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Tax Reform's "Third Rail": Mortgage Interest

In mid-1995, the politically powerful National Association of Realtors launched an attack against the flat tax. Its in-house newsletter even declared, "It's War!"[1] The association is battling to save the mortgage interest deduction, a feature of the tax code that has been in place since the inception of the income tax in 1913 and one that would be abolished along with all other deductions by a pure flat tax.

The deduction has long been considered the untouchable third rail of tax reform. However, a close look at a flat-rate tax suggests that, on balance, homeowners would gain more from it than they would lose.

The Realtors entered the fray armed with a traditional Washington weapon: a study. Their study was done by DRI/McGraw-Hill, a private economic consulting firm. It concluded that enacting a flat-rate income tax such as that proposed by Congressman Dick Armey and others would cause home prices to fall by 15 percent, wiping out $1.7 trillion of homeowners' equity.[2] DRI claimed that a flat income tax would cause housing prices to collapse, primarily because it would eliminate the mortgage interest deduction and increase the aftertax price of housing.

"Realtors have declared 'war' against the flat tax."

Underlying that claim is the theory that being able to deduct mortgage interest increases the value of a home relative to the other goods bought on time, such as a car, and that this tax saving is reflected in the price of a house. If this were true, withdrawing the mortgage interest deduction would reduce housing values.

Of course, how much the deduction reduces anyone's aftertax cost of housing depends on the homeowner's income. Someone paying taxes at a 15 percent effective rate saves approximately $1,200 in taxes per year on a $100,000 mortgage at current mortgage interest rates. Another paying taxes at a 28 percent effective rate saves approximately $2,200 on a similar mortgage.

The DRI analysis largely ignores the other effects of a flat tax on the aftertax income of homeowners:

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- The tax rates under the Armey plan would be 17 percent for all taxpayers, and a typical family of four would pay taxes only on income above the personal allowance of $31,400.
- Although taxpayers could not deduct their mortgage interest, they would pay no tax on the interest they earned from savings.
- The double taxation of corporations' earnings would also end, so that shareholders would not pay taxes again on dividends from corporate profits.

An objective study of the impact of a flat tax on homeowners would have taken these factors into account.

Tax Rates, Interest Rates and Housing Prices

If the deduction increases the value of housing and eliminating it would reduce that value, these effects should have appeared in the past whenever tax rate changes increased or decreased the value of the deduction.

"Historically, declining tax rates have been good for homeowners."

Of course the value of the mortgage interest deduction falls when tax rates fall. A $10,000 interest deduction that saves a taxpayer $3,000 per year if he or she is in the 30 percent tax bracket saves only $2,000 if the tax rate falls to 20 percent. Yet historically, declining tax rates have been good for homeowners.

Tax rates and housing prices. During the 1970s, the inflation that pushed taxpayers into higher tax brackets increased the value of the mortgage interest deduction to homeowners. Thus it should have caused housing prices to rise. By the same logic, the sharp reduction in tax rates during the 1980s should have caused housing prices to fall.[3]

