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HOMESICK: HOW HOUSING TAX BREAKS BENEFIT THE WEALTHY AND CREATE MCMANSIONS

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EXECUTIVE SUMMARY

• The U.S. federal tax code provides large subsidies, in the form of tax breaks, for housing consumption. These tax breaks include the deductions for mortgage interest and property taxes, as well as the capital gains exclusion on home sale profits. Together, these tax breaks amount to $175 billion in foregone revenues to the U.S. Treasury each year.

• For millions of families who struggle to afford a house, these tax breaks offer no relief at all. Most personal income tax filers take the standard deduction, rather than itemizing deductions. Because most tax breaks are in the form of deductions, and the tax code has a progressive rate structure, the benefits from housing tax breaks increase disproportionately with income.

• Benefits from the largest housing tax break, the

deduction for mortgage interest, differ across metropolitan areas and among income groups within metropolitan areas. We find the mortgage interest deduction overwhelmingly benefits taxpayers earning more than $100,000 per year across all metropolitan areas in our sample. We also find that major metropolitan areas on the East and West coasts get the most tax relief from the mortgage interest deduction.

• Within metropolitan areas, benefits from the mortgage interest deduction accrue almost entirely to taxpayers in suburban and exurban areas. We demonstrate that the share of taxpayers benefiting from this deduction is in many cases 2 times as large in suburban areas as it is in inner city and inner ring suburbs.

• Taking the sum total of all tax breaks for housing, we find they generate substantially different cost savings across metropolitan areas. These cost savings do not result in higher homeownership rates, but instead in the purchase of larger, more expensive homes. We estimate that houses today, depending on the metropolitan area in question, are from 250 to 1,000 square feet larger than they otherwise would be, owing to the package of tax breaks.

• If increasing home ownership is to remain a goal of the federal government—and we are not convinced that it should be—then tax breaks for housing need to be reformed or eliminated. To encourage homeownership, federal housing subsidies should be more nar-

rowly targeted to middle-income households buying inexpensive houses. With the congressional tax-writing committees hoping to accomplish comprehensive tax reform within the next year, housing tax breaks represent the best way to generate the revenue necessary to push tax rates down.

INTRODUCTION

SINCE ITS INCEPTION a century ago, the individual income tax code has been exceedingly generous to homeowners. Homeowners may deduct the interest paid on up to $1 million in mortgage loan debt; an additional $100,000 in debt backed by home equity; and state and local property taxes. The tax code also exempts nearly all capital gains from the sale of a primary residence from tax payments.[1]

This paper examines the tax breaks for housing and has four central findings:

1. **The value of the most noticeable and popular of these tax breaks, the mortgage interest deduction (MID), differs vastly across income groups and metropolitan areas.** For example, among Chicago taxpayers who earn less than $100,000, less than 25 percent take the mortgage interest deduction and they save an average of $1,900 in taxes. Among taxpayers who earn more than $100,000, 78 percent take the MID and, on average, their tax savings are 2.5 times as large as those earning less than $100,000

2. **The benefits from the MID are heavily skewed toward suburban areas of major metropolitan areas, with the typical suburb having between 1.5 and 2 times the share of taxpayers claiming the deduction.**

3. **The total package of housing tax breaks greatly reduces the cost of consuming housing, but does so unevenly across metropolitan areas.** Tax breaks reduce the annual cost of owning a home by more than $10,000 in places like Los Angeles, but by less than $2,000 in Atlanta.

4. **The cost reduction caused by housing tax breaks does little to induce homeownership, but instead**

contributes to the building of larger, McMansion-style homes.[2] We estimate that houses today are between 250 and 1,000 square feet larger than they otherwise would be, owing to the package of tax breaks. This is because the deductions are claimed overwhelming by upper-income tax filers, who are not on the margin between owning and renting a home. Instead, the size of the tax breaks help them decide how much extra space to purchase or build.

Proponents of housing tax breaks liken homeownership to apple pie and the American flag, arguing that homeownership leads to greater community engagement and a plethora of other socially desirable behaviors. Without the tax breaks, proponents argue, millions of Americans who currently are homeowners would otherwise be unable to purchase a home. This argument has two flaws. The notion that homeownership induces salutary behaviors – rather than it simply being the case that such habits are correlated with having the wherewithal to buy a house – is a dubious proposition, more wishful thinking than accepted wisdom. An even bigger problem facing apologists for the current system is that the existing tax breaks do almost nothing to increase homeownership. Instead, they mostly serve to encourage people who already have the financial means to buy a house to purchase larger homes and take on more debt. The ability to deduct mortgage interest and property taxes, in fact, gives very little to a middle-class family who would otherwise be on the margin of affording to buy a home.

A major flaw in the design of existing homeownership incentives is that most are tax deductions, which by definition are more valuable to those who face higher marginal tax rates. A progressive tax code like our current system, where marginal rates on income range from 10 percent to nearly 40 percent, means that people who pay only the lowest marginal tax rates receive relatively modest savings from any deductions. High-income households who pay on income earned in the top tax brackets receive a much bigger break.

It isn't just the tax code's progressivity that skews housing tax breaks' benefits toward the wealthy; the fact that households can deduct interest on a mortgage as large as $1 million means that nearly all homeowners are able to deduct every dime of the mortgage interest they pay from their taxable income, even the very wealthy.

The high deductibility limit and the tax code's progressivity result in the benefits from the mortgage interest deduction being widely skewed across the country, both geographically and across income groups. Homeowners in wealthy com-

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1. Internal Revenue Service regulations state that the exclusion is allowed for owners who use a home as their "main home" for a total of two of the last five years prior to sale. The regulation also makes clear that in cases of split residency throughout a calendar year, there is only one primary residence to which the exclusion applies. In cases where residence is split across multiple years, for example two years of consistent residency in one home followed by two years of consistency in another home, the exclusion can apply to both homes as long as they are not sold in the same two year period. IRS publication 523 provides complete definitions and details on the capital gains exclusion.

2. Other contributing factors to the McMansion phenomena are rising incomes and the building of transportation infrastructure (especially interstate highways) connecting areas with cheap land to employment centers.

munities with high housing costs—mainly in the suburbs of major metropolitan areas on the East and West coasts—receive tax benefits much larger than those living in less expensive inner-city neighborhoods or in smaller communities in the middle of the country, where housing prices are more modest.

To give just one example of the discrepancy in tax benefits, the average homeowner in the San Francisco area receives an annual reduction in the cost of home ownership of more than $12,000 a year from the package of tax benefits available in the federal tax code. By contrast, the average savings to a home-owning family in Flint, Mich. is barely more than $500.

HOW MUCH DO HOUSING TAX BREAKS COST THE TREASURY?

WHILE SURVEYS INVARIABLY show that among the public's complaints about the tax code complexity is chief, the reality is that, for most people filing an income tax return, the process is relatively straightforward. Less than one-third of taxpayers take the trouble to keep track of the various deductions the code allows for and to put those down on their returns through the process of "itemizing." 3 Those who choose not to itemize generally avail themselves of the standard deduction, which is $12,200 for married couples, and then proceed to report a few facts about their income and family and be done with it.

