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An Analysis of the Geographic Distribution of the Mortgage Interest Deduction

Mark P. Keightley
Specialist in Economics

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Summary

This report analyzes variation in the mortgage interest deduction tax expenditure across states. Tax expenditures, such as the mortgage interest deduction, can generally be viewed as government spending administered via the tax code, or as tax incentives that are intended to achieve particular policy objectives. Regardless of the interpretation, tax expenditures provide a benefit to qualifying taxpayers by lowering their federal tax liabilities. Recent proposals to change the mortgage interest deduction could affect how its benefits are distributed. Understanding how the deduction's benefits are currently distributed across taxpayers in different states may help Congress in assessing the potential impact on constituents from a particular policy change.

Currently, homeowners may deduct the interest they pay on mortgages that finance a primary or secondary residence as long as they itemize their tax deductions. The amount of interest that may be deducted is limited to the interest incurred on the first $1 million of combined mortgage debt and the first $100,000 of home equity debt ($1.1 million total). If a taxpayer has a mortgage exceeding $1 million they may still claim the deduction, but they must allocate their interest payments appropriately to ensure that only the interest associated with the first $1 million of debt is deducted. The Joint Committee on Taxation (JCT) has consistently estimated the mortgage interest deduction to be one of the largest tax expenditures.

The results of the analysis presented in this report indicate that the benefits of the mortgage interest deduction are not distributed uniformly across the states. A number of reasons that likely explain why the variation exists are discussed, including differences in homeownership rates, home prices, state and local tax policies, and area incomes. The data used in this report, however, are not detailed enough to isolate and quantify the effect each one of these factors has on the variation across states.

In recent years a number of proposals to modify the mortgage interest deduction have emerged. Some proposals would reduce the maximum mortgage amount on which the mortgage interest deduction could be taken, presumably to better target potential new homeowners and moderate-income taxpayers. Other proposals have suggested converting the deduction to a tax credit. A credit would provide the same dollar-for-dollar benefit to claimants regardless of income, and would not require itemization. Still other proposals would preserve the provision as a deduction, but limit the rate at which higher-income taxpayers could deduct interest.

Analysis of several of the more frequently proposed changes suggests that some of them may provide a benefit that is more uniformly distributed. For example, limiting the size of mortgages that qualify for the deduction could reduce some of the variation that is caused by regional differences in home prices. Replacing the deduction with a credit, or limiting the rate at which interest could be deducted, could reduce variation in benefits caused by differences in area incomes. Still, it is important to understand that any change to the mortgage interest deduction would likely require careful consideration over how to transition to the new policy to minimize disruptions to the housing market and overall economy.

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Introduction

This report presents data on the geographic distribution of the mortgage interest deduction (MID) tax expenditure. Tax expenditures can generally be viewed as either government spending administered via the tax code, or tax incentives that are intended to achieve particular policy objectives. Regardless of the interpretation, tax expenditures such as the mortgage interest deduction provide a benefit to qualifying taxpayers by lowering their federal tax liabilities. For this reason, and because policymakers have expressed interest in increasing equity (fairness) in the tax code, it is important to understand how the benefits of the mortgage interest deduction are distributed. Additionally, understanding how the benefits of the deduction are currently distributed across taxpayers in different states may help Congress in assessing the potential impact on constituents from a particular policy change.[1]

Background

Currently, a homeowner may deduct the interest paid on a mortgage that finances a primary or secondary residence as long as they itemize their tax deductions.[2] The amount of interest that may be deducted is limited to the interest incurred on the first $1 million of combined mortgage debt and the first $100,000 of home equity debt ($1.1 million total). If a taxpayer has a mortgage exceeding $1 million they may still claim the deduction, but they must allocate their interest payments appropriately to ensure that only the interest associated with the first $1 million of debt is deducted.

The value of the deduction generally increases with a taxpayer's income. There are two primary reasons for this. First, the value of the mortgage interest deduction, like all deductions, depends on an individual's marginal tax rate. For example, an individual in the 25% marginal tax bracket, paying $10,000 in mortgage interest, would realize a reduction in taxes of $2,500 ($10,000 multiplied by 25%). In comparison, for someone in the 35% tax bracket the reduction in taxes for deducting the identical amount of interest would be $3,500 ($10,000 multiplied by 35%). Second, higher-income individuals tend to purchase more expensive homes, which results in larger mortgage interest payments, and hence, a larger deduction.

Although many contend that the purpose of the mortgage interest deduction is to promote homeownership, this was not the deduction's original purpose. When laying the framework for the modern federal income tax code in 1913, Congress recognized the importance of allowing for the deduction of expenses incurred in the generation of income, which is consistent with traditional economic theories of income taxation.[3] As a result, all interest payments were deductible with no distinction made for business, personal, living, or family expenses.[4] It is likely that no distinction was made because most interest payments were business related expenses at the time and, compared to today, households generally had very little debt on which interest

[1] While there are other distributions that might be of interest to policymakers (e.g., across income levels), analysis of these other distributions is beyond the scope of this report.

[2] The alternative to itemizing one's tax deduction is to claim the standard deduction.

[3] Sen. William Borah, *Congressional Record*, August 28, 1913, p. S3832.

[4] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by Congressional Research Service, 114th Cong., 2nd sess., December 2016, S. Prt. 114-31 (Washington: GPO, 2017), pp. 350-351.

payments were required—credit cards had not yet come into existence and the mortgage finance industry was in its infancy. Among those that did hold a mortgage, the majority were farmers.

For more than 70 years there was no limit on the amount of home mortgage interest that could be deducted. The Tax Reform Act of 1986 (TRA86; P.L. 99-514) eventually restricted the amount of mortgage interest that could be deducted and limited the number of homes for which the deduction could be claimed to two. Mortgage interest deductibility was limited to the purchase price of the home, plus any improvements, and on debt secured by the home but used for qualified medical and educational expenses.[5] Subsequently, the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) resulted in the basic deduction limits that exist today.

In recent years a number of proposals to modify the mortgage interest deduction have emerged. Some proposals would reduce the maximum mortgage amount on which the mortgage interest deduction could be taken, presumably to better target potential new homeowners and moderate income taxpayers. Other proposals have suggested converting the deduction to a tax credit. A credit would provide the same dollar for dollar benefit to claimants regardless of income, and would not require itemization. Still other proposals would preserve the provision as a deduction, but limit the rate at which higher income taxpayers could deduct interest. Specific proposals are presented and analyzed later in this report, after analysis of the data.

Data Analysis

The Joint Committee on Taxation (JCT) has estimated that the mortgage interest deduction reduced federal tax revenues by $59.0 billion in FY2016.[6] This implies that individuals claiming the mortgage interest deduction realized a benefit of the same magnitude in the form of reduced taxes. The following analysis seeks to describe how this benefit is distributed across states using a variety of statistical measures. Because the JCT does not produce tax expenditure estimates on a state-by-state basis, an approach that accounts for state-level differences in incomes and in amounts of mortgage interest deducted was used to allocate the JCT's national expenditure estimate to the states. **Appendix A** presents the data contained in this section in tabular form. A summary of the allocation method and data sources may be found in the **Appendix B**.

