



# The Mortgage Interest and Property Tax Deductions: Analysis and Options

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## Summary

Concern has increased over the size and sustainability of the United States' recent budget deficits and the country's long-run budget outlook. This concern has brought the issues of the government's revenue needs and fundamental tax reform to the forefront of congressional debates. Congress may choose to address these issues by reforming the set of tax benefits for homeowners. According to the Joint Committee on Taxation, federally provided tax benefits for homeowners will cost approximately \$136.3 billion annually between 2014 and 2017. Reducing, modifying, or eliminating all or some of the current tax benefits for homeowners could raise a substantial amount of revenue, while simultaneously simplifying the tax code, increasing equity among taxpayers, and promoting economic efficiency.

This report focuses on the two largest federal tax benefits available to homeowners—the mortgage interest deduction and the deduction for state and local property taxes. While other tax benefits for homeowners exist, these two particular benefits are the most expensive in terms of forgone revenue to the federal government. Between 2014 and 2017 the mortgage interest deduction and property tax deduction are estimated to cost around \$77.3 billion and \$31.5 billion annually. Congress may therefore consider modifying these two tax benefits to raise revenue. The mortgage interest deduction and property tax deduction are also the two tax benefits proponents most often argue promote homeownership. Economists, however, have questioned this claim.

The analysis presented in this report is structured along two dimensions. First, the analysis focuses on the rationales commonly offered for providing tax benefits for homeowners, mainly that homeownership (1) bestows certain benefits on society as a whole such as higher property values, lower crime, higher civic participation, among others; (2) is a means of promoting a more even distribution of income and wealth; and (3) has a positive effect on living conditions, which can lead to a healthier population. Although these benefits may exist, the analysis presented in this report highlights the difficulties that economists have encountered in attempting to establish their existence or magnitude.

The analysis then turns to examining the effect that the mortgage interest deduction and state and local property tax deduction have on the homeownership rate, housing consumption, and the economy. The analysis in this report suggests that these tax incentives may have a larger effect on the size of homes purchased than on the decision to become a homeowner. The possibility that attempting to promote homeownership via the tax code may distort the allocation of capital and labor, which could hinder the performance of the economy in the short-run and long-run, is also raised. In the process of conducting the analysis, this report briefly summarizes the historical trends in homeownership and the more recent trends in foreclosures. The report concludes with policy options that Congress may find useful as it moves forward, including proposals made by House Ways and Means Chairman Dave Camp, President Obama's Fiscal Commission, President George W. Bush's Tax Reform Panel, and the Congressional Budget Office.

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## Introduction

There has been increased concern over the size and sustainability of the United States' recent deficits and the country's long-run budget outlook. This concern has brought the issues of the federal government's revenue needs and fundamental reform of the tax system to the forefront of congressional debates. One place Congress may turn to address these issues is the set of tax benefits for homeowners. The Joint Committee on Taxation (JCT) has estimated that the cost to the federal government in terms of foregone revenue from these benefits will be approximately \$136.3 billion annually between 2014 and 2017.<sup>1</sup> Economists have identified the set of tax benefits for homeowners as one area in which reform may improve economic efficiency.

This report focuses on the two largest federal tax benefits available to homeowners—the mortgage interest deduction and the deduction for state and local property taxes. The goals of this report are five-fold: (1) briefly summarize the trends in homeownership; (2) provide an overview of what tax benefits are available; (3) analyze the rationales commonly provided for offering such benefits; (4) analyze the effect of the mortgage interest deduction and property tax deduction on the homeownership rate, housing consumption, and the economy; and (5) present policy options.

## Homeownership Trends

Until recently, the homeownership rate in this country had generally increased over time. In 1900 only 46.5% of Americans owned the home that they lived in. By 1950, the homeownership rate had increased to 55%, and to 67.4% by 2000. Homeownership peaked in 2004 at 69%, and today hovers around 65%. The most current data show that of 132.6 million homes in the United States, 75.0 million serve as principal residences.<sup>2</sup> Another 39.7 million homes are renter-occupied, and the remaining 17.9 million are either for sale, for rent, or for seasonal use.

### Homeownership at a Glance

Year	Homeownership Rate
1900	46.5%
1950	55.0%
2000	67.4%
2005	68.9%
2010	66.9%
2013	65.1%

Source: U.S. Census Bureau

<sup>1</sup> Based on CRS calculations using estimates reported in U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax for Fiscal Years 2012-2017*, 113<sup>th</sup> Cong., 1<sup>st</sup> sess., 2013, JCS-1-13 (Washington: GPO, 2013).

<sup>2</sup> U.S. Census Bureau, <https://www.census.gov/housing/hvs/data/q413ind.html>.

Home and Family Size		
Year	Median New House Size (sq. ft.)	Average Family Size
1970	1,385	3.58
1980	1,595	3.29
1990	1,905	3.19
2000	2,057	3.17
2009	2,135	3.15

**Source:** Statistical Abstract of The United States

The size of homes that Americans own has also generally trended upward over time, while family size has trended downward. In 1970 the median new home was around 1,385 square feet. By 2009, the median new home was roughly 2,135 square feet—an increase of 54%. Over this same time period the average family size decreased. In 1970 the average family size was 3.58 persons, while in 2009 the average family size was 3.15 persons. Thus, the increase in home size has been even larger after adjusting for family size. The fact is that Americans have tended to build bigger and bigger homes while tending to have smaller and smaller families. This trend can have important ramifications in terms of land use, energy use, transportation, and affordability.

These long-term trends in homeownership behavior may be overshadowed by more recent trends in foreclosures. At the beginning of 2001, near the start of the housing boom, the national foreclosure rate on all mortgage loans was 1.24%. The foreclosure rate among riskier subprime borrowers was slightly higher at 3.58%. Foreclosures began to increase between 2007 and 2008, shortly after the turning point in the housing market. After peaking in late 2009 and early 2010, the foreclosure rate has gradually decreased. By the fourth quarter of 2013 the foreclosure rate on all loans stood at 2.86%, while foreclosures occurring among subprime borrowers stood at 10.43%.

Foreclosure Rates		
Year	All Loans (%)	Subprime (%)
2001 Q1	1.24	3.58
2007 Q1	1.28	5.10
2008 Q1	2.47	10.74
2009 Q1	3.85	14.34
2013 Q4	2.86	10.43

**Source:** MBA National Delinquency Surveys

## What Tax Benefits Are Available

As of March of 2014, there were at least four significant tax incentives that directly or indirectly benefit homeowner-occupiers.<sup>3</sup> The Joint Committee on Taxation (JCT) estimates these benefits will cost the federal government an average of \$136.3 billion in foregone revenue annually between 2013 and 2017.<sup>4</sup> These tax benefits and their associated budget impacts are listed in **Table 1**. The three most expensive tax incentives in the JCT’s estimate are the mortgage interest deduction (\$77.3 billion annually), the itemized state and local property tax deduction (\$31.5

<sup>3</sup> Other tax benefits that benefit investors in housing exist, but are beyond the scope of this paper.

