The Mortgage Interest and Property Tax Deductions: Brief Overview with Revenue Estimates

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There has been increased concern over the size and sustainability of the United States' recent deficits, the country's long-run budget outlook, and most recently, the consequences of reaching the debt limit. 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, particularly the mortgage interest deduction and the property tax deduction for homeowners. The Joint Committee on Taxation (JCT) has estimated that the mortgage interest deduction costs the federal government $96.8 billion annually and the property tax deduction $24.2 billion annually.[1] When these two deductions are combined they represent the largest tax expenditure, exceeding the exclusion for employer-provided health insurance.[2]

This report provides a brief overview of these two provisions, presents policy options with potential revenue effects, and briefly summarizes the economic effects of modifying the provisions. This report is a condensed version of CRS Report R41596, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, by (name redacted). Contained in that report is an in-depth summary of the mortgage interest and property tax deductions, distributional data, and reviews of the original intent of the provisions. Also included in that report is an analysis of the rationale for subsidizing homeownership, as well as an analysis of whether the mortgage interest and property tax deductions affect homeownership.

Mortgage Interest and Property Tax Deductions

The mortgage interest and property tax deductions are both itemized deductions.[3] Of the approximately one-third of taxpayers who itemize (the remainder choose the standard deduction), approximately 80% claim the mortgage interest deduction and 86% claim the property tax deduction.[4] Among homeowners, roughly 51% claim the mortgage interest deduction, while 55% claim the property tax deduction.[5]

Whereas the property tax deduction may be, generally, claimed without limit for all state and local property taxes paid on a home, the mortgage interest deduction may only be claimed for interest incurred on the first $1 million of mortgage debt and the first $100,000 of home equity debt ($1.1 million total). Mortgage debt is debt incurred in the purchase, construction, or substantial improvement of a first or second home.[6] Home equity debt is a loan that uses the

[1] Based on CRS calculations using estimates reported in U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax For Fiscal Years 2010-2014*, 111th Cong., 2nd sess., December 15, 2010, JCS-3-10 (Washington: GPO, 2010).

[2] The exclusion for employer-provided health insurance costs the government approximately $131.9 billion annually.

[3] A deduction reduces a taxpayer's taxable income. The value of a deduction to a taxpayer is equal to their highest marginal tax rate multiplied by the amount of the deduction. For example, the value of a dollar deduction for an individual in the 25% tax bracket is $0.25, while the value of the same dollar deduction for someone in the 35% bracket is $0.35. Thus, higher-income taxpayers typically benefit more than lower-income taxpayers from deductions.

[4] 2008 IRS SOI Data, http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html, Tables 1.1 and 2.2.

[5] Author's estimates using 2008 American Community Survey and the 2008 IRS SOI Data, http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html.

[6] For purposes of the deduction a home includes a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities. See, Internal Revenue Service, *Home Mortgage Interest Deduction*, Publication 936, November 30, 2010, p. 2, http://www.irs.gov/pub/irs-pdf/p936.pdf.

residence as collateral, and that can be used for personal expenditures (college education, vacations, etc.).

Potential Options and Revenue Estimates

There are a number of possible options for changing the mortgage interest and property tax deductions. This report focuses on options whose revenue effects have been estimated. These estimates are listed in **Table 1** at the end of the report. The approximate annual revenue estimates provided are based upon available estimates of fully phased-in provisions converted to an annual basis. This was done in an attempt to place these estimates, done at different times and using different assumptions and methodologies, on a comparable basis. As such, these figures are intended to provide the reader with a relative estimate of the revenue-raising potential of the various proposals. For additional options, see CRS Report R41596, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, by (name redacted).

Summary of Economic Effects

Housing Market and Economy

Changes to homeownership tax policy may effect the broader economy and the homeownership rate. How they effect the economy depends upon how large a change and how quickly it is implemented. Some have argued that a large sudden change in policy could cause home purchases to decrease, leading to a decline in home prices, and a negative shock to the broader economy in the short-run. To the extent that a policy change is smaller or more gradual, these concerns are lessened. In addition, the long-run performance of the economy could improve as federal tax revenues increase, implying less reliance on deficits, and as resources are allocated to more productive uses in the economy.