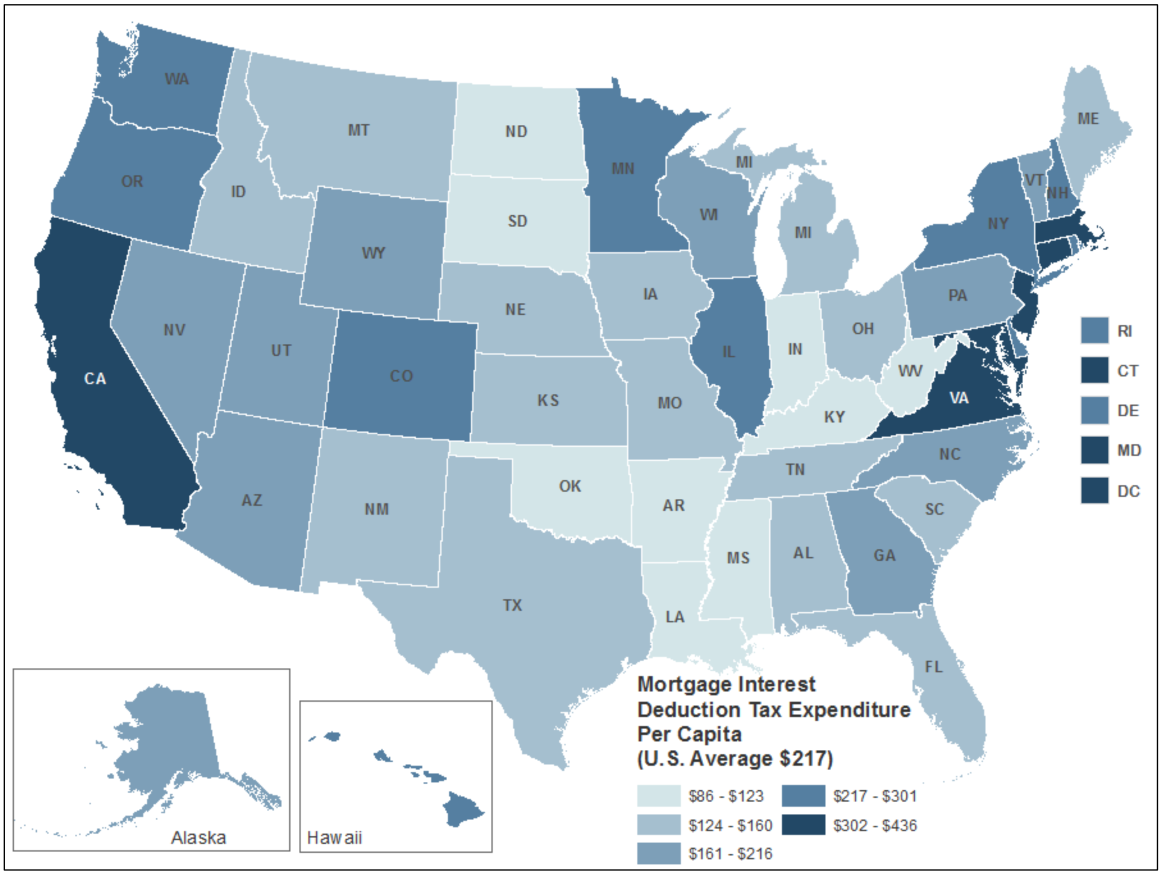
Tax Expenditure Per Capita

Figure 1 displays the estimated per capita mortgage interest deduction tax expenditure for each state. The data presented in the figure may be interpreted in one of two ways: (1) the amount of federal spending per person in each state that is attributable to the mortgage interest deduction that is administered through the tax code; (2) the average reduction in federal tax liability realized by individuals in each state from allowing mortgage interest to be deducted. Nationwide, the average per capita tax expenditure in 2014 was $217.

[5] Ibid.

[6] U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures For Fiscal Years 2016-2020*, committee print, 115th Cong., 1st sess., January 30, 2017, JCX-3-17 (Washington: GPO, 2017).

Figure 1. Mortgage Interest Deduction Tax Expenditure Per Capita, 2014



Source: CRS estimates.

Notes: See **Appendix B** for discussion of methodology.

Figure 1 shows that variation exists between the states in the benefit they receive from the deduction. To account for differences in populations, **Figure 1** displays the tax expenditure data in per capita terms. The residents of Mississippi and West Virginia were the smallest per capita beneficiaries of the mortgage interest deduction. Residents in Mississippi received on average about $87 in mortgage interest deduction tax expenditures in 2014, while West Virginians realized a slightly smaller benefit of $86 per person. In contrast, the residents of the District of Columbia (DC) were the largest beneficiary with a per person tax expenditure estimate of $436, followed by residents of Maryland with a benefit of $402 per person. Stated differently, the per capita benefit in DC and Maryland is estimated to be nearly five times the per capita benefit in Mississippi and West Virginia. The results are similar when the 10 smallest per capita beneficiary states are compared to the 10 largest per capita beneficiary states. Residents of the 10 smallest beneficiary states received an average of $109 per person in mortgage interest deduction tax expenditures while residents of the 10 largest beneficiary states averaged $349 per person, or more than five times as much per person.[7]

