16 Buchanan Circle
Lynn, MA
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1-781-598-2416

Connie Mack
Shaw Pittman LLP

MR Mack:

In a Boston Globe article of 1/8/05, 'President names tax overhaul panel,' John Snow is quoted as saying "Everything is on the table." Yet, in a NYT article of 1/9/05, 'Bush names two Ex-Senators to consider tax changes,' it seems that the Home Mortgage Interest Deduction has fallen off. No surprise there. HMID is the ultimate deduction icon - and the economic third rail for those who would call for it's elimination. Most people believe that it's a tax measure whereby a kindly Government helps the little guy buy a house and get a piece of the American Dream. Not a bit of it! It's more like a nightmare for the truly little guy with more and more going to those who already have more. It is, in effect, the ultimate regressive tax - and I've written a paper in support of that view.

Because you are on the tax panel, I'm sending:

A. A copy of my essay on HMID

B. A paper giving some of my background and how I came to write the 'essay' (Includes comments about it)

C. A Real Estate Booklet which I've re-named!

I'd appreciate any comments you wish to make.

Charles H. Donnell

* There's a famous saying about show business (in New York) - "If you can make it there you can make it anywhere." I think that the same idea can be applied to the HMID subsidy (and it is a subsidy!). If you can eliminate that deduction you can eliminate any deduction!

Charles H. Donnelly
16 Buchanan Circle
Lynn, MA 01902
781-598-2416

The income tax deduction for the interest on home mortgages has, in recent decades, become one of the most important factors responsible for the huge gap that now exists between the economic haves and have-nots. Once a crevice, then a chasm, it is now a canyon, especially in areas of high real estate values. Compared to those on the sunnyside of the abyss, those in the shadows are all but another economic species. But even among those on the winning side there is great disparity--with larger and larger pieces of the pie going to those with more and more. Imagine trying to sell a program which features a graduated income tax, but it is graduated backwards. The lower your income, the higher your tax rate. What?! That's absurd. Nothing like that could ever be passed. The American people would never put up with it. It would be so regressive, and the United States prides itself in its progressive tax system.

Yet, regressive is exactly what the tax deduction for mortgage interest is. Even so, the American people not only put up with it, they embrace it as their own. It is hailed as a device to help those of modest means buy a house and realize "The American Dream." But if you searched high and low you would be hard-pressed to find a measure more apt to destroy that dream for those with the most modest means.

No matter. The snow job in support of this deduction has been so effective, that even those on the losing side sing its praises. So strong is the feeling on this issue, so powerful the lobby in its support, that it may well be the rock upon which any true "flat tax" will founder.

Somehow there is a belief that by means of the mortgage interest deduction a kindly Government gives needy people help in becoming homeowners. Sorry, but that's not the way it works.

First of all, the Government doesn't give, it takes. Secondly, at least in this case, it redistributes that which it takes in such a manner that those with the most expensive homes 'get back' the most; those with less expensive homes get back less; those who don't own a home--why they get back nothing at all!

But it doesn't stop there. Trade up to a much larger home, even buy a second one. No problem. Other taxpayers, even those who can't afford a home, will help you pay for it!

What a system! They sure don't do that in most other Western Industrial Nations. Right. And none of them have as large a gap between their haves and have-nots as we do.

Tax deductions such as those for home mortgage interest don't come without a price to pay, and part of that price is a larger deficit and all that flows from it. The home mortgage interest deduction should be done away with. It never should have been in the first place. Any measure which claims to be helping those most in need, while providing much more to many who are clearly not in need, is nothing but a fraud. With over 70% of the deductions going to those with mortgages on homes valued at over $250,000, and at least 40% going to those with incomes in excess of $100,000, the true little guy need not be concerned. With the elimination of HMID he would, in fact, realize a significant gain--further evidence that such a tax write-out is inherently regressive.

There's an additional bonus payable upon elimination of any tax deduction based upon mortgage interest--at least for those in most of the country. They will no longer have to subsidize homeowners in such super-expensive housing places such as Massachusetts, California, and Hawaii. They do now!

In any discussion it often helps to give some examples--to flesh things out a bit:

-Mr. A has a low income and very little in savings. He can't afford to buy. He rents.