Assuming a gradual policy change, housing tax policy changes are expected to have minimal impact on the homeownership rate. In order to have an effect on the homeownership rate, tax incentives must address the most pressing barrier to households on the verge of homeownership—the down payment. The effects of the mortgage interest deduction and the property tax deduction on the homeownership rate are likely small because they are not well targeted toward lowering this barrier. The deductions' effects on homeownership are also limited because they are not well targeted toward the group of potential buyers most in need of assistance—lower-income households—which includes younger potential first-time buyers. A policy change could, however, have an effect on the size of homes purchased, as research suggests this is the primary margin the two deductions influence.

Distributional Impact on Taxpayers

The distributional impact of eliminating or limiting either deduction would tend to be concentrated among middle- and upper-income taxpayers. The current deductions provide a proportionally bigger benefit to higher-income taxpayers, since they are more likely to be homeowners, buy more expensive homes, and are subject to higher marginal tax rates. The requirement that homeowners itemize their tax returns to claim the deductions also limits who currently benefits to middle- and upper-income taxpayers.

Converting either deduction to a tax credit 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 a credit it could create a more consistent rate of subsidization across homeowners. The value of a given dollar deduction for interest or taxes tends to increase as homeowner income increases. With a credit the subsidy can be fixed at a certain rate (e.g., 15%) across income levels. Progressivity in the tax code could also be increased by limiting the deductions or converting the deductions into credits.

Table 1. Potential Policy Options with Revenue Effects

Policy Option	Key Features	Approximate Annual Revenue Raised	Source
Mortgage Interest Deduction			
Eliminate the deduction	The mortgage interest deduction would be eliminated. The elimination of the deduction could be phased in over time.	$96.8 billion	U.S. Congress, Joint Committee on Taxation, Estimates of Federal Tax For Fiscal Years 2009-2013, 111th Cong., 2nd sess., January 2010, JCS-1-10 (Washington: GPO, 2010).
Replace deduction with credit	Replace the mortgage interest deduction with a 15% credit.[a]	$64 billion	Congressional Budget Office, Budget Options Volume 2, August 2009, p. 187, http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.
Reduce maximum mortgage amount	The CBO examined one particular option in which the maximum eligible mortgage amount would be reduced from $1.1 million (including home equity debt) to $500,000. The reduction would not take effect until 2013, and the maximum mortgage amount would decrease by $100,000 annually until it reached $500,000 in 2018.	$41.4billion[b]	Congressional Budget Office, Budget Options Volume 2, August 2009, p. 187, http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.
Limit amount of deductible interest	(1) Limit the amount of interest that a taxpayer is allowed to deduct to 10% of adjusted gross income (AGI).	(1) $30 billion	(1) Thomas Hungerford, specialist in public finance at CRS.
	(2) Limit the amount of interest that a taxpayer is allowed to deduct to 30% of adjusted gross income (AGI).	(2) $4 billion	(2) Thomas Hungerford, specialist in public finance at CRS.
	(3) Limit the amount of interest taxpayers in the top two tax brackets (33% and 35%) could deduct to as if they were in the 28% bracket.	(3) $3.92 billion[c]	(3) Eric Toder, Margery Austin Turner, and Katherine Lim, et al., Reforming The Mortgage Interest Deduction, Tax Policy Center, April 2010, p. 18, http://www.taxpolicycenter.org/uploadedpdf/412099-mortgage-deduction-reform.pdf.
Limit deduction to primary residences	The mortgage interested deduction would be limited to primary residences so that the deduction was no longer available for secondary residences and home equity loans.	$1 billion	Congressional Budget Office, Budget Options, March 2000, p. 288, http://www.cbo.gov/ftpdocs/18xx/doc1845/wholereport.pdf.

Policy Option	Key Features	Approximate Annual Revenue Raised	Source
Property Tax Deduction			
Eliminate the deduction	The property tax deduction for homeowners would be eliminated. The elimination of the deduction could be phased in over time.	$24.2 billion	U.S. Congress, Joint Committee on Taxation, Estimates of Federal Tax For Fiscal Years 2009-2013, 111th Cong., 2nd sess., January 2010, JCS-1-10 (Washington: GPO, 2010).

Notes:

a. A number of different credits have been proposed over time with the credit rate ranging from 12% to 30%. For a summary of these other credits, see CRS Report R41596, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, by (name redacted).

b. The CBO estimates this option would raise a total of $41.4 billion between enactment (2013) and 2019. Because this estimate includes the first year the proposal is fully phased in, as well as the savings realized as it is phased in, $41.4 billion should be interpreted as a rough approximation of the maximum annual increase in federal revenue that could be realized each year this modification is fully enacted.

c. The TPC produced two differences estimates, one based on a static model and another that incorporate behavioral responses. The number reported here is the average of the two estimates.

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