<sup>4</sup> Based on CRS calculations using estimates reported in U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax for Fiscal Years 2012-2017*, 113<sup>th</sup> Cong., 1<sup>st</sup> sess., 2013, JCS-1-13 (Washington: GPO, 2013). The tax incentives included are listed in the table contained in this section.

billion annually), and the exclusion of capital gains on the sale of a principal residence (\$26.5 billion annually).<sup>5</sup>

**Table I. Estimated Budgetary Impact of Tax Benefits for Homeowners**  
(Billions of dollars)

<b>Tax Benefit</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>Total</b>
Mortgage Interest Deduction	71.7	75	79.2	83.4	309.3
State and Local Property Tax Deduction	28.6	30.4	32.5	34.4	125.9
Capital Gains Exclusion	24.8	26.0	27.1	28.0	105.9
Mortgage Revenue Bonds	0.9	1.0	1.0	1.0	3.9
<b>Total</b>	<b>126</b>	<b>132.4</b>	<b>139.8</b>	<b>146.8</b>	<b>545.0</b>

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

Some argue that another tax expenditure not included in official costs estimates—the exclusion of imputed rental income—should be included. Unofficial cost estimates place the foregone revenue generated by this exclusion at between \$20 billion and \$30 billion annually.<sup>6</sup> The following overview focuses on the mortgage interest and property tax deductions. The exclusion of capital gains is not reviewed in detail because its effects on the housing decisions of taxpayers is fundamentally different than the effects of the deductions for mortgage interest and property taxes. A brief summary of the capital gains exclusions, as well as the other tax benefits, is provided at the end of this section.

## Mortgage Interest Deduction

The largest and most well-known tax benefit that homeowners can take advantage of is the mortgage interest deduction. Specifically, homeowners are allowed to deduct the interest they pay on a mortgage that finances a primary or secondary residence as long as they itemize their tax deductions. For example, an itemizing homeowner who pays \$10,000 in mortgage interest in a given year can deduct \$10,000 from his or her adjusted gross income. If this individual is in the 25% marginal tax bracket, a \$10,000 tax deduction reduces his or her income taxes by \$2,500 (\$10,000 multiplied by 25%).

<sup>5</sup> The figures reported in parentheses are the average annual estimates over the 2014-2017 period.

<sup>6</sup> The Tax Policy Center estimated the cost in 2005 of excluded imputed rental income to be \$28.6 billion. See, Adam Carasso, C. Eugene Steuerle, and Elizabeth Bell, “The Trend in Federal Housing Tax Expenditures,” *Tax Notes*, February 28, 2005, p. 1081. Extrapolating their estimates to 2014 is made difficult by the recent turmoil in the housing market. Therefore, providing an estimated range for the cost is more appropriate.

**Distribution of Mortgage Interest Claimed by Income Class in 2011 (\$ in thousands)**

Income Class	Total \$ Amount Deducted	Share of Total \$ Amount Deducted
Below \$30k	\$24,189,395	7%
\$30k to \$40k	\$17,052,350	5%
\$40k to \$50k	\$19,897,496	5%
\$50k to \$75k	\$57,876,345	16%
\$75k to \$100k	\$59,420,197	16%
\$100k to \$200k	\$119,921,358	33%
\$200k and over	\$65,939,264	18%
<b>Total</b>	<b>\$364,296,405</b>	<b>100%</b>

Source: CRS calculations using 2011 IRS SOI, Table 2.1

The value of the deduction generally increases with taxpayer income for two reasons. First, the marginal tax rate a homeowner faces increases with income. So an individual in the 35% marginal tax bracket, paying \$10,000 in mortgage interest, would realize a reduction in taxes of \$3,500 in comparison to a \$2,500 reduction for someone in the 25% tax bracket. Second, higher-income individuals tend to purchase more expensive homes, which results in larger mortgage interest payments, and hence, a larger deduction. This relationship explains why most of the total dollar amount of mortgage interest claimed is done so by middle- and upper-income households.

There are limits to the amount of mortgage interest that may be deducted. Only the interest paid on the first \$1 million of mortgage debt that is incurred in the purchase, construction, or substantial improvement of a residence, and only the interest paid on up to \$100,000 of home equity debt may be deducted. Home equity indebtedness is debt that is not incurred in the purchase, construction, or substantial improvement of a residence, but that is secured by the residence. Home equity debt may be used to finance personal expenditures (college education, vacations, etc.) unrelated to the home.

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>7</sup> As a result, all interest payments were made deductible with no distinction made for business, personal, living, or family expenses.<sup>8</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 business farmers.

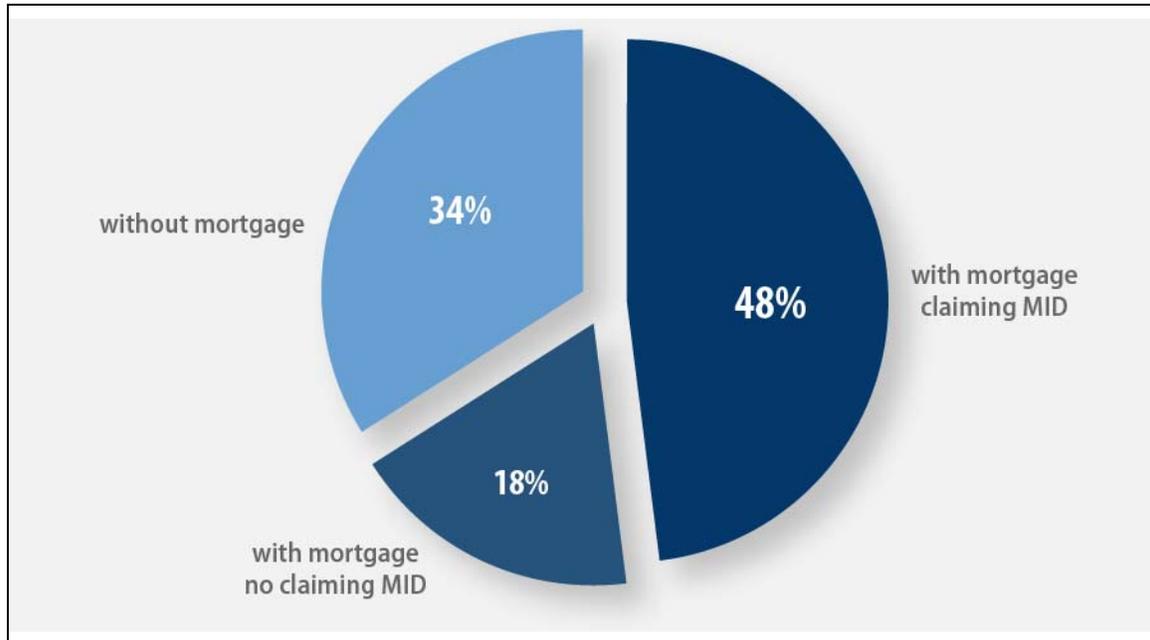
For more than 70 years there was no limit on the amount of home mortgage interest that could be deducted. The Tax Reform Act of 1986 (TRA86; P.L. 99-514) eventually restricted the amount of mortgage interest that could be deducted and limited the number of homes for which the deduction could be claimed 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

<sup>7</sup> Sen. William Borah, *Congressional Record*, August 28, 1913, p. S3832.

<sup>8</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, 112<sup>th</sup> Cong., 2<sup>nd</sup> sess., December 2012, S. Prt. 112-45 (Washington: GPO, 2012), p. 357.

qualified medical and educational expenses.<sup>9</sup> Subsequently, the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) resulted in the basic deduction limits that exist today.

**Figure 1. Distribution of Homeowners in 2011 Claiming the Mortgage Interest Deduction By Mortgage Status**



**Source:** Author's estimates using 2011 American Community Survey and the 2011 IRS SOI Data.

Not all homeowners claim the mortgage interest deduction.<sup>10</sup> Some homeowners have no mortgage, and hence no interest to deduct. The most recent data (2011) show that this group accounts for 34% of homeowners. Among the 66% of homeowners with a mortgage, 73% claim the deduction. This implies that around 48% of all homeowners claim the mortgage interest deduction. The remaining 27% of mortgage holders (or 18% of homeowners) who do not claim the deduction are likely either (1) toward the end of their mortgage payments so that the deduction is not worth much, (2) live in a state with low state and local taxes and thus claim the standard deduction, or (3) live in a low-cost area and therefore have a relatively small mortgage.<sup>11</sup> In terms of tax returns filed, the deduction is claimed on about 25% of all federal income tax returns and 78% of itemized returns.

