MISDIRECTED INVESTMENTS:

How the Mortgage Interest Deduction Drives Inequality and the Racial Wealth Gap

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A joint report by:
Institute on Assets and Social Policy (IASP) &
National Low Income Housing Coalition

NATIONAL LOW INCOME HOUSING COALITION

IASP

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IASP Mission

The Institute on Assets and Social Policy (IASP) is a research institute that advances economic opportunity and equity for individuals and families, particularly households of color and those kept out of the economic mainstream. Our work furthers the understanding that assets and wealth are critical to household well-being and all families should have access to the resources and opportunities needed to participate fully in social and economic life. Working at the intersections of academia, policy, and practice, IASP partners with diverse communities to transform structures, policies, and narratives. Grounded in a social justice tradition, our research informs strategic action for racial and economic justice to achieve an inclusive, equitable society.

About NLIHC

The National Low Income Housing Coalition is dedicated solely to achieving socially just public policy that assures people with the lowest incomes in the United States have affordable and decent homes.

Founded in 1974 by Cushing N. Dolbeare, NLIHC educates, organizes and advocates to ensure decent, affordable housing for everyone.

Our goals are to preserve existing federally assisted homes and housing resources, expand the supply of low income housing, and establish housing stability as the primary purpose of federal low income housing policy

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Introduction

As a nation, we value ensuring that every family has the ability and opportunity to live in stable, secure housing in a safe neighborhood. However, today our public policies supporting housing fail to invest in this ideal and instead direct billions of dollars to support the home purchases of the already well-off. Rather than helping low and middle-income households buy their first homes and maintain steady and secure housing, federal housing policy subsidizes the purchases of larger homes by high-income households who would likely buy homes without government support.

These misdirected investments are exemplified by one of our largest housing policies, the **Home Mortgage Interest Deduction**, which promotes both racial and economic inequality by distributing the lion's share of this tax benefits towards wealthy, white households, while failing to invest in lower-income households and households of color. In particular, in addition to the well-documented investments in the highest-income households (Joint Committee on Taxation, 2017), we present new evidence that black and Latino households are able to access just 6 and 7 percent of total benefits from the mortgage interest deduction respectively, despite the fact that black and Latino households each make up about 13 percent of the U.S. population. This amounts to an estimated $4.8 billion in lost housing investments for black families and $4.1 billion dollars directed away from Latino families, relative to a more equitable distribution of benefits.

What can we do to ensure more equitable investments in the housing and security of all communities and families in the U.S.? Reform of the mortgage interest deduction is an important place to start. This brief provides further evidence of the ways in which the mortgage interest deduction promotes economic and racial inequality and helps to identify concrete steps for reform. Our current housing investments in the U.S. are inverted from where they need to be to support financial and housing security for all families. It's time for a U-turn in our housing investments. With growing momentum for reform of the mortgage interest deduction and tax policy on the Congressional agenda, the time is ripe to restructure our housing investments to support striving families reaching for security and to expand prosperity to all communities.

Background

Despite the housing crisis and the Great Recession, housing remains an important way that families can build wealth due to the regular savings mechanisms built into paying a mortgage. Yet, the Mortgage Interest Deduction (MID) is poorly designed to support homeownership and very costly for the federal government. One of the largest tax expenditures in the U.S. tax code, it is well-documented that the MID does not help bring households into homeownership because benefits are concentrated among high income households, rather than enhancing first-time homeownership (Fischer & Huang, 2013). The most recent estimates from the government suggest that 84 percent of benefits from the MID go to households with $100,000 or more in income (Joint Committee on Taxation, 2017), or almost twice the national median household income of $55,755 (Posey, 2016). In fact, 64 percent of benefits go to households with incomes above $200,000 (Joint Committee, 2017), exemplifying its lopsided, inequality producing function.

