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Key Issues in Tax Reform: The Mortgage Interest Deduction

Tax reform proposals are generally structured around lowering tax rates while broadening the taxable base. The base-broadening component of tax reform could be most directly accomplished by eliminating special provisions in the tax code known as tax expenditures. One of the largest tax expenditures is the mortgage interest deduction (MID). On the one hand, modifying or eliminating the mortgage interest deduction could raise significant revenue. On the other hand, any change could affect individual homeowners and the overall economy.

Brief Summary of Current Law

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

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. As a result, all interest payments were made deductible with no distinction made for business, personal, living, or family expenses. It is likely that no distinction was made because most interest payments were business related at the time and, compared to today, households generally had 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 who did hold a mortgage, the majority were farmers.

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

Based on 2014 IRS data (the most recent year available), 44% of all homeowners claimed the mortgage interest deduction. Among the 56% of homeowners who did not take advantage of the deduction, 36% had no mortgage, and hence no interest to deduct. The remaining 20% of non-claimants had mortgages, but likely either (1) were toward the end of their mortgage payments so that the deduction was not worth much, (2) lived in a state with low state and local taxes and thus claimed the standard deduction, or (3) lived in a low-cost area and therefore had a relatively small mortgage. In 2014, the deduction was claimed on about 22% of all federal income tax returns and 74% of itemized returns.

Proposals to Reform the MID

The Tax Cuts and Jobs Act (H.R. 1), introduced on November 2, 2017, proposes reducing the maximum mortgage amount eligible for the deduction from $1 million to $500,000 for new mortgages. The bill would also eliminate the deduction for interest paid on mortgages on second homes and home equity loans. The Senate Finance Chairman's mark of H.R. 1 proposes only eliminating the deduction for interest on home equity loans.

The Congressional Budget Office (CBO), in its December 8, 2016, *Options for Reducing the Deficit* report, presented the option of converting the mortgage interest deduction to a 15% nonrefundable tax credit and limiting the eligible mortgage amount to $500,000. The ability to deduct interest associated with second homes or home equity debt would be eliminated. The conversion would take place gradually over six years.

The Unified Framework for Fixing Our Broken Tax Code, issued by the Office of the Speaker on September 27, 2017, states that it would retain the mortgage interest deduction. The House Republican Conference's "A Better Way" tax reform blueprint plan calls for the Committee on Ways and Means to evaluate potential options to increase the deduction's effectiveness and efficiency. Regardless of the committee's findings, the plan states that the deduction will not be altered for those who continue to itemize, even if the homeowner refinances. The tax reform blueprint does not suggest options for altering the deduction.

Former House Ways and Means Committee Chairman Dave Camp's Tax Reform Act of 2014 (H.R. 1) proposed preserving the deduction but reducing the eligible mortgage amount to $500,000 over a four-year period. To lessen the impact on the housing market, the new limitations would only apply to new mortgage debt. Furthermore, the proposal included a grandfather provision for refinanced debt if the original mortgage debt was incurred prior to the mortgage limits being reduced.

President Obama's National Commission on Fiscal Responsibility and Reform (Fiscal Commission) recommended replacing the mortgage interest deduction with a nonrefundable credit equal to 12% of the interest paid on mortgages of $500,000 or less. The credit would be restricted to a taxpayer's primary residence, and no credit would be allowed for interest associated with home equity loans.

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 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.

The mortgage interest deduction could also be eliminated. The key to such a step is the choice of time period over which it would be phased out. Completing the phase-out within the budget window would generate the most revenue for scoring purposes, but could be too abrupt for the housing market and economy. Alternatively, the deduction could be eliminated over 15, 20, or 30 years, with a fixed date after which the deduction would no longer be available. For example, if January 1, 2047, were chosen as the cut-off date, taxpayers who buy a home in 2017 could claim the deductions for 30 years, buyers in 2018 could claim the deduction for 29 years, and so on.

Budgetary and Economic Issues

Limiting or eliminating the mortgage interest deduction could increase federal tax revenues. The Joint Committee on Taxation (JCT) estimates that the deduction will cost $84 billion per year, on average, between FY2015 and FY2019. Thus, modifying the deduction could be used to finance a reduction in deficits and the debt, lower tax rates, or provide for alternative tax incentives or direct spending programs.

While the mortgage interest deduction is commonly believed to promote homeownership, the economic literature tends to suggest that this effect may be rather small. This is because the deduction is not well targeted to the largest barriers to homeownership—down payment and closing costs. The deduction's effect on homeownership is also likely limited, because it is not well targeted toward the group of potential buyers most in need of assistance—lower-income households—which includes younger potential first-time buyers.

Homeownership promotion is often thought to be desirable, because it may produce social spillover benefits. For example, homeownership may lead to safer neighborhoods, greater civic participation, higher overall property values, and greater income and wealth equality. The economic literature, however, has not been able to support those claims. Does homeownership lead to higher income and wealth, or is the relationship reversed, and higher income and wealthier households are more inclined to become homeowners?

The inability to establish causality, 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. In this case, the overall performance of the economy could be enhanced by eliminating the deduction, and allowing resources to be reallocated to more productive uses in other sectors. Eliminating the deduction could, however, have an effect on the size of homes purchased and home prices, as research suggests these are the primary margins that the mortgage interest deduction influences.

An alternative to eliminating the mortgage interest deduction would be limiting its availability to better target it toward those needing assistance to purchase a home. This could be accomplished by lowering the eligible mortgage amount to more closely resemble that of a first-time homebuyer, limiting the amount of deductible interest, restricting the deduction to primary residences, instituting income restrictions, or capping the tax rate at which the deduction could be claimed. If Congress is concerned about the distributional objectives of tax reform, a more-limited deduction would also promote progressivity in the tax code.

The objective of homeownership promotion might also be better achieved by converting the deduction to a tax credit. A credit could better target potential first-time homeowners, since itemization would no longer be required. Without the need to itemize, the burden of tax preparation on homeowners would also be lessened. Depending on the design of the credit, it could create a more consistent rate of subsidization across homeowners. The value of a dollar deduction for interest 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 which would increase progressivity in the tax code relative to current policy.

The short-run economic effects from modifying or eliminating the mortgage interest deduction would depend upon how large the change was relative to current policy and how quickly it was 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 would be 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.

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