Implications of a Mortgage Interest Credit for the United States

Austin J. Drukker[1]

Abstract

The US mortgage interest deduction allows homeowners to deduct the interest paid on their mortgages from their federal tax returns, provided that they itemize deductions. Since the benefit depends on a taxpayer's marginal tax rate, which increases with income, the mortgage interest deduction is an "upside-down subsidy" that becomes more valuable for higher-income homeowners. I analyze the implications of converting the US mortgage interest deduction to a mortgage interest credit and evaluate the effects on federal revenue and the distribution of income. I argue that a mortgage interest credit could be better targeted at low- and middle-income taxpayers on the margin of homeownership while also being more progressive and less expensive than the current mortgage interest deduction.

Keywords

mortgage interest deduction, mortgage interest credit, taxation, tax expenditure

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The US mortgage interest deduction (MID) is a federal tax policy that allows itemizers to deduct the value of mortgage interest paid from their taxable income. It is largest source of US federal homeowner support and has become deeply ingrained in the country's economic and social fabric. However, since most low- and moderate-income taxpayers do not itemize their deductions, they are not able to take advantage of the benefit. Furthermore, since the MID is a tax *deduction* rather than a tax *credit*, high-income taxpayers who face higher marginal tax rates than do low-income taxpayers benefit more because they can deduct at a higher rate. Thus, despite Congress's objective to encourage homeownership through the tax code, the MID largely serves as a subsidy to high-income households.[1]

The MID is a deduction, meaning it factors in to the computation of taxable income, while a mortgage interest credit (MIC) could be claimed after taxes are computed. This subtle difference in the tax treatment of mortgage interest means that the MID increases in value with one's marginal tax rate, which in turn increases with income, while a MIC benefits all mortgage-holders equally in proportion to mortgage interest claimed. Thus, even if two taxpayers have identical mortgages, the MID is more valuable to the higher-income taxpayer. But both taxpayers would receive the same subsidy under a MIC, since the subsidy rate for a MIC is not a function of income.

The most important distributional aspect of the MID relates to the extensive margin of homeownership. By structuring the tax incentive for owner-occupied housing as a deduction, the MID imposes several disadvantages on potential homeowners of modest means. In addition to the fact that the MID increases in value with one's marginal tax rate, the MID can only be claimed if a household itemizes deductions. Since most low- and middle-income households often do not have enough other deductions to justify itemizing—such as charitable contributions or state and

local taxes—it is often more advantageous for such household *not* to claim the MID, which could have first-order implications for the decision to rent rather than to buy.[2]

But structuring the tax incentive as a *credit* rather than a *deduction* has the potential to greatly increase the number of homeowners who qualify for subsidized interest while reducing the subsidy rate for high-income homeowners. Lower-income families, who most need help affording a home, would receive much larger subsidies than under current law, while higher-income households, who are likely to own a home even without a subsidy, would receive smaller benefits. Thus, a MIC could serve to increase the rate of homeownership (Green and Vandell 1999; Domenici–Rivlin Debt Reduction Task Force 2010).

The MID has been the object of considerable criticism. From a public policy standpoint, the most fundamental critique is the lack of a homeownership response.[3] Evidence that the MID increases homeownership is scant (Hanson 2012a; Hilber and Turner 2014; Damen, Vastmans, and Buyst 2016; Council of Economic Advisers 2017; Gruber, Jensen, and Kleven 2021). Moreover, some have argued that it is unclear whether the promotion of homeownership is a worthy public policy goal in the first place (Glaeser and Shapiro 2003; Gale, Gruber, and Stephens-Davidowitz 2007; Davis 2012; Council of Economic Advisers 2017).[4] That people want to own their own homes is not a sufficient reason to subsidize home purchase. From a public finance perspective, subsidies can be justified to the extent there are societal benefits of homeownership beyond the individual benefits received by the homebuyer. While there are some compelling arguments, in theory, for external benefits from homeownership, there is little empirical evidence to support those arguments. Glaeser and Shapiro (2003) note that there is little evidence to suggest there are large externalities from the level of housing consumption or from living around

homeowners. While the externalities from homeownership are larger, they argue that the MID is a poor instrument for encouraging homeownership.

