

# Home Mortgage Interest Deduction Tax Expenditure Evaluation

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PREPARED FOR THE TAX EXPENDITURE REVIEW COMMISSION

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# Agenda

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- Background
- Tax Expenditure Objective
- Evaluation Overview and Findings

# Background: Home Mortgage Interest Deduction (MID)

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- **Minnesota Personal Deduction** from the **Individual Income Tax** for interest paid on debt secured by a principal or second residence
- The MID is claimed using the **Schedule M1SA**, Minnesota Itemized Deduction worksheet included with a Minnesota tax return
- **Mortgage interest is deductible** on up to **\$750,000 of debt** used to buy, build, or improve a principal or second residence
- Minnesota conformed to the 2017 Tax Cuts and Jobs Act (TCJA), implementing its own set of amendments for itemized deductions beginning in 2019

## Background (cont.)

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- The MID has an estimate of **annual revenue lost** of **\$49.4 million** in **FY 2024** and is projected to increase to **\$74.9 million** in **FY 2027**
- If the tax expenditure were **repealed** and **revenue was held constant**, **each income tax rate could be reduced by 0.023 percentage points**, to 5.327%, 6.777%, 7.827%, and 9.827%

# Tax Expenditure Objectives

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“The objective of the Minnesota Home Mortgage Interest Deduction is to recognize expenses incurred in generating personal income or wealth and encourage home ownership at all levels of income”

*The objective was amended and approved by TERC on July 10, 2024.*

# Scope of Evaluation

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- Data Analysis
  - Summary of Minnesota MID claims data from Minnesota Department of Revenue (DOR)
  - Literature review on the impact of the federal and state MID on homeownership
  - Analysis of administrative burden for both MID filers and DOR

# Evaluation Findings

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- Number of MID claims dropped after the enactment of the TCJA of 2017 due to the doubling of the standard deduction
- High income Minnesotans receive most of the MID benefit
- The academic literature suggests that the MID does not encourage homeownership
- The MID is not administratively burdensome

# Minnesota Itemized Deductions

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- Itemized deductions dropped after the 2017 TCJA doubled the standard deduction
  - Fewer Minnesotans chose itemized deductions after 2017
  - In 2017, **59%** of Minnesotans itemized vs only **6%** in 2021-2023
  - Similar downward trends in itemized deductions across all income deciles
  - Overall, in 2017-2023, **high income** Minnesotans are **more likely to itemize** their deductions

# Minnesota MID Claims

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- MID claims dropped after the 2017 TCJA doubled the standard deduction
  - In 2017, an estimated **750,389 filers** claimed the Minnesota MID
  - In 2023, an estimated **118,452 filers** claimed the Minnesota MID
  - From 2018 to 2019 shows the largest yearly percentage decrease (**68%**)
  - Except the very top of the income distribution, the number of MID claimants in each income decile decreases from 2017 to 2021

# Income Distribution of MID Beneficiaries

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- High income Minnesotans receive most of the MID benefit
  - In 2017, **30% of filers** in the highest income decile claimed the MID vs **5% of filers** from the lowest income decile
  - In 2019-2023, **10-16% of filers** in the highest income decile claimed the MID vs **1% of filers** in the lowest income decile
  - In 2019, **lowest 70% of all tax filers** received only **22 percent of MID benefits**
  - In 2019, **highest 9% of all tax filers** received over **50 percent of MID benefits**

# MID and Homeownership

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- ***Academic literature: MID has no impact on homeownership***
  - Federal Reserve Bank of St. Louis (2018): MID encourages the purchase and construction of larger homes
  - U.S. Congressional Research Service (2017): MID is ineffective in promoting homeownership (down payments—not mortgages—are a higher barrier to homeownership)
  - Hansen(2012): MID increased the size of home purchased, but no relationship exists between MID and homeownership
  - Hilbert and Turner (2014): MID is an ineffective policy to promote homeownership