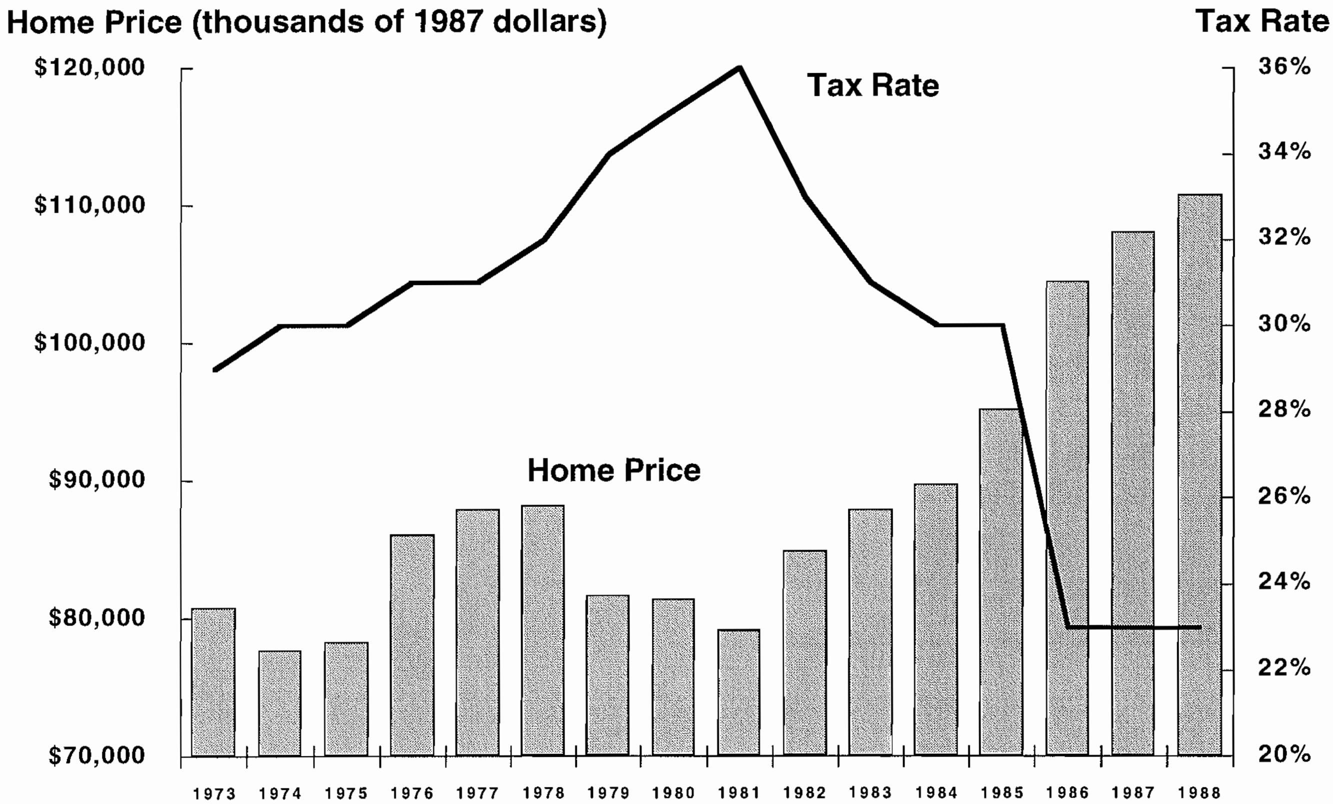
In both cases, the reverse happened.

Figure I looks at the inflation-adjusted median price for new homes and the average marginal tax rate. It shows that rising marginal tax rates did not raise the real price of new homes. The real median new home price was actually less in 1982 than it was in 1973. By contrast, housing prices shot up when the Reagan tax cut became fully effective in 1983 and continued to rise even after the 1986 tax reform dropped tax rates further.

Interest rates and housing prices. One can argue that housing prices were flat in the 1970s and rose in the 1980s despite the tax changes because changes in interest rates overwhelmed the tax effects. The home mortgage interest rate rose from an average of 7.96 percent in 1973 to 15.14 percent in 1982. Rates fell thereafter, bottomed in 1986 at 6.39 percent and rose to 8.8 percent by 1989. Thus much of the rise in home prices in the 1980s took place while interest rates were rising.

FIGURE I

Real Median New Home Prices and Average Marginal Tax Rate



Source: Census Bureau, Treasury Dept.

"Housing prices shot up with the Reagan tax cut and continued to rise after the 1986 tax reform dropped tax rates further."

Nevertheless, the interest rate is an important factor in setting prices. The lower the interest rate, the more house one can afford on the same income. However, market interest rates are to a large extent set by tax rates. The higher the tax rate, the higher the interest rate must be for lenders to get the same aftertax return.

Tax Rates and Interest Rates

The impact of tax rates on interest rates can be measured precisely because yields on municipal bonds are tax free. In recent weeks the difference in the interest rate between municipal bonds and high-grade taxable bonds has been 1.35 percentage points. In theory, this spread should roughly equal the average marginal tax rate.