In this paper, I analyze the revenue and distributional implications of converting the MID to a MIC using a simulation approach. Although from a purely economic standpoint one might prefer to entirely remove all tax preferences for owner-occupied housing, a proposal to convert the MID to a MIC recognizes the political reality that complete removal would be extremely difficult. A MIC can therefore be viewed as a second-best approach that targets the tax preference in a more rational manner. I show that a MIC could be more progressive and less expensive than the current MID. Although I do not estimate homeownership rates under a MIC compared to a MID, the fact that a MIC could be made available to all mortgage-holders regardless of itemization status means that many more low- and moderate-income homeowners who would not normally itemize deductions could claim the credit, which could serve to increase homeownership rates in the long run.

Reform Options and Previous Literature

Most major tax reform proposals have called for limiting the MID and replacing it with a MIC. Before the 2017 tax law, commonly known as the Tax Cuts and Jobs Act (TCJA), the MID provision allowed an itemized deduction for any interest paid on mortgage debt of up to $1 million for a main or second home, plus interest on up to $100,000 in home equity debt. The TCJA lowered the eligible mortgage cap to $750,000 on a main home and essentially eliminated the deduction for home equity debt (Internal Revenue Service 2018). The TCJA also doubled the standard deduction, which substantially decreased the number of taxpayers who itemize deductions, thus decreasing the number who claim the MID.

In addition to calling for a MIC, almost every major MID reform proposal has called for eliminating the eligibility of mortgages on second homes, limiting the eligibility of home equity debt, and lowering the eligible mortgage cap. The TCJA addressed these three issues, yet criticisms of the MID remain. Chief among them are the inability of nonitemizers to take the deduction and the regressive nature of the benefit, which stems from the fact that high-income homeowners can deduct mortgage interest expenses at a higher rate than low-income homeowners due to having a higher marginal tax rate.[5]

Several studies have analyzed the distributional implications of the MID, including Brady, Cronin, and Houser (2003), Gyourko and Sinai (2003), and Drukker, Gayer, and Rosen (2021). Many of the distributional concerns about the MID could be remedied by converting the MID to a MIC because a MIC could be applied at a uniform rate to all homeowners with a mortgage, regardless of itemization status. According to the President's Advisory Panel on Federal Tax Reform (2005), only 54 percent of taxpayers who pay interest on their mortgages receive a tax benefit under the MID, while approximately 88 percent of taxpayers who pay mortgage interest would receive a benefit under a MIC.

Most MIC proposals follow the structure of a refundable or nonrefundable credit, applied at a rate of between 12 and 15 percent of mortgage interest paid, applying only to the purchase of primary residences, phased in over several years, with eligible mortgages capped at between $300,000 and $500,000. Table 1 summarizes some of the major tax reform proposals calling for a MIC. The President's Advisory Panel on Federal Tax Reform (2005) proposed to replace the MID with a MIC equal to 15 percent of interest paid on a mortgage for a principal residence, available to all homeowners, with the eligible mortgage cap indexed to an average regional housing price. The Domenici–Rivlin Debt Reduction Task Force (2010) proposed eliminating standard and

itemized deductions altogether, and instead all taxpayers could claim a refundable 15 percent credit for up to $25,000 in home mortgage interest expenses on a principal residence. The Simpson–Bowles Commission (2010) proposed converting the MID to a 12 percent nonrefundable credit available to all taxpayers, with the eligible mortgage cap set at $500,000 for principal residences. Viard (2013) proposed converting the MID to a 15 percent refundable credit available to all homeowners, with the eligible mortgage cap set at $300,000 for principal residences, but he notes that the 15 percent credit rate is merely illustrative and that a lower value may be necessary to ensure a revenue gain relative to current law.[6]

It is important to stress that all these proposals were formulated *before* the TCJA was enacted and so should be viewed through that lens. In particular, none called for a doubling of the standard deduction, which was part of the TCJA and has major implications for cost estimates of the MID. According to the Joint Committee on Taxation (2018), the estimated cost of the MID fell by about half between 2017 and 2018. Therefore, one should be careful when making direct comparisons between proposals made before the TCJA and those made after.

