Study finds key tax break has adverse effect on homeownership, social welfare

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The American dream of owning a home with a white picket fence may stay a dream for many, according to a recent study by a Kansas State University economist.

Tracy Turner, associate professor of economics at K-State, and Christian Hilber, a professor at the London School of Economics in the United Kingdom, completed a study on America's mortgage interest deduction and how effectively it promotes homeownership.

The mortgage interest deduction, also called the MID, is the second largest tax break in the federal tax code and is meant to promote homeownership by allowing itemizing homeowners to deduct the annual interest payments they make on their primary residence and second home real estate loans. For the 2011 fiscal year, the deduction will account for an estimated $104.5 billion in revenue loss for the U.S. Treasury.

However, since the Reagan administration, the deduction has been viewed as a vehicle for promoting homeownership, Turner said.

"In urban places suffering from neighborhood instability, underperforming schools, low social capital and poor governance, increasing homeownership rates may improve conditions in these communities. This is because when households own their housing, they have more of a stake in the success of their communities," Turner said. "But in these urban places the MID is doing the opposite; it's actually lowering the likelihood of owning a home."

The duo's study analyzed household data collected from 1984-2007 by the Panel Study of Income Dynamics.

Findings showed that the mortgage interest deduction boosts homeownership rates only in areas with an abundant housing supply, like the Midwest -- but only for higher-income households. In denser urban cities with limited housing available, the deduction actually has a negative impact, reducing homeownership and instead inflating housing prices.

According to Turner, the finding is consistent with economic theory: tight land restrictions mean that the higher demand for owner-occupied housing – because of increases in the mortgage interest deduction -- will only bid up house prices without expanding the house stock, which in turn means higher down payments.

Consequently, though households may be able to make monthly payments, low-wealth households can't afford the elevated down payment. These high house prices, and therefore higher transaction costs, also make homeownership a less attractive option to mobile households that may not be looking for a long-term purchase.

Turner and Hilber's initial study, "The mortgage interest deduction and its impact on homeownership decisions," is currently being revised for journal publication.

Most recently Turner presented the findings in October 2010 at an invitation-only research symposium on the future of housing and finance. The symposium, "Mortgage Foreclosures and the Future of Housing Finance," was hosted by the Federal Deposit Insurance Corporation/Federal Reserve Bank. It included opening remarks from

Ben Bernanke, chairman of the U.S. Federal Reserve, who touched on the importance of homeownership and its role in improving communities.

Provided by Kansas State University