-Mr. B, of modest income, owns a small house and gets back about $800 each year from his mortgage interest deduction. It's not a lot of money--but it's more than A gets.

-Mr. C is a bit more comfortable. He owns a larger house and gets back about $1,500 each spring.

-Mr. D is on his way up. He owns a very nice house. Other taxpayers kick in a solid $3,500/yr. for him.

-Mr. E is a corporate CEO, has a very substantial 'income' and a very expensive home. He also has a vacation house up on the lake. We award him about $12,000/yr.

-Mr. F is what it's all about! Not yet 30, he makes several million a year for hitting a little ball over a high fence with a big stick. He owns a regular mansion. It costs us about $35,000 every year to keep him there.

But none of this seems to matter. The American people want to keep the mortgage interest deduction. They look upon it as their due--all but a birthright. They want their benefits left alone. What they want to get rid of is WELFARE! But the housing cost of what they call welfare pales in comparison to the cost of mortgage interest deduction. For many people, HMID is super-welfare beyond the dreams of some single mother in the innercity.

By the way, did I tell you? Mr. F recently bought one of those fancy European sports cars. It's a real beauty. (It ought to be for $195,000!) Well, at least we won't have to help him pay the interest on that note. Tax law changes of the mid-80s did away with interest deductions on car loans--didn't they? Well, yes and no. You see, the tax laws allow for an amazing economic sleight of hand. When is a car not a car? When it's a house!

Take out a Home Equity Loan--or, in Mr. F's case, a Mansion Equity Loan--and, like magic, it's deductible. Is it legal? You bet it is! Anyone of our guys can do it--<u>except</u> Mr. A. No home--no Home Equity Loan--no tax deduction. Tough luck for him.

Earlier, I mentioned that homeowners want to keep their housing benefits. They do this while supporting, even advocating, a crackdown on 'handouts' such as rent 'subsidies' which go mostly to the poor. They don't consider themselves to have been handed anything. They don't believe that what they get is a subsidy--and they certainly don't think that they are on WELFARE. But it is--and they are!

This desire for a crackdown has not gone unnoticed by political types, and the result has been the adoption and enforcement of much more stringent requirements which must be met before one can qualify for a rent subsidy. There are now time limits (usually about 3 years) and all subsidy recipients are required to do so many hours of 'Community Service' each week. Some people sweep up in front of the apartments; some rake leaves in a city park. Last year, a TV program showed a rent subsidy shovel brigade setting off one morning at 8 AM to clean up abandoned city lots.

Those who champion such 'work for benefits received' claim that they are not being vindictive. They say that it helps people learn to stand on their own two feet, that it boosts their self-esteem. Maybe so, but I can't help wondering why it doesn't apply equally to all.

Massachusetts has a lot more than its share of affluent towns, where housing values are sky high and where the % of owner-occupied, single family homes is extraordinary. Since this is so, it seems reasonable to conclude that a very high % of the homeowners in such places are now, once were, or again will be, receiving checks from the I.R.S. based upon the home mortgage interest deduction. They are given someone else's money simply because they own a house with a mortgage and itemize on their tax returns! I hate to say it but the evidence is inescapable--those leafy enclaves are really vast tracts of subsidized housing! It's the economic world turned upside down. All along we have been led to believe that it's in the older cities where people are getting handouts--while in reality it happens mostly in suburbia! Isn't that something!

Despite the reality of subsidies, life in those towns goes on pretty much as it always has. You never see any homeowners out meeting their "Community Service" requirements. I've never seen residents of Lexington raking the grass on the Battle Green; I've never seen those in Concord applying a fresh coat of paint to that "Rude Bridge That Arched the Flood;" nowhere along the idyllic North Shore have I seen mortgage interest deductees picking up litter on the beaches. They don't do such things because, unlike fellow subsidy receivers of the innercity, they don't have to! All things considered, their self-esteem must be at rock bottom!

Sarcasm, to be sure. But the present system cries out for a sarcastic response. A couple can have a multi-million dollar home, with a million dollar mortgage, and, year after year, get back a big check from the I.R.S. No work requirements--no time limits. They could sell the property, make up to $500,000 in capital gains, and not pay a cent in taxes. This is not rocket science, it's not even model rocket science. When someone is given a tax dispensation, especially one as large as that, someone else has to pay!