Model and Data

I compare the MID to two MIC proposals under two different regimes: *before* the TCJA and *after* the TCJA. I structure both proposals to be approximately revenue neutral, though Congress could adjust the exact parameters and design features of the proposal in order to best meet its objectives. The proposals I analyze are meant to be illustrative of a MIC's potential as a policy, and disagreements about the details should not impede the adoption of a reform that better targets the tax preference for housing.

For the pre-TCJA regime, I compare the MID with a nonrefundable 16 percent credit that applies to interest paid on a mortgage of up to $500,000, which is almost identical to the Congressional Budget Office's (2016) proposal from table 1. For the post-TCJA regime, I compare the MID with a nonrefundable 5 percent credit that applies to interest paid on a mortgage of up to $500,000. The post-TCJA credit rate was chosen so that the costs of the MID and MIC would be approximately the same, though Congress may wish to set a higher credit rate even if it means increasing the overall cost of the tax expenditure. Alternatively, the cost of the proposals could be adjusted by altering the eligible mortgage cap.

The underlying data used in the simulations are from the 2016 Survey of Consumer Finances (SCF), a triennial, cross-sectional survey of roughly 4,500 US families, sponsored by the Federal Reserve Board. The SCF includes detailed balance sheet information, including assets such as bank accounts, retirement accounts, mutual funds, stocks, and bonds, and liabilities such as mortgages and various personal loans. In addition to balance sheet information, the SCF reports data on household demographic characteristics and income. The data also include sample weights for aggregating results to the national level.[7] Table 2 provides summary statistics broken down by homeownership status for several of the key variables. Unsurprisingly, homeowners tend to have higher income and higher wealth than renters, and homeowners without a mortgage tend to have more wealth and less income than homeowners with a mortgage, which is reasonable given that they are older on average.

My simulation strategy follows Drukker, Gayer, and Rosen (2021), who use the TAXSIM model to calculate tax liabilities under alternative tax scenarios. TAXSIM is a microsimulation function for calculating tax liabilities from individual data under US federal and state income tax laws (Feenberg and Coutts 1993). An individual's tax liability can be thought of as a function of a

vector of TAXSIM variables, including tax year, state of residence, marital status, number of dependents, wages, and capital gains.[8] Total tax revenue is simply the weighted sum over all individuals in the sample. Alternative scenarios can be simulated by changing the vector of TAXSIM variables. To calculate the change in tax liability from a change in policy, I take the difference between a baseline revenue calculation and an alternative revenue calculation. The cost of a policy that induces this alternative state of the world—for example, a change to the MID—is the difference between tax revenues under the alternative and the baseline scenarios.

Determining the cost of the MID requires knowledge of counterfactual tax revenues absent the MID. A naïve approach to computing counterfactual tax revenues would be to simply eliminate the portion of taxpayers' itemized deductions corresponding to mortgage interest. But this approach is flawed because it ignores the possibility that taxpayers might make portfolio adjustments to decrease the loan-to-value ratios on their homes if mortgage interest were not deductible, a phenomenon known as portfolio rebalancing (Follain and Dunsky 1997; Ling and McGill 1998; Dunsky and Follain 2000). As shown by Drukker, Gayer, and Rosen (2021), conventional estimates of the MID (before the TCJA) that do not account for portfolio rebalancing overstate the MID's costs by about 15 percent.[9]

