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# **An Analysis of the Geographic Distribution of the Mortgage Interest Deduction**

**Mark P. Keightley**  
Specialist in Economics

January 30, 2014

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

R43385

## 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, a homeowner may deduct the interest they pay on a mortgage that finances 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 unable 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 mortgage which qualifies 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 in the tax code, it is important to understand how the benefits of the mortgage interest deduction are distributed.<sup>1</sup> 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.<sup>2</sup>

## 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.<sup>3</sup> 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.<sup>4</sup> As a result, all interest payments were made

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<sup>1</sup> For example, Senate Finance Committee Chairman Max Baucus and House Ways and Means Committee Chairman Dave Camp stated jointly "For the good of our economy, and for the sake of making the tax code simpler and fairer for families, Congress needs to come together to realign the tax code." <https://taxreform.gov/why-reform.html>.

<sup>2</sup> While there are other distributions that might be of interest to policy makers (e.g., across income levels), analysis of these other distributions is beyond the scope of this report.

<sup>3</sup> The alternative to itemizing one's tax deduction is to claim the standard deduction.

<sup>4</sup> Sen. William Borah, *Congressional Record*, August 28, 1913, p. S3832.

deductible with no distinction made for business, personal, living, or family expenses.<sup>5</sup> 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 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.<sup>6</sup> 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 \$68.5 billion in FY2012.<sup>7</sup> 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. A summary of the allocation method and data sources may be found in the **Appendix**.

## 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

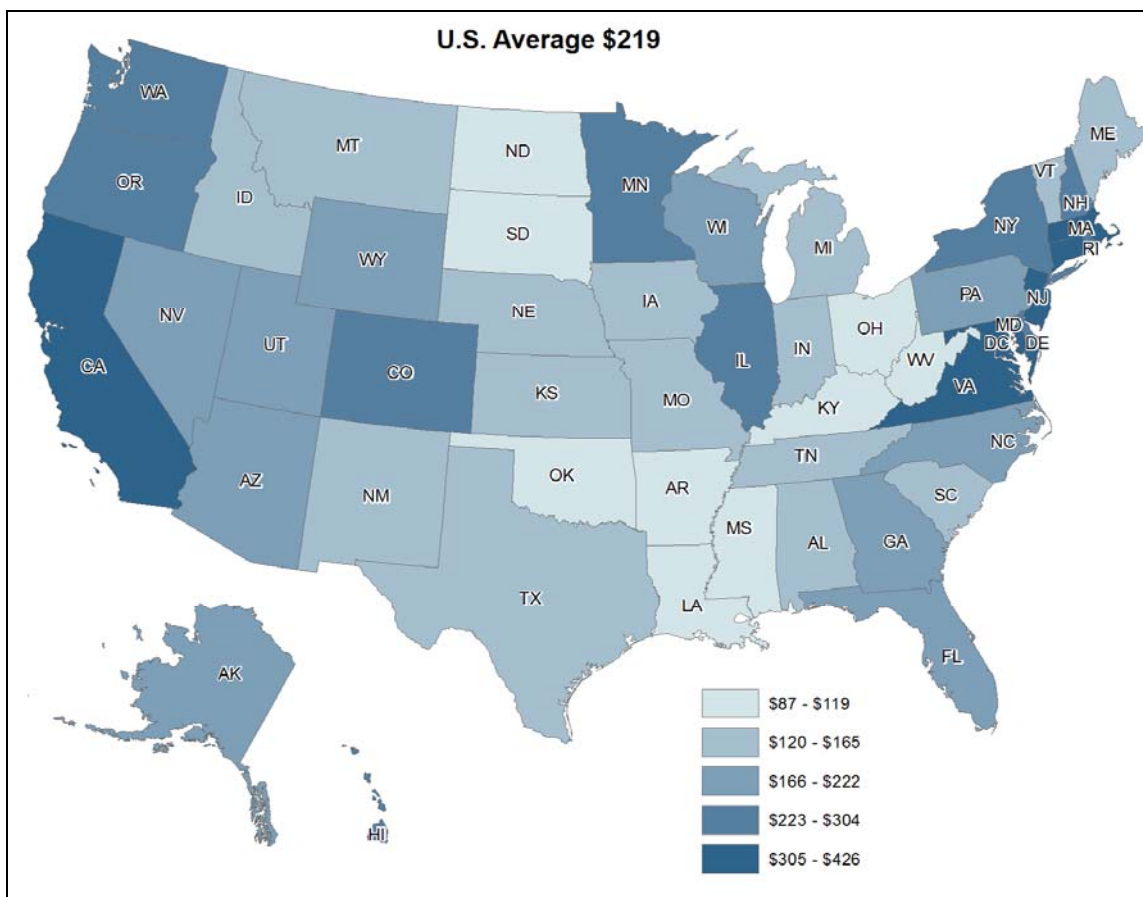
<sup>5</sup> U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by Congressional Research Service, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., December 2008, S. Prt. 110-667 (Washington: GPO, 2008), p. 330.

