment made by a millionaire on his second home unless that millionaire is subject to the alternative minimum tax.

228. William Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. MICH. J.L. REFORM 43, 62 (1998).

229. *The Moment of Truth*, REPORT OF THE NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM, 31 (Dec. 2010), http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

tax code is loaded up with spending on things like itemized deductions. And while I agree with the goals of many of these deductions, like homeownership and charitable giving, we cannot ignore the fact that they provide millionaires with an average tax break of $75,000 while doing nothing for the typical middle-class family that doesn't itemize."[230] President Obama has proposed capping the value of itemized deductions (including the mortgage interest deduction) for single taxpayers with more than $200,000 annual income and married couples with more than $250,000 combined annual income.[231] Under his proposal, the value of all itemized deductions would be capped at 28 percent, rather than the taxpayer's marginal rate.[232]

Finally, in a July 2011 report, the bipartisan deficit reduction panel commonly known as The Gang of Six, also recommended cuts to the mortgage interest deduction.[233] The report used a proposed reduction in tax expenditures to fund elimination of the alternative minimum tax and reduction in the highest marginal tax rates.[234] It received broad political support[235] despite proposing a reduction to the mortgage interest deduction.

Whether or not the mortgage interest deduction is well-liked by the public, and therefore by politicians, the current economic climate has forced many leaders to advocate reducing it. These leaders should provide the public with information about its cost and effects. Such information likely would erode public support for the mortgage interest deduction.

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230. Barack Obama, President of the United States, Remarks at George Washington University (Apr. 13, 2011).

231. *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals,* DEP'T OF THE TREASURY, 131 (Feb. 2011), http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf.

232. *Id.* at 132.

233. Stephen Ohlemacher, *'Gang of Six' Debt Deal Targets Mortgage Deduction,* SEATTLE TIMES, July 20, 2011, *available at* http://seattletimes.nwsource.com/html/businesstechnology/2015676503_debt21.html.

234. *Id.*

235. John Nichols, *"Gang of Six" Plan? "Not So Fast" Says Bernie Sanders,* THE NATION THE BEAT BLOG, July 19, 2011, http://www.thenation.com/blog/162166/gang-six-plan-not-so-fast-says-bernie-sanders ("[T]he cheerleading for the "Gang of Six" plan is considerable and enthusiastic.").

CONCLUSION

The mortgage interest deduction is widely believed to be America's favorite tax deduction. Instead of carefully evaluating its effectiveness, politicians pledge allegiance to the American dream of homeownership and continue this incentive. Unfortunately, the failure to evaluate its effectiveness has been a costly oversight. The mortgage interest deduction costs nearly $120 billion annually in lost revenue. Yet international comparisons, interstate comparisons, time comparisons and economic projections show that the mortgage interest deduction fails to promote homeownership. Instead, it inflates housing prices, encourages excessive borrowing and contributes to instability in the real estate economy.

The housing bubble of 2006, and the economic collapse that followed it, provide a window of opportunity and the current deficit crisis provides a necessary motivation to repeal the mortgage interest deduction. While many Americans still believe that homeownership is a valuable goal, their belief has recently and dramatically weakened. For the first time in years, many Americans have experienced losses in their home values and some have experienced the tragedy of foreclosure. In truth, the mortgage interest deduction did not cause them to purchase their homes, did not help them stay in their homes, inflated an unsustainable housing bubble and contributed to a damaging bust in the real estate market. Instead of perpetuating this costly and ineffective incentive, Congress should repeal it in its entirety. Congress should replace the mortgage interest deduction with targeted, market-responsive, time-limited homebuyer tax credits that avoid the failures of the mortgage interest deduction.