Simulations calculated within the framework of portfolio rebalancing require assumptions about which assets households would sell to pay down mortgage debt if the MID were eliminated. Since there is no direct evidence of which assets households would sell if the MID were eliminated, one approach is to create groups of arguably similar assets and then explore the robustness of the results to different assumptions about the extent to which these different asset groups are used to pay down one's mortgage. Following Drukker, Gayer, and Rosen (2021), revenue estimates for the MID assume that households would pay down their mortgage balances by selling

nontransaction financial assets (namely, certificates of deposit, stocks, bonds, and mutual funds) in order from lowest return to highest return.[10]

To simulate the cost of the MIC, I do not make any such assumptions about household behavior, since it is not clear if or how households would adjust their borrowing if the MID was converted to a MIC. Using a simulation approach, Martin and Hanson (2016) suggest that converting the MID to a MIC would have little effect on loan-to-value ratios compared to the effect from eliminating the MID. Thus, for each household currently claiming the MID, I simply multiply their mortgage interest by the credit rate. For a nonrefundable MIC, I then compare this number to a household's tax liability to determine if and how much of the MIC they can claim.

Results

I use tax year 2016 for the pre-TCJA baseline scenario and tax year 2018 for the post-TCJA baseline scenario. While a complete summary of the TCJA is beyond the scope of this paper, I highlight some of the major changes related to individual income taxation and the MID. First, the TCJA lowered the eligible mortgage cap from $1 million to $750,000, eliminated the eligibility of second homes, and essentially eliminated the deductibility of interest on home equity lines of credit. Second, the law eliminated personal exemptions and doubled the standard deduction from $12,000 ($6,000) to $24,000 ($12,000) for married (single) filers. This provision affects the MID because a larger standard deduction will encourage taxpayers on the margin to switch from itemizing to claiming the standard deduction. Third, the TCJA lowered individual marginal income tax rates. I use TAXSIM Version 32 in my revenue calculations, which incorporates all the relevant individual income tax provisions of the TCJA.

Figure 1 plots Lorenz curves for the MID and MIC proposals. The shape of the curves is a crude measure of the progressivity of the policy: a deeper curve signifies less progressivity and a shallower curve signifies more progressivity. The 45° line signifies perfect equality, for example, a policy that gives the same, flat-dollar benefit to all eligible taxpayers. Note that the curve will be bowed as long as the tax benefit depends on the amount of mortgage interest paid, since those with a larger mortgage will mechanically receive more benefits. For both before and after the TCJA, the MIC is clearly more progressive than the MID, as evidenced by a deeper bend. The cost of the pre-TCJA MID is $51.9 billion with a Gini coefficient of .746, while the cost of the pre-TCJA MIC is $50.4 billion with a Gini coefficient of .588. The cost of the post-TCJA MID is $14.1 billion with a Gini coefficient of .796, while the cost of the post-TCJA MIC is $15.9 billion with a Gini coefficient of .604. All dollar values are expressed as 2021 dollars.

Figure 2 plots the distribution of the MID and MIC benefits as a share of adjusted gross income by income decile. For the pre-TCJA policies, the MID is a substantially larger share of income for the 9th and 10th deciles of income compared to the lower deciles, while the MIC is equal to roughly the same share of income for the 5th through 9th deciles, and only a slightly higher share than that for the 3rd and 4th deciles. Notably, the MIC as a share of income for the 10th decile is about equal to that for the 4th decile, while the MID as a share of income for the 10th decile is about five times that for the 4th decile. For the 8th decile and below, the MIC benefit is about twice as large as the MID benefit as a share of income. The same conclusions broadly hold for the post-TCJA policies, though at lower levels.

Conclusions

This paper analyzes the revenue and distributional implications of converting the MID to a MIC using simulation methods. The analysis shows that a MIC could be more progressive than the MID for about the same cost. A MIC also provides several advantages to low- and moderate-income households compared to the MID. Most importantly, a MIC could be better targeted at taxpayers on the margin of homeownership, meaning it could serve to increase homeownership rates.