But apparently even that is not enough. A recent newspaper story told of the 'plight' (yes, they really used that word) of people who have seen their homes increase in value by over $500,000 (not at all uncommon around here). As it stands now if one of those couples were to sell their home--and not buy another--they would actually have to pay some tax. Isn't that awful! How can they possibly survive? It makes you want to go right out and have a bake sale for them!

When a person (me, for example) attacks an icon such as the Home Mortgage Interest Deduction he is already at risk so why not step it up another notch and go after that, now ubiquitous nonsense-phrase 'House Poor'. Saying someone is House Poor is a bit like saying that the owner of a valuable painting is 'canvas poor' or that the owner of the Hope Diamond is 'carbon poor'. Not long ago another newspaper ran its own 'plight' story and made liberal use of it. A group of retired couples, all owners of fully paid for expensive homes, want--indeed, say they need--help in paying their property tax. Many towns have responded by giving those below a certain income level a tax rebate or by creating a 'job' of a few hours per day justifying a tax reduction. On the surface, fine. It takes the pressure off of people who have a low income. But, below the surface, this is how it often works out:

Mr. and Mrs. X are retired, both 65, live in a fully paid for home valued at $600,000. They have an income of $25,000 and pay $4,200/year in property tax.

Mr. and Mrs. Y are also each 65 and retired with same income. They have no $600,000 asset and pay $12,000/year to rent a small apartment.

(To keep it simple we will leave out 'other assets' that the couples might have. If we did include them the tilt would more than likely, go even more strongly toward the Xs.)

Now if there's any doubt that these two couples, qualify as examples of 'two different economic species' which I mentioned earlier, then the doubter has to be operating at an emotional rather than a rational level. Yet, as far as the Town is concerned, it's the Xs who are in need! The Ys are not even eligible for any of those 'jobs'. How do I know that? I asked. As usual money flows toward those who have the most.

That mindset, perhaps a tiny bit understandable at the local level, pervades national organizations, as well. An economist for a nationwide secondary mortgage group was quoted in a major newspaper on the subject of the 'problem' faced by those who have seen their homes skyrocket in value--with: "But you cannot eat your house." Of all the cliche-driven gobbledegook which is out and about these days--that takes the cake. As long as an attitude like that continues to prevail--it will allow those who have more not only to have their cake and eat it too--but to eat yours as well!

If there is ever to be meaningful tax reform, the enactment of a true flat tax, for example, the Home Mortgage Interest Deduction (and the $500,000 capital gains exclusion) must end. It must not be modified, or adjusted or capped--it must end. A flat tax with HMID is really a non-flat flat tax, an economic oxymoron. A bit like a square circle.

But hasn't Home Mortgage Interest Deduction made the U.S. first in the % of homeownership? We are not No. 1, although near the top but that may well be in spite of, not because of, the interest deduction subsidy. After all we are the richest nation on Earth. Would housing prices drop if mortgage interest deduction were eliminated? Probably. But if they did, that would support my case. They are artificially high due to subsidies.

For a couple of years now, during this economic downturn, 'experts' have been amazed at resilience of housing. They say that it has propped-up the economy and prevented an even more disasterous slide. Housing is not the propper-upper of the economy, it's a propee! Housing is super subsidized and the way it is subsidized makes it a super-regressive tax.

It's a bit frustrating trying to get this point across: There are no Government Subsidies, no Government Grants; there are only other People's Money Subsidies, other People's Money Grants. If you do lose your Home Mortgage Interest Deduction you are losing your license to take other people's money from them--a license that should never have been granted in the first place!

V

- Some Comments On My Essay -

① Carolyn Shaw Bell (Katharine Coman Emerita Professor of Economics at Wellesley College)
--- Her reply: "Oh my, this is really interesting!" followed by two full pages (In agreement)

② Milton Friedman (Senior Research Fellow at the Hoover Institution in Stanford, CA)
While saying that "it (The Home Mortgage Interest Deduction) raises house prices and benefits owners of homes", Dr. Friedman goes even further than I do. He writes, "The real subsidy to homeowners is the failure to include the rental value of owned homes as part of the income which is subject to tax".