# MID and Homeownership (cont.)

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- ***Academic literature: MID has no impact on homeownership***
  - Glaeser and Shapiro (2003): MID is a poor instrument for encouraging homeownership because it is targeted at the wealthy, who are almost always homeowners
  - Bourassa et al. (2013): MID generally does not increase the homeownership rates in European countries
  - Gruber et al. (2017): MID has a precisely estimated zero effect on homeownership in Denmark
  - Oregon MID evaluation: MID is regressive, and does not encourage homeownership

# Administrative Burden of MID

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- Minnesota Department of Revenue:
  - Approximately **0.5 FTE** for specific issues with the M1SA itemized deduction
  - If the MID was removed from the M1SA itemized deduction paperwork, there would be an insignificant reduction in administrative burden
- Taxpayers:
  - Schedule M1SA is utilized to itemize deductions and report home mortgage interest and points reported and not reported from federal form 1098
  - No income threshold, and no additional filing is required

# Conclusion

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- The Minnesota MID aims to recognize expenses incurred in generating personal income or wealth and encourage homeownership at all levels of income
  - MID claims decreased after 2017 due to the TCJA
  - High income Minnesotans receive most of the MID benefit
  - Academic evidence suggests that MID does not encourage home ownership
  - The MID is not administratively burdensome

# Thank you

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# Appendix Slides

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# Component of Review #1:

## Estimate of Annual Revenue Lost

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| Fiscal Year                                | 2024         | 2025         | 2026         | 2027         |
|--------------------------------------------|--------------|--------------|--------------|--------------|
| Minnesota Home Mortgage Interest Deduction | \$49,400,000 | \$54,700,000 | \$63,400,000 | \$74,900,000 |

*The 2024 Tax Expenditure Budget showed forgone revenue of \$73.5 million in FY24 for this provision, growing to \$90.9 million in FY27. Those estimates included a coding error that overstated the revenue loss. The estimates shown here are corrected and updated for the most recent economic forecast.*

## Component of Review #5:

### Potential Modifications to Increase Efficiency or Effectiveness

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- Lowering of the interest limit to either \$20,000 or \$10,000. This is estimated to lead to a ten-year revenue increase of \$170 and \$521 billion respectively. Another possible modification discussed was a full repeal of the MID.
- Currently the MID applies to interest paid on second homes, including vacation homes. Limiting to primary residences is estimated to lead to half a million fewer returns itemizing deductions, approximately one percent of itemizers at the federal level.

# Component of Review #7:

## Incidence of the Tax Expenditure and Effect on State Tax System

| Resident by Population Decile | Total Individual Income Tax | Tax Change   | Share of Tax Change | Count   |
|-------------------------------|-----------------------------|--------------|---------------------|---------|
| <b>\$15,544 &amp; under</b>   | -\$12,885,164               | \$77,873     | 0.1%                | 89      |
| <b>\$15,545 - \$24,961</b>    | -\$8,897,060                | \$79,163     | 0.1%                | 136     |
| <b>\$24,962 - \$35,168</b>    | \$50,299,493                | \$161,917    | 0.2%                | 548     |
| <b>\$35,169 - \$45,808</b>    | \$162,527,171               | \$665,684    | 0.9%                | 2,352   |
| <b>\$45,809 - \$58,014</b>    | \$329,724,240               | \$912,309    | 1.2%                | 4,959   |
| <b>\$58,015 - \$73,668</b>    | \$536,303,127               | \$1,826,399  | 2.5%                | 7,845   |
| <b>\$73,669 - \$95,360</b>    | \$819,647,313               | \$3,723,126  | 5.1%                | 11,332  |
| <b>\$95,361 - \$127,780</b>   | \$1,210,630,834             | \$4,164,498  | 5.7%                | 14,749  |
| <b>\$127,781 - \$183,475</b>  | \$1,954,222,647             | \$6,899,383  | 9.4%                | 16,250  |
| <b>\$183,476 &amp; over</b>   | \$8,869,633,832             | \$48,164,712 | 65.5%               | 45,084  |
| <b>Nonresidents</b>           | \$961,801,005               | \$6,824,937  | 9.3%                | 14,366  |
| <b>All</b>                    | \$14,873,000,000            | \$73,500,000 | 100.0%              | 117,700 |

