CUT TO INVEST

Reform the Mortgage Interest Deduction to Invest in Innovation and Advanced Industries

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Summary

Reforming the mortgage interest deduction (MID) offers an opportunity for the federal government to realize hundreds of billions of dollars in savings over a 10-year period to contribute toward deficit reduction as well as to invest a portion of the savings in policies and programs that are likely to spur more productive and innovative economic growth. "Cutting to invest" represents a fiscally responsible way to create jobs in the near term and help restructure the economy for the long haul.

Background

The United States economy is at a crossroads. The Great Recession revealed an economy focused inward and fueled by excessive consumption and debt. Post-recession, it is clear that the U.S. economy must be purposefully restructured to become more globally engaged and driven by production and innovation. Transitioning to this new economic growth model will require targeted investments at the federal level in innovation, human capital, and infrastructure to set the platform for productive and innovative growth at the state and metropolitan levels.

Given the federal government's record budget deficits—which have exceeded $1 trillion dollars in each of the past four fiscal years—the path forward is clear: Washington must "cut to invest."

Smart tax reform provides an avenue to free up capital for productive investment. To that end, Congress and the White House must consider shifting away from expensive consumption-oriented tax expenditures that feed the bad habits of a failed growth model as part of a larger agreement on tax and spending reform.

The worst offender in the U.S. tax code is the home mortgage interest deduction (MID).

Created as part of the Revenue Act of 1913, the mortgage interest deduction is now justified as an incentive to promote homeownership by allowing homeowners to deduct the interest paid on their mortgages from their federal income taxes. Current law allows taxpayers that itemize tax deductions to deduct the interest paid on the first $1 million of a home mortgage for either a primary or secondary residence, as well as an additional $100,000 for a home-equity loan.

The Problem

Over time, the budget impact of the MID has grown exponentially, and it is projected to continue on this upward growth trajectory in the coming years. It is now the second largest income tax expenditure in the federal budget and among the most regressive tax subsidies in the United States.

- In the next five fiscal years, between FY2013 and FY2017, the federal government is **projected to forgo over $606 billion dollars in income tax revenue** as the budget impact of the MID grows from $100.9 billion in FY2013 to $143.5 billion in FY2017

- Given its overall size, the mortgage interest deduction **only benefits a small share of taxpayers** in the United States. In 2009, just 26 percent of the 140.5 million taxpayers claimed the mortgage interest deduction

- Research indicates that the mortgage interest deduction largely **fails to fulfill its stated purpose of increasing homeownership**. Glaeser and Shapiro (2003) found that, after the immediate post-World War II growth in homeownership fuelled by the passage of the G.I. Bill, the homeownership rate in the United States has fluctuated in a limited range between 63 and 68 percent since 1950, and several countries without mortgage subsidies have comparable rates of homeownership. The current homeownership rate in the United States is 65 percent, below the rates of countries without mortgage subsidies like Canada (69 percent) and the United Kingdom (71 percent)

- The current $1 million cap on the total mortgage debt on which interest payments can be deducted, set in the 1986 Tax Reform Act, ensures that **upper-income households primarily benefit from the subsidy**. An analysis by Poterba and Sinai (2011) found that lowering the total cap on mortgage value from $1 million to $250,000 would impact "less than seven percent of homeowners," based on 2004 income tax data. Many taxpayers in the upper tax brackets would likely own homes regardless of whether or not they receive a tax subsidy from the mortgage interest deduction, so the generous mortgage value cap on the MID simply allows a relatively small number of upper income households to, in many cases, purchase larger and more expensive homes

- **States on the East and West coasts receive the largest share of the value of the mortgage interest deduction**. In 2010, for instance, a larger share of taxpayers in Wisconsin (29 percent) than in California (27 percent) deducted their home mortgage interest, but the difference in the average value for returns claiming the deduction between the two states was stark. In California, the average value was $15,755, well above the national average of $10,640, while in Wisconsin, the average mortgage interest deduction was $7,793