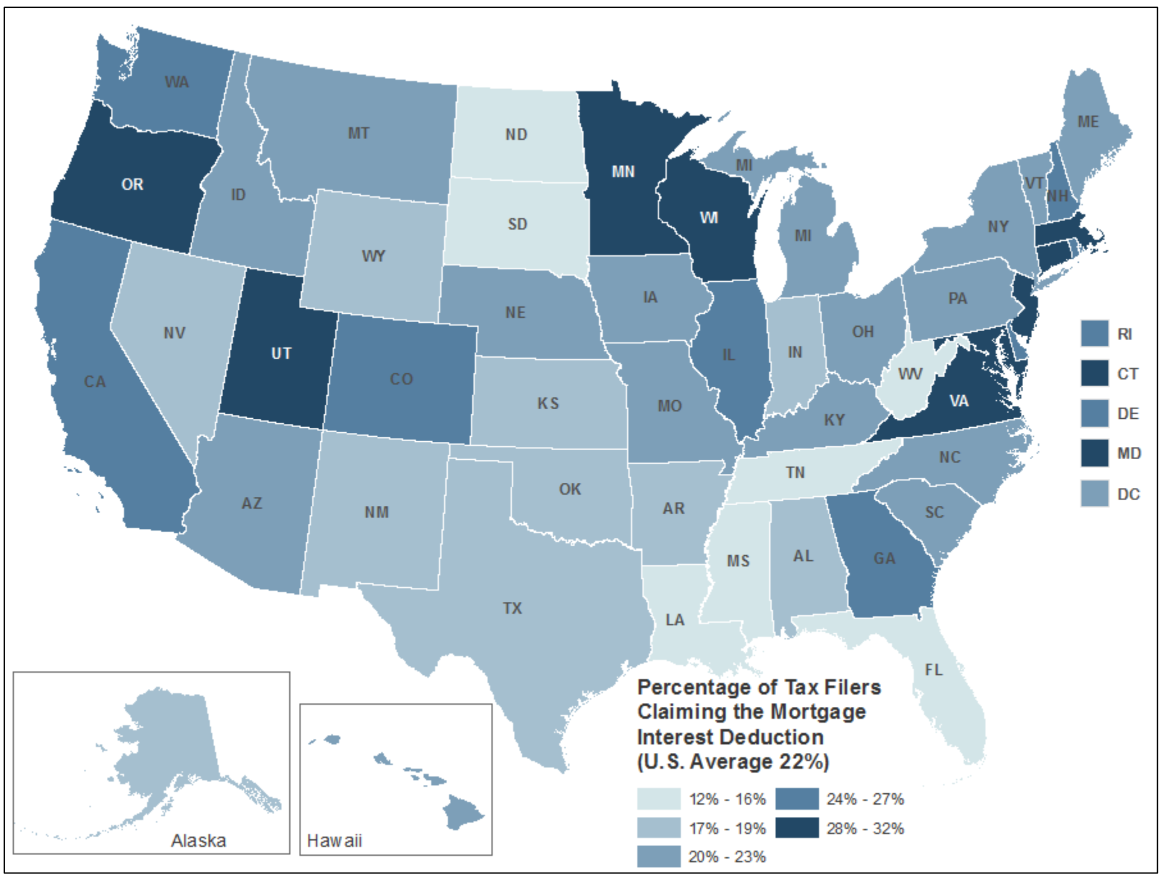
[7] The 10 largest beneficiaries were (by descending order) DC, Maryland, Virginia, Connecticut, California, New Jersey, Massachusetts, Washington, Colorado, and Hawaii. The 10 smallest beneficiaries were (by ascending order) West Virginia, Mississippi, South Dakota, Arkansas, Oklahoma, Kentucky, North Dakota, Louisiana, Indiana, and Tennessee.

Figure 1 also highlights where the largest and smallest beneficiary states are located. The benefits are most highly concentrated along the mid-Atlantic and northeastern coastal states, and the west coast. Several other states scattered throughout the country also are among the largest beneficiaries, such as Colorado, Hawaii, Illinois, and Minnesota. The states receiving the least benefit per person are mostly found in the Midwest and Southern regions of the country, as well as portions of the Southwest and Northwest.

Share of Tax Filers Claiming the MID

Another way to examine the mortgage interest deduction is to look at the distribution of tax filers claiming the deduction. The deduction was claimed on 22% of tax returns nationally. However, there was considerable variation in claim rates across the country (see **Figure 2**). For example, North Dakota and South Dakota had the lowest claim rates, with 11.8% and 12.0% of their tax filers claiming the deduction, respectively. The highest claim rates were found in Connecticut, where 30.7% of filers claimed the deduction, and Maryland, where 32.4% of filers claimed it. Generally, claim rates were highest along the west coast and portions of the east coast. Tax filers in several western states, such as Colorado, Idaho, and Utah, and Midwestern states such as Illinois, Minnesota, and Wisconsin also claimed the deduction at rates higher than the national average.

Figure 2. Percentage of Tax Filers Claiming the Mortgage Interest Deduction, 2014



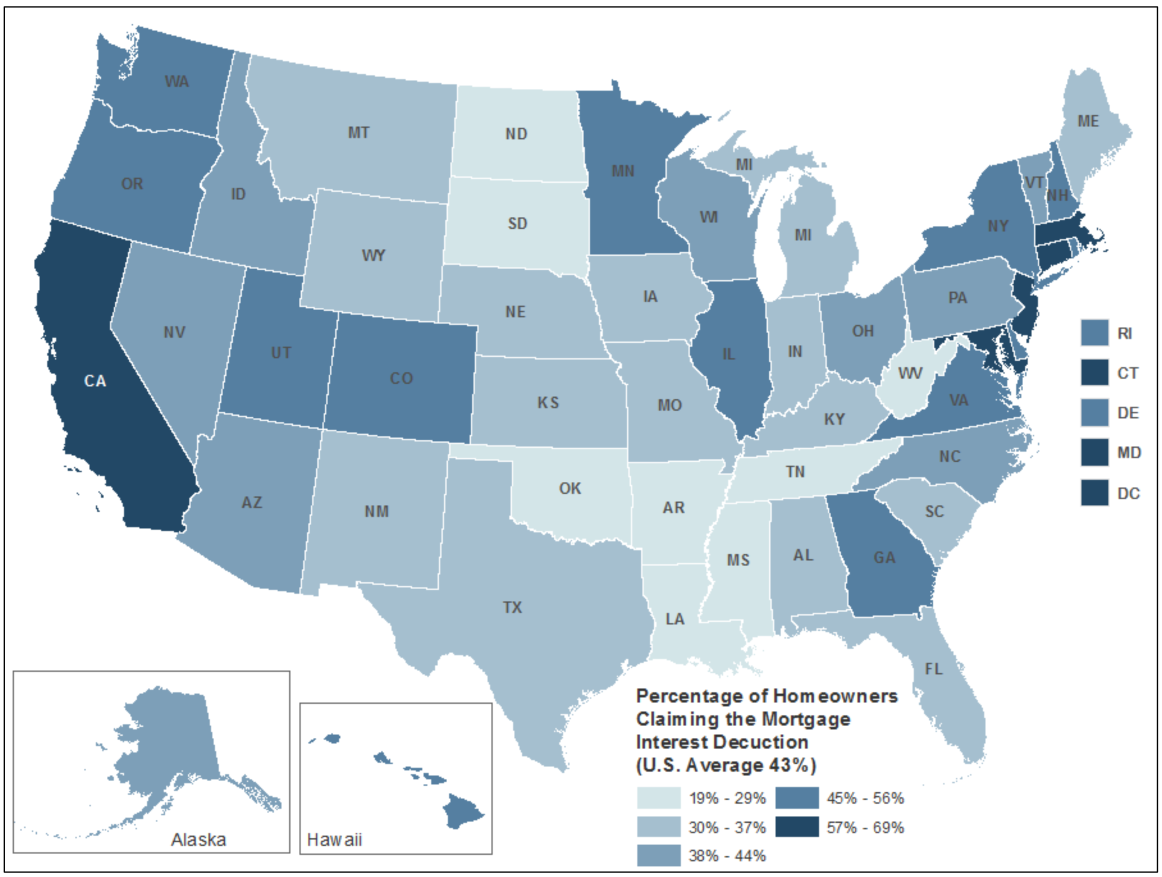
Source: CRS calculations using Internal Revenue Service's 2014 Statistics of Income (SOI), http://www.irs.gov/uac/SOI-Tax-Stats—Historic-Table-2.

