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The Richer You Are, The Larger The Tax Break

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Tax breaks! Everyone loves them – who wouldn't? There are many common tax breaks we use and see every day: Child tax credit, solar panels, giving to charity, healthcare premiums…and one of the most popular, the mortgage interest deduction.

The mortgage interest deduction is now recognized as an important government program that helps more Americans afford homes. In 1984, President Reagan even described the mortgage interest deduction as symbolic of the American dream.

With any government program, the merits of these tax breaks are now coming to the forefront of subsidiaries debate. The third largest of these tax breaks by aggregate dollars, the mortgage interest tax deduction, which, at an annual estimated cost of $77 to $100 billion, allows people to deduct the cost of paying interest on a home loan— has come under scrutiny recently.

The mortgage interest deduction is perceived as helping the middle class afford homes. Yet government officials who do not hold elected office, whether Republican, Democrat, or technocrat, believes that the mortgage interest deduction is an outdated policy that does more to subsidize the wealthy's vacation homes than to help the middle class obtain housing at affordable total cost of ownership. It influences how we invest our money and where we live, at times in a negative way.

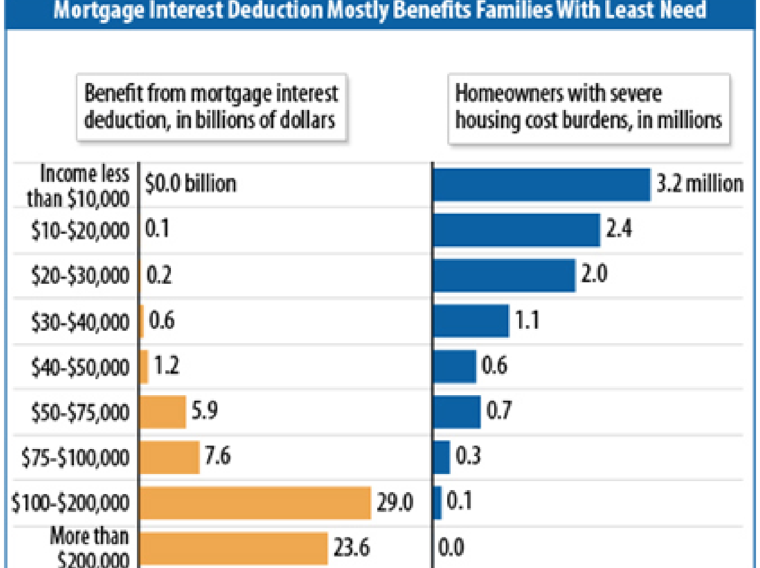
On the outlier, the mortgage interest deduction does not raise home ownership rates much, if at all, and there is not much clear data on that particular variable influencing ownership rates. Countries like Canada, the United Kingdom, and Australia have no subsidies for mortgage debt, yet their home ownership rates are slightly higher than ours. Many new U.S. homeowners do not itemize or are in the 15 percent bracket or lower, so the mortgage interest deduction provides little or no current benefit to them anyway.

At the same time, approximately 77 percent of the benefits from the mortgage interest deduction went to homeowners with incomes above $100,000, most of whom face severe housing cost burdens. This is defined as people whom housing is greater than 42.5% of their gross income. Some 35 percent of the benefits went to homeowners with incomes above $200,000; taxpayers in this income group who claimed the deduction received an average subsidy of about $5,000 per year.

Ultimately, the deduction's value depends on a household's marginal tax rate, so households in higher tax brackets benefit more. To see why, consider this example of two households. A physician making $275,000 who has a $1 million mortgage and pays $40,000 in mortgage interest each year receives a housing subsidy of about $14,000 annually from the mortgage interest deduction. The physician pays about 65 cents per dollar of mortgage interest, and the taxpayers pick up the remaining 35 cents. By contrast, a schoolteacher making $45,000 and paying $10,000 a year in mortgage interest on a more modest home receives a housing subsidy worth $1,500 annually. Here, the family pays 85 cents of every dollar of mortgage interest and taxpayers pick up 15 cents. The physician's subsidy is not only larger than the teacher's in dollar terms, but also represents a greater share of the physician's mortgage interest expenses.

Interesting outcomes…mainly that the higher up the wealth bracket a homeowner is, the more incentives available and the large wealth building effect of the subsidiary.

Figure 1
Mortgage Interest Deduction Mostly Benefits Families With Least Need



Note: Households are considered severely cost burdened if they pay more than half of their income for housing. Incomes for mortgage interest deduction benefits are for tax filing units, and incomes for homeowners with severe housing cost burdens are for households

Source: Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017 (data shown are for 2012), and CBPP tabulations of data from the American Housing Survey (data shown are for 2011).

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1. Brookings Institution. www.brookings.edu

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