<sup>6</sup> Ibid.

<sup>7</sup> U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures For Fiscal Years 2012-2017*, committee print, 113<sup>th</sup> Cong., 1<sup>st</sup> sess., February 1, 2013, JCS-1-13 (Washington: GPO, 2013).

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 2012 was \$219.

**Figure 1. Mortgage Interest Deduction Tax Expenditure Per Capita, 2012**



**Source:** CRS estimates.

**Notes:** See **Appendix** 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 2012, while West Virginians realized a slightly larger benefit of \$88 per person. In contrast, the residents of the District of Columbia were the largest beneficiary with a per person tax expenditure estimate of \$426, followed by residents of Maryland with a benefit of \$414 per person. Stated differently, the per capita benefit in the District of Columbia 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 \$106 per person in mortgage interest deduction

tax expenditures while residents of the 10 largest beneficiary states averaged \$350 per person, or nearly 3.5 times as much per person.<sup>8</sup>

**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.

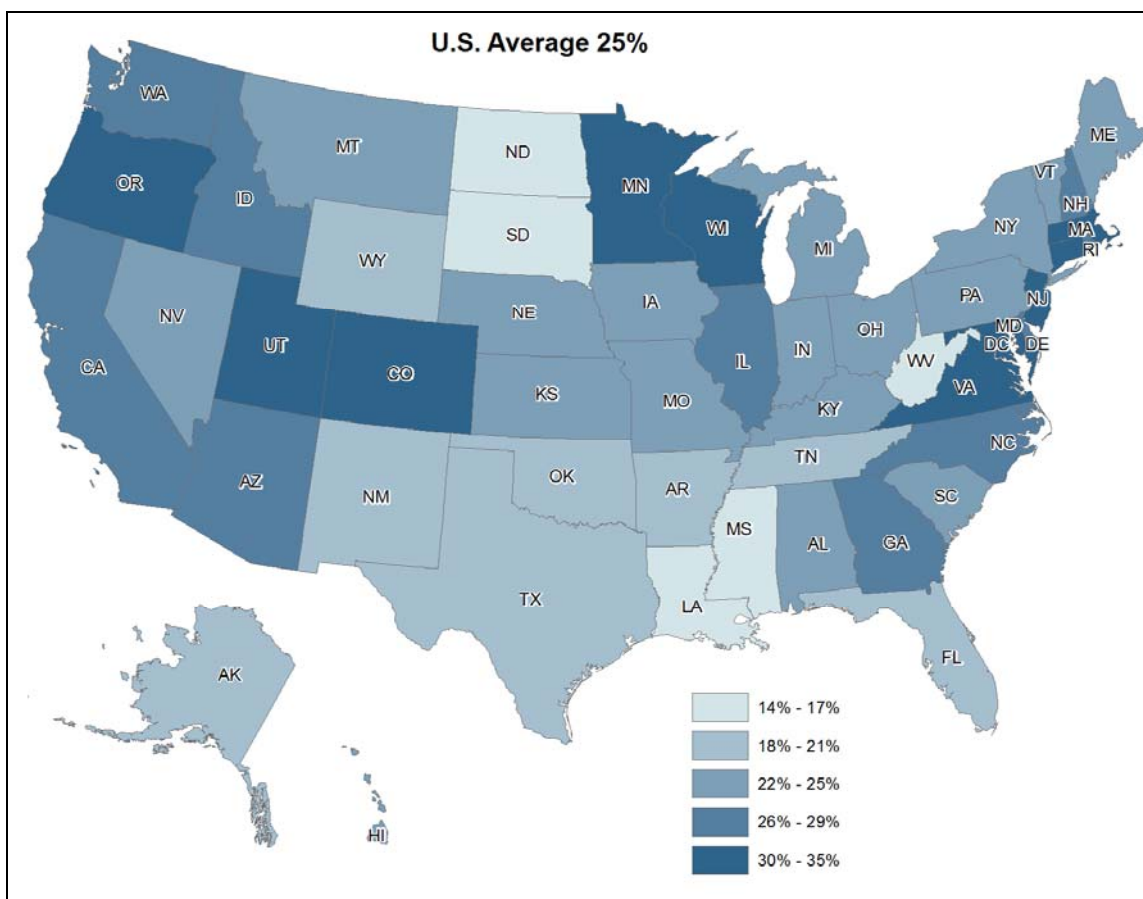