③ Robert Reich (Former Secretary of Labor - now Professor of Economics at Brandeis University)
Someone from his office at Brandeis called to tell me that MR. Reich "found my analysis to be very interesting. Later, I spoke to him briefly at the Waltham campus.

④ Steve Moore (The Cato Institute)
From his letter: "You are entirely correct that this is a deduction that takes from the poor and gives to the rich. I hope to cite your findings myself" (He did - Washington Times 4/19/98)

⑤ Casey Mulligan - Professor of Economics at The University of Chicago - "I have read your essay on HMID and I'm quite impressed with your reasoning."

⑥ Millard Fuller - (Habitat For Humanity)
"I think that your logic and insight are correct"

⑦ Steve Forbes - "Your essay on the Home Mortgage Deduction is most impressive indeed"

(8) Lester Thurow - (Massachusetts Institute of Technology) His letter begins with a succinct "Your point about the interest deduction is Correct"

(9) Rachel Bratt - (Tufts University Department of Urban and Environmental Policy) - "Good for you for puzzling through the homeowner deduction puzzle"

(10) Barbara Anderson - (Citizens For Limited Taxation and Government) "I cant think of anything I needed for my 'Flat Tax' files more than this"

(11) Board of Governors of the Federal Reserve System - "Chairman Greenspan has asked me to thank you for your letter and your paper, entitled, 'Home Mortgage Interest Deduction'."

⑫ Michele McGeoy (CEO, R.H. Solutions, Inc
Berkeley, CA.)
"I was absolutely thrilled to read your article about HMID. It's something that's been eating at me lately and I actually started to write an article, but never finished. You really did a brilliant job of laying this out"!

⑬ Larry Linsey (Assistant To the President for Economic Policy)
---"Your articles on this topic are certainly interesting and thought provoking. Indeed upper-income taxpayers are more likely to claim the home mortgage interest deduction than low-income taxpayers"

⑭ Department of Housing & Urban Development-
"On behalf of Secretary Cuomo ---- I am forwarding your letter directly to the Department of Treasury's Internal Revenue Service"

(15) <u>Local</u> <u>Initiatives</u> <u>Support</u> <u>Corporation</u> New York, N.Y.
Paul S. Grogan - President

"You are right to point out that the Home Mortgage Interest Deduction is a 'sacred icon' of housing. As you are aware, the amount of tax dollars forgiven under HMID is significantly higher than all the money the Government spends* on affordable housing.

* My note: The Government doesn't spend - at least it doesn't spend it's money because it doesn't have any. A 'Government Grant' or a 'Government Subsidy' is, in essence, an 'Other People's Money Grant' or an 'Other People's Money Subsidy'. When someone is given a tax 'deduction' he or she is really being given someone else's money.

(16) <u>Citizens</u> <u>Housing</u> <u>Access</u> <u>Inc</u> Boston, MA
Their comment: "As you correctly point out, there is a bias in our housing law toward homeownership versus renting. We think people ought to turn that bias to their own self-interest and buy a home if they can."
(Andrew M. Olins, President)

(17) Richard Kagan - (Center On Budget and Policy Priorities - Washington, D.C.)
"Thank you for your letter on Home Mortgage Interest Deduction which is a tax subsidy for borrowing to buy housing. I generally agree with your analysis: Like all income tax deductions, it is regressive in that it benefits a wealthy person more than one of modest means.

(18) Eric Belsky (Joint Center For Housing Studies - Harvard University)
From his letter: "Your logic concerning the mortgage interest deduction is unimpeachable. It most definitely does primarily benefit wealthy individuals and provides an enormous subsidy (but on a smaller per capita basis than for the wealthy) to the middle class", etc.

--- I've also spoken to Professors of Economics at Brown, Brandeis, Syracuse, and the University of New Hampshire. All of them agreed that my analysis was sound.

Charles H. Donnelly

- Additional Comments -

<u>MR. Ray Boshara</u> - New America Foundation
"You are exactly right that the mortgage deductions are a form of welfare that has no public policy justification whatsoever".

<u>MR. Shawn Tully</u> - Fortune Magazine
Your Criticism of the mortgage deduction is provocative, and your praise of the flat tax is perceptive.