For middle-class families, the standard deduction is usually the optimal option, since it constitutes a sizeable fraction of their income. It would take a lot of spending on tax-deductible goods and services to have itemized deductions that exceed the optional standard deduction. For a fairly modest $200,000, 30-year amortized mortgage loan with an interest rate of 4 percent, the tax-deductible interest payments in the first year would be only $8,000, and the proportion of the loan payment schedule that is comprised of interest would decline gradually in each successive year. If we assume this family faces a property tax of 1 percent and gives 2 percent of its income to charity—roughly the national averages for each—then the three largest deductions in the code for this prototypical household sum to the standard deduction. In other words, this household does not save anything on its taxes from purchasing a house. And for the 90 percent of all households with an income of less than $146,400 – the upper threshold for the 25% tax bracket – each dollar above the standard deduction reduces their federal tax bill by a mere 25 cents, at most.

Because the U.S. income tax code is progressive, with rates rising with income, deductions provide more tax savings to higher-income households. For instance, a household earning an income of $70,000, which is in the 15 percent tax bracket, would see a tax savings of $1,200 from a $200,000, 4 percent mortgage. A family with an income of $500,000 would save nearly $3,000 in taxes, or two and a half times more than the household in the 15 percent tax bracket.

Of course, the tax rate differential is not the only factor driving the difference in tax benefits between the middle class and the wealthy. The fact that upper-income households have bigger and more expensive homes further exacerbates the difference in tax benefits from homeownership. Income differences and housing differences combine to have a multiplicative impact. A doubling of income more than doubles the expected tax savings from the mortgage interest deduction, as it boosts the family into higher tax bracket as well as proportionally increasing the amount they can borrow to purchase a home.

A household with an income of $500,000 can afford a $1 million mortgage, while a family earning near the national median income of $51,000 would struggle to afford more than twenty percent of that. But the tax code awards the $500,000 household with the large mortgage a much larger subsidy. For this family, a $1 million dollar mortgage at 4 percent interest results in a tax savings of nearly $16,000 a year, or more than 10 times that of the family with the national median income who borrow the cost of an average house ($212,000).

All of these savings for borrowers add up to big bills for the Treasury. The cost of the tax benefits for owner-occupied housing sum to $175 billion per annum[4] with the mortgage interest deduction alone costing the U.S. Treasury roughly $100 billion each year. The five-year estimates for these tax benefits sum to well over $1 trillion.

FEDERAL TAX BENEFITS FOR HOUSING DIFFER ACROSS THE COUNTRY

Because tax benefits depend on housing costs and income, the value of tax breaks vary widely across metropolitan areas, as incomes and home prices differ substantially across the country. Incomes and home prices tend to be higher around major metropolitan areas—especially the suburbs—and along the East and West coasts, while the close-in neighborhoods and inner-ring suburbs[5] of most major cities, as well as

3. The latest available IRS data show that 46.2 million tax filers itemized deductions in 2011, or roughly 32 percent of the total of 145.3 million tax returns.

4. Not included in the $175 billion is the exclusion of imputed rent from taxable income, estimated to reduce revenues by $50 billion annually.

5. Puentes and Orfield (2002) examine the economic environment of inner-ring suburbs and report that although they are heterogeneous across metropolitan areas, they often have older housing and infrastructure and depreciated commercial areas. These facts, along with lower than average incomes, all contribute to the small

TABLE I: TAX SAVINGS FROM MORTGAGE INTEREST DEDUCTION BETWEEN INCOME GROUPS (REPRESENTATIVE CITIES)

	Tax Filers with <$100K AGI		Tax Filers with >$100K AGI	
	% with MID benefit	Average Tax Savings for MID Filers	% with MID benefit	Average Tax Savings for MID Filers
<u>Large Metros</u>				
Atlanta, GA	28.62%	$1,794	84.76%	$4,894
Boston, MA	21.49%	$2,101	77.47%	$5,068
Chicago, IL	24.71%	$1,918	78.40%	$4,819
Dallas- Fort Worth, TX	18.00%	$1,474	73.60%	$4,004
Denver, CO	29.32%	$2,199	82.73%	$5,183
Detroit, MI	26.34%	$1,582	80.40%	$4,053
Houston, TX	15.84%	$1,428	67.69%	$3,538
Los Angeles-Long Beach, CA	19.02%	$3,210	74.97%	$7,548
Minneapolis-Saint Paul, MN	31.49%	$1,946	84.87%	$4,528
New York City, NY	16.80%	$2,160	70.72%	$5,346
Philadelphia, PA-NJ	23.25%	$1,616	80.35%	$4,316
Phoenix, AZ	28.38%	$2,417	81.92%	$5,849
San Francisco- Oakland, CA	20.40%	$3,667	72.40%	$8,039
Seattle, WA	25.64%	$2,541	77.01%	$5,716
Washington, DC-MD-VA	27.65%	$2,815	82.83%	$6,101
<u>Small Metros</u>				
Austin, TX	20.13%	$1,603	73.11%	$4,142
Baton Rouge, LA	15.65%	$1,449	68.51%	$3,343
Chattanooga, TN-GA	17.07%	$1,411	67.61%	$3,989
El Paso, TX	10.26%	$1,075	62.88%	$3,209
Erie, PA	14.05%	$1,063	67.17%	$2,747
Flint, MI	22.04%	$1,345	77.66%	$3,180
Fresno, CA	18.73%	$2,238	79.86%	$5,105
Peoria, IL	16.47%	$1,186	65.97%	$2,908
Salinas-Seaside-Monterey, CA	19.59%	$3,691	71.95%	$7,790
Wichita, KS	18.77%	$1,157	74.41%	$2,723

Large metros are chosen to be geographically representative among areas with a population over 3 million. Smaller metros are chosen to be geographically representative among areas with a population under 1.5 million.

Source: Authors' calculations
Notes: Percentages of filers with mortgage interest deduction are categorized into two adjusted gross income (AGI) groups: <$100K and >$100K imply an AGI less than or greater than $100,000, respectively.

the more rural regions of the country, tend to have incomes and home prices that are lower.

Incidentally, the difference in housing prices across the country are driven not just by differences in demand, but also differences in supply. In places like New York, California, and the Maryland suburbs of Washington, D.C., various regulatory restrictions make building houses more expensive, something Harvard economist Ed Glaeser has amply documented.[6]

To quantify how the impact of housing tax breaks differ across various regions of the country, we used a ZIP code level Internal Revenue Service data file that contains information on average income, how many tax filers claim the mortgage interest deduction, and how much was deducted. From this information, we can calculate the tax savings from taking the deduction. We incorporated local housing market data from the American Housing Survey on property taxes, debt financing, and self-reported home values with the IRS data to measure how the reductions in the cost of owning a

home differ as a result of the tax code across metropolitan areas.[7]

The data show that the tax savings that accrue from the MID are highly skewed both across metropolitan areas and across income groups within the same metropolitan area. They also vary between central city and suburban locations within a metro area.

