Thomas Malthouse
Reforming Tax Incentives for Homeownership
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The Mortgage Interest Deduction (MID) is one of the most popular provisions of the American tax code, credited with providing a path to homeownership and the middle class for millions. As of 2020Q1, 65% of Americans lived in owner-occupied housing [1], and real-estate and construction interests have a vested interest in maintaining the status-quo to keep home values high and encourage new construction. However, the deduction as currently structured encourages unsustainably high debt levels, contributes to urban sprawl, and is a major contributor to the ongoing crisis of housing affordability.

There are public benefits to homeownership. Americans are generally reluctant savers, and holding a mortgage forces homeowners to build wealth over time. The substantial investment and long-term commitment of buying a home encourages homeowners to engage with their communities, supporting the development of public goods and services that improve their quality of life and improving their investment's value [2]. In many cases, homeowners are more resilient to financial shocks than renters [3].

However, the MID is a poor vehicle for accomplishing these goals. Despite its massive cost (Slemrod and Bakija estimate that individual rates could be cut by 5% with the elimination of the deduction), 80% of its benefits go to households making over $100k annually [4]. Marginal homeowners—renters who, with a little assistance, would become owners—are subject to lower marginal rates and are more likely to take the standard deduction, minimizing the MID's usefulness to them. By regressively subsidizing mortgage indebtedness instead of homeownership directly, the MID does little to encourage homeownership—instead, it encourages the well-off to overleverage themselves, buying larger houses and decreasing the capital available for non-housing investments. Empirical research bears this out, with little correlation between homeownership rates and mortgage deductibility in peer countries [5].

Ideally, the federal government would end tax incentives for homebuying. The benefits associated with homeownership are either strictly local (and so should be rewarded by local governments) or better accomplished through alternative policies. Encouraging investment in a single, highly leveraged asset increases owners' exposure to risk (as seen, dramatically, in 2008), and raises housing costs for buyers and renters alike [6]. If our goal is to encourage saving and wealth-building, the resources spent on the MID would be better used subsidizing savings accounts and increasing access to the banking system.

Historically, eliminating the mortgage interest deduction would have been unthinkable. Homeownership was and is deeply rooted in the American identity as a marker of success and stability, and enough taxpayers benefitted from the deduction that reducing it would have been politically disastrous. However, the 2017 Tax Cuts and Jobs act, by doubling the standard deduction and capping mortgages eligible for the deduction at $750k, significantly reduced the share of taxpayers itemizing deductions and made the benefits of the MID even more regressive. 87% of the deduction's benefits now flow to five metropolitan areas, and very few marginal homebuyers could realistically benefit from the deduction as it stands today [7]. A wholesale repeal of the mortgage interest deduction, especially if coupled with a decrease in individual tax rates or increased tax preferences for other forms of saving, could be—accurately—sold as a populist reform that simplified the tax code and eliminated a major handout to the upper-middle class.

Bibliography

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