Share of Homeowners Claiming the MID

Some may have the impression that all homeowners benefit from the mortgage interest deduction. In fact, only about half of all homeowners nationally (43%) claim the deduction, as shown in **Figure 3**. Several factors may explain why some homeowners do not claim the deduction, including not having a mortgage, low mortgage payments (either from being towards the end of the mortgage period or due to living in a low cost area), or living in a state without an income tax. These factors are discussed in greater detail below.

The distribution of homeowners who claim the mortgage interest deduction generally mimics the distribution of tax filers who claim the mortgage interest deduction. States such as Mississippi, North Dakota, South Dakota, Tennessee, and West Virginia had the lowest percentage of homeowners who claimed the deduction. Homeowners on the west coast and parts of the mid-Atlantic and northeastern states had some of the highest claim rates, as did Colorado, Utah, and a handful of other states scattered across the country.

Figure 3. Percentage of Homeowners Claiming the Mortgage Interest Deduction



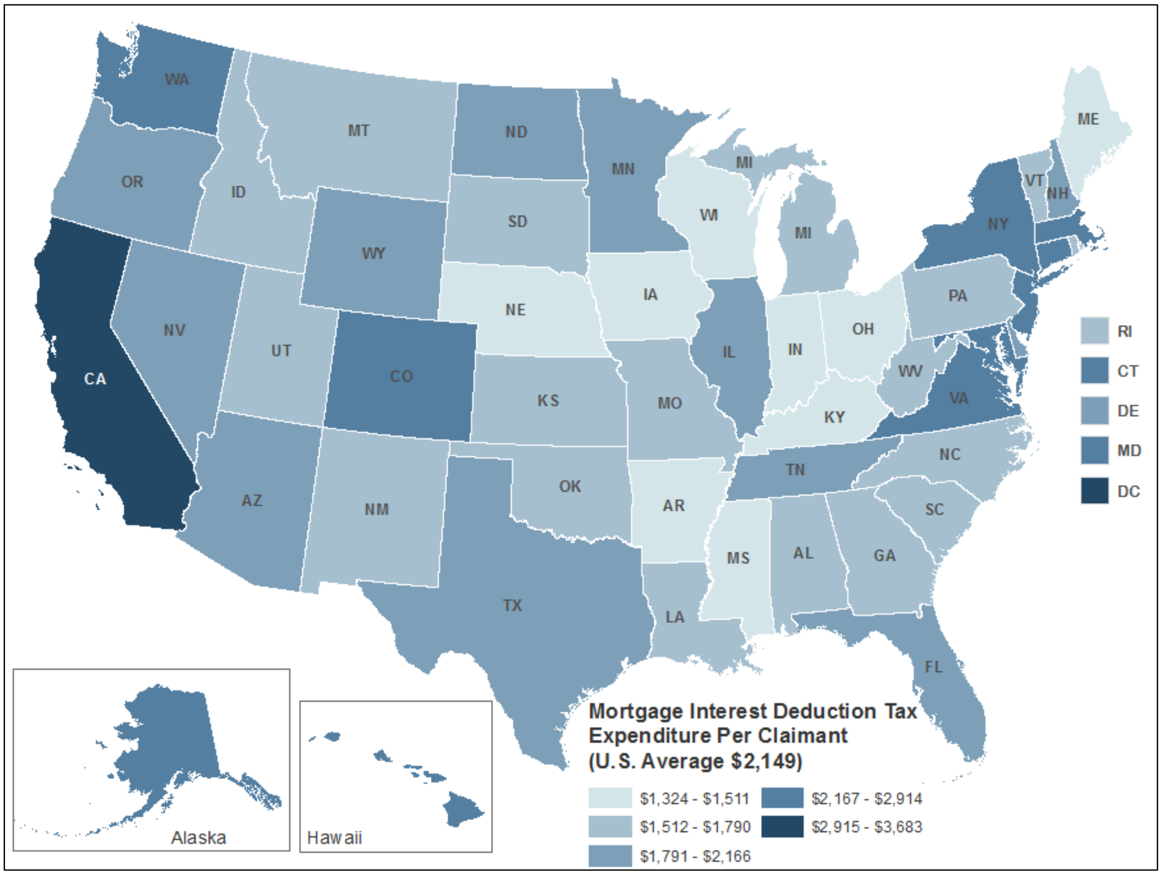
Source: CRS estimates.

Notes: See **Appendix B** for discussion of methodology.

Tax Expenditure Per MID Claimant

Figure 4 displays geographic distribution of the mortgage interest deduction tax expenditure per claimant for each state. The data show that Americans claiming the mortgage interest deduction saved approximately $2,149 in taxes on average in 2014. Given the variation in tax filers claiming the mortgage interest deduction and variation in the percent of homeowners claiming the deduction, it is not surprising that **Figure 4** indicates that there is variation across the country in the benefit received by those claiming the deduction. Claimants in DC received the largest average benefit ($3,683) as the result of the deduction, followed by homeowners claiming the deduction in California ($3,223). At the other end of the spectrum, homeowners in Iowa who claimed the deduction received the smallest average benefit ($1,324), followed by Kentucky claimants ($1,345). Stated differently, on average, DC tax filers who claimed the deduction realized a reduction in their tax liability that was nearly three times that of claimants in Iowa.

Figure 4. Mortgage Interest Deduction Tax Expenditure Per Claimant



Source: CRS estimates.

Notes: See **Appendix B** for discussion of methodology.

More generally the distribution shown in **Figure 4**, like the previous two, is skewed toward particular geographic areas of the country. Claimants in a number of mid-Atlantic and northeast coast states, such as Connecticut, Massachusetts, Maryland, New Jersey, New York, Virginia, and DC, typically benefited the most. The same is true for the west coast states of California and Washington (beneficiaries in Oregon received less than the national average). Homeowners in Alaska, Colorado, and Hawaii were also some of the largest beneficiaries of the deduction. Claimants in the Midwest and southern states, along with Maine, were generally those who benefited the least from the deduction.