The differences across income groups are enormous. In most cities, tax filers with an income greater than $100,000 are between three and four times more likely to take the mortgage interest deduction than taxpayers below that threshold. The average tax savings for high-income households are more than double those of the lower-income cohort. Generally, the suburban areas of major metros have a larger percentage of tax filers that benefit from the MID, but the average tax savings in these areas is only slightly larger than in central cities. Looking at the combined benefit of all housing tax breaks shows that these benefits barely benefit some smaller cities in the form of reduced housing costs, while residents of large metro areas on the coasts save well into five figures annually.

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benefit these areas receive from housing tax benefits.

6. See for example, Glaeser and Ward (2009) that examines land use regulations in eastern Massachusetts and Glaeser, Gyourko, and Saks (2005) that make this point using data from Manhattan.
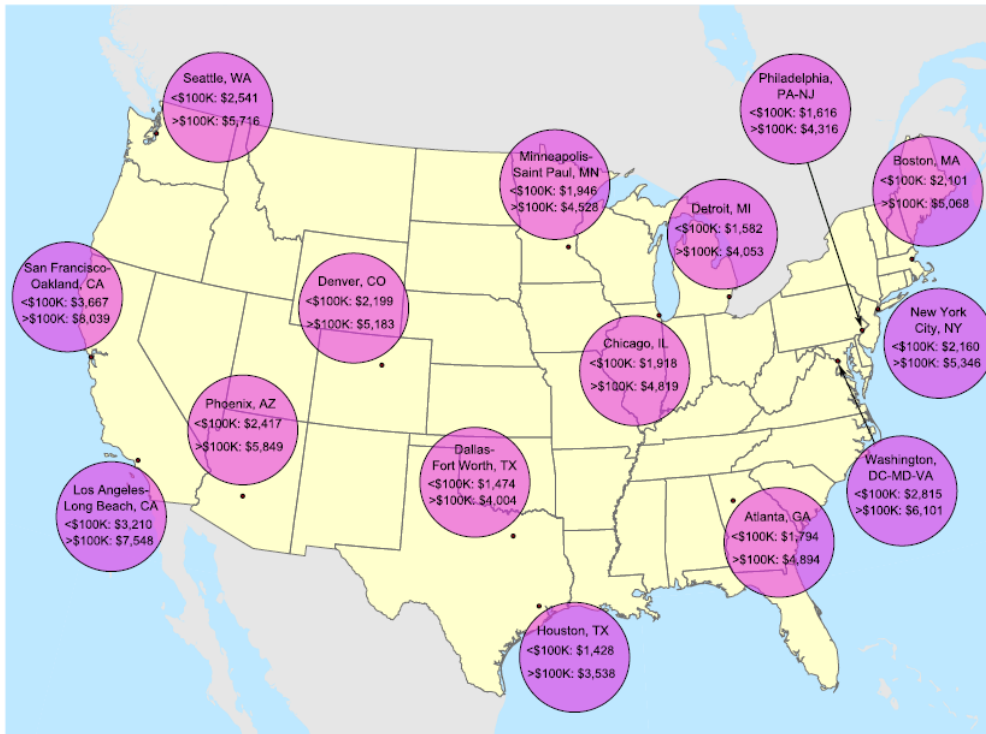
7. See the appendix for a full explanation of the model and data sources.

Source: Authors' calculations
Notes: Percentages of filers with mortgage interest deduction are categorized into two adjusted gross income (AGI) groups: <$100K and >$100K imply an AGI less than or greater than $100,000, respectively.

TAX SAVINGS ACROSS METRO AREAS AND INCOME GROUPS

TABLE 1 SHOWS average tax savings for 15 representative large metropolitan areas, and ten small metropolitan areas (the appendix contains this information for all metro areas in the data),[8] with the beneficiaries split into two groups: those above $100,000 of income and those below. The most revealing datum from the table is how few tax filers earning below $100,000 benefit from the MID, regardless of metro area. For example, Minneapolis has by far the most tax filers earning below $100,000 who take the MID, at 31.5%, but even there, the gap between tax filers under and over $100,000 in AGI is large, as nearly 85 percent of tax filers earning more than $100,000 benefit from the MID. About 25 percent of taxpayers earning under $100,000 take the mortgage interest deduction.

Houston has the smallest percentage of tax filers under $100,000 that benefit from the MID, with just under 16 percent receive any tax savings, while more than four times that proportion of taxpayers in Houston earning more than $100,000 benefit from the deduction. The share of tax filers that benefit from the MID and earn more than $100,000 is between three and four times larger than those earning less than $100,000 in most cities.

Smaller metropolitan areas show a similar—albeit slightly less disparate—distribution of benefits as larger metropolitan areas. While vast differences persist in the proportion of those claiming MID between cohorts above and below the $100,000 threshold, those earning less than $100,000 are even less likely to receive a benefit in smaller metros. For instance, just over 10 percent of tax filers in El Paso, Texas earning less than $100,000 take the mortgage interest deduction, while nearly 63 percent earning over $100,000 do so. In addition to large differences in the share of tax filers above and below the $100,000 threshold benefiting from the MID, there are also substantial differences in how much money each group saves. For instance, residents of the San Francisco-Oakland metro area who earn more than $100,000 save $8,000 a year from the MID, more than double what residents who earn less than $100,000 save. The tax savings for higher-income residents is more than double the savings of lower-income residents for every metro area we examine.

A similar gap between the tax benefits of upper-income and lower-income taxpayers exists in smaller metropolitan areas as well, with upper-income taxpayers saving between two and three times the tax payments that lower-income residents save. The difference in average tax savings between income groups can be attributed both to higher marginal tax rates, which result in each dollar deducted from a higher-income filer's income creating relatively greater savings, and to the fact that upper income taxpayers have 60 percent more

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8. We chose large and small metropolitan areas to be geographically representative. Large metro areas are chosen among areas with a population over 3 million. Small metro areas are chosen from areas with a population under 1.5 million.

	Central Cities		Suburbs	
	% with MID benefit	Average Tax Savings for MID Filers	% with MID benefit	Average Tax Savings for MID Filers
Large Metros				
Atlanta, GA	24.05%	$2,189	39.20%	$2,221
Boston, MA	23.84%	$2,639	36.51%	$2,669
Chicago, IL	21.27%	$2,362	36.70%	$2,363
Dallas- Fort Worth, TX	19.20%	$1,627	30.08%	$1,941
Denver, CO	29.41%	$2,317	46.66%	$3,012
Detroit, MI	17.97%	$1,200	37.04%	$2,054
Houston, TX	14.28%	$1,745	25.72%	$1,719
Los Angeles-Long Beach, CA	17.04%	$3,261	30.06%	$3,978
Minneapolis-Saint Paul, MN	32.01%	$2,085	45.18%	$2,521
New York City, NY	15.06%	$2,460	31.38%	$2,790
Philadelphia, PA-NJ	22.49%	$1,491	37.25%	$2,302
Phoenix, AZ	28.16%	$2,427	42.08%	$3,229
San Francisco- Oakland, CA	24.15%	$4,195	37.65%	$4,894
Seattle, WA	30.42%	$3,048	38.25%	$3,122
Washington, DC-MD-VA	30.92%	$3,191	44.72%	$3,707

mortgage interest to deduct. Their higher relative incomes allow them to purchase more expensive homes and thus take on larger loans.