<u>MR Robert H. Edelstein</u> - Chairman, Fisher Center For Real Estate and Urban Economics
U. of California, Berkeley
"In brief, you are fundamentally correct; the interest rate mortgage deduction (in combination with the "failure" to account for the implicit rental income of housing) creates a subsidy and set of incentives for homeownership that will tend to bestow more benefits upon higher income households"

I'm a retired teacher - of 9th Grade Physical Science and Mathematics. At a social function in one of those affluent towns West of Boston - in 1996 - someone was 'sounding off' about, what he called, "those lazy welfare cheats". He had seen a TV program about a 'crackdown' on those who were receiving rent subsidies in a major East Coast city. From 'now on' all able-bodied recipients of such aid would have to perform so many hours of Community Service each month - and there would be a strictly enforced time limit about 2-3 years. He was elated that someone had finally caught up with those "no-goods" who were "stealing taxpayers money".

I didn't say anything - until someone asked my opinion then I did! I said that virtually every house in that 'leafy enclave' is now, once was, or again will be - subsidized. And the 'subsidy getters' - the owners of those homes - don't have to report 'so many hours per month' for their stint of Community Service. And they have no time limits. They can collect their subsidies forever!

The vehicle for those subsidies is the Home Mortgage Interest Deduction on the Federal Income Tax - a measure which is right up there with ~~God~~ Motherhood, the Flag, and Apple Pie. Those three deserve their lofty status - the Home Mortgage Interest Deduction does not. It is, in fact, the Ultimate Regressive Tax. After escaping from that town, I set out to prove it!

I did some research and then wrote a paper - an essay of four pages: The Home Mortgage Interest Deduction. I knew that the ideas I expressed - especially when such ideas came from an unknown wouldn't get very far, so I sent my paper to Carolyn Shaw Bell, who is the Katharine Coman Emerita Professor of Economics at Wellesley College. I didn't know Professor Bell. I wrote to her simply because I read her weekly column in the Boston Globe. I asked for her opinion of my essay. In a letter that began with, "My this is interesting!" - and then went on for 2-3 more pages, Professor Bell urged me to try to get it published - and told me to say that she suggested that I write. I took her advice. I sent my essay to about 15 newspapers. All replied - some even by phone. I got 1 call from the Philadelphia Inquirer and 2 calls from the Chicago Sun-Times. It ultimately ended up in just two papers: The Corpus Christi Caller-Times and the Lawrence (MA) Eagle Tribune. The Caller-Times gave me nearly a full page, even an 'Editoral Cartoon'! Several papers suggested I re-submit it as a Letter To The Editor. I wasn't interested in going that route.

I next sent copies of my essay to people in Academia, in Government, in Business. I asked for their opinion. Nearly all replied (I've included some here) "Some Comments On My Essay"

I even went further. Over the years I've visited many of my former students at college I've been to: Boston College; Brandeis; Harvard; Stonehill; Wheaton (M. Northeastern; U.Mass; Wellesley; Brown; Syracuse; U. of Vermont; U. of New Hampshire; Loyola of Baltimore; Johns Hopkins. At several of those schools I arranged to sit across the desk from a member of the Economics Faculty and discuss my paper. All said that my basic argument was sound. I even 'converted' a few people! One man sure was honest about the whole thing. While he acknowledged that I was correct, he didn't want to see the HMID eliminated. He owned an expensive home with a big mortgage and he got back a big check from the I.R.S each and every Spring. The system that we have forced other people (even those less well-off than he was) to help him pay for his very expensive home! He wants that to continue! Like many others he wants to get rid of unfairness in the tax system - unless that unfairness favors them! That, of course, is the essential problem

I shelved my little project for a few years and went on to other things. Then, about a year ago, the astonishing [there's no other word for it] increase in housing values around here caused me to dust off my essay and eventually to expand it - to over twice its original length. The reviews on this elongated version are now coming in. They are even more positive. A couple of people said that I've written the definitive paper on the subject. I guess that's good - at least 'definitive paper' sounds good! Professor Bell said that my paper is not written in 'stuffy' economics jargon either. I don't know about that. I just have my own style.

So I'm sending you a copy. I've also enclosed a little Real Estate booklet. You will notice that I've re-named it the 'Massachusetts Subsidized Housing' booklet. Sarcasm - of course! But its true!!

Charles H Donnelly