



## Insight

# The Mortgage Interest Boondoggle

**AUGUST 8, 2011**

The home mortgage interest deduction costs the U.S. Treasury nearly \$100 billion a year without actually doing much to encourage home ownership, most evidence suggests. Providing an impetus for home ownership in the form of a tax deduction means that most of the benefits go to taxpayers in the highest tax brackets, most of whom can afford to buy a house without subsidies, while middle-class households receive a much smaller tax break. Only 26 percent of households take the mortgage interest deduction—and many of them live in the wealthy suburbs of major metropolitan areas in the Northeast Corridor or along the Pacific coast.

What's more, it isn't even clear that home ownership is something worth subsidizing in the first place—most studies purporting to find that home ownership begets people who are more civic-minded, responsible, and provident also acknowledge that it might well be the case that such people are merely more likely to be in a position to buy a house in the first place.

In short, the federal government gives up a lot of money to encourage people to buy homes without compelling evidence that it is effective in doing so or even that this is a worthwhile goal.

But if the citizenry (or its representatives in Congress) insists on continuing to encourage home ownership, perhaps it can do so in a more cost-effective way.

A good example of an inexpensive, targeted plan that has been successful in encouraging home ownership is one run by the Wisconsin Housing and Economic Development Authority (WHEDA). It does two things to help new homebuyers in the state: First, it subsidizes closing costs so that most people financing a mortgage through WHEDA only pay \$1,000 to \$3,000 in such fees, well below the typical closing costs in other states for comparably priced properties. Studies suggest that closing costs—which don't vary all that much with the price of a house—are a major barrier to home ownership for low- and middle-income households. The lower closing costs do not represent a mere gift: WHEDA makes up most of the subsidy by charging a slightly above market interest rate on the mortgage it provides.

Second, WHEDA does a thorough vetting of potential homebuyers—in addition to the normal credit checks and income history—and requires eight hours of classes on financial management and home buying. The education and additional vetting give WHEDA the ability to issue mortgages with lower down payments without substantially increasing the risk of foreclosures. Of course, since the housing collapse, nearly all mortgage originators have been compelled to do a much better job of vetting, but WHEDA's experience at this allows it to be less draconian about who is an acceptable risk today.

WHEDA limits participation in its program to first-time homebuyers with incomes below about \$80,000 purchasing a home priced below \$300,000—precisely the people who are likely to be on the fence between buying and renting.

By all measures the program works: Wisconsin's homeownership rate of 69.9 percent is 3 percentage points above the national average, even though the state's median income is below the national average. The state also has a foreclosure rate that is half the national rate. By targeting people who need assistance only with their closing costs, WHEDA has spent very little to give over 100,000 middle-income households the means to buy a home.

Other states offer similar assistance to first-time homebuyers. For example, Arkansas provides loans to cover closing costs for low-income first-time homebuyers that are potentially forgivable, and New Jersey offers a 30-year below-market fixed-rate mortgage with a smaller required down payment for their first-time low-income homebuyers.

By devolving home ownership incentive programs to the states it should be possible for them to tailor the programs to make them even more effective. What works in Wisconsin won't necessarily work for New York.

Wisconsin and other states with narrowly targeted home-buying incentive programs get a lot of bang for the buck, costing the states nearly nothing while materially increasing home ownership. None of which can be said of the federal mortgage interest deduction. If policymakers are serious about eliminating misplaced incentives and reducing our mountain of debt, then it makes sense to phase out the mortgage interest deduction and encourage states to develop more programs like WHEDA.

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This originally appeared in [The Weekly Standard](#) on August 6th, 2011.