Can You Hear Opportunity Knocking?

By David Cay Johnston

David Cay Johnston is a former tax reporter for *The New York Times*. He is also the author of two books about taxes: *Free Lunch* and *Perfectly Legal*.

What we make of life's opportunities depends on how well we have prepared to take advantage of them. But first we must recognize opportunity when it comes knocking, or the chance is lost. And lost opportunity costs can be huge not just for individuals, but nations as well.

Right now the subprime mortgage mess has created an opportunity to improve our tax system and the economic lives of virtually all Americans, while also improving the social quality of our lives. An issue that economists and affordable housing advocates bring up all the time to no avail could actually gain traction because of the mortgage mess.

Neither our politicians nor our journalists seem to hear the pounding at the door. They focus, with increasing precision, on the short-term and more obvious problems of falling housing prices, junk securities that were sold as triple-A-rated investments, and the risk of a broader collapse of the suddenly cautious credit markets. Those are big problems, to be sure. But there is a much bigger issue.

The news media typically report with a bias in favor of higher home (and stock) prices, which are presented as a good thing. This is a bizarre assumption unless you are a banker or real estate broker, whose income rises when people borrow more money or pay percentage commissions on artificially inflated prices.

A major reason housing costs so much is that Uncle Sam has effectively put his thumb on the scale on the side of the existing owners. Making mortgage interest tax deductible inflates the price of housing as people chase the subsidy. The mortgage interest deduction, representatives of the National Association of Realtors once told me, explains a third of the price of homes that cost more than $250,000.

Together the mortgage interest deduction and the property tax deduction artificially inflate the value of residential real estate, which forces people to borrow excess amounts of money, leaving them with less after-tax income to save or consume. If the Realtors' estimate is right, the buyer of a $300,000 house is spending about $600 per month more in principle and interest payments per month, money that could have been saved for old age, or spent on vacations, fresh flowers for the living room, or anything else.

In turn, this official policy of inflating housing prices encourages longer commutes as millions of people try to overcome high housing prices with distance. Commuting takes time away from family (and especially child-rearing). It requires people to spend more on cars and the government to spend more on roads. This further enriches government road contractors and the rulers of countries sitting atop oil fields, while reducing the money in our pockets. And of course, burning more oil puts more carbon into the atmosphere, contributing to global warming.

While the mortgage interest deduction is widely perceived as a middle-class tax break, government data and innumerable studies show that it actually showers federal tax benefits on those who do not need them while giving nothing to more than half of all homeowners.

When I bought my first home, back in 1971 at age 22, my betters told me how wise I was because Uncle Sam was helping to pay for it. Bankers (who at first thought I was too young) told me that even with the 20 percent down payment, I could borrow only about twice my annual income. That first house is a good example of what subsidies have done to housing prices. Based on inflation alone, the house should have gone up a little more than five times in price, but last year it sold for 32 times what I paid — almost a million bucks for a three-bedroom, two-bath stucco ranch. A lot of things caused that inflation, but federal tax subsidies were part of that phenomenal and artificial price increase.

When my brother bought his first house a decade ago, he called me all excited and told me he was going to save a bundle on his taxes because he could deduct his mortgage interest and property taxes. I had to explain to him that he was not getting any tax benefits from homeownership because his income is such that he takes the standard deduction. Like most homeowners who make modest incomes and buy modestly priced houses, my brother gets no federal tax benefits.

To understand the tax benefits, let's look at the latest Statistics of Income data (see table on p. 685) and the mortgage interest deduction taken in 2006 by two groups: people making $40,000 to $50,000 and those making more than $10 million. According to my calculations, the savings averaged $426 per taxpayer in the middle-class group, but $7,407 for those in the top group. That is a benefit ratio of 17 to 1.

For people at the $1 million income level who take the mortgage interest deduction (and two-thirds of them do), the federal tax savings averages $10,751, a tax savings roughly equal to 1 percent of their income. What argument can be made for subsidizing housing for people with seven-figure and larger incomes? And if we continue this subsidy, how do we rationalize giving no subsidy to more than half of homeowners, the people like my brother who struggle on modest incomes to keep a small roof over their heads?

In total dollars, most of the deductions go to the middle class, because there are so many people in the middle. Taxpayers making $30,000 to $100,000 took 44 percent of the tax deductions. Because their tax rates were as low as 10 percent, however, their tax savings were much smaller than their share of the deductions. The Tax Policy Center estimated, based on 2005 data, that more than 80 percent of the tax savings from mortgage interest and property tax deductions went to the top fifth.

Interesting detail: The total mortgage interest deducted ($443 billion) was slightly less than the total income of the tiny group of people who made more than $10 million in 2006 ($452 billion).

For years, tax economists, housing reformers, and a few politicians who sought the White House, like Sen. Arlen Specter, R-Pa., have recommended that we abandon this deduction and replace it with a tax credit. That way benefits are not skewed toward those who need the help least, if at all. The most widely recommended credit is 15 percent.

That is a namby-pamby approach. We can do better.

The real opportunity is to get rid of the income tax deductions for mortgage interest and property taxes. Kill them outright or, to make it more palatable, phase them out. We could not only reap immediate and lasting financial gains and slower-to-realize but long-lasting social gains, we could also move toward simplifying our income tax system.

Canada has no income tax deduction for mortgages or property taxes. The homeownership rate, Statistics Canada reports, is 65 percent. That was almost exactly the rate in the United States before Wall Street went wild and began promoting subprime loans as a standard, artificially raising the homeownership rate by about 4 percentage points to 69 percent or so.