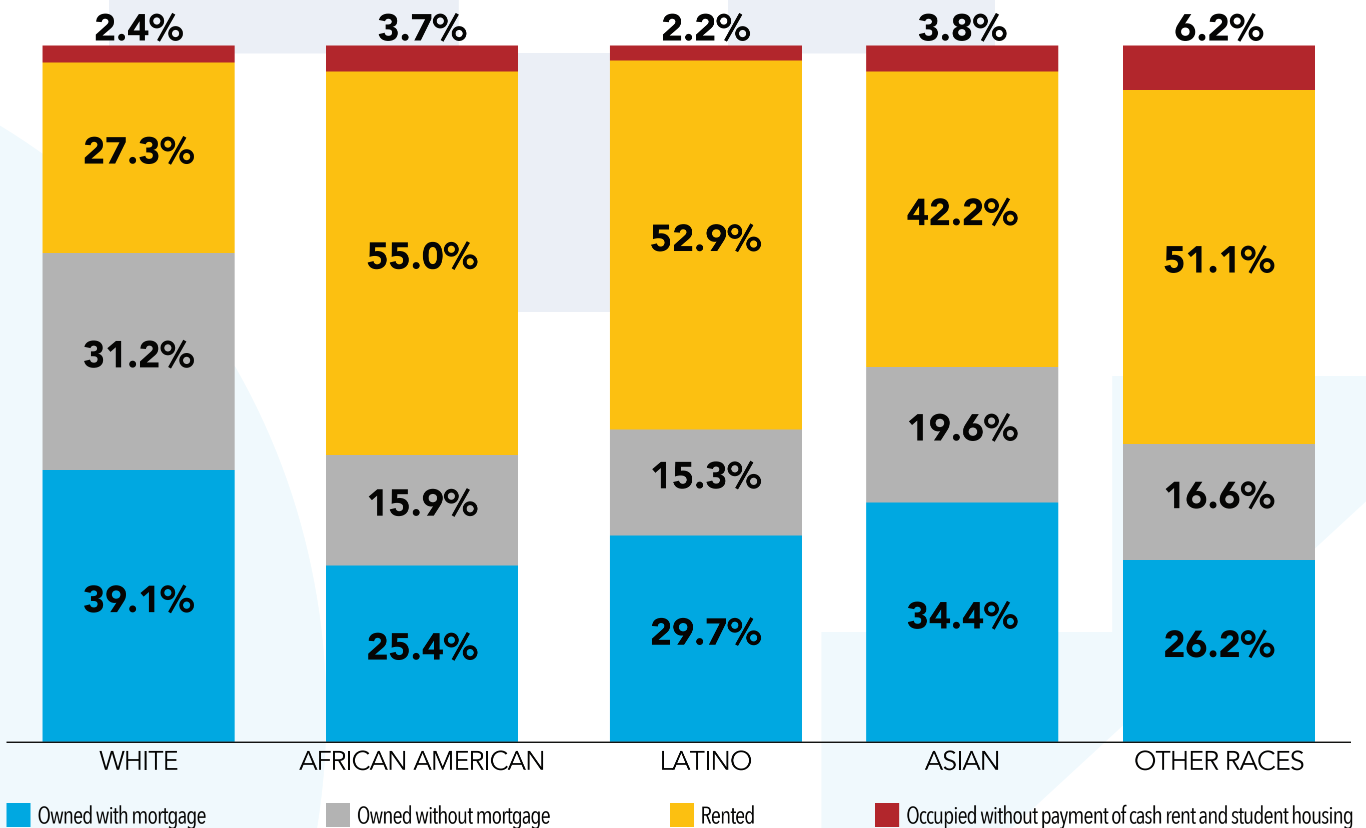
The economic inequalities in the current design and application of the MID are well understood; however, in addition to the lopsided benefits by income, the policy also is unequal by race/ethnicity. Tax data do not collect income by race/ethnicity, yet analysis of national survey data along with government data on the distribution of the benefits of the policy helps to reveal that

the MID actively exacerbates racial inequality. Thus, rather than supporting widespread prosperity and asset development, the MID serves to intensify both economic and racial inequality. By analyzing eligibility and benefits by race/ethnicity, the evidence makes clear that the policy serves to promote inequality and does not support homeownership or housing security.

Who is eligible for the Mortgage Interest Deduction (MID)?

A major reason that the mortgage interest deduction does little to promote homeownership is that it does nothing to help prospective homeowners acquire a down-payment, but instead, provides a tax benefit only to existing homeowners with a mortgage who itemize their deductions. Previous analysis by the Urban Institute revealed that zip codes with higher proportions of households claiming the MID had notably higher percentages of white and higher-income households and proportionately fewer black households and lower income households than those with fewer MID beneficiaries (Harris & Parker, 2014). These disparities result from the fact that those who have mortgage interest from a primary or second home—not homeowners without a mortgage or perspective homeowners—are eligible to take the MID. Figure 1 highlights housing tenure by race/ethnicity to reveal current disparities in homeownership—which the MID does nothing to remedy—and exposes the relatively few households that may be eligible for benefits from the MID due to being a homeowner with a mortgage.