## Share of Tax Filers Claiming the MID

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 25% of tax returns nationally. However, there was considerable variation in claim rates across the country (see **Figure 2**). For example, South Dakota and North Dakota had the lowest claim rates, with 14% and 15% of their tax filers claiming the deduction, respectively. The highest claim rates were found in Connecticut, where 33% of filers claimed the deduction, and Maryland, where 35% 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.

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<sup>8</sup> The 10 largest beneficiaries were California, Colorado, Connecticut, D.C., Hawaii, Massachusetts, Maryland, New Jersey, Virginia, and Washington. The 10 smallest beneficiaries were Arkansas, Iowa, Kentucky, Louisiana, Mississippi, North Dakota, Oklahoma, Ohio, South Dakota, and West Virginia.



**Figure 2. Percentage of Tax Filers Claiming the Mortgage Interest Deduction, 2011**

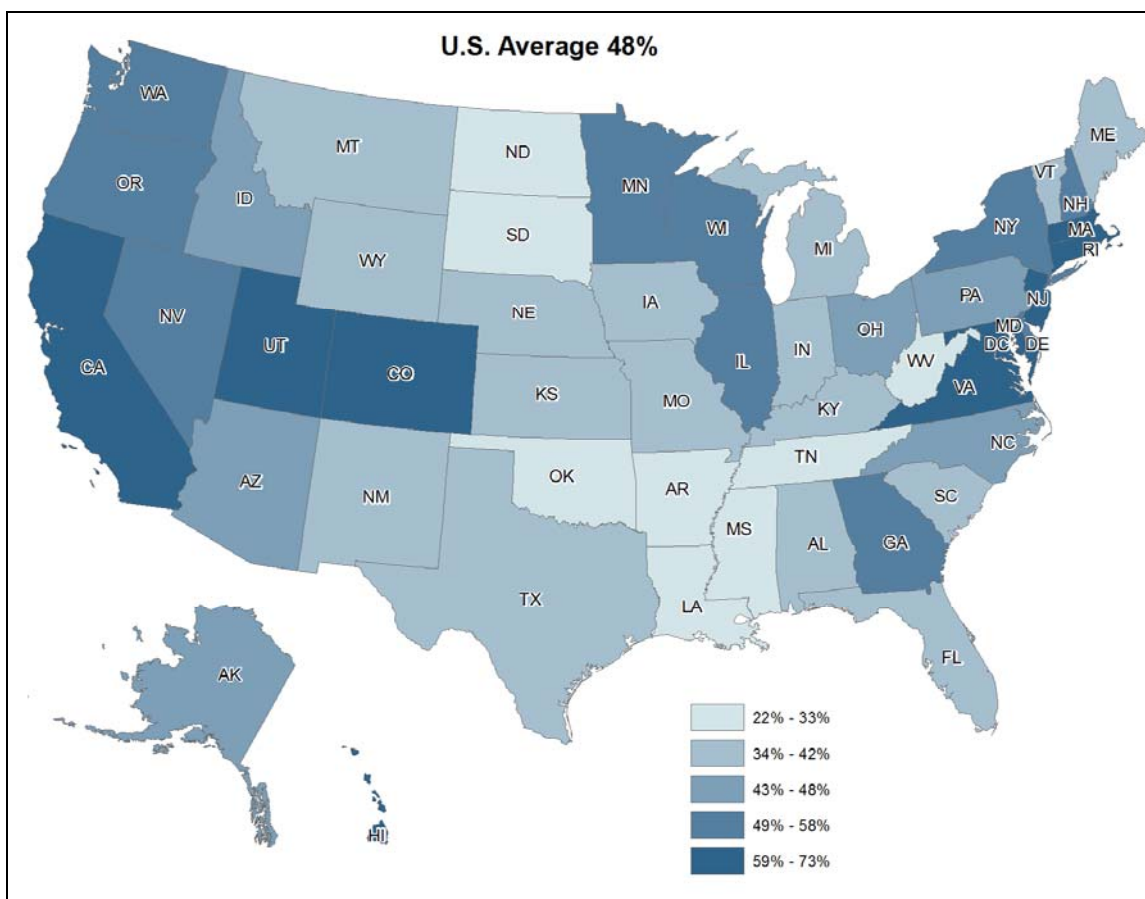
**Source:** CRS calculations using Internal Revenue Service's 2011 Statistics of Income (SOI)  
<http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2>.