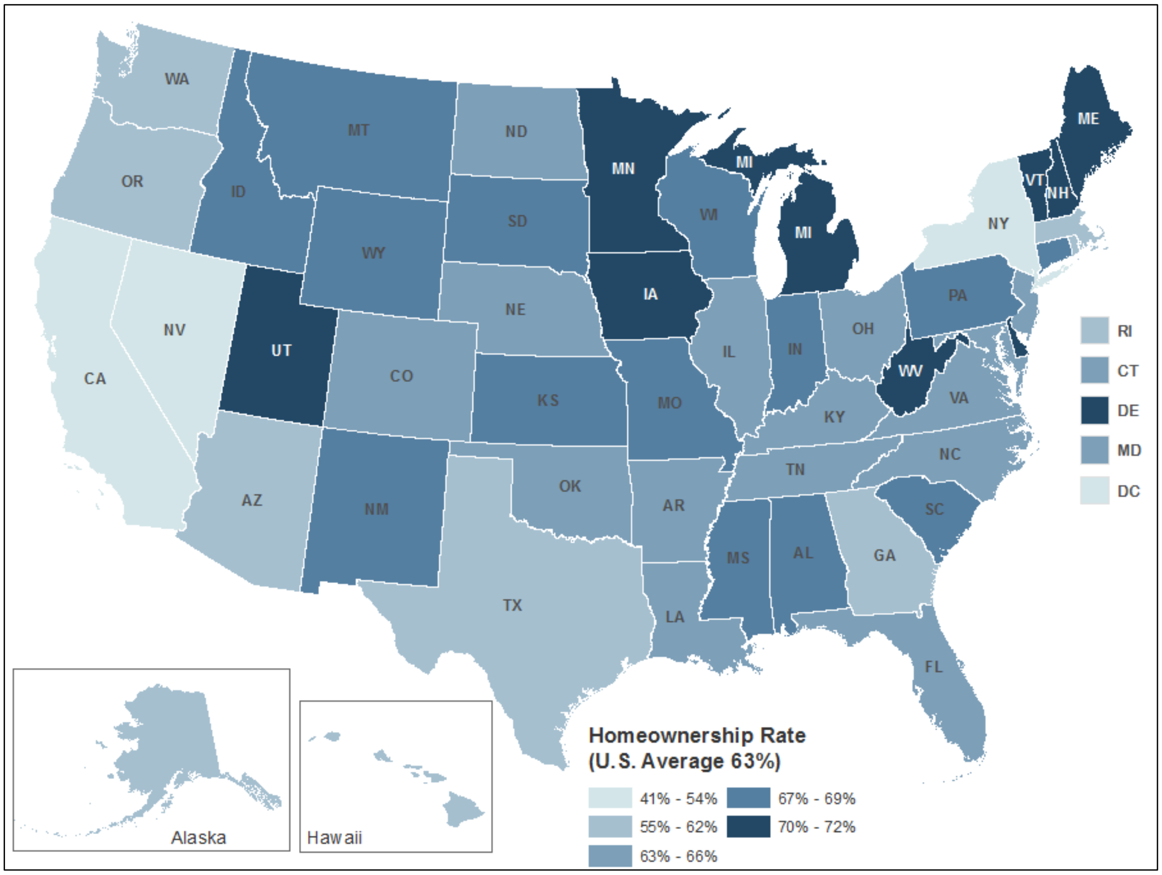
Reasons for the Variation in MID Beneficiaries

There a number of factors that are likely contributing to the state variation in the various mortgage interest deduction tax expenditure figures presented thus far. Isolating and quantifying the precise effect each factor may have on how many homeowners in a state claim the deduction or on the average benefit received from the deduction is complicated by the interaction of the various factors and the use of state-level data. Still, it is useful to highlight general differences among states that are likely contributing to the variation. Understanding what is causing variation in the benefits bestowed by the mortgage interest deduction is helpful in analyzing potential policy changes.

Homeownership Rates

Since the mortgage interest deduction is only available to homeowners, variation in homeownership rates will naturally contribute to variation in which tax filers claim the deduction and therefore who benefits from the deduction. **Figure 5** shows that homeownership rates varied across states from a low of 40.6% in DC to a high of 72.2% in West Virginia in 2014. Homeownership rates appear to be lowest in several states that have a concentration of their population in relatively higher cost-of-living areas such as New York, California, and Hawaii, and highest in less densely populated and lower cost-of-living areas such as Minnesota, Maine, Iowa, Delaware, New Hampshire, and Vermont.

Figure 5. Homeownership Rates in 2014



Source: CRS estimates using the U.S Census Bureau's 2014 American Community Survey, http://www.census.gov/acs/.

Notes: The homeownership rate for each state is defined as the number of owner occupied units divided by the total number of occupied units.

All else equal, states with higher homeownership rates should expect to see higher claims rates because more taxpayers would be eligible for the deduction. How well variation in the homeownership rate explains variation in the average amount of interest homeowners deduct or the average tax savings realized from the deduction is less clear. Two states could have different homeownership rates, but have similar average home prices and incomes, resulting in homeowners in both states deducting similar amounts of interest on average. Of course, all else is not equal in reality and other factors influencing the claims rate may also be interacting with the decision to become a homeowner, which in turn will influence how many people benefit from the deduction.

Home Prices

Area home prices contribute to the variation in the mortgage interest deduction data in two primary ways. First, homeowners are more likely to claim the deduction in higher priced areas since higher home prices generally require larger mortgages, and hence more interest to be paid. Second, higher home prices will also result in a larger average benefit from claiming the deduction because of the larger amounts of deductible interest. Thus, homeowners in two different states that are otherwise identical except for the price of their homes will benefit differently from the deduction. Home prices are typically lower in less populated markets than in densely populated areas and metropolitan markets.[8] Thus, higher average home prices along the east and west coasts likely explain some of the concentration of mortgage interest deduction beneficiaries.

State and Local Taxes

Variation in state and local taxes, historically state income and property taxes, but more recently state sales taxes, likely contributes to variation in the mortgage interest deduction data.[9] Only homeowners who itemize their deductions can claim the mortgage interest deduction. An individual will only itemize if his or her itemized deductions exceed that of the standard deduction. As state and local taxes increase, all else equal, it becomes more likely that homeowners will claim the mortgage interest deduction. Thus a portion of the geographic variation in the data presented in this report is attributable to variation in state and local taxes.

Incomes

Area incomes also influence the decision to claim the deduction. Higher area incomes will support higher home prices, which implies greater mortgages and higher interest payments. But higher incomes also imply that the same dollar of mortgage interest deducted will be more valuable than the same dollar deduction at a lower income level. Thus, all else equal, markets with higher incomes should be expected to have a higher claim rate.

Policy Options and Considerations

There are a number of options available to Congress regarding the mortgage interest deduction. This section presents several of the options that are most frequently discussed. It is important to note that any change to the mortgage interest deduction would likely require careful consideration of how to transition to the new policy so as to minimize disruptions to the housing market and overall economy. Depending on its design, a policy modification could result in a more evenly distributed benefit to homeowners.

Before discussing specific options, it may be important to note that the House GOP "Better Way" Blueprint for tax reform does not indicate which avenue it may pursue. The plan calls for evaluating options to make the mortgage interest deduction "more effective and efficient" at promoting homeownership but states that any changes would include a grandfather provision for existing mortgages and refinancing of existing mortgages.[10] Aside from these general guidelines, no other details are provided.

Retain the Current Deduction

One option available to Congress is to leave the deduction in its current form. The deduction is popular among homeowners as well as industry groups such as the National Association of

[8] Home prices can even vary greatly within a state. Other factors that influence the decision to claim the mortgage interest deduction can also vary within states. This is one of the reasons it is particularly difficult to use state-level data to isolate the effects the various factors have on the decision to claim the deduction.