- As with states, **the benefits of the mortgage interest deduction are concentrated in a few regions and metropolitan areas**. A study by Gyourko and Sinai (2003) found that only 29 of the 312 metropolitan areas in 1990 received a greater total amount of money in subsidies from housing-related income tax benefits, including the MID, than residents in these metros paid in income taxes to finance the subsidies. The 29 metropolitan areas were primarily located in the country's most expensive housing markets, including California and the Boston-to-Washington, D.C. corridor, while the metropolitan areas that received significantly less benefits were located mostly in the Midwest and the South

- The MID also impacts home prices within a metropolitan area. In metropolitan real estate markets with a relatively limited supply of housing, the mortgage interest deduction **often has the effect of driving up real estate prices**

Proposal

Given these challenges, the Metropolitan Policy Program at Brookings proposes **making significant reforms to the home mortgage interest deduction.**

A number of potential options for reform have recently been proposed.

The recommendation to cap the income tax rate at which taxpayers can take itemized deductions, including the mortgage interest deduction, at 28 percent has been proposed by the Obama administration in each of its past four fiscal year budgets. This reform would only affect married taxpayers filing jointly with adjusted gross income (AGI) over $250,000 and single taxpayers with an AGI over $200,000.

A second common proposal has been to convert the mortgage interest deduction from a tax deduction to either a refundable or non-refundable tax credit, and to lower the cap on the overall mortgage value eligible for the subsidy. This course of action was proposed in various forms in reports by both of the major bipartisan deficit reduction committees in 2010.

- The Bipartisan Policy Center's Debt Reduction Task Force Plan (Domenici-Rivlin) proposed shifting the MID to a 15 percent refundable tax credit to all taxpayers, lowering the mortgage limit from $1.1 million to $500,000, and eliminating the provision that allows taxpayers to deduct mortgage interest for second homes and home equity loans

- The National Commission on Fiscal Responsibility and Reform's plan (Simpson-Bowles) largely mirrored the Domenici-Rivlin plan for reforming the MID, but instead called for a 12 percent non-refundable tax credit

The most important reason for shifting the MID from a tax deduction to a tax credit is that it would allow homeowners who do not itemize deductions—who tend to be lower income taxpayers—to benefit from the subsidy. A tax credit also provides the same percentage cost reduction to all homeowners deducting interest payments, unlike the current deduction, which provides a deeper housing subsidy to higher income homeowners in higher marginal tax rate brackets.

In recent months, a third common reform proposal has been to implement an overall cap of between $25,000 and $50,000 on itemized deductions, which would include the MID, the deduction for charitable contributions, and other subsidies in the tax code. This option was considered by Republican presidential nominee Mitt Romney as part of his tax reform plan, and has been discussed publicly by both Democrats and Republicans in statements on a comprehensive deficit reduction plan in the wake of the 2012 presidential election.

Adopting any of these proposals for reforming the home mortgage interest deduction would:

- **Raise hundreds of billions of dollars in income tax revenue over ten years for the federal government** to contribute to deficit reduction and investment in productive and innovative growth

- **Create a fairer balance in benefits among lower, middle, and upper income homeowners**

Budget Implications

The budget savings from altering the mortgage interest deduction depend on many factors, including whether the reforms are implemented immediately or phased in gradually via a set of transition rules. Below are illustrative examples of potential savings for each of the three proposals discussed above, based on reforms that would be implemented all at once.

By the Obama Administration's estimate, limiting the income tax rate at which taxpayers can deduct certain itemized deductions and exclusions, including the mortgage interest deduction, to 28 percent would generate $580 billion in revenue for the federal government between FY2013 and FY2022. This estimate assumes that the Bush era tax cuts are extended for married couples filing a joint return with a combined adjusted gross income below $250,000 and single taxpayers with an AGI below $200,000, but permanently expire on January 1, 2013 for those with incomes in excess of these amounts.

The overall budget impact of converting the MID from a tax deduction to a refundable or non-refundable tax credit depends on the rate at which the credit is set. In one example, the Tax Policy Center estimates that replacing the MID with a 15 percent non-refundable credit and limiting the credit to interest on the first $500,000 of a mortgage for primary residences only would raise $378 billion in revenues for the federal government between 2012 and 2021, assuming the extension of current tax policy.