## 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 (48%) 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 Louisiana, Mississippi, North Dakota, South Dakota, 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**

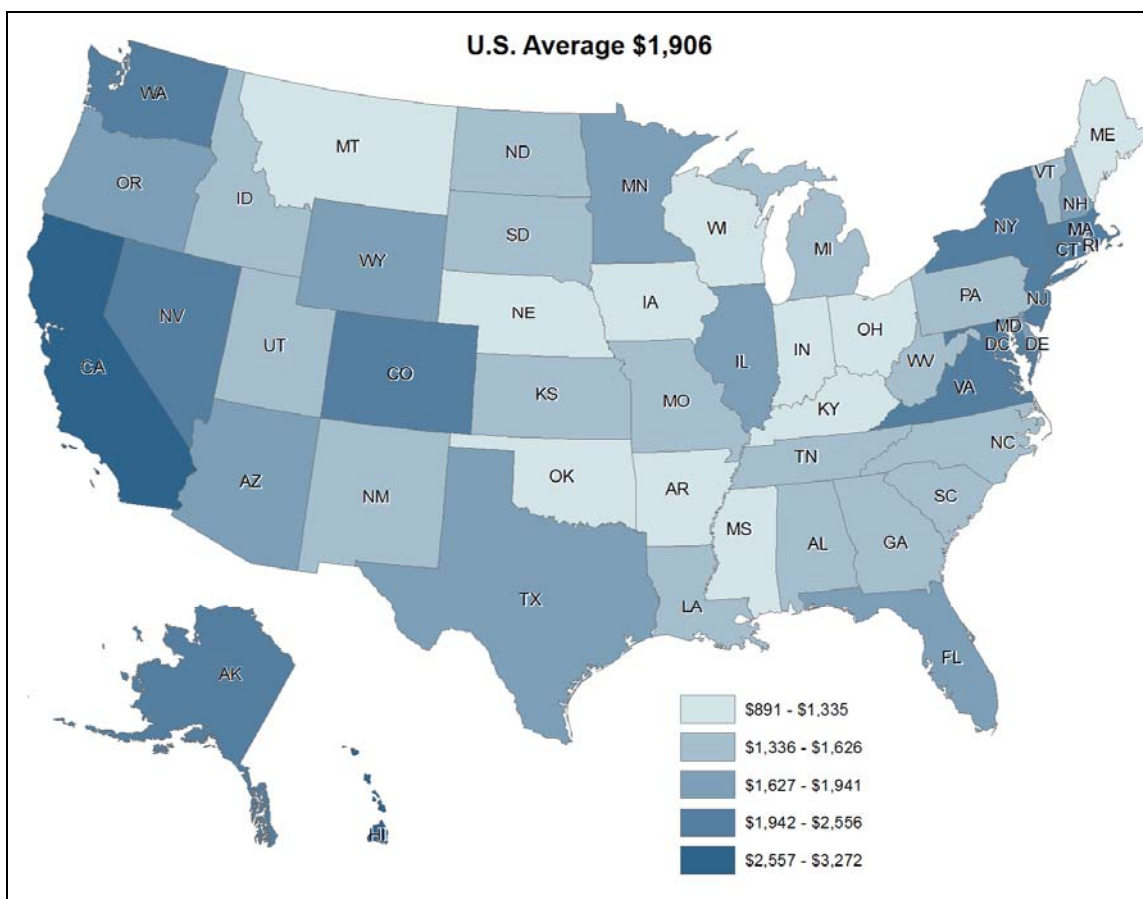


**Source:** CRS estimates.

**Notes:** See Appendix 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 \$1,906 in taxes on average in 2012. 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 D.C. received the largest average benefit (\$3,272) as the result of the deduction, followed by homeowners claiming the deduction in California (\$2,974). At the other end of the spectrum, homeowners in Ohio who claimed the deduction received the smallest average benefit (\$891), followed by Iowa claimants (\$1,177). Stated differently, on average, D.C. tax filers who claimed the deduction realized a reduction in their tax liability that was nearly four times that of claimants in Ohio.