These overall conclusions do not depend critically on the specific calibration of the model, and the proposals analyzed are merely illustrative of a MIC's potential as a policy. The cost of a MIC could be easily adjusted by changing the credit rate or eligible mortgage cap, rather than by changing marginal tax rates. A MIC, therefore, gives Congress more flexibility than a MID to meet its policy objectives.

This paper recognizes the political reality that eliminating the tax preference for owner-occupied housing would be extremely difficult, even if doing so makes the most sense from an economic perspective. Reforming the MIC can be thought of as an incremental, second-best approach that shifts the tax benefit away from high-income taxpayers and toward taxpayers of more modest means.

The analysis presented is not without its limitations. For one, I have ignored the possibility that converting the MID to a MIC would influence house prices or interest rates, possibly by increasing demand. Hilber and Turner (2014) note that if the supply of owner-occupied housing is inelastic then the MID will be capitalized into the purchase price. Martin and Hanson (2016) find that converting the MID to a MIC would increase house prices, suggesting that the price drop experienced by itemizers whose marginal tax rates are above the credit rate would be offset by

capitalization from homeowners who previously could not claim the deduction but can now claim the credit.

Second, I have assumed that converting the MID to a MIC would not induce households to rebalance their financial portfolios, which could happen because they sell assets to retire mortgage debt, though Martin and Hanson (2016) suggest the effect of portfolio rebalancing from converting the MID to a MIC would be small. Third, I have implicitly assumed that the economic incidence of a MIC subsidy would fall entirely on borrowers; in other words, all tax changes would be completely passed through to house prices. Hanson (2012b) finds that lenders capture between 9 and 17 percent of the MID subsidy through charging higher interest rates. Whether and how households or lenders would respond to a MIC remains an open question and future work should investigate other potential economic implications of a mortgage interest credit.

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Notes

1. Although the MID was originally incorporated into the US tax code in the 1920s to overcome the complexities of business versus personal assets for farmers, Congress's primary intention for keeping the deduction is to encourage homeownership (Joint Committee on Taxation 1987, 263–64).
2. Martin and Hanson (2016) find that converting the MID to a 15 percent refundable credit would decrease itemization rates by between 11 and 22 percentage points due to the incentive to itemize being diluted for many current itemizers, specifically, those in the marginal tax brackets exceeding the credit rate.
3. From an economic efficiency standpoint, the MID has been shown to create significant deadweight loss (Hanson and Martin 2014; Hanson 2020). From an income-tax purist perspective, the most fundamental critique stems from the observation that if the policy goal is to tax a comprehensive measure of income then the tax base should include the net income generated by an owner-occupied home (Poterba and Sinai 2008; Viard 2013).
4. In fact, the MID may actually lower homeownership by putting upward pressure on home prices, suggesting a reduction in the potency of the MID may serve to increase homeownership (Council of Economic Advisers 2017; Sommer and Sullivan 2018). Furthermore, the MID acts as an automatic *de*stabilizer that exacerbates business cycles (Splinter 2019).
5. Additionally, since the MID benefit increases with the size of the mortgage, there is an incentive for homeowners to borrow more and to buy larger houses than they otherwise would (Hanson 2012a), a criticism that would remain under a MIC.
6. A mortgage subsidy is not the only policy proposal available to encourage homeownership. Alternatively, a flat or income-based progressive credit that is independent of the amount of mortgage interest paid could be applied. Gale, Gruber, and Stephens-Davidowitz (2007) propose a one-time, refundable, first-time homebuyers' credit, available only to households in which no members have owned a home in the previous three years. Hembre (2018) analyzes the first-time homebuyer credit that

was implemented in response to the 2008 housing bust, which offered up to $8,000 to first-time homebuyers between April 2008 and September 2010.