# Compare to Direct Expenditure with the Same Objective and Other State/Federal Programs

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- This review was limited to the following state-level programs:
  - Start Up and Step Up Loan Programs
  - Homeownership Capacity Program
  - Homebuyer Education Counseling and Training (HECAT)
- At the federal level, this review was limited to the following programs:
  - Homeowner Assistance Fund
  - Federal Home Mortgage Interest Deduction

# Federal Programs

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- The **Homeowner Assistance Fund** was established to be utilized for mortgage and utility payments as well as homeowner insurance for individuals unable to make payments due to COVID-19 related financial crises. In Minnesota, 7,485 homeowners were assisted through 2023.
- **Federal Housing Administration Loans** are government-backed mortgages designed with income restrictions. MHFA approved lenders provide mortgage insurance through the Federal Housing Administration to provide mortgage insurance for both single and multifamily loans.
- **The Indian Housing Loan Guarantee Program** provides single-family housing fixed-rate home mortgage loans for 30 years or less for Native communities and tribally designated housing entities. Eight tribes within Minnesota participate in the program and all counties in Minnesota are approved program areas.
- **Veterans Affairs (VA)** provides home mortgage loans to Veterans based on service, duty status, and character of service.

# General Appendix Slides

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# Appendix: Best Practices to Evaluate Tax Expenditures

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- At minimum, evaluations should include:
  - A description of the incentive, including its history and goals
  - An assessment of the program's design and administration
  - Estimates of the expenditure's economic and fiscal impacts
  - Policy recommendations

*Best Practices presented to TERC August 11, 2022, by PEW Charitable Trusts*

## Appendix: Best Practices... Other Criteria to Consider

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- Displacement – to what extent does the expenditure benefit certain taxpayers at the expense of others?
- Leakage – does the expenditure benefit non-state residents?
- Timing – how does timing impact the level of fiscal risk and economic return to the state?
- Opportunity costs – are there trade-offs related to expenditure costs?
- “But for” – does the credit change taxpayer behavior?

*Best Practices presented to TERC August 11, 2022, by PEW Charitable Trusts*

# General Tax Principles

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I. Allocative Efficiency (Neutrality)

II. Fairness and Equity

- Horizontal Equity – Equal treatment of equals

III. Simplicity

- Transparency
- Ease of compliance and administration

May conflict with each other or with policy goals (vertical equity, maintaining state competitiveness, promoting economic development)

# Minnesota Statutes, Section 3.8855, Subdivision 5

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Tax expenditure review must include:

1. **Annual revenue lost** as a result of the expenditure
2. **Objective** of the tax expenditure
3. **Impacts and efficiency** in accomplishing its objective
4. **Compare the effectiveness** of a tax expenditure and a direct expenditure with the same objective
5. **Potential modifications** to the tax expenditure to increase efficiency or effectiveness
6. **Amount the tax rate could be reduced** if the revenue lost due to the tax expenditure were applied to a rate reduction

# Minn. Stat. 3.8855, Subdivision 5 (continued)

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7. **Incidence** of the tax expenditure and the effect of the expenditure on the incidence of the state's tax system (if tax expenditure is significant)
  - A significant tax expenditure, as defined in [Minnesota Statutes, section 270C.11, subdivision 6](#), is a tax expenditure but excludes any tax expenditure that:
    - a) is incorporated into state law by reference to a federal definition of income;
    - b) results in a revenue reduction of less than \$10,000,000 per biennium; or
    - c) is a business tax credit
8. **Fiscal impacts of other state and federal taxes** providing benefits to taxpayer for similar activities
9. **Recommend** whether the tax expenditure be continued, repealed, or modified