Tax Reform Must Not Keep Tax Breaks for Real Estate

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As the House Ways and Means committee proceeds with the markup of its landmark tax reform proposal, one change that seems inevitable is the curtailment of the modest reforms of the myriad home ownership tax breaks contained in the original legislation. These included capping the deduction for mortgages below $500,000, limiting the deductibility of property taxes to $10,000, and eliminating the deductibility of state and local taxes altogether.

While the realtors, homebuilders, and mortgage bankers howled at the original proposal and look as if they will soon get their way, mostly, the reality is that no tax reform worth its name can keep these expensive and economically unproductive tax breaks and still manage to lower rates and boost economic growth—the ostensible goals of the entire exercise.

The tax writers' acquiescence is politically expedient, of course: The realtors and home builders are angry because the proposed doubling of the standard deduction, combined with curtailing the deductibility of state and local taxes, would result in most taxpayers ceasing to itemize and thus foregoing the mortgage interest and property tax deductions. Should that come to pass, the pretense that these actually boost home ownership would be exposed as the bald faced lie it actually is.

The partial cave-in to Big Housing has not diminished its outrage one bit and sets a lamentable precedent for when we need to eliminate even more tax breaks for reform to succeed. Other losers from tax reform will be agitating for a similar appeasement as well, and the more tax breaks that remain, the less we can cut rates.

But the larger problem this surrender creates is that deductions for home ownership are costly and economically harmful. Under current law, the deduction for mortgage interest and property taxes alone will reduce tax revenue by over $1.3 trillion in the next decade, which would finance a sizeable reduction in tax rates. Keeping both around, even in diminished form, would significantly reduce those potential savings.

The various deductions for home ownership also happen to be amazingly regressive, since only 30 percent of all taxpayers—pretty much the wealthiest 30 percent—currently find it worthwhile to eschew the standard deduction and deduct mortgage interest as well as state and local taxes. And since the savings from these deductions go up sharply with a homeowner's income and home value, the benefits increasingly accrue to the richest homeowners in the most expensive homes. Marquette University professor Andrew Hanson discovered that the average household in well-to-do Redwood City, California, receives fifty times the tax savings from the mortgage interest deduction as a household in Mossville, Illinois, a blue-collar community in Central Illinois that happens to be my hometown.

The tax breaks for housing would become even more regressive under the Ways and Means plan: The doubling of the standard deduction would result in just five percent of households itemizing. For reference, the 95th percentile for income starts at $225,000.

The staggering regressivity of the deduction for mortgage interest and property taxes—both before and after the proposed reform—means that in neither scenario does it do a whit to boost home ownership, since the tax breaks don't go to the middle class families who might need help to afford a house. In fact, research by Federal Reserve economist David Rappoport suggests that the mortgage interest deduction actually *boosts* home prices at all price levels, even homes likely to be bought by people who can't avail themselves of the mortgage interest deduction. In short, the home ownership tax breaks probably *reduce* homeownership rates in the aggregate.
The tax deductions for homeownership also reduce economic growth. Encouraging the well-off to buy or build bigger, fancier homes, which are economically unproductive assets, results in them putting less savings into their banks or retirement accounts, where it could be lent to businesses to invest and expand.

To be sure, getting rid of the deduction for state and local taxes, along with the mortgage interest deduction, might hurt some homeowners: Rappoport's researchestimates housing values would decline by 6.9 percent if the mortgage interest deduction disappeared. But to put that into perspective, that happens to precisely equal the average price increase for a home in 2016.
If we want achieve a tax reform that is constrained to be progressive, boosts economic growth and does not grow the deficit then there cannot be any room in the tax code for regressive, growth-reducing and costly provisions that do not even accomplish their ostensible purpose, even if their supporters happen to be politically powerful. If Congress feels compelled to make sure no one loses from reform, the answer is not to maintain costly tax breaks for well-to-do homeowners but to lower tax rates for all households to the greatest extent possible.
If that is insufficient then we may as well dispense with the entire exercise.

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