FIGURE 1. HOUSING TENURE BY RACE/ETHNICITY



Authors' calculations of Consumer Expenditure Survey (2015).

The data highlight existing racial disparities in homeownership as well as exposing the fact that the eligible population for the MID is relatively small relative to all households in the U.S.; these data belie the image of the MID as a broad-based policy to expand homeownership.

Whites are the most likely to be eligible for the MID; however, for all groups, a majority of households do not meet the central eligibility requirement for the MID because they do not own homes with mortgages. About four in ten white households own homes with mortgages and thus MID eligible, just 25 percent of black households and 30 percent of Latino do. About a third of Asian households own home with mortgages. Since renters seeking to enter into homeownership and homeowners without mortgages cannot utilize the mortgage interest deduction, most households in the U.S. are ineligible for the policy and the percentage of households of color who are eligible is low relative to their white peers. Thus, the MID *does not* support homeownership broadly across the nation and its current design increases disparities in homeownership by race/ethnicity.

Who benefits from the MID?

In addition to the policy design focus on existing homeowners with mortgages, in order for families to benefit from the MID, their total deductions including mortgage interest need to be higher than the standard deduction for their household to get any benefit from itemizing deductions. However, in fact, 70 percent of Americans take the standard deduction meaning that even among homeowners with mortgages, if their total deductions are not greater than their household standard deduction, they get no benefit from the MID (Auxier, 2017). With higher income households more likely to have sufficient deductions to itemize due to larger home mortgage interest payments and higher state and local tax deductions, the policy fails to target most U.S. households who do not itemize. Our analysis reveals that even among homeowners with mortgages, most have less mortgage interest than the current standard deduction levels ($6,300 for individuals and $12,600 for couples (Internal Revenue Service, 2017)[1]).[2] With the vast majority of benefits going to the highest income households who are most likely to itemize deductions, the most recent estimates suggest that the federal government spends $55 billion dollars annually subsidizing homeownership for households making $100,000 per year or more (Joint Committee on Taxation, 2017).

Our analysis also suggests that the MID serves to reinforce racial inequities, rather than help expand opportunity to all households. Utilizing data from the Joint Committee on Taxation (2017) and the Survey of Income and Program Participation (SIPP),[3] our findings indicate that white households benefit much more from MID than black and Latino households relative to their proportion of the population. While whites are 67 percent of households, they gain about 78 percent of benefits from the MID. As noted above, while representing about 13 percent of households, blacks and Latinos are estimated to enjoy just 6 and 7 percent of the total MID benefits provided by the federal government. As whites are more likely to be homeowners and more likely to be among the highest income households who benefit from the MID, they disproportionately benefit from the current MID. Because the total benefits of the MID nationally represent billions of dollars, these unequally directed benefits represent billions of dollars in lost investment for families of color. Redirecting MID benefits towards a more equitable distribution would lead to billions invested in more economically vulnerable households (see Appendix).

1 Individuals over 65, who are blind, or who can be claimed as a dependent on someone else's return have standard deduction levels that differ from other tax filers and may be examined in the IRS Publication 501.

2 Our analysis of data from the Consumer Expenditure Survey finds that median annual mortgage interest payments for households with mortgages (including both single and couple households) is $6,100 per year.

3 See appendix for description of analysis methods.

TABLE 1. MORTGAGE INTEREST DEDUCTION ESTIMATED RETURNS AND PERCENTAGE OF BENEFITS FROM THE DEDUCTION BY RACE/ETHNICITY FOR HOUSEHOLDS WITH MORTGAGES (2015)[4]

	ESTIMATED NUMBER OF TAX RETURNS WITH DEDUCTION	ESTIMATED PERCENTAGE OF TAX RETURNS WITH DEDUCTION	PERCENTAGE OF TOTAL BENEFITS FROM DEDUCTION	PERCENTAGE OF HOMEOWNERS BY RACE/ ETHNICITY	PERCENTAGE OF HOUSEHOLDS BY RACE/ ETHNICITY
White	25,910,000	77.2%	77.9%	76.5%	67.4%
Black	2,350,000	7.0%	6.2%	8.5%	12.8%
Latino	2,850,000	8.5%	7.3%	9.2%	12.9%
Asian	1,940,000	5.8%	7.2%	4.1%	4.7%
Other Races	530,000	1.6%	1.5%	1.7%	2.2%
TOTAL	**33,580,000**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Thus, this policy serves to consolidate benefits among households that are already relatively financially secure, while reinforcing enduring economic disparities by race/ethnicity that have been a part of the fabric of our society for generations. Instead of combating existing racial inequalities by race/ethnicity which have been bolstered by past and current policy decisions (Sullivan et al., 2015), the MID serves to reinforce them.