## Property Tax Deduction

Homeowners also benefit from the ability to deduct state and local property taxes. In general, homeowners are allowed to claim an itemized deduction equal to the full amount of state and local property taxes paid.<sup>12</sup> For example, an itemizing homeowner who pays \$1,000 in property

<sup>9</sup> Ibid.

<sup>10</sup> The figures reported here are based on the author's calculations using data from the 2011 American Community Survey (ACS) and the 2011 IRS SOI Data, Tables 1.1 and 2.2.

<sup>11</sup> State and local taxes are a major determinate of whether taxpayers itemize their federal tax returns.

<sup>12</sup> Because a taxpayer must itemize to claim the deduction, those taxpayers that claim the standard deduction (continued...)

taxes can deduct \$1,000 from his or her adjusted gross income. If this individual is in the 25% marginal tax bracket, a \$1,000 tax deduction reduces his or her income taxes by \$250 (\$1,000 multiplied by 25%).

As with the mortgage interest deduction, the value of the property tax deduction generally increases with taxpayer income for two reasons. First, the marginal tax rates that a homeowner faces increase with income, so an individual in the 35% marginal tax bracket paying \$1,000 in property taxes would realize a tax savings of \$350. Second, higher-income individuals tend to purchase more expensive homes, which results in higher property taxes, and therefore a larger deduction. Because there is no limit on the amount of property taxes that can be deducted—as there is with the mortgage interest deduction—the majority of property taxes claimed is done so by upper-middle- and upper-income households.

The deduction for state and local property taxes was never intended to encourage homeownership. When the modern federal income tax code was created in 1913 almost all state and local taxes were deductible.<sup>13</sup> A major rationale for providing the deduction was that the payment of the state and local taxes was compulsory and thus should be deducted when determining a taxpayer’s ability to pay the federal income tax.<sup>14</sup> Over the years Congress has gradually restricted the types of state and local taxes that could be deducted. Today, deductible taxes include real estate taxes, personal property taxes, income taxes, and sales taxes. The deduction for state and local sales taxes was only available through 2013, and may only be taken in lieu of the deduction for income taxes.<sup>15</sup>

Income Class	Total \$ Amount Deducted	Share of Total \$ Amount Deducted
Below \$30k	11,996,473	7%
\$30k to \$40k	7,238,756	4%
\$40k to \$50k	8,400,533	5%
\$50k to \$75k	24,654,551	14%
\$75k to \$100k	24,368,297	14%
\$100k to \$200k	54,160,830	31%
\$200k and over	42,130,861	24%
<b>Total</b>	<b>172,950,301</b>	<b>100%</b>

**Source:** CRS calculations using 2011 IRS SOI, Table 2.1

(...continued)

historically have not been allowed to claim a deduction for property taxes. This was changed temporarily, however. The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) includes a temporary provision that allowed non-itemizing homeowners to claim an additional standard deduction for property taxes in an amount up to \$500 (\$1,000 for married couples filing jointly) for 2008 and 2009. This additional standard deduction was not extended, however. As with the mortgage interest deduction, the property tax deduction lowers the cost of homeownership relative to what it otherwise would be.

<sup>13</sup> State and local taxes assessed against local benefits were not deductible.

<sup>14</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. 336.

<sup>15</sup> The Tax Reform Act of 1986 (TRA86, P.L. 99-514) limited deductibility of taxes to the first three classes of taxes. The American Jobs Creation Act of 2004 (AJCA, P.L. 108-357) provided the temporary deduction for sales taxes. This provision has been extended several times, most recently by the P.L. 112-240.

In 2011, 54% of all homeowners claimed the deduction for state and local property taxes.<sup>16</sup> The deduction was claimed on slightly over 28% of all federal income tax returns.<sup>17</sup> Approximately 87% of those taxpayers who itemized their federal return claimed the property tax deduction—higher than the fraction of itemizers who claimed the mortgage interest deduction (see previous section).

## **Other Tax Benefits**

Following the mortgage interest deduction and property tax deduction, the next largest tax benefit is the exclusion of capital gains from the sale of a principal residence. A capital gain is realized when the sales price of a home exceeds the original cost of the home plus improvements. In general, a capital gain on the sale of a principal residence of up to \$250,000 for single taxpayers, and \$500,000 for married taxpayers filing jointly, may be excluded from taxable income. The capital gains exclusion probably has a rather small effect on the homeownership rate. This is likely due to the fact that the benefit of the exclusion cannot be realized until a taxpayer sells a house, while, as discussed later, the main barrier to homeownership is the upfront down payment. The tax treatment of capital gains on housing does have important effects on other aspects of the economy.<sup>18</sup>

A rather abstract tax benefit that homeowners receive, but one which is well-known in the academic community, is the exclusion of imputed rental income. To understand imputed rental income, consider that a homeowner is effectively both a rental property owner and a tenant (renter)—they own a home which they choose to rent to themselves instead of to someone else. Economic theories of taxation suggest that homeowners and rental property owners should therefore be taxed similarly. Currently, they are not. Rental property owners are taxed on their net rental income, which is their rental income after deducting the costs they incur in generating this income—mainly mortgage interest, taxes, insurance, maintenance, and depreciation. Homeowners, however, are allowed to deduct mortgage interest and taxes without having to pay taxes on the “rent” they pay themselves. Therefore, owner-occupied housing is subsidized relative to rental housing.

There are a number of other smaller tax benefits that are currently available to homeowners or that recently expired. The interest on mortgage revenue bonds (MRBs) is tax exempt, which allows MRBs to finance below-market rate mortgages for potential homebuyers that meet certain criteria. Through 2013, certain homeowners who itemized their tax returns were able to deduct from their taxable income premiums paid for qualified mortgage insurance. Additionally, through 2013, homeowners whose mortgage debt was forgiven (wholly or partially) were able to exclude from taxable income the amount of forgiven debt. Historically, when an individual is granted debt forgiveness by a lender—be it credit card debt, a car loan, etc.—they must include the forgiven debt as taxable income.

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<sup>16</sup> This figure was computed by combining tax information from the 2011 SOI data with homeownership information from the 2011 AHS.

<sup>17</sup> 2011 IRS SOI Data, <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html>, Tables 1.1 and 2.2 .

<sup>18</sup> See CRS Report RL32978, *The Exclusion of Capital Gains for Owner-Occupied Housing*, by Jane G. Gravelle and Pamela J. Jackson.

## **Non-Tax-Related Benefits**

In addition to the numerous tax benefits that exist for homeowners, there are also a number of non-tax-related programs that either directly or indirectly assist homeowners. For example, homeownership is also subsidized by the favorable treatment of lending institutions that make home loans (federal home loan banks); by federal programs that insure lenders against losses on home loans which lowers the down payment homebuyers must make (FHA and VA); by federal programs that provide favorable loan terms to farmers (USDA); by guaranteeing certain federally chartered financial institutions that assist in maintaining a viable secondary market for mortgages which enables mortgage financing to be more readily available (Fannie Mae, Freddie Mac, and Ginnie Mae); by establishing programs within HUD and USDA that fund agencies that counsel prospective homebuyers on obtaining and maintaining homeownership; and by funding grant programs that provide down payment and closing cost assistance to some homebuyers.<sup>19</sup>

## **Analysis of the Rationale for Subsidizing Homeownership**

A number of possible rationales for subsidizing homeownership have been put forth. First, a high homeownership rates may bestow certain benefits to society as a whole such as higher property values, lower crime, and higher civic participation, among others. Second, homeownership may promote a more even distribution of income and wealth, as well as establish greater individual financial security. And lastly, homeownership may have a positive effect on living conditions, which can lead to a healthier population. This section provides a review and analysis of these rationales. The analysis presented here is distinct from the analysis of the economic effects of the mortgage interest and property tax deductions, which is presented in the next section.