7. For more details about the SCF construction, see Kennickell and Woodburn (1999) and Moore (2003). The TAXSIM variables used for the simulations were constructed by Kevin Moore, and the data and code used to construct the variables are freely available on the TAXSIM website.
8. The SCF data do not provide taxpayers' state of residence. Since state and local taxes are an important determinant of federal tax liability, I randomly assign states based on state-level income and age distributions.
9. The degree of overstatement is even larger post-TCJA, as the doubling of the standard deduction caused fewer households to itemize, and those that still do are those with the highest incomes.
10. The estimates are robust to including a larger set of financial assets, such as checking accounts, savings accounts, money market accounts, and brokerage call accounts.

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Author Biography

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Table 1. Summary of Major Tax Reform Proposals to Convert the MID to a MIC

	Credit rate	Eligible mortgage cap	Itemizers only	Second homes and home equity debt	Refundable	Adjusted for inflation	Phase-in period
Pre-TCJA	Marginal tax rate	$1 million	Yes	Yes	--	No	--
President's Advisory Panel on Federal Tax Reform (2005)	15%	125% median home price	No	No	Not specified	Yes	5 years
Domenici–Rivlin Debt Reduction Task Force (2010)	15%	Interest up to $25,000	No	No	Yes	No	Not specified
Simpson–Bowles Commission (2010)	12%	$500,000	No	No	No	No	Not specified
Alan Viard (2013)	15%	$300,000	No	No	Yes	Yes	Flexible[b]
Congressional Budget Office (2016)	15%	$500,000	No	No	No	No	6 years
Post-TCJA	Marginal tax rate	$750,000	Yes	No[a]	--	No	0 years[c]

Sources: Author's tabulations from the sources listed in the table.

a. Only home equity debt used to buy, build, or substantially improve the home is eligible, and is subject to the eligible mortgage cap.

b. Taxpayers with existing debt could claim 90 percent of the current-law deduction in the first year, declining by 10 percentage points per year thereafter, with the option to switch to the credit at any time.

c. Grandfathered debt acquired before passage of the law is subject to a $1 million eligible mortgage cap, though the new home equity debt limitations apply.

Table 2. Descriptive Statistics

Status	Individuals (millions)	Median age	Mean home value	Mean mortgage	Mean wealth	Mean income	Mean mortgage interest rate
Mortgagors	45.2	51	369,122	183,473	184,044	145,360	4.29
Homeowners	24.6	67	312,443	--	492,660	128,282	--
Renters	46.4	41	--	--	72,443	55,233	--

Sources: Author's calculations; 2016 Survey of Consumer Finances.
Notes: Dollar values are expressed in 2021 dollars. Mortgage value and mortgage interest rate are for first mortgages. Income is adjusted gross income. Wealth includes certificates of deposit, mutual funds, stocks, bonds, checking accounts, savings accounts, money market mutual funds, and brokerage call accounts.