THE MID BENEFITS SUBURBS MORE THAN THE CITIES

In most major metropolitan areas, the percentage of suburban residents that benefit from the MID is much greater than in the central city, owing to the fact that housing prices and incomes tend to be higher in the suburbs. This difference is the largest in Detroit, where twice the proportion of suburbanites claim the deduction as compared to central city residents. In cities such as Boston, Dallas, Denver, Minneapolis, Phoenix, San Francisco and Washington, D.C, suburban residents are 50 percent more likely to claim the MID than central city residents, with that ratio being slightly higher in Atlanta, Chicago, Houston, Los Angeles, and Philadelphia.
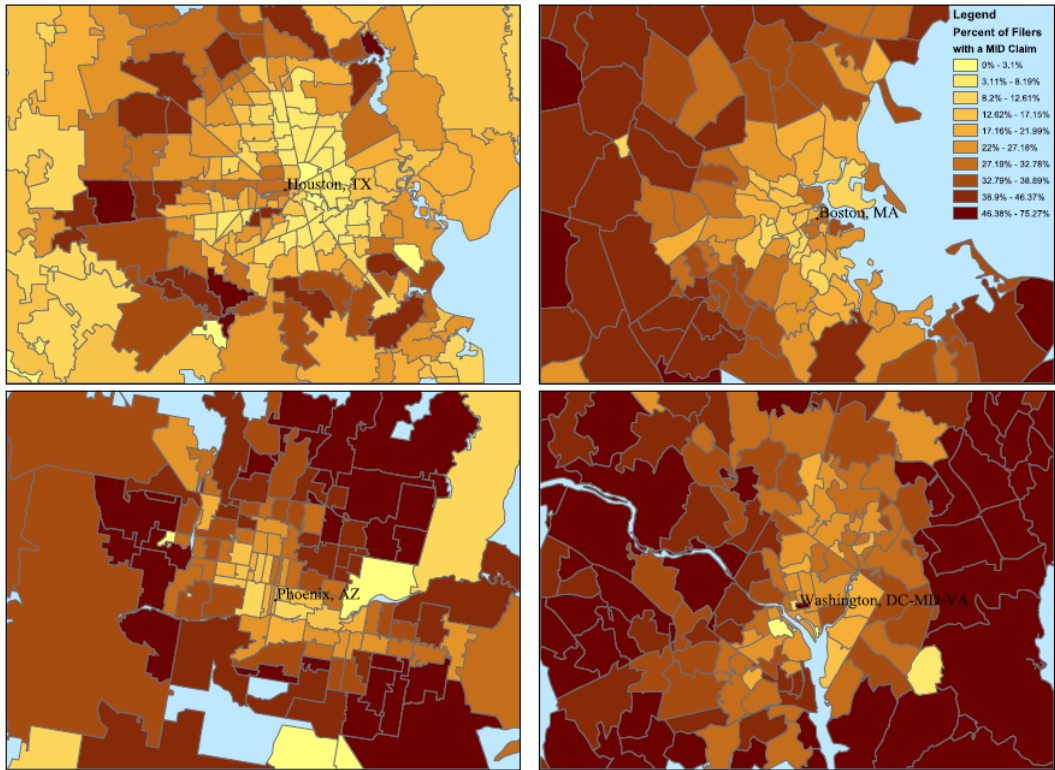
While suburban taxpayers are more likely to claim the MID than those living in the central city, the average savings for taxpayers who do claim the deduction are roughly the same. The difference in tax savings as a result of the MID are within $100 for Atlanta, Boston, Chicago, Houston and Washington, and even in metro areas with the greatest disparities—such as Detroit, Los Angeles, Philadelphia, Phoenix and San Francisco—they remain within $850. The similarities in average tax savings between central city and suburban residents likely reflect similar marginal tax rates, and generally similar home values across the metropolitan area. While wealthy people do live in cities, so do less-wealthy families who don't own a home or who have a mortgage and income level too small to avail themselves of the MID.

Figure 3.1 shows how residents of representative metropolitan areas (Houston, Boston, Phoenix and Washington) claim the MID. The pattern of relatively sparse claims near the central city and inner-ring residential areas, compared to a much larger percentage of tax filers in suburban enclaves and exurbs, is apparent in all four cities to varying degrees. Houston is the classic example, and representative of many sun-belt cities, showing next to no MID claims in inner-city areas and inner-ring suburbs inside of the beltline freeway system, and an abundance of claims just outside and in the exurb areas. Also noticeable from these maps is that, while inner-city areas in D.C. and Boston have a relative dearth of MID claims compared to their own suburbs, in many cases, these areas still benefit as much as the suburbs of Houston and Phoenix.
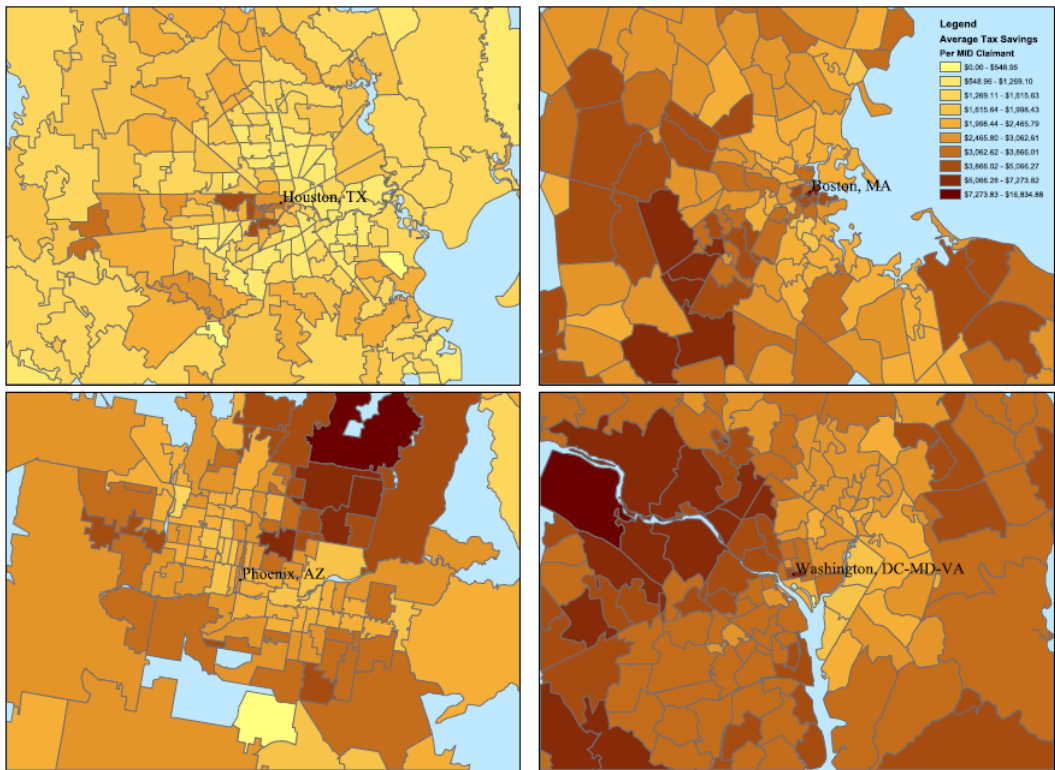
Although less stark than the difference in the percentage of tax filers claiming, Figure 3.2 shows the difference in the

FIGURE 3.1: ZOOMED-IN METROS: HOUSTON, PHOENIX, D.C., BOSTON

Legend
Percent of Filers with a MID Claim

- 0% - 3.1%
- 3.11% - 8.19%
- 8.2% - 12.61%
- 12.62% - 17.15%
- 17.16% - 21.99%
- 22% - 27.18%
- 27.19% - 32.78%
- 32.79% - 38.89%
- 38.9% - 46.37%
- 46.38% - 75.27%

Source: Internal Revenue Service SOI Individual Income Tax return data from 2007. The breaks shown in the legend using the Jenks natural breaks classification method.