Subprime loans were sold because they offered fat fees. Roughly a fifth of subprime loans were made to borrowers who would have qualified for prime loans, unpublished Federal Reserve studies show. Congress should ask for that data.

The point here is that this subsidy does nothing to increase homeownership. Thomas L. Hungerford of the Congressional Research Service estimates that in 2007, the mortgage interest deduction cost the government $73.7 billion in lost revenue. And what did all that money buy us? Not more homeownership. Not more time with family. Not less pollution.

To get out of this mess, we need to understand how we got into it.

The subsidy problem began after World War II as part of a noble attempt to encourage people to become homeowners. Think of Frank Capra's Christmas vision of the ruthless slumlord Mr. Potter, and naïve George Bailey trying to help people create a wonderful life by financing the purchase of well-built little homes. The film seems schmaltzy today, but the economics were close enough to the reality of 1946 that the story resonated with audiences.

Before World War II, mortgages often had to be paid off in five years, and few people could muster the down payment, so most rented. Many people built their own homes. But that era ended thanks to subsidies in the form of VA, GI, and state-government-subsidized loans, 30-year mortgages with low, fixed interest rates, and ticky-tacky houses that all looked the same and could be bought with $99 at closing (less than $1,000 in today's money).

The problem was that, like all subsidies, it interfered with the market. It also outlived its usefulness. We have a vibrant mortgage market today, and it will continue with or without subsidies.

Designed right, new rules ending these subsidies could help reduce the subprime mortgage mess, in which many people walk away from homes that are worth less than the mortgages on them. That is a problem with a second worrisome potential: the devastation of solid neighborhoods that often follows when just a few homes are abandoned and begin to fall into disrepair while attracting everything from teens looking for places to party to thieves who strip everything of value and leave a shell.

There is little to be done when people put no money down to acquire a house, especially if it is not really their residence. But many people put money down and are still underwater. How to end the subsidy and get them to stay put?

Offer as a transition a one-time chance to keep your home and either deduct the interest or get a 15 percent refundable tax credit. The deal would stay until you sell that house, which could make some homes that are now underwater appear to be more attractive.

For new buyers, allow the tax credit only for the first few years, perhaps 5 or maybe 10, but only if necessary to make it palatable politically. But by 2018 end all deductions or credits for home mortgage interest or property taxes.

Yes, this will cost those who bought houses at inflated prices, because the tax benefits they paid for will not all be captured. Without a doubt, real estate economists can devise something more elegant than this proposal. But let's get the debate going on how to end this stupid upside-down subsidy and focus on a policy of making housing cost as little as possible, not as much as possible.

Your thoughts? E-mail me at *JohnstonsTake@tax.org*.

Distribution of Mortgage Interest Deduction Tax Savings in 2006

	Tax Returns Filed	Number Deducting Mortgage Interest	Percent Taking Deduction	Amount Deducted (in Thousands)	Average Deduction for Income Group	Average Deduction for Those Who Deduct	Estimated Average Tax Savings Per Income Group	Estimated Average Tax Savings for Those Who Deduct
All returns, total	138,394,754	39,831,381	28.8%	$443,151,695	$3,202	$11,126	$384	$1,335
$10,000 under $15,000	11,711,680	656,883	5.6%	$5,615,944	$480	$8,549	$48	$855
$15,000 under $20,000	10,937,694	790,362	7.2%	$6,934,533	$634	$8,774	$63	$877
$20,000 under $25,000	9,912,261	1,053,810	10.6%	$8,991,482	$907	$8,532	$136	$1,280
$25,000 under $30,000	8,749,761	1,263,054	14.4%	$10,309,494	$1,178	$8,162	$177	$1,224
$30,000 under $40,000	14,151,824	3,313,620	23.4%	$2,778,079	$196	$838	$29	$126
$40,000 under $50,000	10,687,193	3,549,521	33.2%	$30,367,338	$2,841	$8,555	$426	$1,283
$50,000 under $75,000	18,854,917	9,074,396	48.1%	$85,110,942	$4,514	$9,379	$1,128	$2,345
$75,000 under $100,000	11,140,408	7,215,595	64.8%	$75,466,112	$6,774	$10,459	$1,694	$2,615
$100,000 under $200,000	12,088,423	9,250,722	76.5%	$120,380,179	$9,958	$13,013	$2,788	$3,644
$200,000 under $500,000	3,121,485	2,425,757	77.7%	$47,714,366	$15,286	$19,670	$4,739	$6,098
$500,000 under $1,000,000	589,306	417,098	70.8%	$11,276,276	$19,135	$27,035	$5,932	$8,381
$1,000,000 under $1,500,000	150,431	101,144	67.2%	$3,106,893	$20,653	$30,718	$7,229	$10,751
$1,500,000 under $2,000,000	64,007	41,442	64.7%	$1,370,257	$21,408	$33,064	$7,493	$11,573
$2,000,000 under $5,000,000	98,724	61,740	62.5%	$2,171,039	$21,991	$35,164	$7,697	$12,307
$5,000,000 under $10,000,000	24,975	14,555	58.3%	$563,645	$22,568	$38,725	$7,899	$13,554
$10,000,000 or more	15,956	8,198	51.4%	$337,660	$21,162	$41,188	$7,407	$14,416

Tax Savings estimates calculated by author from 2006 SOI preliminary Tables 1.2 and 1.4.