### **Positive Externalities**

Tax benefits for homeowners are most often rationalized on the basis that homeownership generates positive externalities. Positive externalities, also known as spillover benefits, occur when the actions of one individual benefit others in society. Because a given individual will tend to only consider his or her own (private) benefit from an activity, and not the total benefit to society, too little of the positive-externality-generating activity is undertaken from society's perspective. Governments, however, may intervene through the use of taxes and subsidies to align the interests of individuals with the interests of society to achieve a more economically efficient outcome.

A concrete example of a positive externality, often cited by homeownership advocates, is the positive effect ownership is believed to have on property values in a community. The theory is that since homeowners have a larger financial stake in their homes than renters, they are more

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<sup>19</sup> For more information about these programs, see the following reports: CRS Report RL32815, *Federal Home Loan Bank System: Policy Issues*, by Edward V. Murphy; CRS Report RS20530, *FHA-Insured Home Loans: An Overview*, by Katie Jones; CRS Report RS20533, *VA-Home Loan Guaranty Program: An Overview*, by Bruce E. Foote; CRS Report RL33421, *USDA Rural Housing Programs: An Overview*, by Bruce E. Foote; CRS Report RL34661, *Fannie Mae's and Freddie Mac's Financial Problems*, by N. Eric Weiss; and CRS Report RL34591, *Overview of Federal Housing Assistance Programs and Policy*, by Maggie McCarty et al.

likely to make investments that raise surrounding property values. For example, a homeowner may be more inclined than a renter to paint the exterior of his or her home, fix a hanging gutter, or remove street debris outside his or her house. While the owner may be only seeking to improve the appearance and resale value of the house, he or she is also positively influencing the values of surrounding properties (the spillover effect).

There is a long list of other externalities that proponents claim homeownership generates.<sup>20</sup> Homeownership is believed by some to create neighborhood stability since owners are more inclined to remain in the community for a longer period of time than renters. Proponents also associate homeownership with a greater degree of social and political involvement due to the concern about one's property value. Homeownership is also believed by some to lead to lower neighborhood crime. It has also been suggested that homeownership fosters more responsible behavior among youths in the community, such as higher academic achievement and lower teen pregnancy rates, due to the monitoring mechanism put in place to maintain the attractiveness of a community.

Economists have been able to establish that a correlation between homeownership and these positive neighborhood effects does exist. For example, Denise DiPasquale and Edward Glaeser found that homeowners are more likely than renters to belong to more non-professional organizations, know the head of their local school board and U.S. House Representative, vote in local elections, and garden.<sup>21</sup> In separate investigations into the effects of homeownership on the academic performance of children, Richard Green and Michelle White, and later Donald Haurin, Toby Parcel, and R. Jean Haurin, reported statistical evidence that there is a positive relationship between homeownership and the educational performance of owners' children.<sup>22</sup> And William Rohe and Leslie Stewart found that every one percentage point increase in an area's homeownership rate was correlated with an \$800 increase in home values over a 10-year period.<sup>23</sup>

At the same time economists have found it difficult to establish causality (i.e., homeownership causes these positive effects).<sup>24</sup> There are a number of reasons for this. First, there may be *observable differences* between owners and renters, that when not accounted for, may lead researchers to false conclusions. For example, Green and White (discussed above) did not account for differences in net worth, mobility, and home location when studying the effect of homeownership on a child's educational outcome. But these factors are likely strongly correlated with homeownership. Thus, by not accounting for these observable difference the authors may

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<sup>20</sup> See William Rohe, Shannon Van Zandt, and George McCarthy, "Social Benefits and Costs of Homeownership," in *Low-Income Homeownership*, ed. Nicolas P. Retsinas and Eric S. Belsky (Washington, DC: Brookings Institution Press, 2002), pp. 381-406.

<sup>21</sup> Denise DiPasquale and Edward Glaeser, "Incentive and Social Capital: Are Homeowners Better Citizens?" *Journal of Urban Economics*, vol. 45, no. 2 (1999), pp. 354-384.

<sup>22</sup> Richard Green and Michelle White, "Measuring the Benefits of Homeowning: Effects on Children," *Journal of Urban Economics*, vol. 41, no. 3 (1997), pp. 441-461. Donald R. Haurin, Toby L. Parcel, and R. Jean Haurin, "Impact of Homeownership on Child Outcomes," in *Low Income Homeownership: Examining the Unexamined Goal*, ed. Nicholas P. Retsinas and Eric S. Belsky (Washington, DC: Brookings Institution Press, 2002), pp. 427-446.

<sup>23</sup> William Rohe and Leslie Stewart, "Homeownership and Neighborhood Stability," *Housing Policy Debate*, vol. 7, no. 1 (1996), pp. 37-81.

<sup>24</sup> For a very accessible review of the literature on the topic see Donald R. Haurin, Robert D. Dietz, and Bruce A. Weinberg, "The Impact of Neighborhood Homeownership Rates: A Review of the Theoretical and Empirical Literature," *Journal of Housing Research*, vol. 13, no. 2 (2003), pp. 119-151.

have been attributing the influence of these other factors on a child's educational outcome to homeownership.<sup>25</sup>

Second, there may be *unobservable differences* that exist between homeowners and renters that researchers may not be able to account for, which leads them to infer causality when it is not present. For example, certain traits or attitudes may lead some people both to homeownership and community activism. Statistical methods can be employed to overcome the problem of unobservable differences. These methods, however, are typically only reliable if particular assumptions hold. This limitation generates a great deal of debate among researchers as to whether the assumptions hold, and therefore whether the reported results are reliable.

A third problem that researchers commonly face in determining causality is the possible existence of an interaction between homeownership and the positive outcome policymakers wish to promote. Take for example the claim that increased homeownership rates boost neighborhood property values. Determining causality is difficult because homeowners may prefer to purchase homes in neighborhoods where home values are rising. Statistical methods have been developed to determine causation when such interdependence exists. Again, however, particular assumptions must hold for these methods to produce reliable results, generating debate among researchers about findings.

Because of these difficulties, a definitive answer to whether homeownership produces the purported externalities has eluded economists. This limitation, however, does not mean that homeownership does not result in positive externalities that justify housing subsidies. But one could argue that determining whether to provide subsidies for homeownership depends on establishing cause and effect. If homeownership does not generate the positive effects some believe it does, then the economic justification for subsidization is diminished.

It has been even more difficult for researchers to determine the magnitude of the purported benefits of homeownership. Without accurate estimates of how large the social benefits are from homeownership, it is difficult to determine the amount of subsidization homeownership should receive. If the social benefits associated with homeownership are small then the current amount of subsidization, which some economists view as substantial, could have the unintended consequence of decreasing, not increasing, economic efficiency. This outcome is especially true if the social return to investment in other activities in the economy, such as education and other non-housing-related capital, are higher than the return to homeownership. In such a situation, reducing housing subsidies would free up resources for these more socially valuable investments.