How the Mortgage Interest Deduction is poorly designed to help expand homeownership

As noted, the design of the MID (and many other tax expenditures for housing) do little to help low and moderate-income households because they are only available to households who already own a home and only benefit those households that itemize their deductions. In addition, the benefits of deductions rise for households with higher tax rates, so that even among households with similar amounts of deductions, higher income households amass greater benefits. Given all of the ways in which the MID is inappropriately structured to support homeownership, it is not surprising that despite common perceptions to the contrary, the MID was never intentionally developed as a policy to expand homeownership. In fact, the policy was just a part of the general exclusion of personal interest that was included in tax policy when the federal income tax was created in 1913 (Ventry, 2010). Thus, it is not particularly unexpected that the MID is not successful at expanding homeownership, when it was never designed to do so. In fact, recent quasi-experimental research conducted after a major reform of a mortgage deduction policy in Denmark estimates that a mortgage interest deduction policy has no impact at all on homeownership and instead serves to incentivize indebtedness and the purchase of larger homes (Gruber, Jensen, & Kleven, 2017). Rather than promote and expand homeownership, the MID bolsters the purchase of larger homes among wealthier households who gain the most from the policy by accumulating higher interest payments on larger mortgages.

4 Calculations based on percent by race/ethnicity within income groups among homeowners with mortgages only, i.e. those who could potentially benefit from MID.

While federal support for housing programs is primarily administered through tax programs, including the MID and other tax preferences,[5] as a whole these programs do little to reach households who need housing support and in fact, exacerbate inequality by supporting the highest income households. Not only are the tax benefits available to homeowners concentrated among the most well-off, but all homeownership tax programs are more expensive to the federal government than the discretionary budget of the Department of Housing and Urban Development (HUD) along with nine additional federal agencies (Levin, Greer, & Rademacher, 2014). Given the large sums of federal dollars dedicated to the MID and the failure of the policy to adequately promote home ownership and broad-based financial prosperity for all, numerous policy experts and analysts have proposed reforms to the policy to better support wealth creation and housing security for all communities in the U.S. through homeownership (Desmond, 2017; Fischer & Huang, 2013; Toder, Turner, Lim, & Getsinger, 2010; Ventry, 2010; Viard, 2013).

What can be done to easily reform the Mortgage Interest Deduction?

This paper helps to add to the urgency of reform by emphasizing the unequal impacts of the policy for U.S. households by race/ethnicity in addition to the well-documented inequalities by income. Not only does the policy promote inequality by income, but it further ingrains the racial wealth gap into the landscape of U.S. inequality.

The U.S. needs to redirect its housing budget to promote greater housing security and prosperity. Without a major redirection of our housing investments, the nation will continue to spend billions of dollars annually to subsidize the housing of well-off households, while leaving many housing insecure and with no support. A substantial adjustment of our federal housing portfolio is needed to ensure that federal dollars are invested to promote the housing security of all families, rather than spending billions to lower the taxes of the wealthiest homeowners.

Housing security means shelter and thus renters must be included in serious reform. More than eleven million households spend more than half of their income on rent. More than eight million (73%) of them have extremely low incomes, leaving few resources for other necessities. Impoverished families forced to spend such a high proportion of their income on housing are at-risk of housing instability and homelessness if they have a sudden financial emergency, such as loss of a job or unexpected bills.

PROMISING HOMEOWNERSHIP OPTIONS INCLUDE:

1. *Convert the mortgage interest deduction into a tax credit, rather than a deduction*: This policy shift would ensure that the value of the deduction is not worth more for higher income households. The credit would be available to households that do not itemize deductions and capping the dollar value of the credit would also limit the value for the wealthiest households with large mortgages on very expensive homes (United for Homes, 2017).
2. *Eliminate deductibility for second homes*: There is no clear policy objective in subsidizing second homes for wealthy families who purchase property in addition to their primary residence. Eliminating the deduction for second homes is a common-sense reform aimed at redirecting federal dollars toward housing security for all.

