

# Eliminate the Mortgage Interest Deduction or Tax Imputed Rent? Leveling the Real-Estate Playing Field

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Many commentators call for reducing or eliminating the mortgage interest deduction, arguing that the tax subsidy to owner-occupied housing distorts the economy by encouraging excessive housing investment and costing the government a substantial amount of tax revenue. They argue that nothing is sacred about this deduction, pointing to other countries (including our neighbor Canada) that do not provide it. It is not widely recognized, however, that the tax subsidy to homeownership arises not from the mortgage interest deduction per se but rather from a broader failure to treat owner-occupiers and landlords symmetrically. The failure of the tax code to treat owner-occupiers as landlords renting to themselves, as symmetry would require, is the real source of the subsidy. Eliminating this asymmetry, thus “leveling the playing field” in the tax treatment of real estate, would require taxing imputed rent and preserving, not eliminating, the interest deduction. The argument is that, if the tax code treated the owner-occupier as a landlord renting to himself or herself, this rent payment would be treated as income and taxed. The owner-occupier, like any business, would then be allowed to deduct all operating costs in computing taxable income, with mortgage interest being one of these costs.

Taxing imputed rent involves a measurement problem, because the rent that any particular owner-occupied dwelling would command in the rental market is not observed. However, a number of countries, including Switzerland and the Netherlands, follow this practice, and the United States could implement it by setting imputed rent equal to some fraction of the assessed value used for property tax purposes. Although feasible, taxing imputed rent would be very unpopular and thus politically problematic. Because their tax liabilities would rise, homeowners would strongly oppose paying taxes on imputed rent, matching their likely opposition to eliminating the mortgage interest deduction. It is nevertheless important for policymakers to gain a better understanding of the logic behind taxing imputed rent, and a better understanding requires a deeper analysis.

The analysis relies on the notion of the “user cost” of owner-occupied housing, a concept familiar to real estate economists. The *user cost*, in effect, gives the annual cost of inhabiting an owner-occupied house, a cost that is composed of mortgage interest, property taxes, and depreciation, with capital gains netted out. Let  $i$  denote the mortgage interest rate,  $p$  denote the property tax rate,  $d$  denote the

depreciation rate,  $g$  denote the rate of capital gains (the growth rate of house prices), and  $V$  denote the value of the dwelling. The owner-occupier's costs are  $(i + p + d - g)V$ , with  $iV$  equal to mortgage interest,<sup>1</sup>  $pV$  equal to the property tax payment,  $dV$  equal to the loss from physical depreciation, and  $gV$  equal to the gain from price appreciation (a negative cost). Because mortgage interest and property taxes are tax deductible, however, the owner-occupier in effect pays only a fraction,  $1 - t$ , of these two costs, where  $t$  denotes the (marginal) tax rate. Therefore, the user cost of owner-occupied housing equals

$$u = [(1 - t)(i + p) + d - g]V. \quad (1)$$

Note that, because depreciation is not tax deductible and capital gains earned by homeowners are effectively untaxed, neither  $d$  nor  $g$  is multiplied by the  $1 - t$  factor.

In deciding whether to own or rent, a consumer compares the user cost  $u$  with the rental cost of a comparable dwelling,  $R$ . In purchasing this dwelling for rental purposes, the landlord pays  $V$ , the same price that an owner-occupier would pay to purchase it. In a competitive housing market, in which profit is competed away, rent should just cover the landlord's costs (net of capital gains) on an after-tax basis. Letting  $t$  be the landlord's tax rate (assumed the same as the owner-occupier's tax rate), the net-of-tax income from renting out the dwelling is  $(1 - t)R$ , and the costs are the same ones incurred by the homeowner: mortgage interest, property taxes, and depreciation (net of capital gains). Because all three costs are tax deductible for landlords, and capital gains are taxable, all these elements are, like  $R$ , multiplied by  $1 - t$  to get net-of-tax costs. Because the  $1 - t$  factor cancels out when equating after-tax rental income to after-tax costs, however, the equality requires  $R$  to equal the landlord's costs on a *before-tax* basis. Therefore,  $R$  is given by

