A Defense of the Mortgage Interest Deduction

By SUSAN E. WOODWARD

The mortgage interest deduction is under attack. The General Accounting Office and Office of Management and Budget are circulating juicy estimates of the revenue that could be gained by eliminating the deduction. Forbes thinks its demise is imminent and that home buyers should beware.

Opponents of the deduction are concerned that it benefits affluent households disproportionately, and that with such a big tax preference for housing, we end up with too much investment in housing and too little in everything else. But the mortgage interest deduction not only is *not* the problem, it is an efficient and egalitarian part of the tax code.

First, the deduction is not a "subsidy to home ownership" per se. Interest is deductible for mortgages not only on owner-occupied homes, but on rental properties. Interest is also a deductible expense for businesses. The interest deduction is not even exclusive to housing generally, much less to owner-occupied housing.

However, owner-occupied housing does receive an important benefit in the tax code: The services derived from owner-occupied housing are not taxed. If you rent a house to someone else, the rent (less depreciation and expenses) is taxable income. If you live in your own house, essentially renting to yourself, no taxable income results. Despite problems in estimating this "imputed" rent, some industrialized countries do tax it, albeit at a low rate.

How much more expensive is it to rent than to own? Well, it depends on your tax bracket. Taking into account the depreciation write-off on rental housing, renting *is* 20% to 30% percent more expensive than owning an identical dwelling for taxpayers in the highest brackets. For taxpayers in low brackets, renting is actually cheaper than owning because the depreciation write-off on a rental is worth more to the high-bracket landlord, and then is passed on to the tenant in a competitive market, than is the tax break on the imputed rent to a low-bracket owner. This is simply an artifact of progressive income taxes. Had we only a single tax rate, renting would be more expensive than owning for everyone. But this is due to the income tax landlords pay on rents, not because of the interest deduction.

Given that interest earned is taxed, deductible interest tends to make the cost of owning the same regardless of whether the home owner borrows or pays cash for a house. For example, consider a household with a $100,000 house and a marginal tax rate of 28% that faces an interest rate of 10%. If savings are used to buy the house, the annual cost is the forgone interest of $10,000 (on a similarly risky investment, say a Ginnie Mae pass-through) less the tax that would be paid, $2,800, leaving $7,200. If the entire $100,000 is borrowed, the interest paid is $10,000, but since it is deductible, it costs the household, after taxes, the same $7,200.

Thus, it cannot be the mortgage interest deduction that "drives a wedge between the cost of owning and the cost of renting," as claimed by Milton Friedman in the March 20 issue of Forbes magazine. With interest both taxable and deductible, the cost of owning via debt and equity are roughly equal. And, again, interest is deductible for the landlord, too. Owning is cheaper for those in high brackets because there is no tax to pay on rent received from themselves.

If interest were not deductible, owning would be more expensive for borrowers than for those who have cash. Older and wealthier people would be unaffected, because they would simply use other assets to increase home equity and avoid expensive debt. Only those who must borrow to own would face higher costs. Thus, an especially American sense of equity is served by deductible mortgage interest because it allows people with only wages and salaries to have the same access to ownership as those with income from securities.

Distribution of Existing Mortgages by Size

BALANCE	NO. OF MORTGAGES
Below $100,000	32,000,000
$100,000-120,000	433,000
$120,000-150,000	264,000
$150,000-200,000	134,000
$200,000-300,000	58,000
Over $300,000	16,000

Given that over a lifetime we all have a certain amount of tax to pay, the best tax system is not one that imposes taxes disproportionately at any point. For example, even though education is correlated with income, it would not make sense to replace part of the income tax with a tax on a college education, payable at graduation. Similarly—present values of the tax being equal—people would not choose to give up the mortgage interest deduction in exchange for lower income tax rates, because the deduction helps smooth expense burdens over their lifetimes.

Eliminating the deduction is tantamount to a new tax that falls at a very inconvenient time in most people's lives—when they have recently bought homes and are feeling pinched anyway. And the front-end burden of our traditional mortgages is large: With interest rates at 11%, 96% of the initial payment on a 30-year mortgage is interest. But as the loan is paid off, inflation erodes the real value of the payments and the interest portion declines.

For a taxpayer in the 35% bracket, the present value of the entire deduction on a $100,000 loan is just under $35,000. The cash necessary to carry a $100,000 mortgage over its first six years would increase by $17,500 if interest were no longer deductible, with $3,750 of it in the first year alone. The mortgage interest deduction helps shift the tax burden to years in which it is easier to bear.

In 1987, 58 million households owned their homes. Of these, 25 million had no mortgage. The top end of the distribution of existing mortgages by size can be seen in the accompanying chart. Clearly, the current limit of $1.1 million as the maximum mortgage debt on which interest is deductible was a mere political gesture. The affected individuals may as well have been listed in the bill. Even for mortgages written in 1988, fewer than 10% were greater than $190,000.

The simple fact that 25 million households have no mortgage tells us that the relation between mortgage debt and either housing consumption or income is weak. But home owners tend to be middle- and upper-income people, and why should we make paying taxes easier for them? Because by taxing them in a less burdensome way, we can both improve their situation and ultimately get more revenue from them. Those who care about redistribution to the poor should want the most efficient of taxes to be imposed on the well-to-do.

The American Dream of home ownership is indeed intertwined with the deductibility of mortgage interest. Only when the treatment of interest is symmetric—both taxable and deductible (or untaxed and not deductible)—does the tax code not skew the distribution of ownership toward the wealthy. And deductible interest improves the allocation of the tax burden across people's lives. The mortgage interest deduction should remain intact. There are less painful ways to collect the revenue.

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