[9] For more on state and local taxes, see CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Grant A. Driessen and Steven Maguire.

[10] House Republican Tax Reform Task Force Blueprint, *A Better Way: Our Vision for a Confident America: Tax*, June 2016, http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

Realtors, the National Association of Homebuilders, and the Mortgage Bankers Association. Additionally, the deduction is commonly thought to promote homeownership, which may produce desirable social spillovers. The economic research on the ability of the deduction to increase homeownership and produce social spillovers, however, generally suggests that the deduction does not achieve the often stated policy objective of increasing homeownership. This issue is discussed in greater detail in the next section.

Leaving the mortgage interest deduction unaltered would result in continued differences across states in the deduction's beneficiaries. States with higher homeownership rates, home prices, and average incomes would continue to benefit the most on average. This could be of concern to some if tax expenditures are viewed as government spending administered via the tax code since the spending would continue to be distributed unevenly (in per capita terms). If Congress decides to assist homeowners via the tax code, several alternatives to the mortgage interest deduction may accomplish that objective in a more equitable, and possibly efficient, manner.

Eliminate the Deduction

Congress could eliminate the mortgage interest deduction. This option can be evaluated along several dimensions, starting first with its effect on the tax treatment of taxpayers. The variation in the claims rates and benefit value documented in this report suggests that eliminating the deduction could help promote a more uniform tax treatment across taxpayers. Eliminating the mortgage interest deduction would result in two homeowners, who are equally situated in terms of financial resources but who are located in different states, being treated more equally for tax purposes. Eliminating the mortgage interest deduction would also result in equally positioned homeowners and renters being treated similarly by the tax code.

Elimination of the deduction can also be evaluated by its effect on economic performance or its contribution to improving economic efficiency. Elimination of the deduction could improve the overall performance of the economy if the deduction is currently leading labor and capital to be allocated to less productive uses in the owner-occupied housing sector. A number of studies have found that owner-occupied housing is generally taxed favorably compared to other sectors in the economy.[11] Elimination of the deduction would be a step in the direction of creating more uniformity in the tax treatment of various sectors, which would assist in a more efficient allocation of resources across the economy. The increase in federal revenue from eliminating the deduction could also improve the long-term budgetary situation of the United States, implying less reliance on deficits to finance spending.

Additionally, elimination of the deduction can be analyzed by examining the potential effect on the homeownership rate. Economists have identified the primary barrier to homeownership to be the high transaction costs associated with a home purchase—mostly resulting from the down payment requirement.[12] Because the deduction does not directly address the largest barrier to

[11] See for example, CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle; A Joint Report by The White House and the Department of the Treasury, *The President's Framework For Business Tax Reform: An Update*, April 2016, https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf; and Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform*, October 2005, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/67xx/doc6792/10-18-tax.pdf.

[12] See for example, Peter D. Linneman and Susan M. Wachter, "The Impacts of Borrowing Constraints," *Journal of the American Real Estate and Urban Economics Association*, vol. 17, no. 4 (Winter 1989), pp. 389-402; Donald R. Haurin, Patrick H. Hendershott, and Susan M. Wachter, "Borrowing Constraints and the Tenure Choice of Young Households," *Journal of Housing Research*, vol. 8, no. 2 (1997), pp. 137-154; and Mathew Chambers, Carlos Garriga, and Donald (continued...)

homeownership, and also because the deduction is not well targeted to the group of potential homebuyers most in need of assistance—lower-income households, which includes younger first-time buyers who do not itemize—the effect of eliminating the deduction is likely to be small in the long run.[13]

While elimination of the deduction may in the long run lead to improved economic efficiency with potentially little effect on the homeownership rate, careful consideration would still be required to minimize the likelihood of short-run negative consequences. For example, sudden elimination of the deduction could cause a drop in home demand, leading to a decrease in home prices. The decrease in home prices would impose capital losses on current owners and perhaps produce a lock-in effect—current homeowners could be reluctant to sell at a loss. In addition, the decrease in home prices could lead to a reduction in new home construction, a reduction in homeowner wealth, and the possibility of higher defaults since some homeowners would have mortgage debt that exceeds the value of their home. These three events could lead to a negative impact on the broader economy in the short run.

Gradually phasing out the deduction over time could help mitigate the negative consequences for the economy and housing market. Researchers Steven Bourassa and William Grigsby propose eliminating the deduction over a 15- to 20-year period with a fixed date after which the deduction would no longer be available.[14] For example, if January 1, 2037, were chosen as the cut-off date, taxpayers who buy a home in 2017 could claim the deduction for 20 years, buyers in 2018 could claim the deduction for 19 years, and so on. Bourassa and Grigsby postulate that there would be no effect on home demand or prices, although no modeling is done to support their proposal. It is possible that gradually eliminating the deduction could simply delay the negative short-term consequences for the economy and housing market. This could happen if households do not anticipate the full effects of the deduction's elimination until closer to the chosen cut-off date.

Limit the Deduction

In between retaining the deduction and eliminating the deduction is the option of limiting its scope. Currently, the mortgage interest deduction may be claimed on interest paid on up to $1 million of mortgage debt that finances a primary or secondary residence or interest paid on up to $100,000 of home equity debt (which may be used to finance spending unrelated to the home). It is available every year the mortgage is in repayment. There have been concerns that the rather high mortgage limit and the ability to deduct interest on home equity debt may be providing a tax benefit to taxpayers who would have become homeowners regardless of its existence.

To increase the target effectiveness of the deduction it could be limited to interest paid on a mortgage amount that more closely resembles that of a first-time homebuyer. In 2009, the Congressional Budget Office (CBO) estimated the revenue effect of gradually reducing the maximum mortgage amount on which interest can be deducted from $1.1 million to $500,000.[15]

(...continued)

Schlagenhauf, "Accounting for Changes in the Homeownership Rate," *International Economic Review*, vol. 50, no. 3 (August 2009), pp. 677-726.

[13] For an more in depth analysis and discussion of the effects of the mortgage interest deduction on homeownership, see CRS Report R41596, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, by Mark P. Keightley.

[14] Steven C. Bourassa and William G. Grigsby, "Income Tax Concessions for Owner-Occupied," Housing Policy Debate, vol. 11, no. 3 (2000), pp. 521-546.

[15] Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 189, http://www.cbo.gov/ftpdocs/102xx/ (continued...)

The CBO option would not take effect for four years (2013 at the time the report was published), and would decrease the maximum mortgage amount by $100,000 annually until it reached $500,000. The CBO estimates this option would raise a total of $41.4 billion between enactment (2013) and 2019.

Similarly, House Ways and Means Committee Chairman Dave Camp in 2014 released a comprehensive tax reform draft that proposed limiting the size of mortgages eligible for the deduction. The proposal would reduce the eligible mortgage amount to $500,000 over a four-year period beginning in 2015. Interest on home equity debt incurred after 2014 would no longer be deductible. To lessen the impact on the housing market, the new limitations would only apply to new mortgage debt. Furthermore, the proposal includes a grandfather provision for refinanced debt if the original mortgage debt is incurred before the mortgage limit reduction. Because of the comprehensive nature of Chairman Camp's proposal, the JCT grouped the revenue estimates for this proposal along with a number of other changes to itemized deductions.