FIGURE 3.2: ZOOMED-IN METROS: HOUSTON, PHOENIX, D.C., BOSTON

Legend
Average Tax Savings Per MID Claimant

- $0.00 - $548.95
- $548.96 - $1,269.10
- $1,269.11 - $1,615.63
- $1,615.64 - $1,998.43
- $1,998.44 - $2,465.79
- $2,465.80 - $3,062.61
- $3,062.62 - $3,666.01
- $3,666.02 - $5,066.27
- $5,066.28 - $7,273.82
- $7,273.83 - $16,834.88

Source: Internal Revenue Service SOI Individual Income Tax return data from 2007. The breaks shown in the legend using the Jenks natural breaks classification method.

	Standard Annual Home Owning Cost	Annual Home Owning Cost with Tax Preferences
<u>Large Metros</u>		
Atlanta, GA	$17,627	$15,999
Boston, MA	$18,033	$11,677
Chicago, IL	$19,479	$15,345
Dallas- Fort Worth, TX	$13,759	$10,853
Denver, CO	$17,935	$15,191
Detroit, MI	$18,318	$16,720
Houston, TX	$12,662	$9,291
Los Angeles-Long Beach, CA	$13,471	$2,819
Minneapolis-Saint Paul, MN	$19,843	$17,564
New York City, NY	$18,915	$8,469
Philadelphia, PA-NJ	$11,264	$5,745
Phoenix, AZ	$14,423	$11,785
San Francisco- Oakland, CA	$37,647	$25,373
Seattle, WA	$19,112	$12,771
Washington, DC-MD-VA	$11,464	$2,249
<u>Small Metros</u>		
Austin, TX	$17,555	$11,967
Baton Rouge, LA	$9,530	$6,508
Chattanooga, TN-GA	$10,882	$8,933
El Paso, TX	$7,606	$5,486
Erie, PA	$6,107	$4,759
Flint, MI	$7,117	$6,588
Fresno, CA	$15,432	$13,424
Peoria, IL	$11,457	$9,445
Salinas-Seaside-Monterey, CA	$25,625	$22,706
Wichita, KS	$8,830	$7,255

Large metros are chosen to be geographically representative among areas with a population over 3 million. Smaller metros are chosen to be geographically representative among areas with a population under 1.5 million.
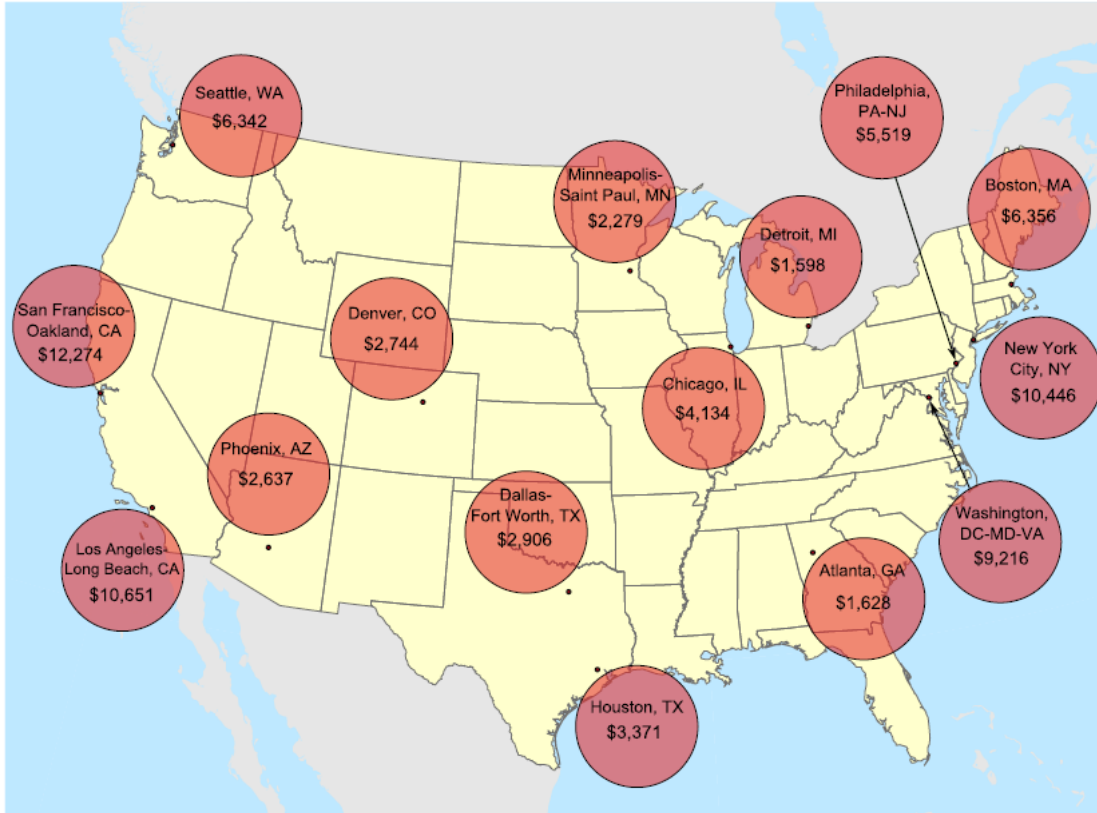
average MID claim amount across representative metropolitan areas (Houston, Boston, Phoenix and Washington). This figure shows that, while the average benefit is mostly flat across a given metropolitan area, each city has areas with much higher average claims, heading northwest from the capital in D.C. for example, or west-southwest from downtown Houston. These figures make that point that, even though the inner-metropolitan distribution of benefits from housing tax breaks is substantial, the intra-metropolitan distribution adds to the skewedness of these benefits.

HOW DO HOUSING TAX BENEFITS IMPACT THE HOUSING MARKET?

Although the MID is the costliest housing tax break in the code, the deduction for property tax payments and the exclusion of capital gains from the sale of a home also reduce tax revenue by tens of billions of dollars. As with our analysis of the MID, most of the tax benefits for these other housing tax breaks go to wealthier filers who live in suburbs.