Often absent from the debate over the existence of positive externalities is the possibility that homeownership results in negative externalities. Negative externalities occur when the actions of one individual impose a cost on others in society. On the one hand, a higher concentration of homeowners may result in increased property values. On the other hand, the opposite may be true at times. If enough homeowners in a given community default and are foreclosed upon, the effect could be to reduce the value of surrounding properties in the neighborhood. This, in turn, could lead to more defaults and foreclosures, which reinforces the downward pressure on surrounding home values. In effect, the community's "portfolio" of homeowners and renters is undiversified,

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<sup>25</sup> The statistical terminology that is used for this type of estimation error is "omitted variable bias." When important variables are omitted from an analysis the estimates of the importance of the variables that are included in the analysis may be biased or over/understated.

so that a negative economic shock to a small group of homeowners can be transmitted to a larger group.

Homeownership may also result in less than desirable social and community involvement.<sup>26</sup> The same incentive that is believed to lead homeowners to make investments that raise surrounding property values—mainly homeowners’ financial stake in their property—may also lead homeowners to push for local initiatives that exclude certain groups of people from their communities. Zoning restrictions, for example, may be supported by homeowners if it prevents the construction of low-income rental housing that they fear could impact their property values.

If the positive externalities outweigh the negative externalities, economic theory still suggests that subsidizing homeownership to generate socially desirable outcomes may not be the most efficient remedy. If landscaping, painting, and other exterior investments increase surrounding properties’ values, it is not clear why subsidizing homeownership to generate this result is the ideal method. Theories of public finance and externalities suggest that a more efficient policy would be to subsidize the externality-generating activity directly. The government could offer a tax credit, deduction, or voucher for painting or landscaping one’s house, for example. Renters and owners alike could then benefit from the incentive while producing the desired result—higher property values from more aesthetically pleasing neighborhoods. Directly subsidizing socially beneficial investment in one’s home could also be more cost effective than indirect subsidization via homeownership incentives.

## **Financial Benefits**

Some contend that homeownership promotes economic equality. Data reveal that homeowners on average earn higher incomes and have higher savings than renters.<sup>27</sup> In general, homeowners also have greater access to wealth via their home’s equity which can be used to finance discretionary and emergency spending. In addition, homeowners may have greater access to credit to borrow for such things as a child’s education, which can increase the child’s income, and, in turn, increase his or her ability to become homeowners. Thus, because of these positive correlations, promoting ownership may be a tool used to achieve a more even distribution of income and wealth within and across generations.

Again, economists confront the issue of distinguishing causation from correlation. Does homeownership positively influence one’s income and wealth, or is the relationship reversed, and higher income and wealthier households are more inclined to become homeowners? Likewise, there may be some intergenerational wealth transmission mechanism that homeownership helps facilitate, but it could also have something to do with the general ability of higher-income households to invest in their children. If this is the case, more effective investment in education may be a more economically efficient way to achieve an equitable distribution of wealth.

Homeownership is also often viewed as way to promote the accumulation of an individual nest egg. This argument has become more prominent over the past decade as personal saving rates in

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<sup>26</sup> See William Rohe, Shannon Van Zandt, and George McCarthy, “Social Benefits and Costs of Homeownership,” in *Low-Income Homeownership*, ed. Nicolas P. Retsinas and Eric S. Belsky (Washington, DC: Brookings Institution Press, 2002), pp. 394-396.

<sup>27</sup> See for example the American Housing Survey: <http://content.knowledgeplex.org/kp2/img/cache/documents/1373.pdf>

the United States have decreased. As long as home prices are stable or increasing, a homeowner, as opposed to a renter, automatically builds his or her net wealth (equity) with each successive mortgage payment. Home equity can be used to make improvements to the house, finance college expenses, or be converted into income for retirement later in life, among other things.<sup>28</sup> Being a homeowner also allows individuals to build or improve their credit scores. As a result, a homeowner may have access to cheaper credit than a renter.

Encouraging homeownership as a means of saving carries with it certain risks that policy makers and potential homeowners may want to consider. First, it is not clear that the financial return to homeownership is as high or as predictable as some believe. When viewed as an investment vehicle, there appears to be differences across income groups and regional markets that should be taken into account with a home that are not present with other assets. For example, there is evidence that lower-income households are less likely than higher-income households to claim the mortgage interest and property tax deductions, are more likely to pay higher “sub-prime” mortgage rates, and spend less on maintaining their homes—all behaviors which should lower their return to homeownership.<sup>29</sup> At the same time, there is some evidence that homes in lower-income markets may experience greater home appreciation relative to homes in the higher-income markets.<sup>30</sup> In addition, like all other investments, the financial return to homeownership depends on market conditions at the time the home is bought and sold and the expected return from alternative investments. Instead of purchasing a home, an individual could invest down-payment funds in financial instruments, such as stocks and bonds.

Second, policies that promote homeownership may result in households holding relatively undiversified portfolios. To minimize risk, households should hold a portfolio containing a wide range of assets. Returns should not be too closely related so that if some assets in the portfolio fall, others may rise. But a home is an inherently large and practically indivisible asset. In fact, for those who are homeowners, their house is typically the largest asset in their portfolio. Committing such a large fraction of one’s portfolio can complicate diversification. Also complicating diversification is the combination of a home with an individual’s other largest asset, his or her human capital, the return to which is labor income. The recent housing boom and bust showed that the return to housing and the labor income of some workers in certain industries or certain age groups may be closely related. Areas with high unemployment also suffered high foreclosure rates which had a downward reinforcing effect. Thus, from a portfolio perspective, homeownership may not be a financially prudent decision for all Americans.

Third, unlike most other assets in the typical household’s portfolio, a home purchase is often financed using a substantial amount of debt. The use of mortgage debt to acquire a home increases the homeowner’s exposure to fluctuations in home prices. Specifically, more mortgage debt causes greater changes in an owner’s equity—the difference between a home’s value and what is owed on the house—in response to a given price change. If prices fall enough, an individual can end up owing more on the house than it is worth—a scenario referred to as having negative equity, or being “underwater” on the mortgage. Selling a house also requires the owner

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<sup>28</sup> The conversion of equity to income for retirement is often carried out using a “reverse mortgage.” For more information, see CRS Report RL33843, *Reverse Mortgages: Background and Issues*, by Bruce E. Foote.

<sup>29</sup> Eric S. Belsky, Nicolas P. Retsinas, and Mark Duda, *The Financial Returns to Low-Income Homeownership*, Joint Center for Housing Studies of Harvard University, Cambridge, MA, September 2005, <http://www.jchs.harvard.edu/publications/finance/w05-9.pdf>.

<sup>30</sup> See for example *Low-Income Homeownership: Examining the Unexamined Goal*, ed. Nicolas P. Retsinas and Eric S. Belsky (Brookings Institution Press, 2002), pp. 208-256.

to incur significant transaction costs, implying that a house is an “illiquid” asset, which further increases risk.

## **Psychological and Physical Health Benefits**

Some believe homeownership bestows certain benefits exclusively to individual homeowners, including improved psychological wellbeing. The pride associated with owning one’s home could lead to higher levels of self-esteem and overall life satisfaction. Self-esteem and satisfaction could also be lifted by the pleasure one takes in maintaining and improving his or her property. Homeownership could also promote a sense of individual security, stability, and control leading to less stress than being a renter. As the current economic environment has made clear, however, homeownership can also produce the opposite feelings if it becomes a struggle to make mortgage payments.