5 Other important tax preferences for homeowners include the exclusion for net imputed rent, the exclusion of capital gains from the sale of a primary residence, and the real estate tax deduction (state and local property taxes). (For more, see Levin et al. 2014)

3. *Lower cap for amount of mortgage eligible to $500,000 from $1 million*: Today, the median home value is about $317,000 (Federal Reserve Bank of St. Louis, 2017), but interest on up to $1 million dollars in mortgage debt is subsidized by the federal government. To ensure that federal dollars are not subsidizing the purchase of expensive homes for the wealthiest households, the amount of interest eligible for a credit or deduction should be significantly reduced.

PROMISING OPTIONS TO PROMOTE HOUSING SECURITY FOR RENTERS INCLUDE:

1. *Increase investment in rental housing programs for renters at the greatest risk of housing insecurity.* These investments can be funded by savings achieved through reform of the mortgage interest deduction. Tenant-based vouchers, for example, are an important yet underfunded approach to helping low income renters afford housing in the private market. Voucher recipients find a rental home in the private market and contribute 30% of their income toward housing costs. The voucher pays the remaining costs up to the local housing agency's payment standard. Seventy-five percent of new voucher households must be extremely low income, earning no more than the federal poverty limit or 30% of Area Median Income.

   The national Housing Trust Fund, another example, provides to each state and the District of Columbia money to build and preserve housing for people with low incomes. At least 90% of trust fund dollars must be used for rental housing, while up to 10% may be used for homeownership activities for first-time homebuyers. At least 75% of dollars used to support rental housing must serve extremely low income households.

2. *Establish a renter's tax credit.* A renter's tax credit would help low income renters afford their housing and reduce the existing disparity between homeowners and renters regarding the potential tax benefits of their housing costs. A current proposal by Representative Crowley would provide a refundable tax credit to qualified households who spend more than 30% of their income on rent. The Terner Center for Housing Innovation has put forward a similar proposal, while the Center on Budget and Policy Priorities proposes a renters' tax credit that would be distributed by states to developments that house low income renters (Galante, Reid, & Decker, 2016; Fischer, Sard, & Mazzara, 2017).

With tax reform on the Congressional agenda, policymakers should incorporate substantial changes of the MID into any tax reform proposals. As a nation, we should continue to ensure that we make substantial investments in housing; however, a significant shift in the allocation of our housing budget is needed. To reverse the deleterious impacts of the current MID on equity in the nation, policymakers should promote these common-sense reforms that help to better align our national housing investments with our values as a nation.

Conclusions

This brief adds to the urgency and ongoing discussion of the need for reform of the MID by helping to elucidate the ways in which the MID contributes to racial wealth disparities. The racial wealth gap is a major barrier to racial equality. As tax reform is under consideration, we have the opportunity to expand opportunities for homeownership and promote more equitable benefits across all communities, rather than solidify existing economic and racial inequalities.

Appendix

DATA SOURCES

Consumer Expenditure Survey

The Consumer Expenditure Survey (CE) provides detailed information on household expenditures as well as income and demographic characteristics of U.S. residents. Unique among U.S. national surveys for its focus on expenditures as well as income and other household characteristics, the CE survey provides important insights into household spending behavior and helps analysts to better understand household budgets and consumer trends. More information on the CE survey is available at: https://www.bls.gov/cex/.

Survey of Income and Program Participation

The Survey of Income and Program Participation (SIPP) is one of the most important national surveys on household economic well-being in the United States and provides detailed information on income, assets, and program participation of families. Conducted by the U.S. Census Bureau, the SIPP is a series of national panels lasting from 2.5 to 4 years that follow the same households during each panel period to better understand the income and program dynamics of families over time. For this analysis, we utilize the most recent SIPP panel, the 2014 SIPP, which captures assets and wealth data of individuals and households in December 2013. Utilizing the data at the household-level our analysis sample includes 29,662 total households. More information on the SIPP survey design is available at: https://www.census.gov/sipp/.

Joint Committee on Taxation Report on "Estimates of Federal Tax Expenditures"

The Joint Committee on Taxation of the U.S. Congress regularly publishes a report outlining estimates of tax expenditures—that is, lost revenue to the government due to tax benefits written into current tax policy that benefits specific taxpayers. The report is prepared for the House Committee on Ways and Means and the Senate Committee on Finance to help Congress better understand the fiscal impacts of existing tax expenditures. For the detailed analysis of benefits by race/ethnicity (described further below), we utilize the December 2015 Joint Committee report, which presents tax expenditure estimates for 2014, the data closest in calendar year to our SIPP data.