A look across large metro areas shows that the annual cost

Source: Authors' calculations
Notes: Annual cost of housing savings from tax expenditures includes deductions for both mortgage interest and property taxes
as well as the elimination of capital gains taxation.

of owning a home varies widely. The lowest cost among the metro areas in Table 3 is Philadelphia, with an average annual cost of homeownership just over $11,000, while San Francisco-Oakland homeowners spend $37,600 annually. In some instances, disentangling this particular piece of data can be complicated. For instance, the annual cost of ownership is quite low in Washington, because homeowners carry relatively little debt, while in Houston, another low-cost city, it is driven by low housing prices, the result of a vast supply of buildable land in the metro area and an uncommon lack of regulatory interference to build on that land.

Differences in income tax rates,[9] debt-to-value ratios, property taxes and local home price inflation all contribute to the tax benefits to owner-occupied housing. Each have differing effects on the annual cost of homeownership. Table 3 shows that the difference in the discount offered by housing tax expenditures varies widely across metro areas. In Atlanta – where marginal tax rates are relatively low, few residents claim the MID and property tax deductions and home prices have been tame – homeowners benefit relatively little. On the other hand, families in Washington have higher incomes

than in Atlanta, which means they face higher tax rates and are more likely to take the housing deductions. Combined with the steady increase in home prices throughout the D.C. area, the various housing tax breaks save D.C. homeowners more than $9,000 a year, while saving Atlanta homeowners only about $1,600. In New York, San Francisco and Los Angeles, average annual savings exceed $10,000.

Homeowners in smaller communities benefit less from housing tax breaks than people who live in bigger cities, owing to lower incomes and home prices. Residents of Austin, Texas have an average annual savings that exceeds $5,000, the largest of the smaller metros in the data. The only other community within this cohort whose average benefit is greater than $3,000 was Baton Rouge, La. Even homeowners in Salinas, Calif., where home prices remain relatively high, save relatively little from the tax breaks.

The average cost savings in smaller metropolitan areas is also driven by a narrower income distribution. Even though there are high claim rates for tax filers earning more than $100,000 in these areas, there's relatively fewer of them in small communities. In communities where incomes are low and housing prices have plummeted, very few people have much to gain from deviating from the standard deduction. At

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9. Our model uses only differences in income tax rates that come from income differences across areas. Income differences create income tax differences because of the progressive federal income tax.

	Current Average Home Size (square feet)	Estimated Average Home Size with No Tax Preferences (square feet)
Large Metros		
Atlanta, GA	2654	2350
Boston, MA	2221	1487
Chicago, IL	2359	1819
Dallas- Fort Worth, TX	2383	1839
Denver, CO	2215	1824
Detroit, MI	2408	2146
Houston, TX	2345	1709
Los Angeles-Long Beach, CA	2059	977
Minneapolis-Saint Paul, MN	1979	1705
New York City, NY	1927	1087
Philadelphia, PA-NJ	2527	1499
Phoenix, AZ	2094	1667
San Francisco- Oakland, CA	2051	1408
Seattle, WA	2168	1480
Washington, DC-MD-VA	2689	1265
Small Metros		
Austin, TX	2290	1584
Baton Rouge, LA	3121	2162
Chattanooga, TN-GA	2089	1670
El Paso, TX	1621	1166
Erie, PA	1800	1375
Flint, MI	1447	1311
Fresno, CA	2042	1728
Peoria, IL	2471	1984
Salinas-Seaside-Monterey, CA	2014	1737
Wichita, KS	1989	1591

Large metros are chosen to be geographically representative among areas with a population over 3 million. Smaller metros are chosen to be geographically representative among areas with a population under 1.5 million.

the bottom end of the distribution, homeowners who itemize their taxes in Flint, Mich., and Erie, Pa., save an average of less than $1,500 a year.

The tax code does not adjust for different costs of living across the country: a $300,000 annual income could make someone feel rich in Peoria, Ill. but staunchly middle class in Manhattan. The MID effectively adjusts for cost-of-living differences by giving people in high-cost areas a bigger break, albeit along with wealthy people in low-cost areas as well.

At the same time, housing tax breaks also influence where people choose to live. Fewer people would leave the hinterlands for the big city if it weren't for the fact that the tax code can reduce their effective cost of buying a home once they get there.

THE TAX CODE CREATED MCMANSIONS

THE ONE TANGIBLE result of the MID that is beyond dispute is that it has resulted in larger, more expensive homes. This is a result inimical to economic growth: if society allocates
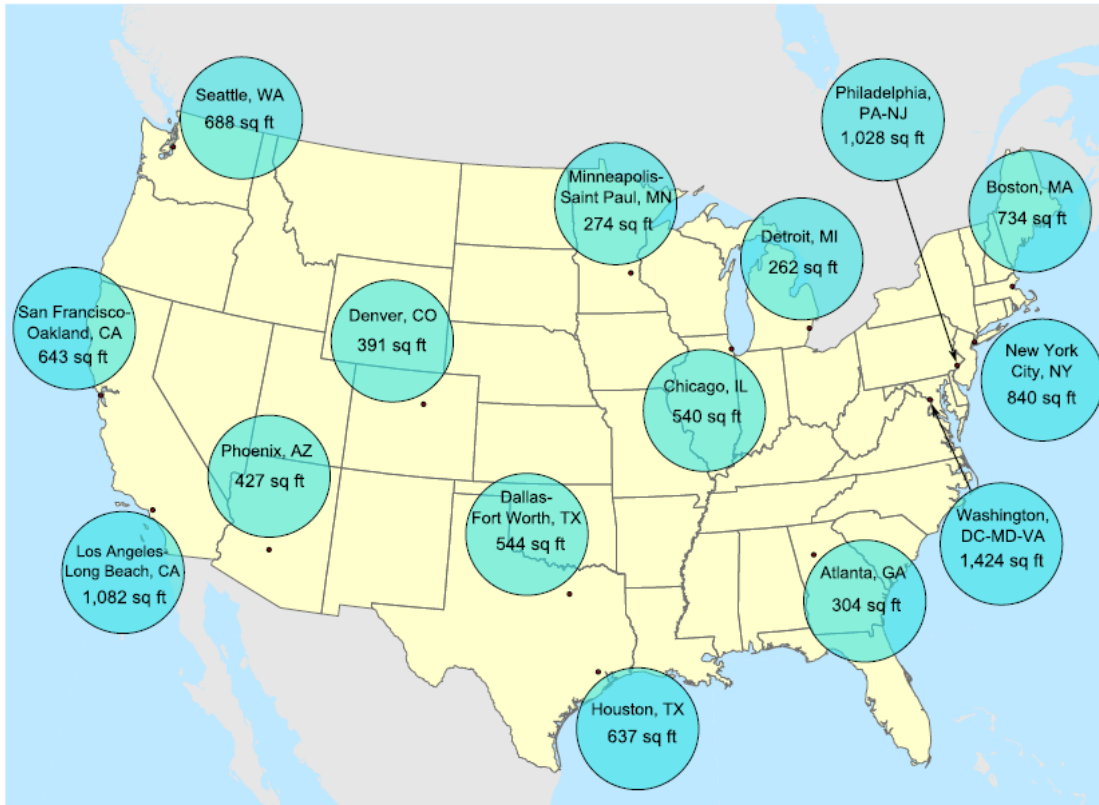
Source: Estimates of increased square footage from Hanson (2012)
Notes: Additional average home size is measured in square footage by tax expenditure savings including deductions for both mortgage interest and property taxes as well as the elimination of capital gains taxation.

more capital to construct larger houses, it means there is less money available for companies to invest expanding profitable operations.