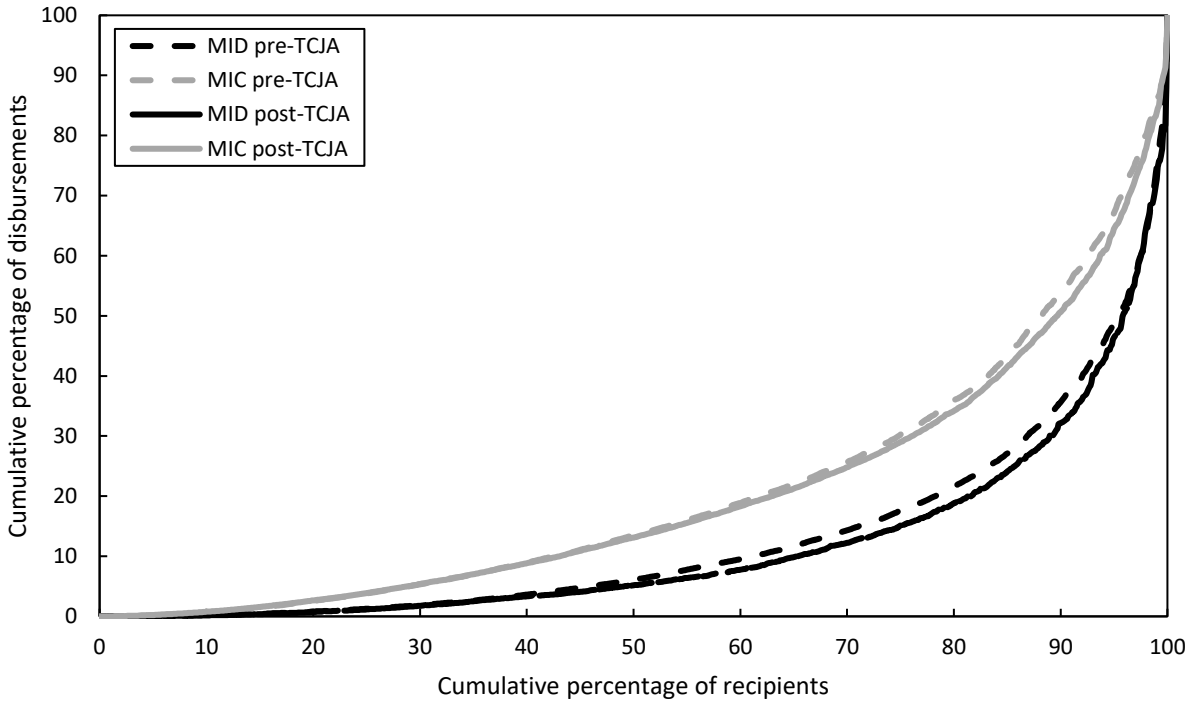
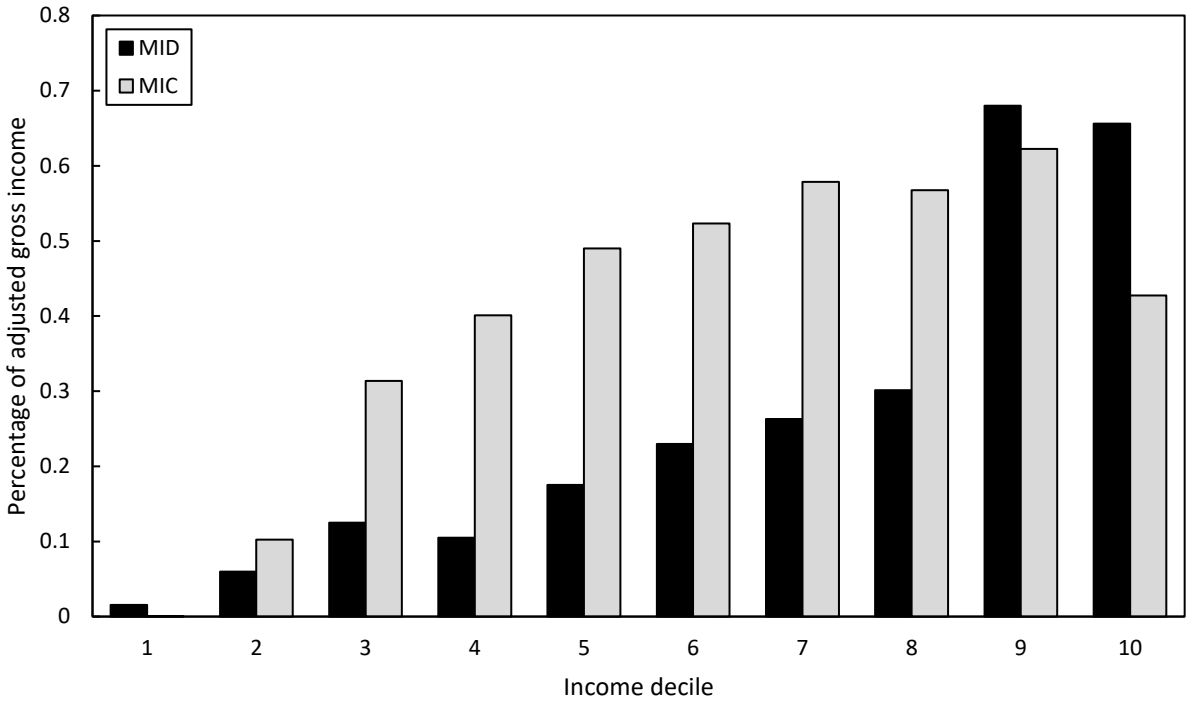


