Despised, Rejected and Acquainted with Grief: The Tragic Tale of Mortgage Interest Deduction

Gwilym Pryce 10th April 2007

It's a rare occurrence indeed; a truly special moment; something to tell your grandchildren about. I am talking of course, not of England winning the World Cup, but of those fairy-tale moments when policy advice from academics concurs with actual policy outcomes – an alignment of almost mythical proportions and one to make a solar eclipse seem as common as a rainy day in Glasgow.

The last known instance of such serendipity was, of course, the withdrawal by the UK government in 1999 of Mortgage Interest Tax Relief (MITR) – a form of *Mortgage Interest Deduction* (MID). UK academic policy advisors, who had been arguing for the abolition of the policy for years, could hardly believe their luck. And reading the reviews almost a decade later, one gets the feeling that they are still pinching themselves that someone with their finger on the policy button actually heeded the counsel of bearded and bespectacled boffins.

Even the timing was perfect. MITR was withdrawn during a period of falling interest rates so hardly anyone noticed. An uncommon case of a sound strategy and impeccable timing. A text-book example of how to crucify a pernicious policy.

But is Mortgage Interest Deduction (MID) really the demon it has been made out to be? Have we, in fact, witnessed a witch-hunt fuelled by ignorance of truly medieval proportions? MID is the most misunderstood of policies, and rather than rejoicing at its demise, perhaps we should be praying for its resurrection.

In hindsight, it is unfortunate that the debate over mortgage interest deduction in the UK was so one-sided and, indeed, so shallow, at least compared to the same discussion taking place in the academic literature on the other side of the Atlantic. In the UK, MID was blamed for inflating house prices, exacerbating the over-consumption of housing and, worst of all, squandering much needed tax revenues on lining the pockets of the middle-classes. So revoking the privilege of mortgage interest tax deductibility could not have come too soon.

Unfortunately, there is more to MID than pandering to the avarice of the bourgeois homeowners. Housing economists[1] have recently argued that eliminating interest deductibility leads households to adjust the balance of wealth held in housing assets in order to avoid the tax penalty implied by removing deductibility. Crucially, however, wealthier households will have greater capacity to adjust their balance sheet and so the distributional effect of removing MITR is likely to be much smaller than typically assumed in the UK policy debate.

[1] See, for example, Pryce and Hendershott (2006); Hendershott, Pryce, and White, (2003) and Gervais and Pandey (2006).

Note that the extent of the asymmetry between the wealthy and the poor in their ability to adjust their household asset portfolio will be concealed by credit rationing. For example, if a household's true (unconstrained) mortgage demand is £100,000 but their actual mortgage is just £80,000 because of credit constraints (due to binding loan-to-value limits set by the bank, for example), then a 20% fall in their mortgage demand due to changes in the tax laws will not result in any change in observable mortgage demand. Wealthier households, for whom credit constraints are not binding, will have much greater freedom to pay down their mortgage by transferring funds from taxable interest-bearing deposits and investments.

At a time of rising mortgage defaults both in the US and in the UK, it is also worth remembering the positive effects of MID in helping lower income taxpayers to maintain their monthly mortgage costs. Default rates are being driven upwards (particularly in the US) by the collapse of sub-prime mortgage lending[2] – low income households struggling to maintain their mortgage payments as interest rates rise. In the UK, MID was capped at the basic rate of taxation and only applied to the first £30,000 of mortgage debt. In terms of the impact on the ability of mortgage-borrowers to maintain their monthly debt service costs, it is likely that the removal of such a scheme would have the greatest impact on borrowers that have total mortgage debt close to the MID debt-limit, and have an annual income in the basic-rate tax band. In other words, the poorest and most vulnerable homeowners.

Time to resurrect MID? Perhaps. If, as before, MID were capped at the basic tax rate and only applied to a fixed amount of mortgage debt, then it would certainly heap the greatest benefits on first-time buyers and those at the lower end of the home-owning spectrum, the very people the Chancellor is seeking to help as part of his strategy of widening further access to owner-occupancy. Combined with taxation on capital gains or taxation of property values[3] the inflationary effects of MID could be neutralised and the barrier between owning and renting lowered.

Perhaps the tale of MID can have a happy ending after all?

Click here to download the full paper by Hendershott and Pryce (2006).

See the Housing Research page of www.gpryce.com for more articles and resources on housing related topics.

[2] See Duncan, 2007.

[3] see Muellbauer 2005.

References:

Duncan, G. (2007) "Greed could bring America's housing sector to grief", Economic View, *The Times*, 2nd April 2007.

Gervais, M. and Pandey, M. (2006) "*Who Cares about Mortgage Interest Deductibility?*" The University of Western Ontario Working Paper, http://economics.uwo.ca/faculty/gervais/workingpapers/mid.pdf

Hendershott, P. and Pryce, G. (2006) The Sensitivity of Homeowner Leverage to the Deductibility of Home Mortgage Interest, *Journal of Urban Economics*, 60 (1): 50-68.

Hendershott, P., Pryce, G. and White, M. (2003) Household Leverage and the Deductibility of Home Mortgage Interest: Evidence from UK House Purchasers, *Journal of Housing Research*, 14(1) pp. 49-82.

Muellbauer, J. (2005) Property Taxation and the Economy After the Barker Review, *Economic Journal*, 115, C99-C117.