There is nothing wrong with people choosing to spend more of their wealth on housing, or for them to move up to a bigger house as their income grows. To some degree, the fact that we live in nicer and larger homes than a generation or two ago is a manifestation of the gradual increase in income for the middle class. But there is no reason for the government to provide financial encouragement for people to buy bigger and better homes. Moreover, there is substantial evidence that the decades-long increase in the size of the average U.S. house owes more to insipid tax policy than to our growing wealth.

## HOW MUCH DOES THE TAX CODE INCREASE HOUSING SIZE?

Economists have shown that home purchasers are quite sensitive to tax-induced changes in the annual cost of home ownership, but not in the ways lobbyists of the housing industry tend to claim. When the tax benefits to housing increase, we don't see more people buying homes but instead, people buy *bigger* homes.

Table 4 shows both the current distribution of home sizes (in square footage) across metropolitan areas, and our estimate for how different the average size of homes would be without tax preferences for housing. These estimates are based on how strongly home buyers react to the cost reduction from housing tax preferences.

In some areas with large homes, like Atlanta, the estimated effect is small. The current average size of a single-family dwelling in Atlanta is about 2,650 square feet, only slightly larger than our estimates show would be the case in this market if not for tax benefits. In other areas, like Los Angeles, the tax expenditures are pushing the purchase of homes that are more than double what our estimates suggest would be, if not for the generous tax breaks afforded to home buyers. The inducement to buy larger homes is also apparent in smaller metropolitan areas, although to a smaller extent, with most of these areas experiencing about a 400-square-foot bump in average home size.

The map below displays the difference between actual average home sizes and our estimates of how homes would be sized in markets without tax breaks. Across the country, housing tax breaks contribute to larger homes. The effect is most noticeable in Washington, D.C., Philadelphia and Los Angeles, where the average home size is more than 1,000
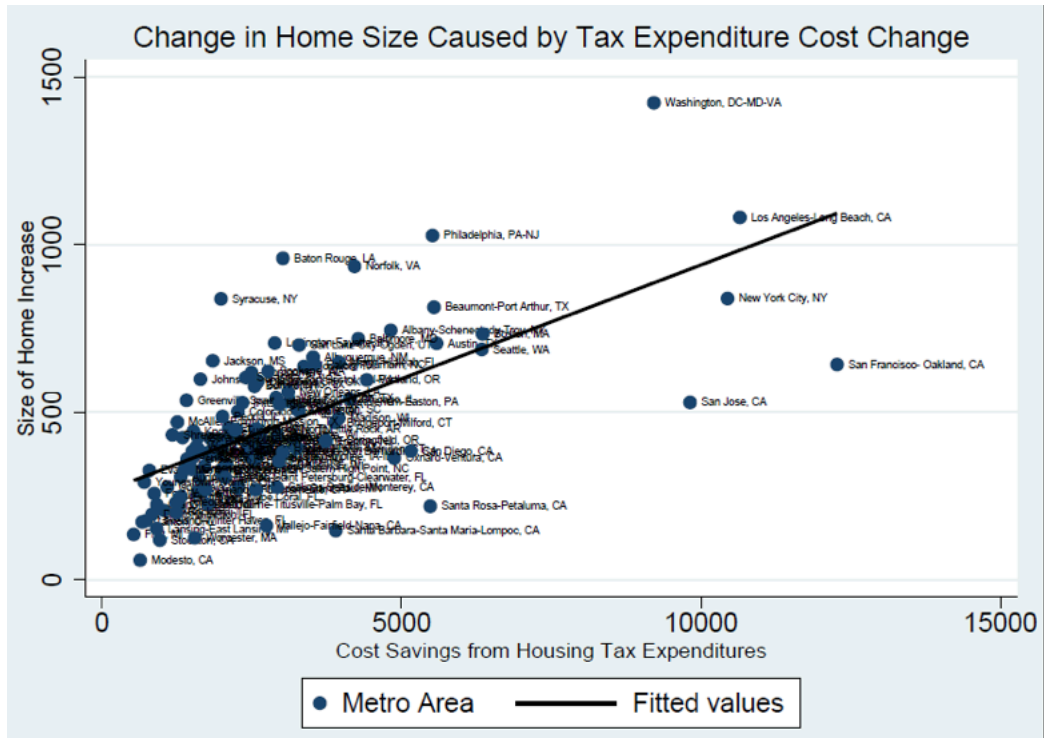
square feet larger than we estimate that it would have been in the absence of favored treatment for housing. While still inducing significant changes in the size of home purchased, the magnitude of difference in home size is smaller for Midwestern and Southern cities, which is largely driven by a smaller propensity of residents in these regions to use the deduction.

Differences in the size home that residents choose as a result of tax breaks are driven by the fact that the breaks make housing cheaper to purchase on the margin. This effect is magnified in areas with higher incomes, as the discount afforded to those in the top tax brackets results in an even larger cost reduction from deductions. On top of this, the capital gains exclusion ensures that a growing amount of income from the sale of a home will be earned tax free, making the tax breaks especially valuable in hot housing markets like San Francisco.

The graphic below shows a strong correlation between the cost reduction from housing tax breaks and the resulting increase in home size, using data from 120 metropolitan areas across the United States. Where housing tax breaks offer the largest reduction in cost, the metro areas tend to have the largest estimated increases in size relative to how large houses would have been in the absence of these breaks. Cities in the Northeast (New York, Philadelphia, Washington, D.C.) and California (San Francisco, Los Angeles, San Jose) are well represented in the tail of the figure, showing

both large cost reductions and larger-than-expected homes. This is not to say that places like New York or San Francisco have especially large homes. They do not. Rather, our conclusion is that they would have even smaller homes, on average, if not for the associated tax breaks.

The question that naturally arises when thinking about how housing tax breaks change buyers' decisions is, "doesn't the cost reduction from these tax breaks also encourage homeownership?" The answer is a resounding "no," a conclusion that is confirmed by numerous empirical studies, as well as a look at the design of the incentives themselves.10 The size of the standard deduction makes most of the tax breaks useless to most homeowners. Those who do claim the deductions are upper-income tax filers, who are not on the margin between owning and renting a home. Rather, the choices they face include the number of bedrooms, whether to demand a finished basement or a home with more elaborate fixtures on a larger lot.

WHAT MIGHT A REAL HOMEOWNERSHIP POLICY LOOK LIKE?

LET US GRANT the assumption that homeownership does convey tangible societal benefits that make it worthy of some

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10. Glaeser and Shapiro (2003) find no correlation between generosity of the mortgage interest deduction and homeownership rates using national time series data. Hanson (2012) finds no correlation between mortgage interest deduction policies at the state level and homeownership rates.

form of government policy preference. What would a policy designed to encourage ownership look like, if we were starting from scratch?

For starters, there would be no government tax breaks or subsidies available to the wealthy, who can easily afford houses without such incentives. The amount of the subsidy would not be tied to the size of the mortgage, either, and most of the subsidy would be received immediately, when the aspiring middle-class homeowners are young and presumably earning less than in subsequent years.

