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RESEARCH SUMMARY

REFORMING THE MORTGAGE INTEREST DEDUCTION

The mortgage interest deduction (MID)—the second largest tax break in the United States at $69 billion per year—has long been touted as a critical tool for promoting middle-class prosperity and homeownership. But Americans may be surprised to learn that the only taxpayers who receive a large benefit from this deduction are those in upper income brackets; most taxpayers don't benefit at all from the deduction.

In a new study for the Mercatus Center at George Mason University, Jason Fichtner and Jacob Feldman review why the current MID has failed to accomplish its intended purpose of expanding homeownership for the middle class, and instead has encouraged higher levels of debt and borrowing by households that can already afford a home. The study examines various reform proposals, and concludes that—failing the ideal but politically difficult reform of repealing the tax break and lowering marginal rates—policymakers should replace the MID with a nonrefundable credit for homeownership to better align the tax break with purported policy goals.

To read the study in its entirety, please see "Reforming the Mortgage Interest Deduction."

KEY POINTS

Who Benefits from the Current MID?
Supporters of the mortgage interest deduction often argue that it promotes middle-class homeownership. However, 64 percent of the benefits—as measured by effective tax reduction—go to households earning more than $100,000.

- Very few lower-income households claim the MID. Of the 65 percent of taxpayers claiming income of $50,000 or less, fewer than 10 percent use the MID. Households earning $50,000 or less typically don't pay enough in mortgage interest expenses (and other tax-deductible items) to itemize rather than using the standard deduction ($6,200 for an individual, $12,400 for married couples).

- Because higher-income earners pay higher marginal tax rates, they benefit from claiming the MID. The average effective tax reduction for a filer earning between $100,000 and $200,000 is $1,420—nearly 10 times larger than the $150 saved by taxpayers earning between $30,000 and $50,000 who are able to use the deduction.

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- The MID generally encourages high-income earners who are already likely to buy homes to buy homes that are 10 to 20 percent larger than those they would have purchased without the MID.

- The United States has a lower homeownership rate (65 percent) than a number of countries that do not have mortgage interest deductibility, including Italy (71 percent), Australia (70 percent), Canada (68 percent) and the United Kingdom (68 percent).

Economic Impact of the MID

The preferential tax treatment for housing under the MID encourages overinvestment in housing at the expense of more economically productive investments.

- Because the MID increases the demand for housing, the deduction has increased home prices by between 10 and 15 percent. Also, a greater demand for housing increases the demand for debt. As a result, higher interest rates may offset between 9 and 17 percent of the MID's benefit for taxpayers.

- Taxpayers in the past have altered their investment portfolios in response to tax code changes. For example, when the Tax Reform Act of 1986 ended the deduction for consumer debt, higher-income earners increased their consumption of mortgage interest, which was still deductible, rather than investing those funds in non-tax-favored investments.

- As with most tax deductions, it is a mistake to assume that eliminating the MID would allow the government to collect all the forgone revenue, as taxpayers would find other ways to minimize their tax burden. It is estimated that eliminating the MID could generate as little as 25 percent of the revenue currently forgone by the deduction.

Policy Options

Due to the regressive effects of the benefit distribution from the MID and the deduction's failure to achieve stated policy goals, several reforms could make tax policy related to housing more effective at helping intended beneficiaries. But these proposals are unlikely to eliminate the negative economic impacts created by tax preferences for housing.

- *Refundable and nonrefundable tax credits*. Research finds that a refundable credit equal to 21 percent of mortgage interest paid would raise total homeownership by 3 percentage points. This strategy represents a useful starting point for reform, but could be simpler and better targeted by setting the credit at a specific value.

- *Fixed credit for homeownership*. Under this option, taxpayers would receive an annual credit for owning a home, regardless of whether they held a mortgage. Analysis of this option with a 1.03 percent credit on the purchase prices of homes costing up to $100,000 finds that it would lower taxes on the bottom four income quintiles. However, there is no estimate of how such a proposal would impact housing demand.

- *One-time homebuyer credit*. Some have suggested replacing the MID with a one-time credit for first-time homebuyers. Supporters argue this would promote homeownership among lower-income households. Critics counter that it would not increase aggregate homeownership.

RECOMMENDATIONS

Ideally, policymakers would repeal the MID and lower marginal tax rates to eliminate the economic inefficiencies created by tax preferences for housing. The impact on lower-income households would be minimal, as only a small percentage file itemized tax returns. Revenue-neutral reform would prompt higher-income households to shift money toward more productive investments.

Considering the political hurdles that full repeal would create, policymakers could instead seek to replace the MID with a fixed $900 credit for all taxpayers with a mortgage. This revenue-neutral credit could be granted for a set number of years for owner-occupied homes and adjusted periodically for inflation. Such a credit could increase the homeownership rate, while also reducing tax code complexity and without encouraging greater debt-financing by home purchasers.