Therefore, eliminating taxes on interest received should cause all interest rates to fall by approximately the spread between tax-free municipal bonds and comparable taxable securities, including mortgages. Mortgage rates should fall about 1.35 percentage points, from approximately 7.6 percent today to 6.25 percent (a drop of about 18 percent), as soon as the flat tax takes effect. This is because a tax-free yield of 6.25 percent to mortgage lenders is approximately the same as a taxable 7.6 percent yield.

The median marginal tax rate is well below the average (mean) marginal tax rate, so mortgage rates should fall by more than the aftertax interest cost would rise on existing mortgages. (The average is higher than the median because more income is earned by people in higher tax brackets.) Since most taxpayers are in the 15 percent bracket, they would in effect pay 15 percent more on their existing mortgages without deductibility. But if market interest rates fall by more than 15 percent, they could refinance their mortgages and still come out ahead — even without the interest deduction.

"Mortgage rates should fall by about 18 percent as soon as the flat tax takes effect."

The decline in interest rates does not depend at all on any increase in the saving rate. It simply involves an equalization of taxable and tax-exempt yields. However, eliminating all taxes on interest and ending the double taxation of dividends and capital gains will increase saving to some extent. All other things being equal, interest rates should fall even more as saving rises, which will further cushion homeowners from the loss of mortgage interest deductibility.

The DRI study assumed a fall in interest rates but understated the amount by comparing municipal bond rates to 10-year Treasury bond rates. However, municipal bonds are much riskier than Treasury bonds (as holders of Orange County, Calif., bonds recently discovered) and Treasury bonds are also free of state taxes. Thus the spread is much less than between municipals and, for example, high-grade corporate bonds.

Rates of Home Ownership Where Interest Is Not Deductible

Even without a decline in tax rates and interest rates, international data suggest that the loss of mortgage interest deductibility would not devastate housing. Figure II shows that home ownership rates in other countries are not sensitive to deductibility. Israel and Australia have home ownership rates significantly higher than the United States and no mortgage interest deductibility. Rates in Canada and Japan are about the same as in the U.S., also without deductibility. By contrast, France and the Netherlands have much lower home ownership rates despite mortgage interest deductibility and higher tax rates.

The states also provide a laboratory: 18 states either have no income tax or do not allow mortgage interest deductions from state taxes. States with income taxes and no mortgage interest deductions are Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio and Pennsylvania.

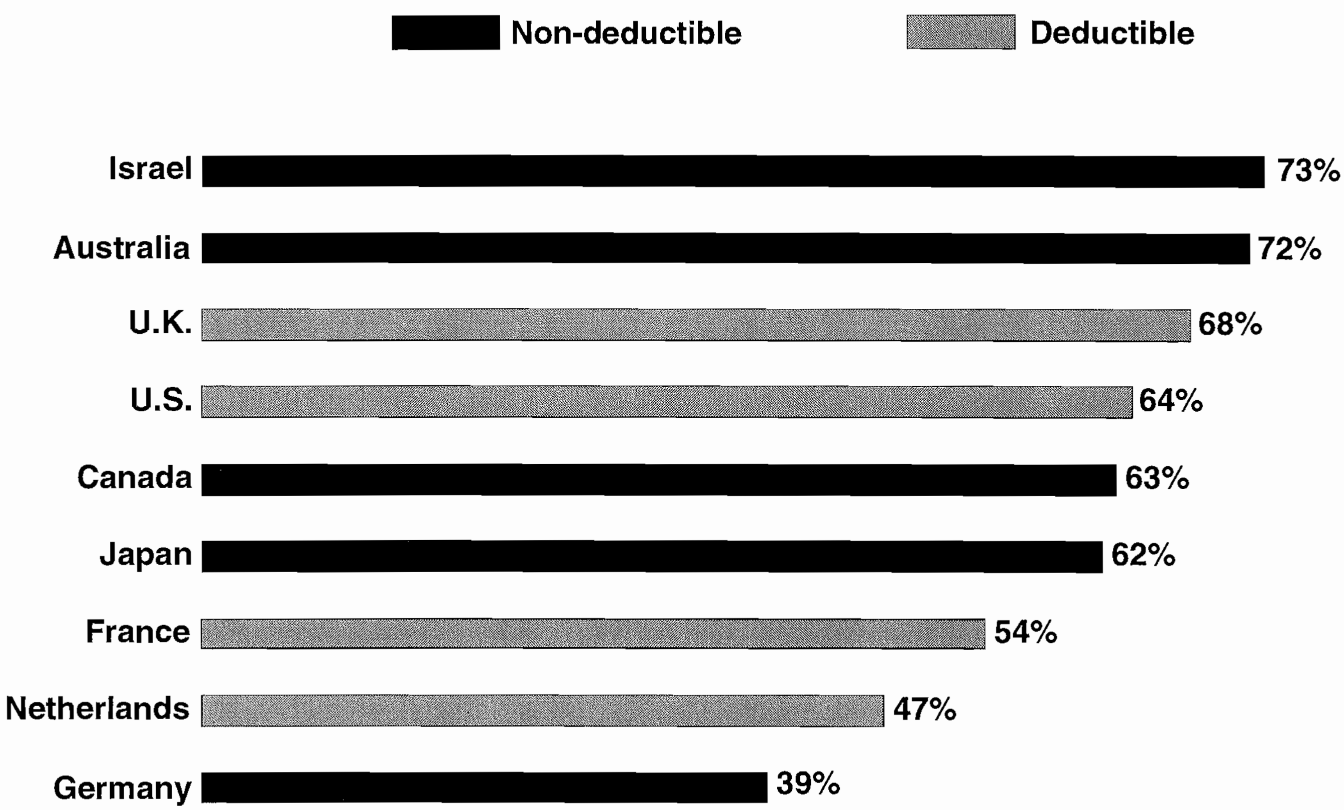
"Home ownership rates in other countries are not sensitive to interest deductibility."