In addition to the psychological benefits, some also point to the possible physical health benefits associated with homeownership.<sup>31</sup> Homeownership may provide higher-quality living conditions which lead owners to be, in general, physically healthier than renters. Homeownership may also allow households to better cope with unforeseen health events by drawing on equity in the home and thus affecting the outcome of certain illnesses.

Researchers studying the psychological and health benefits of homeownership have encountered the same problems as those studying homeownership externalities—primarily, distinguishing causation from correlation.<sup>32</sup> Some economists have also noted that if these benefits of homeownership accrue to the individual and not to society, then widespread homeownership subsidy programs may be unwarranted. Economic theory generally predicts that when only private benefits exist (i.e., there are no externalities), the market will tend to allocate resources most efficiently. At the same time, one could argue that individual health and well-being are fundamental features of a prosperous society, and if owning a home contributes to one’s health, society should subsidize homeownership.

## **Economic Analysis of Current Tax Benefits for Homeowners**

While some policy makers may or may not want to promote homeownership based on the reasons just discussed, a separate issue that arises is—what are the effects of the mortgage interest deduction and property tax deduction? In particular, do these two tax provisions actually increase homeownership as some argue? How do they affect other dimensions of homeownership, such as the quality and size of homes taxpayers purchase? And how does subsidizing owner-occupied

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<sup>31</sup> See William Rohe, Shannon Van Zandt, and George McCarthy, “Social Benefits and Costs of Homeownership,” in *Low-Income Homeownership*, ed. Nicolas P. Retsinas and Eric S. Belsky (Washington, DC: Brookings Institution Press, 2002), pp. 388-390, and National Association of Realtors, *Social Benefits of Homeownership and Stable Housing*, August 2010, [http://www.realtor.org/Research.nsf/files/05%20Social%20Benefits%20of%20Stable%20Housing.pdf/\\$FILE/05%20Social%20Benefits%20of%20Stable%20Housing.pdf](http://www.realtor.org/Research.nsf/files/05%20Social%20Benefits%20of%20Stable%20Housing.pdf/$FILE/05%20Social%20Benefits%20of%20Stable%20Housing.pdf).

<sup>32</sup> Peter H. Rossi and Eleanor Weber, “The Social Benefits of Homeownership: Empirical Evidence from National Surveys,” *Housing Policy Debate*, vol. 7, no. 1 (1996), pp. 1-35.

housing affect the performance of the overall economy? This section analyzes these questions in turn.

## **Effect on Homeownership**

In order to have an effect on the homeownership rate, tax incentives must address the barriers that households on the verge of homeownership face. Economists have identified the high transaction costs associated with a home purchase—mostly resulting from the down payment requirement, but also closing costs—as the primary barrier to homeownership.<sup>33</sup> Household income has also been found to influence the home-buying decision, although its effect on the decision to become a homeowner is smaller than the ability to finance a down payment. This finding is likely because those seriously considering making the transition from renter to owner already have sufficient income to rent.

The effects of the mortgage interest deduction and property tax deduction on the homeownership rate are likely to be small because they are not well targeted toward lowering the down payment barrier. While the deductions lower the annual cost of homeownership, they do not provide any upfront benefit that can assist in completing a home purchase. Instead the deductions enable homeowners to have a greater after-tax income than they otherwise would. This may have an important effect on another aspect of homeownership—the size of home taxpayers purchase, or housing consumption. The next section elaborates on this issue.

The deductions' effect on homeownership is also limited because the deductions are not well targeted toward the group of potential homebuyers most in need of assistance—lower-income households, which includes younger potential first-time buyers. The mortgage interest deduction and property tax deduction are not well targeted toward this group because homeowners must itemize their tax return to benefit, but lower-income households itemize their tax returns at a very low rate. Thus, very few lower-income households benefit from the mortgage interest deduction or property tax deduction.

The academic community has debated the virtues of the mortgage interest deduction as a tool for promoting homeownership for some time. In the early 1980s two economics professors, Harvey Rosen and Kenneth Rosen, presented research that suggested that when taken together, the mortgage interest deduction, the deduction of property taxes, and the exclusion of imputed rental income explained one-fourth of the increase in the post-World War II homeownership rate.<sup>34</sup> Their results suggest that if these three tax benefits were repealed, the homeownership rate in this country would fall about four percentage points. In the long term, the effect on the homeownership rate would depend on interaction between the supply and demand for rental housing and the supply and demand for owner-occupied housing.

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<sup>33</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>34</sup> Harvey S. Rosen and Kenneth T. Rosen, “Federal Taxes and Homeownership: Evidence from Time Series,” *The Journal of Political Economy*, vol. 88, no. 1 (February 1980), pp. 59-75.

There are at least two problems with the researchers' approach. First, their results do not separate out the effect of each individual tax benefit, so it is not possible to determine, for instance, what would be the effect of only repealing the mortgage interest deduction, or only the property tax deduction. Second, and arguably more important, the model employed does not allow for changes in the rental market following the repeal of the tax benefits. As a result, their model may be overestimating the effect of repealing the tax benefits since in their model a lower homeownership rate would imply more renters. But in the short term, more renters would increase rental rates, providing an offsetting disincentive to become a renter. Over time increased rental rates would encourage the development of more rental housing, which should lower the cost of renting. The long-term effects of repeal may be uncertain.

Economists Edward Glaeser and Jesse Shapiro have compiled research that partially refutes the findings of Rosen and Rosen. Glaeser and Shapiro undertook an empirical investigation concerning the effect of the mortgage interest deduction on the homeownership rate.<sup>35</sup> The pair looked first at the relationship between inflation and the homeownership rate. The value of the mortgage interest deduction is positively related to inflation—when inflation is high, the value of the deduction correspondingly increases. Thus, if the mortgage interest deduction affects the homeownership rate, one should see homeownership change as inflation changes. But the inflation rate fluctuated considerably between 1965 and 2000 while the homeownership rate was relatively stable. Next the authors looked at the relationship between the itemization rate and the homeownership rate. If the mortgage interest deduction influences home buying, changes to the itemization rate should also result in changes in the homeownership rate. Again, no such relationship was found. Glaeser and Shapiro conclude,

... the home mortgage interest deduction is really not a pro-homeownership policy in any meaningful sense. It subsidizes housing consumption, but its impact on the homeownership rate appears to be minimal.

More recently, economists Matthew Chambers, Carlos Garriga, and Don Schlagenhauf examined the factors that best explain the increase in homeownership over the last decade. In a series of papers the authors present both empirical and theoretical evidence that suggests that the most influential factor was innovation in the mortgage markets, not tax policy. Mortgage market innovations reduced—sometimes to zero—the down payment requirement for constrained households, allowing more households to purchase a home. Tax policy, however, may have interacted with some of the innovative financial products to increase the attractiveness of using them—for example, the ability to deduct mortgage interest may have led some households to rely on interest-only mortgage products.<sup>36</sup>

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<sup>35</sup> Edward Glaeser and Jesse Shapiro, "The Benefits of the Home Mortgage Interest Deduction," *Tax Policy and the Economy*, vol. 17 (2003), pp. 37-82.

<sup>36</sup> See Matthew Chambers, Carlos Garriga, and Don Schlagenhauf, "The Loan Structure and Housing Tenure Decisions in an Equilibrium Model of Mortgage Choice," *Review of Economic Dynamics*, vol. 12, no. 3 (July 2009), pp. 444-468; Matthew Chambers, Carlos Garriga, and Don Schlagenhauf, "Accounting for Changes in the Homeownership Rate," *International Economic Review*, vol. 50, no. 3 (August 2009), pp. 677-726; Matthew Chambers, Carlos Garriga, and Don Schlagenhauf, "Mortgage Innovation, Mortgage Choice, and Housing Decisions," *Federal Reserve Bank of St. Louis Review*, vol. 90, no. 6 (November/December 2008), pp. 585-608. In addition, see Carlos Garriga, William Gavin, and Don Schlagenhauf, "Recent Trends in Homeownership," *Federal Reserve Bank of St. Louis Review*, vol. 88, no. 5 (September/October 2006), pp. 397-411.