The third potential reform proposal of imposing a cap on itemized deductions could yield significant budget savings, with the overall amount saved varying by the dollar limit of the cap, the specific itemized deductions included within the cap, and federal income tax rates. Under one scenario in which current tax policy (i.e., Bush-era income tax rates) is extended, a $50,000 cap on itemized deductions that includes both the mortgage interest deduction and the charitable contribution deduction would generate $749 billion in tax revenue between 2013 and 2022, while a $50,000 cap on itemized deductions excluding the deduction for charitable contributions would raise $490 billion over that same time period, according to estimates from the Tax Policy Center.

Any of these three proposed reforms to the MID could be gradually implemented using transition rules over the course of several fiscal years. While the ten-year budget savings would be reduced from the estimates above, this approach would lessen the immediate impact, if any, on the housing recovery in the near term, and it would allow the housing market time to adjust to a new normal.

The impact of reforming the mortgage interest deduction would impact regional housing markets in different ways, but given the concentrated benefits of the MID in a relatively small number of housing markets primarily on the East and West coasts, it is likely that only a few regions would be negatively impacted in any significant way. The long-term impact on housing markets, however, might be limited by strong household growth in the coming decade. The Joint Center for Housing Studies at Harvard University estimates that growth in the United States from 2010 to 2020 will average 1.18 million new households per year, higher than the 1.15 million per year average of the late 1990s. This suggests that housing demand, and therefore housing markets, will improve over the long term.

In summary, reforming the mortgage interest deduction along the lines of one of the three proposals outlined above stands to generate large budget savings over ten years—perhaps between $378 billion and $790 billion, depending on which proposal is adopted.

Savings from reforming the MID could both pay for one or several productive, high-return investments and also be used to reduce the federal budget deficit. Possible investments include:

Innovation

- A permanent reauthorization of the Research and Experimentation (R&E) Tax Credit ($6 billion to $8 billion per year)

- Increased investment in clean energy innovation ($16 billion per year)

Infrastructure

- Revival of the Build America Bonds (BABs) program (revenue cost of $95 million per year)
- Capitalize a National Infrastructure Bank ($10 billion to $25 billion per year). The 2011 BUILD Act offers one possible model

Human Capital

- Fully fund the Community College to Career Fund ($8 billion per year)

State of Play

For decades, reform to the home mortgage interest deduction has been considered a “third rail” issue in American politics. Since the nation’s last comprehensive federal tax reform in 1986, the MID has remained unchanged as a strong lobby of traditional real estate constituencies, including the National Association of Home Builders and the National Association of Realtors, have continually extolled its virtues as a successful tool for promoting homeownership. In the past ten years, several bipartisan deficit reduction committees, including the Bush Administration’s Advisory Panel on Federal Tax Reform, the National Commission on Fiscal Responsibility and Reform, and the Bipartisan Policy Center’s Debt Reduction Task Force, as well as a broad cross-section of respected economists and academics, have endorsed altering the MID, but to date no reforms have been made.

With federal debt at 73 percent of GDP—its highest level since 1950—politicians on both sides of the aisle are now signaling that a scale-back on the MID could a part of an agreement to bring the federal budget under control. As Republicans and Democrats spar over how to reduce spending and increase tax revenues in the coming weeks and months, a significant reform to the mortgage interest deduction offers an opportunity for the federal government to realize hundreds of billions of dollars in deficit reduction over the next ten years, and to make smart, targeted investments in innovation, human capital, and infrastructure that will drive American economic growth and prosperity in the coming decades.

Implementation Requirements

Legislative action would be required to make any reforms to the mortgage interest deduction. Given the expiration of the Bush-era tax cuts on January 1, 2013 and the ongoing debate on deficit reduction, legislation to alter the MID might be included as part of a larger deal on tax reform and deficit reduction.

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Remaking Federalism | Renewing the Economy

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