$$R = (i + p + d - g)V. \quad (2)$$

Comparing equations 1 and 2 reveals the tax subsidy to homeownership. The presence of the  $1 - t$  factor multiplying  $i + p$  in the user cost formula makes  $u$  smaller than  $R$ . As a result, a consumer would achieve a lower housing cost by owning than by renting. The implication, then, is that no household should want to rent. Although this conclusion is unrealistic, introducing other factors that are ignored in this simple framework would upset the prediction, leading to a more realistic outcome in which both renters and owner-occupiers coexist. For example, downpayment accumulation provides a barrier to homeownership for some households, forcing them to rent, and landlord tax benefits such as accelerated depreciation, which tend to depress  $R$  and thus make renting more attractive for some households, have been omitted.

The superiority of owning in this framework is a consequence of the asymmetric tax treatment of owner-occupiers and landlords. Owner-occupiers do not pay any tax on imputed rent or capital gains, which decreases their user cost. They are not allowed to deduct depreciation, a prohibition that increases their user cost. Depreciation is not important enough, however, for this omission to reverse the negative effect on user cost from nontaxation of imputed rent and capital gains.

<sup>1</sup> The owner-occupier is assumed to use a 100-percent, interest-only mortgage. Using a smaller mortgage has no effect on the formula (the forgone interest income on the funds used for a downpayment [a cost] exactly offsets the reduction in mortgage interest). Recognizing that mortgage payments usually contain both interest and principal, however, would lead to a more complicated formula.

If this asymmetry were eliminated, the owner-occupier's user cost would rise, becoming equal to rent,  $R$ . In particular, the tax on imputed rent,  $tR$ , would increase the owner-occupier's cost, as would the tax on capital gains,  $tgV$ . Conversely, the tax savings from deducting depreciation,  $tdV$ , would decrease the owner-occupier's cost. Totaling these changes and substituting for  $R$  using the rent formula, the increase in user cost turns out to equal  $t(i + p)V$ . It is easy to see that, by adding this amount to the  $u$  formula, the user cost becomes equal to  $R$ .

Therefore, leveling the playing field in the tax treatment of real estate requires not only taxing imputed rent but also taxing capital gains and allowing deduction of depreciation. These alterations are substantial changes to the tax code, but symmetric treatment of owner-occupiers and landlords requires them.

Eliminating the mortgage interest deduction could also narrow the gap between the owner-occupier's user cost and rent. By eliminating the deduction, the  $(1 - t)(i + p)$  term in the  $u$  formula would be replaced by  $i + (1 - t)p$ , which is larger and thus nearer to the  $i + p$  term in the rent formula, reducing the advantage of homeownership over renting. In fact, the advantage could be completely eliminated by also eliminating the deductibility of property taxes, in which case the  $i + (1 - t)p$  term would become  $i + p$ , making the owner-occupier's user cost and rent identical.

This outcome is the same as that generated by taxing imputed rent and capital gains and allowing deduction of depreciation. In both cases, renting and owning are equivalent from the consumer's point of view, entailing identical costs. Does this equivalence mean that policymakers should be indifferent between these two different routes for leveling the playing field? The answer is *no*, and the reason comes from taking the point of view of an investor rather than a consumer.

An investor in rental housing earns the difference between rent and costs, multiplied by  $1 - t$  to convert to an after-tax basis. Under the imputed-rent approach, the earnings of the owner-occupier (viewed as an investor) take an equivalent form: imputed rent minus costs multiplied by  $1 - t$ . Under the approach that eliminates the deductibility of mortgage interest and property taxes, however, no income elements are taxed and no costs are deductible, which means that earnings simply equal imputed rent minus costs, with the shrinkage factor of  $1 - t$  absent. As a result, investment in owner-occupied housing appears more favorable than investment in rental housing or any other productive activity wherein taxes deflate net income. As a result, although eliminating the deductibility of mortgage interest and property taxes makes rental and owner-occupied housing appear equivalent from the consumer's point of view, it does not eliminate the investment bias toward the latter type of housing created by the current tax subsidy. Therefore, a true leveling of the playing field in the tax treatment of real estate requires following the imputed-rent route, not the path that focuses on eliminating the mortgage interest deduction.

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