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Mortgage interest deduction mostly benefits the rich — end it

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The tax reform plan put forward by congressional Republicans last week includes many complicated and controversial provisions. One that deserves widespread support is their proposal to limit the tax deduction for home mortgages.

Currently, homebuyers can deduct the interest paid on home mortgages with a principal value of up to $1 million. The GOP proposal would reduce that to $500,000. If there is a flaw in this plan, it is that it does not go far enough.

Congress would do well to abolish the home mortgage interest deduction completely. Such a policy could promote equity and efficiency at the same time.

The mortgage interest deduction costs the federal government some $77 billion in revenue per year, making it one of the five biggest tax deductions. It produces little benefit for all that cost. Harvard economist Edward Glaeser — one of the world's leading experts on the economics of housing — calls the mortgage interest deduction a "sacred cow that has long been in need of a good stockyard."

That view is widely shared by economists and property law scholars across the political spectrum. President Barack Obama repeatedly proposed limiting the deduction for higher-income taxpayers — a rare area of agreement between him and the architects of the GOP tax reform plan.

The deduction subsidizes the purchase of relatively expensive houses. As a result, it artificially skews the real estate market toward utilizing more space for large, single-family homes, and less for multifamily rental housing of the kind needed by the working and lower-middle class.

This makes our use of real estate less efficient and exacerbates an already very serious problem: the high cost of housing for lower-income households in many metropolitan areas, already driven to ridiculous levels by zoning restrictions.

Artificially inflated housing costs are not only problematic in themselves, but also one of the main factors making it difficult for the poor to improve their lot by moving to areas with greater job opportunities.

The benefits of the mortgage interest deduction flow overwhelmingly to the wealthy. Some 73 percent goes to the top 20 percent of the income distribution.

The lower middle class and poor get almost no benefit from it, because nearly all of them either do not own their homes, take the standard deduction instead of itemizing (the mortgage interest deduction is only available to itemizers) or both.

Some defenders of the deduction claim that it promotes the American tradition of homeownership. But studies suggest that it probably has close to no effect on the homeownership rate, because nearly all of the gains go to affluent taxpayers who are likely to own homes even without it, though the deduction does enable them to buy bigger houses than they might have otherwise.

Other defenders of the deduction, such as the National Association of Realtors and other real estate industry groups, argue that eliminating it will actually lower housing prices by reducing the amount buyers are willing to pay. If so, this is likely to be a feature rather than a bug.

Lower prices might actually benefit those most in need of affordable housing. Such people overwhelmingly fall within the two-thirds of American households who do not itemize deductions and therefore cannot take advantage of the mortgage interest deduction, but do suffer from the higher prices it creates.

There is a case to be made for reducing the overall tax burden imposed on Americans, including those wealthy enough to benefit from the mortgage interest deduction. But the more economically sound way to do so would be to lower taxes across the board, without pressuring taxpayers to spend their money on home purchases, as opposed to other purposes.

It makes little sense to treat expenditures on home mortgage interest more favorably than almost any other purchases a household makes. As a general rule, families are in a better position than the government to figure out whether an additional dollar is best spent on housing or on something else.

Perhaps we should be hesitant to disrupt the settled expectations of people who already have mortgages they took out on the expectation that the tax deduction would be available. The GOP plan deals with that problem by "grandfathering" in tax deductions for existing mortgages and only applying the new limitation to new ones. But even if we should spare existing mortgages, we can at least end the deduction going forward.

Previous efforts to limit the mortgage interest deduction all failed, including President Obama's proposals, which were repeatedly rejected by Congress. The real estate industry has considerable clout on Capitol Hill, as do high-income beneficiaries of the deduction.

Most of the general public does not realize how abolishing the deduction could benefit the economy and help increase access to housing for the poor and lower-middle class. The current reform effort might well fail, as well. But perhaps it will be feasible to finally bring change we can believe in to this particular public policy swamp.

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