ANALYSIS APPROACH

With no data on the race and ethnicity of taxpayers, the estimates provided in this research brief are based on demographic data from the SIPP along with the estimates of benefits of tax expenditures by income provided by the Joint Committee on Taxation.

To obtain the estimates highlighted in this report, we started with the tax expenditure estimates provided by Joint Committee report highlighted in "Table 3—Distribution by Income Class of Selected Tax Expenditure Items, at 2014 Rates and 2014 Income Levels" from the December 2015 report. Utilizing the estimated benefits of households by income categories established in the Joint Committee report, we then estimated the proportions of households with mortgages within each income category by race/ethnicity using demographic data from the 2014 SIPP for households with mortgages.

We assumed that all households within each income category benefited equally from the MID. This assumption provides an estimate of potential benefits to each household, although specific

benefits to each household will be affected by total household deductions taken; exact household income, and other financial decisions of the household. Given that whites are over-represented among the very wealthiest households and home equity values in white neighborhoods tend to have higher home values, the assumption likely leads to a conservative (i.e. lower) estimate of benefits to white households. Applying the assumption of equal benefits per mortgage-holding household within each income group, we estimated benefits from the MID among each race/ ethnicity subgroup within each income group. Then, we summed total benefits for each race/ ethnicity subgroup to estimate the total and proportion of MID benefits that are currently enjoyed by households in the U.S. by race/ethnicity. Comparing the proportion of benefits by race/ ethnicity to the proportions of households overall in the U.S. by race/ethnicity provides a basis for the comparisons described in this brief.

Detailed results of the analysis of MID benefits by race/ethnicity are seen in the following table.

COMPARISON OF CURRENT ESTIMATED MID BENEFITS BY RACE/ETHNICITY WITH EQUALLY DISTRIBUTED BENEFITS (2014)

	CURRENT ESTIMATES OF BENEFITS		EQUAL DISTRIBUTION OF BENEFITS		
	TOTAL ESTIMATED AMOUNT OF BENEFIT FROM DEDUCTION	PERCENTAGE OF TOTAL BENEFIT FROM DEDUCTION	EQUAL PROJECTED DISTRIBUTION OF BENEFITS	PERCENTAGE OF HOUSEHOLDS BY RACE/ ETHNICITY	DIFFERENCE BETWEEN CURRENT ESTIMATED BENEFITS AND EQUALLY DISTRIBUTED BENEFITS
White	$56,400,000,000	77.9%	$48,800,000,000	67.4%	$7,600,000,000
Black	$4,500,000,000	6.2%	$9,300,000,000	12.8%	-$4,800,000,000
Latino	$5,300,000,000	7.3%	$9,400,000,000	12.9%	-$4,100,000,000
Asian	$5,200,000,000	7.2%	$3,400,000,000	4.7%	$1,800,000,000
Others	$1,100,000,000	1.5%	$1,600,000,000	2.2%	-$500,000,000
TOTAL	**$72,400,000,000**	**100.0%**	**$72,400,000,000**	**100.0%**	

*Totals do not sum exactly due to rounding.

While the SIPP has relatively large sample sizes, selecting for only mortgage-holding, home owning households and then, conducting analysis jointly by race/ethnicity and income reduces the sample size of each subgroup within each analysis category. Given smaller sample sizes, the results for Asians and those of other races should be interpreted with caution. To validate our results, we conducted the same analyses among all homeowners, rather than just mortgage holders, using the SIPP data to increase overall sample size and results were similar.

Race and ethnicity subgroups analyzed were defined by data availability in the SIPP. While providing important information about the distribution of MID benefits by race/ethnicity, much diversity exists *within* the racial and ethnic subgroups studied in this analysis that is not visible from the available data. In particular, among Asians and Latinos a number of factors including country of origin, immigration status, and time living in U.S. have substantial impacts on the economic outcomes of households. Recent research has shown high levels of economic inequality among Asian households in the U.S. at both the national and local levels (De La Cruz-Viesca, Chen, Ong, Hamilton, & William Darity, 2016; Weller & Thomson, 2016); thus, in addition to small sample sizes, it is important to interpret the results for Asian households with the understanding

that the diversity within the Asian-American community is not captured in the aggregated numbers provided. We support the ongoing efforts to improve data quality on race/ethnicity in the U.S. and to help improve our understanding of economic experiences of households through expanded collection of disaggregated data among race/ethnicity subgroups in the U.S.

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