**Figure 4. Mortgage Interest Deduction Tax Expenditure Per Claimant**

**Source:** CRS estimates.

**Notes:** See [Appendix](#) 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 the mid-Atlantic states, as well as those on the northeast coast typically benefited the most. The same is true for most of the west coast (although, beneficiaries in Oregon received less than the national average). Homeowners in Colorado and Utah, as well as Alaska and Hawaii, were also some of the largest beneficiaries of the deduction. Claimants in the Midwest and southern states were generally those who benefited the least from the deduction.

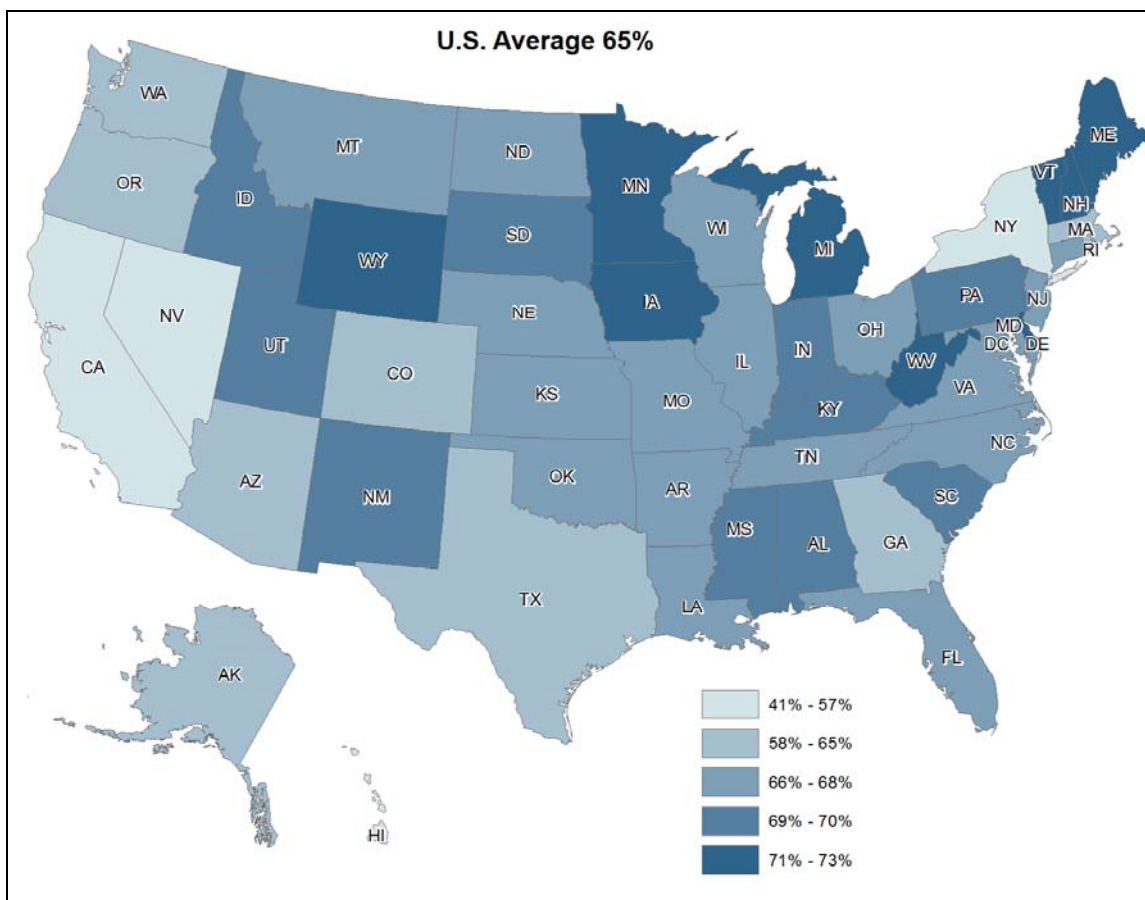
## Reasons for the Variation in MID Beneficiaries