## **Effect on Housing Consumption**

Some economists have argued that the mortgage interest deduction and property tax deduction exert a non-trivial influence on the size of homes that taxpayers purchase. As was discussed above, the main factor that prevents renters from transitioning to homeownership is the down-payment barrier. But tax benefits—particularly the mortgage interest deduction and property tax deduction—increase the after-tax income of those households that are able to take advantage of them. And because the value of these benefits increase with taxpayer income and mortgage size, it is argued that they tend to encourage larger home purchases among higher-income households. In essence, they lower the effective annual price of homeownership. Individuals tend to consume more of a good or service when its price falls.

The mortgage interest and property tax deductions could be capitalized into home prices, which would limit their effect on housing consumption. Because the deductions increase the after-tax income of homeowners, they may lead to home prices being bid-up higher than they otherwise would be. In theory, the disincentive provided by higher prices to purchase more home could be such that it exactly offsets the incentive provided by the deductions. In this case, there would be no effect on housing consumption.

If tax policy does affect home size, it may also affect land use, energy use, and transportation. Larger homes generally require more land on which to be built, which, in densely populated areas, is typically found the furthest away from employment opportunities. The increased commuting distance may lead to greater carbon emissions. Traffic congestion may also increase if the transportation infrastructure is not enhanced to support the transition outward. And if taxpayers are building homes larger than they would otherwise, energy use may also increase as larger homes generally require more energy to heat and cool.

The mortgage interest deduction may have exerted a larger effect on housing consumption during the recent housing boom than it historically has. Some homebuyers used mortgage products that required very low or interest-only payments, such as an interest-only adjustable rate mortgage (ARM). When home prices are rising and interest rates are low, these products can be attractive because the homeowner can refinance into a more traditional mortgage before the interest-only period is over. They are also attractive because the whole interest payment can be deducted due to the mortgage interest deduction, which frees up income for a larger mortgage payment. Of course, as is clear now, home prices do not always rise. Some of these borrowers were unable to refinance because prices fell to the point that their home was worth less than what they owed in mortgage debt.

## **Long-Term and Short-Term Effects**

The mortgage interest deduction and property tax deduction can improve the long-term performance of the U.S. economy if the tax preferences promote homeownership, and if homeownership produces positive externalities or if other market failures exist. When externalities or market failures do exist, the free-market outcome will result in capital and labor being employed in sectors of economy where they generate relatively low returns compared to housing. Economic output and well-being will be below its potential. Providing preferential tax treatment for homeowners can improve the long-run performance of the economy by encouraging capital and labor to flow to the higher return producing housing sector.

It is also true that providing homeowners with preferential tax treatment can also harm the long-run performance of the U.S. economy. If there are no externalities or market failures associated with homeownership, then providing preferential tax treatment to homeowners causes capital and labor to be diverted away from more productive employment in the non-housing sectors of the economy. The same result occurs if homeownership produces externalities, but the level of subsidization is greater than the external benefits produced. Although homeownership is often claimed to generate positive externalities, such benefits have not generally been measured; nor is there reason to believe that they justify such significant subsidies. Reducing the amount of tax preferences available to homeowners could also improve the long-run budgetary situation of the United States as federal tax revenues would increase, implying less reliance on deficits to finance spending.

Housing tax policy can also exert an influence on the economy in the short term. Most economists agree that a combination of mortgage market innovations, loose lending standards, and low interest rates were the primary drivers of the run-up in home prices over the last decade. But housing tax policy may have reinforced these factors, making the economic expansion and subsequent contraction more acute than it otherwise would have been. The ability to deduct the interest on exotic mortgage products may have reinforced these products' influence on expensive home purchases. The ability to deduct interest on home equity loans may have reinforced the ability to withdraw equity to increase housing-related and non-housing-related consumption. More homeowners and larger home purchases required increasing levels of capital and labor from other areas of the economy. In 2005, *The Economist* estimated that "over two-fifths of all private-sector jobs created since 2001 have been in housing-related sectors, such as construction, real estate, and mortgage brokering."<sup>37</sup>

Attempting to encourage homeownership may also have the adverse consequence of slowing the economy's recover when it does fall into a recession. Most economic recoveries are characterized by an elevated unemployment rate. The more quickly workers can transition from the weaker sectors of the economy to the stronger sectors, the more quickly the economy can recover. Homeownership can slow this transition because it reduces the ability of workers to move. For example, an unemployed auto worker in Michigan may have to first sell his or her house to accept a job somewhere else in the country. This may be infeasible if the worker is unable or unwilling to sell his or her home. A renter, however, would at most be required to pay the remaining rent on their lease before moving and could therefore be expected to transition to another form of employment or location more quickly than a homeowner.

## **Compulsory Tax Relief**

As mentioned previously, a major rationale for providing the deduction for state and local property taxes is that such payments are compulsory and thus should be deducted when determining a taxpayer's ability to pay the federal income tax. In actuality, whether or not compulsory taxes should be deductible depends on what the taxpayer receives in exchange. If a taxpayer receives a benefit in exchange for paying local property taxes, deductibility may not be justified. Consider a homeowner who pays a private company for trash collection services every year. This homeowner would not be permitted to deduct such payment for tax purposes because the payments were to a private company in exchange for a benefit. But if the taxpayer's locality

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<sup>37</sup> "The Global Housing Boom," *The Economist*, June 18, 2005, p. 66.

handled trash collection in exchange for property taxes, the homeowner would be permitted to deduct the taxes. Both homeowners are paying for trash collection, but one homeowner is better off simply because the service was provided by the local government. Therefore, one could argue that when property taxes are used to finance government services, the property tax deduction is not justified.

It could still be argued that property taxes should be deductible even if a taxpayer receives a service because it is the local government, and not the taxpayer, that determines which services are provided. Thus, a taxpayer could be paying property taxes in exchange for services that he or she does not value at all—a childless homeowner who pays taxes in exchange for a public school system may be an example. Taxpayers, however, can still “vote with their feet” and choose a locality and state that provides services that are more consistent with their preferences. In reality, even when homeowners can vote with their feet they probably receive a mix of services that they do and do not desire in exchange for paying property taxes. Therefore, it may still be justified to provide at least a partial deduction for property taxes.

## **Debt- and Equity-Financing Neutrality**

One justification that has been offered for the mortgage interest deduction is that it promotes neutrality between homeowners who rely primarily on debt financing (borrowing) and homeowners who rely primarily on equity financing (one’s own financial assets). Without the mortgage interest deduction, equity financing would be tax preferred. Since those who have enough assets to rely more on equity financing tend to earn higher income, the mortgage interest deduction promotes financing neutrality among homeowners of different income levels.<sup>38</sup> Because equity would be tax preferred, absent the mortgage interest deduction, it could be expected that borrowers would tend to finance more of their home purchases with larger down payments (equity contributions).

In light of the recent housing boom and subsequent bust, it could be argued that debt/equity neutrality is not necessarily a desired policy objective. Debt financing—also known as leveraging—increases a homeowner’s exposure to home price fluctuations. When a taxpayer is highly leveraged, a relatively small decrease in home price can lead to owing more on his or her house than the house is worth. This can cause problems should the taxpayer need to move or sell their house unexpectedly. As was previously discussed, increased leveraging can also lead to costs being imposed on surrounding property owners if it increases the risk of foreclosure, which can negatively impact the value of neighboring homes. To the extent that this negative externality exists, economic theory suggests that debt/equity neutrality may be suboptimal.

