

# Congress Should Phase Out the Mortgage Interest Deduction

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The mortgage interest deduction is one of the most expensive federal tax preferences. The Joint Committee on Taxation (2013) estimated that the deduction will cost about \$380 billion from fiscal years 2013 through 2017. Homeowners also benefit from the deduction of real property taxes and the exemption of the first \$250,000 (\$500,000 for couples) of capital gains on the sale of principal residences.

Defenders of the mortgage interest deduction claim that it stimulates homeownership, which they argue has many broader benefits to society beyond the benefits to the owners themselves. I argue instead that the case for these “external” social benefits is unproven and that, even if these benefits exist, the mortgage interest deduction is an ineffective tool for increasing homeownership. Instead, the deduction mostly serves as an incentive for middle-income and upper income people to acquire larger and more expensive homes than they otherwise would have purchased. These increased investments in homes that the tax subsidy generates divert resources from business investments with a larger social yield but without a comparable tax subsidy. If promoting homeownership is the goal, a subsidy directed to people who might be choosing between buying and renting would be a more effective tool for doing so.

## Does Owning Instead of Renting Provide Net Social Benefits?

Proponents of homeownership subsidies cite social benefits of homeownership. An extensive body of research (DiPasquale and Glaeser, 1999; Galster, 1983; Glaeser and Sacerdote, 2000; Glaeser and Shapiro, 2003; Rossi and Weber, 1996) has found that owner-occupied homes are better maintained than rental properties, homeowners have higher rates of voting and other forms of civic participation than renters, and crime rates are lower in areas with more homeowners. The studies do not establish, however, whether homeownership *causes* these benefits or whether people who are civic-minded or less likely to commit crimes are more likely to buy homes (Gale, Gruber, and Stephens-Davidowitz, 2007). Some analysts also suggest that promoting homeownership among low-income people may help them accumulate wealth and thereby promote social mobility (Lerman and McKernan, 2008). Homeownership also comes with downsides, however. Homeownership may limit job mobility because of the much greater costs associated with buying and selling homes than with moving

from one rental property to another. Events in the past few years have shown that excessive home mortgage debt can expose individuals and the broader economy to significant risk. Although it is important to maintain financial arrangements that enable people to obtain long-term loans to buy homes, doing so does not mean that federal policy should tilt the playing field toward owning instead of renting.

## **Does the Mortgage Interest Deduction Increase Homeownership?**

Even if one accepts that the federal government should promote homeownership, it does not follow that the mortgage interest deduction is a good way to do it. The current deduction provides no subsidy to the 65 percent of taxpayers who do not itemize deductions on their tax returns or the many households that have no tax liability at all. It provides only a modest subsidy to itemizers in the 15-percent tax bracket. The subsidy value is greatest among upper middle-income taxpayers, those who are most likely to own a home without a subsidy. Studies have found no evidence that the change in the value of the mortgage deduction over time (as marginal tax rates have changed) has affected homeownership rates in the United States (Glaeser and Shapiro, 2003), and no drop in homeownership occurred when the United Kingdom reduced its mortgage interest subsidy (Gale, 2001, 1997). Culturally similar countries, including Canada, New Zealand, and Australia offer no mortgage interest deduction but have homeownership rates similar to those in the United States (Mann, 2000).

The subsidy very well might help upper middle-income taxpayers in high-rate brackets to afford larger mortgages and thereby purchase more expensive homes. It is unclear, however, why federal taxpayers should subsidize relatively well-off people's acquisition of more expensive homes.

## **What Are More Effective Ways of Promoting Homeownership?**

Subsidies that are better directed to those on the margin between buying and renting would more effectively increase homeownership, in general, and would enable low-income people to become homeowners, assuming that the social benefits of community stability and the need for asset building are greatest among that population. Converting the deduction to a uniform percentage credit for mortgage interest or to an investment credit for first-time homeowners would provide a more direct incentive for homeownership and reduce the subsidy for upper income households to buy more expensive homes with borrowed money. Decreasing the cap on the amount of debt eligible for a tax subsidy and eliminating the deductibility of interest for vacation homes and home equity loans could achieve further budgetary savings to pay for homeownership incentives or deficit reduction.

## **What Would Be the Effects of Phasing Out the Mortgage Interest Deduction on Housing Markets?**

If the mortgage interest deduction did not exist, the federal government would have no good reason to invent it. Taking away the deduction quickly, however, would have adverse effects on

housing markets. Housing prices have recovered much of the ground lost in the Great Recession but are still weak in many regions. Some homeowners, especially younger people who have recently purchased homes, would experience increased housing costs and reduced home value.

For these reasons, any limits on deductibility should be phased in gradually to allow markets to adjust and to limit capital losses to homeowners. Permanently maintaining a subsidy, however, that is not effective in achieving its stated goal, contributes billions to the federal deficit, and diverts scarce capital from better uses to larger homes is not the answer. We should phase out the mortgage interest deduction.

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