Another option would be to leave the maximum mortgage amount unchanged, but limit the amount of interest that could be deducted. For example, the amount of interest that a taxpayer may deduct could be limited to a percentage of their adjusted gross income (AGI), such as 10%, 12%, or 15%. The CBO has offered a similar limitation option for another tax benefit for homeowners—the deduction for state and local property taxes.[16] A more general cap on all itemized deductions has also been the subject of past tax reform discussions.[17]

Limiting the deduction would likely help lessen the interstate variation in the mortgage interest deduction. As discussed, a portion of the variation is attributable to differences across states in income levels and home prices. States with higher average incomes should, all else equal, expect to benefit more from the deduction; itemization is more frequent with higher income households, higher incomes can support larger mortgages, and higher incomes imply a higher deduction value per dollar deducted. Placing limits on the amount of interest that can be deducted should help to decrease the variation to some degree, although deductions in general will typically display some variation simply because they increase in value as incomes rise.

Replace the Deduction with a Credit

Another option available to Congress is to replace the mortgage interest deduction with a tax credit. The current deduction tends to provide a proportionally bigger benefit to higher-income homeowners since they buy more expensive homes and are subject to higher marginal tax rates. The requirement that homeowners itemize their tax returns also limits the number of owners who receive the tax benefit. A tax credit for mortgage interest could provide a benefit to more homeowners since itemization would no longer be required. A credit, unlike the current deduction, would have the same dollar-for-dollar value to a homeowner regardless of income, creating a more consistent rate of subsidization across homeowners. Making the tax credit refundable would serve to make it better targeted to lower-income homeowners.

(...continued)

doc10294/08-06-BudgetOptions.pdf.

[16] Congressional Budget Office, *Options for Reducing the Deficit: 2017 to 2026*, December 2016, p. 140, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52142-budgetoptions2.pdf.

[17] For more information, see CRS Report R43079, *Restrictions on Itemized Tax Deductions: Policy Options and Analysis*, by Jane G. Gravelle and Sean Lowry.

Over the years, several mortgage interest tax credit options have been proposed. Five of the more prominent ones are listed below. All five would limit the deduction to a taxpayer's principal residence. Four out of the five would allow a 15% credit rate. Three of the five credit options would be nonrefundable. Two of the options would limit the size of the mortgage eligible for the credit to $500,000, while one would limit eligible mortgages to no greater than $300,000 (with an inflation adjustment). Another option would limit the maximum eligible mortgage to 125% of the area median home prices. And still another would place no cap on the maximum eligible mortgage, but would limit the maximum tax credit one could claim to $25,000.

- The CBO, in its most recent *Options for Reducing the Deficit* report, presented the option of converting the mortgage interest deduction to a nonrefundable tax credit equal to 15% of interest paid.[18] The credit would be restricted to a taxpayer's primary residence. No credit would be allowed for interest associated with home equity loans. Under this option, the deduction would still be available between 2017 and 2021 as the credit was phased in. Simultaneously, the maximum mortgage amount that would be eligible for the credit would be reduced by $100,000 during the phase in. From 2022 on, only the credit could be claimed on mortgage amounts up to $500,000. The CBO indicates that this option would raise $105 billion from 2017 to 2026, according to estimates provided to them by the JCT. A similar option was presented by the CBO in 2013 and 2009.[19]
- The American Enterprise Institute's Alan Viard proposed converting the deduction in a 15% refundable tax credit starting in 2015.[20] The credit would have been limited to the interest on the first $300,000 of mortgage debt (in 2013 dollars) associated with one's primary residence (second homes and home equity debt would be excluded). The qualifying mortgage amount would be adjusted annually for inflation. Homeowners could still claim the deduction but only at 90% of its current value, decreasing by 10% annually. A homeowner could switch to the tax credit regime at any time.
- President Obama's National Commission on Fiscal Responsibility and Reform (Fiscal Commission) recommended replacing the mortgage interest deduction with a nonrefundable credit equal to 12% of the interest paid on mortgages of $500,000 or less.[21] The credit would be restricted to a taxpayer's primary residence. No credit would be allowed for interest associated with home equity loans.
- The Bipartisan Policy Center's Debt Reduction Taskforce, co-chaired by former Senator Pete Domenici and former CBO Director Alice Rivlin, proposes a 15%

[18] Congressional Budget Office, *Options for Reducing the Deficit: 2017 to 2026*, December 2016, p. 136, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52142-budgetoptions2.pdf.

[19] U.S. Congress, Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 187, http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf. Congressional Budget Office, Options for Reducing the Deficit: 2014 to 2023, November 2013, p. 115, http://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-2_1.pdf.

[20] Alan D. Viard, "Replacing the Home Mortgage Interest Deduction," in *15 Ways to Rethink the Federal Budget*, ed. Michael Greenstone, Max Harris, Karen Li, Adam Looney, and Jeremy Patashnik (The Hamilton Project, 2013), pp. 45-49.

[21] The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, Washington, DC, December 2010, p. 31, http://momentoftruthproject.org/sites/default/files/TheMomentofTruth12_1_2010.pdf.

credit for up to $25,000 of interest paid on a mortgage associated with a principal residence—interest paid on home equity loans, and second homes would be ineligible.[22] The tax credit would be refundable, which would help lower-income homeowners, who could claim the credit. The proposed credit would be administered via mortgage lenders who would apply for the credit and transfer it to homeowners by lowering their interest payments in an amount equal to the credit.

- In 2005, President George W. Bush's Advisory Panel on Federal Tax Reform (Tax Reform Panel) also proposed replacing the mortgage interest deduction with a credit.[23] Specifically, the Tax Reform Panel proposed a tax credit equal to 15% of mortgage interest paid. Under the proposal, the credit would be restricted to a taxpayer's primary residence. The size of the mortgage for which claiming the interest credit would be limited to 125% of median home price in the taxpayer's region. It appears from the Panel's report that the credit would be nonrefundable.

[22] The Debt Reduction Task Force, *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*, Bipartisan Policy Center, Washington, DC, November 2010, pp. 35-36, http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf.

[23] The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, https://www.brookings.edu/wp-content/uploads/2015/10/presidents_advisory_panel_report_2005.pdf.