One might expect that states that do not allow such deductions would have lower home ownership rates than states that do. One also might expect that the higher a state's tax rate, the higher the home ownership rate would be because the aftertax cost of housing would be lower. The data show the opposite.

In 1993, the 18 states without an income tax or mortgage interest deductibility had an average home ownership rate of 64.8 percent — slightly higher than the national average of 64 percent. Three of the five states with the highest home ownership rates — West Virginia (73.3 percent home ownership), Michigan (72.3 percent) and Pennsylvania (72 percent) — do not allow mortgage interest deductions.

FIGURE II

Home Ownership Rates and Mortgage Interest Deductibility, 1992



Source: International Housing Association, OECD.

By contrast, the 12 states with the highest statutory tax rates, and the District of Columbia, have an average home ownership rate of just 61.8 percent. Of the six states with the lowest home ownership rates, four are among this group of 13. For example, California's top tax rate is 11 percent — tied with Montana for the highest in the nation — yet its home ownership rate is among the lowest at 56 percent. New York, Hawaii and the District of Columbia also have high tax rates and home ownership rates well below average.

Further, according to the Bureau of Labor Statistics, about 40 percent of homeowners have no mortgage on their homes and thus no mortgage interest to deduct. Finally, any flat tax passed by Congress likely would allow homeowners to deduct interest for the life of their existing mortgages, losing deductibility only with a sale or refinancing.

The Impact of a Flat Tax

In the unlikely event that the institution of a flat tax caused housing prices to decline, the decline must be viewed in context. First, the drop would not be permanent. If home prices were to fall by, say, 15 percent, home construction would decline as well. This reduction in the supply of housing would cause home prices to rise again within a short time.

"The lower prices on homes people sell would be exactly offset by lower prices on those they buy."

Second, any loss of wealth would affect only those who had planned to sell their homes and realize the gain. But the vast majority of homeowners sell in order to buy another home. Since the loss of deductibility would affect all houses, the lower prices on homes people sell would be exactly offset by lower prices on those they buy.

Any decline in housing prices would greatly benefit first-time home buyers, many of whom rent and receive no benefit from the current deductibility of mortgage interest. Home buyers also would benefit from the increase in aftertax income that would enable them to save for a down payment, once taxation of interest and the double taxation of dividends and capital gains are eliminated. Many studies have identified the lack of a sufficient down payment as a greater barrier to first-time home buying than housing prices or interest rates.