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<sup>38</sup> To understand how the mortgage interest deduction promotes neutrality between debt and equity financing, consider the cost of each option. The cost of equity financing is the after-tax return that could be earned if the taxpayer invested the funds elsewhere (stocks, bonds, etc.). The cost of debt financing is the after-tax interest that the homeowner must pay on his or her mortgage. For example, if a taxpayer chooses to withdraw \$250,000 from an investment account to purchase a home, the cost of this option is the forgone investment earnings after taxes. Assuming a 6% return on the investment account and a marginal tax rate of 28%, the annual pre-tax earnings would have been \$15,000 (6% multiplied by \$250,000), which would have yielded a return of \$10,800 (\$15,000 minus \$4,200 in taxes) after taxes. Alternatively, if the taxpayer finances the purchase by borrowing \$250,000 at an interest rate of 6% they would pay \$15,000 in interest before taxes. Assuming a marginal tax rate of 28% the after-tax interest cost would be \$10,800 (\$15,000 minus \$4,200 in tax deductions). Thus, the two financing options are neutral with respect to taxation.

## Potential Options for Change

If Congress chooses to do so, there are a number of options at its disposal for changing the mortgage interest deduction and the state and local property tax deduction. This section discusses several of these options. Actual implementation of any of the options presented here would require careful consideration about how specifically to modify the parameters of the tax benefit(s) of interest. It appears that the two options that have generally received the most attention so far are converting the mortgage interest deduction into a credit, and limiting the deductibility of state and local property taxes. The list of options presented here is by no means exhaustive.

### Eliminate the Deductions

One possible option would be to eliminate the mortgage interest and property tax deductions. Elimination of the deductions could be justified as a second-best policy alternative to taxing net imputed rental income. It was discussed earlier in this report that net imputed rental income is currently excluded from taxation. This is due in part to limited acceptance by non-economists of the idea that owning a home provides owners with implicit income that should be taxed, and in part to the practical difficulty of taxing such income. Little is known, for example, about the probable rental value of individual owner-occupied homes and available data on rental rates is of limited use because of the differences in size and quality of rental units as compared to owner-occupied properties.<sup>39</sup>

The impact on the economy and housing market would depend on how quickly the elimination of the deductions were phased in. Sudden elimination of the deductions could cause home purchases to decrease, leading to a decrease in home prices. The decrease in home prices would be more severe if the deductions are capitalized to some degree into current 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 the broader economy being negatively impacted in the short term.

If elimination of the deductions were gradually phased in over time it could help mitigate the negative consequences for the economy and housing market. Researchers Steven Bourassa and William Grigsby propose eliminating the deductions over a 15- to 20-year period with a fixed date after which the deductions would no longer be available.<sup>40</sup> For example, if January 1, 2034, were chosen as the cut-off date, taxpayers who buy a home in 2014 could claim the deductions 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 complement their proposal. It is possible that gradually eliminating the deductions

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<sup>39</sup> The government does compute the imputed rental value of owner-occupied housing when calculating gross domestic product (GDP). GDP is a measure of all income earned in an economy in a given year. As a result, individual estimates of imputed rental income for purposes of GDP likely do not need to be as precise as would be required for tax purposes since errors in the estimation of individual imputed rental values likely aggregate out.

<sup>40</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.

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 deductions' elimination until closer to the chosen cut-off date.

A net improvement in the long-term performance of the economy relative to today could be expected from elimination of the mortgage interest and property tax deduction if the deductions lead to distortions in the economy. A reduction in economic distortions would result in capital and labor being directed to more productive employment in the non-housing sectors of the economy. The resulting increase in federal revenue from the elimination of the deductions could also improve the long-term budgetary situation of the United States as federal tax revenues would increase, implying less reliance on deficits to finance spending. A ballpark estimate of the expected increase in federal revenue from eliminating these two deductions is equal to what these benefits currently cost the government—\$108.8 billion annually.

## **Limit the Deductions**

If the policy objective of Congress is to promote homeownership through the tax code, and Congress believes the mortgage interest and property tax deductions increase homeownership, then limiting the deductions to more effectively target the benefits is an option. 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. State and local property taxes are also fully deductible. It could be argued that the deductions provide a tax benefit to a large number of taxpayers that would become homeowners regardless if they existed or not.

The mortgage interest deduction could be limited to interest paid on a mortgage amount that more closely resembles that of a first-time homebuyer. The Congressional Budget Office (CBO) has estimated the cost of gradually reducing the maximum mortgage amount on which interest can be deducted from \$1.1 million to \$500,000.<sup>41</sup> The CBO proposal would not take effect until 2013 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.<sup>42</sup>

Similarly, House Ways and Means Committee Chairman Dave Camp recently released a comprehensive tax reform draft that proposes 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 prior to the mortgage limits being reduced. 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.

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<sup>41</sup> 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 and interest paid on up to \$100,000 of home equity debt.

<sup>42</sup> Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 189, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.

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 such an option for the deduction for all state and local property taxes.<sup>43</sup> Specifically, the CBO presented the option of limiting the deduction for all state and local taxes to 2% of AGI. Their estimates suggest that such a proposal could raise \$625.7 billion between 2010 and 2019. Since property taxes account for about 30% of all state and local taxes households pay, the CBO estimates suggest that limiting the property tax deduction could be an effective option for increasing revenue.<sup>44</sup>

Other options include limiting the mortgage interest or property tax deduction to interest and taxes paid on a taxpayer's first home. This could encourage first-time buyers to remain in their homes longer as the deductions would no longer be available if they moved. Another option would be to limit both deductions to a taxpayer's primary residence. Current law allows for the deduction of interest on a second residence and home equity loan, as well as the deduction of property taxes on every home a taxpayer owns. The deductions could also be limited to those homeowners below a certain income threshold. Currently the deductions are generally available to homeowners of all income limits, although there are some restrictions based on income as a result of limitations on the amount of itemized deductions some higher-income taxpayers may claim.

## **Replace the Deductions with a Credit**

The mortgage interest deduction and property tax deduction could be replaced with a tax credit. The current deductions tend 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 or property taxes could provide a benefit to more homeowners since itemization would no longer be required. Without the need to itemize, the burden of tax preparation on homeowners would be lessened. Depending on the design of the credit, it could create 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

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<sup>43</sup> Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 190, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.

<sup>44</sup> For breakdown of total state and local tax revenue by source see Table 4 in CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire.

tax credit.<sup>45</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>46</sup>

- The American Enterprise Institute's Alan Viard has proposed converting the deduction to a 15% refundable tax credit starting in 2015.<sup>47</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) has recently recommended replacing the mortgage interest deduction with a nonrefundable credit equal to 12% of the interest paid on mortgages of \$500,000 or less.<sup>48</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 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>49</sup> The tax credit would be refundable, which would ensure 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. 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

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<sup>45</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>46</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>47</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.

<sup>48</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>49</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>.

taxpayer's primary residence. The size of the mortgage eligible for claiming the interest credit would be limited to the average home price in the taxpayer's region. A similar option was presented by the Congressional Budget Office (CBO) in 2009. CBO's proposal called for a 15% credit for interest on mortgages of less than \$500,000.<sup>50</sup>

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<sup>50</sup> U.S. Congress, Congressional Budget Office, *Budget Options Volume 2*, August 2009, p. 186, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.