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 41.2% in D.C. to a high of 72.8% in Minnesota in 2011.<sup>9</sup> 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 Iowa, West Virginia, Delaware, and Wyoming.

**Figure 5. Homeownership Rates in 2011**



**Source:** CRS estimates using the U.S. Census Bureau's 2011 American Community Survey produced by the, <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

<sup>9</sup> Homeownership rates displayed in **Figure 5** may be below average historical levels in some states that were particularly hard hit by the Great Recession.

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. Correspondingly, 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 expect 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.<sup>10</sup> 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, particularly state income and property taxes, likely contribute to variation in the mortgage interest deduction data.<sup>11</sup> 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 income and property taxes increase, all else equal it becomes more likely that homeowners will claim the mortgage interest deduction. Nine states currently have no broad-based income tax, including Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. These states accounted for roughly 20% of all homeowners in the United States, with Florida and Texas combining to account for 14% of all homeowners. Florida and Texas both are ranked in the 10 least likely states where tax returns claim the mortgage interest deduction, and the 20 least likely states where homeowners claim the deduction.

## **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.

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<sup>10</sup> 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.

<sup>11</sup> For more on state and local taxes, see CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire.



## 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.

### 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 Realtors, National Association of Homebuilders, and 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.<sup>12</sup> Elimination of the deduction would be a step in the direction of creating more

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<sup>12</sup> See, for example CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle; A Joint (continued...)

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.<sup>13</sup> Because the deduction does not directly address the largest barrier to 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.<sup>14</sup>

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 could find themselves underwater on their mortgages. 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.<sup>15</sup> For example, if January 1, 2034, were chosen as the cut-off date, taxpayers who buy a home in 2014 could claim the deduction for 20 years, buyers in 2015 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

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(...continued)

Report by The White House and the Department of the Treasury, *The President's Framework For Business Tax Reform*, February 2012, <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.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>.

<sup>13</sup> 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 Schlagenhauf, "Accounting for Changes in the Homeownership Rate," *International Economic Review*, vol. 50, no. 3 (August 2009), pp. 677-726.

<sup>14</sup> 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

<sup>15</sup> Steven C. Bourassa and William G. Grigsby, "Income Tax Concessions for Owner-Occupied," *Housing Policy Debate*, vol. 11, no. 3 (2000), pp. 521-546.

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, interest paid on up to \$100,000 of home equity debt (which may be used to finance spending unrelated to the home), and 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 that would have become homeowners regardless if it existed.

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.<sup>16</sup> 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.

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 option for another tax benefit for homeowners—the deduction for state and local property taxes.<sup>17</sup> A more general cap on all itemized deductions has also been the subject of recent discussions.<sup>18</sup>

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 difference across states in income levels. 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 increase.

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<sup>16</sup> Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 189, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.

<sup>17</sup> Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 190, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.

<sup>18</sup> For more information, see CRS Report R43079, *Restrictions on Itemized Tax Deductions: Policy Options and Analysis*, by Jane G. Gravelle and Sean Lowry.