Third, the flat tax would benefit homeowners by eliminating the capital gains tax. Currently, homeowners must buy a new home of equal or greater value within two years or pay capital gains tax on all accumulated gains, including gains on earlier home sales. This causes some people to overbuy housing and incur a large debt, since they can only tap into their home equity by borrowing against it. It also puts an enormous burden on those who must realize their gains because of a lost job, unforeseen medical or other expenses or divorce — and those who cannot roll over the gain from their home sales into higher-priced homes.[4]

Fourth, enactment of a flat tax would increase growth and increase the value of stocks, bonds and other investments. Professor Dale Jorgenson of Harvard estimates that national wealth would immediately rise by $1 trillion if a flat-rate consumption tax were implemented.[5] And much of the increase in growth would come from eliminating the current tax bias in favor of housing over other investments. A 1987 study by Professor Edwin Mills of Princeton estimated that equalizing the aftertax rate of return between housing and other capital would increase the stock of non-housing capital by 12 percent and increase real growth by 10 percent.[6]

A long line of tax reformers has criticized the mortgage interest deduction as unfair because its benefit rises with one's marginal tax rate and thus one's income. According to the Joint Committee on Taxation, 89 percent of all the mortgage interest deductions are claimed by taxpayers with incomes over $50,000. And because only 21.2 percent of taxpayers claim the mortgage interest deduction, it is of no value to 78.8 percent of taxpayers.[7]

The deduction also would be unfair under a flat tax plan, since all taxpayers — including renters — would have to pay a higher rate to make up for the lost revenue. The tax revenue lost because of the deduction is estimated by the Joint Committee on Taxation to be $58 billion.

The DRI study makes some valid points about the possible effects of a flat tax on the housing market. But the $70,000 study, financed by Realtors, addressed only the tax's impact on housing. It ignored the effects of a flat tax on economic growth, saving and other portions of the financial landscape.

"Despite the attack by their association, individual Realtors support a flat tax with no mortgage deduction."

The prospect of losing the mortgage interest deduction does not appear to be hurting the flat tax drive. A 1995 poll by Mitchell Research found that 56 percent of people support a flat tax without the mortgage interest deduction, but only 41 percent with the deduction. A recent survey commissioned by Citizens for a Sound Economy showed that many individual Realtors also support a flat tax without the mortgage deduction. By a 2-to-1 margin, the Realtors surveyed would give up their own deduction if it meant a lower tax burden. Only 11 percent rated the mortgage interest deduction as the most important reason people buy a home.

Many Americans understand that allowing one deduction would bring back others, and soon we would have a new tax system as complex and unfair as the old.

Bruce Bartlett

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

Notes

[1] Dave Skidmore, "'It's War!' Cry Realtors Over Mortgage Idea," *Washington Times*, May 31, 1995.

[2] Roger E. Brinner, Mark Lasky and David Wyss, *Residential Real Estate Impacts of Flat Tax Legislation* (Lexington, MA: DRI/McGraw-Hill, 1995); H. Jane Lehman, "Flat Tax Could Cost Owners," *Washington Post,* July 1, 1995.

[3] James M. Poterba, "House Price Dynamics: The Role of Tax Policy and Demography," *Brookings Papers on Economic Activity*, No. 2, 1991, pp. 152-155.

[4] Lee A. Sheppard, "Should Sales of Personal Residences Be Exempt from Tax?" *Tax Notes,* March 25, 1991, pp. 1433-1434.

[5] Dale W. Jorgenson and Kun-Young Yun, "Tax Reform and U.S. Economic Growth," *Journal of Political Economy*, vol. 98, no. 5, pt. 2, October 1990, pp. S151-S193. Allowing immediate expensing of capital equipment and taxing all income only once removes savings and investment from the tax base, making the flat tax a consumption tax.

[6] Edwin S. Mills, "Dividing Up the Investment Pie: Have We Overinvested in Housing?" *Business Review*, Federal Reserve Bank of Philadelphia, March-April 1987, pp. 13-23.

[7] U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000* (Washington: U.S. Government Printing Office, 1995), p. 25.

About the NCPA

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- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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