It doesn't take a team of economists to arrive at these precepts. A number of states have their own homeownership incentive programs that attempt to do precisely this. These programs also differ from the plethora of tax breaks at the federal level by being less expensive, while also much more effective at helping people buy houses.

For example, the Wisconsin Housing and Economic Development Authority (WHEDA) offers assistance to first-time home buyers with an income below approximately $90,000 who are purchasing a home that costs less than $250,000. The program substantially defrays closing costs, which can be a serious impediment to buying a home for young families who have not had time to accumulate significant savings. WHEDA assistance is provided in the form of low-interest loans, which are recouped by wrapping them into the mortgage payment. On net, the program costs the state nearly nothing. Wisconsin's home ownership rate is 70 percent, more than five percentage points higher than the national average, even though the median income in the state is below the national average.

Common sense reforms to the current package of federal tax breaks for housing have been proposed from both sides of the political aisle. President George W. Bush's tax reform panel, as well as President Barack Obama's National Commission on Fiscal Responsibility and Reform, both have recommended scaling back housing's tax-preferred status. These plans both recommend capping the size of mortgage that qualifies for subsidy. They both recommend eliminating the deductibility of mortgage interest in favor of a tax credit, which would limit the subsidy to upper-income taxpayers, while simultaneously expanding it at the lower end of the income distribution. Other intermediate steps toward using subsidy dollars to encourage ownership could include eliminating tax breaks on anything but a primary residence and limiting the amount of housing capital gains exempt from taxation. In an era when entitlement costs threaten to balloon the federal budget deficit beyond the mere $1 trillion of recent years, sacrificing $150 billion a year to a tax break that utterly fails at achieving its ostensible goal and gives the preponderance of its benefits to the well-off is a luxury the federal government can no longer afford.

The *nomenclatura* of Washington D.C. recognize this as well. Few bother to put forward a policy rationale for keeping housing-related deductions in the tax code. Instead, they protest that the immense power of the lobbies that benefit from these breaks are reason enough not to even bother spending the immense political capital necessary to fix the problem.

APPENDIX: METHOD OF QUANTIFYING THE TAX BENEFITS OF OWNER-OCCUPIED HOUSING

THE U.S. INCOME tax code offers several provisions that favor owner-occupied housing. The largest of these are the mortgage interest deduction ($640 billion, FY 2014-2018); the exclusion of imputed rental income ($437 billion, FY 2014-2018); the exclusion of capital gains on home sales ($263 billion, FY 2014-2018); and the deductibility of state and local property taxes ($137 billion, FY 2014-1018).[11] While homeowners benefit by not counting imputed rent or gains from the sale of a home as taxable income, the mortgage interest and property tax deduction benefits accrue only to tax filers who itemize deductions. Given the rise in the standard deduction, and several years of historically low mortgage interest rates, only about a third of the tax-filing population itemizes deductions.

Both the mortgage interest and property tax deductions work the same way. They are line items on a tax return that reduce the amount of income subject to tax. Because the U.S. income tax code has a graduated rate structure (marginal rates rise with income), deductions provide more tax savings to those at the upper part of the income distribution. Consider two tax filers both paying $5,000 in mortgage interest, one in the top bracket (39.6 percent) and the other in the bottom bracket (10 percent). The taxes saved because of the MID for the top-bracket filer are $1,980, and only $500 for the bottom-bracket filer. In reality, these differences are exacerbated by the fact that upper-income tax filers live in larger, more expensive homes and in areas with higher property taxes, and thus have larger deductions than those in lower tax brackets.

To accurately quantify the difference in tax benefits across areas, this report first examines Internal Revenue Service (IRS) data on actual MID claims. This data comes from a special release of the IRS ZIP code file in 2007, which reports the number of tax filers claiming the MID and the dollars deducted under the MID. This data also contains information on both adjusted gross and taxable income, allowing an estimate of marginal tax rates, so that a reasonably accurate measure of the actual tax savings can be calculated.

To summarize the combined benefits of the major tax preferences for housing (MID, property tax deduction, and capital gains exclusion) we measure how they reduce the annual average cost of homeownership at the metropolitan area level.[12] Following a long tradition of research in economics, we

represent the annual cost of homeownership in a user cost framework. This framework considers most of the major reoccurring costs associated with homeownership as a percentage of the purchase price. The user cost model we use, without the preferential tax treatment for housing, is represented by the following equation:

$$A=(Or_1+(1-O)r_2+m+d+t_p-\pi1-t))V_H$$

Where is the annual cost of owning a home and V_H is the value of the home. O represents the share of the home that is debt financed, and is the interest rate paid on that debt. The user cost model also considers that any portion of the home that is paid in equity $(1-O)$, is subject to the opportunity cost at an interest rate, r_2. Also included are annual costs for maintenance (m) and depreciation (d), and property taxes (t_p). Finally, the user cost model considers that housing markets are subject to general price inflation (or possible deflation), and that this is a benefit to homeowners. Price inflation is measured in the π parameter. This would be negative (and add to cost) if the local market has price deflation. Notice that when housing is treated like other assets, the capital gain from price inflation is subject to tax at rate t.

Amending the user cost model to incorporate housing tax preferences, we eliminate the taxation of capital gains (price inflation), and insert deductions for both mortgage interest and property taxes at marginal tax rate t. The user cost model with housing tax preferences is then:

$$A=((1-t)Or_1+(1-O)r_2+m+d+(1-t)t_p-\pi)V_H$$

Where the parameters are the same as described above. We incorporate local housing market data from the American Housing Survey on property taxes, debt financing and self-reported home values, combined with IRS data on marginal tax rates to examine how the annual costs of homeownership differ as a result of the tax code across metropolitan areas.[13] We take the results from the user cost model and apply them to each metropolitan area housing market to examine how the package of housing tax preferences influences the choice of how much housing to purchase. To do this, we incorporate the findings in Hanson (2012) that estimates the sensitivity of housing size to tax-driven changes in the cost of housing. Hanson (2012) finds that the primary function of housing tax preferences is to encourage the purchase of a larger home, and not to encourage renters to become owners. We use these results, compared with actual data on home size distribution, to estimate how much larger homes are in metropolitan areas because of housing tax preferences.

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11. Tax policy experts often point out that under a pure Haig-Simons view of the income tax, a mortgage interest deduction is necessary to balance owner-occupied net benefits with landlord net benefits for housing. This is because in a Haig-Simons income tax, the imputed rent— or value that owner occupiers get from living in their house and not actually paying rent— would be counted as income. Because imputed rent is not taxed, and the logistics behind accurately counting it as income seem intractable, we do not consider their treatment in this analysis.

12. We also incorporate the degree to which tax filers use housing tax expenditures,

based on the fraction of tax filers that itemize deductions in each metropolitan area. To do this, we calculate a weighted average annual cost for itemizers and non-itemizers at the metropolitan area level.

13. We use a nationally representative mortgage interest rate of 4 percent, an opportunity cost of capital of 2 percent, annual maintenance rate of 2 percent and depreciation rate of 1 percent across all metropolitan areas.

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