## 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.

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 15% nonrefundable tax credit.<sup>19</sup> 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 2014 and 2018 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 2019 on, only the credit could be claimed on mortgage amounts up to \$500,000. A similar option was presented by the CBO in 2009.<sup>20</sup>
- The American Enterprise Institute's Alan Viard has proposed converting the deduction in a 15% refundable tax credit starting in 2015.<sup>21</sup> The credit would be 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

<sup>19</sup> 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](http://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-2_1.pdf)

<sup>20</sup> 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>.

<sup>21</sup> 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.

- with a nonrefundable credit equal to 12% of the interest paid on mortgages of \$500,000 or less.<sup>22</sup> 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% 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.<sup>23</sup> The tax credit would be refundable, which would help lower-income homeowners would be allowed to take advantage of 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.<sup>24</sup> 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.

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<sup>22</sup> The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, Washington, DC, December 2010, p. 31, [http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12\\_1\\_2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf).

<sup>23</sup> 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://www.bipartisanpolicy.org/sites/default/files/FINAL%20DRTF%20REPORT%2011.16.10.pdf>.

<sup>24</sup> The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, <http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf>.

## Appendix. Data and Estimate Methodology

The data used in this report came from the four sources listed below. All data is for year 2011 except for the JCT's aggregate tax expenditure estimate for the mortgage interest deduction. 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. Unfortunately, there was no such distributional estimate for 2011, but there was one for 2010 and 2012. The 2012 distributional estimate was used because it likely better reflects the current state of the housing market.

1. The 2011 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 2011 Population Estimates produced by the U.S. Census Bureau ([http://www.census.gov/popest/data/historical/2010s/vintage\\_2011/index.html](http://www.census.gov/popest/data/historical/2010s/vintage_2011/index.html)).
  - Population estimates.
3. The 2011 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 2012-2017* (<https://www.jct.gov/>).
  - Mortgage interest deduction tax expenditures estimates for 2012.

The estimate for the geographic distribution of the mortgage interest deduction tax expenditure was produced using an approach developed by economist Martin A. Sullivan.<sup>25</sup> 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 A-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.

<sup>25</sup> Martin A. Sullivan, “Mortgage Deduction Heavily Favors Blue States,” *Tax Notes*, January 24, 2011, pp. 364-367.

**Table A-1. Distribution by Income Class of Mortgage Interest Deduction Tax Expenditure, at 2012 Rates and 2012 Income Levels**

Income Class	Mortgage Interest Deduction	
	Returns (thousands)	Amount (millions)
Below \$10,000	1	\$1
\$10,000 to \$20,000	177	\$48
\$20,000 to \$30,000	489	\$235
\$30,000 to \$40,000	997	\$585
\$40,000 to \$50,000	1,792	\$1,151
\$50,000 to \$75,000	5,799	\$5,906
\$75,000 to \$100,000	6,081	\$7,567
\$100,000 to \$200,000	14,065	\$29,068
\$200,000 and over	4,701	\$23,606
Total	34,102	\$68,166

**Source:** Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2012-2017*, <https://www.jct.gov/publications.html?func=startdown&id=4503>.

For each state, the tax rates were then multiplied by the amount of mortgage interest deducted in each respective income class and then summed. Finally, the tax rates were increased uniformly until the aggregate summed amount exactly matched the JCT's aggregate tax expenditure estimate. 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 A-2**.

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

Income Class	Estimated Tax Rate
Below \$50,000	3.31%
\$50,000 to \$75,000	10.21%
\$75,000 to \$100,000	13.02%
\$100,000 to \$200,000	24.82%
Above \$200,000	37.11% <sup>a</sup>

**Source:** CRS calculations using Internal Revenue Service's 2011 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 2012-2017*, <https://www.jct.gov/publications.html?func=startdown&id=4503>.

**Note:**

- a. 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 to in the tax rate calculation are estimates. Third, as explained in the methodology description, the tax rates presented here were adjusted to ensure that the aggregate estimates allocated to the states matched exactly the JCT's aggregate tax expenditure estimate.

## **Author Contact Information**

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

## **Acknowledgments**

James C. Uzel, Geospatial Information Systems Analyst, produced the figures presented in this report.