Figure 1. Cumulative Distributions of MID and MIC Benefits. *Sources*: Author's calculations; 2016 Survey of Consumer Finances. *Note*: See the text for the specific model calibrations.

Pre-TCJA



Post-TCJA

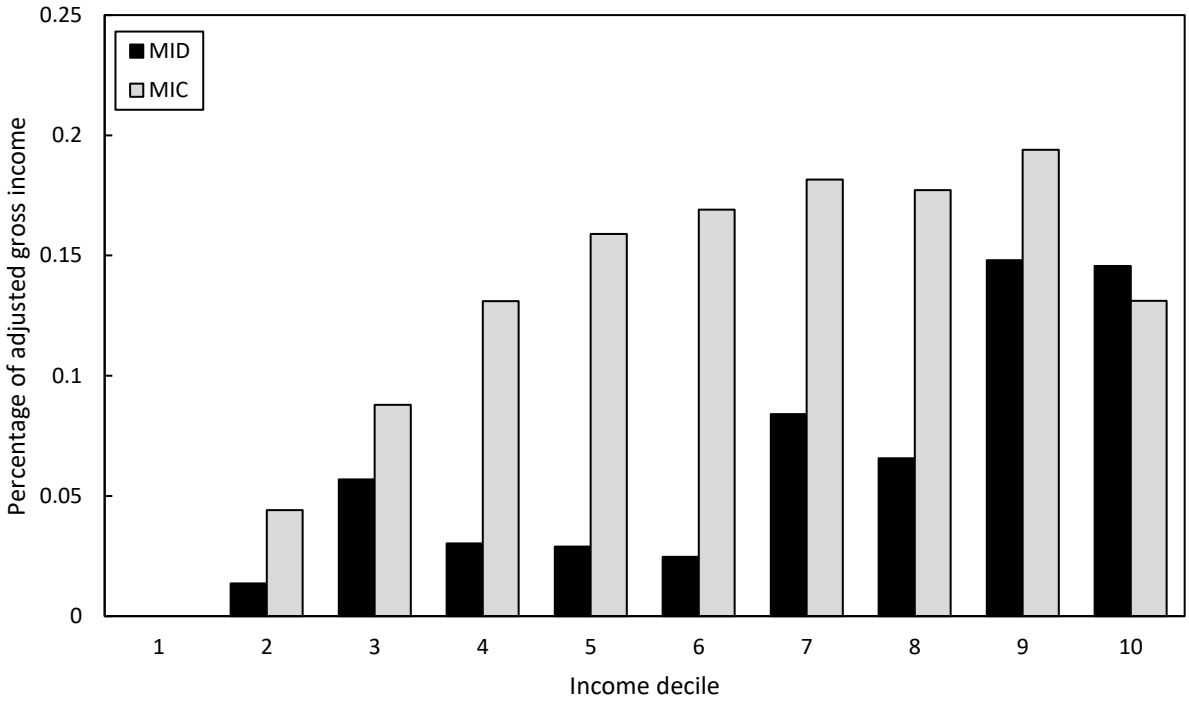


Figure 2. MID and MIC Benefits as a Share of Income. *Sources*: Author's calculations; 2016 Survey of Consumer Finances. *Notes*: Income is adjusted gross income. See the text for the specific model calibrations.