Appendix A. Tabular Presentation of Report Data

Table A-1. Statistics on Mortgage Interest Deduction Tax Expenditures, by State

State	Mortgage Interest Deduction Tax Expenditure Per Capita	Percentage of Tax Filers Claiming the Mortgage Interest Deduction	Percentage of Homeowners Claiming the Mortgage Interest Deduction	Mortgage Interest Deduction Tax Expenditure Per Claimant	Homeownership Rate
AK	$216	18%	43%	$2,380	62%
AL	$131	19%	31%	$1,630	68%
AR	$101	16%	27%	$1,511	66%
AZ	$191	22%	42%	$2,053	61%
CA	$351	24%	61%	$3,223	54%
CO	$298	27%	52%	$2,333	64%
CT	$355	31%	60%	$2,380	66%
DC	$436	23%	69%	$3,683	41%
DE	$246	26%	47%	$1,990	70%
FL	$160	16%	31%	$2,166	64%
GA	$189	24%	48%	$1,790	62%
HI	$289	21%	55%	$2,914	57%
IA	$129	21%	34%	$1,324	71%
ID	$148	22%	38%	$1,569	68%
IL	$224	24%	48%	$1,939	65%
IN	$123	18%	33%	$1,458	69%
KS	$140	19%	34%	$1,613	67%
KY	$116	20%	34%	$1,345	66%
LA	$121	16%	28%	$1,787	64%
MA	$344	28%	60%	$2,481	62%
MD	$402	32%	67%	$2,519	66%
ME	$151	21%	35%	$1,466	71%
MI	$150	20%	36%	$1,552	70%
MN	$258	27%	48%	$1,915	72%
MO	$140	20%	35%	$1,553	67%
MS	$87	15%	26%	$1,380	68%
MT	$155	20%	37%	$1,586	66%
NC	$176	23%	41%	$1,768	64%
ND	$118	12%	22%	$2,001	64%
NE	$134	20%	37%	$1,408	66%
NH	$260	25%	48%	$1,990	70%

State	Mortgage Interest Deduction Tax Expenditure Per Capita	Percentage of Tax Filers Claiming the Mortgage Interest Deduction	Percentage of Homeowners Claiming the Mortgage Interest Deduction	Mortgage Interest Deduction Tax Expenditure Per Claimant	Homeownership Rate
NJ	$349	29%	62%	$2,486	63%
NM	$131	17%	31%	$1,737	67%
NV	$177	18%	44%	$2,086	54%
NY	$236	21%	51%	$2,368	53%
OH	$135	20%	38%	$1,373	65%
OK	$112	17%	29%	$1,583	65%
OR	$233	27%	53%	$1,861	61%
PA	$188	22%	40%	$1,779	69%
RI	$225	26%	56%	$1,746	59%
SC	$154	21%	36%	$1,667	68%
SD	$100	12%	22%	$1,732	68%
TN	$127	15%	27%	$1,874	66%
TX	$150	16%	35%	$2,047	61%
UT	$204	28%	54%	$1,754	69%
VA	$363	29%	56%	$2,678	65%
VT	$168	21%	38%	$1,543	70%
WA	$301	25%	50%	$2,569	62%
WI	$164	29%	44%	$1,394	67%
WV	$86	13%	19%	$1,574	72%
WY	$167	19%	30%	$2,106	67%
U.S.	$217	22%	43%	$2,149	63%

Source: CRS estimates.

Notes: CRS estimates based on the data cited in **Appendix B**.

Appendix B. Data and Estimate Methodology

The data used in this report came from the four sources listed below. All data are for year 2014. The methodology for producing the state-by-state distributional estimates (described below) required use of the JCT's estimate of the mortgage interest deduction tax expenditure by income.

1. The 2014 American Community Survey produced by the U.S Census Bureau (http://www.census.gov/acs/).
   - Housing unit data and mortgage status data, by state.
2. The 2014 Population Estimates produced by the U.S. Census Bureau (https://www.census.gov/data/datasets/2016/demo/popest/state-total.html).
   - Population estimates.
3. The 2014 Statistics of Income produced by the Internal Revenue Service (http://www.irs.gov/uac/SOI-Tax-Stats—Historic-Table-2).
   - All individual tax filer related data, by state.
4. The Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018* (https://www.jct.gov/).
   - Mortgage interest deduction tax expenditures estimates for 2014.

The estimate for the geographic distribution of the mortgage interest deduction tax expenditure was produced using an approach developed by economist Martin A. Sullivan.[24] Sullivan's method accounts for both differences in incomes across states—and therefore, differences in tax rates—and differences in the amount of interest deducted in each state.

The first step is to compute national "average marginal" tax rates for various income groups. The tax rates were calculated by first consolidating the income classes used by the JCT in their distributional estimates so that they matched the smaller number of income classes in IRS's Statistics of Income (SOI) data. The JCT's distributional estimates are reproduced in **Table B-1**. Next, the JCT expenditure estimate for each income class was divided by the amount of mortgage interest deducted in each income class as reported in the SOI data. This produced an estimate of the national "average marginal" tax rate for each income class.

Table B-1. Distribution by Income Class of Mortgage Interest Deduction Tax Expenditure, at 2014 Rates and 2014 Income Levels

	Mortgage Interest Deduction	
Income Class	Returns (thousands)	Amount (millions)
Below $10,000	1	$2
$10,000 to $20,000	107	$26
$20,000 to $30,000	401	$166
$30,000 to $40,0000	817	$426
$40,0000 to $50,000	1455	$823

[24] Martin A. Sullivan, "Mortgage Deduction Heavily Favors Blue States," *Tax Notes*, January 24, 2011, pp. 364-367.

Income Class	Mortgage Interest Deduction Returns (thousands)	Mortgage Interest Deduction Amount (millions)
$50,000 to $75,000	5,137	$4,330
$75,000 to $100,000	5,727	$6,581
$100,000 to $200,000	14,975	$27,421
$200,000 and over	6,246	$29,340
Total	34,866	$69,115

Source: Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018,* https://www.jct.gov/publications.html?func=startdown&id=4663.

For each state, the tax rates were then multiplied by the amount of mortgage interest deducted in each respective income class and then summed. This produced an estimate of each state's share of the JCT's mortgage interest deduction tax expenditure estimate. The estimated tax rates produced by this approach are reported in **Table B-2**.

Table B-2. Estimated Average Tax Rates for Purposes of Allocating the Mortgage Interest Deduction Tax Expenditure to States

Income Class	**Estimated Tax Rate**Error! Reference source not found.
Below $10,000	0.08%
$10,000 to $50,000	4.14%
$50,000 to $75,000	11.28%
$75,000 to $100,000	15.91%
$100,000 to $200,000	27.57%
Above $200,000	47.03%[b]

Source: CRS calculations using Internal Revenue Service's 2014 Statistics of Income (SOI) http://www.irs.gov/uac/SOI-Tax-Stats—Historic-Table-2 and Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018,* https://www.jct.gov/publications.html?func=startdown&id=4663.

Note:

a. The estimated tax rate is equal to the tax expenditure attributable to the respective income class divided by the amount of interest deducted by individuals in the income class.

b. This estimated tax rate exceeds the highest marginal tax rate for this income group (35%) for several reasons. First, the definitions of income used in the JCT estimates and the IRS data are not identical. Second, the JCT data used in the tax rate calculation are estimates.

Author Contact Information

Mark P. Keightley
Specialist in Economics
mkeightley@crs.loc.gov, 7-1049

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